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INTERNATIONAL ECONOMIC DEVELOPMENTS

Two years of war: The state of the Ukrainian economy in 10 charts

Economic growth in 2023 has surpassed expectations but the road to full recovery is long and uncertain

▸ *Information on how to donate and engage to help Ukrainians.*

▸ *National Bank of Ukraine's Fundraising Account for Humanitarian Assistance to Ukrainians Affected by Russia's Aggression.*

In 2022, as a result of Russia's full-scale invasion, Ukraine's gross domestic product (GDP) fell by almost 30%. In 2023, economic growth exceeded expectations, with the National Bank of Ukraine (NBU) putting the latest estimate of the annual real GDP growth rate at 5.7% (at the beginning of 2023, the NBU's forecast was 0.3%). According to the NBU and the International Monetary Fund (IMF) baseline forecasts, growth in the coming years is expected to be above 4%. The intensity and the duration of the Russian aggression remains the major source of forecast uncertainty. Baseline scenarios make a key assumption in that respect that the war will wind down as of end-2024.

Even in this baseline scenario, Ukraine's real GDP would reach its pre-war level only in 2030. Potential output is considered to have dropped by more than USD 150 billion (or about 20%) in 2022, and a large share of Ukraine's productive capacity and infrastructure has been devastated by the Russian aggression.

The Third Rapid Damage and Needs Assessment, issued by the World Bank, the Government of Ukraine, the European Union (EU) and the United Nations, **estimates the total cost of reconstruction and recovery over the next decade at USD 486 billion**. As of end-2023, the direct damage is measured at USD 152 billion, with housing, transport, commerce and industry, agriculture, and energy being the sectors most affected. Indirect costs of the war, including disruptions to economic flows and

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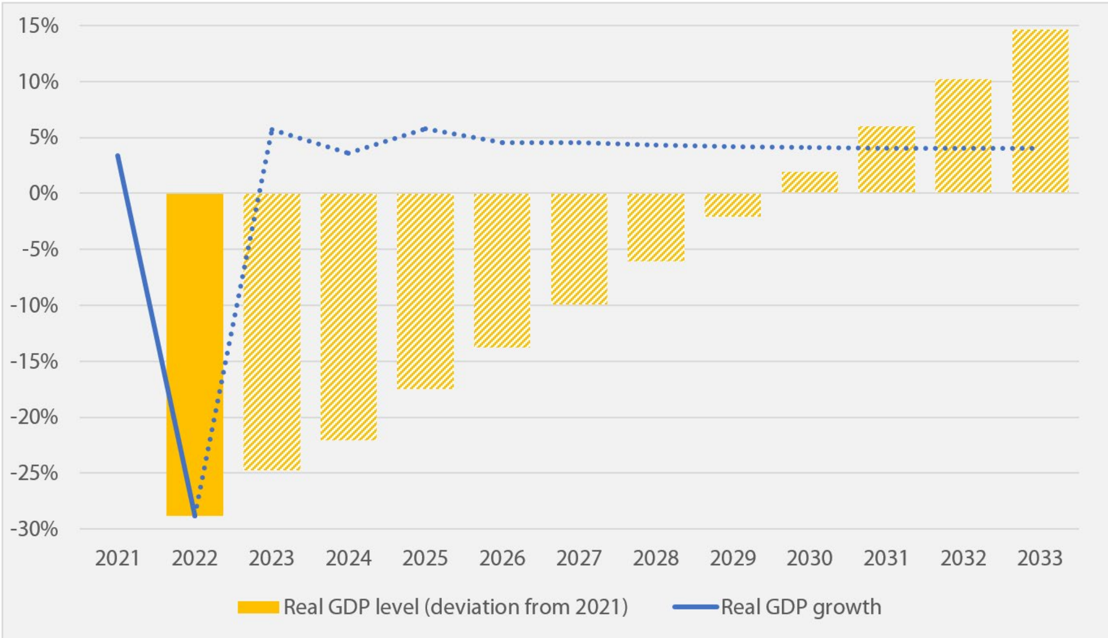
production, and other additional costs climb to almost USD 500 billion. Human life and human capital is also severely affected. In addition to the large number of people mobilised for the war, injured or killed, more than 6.4 million Ukrainian refugees were registered worldwide and there are close to 3.7 million internally-displaced people (the two groups together representing 23% of Ukraine's pre-war population). Significant deterioration in educational outcomes and workers' skills and abilities are directly caused by the war and these effects will fade only gradually over the course of the coming decades. Findings suggest that these impacts on human capital will lead to a fall in total factor productivity by about 7% by 2035.

