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Macro Update

Smooth Sailing despite Storms of War

TUESDAY, 25 JULY 2023

The Ukrainian economy continues to exceed expectations by a significant margin thanks to uninterrupted flows of international financial aid. GDP growth may exceed 5% this year, as the better safety situation helped improve business sentiment. On the demand side, the recovery is upheld by household consumption. A gradual recovery in real incomes combined with higher propensity to consume make private spending a powerful engine for recovery. We expect security risks will continue to diminish but our base case does not assume a rapid improvement that could lead to a wave of investments and a large-scale return of refugees. There has been a remarkable slowdown in inflation, and CPI will decelerate to 11% by end-2023 on a combination of supportive factors and will likely stay in the range of 10–13% in 2024. The bright inflation prospects leave the NBU little choice but to start monetary policy easing from July. We expect the key policy rate to decline to 20% by the end of the year. The huge external trade deficit will remain the key economic risk in the foreseeable future, but foreign loans and grants are set to be sufficient to cover the gap. They also helped the NBU grow its reserves to an all-time high, and we expect that reserves will increase further in 2H23 and in 2024. The NBU is becoming increasingly inclined to introduce some degree of exchange rate flexibility so as to let market forces partially reduce external imbalances. Yet, we believe the NBU will be prepared to move away from the fixed exchange-rate regime only in late 1Q24, and the official exchange rate will remain unchanged at UAH36.6/US$ till the end of 2023. The performance of the state budget remains broadly in line with the government's plan; external debt and grants remain the only source of the deficit financing. Public debt-to-GDP will approach 90% in 2023. However, the benign debt-servicing schedule implies high indebtedness is not creating liquidity pressures on public finances.

Key macroeconomic projections

	2023F	2024F
Real GDP, YoY, %	5.8	6.4
Nominal GDP, US$bn	180	209
Inflation, YoY, %, e.o.p.	11.2	12.1
Key policy rate, %, e.o.p.	20.0	16.0
UAH/USD, e.o.p.	36.6	42.1
C/A balance, % of GDP	(2.7)	(4.8)
NBU reserves, US$bn	44	49
Budget gap, % of GDP*	(27)	(21)
Public debt, % of GDP	90	98

* budget balance before official grants to government
Source: ICU

Economy recovers on improved safety, better business sentiment

Economic performance in 1H23 was well above beginning-of-the-year consensus estimates. Economic activity now seems to be settled at 74–76% of the level of 2021, which was the last full, pre-war year. There are good reasons to expect this ratio will be maintained though to year-end, implying GDP growth of 5–6% for full-2023. Recent agriculture statistics confirm this assessment. The sector was expected to be a significant drag on economic growth, but early harvesting statistics show grain and oilseeds output will be down by less than 10% YoY, much better than the early-year estimate of a 15–20% decline.

The two most important drivers of recovery are a significant improvement in the safety situation and the smooth functioning of electricity–generating infrastructure.

Business sentiment improved substantially

These helped improve business and consumer sentiment and the economy entered a recovery path without any additional fiscal or monetary stimulus (vs 2022).

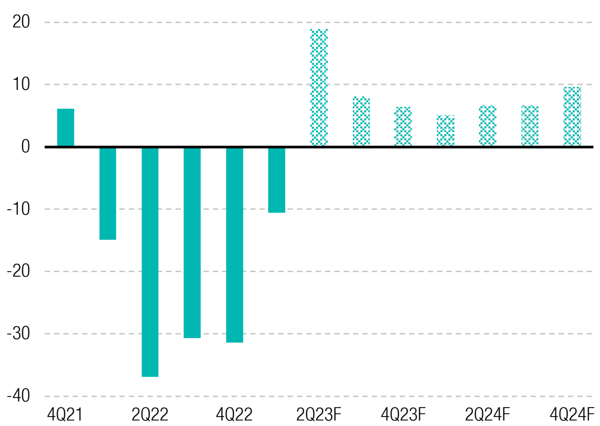
The corporate sector is showing more and more solid signs of confidence as proved by NBU surveys. Results of a freshly published quarterly survey indicate a positive balance of companies that expect an increase in production over the next 12 months. This marks a noticeable shift after balances have been negative over the past six quarters since the start of russia's full-scale invasion. Additionally, the monthly business-activity index of the NBU has exceeded a 50% threshold since April, which means that positive expectations dominate negative ones. Positive business sentiment implies companies are increasing utilization of their existing production capacity that stayed partially idle since February 2022.

