Ukraine Watch: weekly update - economy in war (week 10)

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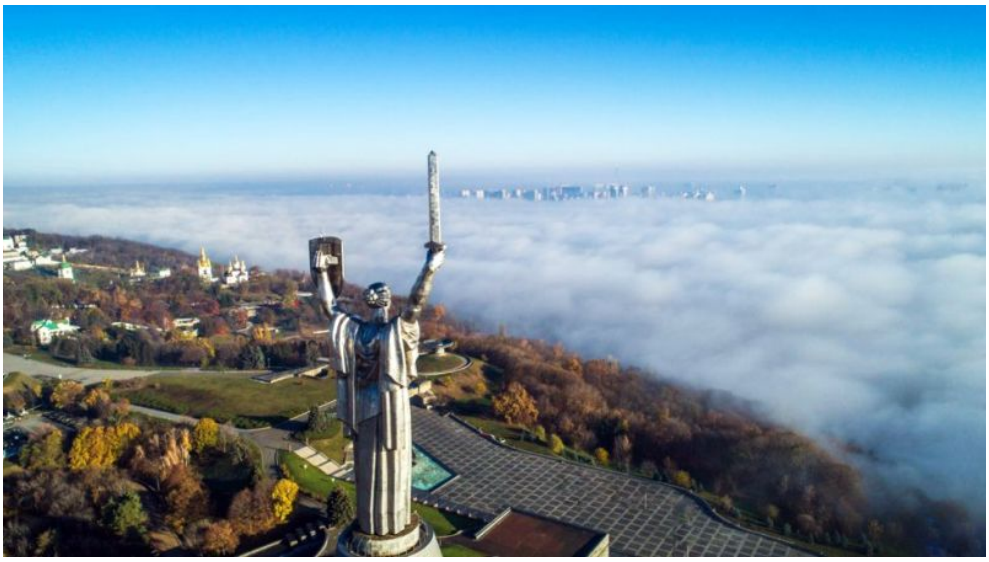
The tenth week of the war has reminded us that the risk remains quite high for the economy. This was clearly seen in the attempts of the enemy to deteriorate the domestic railway system, which is crucial currently for almost all Ukrainian exports. However, the figures on external trade in March still do not look quite worrisome, while NBU imposed additional capital controls for FX market operations to minimise imbalances in the market. Business keeps the trend on gradual recovery of its activity, albeit restoring its operation just partially.



Business restores activity, but still faces solid logistic risks

Transformation of the war into more prolonged conflict causes adaptation of the economy to new circumstances, thus adjusting to new risks in the operating activity of the domestic business. We already see more signals from multinational companies that are present in Ukraine on the restoration of their business where possible. This clearly correlates with recent polls made by the NBU that the **share of the non-working economy continued its contraction**, thus reducing from 32% in early March to 17% currently. Definitely, this does not mean that the companies restored their output to the pre-war level. For example, according to NBU, **around 60% of companies are working below** their levels seen before the war. However, improving the dynamic of relaunching business is encouraging, thus providing hopes for their acceleration in performance as soon as the war ends. We also should not forget about progress in the companies that decided to relocate, while the progress is still little there. Among entrepreneurs that lost their business due to war, just 32% of them are ready to restore their operations immediately, while the majority (62%) would do this after the war. It is good to see that more than 90% of them are ready to renew business, which definitely indicates substantial business optimism. This would mainly happen only after finishing the active war conflict.

We positively assess **the improving dynamic of Ukrainian companies with the availability of their inputs**, where around a third of companies from NBU polls do not have any problems with their supplies, while an additional 48% have stock of inputs for at least one month. This is quite positive in terms of preserving the operating flow of business even in case they would face some temporary shortages. Nevertheless, the latest example of a temporary shortage of fuel, interruptions with railway deliveries of products to Ukrainian harbours at the Danube river or a deteriorating railway network in western

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Ukraine indicates that the **war is still active and it may cause some short-term risks for companies' supplies**. On the other hand, companies must consider this risk in their operational activity. Therefore, creating the stock of inputs for at least a month of their operation would mitigate these risks.

