Focus
Ukraine

Scope
Economics

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Macro Review

Rising hopes from a shot in the arm

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Contents

Executive Rundown

This year's roller coaster for the Ukrainian economy keeps going. After a lockdown-induced sharp collapse in 2Q20, the economy rapidly recovered in the next quarter, exceeding expectations of most economic forecasters. However, growth momentum slowed in the autumn amid the second wave of the coronavirus pandemic and the tightening of quarantine measures both in Ukraine and in other European countries. At the same time, positive news about vaccines has given new hope that next year, new waves of COVID-19 spread and severe lockdowns will be avoided, and the economy will get a new impetus for the return to the pre-pandemic trajectory.

We improve our GDP estimate for 2020 to -4.8% and reiterate our optimistic view for 2021 catch-up growth of +5.6%. As before, we believe that the Ukrainian economy is well prepared for this crisis due to its structure, with a high share of agri and IT, and strengthening macro-financial stability after the crisis of 2014–15. However, the results could be much better if the government fully took advantage of available opportunities to attract official financing and provide the economy with stronger fiscal and monetary stimulus.

Unfortunately, our previous expectations that the second tranche from the IMF will not come until next year are confirmed. A number of problematic issues, such as the independence of the central bank, the budget-2021, and the wages cap in the public sector were complemented recently by the decisions of the Constitutional Court on the abolition of criminal responsibility for false declaration and on activities of anti-corruption bodies. However, the authorities' efforts to resolve these issues and their willingness to cooperate actively with Western partners are encouraging. Therefore, we believe that in 1H21, Ukraine will finally receive the second tranche from the IMF and related official financing, which is especially important given the significant amount of external debt repayments in 3Q21.

Fiscal policy in 2021 will be more expansionary. Although banks increased their holdings of UAH government bonds by a significant 46% in 11M2020, in particular exploiting NBU refinancing loans and accumulated liquidity in certificates of deposit, fears of large-scale monetary financing of the budget have not materialized. Both the NBU and banks have behaved rather conservatively. Therefore, given limited funding from other sources, the 2020 budget deficit will amount to c5% of GDP, well below plan and the corresponding level in other countries. In 2021, budget constraints will be eased through the resumption of official funding and increased opportunities for borrowings in the domestic and international capital markets. As a result, the budget deficit as a percent of GDP will hardly change, but the structural balance, adjusted for the business cycle, will decrease sizably.

Monetary conditions will remain loose. First, inflationary pressures are growing rather slowly, and we expect that in 2021, despite a sharp rise in the minimum wage, inflation will fluctuate close to the upper limit of the target range, 6%. Although the economy will actively recover starting from 2Q21, the global low-inflation environment and some strengthening of the exchange rate due to improved external accounts will be important headwinds for inflation. Second, world interest rates will remain low at least through next year. And finally, the resumption of official funding will reduce medium-term risks to external sustainability and financial stability. Therefore, the NBU will have arguments to delay until

July the first interest rate hike in the new cycle, and we expect the rate to be raised in 2H21 by only 100 bps to 7.0%, compared with 7.5% envisaged in the October NBU forecast. As a result, the average real rate, deflated by inflation expectations, will be even lower than this year.

Solid external accounts support the exchange rate. In September–November, global factors have been favourable for the Ukrainian economy and its currency. Namely, prices for export commodities—steel, iron ore, grains, sunflower oil—have remained elevated or have even risen, and vaccine news has generated a return of investors' appetite for EM assets. Adding to that depressed domestic demand and travelling restrictions, the current account runs a significant surplus, c.4% of GDP for the entire 2020. Next year, with the recovery of domestic demand, including for tourism, and rising prices for imported natural gas, crude oil, and petroleum products, we expect a return to a small deficit slightly above 1% of GDP. Meanwhile, the capital flows will be sufficient not only to finance the current account deficit, but also for further accumulation of reserves—up to US$31bn by the end of 2021. Under such conditions, the hryvnia will strengthen to UAH27–27.5/USD by mid-2021 and then will end 2021 within UAH27.5–28/USD.

Global Macro: Vaccines raise hopes

- **Effective vaccines raise expectations of faster global economic recovery, despite much uncertainty around their production, distribution, and public acceptance**
- **New US administration to favour more predictable international trade and less likely to impose new import tariffs**
- **Advanced Economies will continue to have strong liquidity support from their governments and central banks; inflation likely to remain subdued in 2021–22**
- **Economic recovery and the weakening USD will support commodities: oil and other energy resources to be top gainers**
- **Emerging Markets may see rising capital inflows in 4Q20 and 1H21**

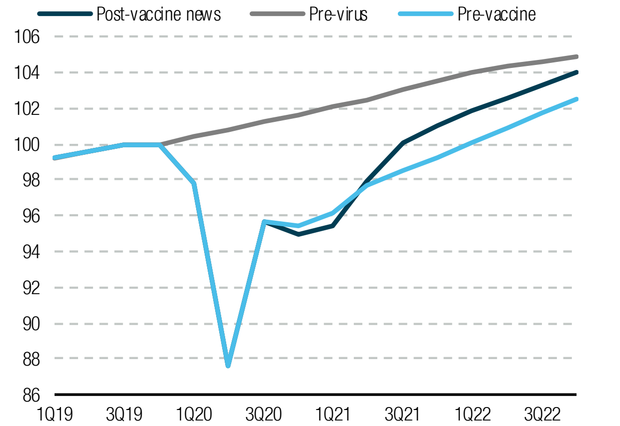
Effective vaccines boost recovery expectations

Effective vaccines may accelerate global economic recovery

Successful testing of a number of COVID-19 vaccines boosted hopes of investors and businesses that global economic recovery will accelerate in 2021. The consensus forecast of world GDP growth, likewise, gained an additional 0.5–0.8ppt in 2021 and 2022 on news of effective vaccines. Advanced economies (AEs) should have the greatest positive effect as they have good access to vaccines, taking into account that they suffered the most from COVID-19 lockdowns given their heavy reliance on the service sector. The pace of this normalization still depends on many uncertainties, the key ones are production and distribution abilities as well as public acceptance of vaccination.

Chart 1. Advanced Economies GDP (US$tn)

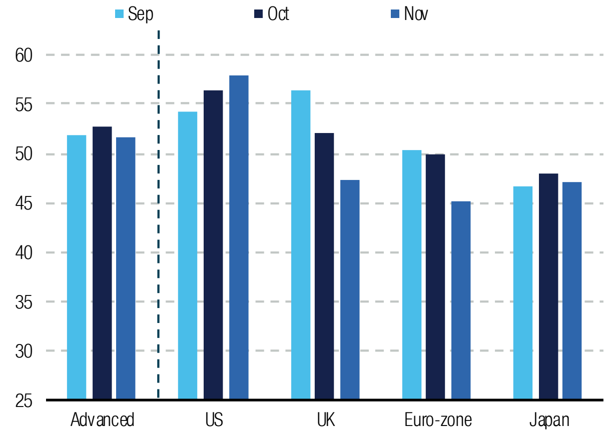
Vaccine news prompted upgrades in AE GDP forecasts in 2021-22



Source: Bloomberg, IMF, ICU.

Chart 2. Composite PMIs for AEs in 2020

Business sentiment in most AEs is deteriorating in 4Q20

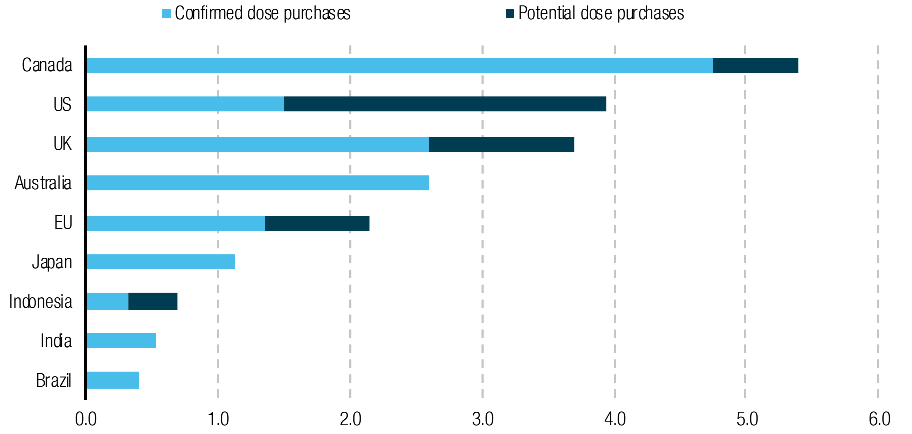


Source: Bloomberg, ICU.

The second wave of COVID-19 has forced many governments to renew lockdowns, albeit less stringent than in the spring. This has led analysts to downgrade their global GDP forecasts for 4Q20 and 1Q21. In particular, the European economy should contract significantly in 4Q20. Overall, the near-term risks remain on the downside for AEs. However, once vaccination gathers pace next year, the global economy should rebound very quickly just as it did in 3Q20. While the timing of full-blown vaccination and a decline in COVID-19 cases remains in question, such a rebound is likely to take place as soon as 2Q21. Later on, growth may again slow substantially and the global GDP may not return to pre-virus levels any sooner than the end of 2022.

Chart 3. Vaccine orders per capita in selected economies

Advanced Economies have already secured a major supply of COVID-19 vaccines



Source: Duke Global Health Innovation Centre, ICU.

US election results to improve global trade

The main outcome of US elections for the global economy is more prudency and predictability in international relations

It is very likely that US president-elect Joe Biden will have to work with a Republican majority in the senate. This will limit Biden's ability to implement the Democratic Party's programs, in particular increasing the corporate profit tax, implementing stricter antitrust regulations, and introducing significant fiscal stimulus. Although a less-than-expected fiscal stimulus package may sound disappointing for financial markets, no tax hikes is positive for US equities.

At the same time, Biden will have enough freedom to act in international affairs. Biden's expected prudent and predictable international policy looks to be the most important outcome of US elections for the global economy and should result in a more favourable international trade environment and better business sentiment.

