Focus
Ukraine

Scope
Economics

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Macro Review

In Transition

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Executive rundown

Politics still in transition: Timing of new IMF deal uncertain. With early parliamentary elections, there is a strong likelihood that Ukraine will resume cooperation with the IMF in November–December. This is our base case, and we expect the Ukrainian government will receive EUR500m of macrofinancial aid from the EU and raise US$1-2bn from the markets before YE2019. However, creation of a coalition, formation of the government, and finally negotiations with the IMF could take longer than expected and postpone needed FX inflows until 2020. So far, markets have had little clarity about what the economic policies of the new authorities will be. These uncertainties will keep investors on edge, and, thus, will limit the government's borrowing ability, weighing on the UAH and boosting inflation.

Sovereign debt: redemptions still heavy. Ukraine will have to pay US$4.6bn of FX debt in 2H19. It is unlikely that the government will be able to roll over more than 70-80% of its US$2.6bn debt in domestic FX bonds due in 2H19. To fund these payments, Ukraine will need the second tranche of the EU's EUR500m macrofinancial aid, and will still have to tap markets for an additional US$1–2bn Eurobond issue. Without these borrowings, Ukraine's FX reserves could decline to US$18bn by YE2019, below the comfort level of 3x monthly imports.

Government debt: UAH paper enjoys growing demand. Attractive 17–18% yields and simplified access to the market thanks to opening the Clearstream link will further drive demand from foreign investors for government-issued UAH instruments. Foreign investors' holdings grew 9x YTD to UAH57.2bn (US$2.2bn) at the end of 1H19. The high risk of UAH depreciation and delay of the IMF deal likely will cause a slowdown in their demand. Nonetheless, by YE2019, foreign holdings could grow to UAH70-85bn (US$2.5–3bn), as investors will try to mitigate these risks by purchasing longer-term UAH notes.

Monetary policy: Key rate to stay at 17.5% in 3Q19. NBU abstained from another rate cut in June after commencing a long-awaited cycle of rate decreases back in April. Uncertainties with the IMF programme and risks of higher-than-expected inflation will give the regulator few options other than to keep the key rate unchanged in July as well. Our base-case scenario implies the continuity of cooperation with the IMF that eventually will allow NBU to cut the rate by another 150 bps to 16% by the end of 2019.

Banks: Another profitable year. Total YTD net profit of the banking system reached UAH23bn in May, which is already higher than the total amount for full-year 2018 (UAH22bn). This suggests that the 2019 result will greatly outperform previous year's results. Booming consumer lending is responsible for most of the positive net interest income, at a time when provisioning expenses remain low, as banks have made adequate reserves against NPLs on their balance sheets. Increased profits will result in proportionately amplified dividends in 2020. On one hand, it will make Ukrainian banks attractive for equity investors. On the other, it will put additional pressure on the FX market when foreign banks pay dividends.

GDP and inflation: Moderating. We expect real GDP growth to slow to 2.7% in 2019, from 3.3% in 2018, as policies remain tight, consumer and investment demand is to slow, and global markets cool. That said, domestic demand may still surprise to the upside. The same factors should work to bring inflation down to 8% by YE2019. However, more inflationary pressures may come from UAH depreciation, domestic fuel market volatility, and higher-than-expected food prices.

UAH: About to weaken. The weakening season should start in 2H19, when pressure on the hryvnia will rise from higher demand for USD from importers and FX dividend payers. We expect UAH to soften to UAH27/USD by August, and further to UAH28.5/USD by YE2019. Rising demand from foreign investors for government UAH paper may cause the hryvnia to outperform our forecasts. On the other hand, we think that downside risks for the national currency are higher due to possible delays in the IMF deal, fragile investor sentiment, and a possible rise in FX dividend repatriation from Ukraine.

Politics still in transition

Political uncertainty and lack of a clear economic policy from the new authorities weigh on sentiment of businesses and investors

With parliamentary elections and formation of a government pending, Ukraine is still in the midst of political transition, which brings heightened risks for the economy and, therefore, investors. The new president and his team have expressed a commitment to reforms and cooperation with the IMF. However, so far, the market has little understanding of what the economic policies of the new administration will actually look like. The most recent pre-election polls indicated some decline of voters' support for the president's party, the Servant of the People, to 43–45%. This implies the party's growing dependence on a coalition, which will ultimately influence the composition of the new government. Hence, economic policies are most likely to crystallize when the new government is up and running. Until then, political uncertainty will continue to weigh on investor and business sentiment.

Ukraine will manage to agree a new EFF program with the IMF, unlocking EUR500m from the EU, and helping raise US$1–2bn from the markets

Approved by the Constitutional Court, snap elections of Ukrainian parliament open a path for an early formation of the government. After the parliamentary elections results are announced in the end of July/beginning of August, the new parliament should convene by early September, and form the new government in September/October. Therefore, the government may have about two months to negotiate and ink a new financial support program with the IMF. Our base case scenario is that Ukraine will manage to agree a new EFF programme with the IMF, unlocking EUR500m from the EU before the end 2019, and helping raise US$1–2bn in the markets.

The IMF is ready to discuss the conditionality of benchmarks with the new government, but it is likely to take a hard stance on the key issues outstanding, such as market pricing for natural gas tariffs, criminal responsibility for illegal enrichment, adoption of the Split law, Privatbank nationalization, and independence of the NBU.

Table 1. The key pending issues of Ukraine–IMF dialogue

	Issue	Note
1	Natural gas tariffs for the population: should be in line with market prices and import parity	May become a hot issue again, when EU gas prices recover 40-50% by YE2019
2	Criminal responsibility for illegal enrichment: cancelled by the Constitutional Court	Cancelled by the Constitutional Court
3	Split law to redistribute supervision of financial intermediaries: pending since April 2015	One of the incomplete structural benchmarks of the SBA
4	Lower court decisions challenging nationalization of Privatbank	One of the key concerns of the IMF
5	Independence of the NBU: challenged by local courts	One of the key benchmarks of the IMF

Sources: ICU

In 2019, Ukraine needs to finance a gap between the US$4.3bn current-account deficit and US$2.1bn of FDIs

With US$20bn FX reserves available at the NBU, the government can weather a delay in the IMF tranche until early 2020. However, Ukraine also needs to finance the gap between the US$4.3bn current-account deficit and US$2.1bn of FDIs expected this year. The delay with the IMF agreement will decrease FX reserves to US$18bn, covering slightly below 3x of monthly imports, and will put the hryvnia under pressure and accelerate inflation.

Table 2. Government FX debt payments and their funding, 2H19 (US$bn)

Government FX accounts at 1Jul19	**3.0**		
Government FX funding	**3.6**	**Government FX debt payments**	**4.6**
IMF	0.0	IMF	0.3
Eurobonds	1.0	Eurobonds	0.7
EU	0.6	Other external debt repayments	0.3
Domestic FX bonds	2.0	Domestic FX bonds	2.6
FX purchased from NBU	0.0	Interest payments	0.7
Assumed balance at the end of 2019	**2.0**		

Sources: Ministry of Finance of Ukraine, World Bank, European Commission, IMF, ICU.