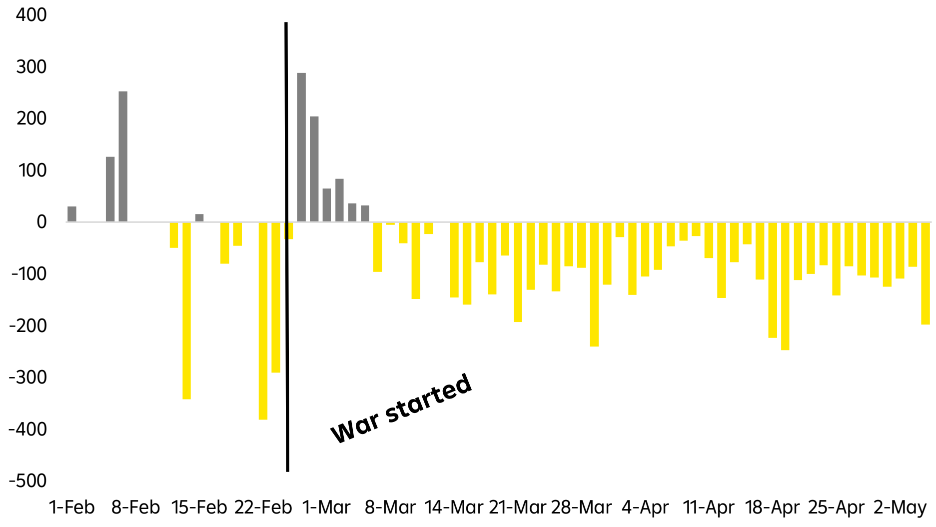
Another opinion poll on personal situation indicates **an improvement in the share of individuals who continued working or studying** to 64% in April vs just 53% in March. However, the worrisome signal is that the percentage of individuals who have their available savings for no more than just a month has increased from 14% in March to 19% in April. This poses a threat to potential consumer demand in the coming few months, thus also hinting at increasing unemployment and increasing costs of the government for their support.

New FX capital controls imposed by the NBU to reduce FX imbalances

The FX market in Ukraine remains subject to severe restrictions by the NBU due to the active military conflict and the imposition of martial law. Hence, trading volumes are incomparable to pre-war levels. However, the current level of capital controls was not perfect, with **some FX outflows tied to cross-border transactions** of individuals and businesses. This caused an expansion of net foreign currency outflow on the FX market to USD 2.2bn in April, thus generating pressure on NBU reserves. Hence, it became the core factor behind an estimated **decline in NBU FX reserves to USD 26.6bn** as of the beginning of May.

Even though, since the start of the martial law regime, the NBU has tried to lift some capital controls that do not have an additional negative impact on FX outflows, it still remains ready to impose new ones in case of necessity. Hence, in order to prevent capital outflows and to smooth the constant deficit of foreign currency in daily market operations, the NBU decided to impose additional capital controls **on April 30**. The new measures include **the ban on derivative operations** (except swaps) with basic assets being exchange rate, FX index or gold to hryvnia. Also, the NBU **restricted the value of the exchange rate** for operations with electronic payment systems at the official rate or higher (in case of paying hryvnia to the client's account) or no higher than the official exchange rate plus 10% (in case of paying foreign currency on client's account). We believe these measures could limit some cross-border operations of bank clients and reduce the exchange rate volatility.

Chart 1 - Net NBU interventions, USD mn equivalent



NBU, RBI / Raiffeisen Research

Additionally, the NBU ordered to **narrow banks' open currency position** from 15% to 5% of their regulatory capital **from May 4 onwards**. Considering that banks tried to use their currency positions at their maximums before the war, changing NBU regulation will free up to USD 0.7bn, thus increasing FX supply on the market and lowering imbalances. We also do not exclude additional restrictive measures from the NBU in case of widening imbalances in the market. In any case, **we leave our USD/UAH exchange rate forecasts for this year unchanged**.

Recent update on the economy and monetary policy from the NBU reveals a high portion of uncertainty even within the short-term period, putting pressure on almost every macroeconomic estimates and forecasts. NBU officials reiterated their readiness **to return to a free exchange rate regime and inflation targeting as soon as martial law ends**. However, the transition period (especially in FX regulation) could take some time. This fully supports our view that **NBU would not switch sharply and immediately to free-market** but would instead lift capital controls rather gradually in order not to create any sudden imbalances and not send a wrong signal to the market. We have already seen a similar strategy of the NBU after the crisis in 2014-2015, when several years must have passed until NBU lifted almost all capital controls imposed then.