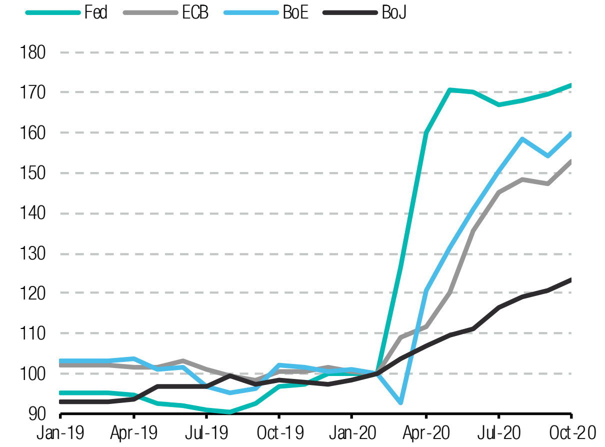
Monetary and fiscal policy to remain supportive

AE central banks will continue applying their main tool in the COVID-19 crisis—purchasing assets in financial markets

The Fed, the ECB, and other AE central banks will pursue a dovish monetary policy for the next several years, as even under the most optimistic scenario, the labour market will recover very gradually, while inflation should remain below central bank targets. As these central banks are not able to lower key policy rates significantly due to effective lower bound constraints, they actively engage in asset purchase programs. It is likely that central banks will not cease expanding their balance sheets until end-2022 or even 2023. Fiscal stimulus has also surged, which is reflected in soaring government deficits. Aggressive monetary and fiscal support in the US should maintain US Treasury yields low and deepen the US current account deficit. As a result, the US dollar will further weaken in 2021, additionally weighed by improving market sentiment and outflows from safe-haven US Treasuries.

Chart 4. Balance sheets of major AE CBs (Feb 20=100)

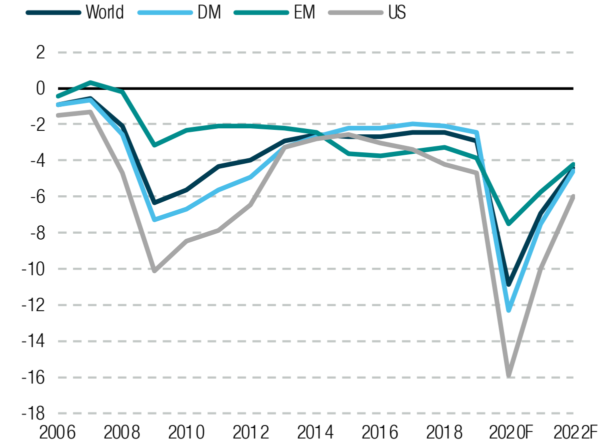
Balance sheets of AE central banks will continue to expand in 2021



Source: Bloomberg, Refiinitiv, ICU.

Chart 5. State budget balance (% of GDP)

Government budget deficits in 2020 will substantially exceed levels reached during the GFC in 2008-09



Source: Bloomberg, Refinitiv, ICU.

Energy commodities to become top gainers in 2021

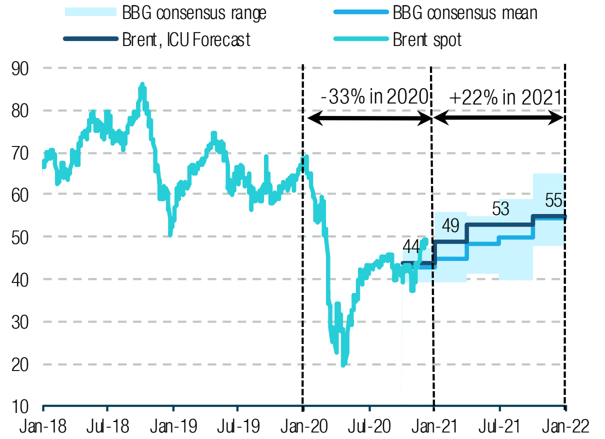
Having suffered the most from COVID-19 and the resulting drop in the population's mobility, oil, natural gas, and other energy commodities will see the fastest growth as economic activity returns to normal. Industrial metals should also benefit from the recovering global economy; however, they have already been much supported by strong China demand. As China recovery from COVID-19 is one of fastest in the world, Chinese policy makers can decide to harness further growth in financial stimulus. This may become the main headwind for industrial metal prices next year.

Oil: The physical market should remain weak in 4Q20 and 1H21 because of COVID-19. However, financial markets backed by plenty of liquidity and vaccine optimism will support the Brent price in the $45–50/bbl range in 4Q20, with gradual growth towards $55 in 1H21 and a high risk of growth to $60 levels in 2H21. On average, oil prices will grow 22% in 2021.

European Natural gas: Prices will be supported by economic recovery in 2021; however, likely strong supply will limit their growth. Nevertheless, due to the low 2020 base, the average 2021 price will grow 42%.

Chart 6. Oil prices (US$/bbl)

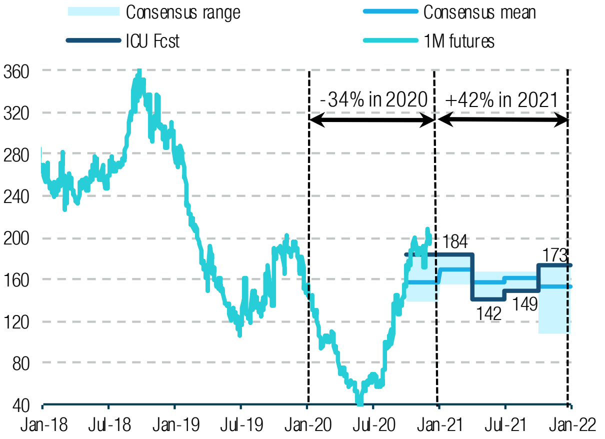
Oil prices will continue to grow in 2021 as demand recovers



Source: Bloomberg, Refinitiv, ICU.

Chart 7. Natural gas prices in Europe (US$/tcm)

Gas prices will be supported by rising oil prices



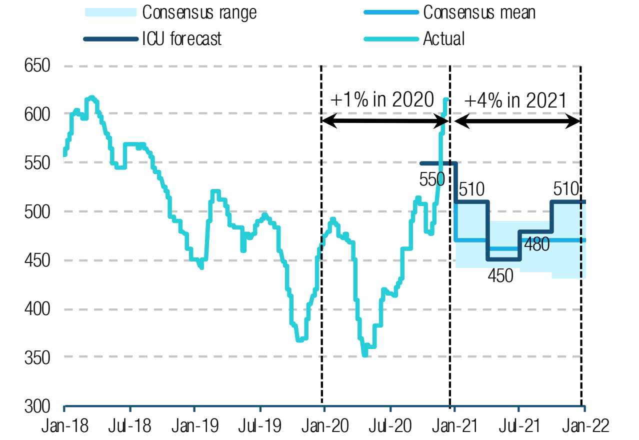
Source: Bloomberg, Refinitiv, ICU.

Iron ore: Strong industrial and investment demand for iron ore in China should cause a rapid 14% growth in its prices in 2020. However, as China stimulus is expected to slow down, while seaborne supply of iron ore will continue to grow, iron ore prices should see a 5% decline in 2021.

European and MENA steel: Recovery in steel consumption in these two regions is likely to remain bumpy. Decline in iron ore prices will further limit rebound in steel prices to 4% in 2021.

Chart 8. Steel HRC price in Black Sea region (US$/t)

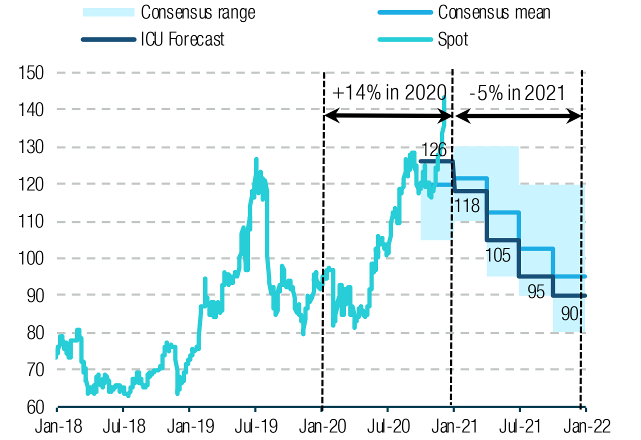
Recovery in steel prices in the region will be limited by the weak EU market and declining iron ore prices



Source: Bloomberg, Refinitiv, ICU.

Chart 9. Benchmark iron ore prices (US$/t)

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



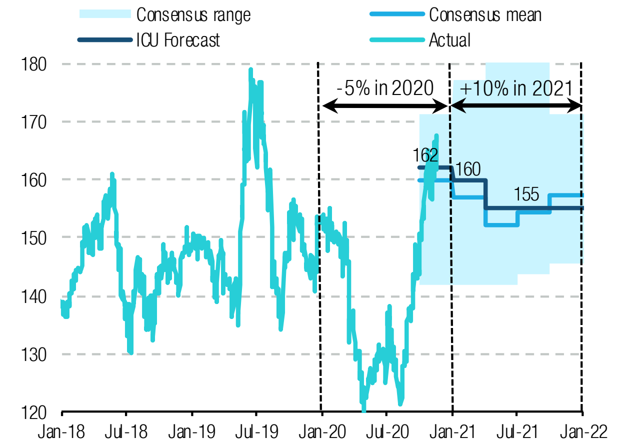
Source: Bloomberg, Refinitiv, ICU.

Corn: Prices will be supported by strong China demand, recovery in oil prices, lower 2020/21 production, and tighter US stocks. As a result, corn prices may rise on average by 10% in 2021.

Wheat: The 2020/21 global wheat outlook is supported by consumption growth (globally and in China in particular), higher corn prices (as this could increase demand for wheat in feed) and reduced stocks. At the same time, stronger supply may lead to broadly flat prices for wheat in 2021.

Chart 10. Corn prices (US$/t)

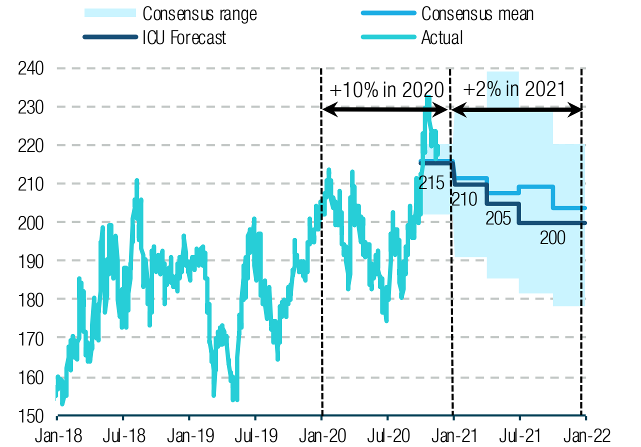
Corn prices should remain elevated in 2021, supported by higher oil prices, China demand, and lower 2020/21 production



Source: Bloomberg, Refinitiv, ICU.

Chart 11. Wheat prices (US$/t)

Wheat prices should moderately decline due to high stocks and ample supply, however will remain broadly flat in YoY terms in 2021



Source: Bloomberg, Refinitiv, ICU.

