Ukraine Watch: Weekly update – Economy in war (week 15)

Raiffeisen RESEARCH

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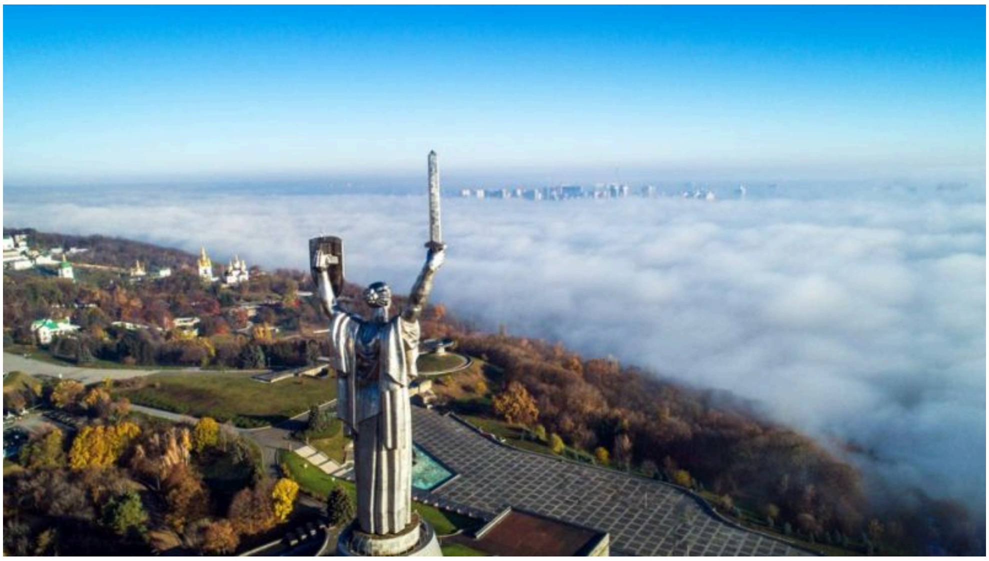
Another week of the war preserved a heavy concentration of enemy forces and their unsuccessful attempts to encircle the key city Siverodonetsk in the Donbas area. The financial sector remained impressed by the recent NBU policy rate decision, thus still waiting for the reaction of interest rates in different segments of the money market, which is not uniform. In the FX market, the NBU applied some additional changes in currency regulation, while its reserves quickly melted down over May on heavy imbalances in the cash market. The first official estimates of GDP dynamic over Q1 2022 arrived, but with a month delay.



War led to a sharp drop in GDP in the first quarter

According to preliminary data, GDP fell 15.1% yoy in the first quarter of 2022, which fits, in general, our estimates. Compared to the fourth quarter of 2021, the drop was 19.3%.

First of all, the **release of GDP data** by the State Statistics Service **came** quite **unexpectedly** on June 9, and it was delayed for more than a month compared to the scheduled date of its publication of May 5. We understand the reasons because it is rather complicated to make accurate and timely calculations of aggregate macroeconomic indicators under current war conditions, while **Ukrstat** has additionally **stopped publishing high-frequency indicators** of business activity.

The estimate of a **15.1% yoy drop in GDP** did **not** come as **a surprise** to us. We also understand that the **largest drop in** domestic **GDP** over the last **20 years** is not tied to relatively mild negative consequences of the war but rather to the fact that over **60% of the reported period** (i.e. 54 of 90 days), the economy demonstrated a rather visible **economic upturn** at an estimated rate of **about 5% yoy** on the back of the dynamic of high-frequency business activity indicators in January and the first part of February. Having almost no access to specific economic indicators within the first few weeks of the war, we estimated the **fall in GDP** during the war (i.e. **other 40% of the duration** of the first quarter) at **about 45% yoy**. Therefore, our forecast of a 15.0% of GDP decline over Q1 2022 fits the figure being officially published recently almost fully.

As usual, the preliminary estimate of GDP dynamic by Ukrstat does not provide its breakdown by either sectors or expenditure components. This would be especially

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difficult to do under war conditions and the inability to gather data on high-frequency economic indicators. However, according to our estimates, we consider a **large decline in investments** (with an estimated drop of 25% yoy) as the primary driver of a significant reduction in GDP on the expenditures side. An estimated **negative impact** of war on **consumer spending** (-15.0% yoy) was also quite substantial in the first quarter, albeit milder vs the investments' figure, as we still noticed some hikes in consumption a few days before and after the war started. The negative contribution of net exports and government consumption was, according to our estimates, negligible to the GDP figure over Q1 2022.

