Research team
Vitaliy Vavryshchuk

Macro Update

Macro risks edge up on large fiscal needs

TUESDAY, 20 AUGUST 2024

Macroeconomic risks have increased in the past months, but even so, they remain fully manageable. The recent resumption of inflow of foreign financial aid provides a comfortable safety cushion for the FX market and a vital liquidity source for the state budget. Expected disruptions in electricity supplies in late autumn and winter is currently the second most significant risk for the economy, while the shaky safety situation remains the top risk. The economy was off to a great start in 2024, but it is set to slow considerably in 2H due to likely blackouts, shortage of labor, and a reduction in agricultural harvest. Yet, we still expect a decent growth rate close to 4% for the full year. Inflation expectedly started to pick up from May, and it is accelerating at a faster pace than expected. It is set to reach 7-8% by the end of the year, will likely accelerate even further in 1Q25, but remain in single digits. The NBU could have gone a bit further with reducing interest rates in 1H, but now a pickup in inflation and the recent jitters in the FX market make it hardly possible for the central bank to cut the key policy rate in the coming months. The FX market continues to operate with significant gaps, which widened substantially of late. The NBU's exchange-rate-smoothing mechanism does not always work perfectly, and once in a while, markets get upset with high volatility. Yet, fundamentally, the central bank is moving in the right direction by letting the hryvnia depreciate in a controlled manner. We keep our exchange rate projection broadly unchanged and see the rate at UAH42.6/US$ at the end of 2024. The budget deficit remains the major headache for the authorities given that expenditure on the defence sector are going to be some US$12bn higher than the current budget plan assumes. A big part of it is expected to be financed with higher taxes, but a large hole is still set to be covered with domestic borrowings. It's very unlikely this amount can be raised in the market even if the NBU resorts to financial repression measures. We, thus, believe the scenario of limited monetary financing of the budget from the NBU is becoming very likely.

Key macroeconomic data and projections

	2024F	2025F
Real GDP, YoY, %	4.0	4.0
Nominal GDP, US$bn	188	195
Inflation, YoY, %, e.o.p.	7.8	8.0
Key policy rate, %, e.o.p.	13.0	11.0
UAH/USD, e.o.p.	42.6	47.7
C/A balance, % of GDP	(5.6)	(9.5)
NBU reserves, US$bn	43.7	37.5
Budget gap, % of GDP*	(24)	(18)
Public debt, % of GDP	89	101

* budget balance before official grants to government
Source: NBU, UkrStat, ICU

Economic recovery broad-based, but set to slow in 2H

Ukraine's GDP continues to grow and the recovery is broad-based. In 1Q24, the economy expanded by an impressive 6.5% YoY. While no GDP breakdown by components is available, we estimate private domestic demand played the key role. A good indication of the strength of private consumption is retail trade. In 1Q, in this segment the volumes (adjusted for inflation) exceeded the level of pre-war 1Q21. Private household consumption is well supported by a rapid increase in nominal salaries against the backdrop of reasonably low inflation. Another booster is growth in the number of military personnel who receive relatively high wages.

READ FIRST THE DISCLOSURES SECTION (ON LAST PAGE) FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION

Economic recovery is broad-based

Household incomes are set to continue to increase since the labor market remains tight and the continuing mobilization of new conscripts does little to ease the problem. Domestic demand likely weakened somewhat in 2Q as the authorities stepped up mobilization efforts, but that was a temporary psychological effect.

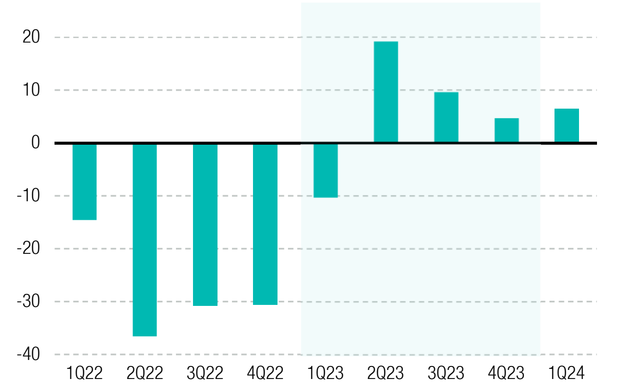
The contribution of government consumption to economic growth likely weakened vs 2023 as the government is gradually pursuing fiscal consolidation. On the other hand, export is playing a more and more important role thanks to uninterrupted operations of the Black Sea corridor. A helpful development was suspension of the blockade of Ukraine's western borders by Polish farmers and truck drivers. At the same time, import is also growing thus offsetting a significant part of the domestic demand.

