Focus
Ukraine

Markets
Economics

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Macro Insight

2025: Year of Challenges and Great Hopes

13 DECEMBER 2024

The year 2025 will be one of great expectations along with hope for a sustained ceasefire agreement with russia. The US President-elect has yet to reveal his recipe for peace, which we expect after the inauguration. However, the growing economic and human toll of the war leaves no other options for the two sides but to seek a settlement and the sooner the better. Yet, we remain skeptical that a solution will be reached quickly. Rather, we expect that the Ukrainian economy will continue to operate under the conditions of a full-fledged war for most of the coming year. Fortunately, the financial commitments made by Ukraine's key partners for 2025 are entirely sufficient to ensure that macroeconomic and financial stability is preserved and that businesses and households do not face significant economic challenges. The financial support from foreign partners will be primarily funded with interest incomes generated by russian frozen assets. This is a bold move in the right direction. Economic growth will likely decelerate on fiscal consolidation and moderation in household income next year. Inflation delivered an upside surprise recently due to surging food prices, but good preconditions are in place for the CPI to decelerate to about 7% by the end of 2025, implying some room for monetary-policy easing in 2H25. Gaps in external accounts will remain significant, with the foreign trade deficit hovering near 18% of GDP and demand for FX cash from the population hitting all-time highs. Yet, foreign financial aid will be fully sufficient for the NBU to address the shortages in the FX market and keep it reasonably balanced. We see little appetite from the NBU for further near-term hryvnia depreciation. However, after inflation decelerates, the central bank may be more inclined to weaken the hryvnia in 2H25. In any case, we think depreciation vs US$ of more than 10% over the next 12 months can be completely ruled out under a baseline scenario. Fiscal challenges will remain high as outlays on the army will continue to exceed 50% of state budget expenditures. Fortunately, foreign aid is estimated to be just sufficient to cover the planned fiscal gap of 19% of GDP in 2025.

Key macroeconomic data and projections

	2024F	2025F
Real GDP, YoY, %	4.0	3.4
Nominal GDP, US$bn	191	203
Inflation, YoY, %, e.o.p.	11.5	7.0
Key policy rate, %, e.o.p.	13.5	12.0
UAH/USD, e.o.p.	42.0	45.7
C/A balance, % of GDP	(7.7)	(3.6)
NBU reserves, US$bn	44.1	43.0
Budget gap, % of GDP*	(23)	(19)
Public debt, % of GDP	90	94

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

Economic recovery slower in baseline scenario

The economy has performed fairly well in 2024 despite numerous headwinds related to the safety situation and a significant decline in agricultural production due to summer drought. Economic growth remains broad-based, and nearly all demand-side GDP components make substantial positive contributions. The key driver is private consumption, supported by a rapid recovery in household incomes. Intense competition for labor in the private sector forces businesses to revise salaries to retain employees. Export is also estimated to be an important contributor thanks to a nearly

Economic growth will be close to 4% this year…

seamless functioning of the Black Sea shipping route operated by Ukraine. This route replaced the so-called grain corridor that russia unilaterally suspended in 2023. Meanwhile, our estimates show that the role of government consumption is minimal due to an ongoing fiscal consolidation. The economy is set to grow by 4% this year to reach about 78% of the pre-war real GDP. However, a significant part of this is supported by an outsized contribution of the defense sector. The production of goods and provision of services unrelated to the defense sector is estimated to be below 70% of the pre-war GDP.