Growth-enhancing reforms are key to a robust and sustainable recovery. International financial assistance, in particular from the EU and the IMF, comes with a set of structural conditionalities that the government of Ukraine has committed to implement, including reforms related to fiscal policy, governance, and anti-corruption. Substantial reforms will be also undertaken in the context of the EU accession process. On 14 February 2024, the Ukrainian Ministry of Finance presented the "Reforms Matrix" that provides an overview of key conditions and the status of their fulfilment.

Chart 1: Real GDP, annual growth rate and real GDP level, deviation from 2021



Source: NBU, IMF, own calculations.

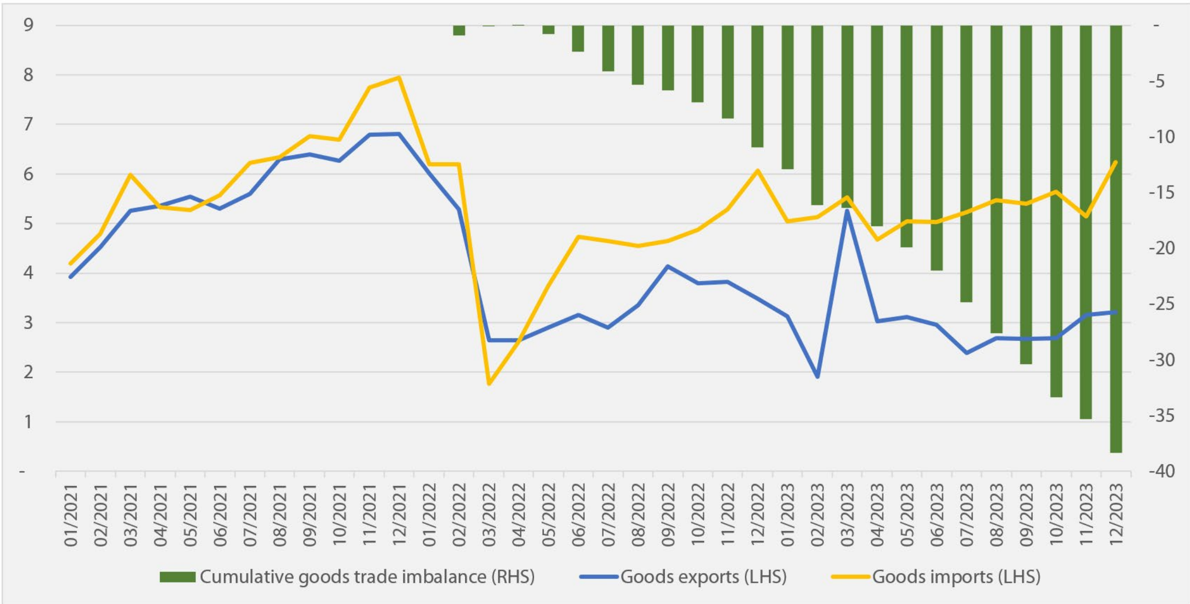
Notes: 2021-2022 actual, 2023 estimate and 2024-2026 forecast from the NBU's January 2024 Inflation Report. 2027-2033 from the IMF's 2nd review under the Extended Fund Facility (EFF) programme, December 2023.

Current account imbalances will persist over a longer period

Ukraine will experience sizable current account deficits in the coming years, driven by widening goods trade deficits. In 2022, Ukraine actually recorded a current account surplus of USD 8 billion, because of the massive amount of international aid provided. This concealed the beginning of a severe imbalance in goods flows, following a major contraction of Ukraine's exports and coupled with increased import needs, in particular of energy. Ukraine's energy production facilities continue to be targeted by Russian strikes and there is an increased dependence on fuel-intensive power generators. In addition to lower international aid in coming years, the IMF's baseline scenario estimates a cumulative current account deficit of USD 52.6 billion between 2024 and 2033, driven by large goods trade deficits in the USD 30-40 billion per year range.

