Focus
Ukraine

Scope
Economics

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Macro Review

Heading into 2020 with Confidence

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Executive Rundown

Ukraine is heading into 2020 with confidence, as its macroeconomic situation is as good as it gets under current circumstances: GDP real growth is staying within the 3-4% range, Debt/GDP ratio is poised to decline below 50%, the current-account deficit as a percentage of GDP contracts to the relatively safe 3% level, and the hryvnia has become the world's top performer versus USD this year. In 2020, the external environment may appear more challenging, with higher risks stemming from global-economy slowdown and trade wars. The IMF programme is far from being a done deal considering uncertainties with banking-sector reforms. Nevertheless, investors are still giving the Ukrainian investment case the benefit of the doubt as Ukraine's sovereign and domestic UAH-denominated paper offer attractive pricing amidst the ongoing global hunt for yields.

Sovereign debt: Burden eases, but still requires IFI funding. The hryvnia's 16% appreciation helped Ukraine reduce its debt-to-GDP ratio to around 50% by YE19 from 61% as of YE18. By YE20, the ratio is likely to decline to 47%, which may be the fastest deleveraging among peers in its country group. Nevertheless, the government's FX-denominated debt repayments remain high at US$9bn and US$6.8bn in 2020 and 2021, respectively. Favourable markets and high foreign demand for UAH T-notes could allow the government to go through 2020 without IMF and other IFI support and without substantially undermining international reserves. However, still high debt repayments in 2021, and the risk of market sentiment deterioration still requires the government to ink a new agreement with the IMF.

Government debt: UAH paper poised for more foreign inflows. Attractive yields, the Clearstream link, and Ukraine's overall robust investment case keep Treasury paper very attractive to foreign investors. Even as we expect the NBU to cut its key rate by 300bps to 10.5% by YE2020, the government's UAH instruments may still be offering 4-5% real yields, which will face little competition from investment alternatives of a similar risk-reward combinations. Foreign positioning has built up to a substantial 24% of total outstandings (excluding the NBU). We don't see this as an issue yet, as it has still some way to go towards 28-30%, closer to higher levels of the regional peers. We expect foreign inflows of US$2-2.5bn equivalent into UAH paper incoming mostly in 1H20.

NBU key rate: Poised for further cuts. The NBU could lower its key policy rate to 10.5% by the end of 2020, according to our expectations. In real terms, the key rate will drop to below 7% by the end of 1Q20 and further to 5% by the end of 2020, after staying within the 7-10% band during the 2018-19 period of very tight monetary policy. Therefore, the central bank will partly catch up with the monetary easing wave of most EM central banks. Nevertheless, NBU's key real rate is likely to stay 200-250bps higher than policy rates of Ukraine's high-yielding peers by end-2020.

Banks: Record high profits. Ukrainian banks had another record year in terms of profitability, as their expected aggregate profit is set to exceed UAH60bn. Due to the boom in consumer lending and lack of high provisioning expenses that were made in the past, banks can expect yet another profitable year in 2020, as the consumer confidence index is at a 10-year high. While the regulator begins to focus more on assessing the retail lending segment, the Ukrainian market still is a year or two away from saturation. Corporate lending remains stagnant with 7.3% YoY decline in amount of the gross portfolio in October 2019. Lowering of the interest rates should allow for up to 10% YoY portfolio increase in 2020, as the demand for loans picks up.

Economy: Beats expectations. Ukraine's real GDP growth in 2-3Q19 exceeded 4% and beat the consensus forecast. Record-high consumer confidence since 2008, growing wages, and surging retail loans boost consumer demand, the key driver of the Ukrainian economy in 2019–20. At the same time, cooling external markets are weighing on industrial production and will likely continue to do so in 2020. Also, still-high external debt repayments will hinder the government from substantially stimulating consumer and investment demand. Lower transit volumes of Russian natural gas will additionally hamper growth. We expect real GDP growth to slow to 3.2% in 2020 from 3.6% in 2019.

Inflation: Slowing into the NBU's target range. Inflation should slow to 4.9% YoY by YE2019, thanks to the strong hryvnia, low oil and gas prices, and a good grain harvest. In 2020, low energy prices together with tight fiscal policy and still-high rates should continue to hamper growth in consumer prices. Expected by us, appreciation in the hryvnia in 1H20 should further decelerate the growth in consumer prices. The FX effect may turn negative in 2H20, when the hryvnia starts weakening. Other pro-inflationary risks include stronger-than-expected consumer demand, a worse agri harvest, and higher-than-expected oil prices. We expect inflation to amount to 5.3% YoY by the end of 2020.

C/A deficit: Narrows. Favourable pricing of global commodities, a record grain harvest, and rising private remittances help Ukraine to contract its current account deficit to 2.7% of GDP in 2019. However, more challenging external markets and declining gas transit revenues will widen the current-account deficit to 3% of GDP in 2020. Despite this widening, the hryvnia should finish 2020 in a relatively strong position of UAH25.5/USD. Moreover, supported by more foreign inflows into government UAH paper, the national currency may strengthen to UAH22-23/USD in 2Q20.

Sovereign Debt: Burden eases

Debt burden eases; IMF cooperation still vital

- **Ukraine's debt-to-GDP ratio is declining at the fastest rate within its peer group, and could reach 47% in 2020 compared with 61% in 2018**
- **Favourable markets may allow the government to make FX debt repayments without IMF's aid until the end of 2020**
- **However, the government will anyway have to ask for aid from the IMF and other IFIs to service US$6.8bn FX debt repayments in 2021**

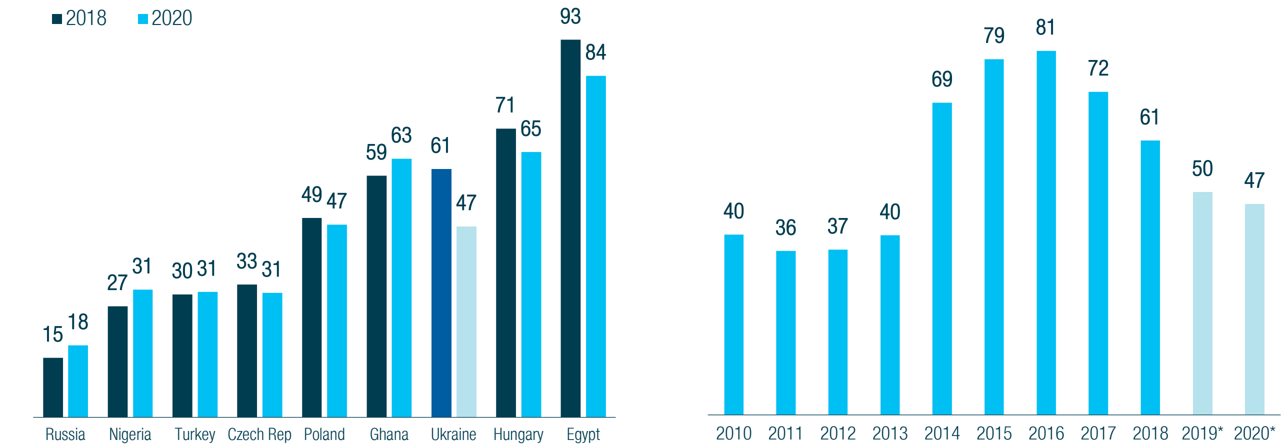
Ukraine's Debt-to-GDP ratio likely to improve the fastest in its peer group

Debt-to-GDP ratio will fall to around 50% in 2019, and then to 47% by end-2020

During 10M19, sovereign debt in UAH terms declined due to the 10.5% appreciation in the hryvnia, which weighed on the FX portion (65% of total debt). Together with GDP growth, this will allow a steady decline in the debt-to-GDP ratio to around 50% by the end of 2019, from 61% as of end-2018. If the government implements its 2020 financing plans and the economy grows as we expect, the ratio may further decline to 47% by end-2020. In such case, within its peer group, Ukraine's debt-to-GDP ratio may drop at the fastest rate and come close the group's mean, similar to the ratio of Poland (see Chart 1).

