Focus
Ukraine

Scope
Economics

Analysts
Alexander Martynenko
Sergiy Nikolaychuk
Taras Kotovych
Mykhaylo Demkiv
Dmytro Dyachenko

Macro Review

Bumpy recovery underway

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Executive Rundown

Ukrainian economy continues to recover after the lockdown. The sharp easing of restrictions in June gave a strong impetus to economic recovery. In July, some indicators of economic activity exceeded pre-pandemic levels, such as retail sales, or came close, as industrial production and real wages did. However, new outbreaks of coronavirus globally and in Ukraine, accompanied by the return of certain restrictions or the delay of previously planned mitigants, made consumers and business more cautious, and this started to restrain the rapid growth. And while we do not expect another severe lockdown, the negative effects of the pandemic will be felt on both potential output and aggregate demand.

Still, we improve our 2020 GDP forecast to a decline of 5.7% from 6.7%. This upgrade was caused primarily by the rapid "turn-on" of the economy in the summer and better terms of trade as iron ore prices surged. As we have assessed before, the Ukrainian economy is weathering the global crisis quite well due to its structural characteristics and macro-financial stabilization accomplished in previous years. However, the results could be better if more monetary and fiscal stimulus is applied, which is constrained by uncertainty over obtaining official financing amid limited market access. While the MoF has done a good job tapping international capital markets and lowering the debt burden for next few years, non-residents continue to reduce their portfolios of UAH government bonds.

We continue to expect another tranche from the IMF, but not before early 2021. Changes in NBU management, attacks on corporate governance reforms and anticorruption bodies, caps on salaries in the public sector, and the start of the budget cycle amid plans to hike the minimum wage seriously complicate the first review of the IMF programme and financing from other official creditors. Nevertheless, sizable financial needs will force Ukrainian authorities to speed up negotiations and reach an agreement early next year.

We leave almost unchanged our forecast for GDP growth in 2021 at 5.6%. The recovery will be fuelled by domestic demand, with net exports returning to the negative area. Minimum wage hikes will provide an additional boost to consumer spending while putting a drag on investment. Nevertheless, we expect a rebound in investment, factoring in the recovery of the global economy, easing credit conditions, and some monetary accommodation.

Inflation surges above target range in 1Q21 and reaches 6.5% YoY in 2021. Our expectations for the prevailing effect of the contraction in aggregate demand on the inflation slowdown have been confirmed. However, growing inflationary pressure is evident for some components of the consumer basket, while aggregated indicators have been subdued by a sharp fall in prices of energy and depressed services inflation. On the forecast horizon, despite our projection of a negative output gap, pent-up demand in some sectors, cost-push effects from minimum wage hikes, UAH depreciation, and recovery in energy prices will keep the CPI growing at a slightly accelerated pace.

NBU response will be muted, raising the rate to only 7% in 1H21. We expect that first, the NBU will take a wait-and-see approach keeping the rate unchanged at 6% to YE2020. Then, reacting to growing inflationary pressure, it will deliver two 50 bps hikes, still leaving the monetary stance slightly accommodative.

Hryvnia depreciates despite better fundamentals. We improve our 2020 C/A outlook and raise the projected surplus to US$6.2bn, or 4.2% of GDP, as COVID-19 depresses demand for imports, constrains travel, and lowers investment income payments more than was earlier expected, while remittances prove resilient. Although fundamentals for the hryvnia remain solid, effects of worsening sentiment have prevailed so far. Factoring in exaggerated devaluation expectations, domestic consumption recovery, expected worsening global conjuncture, unsupportive capital flows, and a surge in fiscal spending, we project the hryvnia to depreciate by the end of the year to the range of UAH29–30/USD. In 2021, recovering capital flows will partly compensate the negative impact of C/A turning to deficit (US$3.7bn or 2.4% of GDP). As a result, the hryvnia should slide into the UAH29.5–30.5/USD range by the end of 2021.

Global Macro: Recovery slows

- **Brisk recovery in the world's leading economies slowed in July–August**
- **Abundant liquidity provided by national authorities will continue boosting asset values in financial markets; however, it is unlikely to accelerate economic recovery**
- **COVID-19 undermines the key drivers of long-term economic growth—employment and business investment—thus jeopardizing economic recovery in 2021**
- **Likely introduction of first vaccines by the end of 2020 will not eliminate the threat of further COVID-19 outbreaks, which will continue to affect global economy**

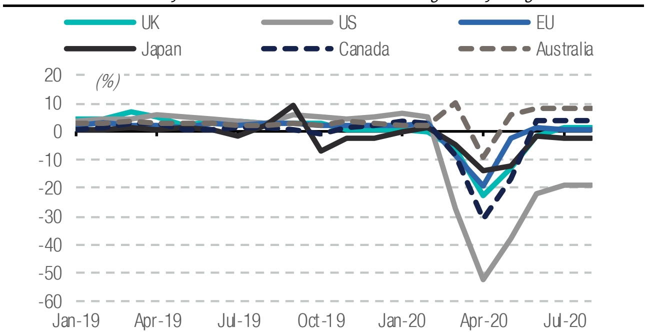
Weak consumption cancels V-shape recovery

After a rigorous pick-up in May–June, global consumption recovery started to slow

The fall-off of consumer spending was the key driver of the sharp 5.7% YoY decline in global GDP in 2Q20. May and June showed a sharper-than-expected rebound in retail sales in the US and Eurozone that exceeded pre-virus levels. However, renewed virus outbreaks caused these improvements in AE (advanced economies) consumption to stall in July–August. August Purchase Manager Indexes confirm that the Eurozone's economic rebound is losing steam. Consumption recovery is even less pronounced in EMs where support for household incomes is weaker and in some regions, such as Latin America, India, and South Africa, has been plagued by continued COVID-19 outbreaks. Even in China, which by far looks to be the most successful in containing the virus, retail sales remained below pre-virus levels in June.

Chart 1. Retail sales in selected AEs (YoY, %)

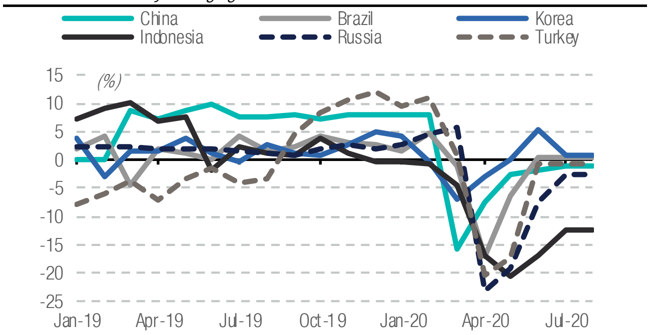
Retail sales recovery in advanced economies is slowing in July–August



Source: Bloomberg, IMF, ICU.

Chart 2. Retail sales in selected EMs (YoY, %)

Retail sales of key emerging economies remain subdued

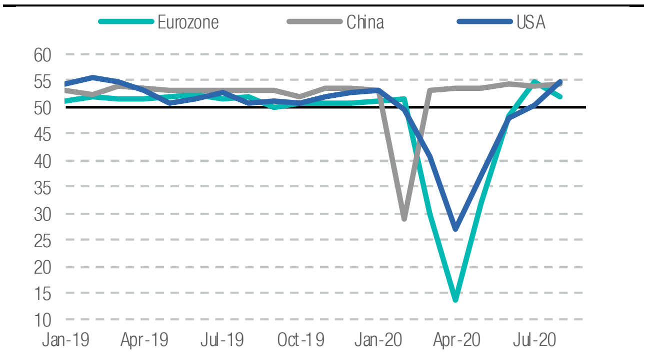


Source: Bloomberg, ICU.

While a return to severe lockdowns is now unlikely, extended mobility constraints and consumer caution may lead to another bout of consumption decline driven most of all by a slump in travelling, catering, and entertainment. Therefore, a V-shaped global economic recovery is becoming less likely, and analysts may continue downgrading global GDP growth forecasts in 2020 below the current -3.9%.

Chart 3. Purchase Manager Indexes in key economies

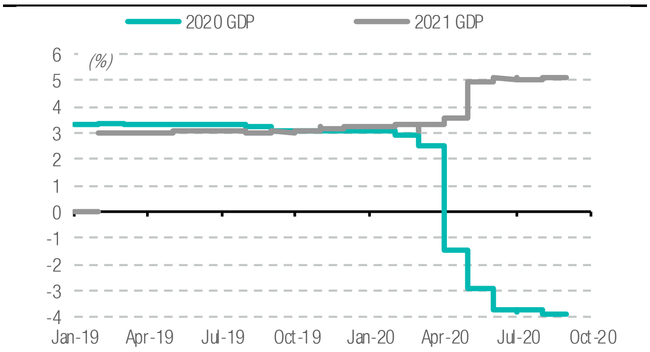
Business activity surveys show Eurozone recovery slows



Source: Bloomberg, ICU.

Chart 4. Global GDP growth forecasts for 2020-21 (YoY, %)

Global GDP forecasts may worsen for both 2020 and 2021



Source: Bloomberg, ICU.

Liquidity supports markets, but does not cure economy

Supportive fiscal and monetary policies will encourage further investment flows into financial-market instruments and commodities

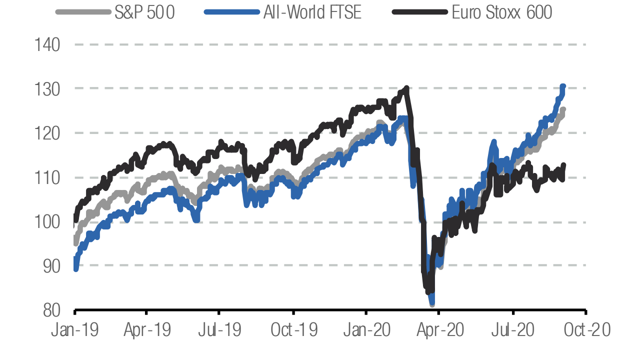
Most national governments and central banks keep pushing liquidity into the market. This has already caused a surge in credit volumes, corporate bond issuances, equity and commodity prices—in particular, industrial metals and gold—as well as corporate M&A activity.

That said, bank-lending growth has already begun to moderate in some cases as reopening economies diminish the need for emergency credit. In AEs, business-lending growth is peaking, while household lending has already slowed. Banks are tightening lending standards due to the uncertain economic outlook and reduced risk tolerance. In this regard, China is one of few exceptions, as its credit growth should be strong until the end of 2020.

Abundant liquidity should keep AE sovereign yields close to zero or even in sub-zero territory over the rest of 2020 and beyond. The market value of worldwide negative-yielding debt has reached US$16tn in June 2020, and may grow further. The ongoing hunt for yield will thus help equity and commodity prices continue rising. This growth, however, will be restrained by still-high COVID-19 risk and slowing economic recovery. Industrial metals are additionally supported by strong China demand, which may abate only by the end of 2020 together with slowing credit stimulus.

Chart 5. Key world equity indexes (11 Mar 20=100)

Global equities should further benefit from rising global liquidity



Source: Bloomberg, ICU.

Chart 6. Market value of global negative-yielding debt ($tn)

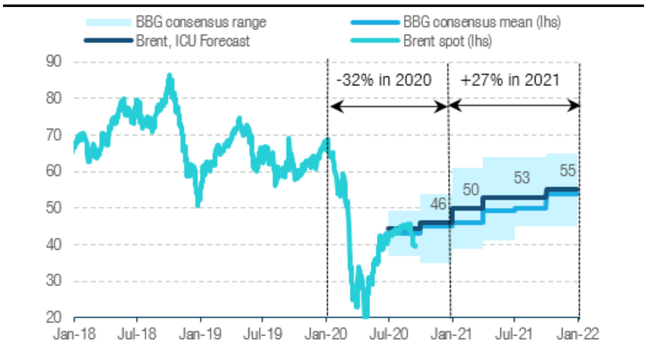
Negative-yielding instrument volumes have grown to $16tn in June 2020

Source: Bloomberg, ICU.

Oil prices should continue to grow to $46–50/bbl by YE2020 and to $55/bbl by YE2021, as recovering mobility will prop up demand and turn the market to deficit starting from 3Q20. Rising oil prices, and a decline in Russia's and LNG supply will support natural gas prices in Europe. However, natural-gas price growth will be capped by a flexible supply response.

Chart 7. Oil prices (US$/bbl)

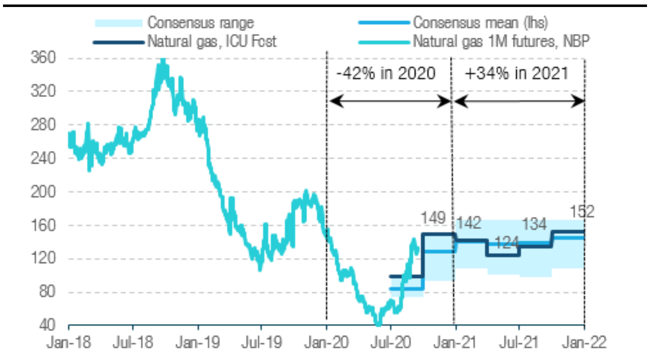
Oil prices will continue to grow in 2H20–2021 as markets turns to deficit



Source: Bloomberg, Refinitiv, ICU.

Chart 8. Natural gas prices in Europe (US$/tcm)

Gas prices will be supported by rising oil prices and drop in gas supplies

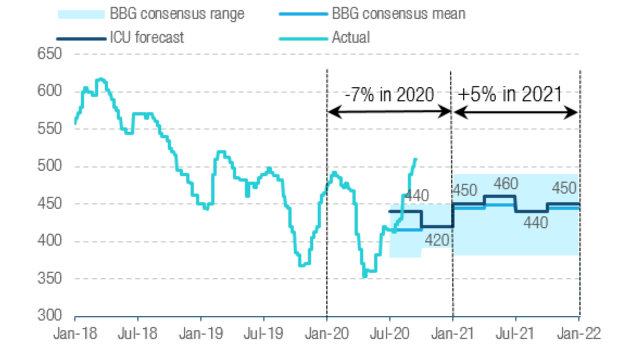


Source: Bloomberg, Refinitiv, ICU.

Iron ore prices are already hovering at seven-year highs. They are very likely to drop 15–20% in 4Q20, as seaborne supplies will grow and while China demand should slow. Lower iron ore prices should further negatively impact steel prices in the still weak European market. In 2021, iron ore prices should continue to fall, while steel prices may see a slight recovery.

Chart 9. Steel HRC price in Black Sea region (US$/t)

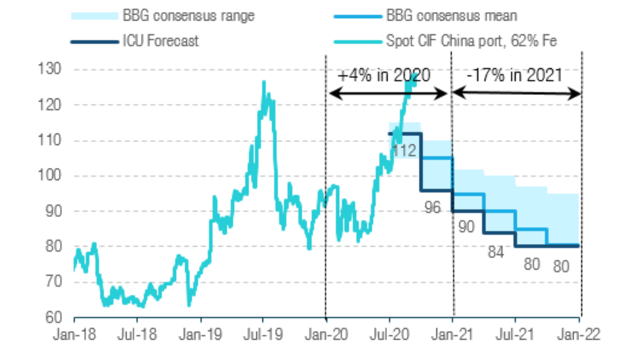
Steel prices in the region will keep underperforming due to weak EU market



Source: Bloomberg, Refinitiv, ICU.

Chart 10. Benchmark iron ore prices (US$/t)

Ore prices may drop due to strong seaborne supplies and slowing China demand

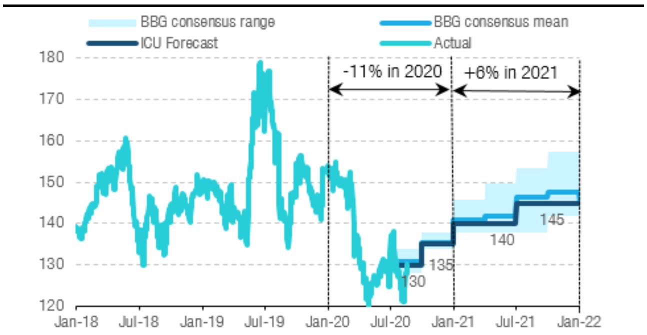


Source: Bloomberg, Refinitiv, ICU.

Grain prices are the least affected by the COVID-19 crisis and should remain mostly stable for the rest of 2020. In 2021, corn prices should moderately grow driven by oil prices, while prices for wheat will slightly decline on ample stocks and strong supply.