Government Debt: Heavy in FX; UAH paper in high demand

Refinancing FX debt hinges on IMF

- **In order to finance US$4.6bn sovereign debt redemptions in 2H19, the government needs to strike a new deal with the IMF**
- **Most likely, the government will be unable to roll over more than 70–80% of its FX domestic bills due in 2H19**
- **Without new external borrowing, FX reserves may drop to US$18bn by YE2019**

Without external financing, debt repayments will reduce FX reserves to about US$18bn by YE2019

In 2H19, Ukraine must pay US$4.6bn of FX-denominated sovereign debt. To fund these payments, the government needs the second tranche of the EU's macrofinancial aid of EUR500m, and will have to tap into markets for an additional US$1-2bn Eurobond issue. We believe that all these sources will become available before YE2019 with the relaunch of the IMF programme. However, the process of creating a coalition in parliament, formation of the government, and negotiations with the IMF may cause delays in obtaining financial aid and raising funds through Eurobonds. Without these borrowings, FX debt repayments could reduce Ukraine's FX reserves to US$18bn by YE2019, slightly below 3x of monthly imports.

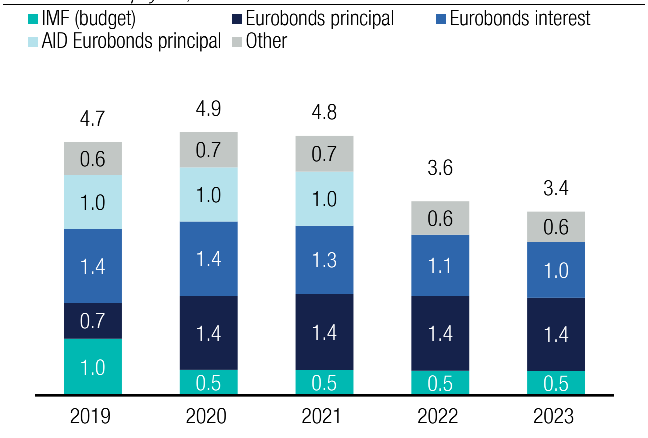
After successful placement of EUR1bn notes versus EUR6bn of demand, the government may access the markets again before the deal with the IMF is secured. However, this would be highly dependent on global market sentiment.

Ability to fully refinance domestic FX debt is low, requiring use of other sources

The government's ability to roll over its FX local debt remains uncertain. In 1H19, with traditionally low demand for FX paper, the Ministry of Finance was able to raise just US$2bn. The resulting rollover ratio was as low as 74%. This was despite the Ministry's efforts to create an arsenal of attractive instruments by offering short maturities and bills with an any-time put-option. Although demand slightly increased in June, it is unlikely that the government will be able to increase the rollover ratio substantially in 2H19. This means that the MoF will have to use US$600m from other sources to repay local FX instruments in 2H19.

Chart 1. Ukraine's external-debt annual payments (US$bn)

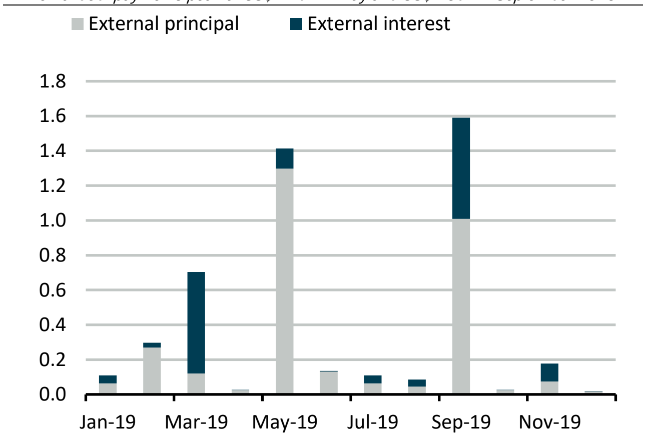
Ukraine has to pay US$4.7–4.9bn of external debt in 2019-21



Source: Ministry of Finance of Ukraine, ICU.

Chart 2. Ukraine's external-debt monthly payments (US$bn)

External debt payments peak at US$1.4bn in May and US$1.6bn in September 2019



Source: Ministry of Finance of Ukraine, ICU.

To meet all debt repayments in FX in May, government had to buy US$3bn of FX from NBU reserves

At the end of 1H19 the government had US$3bn and UAH13bn (US$0.5bn) in its accounts. Having started the year with US$2bn of FX in government accounts with the NBU, it received US$2bn of new borrowings from external sources. However, the government has used all these funds, even before paying large FX redemptions in May. Therefore, to meet all debt repayments in FX in May, the MoF had to buy FX from NBU, as it is the only source of foreign currency that does not have a direct impact on the FX market. According to our estimates, NBU sold to the MoF around US$3bn.

Clearstream and high yields boost demand for UAH paper

- **Foreign investors increased their holdings in government instruments 9x YTD to US$2.2bn in 1H19, making their role critical to government UAH debt**
- **We expect foreign investors to further increase their holdings to UAH70-85bn (US$2.5–3bn) by YE2019, shifting focus to longer-term maturities**

Foreign investors hold about US$2.2bn of UAH-denominated debt at the end of June 2019

Thanks to attractive 17-18% yields and expectations of the hryvnia's seasonal strengthening, the volume of issued domestic UAH bonds grew 2.3% YTD or by UAH17.6bn (US$0.7bn) to UAH773.3bn at the end of June 2019. Foreign investors invested UAH50.9bn (US$1.9bn) this year, as their holdings grew 9x YTD to UAH57.2bn (US$2.2bn) as of end of 1H19.

In 2019–21, government is going to increase share of UAH debt to 50% from the current 32%

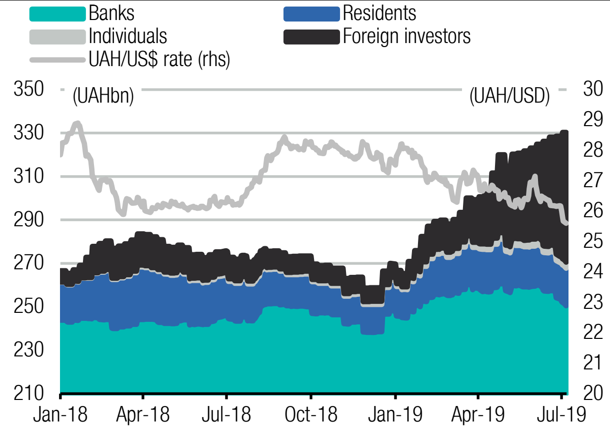
Opening the link to the global depositary Clearstream on 27 May eased access of foreign investors to the domestic bond market. Therefore, we expect demand from foreign investors will continue to grow in 2H19. The supply should be ample, as the government's strategy is to raise the share in UAH-denominated debt to 50% from the current 32% over three years. There is a risk that demand growth will slow in 2H19 due to rising expectations of UAH seasonal depreciation and uncertainties of further cooperation with the IMF.

