Ukrainian economy during the war

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Key macroeconomic indicators

Indicator	Unit of measurement	Last reporting date	2020	2021	2022	2023	2024 (last reporting date)
Nominal GDP	UAH billion	2023	4222	5451	5239	6466*	…
Real GDP	as % of the previous year	2023	-3.8	+3.4	-28.8	+5.0*	…
Industrial production growth	as % of the previous year	9 months 2023	-4.5	1.9	-36.7	+2.4	…
Inflation	as % of the previous year	January 2024	+5.0	+10.0	+26.6	+5.1	+4.7
Gross fixed capital formation	% GDP	2022	13.0	13.2	11.6	…	…
Final consumption expenditures of households	% GDP	2022	72.3	68.2	67.8	…	…
Net exports of goods and services	USD billion	2023	-2.4	-2.7	-25.7	-37.7	…
Current account balance	USD billion	2023	5.3	-3.9	7.9	-9.8	…
UAH exchange rate	UAH per USD at the end of the period	19.02.2024	28.3	27.3	36.6	38.0	38.0
Balance of the State Budget of Ukraine	UAH billion	January 2024	-217.6	-197.9	-914.7	-1333.1	-14.9
Performing loans	as % of the previous year	December 2023	+9.3	+32.1	-14.2	+0.1	…
Interest rate on new corporate loans in UAH	% per annum	January 2024	10.5	9.0	16.6	19.3	18.1

* Government estimates

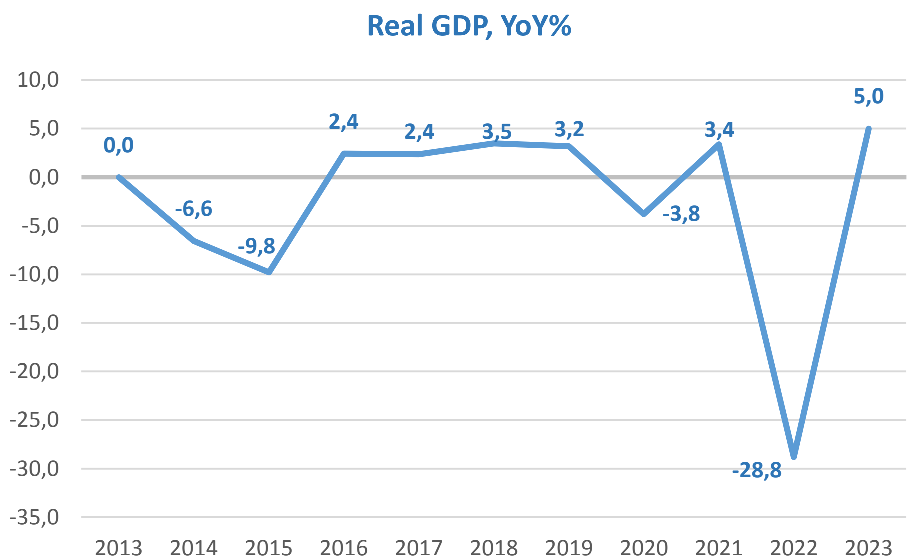
Macroeconomic forecasts of the NBU, the Government, and the IMF for 2024

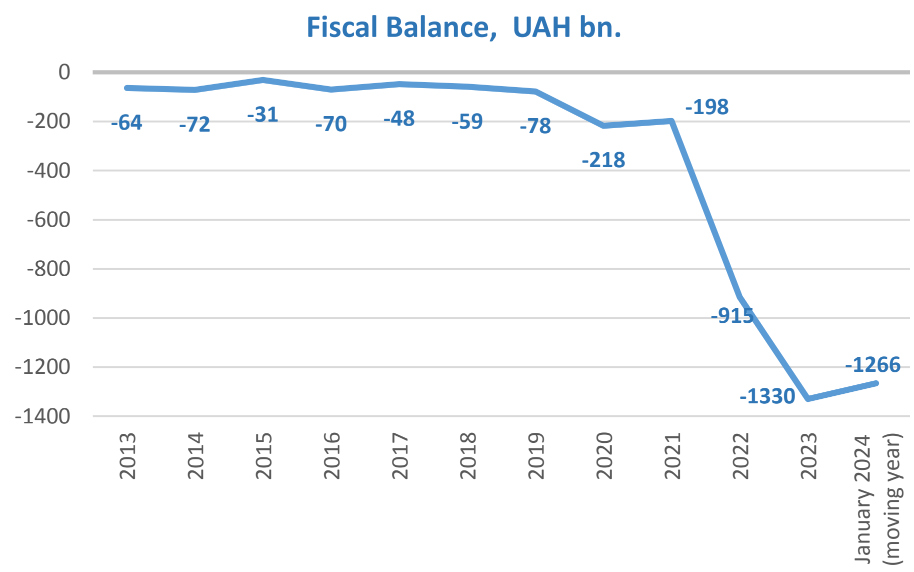
Indicator	2023 (Government's estimate)	2024 (forecast)		
		Government	NBU	IMF
Real GDP growth, %	+5,0	+4,6	+3,6	+3,5
GDP deflator, %	+18,6	+13,0	+12,4	+14,7
Nominal GDP, UAH bn	6466	7643	7580	7640
CPI, December to December, %	+5,1	+9,7	+8,6	+9,5
Average salary, % yoy (nominal)	+24,8	17,7	+16,2	+16,8
(real.)	+10,1	+8,5	+8,7	+8,5
Unemployment rate, %	18,8	13,4	16,2	13,9
Exports of goods and services, % yoy	-10,3	+9,0	+4,7	+13,5
Imports of goods and services, % yoy	+9,4	+5,9	+2,6	+2,0

Note: the table shows the data of the Government's forecasts from November 2023, the NBU's from January 2024, and the IMF's from December 2023.

- **Real GDP.** Real GDP growth forecasts vary between 3.5 and 4.5%.
- **Inflation**. Inflation is expected to accelerate to around 10% for the year across all forecasters.
- **Foreign trade.** The balance of foreign trade is forecast to improve: exports will significantly outpace imports. The most optimistic forecast for the external balance is given by the IMF.
- **Unemployment rate.** The NBU, the IMF, and the Government expect a slight decline in unemployment to around 15% of the labor force.
- **Real wages**. Real wage growth is estimated at around +8.5% across all forecasters.

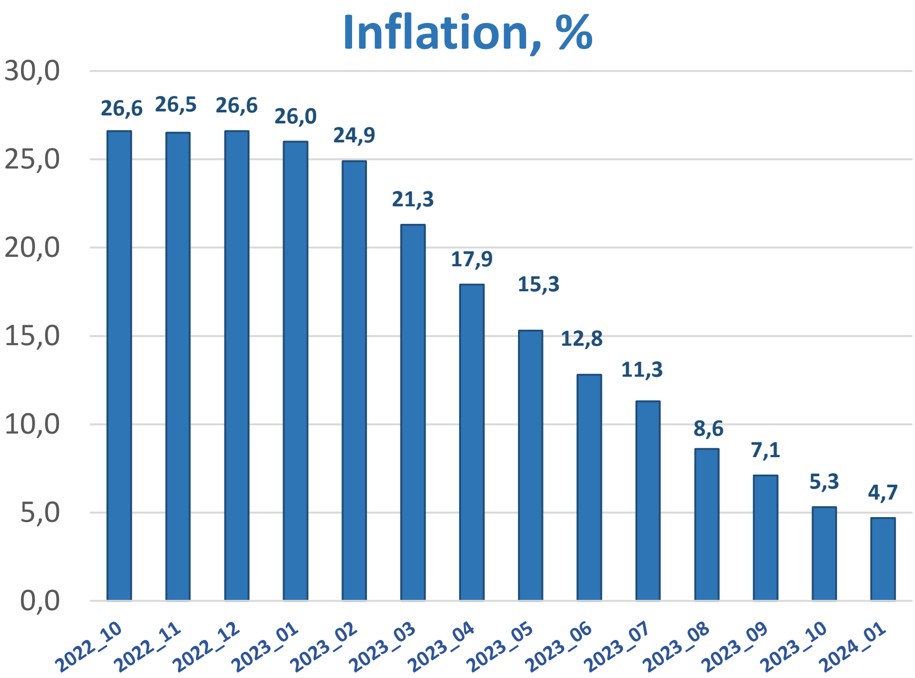
Economic recovery in 2023 will not compensate for the decline of 2022
State budget deficit for the year - 27% of GDP (excluding grants)

