UKRAINE: Economy defying the odds

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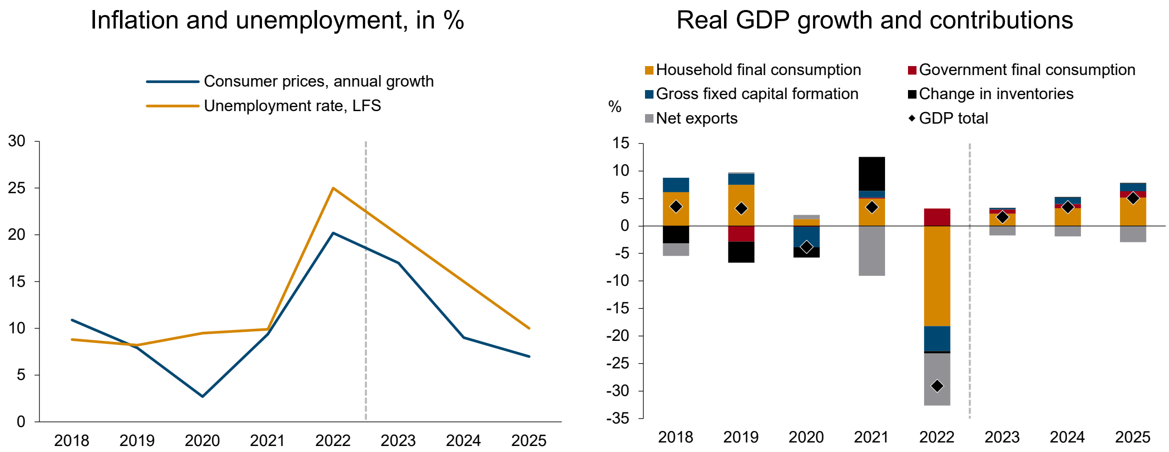
Ukraine's economy has been performing relatively well, considering the wartime conditions and the targeted destruction of its energy infrastructure by Russia. International financial aid will remain crucial for the economy's functioning in the short term. We expect economic growth to resume in 2023 and to accelerate in 2024-2025. But this forecast is subject to major downside risks related primarily to the intensity and duration of Russia's war in Ukraine and the continued willingness of international partners to support Ukraine.

Figure 5.23 / Ukraine: Main macroeconomic indicators



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

In 2022, Ukraine's economic decline was less dramatic than had been expected at the outset of Russia's full-scale invasion. GDP declined by 29.1%, year on year, and in US dollar terms was at the level of 2020 (about USD 160bn). This is quite a remarkable result, given that about 15% of the country's territory has been either occupied by Russia or is the scene of active military hostilities; about 15% of the population has left the country; a significant part of the infrastructure and industry assets have been destroyed;[27] and the Black Sea ports have been blockaded for non-agricultural exports.[28] The economy could have suffered an even smaller decline, had it not been for Russia's missile attacks

27 According to the Kyiv School of Economics, as of December 2022, the total amount of documented damage to Ukraine's infrastructure due to the full-scale invasion launched by Russia on 24 February 2022, was estimated at USD 137.8bn at replacement cost (or 86% of GDP).

28 For agricultural exports, access to the seaports was blocked until the establishment of the Black Sea grain corridor in July 2022.

on the country's electricity infrastructure in the autumn, which caused damage of between 1.9% and 3.6% of GDP for the whole year, according to calculations by the National Bank of Ukraine (NBU).

Industrial production and construction have been hit hard by the war and in 2022 contracted by 37% and 65%, respectively (both year on year). Among the industrial sectors, it was the chemical industry and metallurgy that were worst affected by the energy shortages and the lack of export possibilities – they lost about two thirds of their output in 2022. Non-durable consumer goods sectors, supported by domestic and external demand, have been able to withstand the wartime conditions somewhat better, and the decline in their production in 2022 was 24%, year on year.

