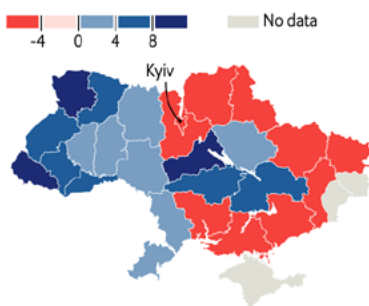


A Tough Macroeconomic Balancing Act in Ukraine

Due to the brutal war, Ukraine has a big budget deficit. The National Bank finances almost a third of it, being forced to tighten the other parts of its monetary policy. Ukraine's macroeconomic balancing is tough. But thanks to the foreign partners' aid and an able economic management, the situation in August is better than a month ago.

GDP Estimate:

By region, March 2022, % change on 2021



*Based on Google Trends data.
Excludes occupied Donbas

In the 1st quarter of 2022 Ukraine's **GDP** shrank by 15%. The National Bank assesses that in the 2nd quarter, GDP has fallen by 40% y-o-y. It is projected to reduce by 30-45% by the end of the year. At the beginning of March about a third of enterprises were partly out of operations, and at the end of May this number decreased to 14%¹.

But GDP fall obviously is not uniform. The Economist, quoting VoxEU, illustrates that there are regions in Ukraine that have enjoyed GDP growth (!) higher than 8 per cent(!)² "The war has shifted economic activity westward."

Tax revenues decreased significantly from \$3.7bn per month a year ago to \$2.5bn in May 2022 to less than \$2bn in June. Thus tax revenues covered less than quarter of the current government expenditures. National Bank covered 31%, and internal borrowing covered 7% of expenditures. The situation with tax revenues improved in July mostly to tax schedule reasons and reinstated import taxes. Yet significantly lower VAT refunds in July are the reason for concern.

Ukraine spends on defence in one month of 2022 almost as much as it spent in the whole of 2021. Government spent 56% (\$4.4bn in June) of its total expenditures (\$8bn in June) on defence³. Amid \$4.8bn **budget deficit** in June (and \$13.8bn for the 1st half of the year), Ukraine's Parliament increased **government social spending** by another \$2.5bn on July 9th to be financed by borrowing, mostly, external.

All of this most likely will bring **government debt** to about 100% of GDP by the end of the year. (It was down to 50% in 2021.)

The international partners loaned or granted \$3.8bn in June. The **foreign aid** is 48% (\$13bn) of the government budget revenues since Feb 24. \$19bn more of foreign aid is promised. This will be enough till November 2022. Then an additional \$10bn is required until the end of the year.⁴

The National Bank bought \$8.5bn of government bonds (which basically amounts to printing new money) since Feb 24th. The Bank kept an **exchange rate** fixed since the beginning of the war until July 21st. The market exchange rate for Hryvnia was 25% higher than an official fixed rate by mid-July, which created the ample opportunities for currency exchange arbitrage both for banks and for entre-

¹ <https://rabbitholemag.com/sergiy-nikolaychuk-on-the-economics-of-war/>

² "Estimating the short-term impact of war on economic activity in Ukraine", Constantinescu, Kappner, Szumilo 21 June 2022, VoxEU <https://voxeu.org/article/short-term-impact-war-economic-activity-ukraine> via "Tracking changes to Ukraine's economy", <https://www.economist.com/graphic-detail/2022/06/30/tracking-changes-to-ukraines-economy>

³ Data from <https://forbes.ua/inside/zbilshiti-pensii-dopomogti-lyudyam-derzhavi-kritichno-ne-vistachae-groshey-ale-uryad-i-deputati-zbilshili-sotsialni-vidatki-do-chogo-tse-prizvede-14072022-7182>