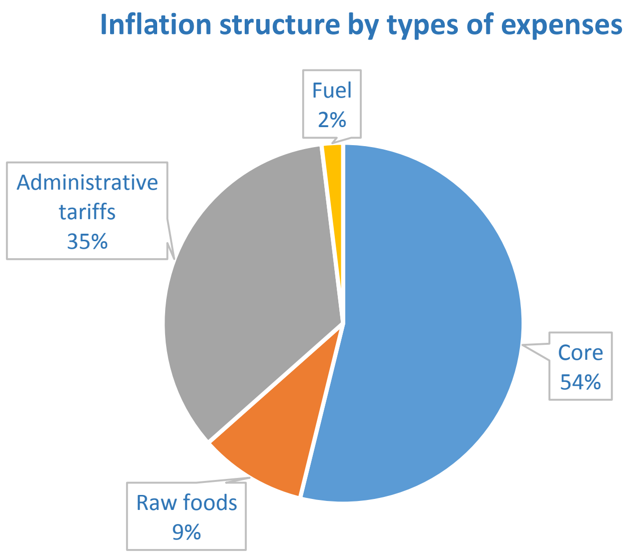




- **The production potential of the economy has declined significantly.** Real GDP in 2023 is only 75% of the pre-war level, millions of jobs have been lost, 6.4 million people (15% of the population) have left the country, and a significant part of the labor force has been mobilized for the needs of the front.
- **The losses caused by the war amount to hundreds of billions of** dollars (Total losses - $499 billion as of January 1, 2024, according to RDNA3 by the World Bank, EU and UN)
- **State budget expenditures in 2023 were only 56% covered by own revenues** (excluding international grants).
- **The economic contraction, coupled with an increase in military spending, led to an increase in the state budget deficit in 2023 to UAH 1.3 trillion,** and excluding international grants - to UAH 1.8 trillion (27% of GDP).
- **In January 2024, the execution of the state budget slightly improved** due to an almost twofold increase in tax revenues compared to January last year, as well as due to austerity measures (the reduction in expenditures was 13% compared to January 2023). As a result, the level of expenditure coverage by own revenues in January 2024 amounted to 90%.

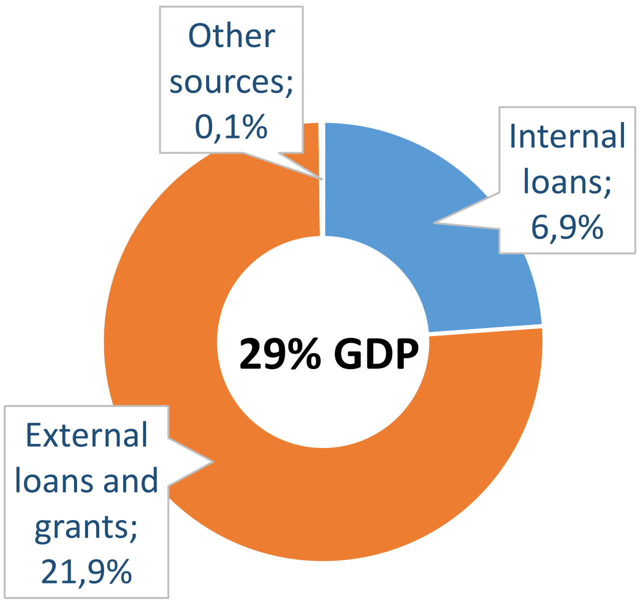
Inflation subsided much faster than expected in 2023

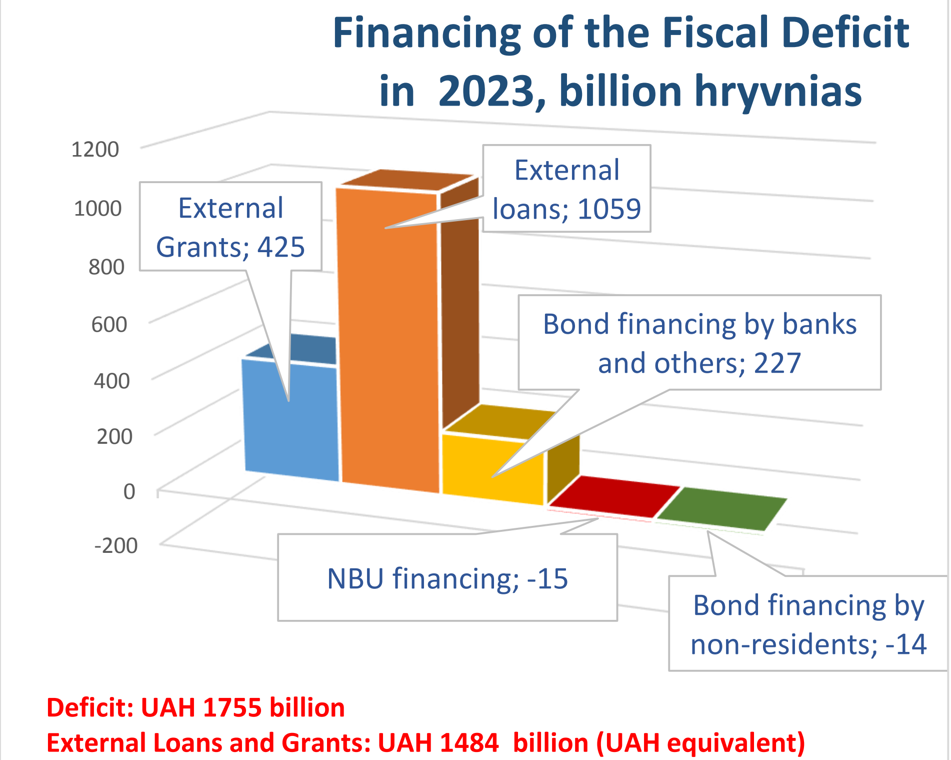




- **Inflation dropped sharply from 26.6% in early 2023 to 4.7% in January 2024.**
- Low price growth rates were reported for bakery products, eggs, oil, sugar, clothing and footwear, household appliances, railroad transportation services, and utilities. Relatively high price increases were recorded for meat, electricity, medical services, education, food and accommodation.
- **The main drivers of the decline in inflation are depressed demand, exchange rate stability, a bumper grain harvest, and a moratorium on utility tariff increases.**