Things seem to be looking up in 2023, as business expectations are improving on the back of stabilisation of the situation in the energy sector. In April 2023, the country even returned to being an electricity exporter. In March 2023, the NBU's business expectations index increased to 49.5 (from 45.0 in February) and almost reached the 'neutral' level of 50.0. Some sectors are already more optimistic than others: the index exceeded 50.0 in trade (53.6) and industry (51.2). This year economic activity is expected to revive and industrial production should achieve a slight positive growth. That said, the forecast is subject to a high level of downside risks: primarily the further destruction of infrastructure and the fixed capital assets of enterprises, and continuing bottlenecks in transport logistics.

Consumer price inflation has been falling quite rapidly and should be well below 20% by the end of the year. Having reached 26.6%, year on year, in December 2022, it dropped to 21.5%, year on year, in March 2023, with prices declining for some food categories and transport services. The main factors behind the better figures are the stabilisation of electricity supplies, lower global energy prices and an improved situation on the forex market. By the end of 2023, average annual inflation is expected to slow to 17%, and by 2025 to reach 7%. In the coming years, inflation will decelerate more rapidly, thanks to the receding security risks, the recovery in logistics and better harvests.

Exports decreased sharply in 2022, but the decline was not uniform across sectors and resulted in big changes in the export structure. The fall in merchandise exports amounted to 35%, year on year, in US dollar terms, while services exports did not decline so dramatically – by just 12%, on the back of a strong performance by IT services exports (which increased by 6%). Agri-food exporters were able to benefit from the Grain Deal, which partly de-blockaded the Black Sea transport corridors, and from better access to the markets of the EU, which adopted a regulation allowing for temporary full trade liberalisation and the suspension of trade protection measures for one year, as from June 2022. The preliminary data show that this measure contributed to a recovery in Ukraine's exports to the EU of products under the Deep and Comprehensive Free Trade Area's Tariff Rate Quotas, with a significant increase in exports of poultry, eggs, milk powder, butter, sugar and oil seeds. As a result, the share of agri-food exports increased to 53% in 2022 (9 percentage points (pp) higher than a year before), and the EU's share of the country's merchandise exports increased to 57% (23 pp up on 2021). At the same time, the share of metals in exports dropped to 14% of the total (about two thirds of the previous level), as the sector lost its factories in occupied territories and did not have access to seaports.

After a sharp decline in 2022, private consumption is expected to revive slightly this year. Last year final demand contracted sharply – a consequence of a large share of the population fleeing the country; a decrease in real household incomes, brought about by a contraction in real wages (of 12%, year on year) and pensions; and persistently high unemployment, especially among internally displaced people, among whom the figure reached 51% in February 2023.[29] In Q1 2023, private demand started to show some sign of recovery, as consumer sentiment improved, and retail trade revived in March 2023 – 95% of retail chains and shops were operating. The labour markets have been recovering as well, as evidenced by the rapid rise in the number of vacancies, which serves to push wages up. The growth in real wages in 2023 will also be supported by payments in the public sector, especially to the military.

International aid remains critical if the economy is to function under wartime conditions, as foreign financing is an important source of budget deficit coverage. As of the end of March 2023, the amount of international aid received since February 2022 exceeded USD 44bn. On 21 March 2023, Ukraine and the IMF reached staff-level agreement on a four-year Extended Fund Facility (EFF) arrangement of USD 15.6bn, which was ratified by the IMF's board on 31 March. This is the first time that the IMF has lent to a country at war. Following the budget amendments enacted on 21 March (related to extra expenditure for the army), the budget deficit target for 2023 was raised to USD 49bn (around 27% of forecast 2023 GDP). The government expects to finance it via foreign borrowing/grants (with the EU having already pledged to provide about half of the amount; the US – USD 13.4bn; and Japan – USD 5.1bn) and financing obtained directly from the IMF, and by using the IMF assistance to secure additional funds from other sources, as well as through the domestic borrowing market.

The inflow of foreign financing supports macro-financial stabilisation in the country and will be of critical importance during the forecast period. With increased inflows of external financial aid, the NBU could accumulate gross international reserves: between September 2022 and March 2023, these increased by USD 3.2bn to reach USD 31.9bn (exceeding four months' worth of imports). Depreciation pressures have been easing, as evidenced by decreasing NBU intervention on the forex market and a narrowing of the gap between the cash and non-cash exchange rates. If foreign financing continues to arrive in line with the Ukrainian government's needs, the NBU will be able to avoid having to provide monetary financing of the budget deficit, and the macro-financial situation should remain relatively stable over the forecast period.