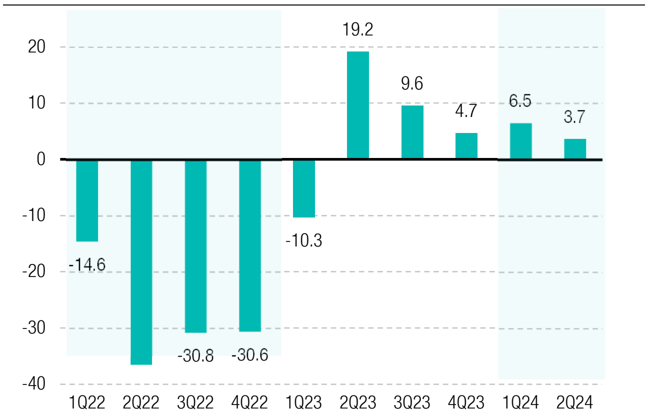
… but is set to slow in 2025

The pre-conditions for economic growth in 2025 are not significantly different from those of 2024. Yet, we see some additional looming headwinds. Firstly, the government will continue narrowing the state budget deficit, likely to 19% of GDP in 2025 from 23% in 2024. This will be a drag on government consumption and transfers to the population. Private consumption dynamics are likely to weaken marginally due to decelerating income growth. Even though competition for labor will continue to fuel growth in salaries in the private sector, the public sector is unlikely to see any significant increases as the minimum wage is set to remain unchanged vs 2024. Moreover, a recent hike in military levy (a special temporary income tax) on household incomes from 1.5% to 5% will also contain growth in disposable incomes. Export-wise, the situation should not change dramatically, provided the sea transportation routes continue to operate without interruptions. However, it will be increasingly difficult to maintain the same growth in the volume of shipments in the future. 2024 was the first full year during the war when Ukrainian producers could take full advantage of the available sea transportation infrastructure. This effect of a newly available export route that drove a one-off increase in exports will fade gradually. Disruptions of the electricity supply are also an impediment to growth. Overall, we expect a deceleration in GDP growth to 3.4% in 2025.

Ukraine needs significant investments to boost growth

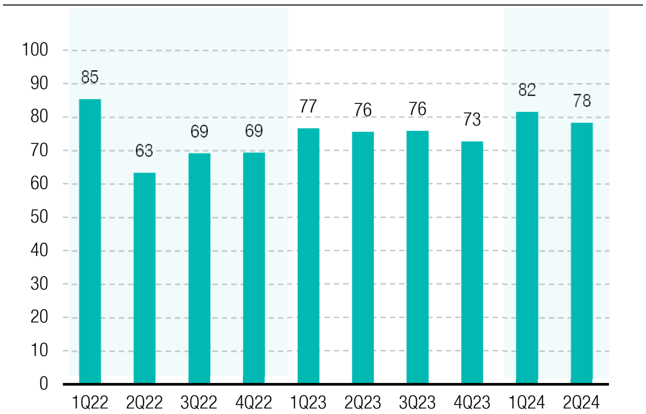
The prospects for mid-term economic growth entirely depend on safety conditions. To reach a decent growth rate of at least 5%, Ukraine badly needs new investment to the tune of tens of billions of dollars. Significant inflows of FDIs and external private credit are very unlikely until there is clear visibility of a prolonged ceasefire and affordable (and subsidized) war risk insurance becomes readily available in the market.

Chart 1. Real GDP, change, YoY



Source: UkrStat, ICU.

Chart 2. Real quarterly GDP, respective quarter of 2021 = 100%



Source: UkrStat, ICU.

Inflation reaches double-digit territory on food prices

Inflation accelerating on food prices

The past several months brought significant upside surprises to consumer inflation as CPI reached 11.2% YoY in November, up from 3.3% at the beginning of the summer. Food prices remain the most significant driver, contributing about half to the annual CPI tally. The summer drought had a much more pronounced effect on agricultural harvest than initially thought, and those effects still linger. A good illustration is the prices of vegetables, which are up 63% YoY in November, butter (+31%), and fruits (+25%).

There are also several other important accompanying factors that drive inflation higher. A June hike in electricity tariffs by 64% contributed nearly 15% to the CPI tally. Also, the passthrough effects of hryvnia depreciation over January-July played a role in inflation pickup. Despite recent significant acceleration in headline CPI, we don't think that inflation risks are severe and of a long-term nature. Apart from food, alcohol, tobacco, and electricity, price growth for most other consumer basket categories has remained mostly the same. Prices for clothes and footwear are 4% below last year's levels, prices for home appliances are nearly unchanged from last November, and prices of motor fuel are just 1% up YoY. This indicates that an upsurge in inflation is primarily driven by temporary factors that are set to weaken next year.