In terms of economic growth, the key risk right now is expected prolonged periods of blackouts in late autumn and winter. Despite all the efforts to repair large electricity-generating plants and install additional smaller power production units, the supply is set to fall short of demand in cold months. Many energy-intensive companies will likely be forced to limit their operations. Another headwind is deterioration in sentiment of Ukrainian businesses against the backdrop of lingering safety risks, mobilization of employees, and power outages that force companies to invest heavily to become less dependent on centralized electricity supplies.

GDP slowdown inevitable in 2H24

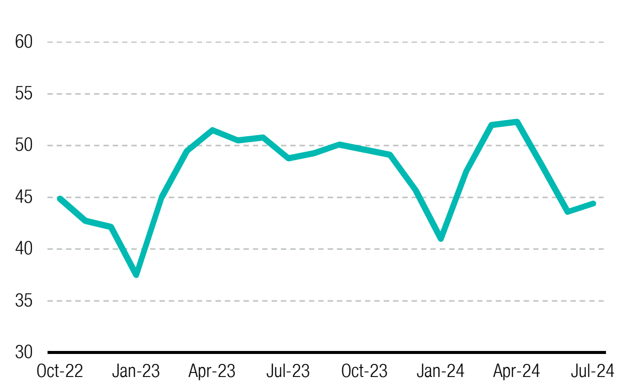
The broad consensus is that the economy is going to slow significantly in 2H24, mainly due to expected power shortages. Another culprit is a decline in agricultural harvest. The total production of grains and oilseeds is likely to decline by about 10% this year due to unfavorable weather conditions. This will affect GDP growth numbers in 2H when the share of agriculture in total economic output spikes. Despite all these risk factors, we expect the economy may expand 4.0% in 2024 (previous forecast: 4.1%) and may continue to grow at this pace in 2025.

Chart 1. Real GDP, change, YoY



Source: UkrStat, ICU.

Chart 2. Business Activity index of the NBU*



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

Source: NBU, ICU.

Inflationary pressure building, but no risk of spiralling out of control

Inflation started to accelerate

Inflation expectedly started to accelerate since May, but the pace of acceleration has been somewhat above our projection. CPI was up to 5.4% YoY in July from 3.3% in May. The substantial CPI increase in June (+2.2% MoM) was primarily driven by an upsurge in electricity tariffs for households, and its effect significantly exceeded our expectation, likely because the statistical agency increased the share of electricity in the consumer basket. In 2H24, the increase in CPI will be driven by a combination of factors.

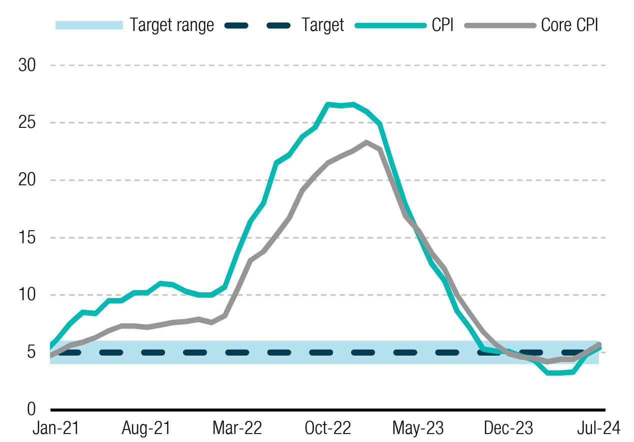
Firstly, summer draughts had a negative impact on agricultural harvest and the prices of food resumed growth in YoY terms starting from July (in 2Q they were just below last year's level). Secondly, apart from the higher cost of agricultural inputs, the food industry is also taking a toll from blackouts that force businesses to use (where possible) much more expensive electricity from small generators. Interruptions with energy supply and more expensive electricity is also a significant cost driver for small business. Thirdly, gradual hryvnia depreciation is being passed on to consumers of imported goods, even though the pass-through rate remains relatively low.