Regarding the sectoral breakdown, we estimate the rather **substantial negative impact** of war on the value-added of **almost all core sectors**. The only notable exception is the IT sector which showed strong resilience to the previous Covid-crisis and became the most immune to the current crisis as well. However, we could expect the most substantial decline in transport and trade sectors due to the primary and most immediate negative impact of the war on their performance as the enemy tried to do significant damage to the infrastructure. The primary negative impact on agriculture is also estimated to be relatively mild over Q1 2022 compared to other sectors, as activity in the sector was not strong due to seasonal factors.

We expect to see a **substantial worsening in GDP dynamic** in the second quarter, where the most negative impact of the war on the domestic economy was noticed, and a certain time lag was required before the economy started to restore. However, ongoing hard battles, attempts of the enemy to capture Ukrainian Donbas and the constant bombing of critical infrastructure throughout the whole Ukrainian territory would be the core factors behind a substantial drop in GDP over the second quarter of this year. We think it **may demonstrate a decline of close to 50% yoy**, with a catastrophic slump in investments by 70-80% yoy and a fall by half in private consumption. Even though **we still keep our whole-year GDP forecast of -33.0% yoy**, evident delay in the war conflict and the threat to transform it into a long-lasting conflict may require a downward adjustment in our forecasts already quite soon.

Stability on FX market remains fragile, NBU still wastes reserves actively

The **first reaction** of the **unofficial FX market to the NBU policy rate decision** was rather **restrained**, without any substantial immediate movements in the exchange rate in either direction, while corresponding expectations on shortening external imbalances might weaken speculative sentiment there. The NBU decision has not caused a quick decline in the USD/UAH on the unofficial market, thus preserving the difference between it and the official exchange rate at a quite wide level of 20%. This is definitely still better than the 28% spread seen at the end of May, while it provides incentives for arbitrage and involvement in grey schemes to profit from the difference in exchange rates in multiple market segments. Even though **we expect gradual adjustment of the unofficial exchange rate downwards** within the coming weeks, **we** still **wait for more actions from the NBU** regarding simultaneous upward adjustment in the official exchange rate and, correspondingly, the rate of non-cash operations. We still expect a gradual switch to a flexible exchange rate (with a number of additional restrictions) would be done soon. In particular, the return of the NBU to inflation targeting through a policy rate mechanism reduces the necessity to keep a fixed exchange rate as a method to prevent imported inflation.

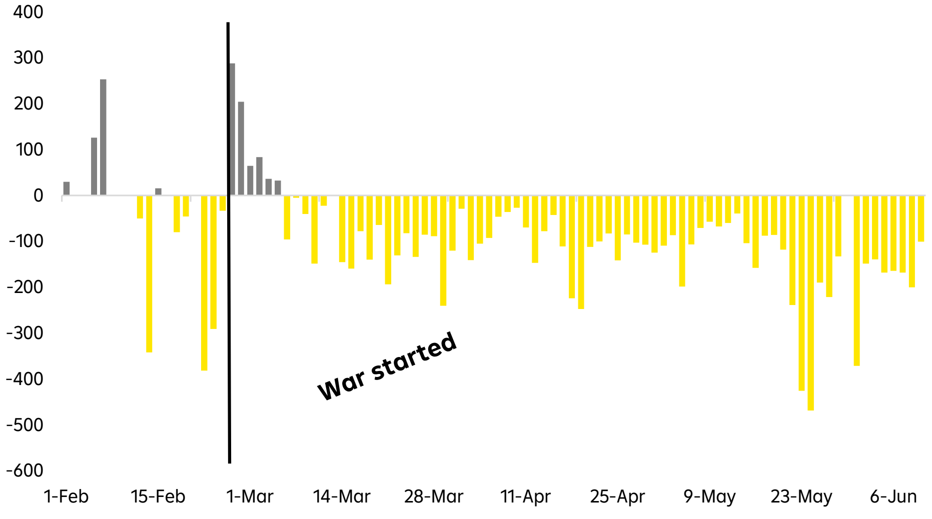
In currency regulation, the **NBU made additional adjustments** this week by widening the maximum limits for payments on import and export operations **from 90 to 120 days**. Theoretically, these actions may additionally raise market imbalances as exporters have more time to sell their foreign currency proceeds. However, in the absence of mandatory FC sales, this measure would not impact the market substantially, while the extension of the time for payment is tied to longer operations after the destruction of supply chains for

Ukrainian external trade, especially because of the closure of marine routes. Therefore, we consider the recent NBU decision as an intention to smooth the market and remove additional inefficiencies there.