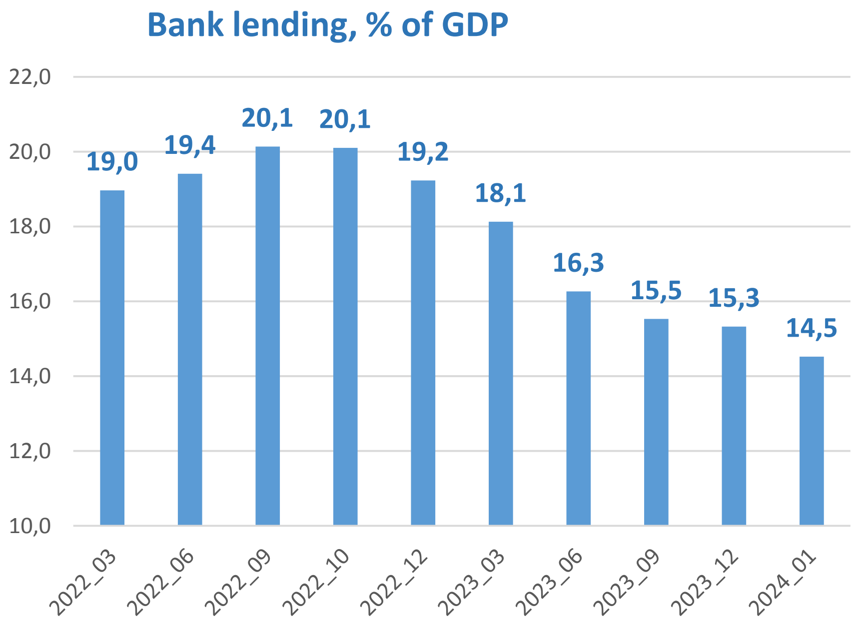
The government has huge borrowing needs and needs to reduce the cost of debt financing

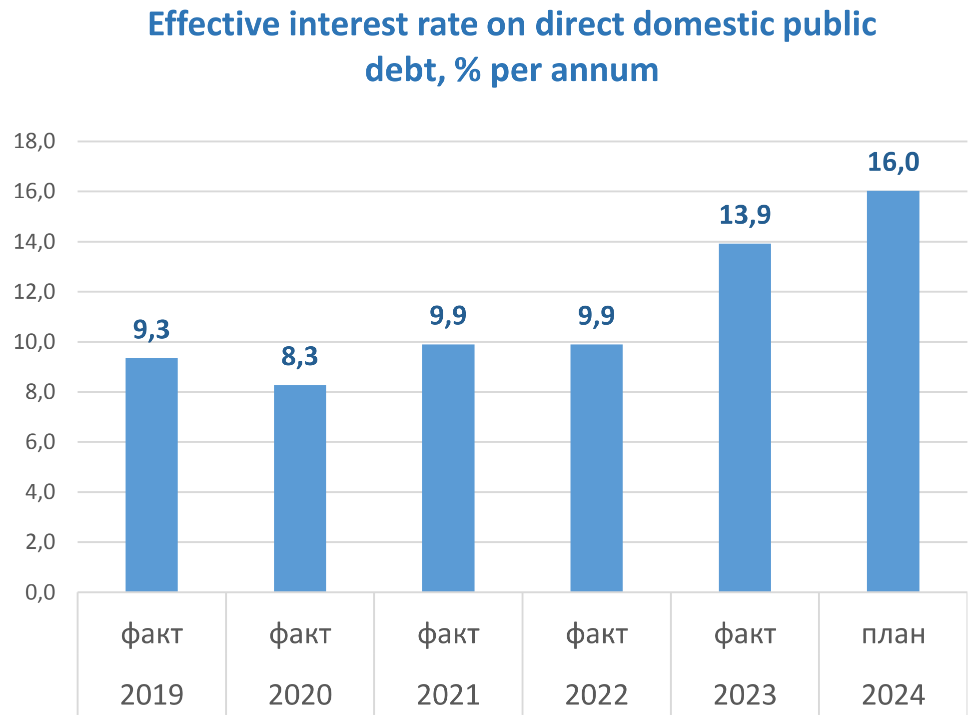




- **Own revenues cover only 53% of expenditures. Defense expenditures account for more than 50% of the state budget expenditures and have increased 20 times compared to pre-war 2021.** In order to finance the deficit and repay the debt, Ukraine needs to raise additional UAH 2.2 trillion or 28% of GDP in 2024. 99.9% of the borrowings are expected to be covered by new loans (of which 24% are expected to be covered by domestic loans).
- **However, the cost of domestic government borrowing has increased by 1.5 times compared to the pre-war period, while the inflation rate is half that of the pre-war period.** In 2024, the government will have to pay UAH 254 billion in interest on domestic government bonds, which is 2.5 times higher than pre-war levels, while domestic debt itself has grown only 1.5 times over the same period.

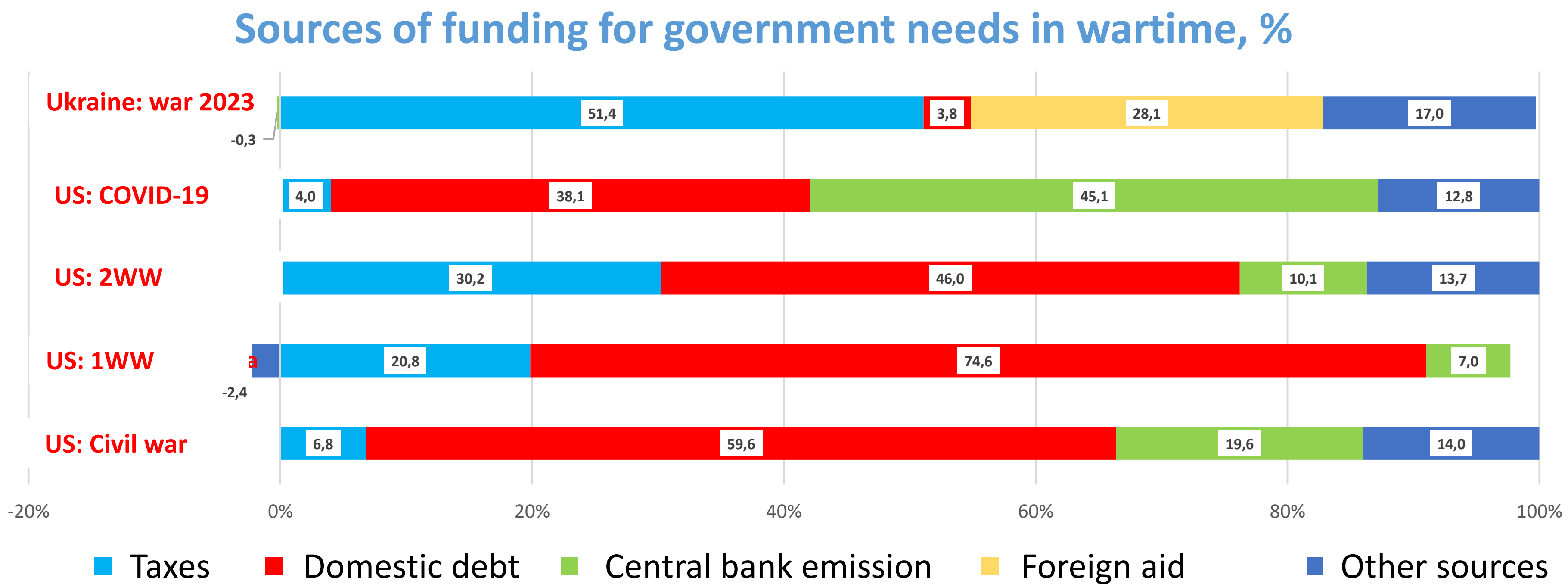
Lending to the economy declined, while the cost of financing the budget deficit increased





- **Lending to the economy declined sharply, from 20.1% to 14.5% of GDP as of early 2024.** About 13% of banks' loan portfolios are covered by the government's preferential programs. Excluding them, the drop in lending would be even more significant.
- **The cost of servicing the domestic public debt has increased significantly, from 9.9% per annum in 2021 to 16% per annum in 2024.** The Government is making new offerings of domestic government bonds at rates of up to 17% per annum.

