Focus	Markets	Research team
Ukraine	**Economics**	**Vitaliy Vavryshchuk**

Macro Update

Economy Stabilized; Dependence on Foreign Aid Critical

TUESDAY, 21 MARCH 2023

The Ukrainian economy has stabilized and, assuming no major escalation of the war, we expect an otherwise uneventful 2023. Real GDP is set to stay close to last year's level following a 29% contraction in 2022. We expect a marginal recovery thanks to the improved safety situation and logistics. We are growing increasingly confident that consumer inflation will decelerate rapidly on weak domestic demand, stable utility tariffs, and a still fixed exchange rate. Slower price growth combined with receding pressures on the FX market led the NBU to abandon its tough hawkish stance and we expect it to lower its key policy rate in April or June. On the external-sector side, the key risk will be the growing trade deficit and continued flight of private capital. However, like in 2022, the gap will be fully offset with international loans and grants from Ukraine's allies. They will remain critical in supporting stability in the FX market, financing the huge budget deficit, and will help maintain NBU reserves close to US$30bn through 2023. The NBU will be able to maintain the current UAH/US$ exchange rate in the coming quarters, but may choose to weaken the hryvnia marginally by the end of the year to reduce external imbalances. Its decision will largely depend on expectations about the size of possible foreign aid in 2024. The budget deficit is likely remain close to 28% of GDP. Foreign financing will be the only source to fund the fiscal gap. Ukraine is close to launching a new IMF program. This implies conditionalities related to fiscal, monetary, energy, and financial-sector policies, but it also means additional flexibility in raising more external funding should unexpected circumstances necessitate it.

Key macroeconomic projections

	2022	2023F
Real GDP, YoY, %	(29)	2
Nominal GDP, US$bn	154	161
Inflation, YoY, %, e.o.p.	27	15
Key policy rate, %, e.o.p.	25	20
UAH/USD, e.o.p.	36.6	40.2
C/A balance, % of GDP	5.4	(2.3)
Reserves, US$bn	28	31
Budget gap, % of GDP*	(28)	(28)
Public debt, % of GDP	82	90

* budget balance before official grants to government
Source: ICU

Marginal GDP recovery likely in 2023

There is broad consensus that Ukraine's economic growth is going to be close to zero in 2023, with a difference in individual forecasts stemming from a difference in underlying assumptions regarding further intensity of the war, continuity of the Black Sea grain export routes, and risks to the energy infrastructure. We expect a moderate recovery in real GDP of 2% YoY, which implies the economic output will be at 71–73% of the pre-war level.

Last year, the economy received a powerful stimulus from huge government expenditures related to the war. The direct and indirect effects of the fiscal impulse likely exceeded 10% of GDP, thus preventing an even deeper fall of the economy. External financing will keep budget expenditures significantly above the pre-war level and will help maintain the current economic output, but it is very unlikely to have a positive contribution to GDP growth going forward.

Improved safety supports recovery

The main factor supportive of economic recovery is considerable improvement in the safety situation vs. 2022. Businesses were in a rush to resume provision of goods and services in summer 2022, once the front line was pushed back to the eastern regions. Before the economy was hit by massive blackouts, it likely was on a growth trend with production improving month to month. The high adaptability of business, an abundant labor force combined with a fully functioning financial sector and telecommunications would be highly conductive to gradual recovery.

Another supportive factor may be a gradual improvement in logistics. Our baseline forecast assumes the Black Sea grain corridor will function through 2023, but we also may see growth in throughput of railway and road transportation that may help recover exports.

Meanwhile, there will be two major drags on the economy on 2023:

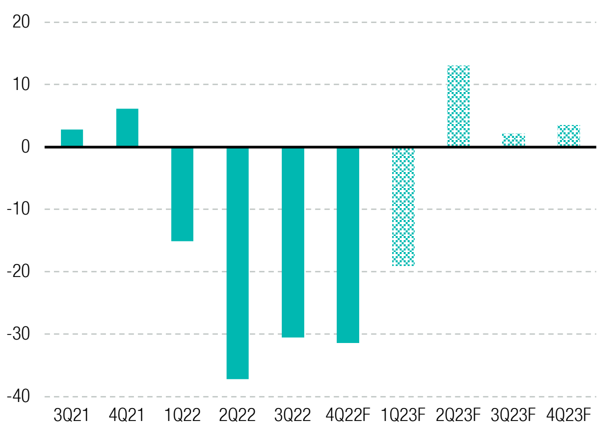
Blackouts and declining agricultural production are key risks

- power blackouts that started back in October and reached their peak intensity in December and January. Uninterrupted power supply has been restored since mid-February, and blackouts are not a current problem. However, it's almost certain that russia will again try to destroy key elements of the energy infrastructure.