It was not a surprise to us to see in May **the sharpest monthly decline** (by USD 1.8 bn) **in NBU FC reserves over the last eight months** to a two-year minimum of USD 25.1 bn. This happened mostly due to quite **intensive "wasting" of NBU reserves** via its interventions (-3.4bn) **not seen since the financial crisis** of 2008. Definitely, the bulk of this outflow was tied to the necessity to cover the gaps with the cash FX market due to the substantial difference between official and unofficial exchange rates because this inefficiency allowed to raise the intensity of "card tourism" in the first half of May. We hope that corresponding changes in FX regulation regarding the limits of cash withdrawals abroad and flexibility of cash conversion rates have reduced these outflows in the second half of the past month. A solid drop in NBU reserves over May also occurred on **substantial underfunding of the budget via external financial assistance**. In particular, the government received just USD 1.7 bn of external loans and grants over the last month, which looks quite small vs. the estimated level of USD 5.0 bn. In any case, a decline in NBU FC reserves has not worsened their import coverage substantially by lowering this indicator moderately to an estimated level of 3.6 months of imports. This still indicates the good ability of the NBU to keep the exchange rate and FX market controlled in the medium term.

We expect to see a **milder outflow from NBU FC reserves** in June due to smaller imbalances in the cash FX market. However, a still wide gap between cash and non-cash exchange rates, as well as the inability to restore exports in full amount, would still require some supportive interventions from the NBU. We think that the recent policy rate decision could gradually diminish market imbalances, while this should take more time in order to adjust to new conditions, especially under conditions of very limited freedom of financial markets. However, as soon as external financial assistance is expected to be substantially increased, we even can see a stabilisation of FC reserves this month in case the former would be disbursed in the amount of no less than USD3.0 bn.

Chart 1 - Net NBU interventions (USD mn equivalent)



NBU, RBI/Raiffeisen Research

Inflation keeps visibly accelerating in May (18.0% yoy)

CPI remains on an upward trend, caused by both domestic, war-related reasons and the impact of global inflation. The latter factor is also partially tied to the war in Ukraine. On the other hand, the magnitude of the initial inflationary shock slowly winds off as the economy adjusts to new conditions. In particular, yoy inflation slowed down its growth pace, with 160bp acceleration in May vs 271bp acceleration in April. Monthly CPI also recorded a slowdown to 2.7% in May vs 3.1% the month before. This is mostly in line with our estimates of 2.5% but visibly higher than consensus forecasts. **Inflation dynamics remained geographically heterogeneous**, as places closer to the conflict zones showed higher increases on average.

In May, a traditional hike in the prices of food products is mostly attributed to seasonal factors, and an increase in their prices is mostly reflected in fruits (11.5% mom) and vegetables (5.4%). However, this time they are also dependent on the limited availability of early fruits and vegetables due to the temporary occupation of the Kherson region – the core supplier of these products. A visible hike in the price of alcohol and tobacco products by 3.9% mom is also the result of disrupted supply chains and increasing logistics costs, while the price growth in imported products is still restrained by the fixed exchange rate. Administrative measures on public utility tariffs also preserved low inflation in this segment.

As we mentioned earlier, **we expected a visible influence of consequences of administrative price regulation** to be reflected **in the price of fuel** in May when this regulation was relaxed due to a fuel crisis inside the country. This caused an upward adjustment in the price of fuel by 22.8% over the month, which transformed into serious yoy fuel inflation of 57.5%. It also already caused a moderate increase in transport tariffs (by 6.7% mom), while we could see the influence of the fuel factor on the price of final goods from other groups, which would keep general inflation elevated within the coming few months.

Same as headline inflation, the **core CPI also recorded an acceleration** in yoy terms in May to a six-year maximum of 13.8%. Even though the gap between headline and core inflation has been expanding recently due to the acceleration in fuel and food inflation, the increasing dynamic of core CPI is still solid enough to be concerning, with potential threats in the medium-term. The concerns would be even more severe in case of movement to a floating FX regime and corresponding pressure of imported inflation. Therefore, we again reiterate our view that the recent NBU decision to hike its policy rate substantially to 25% was the right move in order to limit the monetary component of inflation acceleration this year.

As **the risks of further acceleration of inflation have not evaporated for the near-term future**, we maintain our year-end **inflation forecasts at 20.5% yoy**. However, within the coming month, the pace of monthly inflation would be again weaker due to seasonal factors, while limited availability of fruits and vegetables from occupied territories as well as the pass-through effect of fuel prices on other goods and services would keep monthly inflation in June high, at 0.7%, in our view.

