

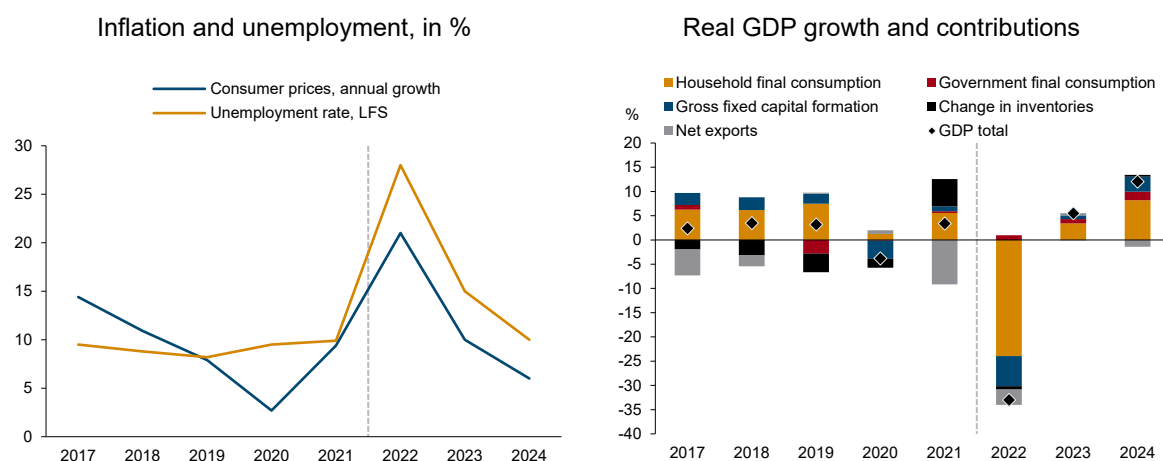


## UKRAINE: Economy adjusting to the war

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The Russian invasion is causing significant human loss and physical capital destruction in Ukraine. However, after a sharp contraction, Ukraine's economy has started to show signs of adjusting to the war conditions. External financial assistance is crucial both to keep the economy functioning and to achieve military victory. An accelerated recovery in the post-war period will depend on the establishment of a Marshall Plan-style international agency capable of providing adequate financing for the reconstruction of Ukraine's economy.

Figure 6.23 / Ukraine: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**Ukraine's economy has been severely affected by Russia's war, which is now in its eighth month...** As of the beginning of September, the damage caused to Ukraine's infrastructure was estimated at USD 114.5bn (or 58% of 2021 GDP).<sup>31</sup> Some 422 enterprises had been totally or partially destroyed, while the assets of the basic metals industry, one of the key industrial sectors in Ukraine, had been almost completely wiped out. According to the UN High Commissioner for Refugees, more than 7.6m refugees have been registered across Europe (with 4.2m individual refugees registered for temporary protection or similar national protection schemes), while more than 6.9m people have been internally displaced since 24 February.

<sup>31</sup> The assessment is the result of joint work by the Kyiv School of Economics and government authorities under the leadership of the Ministry of Reintegration of Temporarily Occupied Territories, the Ministry for Communities and Territories Development and the Ministry of Infrastructure, in cooperation with other ministries and partner organisations under the umbrella of the National Council for the Recovery of Ukraine from the Consequences of the War. <https://kse.ua/about-the-school/news/due-to-the-last-estimates-damage-caused-to-ukraine-s-infrastructure-during-the-war-is-114-5-bln/>

**...but appears to be adjusting to the new reality of operating in conditions of war.** The Ministry of Economy estimates that in August 2022, the real GDP decline slowed to about 35% in annual terms, having falling by 37.2% year on year in Q2. According to a recent survey of small and medium-sized enterprises carried out by the Center for Innovations Development, Entrepreneurship and Export Promotion Office, in conjunction with the Advanter Group,<sup>32</sup> the number of businesses that have fully or almost fully suspended their operations had fallen from 80% in March to 40% in July. We expect that for the full year the economy will contract by about a third.