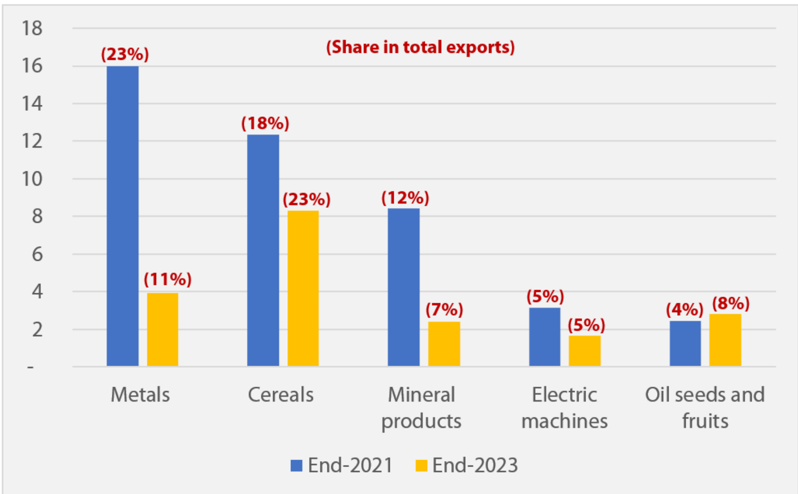
So far, the cumulative size of the goods trade deficit triggered by the Russian invasion has approached USD 40 billion until the end of 2023. Ukraine's total exports remain below one half of the pre-war level. Metals were the main export product at the end of 2021, accounting for 23% of total goods exports. Their export value has now shrunk to one quarter of that level, as metal production is concentrated in the heavily conflict-affected parts of East Ukraine and regularly targeted by Russian attacks. Mineral products, in particular ores, slag and ash, have been similarly affected. Cereals exports, the second main export good (18% in 2021), have also been affected significantly but the impact was cushioned by the decentralised production and constant efforts to keep export corridors open, both on land and at sea. Since Russia exited the UN-supported Black Sea Grain Initiative in July 2023, Ukraine has successfully established a self-enforced corridor in the western Black Sea that follows closely the coast near Romania and Bulgaria.

Chart 2: Goods trade, USD billion



Source: Own elaboration based on State Statistics Service of Ukraine.

Chart 3: Top 5 export goods, nominal value, USD billion

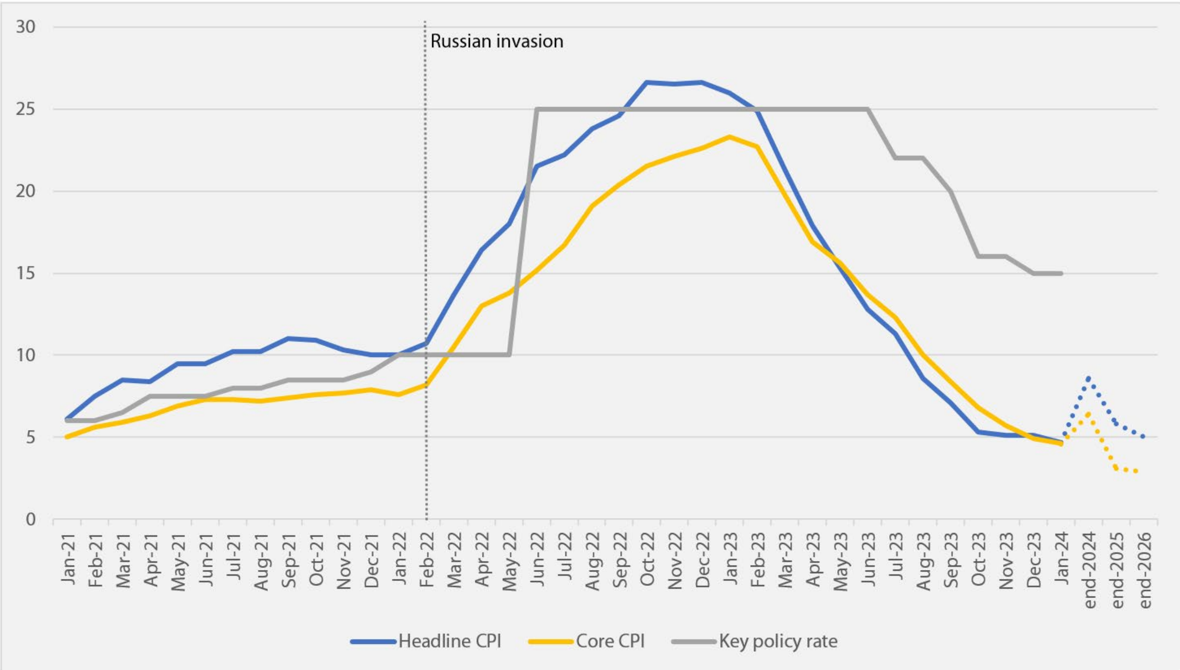


Source: Own elaboration based on State Statistics Service of Ukraine.