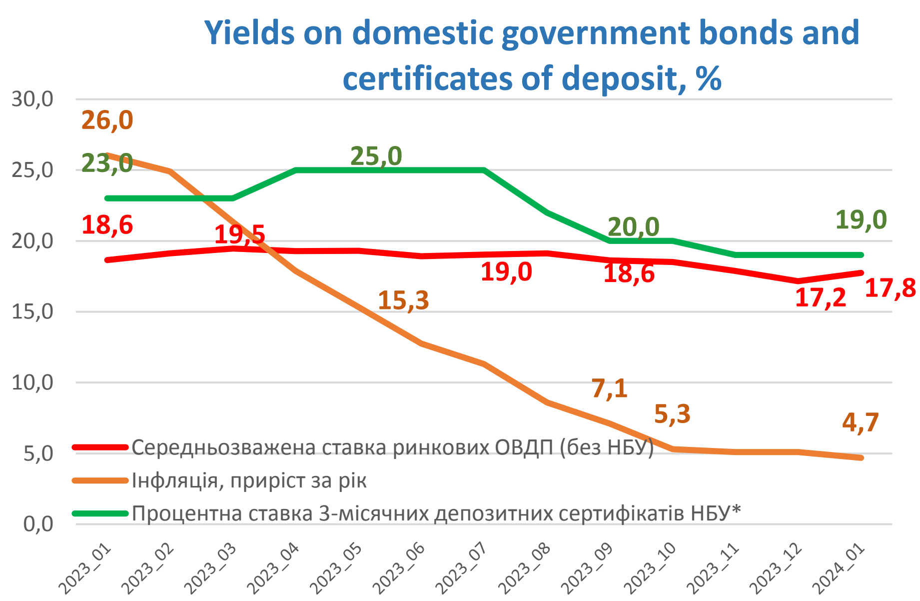
Domestic borrowings account for an insignificant part of the Government's financing needs



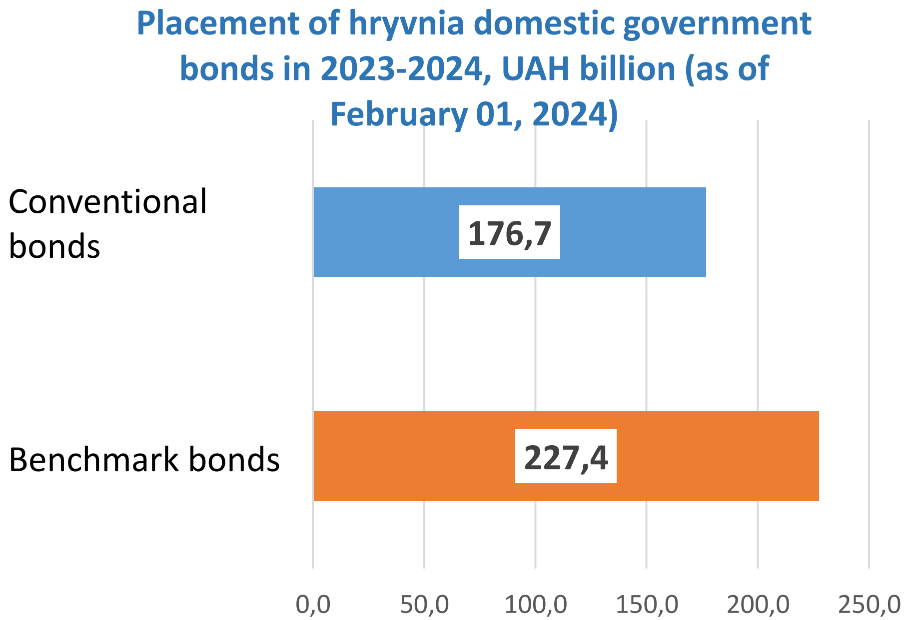
Source: Hall & Sargent (2023). Fiscal Consequences of the US War on COVID, own calculations based on MoF data

- **In 2023, only 3.8% of the Government's needs were financed by the expansion of domestic public debt.**
- **In the United States, in all military campaigns and during the COVID-19 pandemic, the bulk of budget expenditures were financed by domestic debt and Fed issuance, accounting for 55 to 80% of the needs.**
- The low share of debt in financing the Government's spending leads to maximization of tax levies, which hinders economic recovery and business development.

Banks invest less in domestic government bonds as the NBU's deposit certificates provide banks with much higher yields



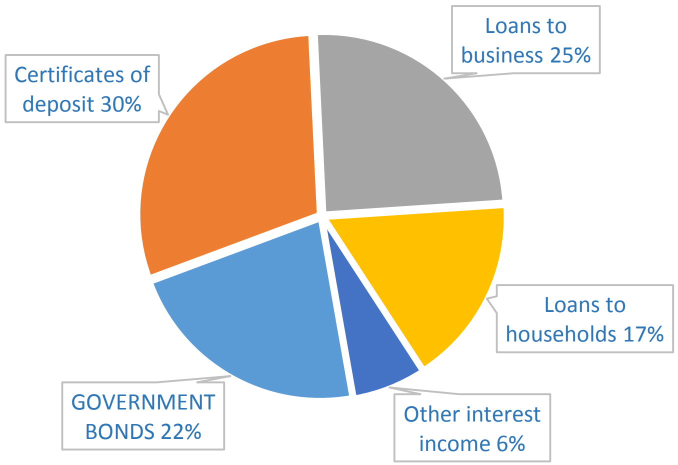
* до квітня 2023 зазначено ставку за депозитними сертифікатами овернайт



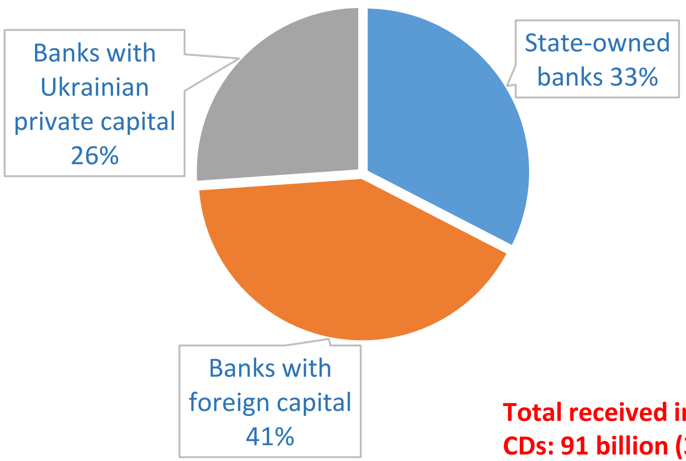
- **Banks have record high levels of free liquidity (over UAH 720 billion as of February 20, 2024), and the yields on domestic government bonds are three times higher than the annual inflation rate (up to 17% p.a. for 1-year domestic government bonds).** However, banks' activity in investing in domestic government bonds is low, as NBU certificates of deposit remain a more attractive instrument for them (providing yields of up to 19% per annum).
- **The NBU used administrative tools to attract banks' funds to purchase government bonds.** Since the beginning of 2023, banks have been allowed to cover 50% of their required reserves by purchasing benchmark government bonds. As a result, most of the domestic government bonds placed since the beginning of 2023 were benchmark government bonds to cover the banks' required reserves. However, as of the beginning of 2024, the potential pool of funds available to banks from investments in benchmark domestic government bonds is almost exhausted.
- **The market placement of domestic government bonds is mainly due to the rollover of redeemed domestic government bonds, which is not enough to finance the Government's large fiscal deficit.**