The rates of the financial sector still respond mostly sluggish to the NBU policy rate decision

After more than a week has passed following the interest rate hike by the NBU, **some segments of financial markets remained mostly sluggish** in their reaction to this decision. In particular, banks' deposit rates remained unchanged at around 6.2% for 3-month deposits and 7.8%-8% for the 12-month deposits, as measured by Ukrainian Index Rates for Deposits (UIRD). This can be explained by the urgent necessity to raise the yields in the absence of alternative investment opportunities with a higher yield. Additionally, lower demand for new loans during the war requires a smaller volume of banks' resources. However, the **process of deposit hikes has already started, mainly from small banks**, which rely more significantly on deposits as their core resources. Also, there is a big difference between the potential hike in the rates of short- and long-term deposits because almost everyone understands that the current level of NBU policy rate is a local ceiling, and it will not stay the same for a long time. Therefore, w**e consider**

a smaller hike in 12-month deposits compared with the products maturing in three months or earlier.

Contrary to deposit rates, **the transmission mechanism from the NBU policy rate decision works much faster for banks' loan rates**, while upside potential there might also be limited by increasing risks of non-payments and weaker demand for loans. In any case, we maintain our view that **it may take several weeks or even months for all banking rates to react to the NBU policy rate decision**, while the magnitude of this reaction would highly depend on the type of banking products, their duration, overall expectations of market participants regarding further actions of the NBU and the dynamic of yields on other hryvnia-denominated assets.

It seems that the intention of NBU to stimulate the Finance Ministry to make the corresponding adjustment in war bonds' yields has not materialised yet, while the positions of the two institutions as to the strategy on bonds' market still remain under active discussions. It is a matter of fact that **the government has not reacted anyhow to the NBU policy rate decision this week** by deciding to preserve placement yields on war bonds unchanged this week at 9.5%-11.5%. This shaped the decline in the placement volumes of new bonds to the lowest level seen since the start of the war. We estimate that the sharpest fall in demand for bonds was recorded, especially from the side of banks, which currently have a good alternative to invest their assets into NBU deposit certificates with a yield of 23% on O/N CDs. Therefore, **we still see a high probability of gradual upward adjustment in war bonds' yields** within the coming weeks. In its turn, this could be a good instrument to prevent the active flow of free hryvnia liquidity into the FX market.

The pace of external financing has not accelerated yet, although preconditions have already been created

Over the last week, **the volume of external financing has not changed significantly**: Ukraine has received a EUR 150 mn loan from the German state reconstruction bank (KfW) to finance its social needs. As a result, the total amount of external financing received since the beginning of the war amounted to USD 6.8 bn, slightly lower than initially expected. At the same time, the share of grant aid, which is included in the state budget revenues, was 21%, which is very close to our preliminary estimate made earlier (**Ukraine Insights: War leads to serious budget revision and record-high deficit**). The total amount of announced external financing for the budget needs in 2022 is USD 36.3 bn, 19% of which Ukraine has already received.

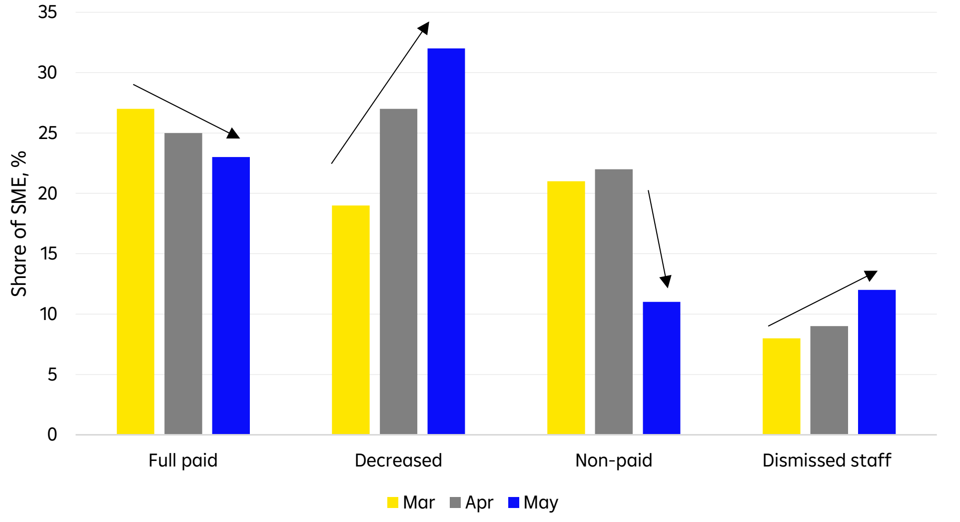
However, **we still believe** that there are prerequisites for **increased external financing** as early as July. The World Bank has approved a USD 1.5 bn package for additional funding, under which the UK has already signed guarantees for USD 450 mn. Japan, in turn, has expanded its concessional lending program from USD 100 mn to 600 mn. The newly appointed US Ambassador to Ukraine, Bridget A. Brink, announced that Ukraine would soon receive an additional USD 7.5 bn in grant assistance in addition to the USD 1.0 bn it has already received from the US in April and May. In this case, the share of grants, taking into account the previously announced but not yet received tranche from Germany and other countries, may increase to 28%, which will positively impact the dynamics of the state debt.

