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Macro Update

Economy becoming more resilient, but needs helping hand

THURSDAY, 30 NOVEMBER 2023

Despite the significant headwinds Ukraine has faced in 2023, economic activity is surprising to the upside. Real GDP will be up more than 5% this year, inflation has plummeted to single digits, NBU reserves hit historical highs, and budget-deficit financing has been relatively smooth. Thanks to these positive developments, the economy is on a much firmer footing. Domestic demand strengthened and business sentiment improved. The financial sector continues to operate seamlessly. Nonetheless, we expect 2024 to present a new set of challenges, not the least of which is uncertainty about the size and sustainability of foreign financial aid. At this point, the risk of a significant cut in financial aid is low, and we see Ukraine securing at least what is needed to keep the country's external accounts fully balanced through 2024. This means the NBU will remain in a position to keep the FX market firmly under control and may even take decisive FX liberalization steps. Also, all preconditions are now in place for managed and gradual hryvnia depreciation. We see the end-2024 exchange rate at USH41/US$. The economy is likely to remain on track to grow if no new, major safety risks materialize, although we expect it will slow vs. 2023. Inflation will stay in the range of 6–7% at least until summer before picking up somewhat by the end of the year. NBU's monetary-policy easing cycle is almost done, but symbolic cuts are possible in 2H24 if inflation and FX market risks remain balanced. While Ukraine is set to receive enough foreign funding to cover gaps in external accounts, the aid package may fall short of the budget needs. Raising over US$40bn in external funding that the government needs is not guaranteed, and the risk of money printing by the NBU will be present in 2024. One of the things to keep an eye on next year is the restructuring of Ukraine's Eurobonds. Its terms will heavily depend on the government's assessment of the length of the war and sustainability of foreign financial aid.

Key macroeconomic projections

	2023F	2024F
Real GDP, YoY, %	5.8	5.0
Nominal GDP, US$bn	180	199
Inflation, YoY, %, e.o.p.	6.2	10.1
Key policy rate, %, e.o.p.	15.0	13.0
UAH/USD, e.o.p.	36.7	40.7
C/A balance, % of GDP	(4.4)	(5.2)
NBU reserves, US$bn	42	44
Budget gap, % of GDP*	(29)	(21)
Public debt, % of GDP	81	90

* budget balance before official grants to government
Source: ICU

Economic recovery driven by household demand

Economic recovery YTD has been impressive. We expect GDP to be up 5.8% YoY in 2023, thus reaching 75% of pre-war real output. The pick-up in economic activity has been mainly driven by a rapid recovery in household demand since the decline in real income in the private sector has been offset with high and robust income of military personnel. The recovery was also helped by a dramatic improvement in internal logistics and better sentiment of businesses and consumers. Agriculture is a large contributor to GDP growth this year thanks to very favorable weather conditions. The harvest of grains and oilseeds has far exceeded beginning-of-the-year expectations and grew about 15% YoY.

Economy set to slow next year

The broad consensus now is that economic recovery will continue in 2024, but growth will slow vs. 2023. We share this view and expect a GDP increase of 5.0% next year (vs. our earlier forecast of 6.4%). The balance of upside and downside risks for the next year remains very fragile, but we believe the upsides are very likely to prevail.

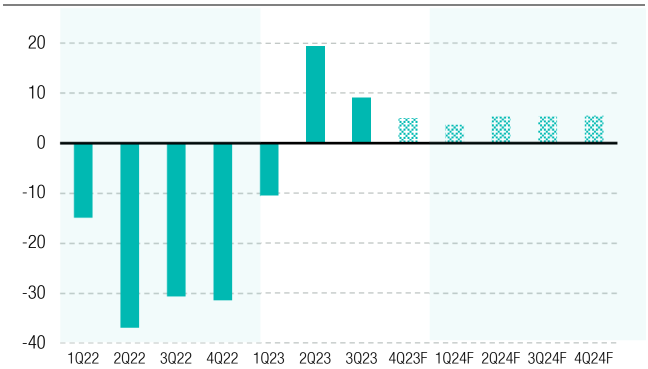
Private household demand will continue to be the engine of economic recovery. So far, real incomes have been supported by an upsurge in the salaries of military personnel, but the situation will change next year. The budget incorporates a 16% YoY reduction in salary payments to the defense sector in 2024, implying an even deeper decline in real terms. However, this decline is likely to be fully compensated with an increase in salaries in the private sector.