We forecast that the economy will grow only modestly in 2023, with growth speeding up significantly in 2024-2025. Exports are expected to recover, supported by the overall revival in economic activity and an improvement in logistics. Private consumption will be supported by a recovery of the labour market and the partial return of refugees. Continued operation of the Black Sea grain corridor is crucial to avoid economic fall this year. Although the war is likely to persist, the recent battlefield dynamics suggest that it will probably be limited in scale. The economy will adapt further to conditions of war, and reconstruction work on the main infrastructure in those territories freed from Russian occupation will boost investment. Accelerated growth in 2024-2025 is conditional on there being no escalation of the war or any further deterioration in security; on a favourable outcome to the US presidential elections in 2024; on uninterrupted foreign financial and military aid; and on there being no further increase in the number of refugees from Ukraine.

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29 According to the Rating survey https://ratinggroup.ua/en/research/ukraine/kompleksne_dosl_dzhennya_yak_v_yna_zm_nila_mene_ta_kra_nu_p_dsumki_roku.html

Downside risks to the forecast are especially high for the period after the US presidential elections in November 2024. Although there continues to be strong bipartisan backing for Ukraine among US voters (with 84% of Democrats and 70% of Republicans in favour of at least some US involvement), support for the provision of aid to Ukraine (and especially for the transmission of government funds direct to the country) has waned somewhat, especially among Republican voters.[30] The issue of how involved the United States should be in supporting Ukraine has gained prominence in the Republican presidential primary campaigns, and the GOP's potential presidential candidates remain divided on whether Russia's invasion of Ukraine amounts to a critical threat to America's interests. A win by Trump or some other candidate with similar views could mean a reversal of US foreign policy and would be a blow to Ukraine's military capabilities and economy.

Looking on the bright side, the strongly negative voter sentiment toward Russia could prevent politicians from changing course too abruptly. Gallup's 2023 World Affairs poll, conducted in February 2023,[31] finds that 90% of Americans hold an unfavourable opinion of Russia, which makes it the fourth country in the history of Gallup's polling to register a sub-10% approval score (after Iran, Iraq and North Korea). At the same time, 68% have a favourable opinion of Ukraine, 6 pp higher than a year ago. According to the Gallup web survey conducted in January 2023,[32] a stable 65% of Americans prefer that the US support Ukraine in reclaiming its territory, even if that results in prolonged conflict. Similar trends have been observed in the EU, where a recent multi-country poll for the European Council on Foreign Relations shows that Europeans have become more united in their support for Ukraine since last year, and the desire for the war to end as soon as possible is no longer as popular.[33]

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30 https://apnorc.org/projects/acontinuing-support-for-u-s-involvement-a-year-into-the-war-between-russia-and-ukraine-a/

31 https://news.gallup.com/poll/1624/Perceptions-Foreign-Countries.aspx

32 https://news.gallup.com/poll/469328/one-year-later-americans-stand-ukraine.aspx

33 A poll was conducted in January 2023 in ten European countries: Denmark, Estonia, France, Germany, Great Britain, Italy, Poland, Portugal, Romania and Spain. https://ecfr.eu/publication/fragile-unity-why-europeans-are-coming-together-on-ukraine/