Economic growth driven by private household consumption

The recovery of production is supported by growing household consumption. Private domestic consumption is currently the only significant driver of economic growth on the demand side. While official statistics are scarce these days, bits of information from banks indicate household expenditures are growing rapidly. Their expenditures in 2Q23 may have nearly reached volumes of 4Q21 in real terms. Real incomes of households likely remained little changed in 2022 vs 2021 thanks to a boost in salaries of military personnel. This year, real incomes may grow marginally. Even though the level of salaries will remain little changed, the increase in employment will be the key supportive factor. Private consumption is also getting a boost due to changing saving/spending preferences. As the safety situation improved, households significantly slashed the share of income they save for rainy days and increased the share of current expenditures.

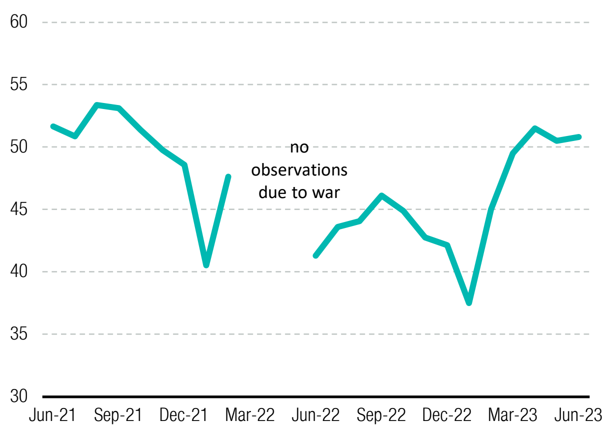
Needless to say, investment will not be a material growth driver this year. The private sector still has abundant underutilized capacity, while government is prioritizing military expenditures over infrastructure projects. The contribution of new exports to growth will be negative, as recovering domestic demand will drive rapid increase in imports while exports remain constrained due to logistics bottlenecks.

Chart 1. Real quarterly GDP, change YoY, %



Source: UkrStat, ICU.

Chart 2. Business activity index of the NBU*



* numbers below 50 indicate negative expectations of economic activities, based on survey of enterprises

Source: NBU, ICU.

New missile attacks on energy infrastructure is the key risk to economy

The key risk to economic recovery remains unchanged. Russia is very likely to repeat its missile strikes on energy infrastructure in late autumn and winter. As a larger share of thermal electricity generating capacity is damaged, the likelihood of electricity rationing for households and businesses is very high. Yet, improved anti-missile protection may help keep the risk under control.

The suspension of the Black Sea grain corridor is yet another risk. Russia refused to guarantee the safety of cargo vessels since mid-July. Black Sea ports were a major export channel accounting for just under half of all grain and oilseeds delivered in the 2022/23 marketing year. Blockage of these ports is a less of a problem in the current marketing year due to lower grain and oilseeds leftovers and a decline in this year's harvest. Increased throughput of the Danube ports and railways should be enough to export agricultural produce. However, in a recent escalation russia started to target Danube ports, and that is a new sort of problem that may pose significant risks to exports.