GDP recovery will remain driven by private household demand

The real average salary was little changed in 1H23 vs. 1H22, but it increased substantially in 2H23 due to a rapid slowdown in inflation. In 2024, businesses will be forced to raise salaries due to a tight labor market and high competition for employees. A gradual reduction in unemployment will also increase total disposable income. A supporting factor is a scheduled 19% increase in minimum salary over 1Q24. Against the background of low inflation, these factors combined will be a powerful catalyst for an increase in real incomes of households.

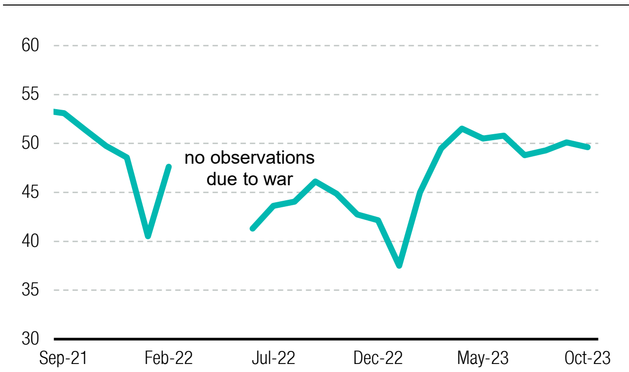
Other demand components, specifically export and investments, will remain weak. Export is severely constrained by the blockade of the Black Sea routes. Although shipments are now possible even without a russia-approved grain corridor, they remain nonsystematic. The blockade of cargo trucks carrying goods to and from Ukraine through Poland has become a new major concern. The problem, if it persists, may have huge negative implications for the Ukrainian economy. Yet, at this point, we assume that a reasonable long-term solution will be found once the transition of power in Poland is complete. Investments, both public and private, are unlikely to pick up substantially any time soon while the safety situation remains shaky. Companies only approve maintenance capex to keep their production current.

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.

Business sentiment, as approximated by the NBU business activity index, remains largely neutral following a significant improvement in 1Q23. While the overall mood is volatile, companies in the industrial sector and trade expect a further increase in output and turnover. Also inspiring are results of the survey of European Business Association. Nearly 77% of respondents, among which are Ukraine's largest businesses, said they operate without any restrictions in 4Q. This is a sharp increase from 68–69% in 2Q and 3Q.

On a 12-month horizon, single-digit inflation is here to stay

Inflation slowed to 5.3% in October from 26.6% at end-2022

The strong disinflationary trend YTD has far exceeded market expectations. CPI slowed to 5.3% YoY in October from 26.6% at end-2022. The sharp deceleration in consumer prices was brought about by a combination of positive factors:

- Bumper agricultural harvest thanks to extremely favorable weather conditions. The prices of vegetables in October were, on average, 20% YoY lower while fruits were 8% cheaper.

- Export bottlenecks that make exports expensive and drive down domestic prices for grains and oilseeds. The domestic market is, thus, fully saturated with agri produce with prices below international levels.

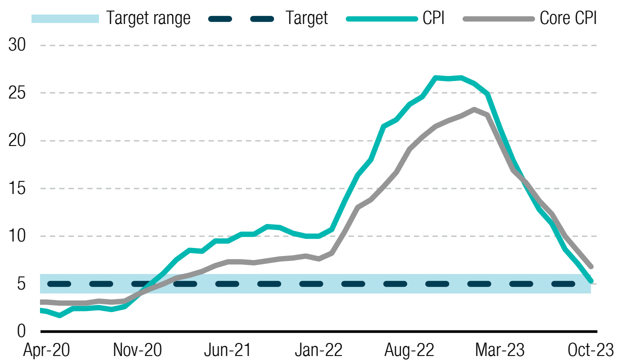
- Stability of the exchange rate that helped reduce margins that importers add to prices to compensate for possible exchange-rate risks.

- Still relatively weak domestic private demand despite its recovery since the start of the year.

CPI to stay in the range of 6-7% till next summer

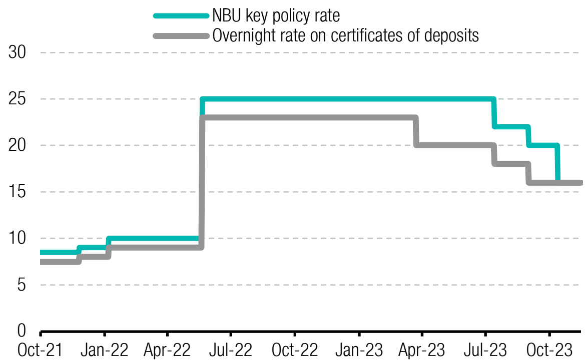
We expect most of these positive factors will continue to have a positive, lasting effect over the next several quarters. In view of this, we now believe inflation will accelerate only marginally by the end of this year and will remain in the range of 6–7% until next summer. Looking further, prices are likely to accelerate again in 2H due to normalization of the agricultural harvest (a decline from an abnormally high level) and moderate pressures arising from gradual and managed hryvnia depreciation, which we think is inevitable next year. We see end-2024 CPI close to 10% with inflationary expectations remaining fairly anchored and the risk of further CPI acceleration fully contained.