Table 5.23 / Ukraine: Selected economic indicators

	2019	2020	2021	2022 1)	2023	2024	2025
						Forecast	
Population, th pers., average	42,028	41,745	41,378	35,000	36,500	37,000	38,000
Gross domestic product, UAH bn, nom.	3,977	4,222	5,451	5,191	6,200	7,000	7,900
annual change in % (real)	3.2	-3.8	3.4	-29.1	1.6	3.4	5.0
GDP/capita (EUR at PPP)	8,810	8,570	9,410	9,030	.	.	.
Consumption of households, UAH bn, nom.	2,918	3,054	3,718	3,342	.	.	.
annual change in % (real)	10.9	1.7	6.9	-26.7	3.5	5.0	8.0
Gross fixed capital form., UAH bn, nom.	701	564	720	603	.	.	.
annual change in % (real)	11.7	-21.3	9.3	-34.3	2.0	10.0	12.0
Gross industrial production							
annual change in % (real)	-0.5	-4.5	1.9	-36.9	4.0	6.0	10.0
Gross agricultural production							
annual change in % (real)	1.4	-10.1	16.4	-30.0	.	.	.
Construction output							
annual change in % (real)	23.6	5.6	6.8	-65.1	.	.	.
Employed persons, LFS, th, average	16,578	15,915	15,610	13,000	13,500	14,000	14,500
annual change in %	1.3	-4.0	-1.9	-16.7	3.8	3.7	3.6
Unemployed persons, LFS, th, average	1,488	1,674	1,712	4,330	3,380	2,470	1,610
Unemployment rate, LFS, in %, average	8.2	9.5	9.9	25.0	20	15	10
Reg. unemployment rate, in %, eop 2)	1.2	1.6	1.1	.	.	.	.
Average monthly gross wages, UAH 3)	10,497	11,591	14,014	14,847	18,100	20,900	24,600
annual change in % (real, gross)	9.7	7.5	10.5	-11.9	4.0	6.0	10.0
Consumer prices, % p.a.	7.9	2.7	9.4	20.2	17.0	9.0	7.0
Producer prices in industry, % p.a.	4.1	-1.6	40.8	26.0	10.0	5.0	5.0
General governm. budget, nat. def., % of GDP							
Revenues	32.4	32.6	30.5	42.3	40.0	40.0	40.0
Expenditures	34.6	37.9	33.9	58.6	67.0	55.0	50.0
Deficit (-) / surplus (+)	-2.2	-5.3	-3.4	-16.3	-27.0	-15.0	-10.0
General gov. gross debt, nat. def., % of GDP	50.2	60.4	49.0	78.5	88.0	90.0	93.0
Stock of loans of non-fin. private sector, % p.a.	-9.8	-2.8	8.2	-3.1	.	.	.
Non-performing loans (NPL), in %, eop	48.4	41.0	30.0	38.1	.	.	.
Central bank policy rate, % p.a., eop 4)	13.50	6.00	9.00	25.00	20.0	15.0	10.0
Current account, EUR m 5)	-3,682	4,612	-3,278	7,619	4,800	-2,300	-8,200
Current account, % of GDP	-2.7	3.4	-1.9	5.0	3.1	-1.4	-4.6
Exports of goods, BOP, EUR m 5)	41,146	39,527	53,301	38,938	39,400	41,800	45,100
annual change in %	12.2	-3.9	34.8	-26.9	1.2	6.1	7.9
Imports of goods, BOP, EUR m 5)	53,877	45,462	58,911	53,478	55,600	62,400	72,300
annual change in %	13.6	-15.6	29.6	-9.2	4.0	12.2	15.9
Exports of services, BOP, EUR m 5)	15,591	13,628	15,532	15,329	15,200	16,000	17,200
annual change in %	16.3	-12.6	14.0	-1.3	-0.8	5.3	7.5
Imports of services, BOP, EUR m 5)	14,029	9,775	12,178	25,480	21,000	19,000	19,500
annual change in %	14.3	-30.3	24.6	109.2	-17.6	-9.5	2.6
FDI liabilities, EUR m 5)	5,174	266	6,717	512	.	.	.
FDI assets, EUR m 5)	554	317	368	32	.	.	.
Gross reserves of CB excl. gold, EUR m 5)	21,590	22,422	25,920	25,282	.	.	.
Gross external debt, EUR m 5)	109,134	102,293	114,426	123,924	125,000	130,000	135,000
Gross external debt, % of GDP	79.4	74.6	67.8	81.1	81.0	67.0	62.0
Average exchange rate UAH/EUR	28.95	30.79	32.31	33.98	40.0	42.1	44.3

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 and wiiw estimates. - 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.