Inflationary pressure noticeably eases

Inflation slowed to 12.8% in June and will continue to decelerate further

Inflationary pressures eased considerably since the start of the year as, unlike in 2022, the safety situation improved and repaired domestic logistics allow smooth supply of goods and services to consumers. The CPI slowed remarkedly to 12.8% YoY in June from 26.6% at the end of 2022. Several powerful disinflationary factors remain in place:

- Stable official UAH/USD exchange rate and an 8% YTD strengthening of cash rate, which recently approached the official level.

- Abundant domestic supply of grains and oilseed due to high export transportation costs. Another agro-related supportive factor is an increased supply of fruits and vegetables from southern regions thanks to the liberation of new territories last year. The continued global decline of prices for agricultural products is yet a positive development inflation-wise.

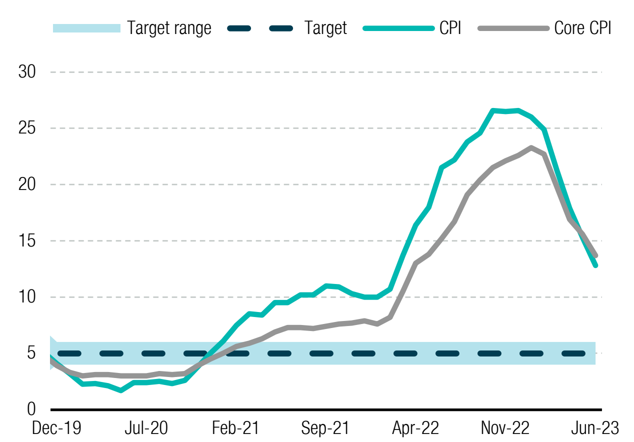
- Relatively stable utility tariffs that regulators/government remain reluctant to revise up despite surging costs. The recent 70% hike in electricity tariffs for households will not have an outsized impact on inflation.

The positive effect of the above factors will remain powerful over the next couple of quarters, and we now see end-2023 inflation in the range of 10.5–11.5% YoY.

CPI likely to stay in the range of 10-13% till the end of 2024

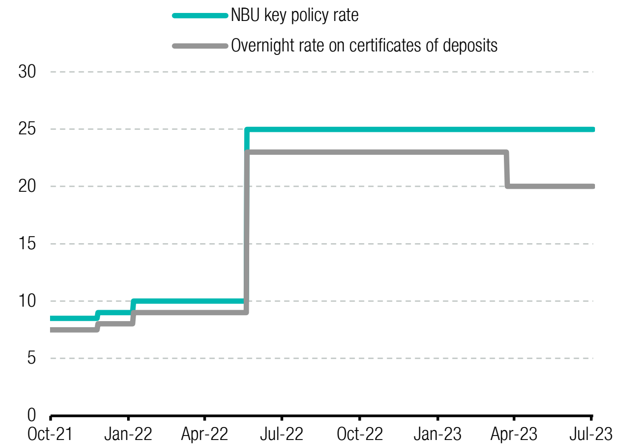
While inflation is set to cool this year to low double digits, we see practically no room for a further decline to single-digit territory in the foreseeable future. Looking ahead, we believe continued upward price adjustments are inevitable. Firstly, household incomes are likely to continue recovering gradually and so will be the propensity to consume, as safety concerns are easing. This will add demand-side pressure to prices. Secondly, we expect that the NBU will switch to a flexible exchange-rate regime in 2024, which implies the gradual depreciation of hryvnia. A weaker hryvnia, in turn, implies an adjustment of prices for imports. Third, the issue of very-low, significantly-below-cost, utility tariffs for households remains open and chances are high that it will be back on the agenda next year. With all this in mind, we expect Ukraine's annual inflation to remain in the range of 10–13% at least until the end of 2024.

Chart 3. CPI, core CPI and inflation target, YoY, %



Source: NBU, ICU.

Chart 4. NBU key policy rate and overnight CD rate, %



Source: NBU, ICU.

