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NEWSLETTER
UKRAINE

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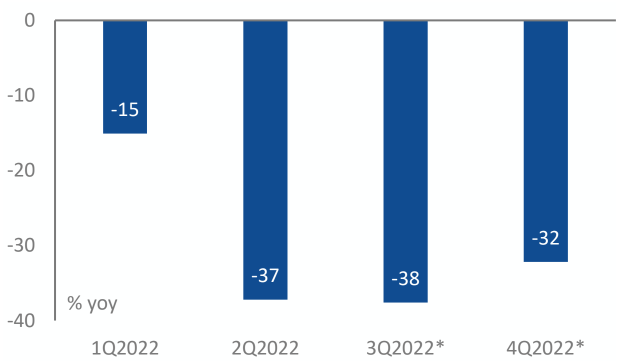
Seven months of war economy: all eyes on the budget

Ukraine's war-torn economy seems to have reached its bottom during the summer of 2022, with a full-year decline of real GDP projected at 32%. Next year, the economy might grow by 4.6% according to the official forecast, even though this number is highly uncertain, as the war continues. The state of public finances is decisive for the war economy. While revenues decreased due to the difficult economic situation, expenditures increased. Military expenditures account for 40% of total; a number that was below 10% during peacetimes. This development created massive funding needs. However, Ukraine is cut off from foreign private borrowings, which traditionally financed a substantial part of the deficit. If direct monetary financing by the National Bank (NBU) is to be curtailed, this support must come from international partners of Ukraine. They have pledged USD 35 bn, of which slightly more than a half was disbursed. This support comes more often in form of loans rather than grants, which will create further challenges in the future.

Russia's war keeps causing economic suffering

Russia's ongoing invasion of Ukraine has left thousands killed and forced 6 m people to flee abroad; a further 6 m are recorded as internally displaced – a large shock to private consumption and labour supply in Ukraine. Also, destruction of business, transport and housing infrastructure are recorded above USD 120 bn, affecting the capital stock and labour demand. Overall, the mismatch on the labour market led to an unemployment rate of 35% during 2Q2022. Russia's blockade of seaports led to a decline of exports by 28% yoy after seven months. Imports declined by 16% yoy, less strongly due to tax and fee cuts and a favourable exchange rate.

Quarterly economic development in 2022



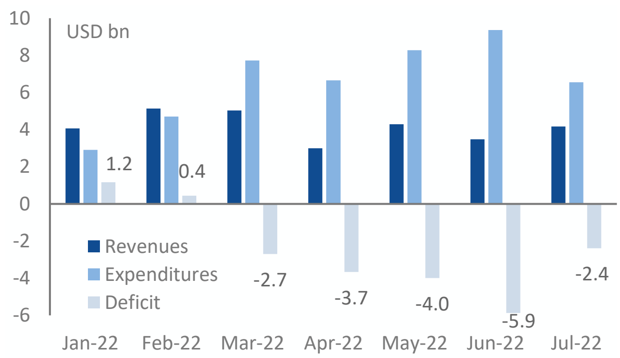
*Sources: Ukrstat, GET/IER, *GET/IER forecast*

As a result, GDP declined by 37% yoy in the second quarter after a lower decline of 15% yoy in the first one. For the whole year 2022, we estimate that GDP will decline by 32%. The uncertainty for next year is exceptionally high, as all depends on the future intensity and duration of the war. Ukraine's Ministry of Economy forecasts 4.6% yoy real growth as a base scenario for the budget draft but underlines a large degree of uncertainty.

The fiscal position is decisive for the war economy

With the beginning of the full-scale war, Ukraine was forced to massively increase its military expenditures. They accounted for 40% (!) of public expenditures in July 2022, compared to 7% a year before. At the same time, public revenues went down by 1% yoy. This development has resulted in a large fiscal deficit, which is projected to correspond to 25.6% of GDP this year, if financial aid in the form of grants is not taken into account.