Foreign investors will likely boost exposure to government long-term UAH notes

To handle these risks, investors will increase their demand for long-term notes. These instruments will allow investors to receive high yield for longer periods of time, given expectations that the NBU will decrease its key policy rate by 150bp by YE2019. Overall, by YE2019, the holdings of foreign investors in UAH government bonds could grow to UAH70–85bn (US$2.5–3bn).

Chart 3. Local-currency bond portfolios, 2018-2019

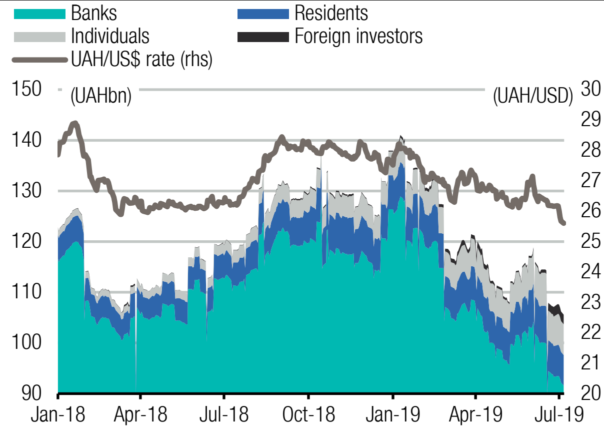
Foreign investors sharply increased their portfolio to US$2.2bn in 1H19



Source: National Bank of Ukraine, Bloomberg, ICU.

Chart 4. FX-denominated bond portfolios, 2018-2019

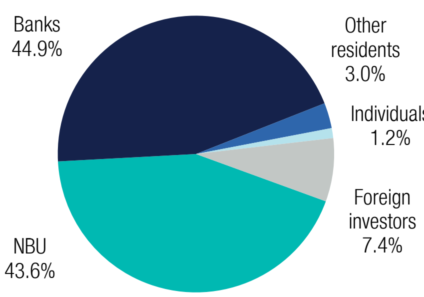
Portfolios of the government's FX-denominated bonds are low



Source: National Bank of Ukraine, ICU.

Chart 5. Structure of domestic bonds holders, as of 1 July 2019, (%)

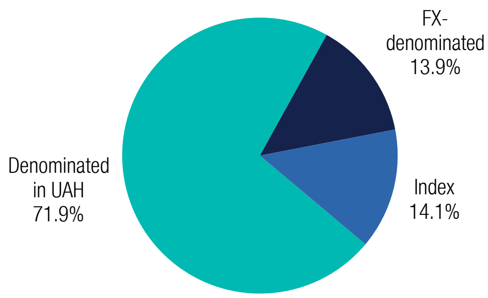
Foreign investors share sharply rose to 7.4% from 0.8% YE2018



Source: National Bank of Ukraine, ICU.

Chart 6. Currency structure of bonds outstanding, as of 1 July 2019, (%)

UAH-denominated part is growing



Source: National Bank of Ukraine, ICU.

Budget: Spending limited

- **The government will reduce expenditures to keep budget deficit below 2.5%**
- **Revenue underperformance for the state budget was near 9% in 5M19**

Underperformance in expenditures will have negative impact on GDP

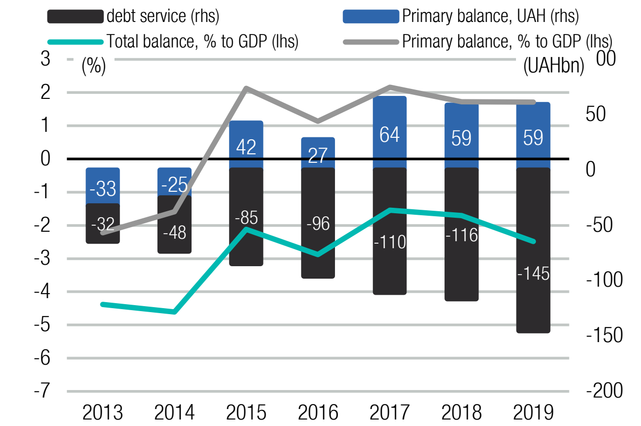
The need to keep the budget deficit as low as 2.5% to remain in accordance with IMF guidance, and the likely underperformance in collecting revenues will limit the government's spending ability for the rest of 2019. The most likely areas that will suffer from underfinancing will be economic activities, security services, and health care, which will have some impact on national economic growth. Overall, we expect the budget deficit to be below 2.4% in 2019.

The government manages to target budget deficit through underperformance of budget expenditures

In 5M19, the collection of state budget revenues (general fund) was 2.6% lower than planned, mainly due to the stronger-than-expected hryvnia that negatively affected collection of VAT, and customs duties on imports, higher internal VAT refunds, and lower volumes of excise taxes. Nevertheless, revenues were significantly supported by the NBU due to its payments of extra revenues from last year, which were transferred to the budget in April and May. Without these funds, the MoF could have a large deficit of UAH64.9bn or 15% of 5M19 state budget revenues.

Chart 7. Budget deficit (UAHbn, % to GDP)

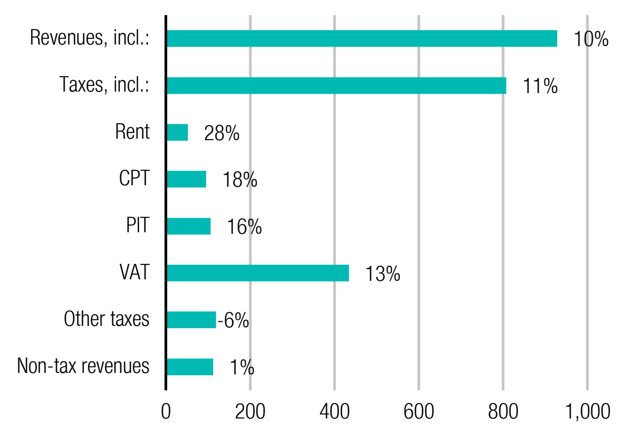
The government targets an even lower budget deficit in the double-election year of 2019



Source: National Bank of Ukraine, Bloomberg, ICU.

Chart 8. Key sources of budget revenue growth, 2019, (UAHbn)

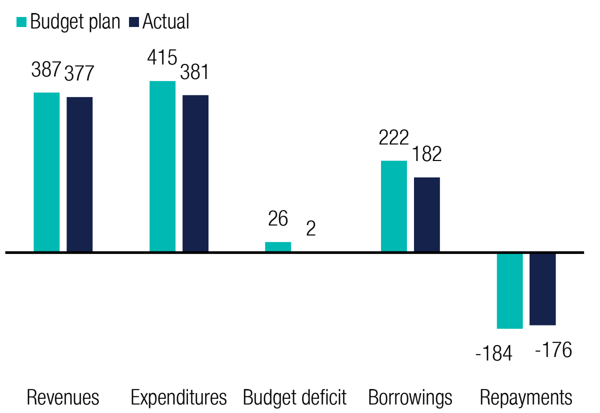
The key sources of budget revenue growth are subject to high risks



Source: National Bank of Ukraine, ICU.

