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German Economic Team

ECONOMIC MONITOR
UKRAINE

Overview

- Real GDP: After a decline of 29.1% in 2022, moderate growth of 4.1% and 5.5% is projected in 2023 and 2024, respectively, but GDP is expected to remain 22% below pre-war level in 2024.
- Inflation decelerates stronger (Oct-23: 5.3%) than expected. The monetary policy easing cycle has accelerated.
- External sector: International financial aid has stabilised external balances, allowing for a gradual liberalization of capital controls and a return to a managed floating exchange rate regime.
- Public finances: Significant budget deficits amounting to ca. USD 40 bn in 2023 resp. 2024, implying further reliance on foreign aid.
- Foreign trade: Exports lag imports, which are recovering, leading to increasing trade balance (and current account) deficits.
- IMF programme: Anchor for macroeconomic stability to coordinate reforms and international aid efforts

Special issues

- Ukraine Facility of the EU: Support for budget and accession, but not sufficient to close fiscal gap
- Banking sector: Stable functioning so far, but hardly prepared for its future role in reconstruction
- Business stimulation: Comprehensive response to challenges, but further measures and reforms needed
- Economic reconstruction: Progress in coordinating support, but financing issues still unresolved

Basic indicators

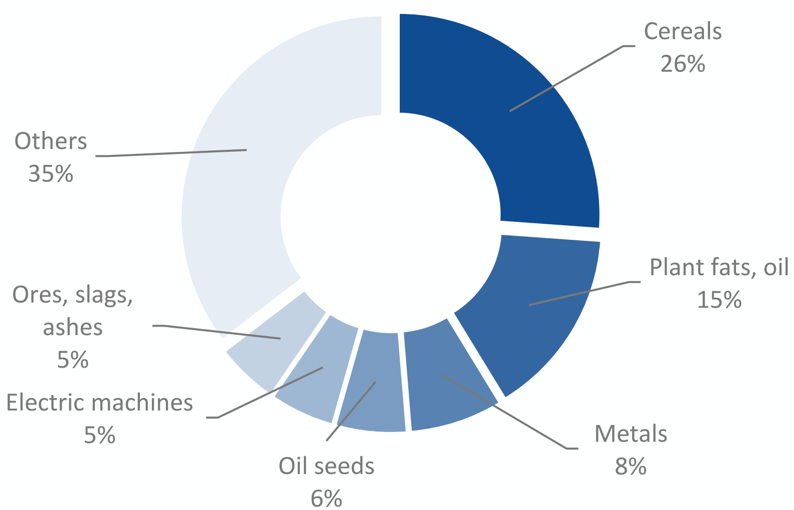
	Ukraine	Moldova	Georgia	Romania	Poland
GDP, USD bn	151.5	14.4	24.6	301.8	690.7
GDP/capita, USD	4,346	5,671	6,671	15,851	18,343
Population, m	34.8	2.5	3.7	19.0	37.7