Preconditions are in place for lower CPI in 2025

We remain optimistic about future inflation prospects and expect consumer prices to decelerate to about 7% by the end of 2025 (but price growth is likely to be in double digits in winter and spring). We see several supporting disinflationary factors:

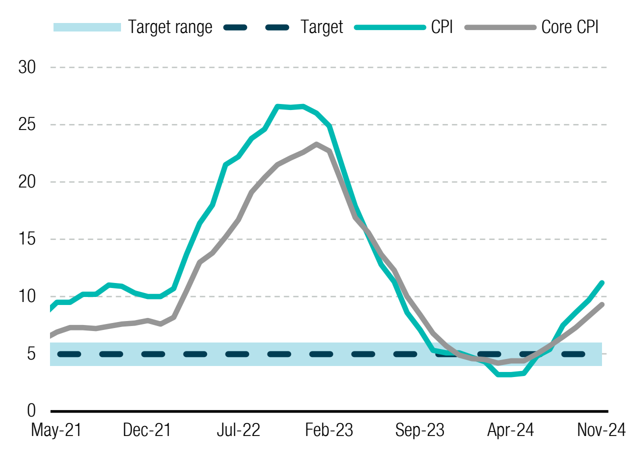
- an expected normalization of harvest of grains, fruits, and vegetables as uniquely adverse weather conditions are unlikely to repeat next year.

- end of a two-year hiking cycle for household electricity tariffs. They were cumulatively increased by 178% (2.8x) since June 2023, and any further revisions are extremely unlikely.

- a moderation in household income as salaries in the public sector are unlikely to grow significantly, and a higher military levy will eat a part of incomes.

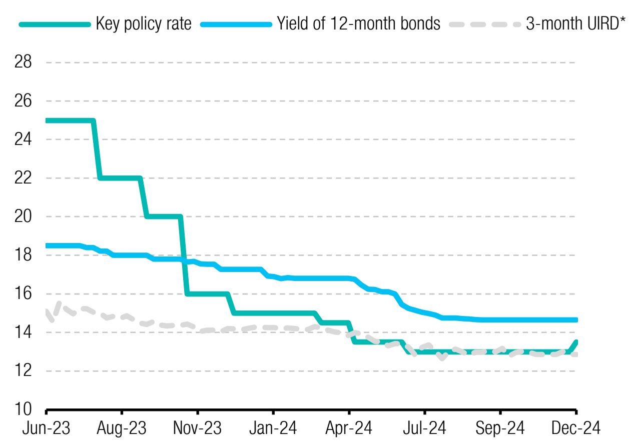
- only a moderate weakening of hryvnia in 1H25, as we think a visible depreciation will be on the NBU agenda no sooner than 2H25.

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 increased the key rate in a symbolic move

NBU increased the key policy rate in a symbolic move

Since all preconditions seem to be in place for a significant deceleration in inflation next year, we think the NBU could have avoided an interest rate revision. Yet, the central bank recently increased the key policy rate by 50bp to 13.5% for two reasons: 1. it wanted to send a signal that it takes the evolving inflationary risks seriously, and 2. it wants to encourage banks to increase rates on retail deposits somewhat so that they remain in positive territory on an ex-ante basis if assessed against inflationary expectations of households. The argument for higher nominal deposit rates is further reinforced by a hike in the military levy from 1.5% to 5%, which also applies to interest income paid by banks to households. We think any increase in the key policy rate will be short-lived, and a switch to a monetary-policy easing cycle is nearly certain in 2H25. We see the key policy rate at 12% at the end of 2025.

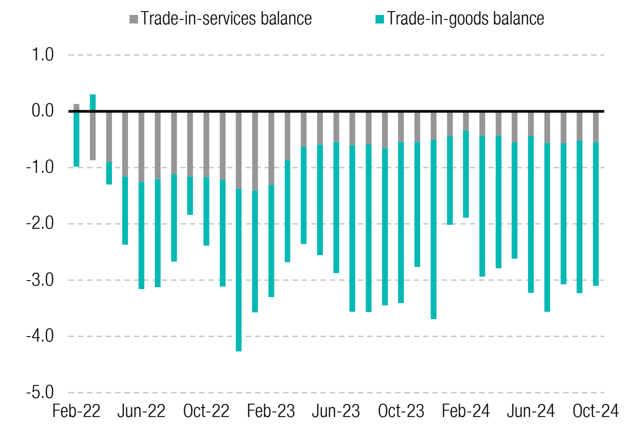
We see a muted reaction of bank deposit rates to a possible hike in the key policy rate and expect that hryvnia deposit rates, as measured by UIRD, will likely stay within the 12.5-13.0% range over 2025. We also don't expect any visible moves in yields of government bonds at least until 2Q25, rather, we think they will adjust down by 100-150bp from current levels by the end of 2025. The yields on one-year government bonds may thus reach 13.5% (vs. 14.7% today).

