Ukraine Watch: Weekly update - economy in war (week 11)

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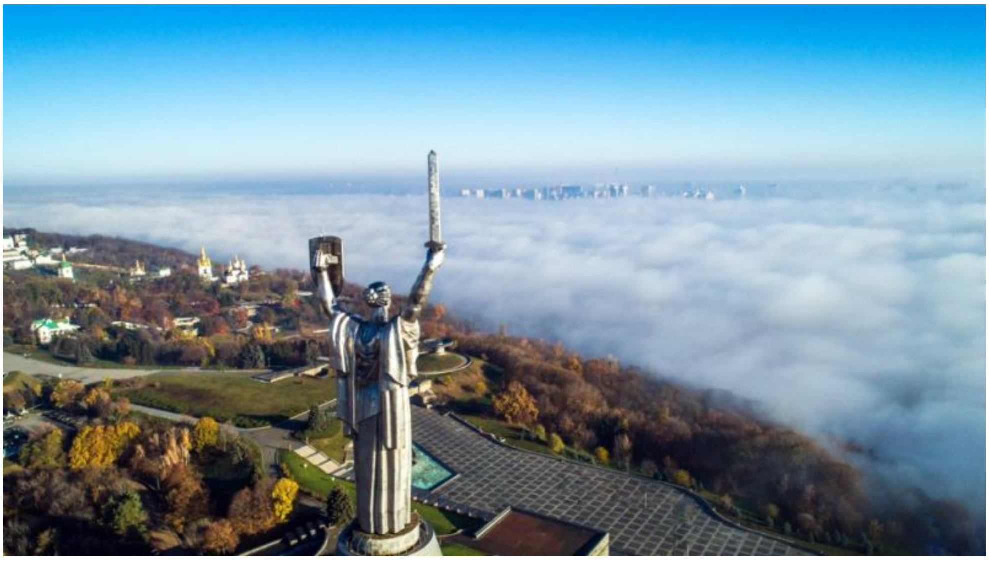
The eleventh week of the war has brought the front further away from Kharkiv, thus allowing a restoration of economic activity and a start to partial repairs in the city. The government still seeks sources to cover monthly budget gaps, while the NBU continues purchasing bonds. Inflation exceeded expectations in April, which forced us to increase the year-end forecast. Still, large imbalances in the FX market caused a further decline in NBU foreign currency reserves.



Business and consumer optimism slowed down in April after a tremendous upturn in March

Undoubtedly, Ukrainians fully believe in their victory in the current war. However, evident delays in the war, the additional time necessary to get and adjust to new weapons from the West, and slow liberation of temporarily occupied territories postpone hopes of a quick end to the war and a full return to normal life. This is clearly seen in recent estimates of **consumer and business sentiment that slightly lost steam regarding hopes for a quick economic recovery**. Indeed, recent opinion polls show that around half of companies that ceased their activity due to the war do not have any plans on restoring their operation until after the war fully ends, while only 20% of these companies plan to relaunch their business within the coming two months. We think this clearly reflects uncertainty regarding the outcome of the war and some business fears about the expediency of restoring their activity in the near term. However, on the positive side, we should point out that most companies operating currently or planning to do this soon believe in their full recovery to pre-war levels. However, we definitely think this would happen more actively only in case the war ends. Hence, if considering current estimates on delaying the end of the war for an additional one to three months, we think a **more active recovery could be started with a corresponding delay**, which would, in turn, negatively weigh on the economic dynamic for this year.

Expectations of a delayed recovery are clearly seen in the dynamics of **the consumer confidence index over April, which recorded a modest decline (-7.4% mom)** after a substantial hike in optimism (44.1% mom) the month before. All components of the index (with the exception of reasonability of large purchases) diminished last month. The largest monthly drop occurred on the sub-index of personal living standards, which dropped by 20.1% and returned to the February level. This is fully in line with our estimates and

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corresponds to recent opinion polls that the living standards of individuals are declining sharply due to the war.