Chart 11. Corn prices (US$/t)

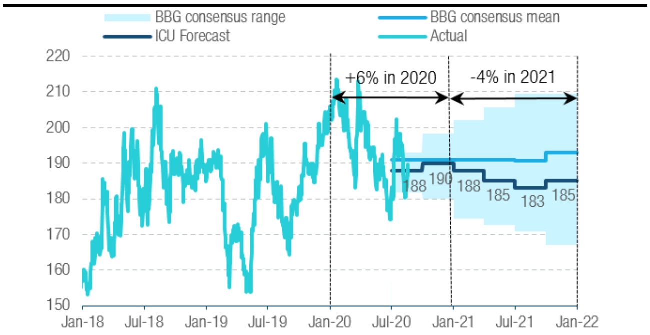
Corn prices should keep growing, supported by higher oil prices



Source: Bloomberg, Refinitiv, ICU.

Chart 12. Wheat prices (US$/t)

Wheat prices should moderately decline due to high stocks and ample supply



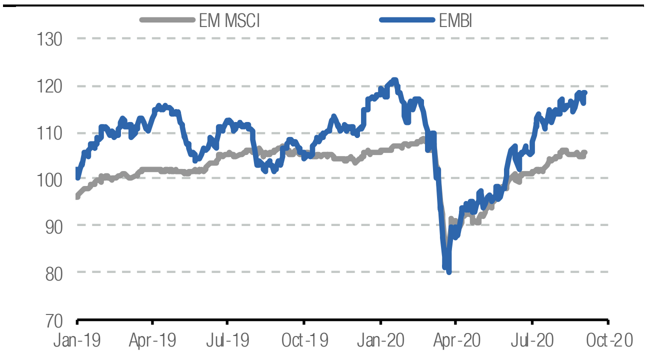
Source: Bloomberg, Refinitiv, ICU.

Foreign capital is slowly returning to EM, although it remains selective due to falling rewards and still high risk

The deficit of high-yielding assets should support investor demand for EM assets. This demand, however, is likely to remain cautious and selective. One of the key reasons is highly accommodative monetary policy of EM central banks, which followed the suit of the AEs in lowering key policy rates. Declining interest rates significantly reduced investors' compensation for higher EM risks and made EM currencies less attractive. The critical factor for EM attractiveness will be current account strength and availability of financing from IFIs.

Chart 13. Key EM equity and fixed income indexes (1 Jan 19=100)

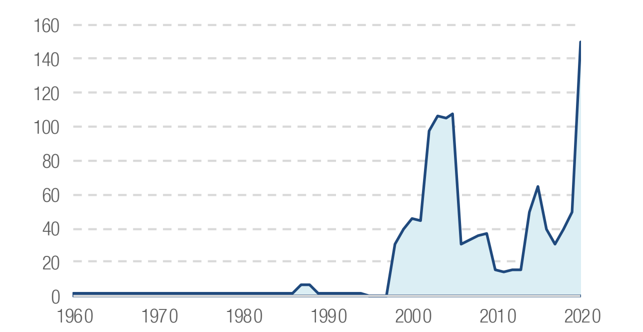
Foreign capital is starting slowly return to EMs



Source: Bloomberg, ICU.

Chart 14. Volume of EM defaulted debt (US$bn)

Volumes of sovereign defaults in EMs have are poised for further growth



Source: Bloomberg, ICU.

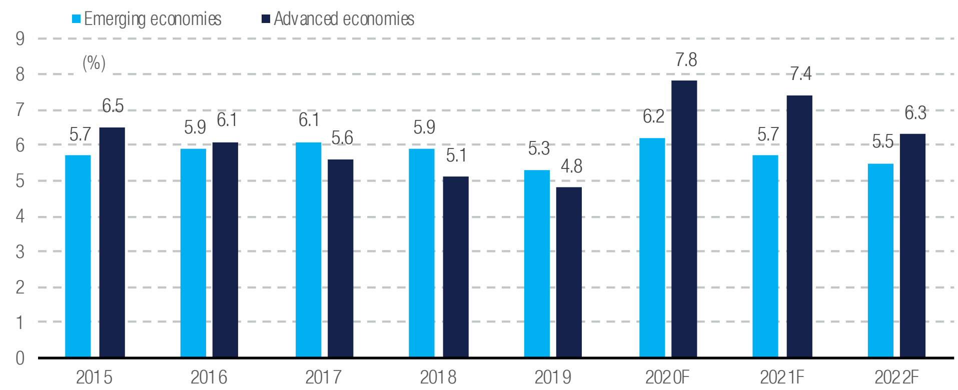
Forecasts of 2021 growth may prove overoptimistic

COVID-19 undermines long-term economic growth through depressed employment and business investment

COVID-19 is substantially undermining such key drivers of long-term economic growth as employment, international trade, and business investment. Jobs lost during the first several months of the pandemic are unlikely to be fully recouped in 2021. There is also a risk of rising unemployment if current job retention schemes in AEs are phased out. Global capex continues to weaken and may turn around only in 2H21, due to high uncertainty and disrupted supply chains. All this makes 2021global GDP growth more likely to miss the current consensus forecast of 5.6%.

Chart 15. Unemployment in AEs and EMs (%)

Unemployment both in AEs and EMs is unlikely to reach the pre-COVID levels in 2020-22



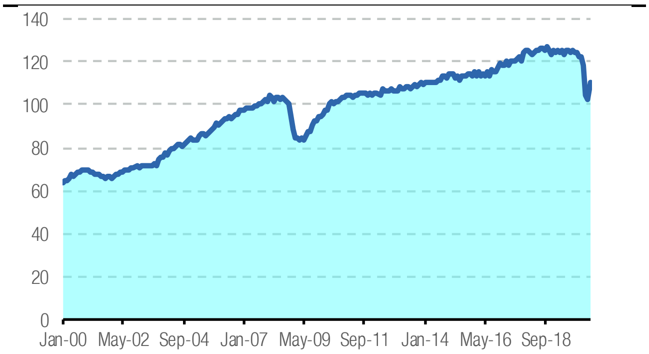
Source: Bloomberg, ICU.

Introduction of first COVID-19 vaccines may improve sentiment, but won't quickly turn the global economy around

The introduction of the first COVID-19 vaccines is becoming increasingly likely by end–2020, as competition for vaccines has accelerated the speed of their development at a record pace. This may improve global business and market sentiment, but it will not dramatically change global economy in 2021. The pace of recovery will depend on vaccines' efficacy, longevity, safety, people's willingness to use it, speed of production, and distribution. Even under an optimistic scenario of mass vaccine production starting at the end of 2020, new COVID-19 waves are still likely in 4Q20 and 1H21. Hence, containment measures are likely to be extended or tightened, particularly in countries where health systems approach their limits.

Chart 16. Global merchandise trade (2010=100)

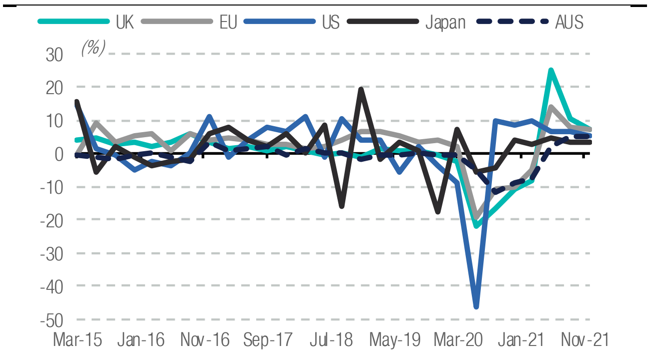
International trade, undermined by trade tensions in 2019, was hit hard by COVID-19 in 2020 and in turn depresses business investment



Source: Bloomberg, ICU

Chart 17. AE investment growth (YoY, %)

AE fixed investments keep weakening and may start their recovery only in 2H21



Source: Bloomberg, ICU

Overall, it is likely that containment measures, including social distancing and restrictions on some foreign travel, will remain for the near future. According to health experts, the COVID-19 pandemic is likely to be a challenge for years to come even with a vaccine, likely to flare up from time to time, and be constantly battled much like the flu and other pathogens.

Economic policy: Search for solutions

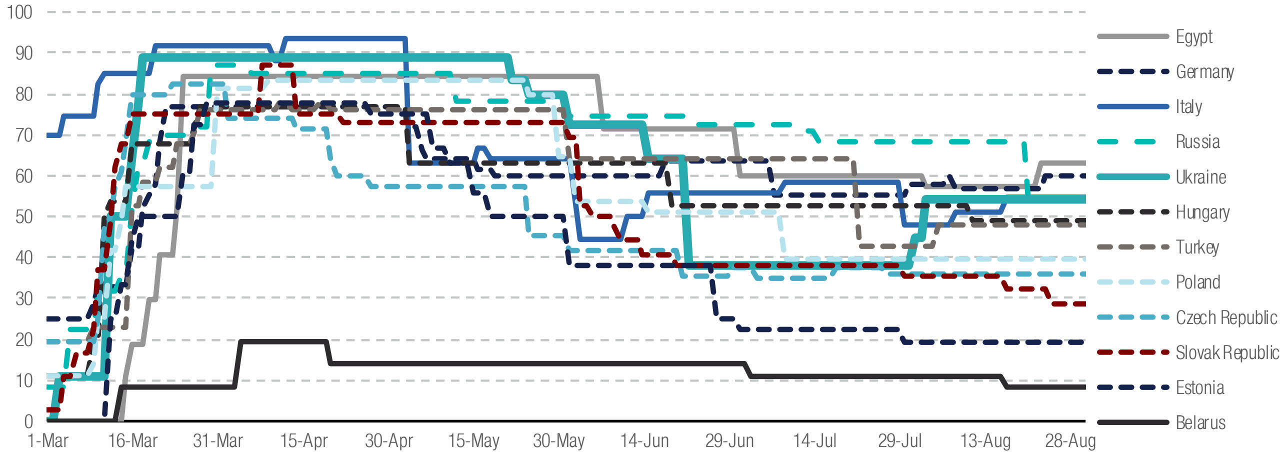
- **Switch to adaptive quarantine lowers economic drag**
- **Economic policy focuses on infrastructure projects and minimum wage hikes**
- **After first tranche, compliance with the IMF programme expectedly fell short**

Containment measures are now much less economically painful than in the spring

After two months of strict lockdown from mid-March to mid-May, the government eased restrictions aggressively. During July, the restrictions in Ukraine were quite mild compared with other countries. But in early August, as the number of infections increased, and, under an adaptive quarantine framework, restrictions started to tighten at the regional level. In particular, strict restrictions on public transportation and the hospitality sector were re-introduced in the regions from the red zone. However, compliance with quarantine confinements sharply deteriorated compared with the spring, as the population's fear of the coronavirus dramatically faded.

Chart 18. COVID-19 government response/stringency indexes in selected countries

While easing of restrictions was short-lived, the intensity of containment measures is much weaker than in spring



Source: University of Oxford, ICU

Economic drag from COVID-19 to be manageable

The number of COVID-19 cases per 100k persons accelerated recently, exceeding the corresponding levels in CEE countries, although Western Europe and CIS countries are far ahead. However, growing evidence coming from reports of new outbreaks is skewed toward younger and less vulnerable groups. Thus, the death toll—58 per 1mn persons at the end of August—is one of the lowest in Europe. In addition, pressure on the healthcare system has so far been quite manageable.

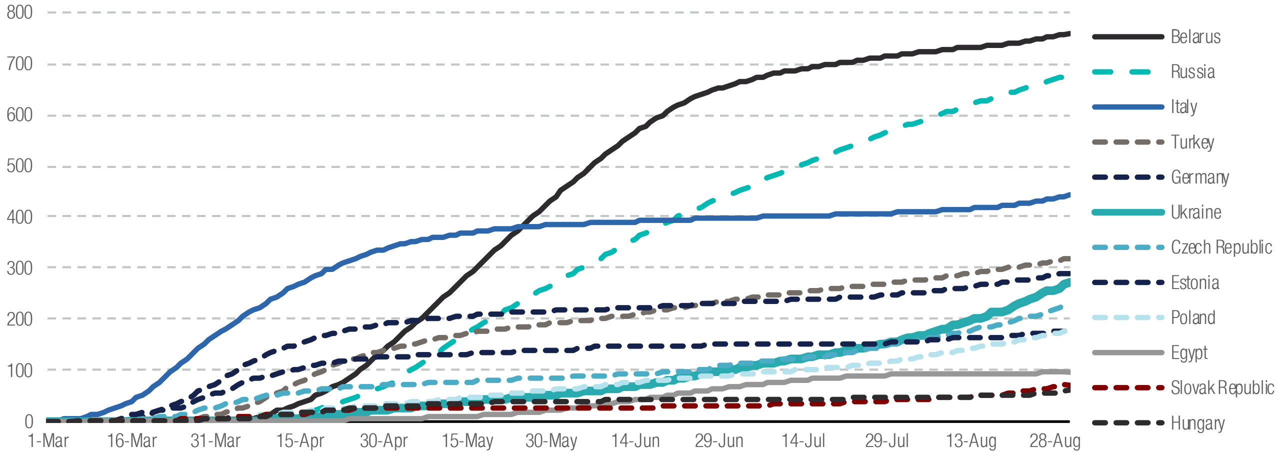
Going forward, cycles of renewed outbreaks and subsequent regional restrictive measures may continue in 4Q20 and 1H21. Also, seasonality and the start of the academic year may fuel the spreading of COVID-19. However, in our baseline scenario, we do not expect that exceptionally tight containment measures will be reintroduced. We do anticipate that the behaviour of the population will again become more cautious and some forms of self-imposed social distancing may return. Meanwhile, households and businesses should be much better adapted to the new waves of distance working and education than they were in the spring.

Authorities' attention has switched from quarantine to other priorities

As the population's attention shifted from the threats they faced from COVID-19 to the financial complications caused by the pandemic and quarantine, this led to corresponding changes in the government's economic policy. The initial response of the authorities to the economic crisis, in particular through increased unemployment benefits, the introduction of a wage furlough scheme, and easing access to lending for small and medium-size enterprises, was rather small in size and provided little support to the real sector.

Chart 19. The number of COVID-19 cases (per 100k persons)

In Ukraine, the number of detected cases is growing, but death toll and pressure on the healthcare system remain relatively low



Source: University of Oxford, ICU

Therefore, the government started to look for other options to stimulate economic recovery out of the crisis. In particular, in July, the government reallocated UAH35bn from the Anti-COVID-19 Fund to road construction. In addition, the government has set up a Ministry of Strategic Industries, signalling a stronger focus on supporting the manufacturing sector.

Almost simultaneously, the President and the government announced ambitious plans to hike the minimum wage from UAH4,723 to UAH5,000 on 1 September, to UAH6,000 on 1 January 2021, and to UAH6,500 on 1 July 2021. This hike, by about 30% on average in 2021, with a corresponding increase in the salaries of public-sector employees, primarily benefits incomes of low-paid workers. However, the tax burden on business is growing, especially for small and medium-size enterprises. Moreover, additional budget expenditures require corresponding adjustments to other items.

Changes in NBU management leave policies in place so far

Another landmark event in the economic sphere was the resignation of NBU governor Yakiv Smolii who named systematic political pressure as the major reason for his leave-taking. Following two weeks of rumours and public statements, the President submitted and Parliament approved Kyrylo Shevchenko as the next NBU governor. In his first steps, Shevchenko, who led state-owned Ukrgasbank since 2015, did his best to reassure foreign officials and markets that the NBU's independence, prudent monetary policy, and national interests in judicial battles against former owners of failed banks will be preserved. Thus, we do not anticipate major changes in NBU policy frameworks. However, more dovish monetary policy and some easing of prudential measures compared with last years' approach look most probable. In addition, the new governor has been vocal on the need to boost lending and continue cooperation with IFIs.

Ukraine cannot afford a long-term pause in official financing

Meanwhile, changes in NBU management complicated the successful implementation of the IMF programme, as safeguarding NBU's independence was one of its cornerstones. Shevchenko's first words and actions helped to ease tensions, but official creditors expectedly switched to "wait-and-see" mode. In addition to NBU independence, recent attacks on corporate governance reforms and anticorruption bodies do not contribute to warm relations with IFIs. Besides, the cap on salaries in the public sector remains in place as it was one of the obligations under the programme. And last but not least, the announced hike in the minimum wage complicates the budget cycle, which may be another obstacle to take into account as the budget process starts up in Parliament. Summing up, we reaffirm our projection of the second tranche not coming until the spring when sizable financial needs will force Ukrainian authorities to speed up negotiations.

