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NEWSLETTER
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German Economic Team

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One year of the full-scale war: impact on Ukraine's economy

Since 24 February 2022, Russia has been attacking the entire territory of Ukraine. Today about 18% of country's area and millions of people remain under occupation. After one year of full-scale war, the number of internally displaced people (IDPs) is about 5.3 million, and over 8 million have fled Ukraine. In October 2022, Russia started targeting Ukraine's energy infrastructure, and the largest nuclear power plant in Europe, the Zaporizhzhya NPP, remains under occupation and cut off from Ukraine's power system. While Ukraine had excessive generation capacities and was able to export electricity before, now it has regular energy shortages. Russia's blockade of Ukrainian ports cut off its main trading channel and contributed to the world food crisis. Ukraine's economy fell by ca. 30% yoy in 2022. But this decline is less than expected during the first months of the full-scale war. Prudent supporting economic measures by government institutions and international support by partner countries helped to manage this period better than expected. In 2023, both need to continue.

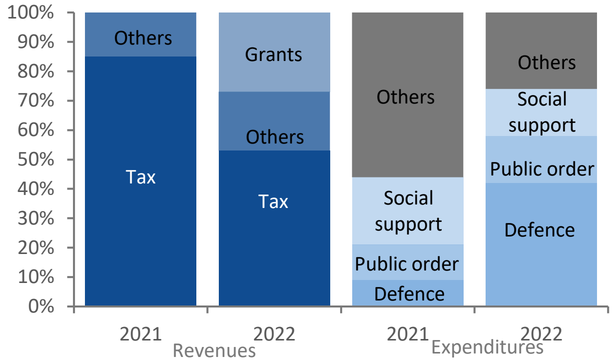
Impact on the aggregate economy

Ukrainian authorities estimate that Ukraine's GDP contracted by 30.3% in 2022 and unemployment grew from about 10% at the end of 2021 to about 30% at the end of 2022. Inflation reached 26.6% yoy in December 2022. A freeze on household tariffs, the outflow of people from Ukraine and capital controls tamed inflation, while high energy prices, disrupted supply chains, exchange rate depreciation and NBU's purchase of government bonds pushed prices up.

After the initial shock, the economy slightly recovered: Industrial production (IP) fell by 54% yoy in March 2022, but stabilised at -40% yoy in September. After 9 months of 2022, IP was 35% below its 9M2021 level. However, the total year 2022 figure is likely to be worse because of heavy attacks on the energy infrastructure, which started in October.

Clearly, huge disruptions in business activities and the outflow of people resulted in lower tax revenues, while financing needs strongly increased to finance the defence effort. Thus, in 2022 the primary budget deficit reached ca. UAH 1.300 bn (ca. USD 39 bn), that is ca. 26% of GDP (without accounting for grants). In this context, financial support from partner countries and international organisations was and remains essential. In 2022, Ukraine received USD 39 bn of external financial aid, 43% of which was in the form of grants. For 2023, the need is about the same. The EU has already provided the first tranche under its EUR 18 bn loan support programme.

Changed structure of revenues and expenditures



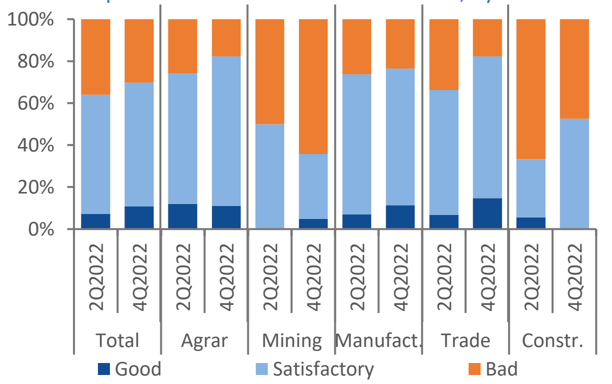
*Source: National Bank of Ukraine, *other expenditures include debt servicing*