NBU deposit certificates account for more than 30% of banks' interest income

Structure of interest income of banks in 2023, %



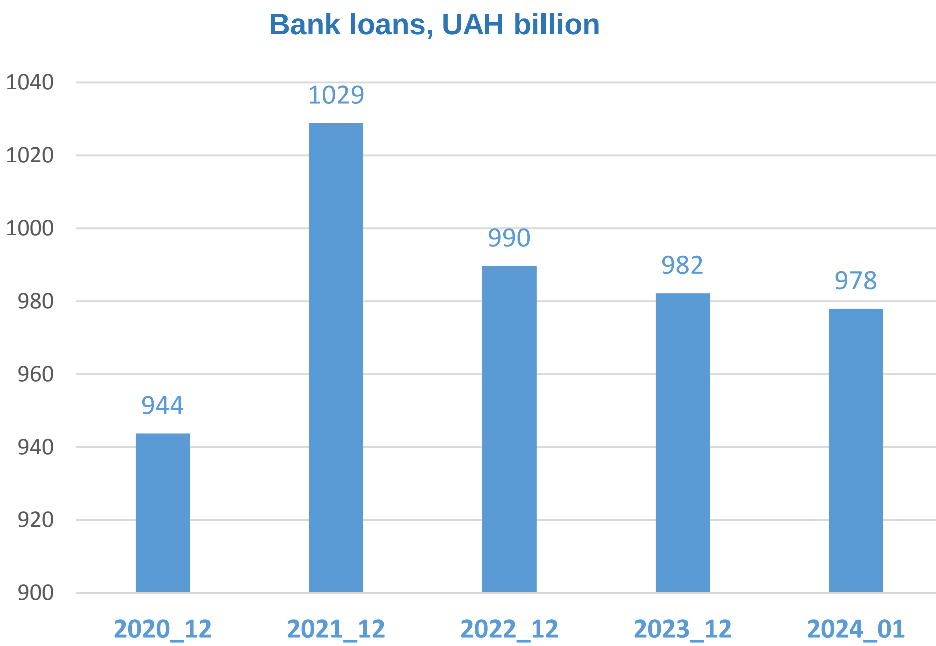
Interest on certificates of deposit in 2023 by banks, %

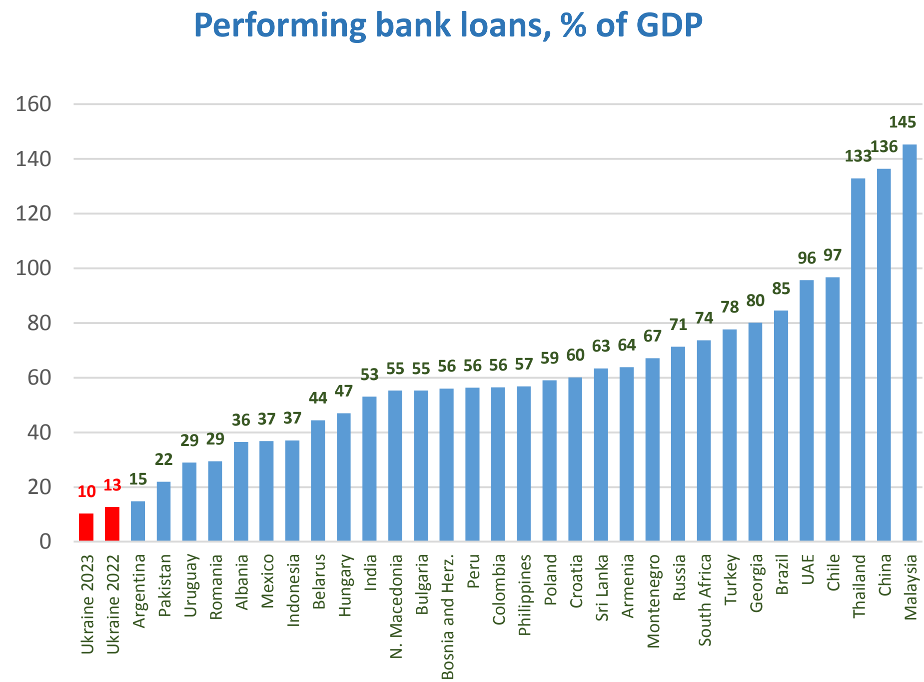


Total received interest on CDs: 91 billion (30% of interest income)

- **The structure of banks' interest income is dominated by income earned on NBU certificates of deposit (over 30%).** In total, in 2023, banks received UAH 91 billion in interest on deposit certificates.
- **Market sources account for only 40% of banks' interest income,** and if we take into account that most new loans are issued by banks under government programs, the actual level is even lower.
- **State-owned banks are more efficient financial intermediaries than other banks.** State-owned banks account for 37% of deposit certificates but over 52% of the banking system's loan portfolio.
- **The reasons for the low intermediation activity of banks include military risks, excessive amounts of bank liquidity, and high requirements for the lending industry.**

Banks reduced loans to the real economy…

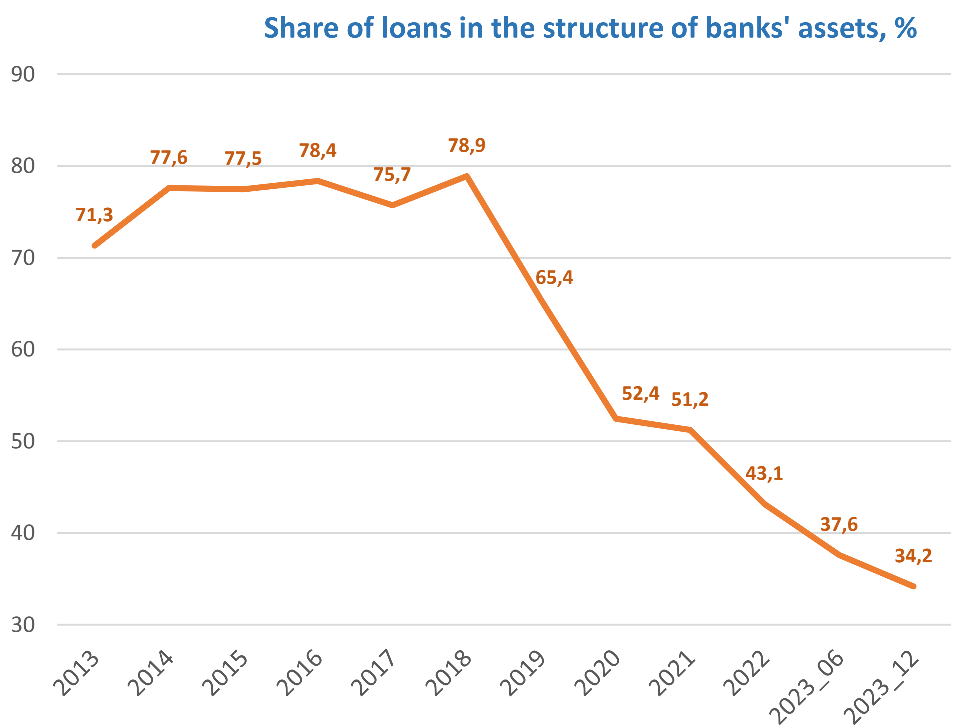


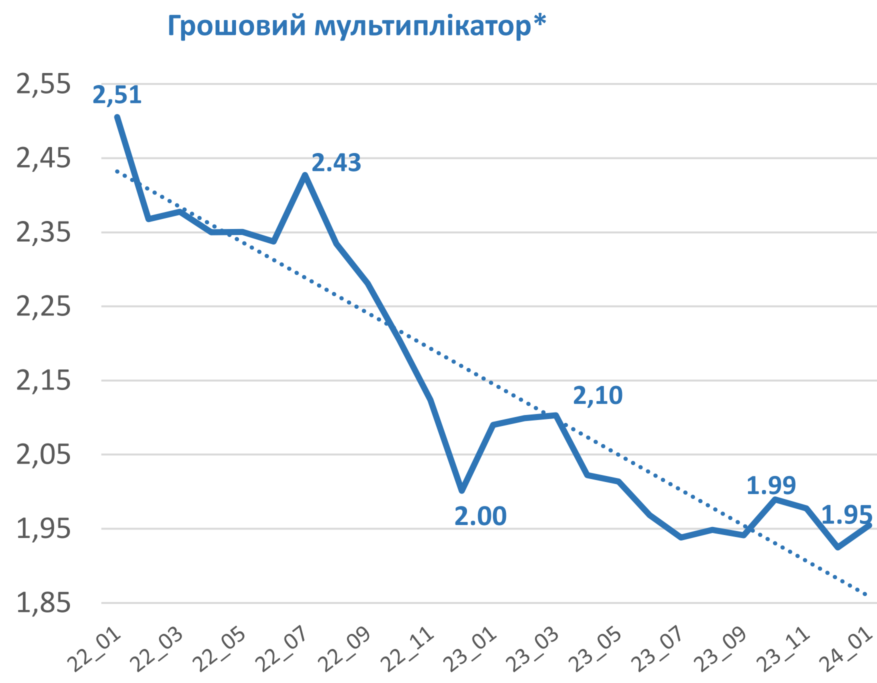


(Note: data from countries for 2021)