Source: IMF; note: data for 2022

Trade structure

Exports

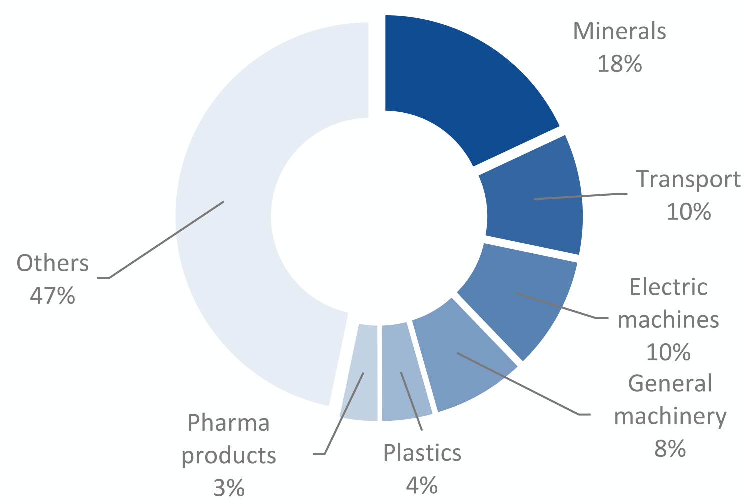
EU 62% | Türkiye 13% | Others 25%



Source: Ukrstat, 8M2023; note: trade in goods

Imports

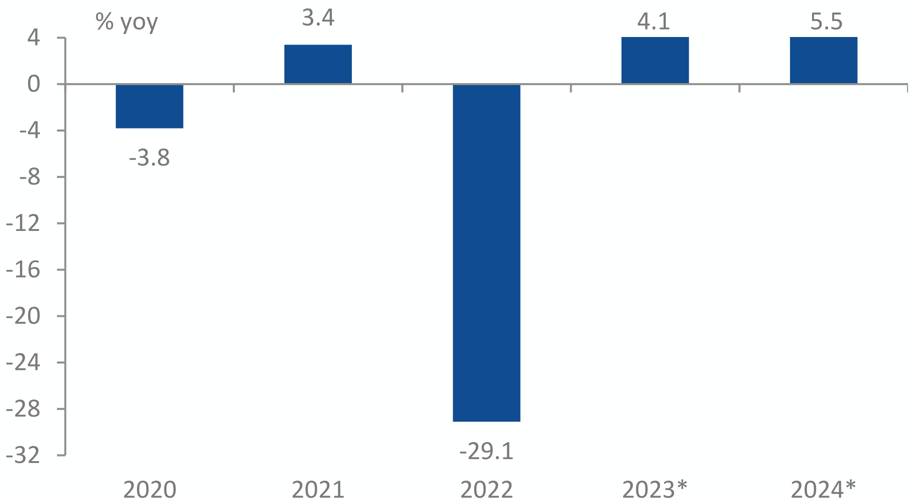
EU 47% | | Türkiye 6% | Others 47%



Source: Ukrstat, 8M2023; note: trade in goods

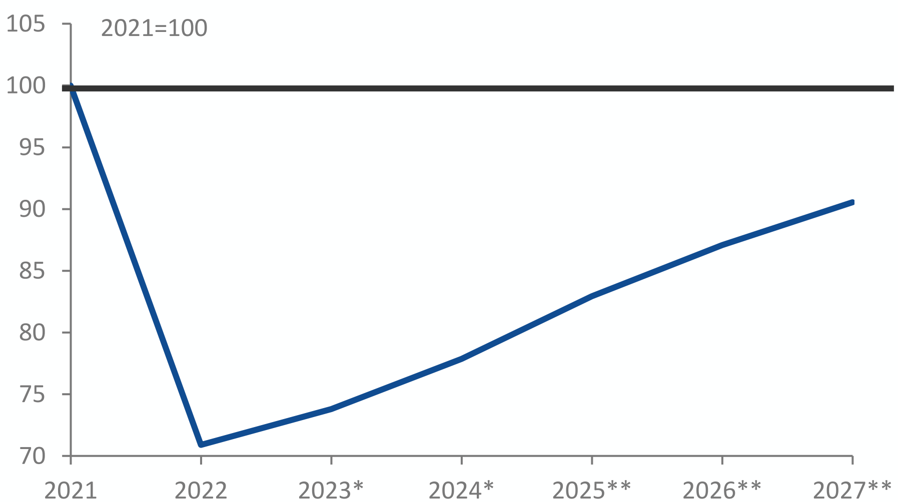
Economic development

Real GDP growth



*Sources: Ukrstat, *IER/GET forecast*

Medium-term forecast vs. pre-war level



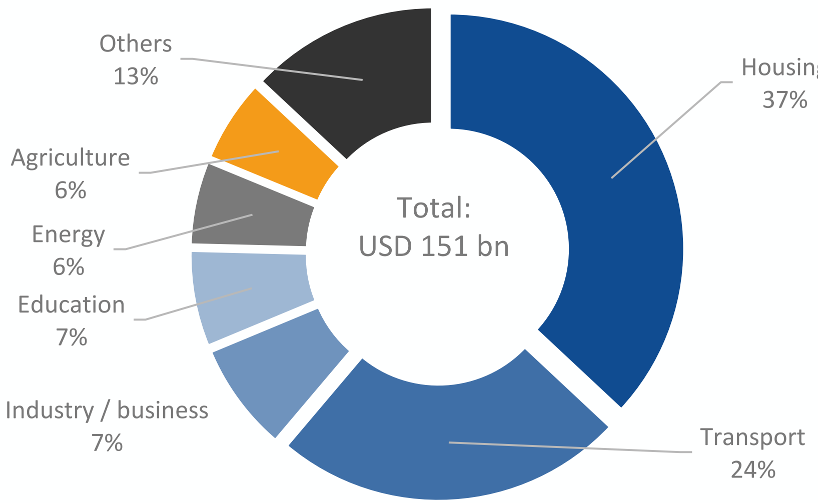
*Sources: Ukrstat, *IER/GET forecast, **IMF forecast*

- 2022: Strong decline of economic activities due to Russia's full-scale war: GDP fell by 29%
- 2023/2024: war consequences keep restraining growth: forecast of moderate growth of 4.1% resp. 5.5%
- Medium-term forecast: GDP will not reach pre-war level even in 2027

- War has led to massive structural break in Ukraine's economic development
- During the period of international support programmes (IMF, Ukraine facility by the EU) GDP will not reach its pre-war level
- Uncertainty is exceptionally large as war continues

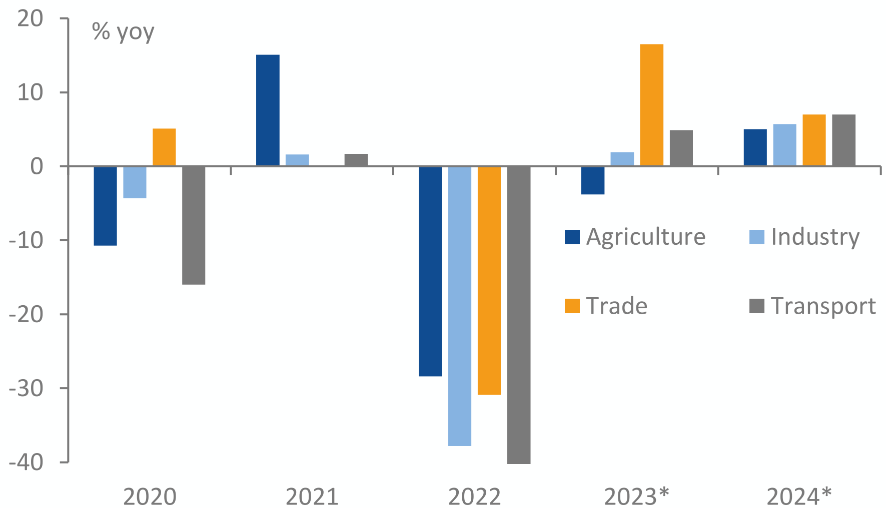
GDP: supply

War damages to infrastructure



Source: Kyiv School of Economics, Sep-23

Development of sectors



*Sources: Ukrstat, *IER/GET forecast*

Production

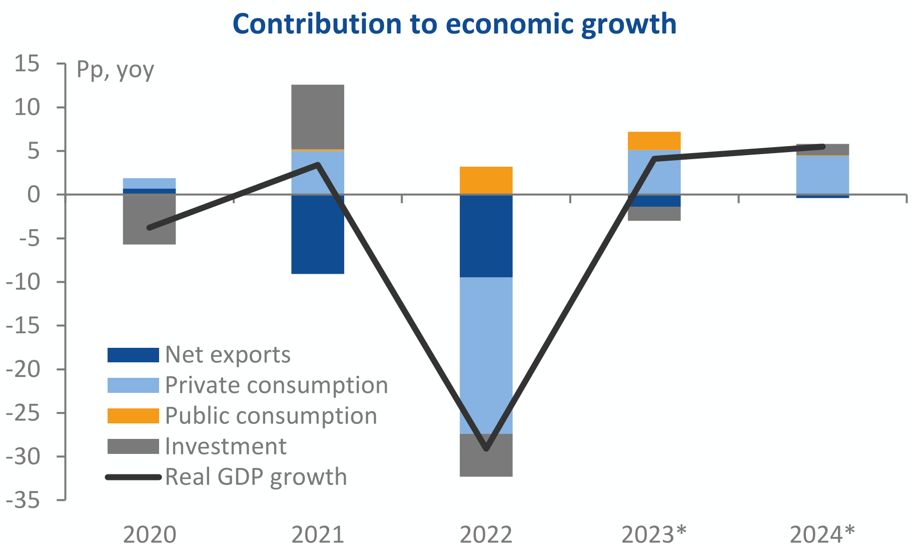
- Infrastructure damages exceed USD 151 bn, mostly social critical infrastructure
- However, rebuilding is ongoing to some extent
- Ca. 5 m Ukrainians remain abroad

Sectoral developments

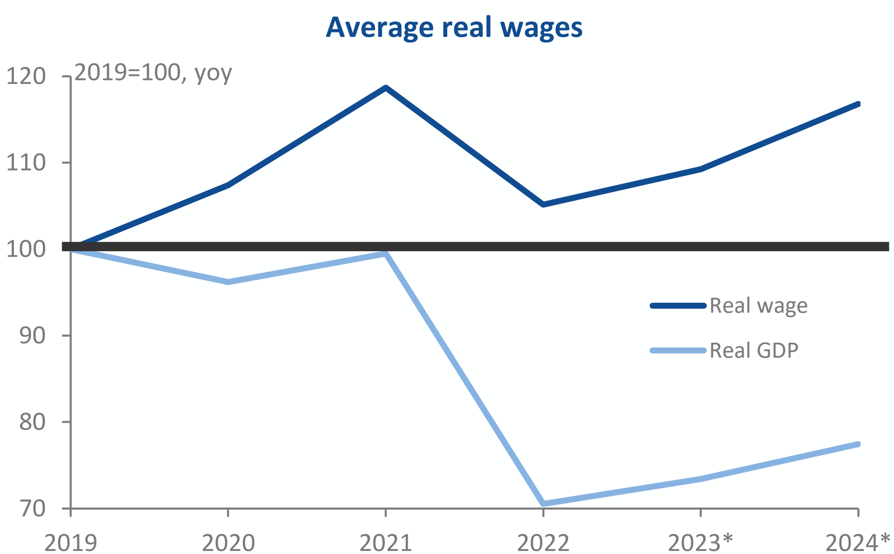
- Industry: massive shock due to destruction/occupation of hubs
- Agriculture: good weather conditions but production and exports affected by adverse factors (mines, blocked exports, financing constraints
- Transport / trade adjust to challenges

