Focus
Ukraine

Markets
Economics

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Macro Insight

Economy Under Lockdown

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Coronavirus pandemic and lockdown will cause sharp recession. Fighting against the pandemic, Ukrainian authorities introduced quarantine measures that are quite stringent compared with other countries. These measures may become even more restrictive if the pandemic continues to spread. As a result, Ukraine's real GDP may fall 6-8% in 2020 in our most optimistic base-case scenario of a two-month strict containment, with a gradual recovery thereafter. High uncertainties of the quarantine's duration, the economy's reaction to it, the pace of recovery, and the possibility of another wave of the virus make this forecast subject to significant risks tilted to the downside.

Deteriorating consumption will pull down economy. Households' consumption—the key driver of GDP growth in 2017–19—accounted for 74% of Ukraine's 2019 GDP. Due to the pandemic and lockdown, consumption may fall 30-40% in 2Q20, and recover slowly afterwards, which may result in a full-year decline of 10-15%. Therefore, consumption may contribute 11-13ppts to the overall decline of 2020 GDP. Another key GDP component, investments, may see an even sharper decline of 30–35%, which will cause another 4-5ppts drop in 2020 GDP decline.

Trade-deficit contraction will soften the blow only partially. Households' demand for imported consumer goods will plunge, and together with falling commodity prices, particularly oil and natural gas, will result in Ukraine's imports falling 30-35%. At the same time, quarantine containments, deteriorating external demand, and a harvest that likely will be worse this year, will weigh on Ukraine's exports. Overall, the trade deficit may fall by 80–90% to $1.5-2bn, or around 1% of GDP.

IMF deal critical to cope with FX debt service and budget deficit. Without access to financial markets due to the pandemic and global recession, Ukraine will not be able to service its debt in 2020 without a working programme from the IMF. However, this will come at the cost of burning $3–4bn of FX reserves and hryvnia devaluation. Moreover, without the IMF's help, the government will not be able to finance the budget deficit, which could rise above 8–9% of GDP, or be in a position to help the economy recover from the lockdown. Striking an agreement with the IMF in the coming weeks is thus the only viable option for Ukraine. Hence, we make it part of our base-case scenario: the government will directly receive $7bn financial aid from IFOs in 2020, including $4–5bn to fight the consequences of the pandemic.

The hryvnia may be volatile, but will be supported by IMF deal. Further negative news flow on the pandemic and lockdown may trigger more selloffs of the hryvnia. However, without such shocks and with the coming IMF deal, the hryvnia could strengthen back to 26-27/USD in 2Q20.

Central bank will further ease monetary policy and provide liquidity. We expect the National Bank of Ukraine will continue to lower its key policy rate to 7.5-8% by year-end. At the same time, the NBU does not plan to buy government bonds from the market. Instead, the central bank is ready to provide more liquidity to banks through long-term refinancing. Banks will therefore be able to issue more credit for the economy, including purchasing central government debt.

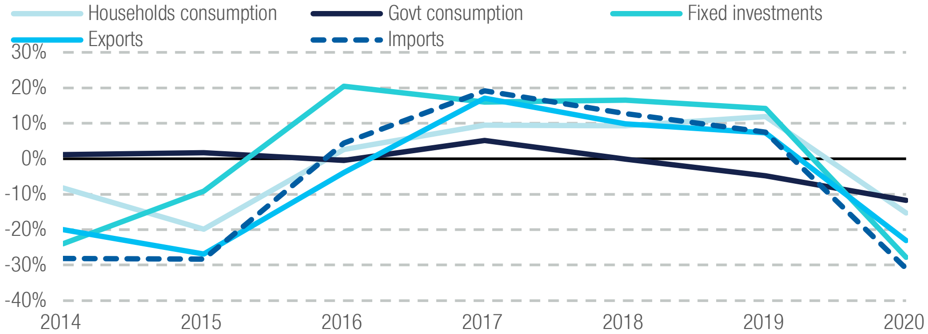
Pandemic and lockdown will cause a sharp economic downturn