- decline of Ukrainian agriculture, which is facing significant price pressures and financing difficulties. As a result, agricultural producers may decrease areas sown and utilization of fertilizers that will lead to a 15–20% YoY decline of the total harvest of grains and oil crops.

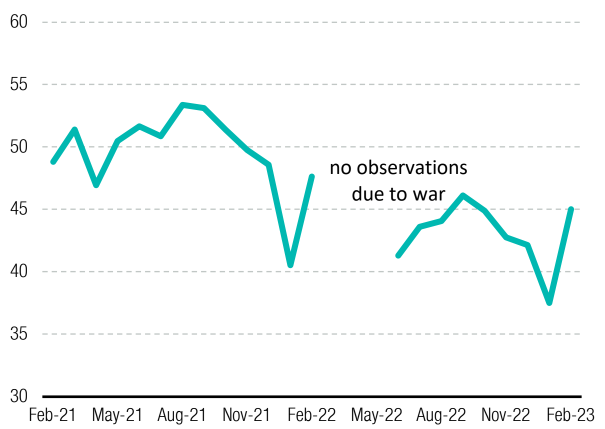
We believe the balance of risks to economic growth is currently symmetric, providing war-escalation risks remain little changed.

Chart 1. Real GDP, change YoY, %



Source: UkrStat, MEU, ICU.

Chart 2. NBU index of business activity*



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

Source: NBU, ICU.

NBU key policy rate likely to be cut sooner than planned on decelerating inflation

Inflation will slow from 26.6% in 2021 to 15-16% this year

We see a good chance of inflation decelerating considerably to 15–16% YoY by the end of 2023 from 26.6% at end-2022. There are a number of powerful disinflationary factors in play:

- a considerable decline in domestic consumption due to stagnating incomes of the population and a much lower number of customers due to massive emigration. That will force local producers to accept lower margins to maintain their customer base.

- the authorities' reluctance to increase utility tariffs. A major tariff revision is long overdue, but any significant hike is very unlikely at least through end-2023. The state budget and state monopolies will bear the burden of the losses to prevent further deterioration in the purchasing power of the population.

Multiple disinflationary factors are in play

- a relatively stable exchange rate that keeps the price of imports broadly unchanged following last year's surge. Margins of many importers grew significantly last year due to a dual cash vs. non-cash exchange rate, and importers are likely to tolerate a decrease in margins for the sake of stronger demand.

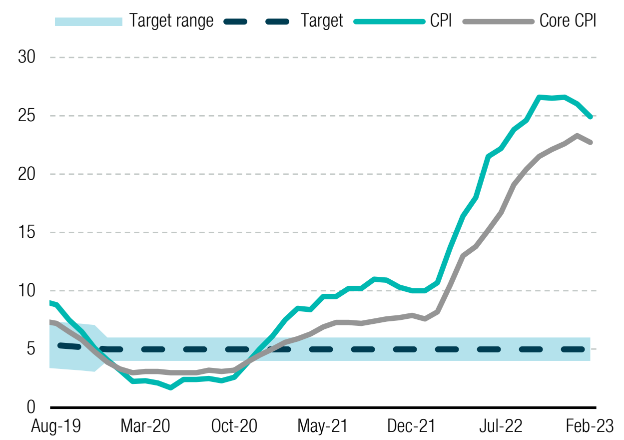
- last year's repeat of a fuel crisis, which drove the price of gasoline up 69% in 2022, is very unlikely thanks to a decline in global oil prices and a redesign of internal logistics.

- global food prices have been declining for almost a year, domestic supply of fruits and vegetables is likely increased thanks to liberation of sizable territories in the south of Ukraine.

Yet, inflationary risks are not dissipating outright; some of them will remain high over the next 12 months. Cost pressures are visible in many segments, including cost of rent and energy. Logistics, though significantly improved following a decline in safety risks, is still a challenge for many producers and importers.

