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HOW THE WORLD ENTERS 2023: ECONOMIC PROSPECTS FOR UKRAINE'S RECOVERY

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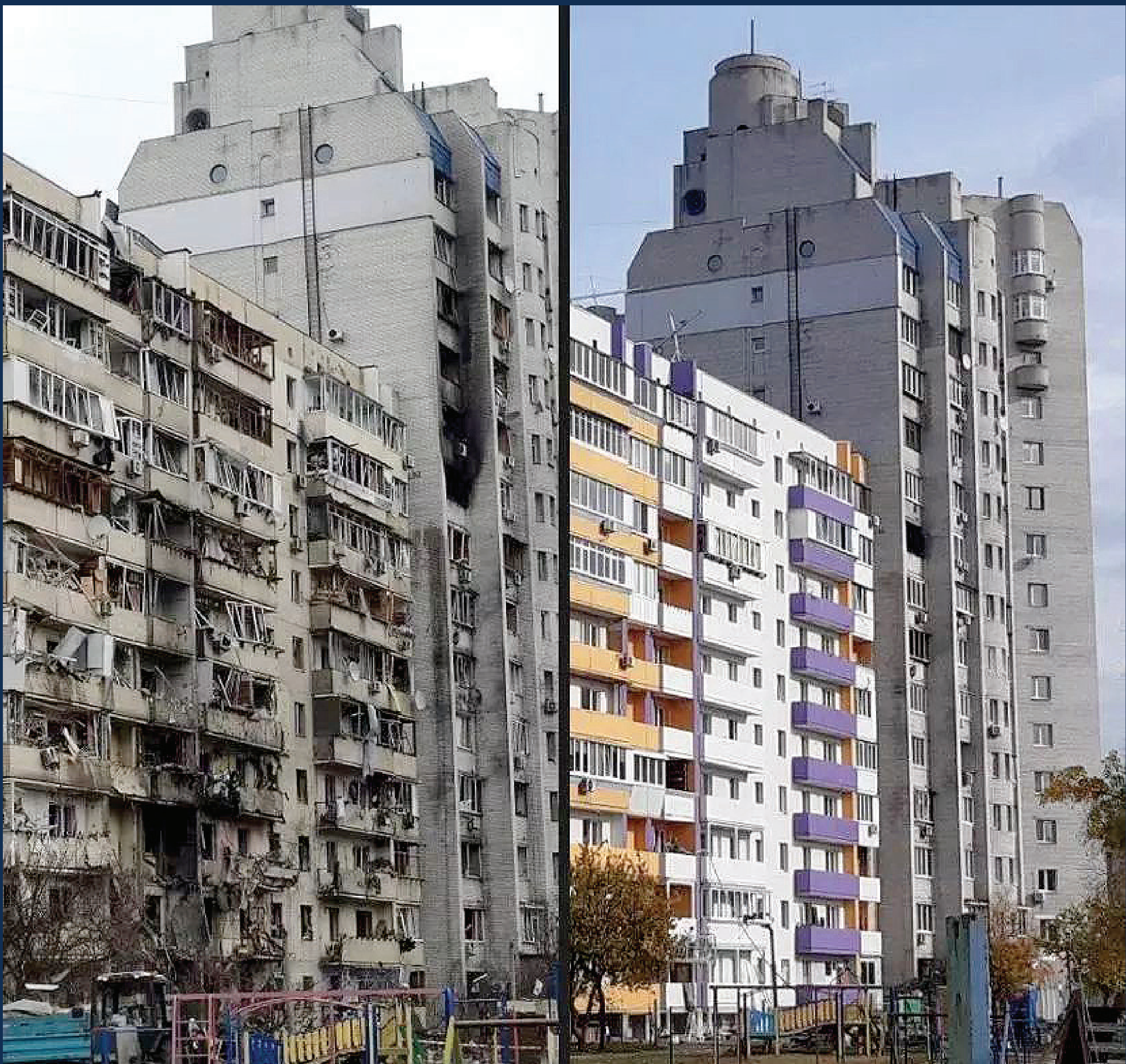

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HOW THE WORLD ENTERS 2023: ECONOMIC PROSPECTS FOR UKRAINE'S RECOVERY

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DOMESTIC REALITIES AND EXPECTATIONS

2022 in Ukraine will go down in history as a year of major trials and losses. 2023 is associated with the beginning of the country's recovery, which still may be hindered by a new escalation by Russia. Although citizens are quite pessimistic about the country's economic situation (Annex 1. Citizen Assessment of the Country's Economic Situation), it is not an indication of economic collapse. Moreover, since the national economy in 2022 managed to preserve a significant share of its potential, this gives sufficient grounds to believe that 2023 may be the year of economy's gradual recovery even in the face of enemy attacks.

