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Macro Update

Macro Risks Remain Manageable

TUESDAY, 23 APRIL 2024

The resilience of Ukraine's economy to unprecedented external shocks remains beyond any doubt. The economy continues to grow in 2024 at a reasonable pace and massive destruction of the country's energy infrastructure will only slow, but not disrupt, the recovery. Ukraine's largest economic achievement of the past quarters is the launch of a fully functioning Black Sea cargo corridor that made it possible to export a wide range of commodities. The biggest positive surprise of 1Q24 was a sharp slowdown of inflation that reached 3.2% in March. Low CPI combined with a stable FX market implies significant potential for a further reduction in interest rates that still remain elevated. We now expect an end-2024 NBU key policy rate of 11.5%, a 3pp reduction from the current level. Yields on government bonds will follow the trend, and we see good chances of the cost of one-year debt slipping below 14% by the end of the year. Apparently, inflows of foreign financial aid remain the key thing to watch as far as macroeconomic risks are concerned. With the US aid package voted, Ukraine should secure enough external financing to ensure that NBU reserves increase in 2024, and the central bank remains in a position to address any disturbances in the FX market. Another welcome development is the gradual and controlled hryvnia depreciation. It is much needed to reduce surging trade balances. Given NBU's revealed appetite for a weaker hryvnia, we downgrade somewhat our end-2024 exchange rate projection to USH41.5–42.5/US$ from 40.7 previously. Government managed to properly address fiscal risks in Jan–Feb, when foreign financial aid was paused, by delaying some non-critical expenditures. A substantial increase in tax collections was also a favorable factor. There remains a risk that budget financing needs will exceed the UAH1.6tn specified in the budget law. Should this happen, government will be able to raise additional funding in the local market to fill the gap.

Key macroeconomic data and projections

	2023	2024F
Real GDP, YoY, %	5.3	4.1
Nominal GDP, US$bn	179	190
Inflation, YoY, %, e.o.p.	5.1	6.4
Key policy rate, %, e.o.p.	15.0	11.5
UAH/USD, e.o.p.	38.0	42.3
C/A balance, % of GDP	(5.2)	(7.8)
NBU reserves, US$bn	41	45
Budget gap, % of GDP*	(27)	(22)
Public debt, % of GDP	84	92

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

Economic recovery will be helped by recovery in exports

Ukraine's real GDP grew by 5.3% YoY in 2023, following a 28.8% slump in 2022. The number is somewhat below our estimate of 5.8%, but we think the data revision next year will bring the final reading close to our estimate. Last year's recovery came on continued expansion of government's role in the economy due to hefty outlays on the defense and security sector. Government consumption reached nearly 42% of nominal GDP in 2023, up from 18% in 2021. A 53% increase in investments (gross fixed capital formation) is also a reflection of increased government spending on military equipment. Recovery of private household consumption also had a substantial positive contribution to GDP recovery. Meanwhile, the key drag on economic growth was international trade. Real exports fell 5.4% YoY in 2023 due to impaired logistics. Import increased 8.5% in real terms, thus satisfying a significant share of domestic demand.

Gradual economic recovery is set to continue through 2024, but at a slower pace compared with 2023. This year, economic growth is supported by a further rise in household demand thanks to an increase in real wages against the backdrop of very low inflation. The 13% increase in the minimum wage and recently approved additional payouts to military personnel will boost incomes of public sector employees. In the private sector, growth in salaries will also be sustained due to high competition for qualified labor. The contribution of government consumption to GDP growth is likely to decrease as gradual fiscal consolidation implies a decline in expenditures relative to GDP. Exports will also become a significant driver of GDP growth thanks to the smooth operation of the Black Sea cargo shipping corridor that now allows deliveries of a wide range of commodities abroad, including agro produce, steel, and iron ore.

We downgrade GDP growth forecast due to destruction of energy infrastructure

All in, we believe the economy is in a position to have another year of decent growth. Two key near-term restraining challenges are volatile business confidence and massive destruction of Ukraine's energy infrastructure that russia restarted recently. Business and consumer sentiment improved markedly in recent months after they plummeted in the winter on a growing realization that the chances of a near-term end to the war are negligible. The NBU Business Activity Index returned to positive expectations territory in March, but it remains extremely volatile. Of course, destruction of electricity generating and distribution facilities implies that energy-intensive industrial companies may face disruption of electricity supply. While the economy demonstrated its resilience to blackouts in 2022, this new wave of disruption will definitely affect the pace of economic recovery. Given the new risk, we downgrade our projection for 2024 GDP growth to 4.1% from a previous 5.0%.