Emerging markets will see more capital inflows

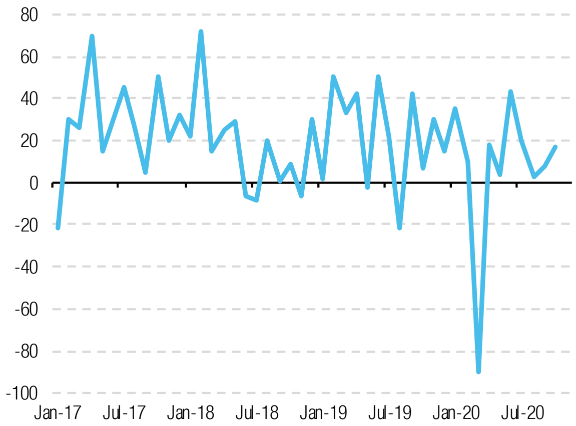
1H21 may become most favourable for EM to attract foreign capital

Effective vaccines, a less tariff-prone US administration, growing commodity prices, and a weakening USD will generally play in favour of EMs. At the same time, wide differences in access to vaccine distribution, debt profile, and economy structure make EMs' recovery very uneven.

Strong monetary and fiscal stimulus in the US and other AEs should boost liquidity in financial markets and support the hunt for yields and risk-on sentiment. After almost US$50bn of foreign portfolio outflows from EM equities and debt in 1H20, there is still scope for further growth in positioning in EMs in 2021. This will cause further tightening in EM sovereign spreads. With this regard, 1H21 may become most favourable for EMs, as global liquidity is likely to reach its peak during that period.

Chart 12. Portfolio flows to EMs

Foreign capital should accelerate return to EMs in 2021



Source: Haver Analytics, Citigroup, ICU.

Chart 13. JP Morgan EMBI Global Spread over US(bps)

EM sovereign spreads will continue tightening in 2021

Source: Bloomberg, Refinitiv, ICU.

Economic policy: Struggle continues

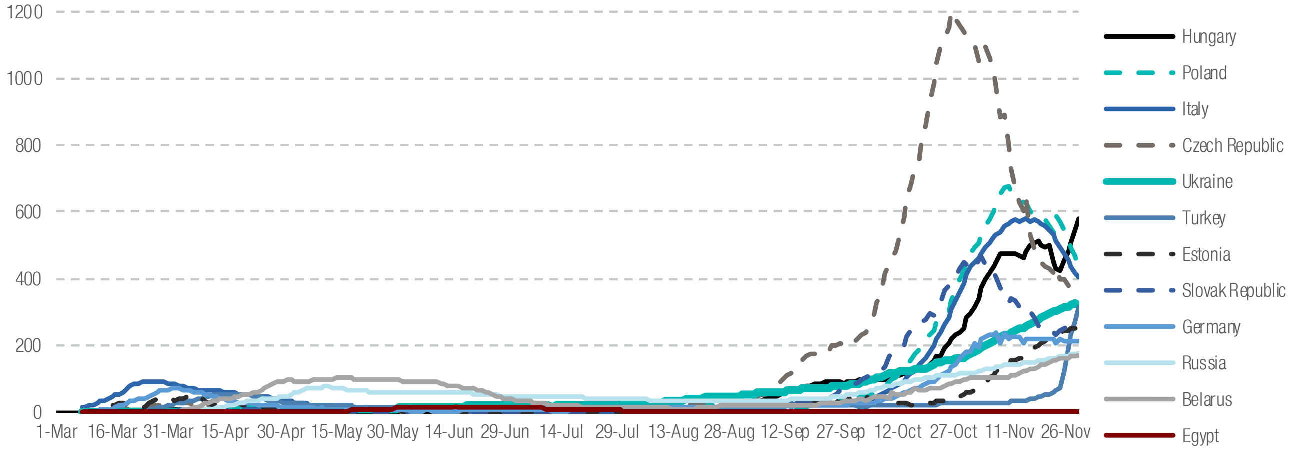
- **COVID-19 strikes again calling for lockdowns**
- **Constitutional Court decisions highlight risks for reforms agenda**
- **IMF financing available no earlier than next year**

The new outbreak of COVID-19 cases and deaths strongly exceeds the first wave

The first wave of COVID-19 brought very low infection cases in Ukraine compared with peers thanks to one of the toughest lockdowns globally last spring. However, this led to the removal of tight restrictions in the summer and a low level of compliance with the rules of social distancing. As a result, COVID-19 cases started to grow rapidly in July, and this trend has continued through to the present. Although in terms of the number of cases and deaths, Ukraine is still significantly behind its neighbouring European countries. But in October–November, the healthcare system started to signal it is approaching critical limits.

Chart 14. The number of new COVID-19 cases (per 100k persons), 7d ma

The second wave in Europe is much stronger in the number of COVID-19 cases than the first. Ukraine is among the middle peasants.



Source: University of Oxford, ICU

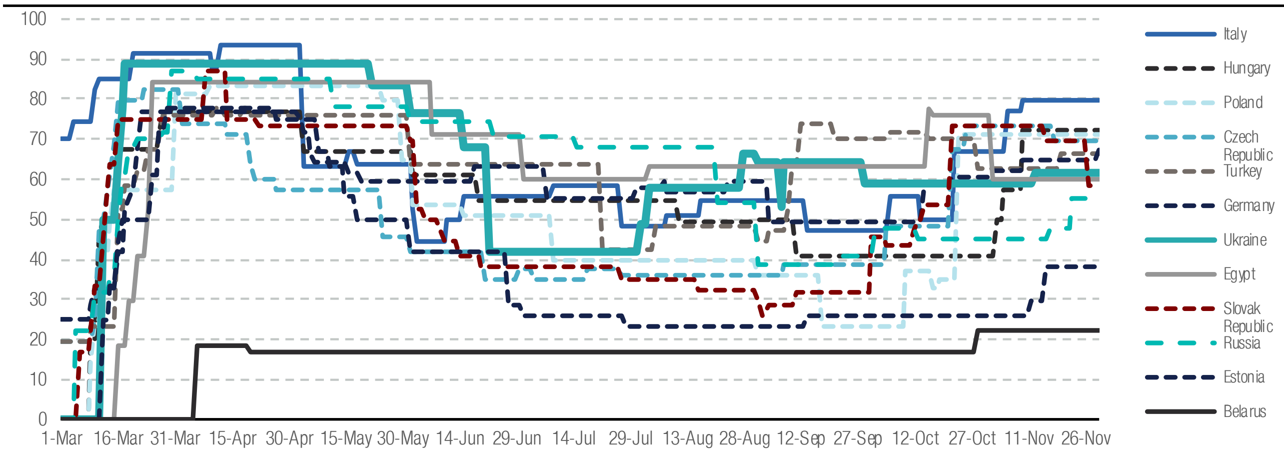
Lockdown: The first one was adaptive, then came a weekend quarantine ... What is next?

The government continues to look for ways to contain the spread of coronavirus while trying to avoid significant losses for the economy and social unrest. Under adaptive quarantine, some restrictions at the regional level were tightened in late July, but their negative impact on the economy was negligible other than for some idiosyncratic issues. For instance, from 29 August to 29 September, the authorities effectively closed the borders to foreigners, provoking outrage from businesses. As a result, since October, foreigners have been allowed to enter Ukraine, subject to testing and self-isolation. In addition, central government intentions to tighten restrictions at the regional level faced significant opposition from local authorities who faced elections on 25 October.

As a result, only on 14 November did the government manage to tighten restrictions noticeably by imposing weekend lockdowns. This approach only marginally hurt economic activity, although the losses sustained by restaurants and shopping malls were significant. However, the ability of a weekend lockdown to curb the spread of coronavirus was quite questionable and the government canceled it at the beginning of December. Meanwhile, it is likely that the government will be forced to impose harsher restrictions again given the increase in the COVID-19 cases and the approaching limits of the healthcare system. We expect these in early January. The exact measures are still being discussed, but it seems that the authorities will be forced to reinstate most of the measures applied in the spring with SMEs in hospitality, transport, culture, and sports suffering the most.

Chart 15. COVID-19 government response/stringency indexes in selected countries

As in other countries, the Ukrainian government is trying to balance the impact of quarantine restrictions on the economy and the spread of coronavirus



Source: University of Oxford, ICU

We anticipate the start of vaccinations in mid-2021

We anticipate that tough restrictions will persist until next spring, when seasonal factors become an important deterrent to the spread of coronavirus. Then, we expect that the most vulnerable people will be vaccinated, and this will be key in curbing the pandemic in 2H21. However, as we wrote earlier, social distancing will persist for several years, as well as its impact on the behaviour of economic agents and potential output.

The support of business is limited by the lack of financial resources, primarily due to the pause in obtaining official funding

Simultaneously, the authorities are discussing mechanisms to support SMEs during the lockdown. As they did during the first wave, they are likely to provide tax breaks for the lockdown period—in particular, the cancellation or reduction of property and land taxes, and contributions to social insurance funds—and unemployment support programs, in particular furlough schemes, which combined amounted to c.0.5% of annual GDP during the first wave. Greater support is restricted by the complexity of administration and the lack of financial resources. The latter issue has been exacerbated by delays in receiving official financing and limited capacity for borrowing in the market (for details, see the section "Public Finance").

In our June Macro Review, based on Ukraine's previous IMF programmes, we correctly predicted that the first tranche under the new SBA most likely would be the only one this year. Although the new commitments of the authorities under this programme were rather easy, the program also relied on the preservation of previous achievements. Unfortunately, this has not happened in a number of areas. In particular, the issues around NBU independence, anti-corruption bodies, and corporate governance have been a persistent concern to Western partners. The state budget was added to this list in the fall, as the parameters of the first draft submitted by the government and approved by the parliament exceeded programme limits. However, the greatest concern was caused by the decisions of the Constitutional Court to abolish criminal responsibilities for false declarations and NABU activities.

Obtaining the IMF tranche in 1H21 is difficult, but possible

The authorities' response has been quite encouraging; with both the President and parliament making strong efforts to resolve the Constitutional Court issues and restore access to official funding. After all, in addition to the IMF tranches, Ukraine lost funds planned for this year from the World Bank, which significantly limits the state financial capabilities. Definitely, rectifying the situation can be a lengthy process, especially given the weakening position of the pro-presidential mono-majority in parliament following the disappointing results of local elections in late October. However, we hope that the authorities will be able to consolidate their efforts to ensure funding from the IMF and other official creditors in 1H21.

