

**UKRAINE**

# War Aggravates Economic Problems

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Intensified fighting around Donetsk and Luhansk triggered a 12.1% y/y industrial output slump in July. The Luhansk oblast reported a 56% y/y decline in industrial production, while the Donetsk oblast's output fell 28.5% y/y that month. In August, military forces intensified their operations, as the Ukrainian Army shut down the last supply lines from Russia to Donetsk. The Kremlin responded by bringing more regular Army squads into the fray, to open a few alternate pathways to Donetsk. As daily reports from the front detail serious destruction, and loss of human life, we should be prepared for a deeper industrial decline in August and September. Even with the most optimistic projections for Ukraine's military offensive, we expect industrial output to decline by at least 6.9% y/y by the yearend.

Given the aggravating industrial performance after latest wave of *hryvnia* devaluation, the situation looks much serious than we previously believed. This new round of devaluation (from 11.7 *hryvnia* per \$1 to below 13) is certainly seen as a temporary phenomenon, since devaluation is mainly driven by war. Still, the looming uncertainty surrounding the armed conflict in eastern Ukraine, and the latest attempts by the Central Bank to stick to a free-floating regime without using any hedging instruments, have made people and businesses very nervous about the *hryvnia*'s prospects. So it comes as no surprise that the *hryvnia* keeps sinking, despite previous positive expectations linked to IMF support, and other IFI's commitments to Ukraine.

The fiscal account situation has stabilized >>>