Chart 9. Budget plan and actual performance, 5M19 (UAHbn)

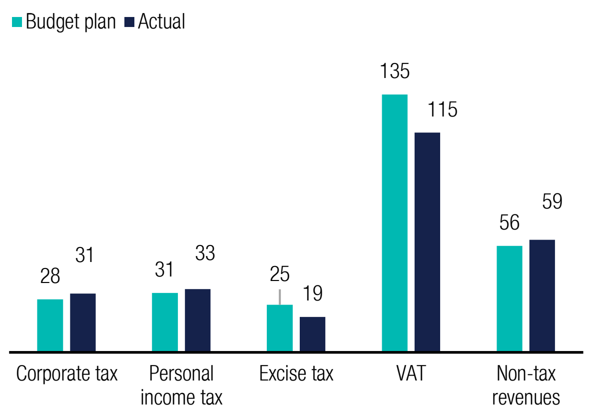
Budget performance is below budget plan in all segments



Source: State Treasury Service of Ukraine, ICU.

Chart 10. Performance of key budget revenues, 5M19 (UAHbn)

VAT and excise tax are reasons for low budget performance



Source: State Treasury Service of Ukraine, ICU.

Current account: Lower deficit

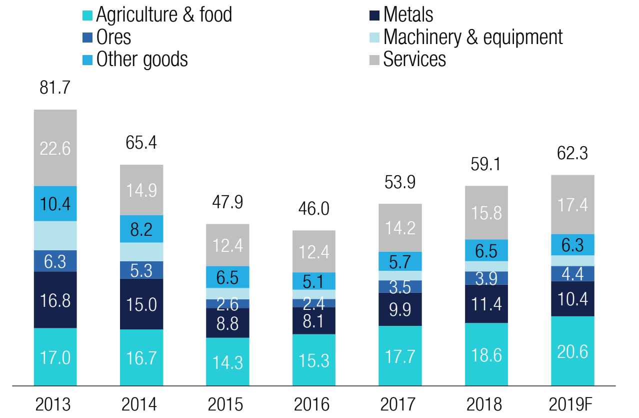
- **Positive impact of lower energy prices will be offset by decrease in metal prices**
- **High consumer and investment demand to push up trade-balance deficit**
- **The C/A deficit to fall to 2.9% of GDP, supported by the further growth of remittances**

Trade-balance deficit to decrease to 8.1% of GDP in 2019 from 8.6% of GDP in 2018

Trade balance deficit amounted to US$11.4bn (8.3% of GDP) in May on a 12-month trailing basis and we estimate it will reach US$12bn but decrease to 8.1% of GDP in the full-year 2019, versus 8.6% of GDP in 2018. Our forecast is based on the assumption that the positive impact on Ukraine's trade balance from lower world energy prices will be mitigated by higher volumes of gas purchases, lower prices on Ukraine's key export products (metals and crops), and weaker demand from the key trading partners of Ukraine.

Chart 11. Exports from Ukraine (US$bn)

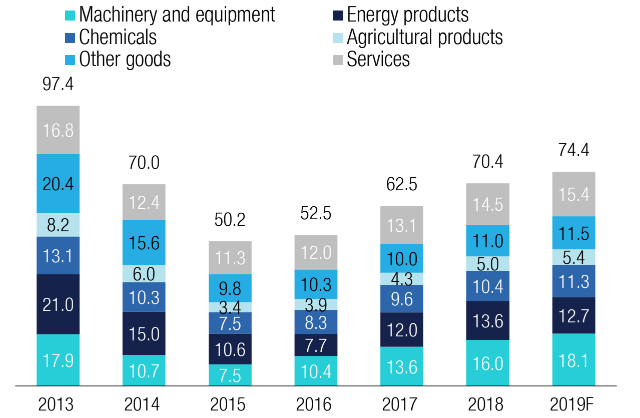
Agriculture, food products, and services will be key growth drivers



Source: National Bank of Ukraine, ICU.

Chart 12. Imports into Ukraine (US$bn)

Domestic consumer and investment demand to push up imports



Source: National Bank of Ukraine, ICU

YTD solid imports growth was boosted by temporary factors; their impact will vanish into 2H19

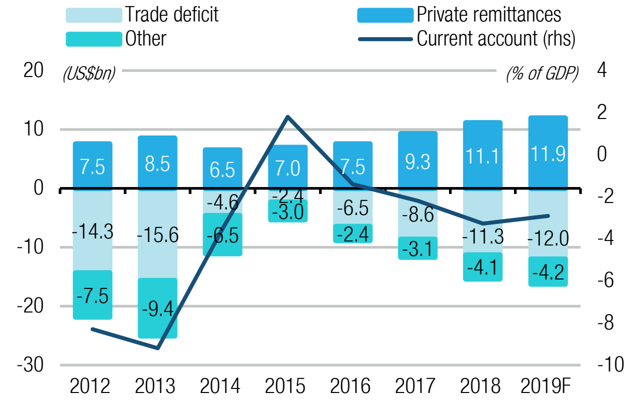
Imports growth will be driven by still solid consumer and investment demand (the later supported by the completion of green energy projects, as green tariffs will be cut into 2020), as well as higher volumes of natural gas imports (+59% YoY in April-May) given the uncertainty with the transit of Russian gas in 2020. On the flip-side, this year Ukraine's exports (+8% YoY in 5M19) were driven by the record harvest of late crops in 2018 and the surge of iron ore price. Expected record harvest this year (better yield of early crops vs. lower yield of late crops) and services exports will be key drivers of exports in 2019.

C/A deficit will be close to 2.9% of GDP in 2019, versus 3.3% of GDP in 2018

The projected increase in the trade balance deficit will be offset by the further growth of remittances, albeit at slower pace (+7.5% YoY). That said, we expect the 2019 C/A deficit to remain flat in nominal terms at US$4.3bn, but to inch down to 2.9% from 3.3% of GDP in 2018, due to the nominal GDP growth.

Chart 13. Ukraine's current account (US$bn, % of GDP)

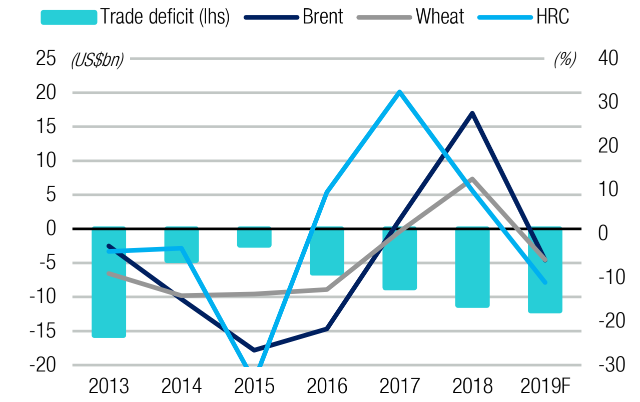
C/A deficit will contract to 2.9% of GDP in 2019 from 3.3% of GDP in 2018



Source: National Bank of Ukraine, ICU.

