Research Briefing | Ukraine
Outlook and key risks for 2023

- After nine months of devastating war, we expect Ukraine’s economic contraction to reach 31% in 2022. Prompt monetary and fiscal policy responses and $23bn of external financing have prevented a much deeper contraction.

- Extreme economic challenges will persist next year, and we expect the economy to contract by a further 2%-2.5% y/y. Our forecast rests on assumptions that the war lasts until at least mid-2023, Russia’s infrastructure attacks subside, the Black Sea grain initiative remains in place, and the West’s financial support is sufficient to maintain financial stability. But the risks are to the downside.

- Policy challenges will also persist. The 2023 budget assumes that nearly all (94%, or $34bn) of Ukraine’s financing needs will be met via external funding, $15bn of which would come from the IMF. This may turn out to be optimistic, and pressure on the central bank to monetise the deficit will persist. Still, we assume this monetary financing remains limited, avoiding runaway inflation.

Nearly nine months into the Russian invasion and with no end in sight, Ukraine’s economy has avoided going into a tailspin. But the damage is severe. Having initially contracted by about 45% in March-April, by August-September the economy showed signs of adjusting, with a 35% y/y contraction. But times have gotten even harder heading into winter, as Russia focuses its strategy on destroying Ukraine’s infrastructure.

Russia’s latest missile strikes have left at least 10 million people without electricity, and about 50% of power generation and distribution infrastructure is estimated to have been damaged. Fourth quarter GDP will therefore suffer a renewed quarterly contraction, which will have carry-over effects into 2023. Consequently, we will revise down our current -30% y/y forecast for 2022 closer to -31% to reflect the latest developments.

Chart 1: Business expectations showing signs of recovery, except in mining

Ukraine: Index of business expectations as of October 2022

Source: Oxford Economics / NBU
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Taking stock of 2022

The estimated 30% y/y contraction in the first three quarters of 2022 has been broad-based, but metals production was hit particularly hard. Although national accounts and high-frequency data are not available, latest survey data give an idea of the relative contraction of various industries in 2022 and their expectations for the next 12 months. Thus, National Bank’s latest (October 2022) Index of Business Expectations shows a particularly deep contraction in the mining industry, with business expectations 53% below the previous four-year average, followed by a similar 31%-32% contraction in manufacturing, construction and trade.

Agriculture is faring slightly better at -24% (Chart 1). Trade data paint a similar picture: exports of metals were down by 62% in the first nine months of the year and grains by 21% y/y.

Compared to the -45% contraction seen in March, the three main sources of recovery have been: the gradual liberalisation of several regions, with Russia’s withdrawal from Kherson being the latest victory; the resumption of seaborne grain exports and return of some displaced people to their initial place of residence as the war effort has become more localised. The liberations were equivalent to bringing back about 9% of pre-war GDP back under Ukraine’s control, according to our estimates. Grain exports will add about 6% of GDP compared to the March-June lows. The prompt policy response and $23bn in external grants and loans prevented a deeper contraction.

The enormous damage inflicted on Ukraine’s infrastructure since October will reverse a fair share of this recovery, and we now expect GDP to contract by about 31% in 2022 (in seasonally adjusted terms, which produced better GDP results than NSA numbers, e.g., the Q2 result was -32.3% y/y SA vs -37.2 y/y NSA).

Assumptions underpinning our forecast

Overall, the economic outlook hinges to a large extent on the length and intensity of the war, which cannot be predicted. Instead, we’ve focused on some key assumptions, which also represent the key risks to our forecast:

- **The war lasts through at least mid-2023**, as both sides are still able to mobilise additional human and military resources to continue the war effort, preventing either from admitting defeat. Ukraine’s recent success in liberating Kherson city – the only regional capital that Russia managed to occupy – may well represent a turning point in the war. We see two-ways risks from this baseline: an upside risk is that Ukrainian military victories result in an earlier end to the war, becoming a White Swan event for global markets; and a downside risk that things turn even nastier than now.

- **The pace of Russia’s missile attacks on energy infrastructure slows from current levels** towards spring 2023, either owing to Russia’s shortage of high-precision missiles or Ukraine obtaining more effective air defence systems. We expect Ukraine to repair significant damage but likely not to previous levels.

- **The Black Sea grain initiative remains in place**, as Russia struggles to exit without severely damaging its relations with the Global South. Potential expansion of the deal to include the ports of Mykolayiv (in addition to Odesa) would be an upside risk to our outlook.

- **Western financial support is sufficient to maintain relative macro-financial stability.** It’s unlikely that Ukraine’s 2023 budget assumption that 94% of its financing needs are met through Western support, without any NBU financing. The latter will most likely be needed, but we assume that monetisation remains sufficiently limited to avoid run-away inflation.

