

- **War in the East.** In the first three weeks of August, Ukrainian troops continued to gradually force back pro-Russian insurgents, which tried to separate Donetsk and Luhansk regions (Donbas) from Ukraine. However, on August 25-27, the situation dramatically changed. Russia, which earlier annexed Ukrainian peninsula of Crimea and heavily supported separatists in Donbas, advanced to a massive military intervention into mainland Ukraine. At least a few thousands of Russian regular troops crossed the border, stopped the offensive of Ukrainian government forces, and slightly extended the territory controlled by insurgents. Even though Russia did not recognize officially that it invaded Ukraine most developed nations condemned Russia's invasion.
Evidently, Russia's ultimate goal with respect to Ukraine is to return Ukraine into the Russian sphere of influence, but the strategy remains unclear. One option for Russia is to continue the offensive to take the Eastern and Southern part of Ukraine or even the whole country under direct control. Another option is to entrench in Donbas, not formally separating it from Ukraine, in order to get a tool to influence external and internal policy of Ukrainian government. The conflict is likely to be long-lasting. On the one hand, Ukraine does not have sufficient military power to defeat Russia, at least in the short-term. On the other hand, it is likely that Russia does not have enough military and economic resources to occupy Ukraine or even its significant part, especially taking into account western economic sanctions.
- **Parliament.** On August 27, Ukraine's President Petro Poroshenko decided to dissolve the the Verkhovna Rada and scheduled the next parliamentary election on October 26. This decision was expected because the governing coalition in the Parliament collapsed on July 24, and no attempts to form a new coalition were taken. The current parliament will retain its power until the first sitting of the new one, and is expected to continue to pass laws, including the law on ratification of the EU-Ukraine Association Agreement. The Verkhovna Rada denied to modify election rules. Thus, a half of the new parliament will be elected through party lists, while the rest from single-member constituencies. It implies that the Parliament may lack about 25 members from the regions that are not controlled by the Government (the total number of MP's is 450). In late August, Petro Poroshenko's party led the polls leaving its opponents far behind.
- **IMF.** On August 29, the IMF Executive Board completed the first review under the Stand-By Arrangement (SBA), allowing for the second disbursement of the loan to the country at USD 1.4 bn (SDR 914.7m), which was received on September 4. About USD 1 bn from that disbursement were allocated to budget support, the rest was provided to the NBU. Given ongoing military conflict in Ukraine, the IMF approved waivers of applicability and nonobservance of performance criteria related to international reserves, general government deficit, net domestic assets of the central bank, and publicly guaranteed debt.
The IMF also decided to merge the remaining two reviews scheduled for 2014, which implied that Ukraine might receive next two tranches of the loan (each worth of USD 1.4 bn or SDR 914.7 m) in December. Previously it was planned that the third disbursement may be made in late September or early October.
- **GDP.** Real GDP declined by 4.6% yoy in the second quarter of 2014. Real private consumption contracted by 2.3% yoy likely due to decline in disposable income. Financial constraints against the background of high economic and political uncertainty resulted in drop of real fixed capital accumulation by 18.5% yoy. Decline in real domestic demand resulted in contraction of real imports at 11.3% yoy. At the same time, real exports declined by 7.4% yoy due to weak external demand and unrest in the Eastern Ukraine. Real net exports likely positively contributed to real GDP growth.

- Sectoral trends.** Military conflict in Donbas resulted in sharp contraction of industrial output in July by 12.1% yoy as many companies of the region had to stop operation. In particular, chemical production dropped by 22.2% yoy. Some metallurgical companies in other regions also were challenged by lack of sufficient coke supplies. As a result, output in metallurgy declined by 12.3% yoy. Trade tensions with Russia contributed largely to a decline in machine building by 23.8% yoy. Decline in manufacture of vehicles reached 79.9% yoy due to weak demand. Overall, manufacturing output dropped by 12.7% yoy. Output in mining industry decreased by 12.5% as several mines stopped working in Luhansk oblast due to military conflict. In July retail trade by enterprises dropped by 10.0% yoy. This might reflect decline in real private consumption due to lower households' disposable income. Rapid drop in construction (31.0% yoy in July) may be explained primarily by military actions in Eastern Ukraine. Construction in other regions also sharply declined due to financial constraints. Agricultural production in July increased by 11.3% yoy due to higher yields of most crops.
- Pension reform.** In the Letter of Intent to the IMF the Government revealed plans to continue pension reform and submit the respective draft law to the Parliament by end-September. Reform efforts will focus on privileged pensions, which are quite expensive at the moment. In particular, their nominal level will be frozen by the end of 2015. Besides, they will not be received by new entrants. This should help to stem increases in central fiscal transfer to the Pension Fund. Besides, the Government plans to expand taxation of high-income pensioners. However, it should be also noted that originally when the pension reform was started in 2003 payment of privileged pensions was to be managed by non-state pension funds.
- Increase in social standards.** The Government plans to limit increases in social standards (minimum wage and minimum pension) in 2015 to expected inflation. This is aimed at preserving purchasing power of Ukrainians from further decline but small real increases previously planned for 2015 will not be provided. This means that private sector will likely also increase wages, but nominal wage increases may be lower than inflation.

Ukraine: Economic Indicators 2011 - 2014

| | | 2011 | 2012 | 2013 | Q2 14 | May* | Jun* | Jul* | Aug* |
|------------------------------|-------------|-------|-------|-------|-------|-------|-------|-------|-------|
| GDP (real) | % yoy | 5.2 | 0.3 | 0.0 | -4.6 | | | | |
| Industrial production (real) | % yoy cum. | 7.3 | -0.5 | -4.7 | -4.7 | -4.6 | -4.7 | -5.8 | |
| Agricultural prod. (real) | % yoy cum. | 17.5 | -4.5 | 13.7 | -3.9 | 4.7 | -3.9 | 3.4 | |
| CPI | % yoy eop | 4.6 | -0.2 | 0.5 | 12.0 | 10.9 | 12.0 | 12.6 | 14.2 |
| Current account | % GDP. cum. | -5.7 | -8.1 | -9.0 | -2.1 | | | | |
| Fiscal balance | % GDP | -1.8 | -3.6 | -4.4 | | | | | |
| External state debt (total) | % GDP eop | 22.8 | 22.0 | 20.6 | | | | | |
| Gross international reserves | USD bn eop | 31.8 | 31.4 | 20.4 | 16.1 | 17.9 | 17.1 | 16.1 | 15.8 |
| Exchange rate (official) | EUR aop | 11.09 | 10.27 | 10.61 | 13.71 | 16.00 | 16.04 | 16.04 | 17.25 |

Source: IER.

*Data exclude Crimea

For further information: Institute for Economic Research and Policy Consulting (link: <http://www.ier.com.ua>).

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