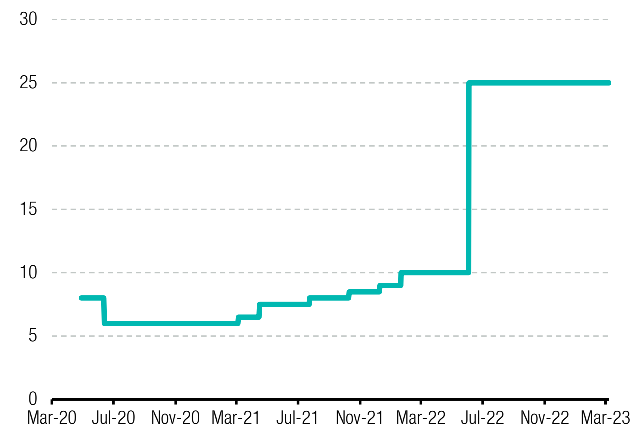
The balance of risk is currently clearly tilted to disinflation and significant negative surprises are very unlikely in the coming quarters.

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



Source: NBU, ICU.

Chart 4. NBU key policy rate, %



Source: NBU, ICU.

Key policy rate likely to decline to 20% by end-2023

The NBU has effectively started to soften its monetary policy stance last week by slashing the rate on overnight certificates of deposit to 20% from 23%, while keeping the key rate intact. With our inflation forecast in mind, we believe that the NBU will continue to weaken its hawkish rhetoric and may also start lowering its key policy rate from April or June. The central bank's current forecast envisages the key policy rate may be somewhat reduced from the current 25%, but not until the beginning of 1Q24. This is a fairly conservative stance that is supposed to encourage banks to keep deposit rates high and the Ministry of Finance to keep raising yields on local hryvnia bonds. High commercial rates on hryvnia assets are supposed to help businesses and the population to preserve the purchasing power of their savings and prevent them from converting hryvnia savings into FX at any cost. However, inflationary pressures are clearly easing faster than the NBU forecasts, and the FX market is likely to remain relatively stable thanks to generous financial aid from Ukraine's allies. The central bank will have fewer and fewer arguments to stay aggressively hawkish in the quarters to come. We see the key policy rate at 20% at the end of 2023, which will still imply a highly restrictive policy stance.

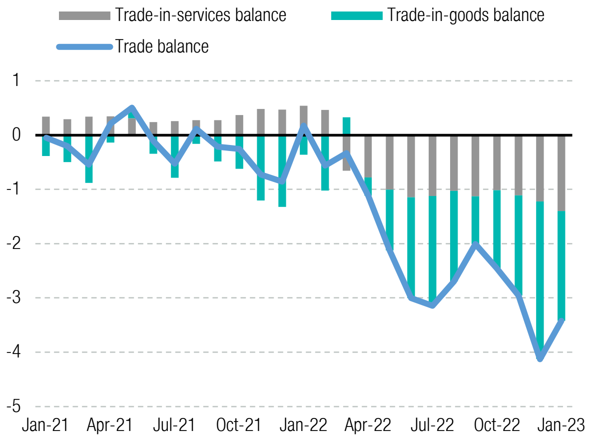
No major risks in external sector in 2023, despite record-high trade deficit

Current account balance to deteriorate on larger trade deficit

We expect Ukraine's current account balance will deteriorate to negative 2–3% of GDP (vs. +5.6% in 2022) on a growing deficit of trade-in-goods. This current account gap will most likely be safely covered with net capital inflows via the financial account. Thus, Ukraine is very unlikely to face any risks related to the external sector thanks to continued generous financial aid from international partners.