NBU has no choice but to start lowering rates sooner than planned

NBU likely to start monetary policy easing from July

The NBU has kept the key policy rate unchanged at 25% since June 2022. So far, a rapid deceleration in consumer prices has not been enough for the NBU to formally start a monetary policy easing cycle. Yet, while keeping the key policy rate unchanged, the central bank considerably changed the operational design of monetary policy, whereby the rate on overnight CDs was lowered in April 2023 to 20% from 23%. Since then, the NBU also started offering three-month CDs, which yield the key policy rate. Banks can only invest deposits with an original maturity of over three months into this three-month instrument. The change in the monetary-policy design effectively led to an easing of the monetary stance, as an average rate on the mix of all CDs has slipped to below 22% from 23% since April.

The NBU keeps justifying a very high key policy rate by the need to keep real returns on hryvnia assets positive to prevent an abrupt surge in demand for hard currency. This is a valid argument in principle, but the current rate of inflation and the expectation of its further slowdown probably make real yields excessively high. We see little justification for the current overly tough monetary policy stance and expect the NBU will move to start a policy-easing cycle as soon as this week. We see end-2023 key policy rate at 20%. However, the decline in the overnight CD rate will likely be somewhat smaller, implying the decline in commercial interest rates, including on local government UAH debt, will also be smaller than 5pp. Looking into 2024, we see room for another 3–5pp cut in the key policy rate to 15–17%, which will still imply a reasonable, real positive return on investments into UAH risk-free instruments.

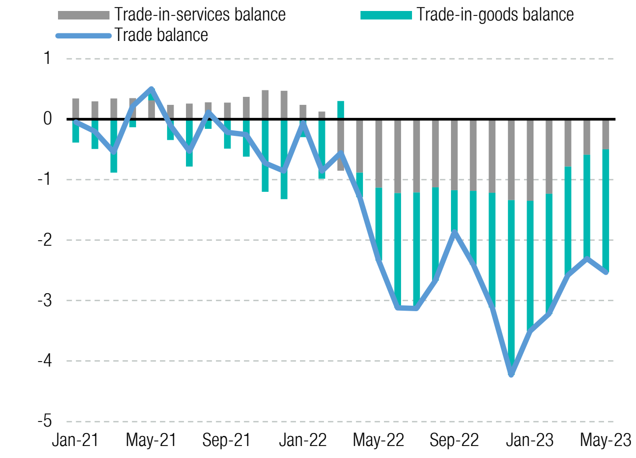
Official funding covers all gaps in Ukraine's external accounts

External trade deficit at all-time high

Ukraine continues to face significant imbalances of external accounts, but they remain covered thanks to generous international financial aid. This pattern will persist in the coming years, and the economy's dependence on foreign grants and loans will remain critical.

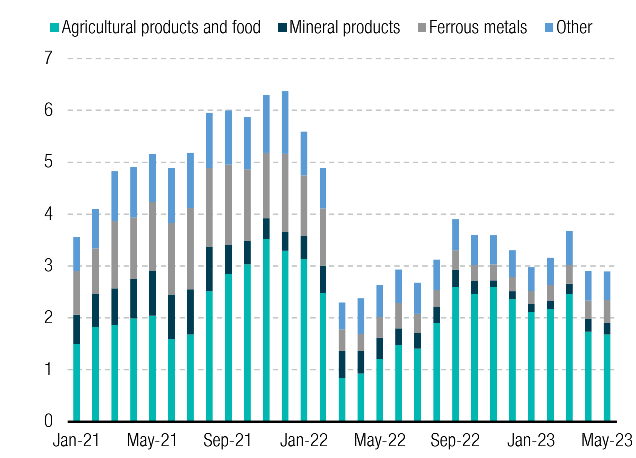
The external trade gap will reach an all-high time and exceed 18% of GDP this year. Export of goods is down 30% in 5M23 vs the same period of 2021, and there are no signs of recovery in sight. Ukraine lost some of its major export-oriented companies, and export logistics bottlenecks pose a challenge for those that remain operational. Meanwhile, the import of goods is already slightly above the pre-war level, as domestic private demand is recovering and Ukraine also keeps importing military equipment in large volumes. Growth of imports will outpace growth of the economy over the next couple of years while exports are likely to remain stagnant.