The budget deficit increased sharply in April

According to preliminary information from the Ministry of Finance, the state budget deficit in April reached UAH 91bn, which widened its YTD figure considerably to UAH 147bn. We think a substantial shortfall in revenues, as well as the increase in expenditures due to the protraction of the war conflict, were **the core causes for widening the budget gap**. However, it should be noted that in April, state budget expenditures were slightly lower compared to March figures, which could reflect the optimisation of their structure to prolonged war conflict as well as to switching of a solid portion of military expenditures towards international programs. It was not a surprise to us that **budget revenues posted a 21% yoy drop in April, while expenditures increased by 61%**. So far, the revenues still accounted for less than 50% of spending in April, thus expanding the role of international financing in closing the gap. According to our basic assumption that the war conflict would last for at least 1-1.5 months, we think a similar situation with a sharply negative balance of budget revenues and expenditures **will remain for at least the coming two months**. On the other hand, the gradual recovery of business activity and the partial return of refugees will accelerate budget revenues slightly, but this will not be a substantial increase until the recovery of export-import operations to at least 75-80% of last year's level.

Table 1 - Budget indicators, UAH bn

Month	Revenues		Expenditures		Budget balance	
	2022	YoY, %	2022	YoY, %	2021	2022
Jan	89	35%	71	-1%	-6	16
Feb	119	54%	112	21%	-15	8
Mar	121	12%	200	79%	-5	-79
Apr	84	-21%	175	61%	-4	-91
YTD	***413***	***15%***	***558***	***45%***	***-29***	***-147***

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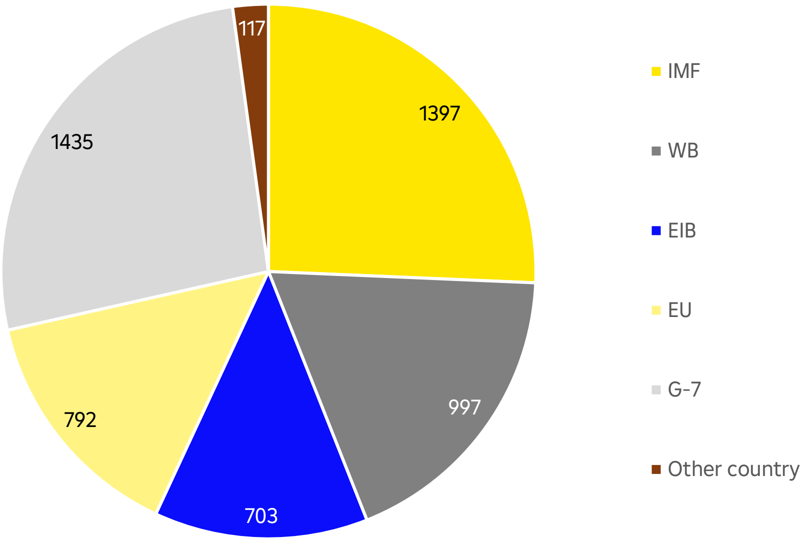
External financing would be accelerated in May

In recent days, Ukraine has received external budget funding in the form of grants totalling USD 0.6bn, most of which (EUR 495mn) represents the second tranche of the trust fund from the World Bank. Unlike other grants, this one is not explicitly earmarked but provides funding for a wide range of budgetary services of a humanitarian nature. In the nearest future, it is expected that the second tranche of grants from the USA will be transferred through this trust fund in the amount of USD 0.5 bn. According to the Ministry of Finance information, since the beginning of the war, the country has **received over USD 5.4bn in external financing**, including USD 0.8 bn (14.8%) in grants. The volume of foreign funding is expected to grow substantially in the coming months. In particular, representatives of the G-7 announced recently the provision of USD 24 bn to Ukraine in loans and grants, while this provision would not be immediate as it requires changes in local budgets of countries-donors.