Chart 14. Change in growth of commodity prices (%)

Oil prices sliding in line with grain and metals in 2019



Source: National Bank of Ukraine, Bloomberg, ICU

UAH: About to weaken

- **Hryvnia is about to start its weakening season in 2H19, weighed by demand for USD from importers and payers of FX dividends**
- **We expect UAH to soften to UAH27/USD by August, and further to UAH28.5/USD by YE2019**
- **Growth in dividend repatriation, souring sentiment in global markets, and delays in resumption of the IMF programme pose high downside risks for the hryvnia**

Pressed by C/A deficit and sovereign redemptions, UAH should start weakening in 3Q

The negative effect on the hryvnia from the current-account deficit and substantial FX debt redemptions will dominate in 2H19. At the same time, costly UAH credit and growing demand for domestic UAH bonds from foreign investors will be mitigating factors. After a strong June, the hryvnia is likely to start weakening in 3Q, when demand for USD from importers and FX dividend payers is likely to overwhelm supply from exporters. We expect that the hryvnia is likely to finish 2019 near UAH28.5/USD under our base-case scenario of Ukraine receiving the IMF tranche in November–December.

Our forecast is subject to high risks due to the uncertain timing of IFI aid, unpredictable changes in market sentiment, and overall thin liquidity of the Ukrainian FX market. With average daily trading volumes not exceeding US$200–300m, relatively minor shifts in the market balance may cause significant volatility in the FX rate. We suspect that devaluation expectations will strengthen their negative influence on the hryvnia during the rest of 2019. Foreign investor demand for government UAH paper is one of the few upside risks for the national currency. On the other hand, unfavourable seasonality of the 2H, possible delays in external financing, and the resulting deterioration of sentiment create much higher risks for the downside.

In 1H19, the hryvnia mostly repeated the seasonal strengthening pattern and rose from UAH28/USD in January to UAH26/USD in June. Breakout of discussions over Ukraine's possible default in the mass media resulted in the national currency's quick drop to UAH27/USD. Nevertheless, media efforts of the MoF and verbal support of the IMF soothed investors' fears. Opening a Clearstream link to the domestic bond market on 27 May also helped reignite foreign investors' interest to UAH instruments and support the hryvnia. Under pressure from importers' and FX dividend payers' demand, we expect the FX rate to subside to 27/USD by August.

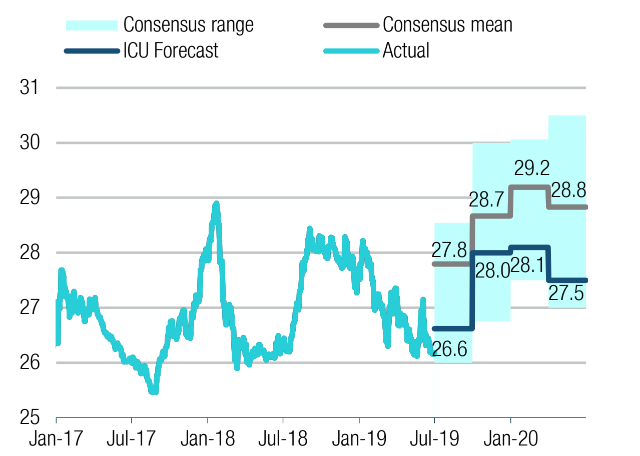
Chart 15. UAH/USD rate in 2016–19

In 1H19, the hryvnia mostly repeated its usual seasonal strengthening pattern

Source: National Bank of Ukraine, Bloomberg, ICU.

Chart 16. UAH/USD forecast

We expect the hryvnia to slightly depreciate over the course of 2019, with weakening about to start in 3Q



Source: National Bank of Ukraine, ICU.

Economy: Slows as expected

- **Real GDP growth to accelerate to 2.8% YoY in 2Q19**
- **Economic expansion will somewhat slow in 2H19 due to weakening consumer and investment demand, and expected lower harvest of late crops**
- **Despite a slowdown, consumer demand will remain the main growth driver, along with strong investment activity**

In 1Q19, economic growth slowed to 0.3% QoQ SA, the lowest in two years

Ukraine's economy saw a material growth slowdown in 1Q19—to revised 0.3% QoQ SA and 2.5% YoY vs. 3.5% YoY in 4Q18, primarily because of the vanishing effect of the last year's record harvest, and weak industrial-production performance (-0.9% YoY). Growth drivers remained unchanged—robust household consumption and investment activity.

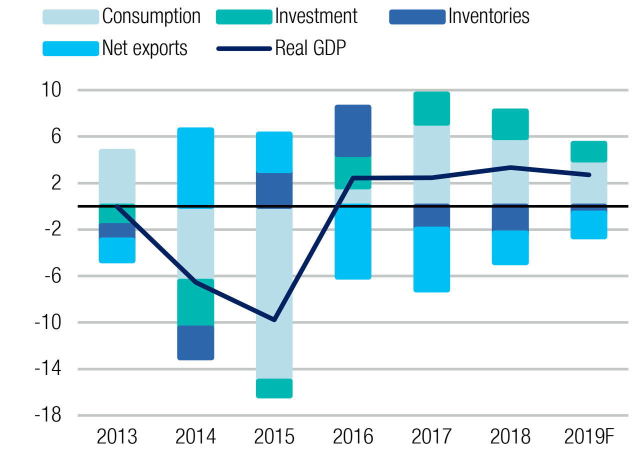
Given the recovery of industrial production in April–May (+3.3% YoY vs. -0.9% YoY in 1Q), strong performance of other real sectors of economy, particularly retail sales (+8.7% YoY) and construction (+23% YoY), as well as the highest-since-2013 level of consumer confidence[1] and high investment activity, we expect 2Q19 real GDP growth will accelerate to 2.8% YoY.

Real GDP growth will decelerate to 2.7% in the full-year 2019

In the full-year 2019, we expect economic growth will be close to 2.7%, driven by strong consumer consumption and investment activity, which to a great extent is supported by the completion of green energy projects, as green tariffs will be cut in 2020. We assume slowing economic growth into 2H19 due to weaker consumer demand subject to slower growth of nominal and real wages and remittances, and underperformance of agriculture (particularly lower corn[2] and oil seeds output) against the backdrop of a record harvest of late crops in 2018. Besides, real GDP growth will be adversely impacted by cooling global growth, and particularly weaker growth of Ukraine's key trading partner, the EU. Conservative fiscal policy due to the need to make large payments on state debt, and still tight monetary policy will also have their negative impact on the economic growth. Still, better-than-expected consumer and investment demand in 2H19, and expected total record harvest this year create upside risks for our full-year 2019 real GDP forecast.