Inflationary pressure continues to ease, allowing the National Bank of Ukraine to cut interest rates

After peaking at 26.6% at the end of 2022, inflation has returned to pre-war levels and within the National Bank of Ukraine (NBU)'s inflation target range (5% ± 1 percentage point). This is mainly attributed to better harvests, lower global energy prices and the NBU monetary policy actions in 2023. The NBU expects inflation to rise again in the second half of 2024, mainly due to a recovery in consumer demand, cost pass-through to consumer prices and wage pressure, before returning to the target range in 2025 and 2026. The main risk to this baseline scenario, which assumes that large-scale hostilities will reduce significantly from 2025, is that the war lasts longer. In that case, renewed inflationary pressure could be expected over the medium term. Core inflation is also expected to rise in 2024 and then fall well below 5% in the coming years.

Chart 4: Headline and core consumer price index (CPI) inflation, in %



Source: Own elaboration based on NBU.

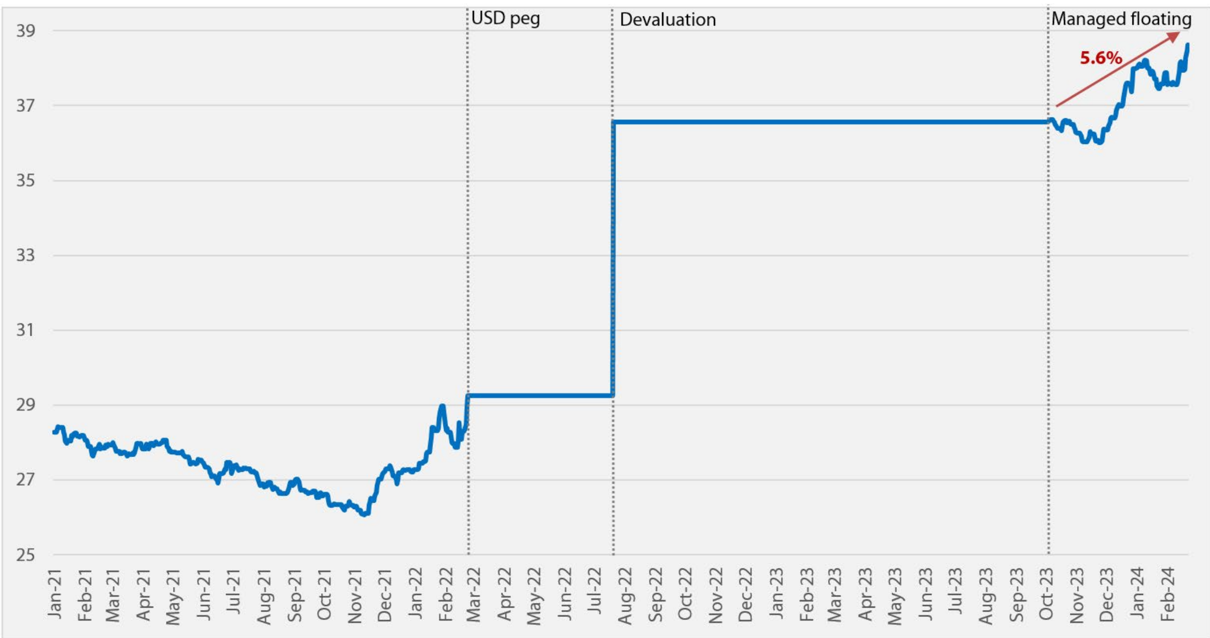
Note: Dotted lines represent the latest (January 2024) NBU forecast.

The hryvnia showed resilience in the transition from a fixed to a managed floating regime

At the start of the war, the NBU quickly implemented a fixed exchange rate regime to stabilise its currency. The peg was initially set at 29.25 Ukrainian hryvnia/US dollar (UAH/USD). Over time, due to foreign exchange demand, pressure has built up on the NBU to devalue the hryvnia, as the gap between the official and shadow exchange rate grew increasingly wide. The NBU eventually decided to devalue on 21 July 2022 by 25% (to 36.57 UAH/USD). Afterwards, the NBU sold foreign currency in the markets to maintain a fixed exchange rate. As a result, the gross international reserves of the NBU fell to USD 22.4 billion by July 2022 (from USD 30.9 billion in January 2022). Driven by international financial assistance, international reserves have recovered since then and even reached a historical peak at USD 41.7 billion in July 2023.