In the meantime, the already «forgotten» problems of the country's public administration system are likely to manifest themselves in 2023; the number and «density» of internal politicised challenges, primarily related to post-war development, will also increase, especially in the practical absence of resources for economic stimulation. Therefore, the development of Ukraine's economy in 2023, as in previous years, will significantly depend on the self-sufficiency and readiness of businesses to achieve positive results relying on their own resources.

Meanwhile, Ukrainians are witnessing a somewhat unique situation, where numerous sociological studies (surveys) indicate a high level of support for the government and its institutions by civil society, which usually demonstrated a very low level of trust. Obviously, this is due to the peculiarities of time, and society fully supports the government in the fight against Russian aggression. This can be rightly viewed as a significant component of military victories. However, in matters of post-war peaceful construction, the authorities' decisions and actions are already causing increasing concern. Therefore, transparency and meaningfulness of government decisions is a prerequisite for the country's accelerated recovery.

Key macroeconomic indicators. The downfall of the economy caused by Russian aggression in 2022 has formed a very **low comparison basis** for the following years. Therefore, possible indicators of growth in 2023 should adequately take this factor into account. And in conditions of an extremely low comparison basis, even minor positive shifts can produce high relative scores.

Whatever the progress, however, it is not yet a question of Ukraine entering the path of stable and balanced development. Rather, it is about «licking wounds», rebuilding and restoring housing and critical infrastructure, which will create minimally acceptable living conditions across the liberated territory of the country.

The approved state budget is one of the basic benchmarks for our vision of economic development in 2023. Note that the Verkhovna Rada adopted the Budget Law for 2023 on 3 November 2022. The main indicators are quite balanced, with GDP growth by 3.2%, inflation at 28%, hryvnia devaluation to 45.8/$1 by the end of 2023, and the average salary at UAH 18.3 thousand.

The key priority of the state budget expenditures is to finance defence and security sector at UAH 1.14 trillion (43% of total expenditures, or 18% of GDP). The deficit limit is set at UAH 1.29 trillion (20.6% of GDP). In US dollar terms, the budget deficit is $38 billion (requiring $3.16 billion in monthly financing), which is expected to be covered by financial assistance from international partners.

While confirming the rationality of these forecasts and assumptions, we are somewhat more optimistic about the development of the domestic economy based on the (preliminary) results of 2022 and the low comparison basis. The main ideological difference between our forecast for 2023 and that of the government is a higher level of real GDP growth and lower inflation.

Today, there is a consensus that Ukraine's economy will collapse by 33-35% in 2022, compared to the rather successful 2021. By the way, the fact that real GDP will decline by about one-third by the end of the year was the main macroeconomic assumption in our first wartime forecast for 2022,[1] which proved totally true and allowed formulating forecast indicators for 2022 that are quite close to the final ones (Table «*Key Macroeconomic Indicators for 2019-2022p...*») (*Annex 2. On the Reliability of Forecasts*). Note that the refinement of the 2022 forecasts was facilitated by the comparative analysis of the development of crisis processes in the national economy in 2022 and COVID-affected 2020.

GDP growth. As for Ukraine's economic forecasts for 2023, presented by international financial institutions (IFIs), the situation is notably different. For example, the October issue of the IMF's World Economic Outlook has no data for Ukraine (a 35% drop in 2022), although the Memorandum of Cooperation states a 1% increase. In October, the World Bank also estimated a 35% decline in 2022, although earlier it had assumed an even deeper 45% decline. However, it allows for 3.3% growth in 2023, provided that the destruction of critical infrastructure is reduced. The government of Ukraine's forecasts were also «weakly positive»: after a 32% downfall in 2022, they expect a 3.2% growth (or 1.5% according to the alternative scenario) in 2023.[2]

Based on our expert observations, we estimate Ukraine's economic growth in 2023 somewhat higher, with real GDP growth at 4-4.5%. In addition to economic incentives, this will have a strong social and psychological stimulus, improving the quality of households' well-being, which, in turn, will strengthen the stabilisation and recovery processes.