With these assumptions in mind, numerous constraints will still prevent a meaningful recovery:

- **High base effects from January-February 2022, will mean Q1 2023 will still see a contraction of about 22-23% y/y.**
- **A significant part of territory (equivalent to about 12% of pre-war GDP) remains either occupied or affected by active fighting.**
- **The outflow and displacement of people will continue to pose a drag on both demand and supply.**
- **Infrastructure damage and destruction of supply chains across the country are creating supply side constraints, which have both direct and indirect (e.g. higher inflation) negative effects on output and consumption.**
As such, we expect GDP to contract by 2.3% in annual terms in 2023 followed by a more robust recovery of about 11% in 2024 and 4.5% y/y in 2025. The risks are skewed to the downside, however.

Domestic demand will continue to suffer

The significant displacement of the population, and a breakdown of supply chains will continue to impact the domestic economy. According to the latest estimates of the IOM, 6.2m people are internally displaced in Ukraine, and a further 7.6m have sought safety abroad – altogether representing about a third of the population. And with more people having lost their jobs inside the country, unemployment is estimated to have reached 28% (according to the NBU). With real earnings declining by 23% y/y (as of June 2022), household consumption will contract by about 24% in 2022 (Chart 2). In 2023, as inflation peaks and businesses continue to reopen, we expect consumption to recover slightly, by 1.6% y/y.

Chart 2: Household consumption set for a record slump and only a moderate rebound

Fixed investment has likely contracted by about 30% y/y in the first nine months of 2022, judging from leading indicators of investment demand (see Chart 3 below). With government funds being redirected towards security and defence spending, public capital spending has declined by about 45%-46% since the start of the war, while private investment has been put on hold due to high economic and political uncertainty.

Net exports will be a drag in both 2022 and 2023

Despite the solid pace of recovery in domestic demand, net exports are likely to be a drag in both 2022 and 2023, as imports grow faster than exports. This year, despite a collapse in domestic demand and initial restrictions, imports still grew faster than exports, which were heavily constrained by Russia’s blockade of Ukraine’s Black Sea ports and destruction of Ukraine’s metallurgy industry. Next year, as domestic demand recovers, so will imports, which will again grow faster than exports.

Reopening of the three greater Odesa ports following the UN-brokered grain deal allowed Ukraine to boost exports of grains close to levels seen last year (Chart 4). According to our estimates, this will add about 6% to 2022 GDP, compared to March-June lows. Once grain stocks clear, however, Ukraine will likely see a lasting negative impact from the war, as some territory is occupied and other regions suffer from direct physical destruction, insufficient funding for the new sowing campaign, and other consequences of the war. For instance, this year’s harvest was 40%-42% lower than last year, and in 2023 farmers expect a rebound to not more than 70% of pre-war levels.

Source: Oxford Economics / NBU
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Chart 4: Grain exports have recovered close to pre-war levels

Source: Oxford Economics / Comtrade / Ukrainian Ministry of Agriculture

Metals production, which prior to the war accounted for 31% of merchandise exports, has suffered an even deeper contraction than agriculture. About a third of production capacity has been permanently destroyed during Russia’s capture of Mariupol city in the south-east, and the rest remains either temporarily closed or has sharply reduced output. As Chart 5 shows, output of main metallurgical products remains 65%-67% lower in annual terms even after a partial rebound since May this year. A full return to pre-war capacity is unlikely in the next five years, which will keep exports firmly below pre-war levels.

Chart 5: Metallurgy suffered a heavy blow from the war

Source: Oxford Economics / Ukrmetallurgprom

Policy challenges will persist

With defence spending eight times higher than it was a year ago (now accounting for 50% of government spending), and revenues having slumped, the fiscal deficit is set to exceed 20% of GDP this year (less, once foreign grants are taken into account) and will remain at a similar level next year.

Financing the war effort and basic public services will therefore be the key policy challenge. As external funding initially lagged behind, the NBU became the major source of financing the huge fiscal gap, having ‘printed’ an equivalent of $10.7bn or about 7% of pre-war GDP (See Chart 6). Next year's budget envisages a deficit of UAH 1280bn (US$30bn, or 20% of GDP), and, combined with debt repayment, overall financing needs will reach $36bn.

The government plans to finance 94% of these needs with external funding, and hopes $15bn of this will be an IMF loan. This plan may not materialise, given that IMF programmes usually require long-term fiscal sustainability. The EU and the US, however, have agreed to provide €18bn and $18bn, respectively, in 2023 – the latter likely in the form of grants. EU support, however, has been coming with significant delays and has undershot the commitments, whereas US funds may be held hostage by the Republican-dominated House of Representatives so may also be delayed.

Pressure on the NBU to monetise the deficit is therefore likely to persist and poses a risk to macro-financial stability. Too much financing would put further pressure on UAH, which is already about 10% cheaper on the parallel market, compared to the UAH36.6/$ official exchange rate. Our baseline assumption, however, is that NBU financing remains limited, helping to avoid runaway inflation. We plan to examine this issue in a future research briefing.

Chart 6: The NBU was the main source of funding before grants stepped up in H2 2022

Source: Oxford Economics / NBU / Ministry of Finance