We now anticipate that the new DPL with the World Bank will not be activated until next year after a successful first review of the IMF programme. However, we still expect that Ukraine will be able to receive the first tranche of the COVID-19-related MFA loan from EU by the end of this year.

Public finances: Sound, but far from plan

- **Budget revenues and most expenditures are low, with budget deficit below plan**
- **Successful debt management and new commercial borrowings are on line, while official financing is postponed**
- **Local investors replace foreigners in domestic bond market**

Fiscal policy: Low fiscal stimulus so far

Budget revenues are close to plan while spending is weak

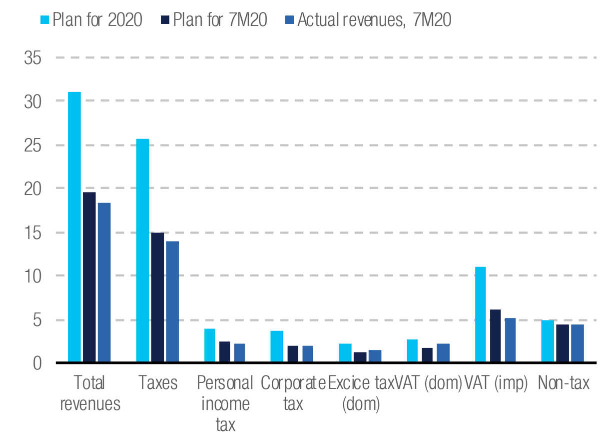
In April, approving changes in the state budget for this year, the government announced plans to increase fiscal stimulus via expanding the budget deficit and with new borrowings. However, as of 7M20, there is little evidence that they have carried out these plans.

Budget revenues came in very close to plan for the period. In total, revenues of the state budget general funds were just 6% below plan for 7M20, or 60% of plan for the year. Given the lockdown and resultant fall in economic activity, this outcome looks quite good.

Tax revenue is still close to plan, except VAT from imported goods, probably due to the stronger-than-anticipated hryvnia exchange rate, lower imports, and falling consumption of imported goods.

Chart 20. State budget revenues (US$bn)

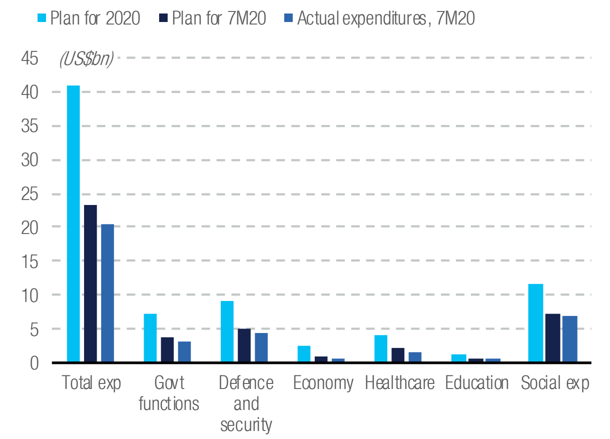
General budget fund



Source: Treasury, MFU, ICU.

Chart 21. State budget expenditures (US$bn)

General budget fund



Source: Treasury, MFU, ICU.

Budget deficit amounted to only UAH57bn in 7M20

However, government has not been in hurry to spend. In 7M20, government expenditures came to only 50% of plan for this year. Expectedly, the largest underperformance was observed in capital expenditures at only 20% of the annual plan. Moreover, government did not increase financing of economic activities during the summer. Currently, expenditures are just 24% of the annual plan and 59% of plan for 7M20.

This resulted in a very low budget deficit in 7M20, which amounted to UAH57bn (US$2bn).

We do not expect a substantial improvement in budget-revenues performance for the remainder of this year. However, with an acceleration of consumption and an increase in imports, additional revenues can come from VAT on imported goods

Budget deficit to reach 6% of GDP both in 2020 and 2021

We expect that government will provide a fiscal boost by accelerating spending before year end. However, the uncertainty over official financing will act as a restraint. Thus, we maintain our forecast for a budget deficit around 6% of GDP, lower than that planned by the state budget.

We do not rule out that government will set the same target of 6% of GDP for the budget deficit next year, as a sharp increase of the minimum wage will sizably push expenditures on wages in the public sector. Since authorities also want to boost capital expenditures, they will have to find corresponding compensators in revenues and reliable financing.

Official financing loses steam, but market operations flower

Budget will not receive official financing in full per initial plans in 2020

Along with the IMF Stand-By Programme, the government expected to receive loans from the WB and EU, but due to the resignation of NBU governor in July, these loans were frozen. In July, an agreement with EU was signed and in August, approved by parliament. However, funds are still not available due to additional steps the Ukrainian side must take to meet lending requirements. We expect that the government will receive the first tranche from the EU COVID-19 programme this year.

Nevertheless, sizable financing needs will force Ukrainian authorities to speed up negotiations and reach an agreement with the IMF early next year. That will allow funds to be freed up from the WB and EU, and facilitate access to market financing.

Ministry of Finance issued Eurobonds and lowered the debt burden for next few years

So far, the MFU has been quite successful in tapping international markets and conducting debt management operations exploiting this window of opportunity. In late July, in a second attempt, the Ministry closed a deal to partially switch Eurobonds due to 2021 and 2022 in new bonds due 2033 and attracted US$1.12bn of new financing. In addition, the Ministry received two loans from Cargill in total at EUR250m, which covered external debt repayments during September. Last but not least, the Ministry announced the successful repurchase of 10% VRIs from the market thus lowering the potential debt service burden in the future.

Looking ahead, we anticipate that government will try to tap international capital markets again this year to borrow up to US$1bn and another US$3bn next year. Taking into account planned official financing and assuming 100% rollover of domestic FX bonds, financing needs will be covered to the end of 2021.

Table 1. FX-denominated debt repayments and sources for financing for 2020 and 2021 (US$bn)

	2020	2021		2020	2021
Government FX accounts balance (beginning of the year)	**0.8**	**0.5**			
Government FX funding	**12.3**	**9.2**	**Government FX debt payments**	**11.3**	**7.8**
IMF	2.1	1.5	IMF	0.5	0.5
Eurobonds	3.3	3.0	Other IFIs	1.3	0.6
WB aid	0.8	1.0	Eurobonds	1.7	1.1
EU aid	1.3	0.7	US-backed Eurobonds	1.0	1.0
Domestic FX bonds	4.5	3.0	Other external debt repayments	0.7	0.1
Cargill F.S.I.	0.3		External interest payments	1.4	1.7
			Domestic FX bonds	4.7	2.8
			Hard currency sold to the NBU	**1.3**	**1.4**
Expected Government FX accounts YE	**0.5**	**0.5**			

Source: MFU, ICU.

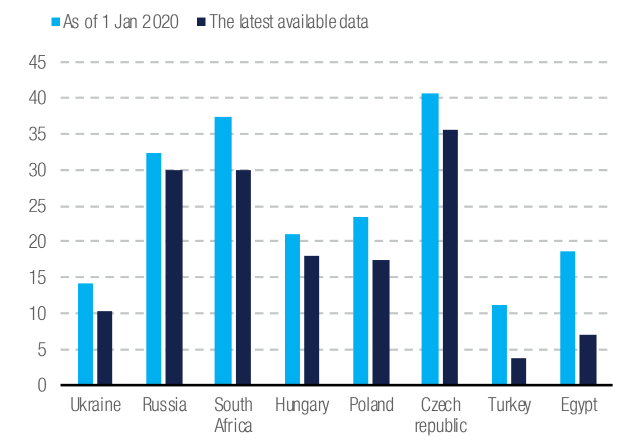
UAH bonds attract locals, but not foreigners

Foreign capital outflow continues from local market and other EMs

This year, demand from foreigners for Ukraine debt was in line with other EM countries, which also saw a decline in foreigners' portfolios. Ukraine fared better than some peers; nonetheless, government's ability to borrow in local currency has been greatly constrained.

Chart 22. Foreigners' share in domestic debt (%)

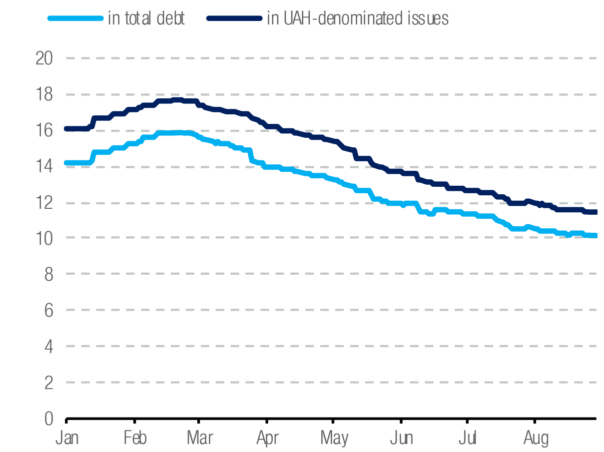
Compared shares at the beginning of the year and after lockdown



Source: NBU, countries data, ICU

Chart 23. Foreigners' share in domestic bonds in 2020 (%)

Share in total domestic bonds outstanding and in UAH-denominated part



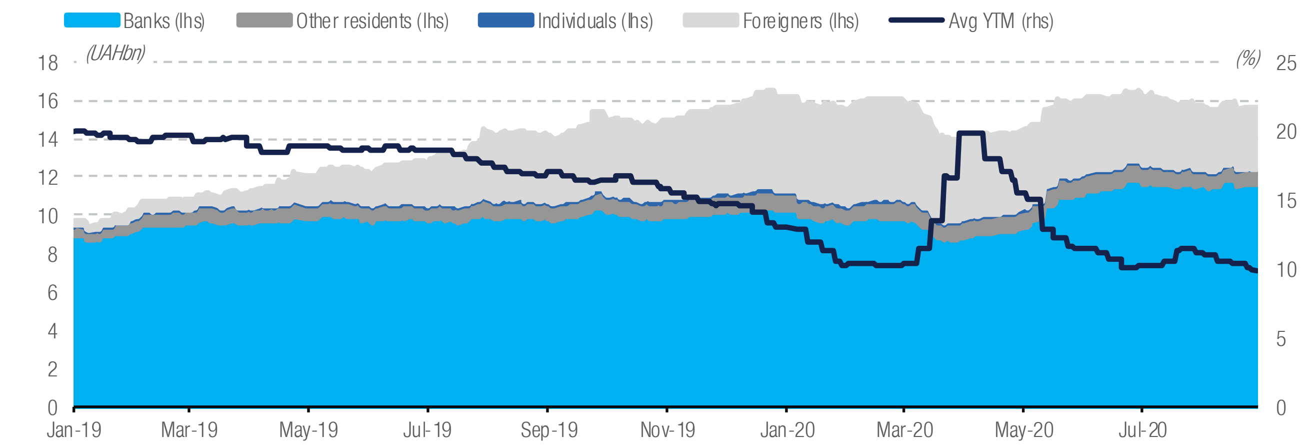
Source: NBU, ICU.

During February–August, foreigners decreased their portfolios by UAH41.4bn—US$1.5bn at the current exchange rate—or by 32%, taking redemptions and selling bonds in the secondary market. We expect they will continue to decrease portfolios to at least UAH80bn (US$2.7bn at the projected exchange rate) by the end of this year.

Meanwhile, low demand for government bonds during the lockdown induced the NBU to change some regulations, e.g. rules for refinancing loans for banks. This resulted in stronger interest to short-term bills from banks, with an expected premium to the key rate of 100-400bp depending on tenor. But this demand from banks was not sufficient to completely cover the MFU's liquidity needs, and they had to increase borrowings via FX-denominated bills.

Chart 24. Bond portfolios (UAHbn) and YTM (%)

UAH-denominated bond portfolios and weighted-average YTM for 12-month bills



Source: NBU, ICU

Banks will expand the purchase of UAH bonds, while foreigners likely to keep portfolios unchanged in 2021

Looking ahead, we expect banks to play a key role in budget financing from domestic sources. Banks have about UAH110bn in NBU CDs, which can be partially moved to short-term bills, and also banks may use an option they have to obtain refinancing loans for purchases of new bills from the Ministry.

Meanwhile, the amount of UAH bonds held by non-residents should stabilize during 2021 as rather high yields and fading devaluation expectations will make the carry trade attractive again. As a result, the share of non-residents in UAH bonds should fall to 9% by the end of 2021, from 16% in February 2020.

UAH bond yields to increase slightly

NBU rate hikes and lower share of non-resident investors will push yields up

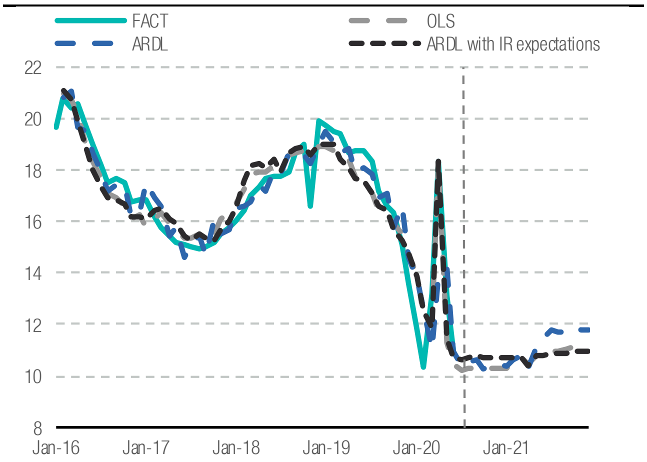
Based on our econometric models and a number of assumptions outlined in this report, we forecast that the yield of one-year bonds will fluctuate in the range of 10–11% this year and will gradually increase over the next year to 10.5–12%. Yields of two-year bonds will be in the range of 11.0–12% this year, and will increase to 12–13.0% next year, although we do not rule out higher rates. These rates do not differ significantly from current levels, indicating that the current spread relative to the NBU key policy rate is close to equilibrium.

For modelling purposes, we used yields of one-year and two-year bonds assessed via NBU's fair prices as dependent variables, and a number of explaining variables, like NBU's key rate, its expectations from FocusEconomics survey, the public debt to GDP ratio, the share of foreigners in holdings of UAH bonds, and the index of key sectors' outputs from the NBU. We combined the results from models like simple OLS with lags for explaining variables, ARDL and ARDL augmented with expectations (see Acram and Das (2017) for details). Data sample runs from January 2016 to June 2020.

Among the main findings of our modelling exercise are the following. Within 12 months, raising the key rate by 1pp leads to an increase in the one-year yield by 0.6–0.7pp and the two-year yield by 0.4–0.6pp. An increase in the share of non-residents among UAH bond owners (excluding the NBU) by 5pp lowers the one-year yield by 0.3–0.8pp and the two-year yield by 0.6–1.0pp. The impact of the public-debt-to-GDP ratio and economic growth are not statistically significant.

Chart 25. Yields on one-year bonds (%)

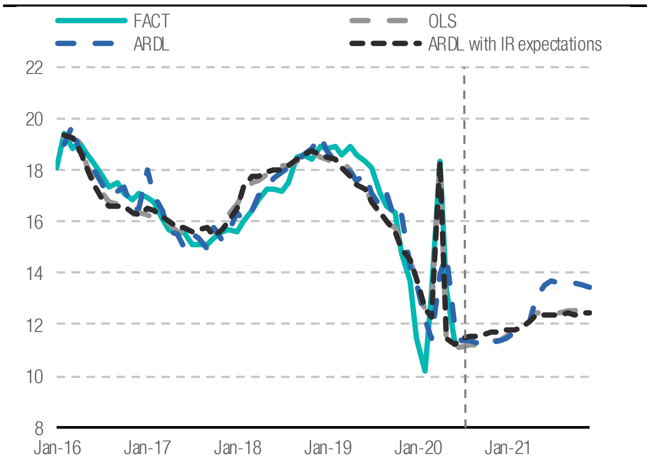
Actual and fitted data from 3 models



Source: NBU, Ukrstat, ICU

Chart 26. Yields on two-year bonds (%)

Actual and fitted data from 3 models



Source: NBU, Ukrstat, ICU.