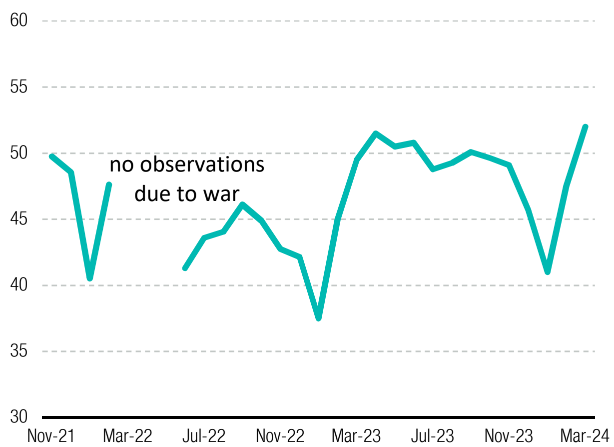
Table 1. Real value added by sectors, 2023 vs 2021

	Share in GDP*	Value added (2021 = 100%)
Government, incl defense	25.3%	146%
Trade	14.4%	72%
Manufacturing	9.4%	66%
Agriculture	8.5%	80%
Real estate	5.6%	68%
Electricity, other utilities	5.4%	66%
Transportation	5.0%	63%
Extraction	4.6%	66%
Communication	4.5%	84%
Education	4.0%	88%
Healthcare	3.0%	90%
Financial activities	2.7%	81%
Other	7.6%	na
GDP	100.0%	75%

* share in 2023 nominal GDP, excluding taxes and subsidies.

Source: UkrStat, ICU.

Chart 1. 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.

Inflation keeps surprising positively on highly saturated agri and food market

A sharp fall in inflation since the start of the year was a major surprise. CPI slowed to 3.2% in March, down from 5.1% in December. The key driving force behind the massive disinflation is the stability of food prices. They fell 0.2% MoM in March, which is highly unusual for this period of the year, and their YoY increase stood at just 0.2%. Many food staples got significantly cheaper in YoY terms. Low global food prices coupled with the high cost of export logistics in Ukraine keep the market for agro produce and related food products highly saturated. Price growth for essential non-food components, including clothes, telecommunications, and transportation also remains muted.

Demand-side pressures remain weak despite a gradual recovery of domestic private consumption. The highly uncertain safety situation makes household consumption behavior very cautious. Besides, any increase in demand is easily met by local businesses given the abundance of underutilized capacity. Looking forward, stronger inflationary risk may stem from two major sources:

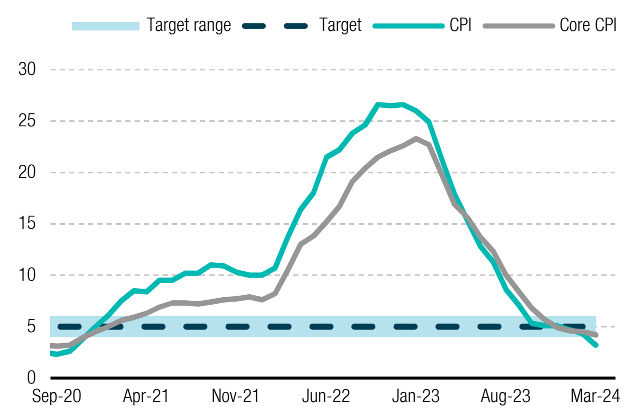
Lower harvest and hryvnia depreciation are the only two sources of inflation risk

- A decline of agricultural harvest from last year's very high levels. Yet, Ukraine's agro ministry is optimistic about the progress with the spring sowing campaign and weather conditions so far. The harvest of grains and oilseeds is expected to decline by a reasonable 10% in 2024 from last year's high level. While prices for some of the products may recover from their unusual low level, the overall prices of the food basket are unlikely to go up significantly.