It is clear that conditions for the development of Ukraine's economy in 2023 will be determined by a complex combination of multidirectional internal and external factors, which will be further intensified by international confrontations between world political and economic leaders, as well as by the high risks of continued full-scale Russian aggression. We do not ignore such risks, but despite them, we see rational opportunities for stabilising Ukraine's macroeconomic environment.

Below are several factors that will facilitate/hinder the achievement of said growth indicator.

KEY MACROECONOMIC INDICATORS FOR 2019-2022 AND 2023 FORECAST

	2019	2020	2021	2022(o)	2023(п)
GDP, UAH billion	3 978	4 222	5 460	4 900	6 520
GDP, $ billion	153.9	156.6	200.1	136.1	151.7
GDP, % of growth	3.2	-3.8	3.4	-33.0	**4.0-4.5**
CPI growth, % (Dec-Dec)	4.1	5.0	10.0	27.0	17.2
CPI growth, % (average)	7.9	2.7	9.4	20.2	19.4
Average annual exchange rate (official), UAH/$1	25.8	27.0	27.3	35.0	43.0
Current account balance, % of GDP	-2.7	3.4	-1.6	7.0	1.5
Average wage, UAH/month	10 497	11 596	14 018	14 550	17 500
Final consumption expenditure, % of GDP	93.2	92.6	87.3	97.0	93.0

[1] What is the Forecast of the Economy of Ukraine? – Razumkov Centre, March 2022, *https://razumkov.org.ua/statti/pro-iakyi-prognoz-ekonomiky-ukrainy-mozhna-govoryty.*

[2] After this publication was already finalised, the Ministry of Economy issued its own estimate of a 30.4% drop in GDP in 2022.

Favourable factors include the following:

- ✓ reinforcement of the Armed Forces of Ukraine, which will accelerate the liberation of the country, free new territories, and boost the ability to protect the country from enemy bombing and other sabotage attacks;
- ✓ continued provision of military and financial aid by developed partner countries, which will strengthen Ukraine's defence capabilities, replenish foreign exchange reserves and protect the hryvnia from devaluation shock, thereby forming the basis for sustainable recovery;
- ✓ launch and implementation of international programmes and projects to rebuild Ukraine's economy (the so-called Marshall Plan) despite the enemy's continued aggression, primarily through the restoration of physical infrastructure;
- ✓ improvement of the population's well-being, its better adaptability to enemy attacks, and increased optimistic expectations, which will be an additional factor and stimulant of production gains;
- ✓ return of Ukrainians who were forced to leave the country earlier, their readiness to be involved in production processes;
- ✓ improvement of mutual understanding between the US and EU with China, which will reduce the risks of economic and security imbalances and will also help expand Ukraine's economic cooperation with China, which does not harm Ukraine's strategic interests and does not threaten its strategic partnership with the United States;
- ✓ inhibition of energy complications in Europe and restoration of aggregate demand, primarily in the partner CEE countries, which will strengthen the domestic economy's export capacity;
- ✓ increased cooperation between the National Bank of Ukraine and the government aimed at supporting the real sector.[3]

The following **inhibiting factors** also deserve attention:

- ✓ IFIs' unpreparedness to consistently support Ukraine, untimely provision of agreed financial resources to the country, delayed allocation of funds for political considerations (Ukraine's poor completion of «homework»);
- ✓ intensification of crisis processes in China, which may negatively affect global trade flows and increase the risks of China's strategic cooperation with Russia;
- ✓ Russia's access to the bomb systems of other countries that are unfriendly to Ukraine, which will increase the destruction and human losses;
- ✓ aggravated confrontation and contradictions between the state's fiscal approaches aimed at expanding the tax base and the interests of business development and stimulation.[4]

Exchange rate and inflation. A rational currency policy should become an important stabilising factor in the entire economic environment, where a weak devaluation of the hryvnia will be acceptable (and in some respects, even desirable), reducing the risks of reserve leaching and capital flight, and helping balance the supply and demand for currency in the cash markets. Given the extreme sensitivity of the domestic socio-economic environment to exchange rate dynamics, the hryvnia will hardly be released into «free float» in 2023.

[3] Of course, the level of the National Bank's intervention in exchange rate formation, expanded lending, and the impact of expansionary monetary policy on macroeconomic balances remain debatable. In our opinion, in crisis settings, the central bank cannot remain an observer with regard to exchange rate dynamics. And the post-war recovery requires maximum facilitation of access to financial resources for economic agents.