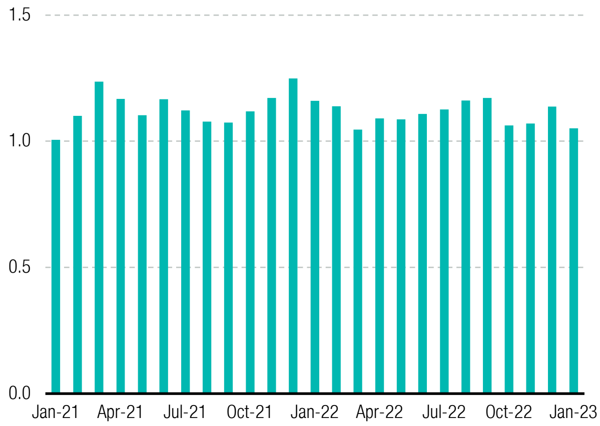
Ukraine's trade-in-goods deficit expanded rapidly during the winter as frequent electricity blackouts increased the economy's reliance on imports. External deliveries of power generators, motor fuel, and certain consumer goods surged. In the first two months of the winter, import of goods was only 12% lower than over the same period a year before. Meanwhile, exports stood at just 52% of last year's volumes. The monthly deficit of trade-in-goods surged to alarming levels. While it will certainly narrow in the spring and summer months, it will still remain wider than in 2022.

Chart 5. Monthly trade balance, US$bn



Source: NBU, ICU.

Chart 6. Monthly migrant incomes, US$bn



Source: NBU, ICU.

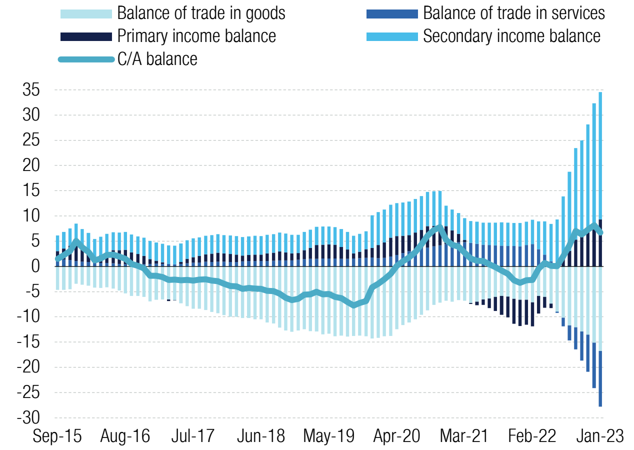
Deficit of foreign trade will be the highest on record

The deficit of external trade-in-services is likely to remain relatively flat vs. 2022. The expenditures of Ukrainian refugees abroad that are recorded as import of tourism is the main driver of the trade gap. The net emigration from Ukraine has been marginal in recent months and, providing no major war escalation happens, we don't expect any pickup in emigration.

The combined deficit of external trade-in-goods-and-services will thus exceed 20% of GDP in 2023, up from an estimated 16% in 2022. This is going to be the highest deficit on record, and a huge trade gap is definitely a source of risk going forward.

There are two C/A components that help cover a significant portion of the trade deficit. The first one is migrant incomes that hold up extremely well and may increase somewhat as more Ukrainians find jobs in host countries. Migrant incomes are expected to total 9–10% of GDP. The second sizable component is official budgetary transfers to the Ukrainian government from foreign governments (primarily the US) and international financial institutions that are recorded in secondary income of the balance of payments. They exceeded 10% of GDP in 2022, and, based on publicly announced commitments, are likely to stay at virtually the same level relative to GDP this year. Incomes of migrants and official budgetary transfers will ensure the deficit of the C/A will be at a reasonable level.

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



Source: NBU, ICU.

Table 1. Current account components, US$mn

	Jan 2023	Dec 2022	Jan 2022
Current account	-762	60	769
Trade in goods	-2,027	-2,899	-365
Trade in services	-1,398	-1,225	539
Primary income	850	787	265
incl. migrant remittances	1,050	1,135	1,159
Secondary income	1,813	3,397	330
incl. transfers to government	1,088	2,377	74
Financial account*	-1,969	-467	2,530
Change in trade credits	-99	521	868
Increase in cash out of banks	1,042	779	854
Net loans to government	-3,050	-1,572	-400

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

Source: NBU, ICU.