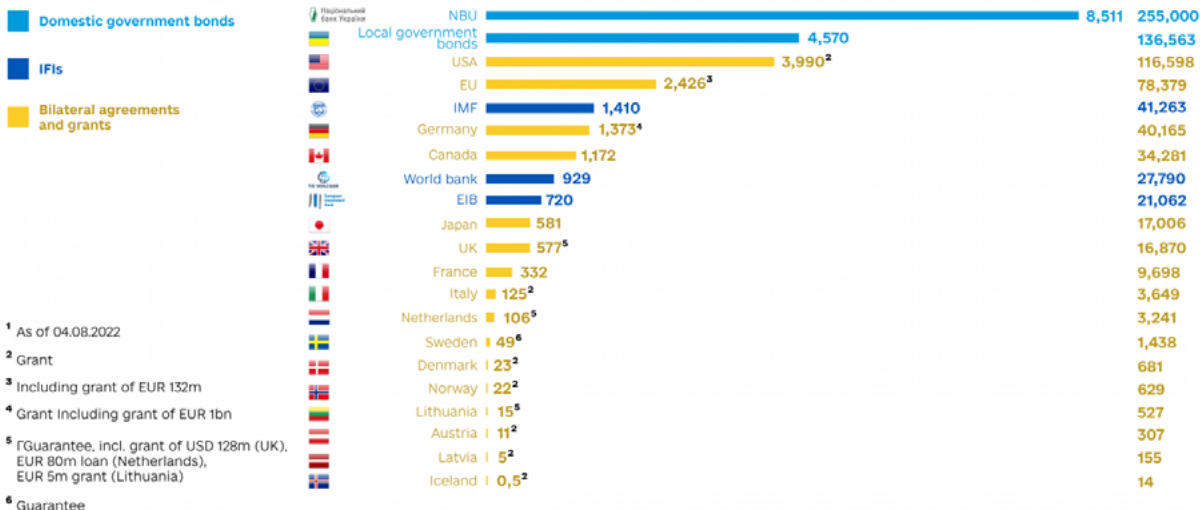
⁴ Ukraine's State Budget Financing Since the Beginning of the Full-scale War. Ministry of Finance of Ukraine. https://www.mof.gov.ua/en/news/ukraines_state_budget_financing_since_the_beginning_of_the_full-scale_war-3435

UKRAINE STATE BUDGET FINANCING SINCE THE BEGINNING OF THE WAR



26,948 US\$m OR 805,317 UAHm Total amount

Received budget financing during the wartime split by sources¹



¹ As of 04.08.2022
² Grant
³ including grant of EUR 132m
⁴ Grant including grant of EUR 1bn
⁵ Guarantee, incl. grant of USD 128m (UK), EUR 80m loan (Netherlands), EUR 5m grant (Lithuania)
⁶ Guarantee

preneurial citizens. To support Hryvnia, the National Bank was forced to raise its discount rate drastically from 15 to 25% on June 2.

Yet the **currency reserves** decreased by \$2.5bn in June. With the speed like this (\$4bn of withdrawals/month + \$1.7bn debt repayment in 2022 and \$2.8bn in 2023 + \$2-4bn payment for natural gas during the wintertime), there was a big danger for currency reserves to reduce to the dangerously low \$12-15bn from the \$23bn as of June 30 (\$31bn as of Jan 1, 2022)

With **inflation** is up to 21.5%, the National Bank had had enough of it and it devalued Hryvnia by 25% on July 21. Currency reserves stayed at \$22.4bn as of August 1, 2022.

At the same time, following a request from Ukraine’s government, its international creditors agreed to **suspend debt repayments** in July until the end of 2023, giving the country breathing room to continue to fend off Russia while avoiding a default.⁵

The US has decided to provide Ukraine with an additional \$4.5 billion in direct budgetary support on August 8, using a World Bank-managed program to mobilize the funds. The first \$3 billion will be distributed in August. “This economic assistance is critical in supporting the Ukrainian people as they defend their democracy against Russia’s unprovoked war of aggression,” Treasury Secretary Janet Yellen said. Once the additional funds are fully disbursed, the US will have provided a total \$8.5 billion in direct budgetary support to Ukraine.⁶

NBU Governor Shevchenko believed that the government should “respond adequately” and raise interest on domestic government bonds. Yet the Finance Ministry is still refusing to increase coupons on its war bonds, arguing that it can’t afford it. “Buyers should consider purchasing the debt as an investment and as an act of good will”, according to the Finance Minister.⁷

⁵ International creditors give Ukraine more time to make debt repayments. NYT, July 20, 2022 <https://www.nytimes.com/2022/07/21/world/europe/international-creditors-are-giving-ukraine-more-time-to-make-debt-repayments.html?referringSource=articleShare>
⁶ <https://www.bloomberg.com/news/articles/2022-08-09/ukraine-latest-zelenskiy-lauds-biden-over-unprecedented-aid>
⁷ Ukraine Seeks New IMF Deal to Boost Its War-Ravaged Budget. Bloomberg, 10 June 2022. <https://www.bloomberg.com/news/articles/2022-06-10/ukraine-seeks-new-imf-deal-to-shore-up-its-war-ravaged-finances>

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In a perilous situation like this the policy recommendations are the following:

1. Given the war realities, there is a rationale to differentiate Ukraine's tax policy with lower taxes in the South-East of the country and the higher taxes in the West. The tax base needs to be broadened everywhere to target shadow economy in order to increase government revenues.
2. The parliament and the government need to refrain from increasing social expenditures until Ukraine receives sufficient foreign aid. Social assistance needs to be better targeted at those who needs it most
3. Foreign aid remains critical for Ukraine to continue functioning as a state and fighting the brutal war
4. Ministry of Finance needs to increase coupons on its war bonds to the market level to attract capital to finance budget deficit
5. The National Bank should consider pegging the national currency to the Euro, not the US Dollar, which may keep appreciating due to the higher interest rates in the US