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.

No significant cut in interest rates expected in 2024

NBU key policy rate seen at 15% at end-2023 and 13% at end-2024

Plummeting inflation made cuts in rates an obvious choice for the NBU. The key policy rate now stands at 16%, down from 25% at the start of the year, while the rate on overnight CDs is down to 16% from 23%. The NBU has experimented with monetary policy designs since December 2022, by introducing three-month certificates of deposits (CDs) and changing the bands around the key policy rate for liquidity-absorption and liquidity-provision operations. Eventually, in October, the NBU switched to a so-called floor regime, whereby the key policy rate sets the overnight rate on CDs.

We expect the NBU will deliver another 100bp cut in December to close the year with the rate at 15%, in line with its recent indication. Yet, we see little room for a further reduction in the NBU key policy rate going forward. Even though inflation will remain in the range of 6–7% throughout most of the next year and may peak at close to 10%, the NBU will prefer to remain extremely cautious and not make any moves at least until 2H24. The elevated, real key policy rate is supposed to keep yields on hryvnia saving instruments relatively high. This should provide sufficient incentives for individuals and businesses to keep savings in the local currency and limit demand for FX. This is an important precondition for gradual hryvnia depreciation that we believe the NBU will allow over the course of 2024. Only in 2H24, if inflation remains fully under control and the FX market stable, would the NBU choose to reduce the key policy rate by another 100–200bp.

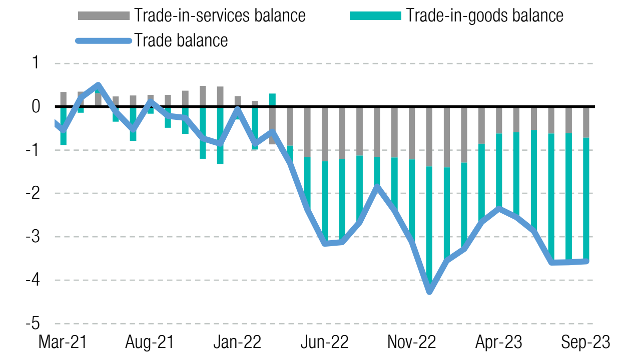
Rates on UAH bonds have been declining recently in response to multiple cuts in the cost of overnight funds by the NBU. We expect yields on UAH bonds to reach 15.5% for maturities below one year and 17–17.5% for longer maturities (vs. 19–21% at end-2022).

Foreign financial aid will cover gaps in external accounts in 2024

Current account deficit widened on trade gap and poses a substantial risk

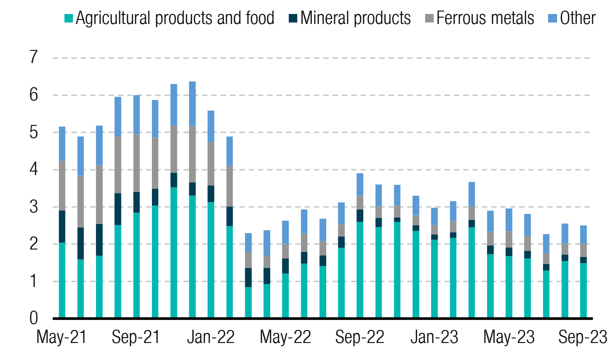
In 2023, Ukraine is facing the largest, historical, external trade deficit, which will exceed 21% of GDP. The culprit is a dramatic decline in export of goods as prices for agricultural commodities remain well below last year's levels and, on top of that, logistics became more complicated due to suspension of the Black Sea grain corridor. In 3Q23, export of goods was down 25% YoY, largely on a decline in the value of exported agricultural products and food. They have made up nearly 60% of total export of goods since the start of the full-scale war. Import of goods, on the other hand, is surging and was up 16% YoY in 3Q23. While the import of military equipment is the key driving force (the vast majority of which is not included in official data), the deliveries of consumer goods are also surging.