Public finances: Over-ambitious plans

- **The deficit of available funds and related weak execution of expenditures determine lower budget deficit in 2020**
- **Borrowings from shallow local market are not able to completely replace planned, but not fully disbursed official financing**
- **Plan for financing fiscal deficit in 2021 is too ambitious again, with elevated risks on market borrowings domestically and globally as well as from official funding**

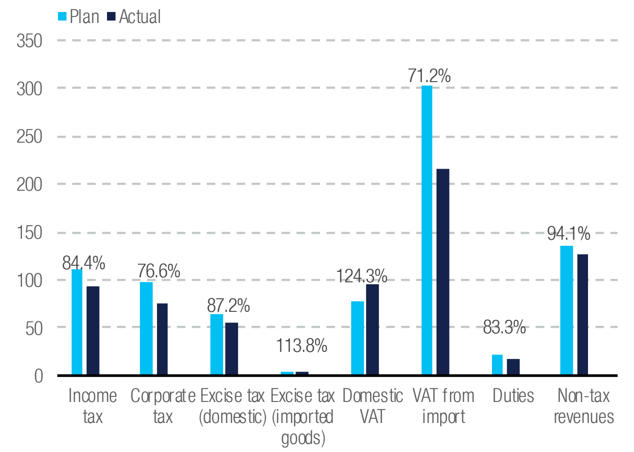
Hidden sequester of 2020 budget

In general, budget revenues are in line with April plan

Budget revenues are very close to the budget plan, having been revised in April due to the COVID-19 pandemic and lockdown. The MoF reported that in 11M20, the budget received UAH806bn of planned revenues for this year. This is about 94% of the annual plan. As the Ministry will publish a detailed report for 11M20 at the end of the year, we rely mostly on the previous report for 10M20 to draw conclusions on specific revenues and expenditures performance. We see a positive dynamic in domestic VAT, excise tax, income tax, and corporate tax as the economy rebounds rather well and some improvement in tax collection is observed. But there was underperformance in collection of VAT from imported goods and export duties as recovery of imports lags and the UAH remains stronger than envisaged in the budget plan.

Chart 16. State budget revenues in 10M20 (UAHbn)

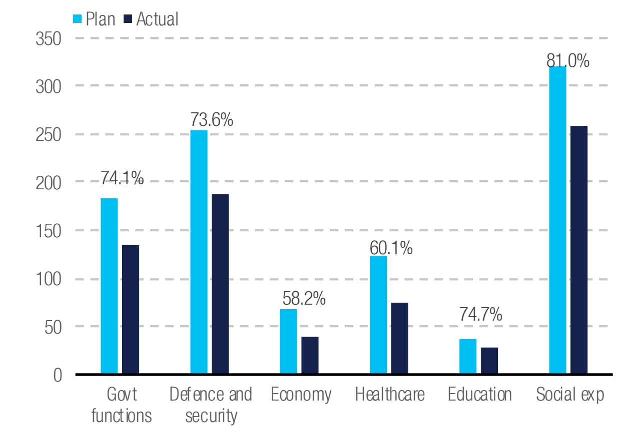
General budget fund revenues collected and yearly plan performance



Source: Treasury, MFU, ICU.

Chart 17. State budget expenditures in 10M20 (UAHbn)

General budget fund expenditures made and yearly plan performance



Source: Treasury, MFU, ICU.

Execution of expenditures suffers, mainly due to the lack of expected financing

Meanwhile, execution of expenditures was much weaker during 11M20; they amounted to UAH941bn or only 90% of the plan for 11M20, and 83% of the annual plan. Thus, the government has not executed more than UAH100bn of expenditures compared with plan. There are several reasons for this. Debt service costs were lower due to the stronger exchange rate and lower external borrowings. In addition, some agencies were not able to perform planned activities and correspondingly, utilize allocated funds. Meanwhile, the underlying reason for underperformance of expenditures has been the lack of available financial resources due to lower amounts of official funding and market borrowings compared with plan. In 10M20, the greatest shortfall in expenditures remained capital expenditures, especially related to ecology, economic activities, and healthcare.

2020 budget deficit expected to reach c.5% of GDP

As a result, the budget deficit was rather small amounting to UAH117bn for 11M20, and UAH163bn (4.1% of GDP) for the last 12 months. In December, we expect expenditures to boom as usual, but the resulting budget deficit for 2020 will be just UAH200bn or 5% of GDP, which is only two thirds of plan.

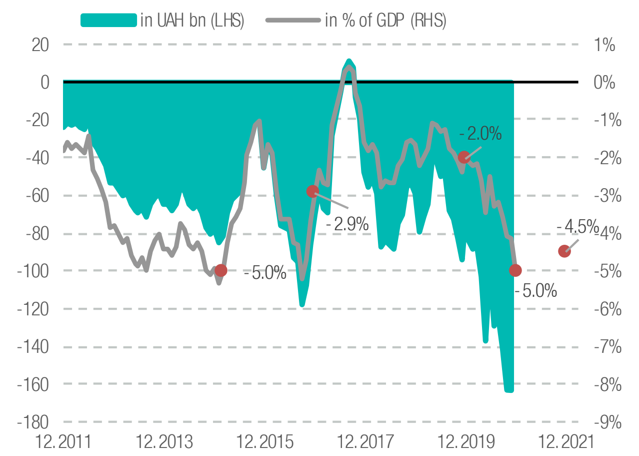
Budget 2021: Unrealistic financing again?

Government plans 2021 budget with deficit of 5.5% of GDP

At the end of November, the government approved and submitted to parliament the revised draft budget for 2021. Its parameters were adjusted and approved by the IMF according to the MoF communication. The deficit was revised downwards to 5.5% of GDP from 6.0% in the initial draft budget mainly due to raising revenues by UAH21bn to UAH1,092bn. We assess the risks of collecting these revenues as rather moderate. In particular, it has become a matter of course for the government to compile a draft budget based on a macroeconomic forecast with inflated nominal indicators, including the nominal GDP that is higher than the average projections by other organizations. Also, once again, the transfer of NBU funds (UAH33bn) is set higher than estimates submitted by the NBU (UAH21bn).

Chart 18. Budget balance (12m trailing)

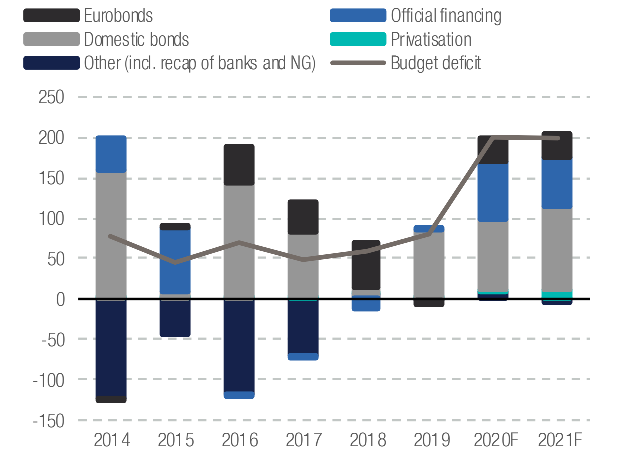
Budget deficit grows due to pandemic, but not so dramatically as predicted



Source: Treasury, MFU, Ukrstat, ICU.

Chart 19. Budget deficit financing sources, net (UAHbn)

In 2021, official and domestic sources cover the lion share of the deficit again



Source: Treasury, MFU, ICU.

But we see a lower deficit, 4.5% of GDP, as financing will be insufficient again

However, already traditionally high risks are related to the sources for financing the deficit, and hence, the execution of budget expenditures. Most likely, the government will not be able to fully obtain the funding it is counting on, namely UAH12bn from privatization, UAH128bn from net borrowings in the domestic market, and UAH106bn of net external borrowings. Accounting for large repayments of domestic and foreign debt in 2021, receiving the required amounts under acceptable terms even assuming the restart of the IMF programme and generous global financial conditions has quite low probability. Thus, we expect that net borrowings will be c.UAH45bn (1% of GDP) lower than envisaged in the draft budget.

As a result, as in previous years, and especially in 2020, expenditures will be lower than planned. Therefore, it is likely that the budget deficit will be smaller in 2021 than set in the draft budget. In our assessment, the actual budget deficit will amount to c.4.5% of GDP.

Pause with IMF moves official financing to 2021

Government borrows a record c.UAH100bn (net), still below the ambitious plan due to the lack of IMF funding

After concluding the new SBA programme with the IMF, the MoF successfully used the window of opportunity and issued Eurobonds maturing in 2033, which amounted to US$2bn at a 7.253% yield, partially using the receipts for the switch of Eurobonds due 2021 and 2022. Positive market sentiment, supported by these news, allowed MoF to repurchase of c.10% of VRIs.

However, due to problems with cooperating with the IMF, the next tranches from the Fund were frozen (c.US$1.4bn), along with prospective loans from the World Bank (US$0.7bn). Moreover, Ukraine was almost effectively cut off from international capital markets.

Only in December did warming relations with the IMF allow the government to receive EUR0.6bn as macro financial assistance from the EU. In addition, due to more benign financial conditions, the government successfully made an additional $600m placement of 2033 Eurobonds in order to accumulate the funds for end-year expenditures. In the end, net external financing (both official and market) amounted to est.UAH100bn in 2020, the highest level historically. Nonetheless, these figures were considerably off plan, as the second review of the Stand-by Programme from the IMF was postponed and the loan from the World Bank was also frozen until the IMF decision at least.

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	**11.9**	**10.2**	**Government FX debt payments**	**11.3**	**8.9**
IMF	2.1	1.5	IMF	0.5	0.5
Eurobonds	3.1	3.0	Other IFIs	1.3	0.6
WB aid	0.5	1.0	Eurobonds	1.7	1.0
EU aid	1.4	0.7	US-backed Eurobonds	1.0	1.0
Domestic FX bonds	4.5	4.0	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	4.0
			Hard currency sold to the NBU	**0.9**	**1.3**
Expected Government FX accounts YE	**0.5**	**0.5**			

Source: MFU, ICU.

As the IMF programme gets back on track, we expect that major undisbursed official financing will be received in 2021. Namely, we assume that c.US$3bn can be provided by the IMF, WB, EBRD, and EU. In addition, US$3bn can be borrowed from commercial sources. That will allow the government not only to smoothly meet the period of large external debt repayments that peak in September, but also to use the FX funds it receives for covering domestic payments.

Domestic market: Higher need pushes yields up

In 2020, the MoF receives half of budget financing from local market, even as foreigners continue to exit

The domestic market provided the MoF with UAH269bn of financing during 11M20 or 71% of the plan for the year. The year started with large demand from foreigners, but with the COVID-19 pandemic, they started to withdraw funds from UAH-denominated bonds. From the peak in February of UAH128bn (US$5.3bn at market exchange rate), foreigners' portfolios fell to UAH76bn (US$2.6bn) at the end of November. Their bonds were partially redeemed and some bonds were sold to locals.