Chart 1-2. Ukraine's debt-to-GDP ratio is close to peers (%)

During 2014-2017, Ukraine's debt-to-GDP ratio was significantly higher than peer countries, but due to hryvnia appreciation, steady growth in GDP, Ukraine has good chance to catch up with Poland at YE2020



Source: WEO, MFU, Ukrstat, ICU.

Source: MFU, Ukrstat, ICU.

Cooperation with IMF remains critical for FX debt service

2020 will be another year for high debt repayments, as the government will have to make US$9bn in FX outlays. As borrowing conditions are likely to remain favourable for emerging and frontier economies, Ukraine looks to be able to meet its FX obligations in 2020 even without IMF financial assistance. Afterwards, however, Ukraine's international reserves may decline well below the comfort level of three months of imports. This will considerably limit the government's ability to tap financial markets or buy hard currency from the NBU, in order to pay around $8bn FX debt in 2021. As before, the IMF deal is also critical for providing investors with confidence in Ukraine's investment case.

We expect that by YE19, the government will have a US$0.8bn hard-currency balance in its accounts, and will have to replenish them by US$9bn next year

We estimate that this year, the government sourced US$3.2bn of hard currency through the NBU from foreign buyers of UAH-denominated T-bills and T-notes. As a result of these FX purchases from the NBU in addition to Eurobonds issues, loans under WB guarantee, partial refinancing of USD-denominated bills redemption, and the loan from Cargill FSI, the government should accumulate about US$0.8bn in hard currency on its accounts as of YE2019. This amount should cover debt repayments scheduled for January 2020, but until the end of 2020, the MoF will need to refill accounts by US$9bn (see Table 1).

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

Government FX accounts at 1Jan20	0.8		
Government FX funding	9.1	Government FX debt payments	9.0
Eurobonds	2.5	IMF	0.5
WB guarantee	1.0	Eurobonds	1.4
Domestic FX bonds	2.0	US-backed Eurobonds	1.0
EU aid	0.6	IFI	1.2
FX purchased from NBU	3.0	Other external debt repayments	0.6
		Interest payments	1.4
		Domestic FX bonds	2.9
Expected Government FX accounts at 1Jan21	0.9		

Source: MFU, EU, IMF, ICU

The MoF may issue about US$2.5bn Eurobonds next year, starting with a EUR-denominated bond in 1Q20…

The 2020 state budget plans for US$4bn of external borrowings. Of that amount, we assume the MoF will issue US$2bn of new FX-denominated domestic bills. As long as investors maintain their current strong interest in high-yield assets, Ukraine's chance to issue Eurobonds is very high, even without an ongoing programme with the IMF. We see high probability that the MoF will look for a window of opportunity for a new Eurobonds issue at the beginning of 2020, to be ready for interest payments in March and the redemption of USA-backed bonds in May. The debut issue will most likely be denominated in euros to exploit cheaper rates compared with USD-denominated Eurobonds. Also, denomination in euros would increase differentiation in the debt structure by currency, as the euro currently accounts for just 10.6% in total Ukrainian debt.

…however, institutional financing will hinge upon the IMF deal

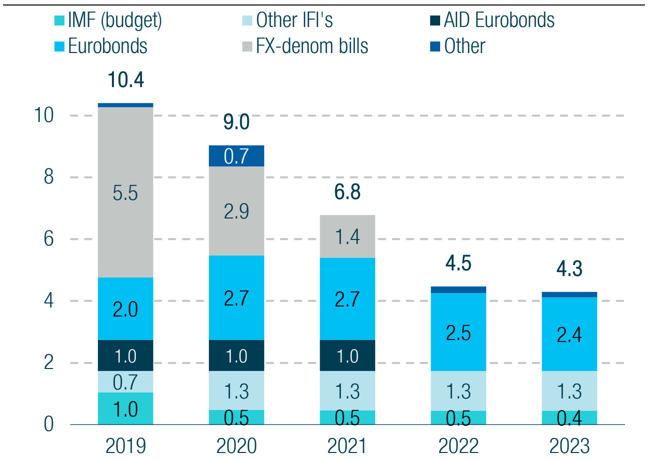
Obtaining a new policy-based guarantee from the WB or the second review of macrofinancial aid from the EU will depend on successfully signing a deal with the IMF. However, high demand for local-currency debt from foreigners and strong domestic demand for FX-denominated bills should allow the MoF to gather the required financing for debt repayments scheduled for 2020.

If market conditions worsen, without the IMF, the MoF can buy FX from NBU reserves, but not much more than to cover repayments scheduled for 2020

In addition to Eurobond issues, the MoF may acquire hard currency from the NBU's international reserves. In this way, we think that the government may obtain up to US$5-6bn until FX reserves decline below the comfort level of three months of imports in 2020. Our key assumption here is that the NBU will purchase at least US$2-3bn in FX market, with the foreign investors in local UAH paper being the key source of hard-currency inflows. Hard currency purchases from the NBU should provide the MoF with enough funds to go through FX debt repayments without the IMF programme, other IFIs aid and commercial borrowings in 2020. However, Ukraine will eventually have to ask the IMF and other IFIs for financial aid to service $6.8bn FX debt repayments in 2021.

Chart 3. Yearly FX-denominated debt repayments by type of borrowing (US$bn)

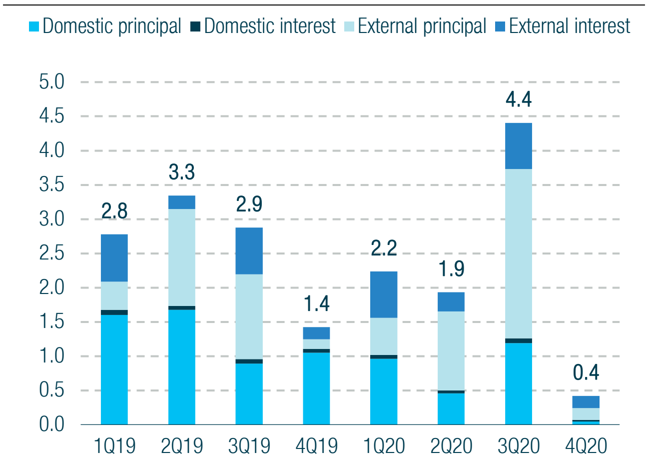
Structure of FX-denominated debt repayments by lender or type of borrowings



Source: MFU, ICU

Chart 4. Quarterly schedule of FX-denominated debt repayments (US$bn)

Domestic and external debt principal and interest repayments in FX



Source: MFU, ICU.

IMF deal is likely in 1Q20

We expect Ukraine will sign the final deal with the IMF in 1Q20

Despite Ukraine has reached an agreement with the IMF on the staff level, the final agreement is not a done deal yet. Ukraine's cooperation with the IMF has stumbled on the issue of asset recovery from the failed banks and especially rescued Privatbank. Courts have issued several rulings that question the legality of the bank's nationalization. However, the clean-up of the Ukrainian banking sector, its recapitalization, and cessation of insider-lending practices were the key issues of the previous IMF programmes, which Ukraine has already met. Reversal of these or other previously achieved benchmarks demerges the efficiency of IMF programmes and targets. Therefore, any possible attempts to return Privatbank to its former shareholders or compensate them would constitute a point of no return for the Fund. Yet, we expect the domestic and foreign legal battles over the bank's nationalization and possible fraud at the bank prior to nationalization will take more than a year to resolve. During this period, Ukraine is likely to abstain from crossing red lines so as to remain in the IMF programme. The most likely scenario will be Ukraine being able to borrow from the market without the support of IMF before a solution to the Privatbank conundrum is reached.

That said, we expect the final deal to be inked and the first tranche of a new programme to arrive in 1Q20.