Increase in indirect taxes is a new potential risk for inflation

A new risk factor to consider is an expected increase in taxes. So far, a hike in the excise tax for motor fuel has been approved by the parliament. The government may also seek to increase VAT rate by 2-4 pp from the current 20% in the near future. A larger part of the tax increase will likely be passed onto consumers. Meanwhile, a possible increase in personal income tax (military tax) by 3.5pp will dent available income and may somewhat weaken the demand-side pressures on prices.

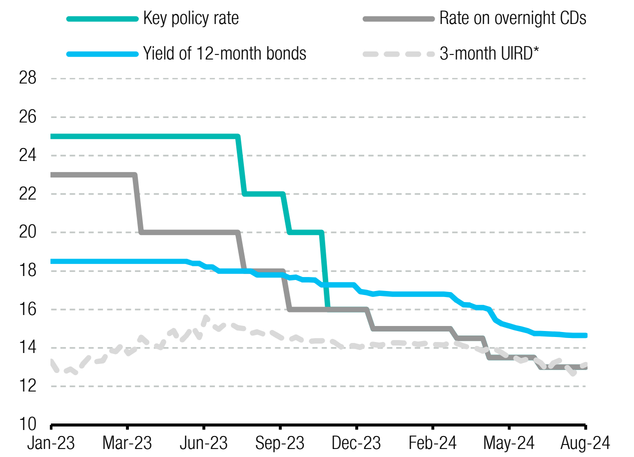
With new information on hand, we downgrade our end-2024 CPI forecast to 7.8% from a previous projection of 6.4%. CPI will accelerate further in 1Q25, but will remain in single-digits. Meanwhile, we keep our end-2025 CPI projection at 8.0% unchanged. New projections imply that real rates on hryvnia terms deposits are very likely to remain in the positive area.

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



Source: NBU, ICU.

Chart 4. NBU key policy rate and commercial rates, %



* Ukrainian Index of Retail Deposit Rates
Source: NBU, ICU.

NBU pauses monetary easing due to new looming risks

NBU takes pause to reassess inflation risks

Due to a combination of rising inflation and temporary jitters in the FX market in July, the NBU decided to suspend its monetary policy easing cycle and recently kept its key policy rate unchanged at 13%. Its updated macroeconomic forecast envisages a possible return to the rate reduction cycle in early 2025. We believe the central bank could have gone further with key policy rate reduction in 1H without jeopardizing macroeconomic stability. Yet, at this point, the central bank had no choice but to take a pause and assess new inflationary risks. The NBU made it clear it wants to keep real commercial interest rates sufficiently positive to provide protection against inflation. However, there is limited evidence the NBU key policy rate is having a decisive impact on deposit rates. We, thus, believe the central bank may take more indirect steps to loosen its monetary policy further in 2H, probably by starting to phase out three-month CDs. This measure will support the MinFin's effort to accumulate more funding from the domestic market. We align our end-2024 key policy rate projection with NBU guidance of 13%. We see the end-2025 key policy rate at 11% (previous forecast: 10%).

Given recent developments, the MinFin has limited room for further reduction in yields on treasuries. Rates on one-year bills were down 2.2pp YTD to 14.65%. MinFin may adjust the rate further up or down within the range of 14-15% depending on its liquidity position. A planned increase in domestic borrowings due to a wider budget deficit should not drive rates higher. A rate increase is very unlikely to produce a much larger demand while making debt management much more complicated for the government. The room for reduction of retail deposit rates also seems to be limited right now, but if the NBU chooses to unwind the three-month CDs, we may see a reduction in the cost of term deposits by about 1pp through end-2024.