Ukraine's real GDP may fall 6-8% as our optimistic base-case scenario

Measures to prevent and contain the spread of the coronavirus will have a devastating effect on the Ukrainian economy. Judging from the rhetoric of authorities about the pandemic spread, the duration of the lockdown until mid-May is the best-case scenario. Meanwhile, quarantine measures still have room for tightening, and further suppress economic activity. At the same time, prolonging the same tough lockdown regime beyond May has low probability in our view, as authorities will be motivated to develop a more flexible approach in order to avoid even harder economic collapse and the resulting grievances from the general public. That said, we expect that the economic recession in Ukraine will be U-shaped with slow recovery in 2H20, as possible gradual lifting of quarantine barriers will also be accompanied with very cautious consumer behavior and low business confidence. **As a result, Ukraine's real GDP may fall 6–8% as our optimistic base-case scenario.** Given extremely high uncertainties of the quarantine's duration, the economy's reaction to it, the pace of recovery, and the possibility of another wave of the virus, this forecast is subject to high risks skewed to the downside.

Chart 1. Change in key expenditure components of Ukraine's GDP (% YoY)

Households' consumption and fixed asset investments may drop 10-15% and 30-35%, respectively, in 2020



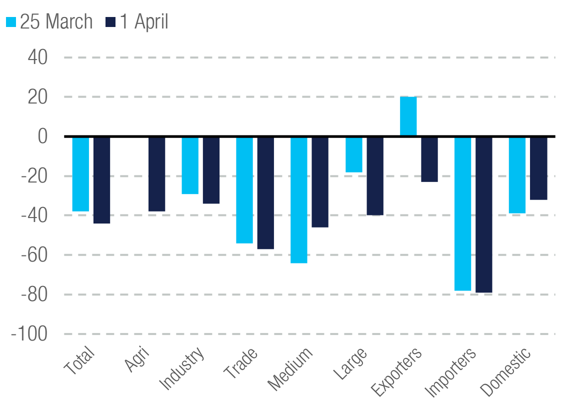
Source: NBU, ICU.

Domestic sales and production may fall 20–40% in the first two weeks of the lockdown with a high risk of acceleration in coming weeks

Falling consumption will take the heaviest toll on the economy. Since consumption was the key driver of GDP growth in 2016–19, it will be the main factor of the plunge in GDP this year. Early statistical data and business polls indicate that domestic sales and production may fall 20–40% in the first two weeks of the lockdown with a high risk of acceleration in coming weeks as businesses shut down, people lose jobs and live off their savings, and consumer confidence plummets. After the lockdown starts unwinding, consumption recovery will be slow and show YoY decline until the end of 2020. **While the decline in household consumption may be as deep as 30–40% in 2Q20, full-year 2020 consumption may decline 10-15% in our optimistic, base-case scenario.**

Chart 2. Ukrainian business expectations on sales drop (%)

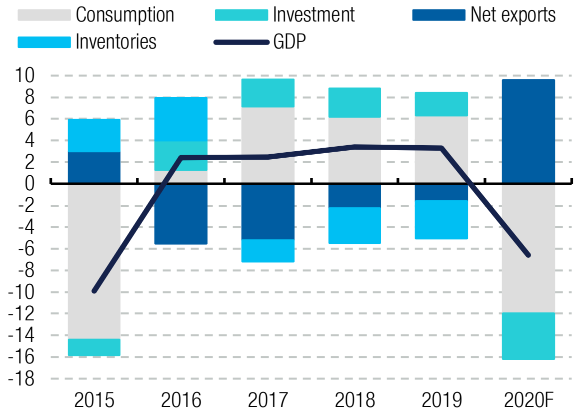
Business sentiment worsened significantly after the lockdown's 2nd week



Source: NBU, ICU

Chart 3. Change in Ukraine's real GDP by expenditures (%)

Consumption was the key driver of Ukraine's GDP in 2017-2019



Source: NBU, Bloomberg, ICU.