UAH-denominated T-notes will still be in high demand

- **Ukraine's improving credit profile, high yields, and Clearstream link support high demand for the government's UAH paper**
- **Even with the NBU cutting its key rate, the real rates of Ukraine's UAH paper should still be attractive 4–5% with little competition from peers**

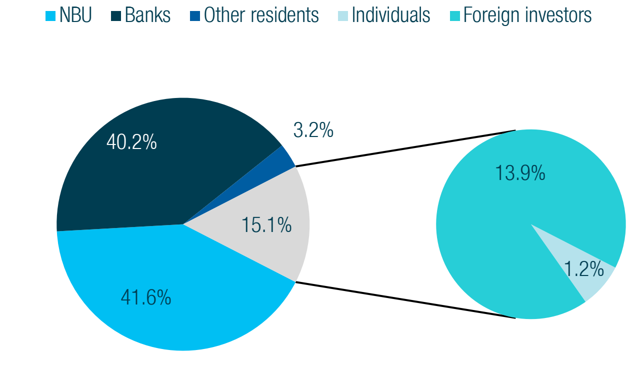
Ukraine's UAH debt remains highly attractive for foreign investors

Foreigners invested UAH113bn in domestic bills including UAH112bn of UAH-denominated paper

In 2019, foreign investors' holdings of Ukrainian government local paper rose by UAH107bn (US$4.6bn) to UAH113bn (US$4.8bn), including UAH112bn (US$4.7bn) in UAH debt. These instruments became attractive due to high interest rates, easing monetary policy, the strong hryvnia, and investors' high expectations of further reforms to be made by the newly-elected administration. Transparent debt policy from the Ministry of Finance and a link to Clearstream, which opened in May, further increased the attractiveness of local-currency debt.

Chart 5. Dynamics of bondholders' portfolios (UAHbn)

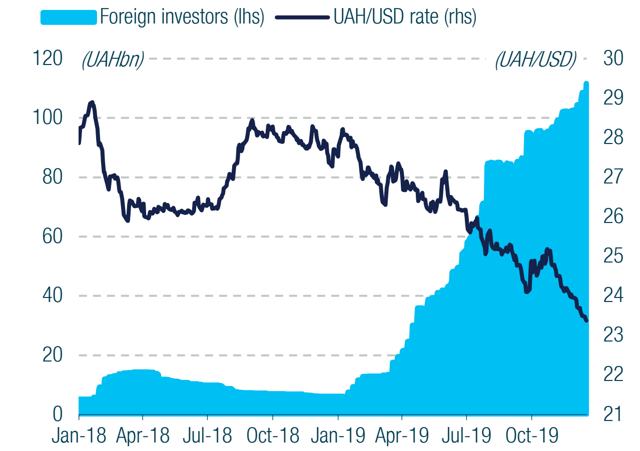
Foreigners' holdings in government domestic bonds rose most rapidly



Source: NBU, ICU

Chart 6. Foreign investors' portfolios (UAHbn) and hryvnia (UAH/USD)

Foreign holdings in UAH-denominated bonds surged by $4.6bn in 2019



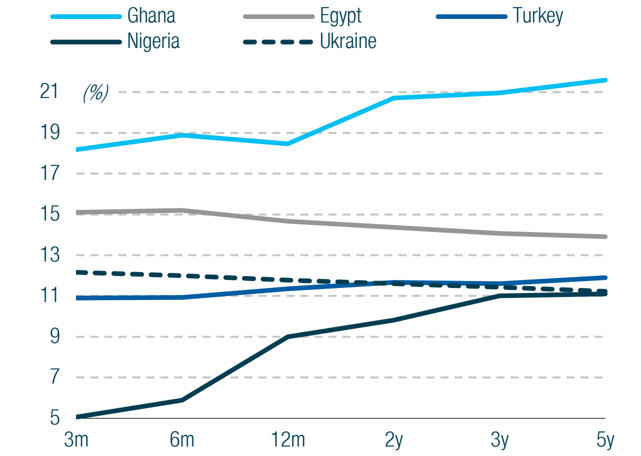
Source: NBU, Bloomberg, ICU.

Foreign investor's share in Ukraine's local-currency debt of 24% (ex.NBU) still has some way to go to equal levels of peers

Ukrainian T-bills and T-notes are still attractive for foreigners despite the decline in rates seen in 2019. The 11-12% YTMs of Ukraine's UAH-denominated debt are close to high-yielding peers (see Chart 7), while the credit profile is better in the majority of cases. In our view, foreign positioning in government local bonds is not overcrowded yet. Foreign investors' share in the total amount of government outstanding UAH paper is 13.4%, which is close to Turkey, and is one of the lowest among high-yielding peers. If we exclude the NBU's holdings from the total outstanding amount, foreigners' share is still almost 24%, being between Hungary and Poland with Ghana, having to go some way to 28-30% next year, closer to level of Russia (see Chart 8).

Chart 7. Peers' YTMs on local-currency debt (%)

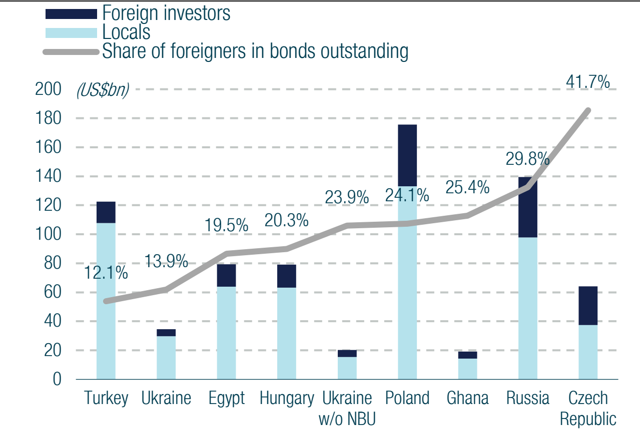
Yields of Ukraine's UAH-denominated debt is close to high-yielding peers



Source: Bloomberg, ICU.

Chart 8. Foreign holdings of debt and share in total (%)

Foreign positioning in government local bonds is not overcrowded yet



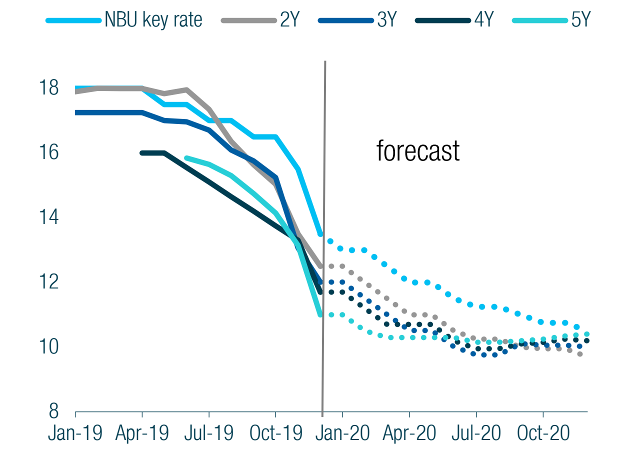
Source: Bloomberg, peers and neighbours' official web-sites, ICU.

Despite the expected aggregate 300bps NBU rate cut, T-note rates may stay attractive at 4-5% in real terms

We expect the NBU to cut its key rate by 300bps to 10.5% by YE2020; rates of UAH T-bills and notes should also decline to 9-10% in nominal terms or 4-5% in real terms. Such real rates will still be highly attractive if Ukraine manages to sustain its current credit profile and achieve notable progress in reforms. During 4Q20, we also expect that the yield curve will cease to be inverted, and longer-term notes will have higher rates, as the government will have to attract foreigners who are main investors at the back end of the curve.