**One positive factor has been an increase in the export of agricultural commodities** after an agreement was signed by Ukraine and Russia on 22 July for a grain shipping corridor in the Black Sea. Still, the volume of exports languishes at less than half the 2021 level. At the current rate, it will take around six months to ship the grain remaining from last year's harvest through the three ports included in the pact (with the help of rail exports).<sup>33</sup> Given that situation, if farmers are unable to sell part of their harvest, they are unlikely to have sufficient funds to invest in their fields, which means that winter sowing and next year's harvest will be significantly lower than in 2022.

**A significant positive development has been an increase in the external financing of the state budget,** which is crucial in keeping the economy functioning, as fiscal revenues have fallen dramatically because of the economic downturn, while expenditure has risen to finance the military effort. In August, the amount of assistance rose significantly (to USD 4.7bn), thanks to a USD 3bn grant from the US. As of 6 September, total international financial support exceeded USD 19bn (about 15% of forecast 2022 GDP). This leaves USD 16.6bn of aid promised but not yet disbursed, with the EU having disbursed only EUR 1bn of the EUR 9bn pledged. The share of foreign aid going to finance the budget deficit has been gradually increasing since the start of the war, and reached 57% in August. This relieves the pressure on the National Bank of Ukraine (NBU) to purchase domestic government bonds, a move that would have had a strong inflationary effect.<sup>34</sup>

**As the war is expected to drag on for at least another year, the external financial assistance needs will remain high.** The draft law on the central government budget for 2023, approved by the government on 13 September, envisages a budget deficit at the level of 20% of GDP, to be covered mainly by financing from the US, the EU and the International Monetary Fund. National security and defence account for 45% of the budget expenditure envisaged.

**Unemployment remains very high, at about 30% in August 2022, with internally displaced persons (IDPs) disproportionately affected.** According to a survey by the International Organization for Migration in August 2022,<sup>35</sup> of those IDPs who were employed before the war, 60% had lost their jobs since their displacement, and in August only 33% of the IDPs aged 18-64 indicated 'salary' as their primary source of income. At the same time, companies that face rising costs and falling demand are quite cautious about hiring additional labour. According to an Institute for Economic Research survey,<sup>36</sup>

<sup>32</sup> <https://decentralization.gov.ua/en/news/15408>

<sup>33</sup> <https://www.reuters.com/markets/europe/even-with-un-deal-ukraine-faces-long-haul-shift-grain-mountain-2022-09-08/>

<sup>34</sup> For more on the recent fiscal developments in Ukraine, see T. Bogdan, Ukraine's public finances: Radical change in time of war, wiiw Monthly Report No. 10, October (forthcoming).

<sup>35</sup> <https://dtm.iom.int/reports/ukraine-%E2%80%94-internal-displacement-report-%E2%80%94-general-population-survey-round-8-17-23-august>

<sup>36</sup> <http://www.ier.com.ua/ua/institute/news?pid=6973>

in July only 15.6% of companies expected to increase their staffing in the next three months (in June, the figure was 17.4%); the majority (79.1%) did not expect any change.

**Inflation continues to accelerate.** Consumer prices increased in August by 23.8% year on year, and this figure is likely to rise to 31% year on year by December. In addition to global factors, prices have been rising because of the war. The destruction of production facilities and infrastructure is creating supply-chain disruption. At the same time, a slowdown in the rise in the cost of fuel (owing to a fall in global oil prices and the normalisation of logistics) and the government's freezing of gas and heat tariffs have constrained the growth of inflation.

**The National Bank of Ukraine was forced to devalue the hryvnia, which was contributing to the acceleration of inflation,** primarily through the cost of imported goods and components. On 21 July, the currency was devalued by 25% against the US dollar (to 36.6 UAH/USD), as maintaining the previous exchange rate was deemed unsustainable (it took more than USD 7bn of forex reserves to defend the previous exchange rate in May-June 2022). As the exchange rate on the cash forex market has increasingly been diverging from the official exchange rate (reaching about 41.5 UAH/USD by mid-September), we believe a further devaluation of the national currency is likely.