Investments will have another contribution to the decline in GDP with their sharp fall caused by low business confidence and state budget constraints. The high 2019 base due to large investment inflows into alternative energy will have an additional negative effect. **We estimate fixed-asset investments to drop 25–30% in 2020, with high downside risks.**

Inflation may accelerate to 6-8% as of end-2020

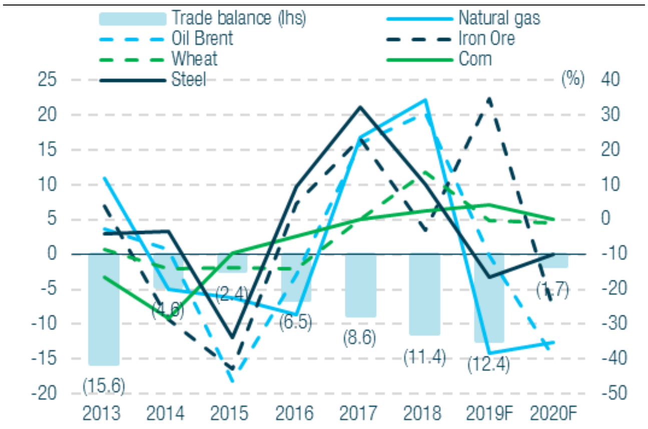
Inflation may accelerate to 6-8% by the end of 2020, while the average growth in CPI for 2020 may amount to 5-6% versus 7.9% in 2019. The key driver for inflation will be food prices boosted by limited supply during the lockdown (first of all, due to closed farmers' markets and open-air bazaars and limited logistics), as well as a likely worse harvest. A weaker hryvnia and rising social payments to unemployed and low-income citizens will be other key boosters for inflation. Lower oil and gas prices and depressed consumption will restrain inflation.

The trade deficit may shrink 80–90% to around 1% of GDP

Decline in trade deficit will just marginally compensate losses in consumption and investments. We expect that the decline in imports caused by falling consumption and lower world prices for oil and natural gas will far outpace losses in Ukraine's export revenues. As a result, the trade deficit could shrink 80–90% to around 1% of GDP. Exporters of agriculture products and IT services will be most resistant to the global recession, while transportation benefits from the pump-or-pay clause and fixed price agreement with Gazprom. At the same time, exports of steel and machinery are most vulnerable to the global economic downturn.

Chart 4. Ukraine's trade deficit ($bn) versus % YoY change in key commodity prices

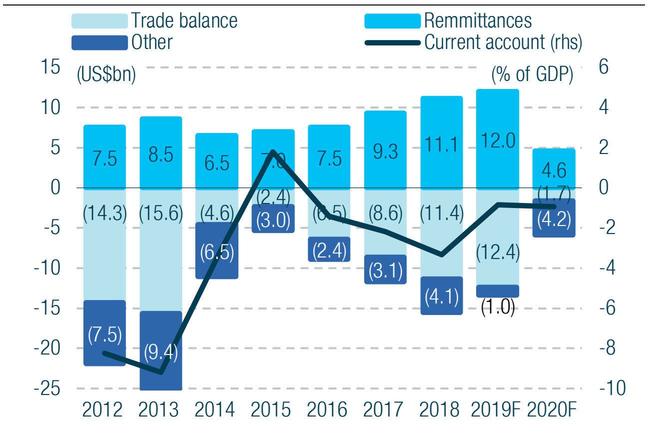
Lower oil and gas prices will be among the key factors of Ukraine's trade deficit contracting to 1% of GDP in 2020



Source: Bloomberg, NBU, ICU

Chart 5. Ukraine's current account (% of GDP) and its key components ($bn)

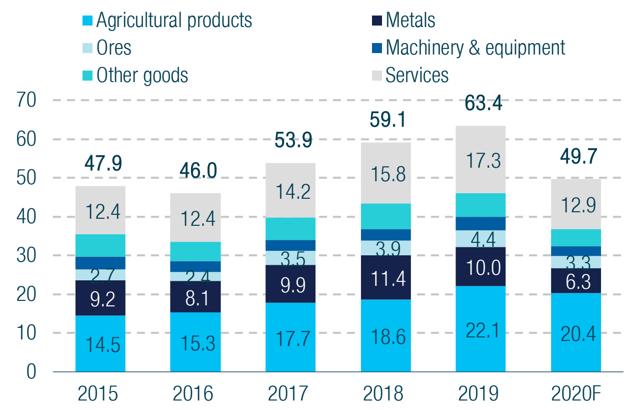
Current account will remain around 1% of GDP in 2020, as plunge in remittances from labour migrants will be offset with dropping trade deficit