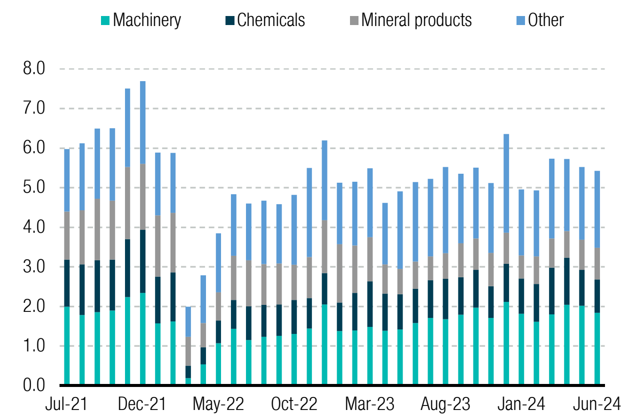
Deficit of external accounts to remain covered by foreign aid

Deficit of foreign trade larger than expected

The story of Ukraine's external accounts has remained unchanged for the past 2.5 years. The deficit of foreign trade remains extremely high and net private capital outflows persist. Nevertheless, the gap has been generously covered with foreign financial aid from Ukraine's allies. This story is very likely to continue in the foreseeable future. The external political risks of less Ukraine-friendly governments coming to power in major ally countries will likely be mitigated by a US$50bn aid package backed by russian frozen assets that is currently being finalized by G7 countries.

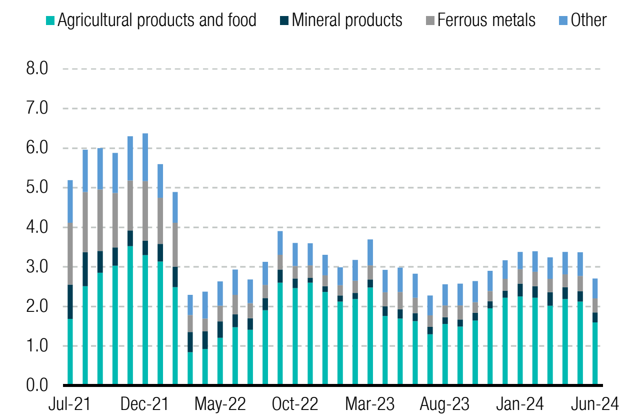
We project Ukraine's foreign trade deficit (both goods and services) will be close to 18% of GDP in 2024, and is likely to be little changed in 2025. This will be a significant narrowing from 21% of GDP in 2023, but it is still worse than our previous forecast of 15% of GDP. The key reason for a new wider estimate is persistently low international prices for Ukraine's key export commodities, primarily for agricultural produce. Export of goods from Ukraine is up by only 5% YoY in 1H24 (and it was down 4% in June) due to stagnating prices. Meanwhile, import remains strong, and it has been recently reinforced by massive purchases of electricity-generating equipment as businesses and households are getting prepared for a winter with prolonged blackouts. Consumer demand for imported goods also remains strong, but the ongoing hryvnia depreciation should contain growth in import of consumer goods in the future.

Chart 5. Monthly import of goods, US$bn



Source: NBU, ICU.

Chart 6. Monthly export of goods, US$bn



Source: NBU, ICU.