Trade deficit and FX cash out of banks are main drags on C/A

Imbalances of external accounts remain huge but covered by foreign aid

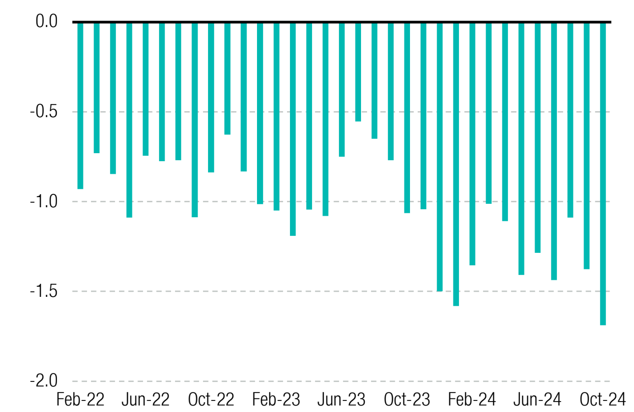
The challenges related to external accounts that the economy will face in 2025 are very similar to those of 2023 and 2024. The two most significant drags on external accounts and, respectively, on the FX market will be the sizeable deficit of external trade (a component of the current account) and withdrawal of FX from banks by the population (recorded in the financial account). Foreign financial aid in the form of grants and loans combined with several other net positive BoP components are expected to be just enough to cover these gaps.

Chart 5. Monthly foreign trade deficit, US$bn



Source: NBU, ICU.

Chart 6. Net flow of FX cash to banks, US$bn



Source: NBU, ICU.

Foreign trade deficit to remain close to 18% of GDP in 2025

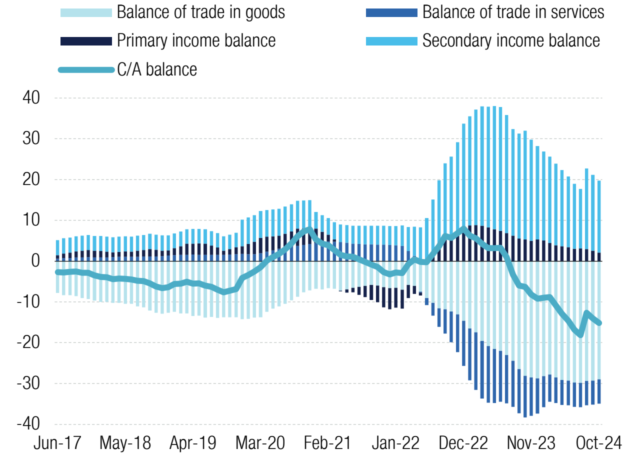
The foreign trade deficit will be close to 18% of GDP, the second largest gap in Ukraine's history after it narrowed from 21% of GDP in 2023. Of 18%, about 15pp is attributed to the deficit of trade in goods, and 3pp is from a deficit of trade in services. There are no reasons to expect the gap to start narrowing, and we forecast the same foreign trade deficit at 18% of GDP in 2025. Imports of goods continue to grow robustly (+7% YoY in 10M24), driven by high consumer demand and larger purchases of energy-saving equipment and military equipment. We expect high single-digit import growth to continue in 2025, supported by further recovery of domestic demand and a relatively strong hryvnia. Purchases of military-related goods are also set to grow robustly. Export of goods recovered notably in 2024 (+13% YoY in 10M24), but it is still at just 55% of total import of goods. Deliveries of goods abroad will likely slow next year as the positive effect of the opening of the Black Sea route for non-agricultural cargo shipments will weaken.