Chart 17. The structure of real GDP growth (YoY, %)

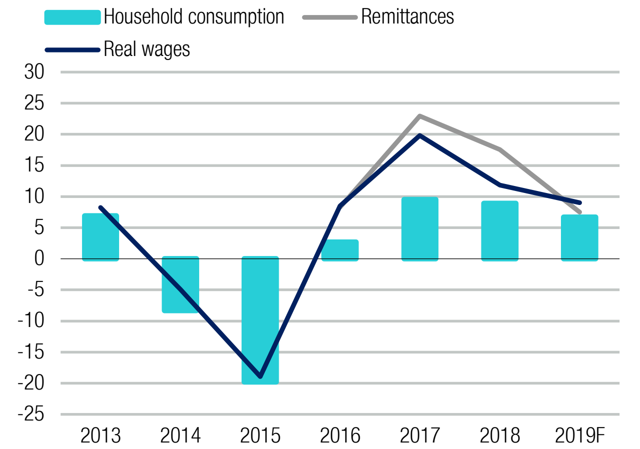
Consumption and investments will remain the key drivers of the GDP growth



Source: State Statistics Service of Ukraine, ICU.

Chart 18. Household consumption and income growth rates (YoY, %)

Consumption will moderate due to slower growth of households' incomes



Source: State Statistics Service of Ukraine, NBU, ICU.

[1] Read: https://sapiens.com.ua/en/publication-single-page?id=76

[2] Read: https://ukranews.com/news/633879-minagropolitiki-ozhidaet-rosta-urozhaya-zernovyh-do-70-8-mln-tonn-v-2019-po-optimistichnomu-prognozu

Inflation: Tamed for now

- **Inflation to resume downward trend after some increase in April and May**
- **CPI will decline to 8% by YE19, supported by tight monetary and restrictive fiscal policies, as well as lower gas prices**
- **Rising nominal wages, volatility in the fuel market, and elevated food prices to support inflationary pressures**

Inflation acceleration in April and May should be temporary

In 1Q19, inflation pressure eased because of lower world oil prices, a stronger UAH, and higher supply of food products thanks to the record harvest last year. Some CPI acceleration in April (8.8% YoY) and May (9.6% YoY) was caused by temporary factors—mostly higher demand for some raw food products and fuel prices growth—and does not imply trend reversion, evidenced by moderation of core inflation to 7.4% YoY in May from 8.7% YoY in December 2018.

Inflation will slow to 8% by YE2019

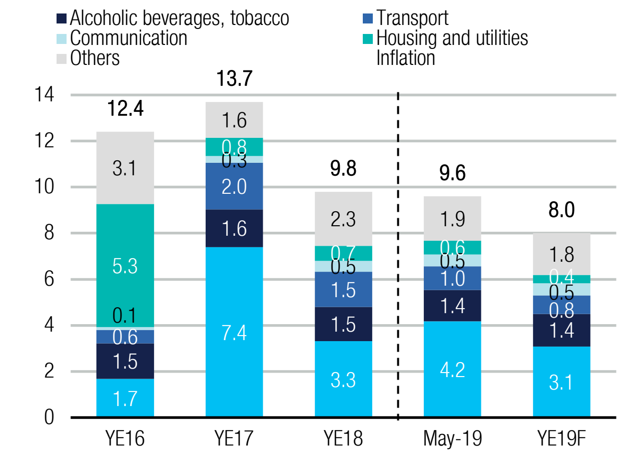
We believe inflation will moderate in the following months supported by still tight monetary policy, cautious spending by the government, cooling markets for commodities, as well as low imported inflation. However, there remain substantial pressures stemming from:

- still-solid consumer demand and rising nominal wages—albeit at a slower pace—which will cause a transition of production costs to final customers;
- expected lower harvest of late crops against the backdrop of the higher cost of sowing this year (+15% YoY according to the Ministry of Agrarian Policy and Food of Ukraine), which will keep food inflation elevated;
- further growth of excises for alcoholic beverages and tobacco products, and rising tariffs for communications;
- tighter domestic petroleum product market because of limitations imposed by Russia on its refineries' supplies to Ukraine

Therefore, given these pressures, we expect inflation at 8% by YE2019.

Chart 19. Headline inflation by components (YoY, %)

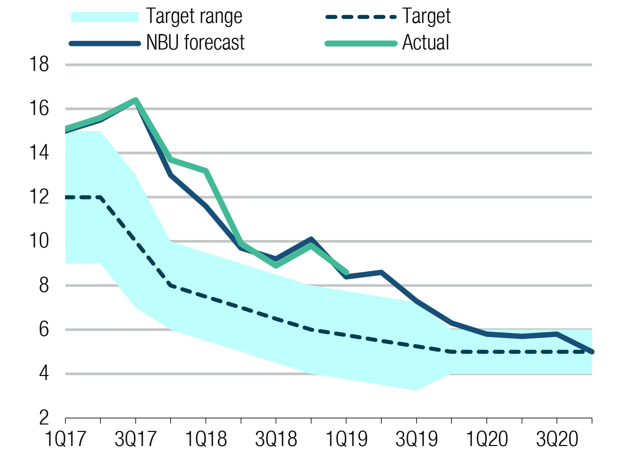
Food inflation will contribute the most to the FY19 inflation reading



Source: State Statistics Service of Ukraine, ICU.

Chart 20. Inflation: forecast and target of the NBU (YoY, %)

NBU expects inflation to slow to 6.3% in 2019 vs. ICU forecast of 8.0%



Source: NBU, State Statistics Service of Ukraine, ICU

Banks: Await record profit

- **Interest rates to fall alongside the key policy rate, but low liquidity will slow the process**
- **Corporate lending stagnates due to the rise of interest rates, and is unlikely to expand in 2019**
- **Banks are showing good profitability with the rapidly growing consumer lending segment, but will face a limit on further expansion in 2020**

Liquidity shortage to prevent rate decline

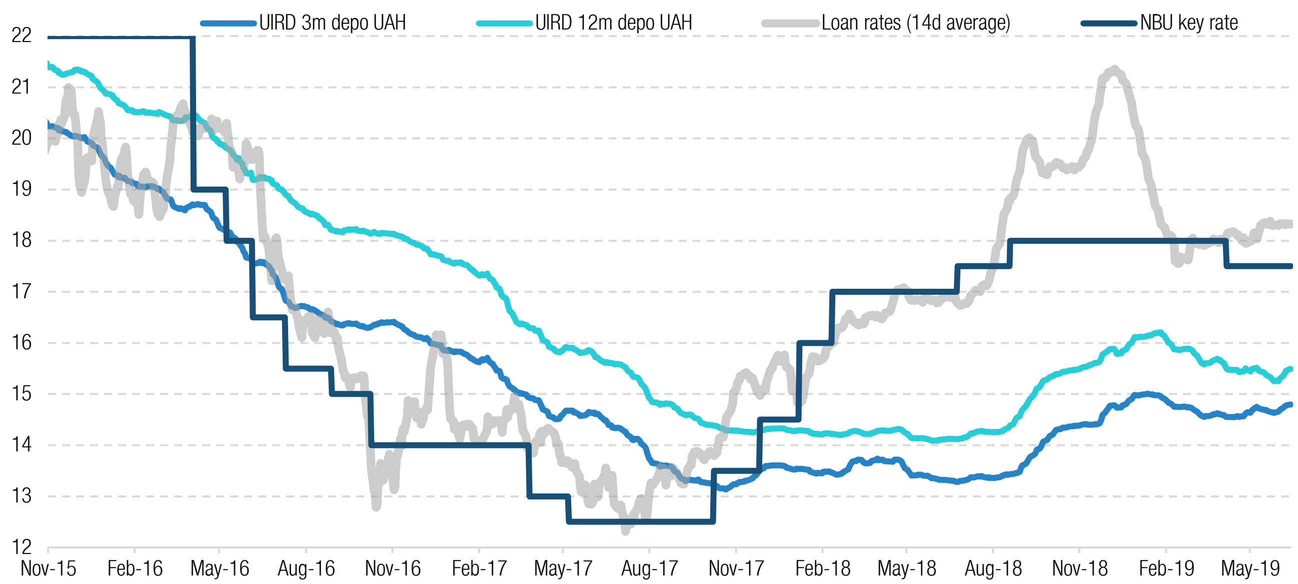
Liquidity is likely to decrease further in 2H19 due to the amortization of government bonds in the portfolio of the national bank. In addition, the MoF may continue FX purchases in the case of a delay in the new IMF deal, lowering liquidity further. This situation will lead to a much more gradual decline in interest rates, as banks will be competing for deposits via price.