Chart 9. UAH-denominated paper and NBU key rate (%)

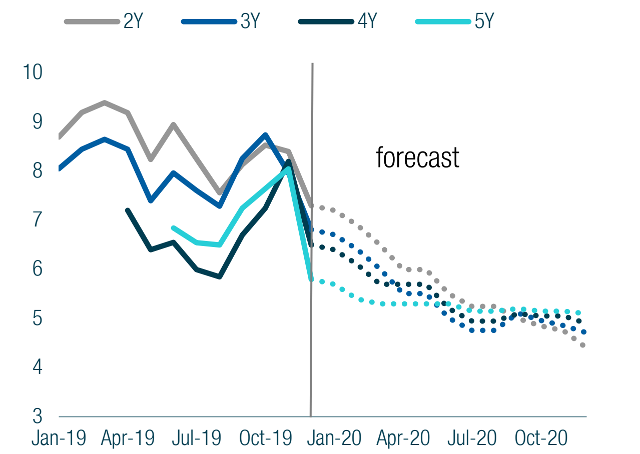
NBU key rate, actual (2019) and expected (2020) rates at primary auctions



Source: NBU, MFU, ICU.

Chart 10. Real rates at primary auctions (%)

NBU key rate, actual (2019) and expected (2020) real rates at primary auctions



Source: NBU, MFU, ICU.

Government to keep focusing on issuance of UAH long-term paper

In 2020, the MoF plans to issue 70% of borrowing domestically and most likely in hryvnia…

According to the budget for 2020, the government is going to borrow UAH343bn (US$13bn, at the exchange rate included in budget calculations). 70% will be domestic (most likely in hryvnias), and only 30% from external sources, including Eurobonds and official loans, like macrofinancial aid from the EU or loans under WB guarantee.

…with main focus on offering five, seven, and 10-year notes

Foreigners' portfolios could rise at least by UAH50bn in 2020

The MoF will seek to satisfy foreign investors' high interest in UAH-denominated debt with maturities above two years. Most likely, the Ministry will continue to offer five-year notes, and will initiate offerings of seven-year and 10-year T-notes. To attract foreign inflows into the government's local instruments, the MoF and the NBU will not cap the holdings of foreigners and/or holdings of specific maturities starting from January 2020. As a result, the foreign investor base should widen significantly, and foreign holdings of the government's UAH-denominated paper may grow at least to UAH170bn or US$6.7bn by YE20 from UAH115bn (US$4.8bn) as of YE19.

Key rate: Poised for more cuts

- **We expect the NBU key rate to drop by 300bps to 10.5% by the end of 2020, as inflation is abating into the central bank's 5±1% target range**
- **Real interest rates have fluctuated in the 7-10% range for two years now—significantly higher than historic values**

The NBU to continue cutting its key rate as inflation slows to the 5±1% target range…

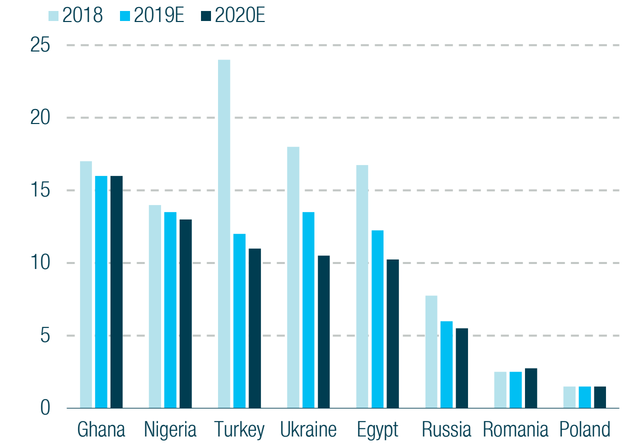
So far, the NBU has maintained a very tight monetary policy, as in real terms its key rate has been above 7% for the last 18 months. The NBU was reluctant to cut the key rate aggressively until December 2019 in order to avoid a bounce back of inflation, which happened during the previous interest rate cut. Therefore, Ukrainian real interest rates are among the highest in its peer group and worldwide.

…but in real terms, the key rate will remain among the highest in the peer group

Ukraine's expected decline in the real rates in 2020 will bring it closer to the peer group of countries. However, Ukraine's policy rate will remain 200-250bps higher than rates of peer high-yielders, Egypt and Nigeria, and particularly Turkey, which has recently performed the most aggressive monetary easing.

Chart 11. Policy rates in nominal terms (%)

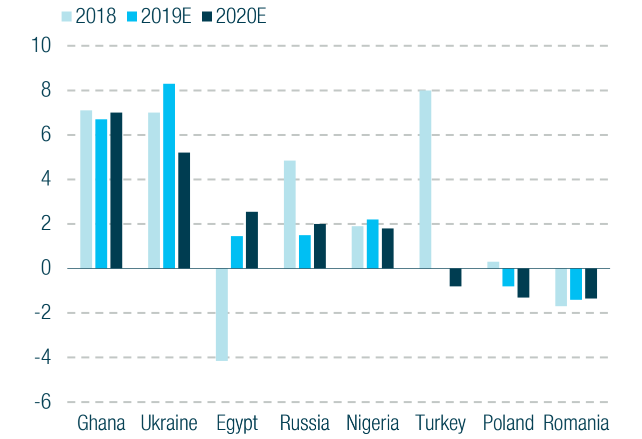
Ukraine is catching up with high-yielding peers in cutting the policy rate in real terms…



Source: NBU, MFU, ICU.

Chart 12. Policy rates in real terms (%)

… however, in real terms, the NBU's key rate will still substantially exceed policy rates of most "high-yielders"

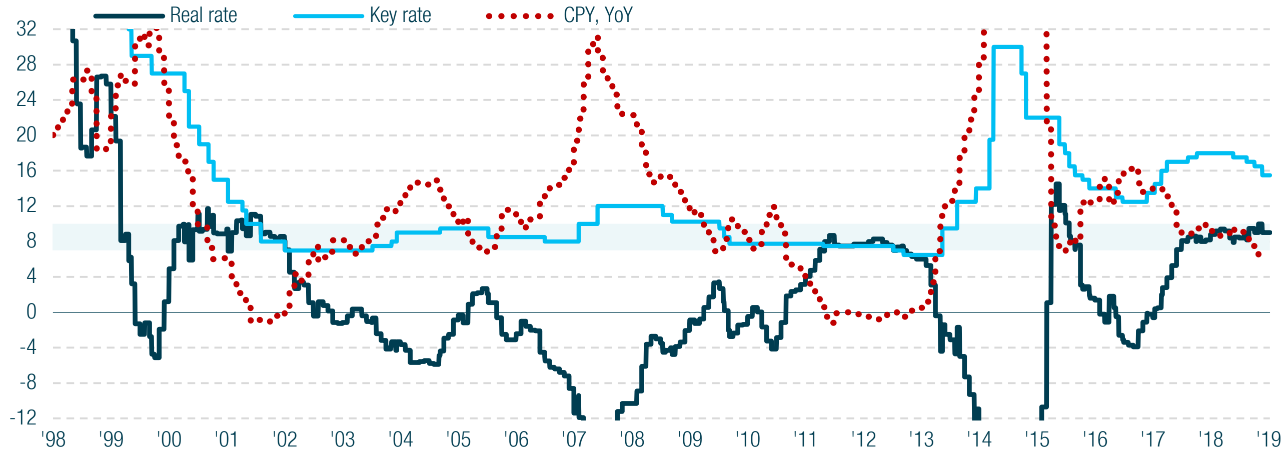


Source: NBU, MFU, ICU.

However, over the last 20 years, there were periods when the central bank was less conservative (see Chart 13). Three times over that period, real rates matched those that we see currently, each time during periods of relatively low inflation.