**The trade deficit widened dramatically, but the current account balance remains in a strong surplus.** Over the period January-July 2022, the trade deficit reached USD 10.0bn, compared with USD 0.7bn over the same period of 2021. The main reasons for this were a smaller decline in merchandise imports relative to merchandise exports, and a significant increase in services imports (of 71% year on year, to USD 13.0bn) on the back of spending by refugees abroad. Telecommunications and computer services, which accounted for about 9% of total exports in 2021, remained the only sector with rising exports (+26% year on year in January-July 2022). The current account, by contrast, had a surplus of USD 4.4bn, owing to a decline in the repayment of investment income and a more than threefold increase in inflows of secondary income on the back of external grants and humanitarian aid. This allowed the NBU to boost its gross international reserves to USD 25.4bn in August, which covers four months of future imports.

**Preparations for the heating season are complicated by challenges due to Russia's invasion.**

Ukraine is currently relatively well prepared for the heating season, as the gas accumulated in the storage facilities is at approximately the same level as this time last year, while demand for gas over the coming winter is forecast to be 19% less than last year. Domestic gas extraction is expected to cover almost 90% of gas consumption; however, according to the national oil and gas company Naftogaz, approximately 94% of its gas production is at high risk of having to cease because of the proximity of facilities to the front line. In addition, the possible destruction of the power lines at the Zaporizhzhia nuclear power plant – the largest in Europe – would be a serious blow to the supply of electricity this winter.

**We expect the Ukrainian economy to start a modest recovery in 2023 and growth to speed up significantly in 2024.** Although the war is likely to persist, the recent success of the Ukrainian counter-offensive suggests that it will probably be limited in scale. We assume that there will be continuous advances by the Ukrainian army, that nuclear weapons will not be used by Russia on the major urban areas, that the grain deal will continue and that there will be a greater influx of international aid. The economy will adapt further to conditions of war, and reconstruction work will continue on the main infrastructure in those territories freed from Russian occupation. Accelerated recovery in the post-war

period will depend on the establishment of a Marshall Plan-style international agency capable of providing adequate financing for the reconstruction of Ukraine's economy.

**The biggest risk to the forecast continues to be related to the duration and outcome of the war.**

Russia's poor military performance and economic troubles, as well as the apparent loss of support from China and India, point to the increased likelihood of a Ukrainian victory, but the course of the war is difficult to predict. The partial mobilisation announced by the Kremlin is not expected to significantly boost the Russian military advantage, as the new conscripts are largely untrained and unmotivated. If the willingness of Ukraine's allies to support it militarily and financially falters, that could have a crucial impact on both the country's military success and its macro-financial stability. If the war drags on for too long and job opportunities remain scarce, there is a risk that many of the refugees will not return to Ukraine, which will damage the prospects for its long-term economic growth. Last, but not least, the attacks by the Russian army on the Zaporizhzhia nuclear power plant increase the risks of nuclear disaster.