C/A gap will shrink on ERA facility

The balance of primary income is likely to shrink close to zero from hefty surpluses in the two previous years. While the income of migrants is declining, the dividend income of foreigners on invested capital and interest income on debt remains robust and edging up due to FX liberalization measures of the NBU. Among C/A components, current transfers to the public and private sectors (secondary income) are set to compensate for the surging trade deficit. We assume that all financial assistance provided through the G7-sponsored Extraordinary Revenue Acceleration (ERA) facility of about US$19bn will be treated as grants in BoP statistics. It will thus ensure that the C/A deficit will be reasonably small in 2025 at just 3-4% of GDP (vs. 7-8% in 2024).

The financial account is also expected to remain net positive despite significant outflows of FX cash from the banking sector. They may exceed US$16bn this year, a record high for Ukraine, as households withdraw FX cash from their bank accounts or buy FX cash from banks. This pattern will likely continue in 2025, as the population sees FX holdings as a safe heaven despite the relative stability of the hryvnia exchange rate and high yields on hryvnia assets. Another explanation is that FX cash withdrawal is used to bypass the NBU-imposed capital controls and to pay for shadow imports or is transported abroad. Financial account-wise, the main positive transformation since the start of russia's full-scale invasion is that capital flight via the build-up of trade credits has finally reversed. Businesses are now more willing to transfer FX export proceeds to Ukraine.

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



Source: NBU, ICU.

Table 1. Balance-of-payments components, US$mn

	10M24	10M23
Current account	**-12,984**	**-7,131**
Trade in goods	-23,624	-23,671
Trade in services	-4,848	-7,685
Primary income	741	3,861
incl. migrant income	6,825	9,428
Secondary income	14,747	20,364
incl. transfers to gov't	7,801	13,176
Financial account*	**-6,130**	**-15,716**
Change in trade credits	-3,552	-1,592
Change in cash out of banks	13,342	9,173
Net loans to government	-14,088	-20,181
Other	-1,832	-3,116

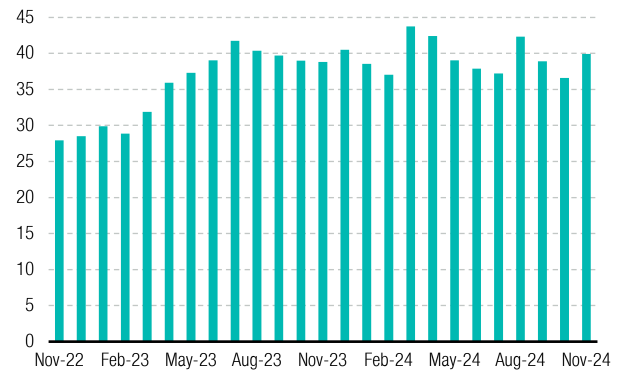
* "–" in F/A indicates an increase in liabilities (cash inflow)
Source: NBU, ICU.

NBU reserves to remain close to historical highs through 2025

NBU reserves to stay in the range of US$40-45bn in 2025

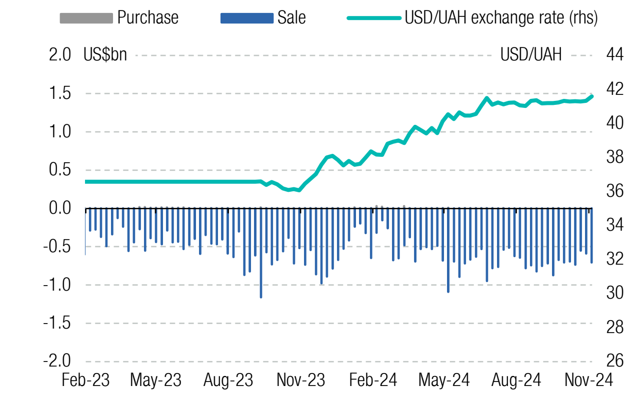
The financial support from Ukraine's foreign partners through grants and loans remains impressive. In 2024, Ukraine is set to receive over US$40bn in external funding. This will bring end-2024 NBU gross reserves to above US$44bn, about 9% above the end-2023 level. The prospects for 2025 are also clearly positive. The announced commitments from international partners now exceed US$38bn, with about half of that amount being the G7-sponsored Extraordinary Revenue Acceleration (ERA) facility. One-third is represented by tranches of the Ukraine Facility from the EU. Should all financial aid arrive as scheduled, the NBU will be fully equipped to sell as much FX in the interbank market as needed while its reserves will remain in the safe range of US$40-45bn through 2025 (above 100% of the IMF composite metric for reserves).