[4] The policy of maximum extraction of resources from businesses and households, including through the introduction of universal declaration and indirect methods of control of spending (the risks of its introduction are rather high) will provoke the escape of activities and income to shadow and increase the intention of many successful businesses to emigrate.

Although the effects of Russia-induced energy crisis will be felt throughout 2023, the main price shocks appear to be localised, which will be an important factor in easing inflationary pressures.[5]

The «grain deal» and the formation of grain hubs on Ukraine's western borders will stabilise Ukrainian agricultural and food exports, which will help determine the supply of such goods on domestic markets and have a steadying effect on domestic consumer markets, thus preventing an inflationary shock in 2023. Under these conditions, although consumer prices will continue to rise gradually, the (estimated) inflation rate will not exceed 20%, that is, it will be lower than in 2022.

Assessing the level of wages is important. There are reasons to believe that the average wage will hardly change in Q1-Q2 2023 (with the exception of certain professions and categories), and not only in the public sector. In general, in the presence of significant inflation, real wages will decline.

The situation may change in the second half of 2023, following the launch of the programmes and projects for Ukraine's recovery. During this period, the demand for skilled labour may increase rapidly, and in the face of a labour shortage (military, migrants), employers will agree to significantly increase wages. This, in turn, will serve as an incentive for Ukrainians to return from abroad, thus becoming a significant factor in economic recovery and GDP growth. Therefore, nominal wage growth in 2023 will be commensurate with inflation, and the real purchasing power of wages will finally stabilise.

External sector. Foreign trade indicators have clearly undergone significant changes recently. According to the NBU, the volume of exports of goods fell by almost one-third, and that of services — by more than 10% over 10 months of 2022. Imports of goods declined by 20%, while imports of services increased by more than 70%, resulting in a significant trade deficit of $17.5 billion. Meanwhile, the current account balance turned out to be positive ($7.8 billion) thanks to significant aid and grants from international partners — their volume considerably exceeded the size of the foreign trade deficit, which will contribute to macroeconomic balance.

Export losses are mainly due to the almost total destruction of industrial potential (including metallurgy, which is still one of key industries for exports) in Dnipropetrovsk, Kharkiv, Donetsk, and Mykolaiv regions. And this export group is unlikely to regain its position in the structure of domestic exports, unless significant structural changes and large-scale investments are made in the latest metallurgical technologies.

Exports of agricultural and food products suffered a significantly lower damage. The relatively small decline at only 10-12% is due to the fact that the domestic agricultural and food sectors already have a steady demand for their products on international markets, as well as due to the above-mentioned «grain deal». So, if it is extended, we can expect further «catching up» of agricultural exports.

If international programmes for Ukraine's recovery are launched starting in the second half of the year, then one can expect contradictory effects in 2023. First, a significant increase in imports of goods and services to be used to meet consumer and project needs will result in the growing foreign trade deficit, which will put pressure on the exchange rate. Second, the inflow of (investment) capital as part of the Marshall Plan projects will intensify, financing part of Ukraine's trade deficit. At the same time, significant resources to help Ukraine will continue to come from partner countries, and this will fully cover the emerging deficit and help strengthen the hryvnia. Therefore, weak devaluation of the hryvnia, which will dominate in the first half of 2023, will be gradually replaced by hryvnia stabilization and the replenishment of foreign exchange reserves.

Debt positions. Rather high macroeconomic risks in early 2022 were associated with Uk raine's external debt positions. However, these risks were localised, including thanks to assistance from partner countries.

Ukraine has managed not only to sustain its debt burden but also to reduce both its total external debt and the NBU's debt dependence on the IMF (Table «*External Debt of Ukraine*»). The reduction in debt obligations was due to timely payments in the face of limited access to new loans on the

[5] ...the risks of importing energy inflation from Europe will also be reduced, as the EU is implementing consistent measures to balance energy supply and demand.

capital markets. The IMF's overly cautious stance on the new support programme for Ukraine is all the more surprising given that leading economies are already providing Ukraine with large grants and large-scale concessional loans to counter the aggressor and strengthen its socioeconomic development.

It is worth mentioning one more feature of Ukraine's foreign debt policy, namely the successful restructuring of payments, including easing of the terms[6] of payments on some debts. Although the «saved» amounts were relatively small, the government demonstrated a competent approach to debt problems, which, by the way, is an important indicator for partners.