- **Quick restoration of critical infrastructure vital for people to return**
- **Sectoral recovery limited; mines restrain growth for years to come**

GDP: demand



*Sources: Ukrstat, *IER/GET forecast*



*Source: NBU, *forecast for 2023, in UAH*

Demand-side contribution

» Private consumption is the main driver for GDP dynamics, underscoring the need for return of migrants

» Investment (incl. inventories) as key component for growth acceleration did not recover due to lack of financing and uncertainty, among other reasons

Real wages

» Real wages decline much less than GDP and are forecast to almost reach pre-war level in 2024

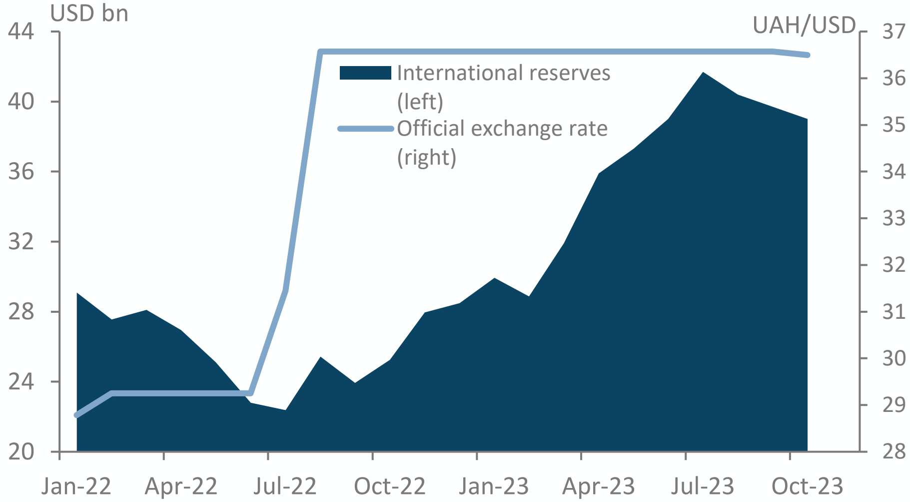
» Skilled labour shortages (migration, mobilization) lead to wage recovery

➢ **Real wage recovery drives private consumption**

➢ **Investment recovery relies on availability of financing and improved risk perspective**

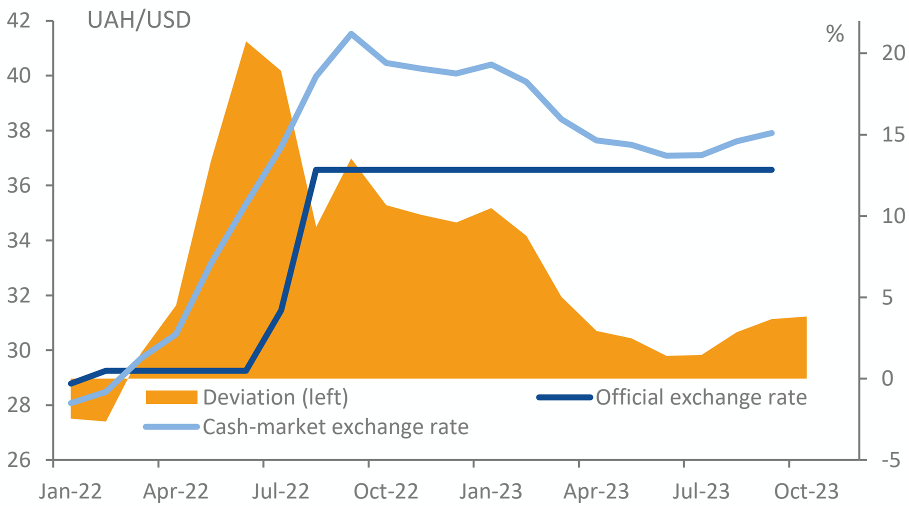
Exchange rate

Exchange rate and FX reserves



Source: NBU

Official exchange rate vs cash market exchange rate

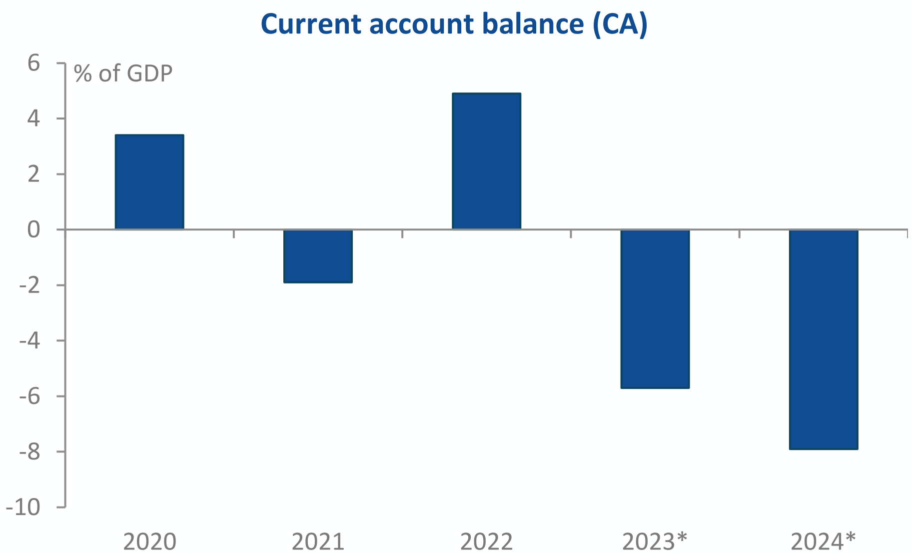


Source: NBU, cash market rate is the average between purchasing and selling rate

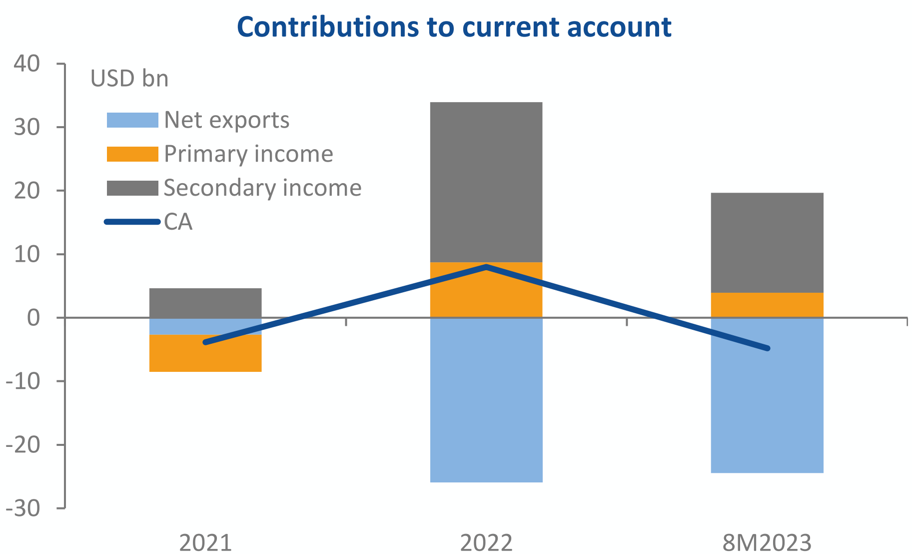
- Starting from Oct-23, the NBU returned to a managed flexible exchange rate regime
- Significant move, revealing trust in the overall economy and signal to return to market mechanisms
- Large level of international reserves due to financial aid is key factor allowing for this step
- Deviation between official exchange rate and cash-market rate has been below 5% since Mar-23