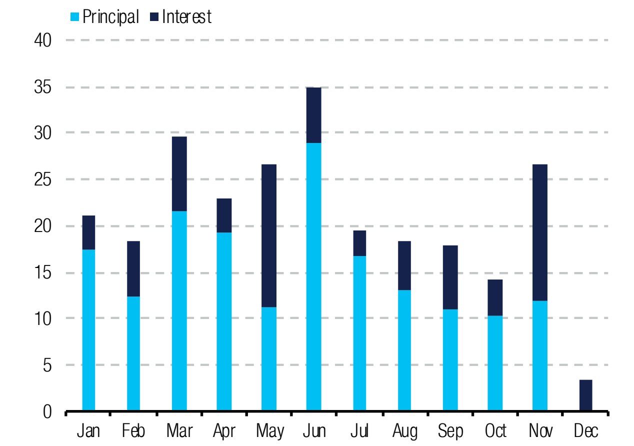
Meanwhile, local banks increased portfolios by UAH140bn (US$5bn), and they became the largest bondholders with 51% in total outstanding. Abundant banking sector liquidity, the NBU lowering interest rates, and the ability to receive NBU refinancing loans at the key policy rate fuelled demand for local bonds (see more details in Monetary Conditions chapter), as since the end of August, the Ministry of Finance started to gradually increase rates for all bills.

In 2020, the MoF receives a half of budget financing from the local market, even when foreigners continue to exit

In November, all rates in the primary market jumped to double-digit levels as the MoF struggled to fill its coffer in advance of December expenditures. Sizable financial needs and the lack of demand from foreign investors resulted in a high premium to the NBU key policy rate. At the beginning of December, this premium was from 400bps for three-month bills and up to 570bps for instruments with 3.5-year maturity.

Chart 20. UAH-denominated debt repayments in 2021 (UAHbn)

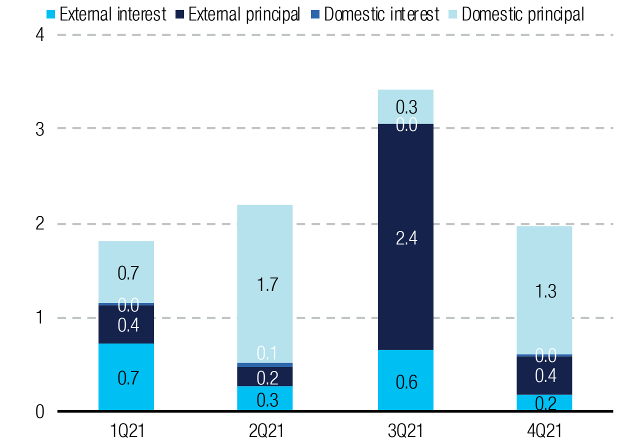
Principal and interest repayments denominated in local currency as of 16 December, 2020



Source: Treasury, MFU, ICU.

Chart 21. FX-denominated debt repayments in 2021 (US$bn)

Domestic and external debt principal and interest repayments in hard currencies as of 16 December, 2020



Source: Treasury, MFU, ICU.

In 2021, the MoF will again struggle with sizable financial needs at local market

In 2021, taking into account sizable debt redemptions, we estimate that the MoF will issue c.UAH350bn of UAH-denominated bonds compared with est. UAH320bn the government was able to issue this year. That is quite an ambitious target, but still lower than envisaged in the draft budget.

Moreover, to borrow this amount next year, the government has to find out how to incentivise banks to purchase larger amounts of bonds and to make them more attractive to foreigners.

Most important will be demand from foreigners. In the global low-yield environment, the current interest rate provides them with a quite attractive risk-reward ratio, especially taking into account declining expectations for depreciation of the UAH. Thus, we expect that next year foreigners will increase their exposure to UAH government debt, but in volumes much lower than in 2019.

Bond yields climbing

All this will offset the impact from sizable financial needs of the government and keep the spread between yields and the NBU's key policy rate relatively steady or even narrowing. Thus, we expect that rates for bills with one-year maturity will fluctuate in the range of 11–12% during 2021. Meanwhile, the term premium will remain elevated, and we project a larger increase in yields for the two-year and the most likely for longer paper, into the range of 12–13% by the end of 2021.

Monetary conditions: Banks increase public sector exposure

- **Sluggish demand will lead to delayed interest rate hike as inflationary pressures are growing relatively slowly**
- **Banks have increased their holdings of UAH government bonds by +46% in 11M20, as loans from NBU soared; however, state enterprises have not increased borrowing**
- **Robust growth of incomes amid worsening consumer sentiment pushed households to accumulate an extra UAH25–30bn in their UAH current accounts ready to be spent should confidence return**

Monetary boost for economy is noticeable, but far from excessive

We expect 100 bps rate increase in 2021

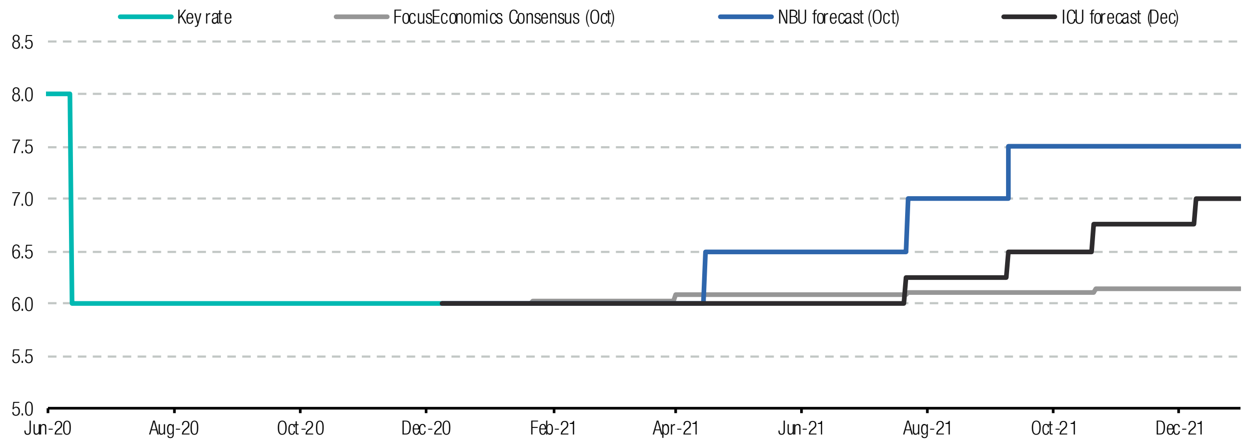
Inflationary pressures are growing slowly. Aggregate demand remains suppressed and is expected to be in 4Q20 and 1Q21 weaker than anticipated earlier due to the deteriorating situation with the COVID-19 pandemic. In addition, the global low-inflation environment and some strengthening of the hryvnia exchange rate due to improved external accounts will be important headwinds for inflation. In addition, world interest rates will remain low at least through next year. And finally, the resumption of official funding will reduce medium-term risks to external sustainability and financial stability.

Therefore, the NBU is very likely to postpone the first interest rate hike in the new cycle until July 2021. Moreover, should Ukraine lag behind in post-pandemic recovery with slowed economic activity, the regulator may give the economy another boost through 2021.

Assuming consumer demand will recover upon a significantly improved situation with the pandemic in spring and summer, and inflation approaches the upper limit of its target range of 6%, we expect a 100bps increase in the key rate in 2H21, reaching 7.0% by the end of the year. Factoring in higher inflation, on average, the real rate will be lower than in 2020.

Chart 22. Key policy rate forecast

We expect the NBU to start increasing the key policy rate not earlier than in 2H21

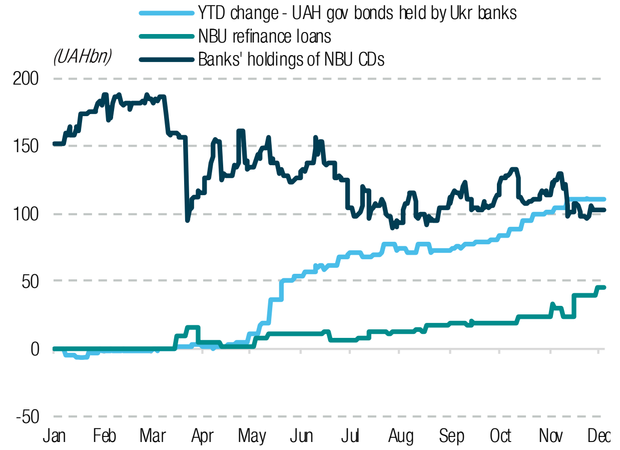


Source: NBU, FOCUSECONOMICS, ICU

Moreover, we do not expect further expanding of the spread between the key rate, representing the price of funding from the regulator, and market yields of the government bonds in UAH. The current spread is already attractive enough for banks, including those that are private, to increase their portfolios of UAH bonds.

Chart 23. Increase in UAH gov bonds holdings by the banks in 2020

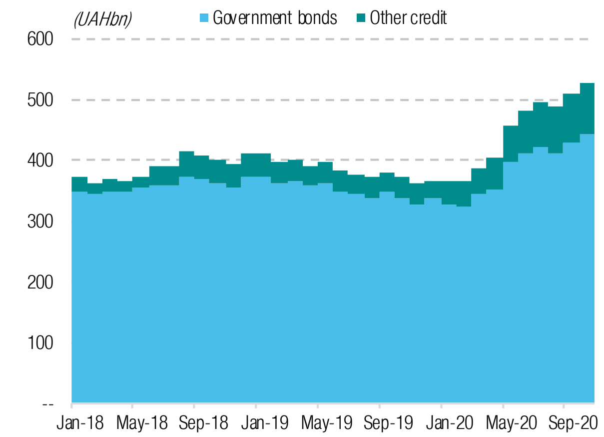
Lower NBU rates made banks to switch their CDs liquidity for bonds



Source: NBU, ICU.

Chart 24 Banks exposure to the public sector

Banks increased their holdings of government and quasi-government bonds



Source: NBU, ICU.

Ukrainian banks have increased their UAH government bond portfolios by UAH111bn (+46%) in 11M20. A rapid lowering of the NBU interest rate—from 13.5% at the beginning of the year to 6% in June—was one of the reasons why banks decreased their position in NBU CDs by UAH48bn (-32%) in 11M20. The interest rate on NBU CDs is derived from the key policy rate and banks saw an opportunity in 2H20 to reduce their positions in those instruments in favour of government bonds that offered higher yields. However, there is no room for another rapid cut of the key rate, therefore, banks are unlikely to further replace their liquidity stored in CDs with government bonds in significant amounts. Unless, of course, there will be a noticeable increase in bank liquidity from cash in circulation returning into the banking system.

NBU refinancing (tender) stock was practically zero at the beginning of the year. It increased to UAH45bn as of 2 December as the cost of such loans fell drastically in line with the key policy rate and the regulator started to offer loans up to five years in addition to short-term lending with the typical maturity of up to 90 days.

State owned banks have not increased lending to SOE but might do so in 2021

Banks have hesitated to increase lending to state-owned enterprises (SOE). Gross loans to SOEs fell by 19.2% YoY in October 2020, as the result of the sharp (-42.5% YoY) reduction of local-currency portfolios. The government as the owner of state banks is not employing this channel to give a boost to the economy as it did a decade ago with a massive increase of such lending (2% of GDP). Currently, gross loans to SOEs stand at just 1.6% of GDP. There is a god possibility we can see increase of loans to SOE by government owned banks in 2021.