Meanwhile, although the volume of debt is showing a downward trend, there is a significant deterioration in the debt in GDP terms (which, as noted, collapsed in 2022 in $ terms. If at the end of 2020, gross external debt amounted to about 80% of GDP, and external public debt slightly exceeded 30% of GDP, then by the end of 2022, these debts will probably exceed 100% and 45%, respectively.

As already agreed, leading countries and IFIs will continue their financial support for Ukraine in 2023. In this context, it is important to know which shares of the resources provided will be in the form of grants and loans, respectfully. Grant assistance would clearly be more appropriate, by not worsening the country's debt position. However, not all potential sponsors are ready to take such steps. Therefore, given external payments, there are reasons to expect a slight increase in total external debt and public debt. At the same time, the debt in GDP terms is likely to reduce, as the dollar equivalent of GDP will increase in 2023.

Instead of conclusions. The fact that the Ukrainian economy demonstrates impressive signs of resilience in the face of lasting large-scale Russian aggression, conveys positive signals that the lessons of previous crises will be taken into account and duly considered by the government in the country's recovery. It is during this period that the country will face significant challenges and risks.

If the country has demonstrated examples of solidarity to repel aggression of «understandable» enemy, then, unfortunately, this does not guarantee that the unity of action will be sustained in the future. The history of Ukraine shows that the greatest losses of independence and freedom occurred in times of peace, when patriotic forces failed to consolidate and lost people's trust while in discord, thus «providing» anti-Ukrainian forces with a foothold for revenge.

Yet we emphasise that Ukraine has sufficient potential to improve its socioeconomic dynamics. And today, there are reasons to expect successful peaceful restoration of the country, including thanks to its partners. And rational institutional changes will allow this potential to be fully realised.

EXTERNAL DEBT OF UKRAINE,
at the end of the period, $ billion

	2020				2022		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Total (gross external debt)	119.9	122.2	122.2	125.7	128.1	128.6	124.2
Public administration sector	44.6	46.9	44.9	47.8	52.9	55.4	55.0
National Bank of Ukraine	6.9	6.9	6.8	6.9	5.2	4.7	3.9
Direct investments: Intercompany debt	15.7	16.9	17.5	17.5	20.6	20.6	20.2

[6] Ukraine has signed a Memorandum of Understanding on the official debt service suspension with a group of official creditors of Ukraine from G7 countries and the Paris Club aimed at mitigating (suspending payments of principal and interest on bilateral debts from 1 August 2022 to the end of 2023) the economic consequences (increasing expenditure on social, healthcare, or economic support) of Russian aggression.

The total debt stock covered by this Memorandum is about $3.1 billion. This decision seems positive in the short term, as it has a stabilising effect (in particular, by reducing the risk of hryvnia devaluation).

Annex 1.

CITIZEN ASSESSMENT OF THE COUNTRY'S ECONOMIC SITUATION

Western partners' support for Ukrainians, – not only military or economic, but also social and humanitarian – became a hallmark of 2022 and contributed to citizens «rejecting» the panic.

With its impressive track record in conducting sociological research in different (including critical) periods of the country's history, the Razumkov Centre, has been holding surveys in the government-controlled areas (GCAs) since the onset of a large-scale war. These surveys revealed important characteristics of the Ukrainian present, primarily in the institutional sphere and people's trust in public institutions.[7] Meanwhile, the results of the Razumkov Centre's research reflect the situation in GCAs with no active hostilities, and cannot be extrapolated to the occupied, frontline, and recently liberated territories.

Here we will focus on some comparative indicators of respondents' assessment of the overall economic situation. The results of the 2022 surveys will be compared with the corresponding results collected 2 years ago – in September 2020 – when Ukrainians had already recovered from the first coronavirus shock and adapted to the requirements and limitations of the first coronavirus wave, and even expected the end of the «hot» phase of the COVID-19 pandemic.

Another period chosen for comparison includes a rather «optimistic» May of 2021, when the next coronavirus wave was declining and there was a fairly visible macroeconomic stabilisation (the hryvnia fluctuated in a narrow range of 26-27; inflation in Q3 was slightly above 1%, and August nominal wages were 16% higher than in January).

Despite heavy losses and destruction, the respondents do not view the current economic situation in Ukraine as a collapse. Of course, assessments for September 2022 look worse compared to May 2021, when the country almost «got rid» of COVID-related worries. At the same time, the overall balance of positive and negative assessments in September 2022 is almost the same as in September 2020 (Table «Assessment of the Economic Situation»).