- **Despite the full-scale war, the NBU has been gradually returning to market-based monetary policy → important step**
- **External financial support is key for stabilisation of exchange rate**

Current account



*Sources: NBU, *IER/GET forecast*



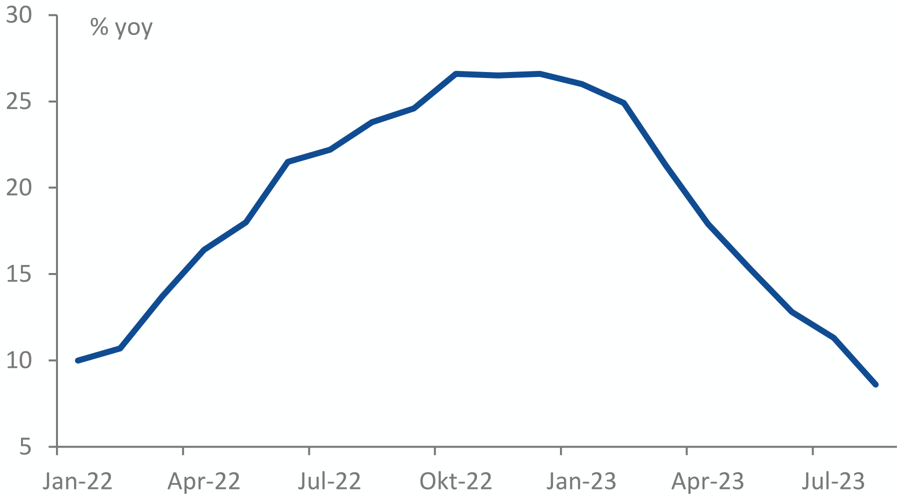
Source: NBU, net exports include goods and services

- » Current account developments are driven by the war
- » Negative: Trade balance deficit is further increasing, almost surpassed 2022 level already after 8M2023
- » Positive: Remittances and financial aid (grants are part of secondary income)
- » But: positive contribution is not sufficient to offset the negative effect
- » CA deficit in 2023 and expected to further rise in 2024

- ➢ **Deteriorating current account dynamics driven by trade balance**
- ➢ **Strong ties between migration destination countries and Ukraine important for remittance flows**
- ➢ **Financial aid essential to ensure stable exchange rate dynamics**

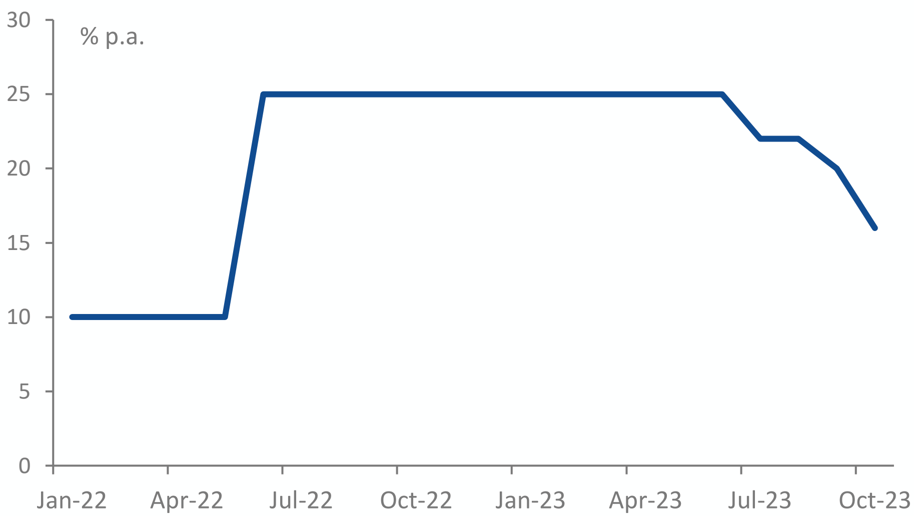
Inflation and monetary policy

Inflation



Source: NBU

Key policy rate



Source: NBU, end of month

Inflation

- Strong disinflation continues: Oct-23: 5.3% yoy
- Supply chains have further adjusted, FX rate is stable and good harvest with limited export possibilities
- But inflation is expected to start growing again to 10% in Dec-24

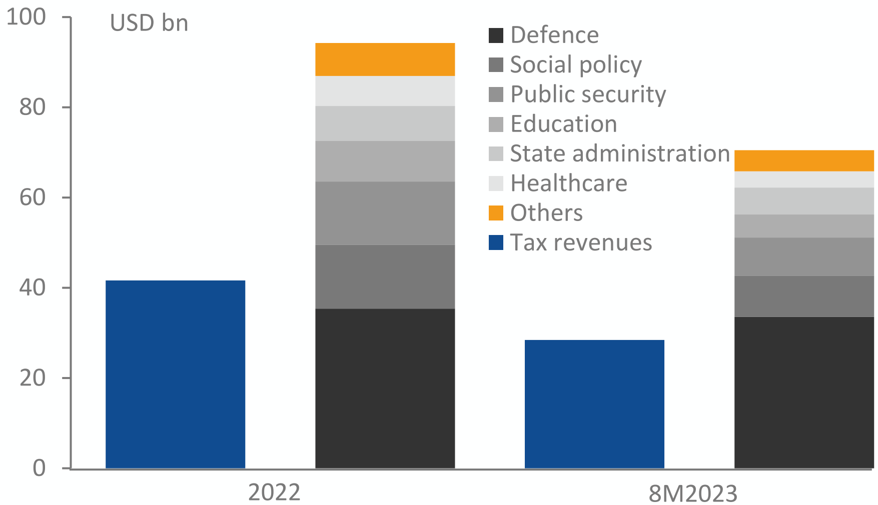
Key policy rate

- Policy rate easing cycle continues from 25% to 16% p.a. in three steps
- A further cautious cut is possible for Dec-20, leaving limited room for cuts in 2024