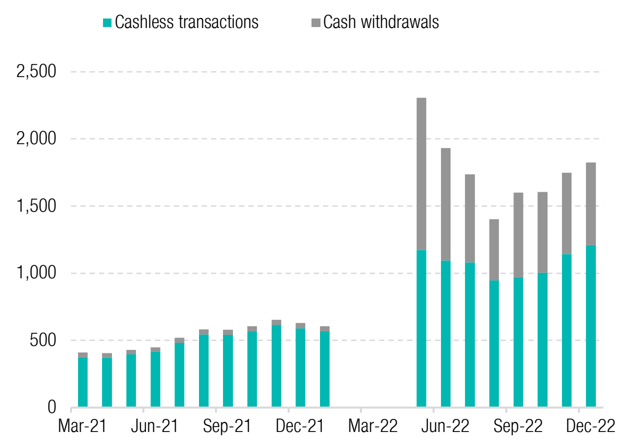
Net official borrowings will exceed private capital flight

The Financial account will likely see net positive capital inflows in 2023 on larger concessional loans and lower flight of private capital. Last year, private capital left the country in large volumes despite capital controls imposed by the NBU. The two main channels were:

- the build-up of external trade credits (equivalent of 8% of 2022 GDP). The larger part of this increase in the stock of credits was likely a shadow leakage of private funds from the country. Since the start of the war, the stock of trade credits grew in every single month, but in January 2023, the first instance of reduction in the stock of trade credits was registered. We expect capital outflows via this channel to subside in 2023, as many businesses may want to return a part of foreign liquidity back to fund their recovery needs. Also, given a relatively stable situation in the FX market, there are fewer and fewer incentives to siphon funds abroad.

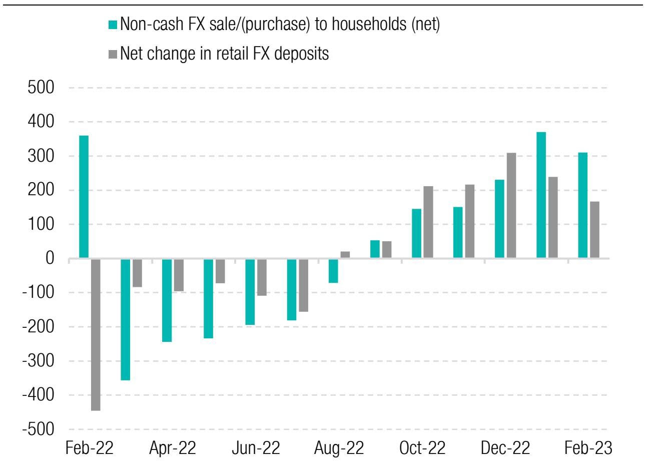
- the second significant channel was the outflow of FX cash from the banking system (equivalent of 7% of 2022 GDP) as Ukrainian refugees withdrew euros and dollars abroad from their hryvnia accounts at Ukrainian banks. Cash withdrawals by refugees may subside significantly as many of them have already used a significant part of their savings. But the smaller cash withdrawals by refugees will be offset with larger cash withdrawals within the country as many retail clients use an NBU-endorsed scheme to buy FX at favorable rates to place in term deposits. A significant share of such deposits may later be withdrawn.

Chart 8. Bank operations of retail clients abroad, EURmn



Source: NBU, ICU.

Chart 9. Purchases of FX cash and change in FX deposits of retai clients at banks, US$mn



Source: NBU, ICU.

We expect the Ukrainian government will receive at least US$25bn in net loans in 2023 (including net funding from the IMF), which is more than a 50% increase compared with 2022. These loans will be sufficient to offset private capital outflows.

Hryvnia to stay relatively stable in 2023; slight depreciation possible by end-2023

The NBU will keep offsetting deficit in the FX market

Thanks to foreign financial aid, the NBU managed to recover its gross international reserves to the pre-war level by the end of 2022. Also, it used international aid to keep the hryvnia stable since late July when it lowered the hryvnia exchange rate vs. the US dollar by 25%.

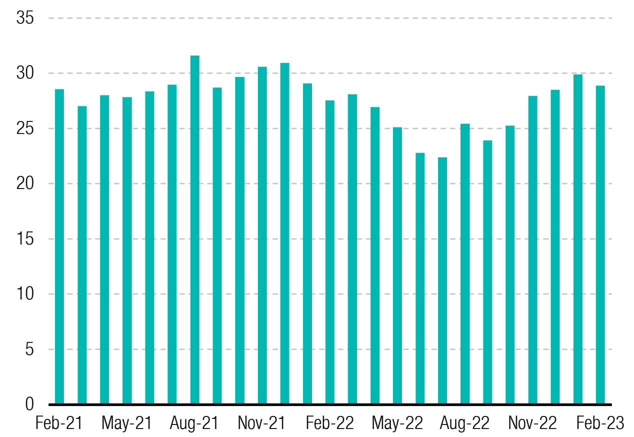
The need for NBU FX sale interventions has been considerable over the winter months and the central bank sold on average US$700mn per week. This is a huge amount that spiked on the back of surging imports of goods when the country suffered major power blackouts. The positive news if that the need for interventions fell to an average US$315mn in the first three weeks of March and is unlikely to surge back to winter levels in the foreseeable future.