Chart 5. Monthly trade balance, US$bn



Source: NBU, ICU.

Chart 6. Monthly export of goods, US$bn

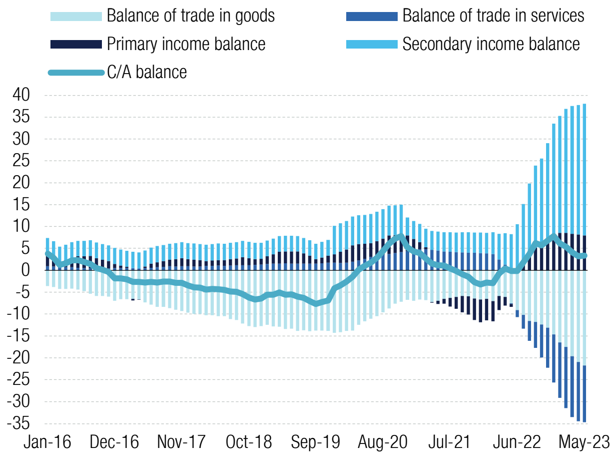


Source: NBU, ICU.

The deficit in trade-in-services narrowed considerably in the last couple of months after it ballooned immediately after russia's full-scale invasion. Ukraine's sizable import of services is nothing but a reflection of refugees' expenditures in host countries. The balance of trade-in-services is set to remain negative for the next couple of years, but may narrow somewhat as refugees return to Ukraine.

A huge trade deficit was fully offset with migrant remittances, humanitarian aid, and budgetary grants from Ukraine's allies in 2022. Yet this year, these components will fall short of fully offsetting the trade deficit, and we expect a reasonable current account gap of 2–3% of GDP. It is set to widen further next year on expanding imports.

Chart 7. Current account, 12-month trailing, US$bn



Source: NBU, ICU.

Table 1. Current account components, US$m

	May 2023	Apr 2023	May 2022
Current account	**-21**	**380**	**-173**
Trade in goods	-2,032	-1,719	-1,209
Trade in services	-501	-591	-1,132
Primary income	529	679	754
incl. migrant remittances	955	952	1,049
Secondary income	1,983	2,011	1,414
incl. transfers to government	1,435	1,426	774
Financial account*	**-1,545**	**-995**	**1,751**
Change in trade credits	-131	28	1,838
Increase in cash out of banks	1,047	1,014	1,089
Net loans to government	-1,925	-1,575	-937

* negative numbers in financial account indicate increase in liabilities (cash inflow)

Source: NBU, ICU.

Government borrowings will keep financial account in hefty surplus

The financial account will continue to see significant net inflows of capital driven by official loans to the government from Ukraine's partners. While loans are given to cover the state budget deficit, they are also critical for keeping Ukraine's external accounts in surplus.

The flight of private capital subsided significantly compared with 2022. The capital that fled the country via the build-up of external trade credits is now gradually returning to the economy thanks to the improved safety situation and stable FX market. The only material drag on the financial account remains the leakage of FX cash from the banking sector. Outflows remain robust and significant at US$0.9–1.1bn per month. They largely represent FX cash withdrawn by individuals from their FX deposits or FX cash that Ukrainians withdraw from their hryvnia accounts when abroad. Yet, these outflows of FX cash from banks is fully compensated by new international concessional borrowings of the government, which may exceed US$25bn in 2023.