➢ **Inflation close to bottom**

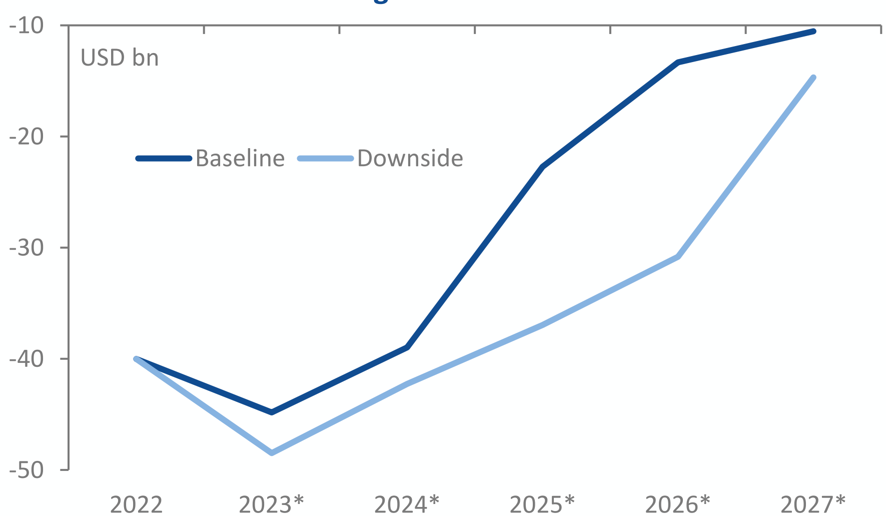
Budget

Gap between tax revenues and expenditures



Source: NBU

General government balance



*Source: IMF, *forecast*

Key budget dynamics

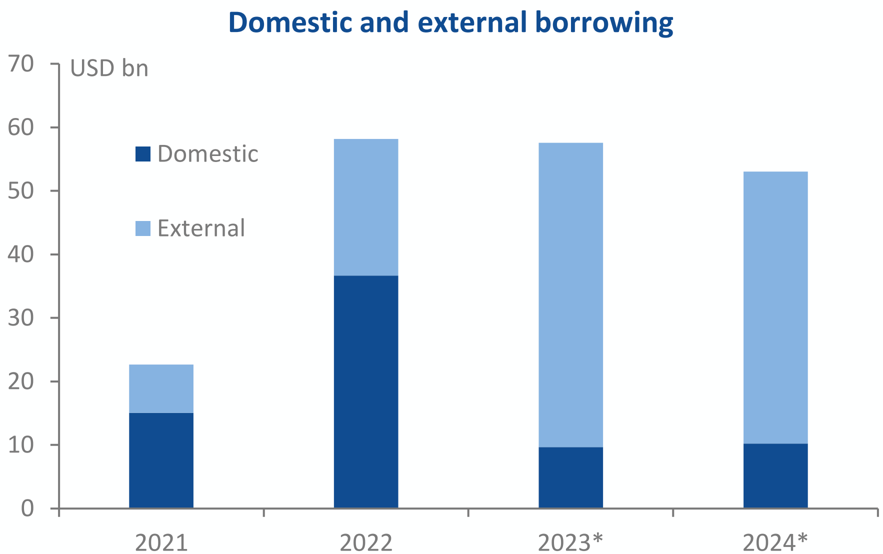
- Tax revenues are on a lower level than before the war
- Just enough to cover defence expenditures
- All other expenditures not covered by domestic revenues sources

Budget deficit

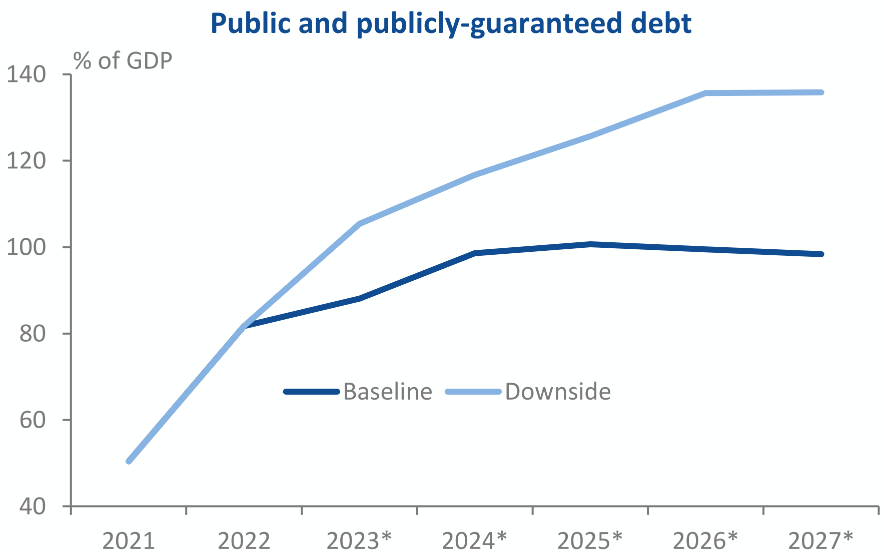
- Massive budget deficits of 26% and 21% of GDP in 2023 and 2024, resp.
- Even in an optimistic scenario, Ukraine must finance a cumulative budget deficit of USD 170 bn (> than 2023 GDP) between 2022 and 2027

- **Revenue increase strategy and its implementation vital to reduce budget gap and reliance on foreign aid**

Deficit financing and debt



Source: Cabinet of Ministers, *budget draft



Source: IMF, *forecast

Borrowing

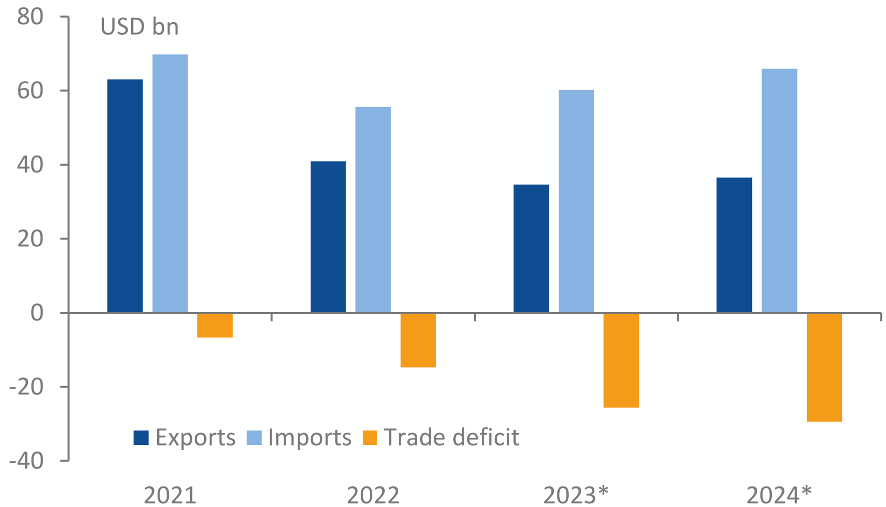
- External borrowing: concessional terms by partner states/IFIs key while no access to international capital markets
- Domestic borrowing: commercial banks and other investors, but currently no NBU financing