**Table 6.23 / Ukraine: Selected economic indicators**

	2019	2020	2021 <sup>1)</sup>	2021 January-June	2022	2022 Forecast	2023 Forecast	2024
Population, th pers., average	42,028	41,745	41,378	.	.	37,000	38,000	39,000
Gross domestic product, UAH bn, nom.	3,977	4,222	5,460	2,209	1,850	4,400	5,100	6,100
annual change in % (real)	3.2	-3.8	3.4	2.2	-27.3	-33.0	5.5	12.0
GDP/capita (EUR at PPP)	9,080	8,740	9,490	.	.	.	.	.
Consumption of households, UAH bn, nom.	2,918	3,054	3,736	.	.	.	.	.
annual change in % (real)	10.9	1.7	7.7	.	.	-35.0	5.0	12.0
Gross fixed capital form., UAH bn, nom.	701	564	679	.	.	.	.	.
annual change in % (real)	11.7	-21.3	7.5	.	.	-50.0	6.0	25.0
Gross industrial production								
annual change in % (real)	-0.5	-4.5	1.9	.	.	-40.0	10.0	15.0
Gross agricultural production								
annual change in % (real)	1.4	-10.1	16.4	.	.	.	.	.
Construction output								
annual change in % (real)	23.6	5.6	6.8	.	.	.	.	.
Employed persons, LFS, th, average	16,578	15,915	15,610	.	.	13,000	13,500	14,500
annual change in %	1.3	-4.0	-1.9	.	.	-16.7	3.8	7.4
Unemployed persons, LFS, th, average	1,488	1,674	1,712	.	.	5,060	2,380	1,610
Unemployment rate, LFS, in %, average	8.2	9.5	9.9	.	.	28.0	15.0	10
Reg. unemployment rate, in %, eop <sup>2)</sup>	1.2	1.6	1.1	.	.	.	.	.
Average monthly gross wages, UAH <sup>3)</sup>	10,497	11,591	14,014	.	.	11,900	14,400	17,600
annual change in % (real, gross)	9.7	7.5	10.5	.	.	-30.0	10.0	15.0
Consumer prices, % p.a.	7.9	2.7	9.4	8.3	15.1	21.0	10.0	6.0
Producer prices in industry, % p.a.	4.1	-1.6	40.8	.	.	20.0	8.0	5.0
General governm. budget, nat. def., % of GDP								
Revenues	32.4	32.6	30.4	34.3	43.7	40.0	30.0	30.0
Expenditures	34.6	37.9	33.9	34.9	62.6	65.0	50.0	38.0
Deficit (-) / surplus (+)	-2.2	-5.3	-3.4	-0.7	-18.9	-25.0	-20.0	-8.0
General gov. gross debt, nat. def., % of GDP	50.2	60.4	48.9	46.1	70.1	90.0	95.0	90.0
Stock of loans of non-fin. private sector, % p.a.	-9.8	-2.8	8.2	-2.1	4.8	.	.	.
Non-performing loans (NPL), in %, eop	48.4	41.0	30.0	37.2	29.7	.	.	.
Central bank policy rate, % p.a., eop <sup>4)</sup>	13.50	6.00	9.00	7.50	25.00	25.0	15.0	10.0
Current account, EUR m <sup>5)</sup>	-3,682	4,612	-2,744	-139	3,069	7,100	6,100	-1,400
Current account, % of GDP	-2.7	3.4	-1.6	-0.2	5.3	5.5	5.0	-1.0
Exports of goods, BOP, EUR m <sup>5)</sup>	41,146	39,527	53,301	22,760	18,923	45,900	57,300	65,900
annual change in %	12.2	-3.9	34.8	18.7	-16.9	-13.9	24.8	15.0
Imports of goods, BOP, EUR m <sup>5)</sup>	53,877	45,462	58,911	24,465	22,904	54,200	67,600	84,500
annual change in %	13.6	-15.6	29.6	15.1	-6.4	-8.0	24.7	25.0
Exports of services, BOP, EUR m <sup>5)</sup>	15,591	13,628	15,532	6,761	7,467	15,900	18,200	20,000
annual change in %	16.3	-12.6	14.0	0.7	10.4	2.4	14.5	9.9
Imports of services, BOP, EUR m <sup>5)</sup>	14,029	9,775	12,178	5,221	9,832	22,400	21,000	18,900
annual change in %	14.3	-30.3	24.6	6.0	88.3	83.9	-6.3	-10.0
FDI liabilities, EUR m <sup>5)</sup>	5,174	266	6,183	2,718	-146	600	.	.
FDI assets, EUR m <sup>5)</sup>	554	317	368	470	119	100	.	.
Gross reserves of CB excl. gold, EUR m <sup>5)</sup>	21,590	22,422	25,920	22,593	20,172	.	.	.
Gross external debt, EUR m <sup>5)</sup>	109,134	102,293	114,426	105,299	121,710	141,000	136,000	121,000
Gross external debt, % of GDP	79.4	74.6	67.7	62.3	94.0	109.0	111.0	87.0
Average exchange rate UAH/EUR	28.95	30.79	32.31	33.49	31.74	34.0	41.6	43.6

Note: Excluding the occupied territories of Crimea and Sevastopol and, with the exception of the population, excluding the temporarily occupied territories in the Donetsk and Luhansk regions. Due to the war in Ukraine, most of the usual statistical data are not being collected or published. This means that all Ukraine forecasts are subject to an unusually high degree of uncertainty.

1) Preliminary. - 2) In % of working age population, wiiw estimate. - 3) Enterprises with 10 and more employees. - 4) Discount rate of CB. - 5) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.