Official hryvnia rate to stay flat till end-2023

NBU is unlikely to change official exchange rate in 2023

Generous financial aid from Ukraine's international partners far exceeds the trade deficit and private capital outflows. This implies the NBU only has to sell roughly half of all hard currency that comes to its accounts. The NBU FX sale interventions stood at an average US$1.7bn per month in 2Q23, down from US$2.4bn in 1Q23 (for a total of US$12.3bn in 1H23). Meanwhile, Ukraine received over US$22bn in loans and grants over the same period. External public debt servicing payments were relatively immaterial over the period and were not a drag on reserves.

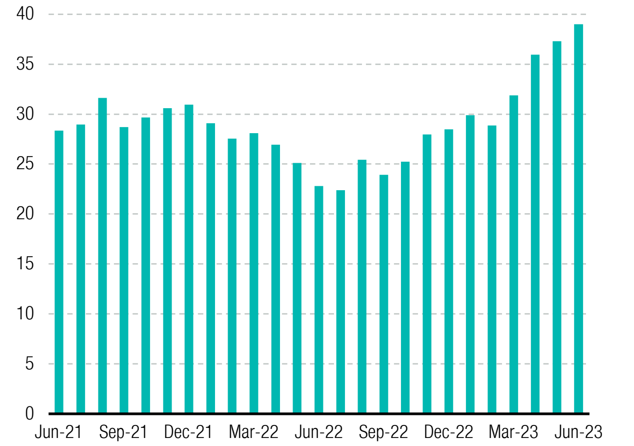
Hefty FX inflows, thus, help the NBU accumulate reserves. Gross reserves reached an all-time high of US$39bn in June, with net reserves being about one-third less. The stock of gross reserves slightly exceeds 100% of IMF Assessing Adequacy Reserve (ARA) criteria.

Shift to a flexible exchange rate regime is nearly certain in 2024

We expect that through end-2023 and in 2024, foreign international aid will remain sufficient for the NBU to build its reserves further even if the hryvnia exchange rate remains fixed. However, the NBU seems to be willing to abandon the fixed exchange rate regime and move to some degree of flexibility. The prospect of a managed float is also clearly articulated in the IMF Memorandum. We argue that this is unlikely to happen in 2023, and a move to a flexible exchange rate may happen no sooner than in 1Q24, most likely in March. We don't think this move is possible until the second review of the IMF program, scheduled for October, is complete. The results of the review won't be stamped by the IMF Board until November. Then comes winter, which is the most challenging period for the Ukrainian FX market. Heightened seasonal demand for FX may be reinforced by the negative sentiment of the population if russia repeats its massive missile strikes on energy infrastructure. By no mean is this going to be the best window of opportunity for a shift in exchange-rate policy by the central bank.

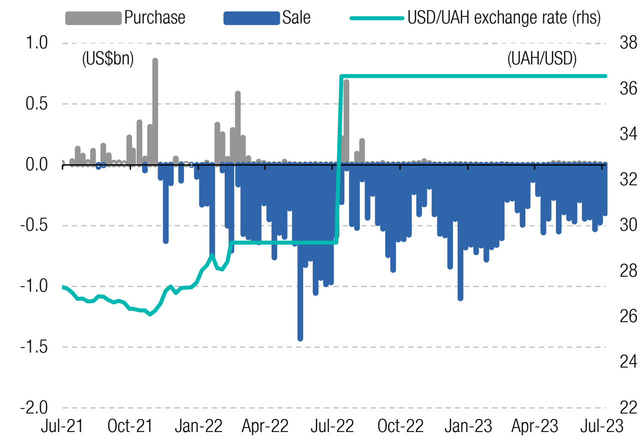
With this in mind, we now expect end-2023 official exchange rate to be unchanged at UAH36.6/US$ with the cash exchange rate remaining close to the official numbers. In 2024, we see a gradual depreciation of about 15% over the course of the year to about UAH42/US$.

Chart 8. NBU gross international reserves, US$bn



Source: NBU, ICU.

Chart 9. FX market weekly indicators (UAH exchange rate and NBU interventions)



Source: NBU, Bloomberg, ICU.