Slight hryvnia depreciation is likely in 4Q23

We expect the net concessional funding will slightly exceed the deficit in the FX market over 2023. This means that the NBU is free to decide whether to continue fully offsetting the deficit in the FX market via interventions. Maintaining the current US$/UAH exchange rate would greatly help the NBU in bringing inflation down. The flipside is that the current exchange rate implies that huge imbalances in the FX market will persist. Our thinking is that the NBU will maintain the current exchange rate at least until the end of 3Q23, but may opt for small depreciation of about 10% in 4Q23. Its decision will largely depend on expectations about the size of possible foreign aid in 2024.

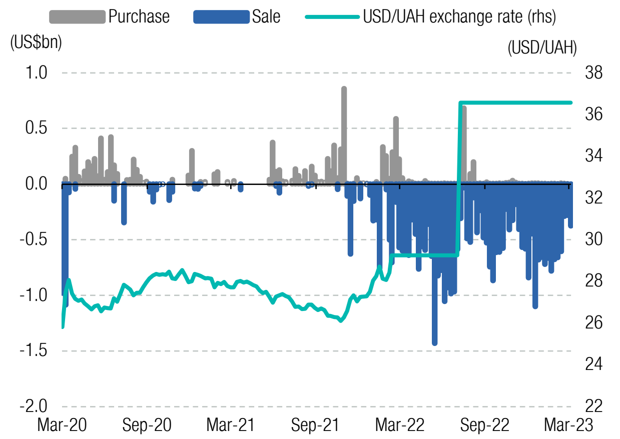
NBU reserves are likely to stay volatile through 2023, as inflows of foreign financial aid may not be perfectly smooth. Nevertheless, gross NBU reserves will slightly exceed US$30bn at the end of 2023, which is a totally comfortable level of just below 19% of GDP.

Chart 10. NBU gross international reserves, US$bn



Source: NBU, ICU.

Chart 11. FX market weekly indicators (UAH exchange rate and NBU interventions)



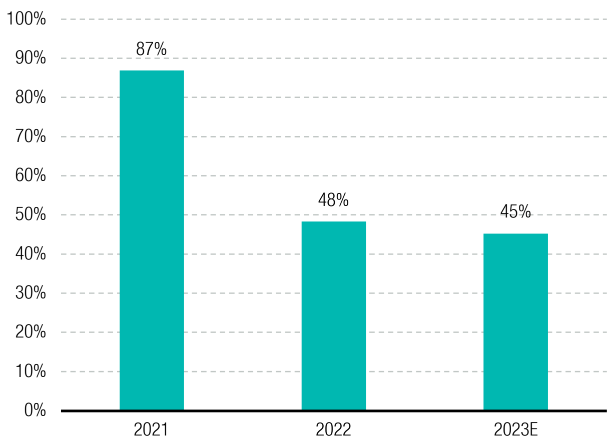
Source: NBU, Bloomberg, ICU.