- A gradual hryvnia depreciation that makes the cost of imports higher. So far, a 7% hryvnia depreciation that occurred since the NBU abandoned the fixed exchange rate in October, made a negligible contribution to inflation. Given broadly stable inflationary expectations of businesses and households, the pass-through of the exchange rate into consumer prices seems to be significantly below historical rates.

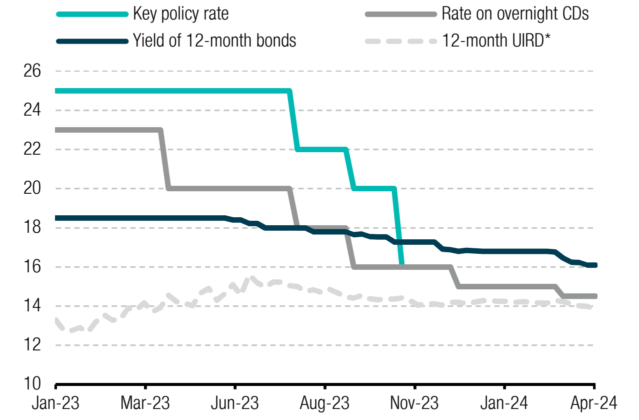
With this in mind, we revise our end-2024 CPI forecast to 6.4% from the previous forecast of 10.1%. Looking longer term, we see limited risks of inflation speeding up significantly given underutilization of production capacity and limited pass-through of the exchange rate into consumer prices.

Chart 2. CPI, core CPI and inflation target, YoY, %



Source: NBU, ICU.

Chart 3. NBU key policy rate and commercial rates, %



* Ukrainian Index of Retail Deposit Rates

Source: NBU, ICU.

NBU will cut rate more than previously expected but will remain cautious nevertheless

NBU will cut rates more significantly than previously expected

Very low inflation definitely opens a way for more rate cuts by the NBU than previously expected. Nevertheless, we don't expect the NBU to be in a rush, and we believe it will prefer to take a series of small steps throughout the year. So far, the central bank has been clearly willing to accept the risk of acting slow and late. We don't expect this pattern to change significantly in the near future. Apart from inflation, the central bank's other important concern is the stability of hryvnia exchange rate. To ensure that hryvnia-denominated saving instruments are sufficiently attractive, the NBU will keep the key policy rate well above what would be considered an acceptable rate in normal non-war times. We see a cumulative cut of the NBU key policy rate of 250–300bp over the rest of this year from the current level of 14.5%. The key policy rate and the rate on overnight CDs will thus reach 11.5%–12.0% at the end of 2024. This is lower than our previous forecast of 13%. Much of the monetary policy loosening is likely to come through a reduction in premium that the NBU pays on its three-month CDs, which currently stands at 300bp over key policy rate. We expect the premium will shrink considerably in the coming months, and the NBU may phase out its three-month instrument completely by the end of the year.

Yields on government bonds may slip below 14% by end-2024

The response of commercial rates to the recent cuts in NBU's rate has been pronounced in the government debt segment, but far much less so in the retail deposit segment. Yields on new one-year government bonds offered at the primary auction are already down by 70bp to 16.1% since the NBU restarted its monetary-policy-easing cycle in March. Meanwhile, rates on hryvnia deposits have remained largely unchanged at close to 14%. The robustness of hryvnia deposit rates can be explained by the high mandatory reserves requirement—the reserves ratio stands at 20% for clients' hryvnia money with maturity of less than three months. This incentivizes banks to offer attractive rates on term deposits so that customers move their money from current accounts into deposits with a maturity of at least three months.

Given our updated forecast of the NBU rate, we now expect end-2024 yields on one-year government bonds to slip below 14.0%, while three-year paper will continue to command a premium of around 200bp over the one-year instrument. The decline in deposit rates will be much less pronounced, and we see rates on three-month facilities at close to 12.5% by end-2024.