We also notice a moderate drop in the sub-index of estimates of economic dynamics within the coming year, that declined by 11.5% mom in April - after a tremendous (52.7%) hike the month before on expectations of a quick victory in the current war. Therefore, **the optimism of consumers regarding a close approach of the end of the war has retreated slightly**, thus gradually changing their minds and adjusting to a more pronounced delay in the conflict. This could cause a deceleration in the recovery of consumer demand, thus also negatively weighing on the economic dynamic for the coming months. We also notice a modest hike in all three indices, i.e. unemployment, inflation and the exchange rate, which additionally reflects **the cautious approach of consumers regarding the macro environment within the coming months**. Therefore, it is already quite evident that every month of delay in the war could deteriorate short-term consumer sentiment, while long-term sentiment should not be changed much as almost everyone in Ukraine believes in their victory in the current battle.

The IT sector proved its resistance to the crisis again

Like during the Covid-19 crisis, the IT sector proved most resistant to the current crisis. As we expected, the sector endured the shock of the war easier than other economic segments. **In the estimates of the drop in total economic output by 40%-50% yoy over March-April, the IT sector looks like a bright spot.** According to recent data, 95% of contracts in the sector remained intact during the war, while 77% of companies even managed to obtain new clients since the war started. In the first quarter, the export of IT services amounted to about USD 2 bn, a historical record. Even though the sector's performance was just 4% weaker in March in yoy terms, this looks like a real success, especially when comparing the dynamic of other economic sectors during the war. We are sure that IT will keep outperforming other economic sectors within the coming months due to its resistance to any economic and political shocks, thus partially mitigating the negative impact of the war on GDP. The IT sector's share of GDP has grown steadily in recent years, rising from 3.5% in 2010 to 5.2% in 2021. Given its relative resilience to the war, including the technological upgrade of the military-industrial complex, the IT sector will be one of the economy's main drivers for the coming years.

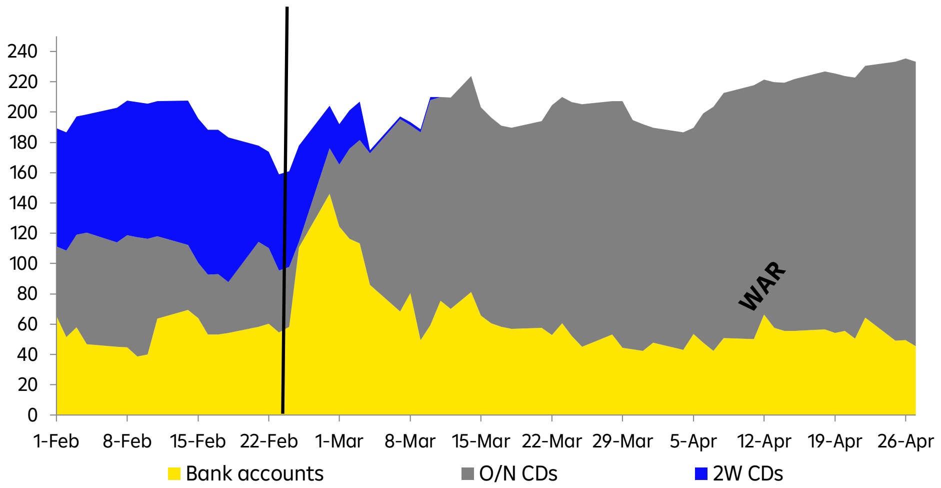
Financing the budget deficit is an urgent task, the government started optimisation of its expenditures

It seems that requests from the Ukrainian government to externally find USD 15 bn over the coming three months, in order to cover the budget gap, could be satisfied soon. First, the US already stated the potential provision of USD 5 bn for these purposes soon. **The rest may be covered through the planned issuance of bonds worth USD 10 bn by the EU** under guarantees of the members of the Union. According to EU officials, the corresponding plan should be released on 18 May. We assess this news positively, as the delay in the war increases the Ukrainian government's need to finance current expenditures, especially when ordinary revenues are quite scarce due to the economic downturn and temporary occupation of part of Ukrainian territory. In any case, we think this financing will be provided no earlier than in two to three weeks from now.