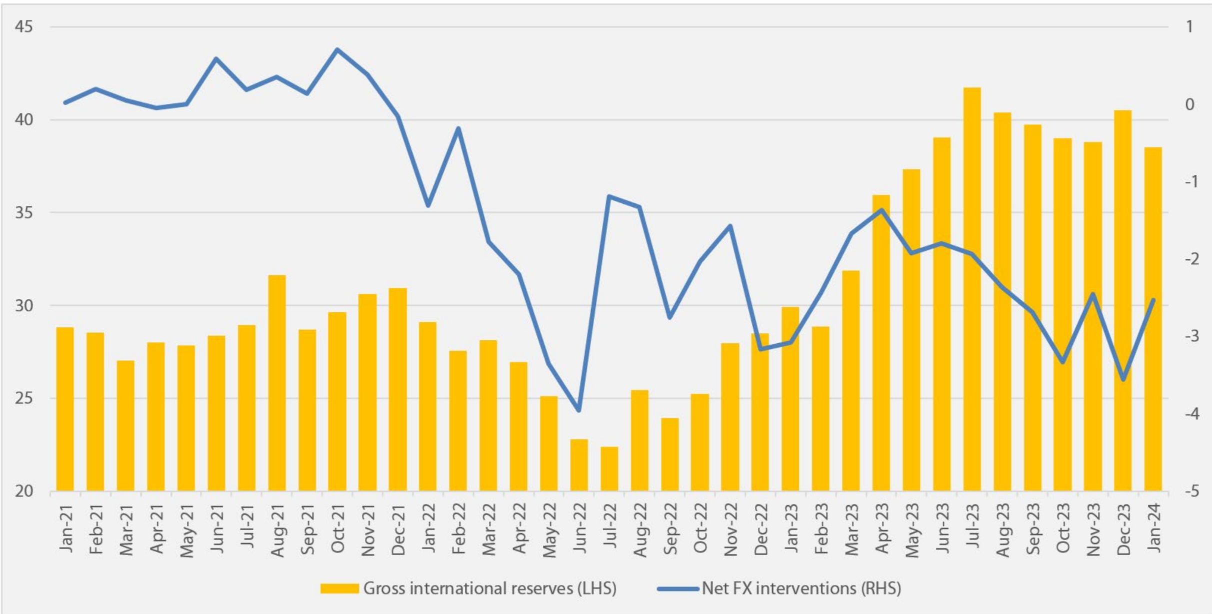
In October 2023, the NBU decided to abandon the exchange rate peg and has rather successfully transitioned to a managed floating exchange rate regime. The NBU engaged in increased foreign exchange interventions in the first days of the transition. Afterwards, the level of interventions stabilised and the UAH/USD remained within a narrow band of -1.5% to +0.5% until mid-December 2023. Since then, it has weakened by about 4.4%, or 5.6% from the peg, spurring increased foreign exchange interventions by the NBU. As of January 2024, international reserves stand at USD 38.5 billion and cover 5.1 months of imports.

Chart 5: UAH/USD official exchange rate



Source: Own elaboration based on NBU.

Chart 6: NBU's foreign exchange interventions and gross international reserves, USD billions



Source: Own elaboration based on NBU.

Public finances remain under pressure, consumed by military expenditures and reliant on external financing

Ukraine's state budget has come under severe pressure due to the war. Tax revenue has fallen in 2022 and somewhat recovered in 2023. Increased financing needs were covered in part by financial support from international partners and for the rest by running sizable fiscal deficits. Total expenditures grew by 270% from 2021 to 2023, with expenditures for defence and security rising dramatically, by more than 16-fold and 3-fold, respectively.