Further disbursements are conditional on implementation of reforms. Ukraine expects some further USD 10 bn under an IMF programme in 2023, USD 10 bn from the US and the rest from other donors. Moreover, the balance of payments is under pressure due to Russia's blockade and occupation of seaports. While the Grain Deal allows for some export of agri-food products via sea, industrial goods are excluded, and their exports have to rely on physically restricted rail or road transport. Imports declined less due to critical imports of equipment for defence and energy goods due to destructions of refineries and the electricity system. In 2022, the trade deficit was USD 23.8 bn compared to USD 2.7 bn in 2021.

Developments in main economic sectors

The majority of regular sectoral statistics is not published for security reasons. But some information can be inferred from surveys. Firms in service sectors, especially those able to work distantly, have suffered relatively less.

How enterprises evaluate their financial stance, by sector



Source: NBU quarterly enterprise survey

The agricultural sector does relatively better. On the one hand, it has benefited from export possibilities due to the

Grain Deal. On the other hand, mine contamination and disrupted supply chains have a negative impact on harvest and production. The extraction industry has suffered the most. Daily steel output is down to 10.000 tonnes per day, from about 60.000 tonnes before the war. Russia's destruction and occupation of Mariupol and constant shelling of plants in Zaporizhzhya and Kryvyi Rih massively restrict production capacities. Thus, the recovery of the metal industry will take some time, even after the war.

Adjustment and resilience of the economy

The government implemented a number of measures to help businesses and people to cope with the war shock. The government helped enterprises to relocate, provided lump-sum payments to entrepreneurs and extended access to cheap financing under the 5-7-9 programme, providing over USD 2 bn between February and December 2022. Also, measures continue to provide support to IDPs. In March 2022 the parliament adopted a large tax cut, partially reversed in July to boost government revenues. Immediately after the invasion, the National Bank (NBU) fixed the exchange rate and introduced capital controls to prevent capital flight. The parliament allowed it to directly finance the government during the war time. However, the government plans not to revert to this instrument in 2023. To contain inflation and stabilise exchange rate expectations, the NBU raised its key rate to 25% p.a. in June. Apart from financial support, Ukraine's partner countries agreed to postpone bilateral debt repayments until 2024, contributed to the Grain Deal for agri-food exports, and the EU opened "solidarity lanes" to support Ukrainian exports.

Past reforms proved to have played an important role in the economy's resilience. A well-supervised and strongly capitalised banking sector has been decisive for households' and enterprises' trust. Ukraine's IT-sector has supported the digitalisation of that sector and the economy as a whole. People who were forced to leave keep receiving both financial and government services from Ukraine. In the last few years, IT sector started playing significant role in Ukraine's exports and may become one of the growth factors after the war. Furthermore, Ukraine completed synchronization of its electricity grid with the EU one just before the full-scale war. This step allowed to generate export revenues in the first months of war and is now ensuring the flow of electricity imports from the EU since Russia has started to deliberately attack Ukraine's energy infrastructure. Further institutional reforms and the support by the population was honoured by the EU granting Candidate Status to Ukraine in June 2022. This resilience and the EU's step create important incentives for Ukraine to remain on this reform path, even during the full-scale war.

Outlook

Initially there were expectations that the war would end quickly. Of course, uncertainty under war conditions is huge. However, even if the war ends tomorrow, the recovery will not be fast. To recover, Ukraine will need enormous investment into physical and human capital. At the same time, there is an opportunity to "build back better" – for example, make Ukraine's energy sector greener, and manufacturing more efficient. It's important to discuss aspects of the reconstruction already now, to have a comprehensive plan ready for the time when the war ends. At the same time, Ukraine and its international partners have to keep their focus on the current resistance as Russia's goals remain unchanged. In order to win, Ukraine needs all the support its allies can provide, in particular in weapons and financial aid.

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This text reflects the opinion of the authors and does not necessarily represent the views of the German Economic Team.

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