Further deterioration of the balance in November 2022 compared to September 2022 is «natural», because it was in late autumn that Russia began to use massive bombing of Ukrainian cities aimed at destroying critical infrastructure, which, of course, worsened the views.

ASSESSMENT OF THE ECONOMIC SITUATION.
% of respondents

	September 2020	May 2021	September 2022	November 2022
Very bad	24.2	22.1	21.5	25.4
Rather bad	38.8	37.9	43.0	42.0
Neither bad not good	32.4	32.2	28.9	25.9
Good	2.3	4.7	3.7	2.5
Very good	0.4	0.7	0.5	0.4
Hard to say	1.9	2.4	2.5	3.8
Balance: (good+very good) – (rather bad+very bad)	**-60.3**	**-54.6**	**-60.3**	**-64.5**

[7] See Y.Yakymenko et al. Ukraine: from War to Peace and Recovery – Razumkov Centre, September 2022, *https://razumkov.org.ua/images/2022/17/2022_MATRA_SEPTEMBER.pdf.*

Annex 2

ON THE RELIABILITY OF FORECASTS

In late March 2022 – a month into the large-scale Russian aggression – the Razumkov Centre published its first vision of the dynamics of Ukraine's key macro-economic indicators for 2022 (see «*What is the Forecast of the Economy of Ukraine?*» – *https://razumkov.org.ua/statti/pro-iakyi-prognoz-ekonomiky-ukrainy-mozhna-govoryty*).

Further on, our forecasts were revised and adjusted depending on the available information, in particular in September. Therefore, to demonstrate the correctness of our economic forecasts in 2022, we compare figures of key macroeconomic indicators for three periods – those presented in March and September (forecasts) and December (preliminary results of the year).

As a result, we note that, first, the nature and direction of changes in both forecasts and estimates are quite similar (with the economic decline estimate remaining unchanged, and inflation and exchange rate dynamics improving). Second, the September forecast looks somewhat more attractive in macro-economic terms and is closer to annual estimates (Table «*Comparison of March and September Forecasts and December Estimates...*»), which is understandable given some clarification of the situation and processes in Ukraine. Third, the December estimates, which are unlikely to differ much from the officially approved ones, confirm our expert assumptions and calculations made in previous periods.

In summary, we have been quite correct in predicting the dynamics of key price and exchange rate indicators from the very beginning, when it became clear that the Russian blitzkrieg was failing, and the NBU would not allow either a hryvnia's collapse or a hyperinflationary «spin-up». Therefore, in June, we adjusted our inflation and exchange rate forecasts for the end of the year. The final inflation figures provided by the State Statistics Service confirmed the validity of our September estimates (an improvement over the March ones).

At the same time, in March, we did not «see» the possibility of a Russian blockade of Ukrainian Black Sea ports, which significantly affected our foreign trade assessments. Yet we were confident about the international partners' wide-ranging support to our economy, so the «grain deal» did not come as something extraordinary, although we did not directly plan such a mechanism. However, even in the face of a worsening foreign trade deficit, the current account balance remains positive «...thanks to significant aid and grants from international partners», as stated in the March forecast, and as it actually happened throughout the year.[8]

Results of 2022 confirm that Ukraine is facing new and very serious challenges.[9] However, this is not a reason for pessimism. Today, the strategic choice is clear, and there is no doubt that Ukraine will successfully build a renewed country with the help of its partners.

COMPARISON OF MARCH AND SEPTEMBER FORECASTS AND DECEMBER ESTMATES OF KEY MACROECONOMIC INDICATORS IN 2022

	March	September	December
GDP, UAH trillion	5.6	4.9	4.9
GDP, $ billion	136.6	125.6	136.1
GDP, %of growth	-33.0	-33.0	-33.0
CPI growth, % (Dec-Dec)	30-40	29.0	27.0
Average annual exchange rate, UAH/$1	41.0	39.0	35.0
Foreign trade deficit (goods and services), % of GDP	1-2	10-12	17-19
Average wage, UAH/month	14 600	14 600	14 550*

* For 2022, the nominal wage is determined through the calculation of pensions in the Pension Fund.

[8] More specifically, the deficit in trade in goods and services in Q1 2022 amounted to $0.7 billion, while the current account balance was positive at $2.4 billion. After 10 months of 2022, the deficit exceeded $17.5 billion, but the current account balance increased to $7.8 billion.

[9] Geopolitical and geoeconomics changes shaped by russain aggression and renewal of the place of Ukraine in the world – the Razumkov Centre, 2022.