Chart 13 Key policy rate vs CPI

Ukrainian monetary policy was tight several times in the past resulting in inflation decrease



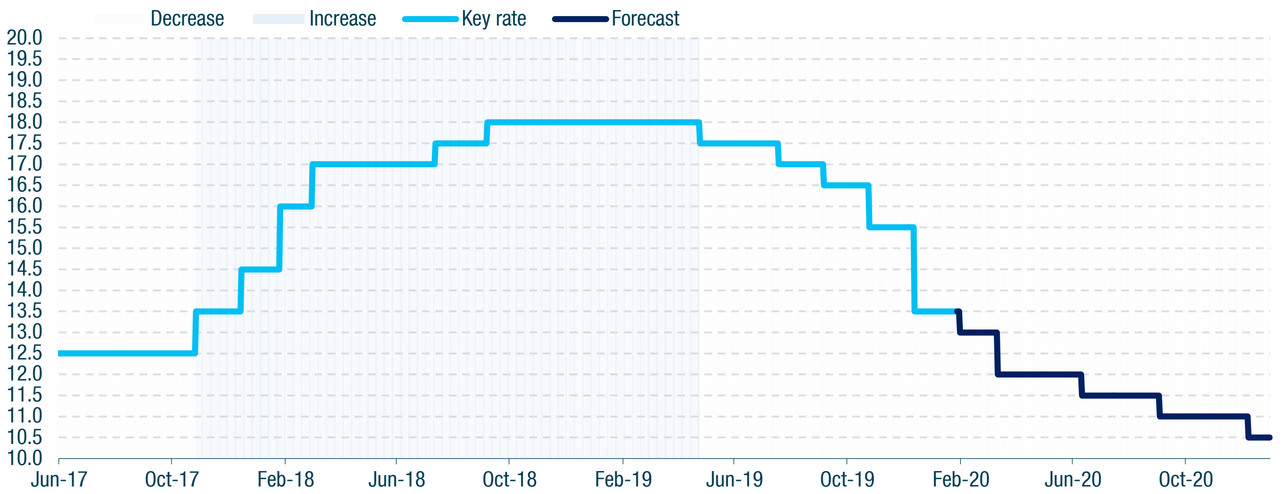
Sources: NBU, ICU

We expect that the NBU will continue the cycle of interest rate cuts and lowering the real rate. It should drop below 7% by the end of 1Q20 and further to 5% by the end of 2020, according to our estimates (see Chart 14). In the longer run, the NBU could aim for a 3-4% real interest rate, which is an uncharted territory.

A successful decrease in interest rates would result in a subsequent drop in government bond yields. Banks with substantial holdings of government bonds—predominantly state-owned banks—will record an increase of equity as a result of revaluations.

Chart 14 Key policy rate forecast

NBU will continue the cycle of interest rate decreases throughout the 2020, lowering the rate to 10.5% by year end



Sources: ICU

Banks: Record high profits

- **Corporate lending remains stagnant as banks continue to restructure portfolios amidst low demand for loans from creditworthy borrowers**
- **Consumer-lending boom ensured record-high profits for banks based on positive macro and improved consumer confidence**
- **Rates on retail deposits are slow to reflect the overall fall of interest rates, which are expected to decline in 2020**

Corporate lending should finally start recovering after 2019 stagnation

7.3% YoY contraction of the corporate loan portfolio was caused by the ongoing restructuring that cannot be offset by new lending.

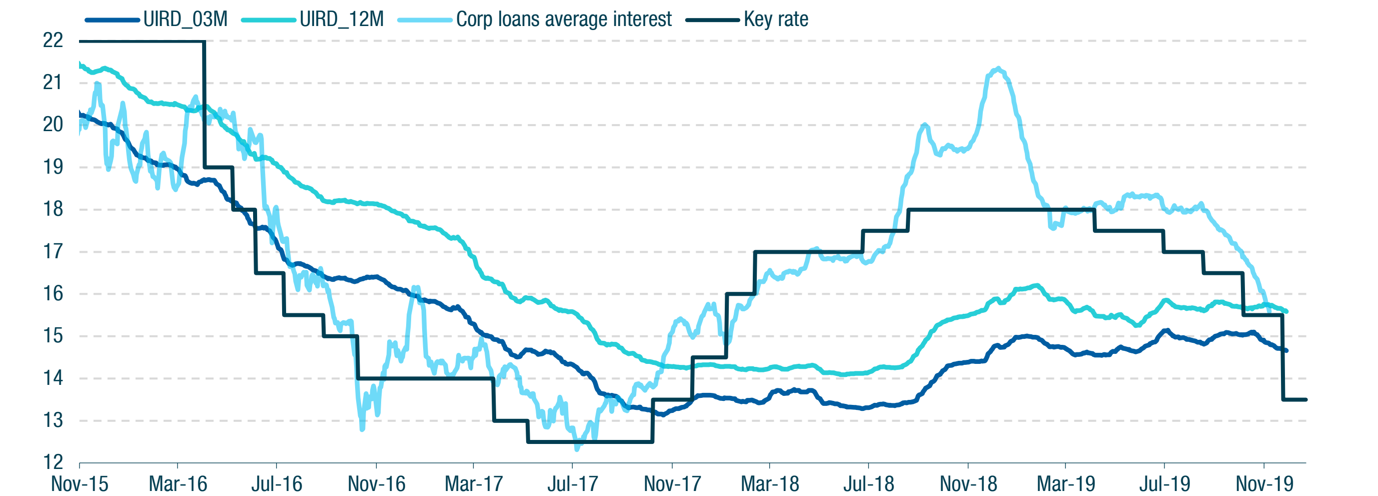
Corporate lending contracted 7.3% YoY in October as both UAH and FX loan portfolios decreased in volume. Russian state banks are the key driver of the decline. During the last 12 months one of them—VTB—became insolvent, while another—Prominvestbank—has significantly shrunk its balance sheet. Both have resulted in the decline of gross loans. The remaining banks with foreign capital, including Ukrsibbank (BNP), Aval (Raiffeisen), and Citi have also decreased their loan portfolios. On the other hand, banks with Ukrainian capital (both private and state owned) largely saw few changes in their portfolios over the year.

Growth in banks' gross portfolios and lower rates should boost a pickup in corporate loans in 2020

As interest rates fall, corporate loan rates have decreased by 300-500 bps over the year. Liquidity shortage at the end of 2018 was a shock that has caused a sharp increase in corporate lending rates. A decrease of the key rate was followed by the decline in the price of business loans, albeit with some lag. Most FX loans portfolio are in decline as banks do not have enough risk appetite for them. One of the exceptions for loan growth is in renewable energy projects. FX loans to electricity-generation entities has increased 21% YoY. We expect corporate loans to pick up in 2020, which should result in the total gross portfolio to increase by 10% YoY by year end as lower rates will make more projects financially viable.

Chart 15 UAH interest rate dynamic (%)

Deposit rates are to follow the key rate with a lag



Sources: NBU, ICU

Retail lending keeps booming, but still far from saturation

Demand for consumer lending should expand in 2020 boosted by elevated consumer confidence

Retail lending continues to boom as gross consumer loans in UAH grew 27.1% YoY in October. The Ukrainian retail lending market is still far from saturation as the demand for consumer lending will expand into 2020 on positive dynamics of the Consumer Confidence Index that is at its highest levels in a decade. The gross retail portfolio should grow by at least 15% YoY by the end of the year.

Despite having better level of consumer-debt-to-disposable-income ratios than peers in neighbouring countries, retail lending is to become a concern for rating agencies and other entities. In 2019, the regulator performed a stress test of the banking sector with a special focus on consumer loans, testing banks capital in the case of macro shocks. While the NBU will disclose detailed figures later this year, banks with a high share of consumer loans in their portfolios tend to underestimate the credit risk associated with it.