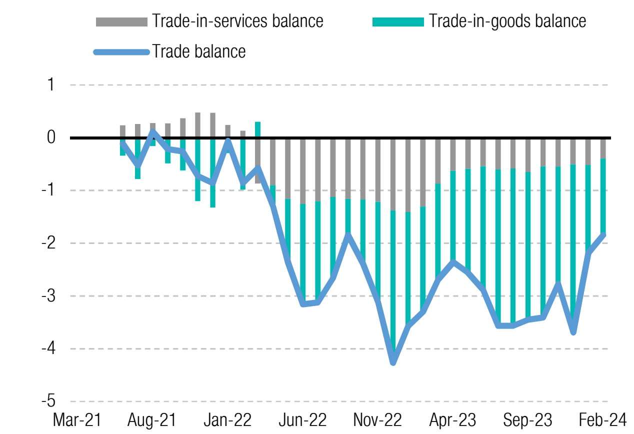
Deficit of external accounts to remain covered with foreign aid through 2024

External account adjustments have already taken place

Ukraine was facing significant challenges on the financial account side in Jan–Feb due to interruptions in the inflows of foreign financial aid. Meanwhile, improvements in the current account were significant and the deficit narrowed to just US$0.6bn in 2M24 and led to a substantial decline in the hard-currency deficit in the interbank market. Over US$9bn in foreign financial aid that arrived in March made a great closing of 1Q24, taking NBU reserves to an all-time high.

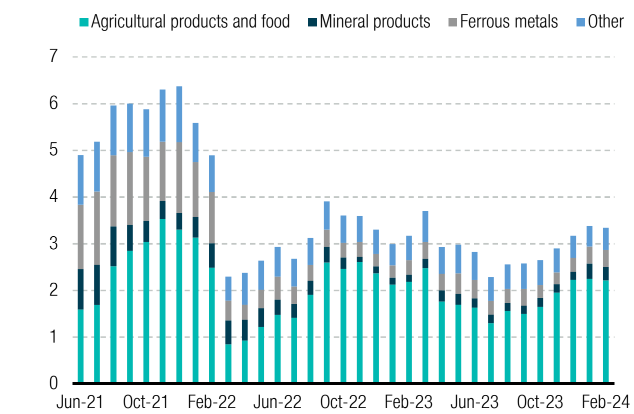
Recent developments indicate that a substantial adjustment in the external trade balance (it widened to US$37bn in 2023 from US$26bn in 2022) and current account balance (deficit of US$9bn vs a surplus of US$8bn) is done. We don't expect any further significant growth in either external trade nor current account gaps this year and next. Imports are unlikely to expand visibly further as an ongoing gradual hryvnia depreciation will help contain demand for foreign-produced goods. Import of services is declining as emigration of refugees is already past its peak. Meanwhile, exports are being supported by the Black Sea shipping corridor, which helped recover transit in volume terms close to pre-war levels. While prices for Ukraine's key commodities remain low by historical metrics, high volumes of shipments continue to support relatively strong total sales.

Chart 4. Monthly trade balance, US$bn



Source: NBU, ICU.

Chart 5. Monthly export of goods, US$bn



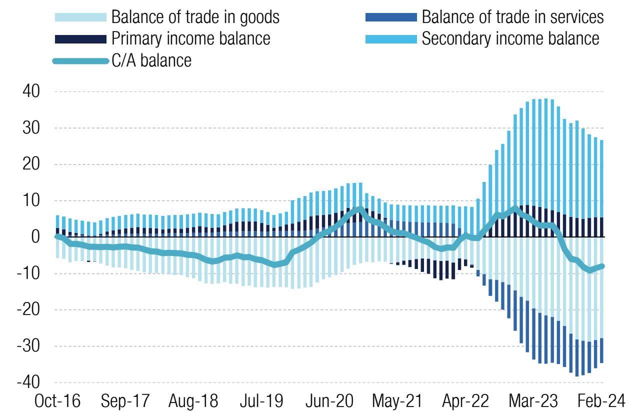
Source: NBU, ICU.

We revise our C/A deficit projection to US$14.9bn from our previous projection of US$13.1bn. The revision is driven by the fact that the US financial aid will come in the form of loans via financial accounts rather than grants that are booked in the current account. However, the downgrade is less than the effect of the US financial aid reclassification as projections for the external trade deficit have been somewhat improved.