Monetary conditions: Neither hawkish nor dovish

- **Recent changes in NBU leadership have not transformed the monetary policy stance to dovish, at least not so far**
- **NBU has ahead new challenges of growing inflationary pressure that will likely require rate hikes in 2021**
- **NPLs rose only slightly as banks can restructure loans without recognizing them as non-performing**
- **As popularity of noncash payments grows, banks rely more on commission income and actively cut operational costs**

Wait-and-see to be followed by cautious hikes

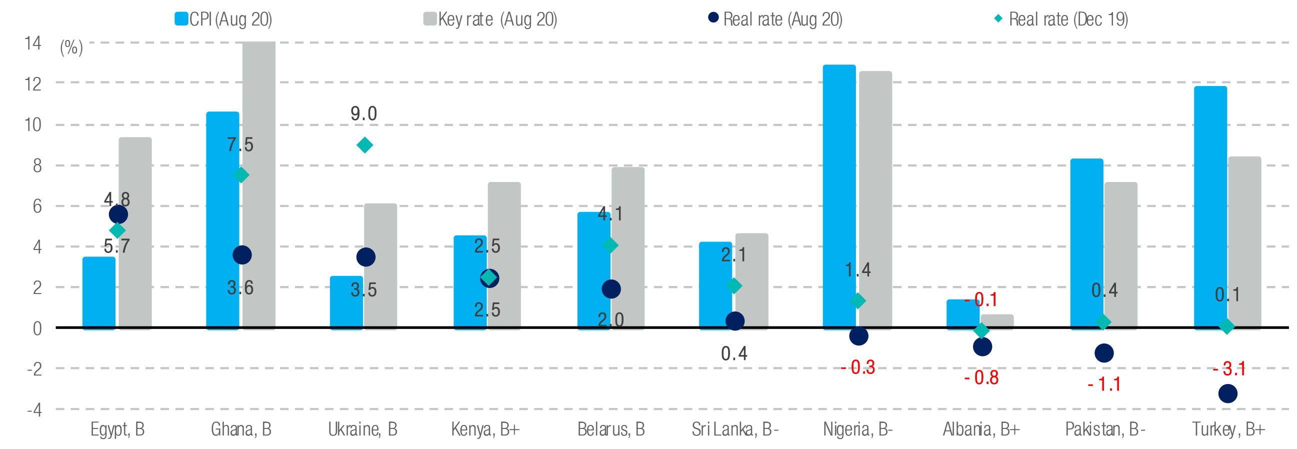
NBU will face the major challenge – the necessity to raise rates in 2021

The NBU did not change its key interest rate at the last two meetings – both of which occurred since Governor Shevchenko assumed his duties. Despite fear of politically motivated easing of monetary policy, the central bank took a conservative approach. On one hand, inflation in Ukraine remained suppressed for a significant period of time, which, in turn, allowed a massive cut over a short period of time. The NBU decreased the rate from 17.0% in June 2019, to 6.0% in June 2020, in response to low inflation. Considering that inflation has been below 3%YoY in February–August 2020, the NBU still could have cut another 50-100 bps in 2020, but decided not to.

However, in the next six to nine months, inflationary pressures will intensify alongside the expectations of UAH weakening and a hike in the minimum wage. NBU will have to address the risk of inflation exceeding its target of 5±1% by ending the current easing cycle and increasing the key rate. Taking this into account, the decision to abstain from the rate cut in July and September indicates that the regulator would like to avoid a higher increase of the rate in the future by not cutting it further now. Among other important factors are the delay in the review of the IMF programme and anticipated massive fiscal spending at the end of the year.

Chart 27. Key rate in Ukraine and peer countries (%)

Real rate (ex-post) is declining, but the NBU remains among the most conservative regulators



Source: NBU, Bloomberg, ICU

Ukraine no longer has one of the highest real rates compared with peer EM countries. Currently, there are nearly two dozen countries where the real interest rate is higher than

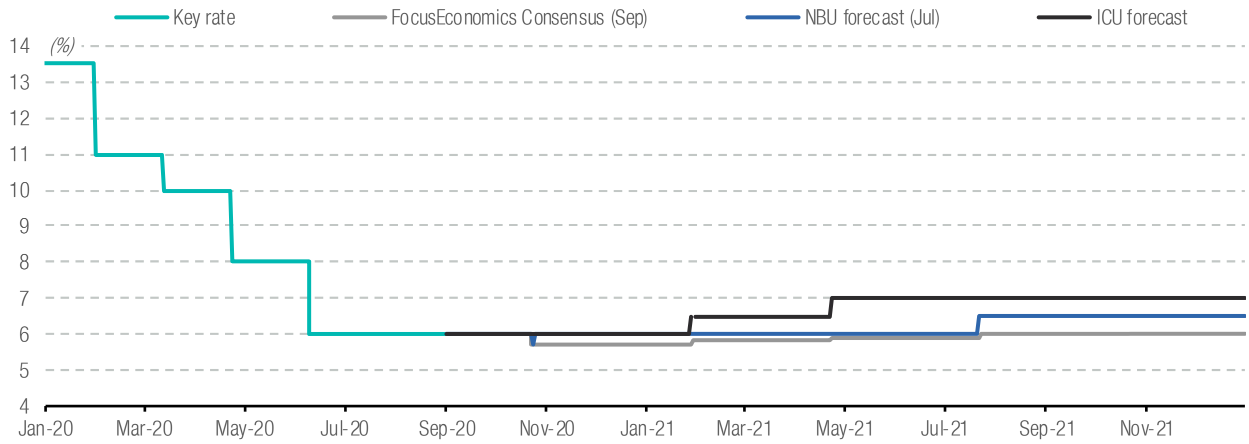
3.5%, which is the current ex-post real rate in Ukraine. While NBU remains among the more conservative institutions as most central banks in peer countries keep lower real rates, the ex-ante approach of using inflation forecasts brings real interest rate estimates close to zero or even negative.

We expect 100 bps rate increase in 2021

We anticipate that the NBU will be less hawkish in 2021, than it has been in previous years. We expect no changes in the key rate this year; we expect two 50 bps hikes, likely in 1H21, bringing the key rate to 7.0%. The central bank will be very reluctant to go higher considering the promises it has made to reduce loan rates. Another reason to keep slightly accommodative monetary policy in 2021 will be the still-negative output gap despite rising demand in some specific segments, including food stuffs.

Chart 28. Key rate forecast (%)

We expect the NBU to start increasing key rate as early as 1Q21



Source: NBU, FOCUSECONOMICS, ICU

Banks recover from lockdown, more challenges ahead

Despite 2019 having been one of the best years so far in terms of high profitability, low provisioning expenses, and good cost efficiency, the Ukrainian banking system is facing asset-quality deterioration as the result of COVID-19 pandemic.

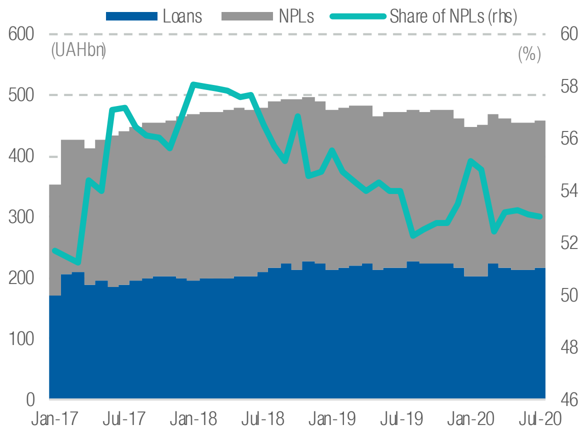
However, lending has been weak and conservative for the past several years at a time when nearly half of gross loans were legacy NPLs. As the regulator allowed non-recognition of restructured loans during the quarantine, the current NPL numbers do not reflect new bad loans. Looking ahead, we expect some of these loans to default and move to NPLs (currently 44% of all loans). However, assuming a sharp recovery in economic activity and household income, the amount of these new NPLs should not be sizable.

Bad debt write-offs by state-owned banks can significantly lower the NPL ratios

The corporate sector has been subject to ongoing deleveraging over the last six years, punctuated by occasional, short periods of growth. Gross corporate loans shrank 5.6% YoY in July 2020; the decline was in both UAH and FX portfolios. The high share of NPLs is one of the most serious impediments for a recovery in lending. Four state-owned banks jointly are responsible for 77% of total NPLs in the corporate sector. One of them, Oschadbank, commenced the write down of NPLs from its balance sheet after the government clarified the procedure. During 1H20, the bank has written off some UAH 22bn, most of which in FX—more than quarter of all its NPLs. Despite the likelihood of additional NPLs as a result of coronacrisis, we expect the NPL ratio to continue declining due to write-offs.

Chart 29. Corporate UAH loan quality (gross)

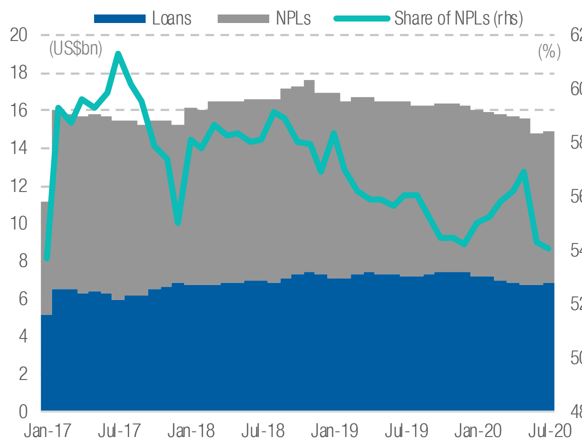
Share of NPLs may drop if government-owned banks massively start writing off bad debts



Source: NBU, ICU

Chart 30. Corporate FX loan quality (gross)

Write offs helped bring down NPLs despite COVID-19



Source: NBU, ICU

Banks are facing worsening debt servicing in retail segment

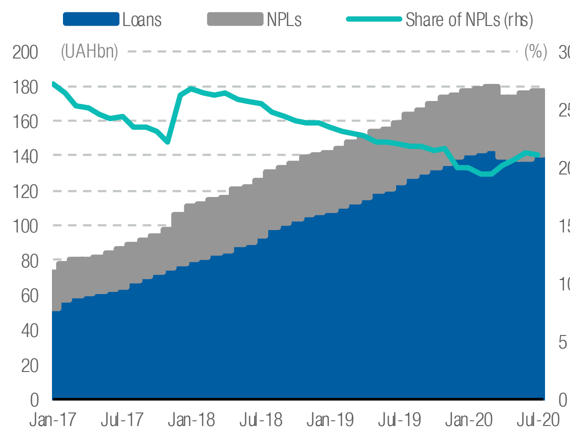
Unlike in the corporate segment, consumer lending has flourished in the past several years. However, the pandemic put an abrupt end to the immense expansion of retail loan portfolios. Banks decreased new-loan origination in March–April, the two months of toughest quarantine restrictions, but the pace picked up thereafter. Yet, banks are cautious now about the creditworthiness of potential customers, and their appetite for risk has abated. Most banks' loan portfolios are around where they were at the beginning of the year.

The gross UAH retail loan portfolio grew just 1.7% YTD in July 2020. At the same time, NPLs increased 6.8% YTD. The NPL ratio increased 117 bps to 21.1%. Banks have reported vastly different results in terms of NPLs. Some of the banks that are very active in retail lending such as Alfa, FUIB, and Universal reported 37–42% YTD growth in UAH retail NPLs while another champion—Privatbank—saw only 5.3% YTD growth in UAH retail NPLs.

We expect the NPL ratio in UAH consumer lending to increase 300 bps when 1) banks recognize part of currently restructured loans as NPLs and 2) new lending does not increase significantly enough to build a higher denominator for the ratio.

Chart 31. Retail UAH loan quality (gross)

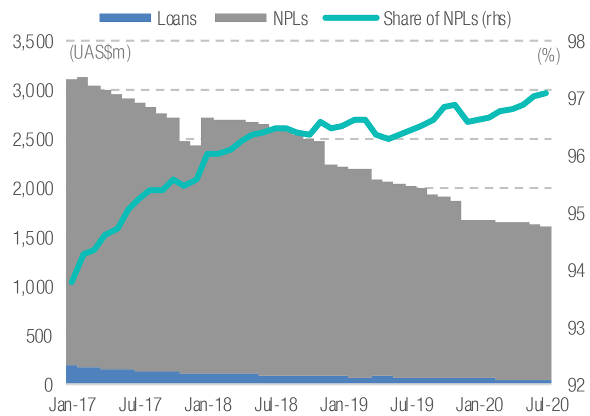
Consumer loans were the first to react to economic slowdown



Source: NBU, ICU

Chart 32. Retail FX loan quality (gross)

Legacy of FX retail loans remains on the bank's balance sheets



Source: NBU, ICU

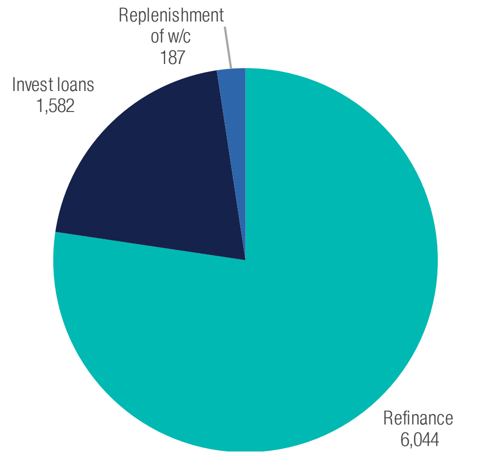
Little success in boosting lending

5-7-9 was intended as a job-creating programme, but turned into a government response to pandemic

The government's 5-7-9 programme was initially designed to reduce the cost of borrowing to SMEs in order to create additional jobs, however, it has quickly turned into an economic stimulus to tackle the pandemic. At the early stage of the programme, banks issued new loans to customers with an average ticket of UAH0.6-0.7m. With only UAH0.5bn of new loans, results of the first stage were very modest. Since June, the 5-7-9 was expended to refinance existing loans. Participating banks have quickly included all of their eligible borrowers into the programme. While initially it was the state-owned banks that were leading, they quickly yielded the way to banks with European capital, which refinanced their SME portfolios. As a result of expanded eligibility, there were 3,238 loans issued or refinanced for a total amount of UAH7.8bn as of 14 September. The average ticket has risen threefold to UAH3.4m.

Chart 33. Distribution of 5-7-9 loans by type (UAHm)

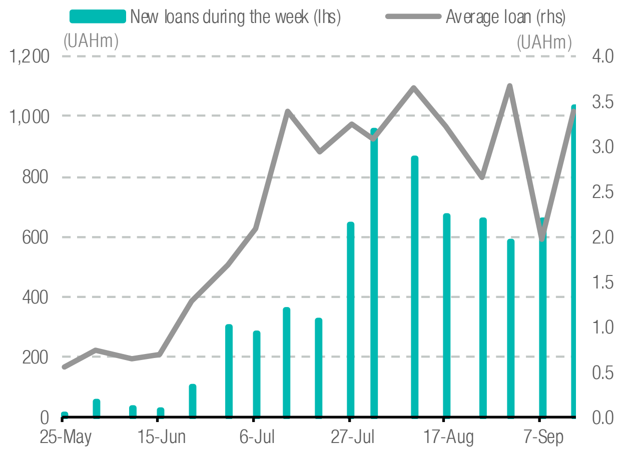
Refinancing existing loans became the most popular type of the government support of SMEs, as of 14 September



Source: MoF, ICU

Chart 34. Average 5-7-9 loan size and issuance (UAHm)

Banks have scaled up the program by starting to refinance existing loans in June



Source: MoF, ICU

The 5-7-9 programme transformed into one of relatively few government support measures for the business during the COVID-19 crisis. It allows SMEs to avoid defaults throughout the period when their revenues are likely to dwindle. Out of UAH7.8bn loans, UAH6.0bn (77%) are refinancing existing loans. While banks with private capital are tending to include their existing borrowers in the programme, four state-owned banks do the opposite; only a third of their loans are refinancings with the rest being newly issued loans.

Portfolio guarantees may provide a new boost for lending to SMEs

Banks are likely to run out of eligible customers after reaching the UAH9–10bn level. We expect that government will not discontinue the programme, but instead will try changing the model to include more new loans. One of the possible solutions might be portfolio guarantees from the government. These should facilitate credit to borrowers that lack proper collateral and, therefore, cannot get loans from banks.

Pandemic drives commission income and cost-cutting

Pandemic accelerates transition to cashless payments

COVID-19 became a major distortion for cashless payments in April when the number of POS terminals declined by 23% MoM. The total number of POS terminals in retail trade locations plummeted from 331k in March to just 255k in April as many businesses were shut down for the quarantine. It took the banking system just two subsequent months to exceed the March figures as the lockdown measures weakened.