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 to continue gradual weakening of hryvnia with faster pace in 2H25

We see end-2025 exchange rate at just below UAH46/US$

The Hryvnia exchange rate is fully determined by the NBU vision of an optimal path, and market forces have a minimal role in that respect. During the full-scale war, the strength of hryvnia is a derivative of two factors: 1. the NBU's willingness to support the hryvnia and 2. the sufficiency of NBU's capacity/resources to support the hryvnia. The sufficiency of resources has not been an issue thanks to generous inflows of foreign financial aid since February 2022. Also, it will not be an issue in 2025, as the scheduled funding will fully cover the NBU's intervention needs. This means that the future hryvnia exchange rate trajectory is solely a matter of the NBU's discretionary decisions. We expect the NBU to pursue a gradual depreciation approach. The hryvnia weakening is likely to be minimal in 1H25 as the central bank will want to avoid adding fuel to the current inflationary pressures. Due to heightened inflation, the NBU has shown very little appetite for hryvnia depreciation since mid-2024. Yet, we expect that once inflationary risks subside significantly by 2H25, the NBU will become open to faster depreciation. Overall, we see a relatively moderate hryvnia depreciation of less than 10% vs US$ next year and see the exchange rate at just below UAH46/US$ at the end-2025. With an assumed depreciation of this reasonable size, we believe that UAH-denominated assets will outperform yields on FX-denominated assets.

Fiscal consolidation will continue at a slow pace

Gradual fiscal consolidation under way

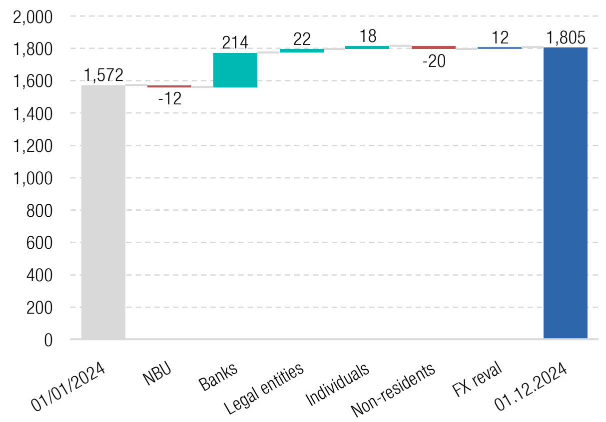
The state budget needs will remain heavily dominated by outlays on defense and national security. Their share will continue to exceed 55% of all expenditures, of which salaries of military personnel will make up more than half. Given this, any meaningful fiscal consolidation would be a very challenging exercise. Government's efforts to boost tax revenues resulted in selected tax-rate hikes, including a retroactive application of an elevated 50% tax rate on banks' 2024 net income and a hike in the military levy on household incomes from 1.5% to 5.0%. Combined with stricter tax administration, this will ensure that the ratio of tax revenues to total budget expenditures exceeds 50% in 2025, up from an estimated 45% in 2024.

Table 2. Key parameters of state budget, UAHbn

	2024	2025
Total revenues (before grants)	1,911	2,327
incl. tax revenues	1,679	1,995
Expenditures	3,736	3,929
inlc. defence and security	2,177	2,225
Net lending	21	39
Budget balance (before grants)	-1,846	-1,641
Total revenues / GDP	25%	26%
incl. tax revenues / GDP	22%	23%
Expenditures / GDP	49%	45%
Budget balance (before grants) / GDP	-24%	-19%
Total revenues / expenditures	51%	59%
Tax revenues / expenditures	45%	51%
Defence, security / total expenditure	58%	57%

Source: MFU, ICU.

Chart 10. Local government debt by holders, UAHbn



Source: NBU, ICU.