C/A set to improve in 2H on new budgetary grants

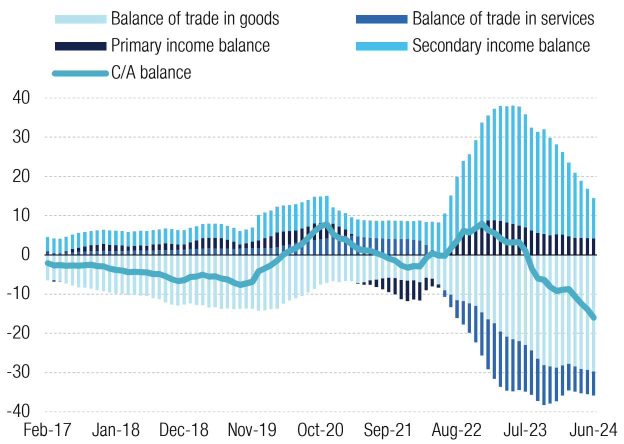
The two largest C/A components that partly offset the significant trade deficit are migrant incomes abroad and transfers/grants to the private and the official sectors. Migrant incomes abroad are on a downward trend—they fell by nearly a quarter YoY in 1H24, and compensated for just below a third of the foreign trade shortfall in 1H. Transfers plummeted in 1H as Ukraine received only relatively small budgetary grants from its allies. Yet, the situation is improving dramatically in 2H, as the government is set to receive US$7.8bn in grants from the US and EUR3.0bn in grants from the EU. They alone will play a decisive role in improving the C/A in 2H. The FX liberalization steps taken by the NBU had no direct impact on C/A (interest payments are accounted for on an accrual basis), but definitely affected the FX market as accrued interest and new FDI-related net income earned can now be freely transferred abroad.

Taking into account the expected grants from Ukraine's allies, we now see Ukraine's 2024 C/A deficit in the range of 5–6% of GDP, little changed from 2023. We see a significant widening of C/A in 2025, but solely due to an expected decline in grants. If grants are taken out of calculations, we see a very gradual narrowing of the C/A gap from 13.4% of GDP in 2023 to about 11.6% in 2025.

End-2024 NBU reserves will exceed end-2023 level

In terms of the financial accounts, the largest pressures remain on the side of the population that keeps withdrawing/purchasing FX cash from banks. Demand of households for FX cash is surging as hryvnia keeps weakening. FX cash outside the banking system increased by US$7.9bn in 1H24 (up 29% YoY). Other forms of private capital flight remain much less significant due to the still tough FX controls that include a prohibition to repay all debts to foreign private creditors. The balance of the financial account was positive at US$6.1bn in 1H24 (although it slipped into negative territory in 2Q) thanks to the inflows of loans from foreign governments and IFIs. We expect roughly similar net inflows in 2H24, which will take the financial account surplus sufficiently high to offset the deficit of the current account. We expect a significant rebound in NBU reserves by the end of the year from the end-July level of US$37.2bn. The inflows of foreign financial aid in 2H will be at least 60% higher than in 1H, and they will replenish the NBU reserves. If all financial aid comes in as planned, we see end-2024 reserves at above US$43bn, or 5–10% above end-2023 level. This level is comfortable and fully enables the NBU to control the FX market.

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



Source: NBU, ICU.

Table 1. Balance of payments components, US$mn

	2Q24	1Q24	2Q23
Current account	**-5,445**	**-3,234**	**-76**
Trade in goods	-7,211	-5,604	-5,935
Trade in services	-1,450	-1,359	-1,809
Primary income	1,025	371	1,202
incl. migrant income	2,099	2,431	2,837
Secondary income	2,191	3,358	6,466
incl. transfers to gov't	332	1,381	4,368
Financial account*	**297**	**-6,352**	**-3,936**
Change in trade credits	-690	-1,037	135
Change in cash out of banks	3,801	4,112	2,877
Net loans to government	-2,788	-8,257	-5,167
Other	-26	-1,170	-1,781

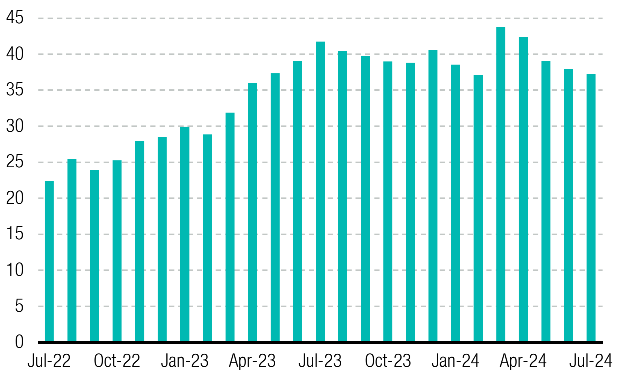
* "–" in F/A indicates an increase in liabilities (cash inflow)

Source: NBU, ICU.