Source: Bloomberg, NBU, ICU

Chart 6. Ukraine's exports ($bn)

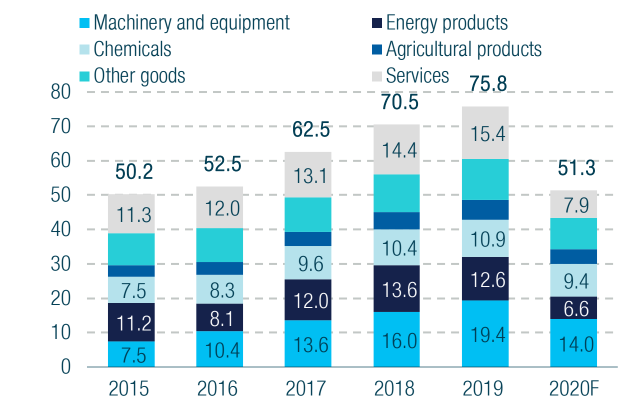
2020 exports of machinery, ore and steel may drop 20-40%, while exports of agri products may be more resistant, suffering mostly from worse harvest



Source: Bloomberg, NBU, ICU

Chart 7. Ukraine's imports ($bn)

Imports of energy products - oil, motor fuels and natural gas – may drop almost 50% due to lower prices and consumption in 2020



Source: Bloomberg, NBU, ICU

The hryvnia may strengthen to 26–27/USD in 2Q20

The hryvnia remains highly dependent on the sentiment: while negative newsflow on the pandemics and lockdown may provoke more selloffs of the national currency, a signed IMF deal will prompt a rally. Availability of FX funds from IFOs and exporters demand may give support to the hryvnia strengthening to the 26–27/USD level in 2Q20. As consumer demand and oil prices will be recovering in 2H20, the hryvnia may depreciate to 28–29/USD with current account deficit expanding by the end of 2020.

IMF deal is critical for financing sovereign debt and budget deficit

The IMF deal will enable the Ukrainian government to receive $7bn of financing from IFOs in 2020

Ukraine is unable to cope with consequences of the pandemic and lockdown without support from external financing. As Ukraine's financial markets will remain shut for at least the next few months, the IMF and other IFOs will be the only financing source. The $5.5bn EFF programme agreed between Ukraine and the IMF on the staff level in December may be extended to $8bn. That amount will include a $4–5bn economic stimulus package. This is equivalent to 3% of 2019 GDP, and comparable with the 2–3% GDP fiscal stimulus announced by the leading national governments in the EU as of end-March. According to sources familiar with the negotiations, $5bn of the IMF facility may come directly to the state budget this year. After the IMF deal is signed, the government will receive an additional $2bn financing from the EU, EBRD, and the World Bank.

Table 1. FX-denominated debt repayments and sources for financing for the rest of 2020 (US$bn)

Estimated government FX accounts at 6Apr20	**1.6**			
Government FX funding	**Without IMF**	**With IMF**	**Government FX debt payments**	**8.3**
Total possible funding	**6.0**	**9.0**		
IMF aid	--	5.0	IMF	0.6
Eurobonds	--	--	Eurobonds principal	1.4
WB guarantee	--	1.0	US-backed Eurobonds	1.0
Domestic FX bonds	3.0	2.0	IFI	1.3
EU aid	--	0.6	Other external debt repayments	0.9
FX purchased from NBU	3.0	--	incl. Eurobonds interest	0.9
EBRD aid	--	0.4	Domestic FX bonds	3.1
Expected Government FX accounts at 1Jan21	**(0.7)**	**2.3**		

Source: MFU, ICU

Finalization of the IMF deal remains our base case as Ukraine does not have any other viable options

In order to receive the extended EFF loan from the IMF, it is necessary to agree on a technical memorandum and to adopt in the Verkhovna Rada the latest package of laws on nationalized banks and changes to the 2020 state budget. The law on banks has already been passed at the first reading, but further voting faces strong resistance from MPs representing interests of former bank owners. Nevertheless, **finalization of the IMF deal remains our base case as Ukraine does not have any other viable options.**