At the same time, the current flow of financial resources from abroad is not sufficient to cover war expenditures. Indeed, since the beginning of the war, international donors provided approximately USD 5.3 bn, most of which (USD 3.2 bn) came in February-March. Probably, this was the core factor **forcing NBU to make another purchase of war bonds worth UAH 30 bn** this week, thus expanding the total volume of purchases (i.e. indirect monetary emission) to UAH 100 bn. This amount is still small (just 5%) in terms of broad money aggregate (M3), while already visible (14%) in terms of the monetary base. Therefore, it may raise the potential pressure on inflation in the medium term, while this effect is still not significant and could be mitigated so far. However, in case the government would again fail to agree on external sources for covering excessive budget expenditures in the coming weeks, additional purchases of bonds by the NBU could be inevitable, thus raising the threat of inflation acceleration.

As an alternative to direct purchasing of government bonds by the NBU, **increasing the activity of banks in investing in the bonds may be quite encouraging for state finances**. In particular, the excessive liquidity of banks is expanding gradually, while banks are investing more into O/N CDs instead. Definitely, one of the reasons for banks is greater uncertainty if investing in one-year bonds vs O/N NBU certificates because this still could be viewed as quite long-term investments in the view of potential rapid change in circumstance under active war conflict. Hence, it is logical that the NBU is seeking ways to encourage banks to invest more in government bonds. However, **in current circumstances, it would be no alternative rather than to increase the placement yields**, while this way faces substantial negative reaction from the government in order not to raise further borrowing costs. In any case, there is no clear decision on the current problem, which would restrain potential investments into war bonds by non-state investors.

Chart 1 - Liquidity in the Banking system, UAH bn



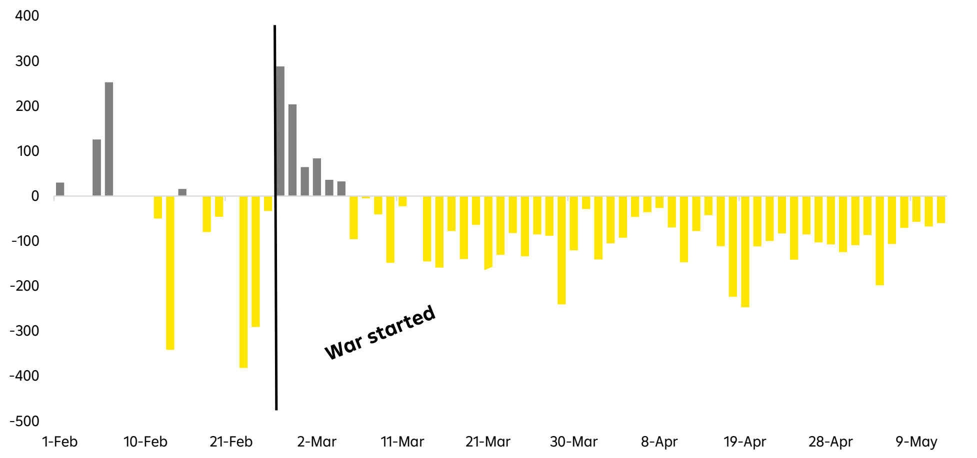
NBU, Raiffeisen Research

In order to balance the budget figures, the government started optimisation of its expenditures. In particular, it recently clarified a list of categories of internally displaced persons who will receive monthly assistance from May onwards. It will focus exclusively on 1) resettlers from the territories where active combat operations were or are being conducted; 2) persons who have lost their housing. Thus, the monthly aid will be strictly targeted in the future, and it will allow for stabilising expenditures to a certain extent. Also, it may be a stimulus for other categories of internally displaced persons to return to their homes and/or to increase efforts in finding jobs, thus helping to restore the economy quicker.

The flow of news on potential assistance is still dense

According to preliminary information, this week, the EU approved the third tranche (EUR 600 mn) of macro-financial assistance, which will arrive by May 20. The World Bank also approved a special program for financial support to budget institutions for USD 1.5 bn. Additionally, the US House of Representatives passed a law on additional financing for Ukraine, providing for military, economic and humanitarian aid of USD 39.8 bn, within which USD 8.7 bn of economic aid, including budget grants, had already been envisaged. Compared to the previously proposed amount of USD 33.0 bn, the new proposal considers a similar increase of USD 3.4 bn for both military and humanitarian aid. Therefore, the total amount of financial assistance announced by international partners has increased over the week by 41.3 USD bn to USD 114.5 bn.