Chart 5. Monthly trade balance, US$bn



Source: NBU, ICU.

Chart 6. Monthly export of goods, US$bn



Source: NBU, ICU.

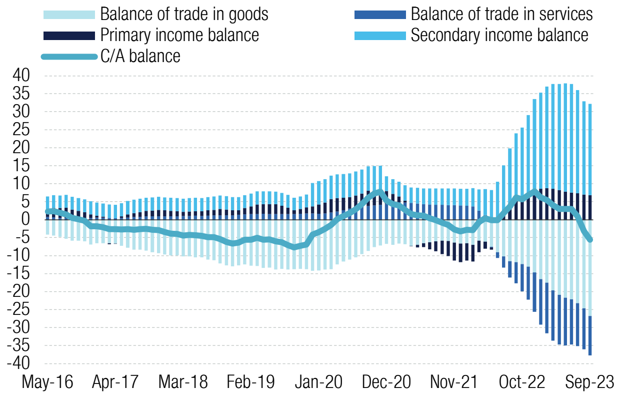
Unlike in 2022, the external trade deficit is no longer compensated by migrant remittances and official budget transfers. Income of migrants abroad are little changed vs. last year while official budgetary transfers will be some 10–15% lower YoY in 2023. They are expected to decline even further as US financial aid in the form of grants, if approved, will be reduced to US$0.8bn per month in 2024 from US$1.1bn this year.

All in, we downgraded our 2023 C/A deficit projection to 4.4% of GDP from 2.7% previously. We also expect the C/A gap will widen to 5.2% of GDP in 2024. This projection assumes the US Congress will approve a US$11.8bn aid package for Ukraine for the 2024 financial year.

Private-capital outflows via the financial account have subsided and are now immaterial via nearly all channels. The only remaining visible channel of capital flight is withdrawal of FX cash from accounts at Ukrainian banks by households within the country and abroad. Such withdrawals of cash are now 1/3 lower than in 1H23. The build-up of external trade credit, which, in large part, represents capital flight and was significant in 2022, has subsided due to additional capital controls and is no longer a major concern.

By our estimates, Ukraine will need US$28–30bn in external financial aid to be able to cover gaps in external accounts (but this amount is definitely not enough to cover the budget deficit). This aid may come either in the form of grants (recorded in the current account) or loans (recorded in the financial account). We believe net inflows of such magnitude are realistic even if the risks of funding from the US materialize in full. These may include an EU loan that should not be significantly lower than EUR18bn earmarked for 2023, facilities from the WB and the IMF, bilateral loans from other governments, and, possibly, interest income on russia's frozen assets. Any additional inflow on top of US$30bn would allow the NBU to further increase its reserves and take ambitious FX liberalization steps. These may include opening the gate for dividends and interests on foreign capital, but within certain limits.

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



Source: NBU, ICU.

Table 1. Balance of payments components, US$bn

	9M23	9M22
Current account (C/A)	**-5.5**	**7.9**
Trade in goods	-20.8	-8.6
Trade in services	-7.2	-7.3
Primary income	4.7	6.2
incl. migrant remittances	9.1	9.6
Secondary income	17.8	17.6
incl. transfers to government	11.5	12.8
Financial account (F/A)*	**-14.9**	**13.9**
Change in trade credits	-1.7	11.2
Increase in cash out of banks	8.1	7.8
Net loans to government	-18.5	-7.6
Other components	-2.8	2.6

* "–" in F/A indicates an increase in liabilities (cash inflow)

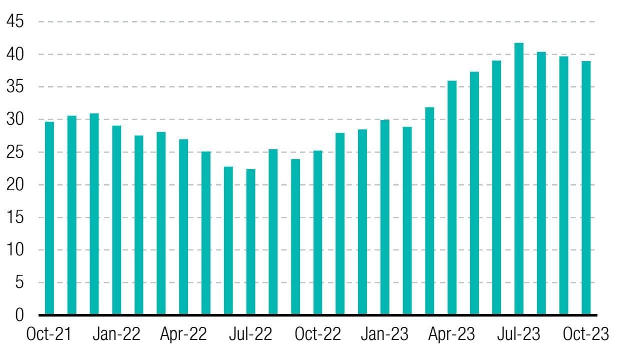
Source: NBU, ICU.