Recovery in deposits to remain slow

Deposits are slowly recovering, but their growth is slowed by the increased propensity to consume …

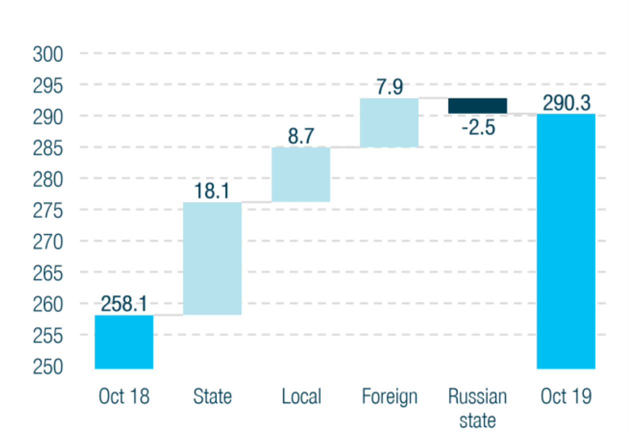
Retail accounts grew 12.2% YoY in October 2019, net of FX revaluation. Local-currency accounts are increasing at much faster pace—14.3% YoY compared with FX (9.9% YoY). However, households currently have a much lower propensity to save as consumer mood is the highest in the past 10 years. As a result, the household-deposits-to-GDP ratio declined from 14.5% in October 2018 to 13.4% in October 2019—less than half of its 2013 relative size. A continuous rise in disposable income is the key driver behind the increase in hryvnia accounts. Demand deposits that include debit cards constitute 50% of the total UAH retail deposits with the banks. Demand UAH deposits will continue to grow in 2020, yet by a slower pace alongside salaries. On the other side, term deposits will accelerate growth during 1H20 as customers will be willing to fix at the current rates anticipating their drop.

… yet increase in UAH deposits is caused by the willingness to fix falling rates and FX deposits by the bet that the exchange rate will bounce back

FX deposits that were stagnant for the past four years picked up. Hryvnia appreciation is the key reason for the growth, which amounted to 6.8% YoY. Households see that as an opportunity to go long the USD at a favourable exchange rate. It is the small deposits—up to UAH100,000 (US$4,000)—that grew the most while the total amount of larger deposits UAH0.5m (US$20,000) and higher remained unchanged, according to the DGF data. It is the large deposits that constitute 55% of the total FX retail deposits.

Chart 16. Changes in hryvnia retail deposits (UAH bn)

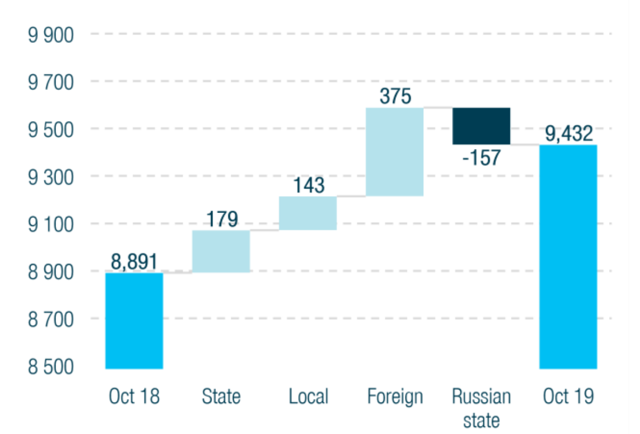
Most of the banks have increased the amount of UAH households' accounts during the last 12 months preceding September 2019



Source: NBU, ICU calculations.

Chart 17. Changes in FX retail deposits (US$ m)

Privatbank and Russian state banks decreased FX households' accounts during the last 12 months preceding September 2019



Source: NBU, ICU calculations

State banks, including Privatbank, dominate the segment of current accounts. Most of the increase in UAH demand retail deposits is attributable to Privatbank and Oschadbank that both have a vast network of branches. However, they are lagging behind the private banks with local capital in terms of term deposits due to the higher interest rates offered. Mid-size Universalbank is number one in absolute terms in net increase of UAH term deposits during the last 12 months, which grew UAH2.3bn or 182% YoY. Contrary to widespread belief, Ukrainian banks do not divert local currency deposits to government bonds. In fact, investments in UAH government bonds have decreed over the year by UAH0.6bn or 0.2% YoY in September 2019.

Banks with foreign capital are more successful in attracting FX deposits—both term and current. This group has increased FX deposits by US$332m 17% YoY in September 2019—far more than any other group—and simultaneously grew the amount of FX government bonds on its balance sheet by US$263m or 114% YoY.

C/A Deficit Narrows

- **Global commodity prices, a record grain harvest, and rising private remittances helped to contract the 2019 C/A deficit to 2.7% of GDP**
- **In 2020, more challenging external markets, and declining gas transit revenues will widen C/A deficit to 3% of GDP**
- **The hryvnia may strengthen to UAH22-23/USD thanks to more foreign inflows into Ukraine's UAH debt in 2Q20, but then return to UAH25.50/USD at YE20 as C/A deficit widens**

External markets are favourable for Ukraine in 2019

Record harvest, and falling prices for oil and gas more than offset falling steel prices and rising imports of consumer goods and machinery

The high degree of exports commoditization and oil-and-gas insufficiency make Ukraine vulnerable to external trade shocks. In 2019, however, favourable weather and a rising reliance on the agri sector helped Ukraine not only to stay unhurt by deteriorating global trade, but also to shorten its trade deficit and C/A deficit.

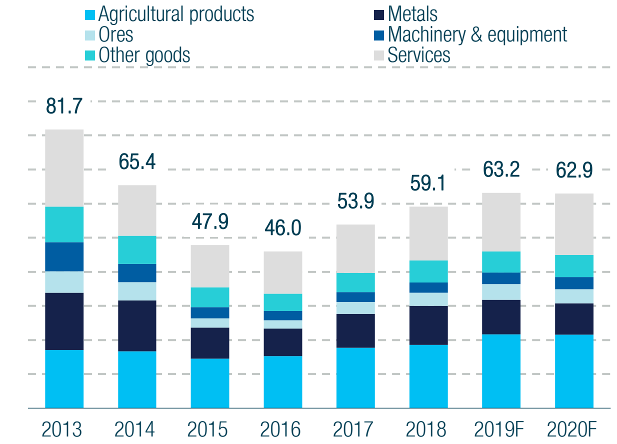
The record corn harvest of 2018 and record harvest of early wheat crops of 2019 were the key drivers of 7% YoY growth in 2019 exports. Another strong driver was 34% YoY growth in 2019 average iron ore prices, which partly compensated the negative impact of the 18% YoY drop in steel prices for the metals-and-mining sector. Imports in 2019 should grow at the same rate, driven by a 13% surge in purchases of machinery, equipment, and consumer imports. At the same time, energy imports declined 4% YTD as natural gas prices dropped 38% YoY and oil prices fell 10% YoY. Overall, the 2019 trade deficit will expand to US$12.2bn vs US$11.4bn in 2018. However, the trade deficit's share of GDP will shrink to 7.8% in 2019 from 8.7% in 2018.

Slowing expansion of the trade deficit and rising private remittances help to narrow C/A deficit

For the current account, the favourable external trade conditions are additionally helped by further growth of remittances (+7% YoY to US$11.9bn). As a result, C/A will narrow to US$4.2bn (2.7% of GDP) in 2019 from US$4.4bn (3.3% of GDP) in 2018.

Chart 18. Exports from Ukraine (US$bn)

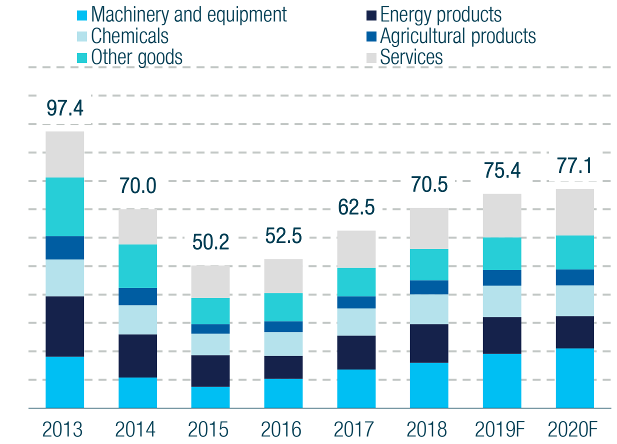
Agriculture, food products, and services are key growth drivers



Source: National Bank of Ukraine, ICU.