Concessional borrowings of government to keep financial account in surplus

The financial account remains primarily shaped by capital flows via two channels. Withdrawal of FX cash from bank accounts by Ukrainians either domestically or abroad by far is the largest channel of capital outflows. Total volumes of withdrawal increased substantially during winter to a monthly average of US$1.5bn from US$1.0bn in autumn. This is primarily the result of increased exchange rate volatility and hryvnia depreciation. We expect the volume will remain elevated in the coming months, and this will be a key drag on the financial account. Other types of capital flight have been negligible due to tight capital controls. Meanwhile, the only channel for significant inflows is borrowings by the Ukrainian government. Ukraine saw a two-month pause with inflows of financial aid in Jan–Feb as its key allies were finalizing their internal loan approval procedures. March brought substantial relief as several IFIs and foreign governments unlocked their funds. We expect Ukraine will attract over US$35bn in external borrowings this year, including a US$7.8bn loan from the US and US$5.4bn in loans from the IMF. This implies Ukraine will have a significant financial account surplus above US$15bn this year. This is more than enough to offset the expected current-account deficit and enable further increase in NBU reserves.

Chart 6. Current account, 12-month trailing, US$bn



Source: NBU, ICU.

Table 2. Balance of payments components, US$bn

	2M24	2M23
Current account (C/A)	**-0.6**	**-1.8**
Trade in goods	-3.1	-4.1
Trade in services	-0.9	-2.7
Primary income	0.9	0.8
incl. migrant income	1.7	2.0
Secondary income	2.5	4.2
incl. transfers to government	1.3	2.8
Financial account (F/A)*	**2.6**	**-2.2**
Change in trade credits	-0.2	-0.9
Increase in cash out of banks	3.1	2.1
Net loans to government	-0.1	-3.7
Other components	-0.1	0.4

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

Source: NBU, ICU.

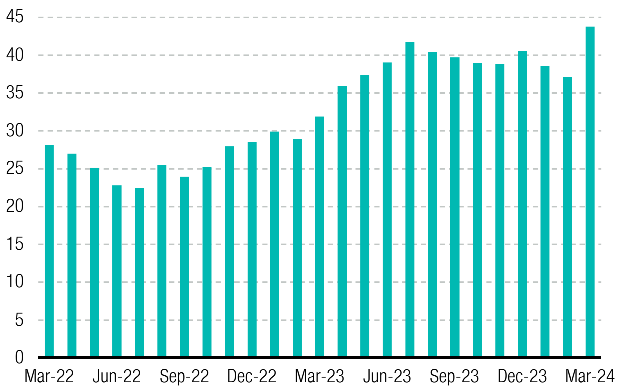
NBU will allow hryvnia to weaken further

NBU showed clear appetite for weaker hryvnia

In a much-expected FX policy shift, the NBU clearly started to weaken the hryvnia since December 2023. The hryvnia exchange rate remains volatile and very little dependent on the demand-supply balance in the FX market. The moves of the exchange rate are largely a reflection of the NBU (unknown) exchange-rate setting approach rather than that of market forces at a specific point of time. Yet, the net result is that the hryvnia weakened by 7% as of mid-April since the NBU abandoned the fixed exchange rate. This reasonable depreciation brought about limited discomfort for the population and businesses. It also had a negligible contribution to inflation.

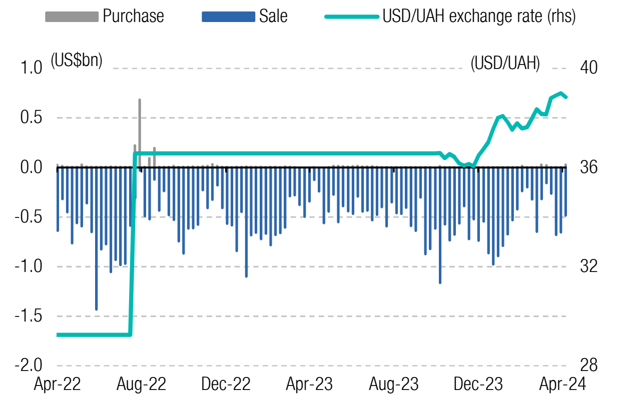
The high level of international reserves implies the central bank is in a perfect position to move ahead proactively to weaken the hryvnia without risking losing credibility of the market. By our estimates, gross NBU reserves will increase close to US$45bn by end-2024 thanks to foreign financial aid, up from US$40.5bn at end-2023. We remain of the view that the pace of depreciation will remain broadly comparable to the yields on hryvnia saving instruments that are now in the range of 11% (one-year deposit yield net of taxes) to 16% (one-year government bond yield). Given that the NBU has clearly shown its appetite for a weaker hryvnia, we marginally downgrade our end-2024 exchange rate projection to UAH42.3/US$ from UAH40.7/US$ previously. Adjustment of exchange rate is a much-needed policy response aimed at reducing imbalances of external accounts, which remain unsustainably high if foreign aid is not considered.