FX market interventions remain at a comfortable level for NBU

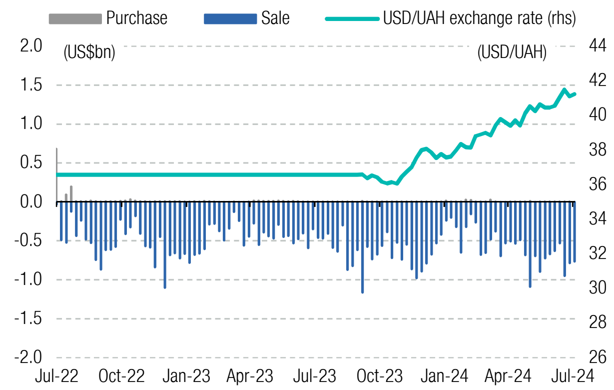
The FX market continues to operate under a substantial deficit, and the NBU is forced to intervene every single day with sizable sales of hard currency. In the past couple of months, sale interventions were upped substantially as the hard currency deficit widened due to a larger gap in foreign trade, larger FX cash purchases by the population, and the effects of FX liberalization measures by the NBU. The NBU sold on average US$660mn per week in April–July vs. US$450mn in 1Q24. Even though current intervention levels are sizeable, the NBU should still be in a comfortable position, as the expected foreign financial aid will help fully replenish the reserves in the coming months.

Chart 8. NBU gross international reserves, US$bn



Source: NBU, ICU.

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



Source: NBU, Bloomberg, ICU.

NBU will continue controlled weakening of the hryvnia

Gradual managed hryvnia depreciation will continue in the coming years

The exchange rate of US dollar is up nearly 12% since the NBU abandoned the fixed exchange rate in October last year. The central bank maintains a "managed flexible" exchange rate regime, which implies the NBU remains committed to covering the structural deficit in the FX market while maintaining a certain degree of exchange rate volatility. The exchange rate volatility has remained below pre-war levels, but several episodes of relatively rapid hryvnia depreciation usually resulted in heightened FX demand from households. The most recent episode was in mid-July when a 2.3% depreciation over a two-week period upset the market, and the NBU had to drastically reverse the exchange rate trend in the following two weeks.

We remain confident the current level of interventions is not critically high for the NBU, and NBU reserves will be up from the current level by the end of the year. This implies the NBU is not under pressure to devalue the hryvnia rapidly due to lack of resources. The central bank is, thus, free to choose the rate of hryvnia depreciation in the foreseeable future. The pace of depreciation should be such that it does not pose significant risk to price stability and does not worsen significantly exchange rate expectations of households and businesses. Even though the NBU made it clear it does not seek to ensure parity of interest-bearing hryvnia-denominated assets and FX assets, we believe it still is and will be an important policy consideration for the central bank. In view of the above arguments, we don't expect a more rapid hryvnia weakening in 2H vs 1H, and we only marginally downgrade our end-2024 ER projection to UAH42.6/US$ from a previous projection of UAH42.3/US$.