Chart 2 - External financing of budget needs by sources since February 24 (USD mn)



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Great hopes were for the **donor's conference of EU countries on the 5th of May in Warsaw**. European leaders announced that it should have been a starting point for a Marshall plan for Ukraine. Definitely, the outcome and concluding remarks of the conference were towards wide support of Ukraine from the EU and increasing their efforts in the provision of financial and humanitarian aid to help Ukraine withstand the current crisis. **The conference collected the financial aid worth USD 6.5bn**, which we should definitely treat as a starting point for the recovery plan. We think the funding should flow to Ukraine already quite soon. However, implementing the Marshall Plan for the active restoration of Ukraine requires much more funding, which we hope will be provided in the near future. According to recent estimates, the direct losses of Ukraine's infrastructure have increased to USD 92bn.

BOP recorded solid changes in March

The balance of payments faced substantial structural changes in March as war approached Ukraine, while **it faced almost no solid imbalances in general**, which looks quite surprising to us. Among the most visible changes in the current account, we notice a sharp drop in both merchandise exports and imports, while a higher decline in imports (by 65% yoy) comparing exports' dynamic (by 52% yoy) turned **the trade balance into a surplus, which was not seen in March for over a decade**. A visible drop in merchandise trade mostly happened because of the issues related to logistics where seaports are blocked or captured by the forces of the country-aggressor. Thus, the only available road and railroad transportation to western borders remained the only trading routes with the EU countries and the rest of the world, thus severely bounding the export/import capacity of Ukraine and causing their sharp fall in March. The seizure or destruction of production facilities by the military forces of the country-aggressor, as happened in Mariupol, became the second-factor bounding external trade during wartime. Finally, a harder drop in imports vs exports was caused by the limitation of imports towards the list of critical items only.

Same as merchandise trade, **external services trade also faced a substantial change** compared to pre-war levels. In particular, its balance suddenly turned into a deficit (USD 0.5bn), which happened for the first time over the last five years. This happened on the simultaneous drop in services' exports by 18.8% yoy (amid a sharp contraction in transport services due to deteriorated logistics) and a hike in imports by 57.4% yoy (amid increasing spending abroad from individuals who left the country during the war). It is worth mentioning that **IT services exports faced the smallest decline** (by 4.4% yoy), which allows us to expect their quick recovery to the pre-war levels, while restoration of the volumes of transportation exports may take time well after the war ends.

It was not a surprise that **remittances from abroad lost a quarter of their volume in March** in yoy terms, which is attributed to sharp emigration outside the country and the reduction of the number of potential recipients. Unfortunately, until the war ends, we should not hope for restoring these flows, which would negatively weigh on the current account. Another structural change in the current account occurred in the secondary income item, which reached a two-year maximum (USD1.1bn) due to the active provision of humanitarian aid. Overall, substantial changes in components of **the current account in March** increased its **surplus to a record level (USD1.4bn) over the last two years**, thus mitigating almost fully the deficit in the capital account.

On the capital account side, we didn't see game-changing dynamics from the beginning of the war: its deficit of USD 1.4bn in March was not quite different from the figures in January and February. Quite surprisingly, **net flows of FDIs turned back to positive in March** (USD 0.3bn) after their outflow in February (-USD 0.6bn) on fears of close invasion. We still do not see a clear, logical explanation for this phenomenon while expecting visible correction further after more precise data collection. Maybe this is tied to the relocation of some international companies to regions not involved in direct war actions. On the external loans side, a **solid FC outflow** (USD3.2bn, which is at maximum over the recent ten years**) occurred in corporate loans** due to a rapid decline in trade loans after a sharp deterioration of external trade due to the war. This outflow was mitigated just partially by a net inflow of USD 1.9bn from international loans into the public sector. As soon as the flow of international financial assistance increases, we should not see the widening of the capital account deficit within the coming months.

We should point out that a preliminary estimate of the balance of payments (especially within the components of the current account) **may be reviewed considerably afterwards** because this was the first approach to assess the volumes of external flows by having rather limited access to precise data due to war and martial law. For example, the value of imports may be reviewed considerably on the upside due to adjusting the value of humanitarian aid to their real prices. So, a large portion of data was obtained chiefly through indirect methods that **would be corrected upon the availability of official data** through traditional channels later on.

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