Chart 7. NBU gross international reserves, US$bn



Source: NBU, ICU.

Chart 8. UAH/US$ rate and NBU weekly interventions



Source: NBU, Bloomberg, ICU.

Fiscal risks to remain high in 2024 and beyond

Government kept fiscal risks in check in 1Q24

The government managed to keep fiscal risks well in check in 1Q24. The first two months of the year were particularly challenging as inflows of foreign financial aid were temporarily paused and the government was forced to delay some non-critical expenditures to later periods. The brightest observation of 1Q24 is a substantial increase in tax collections due to improved fiscal discipline. Increase in the key tax revenues far exceeds the increase in nominal GDP. A part of this increase was driven by one-offs, like a 50% windfall tax on banks' 2023 profits approved last December. A larger part of windfall tax was paid in 1Q24. Given strong revenue performance and delays in some expenditures, the state budget deficit stood at a reasonable UAH198bn in 1Q24. The 2024 budget law provides for the full-year deficit of UAH1.6tn (before grants). We expect the budget deficit to raise substantially in 2Q-4Q as the government will make expenditures that were delayed in 1Q, particularly defense-sector expenditures. The largest fiscal challenge, however, is related to additional mobilization of new draftees to the army and further increases in compensation to soldiers that was recently voted by the parliament. At this point, the balance of risks is such that the target budget deficit for 2024 may be exceeded, but it's too early to make any assessment of additional financing needs at this stage.

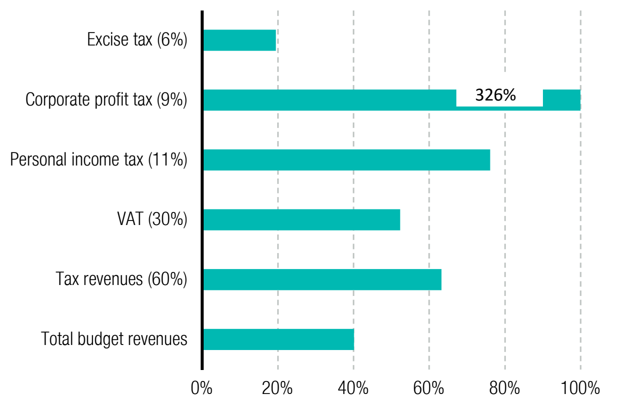
Table 3. Key parameters of state budget, UAHbn*

	2021	2022	2023	2024F
Total revenues (before grants)	1,296	1,306	2,239	1,768
incl. tax revenues	1,107	950	1,204	1,575
Expenditures	1,491	2,705	4,014	3,309
Net lending	5	-3	-9	31
Budget deficit (before grants)	-200	-1,396	-1,767	-1,571
Total revenues / expenditures	87%	48%	56%	53%
Tax revenues / expenditures	74%	35%	30%	48%
Total revenues / GDP	24%	25%	34%	23%
incl. tax revenues / GDP	20%	18%	18%	21%
Expenditures / GDP	27%	52%	61%	44%
Deficit / GDP	-4%	-27%	-27%	-21%

* numbers for 2024 are from the State Budget Law

Source: MFU, ICU.

Chart 9. Revenues of state budget in 2M24, chg YoY, %*



* numbers in brackets indicate shares of components in total budget revenues in 2M24

Source: MFU, ICU.