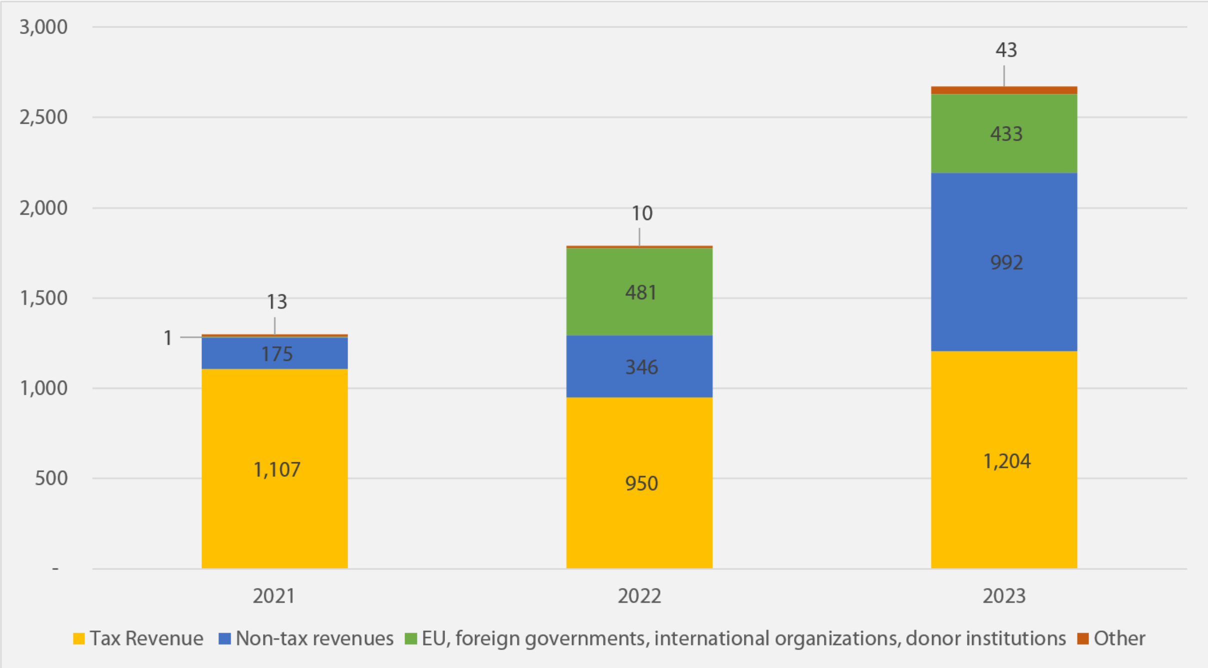
The 2024 state budget anticipates the largest deficit yet in absolute terms, at UAH 1.6 trillion (about USD 41 billion, 19% higher than 2023). Revenues are set at UAH 1.8 trillion, while expenditures are almost double at UAH 3.35 trillion, with half (UAH 1.7 trillion) set aside for defence. Despite the large deficit that is to be covered by debt financing, overall and defence-related expenditures are lower than in absolute terms in 2023, by 17% and 19%, respectively.

The IMF expects Ukraine's public-debt-to-GDP ratio to almost double compared to the pre-war years and peak at close to 100% between 2024 and 2027, falling gradually afterwards to below 80%. This baseline scenario assumes the war to wind down starting end-2024. According to the downside scenario entailing a more intense and one-year longer war, Ukraine would be running more sizable fiscal deficits until 2026, bringing the public debt level to almost 140% of GDP.

To alleviate the debt servicing burden, major official and private creditors have agreed to provide debt suspension. In July 2022, six official bilateral creditors' members of the G7 and the Paris Club ("The Group of Creditors of Ukraine") announced a suspension of Ukraine's debt service payments applicable from August 2022 until the end of 2023. In addition, large private holders of Ukraine's debt have also agreed to temporarily (for a period of two years) suspend debt service payments. Following the approval of the IMF's Extended Fund Facility (EFF) in March 2023, the Group of Creditors of Ukraine have agreed on a two-step approach. First, the standstill is extended for the duration of the EFF programme (until March 2027). Second, there will be an additional debt treatment to restore Ukraine's debt sustainability before the expiry of the EFF programme. This is subject to private creditors delivering a debt treatment that is at least as favourable. Ukrainian authorities are working to engage with private creditors by mid-2024, before the current standstill expires.