However, the amount of cashless transactions is still 4% lower than March levels. Pandemic indeed, cashless transactions have been encouraged as deliveries replaced many person-to-person interactions. At the same time, consumers have started spending less as the average amount of cashless transaction fell.

Cash on hand has increased by 30.8% YoY—significantly higher than in previous five years

As of the beginning of September, the amount of physical cash (UAH) increased 30.8% YoY, at a pace not seen since 2014. During the previous five years, this growth did not exceed 14% YoY, and was as low as 2.8% YoY in November 2019. While a rise in physical cash has been seen across many economies hit by coronavirus, Ukraine did not see an increased amount of cash being withdrawn from ATMs. In fact, it shrank 6% in June compared with March. Nor did bank deposits decrease. UAH retail deposits (both current and term) rose for the fourth consecutive month in July after a 0.7% MoM decline in March.

What drives cash-on-hand is the significantly lower amounts of physical cash returning to the banking system. In 2Q20, banks saw a decline of cash collection from retail stores (-19% QoQ) and a very steep drop (-45% QoQ) in bank cards being replenished by cash. The former is likely to be the result of the pandemic and the switch to informal sectors of economy. The latter might be the consequence of tightened anti-money laundering rules implemented in April that became a barrier for cash funds entering banking system.

Return of cash to the banking system may lead to an increase in UAH liquidity that fell nearly UAH100bn since its peak in February

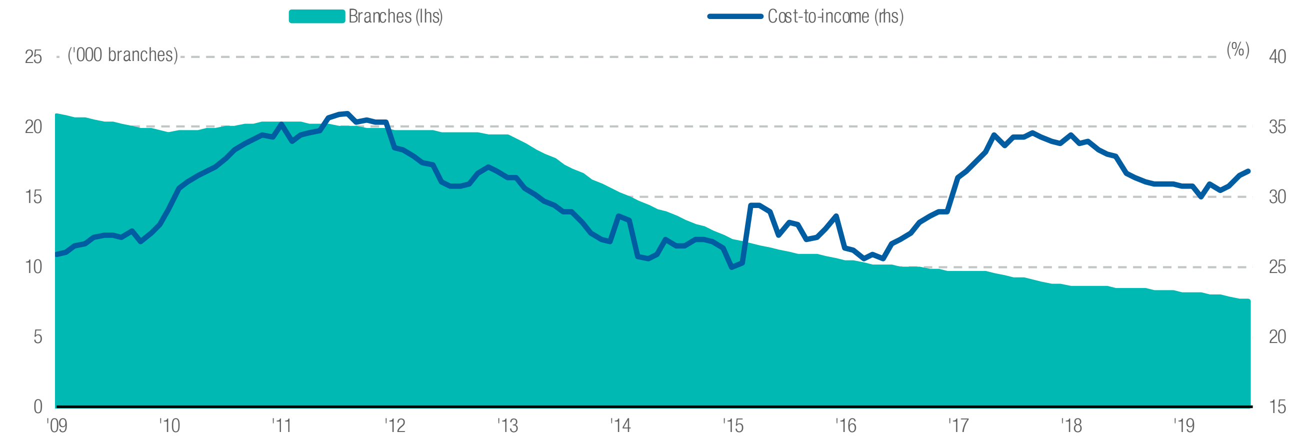
Liquidity of the Ukrainian banking sector fell by some UAH86bn during January–August 2020, as a result of the rise in the amount of physical cash on hands. Compared with the same period last year, liquidity increased by UAH12bn. Banks can expect current trends to reverse should customers change their behaviour back to pre-COVID. This will result in an increase in liquidity, which has declined from the all-time high of UAH253bn in February to UAH150bn as of August 28.

The L12M cost-to-income ratio reached 31.9% in July 2020, 112bps higher than at the beginning of the year despite cost-cutting measures. Banks need to change their business models not only to adapt to COVID challenges, but also to reflect long-term trends in the banking sector.

The total number of bank outlets has declined 8.3% YoY in 2Q20, as banks continue to optimize, cut their networks, and migrate online. The total number of outlets decreased to one third of what it was at the peak in 2008, which is now 7,580 from 22,974. Salary expenses were frozen during April and May bringing YoY growth to nearly zero from 20% in 2019. The subsequent recovery of salary expense growth is in line with the bounce back of the average salary in the Ukrainian economy.

Chart 35. Bank networks and cost-to-income ratio

Closure of bank networks continues, cost-to-income ratio remains stable despite optimization

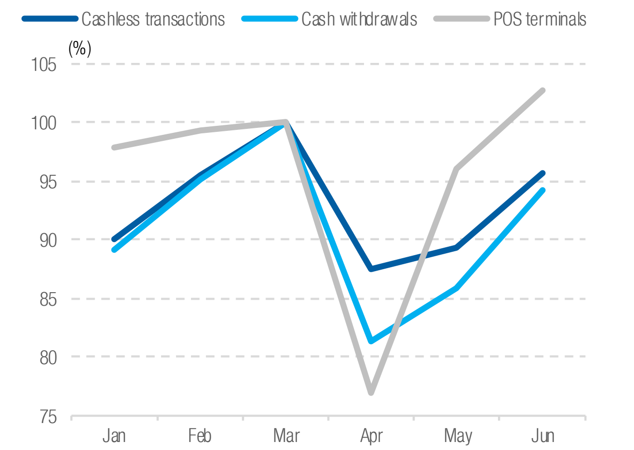


Source: NBU, ICU

Despite the economic slowdown, the share of cashless transactions continues growing at the expense of cash withdrawals and reached 55.5% in 2Q20 up from 49.1% in 2Q19. The increase of the share of commission income in a bank's total income is desirable as it is a less risky and less volatile source of income. L12M commission income amounted to 25.7% of total income of the banking system in July 2020, up 146 bps from July 2019. Banks will seek additional sources of income as interest rates are expected to continue falling, which will result in a decline of NIM.

Chart 36. Payment infrastructure (March = 100%)

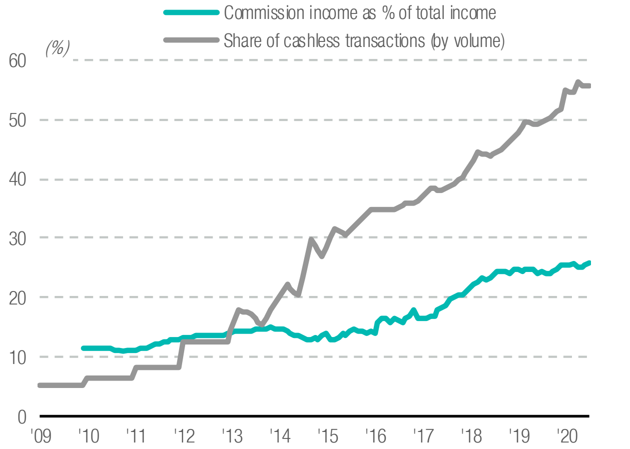
COVID-19 impact on card transactions still felt



Source: NBU, ICU

Chart 37. Commission income and cashless transactions

Fees and commissions become ever larger share of banks' income



Source: NBU, ICU

Economy: Uneven recovery underway

- **Economic potential suffers from long-term pandemic effects**
- **Sharp recovery of demand is uneven and expected to be short-lived**
- **Labour market benefits from demand in specific sectors, but minimum wage hikes will put a drag on employment**

Economic potential suffers due to pandemic

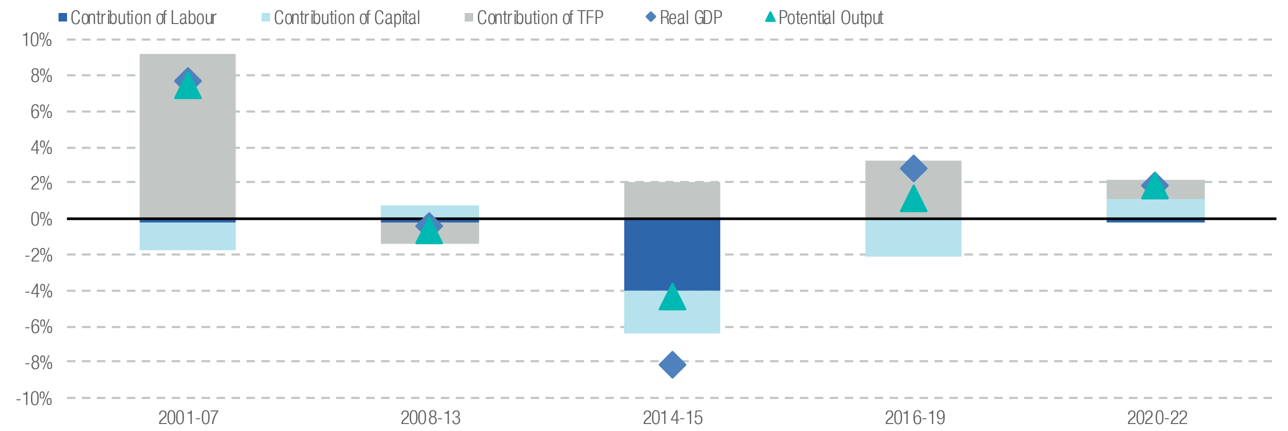
The first effects of the pandemic and lockdown affected the supply-side economy, part of which was "turned off." Removing major restrictions "turned on" the economy again.

COVID-19 lowers potential output growth from 4% to 2% in 2020-22

Meanwhile, the long-term effects of the pandemic on economic potential can be quite significant. Accordingly, we analyse three drivers of potential output growth, namely labour, capital, and the total factor productivity (TFP). Although the results show that the growth rate of potential output in 2020–22 accelerates to almost 2% compared with 1% in 2016–19, the pace is much slower than what one would expect without a pandemic, which would be about 4%.

Chart 38. Average actual and potential output growth (%) and contribution of Labour, Capital, and TFP into potential growth (pp)

Despite the deceleration of investment growth, capital accumulation drives potential output growth while contribution of TFP shrinks sizably in 2020–22



Source: Ukrstat, ICU

Labour's contribution becomes negative again as labour mismatches strengthen

The contribution of labour supply to potential output growth has traditionally been a negative in Ukraine due to the downward demographic trend and labour migration. This negative contribution was usually insignificant, except during the crisis of 2014–15. The occupation of Crimea and parts of Eastern Ukraine cut the labour force and pushed internal migration and labour mismatches. Instead, in 2016–19, pension reform increased incentives for official employment and economic activity for the population in general. Therefore, even against the background of increasing labour migration during this period, the negative contribution of labour to potential output growth shrank to almost zero.

The pandemic is likely to return labour's contribution to small negative values for a number of reasons. First, a prolonged period of unemployment may cause loss of skills and create difficulty in returning to work. Secondly, the crisis significantly complicates the entry of school and university graduates into the labour market, sharply degrading their skills. Third, the pandemic and social distancing may exacerbate labour-market mismatches, in particular through a significant reduction in job mobility, causing a contraction in the labour force.

Moreover, the effect of strengthening the mismatch of labour skills to jobs also weakens TFP growth. At the same time, certain restrictions on labour migration will partially compensate for the negative effects on labour supply.

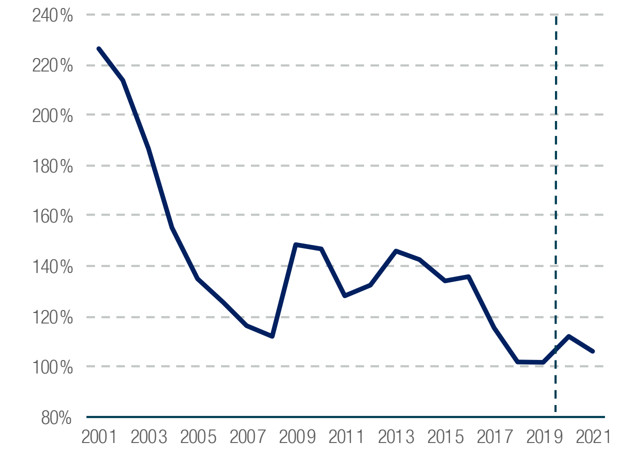
Capital accumulation provides lower boost to potential output as investment contracts sharply in 2020

The contribution of capital to potential output growth is expected to be positive, about 1% annually in 2020–22, in contrast to the significant negative contribution in 2014–19. That may be explained by fast capital depreciation and simultaneous accumulation of fixed capital in previous years. These factors led to an increase in the investment-to-available-fixed-assets ratio to 21% in 2019, while the average level of this indicator in 2009–18 was 11%. Therefore, even with the projected contraction in investment in 2020 by 18%, their volume will be sufficient to cover the depreciation of fixed assets and ensure capital growth.

However, the contribution of capital to long-term growth could have been 1-2 pp higher if there were no pandemic. The pandemic induced a strong drag on investment due to the very high level of uncertainty about the outlook for economic development and demand for products. Continued contraction in global trade is an additional factor that undermines business investment. Partially, the overall negative impact of the pandemic on investment is mitigated by required IT infrastructure upgrade amid rising remote work and education. In addition, food-security issues stimulate further investment in agriculture and the food industry. Potentially, the trend toward localization of value chains at the regional level may stimulate investment in European companies or companies focused on European markets in setting production in Ukraine, but competition in the region for such investment is rather high.

Chart 39. Capital to GDP ratio (%)

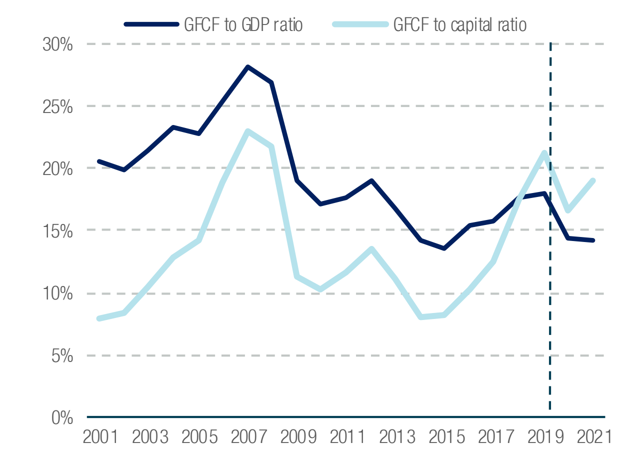
Capital stock to GDP ratio is on downward trend



Source: Ukrstat, ICU.

Chart 40. Investment to GDP and capital ratios (%)

Gross fixed capital formation to capital ratio close to historical peak in 2019



Source: Ukrstat, ICU.

Effectiveness of economy suffers from the adjustment costs

Depressed investment not only undermines long-term growth directly via capital stock, but also negatively affects TFP via reduced innovation. There are plenty of other negative effects of the pandemic on TFP. First, the limited capacity of public transport reduces labour mobility of the population and the optimal distribution of labour resources. The recent ban on foreigners' entry into Ukraine is an example of such restrictions hampering the effectiveness of the economy. Second, switching to distance work may not be efficient or a complete substitute for traditional work in some areas, putting a drag on productivity. Third, the number of pandemic-induced restrictions on businesses, for instance, the limited number of people per square metre in restaurants and cultural events, undermines the productivity of available assets. Meanwhile, in some areas, the boost of investment in IT and the use of modern technologies can partially offset negative effects. In addition, the crisis caused by the pandemic can provoke faster bankruptcy of inefficient companies and a corresponding redistribution of resources in favour of more productive ones. However, in general, the growth of TFP will slow to almost 1% in 2020–22 from 3.2% in 2016–19.

Sharp recovery of consumer demand to be short-lived

Expectedly, GDP bottoms out in 2Q20

According to the flash estimate, GDP declined by 11.4% YoY in 2Q20, slightly more than our June estimate, but not as much as during the 2008–09 GFC and the 2014–15 "perfect storm." Moreover, about 1 p.p. in the quarterly GDP decline was due to a later start of the grain harvest, which should be compensated in the following quarters.

Since May, once restricting measures started easing both in Ukraine and globally, activity in the services and manufacturing sectors has been improving rapidly.

By our estimate, the fall in GDP decelerated to about 6.5% YoY in July. The most sizable part of this decline can be attributed to transport, which still suffers greatly from social-distancing measures and restrictions on international travel. In addition, the negative contribution from the later start of the grain harvest remains sizable. Other sectors look remarkably resilient.