Lingering war leaves little room for meaningful fiscal consolidation

Budget to be revised due to high expenditures on defence sector

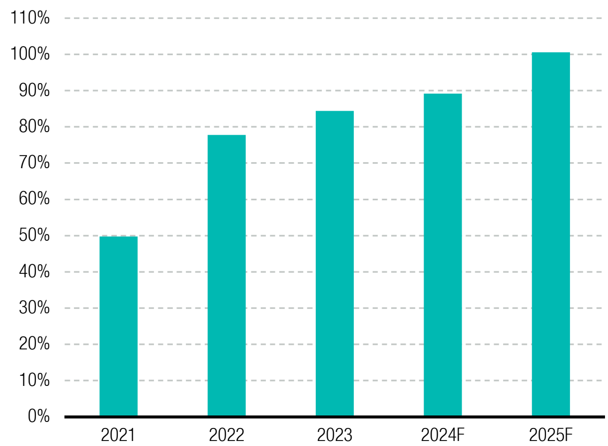
The intensification of the war with no clear prospects for de-escalation in sight rendered the current version of the 2024 state budget plan partly irrelevant. Expenditure on the defence and security sector are going to be about 30% (US$12bn) higher than the government previously planned. The MinFin, thus, came up with a budget adjustment proposal. Over half of these additional needs will be covered from a mix of additional revenues, including taxes collected above the plan in 1H, and higher tax collections due to an increase in tax rates from September (expectedly). The most material increases will likely be military tax on personal incomes (rate expected at 5% vs. the current 1.5%) and VAT (likely an increase by 2–4pp from the current 20%). Accounting for additional taxes, the MinFin now estimates the 2024 deficit at 24% of GDP vs an earlier expectation of 21%.

Table 2. Key parameters of 2024 state budget, UAHbn

	Current	Proposed changes
Total revenues (before grants)	1,768	1,983
incl. tax revenues	1,575	1,759
Expenditures	3,309	3,748
inlc. defence and security	1,673	2,168
Net lending	31	27
Budget balance (before grants)	-1,571	-1,792
Total revenues / GDP	23%	26%
incl. tax revenues / GDP	21%	23%
Expenditures / GDP	44%	49%
Budget balance (before grants) / GDP	-21%	-24%
Total revenues / expenditures	53%	53%
Tax revenues / expenditures	48%	47%
Defence, security / total expenditure	51%	58%

Source: MFU, ICU.

Chart 10. Public debt / GDP, %



Source: MFU, ICU.

Risk of monetary financing of budget substantially increased

Government expects the incremental deficit will be covered with domestic borrowings. An updated draft plan envisages net domestic borrowings of UAH301bn vs the current plan of UAH81bn (net UAH81bn raised 7m24). The new borrowing target is close to 4% of GDP and would imply an increase in the securities portfolios of private investors (banks, non-banking institutions and individuals) by about 22% from the current level. There is almost no chance that an additional UAH220bn can be raised in the open market. We, thus, expect the NBU to adopt new financial repression measures like an increase in mandatory reserve requirements. But even a more likely scenario that is crystallizing right now is monetary financing from the NBU. The probability that this measure of last resort will be activated in 4Q24 has increased significantly in the past months.

Public debt-to-GDP set to grow for another two years

We expect the debt-to-GDP ratio to continue to grow this year and next. We have somewhat improved out estimate for end-2024 ratio to 89% from 91.5% previously. This improvement in an estimated net effect of a partial 37% write-off of sovereign Eurobonds and an expected increase in the state budget deficit. We also revised up the state budget deficit for 2025 to 18% of GDP from an earlier estimate of 16% of GDP due to little chances of the war de-escalating in the foreseeable future. We now expect end-2025 debt-to-GDP just above 100%, and by our estimates this ratio will peak in 2026.