UAH liquidity will remain lower than in 2018, spurring competition for deposits

UAH liquidity of the banking sector was very volatile during the past eight months. The traditional squeeze in the 2H18 was caused by the uneven distribution of budget spending throughout the year. It culminated in a liquidity shortage around the very end of 2018, with a temporary spike in the interest rates (see Chart 21). The situation reversed in 1Q19, with liquidity reaching a record level of UAH125bn (see Chart 22). However, it reversed again in April–May 2019, as companies made large tax payments to the Treasury. The Ministry of Finance used part of the proceeds to purchase USD for external debt payments, so the money never came back into the banking sector, therefore, decreasing the liquidity level.

Chart 21 UAH interest rates dynamic (%)

Liquidity shortage resulted in corporate lending rates spike around the end of 2018 despite NBU's key rate remaining unchanged



Sources: NBU, ICU.

NBU is likely to abstain from cutting the key rate in July, but will decrease it to 16% by year-end, should IMF cooperation continue

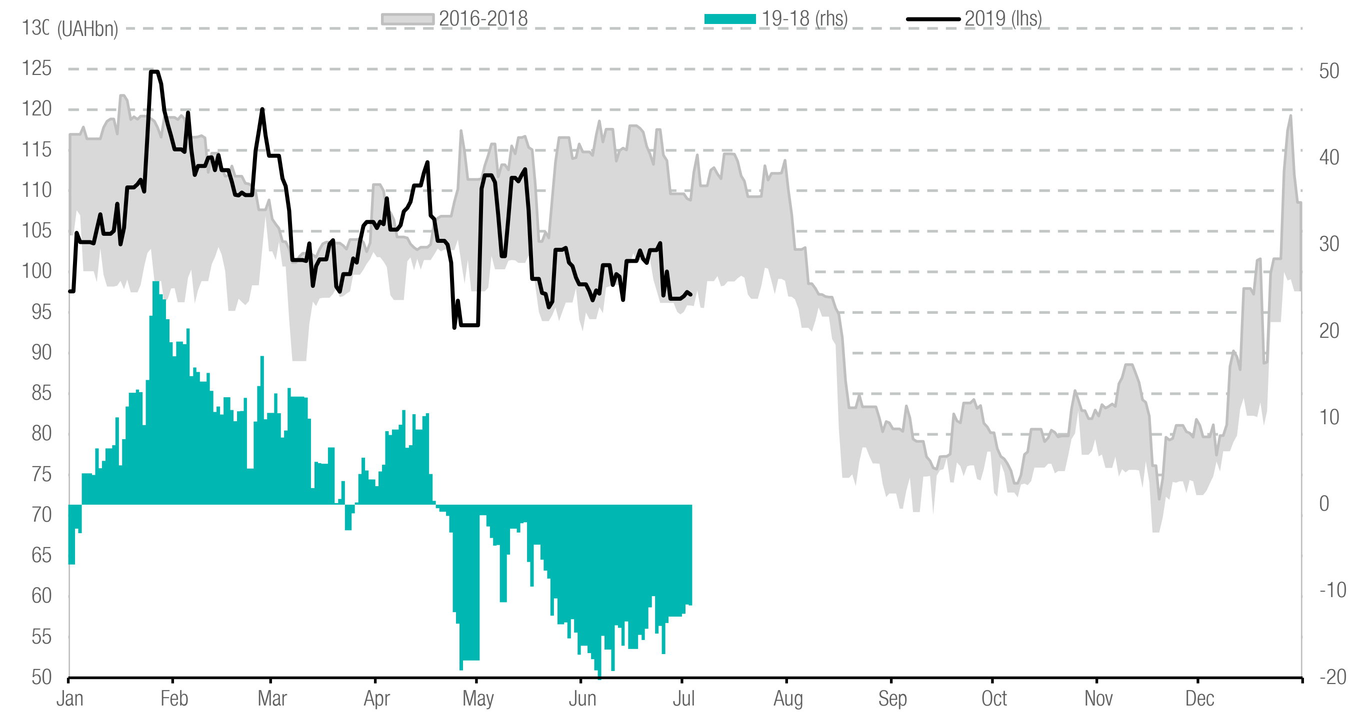
NBU will continue to cut rates to 16% by the end of the year if the base-case scenario of Ukraine maintaining its cooperation with the IMF holds. After commencing the new cycle of interest rate cuts immediately after presidential elections in April, the regulator decided to keep the rate during the following meeting in June. A dubious court ruling challenging the nationalization of Privatbank, and speculation about the artificial default raised concerns about what the economic policy of new administration will be. In addition, dissolution of Parliament led to the decision to postpone cooperation with the IMF until the new one convenes and appoints a new government that will be working on the longer program.

Given these higher political risks, it is likely that NBU will abstain from a rate cut in July. Our base-case scenario is early elections after which Ukraine continues cooperation with the

Fund, and adopts a budget for 2020. This will allow the regulator to cut the rate to 16% by the end of 2019, and continue the cycle in the following year.

Chart 22. UAH liquidity – banks' accounts at NBU + deposit certificates (UAHbn)

Daily historical data from 2016-2018 (grey) and 2019 data compared with previous year (green suggest no more excessive UAH liquidity in 2Q19



Sources: NBU, ICU.