Recovery starting in 3Q20 is mostly consumption-driven and uneven among sectors

Thus, there are clear signs of rebound in consumer demand. In July, retail trade surged by 8.5% YoY and, in seasonally adjusted terms, exceeded the pre-pandemic level of January–February by about 5%. In addition, in July, the production of consumer goods grew by 1.1% YoY for non-durables and fell by only 0.6% YoY for durables. The strong performance of retail trade and the production of consumer goods were to some extent the result of consumers switching to spending locally from abroad due to restrictions on foreign tourism and the realization of deferred demand. However, consumer sentiment remains depressed even as incomes recover. Real wages grew by about 5% YoY in June–July, and private remittances remain robust. Nonetheless, it is unlikely that the growth of consumer spending will continue at the same fast pace going forward.

Private investment is lagging behind and will reach pre-pandemic levels only in 2022

At the same time, the rebound of investment demand still lags due to huge uncertainty related to future development of pandemic and economic recovery. Besides, the scale of fiscal and monetary stimulus in Ukraine remains much lower than in peer countries and in AEs. However, the government's "Great Construction" projects offset partially the sharp decline in private investment as evidenced by rebound in construction, just -0.5% YoY in June–July.

Table 2. Real GDP and its components by expenditures (YoY, %)

	2019	2020(F)	2021(F)
Real GDP	3.2%	(5.7%)	5.6%
Final consumption expenditure	8.1%	(5.0%)	5.9%
Households	11.9%	(4.2%)	6.9%
Government	(4.9%)	(12.3%)	1.0%
Gross capital formation	(19.9%)	(21.0%)	21.9%
Gross fixed capital formation	14.2%	(17.8%)	15.3%
Exports of goods and services	6.7%	(10.1%)	10.7%
Imports of goods and services	6.3%	(13.1%)	13.4%

Source: Ukrstat, ICU.

The recent uptick in commodity prices, especially iron ore, improves the terms-of-trade outlook. This should help Ukraine's recovery in the second half of 2020 and beyond, improving the financial results of companies and providing financial resources for investment.

The pace of recovery should decelerate in coming months due to headwinds from new coronavirus outbreaks both globally and domestically. Moreover, we expect terms of trade to worsen in 4Q20, amid a decline in iron ore prices and the weak stance of the European steel market. Therefore, we project QoQ growth in 4Q20 to be much slower compared with 3Q20.

GDP forecast is revised upwards to 5.7% contraction

Nevertheless, we revise up our forecast of GDP growth in 2020 by almost 1pp to -5.7% as better-than-expected rebound of domestic demand and terms of trade outweighed the weak effects of fiscal stimulus.

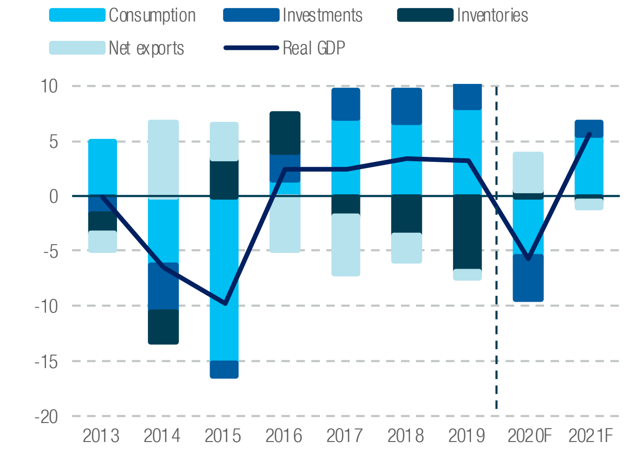
Next year, the recovery will be driven by domestic demand, with net exports returning to the negative area. The hike in the minimum wage will fuel additional consumer spending while putting a drag on investment. Nevertheless, we still expect a recovery in investment taking into account the recovery of the global economy, easing of credit conditions, and monetary accommodation. However, investment will not reach the 2019 level until 2022.

Negative output gap will not close by YE21

Despite this surge in consumer spending, which we consider to be short-lived, aggregate demand is expected to strongly underperform compared with potential output in 2Q20–21. Depressed investment and global trade will play major roles in the formation of a sizable negative output gap. However, it may hide overheating demand in some specific sectors where wages and prices grow much faster compared with aggregated indicators. Among them are pharmaceuticals in 2Q20, healthcare services in 3Q20, cars and appliances in 3Q20, IT services, food stuffs, and fertilizers on the forecast horizon.

Chart 41. The structure of real GDP growth (YoY, %)

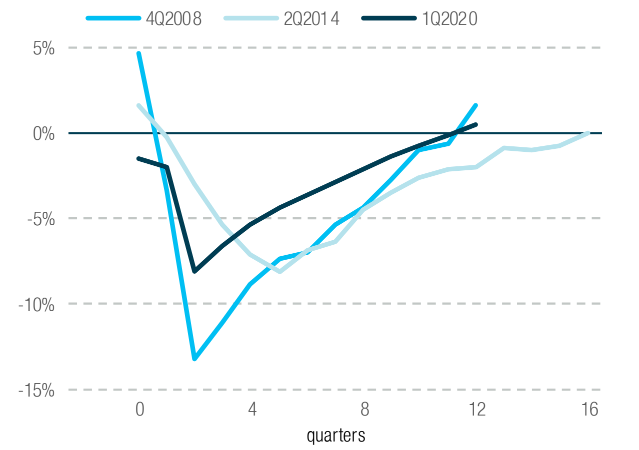
2020 shows temporary drop in domestic demand and positive net exports



Source: Ukrstat, ICU.

Chart 42. Output gap (% of potential GDP), 1Q is in legend

The recovery of demand this time is faster, but still prolonged



Source: Ukrstat, ICU.

Labour market benefits from reopening

Unemployment surges to 11–12% in 2Q20

Labour-market statistics in Ukraine are published with a significant time lag. At the time of writing this Review, 2Q20 data was not available. We can only assume significant negative effects for employment in 2Q20. However, in our opinion, the surge in the unemployment rate in Ukraine should be less than in other countries with a very flexible labour market, like the US. Moreover, Ukrainian companies frequently prefer to put employees on unpaid leave or decrease the number of working days instead of laying off. At the same time, employment support programmes were not as generous as in other countries like Germany or the UK. For example, the distributed money under partial unemployment support, à la furlough scheme, as of mid-August amounted to only UAH1.5 bn (0.04% of annual GDP) and is unlikely to change the labour market stance. Therefore, we assume that the unemployment rate has jumped to 11–12% in 2Q20 from 8–9% in the last two years.

As economy opens, labour market rebound is evidenced by number of job vacancies and sharp growth of wages

Meanwhile, in recent months, high-frequency indicators point to a recovery in labour demand. The number of vacancies on job sites at the end of August has returned to the February level, while the number of submitted CVs reached pre-pandemic levels in June–July.

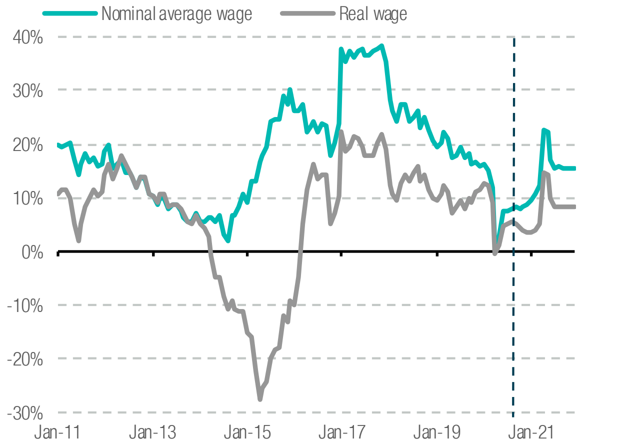
Moreover, the recovery in the demand for labour is confirmed by wages rapidly rising after their slump in March–April. The seasonally adjusted indicator in July already exceeded February's level by 1.7%, while in real terms remaining lower by 0.5%. That resulted in acceleration of growth to 7.6% YoY for nominal and 5.1% YoY for real wages in July. Expectedly, the highest growth rates are observed in healthcare (+17.9% YoY) and the IT sector (+14.4% YoY). Also, since May, wages picked up sharply in industry and trade, causing the acceleration of annual growth rates to 7.0% YoY and 3.8% YoY in July, respectively. Wages in hospitality and transport recovered slightly in June–July, but were still lower in July 2020 than a year ago by 15% and 4%, respectively.

Further real wages growth is boosted by minimum wage hikes…

In the face of ongoing outbreak of coronavirus, we expect real wage growth to slow. The abolition of the salary ceiling of UAH47k in the public sector and the increase of the minimum wage in September by 6% MoM may give a short-term boost. However, further weakening of productivity-growth potential due to social distancing and limited labour mobility will constrain the ability of companies to raise wages at a high rate. For the full year of 2020, real wages are forecast to grow by 5.5% compared with 9.9% in 2019.

Chart 43. Nominal and real wages (YoY, %)

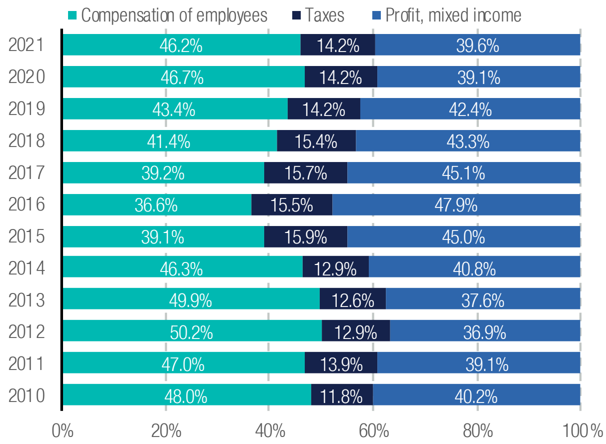
Growth of real wages slows in 2020–21 compared with previous years



Source: Ukrstat, ICU.

Chart 44. The structure of GDP by income (%)

2020 shows sizable increase in share of employees' compensation



Source: Ukrstat, ICU.

In 2021, growth in wages will be driven by minimum wage hikes, on average by 30%, continuation of wages convergence to global levels in IT sector, and a rebound of transport and hospitality. Thus, despite the negative output gap and remaining limitations for labour migration, we expect the acceleration of real-wages growth to 8.4%.

… simultaneously slowing employment recovery and pushing wages' share in GDP

However, the minimum wage hikes will slow the recovery of employment in 2021, as happened in 2017. Adding coronacrisis-induced labour market mismatches, we expect only a marginal fall of unemployment next year to 9.7% compared with 10% in 2020.

Nonetheless, accounting for robust growth of wages, the share of employees' compensation in GDP surges sizably to 46–47% in 2020–21, just marginally lower than 50% in 2012–13. Instead, the share of profit and mixed income is forecast to decline to 39–40%, the lowest level since 2014. Such changes underline the risks related to sustainability of long-term economic growth amid weak generation of resources for capital investments.

Inflation: New push from minimum wage

- **Inflation remains below NBU's 5%+/-1 pp target since the beginning of 2020**
- **YoY growth rates hide growing inflationary pressure from cost-push and demand-pull factors**
- **Weaker UAH and minimum wage hike fuel CPI up to 6.5% YoY by YE2021**

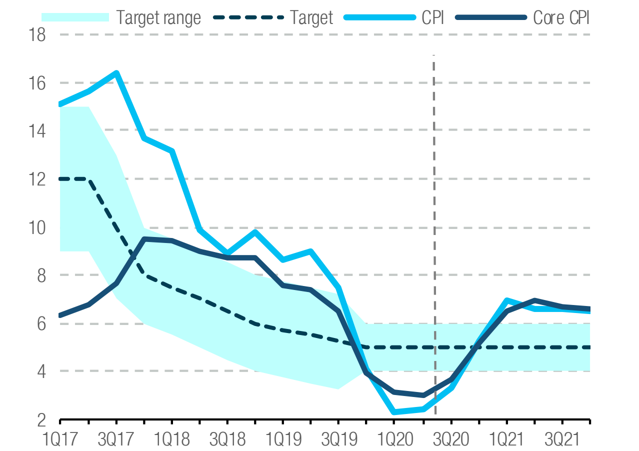
YoY inflation figures hide growing inflationary pressure in last months

Our expectations regarding the prevailing effect of the contraction in aggregate demand on the inflation slowdown have been confirmed so far. In July, annual changes both in headline CPI and core CPI remained low, 2.4% YoY and 3.0% YoY, respectively. Both indicators continued to undershoot NBU's target range of 5% +/- 1 pp since the beginning of the year.

Although annual inflation remained low, when measured by the MoM seasonally adjusted annualized rate (SAAR), in June–August, price growth accelerated to 8–9% both for headline and core inflation. Moreover, growing inflationary pressure is evident for some components of the consumer basket, while aggregated indicators are subdued by a sharp fall in energy prices and depressed services inflation.

Chart 45. CPI and Core CPI (YoY, %)

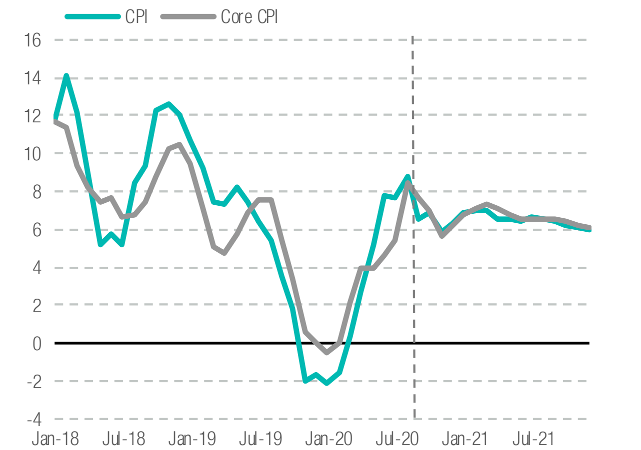
Inflation backs to target range in 4Q20 and then overshoot it



Source: NBU, Ukrstat, ICU.

Chart 46. CPI and Core CPI (3MA MoM SAAR, %)

Annualized growth rates are in the range of 6-8% on forecast horizon



Source: Ukrstat, ICU

Energy and food prices are holding back consumer inflation

Thus, fall in global energy prices led to lower prices for fuel and utilities in August than a year ago, by 17.9% YoY and 3.1% YoY, respectively. However, compared with previous months, the rate of decline decreased thanks to both the recovery of global prices and the weakening of the hryvnia. In addition, prices for a number of non-food products (clothing and footwear, home textiles, household appliances, audio equipment, and cameras) are lower than last year, reflecting the impact of both low demand due to the quarantine and the strengthening of the hryvnia at the end of last year. Recent depreciation was not reflected in the prices of previous purchases. Food inflation is low, 2.3% YoY in August. This year, vegetables, sugar, and meat are cheaper than last year, and egg prices fell sharply again in August. Instead, prices for fruit, bread, and bakery products are rising rapidly. As expected given the conditions of pandemic and social distancing, the growth of prices for hospitality, recreation, and culture services is slowing. At the same time, inflation in the health care sector is accelerating.

Going forward, we project that both headline and core CPI will grow at 6–8% MoM SAAR by YE2021. That will result in 5.3% YoY headline inflation at YE2020 and 6.5% YoY at YE2021. Core inflation figures will be close. However, such steady inflation outlook in MoM SA indicators hides the important changes of relative prices on the forecast horizon due to different underlying factors.

Reversal of food-inflation trend drives goods inflation upward

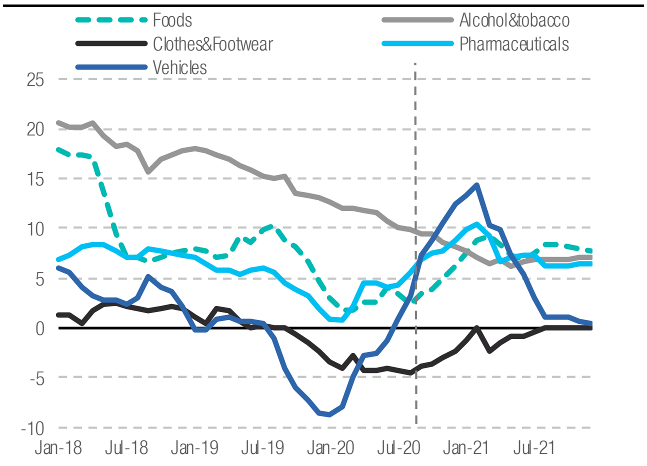
First, we project goods inflation to accelerate sharply from the current subdued levels due to projected UAH depreciation, minimum wage hikes, and idiosyncratic demand-pull factors in some sectors. Thus, food inflation is forecast to accelerate to about 8% at YE2020 and YE2021. The main reason for food CPI acceleration will be hikes in the minimum wage, which push demand from low-paid workers. Additional contribution will come from UAH weakness in 4Q20, which pushes prices for tradable food stuffs both in 2020 and 2021. A similar factor will play an important role for prices of pharmaceuticals for which excessive demand in 2Q20 provided an additional boost. Also, demand for individual vehicles given the limited capacity of public transport drives their prices this year. However, next year, with expected recovery of public transport amid a better situation with the coronavirus, we project that price inflation in vehicles will be subdued.