- **Compared to the pre-war period, bank lending fell both in absolute and relative terms. The nominal volume of total loans decreased by UAH 50 billion (5%), while the relative volume of performing loans fell from 15% to 10% of GDP.** At the same time, consumer prices increased by 34% and the hryvnia devaluation amounted to 25%. Ukraine is the country with the lowest level of bank lending in the world among emerging markets (Czech Republic - 70%, Poland - 60%, Georgia - 80% of GDP).
- **The government has significantly expanded its programs for providing preferential loans** (interest rate compensation, portfolio guarantees for SMEs), which helped to curb the decline in bank lending to the economy. Currently, 45% of operating hryvnia loans to businesses are concessional loans supported by the government.
- **Since the beginning of the war, bank interest rates on hryvnia loans to businesses have doubled to 20% per annum.** This restricts business activity and increases government spending to support lending.

The intermediary capacity of banks has significantly narrowed…

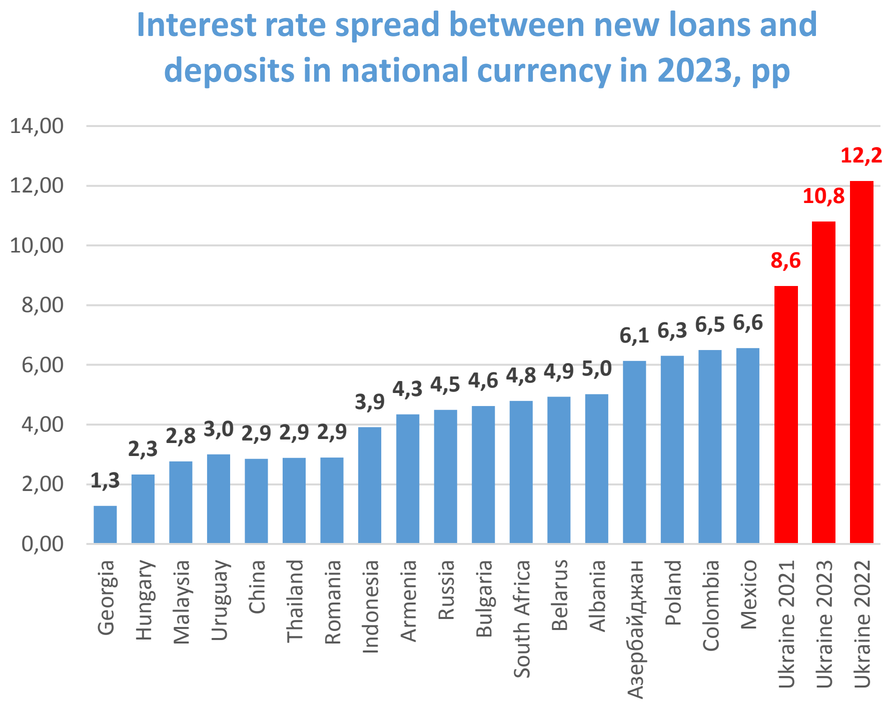


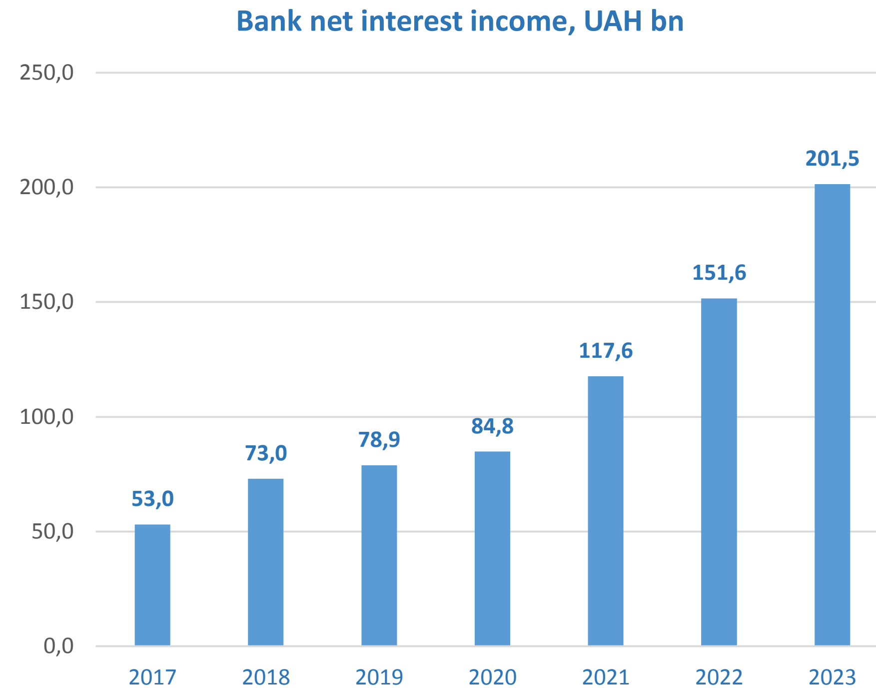


*Money multiplier calculated as M3/(monetary base + certificates of deposit)

- **Despite the increase in bank deposits, their redistribution for lending purposes remains extremely low** - only 28% of funds raised on deposits are redistributed for lending purposes (for reference: the ratio of loans to deposits in Poland is 110%; in Russia - 146%; in Georgia - 184%).
- **Loans account for less than 35% of banks' assets, and the rapid decline in the share of loans began in 2019.** The Ukrainian banking system has significantly weakened its basic function as a financial intermediary between depositors and borrowers.
- **In 2023, the money multiplier fell to a record low of 1.9.** This means that the growth of the economy's money supply is not transformed into a similar increase in loans to businesses and households, and the economy is stagnating. For comparison, the multiplier is 4.0 in the United States, 3.2 in Poland, 3.9 in Russia, and 3.3 in Georgia.