Under control of the IMF the budget deficit may increase to 6–8% of GDP

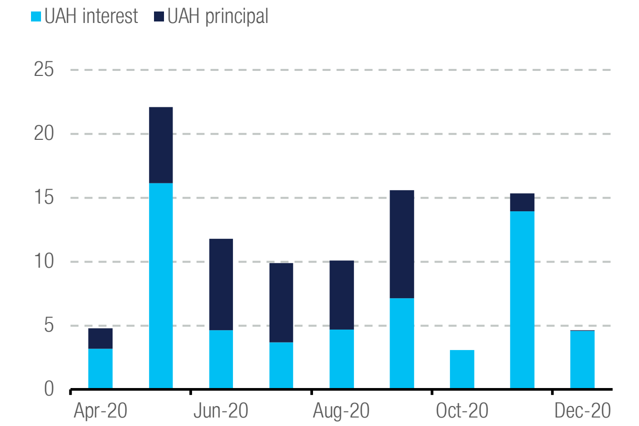
The government will revise the budget to include a greater deficit, because of the pandemic crisis and the need to support the economy. While the latest known drafts provided for an approximate threefold increase of the deficit from the previous 2.2%, the final figure will have to be agreed with the IMF. The Ukrainian parliament may approve a new budget in the coming weeks. The risks of budget-revenue underperformance are high due to falling taxable volumes of imports, sales, and incomes. This will mean, in turn, underperformance of the expense part of the budget, and it may further exacerbate the economic contraction.

The government will have to pay $8.3bn of FX debt and interest until end-2020

Ukraine's ability to pay FX debt is strained. From end-March until the end of the year, the government has to pay $8.3bn of FX debt and interest, including $5.2bn in external and $3.1bn internal payments. The peak external payments are in May ($1.2bn) and September ($2.1 bn), while domestic payments are mainly in the summer: $1.1bn in June, $0.8bn in July, and $0.5bn in August. Without-the IMF deal, the government will be able to service the FX debt at least through the summer by using up its FX cash balance estimated by us at $1.6bn and issuing USD-denominated bonds to domestic banks. After that, however, Ukraine will have to burn $3-4bn of FX reserves till the end of 2020, thus putting additional pressure on the hryvnia and spurring inflation. With the IMF deal inked, the government will comfortably go with debt redemptions through the whole year of 2020 and look confidently into 2021.

Chart 8. Schedule of UAH-denominated debt repayments (UAHbn)

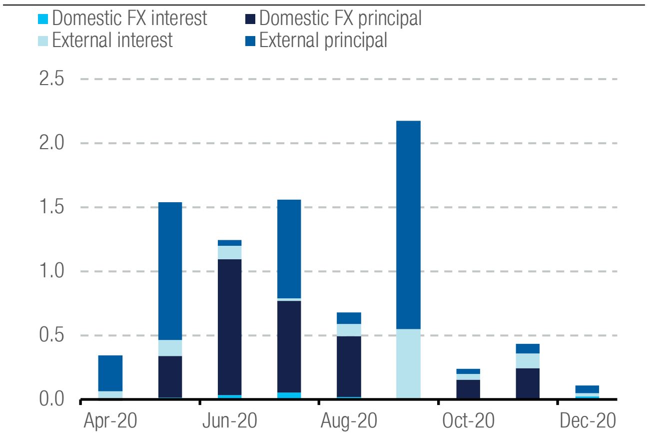
Excluding already done payments in April



Source: MFU, ICU

Chart 9. Schedule of FX-denominated debt repayments (US$bn)

Domestic and external debt repayments, excluding paid in April



Source: MFU, ICU

The government is able to refinance UAH debt repayments through issuing debt to banks

Hryvnia-denominated debt payments are not so critical. Currently, the government will pay UAH84bn including principal and interest by the end of the year, of which UAH18bn will be paid to the NBU and about the same amount to the state banks. We estimate that around UAH20bn will be paid to foreign investors and the remaining UAH28bn to Ukrainian entities and individuals. With the IMF deal secured, foreign investors may return for government paper in 2H20, so the decline in their holdings will slow, if not change to recovery. For the latter to happen, auction yields of around 15% should be attractive to foreigners in terms of risk-reward balance. Higher yields are unlikely to be acceptable for the MoF, which may attract domestic banks with the yields close to interbank loan rates, 13–14%.