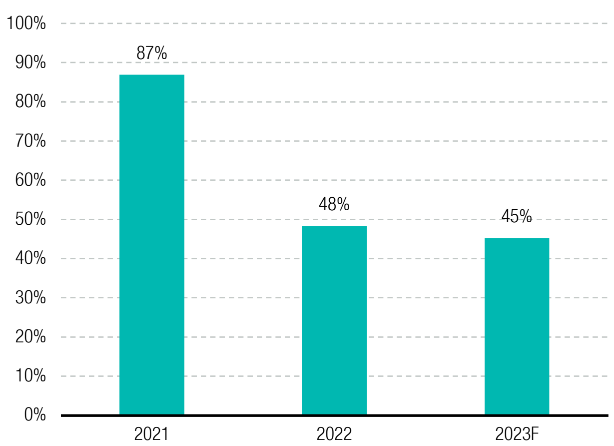
Budget execution goes largely according to plan so far

Tax revenues grow in line with economy

State budget execution remains broadly in line with the plan that was last amended in March 2023. Total tax revenues are up 19% YoY in 5M23 driven by growth in VAT and excise taxes. A gradual elimination of preferential tax rates and a return to the pre-war tax regime will accelerate growth in tax revenues. The full-year tax revenue growth plan of 26%, thus, looks fully achievable. Government's plan envisages that domestic tax and non-tax revenues will cover about 45% of all central budget expenditures in 2023. In 5M23, this ratio stood at 59%, but the number is high thanks to one-off income transfers from the central bank and state-owned banks. So, this ratio will go down considerably in the coming months.

The full-year state budget deficit is currently planned at UAH1,720bn, or 26% of GDP. Net domestic borrowings are planned to be close to zero and redemptions of external debt at UAH86bn. The MoF claims that about US$42.4bn of gross external funding is secured for 2023. This target was set to fully cover the funding needs if based on the government projection of an average exchange rate of UAH42.2/US$. But a much stronger hryvnia (we see the USD to be on average 13% cheaper in 2023) implies the government may need to secure additional funding. Only a small part of that may come from domestic market, while the rest should be raised externally. As before, we don't expect the NBU to step in by printing money this year.

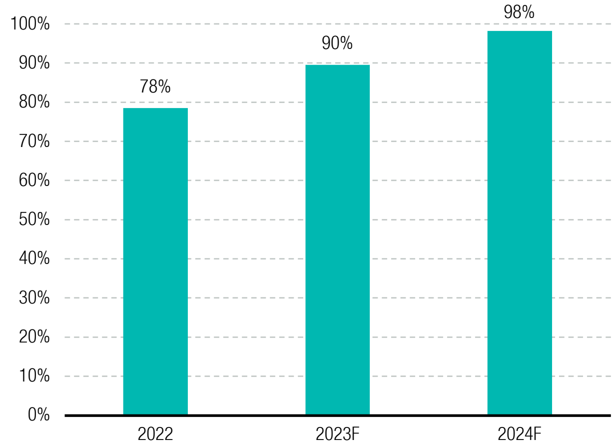
Chart 10. Ratio of state budget revenues to expenditures*



* Revenues excluding external budgetary grants

Source: MFU, ICU.

Chart 11. Public debt-to-GDP ratio



Source: MFU, ICU.

Public debt-to-GDP ratio will approach 90% by end-2023

We expect Ukraine's public debt to grow substantially this year and in the next couple of years on new concessional foreign loans. We see the debt-to-GDP ratio approaching 90% by the end of 2023, and exceeding 95% at the end of 2024.

The public debt is obviously not sustainable and debt restructuring with certain haircuts is inevitable. However, high indebtedness is not a major concern at the moment. Firstly, government has no difficulties in rolling over domestic debt in full. Secondly, scheduled payments on external debt for the near future are minimal, as government managed to push back private and bilateral debt payments. High public debt, thus, is unlikely to pose any significant liquidity risks for the government in the next couple of years. We don't see any major repayments at least till the end of the current IMF program in 1Q27. Ukraine will have enough time and breathing space to design its debt management strategy after the war ends.