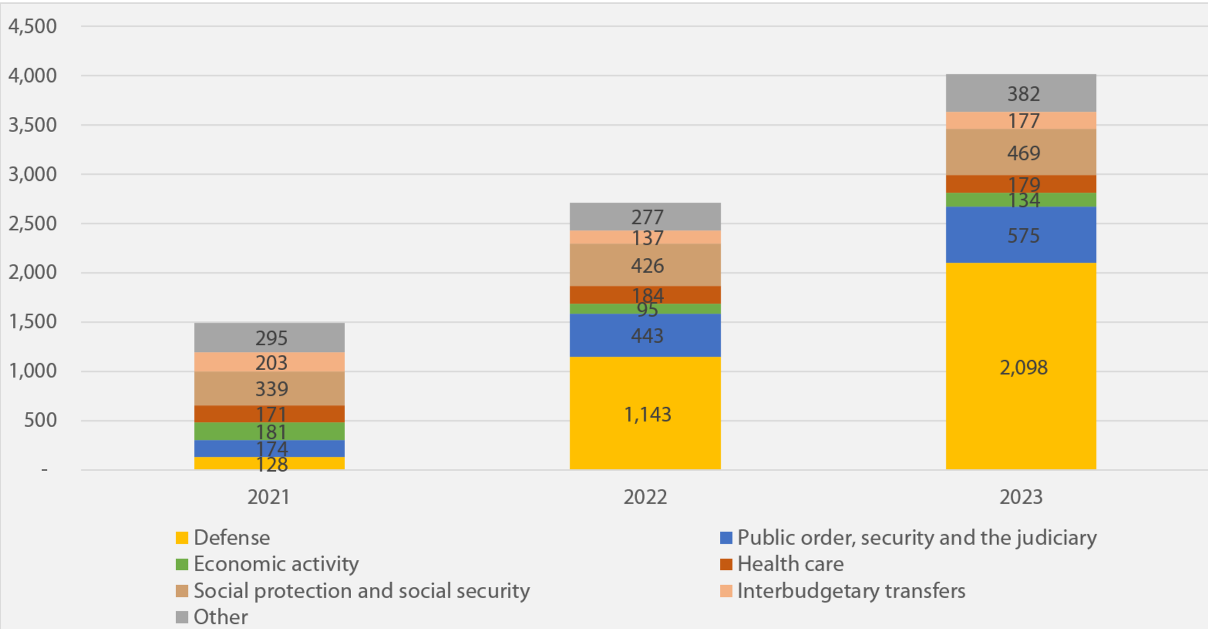
In the coming years, Ukraine will continue to be dependent on external financial support. IMF baseline estimates suggest that Ukraine's external financing gap could amount to USD 85.2 billion for the period 2024-2027. In a downside scenario, this amount could climb to USD 103.9 billion. The largest share of financing would need to come from official creditors such as the EU and the US.

Chart 7: State budget of Ukraine, revenue UAH billion



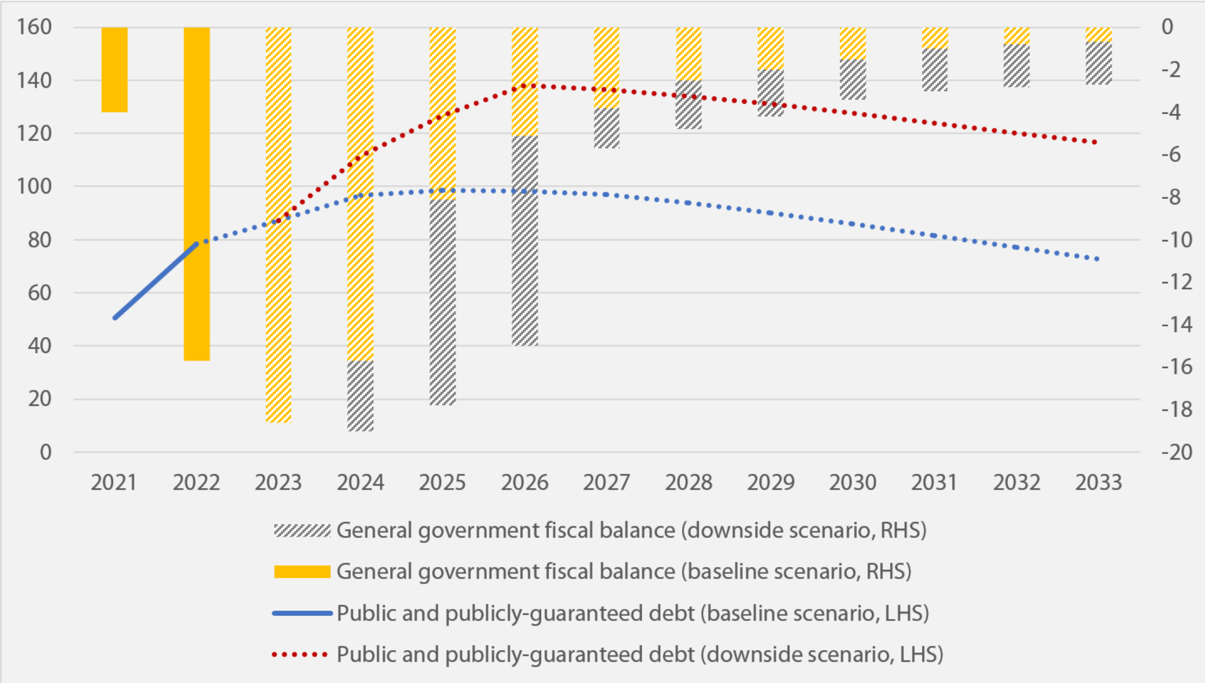
Source: Own elaboration based on Ministry of Finance of Ukraine, Open Budget.