Public debt

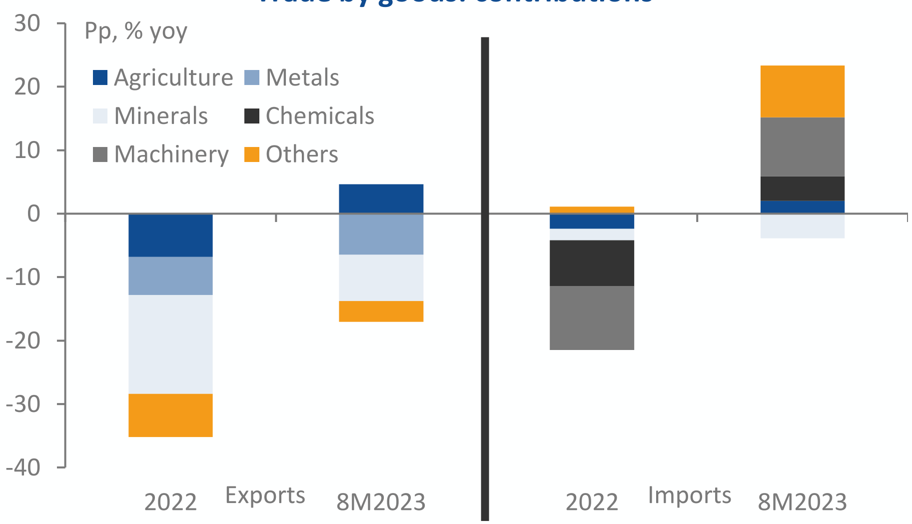
- Beyond 2023, debt is forecast to grow further and reach 100% of GDP
- IMF considers debt as unsustainable → requires future restructuring

- **Public debt sustainability concerns: grants are preferred over loans**
- **Debt restructuring is likely**
- **Usage of frozen RUS assets to improve debt dynamics?**

Foreign trade



*Sources: Ukrstat, *IER/GET forecast*



Source: Ukrstat

Trade

- » Since the war, the trade deficit expands
- » Exports fell by 35% yoy in 2022 and further decrease in 2023
- » Imports fell by 20% yoy in 2022 but are recovering, and will reach almost pre-war level in 2024

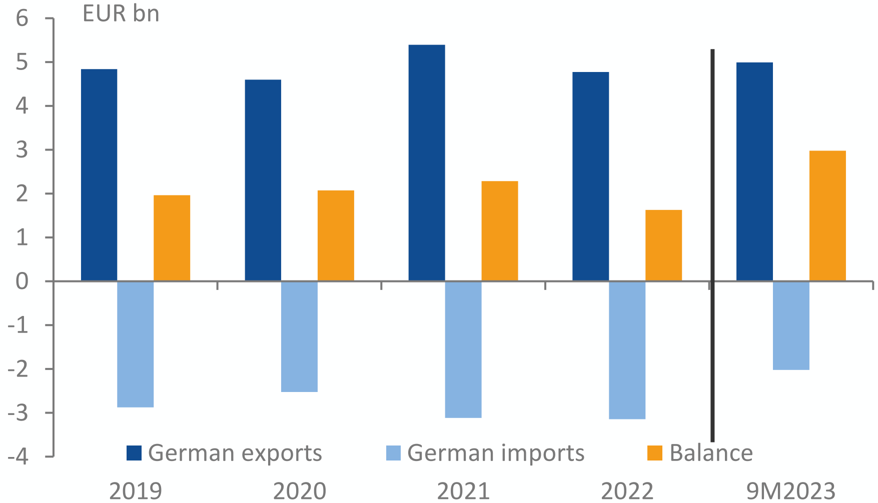
Trade structure

- » Exports: Metals and mineral goods main contributor of the decline, while agriculture recovers during 2023
- » Imports: Machinery drives the recovery
- » EU: 62% of exports and 47% of imports

➢ **Trade deficit increases → Support measures remain of great importance, esp. for metal and mineral sectors**

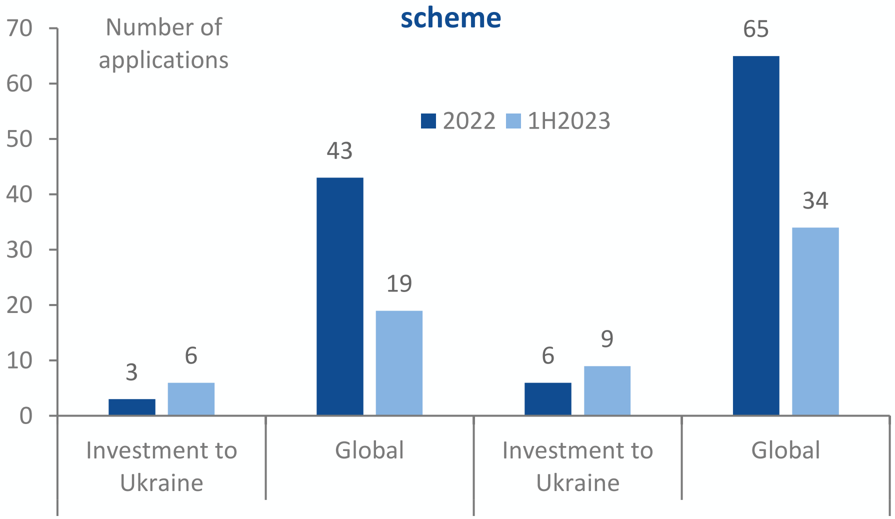
Economic ties between Germany and Ukraine

German trade with Ukraine



Source: German Federal Statistics Service; note: trade in goods

New and approved applications for the German insurance scheme



Source: Federal Ministry for Economic Affairs and Climate Action, Aug-23

Trade

- Trade increased even compared to pre-war, driven by GER exports (incl. military goods) exceeding already 2022 level after 9M2023
- GER imports fell by 6% compared to 9M2022 and by 9% compared to 9M2021

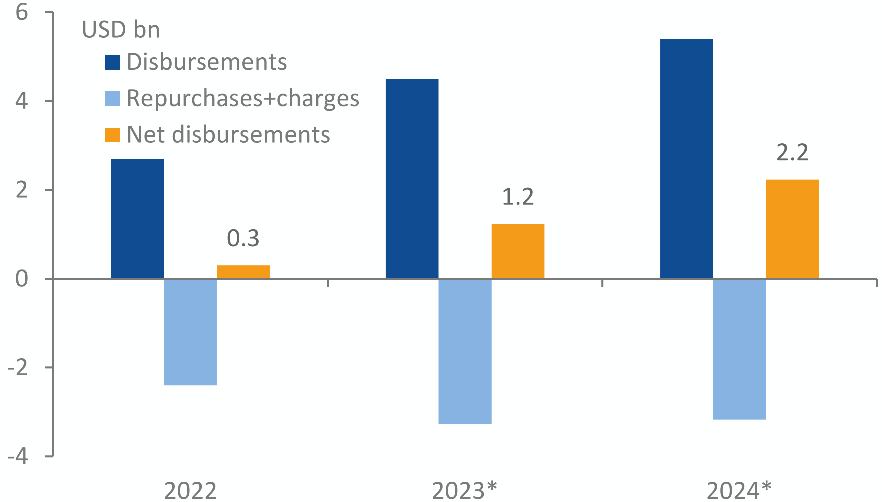
GER investment in Ukraine

- GER gov has kept insurance scheme for private investment explicitly open, covering:
  - Total losses due to war damages
  - Expropriation/nationalisation
  - Transfer risks since Aug-23
- 15 new applications and 9 approved guarantees since early 2022
- In total, 14 enterprises with investments of EUR 280 m (as of Aug-23) insured, ca. 8% of 2021 GER FDI position in UKR