Local debt market can lend more to the government

The government sees the fiscal deficit of UAH1.6tn, or 19% of GDP, next year, which is a contraction from an estimated 23-24% in 2024. Over 98% of that amount is expected to be covered with foreign financial aid, while net local borrowings are planned to be minimal at just UAH17bn (US$400mn). Apparently, the government understands that the banking sector can provide much more funds should the government need them. The banking sector's liquidity remains very high, and the NBU has more room to finetune its mandatory reserve requirements to encourage banks to invest more in local government bonds. We think it's very likely the government will revise its fiscal targets somewhat later in 2H25 and will tap the local debt market to cover these additional funding needs. In 11M24, net government borrowings from the local market stood just above UAH200bn (US$5.0bn), implying a rollover rate of 188%.

Looking forward, we see the government maintaining a budget deficit close to UAH1.6tn in the coming years, which implies a gradual reduction of the gap relative to GDP. Any ceasefire agreement is unlikely to bring quick and significant relief in terms of fiscal pressures. Ukraine will need to keep its army large for years to contain risks of a renewed russia's aggression. Moreover, a gradual reduction in expenditures on the army will be accompanied by higher expenses on infrastructure and housing for displaced people. We thus see Ukraine's public debt going further on sizable fiscal needs and exceeding 94% by end-2025.

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	3.4
Nominal GDP (UAHbn)	1,587	1,989	2,385	2,984	3,561	3,978	4,194	5,460	5,191	6,538	7,649	8,787
Nominal GDP (US$bn)	133	90	93	112	131	155	155	200	161	179	191	203
Unemployment (%)	9.3	9.1	9.3	9.5	8.8	8.2	9.5	9.8	28.0	21.0	15.0	12.0
Inflation												
Headline inflation (%, YoY, e.o.p)	24.9	43.3	12.4	13.7	9.8	4.1	5.0	10.0	26.6	5.1	11.5	7.0
Headline inflation (%, YoY, avg.)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	9.4	20.2	12.9	6.3	9.9
GDP deflator (%, YoY)	15.9	38.9	17.1	22.1	15.4	8.3	9.8	25.1	34.3	18.5	12.5	11.2
Exchange rates												
UAH/USD (e.o.p.)	15.8	24.0	27.3	28.1	27.7	23.8	28.3	27.3	36.6	38.0	42.0	45.7
UAH/USD (avg.)	12.0	21.9	25.6	26.6	27.2	25.8	27.0	27.3	32.3	36.6	40.2	43.3
External balance												
Current account balance (US$bn)	(4.6)	5.0	(1.9)	(3.5)	(6.4)	(4.1)	5.3	(3.2)	7.9	(9.7)	(14.6)	(7.2)
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)	(7.7)	(3.6)
Trade balance (US$bn)	(4.6)	(2.4)	(6.5)	(8.7)	(11.4)	(12.5)	(2.4)	(2.7)	(25.7)	(37.7)	(34.7)	(37.3)
Trade balance (% of GDP)	(3.5)	(2.6)	(6.9)	(7.8)	(8.7)	(8.1)	(1.5)	(1.5)	(16.0)	(21.1)	(18.2)	(18.4)
Capital flows (F/A) (US$bn)	(9.1)	(4.6)	3.1	6.0	9.3	10.1	(3.3)	3.7	(10.9)	19.0	18.2	6.1
FDI (US$bn)	0.3	(0.4)	3.8	3.7	4.5	5.2	0.1	6.9	0.3	4.8	4.4	5.1
FDI (% of GDP)	0.2	(0.5)	4.1	3.3	3.4	3.4	0.1	3.4	0.2	2.7	2.3	2.5
NBU reserves (US$bn)	7.5	13.3	15.5	18.8	20.8	25.3	29.1	30.9	28.5	40.5	44.1	43.0
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	13.5	12.0
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)*	(23.4)*	(19.3)*
Public debt (% of GDP)	69.4	79.0	80.9	71.8	60.9	50.6	60.8	49.7	78.5	84.4	90.0	94.1

* budget balance before official budgetary grants

Source: Ukrstat, NBU, MoF, ICU.

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