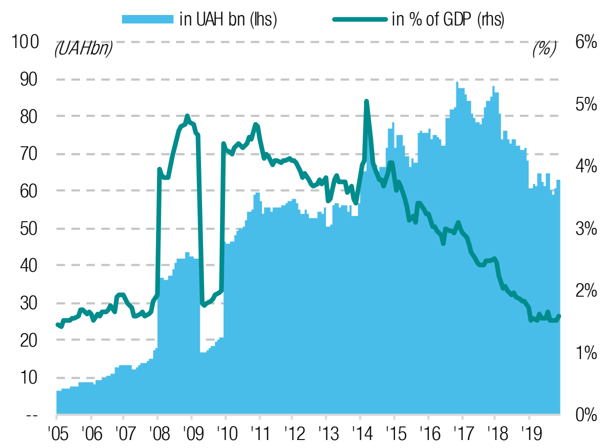
On the other hand, banks have increased their gross exposure to the central government by UAH161bn (4.1% of GDP) in 10M20. This figure includes a UAH108bn increase in government bonds and other exposures such as UAH17bn bonds issued by Ukravtodor, a state road agency.

Banks rely more on retail sector as source of income

Ukrainian banks are evermore relying on the retail sector as the key segment to generate revenue. Retail loans generated more interest income (35% of the total) in September than corporate loans (34%). Gross loans to business are four times higher than retail loans, but have a much higher NPL ratio (49.0% and 30.7%, respectively), while the average interest is significantly lower (6.4% and 27.1%, respectively).

Chart 25. Loans to state owned enterprises by Ukrainian banks

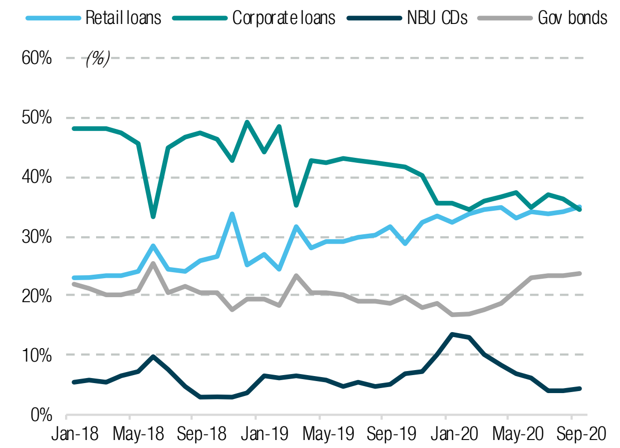
Unlike 2008-2010, banks decrease loans to SOE



Source: NBU, ICU.

Chart 26. Shares of interest income earned by segment

Retail sector overtook corporate as the key earner of interest income



Source: NBU, ICU.

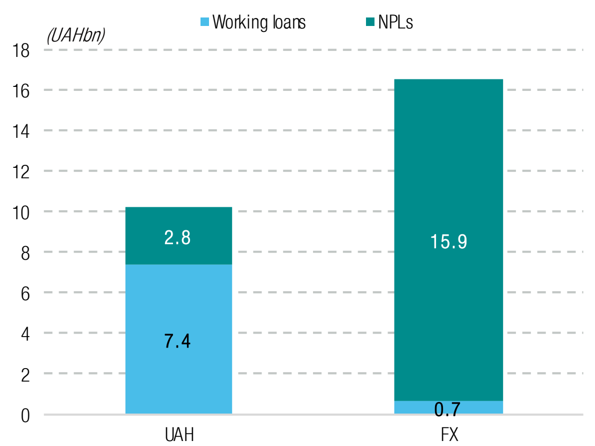
Just two years ago, banks were earning 47% of their interest income from corporate loans and only 26% from the retail segment. However, nearly stagnant corporate lending and the boom in consumer lending, slowed only by COVID-19, has equalled the two in terms of interest income. In 2Q21, the regulator will impose a higher risk coefficient requiring 50% more regulatory capital against consumer loans issued in order to slow consumer lending before it becomes unsustainable.

Mortgage loans have picked up but still tiny

Banks have been issuing c.UAH400m of new mortgage loans every month in 3Q20 compared with less than UAH250m in 3Q19. The average loan size of UAH0.7m, up from UAH0.5m a year ago, translates into 600 new loans per month vs. 490 a year ago. This number is still far from sufficient to spur significant growth in the sector or have a noticeable impact on economic growth. Yet banks report falling interest rates in the segment of secondary market of already built and exploited housing where risks are usually lower.

Chart 27. Mortgage loans on banks' balance sheets as of 1 Nov 2

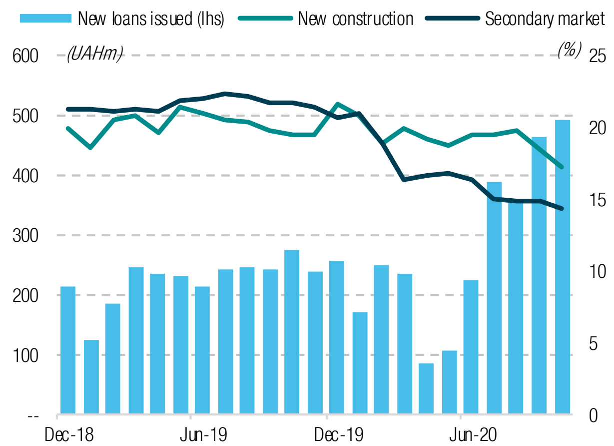
Banks are slowly accumulating mortgages portfolio in local currency



Source: NBU, ICU.

Chart 28. New mortgage loans issued and interest rates

Banks have increased new lending while the interest rates are falling



Source: NBU, ICU.

The government is planning yet another programme aimed to promote mortgages and make them cheaper in terms of interest rates. Likewise, as with the 5-7-9 programme, this one will give a boost to mortgages, a segment that has been nearly dead for more than a decade now. UAH1bn of new loans per month might be good achievement at the end of 2021, but more significant levels of new lending is a more distant prospect.

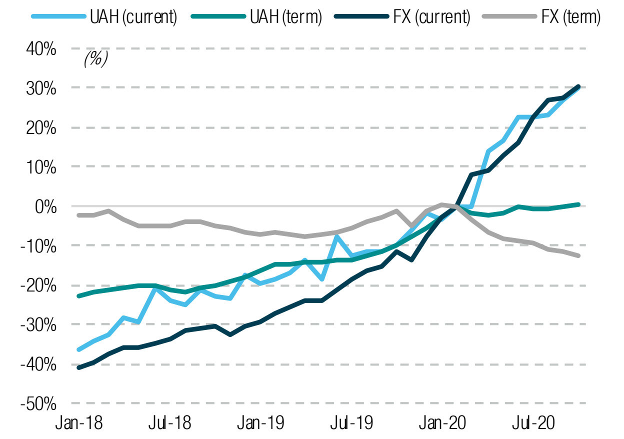
Despite a strong rebound in retail sales indicating a corresponding amount spending by consumers since the summer, retail deposits continued to grow at a fast pace. Of course, the pandemic has made a lot of ordinary spending, especially abroad, unavailable or excessively inconvenient. And consumer sentiment, especially in regard to future income, continues to deteriorate. Thus, consumers are behaving more cautiously and retain more savings in their bank accounts, primarily in their current accounts.

The Ukrainian banking system saw a 27.7% YoY increase in retail deposits (net of FX effect) in October 2020. The pace of growth has increased dramatically since February 2020, the last month before COVID-19 affected the economy.

The main growth comes from current accounts in UAH that grew by 30% in eight months since February while term deposits remained intact (+0.4%). The total outstanding amount of household current accounts in local currency has reached UAH223bn or a record high of 5.7% of GDP. Should consumer sentiment improve and households decide to spend the extra financial resources they have accumulated, this could generate UAH25-30bn of additional demand both for domestic goods and imports.

Chart 29. Retail deposits, % changes to February 2020

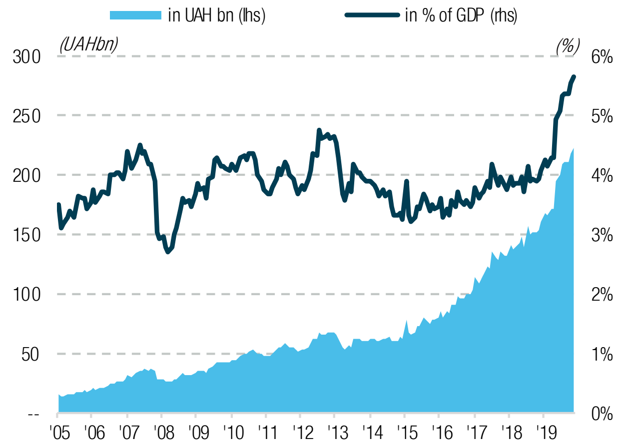
UAH retail current accounts soared since the COVID



Source: NBU, ICU.

Chart 30. Retail current accounts in UAH

Households keep the record amount in their UAH current accounts ready to spend



Source: NBU, ICU.

Economy: Bumpy, but with promise

- **Strong rebound in 3Q20, but short-term outlook suffers from COVID-19 outbreak**
- **Vaccine news supports our optimistic view on recovery next year**
- **Consumption booms amid robust income growth while sentiment worsens**
- **Private investment lags despite positive views on vaccine effects**

Strong rebound in 3Q20, but near-term outlook bumpy

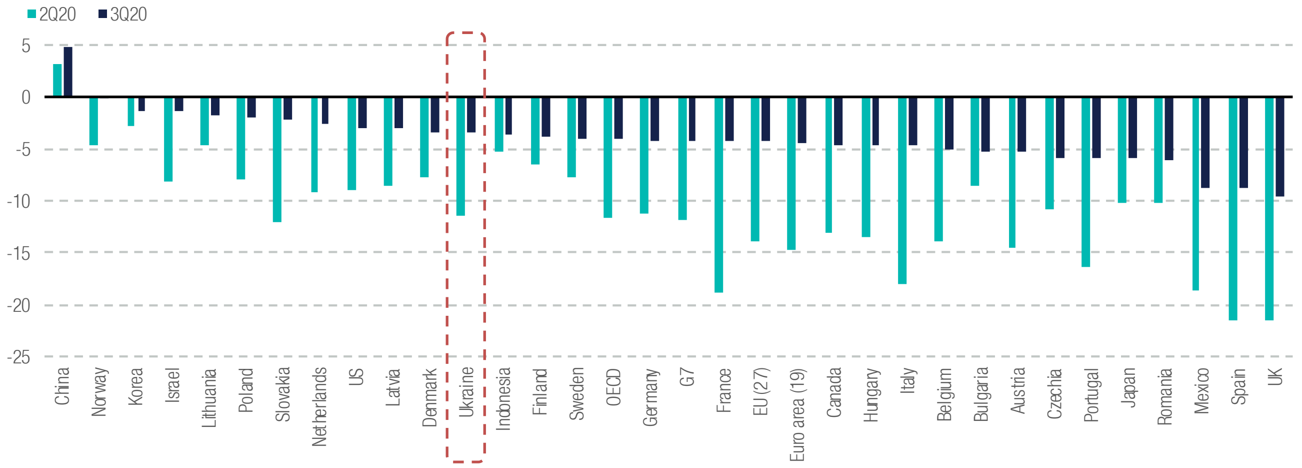
In 3Q20, SA real GDP recovers 72% of losses from 1-2Q20 thanks to lifting containment measures

Flash estimates released by Ukrstat showed a strong 8.5% QoQ SA rebound in Ukraine's GDP in 3Q20 after a plunge of 9.9% QoQ SA in 2Q20. That still left output 3.5% lower than a year ago while improving the figure from -11.4% YoY in 2Q20. The upturn was stronger than expected (Bloomberg consensus: -4.5% YoY; ICU: -5% YoY, NBU: -6.2% YoY), while in line with the recent Ministry of Economy estimate of 3.6% YoY.