Chart 19. Imports into Ukraine (US$bn)

Imports are driven by consumer and investment demand



Source: National Bank of Ukraine, ICU

C/A deficit to stay low despite more challenging foreign trade in 2020

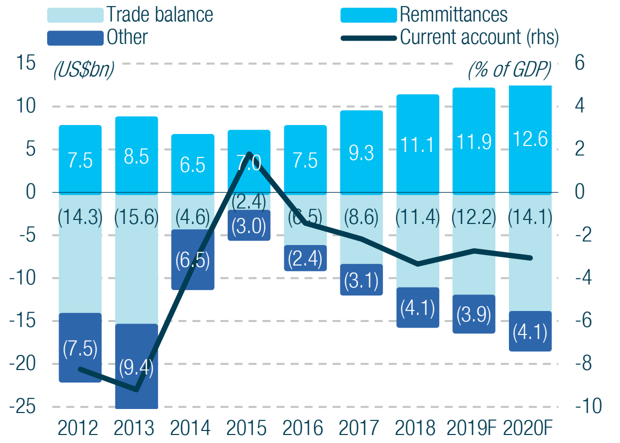
C/A deficit will expand to 3% of GDP in 2020, vs. 2.7% of GDP in 2019

Nevertheless, in 2020, the consequences of the US-China trade conflict and the cooling global economy will further worsen market conditions for Ukrainian exporters, first of all for the metals-and-mining sector. We expect Ukraine's exports will be hit by a further decline in steel prices (-8%), which will be joined by iron ore prices (-15% YoY) suffering from recovery in supply. Lower volumes of Russia's natural gas transit are another negative factor for exports—we forecast a 50% YoY decline in transit volumes in 2020. This implies US$1.4bn of lost export revenues. The prospects for the 2020 harvest add more uncertainty after two consecutive record-high years. On the imports side, the positive impact of lower gas import volumes and lower world prices for oil, gas and coal will be largely offset by further growth in consumer imports due to rising real incomes and a stronger UAH.

All that said, we do not expect substantial expansion of the C/A deficit, as it will be supported by further growth of remittances from labour migrants and strong export of IT services. We expect the C/A balance to modestly widen to 3% of GDP in 2020.

Chart 20. Ukraine's current account (US$bn, % of GDP)

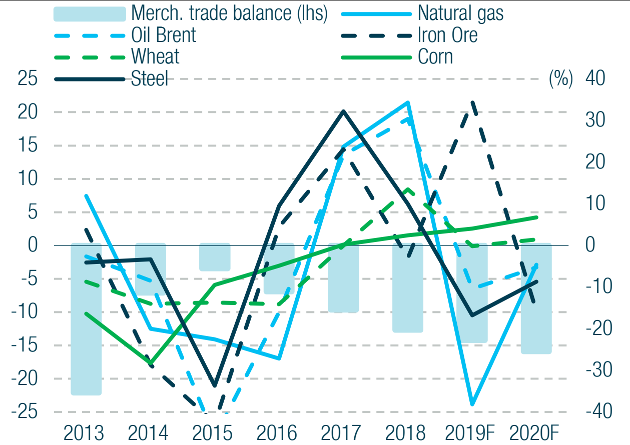
C/A deficit will contract to 2.7% of GDP in 2019



Source: National Bank of Ukraine, ICU.

Chart 21. Change in growth of commodity prices (%)

Decrease in steel and iron ore prices will hit Ukraine's exports



Source: National Bank of Ukraine, Bloomberg, ICU

Hryvnia to stay strong

Powerful support for the hryvnia was provided by the $4bn of foreign investment that flowed into government local paper in 2019, and together with record-high proceeds from agri exports, weakened the negative seasonal effect in 4Q19. As a result, the hryvnia has become the world's top performer versus USD and is about to finish 2019 at levels close to UAH23.5/USD.

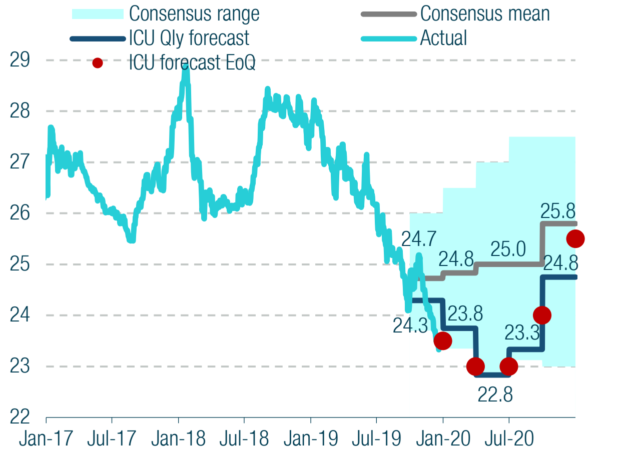
Chart 22. UAH/USD rate in 2016–19

Strong foreign demand for UAH-denominated government bonds helped the hryvnia to defy its usual seasonal pattern in 2019

Source: National Bank of Ukraine, ICU.

Chart 23. UAH/USD forecast

By end-1H20, the hryvnia may appreciate as far as to UAH23/USD before weakening back to UAH25/USD as of end-2020



Source: National Bank of Ukraine, Bloomberg, ICU

The hryvnia may further strengthen to UAH22-23/USD in 2Q20

With expected by us US$2-2.5bn net foreign inflows in government UAH debt, there is strong potential for further hryvnia appreciation to UAH22-23/USD in 2Q20. Demand of Ukrainian agri exporters for UAH funding of their spring sowing campaign will further support the national currency. As foreign investments in Ukraine's T-bills and notes subside and the trade and C/A deficits expand, the hryvnia should start weakening in 2H20. However, as C/A expansion should be moderate, the exchange rate is most likely to end 2020 close to UAH25–25.5/USD.

Economy: Beats expectations

- **Real GDP growth of 4.1% YoY in 3Q19 beat the consensus forecast**
- **Full-year 2019 growth will be close to 3.6%, slowing to 3.2% in 2020**
- **Consumer demand will remain the main growth driver in 2019-20**

Rising wages, consumer credit, and elevated consumer confidence boost consumption, the key driver of 2019-20 GDP growth

In 2019, economic growth in Ukraine kept beating expectations, as in 3Q19, real GDP grew 0.6% QoQ SA and 4.1% YoY versus the consensus estimate of 3.5% YoY. Rising consumption has been the main driver of the economy, as consumer confidence in 3Q19 was at the highest level last seen in 2008, supported by real wage growth (+9.7% YoY LTM) and surging consumer loans (+38% in 9M19). However, industrial production was falling in July–October and was also joined by declining agricultural production in October-November. As a result, 4Q19 real GDP growth will slow to 3% and make real GDP growth 3.6% for the entire year of 2019.

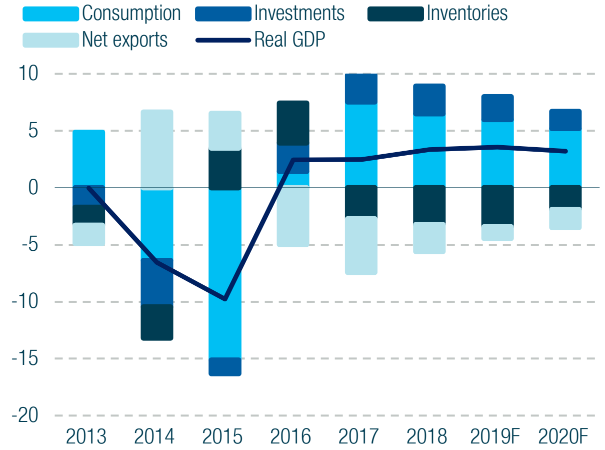
Real GDP growth will slow to 3.2% in 2020

For 2020, we expect household consumption and investment activity will remain key growth drivers supported by 1) further growth of real incomes—the minimum wage is to increase 13% to UAH4,723, while the shortage of qualified specialists and competition for them will continue to drive the overall wages increase, 2) lower interest rates allowing for cheaper financing for businesses and supporting consumer lending, and 3) improvement in consumer and business confidence thanks to slowing inflation and a stronger UAH.