Chart 8: State budget of Ukraine, expenditures UAH billion



Source: Own elaboration based on Ministry of Finance of Ukraine, Open Budget.

Chart 9: Public debt and budget deficit, in % of GDP



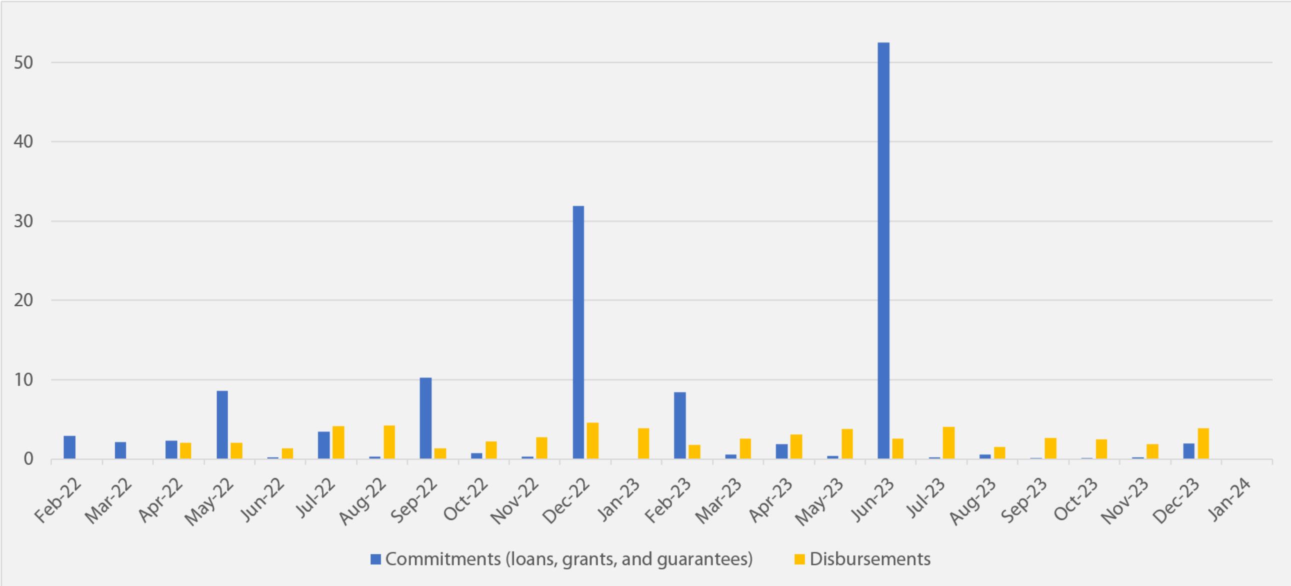
Source: Own elaboration based on [IMF's 2nd review under the Extended Fund Facility (EFF) programme](), December 2023.
Note: 2023-2033 are forecasts.

However, external financial support has been stagnant recently, with some reasons for both concern and optimism

International financial commitments and flows to Ukraine have been stagnant since summer 2023, in particular considering non-EU support. In 2023, besides the EUR 18 billion provided under the Macro-Financial Assistance+ instrument, other international partners of Ukraine have disbursed EUR 16 billion. In addition, since June 2023, no major commitment to provide financing was announced (in the second half of the year, only EUR 3.2 billion were announced in total). January 2024 was the first month since the start of the war that no commitment was announced and no disbursement was made.

On the positive side, the EU's multiannual financial assistance programme for Ukraine worth EUR 50 billion, the Ukraine Facility, is on track to be adopted. However, this will not be sufficient. For 2024, the IMF has estimated that USD 31.9 billion will be needed from external official sources. This assumption included the EU support, USD 5.4 billion from the IMF under the EFF programme, subject to fulfilment of conditionalities under four programme reviews (for the first one, a staff-level agreement was reached), but also USD 8.5 billion from the US. However, the US aid package for Ukraine is currently blocked in the US Congress with an uncertain future. In addition to this, USD 4.6 billion is assumed to be covered from official and private debt relief operations in 2024, the latter still subject to formalisation. Shortfalls in external financial support might compel Ukrainian authorities to, for instance, restart monetary financing, at the detriment of hard-earned and fragile macro-financial stability in the context of an ongoing war.

Chart 10: Budget support, commitments and disbursements, EUR billion



Source: Kiel Institute for the World Economy, Ukraine Support Tracker.

Note: Commitments are shown in the month when they were announced, and not formally adopted. For instance, the EUR 50 billion Ukraine Facility is shown in June 2023 when the European Commission made the proposal.

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