Services inflation rather unchanged as effects of minimum wage hikes offset those of subdued aggregate demand

In the services sector, we expect the prevailing role of still-depressed demand, with hikes in minimum wage, will be an important cost-push factor. First of all, we project steady disinflation in the educational sector related to social distancing and switching to online learning, which may dampen prices. Traditionally, the prices in education are raised in September (by about 10% in last years); this time, price revision may be muted. Price growth in the hospitality sector will suffer from lack of sufficient demand due to social distancing. However, in 2021, an improved situation with COVID-19 and a rising tax burden from the minimum wage hike will boost inflation in this sector. The latter factor together with strong demand for medical services will keep inflation in healthcare quite high, about 10% YoY in 2H20 and 2021.

Chart 47. Goods prices (YoY, %)

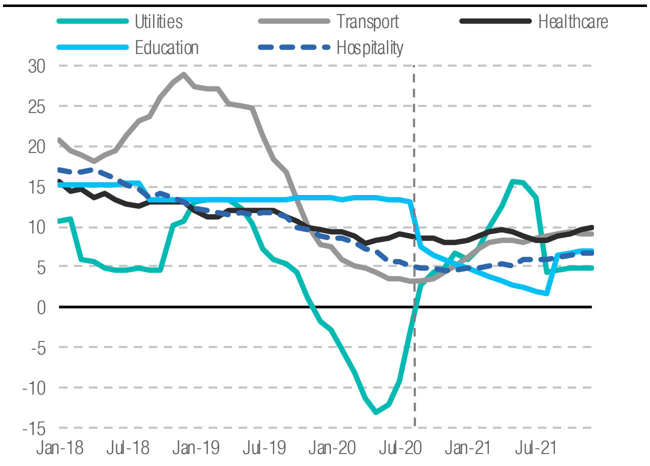
Food price inflation accelerates in 2021



Source: Ukrstat, ICU.

Chart 48. Services prices (YoY, %)

Effects of minimum wage hikes offset those of subdued aggregate demand



Source: Ukrstat, ICU

Ongoing recovery of global oil and gas prices, expected UAH depreciation, and rising costs due to minimum wage hikes will boost prices for utilities and transport services. The former will be 3% lower at YE2020 than a year ago, but will rise next year by 5%. Growth of prices for transport services has been on a downward trend since December 2019, thanks to a sharp fall in energy prices, UAH strength, and a collapse in demand. The reversal of these factors will push inflation in the transport sector in 2H20 and 2021.

Accommodative monetary policy will allow inflation slightly above the target range

So, in general, despite our projection of negative output gap on the forecast horizon reflecting insufficient aggregate demand, the pent-up demand in some sectors, cost-push effects of minimum wage hikes, UAH depreciation, and recovery in energy prices will boost inflation above NBU's target range in 1Q21. Assuming some monetary-policy accommodation, we expect that the CPI will keep growing at a slightly accelerated pace in 2021.

Capital to replace trade in supporting BoP

- **C/A surplus is expectedly fading, but the overall 2020 outlook improves as COVID-19 depresses imports and travel above expectations, while remittances prove resilient**
- **2020 C/A surplus of US$6.2bn should turn into US$3.7bn (2.4% GDP) deficit in 2021**
- **F/A shows return of positive net debt borrowings, while FDI and capital flight are lagging behind and should "normalize" only in 2021**
- **Reserves to reach US$32bn or 110% of IMF ARA metric in 2021**
- **UAH remains quite robust while moderate weakening is expected in 2H20 due to worsening devaluation expectations and C/A returning to deficit**

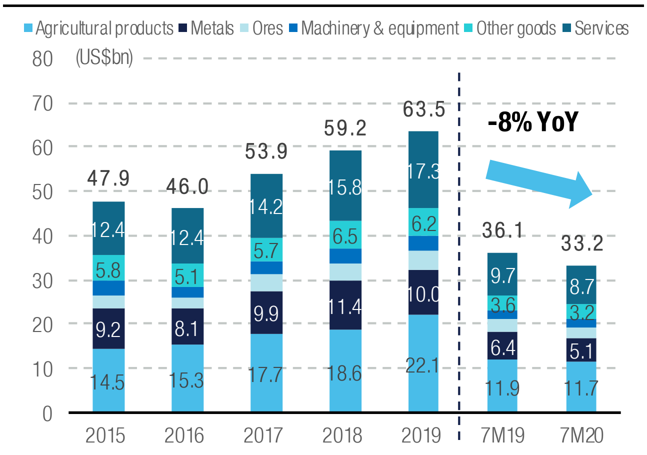
C/A outlook for 2020 improves

The C/A 2020 outlook improves mainly thanks to a slump in imports and travel abroad, resilient private remittances, and favourable iron ore prices. In addition, the NBU revised the methodology for reinvested earnings data compilation, which lowered investment income payments this year. Hence, we revise up our forecast of C/A surplus to US$6.2bn, or 4.2% of GDP.

In 7M20, the C/A surplus reached US$7bn versus the US$2.9bn deficit in 7M19, while the trade deficit amounted to just US$0.4bn, 94% less than a deficit of US$6.3bn for 7M19. Ukraine's 7M20 exports declined by 8% YoY to US$33bn, driven mostly by lower prices and sales volume of steel, as well as by depressed travel, transit, and other transportation services. However, the 7M20 decline in imports was much sharper, by 21% YoY to $34bn, with a decline in imports of energy products, machinery and equipment, and travel services having made the greatest contribution to this decline. One of the key positive contributors to the C/A, private remittances, were surprisingly steady as they declined only 5% YoY to US$6.3bn. Finally, investment income payments fell 88% to US$700m due to weak financial results of Ukrainian companies with foreign capital.

Chart 49. Exports (US$bn)

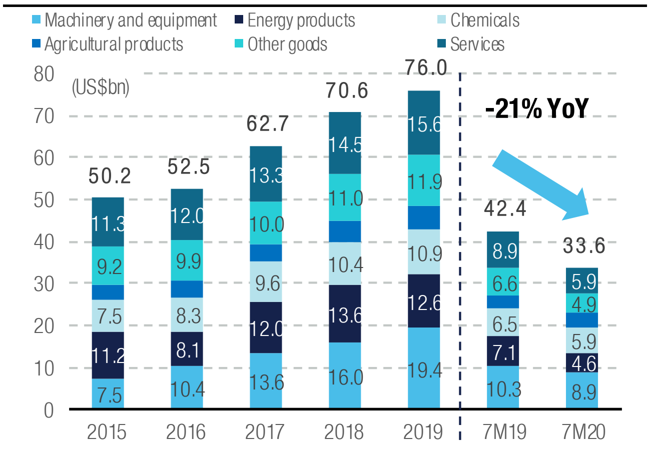
Ukraine's 7M20 exports fell 8% YoY to $33bn, driven mostly by decline in steel (-20%), pipeline transit (-34%), travel services (-75%), and transportation services (-14%)



Source: NBU, ICU.

Chart 50. Imports (US$bn)

Lower purchases in energy products (-36%), machinery and equipment (-14%), and travel services (-49%) contributed most to the 21% YoY decline in 7M20 imports



Source: NBU, ICU

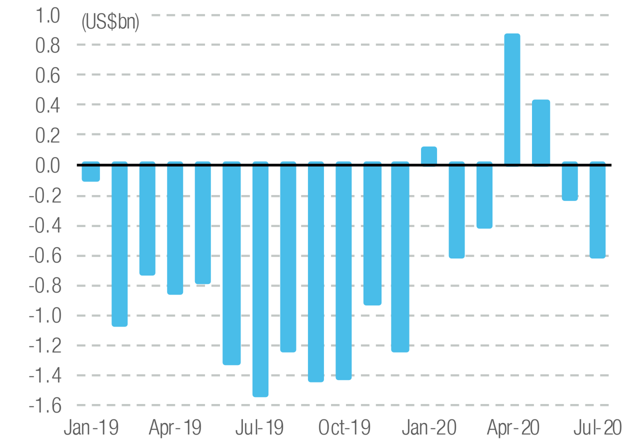
Trade deficit will expand in 4Q20 due to recovering domestic demand and weaker exports

In July, the C/A surplus of US$0.4bn was much lower compared with the previous three months as the trade deficit grew to US$0.6bn, the highest monthly level so far this year. We expect the trade deficit to continue expanding and become the key factor of the C/A surplus turning into deficit through the remainder of 2020. Exports in the metals sector will continue suffering from the weak European market with a rising risk of a 15–20% decline in iron ore prices. The leading exports contributor, agriculture and the food sector, will earn less in 2H20 vs 1H20, as spring and summer droughts will weigh on the new grain harvest, while corn and wheat prices should be lower as well. Recovering domestic demand will further boost imports, first of consumer durables, transportation vehicles, computers and communication equipment. A rebound in the population's mobility and rising prices for oil and petroleum products will boost the energy-product component of imports.

All that said, we see risks for the trade balance skewing to the upside, as resurgence in COVID-19 cases, both in Ukraine and the rest of the world, would mean slowing consumer demand recovery, more import supply disruptions, expanding and/or prolonged border closures, and lower-than-anticipated prices for oil and natural gas.

Chart 51. Foreign trade balance (US$bn)

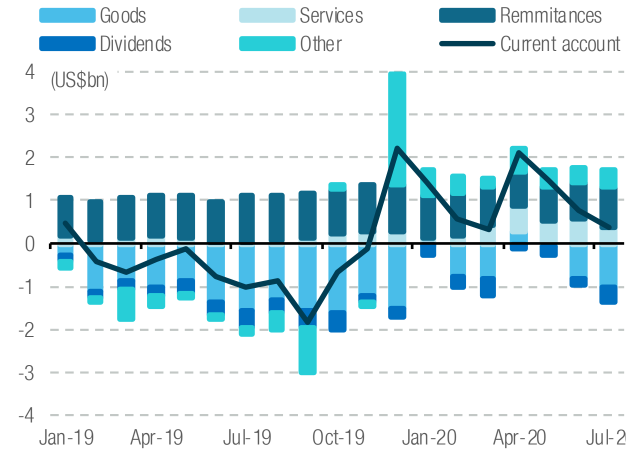
After two months of surplus, the trade balance turned into US$200m deficit in June, and then deficit almost tripled in July



Source: NBU, ICU.

Chart 52. Current account (US$bn)

In July, the C/A surplus shrank to US$0.4bn as trade deficit grew to US$0.6bn



Source: NBU, ICU

We expect gross private remittances to decline 10% to US$10.7bn in 2020

Remittances from labour migrants have proved less dependent on seasonal workers who could not return to work in Europe this year due to border closures. At the same time, the number of Ukrainian workers in Poland, the key recipient of the Ukrainian labour force, was estimated by Statistics Poland to decrease by a relatively moderate 11.5% or 160k as of April end. Still, due to resurging COVID-19 cases in Ukraine and Europe and the high risk of new outbreaks, we do not expect the number of Ukrainian labour migrants to recover to pre-COVID levels by the end of 2020. Overall, we revise up our estimate of private remittances to Ukraine and expect them to decline 10% to US$10.7bn in 2020.

We expect dividend repatriation to fall 20% to US$2.6bn in 2020

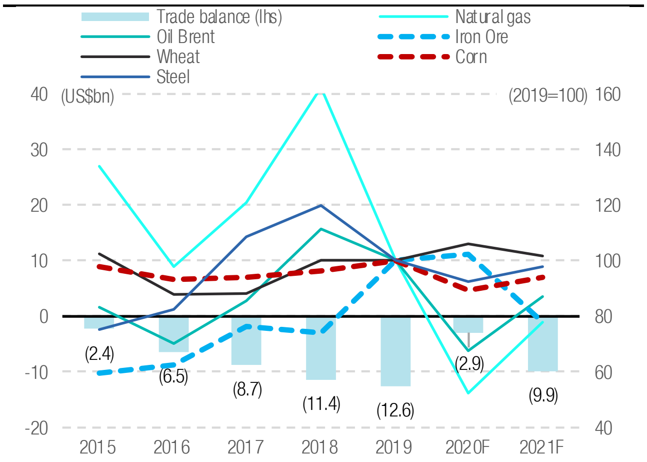
We also expect that one of the key items of the current account's other expenses, dividend expatriation, will decline by 20% to US$2.6bn in 2020, as many Ukrainian corporates are conserving cash in view of the economic recession and hindered access to FX capital. Change in NBU methodology has added reinvested incomes of Ukrainian corporates with foreign capital to the C/A balance. As the coronavirus crisis should make the year of 2020 loss-making for the vast majority of Ukrainian corporates, an estimated aggregate of US$2.8bn of those losses is to be added to the C/A surplus. Net of this new methodology adjustment, the C/A surplus would have amounted to US$3.4bn or 2.3% of GDP in 2020.

As the trade deficit expands with recovering and pent-up internal demand and rising oil and gas prices, C/A surplus should turn into a US$3.7bn (2.4% GDP) deficit in 2021

We maintain our view that in 2021, the current account should turn to a deficit of US$3.7bn or 2.4% of GDP. Such a sharp turnaround will be driven by progress in containing COVID-19, improving domestic consumption, and realization of pent-up demand, especially for foreign travel. The resulting expansion of the trade deficit will be the most significant contributor to the current account balance. We expect that a 24% YoY drop in average iron ore prices, a 38% fall in natural gas transit volumes, and a still weak European steel market will be the main factors dragging down recovery of exports, which should grow just 4% to US$61bn. At the same time, we forecast Ukraine's imports to grow 16% to US$70b. The main contributors to this growth will be rising purchases of petroleum products, natural gas, consumer durables, machinery and equipment, and foreign travel expenses. We expect gross private remittances to grow 3% to US$14.7bn, still below the 2019 level of US$15.9bn, as cross-border constraints and labour market weakness may still remain in place.

Chart 53. Ukraine's trade balance (US$bn) and commodity prices

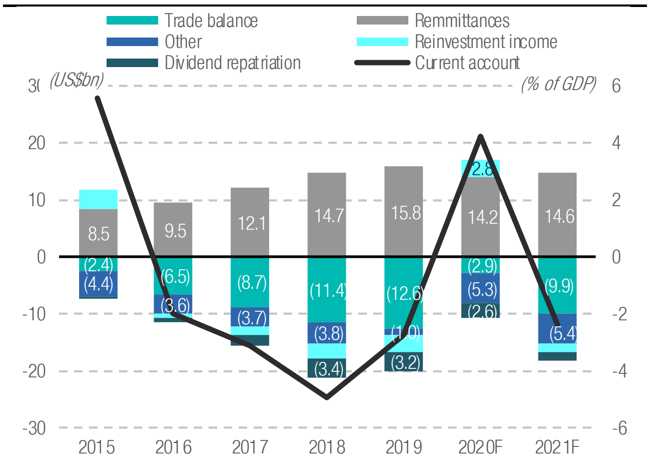
Higher prices for iron ore and lower prices for oil and natural gas cause contraction of Ukraine's trade deficit in 2020



Source: NBU, Bloomberg, ICU

Chart 54. Current account (US$bn, % of GDP)

Ukraine's C/A surplus of 2020 will turn into a 2.4% of GDP deficit in 2021, mostly due more than tripling the trade deficit



Source: NBU, ICU

Gradual and uneven recovery of capital inflows

Debt borrowings are positive again, while capital outflows and decline in FDI persist

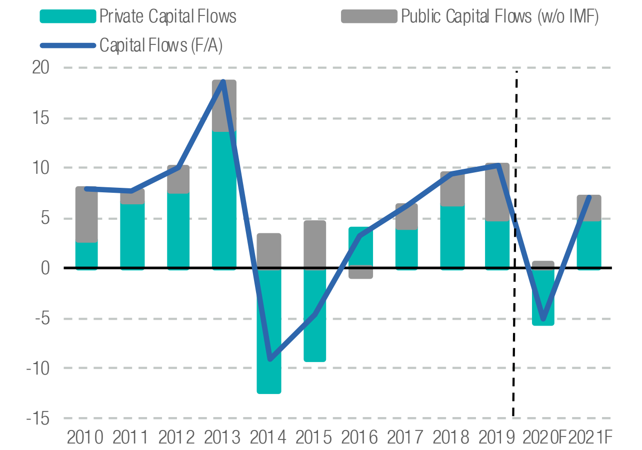
As we forecast in June, capital outflows induced by the pandemic were quite short-lived and moderate in scale. Both government and the private sector switched again to net borrowing of foreign capital after the net repayment in March–April (government had a large repayment of US-backed Eurobonds in May as well). Meanwhile, due to the change in methodology, the outflow was recorded in FDI (US$3.2bn in 7M20), reflecting the assessment of losses in corporates with foreign investment and the corresponding reduction of reinvested earnings in their capital. This "outflow" of reinvested earnings was mirrored with a plus sign in the investment income item contributing to improvement of the current account balance.