Yearly forecast 2022–23

	Historical data for 2013–2022										Forecast	
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023F	2024F
Activity												
Real GDP (%, YoY)	(0.0)	(6.6)	(9.8)	2.4	2.5	3.4	3.2	(4.0)	3.4	(29.1)	5.8	6.4
Nominal GDP (UAHbn)	1,465	1,587	1,989	2,385	2,984	3,561	3,978	4,194	5,460	5,191	6,591	8,134
Nominal GDP (US$bn)	180	133	90	93	112	131	155	155	200	161	180	209
Unemployment (%)	7.3	9.3	9.1	9.3	9.5	8.8	8.2	9.5	9.8	28.0	21.0	17.0
Inflation												
Headline inflation (%, YoY, e.o.p)	0.5	24.9	43.3	12.4	13.7	9.8	4.1	5.0	10.0	26.6	11.2	12.1
Headline inflation (%, YoY, avg.)	(0.3)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	9.4	20.2	15.5	12.7
GDP deflator (%, YoY)	4.3	15.9	38.9	17.1	22.1	15.4	8.3	9.8	25.1	34.3	20.0	16.0
Exchange rates												
UAH/USD (e.o.p.)	8.2	15.8	24.0	27.3	28.1	27.7	23.8	28.3	27.3	36.6	36.6	42.1
UAH/USD (avg.)	8.2	12.0	21.9	25.6	26.6	27.2	25.8	27.0	27.3	32.3	36.6	38.9
External balance												
Current account balance (US$bn)	(16.5)	(4.6)	5.0	(1.9)	(3.5)	(6.4)	(4.1)	5.3	(3.2)	7.9	(4.9)	(10.1)
Current account balance (% of GDP)	(9.2)	(3.5)	5.6	(2.0)	(3.1)	(4.9)	(2.7)	3.4	(1.1)	4.9	(2.7)	(4.8)
Trade balance (US$bn)	(15.6)	(4.6)	(2.4)	(6.5)	(8.7)	(11.4)	(12.5)	(2.4)	(2.7)	(25.7)	(33.8)	(37.8)
Trade balance (% of GDP)	(8.7)	(3.5)	(2.6)	(6.9)	(7.8)	(8.7)	(8.1)	(1.5)	(1.5)	(16.0)	(18.7)	(18.1)
Capital flows (F/A) (US$bn)	18.6	(9.1)	(4.6)	3.1	6.0	9.3	10.1	(3.3)	3.7	(10.9)	20.4	14.7
FDI (US$bn)	4.1	0.3	(0.4)	3.8	3.7	4.5	5.2	0.1	6.9	0.3	(3.5)	(3.9)
FDI (% of GDP)	2.3	0.2	(0.5)	4.1	3.3	3.4	3.4	0.1	3.4	0.2	(2.0)	(1.9)
NBU reserves (US$bn)	20.4	7.5	13.3	15.5	18.8	20.8	25.3	29.1	30.9	28.5	44.0	48.7
Interest rates												
NBU's key policy rate (%, e.o.p.)	6.50	14.00	22.00	14.00	14.50	18.00	13.50	6.0	9.0	25.0	20.0	16.0
Fiscal balance												
Budget balance (% of GDP)	(4.4)	(5.0)	(2.3)	(2.9)	(1.5)	(2.4)	(2.1)	(5.1)	(2.4)	(26.9)*	(26.8)*	(21.1)*
Public debt (% of GDP)	39.9	69.4	79.0	80.9	71.8	60.9	50.6	60.8	49.7	78.5	89.5	98.2

* budget balance before official budgetary grants

Source: Ukrstat, NBU, MFU, ICU.

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