Hryvnia likely to weaken to UAH41/US$ in 2024

Managed, moderate hryvnia depreciation over 2024 the most likely scenario

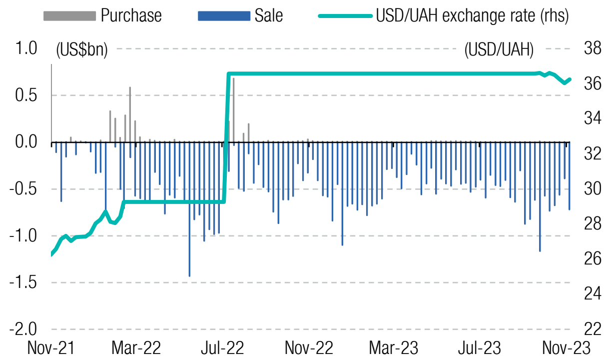
We believe the NBU will be in a position to keep the FX market firmly under control next year without tapping its existing reserves if Ukraine receives US$28–30bn of external financial aid. This looks realistic. In practice, the central bank should have resources to keep the hryvnia even at the current level through end-2024. So far, the NBU showed very little appetite for hryvnia weakening and for exchange-rate volatility since it declared a move to a managed flexible exchange-rate regime in early October. Yet, in our view, the NBU will be inclined to let the hryvnia depreciate gradually so as to address the growing risks related to a huge and unsustainable external trade deficit. All preconditions remain in place for an orderly, managed depreciation including hefty reserves, low inflation, relatively high nominal and real interest rates, and public trust in the banking system. To prevent any stress for businesses and households and disincentivize conversion of savings into hard currency, the NBU will likely make the pace of depreciation comparable to the yield on hryvnia deposits. We, thus, expect the exchange rate to weaken to UAH40.5–41.0.US$ by end-2024. This is a slight improvement from our previous forecast of UAH42.1/US$.

Chart 8. NBU gross international reserves, US$bn



Source: NBU, ICU.

Chart 9. UAH/US$ rate and NBU weekly interventions



Source: NBU, Bloomberg, ICU.

Funding budget deficit is the key challenge in 2024

Budget expenditures may be revised significantly up in 2024

Government expects next year's central budget expenditures will be close to 43% of GDP. This is significantly above 27% of GDP in pre-war 2021, but substantially below 50%+ in 2022 and 2023. In money terms, the expenditures next year are planned to be nearly the same as in 2023, since outlays on national security and defense are expected to be cut by 18%. Such an assumption is one of the main risks to the budget plan. If the war drags on at the current intensity, any cuts in financing for the military sector are very unlikely. Budget revision is thus very likely, just as it was the case last October for the 2023 budget. Tax and non-tax revenues are expected to cover 53% of expenditures, which is a substantial improvement vs. 2022/23.

External borrowing plan for 2024 very ambitious

The budget law envisages a state budget deficit (before grants) of UAH1.6tn, (US$40bn based on our average projected exchange rate). This is an equivalent of 20% of the expected nominal GDP in 2024, which is considerably narrower than in 2022 and 2023. The state budget is supposed to be primarily funded with external loans and grants with net domestic borrowings being equivalent to only 5% of total needs. We believe government's plan to raise a gross US$43bn in external funding in 2024 looks quite ambitious. If external borrowings fall considerably below the target, the authorities will likely have to resort to money printing, similarly to the practice of 2022. While this practice is risky by definition, it may still be the lesser of the evils if compared with underfinancing of military expenditures. As long as the amount of debt financing by the NBU is reasonable and inflationary/exchange rate expectations are anchored, this should not pose material risks to macroeconomic stability.

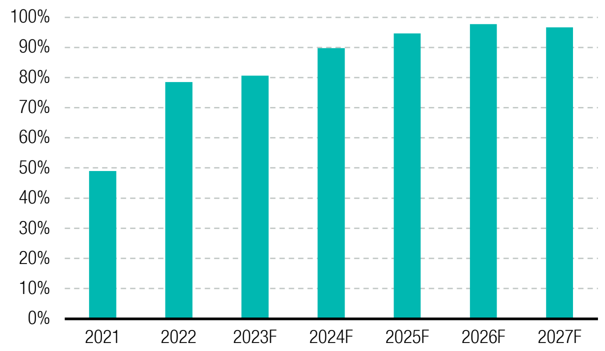
Table 2. Key parameters of state budget, UAHbn*

	2021	2022	2023F	2024F
Total revenues (before grants)	1,296	1,306	1,416	1,768
incl. tax revenues	1,107	950	1,196	1,575
Expenditures	1,491	2,705	3,393	3,309
Net lending	5	-3	34	31
Budget deficit (before grants)	-200	-1,396	-2,011	-1,571
Total revenues / expenditures	87%	48%	42%	53%
Tax revenues / expenditures	74%	35%	35%	48%
Total revenues / GDP	24%	25%	21%	23%
incl. tax revenues / GDP	20%	18%	18%	20%
Expenditures / GDP	27%	52%	51%	43%
Deficit / GDP	-4%	-27%	-31%	-20%

* number for 2023 and 2024 are from the budget laws

Source: MFU, ICU.