Corporate lending stagnant, consumer loans continue booming

Decrease in corporate loans

High interest rates continue to hinder corporate lending growth

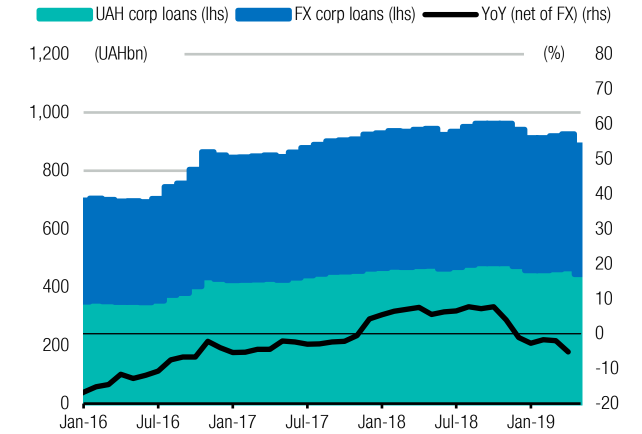
Outstanding loans to the corporate sector declined 4.0% YoY in May 2019. Several statistical impacts contributed such as the fall of VTB Bank, which wiped out around UAH20bn of gross loans from the aggregated balance sheet of the banking sector. However, high interest rates were the main obstacle for portfolio growth. We expect the total gross loan portfolio to increase by no more than 5% YoY, net of exchange-rate fluctuations.

Average interest rates spiked above 21% in December (see Chart 21), and fell as bank liquidity was replenished. We do not expect a decrease due to the postponement in key rate cuts and the expected liquidity shortage in 2H19.

The share of NPLs remained high at 51% as of beginning of June 2019, only marginally declining from 56% a year ago. Nearly 70% of all NPLs are concentrated in state-owned banks (41% in Privatbank, 29% in UkrEximbank, Oschadbank, and Ukrgasbank combined), which were the slowest to restructure bad loans. In fact, this group of banks has been increasing the absolute amount of bad debts. Given the expectation of very slow growth of the gross loan portfolio of the banking sector, the NPLs will remain exceptionally **high** until a viable solution for state-owned banks is implemented.

Chart 23. Dynamics of corporate loan portfolio (UAHbn, %)

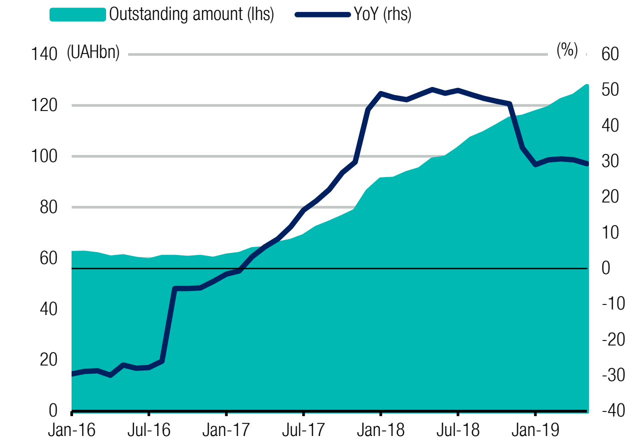
Corporate lending is stagnant as interest rates increased



Source: National Bank of Ukraine, ICU.

Chart 24. UAH loans to households (stock) (UAHbn, %)

Lower growth pace is due to higher comparison base



Source: National Bank of Ukraine, ICU

Consumer lending ensures banks profitability

Consumer lending is growing fast but will face limits in 1.5-2 years

Banks are trying to capitalize on the actively growing consumer-loan market to the greatest extent possible. UAH consumer loans grew by 27.5% YoY in May, and car loans grew by 31.7% YoY. Growth of the overall portfolio is less impressive, as the FX part of the portfolio is amortized and restructured. We expect the gross consumer loan portfolio in hryvnia to continue rising and reach a 30% YoY growth rate by the end of December 2019.

The key question for the next two years will be whether the current level of growth threatens financial stability. As of 1Q19, credit resources constituted less than 10% of total household spending for the period. So far, banks are catching up after the extreme slowdown in lending during 2014–15, as they try to satisfy delayed demand. Should this ratio grow beyond the 12–14% range, the regulator is likely to respond by increasing capital requirements for such loans or set income-based caps on individual indebtedness to prevent borrowers from overextending.

One way or another, banks will face a natural limit to consumer-lending growth by the end of 2020. With around 200 credit cards per 1000 adults, the penetration level is just 15% lower than the historical maximum. And considering the vast number of seasonal workers abroad, it might actually be a de-facto record high. Consumer lending will allow banks to expand their portfolios 1.5–2 years before they reach the point when this segment will provide no further opportunities for growth. A very challenging question is whether the national bank will be successful in its inflation-targeting policy and manage to bring UAH interest rates into the single digit area. It is impossible to expect the initiation of UAH mortgage loans without it. Yet, reaching this target will open a new level for banks in Ukraine.

Economic forecast 2019

	Historical data for 2008-18											Forecast by ICU
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019F
Activity												
Real GDP (%, YoY)	2.6	-15.0	4.2	5.1	0.5	-0.1	-6.4	-10.1	2.4	2.5	3.3	**2.7**
Nominal GDP (UAHbn)	948	913	1,083	1,302	1,405	1,465.2	1,587	1,988	2,385	2,983	3,559	**3,998**
Nominal GDP (US$bn)	147	113	136	162	173	178	108	90	93	112	131	**148**
Inflation												
Headline inflation (%, YoY, e.o.p)	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	12.4	13.7	9.8	**8.0**
Producer price index (%, YoY, e.o.p.)	21.1	15.3	18.8	17.4	0.4	1.7	31.8	25.4	35.7	16.5	14.2	**10.4**
Exchange rates												
UAH/USD (e.o.p.)	7.80	8.00	7.94	8.00	8.05	8.24	15.82	24.03	27.10	28.10	27.69	**28.50**
UAH/EUR (e.o.p.)	10.90	11.45	10.63	10.37	10.62	11.32	19.14	26.10	28.50	33.70	31.71	**32.50**
External balance												
Trade balance (US$bn)	-14.4	-2.0	-4.0	-10.1	-14.3	-15.6	-4.6	-2.4	-6.5	-8.6	-11.3	**-12.0**
Trade balance (% of GDP)	-9.8	-1.7	-2.9	-6.2	-8.3	-8.7	-3.5	-2.6	-6.9	-7.7	-8.6	**-8.1**
Current account balance (US$bn)	-12.8	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	1.6	-1.3	-2.4	-4.3	**-4.3**
Current account balance (% of GDP)	-14.4	-2.0	-4.0	-10.1	-14.3	-15.6	-3.5	1.8	-1.4	-2.2	-3.3	**-2.9**
Interest rates												
NBU's key policy rate (%, e.o.p.)	12.00	10.25	7.75	7.75	7.50	6.50	14.00	22.00	14.00	14.50	18.00	**16.00**
Fiscal balance												
Budget balance (% of GDP)	-1.3	-3.9	-5.9	-1.8	-3.8	-4.4	-5.0	-2.3	-2.9	-1.5	-2.4	**-2.3**

Sources: State Statistics Service of Ukraine, NBU, ICU.

Disclosures

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Buy: Forecasted 12-month total return greater than 20%
Hold: Forecasted 12-month total return 0% to 20%
Sell: Forecasted 12-month total return less than 0%

Note: total return is share price appreciation to a target price in relative terms plus forecasted dividend yield.

DEBT RATING DEFINITIONS

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