As in most other countries around the globe, the main factor of such a sharp recovery was easing of containment measures. Moreover, Ukraine moved from one of the toughest restrictions in the world during April–May to a much looser stance in 3Q20, which determined better performance compared with many peers. Moreover, as we stressed earlier, certain features of the Ukrainian economy fitted the current crisis quite well, such as a high share of IT and agri and low share of contact services. Terms of trade improved, and macrofinancial resilience was rather strong due to the prudent monetary, banking supervision, and fiscal policies in previous years. However, during the crisis, fiscal stimulus was relatively modest and included mostly automatic stabilizers and construction spending. In addition, weak agricultural performance due to the later start of corn harvesting provided a significant negative contribution of about 1.5 p.p. in the 3Q20 GDP growth outcome.

Chart 31. Real GDP (YoY, %)

Ukraine outperformed many peers in 3Q20 GDP recovery



Source: OECD, Ukrstat, ICU

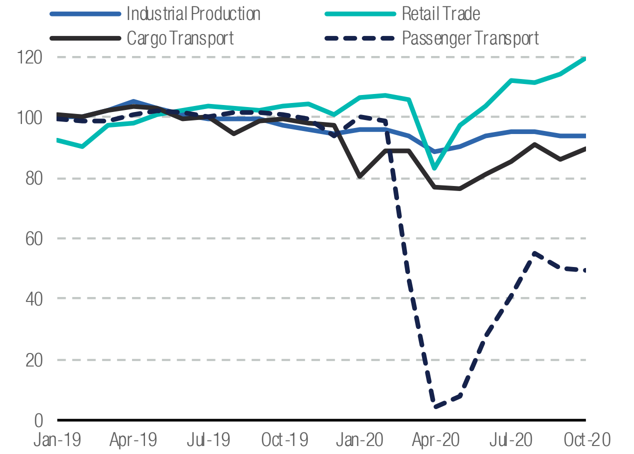
September and October data shows the loss of recovery momentum

However, the recovery lost significant momentum through the quarter. E.g., in September, SA industrial production was slightly lower than in July, and SA transport volumes fell compared with August. This trend continued in October, when in seasonally adjusted terms, industrial output decreased by 0.5% MoM and by 1.3% compared with the average level of 3Q20. As a result, the decline in industrial production deepened to 5.0% YoY from 4.6% YoY on average in 3Q20. The main culprits were plummeting output of machinery and pass-through to food production from falling agricultural output. Meanwhile, the high demand for commodities from China and the low comparison base of last year led to a significant slowdown in the decline of iron ore mining and metallurgy output to -1.5% YoY and -3.3% YoY, respectively. In October, agricultural production remained much lower than last year, by 18.3% YoY, and in 10M20, the decline deepened to 14.2% YoY. First, this was caused by low yields of major agricultural crops: cereals, sugar beets, and sunflower seeds.

Against the background of an increase in Covid-19 cases, for the second month in a row, passenger transport turnover has contracted. In October, it was less than 50% of last year's level. At the same time, cargo turnover improved slightly reaching the highest level this year, although it was 10% less than last year. This was primarily due to the growth of gas transit, which was also the highest this year, but lower by 20% YoY.

Chart 32. Output of activities, SA levels, 2019=100

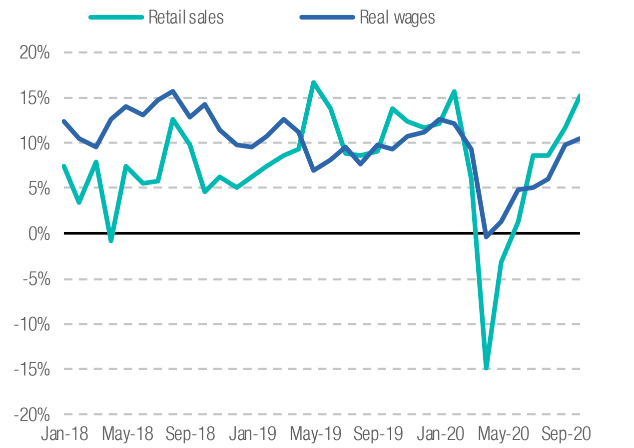
Retail sales have already returned to a pre-pandemic trajectory…



Source: Ukrstat, ICU.

Chart 33. Retail sales and real wages, % YoY

Following the rebound of real wages and other types of income



Source: Ukrstat, ICU.

COVID-19 outbreak puts a drag on further growth in 4Q20 and 1Q21

It appears that the earlier gains from re-opening the economy are fizzling out and further growth is proving much harder to come by. This trend is likely to continue over the coming months or even reverse due to tightening containment measures amid fast growing new COVID-19 cases. However, in general, the negative effects of the lockdown on the economy are to be quite moderate thanks to the adaptation of business and the population to the new conditions, the fiscal impulse at the end of the year, and improving business expectations due to news about vaccines.

Moreover, private consumption seems to continue growing fast supported by return of incomes to their pre-pandemic trajectory, and public infrastructure projects offset the weakness of private investment as evidenced by strong construction data. In addition, the monetary policy stance remains relatively loose, and we expect sizable fiscal impulse at the end of the year albeit lower than envisaged in budget law.

We upgrade our forecast for GDP decline in 2020 to -4.8%

All told, we think that Ukraine's GDP growth in sequential terms will be bumpy and much slower in 4Q20 and 1Q21 while still marginally positive. Overall, the economy is likely to contract by 4.8% in 2020 compared with 5.7% in our September forecast. While this brings GDP below the level of 2018, it would still make Ukraine a better-performing economy compared with the most of its peers.

Vaccine news supports our optimistic view on 2021

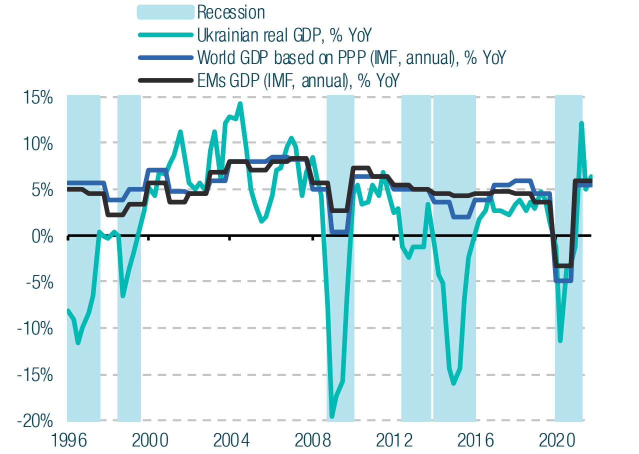
In 2021, vaccination should provide a sizable boon both via external demand and domestic activity

From 2Q21, we expect a sharp recovery of the domestic economy, which will be primarily driven by external demand against the background of improving the pandemic situation through vaccination, especially in developed countries. Also, the seasonal factor will restrain pandemic risks within the country in spring and summer, which will help to restore activity in contact services. Active vaccination from the middle of the year will allow avoidance of significant lockdown restrictions in 4Q21.

Also, unlike other countries, we do not expect significant fiscal consolidation in Ukraine. The budget deficit will not decrease rapidly in 2021, and given the reduction of the negative output gap, the structural deficit may even widen. At the same time, such a scenario is based on the assumption of the availability of reliable and cheap financing sources, in particular from official creditors. This, in turn, will allow authorities to maintain accommodative monetary conditions. In addition, we expect an additional positive effect from a boost in agricultural output against the background of a low comparison base of 2020 due to poor yields of grain, oilseeds, and sugar beets. Despite some adjustment in prices for imported energy, terms of trade will remain favourable as will financial conditions, given the appetite of investors for risk globally, and our assumption of the resumption of IMF tranches in 1H21.

Chart 34. Global and Ukrainian real GDP and crises episodes

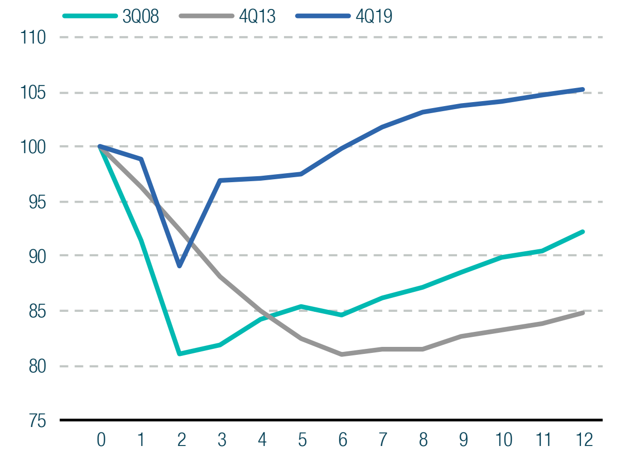
Ukrainian economy goes through current crisis relatively smoothly



Source: Ukrstat, IMF, ICU.

Chart 35. Real GDP, base quarter (in legend) = 100

In 2H21, real GDP should exceed the pre-pandemic level



Source: Ukrstat, ICU.

We still project next year GDP growth of 5.6%, above consensus

As a result, we maintain our forecast for a rapid recovery of GDP next year by 5.6%. Given the lower rate of decline this year, in 2H21, GDP will exceed the pre-pandemic level of the end of 2019. Such a fast rebound from the crisis, in contrast to previous episodes, has been determined by the expected strong recovery of the world economy, in particular China, which last year became Ukraine's main trading partner. Lower investment capital losses, financial sector resilience, and the absence of significant imbalances in the run-up to the crisis also played an important role.