Budget financing almost secure for 2023

Budget deficit to stay close to 28% of GDP in 2023

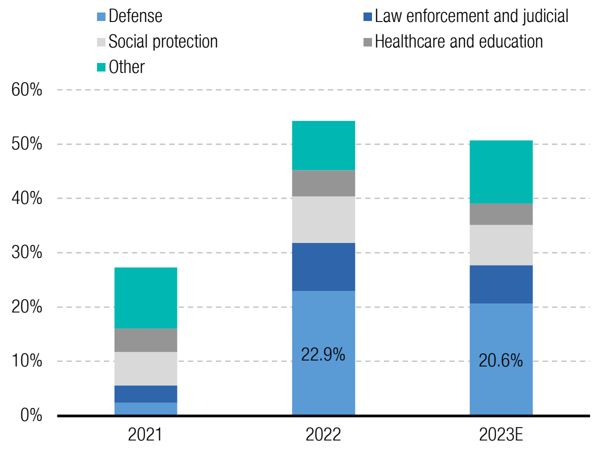
Central budget expenditures are expected to decline marginally relative to GDP, from 54% in 2022 to 51% in 2023. Tax revenues are likely to stay little changed at 19-20% of GDP while non-tax revenues (excluding external budgetary grants) will decline to 3-4% from 7% of GDP. This implies that local tax and non-tax revenues will continue to cover less than half of total budgetary needs in 2023. The state budget deficit is now planned (based on the ongoing budget law revision) to remain virtually unchanged at 28% of GDP in 2023.

Chart 12. Ratio of state budget revenues to expenditures*



* Revenues excluding external budgetary grants
Source: MFU, ICU.

Chart 13. Central budget expenditures, % of GDP



Source: MFU, ICU.

External aid will be the only source of deficit financing

The sources of budget deficit financing seem to be nearly secured for the current year. The government's initial plan was to raise up to US$38bn (net US$35.9bn) in external funding while reducing the stock of local debt by US$5.3bn. The ongoing budget revision raises the target for net foreign aid to above US$40bn (in net terms). The target for international financial aid is achievable as the current largest commitments include US$9.9bn in grants from the US and EUR18.0bn in loans from the EU. The balance is likely to be covered via other bilateral and multilateral loans and grants, including a loan from the IMF. The key possible problem here is that hryvnia may stay much stronger than forecasted by the government and this implies the hryvnia equivalent of foreign aid may be some 10% lower than planned. This may necessitate the search for new funding of more than UAH100bn (US$2.7bn) in 4Q23.

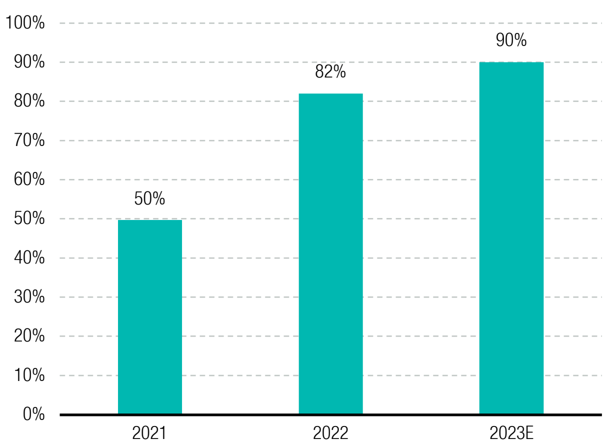
We think there is a significant funding reserve for the government in the domestic market. The placement of local bonds surged in 2M23 and net borrowings exceeded UAH40bn. The higher demand was brought about by a new NBU rule that allows banks to cover up to 50% of mandatory reserve requirements (that increased substantially since January) with designated bonds. MinFin plan to step up its efforts to tap abundant liquidity of the banking sector so as to ensure at least a 100% rollover rate for local debt. A decrease of the key policy rate that we forecast to happen in 2023 will definitely be supportive of a higher rollover rate.

Table 2. Sources of state budget financing, UAHbn

	2022	2023E with revisions
Budget deficit (before grants)	**1,396**	**1,720**
External grants	481	1,712
Net external borrowings	566	
Net placement of domestic bonds	295*	0
Other sources	54	8
Budget deficit (before grants) / GDP	28.0%	28.4%
Budget deficit / GDP	18.3%	n/a

* including sale of UAH400bn bonds to the NBU
Source: MFU, ICU.

Chart 14. Public debt-to-GDP ratio



Source: MFU, ICU.

Public debt-to-GDP ratio unlikely to increase significantly in 2023

Heavy borrowings will push Ukraine's public debt-to-GDP ratio marginally above 90% by the end of 2023. The increase in the ratio is not significant given the size of fresh borrowings, as we expect a rapid expansion of nominal GDP on high inflation and a relatively stable exchange rate. Despite the debt-to-GDP ratio reaching very high levels, we don't expect this will create significant liquidity pressures for public finance. Ukraine has been granted a debt maturity extension by bilateral creditors and holders of sovereign Eurobonds. It's also certain the country will require new concessions after the current debt waivers start to expire in 2H24. Ukraine's only sizable debt-related outflows are related to servicing the facilities of the WB and the IMF.