Fiscal gap



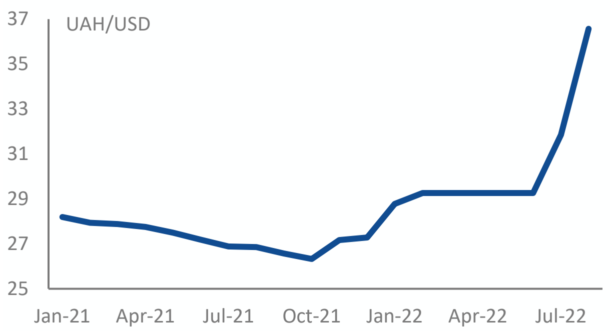
Source: NBU, without accounting for grants

Keeping military expenditures at current levels, while maintaining necessary social and economic support, is critical for the further duration of the war. In the first seven months, deficit financing has both relied on domestic government bond purchases ("money printing") by the NBU, amounting to more than USD 9.3 bn and on international financial aid as Ukraine does not have access to international capital markets. Both are however not sustainable as they severely undermine macro-financial stability by putting pressure on inflation and the exchange rate. Ukraine thus aims at reducing the monthly fiscal gap to ca. USD 2.5 bn in 2023 in the recently presented budget draft.

Monetary financing and supply chain disruptions has spurred consumer prices to grow to ca. 3% monthly between March and June but inflation recently stabilised and reached 23.8% yoy in August. Nevertheless, inflation above 30% is expected for the year end and slightly above 20% in 2023.

As an inflation target could not be seen as a credible nominal anchor for the economy any longer and as market mechanisms were interrupted, the NBU introduced a fixed exchange rate while leaving aside the focus on price stability for the moment. To maintain the rate, strict capital controls were introduced, and large FX interventions were conducted. However, the persistent pressure on FX reserves forced a devaluation to UAH/USD 36.57 in July.

Official exchange rate



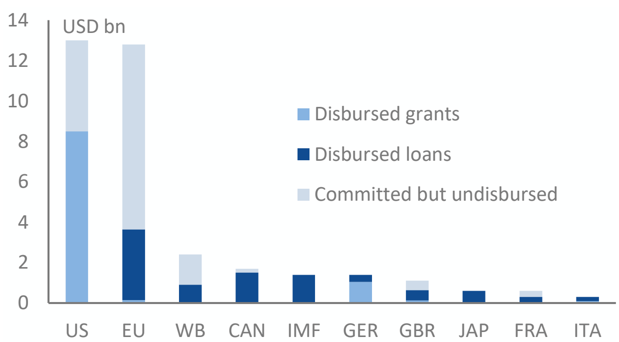
Source: NBU, monthly average

This step positively affected export perspectives while making imports more expensive. Nevertheless, a high trade deficit, cash withdrawals of Ukrainians abroad and slowly arriving financial aid continue to cause a strong balance of payments deficit. The exchange rate is approaching UAH/USD 41.3 on the cash market in September, thus making a further FX rate adjustment possibly necessary in the coming months.

More and faster international financial aid is essential

Both the fiscal and the external position show the essential importance of financial aid. If such support is not arriving in a timely manner, Ukraine would be forced to adjust or shift monthly expenditures accordingly, as Ukraine did in July. Ukraine's partner countries and organisations announced support of USD 35 bn but just 54% were disbursed for the time being.

Top-10 donors of budget support



Sources: Ministry of Finance, Kiel Institute for the World Economy, as of 17 September

Grants are preferred over loans as they do not contribute to the public debt ratio which Ukraine expects to stand at 100% of GDP in 2023. An agreement on debt payment suspension to 2024 with international investors and members of the Paris Club was signed. However, this agreement covers USD 6 bn, just slightly more than one month of fiscal funding needs 2022 and does not address debt sustainability concerns in the medium-term.

Outlook

The positive news is that Ukraine's economy has survived the massive war shock. The strong decline in GDP seems to have brought to a stop during 2022, and the budget planning foresees a small growth during the coming year. However, these estimates and forecasts are surrounded with a huge degree of uncertainty, as the war continues to rage on with no end in sight.
To keep Ukraine afloat, the international support should currently focus on the massive fiscal funding needs, and address them accordingly, as there are no better alternatives to such support. Prospectively, the use of frozen Russian sovereign assets might be a further element of supporting Ukraine in its fiscal and recovery needs. However, significant international efforts will be needed in this regard, which will probably take a lot of time.

This Newsletter is based on the Economic Monitor Ukraine.

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**Advisory activities in Belarus are currently suspended.*

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