Yearly forecast 2024-25

	Historical data for 2014–2023										Forecast	
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Activity												
Real GDP (%, YoY)	(6.6)	(9.8)	2.4	2.5	3.4	3.2	(4.0)	3.4	(29.1)	5.3	4.0	4.0
Nominal GDP (UAHbn)	1,587	1,989	2,385	2,984	3,561	3,978	4,194	5,460	5,191	6,538	7,581	8,791
Nominal GDP (US$bn)	133	90	93	112	131	155	155	200	161	179	188	195
Unemployment (%)	9.3	9.1	9.3	9.5	8.8	8.2	9.5	9.8	28.0	21.0	15.0	12.0
Inflation												
Headline inflation (%, YoY, e.o.p)	24.9	43.3	12.4	13.7	9.8	4.1	5.0	10.0	26.6	5.1	7.8	8.0
Headline inflation (%, YoY, avg.)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	9.4	20.2	12.9	5.4	8.4
GDP deflator (%, YoY)	15.9	38.9	17.1	22.1	15.4	8.3	9.8	25.1	34.3	18.5	11.5	11.5
Exchange rates												
UAH/USD (e.o.p.)	15.8	24.0	27.3	28.1	27.7	23.8	28.3	27.3	36.6	38.0	42.6	47.7
UAH/USD (avg.)	12.0	21.9	25.6	26.6	27.2	25.8	27.0	27.3	32.3	36.6	40.4	45.2
External balance												
Current account balance (US$bn)	(4.6)	5.0	(1.9)	(3.5)	(6.4)	(4.1)	5.3	(3.2)	7.9	(9.7)	(10.6)	(18.5)
Current account balance (% of GDP)	(3.5)	5.6	(2.0)	(3.1)	(4.9)	(2.7)	3.4	(1.1)	4.9	(5.4)	(5.6)	(9.5)
Trade balance (US$bn)	(4.6)	(2.4)	(6.5)	(8.7)	(11.4)	(12.5)	(2.4)	(2.7)	(25.7)	(37.7)	(33.0)	(31.8)
Trade balance (% of GDP)	(3.5)	(2.6)	(6.9)	(7.8)	(8.7)	(8.1)	(1.5)	(1.5)	(16.0)	(21.1)	(17.6)	(16.3)
Capital flows (F/A) (US$bn)	(9.1)	(4.6)	3.1	6.0	9.3	10.1	(3.3)	3.7	(10.9)	19.0	13.8	12.3
FDI (US$bn)	0.3	(0.4)	3.8	3.7	4.5	5.2	0.1	6.9	0.3	4.8	5.1	6.0
FDI (% of GDP)	0.2	(0.5)	4.1	3.3	3.4	3.4	0.1	3.4	0.2	2.7	2.7	3.1
NBU reserves (US$bn)	7.5	13.3	15.5	18.8	20.8	25.3	29.1	30.9	28.5	40.5	43.7	37.5
Interest rates												
NBU's key policy rate (%, e.o.p.)	14.0	22.0	14.0	14.5	18.0	13.5	6.0	9.0	25.0	15.0	13.0	11.0
Fiscal balance												
Budget balance (% of GDP)	(5.0)	(2.3)	(2.9)	(1.5)	(2.4)	(2.1)	(5.1)	(2.4)	(26.9)*	(27.0)*	(23.6)*	(18.2)*
Public debt (% of GDP)	69.4	79.0	80.9	71.8	60.9	50.6	60.8	49.7	78.5	84.4	89.1	100.6

* budget balance before official budgetary grants

Source: Ukrstat, NBU, MoF, ICU.

11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kyiv, 01030 Ukraine
Phone/Fax +38 044 3777040

WEB www.icu.ua

RESEARCH

Vitaliy Vavryshchuk
Head of macro research
vitaliy.vavryshchuk@icu.ua

Alexander Martynenko
Head of corporate research
alexander.martynenko@icu.ua

Taras Kotovych
Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Mykhaylo Demkiv
Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

Dmitriy Dyachenko
Financial analyst
dmitriy.dyachenko@icu.ua

Investment Capital Ukraine LLC is regulated by Securities and Stock Market State Commission of Ukraine (license numbers: dealer activity AE 263019, broker activity AE 263018, underwriting activity AE 263020 dated 11 April 2013).

DISCLAIMER

This research publication has been prepared by Investment Capital Ukraine LLC solely for information purposes for its clients. It does not constitute an investment advice or an offer or solicitation for the purchase of sale of any financial instrument. While reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, Investment Capital Ukraine makes no representation that it is accurate or complete. The information contained herein is subject to change without notice. Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of Investment Capital Ukraine LLC. All rights are reserved. Any investments referred to herein may involve significant risk, are not necessarily available in all jurisdictions, may be illiquid and may not be suitable for all investors. The value of, or income from, any investments referred to herein may fluctuate and/or be affected by changes in exchange rates. Past performance is not indicative of future results. Investors should make their own investigations and investment decisions without relying on this report. Only investors with sufficient knowledge and experience in financial matters to evaluate the merits and risks should consider an investment in any issuer or market discussed herein and other persons should not take any action on the basis of this report.

Additional information is available upon request.