➢ **Public support schemes drive GER exports and investment to Ukraine**

IMF programme

IMF disbursements gross and net



*Source: IMF *projection of maximum disbursement*

Timeline of structural benchmarks

	Financial sector	Fiscal sector	Monetary / exchange rate policy	Energy / corporate governance	Governance / Anti-Corruption
Benchmarks met		6	1	1	1
Sep/Oct-23	1	5		1	2
Dec-23		2			1
2024	2				

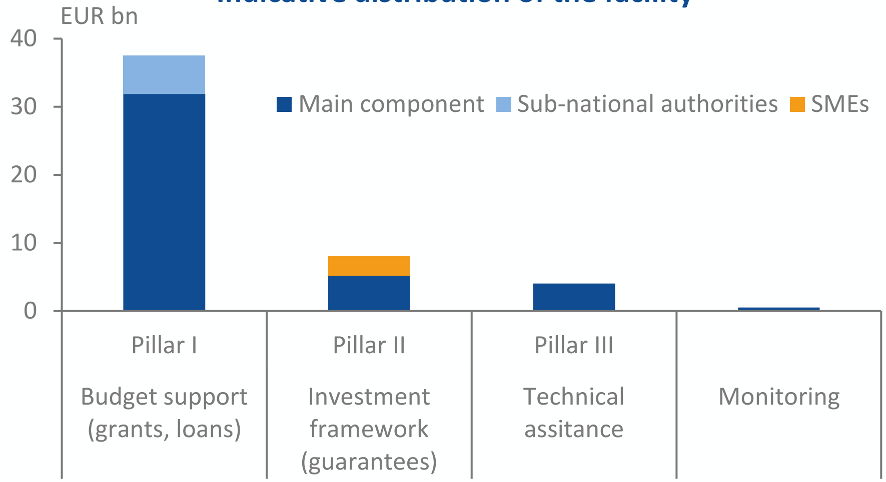
Source: IMF, Jul-23

- Extended Fund Facility (EEF) 2024-2027: Total volume: USD 15.6 bn
  - SLA on 2nd review in Nov-23: subject to approval by Board
- Net contribution of max. USD 3.4 bn for 2023/24 vs. fiscal gap of ca. USD 82 bn
  - Reason: Substantial repayments
  - Only a small role in closing the gap
- However, coordination role of conditionalities as key reform anchor
  - Ensuring macro-financial stability
  - Enhancing long-term growth after the war
  - Strong focus on fiscal sustainability: 13 out of 23 structural benchmarks

➤ **Intersection of financial aid, coordination and conditionality make IMF support unique and decisive**

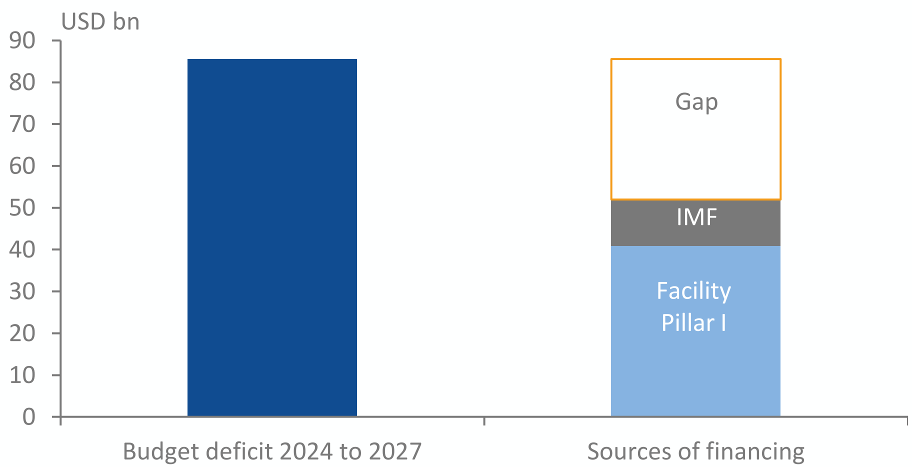
Ukraine facility by the EU

Indicative distribution of the facility



Source: European Parliament

Budget financing needs and commitments 2024-2027



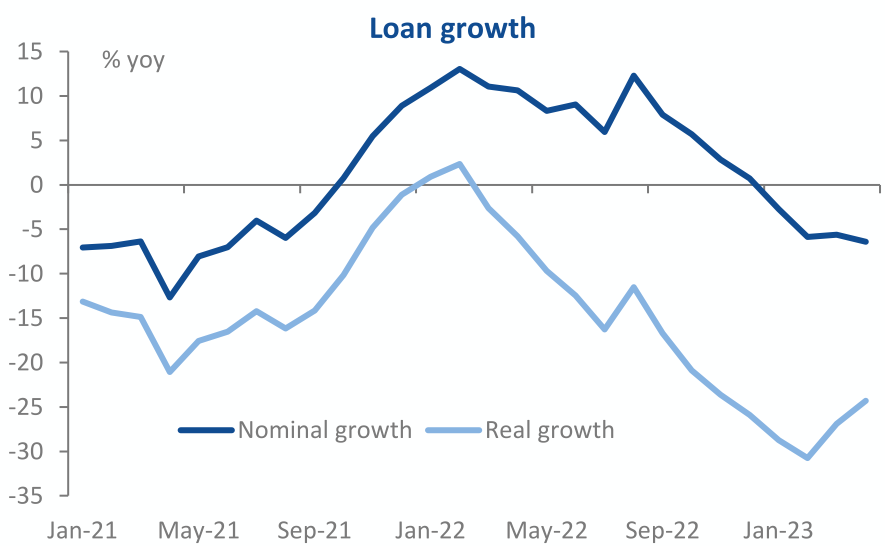
Sources: European Parliament, IMF estimate

- » European Parliament (EP) approved EC proposed facility for 2024 to 2027 of around EUR 50 bn
  - Pillar I: Budget support conditional on "Ukraine Plan" to be submitted by Jan-24 and approved by EU, focus on green transition, rule of law, social inclusion
  - Pillar 2: Investment guarantees
  - Pillar 3: EU accession assistance: It integrates **what would have been available under Instrument for Pre-accession**
- » But: Even in the case of full disbursement of the facility and IMF programme, a gap of more than USD 33 bn remains

- **Main part of the facility is "Ukraine Plan"**
- **Role of further donors to close fiscal gap: coordination of conditionalities?**