...but banks are holding record interest rate spreads



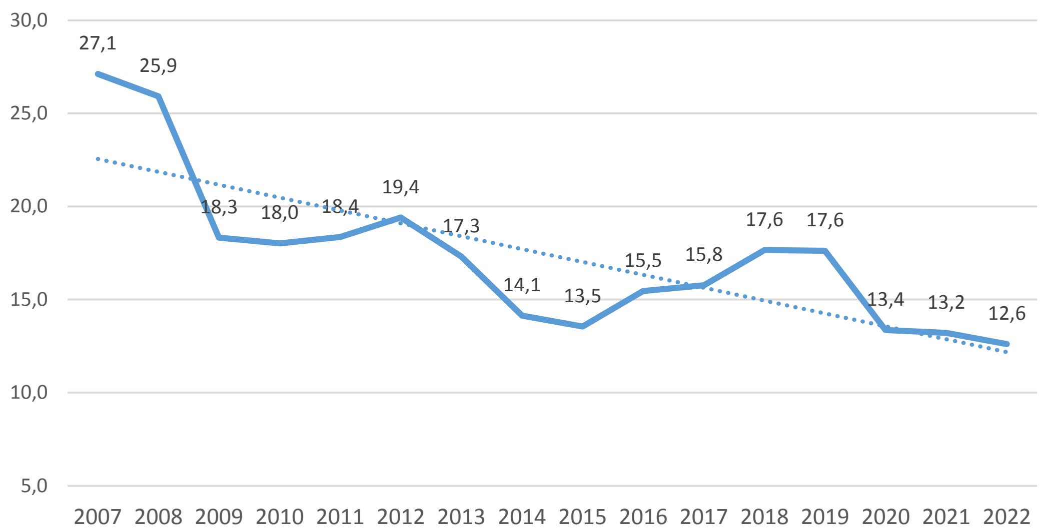


- **The spread between interest rates on new bank loans and deposits in the national currency is at a record high: 10-12 pp, the highest among EM countries.**
- **Banks' net interest income accelerated especially during the pandemic and the war with Russia.** Net operating profit of banks in 2023 amounted to UAH 104 billion (in 2022 it was UAH 143 billion). The risk-free nature of the vast majority of banks' profits distorts the incentives of the banking system and harms the effective redistribution of economic savings for investment.
- **The inefficient financial intermediation sector plunges the country's economy into technological backwardness.** High real interest rates, combined with tight lending standards, has limited credit support for the economy and especially for technologically sophisticated industries.

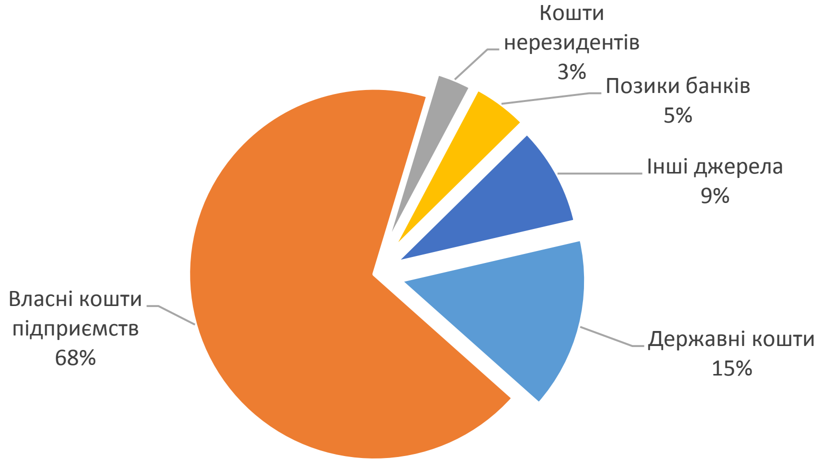
Additional slides

The fundamental problem of economic development is the low level of investment

Gross fixed capital formation, in % of GDP

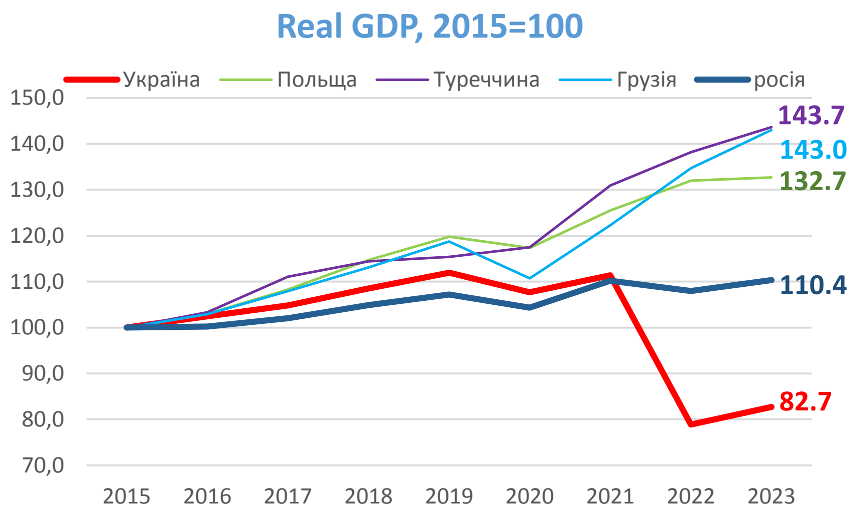


Structure of sources of investment of enterprises in 2017-2021, %

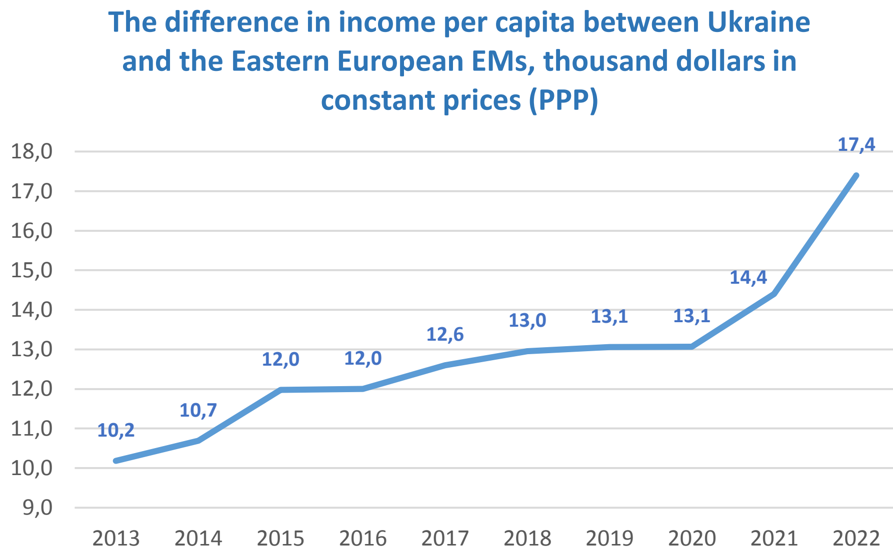


- **Investments in Ukraine's economy in 2022 decreased by 34% to 12.6% of GDP,** which is historically the lowest level and significantly lower than the average level of emerging markets (25-30% of GDP)
- **Over the past 10 years, the structure of sources of financing for corporate investment has been changing towards an increase in the share of companies' own funds and a decrease in the share of bank loans and foreign investors' funds:**
    - In 2021, the share of foreign investors' funds and foreign banks' loans reached a historic low of 2.0%.
    - In 2021, the share of funds of Ukrainian banks reached a historic low of 3.2%
    - public investment has increased significantly during the COVID-19 epidemic, but the state is currently cash-strapped
- **One of the ways to intensify investment could be to attract funds from international organizations and corporate investors to long-term investment projects for Ukraine's post-war recovery**

Before the war, Ukraine lagged behind its neighboring countries in terms of development. Now the income gap is widening