Chart 10. Public debt-to-GDP ratio



Source: MFU, ICU.

Public debt to GDP unlikely to exceed 100% going forward

Debt-to-GDP to stay close to 80% at end-2024

Ukraine will continue to rely heavily on borrowings to patch the gap in the state budget. We see the deficit (before grants) exceeding 10% of GDP at least until 2027, and going below 5% only beyond 2030. The share of grants will be declining rapidly from about 1/3 in 2022 and 2023. If Ukraine doesn't start receiving significant reparations, probably in the form of interest income on russia's assets, debt will continue to grow rapidly. Yet, an increase in nominal GDP will prevent the public debt-to-GDP ratio from surging above 100%. We see the ratio remaining close to last year's 80% at end-2023 and going up to about 90% at end-2024 due to weakening of the hryvnia.

Sovereign Eurobond restructuring a key thing to watch next year

The key event to watch next year is the restructuring of Ukraine's sovereign Eurobonds. It is certain the debt operation will involve a haircut, a (temporary) decrease in coupons, and a significant extension of maturities with specific terms heavily dependent on assumptions about the length of the war as well as the size/sustainability of foreign financial aid. Eurobonds will make up only 12% of total debt by end-2024 and substantial haircuts will not change the solvency fundamentals for the economy. We, thus, expect the government will aim to secure broadly investor-friendly restructuring terms so that it can regain access to the private capital market once war-related risks subside.

Yearly forecast 2023–24

	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	5.0
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	7,716
Nominal GDP (US$bn)	180	133	90	93	112	131	155	155	200	161	180	199
Unemployment (%)	7.3	9.3	9.1	9.3	9.5	8.8	8.2	9.5	9.8	28.0	21.0	17.0
Inflation												
Headline inflation (%, YoY, e.o.p)	0.5	24.9	43.3	12.4	13.7	9.8	4.1	5.0	10.0	26.6	6.2	10.1
Headline inflation (%, YoY, avg.)	(0.3)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	9.4	20.2	13.5	7.9
GDP deflator (%, YoY)	4.3	15.9	38.9	17.1	22.1	15.4	8.3	9.8	25.1	34.3	20.0	11.5
Exchange rates												
UAH/USD (e.o.p.)	8.2	15.8	24.0	27.3	28.1	27.7	23.8	28.3	27.3	36.6	36.7	40.7
UAH/USD (avg.)	8.2	12.0	21.9	25.6	26.6	27.2	25.8	27.0	27.3	32.3	36.6	38.7
External balance												
Current account balance (US$bn)	(16.5)	(4.6)	5.0	(1.9)	(3.5)	(6.4)	(4.1)	5.3	(3.2)	7.9	(7.9)	(13.1)
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	(4.4)	(5.2)
Trade balance (US$bn)	(15.6)	(4.6)	(2.4)	(6.5)	(8.7)	(11.4)	(12.5)	(2.4)	(2.7)	(25.7)	(38.4)	(36.0)
Trade balance (% of GDP)	(8.7)	(3.5)	(2.6)	(6.9)	(7.8)	(8.7)	(8.1)	(1.5)	(1.5)	(16.0)	(21.3)	(18.1)
Capital flows (F/A) (US$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$bn)	4.1	0.3	(0.4)	3.8	3.7	4.5	5.2	0.1	6.9	0.3	3.0	3.0
FDI (% of GDP)	2.3	0.2	(0.5)	4.1	3.3	3.4	3.4	0.1	3.4	0.2	1.7	1.5
NBU reserves (US$bn)	20.4	7.5	13.3	15.5	18.8	20.8	25.3	29.1	30.9	28.5	42.1	43.7
Interest rates												
NBU's key policy rate (%, e.o.p.)	6.5	14.0	22.0	14.0	14.5	18.0	13.5	6.0	9.0	25.0	15.0	13.0
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)*	(28.8)*	(20.7)*
Public debt (% of GDP)	39.9	69.4	79.0	80.9	71.8	60.9	50.6	60.8	49.7	78.5	80.6	89.8

* budget balance before official budgetary grants

Source: Ukrstat, NBU, MoF, ICU.

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