The labour market is gradually recovering, but it passed through significant transformations

It is still hard to estimate the situation in labour markets currently because its main parameters are still not published by Ukrstat. Hence, some general trends can only be assessed through the analysis of surveys and indirect indicators. First of all, since the beginning of May, we notice a slight excess in the number of those entering Ukraine over those leaving the country. Simultaneously, internal displacements also continue, but not at the same pace as in the first months of the war due to some localization of the war in specific regions. In parallel, we see the return of inhabitants of the liberated territories and the largest cities (Kyiv and Kharkiv). All these processes contribute to the **gradual increase in labour supply** in the market, with some **significant changes in the regional context**.

There are certain **differences between the employment indicators in public and private sectors** of the economy: Contracts in the former are more stable. According to the EBA survey, the proportion of SMEs who were not working in May is 17%, much lower than in March (42%). On the payments side, trends are quite contradictory. While the proportion of SMEs that did not pay wages fell from 22% in April to 11% in May, the proportion of businesses that paid wages in full decreased simultaneously, and the level of SMEs that cut wages and laid off employees increased. This still **keeps our outlook on increasing unemployment**, which is estimated at 18.0% for this year vs. just 9.1% the year before. Also, we see the trend of declining personal incomes, which may cause a deterioration in private consumption, thus negatively weighing on the GDP dynamics.

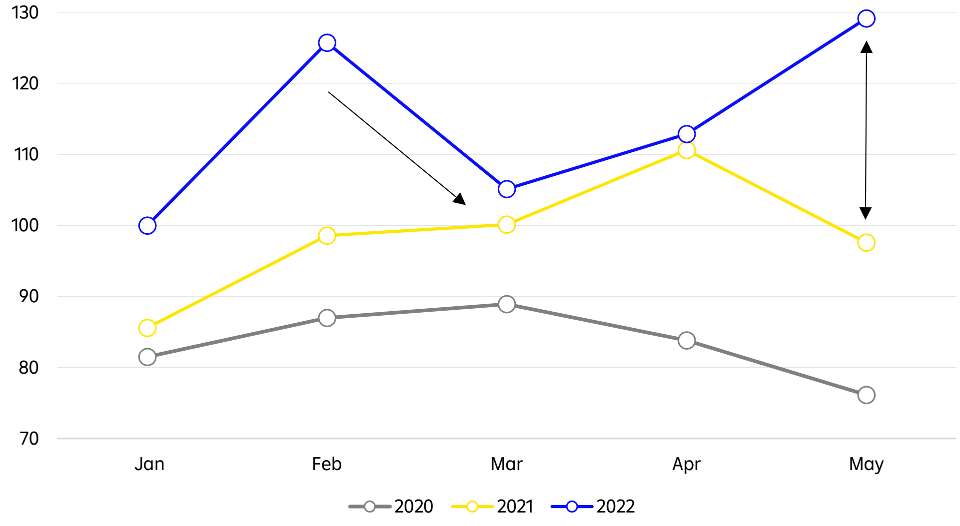
Chart 2 - SME wage survey (EBA poll)



EBA, RBI/Raiffeisen Research

Within the framework of estimating the potential downturn in wages in Ukraine, we are referring to recent data on own revenues of the state-run Pension Fund because unified social taxes accrued from salaries remains the primary source (91%) of revenues. According to recently released data, in January-May, own revenues of the Pension Fund increased by 13.5% yoy, but the monthly dynamic was not uniform. In particular, in March, there was a substantial slump in Pension Fund's receipts, while In April-May, the situation improved significantly. A substantial yoy increase in May revenues looks quite surprising even if taking into account the negative impact of quarantine restrictions in May 2021 and the fact that the number of payroll taxpayers has decreased as a result of military action. Perhaps this happened because a reasonably high percentage of refugees and displaced persons continue to work in their new place of residence. Despite reasonably positive trends in payroll tax revenues, we do not yet see factors that would allow the average nominal wage in 2022 to remain at least the previous year's level, thus predicting a **decline in the average real wage this year at about 25%**.

Chart 3 - Payroll tax monthly inflows to the State pension fund (Index, Jan 2022 = 100)



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