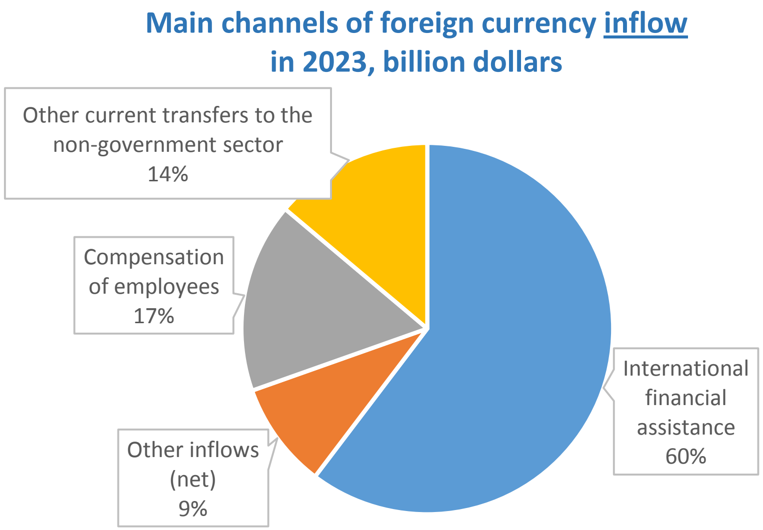
Source: IMF

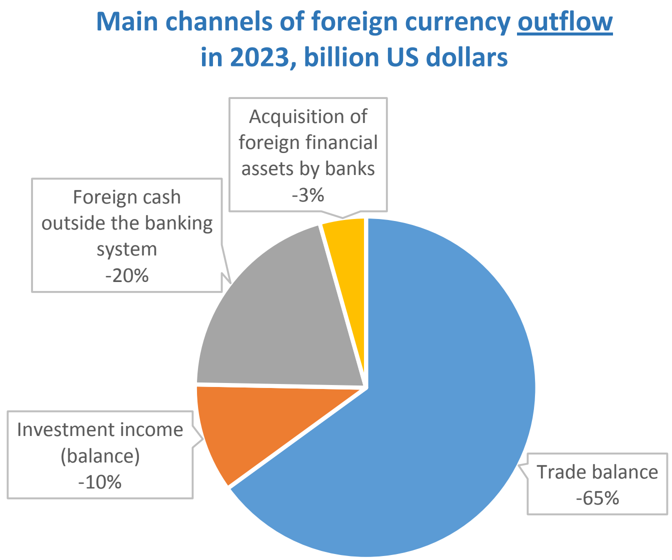


Source: IMF

- **In 2016-2021, Ukraine's real GDP grew much slower than in neighboring countries.** As a result, the gap in living standards was constantly widening. Before the war, the purchasing power of Ukrainians' incomes was the lowest in Europe. In 2015-2019. The Government of Ukraine pursued tight monetary and fiscal policies, which had an anti-inflationary effect, but significantly limited real GDP growth (3% on average in 2016-2019).
- **The decline in inflation and the reduction of the state budget deficit did not stimulate wide-scale domestic and foreign investment.** During the COVID-19 crisis, government incentives began to play a major role in supporting entrepreneurial activity (tax breaks, concessional loans, government contracts, and public investment). However, Ukraine used weaker fiscal incentives than other countries.
- **Low domestic demand and underdeveloped market institutions are the traditional reasons for Ukraine's low investment and slow economic growth.** The military conflict of 2022-23 added to the list of negative factors in Ukraine's investment activity.

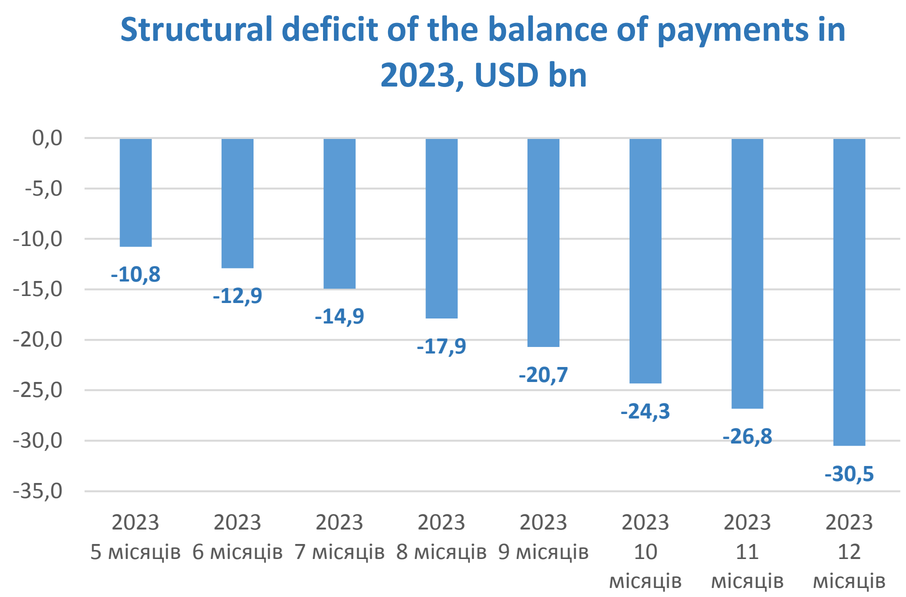
Balance of payments in 2023: surplus reached by large-scale international assistance

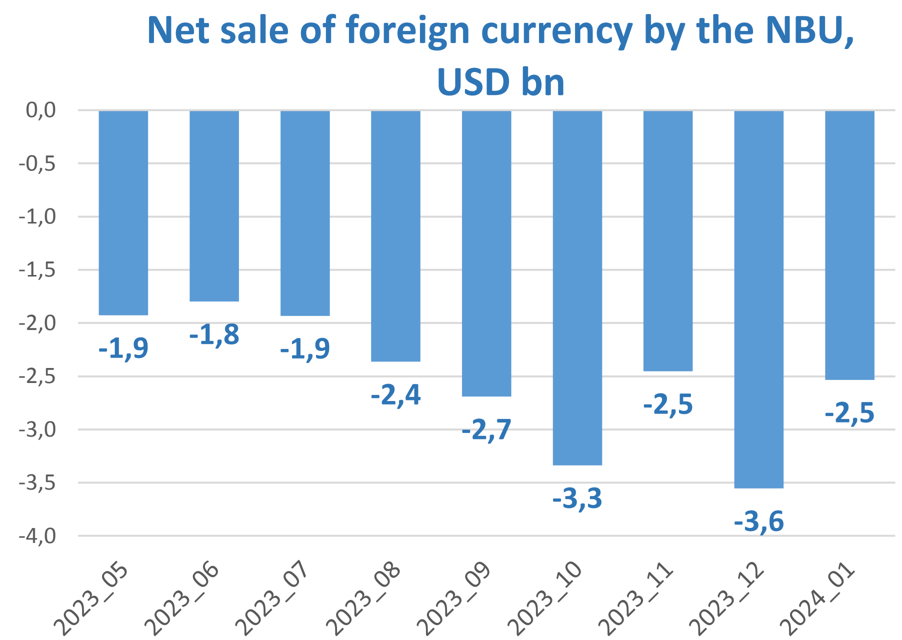




- **In 2023, the overall balance of payments is expected to be in surplus by USD 9.5 bn.**Large-scale international assistance is the main reason for the positive balance.
- **In 2023. The government received $14.0 billion in grants and $27.9 billion in external loans** (total net inflows of $41.9 billion). Without foreign aid, the country's foreign exchange reserves would have been completely exhausted in November 2022.
- **Other key channels of foreign exchange inflows into the country:**
  - remuneration of labor migrants: +$11.5 billion;
  - remittances and transfers to the non-governmental sector: +$9.6 billion;
- **The main channels of currency outflow from the country:**
  - Negative balance of trade in goods: -$28.8 billion;
  - Expenditures of Ukrainian refugees abroad and imports of tourist services: -17.7 billion dollars.
  - Purchase of cash foreign currency (currency outside banks): -$11.8 bn;
  - Payment of income on investments: -$6.0 billion.
- **The continued restrictions on capital outflows from the country also had a positive impact on the FX balance.**

The balance of payments remains in structural deficit





- **The structural balance of payments (excluding external assistance) remains deeply negative,** at more than USD 30 billion per year. To cover this deficit, the NBU has to conduct constant interventions to sell foreign currency (USD 28.6 billion in 2023).
- **After the introduction of the flexible exchange rate regime (starting in October 2023), the demand for foreign currency increased.** The NBU's monthly expenditures to support the exchange rate increased from USD 2 billion per month to USD 3 billion per month. Net purchases of foreign currency by households increased from USD 200 million per month to USD 600 million per month.