Net NBU interventions (USD mn equivalent)



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NBU reserves continued the active meltdown in April

Contrary to March, the inflow of international financial assistance over April was not enough to cover both the net FC interventions of the regulator on the market and servicing current external debt obligations by the government. This caused **a modest decline in NBU reserves by 4.1% mom to a 17-month minimum of USD 26.9 bn**. Indeed, the NBU increased its net interventions in the FX market to USD 2.2 bn in April from USD 1.7 bn in March, which clearly demonstrates the situation there and still higher pressure on FC demand from imports as well as exchange rate transactions of individuals abroad. This outflow was partially offset by USD 1.9 bn, which came as international donors' assistance. However, a part of this financing was also spent on repaying and servicing current external obligations of the government worth USD 0.6 bn. Hence, the government follows its announced strategy of servicing its external debt fully and on time. We do not expect to see any substantial changes in FX market flows in May, thus estimating another USD 1-2 bn total of net interventions from the NBU there. However, this could be fully mitigated by the increasing inflow of international aid. Also, quite small FC payments of the government on external debt (USD 0.1 bn) **allow us to expect even a small restoration of NBU reserves this month**.

Despite a visible decline in NBU reserves, their imports coverage has not changed much, thus **staying at around 3.9 months in April** because of a substantial drop in imports after the war started. Nevertheless, this ratio indicates the preservation of a good ability of the NBU to avoid any sharp fluctuations in the exchange rate within the medium-term future. We also could see **an improvement of this ratio in May** in case of restoring growth in NBU reserves due to more active international assistance.

Inflation in April accelerated to 16.4% yoy on shock attributed to the war

Unsurprisingly, inflation in Ukraine continues to increase in yoy terms in April **to the levels not seen over the last six years (16.4%)**. Even though mom CPI in April (3.1%) was weaker than the figure of the first month of the war (4.5%), it still looks quite high in annual terms if compared to March level (13.7%). With few notable exceptions, we see several interrelated supply shocks across economic sectors that have propagated deep into the prices of goods in Ukraine. The actual CPI figure exceeded our forecast of 15.7%. It recorded a stronger rise in food products' prices than we expected initially and as the adjustment of supply to shocks caused by the war continued. Yet, **inflation dynamics remained geographically heterogeneous**, and places close to the conflict zones increased on average higher due to logistics and other risk factors. It is also **not**

clear whether the price dynamic on temporarily occupied territories was taken into account or not because it could significantly change the actual inflation pattern.

In April, food prices posted a substantial mom growth (4.2%) with an upturn in vegetables and fruits of 8.5% and 14.9%, respectively, reflecting both seasonal patterns and **potential shortage in supplies due to the occupation of southern territories**. War factors also influenced a higher than usual hike in grain-related products by 2.7%-8.6% mom. The dynamics of food prices do not clearly reflect the influence of any administrative price controls that the government tries to apply during the martial law regime. The same increase in prices as in food products was recorded in the price of pharmaceuticals (4.2% mom) which might reflect increasing demand and some supply interruptions due to the war. It was no surprise to see just a mild monthly hike in public utility tariffs (0.6%) as they were under strict control from the government during the martial law. However, **just a 0.5% increase in the price of fuel seems rather unrealistic to us** if considering the global oil price increase and a substantial hike in Ukraine recently due to its deficit after the destruction of fuel bases and oil refineries inside the country. Definitely, **we will see this effect in the dynamics of prices for May**. Nevertheless, preservation of the exchange rate at the same level was effective in restraining the growth in the prices of imported products.

We expect to see some slowdown in price growth in the near future due to adjustment of supply chains to new conditions and gradual weakening of demand shocks caused by the war. However, the return of fuel prices to market-driven levels as well as a seasonal increase in food products would still keep inflation high for at least a month or two. In any case, we think the inflationary trend is likely to persist during the whole of 2022. Hence, **we decided to increase our year-end CPI forecast from 17.0% to 20.5% yoy**, with average inflation for the whole year also adjusting upwards from 15.0% to the current projection of 16.9% yoy. Even though CPI over May (2.5%) could be smaller than in April, this would still be enough **to preserve the acceleration of yoy inflation to 17.8% this month**. We still expect the pressure on inflation from the price of food products due to seasonal factors and declining supply because of the occupation. Also, we expect to see the influence of increasing fuel prices on the inflation level this month.

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