Yearly forecast 2022–23

	Historical data for 2012–2022											Forecast
	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023F
Activity												
Real GDP (%, YoY)	0.2	(0.0)	(6.6)	(9.8)	2.4	2.5	3.4	3.2	(4.0)	3.4	(29.2)	2.0
Nominal GDP (UAHbn)	1,405	1,465	1,587	1,989	2,385	2,984	3,561	3,978	4,194	5,460	4,986	6,052
Nominal GDP (US$bn)	174	180	133	90	93	112	131	155	155	200	154	161
Unemployment (%)	7.6	7.3	9.3	9.1	9.3	9.5	8.8	8.2	9.5	9.8	28.0	24.0
Inflation												
Headline inflation (%, YoY, e.o.p)	(0.2)	0.5	24.9	43.3	12.4	13.7	9.8	4.1	5.0	10.0	26.6	15.4
Headline inflation (%, YoY, avg.)	0.6	(0.3)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	9.4	20.2	17.8
GDP deflator (%, YoY)	7.8	4.3	15.9	38.9	17.1	22.1	15.4	8.3	9.8	25.1	29.0	19.0
Exchange rates												
UAH/USD (e.o.p.)	8.1	8.2	15.8	24.0	27.3	28.1	27.7	23.8	28.3	27.3	36.6	40.2
UAH/USD (avg.)	8.1	8.2	12.0	21.9	25.6	26.6	27.2	25.8	27.0	27.3	32.3	37.5
External balance												
Current account balance (US$bn)	(14.3)	(16.5)	(4.6)	5.0	(1.9)	(3.5)	(6.4)	(4.1)	5.3	(3.2)	8.4	(3.7)
Current account balance (% of GDP)	(8.3)	(9.2)	(3.5)	5.6	(2.0)	(3.1)	(4.9)	(2.7)	3.4	(1.1)	5.4	(2.3)
Trade balance (US$bn)	(14.3)	(15.6)	(4.6)	(2.4)	(6.5)	(8.7)	(11.4)	(12.5)	(2.4)	(2.7)	(24.3)	(34.8)
Trade balance (% of GDP)	(8.3)	(8.7)	(3.5)	(2.6)	(6.9)	(7.8)	(8.7)	(8.1)	(1.5)	(1.5)	(15.8)	(21.6)
Capital flows (F/A) (US$bn)	10.1	18.6	(9.1)	(4.6)	3.1	6.0	9.3	10.1	(3.3)	3.7	(11.3)	5.8
FDI (US$bn)	7.2	4.1	0.3	(0.4)	3.8	3.7	4.5	5.2	0.1	6.9	0.6	0.0
FDI (% of GDP)	4.1	2.3	0.2	(0.5)	4.1	3.3	3.4	3.4	0.1	3.4	0.4	0.0
Reserves (US$bn)	24.5	20.4	7.5	13.3	15.5	18.8	20.8	25.3	29.1	30.9	28.5	30.6
Interest rates												
NBU's key policy rate (%, e.o.p.)	7.50	6.50	14.00	22.00	14.00	14.50	18.00	13.50	6.0	9.0	25.0	20.0
Fiscal balance												
Budget balance (% of GDP)	(3.8)	(4.4)	(5.0)	(2.3)	(2.9)	(1.5)	(2.4)	(2.1)	(5.1)	(2.4)	(28.0)*	(28.4)*
Public debt (% of GDP)	36.7	39.9	69.4	79.0	80.9	71.8	60.9	50.6	60.8	49.7	81.7	90.0

* budget balance before official budgetary grants

Source: Ukrstat, NBU, MoF, ICU.

Disclosures

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EQUITY RATING DEFINITIONS

Buy: Forecast 12-month total return greater than 20%

Hold: Forecast 12-month total return 0% to 20%

Sell: Forecast 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

DEBT RATING DEFINITIONS

Buy: Forecast 12-month total return significantly greater than that of relevant benchmark

Hold: Forecast 12-month total return is in line with or modestly deviates from relevant benchmark

Sell: Forecast 12-month total return significantly less than that of relevant benchmark

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