Banking sector

Source: NBU



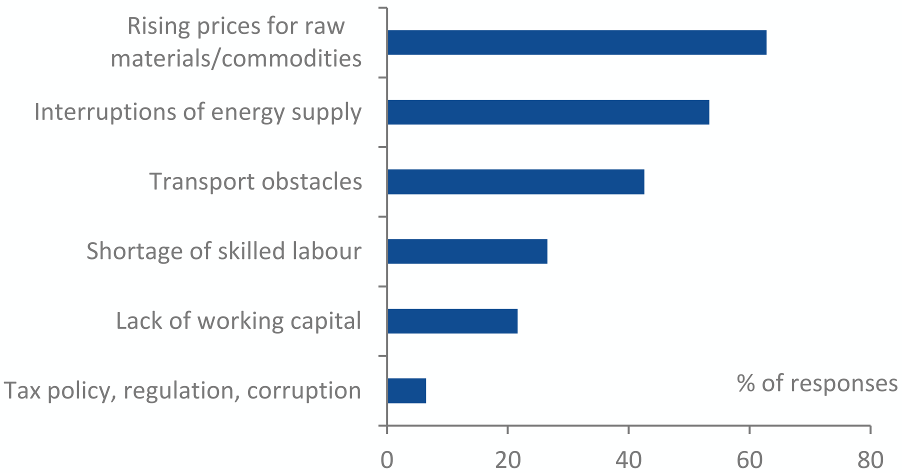
Source: NBU

- » 2022: Financial stress level was more profound than during previous shocks of 2014/2015 (level: 0.138) or COVID (0.03)
- » Policy measures decisive at the beginning to reduce financial stress
- » Measures aimed at liquidity provision, simplified access to cash for customers and FX stability
- » Recovery of loan growth not yet achieved, but vital for financing investment for recovery
  - – Lending fell strongly and decline would have been stronger without state subsidy (1/3 of UAH business loans)
  - – There is a lack of international funding support during the war

➢ **Sector stable but not yet prepared for its essential role in financing investment for reconstruction**

Business stimulation during war

Challenges most frequently mentioned



Sources: own diagram based on NBU, IER surveys, average over time until Sep-23

Challenges most frequently mentioned

Challenges	Evaluation	Comments
Rising prices	0	(-) VAT reduction (+) Fuel import policy (0) Price caps
Transport obstacles	++	(+) assessment of measures
Energy supply interruptions	++	(+) assessment of measures
Lack of working capital, financing	+	(+) assessment of measures but large fiscal resources
Shortage of qualified labour	+	(+) assessment of measures (-) many challenges unaddressed
Tax policy, regulatory burden, corruption	0	(-) tax rate reductions, (+) digitalisation

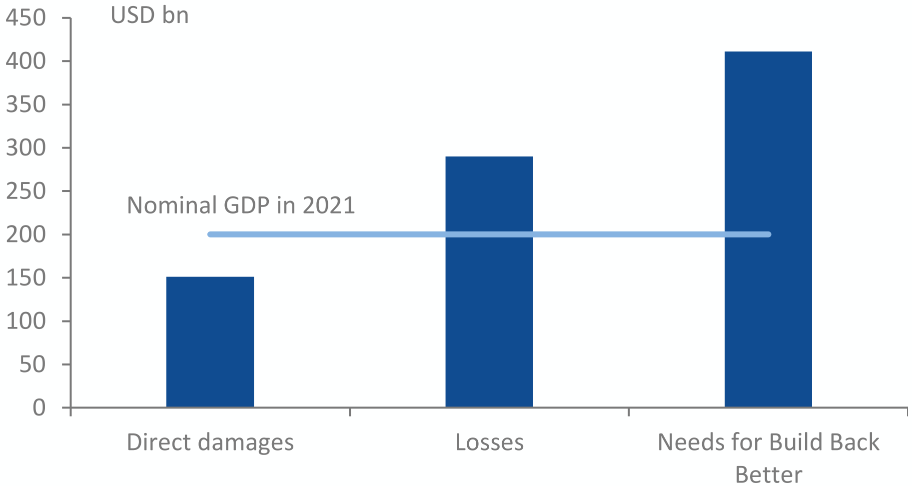
Source: own diagram based on NBU, IER surveys, average over time

- Business sector: just 11% perceive current their business financing standing as “good” in 2Q2023
- IER/GET identified six challenges mostly mentioned by businesses and assessed gov responses
- Transport obstacles + energy supply interruptions well tackled by government
- However, other challenges require further policy reactions, e.g.
  - Competition on energy market + further energy decentralization
  - Guarantee schemes for foreign + local investment → safety net for banks to reduce risk premia in financing
  - Focus on labour market supply side
  - Simplification, not reduction of tax burden, rule of law, digitalisation

- **Comprehensive government response**
- **Further measures needed to stimulate market-based business activities**

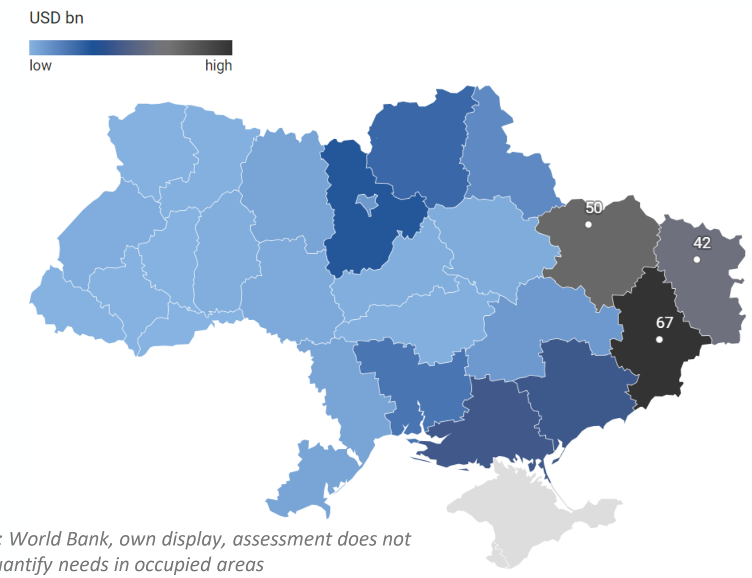
Economic reconstruction

Damage, loss and reconstruction needs assessment



Sources: World Bank, Feb-23, KSE, Apr-23 assessment does not fully quantify needs in occupied areas

Reconstruction needs by oblast by February 2023



Source: World Bank, own display, assessment does not fully quantify needs in occupied areas

- » Three concepts: Direct damages, economic losses, reconstruction needs
- » Reconstruction needs of a "Build Back Better" requiring ca. USD 411 bn, 44% in non-frontline oblasts
- » This amount goes on top of current (ongoing) fiscal needs
- » Reconstruction ongoing during the war to keep cities livable
- » Thus, challenges to financing:
  - Grants rather than loans
  - Legal steps to use frozen RUS assets
  - Public guarantees for private investment
  - International Coordination

➢ **Financing of reconstruction is still open, current efforts focus on fiscal gap**

About the German Economic Team

Financed by the Federal Ministry for Economic Affairs and Climate Action, the German Economic Team (GET) advises the governments of Ukraine, Belarus*, Moldova, Kosovo, Armenia, Georgia and Uzbekistan on economic policy matters. Berlin Economics has been commissioned with the implementation of the consultancy.
Advisory activities in Belarus are currently suspended.

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