Return to FDI inflows and slide in accumulation of FX assets delayed until 2021

For the full year 2020, we project net capital outflows to amount to US$5bn (US$5.9bn in 7M20). A large contribution to that outflow comes from a decline of FDI by US$1.9bn, mostly related to losses sustained by companies with foreign capital and their reflection in reinvested earnings. In addition, the accumulation of FX cash outside the banking system is expected to grow this year to US$3.4bn compared with US$2.5bn over the average last two years as limitations on foreign travel and shadow imports cause additional savings in hard currency among the population and business. Meanwhile, we project marginal positive net borrowings of the public sector, assuming one tranche under the EU COVID programme and one more Eurobond placement up to US$1bn by the end of 2020. Net debt flows of the private sector will be close to zero (US$0.5bn in 7M20).

Chart 55. Capital flows in financial account (US$bn)

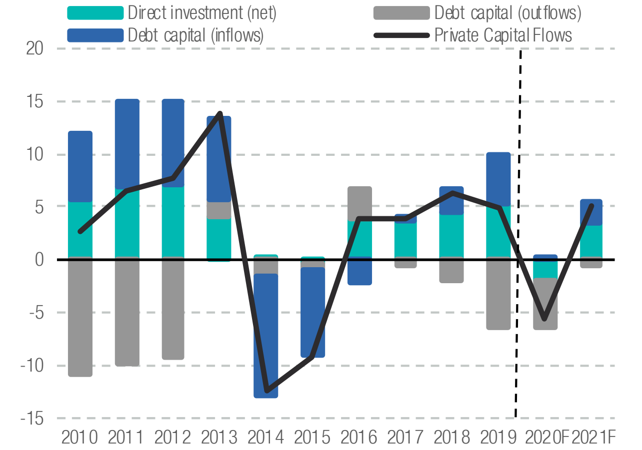
In 2020, F/A turns to negative values due to private sector outflows



Source: NBU, ICU.

Chart 56. Capital flows of private sector (US$bn)

In 2020, inflows of foreign debt capital reverse while residents continue accumulate foreign assets. 2021 shows return to positive private capital flows



Source: NBU, ICU

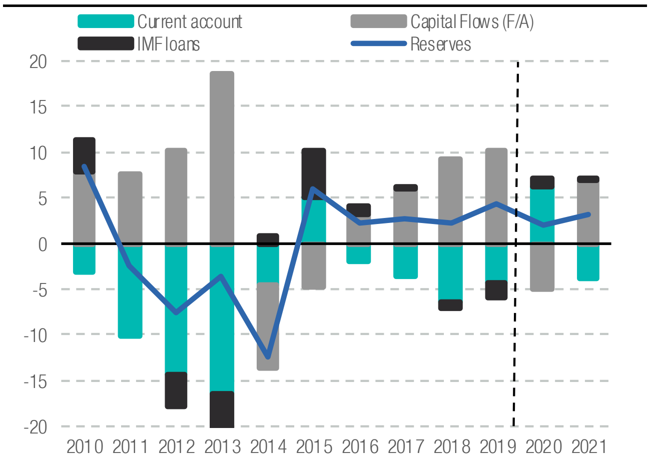
In 2021, we expect that the government will continue to tap international capital markets (US$3bn) and receive new tranches from the World Bank and EU. In addition, the private sector will once again become a net recipient of capital flows, both FDI and debt. Also, an increase in foreign assets will slow sharply as the accumulated amounts will be spent actively. As a result, net capital inflows will become positive again and reach US$7bn, close to the average level in 2016–19.

Reserves are projected to reach 110% of IMF ARA metrics in 2021

Due to the resilience of Ukrainian external accounts to pandemic effects, this year, the current account surplus will exceed capital outflows by US$1bn, compared with BoP surplus about US$3bn in average during 2016–19. Next year, we expect the return to a US$3bn BoP surplus amid recovering capital inflows. Factoring in IMF disbursements (US$3.5bn in 2020–21), we project further growth of reserves to US$32bn. As a result, they should reach 110% of the IMF Aggregate Reserve Adequacy metric for the first time since the GFC.

Chart 57. Changes in Reserves (US$ bn)

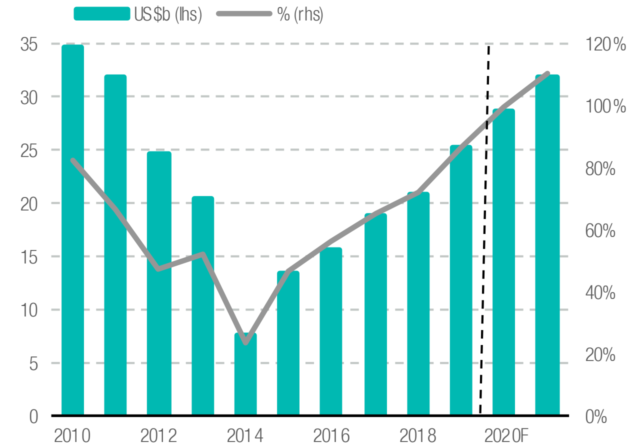
The pace of reserves accumulation is surprisingly stable since 2015



Source: NBU, ICU.

Chart 58. Reserves (US$ bn) and the ratio to IMF ARA metric (%)

Reserves are projected to exceed 100% of IMF ARA metric in 2021



Source: NBU, ICU

Hryvnia: Solid fundamentals, shaky sentiment

Despite losing 14% YTD by end-August, fundamental conditions for the hryvnia remain solid, as hard-currency demand was constrained by weak imports and restricted foreign travel, while export proceeds remained strong and remittances resilient. Changes in sentiment were one of the main sources of FX market volatility and UAH value losses, first in March during the initial COVID-19 outbreak, then in July when government officials increased their rhetoric about the desirability of UAH depreciation to benefit exporters and the state budget. Going forward, worsening devaluation expectations will continue to be one of the sources of pressure on the hryvnia.

We expect moderate depreciation of the hryvnia to UAH29–30/USD by end-2020 and UAH29.5–30.5/USD by end-2021

Through the rest of 2020, we expect the hryvnia to depreciate toward the UAH29–30/USD range. Domestic consumption recovery, restocking, and normalization of logistics should boost imports, first of all of consumer goods. At the same time, hard currency proceeds from exports may moderate as steel demand in the European market will remain weak and should be further exacerbated by a sharp drop of world iron-ore prices. Foreign capital inflows are also likely to remain unsupportive for the national currency as non-residents will stay cautious and continue reducing their holdings of Ukrainian domestic bonds. Investor sentiment on UAH and domestic bonds will be further undermined by slow progress with the first review of the IMF programme and high uncertainties regarding the next tranche. Growth in state budget outlays, which are traditionally high closer to year end, should be particularly sharp this year due to the so far slow realization of the deep, planned budget deficit. Growth in remittances from labour migrants will be one of the key factors restraining hryvnia depreciation.

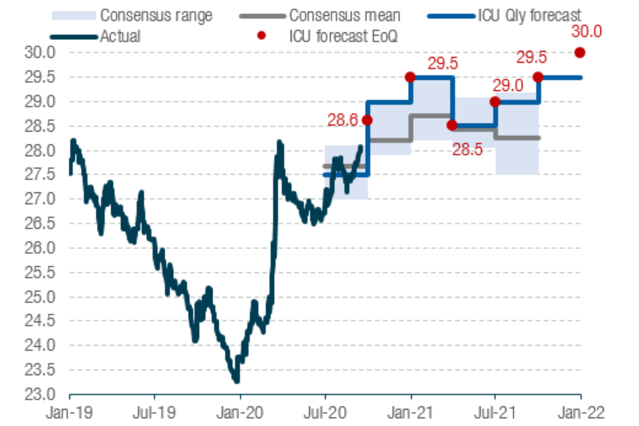
Chart 59. Devaluation expectations in Ukraine

We expect devaluation expectations will keep worsening toward the end of 2020

Source: InfoSapiens, ICU.

Chart 60. UAH/USD forecast

UAH will depreciate to 29–30/USD by end-2020 and then to 29.5–30.5/USD by end-2021



Source: NBU, Bloomberg, ICU

We see the UAH exchange rate risk balance in 2H20 tilting to the upside as resurging COVID-19 cases may slow consumption recovery and bring back more constraint on foreign travel. That said, downside risks are also high and stem mainly from sharp expansion of the C/A deficit, surging fiscal payments, and higher devaluation expectations.

We maintain our view for the hryvnia's gradual depreciation in 2021. Recovering flows of foreign capital will partly compensate the negative impact of a widening C/A deficit. As a result, the hryvnia should slide into UAH29.5–30.5/USD range by the end of 2021.

Yearly forecast 2020–21

	Historical data for 2010-19										Forecast by ICU	
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020F	2021F
Activity												
Real GDP (%, YoY)	4.2	5.5	0.2	(0.0)	(6.6)	(9.8)	2.4	2.5	3.4	3.2	(5.7)	5.6
Nominal GDP (UAHbn)	1,079	1,300	1,405	1,465	1,587	1,989	2,385	2,984	3,561	3,975	3,977	4,603
Nominal GDP (US$bn)	136	163	174	180	133	90	93	112	131	155	147	158
Unemployment (%)	8.2	8.0	7.6	7.3	9.3	9.1	9.3	9.5	8.8	8.2	10.0	9.7
Inflation												
Headline inflation (%, YoY, e.o.p)	9.1	4.6	(0.2)	0.5	24.9	43.3	12.4	13.7	9.8	4.1	5.3	6.5
Headline inflation (%, YoY, avg.)	9.4	8.0	0.6	(0.3)	12.1	48.7	13.9	14.4	10.9	7.9	3.0	6.6
GDP deflator (%, YoY)	13.5	14.2	7.8	4.3	15.9	38.9	17.1	22.1	15.4	8.1	6.1	9.6
Exchange rates												
UAH/USD (e.o.p.)	7.94	8.04	8.05	8.24	15.82	24.03	27.30	28.10	27.72	23.81	29.50	30.00
UAH/USD (avg.)	7.95	7.98	8.08	8.15	12.01	21.95	25.55	26.61	27.19	25.80	27.05	29.03
External balance												
Current account balance (US$bn)	(3.0)	(10.2)	(14.3)	(16.5)	(4.6)	5.0	(1.9)	(3.5)	(6.5)	(4.2)	6.2	(3.7)
Current account balance (% of GDP)	(2.2)	(6.3)	(8.3)	(9.2)	(3.5)	5.6	(2.0)	(3.1)	(4.9)	(2.7)	4.2	(2.4)
Trade balance (US$bn)	(2.7)	1.7	0.8	0.5	(0.7)	(0.6)	(0.4)	(1.0)	0.1	0.7	(2.9)	(9.9)
Trade balance (% of GDP)	(2.0)	1.0	0.4	0.3	(0.6)	(0.7)	(0.5)	(0.9)	0.1	0.4	(2.0)	(6.3)
Exports (US$bn)	(0.6)	(0.3)	(0.3)	0.6	(0.3)	0.3	(0.2)	0.0	(0.0)	(0.6)	57.9	60.5
Imports (US$bn)	11.2	9.1	10.3	12.3	(8.0)	(3.5)	(3.0)	2.5	5.2	9.9	60.8	70.4
Capital flows (F/A) (US$bn)	7.9	7.7	10.1	18.6	(9.1)	(4.6)	3.1	6.1	9.3	10.2	(5.0)	7.0
FDI (US$bn)	5.8	7.0	7.2	4.1	0.3	(0.4)	3.8	3.7	4.5	5.2	(1.9)	3.5
FDI (% of GDP)	4.2	4.3	4.1	2.3	0.2	(0.5)	4.1	3.3	3.4	3.4	(1.3)	2.2
Reserves (US$bn)	34.6	31.8	24.5	20.4	7.5	13.3	15.5	18.8	20.8	25.3	28.6	31.9
Reserves % of ARA metric	82	67	48	52	24	46	56	65	72	87	99	110
Interest rates												
NBU's key policy rate (%, e.o.p.)	7.75	7.75	7.50	6.50	14.00	22.00	14.00	14.50	18.00	13.50	6.00	7.00
Fiscal balance												
Budget balance (% of GDP)	(5.9)	(1.8)	(3.8)	(4.4)	(5.0)	(2.3)	(2.9)	(1.5)	(2.4)	(2.1)	(6.0)	(6.0)
Public debt (% of GDP)	40.1	36.4	36.7	39.9	69.4	79.0	80.9	71.8	60.9	50.6	56.9	56.2
Wages												
Average nominal wage (UAH)	2,247	2,639	3,032	3,274	3,475	4,207	5,187	7,105	8,867	10,504	11,405	13,183
Real wage (%, YoY)	7.6	8.8	14.3	8.2	(5.2)	(18.5)	7.8	19.7	12.6	9.9	5.5	8.4

Source: Ukrstat, NBU, IMF, ICU.

Quarterly forecast 2020–21

	Historical data										Forecast by ICU					
	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
Gross domestic product																
Real GDP (%, YoY)	3.5	3.9	2.7	3.7	2.9	4.7	3.9	1.5	(1.3)	(11.4)	(6.0)	(3.8)	(1.6)	11.4	6.5	5.8
Nominal GDP (UAHbn)	706	810	995	1,050	815	933	1,112	1,115	846	892	1,115	1,125	935	1,056	1,299	1,313
Nominal GDP (US$bn)	26	31	36	38	30	35	44	46	34	33	41	39	33	37	45	44
Prices																
Headline inflation (%, YoY, e.o.p)	13.2	9.9	8.9	9.8	8.6	9.0	7.5	4.1	2.3	2.4	3.3	5.3	6.9	6.6	6.7	6.5
Headline inflation (%, YoY, avg.)	13.8	11.5	8.9	9.7	8.9	9.1	8.5	5.2	2.6	2.1	2.7	4.5	6.5	6.8	6.7	6.5
GDP deflator (%, YoY)	15.1	17.4	16.0	13.5	12.2	9.9	7.6	4.7	5.1	7.9	6.7	4.9	12.4	6.4	9.4	10.3
Exchange rates																
UAH/USD (avg.)	27.28	26.18	27.37	27.92	27.31	26.52	25.21	24.22	25.09	26.89	27.47	28.75	28.67	28.58	29.08	29.78
UAH/USD (e.o.p.)	26.27	26.34	28.24	27.72	27.31	26.16	24.36	23.81	27.59	26.87	28.60	29.50	28.50	29.00	29.50	30.00
Interest rates																
NBU's key policy rate (%, e.o.p.)	17.00	17.00	18.00	18.00	18.00	17.50	16.50	13.50	10.00	6.00	6.00	6.00	6.50	7.00	7.00	7.00

Source: Ukrstat, NBU, ICU.

Disclosures

ANALYST CERTIFICATION

This research publication has been prepared by the analyst(s), whose name(s) appear on the front page of this publication. The analyst(s) hereby certifies that the views expressed within this publication accurately reflect her/his own views about the subject financial instruments or issuers and no part of her/his compensation was, is, or will be directly or indirectly related to the inclusion of specific recommendations or views within this research publication.

EQUITY RATING DEFINITIONS

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

11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kyiv, 01030 Ukraine
Phone/Fax +38 044 3777040

WEB www.icu.ua

RESEARCH

Sergiy Nikolaychuk
Head of macro research
sergiy.nikolaychuk@icu.ua

Alexander Martynenko
Head of corporate research
alexander.martynenko@icu.ua

Taras Kotovych
Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Mykhaylo Demkiv
Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

Dmitriy Dyachenko
Junior financial analyst
dmitriy.dyachenko@icu.ua