Government will tap domestic debt market if fiscal gap exceeds plan

With the aid package from the US nearly approved, we think the total commitments from Ukraine's international partners will nearly equal the size of the deficit envisaged by the current budget law. Should the deficit widen beyond the current target, we think the government will focus on the domestic debt market to cover any additional gap. In 1Q24, government managed to raise net UAH28bn (equivalent of debt in all currencies) in the domestic market, and there is definitely more potential to increase borrowings given abundant liquidity of the domestic market and decreasing interest rates. We, thus, believe that risks of employing monetary financing to cover the state budget deficit are reasonably low this year. Apparently, 2025 is going to be more challenging in terms of fiscal risks. The war is likely to linger and elevated expenditures on the defense sector will be there for another couple of years. With limited room for fiscal consolidation and an expected decline in direct budget support from international partners, fiscal risks will remain the key macroeconomic challenge in the future.

We expect the debt-to-GDP ratio to increase from 84% at the end of 2023 to 92% at the end of 2024. The year-end number will, among other things, depend on the parameters of Eurobond restructuring that government plans to complete in the coming months. Ukraine will enjoy a relatively light external debt servicing schedule in the coming years, with no substantial cash flows directed for repayments of loans.

Yearly forecast 2023-24

	Historical data for 2013–2022										Forecast	
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024F**	**2025F**
Activity												
Real GDP (%, YoY)	(6.6)	(9.8)	2.4	2.5	3.4	3.2	(4.0)	3.4	(29.1)	5.3	4.1	5.0
Nominal GDP (UAHbn)	1,587	1,989	2,385	2,984	3,561	3,978	4,194	5,460	5,191	6,538	7,589	8,884
Nominal GDP (US$bn)	133	90	93	112	131	155	155	200	161	179	190	201
Unemployment (%)	9.3	9.1	9.3	9.5	8.8	8.2	9.5	9.8	28.0	21.0	15.0	12.0
Inflation												
Headline inflation (%, YoY, e.o.p)	24.9	43.3	12.4	13.7	9.8	4.1	5.0	10.0	26.6	5.1	6.4	8.0
Headline inflation (%, YoY, avg.)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	9.4	20.2	12.9	4.4	7.2
GDP deflator (%, YoY)	15.9	38.9	17.1	22.1	15.4	8.3	9.8	25.1	34.3	18.5	11.5	11.5
Exchange rates												
UAH/USD (e.o.p.)	15.8	24.0	27.3	28.1	27.7	23.8	28.3	27.3	36.6	38.0	42.3	46.1
UAH/USD (avg.)	12.0	21.9	25.6	26.6	27.2	25.8	27.0	27.3	32.3	36.6	40.0	44.2
External balance												
Current account balance (US$bn)	(4.6)	5.0	(1.9)	(3.5)	(6.4)	(4.1)	5.3	(3.2)	7.9	(9.2)	(14.9)	(15.2)
Current account balance (% of GDP)	(3.5)	5.6	(2.0)	(3.1)	(4.9)	(2.7)	3.4	(1.1)	4.9	(5.2)	(7.8)	(7.6)
Trade balance (US$bn)	(4.6)	(2.4)	(6.5)	(8.7)	(11.4)	(12.5)	(2.4)	(2.7)	(25.7)	(37.4)	(28.3)	(26.6)
Trade balance (% of GDP)	(3.5)	(2.6)	(6.9)	(7.8)	(8.7)	(8.1)	(1.5)	(1.5)	(16.0)	(20.9)	(14.9)	(13.2)
Capital flows (F/A) (US$bn)	(9.1)	(4.6)	3.1	6.0	9.3	10.1	(3.3)	3.7	(10.9)	18.5	16.1	6.4
FDI (US$bn)	0.3	(0.4)	3.8	3.7	4.5	5.2	0.1	6.9	0.3	4.2	4.0	4.5
FDI (% of GDP)	0.2	(0.5)	4.1	3.3	3.4	3.4	0.1	3.4	0.2	2.4	2.1	2.2
NBU reserves (US$bn)	7.5	13.3	15.5	18.8	20.8	25.3	29.1	30.9	28.5	40.5	44.7	35.4
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	11.5	10.0
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)*	(22.4)*	(16.0)*
Public debt (% of GDP)	69.4	79.0	80.9	71.8	60.9	50.6	60.8	49.7	78.5	84.4	91.5	96.0

* budget balance before official budgetary grants

Source: Ukrstat, NBU, MoF, ICU.

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