However, economic growth will be constrained by 1) lower transit volumes of Russian gas, 2) cooling global growth, and, particularly, weaker growth of Ukraine's key trading partner, the EU, 3) decreasing prices for key exported commodities (iron ore and steel), potentially leading to contraction in production, and 4) conservative fiscal policy due to the need to make large payments on state debt. Hence, we expect real GDP growth to slow to 3.2% in 2020. At the same time, better-than-expected delivery of planned reforms and rebound in global growth pose upside risks to our forecasts.

Chart 24. The structure of real GDP growth (YoY, %)

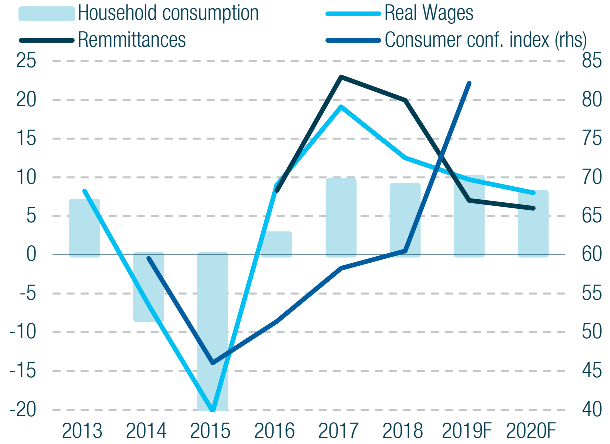
Consumption and investments will remain the key drivers of GDP growth



Source: State Statistics Service of Ukraine, ICU.

Chart 25. Household consumption growth rates (YoY, %)

Consumption is supported by surge in consumer confidence



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

Inflation: Slows into NBU target range

- **Inflation should slow to 4.9% YoY by YE2019 due to a strong UAH, low oil and gas prices, and a good grain harvest**
- **Firm consumer demand and rising nominal wages will maintain inflationary pressure**

In November, inflation fell to the lowest level since early 2014

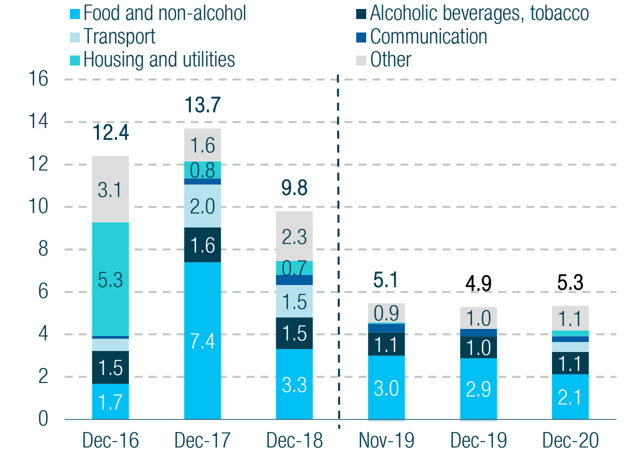
Headline inflation had been decelerating for four consecutive months and fell to 5.1% YoY in November 2019, which is the lowest reading since early 2014. The inflation slowdown was facilitated by a number of factors, including 1) stronger UAH due to tight monetary policy, which lowered prices for imported goods and improved inflation expectations, 2) lower world energy prices—fuel prices fell 12.6% YoY and natural gas prices fell 19.7% YoY in November, and 3) a new record harvest in 2019, which translated into slower growth of prices for cereal products in 4Q19. We believe these factors will continue to positively influence consumer-prices growth in December and will thus result in 4.9% YoY inflation by YE2019.

Inflation will slow to 4.9% by YE2019, and will be close to 5.3% in 2020

For 2020, we expect inflation to be close to 5.3% supported by 1) low world energy prices (flat natural gas price, further decline in oil prices), 2) inflows from foreign investors into domestic government bonds as real rates will remain high, which will support the UAH, 3) conservative fiscal policy because of large debt repayments, and 4) improved inflation expectations among the population. Risks for our forecast are 1) much worse harvest in 2020, which will reduce supply of food products and decrease FX revenues for exporters hurting the UAH, 2) stronger-than-expected consumer demand, and 3) increase in world oil prices.

Chart 26. Headline inflation by components (YoY, %)

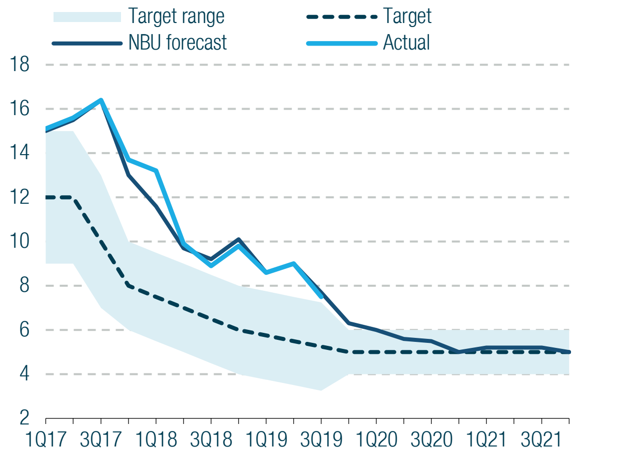
Food inflation contributes the most to consumer-prices growth



Source: State Statistics Service of Ukraine, ICU.

Chart 27. Inflation: forecast and target of the NBU (YoY, %)

NBU expected inflation to slow to 5.0% in 2020, however this has already happened at YE19



Source: NBU, State Statistics Service of Ukraine, ICU

Yearly forecast 2019–20

	Historical data for 2009-18										Forecast by ICU	
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019F**	**2020F**
Activity												
Real GDP (%, YoY)	-14.3	4.2	5.5	0.2	-0.0	-6.6	-9.8	2.4	2.5	3.3	3.6	3.2
Nominal GDP (UAHbn)	913	1,079	1,300	1,405	1,465	1,587	1,989	2,385	2,984	3,559	3,985	4,381
Nominal GDP (US$bn)	113	136	163	174	180	133	90	93	112	131	156	185
Inflation												
Headline inflation (%, YoY, e.o.p)	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	12.4	13.7	9.8	4.9	5.3
Headline inflation (%, YoY, avg.)	15.9	9.4	8.0	0.6	-0.3	12.1	48.7	13.9	14.4	10.9	8.0	5.3
Exchange rates												
UAH/USD (e.o.p.)	7.99	7.96	7.99	7.99	7.99	15.77	24.00	27.19	28.07	27.69	23.50	25.50
UAH/USD (avg.)	7.79	7.94	7.97	7.99	7.99	11.91	21.82	25.55	26.59	27.22	25.81	23.67
External balance												
Trade balance (US$bn)	-2.0	-4.0	-10.1	-14.3	-15.6	-4.6	-2.4	-6.5	-8.6	-11.4	-12.2	-14.1
Trade balance (% of GDP)	-1.7	-2.9	-6.2	-8.3	-8.7	-3.5	-2.6	-6.9	-7.7	-8.7	-7.8	-7.6
Current account balance (US$bn)	-1.7	-3.0	-10.2	-14.3	-16.5	-4.6	1.6	-1.3	-2.4	-4.4	-4.2	-5.6
Current account balance (% of GDP)	-1.5	-2.2	-6.3	-8.3	-9.2	-3.5	1.8	-1.4	-2.2	-3.3	-2.7	-3.0
Interest rates												
NBU's key policy rate (%, e.o.p.)	10.25	7.75	7.75	7.50	6.50	14.00	22.00	14.00	14.50	18.00	**13.50**	**10.50**
Fiscal balance												
Budget balance (% of GDP)	-3.9	-5.9	-1.8	-3.8	-4.4	-5.0	-2.3	-2.9	-1.5	-2.4	**-2.4**	**-2.1**

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

Buy: Forecasted 12-month total return significantly greater than that of relevant benchmark

Hold: Forecasted 12-month total return is in line with or modestly deviates from relevant benchmark

Sell: Forecasted 12-month total return significantly less than that of relevant benchmark

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