Banking sector is resilient, but will become much less profitable

The sector is approaching the pandemic crisis with much better capitalization and liquidity but will see falling consumer lending and face higher provisioning costs.

High-yield consumer loans will decline as banks will cut new lending

Expecting a recession, banks will significantly reduce the volume of new consumer loans issued. Short-term maturities will help to reduce the consumer loan portfolios. As polls show, 57% of respondents have enough savings to live on for up to four weeks, after which they will urgently need credit financing. However, low solvency will push these people towards non-bank financial institutions.

Fewer companies will be able to get loans while rates may rise despite the moratorium

Corporate lending, which, unlike consumer, stagnated in 2019, will shrink even further. Banks will be increasingly reluctant to lend to businesses vulnerable to the lockdown and will likely compete for more resilient borrowers, such as large exporters. While the latter are unlikely to see rising credit costs, the former may have to borrow at rates 2–3ppts higher this year. After their record low in 2019, payments to reserves on existing loans should increase due to worse payment discipline of borrowers.

No depositors' run on banks in March

Fast outflow of deposits from banks is unlikely due to a majority share of current-term deposits without the right of early withdrawal, unlike in the previous crisis in 2013–14. During March, UAH retail deposits (both term and demand deposits) fell by only 0.8% MoM while FX fell by 0.2% MoM. During February-March 2014, deposits fell at a significantly higher rate by 5–7.6% MoM.

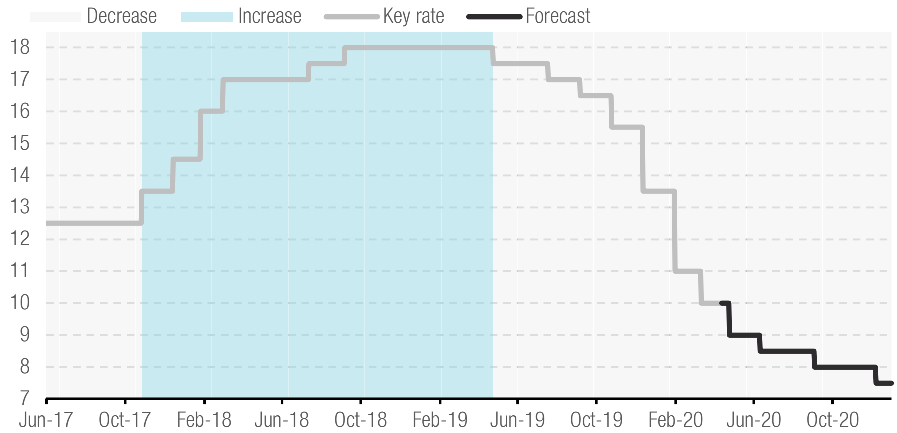
Since December 2019, new 12M deposit rates have fallen by 4 ppts to less than 12%. In the absence of a serious deterioration of the situation, banks will not substantially raise rates, but will reduce their balance sheets to maintain profitability.

NBU will relax monetary policy, but abstain from buying government bonds

The National Bank will soften its monetary policy in 2020. The regulator will continue to lower its nominal rate in line with most other central banks. We expect the key policy rate to drop from the current 10% to 7.5-8% by the end of the year, despite inflation accelerating above NBU's target range. The combination of these two factors will result in a rate lower than the actual discount rate. This will mean the real key policy rate nearing zero. The NBU does not plan to buy government bonds from the market, despite the recommendation of the NBU Council. The regulator is ready to issue long-term refinancing for this purpose. Although demand for such loans remains low, it may increase with further monetary easing. With increased credit from the regulator, banks will be able to increase their exposure to the central government.

Chart 10. NBU key rate dynamics and forecast

Rate decrease cycle will continue in 2020



Source: NBU, ICU estimations.

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