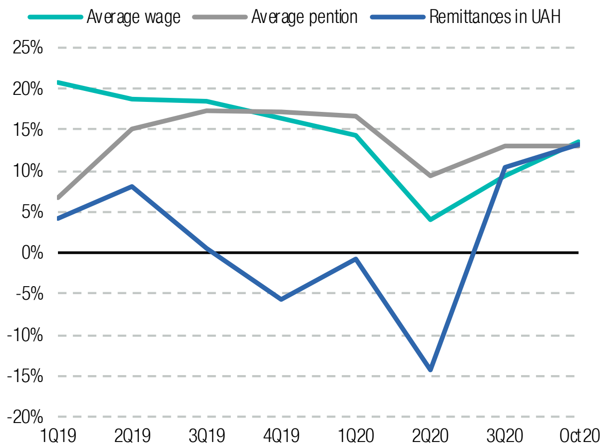
Consumption outperforms investment recovery

Robust income growth supports impressive rebound of consumer demand

Private consumption quickly recovered after the contraction in 2Q20. In October, growth of retail sales accelerated to an impressive 15% YoY compared with 9.6% YoY in 3Q20. This increase in domestic consumer demand was supported by rising incomes of households. In particular, in October, the growth rate of real wages accelerated to 10.6% YoY against the background of higher minimum wages and a boost in payments to medics. The average salary in health care was more than 1.5 times higher YoY. The growth rate of remittances from abroad (in UAH) and average pensions were in line with wage trends in the last months.

Chart 36. Household income indicators (YoY, %)

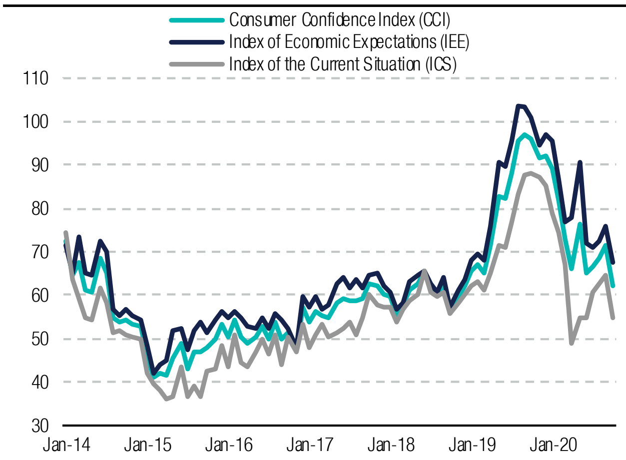
Key revenues grow 10-15% YoY in 2H20



Source: Ukrstat, ICU.

Chart 37. Consumer sentiment

Consumer confidence plummeted amid uncertainty about future revenues



Source: GfK Group, Info Sapiens, ICU.

Meanwhile, due to limited foreign tourism, the expenditures of Ukrainians abroad were much lower than in previous years. As a result, the accumulated financial resources were enough not only for stimulating retail sales, but also for increasing the financial savings as evidenced by acceleration of HH' deposits growth (see chapter on Monetary conditions).

This difference between production, especially in industry and agriculture, and consumption behaviour can be largely explained by favourable terms of trade. After all, world prices for major domestic commodities—grain, sunflower oil, sugar, iron ore and metals—remain high and have even risen in recent months. At the same time, energy prices stayed at low levels. Therefore, even despite the decline in output, the resulting additional financial resources were spent more within the country, stimulating a domestic trade boom.

While consumer demand should decelerate in coming months, private consumption is expected to grow 7% in 2021 fully compensating 1.5% contraction this year

However, in October, the consumer sentiment index, calculated by Info Sapiens, after two months of upward correction fell again to a minimum last seen in early 2019. Given the current and potential tightening of quarantine restrictions and growing social distancing, we expect consumer demand to slow in the coming months. On the other hand, a sharp increase in minimum wage, state support of individual entrepreneurs suffering from the lockdown, and loose monetary conditions should fuel consumption and restrain its slow down. Thus, we retain our forecast of a 7% growth in private consumption in 2021 after just a 1.5% drop this year (revised upward from -4.2% in our September forecast). Meanwhile, the sizable share of this increase in private consumption will be satisfied by import goods and expenses on foreign travels.

Private investments lag – we project a c.22% drop this year and only partial recovery in 2021

Private investment has been subdued since the beginning of the pandemic as evidenced by a sharp fall in capital expenditures and construction other than roads. As we highlighted previously, the recovery is constrained by the uncertainty around the pandemic outlook and growing labour costs. Moreover, recent developments around anticorruption infrastructure and the judicial system in general, as well as unsolved issues of the government with the debts to renewable energy developers, worsen the investment climate. According to a recent survey of foreign investors, only 9% consider that Ukraine became more attractive for investment. At the same time, the economy reopening, favourable terms of trade, loose financial conditions, and positive vaccine news should improve business sentiment. As a result, we still expect that gross fixed capital formation will increase c.20% in 2021 after a fall of c.22% in 2020.

Inflation: Back within target range

- **Inflation is likely to enter target range in December 2020**
- **Both headline CPI and core CPI will hover around 6% for most of 2021**
- **Winter lockdown, delay of the next round of minimum wage hike, resilient exchange rate, and prudent monetary policy should restrain more sizable upturn of inflation**

Pandemic and rich food supply keep CPI low in 2020

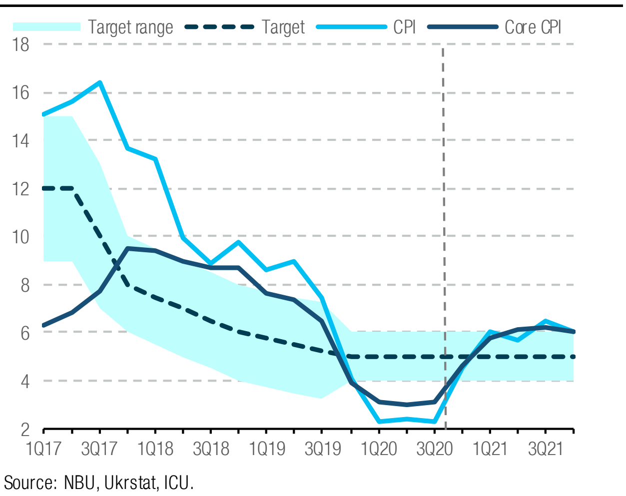
Expectedly, inflation is accelerating

Consumer inflation accelerated during the last two months to 3.8% YoY for headline CPI and to 3.9% YoY for core CPI in November. This mainly reflected the effects of the low statistical base of the previous year, while underlying inflation pressure remains moderate and even lower compared with our previous projection. Both indicators continued to undershoot NBU's target range of 5% +/- 1 pp since the beginning of the year. We expect inflation to continue to drift higher, and in December, both headline CPI and core CPI are likely to exceed the lower bound of the NBU's target range, 4%.

There are several reasons why inflation remained weak this year and the NBU has struggled with the unusual task of pushing prices up. As we've argued for a long time, despite all monetary and fiscal stimulus, the effects of the pandemic on inflation turned out strongly anti-inflationary both globally and in Ukraine (see our analytics here). In Ukraine, it was evidenced by a fall or subdued growth of prices on clothes and footwear (-6.1% YoY in November), recreation and culture (-1.1% YoY), and household furnishing and equipment (+0.4% YoY). In addition, unlike other countries where food inflation was relatively high due to inelastic demand, in Ukraine an increase in food prices was surprisingly weak, mainly thanks to vast supply of vegetables and other food products.

Chart 38. CPI and Core CPI (YoY, %)

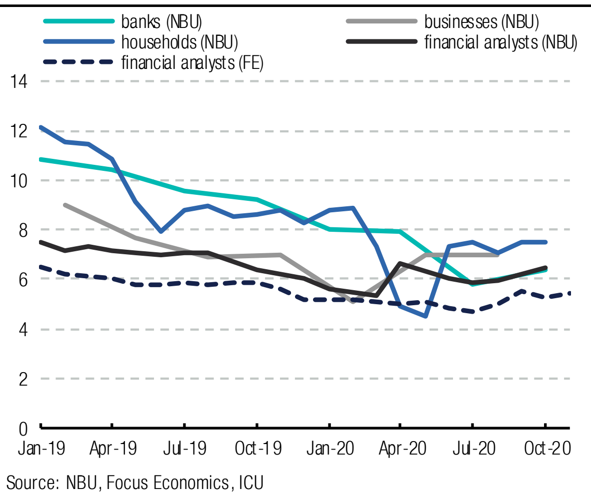
Inflation backs to the target range in December 2020 and then will be close to the upper band during 2021



Source: NBU, Ukrstat, ICU.

Chart 39. Inflation expectations (YoY, %)

Results of NBU surveys on 12m forward inflation expectations and Focus Economics survey on CPI-21 (eop) forecasts



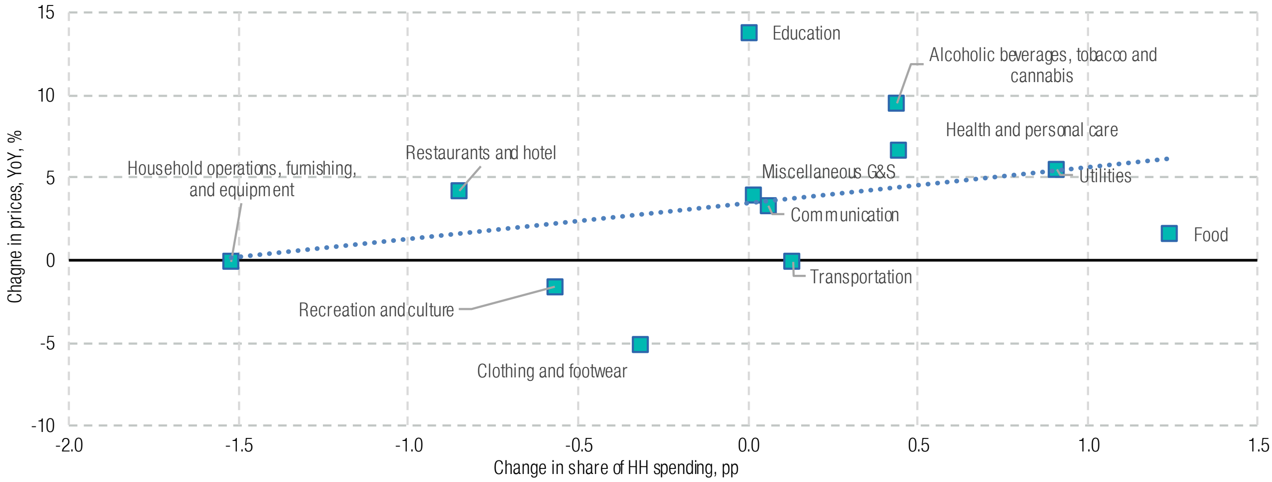
Source: NBU, Focus Economics, ICU

Official CPI data underestimate "true" inflation due to changes in spending patterns

There is also another interesting reason for low inflation related to measurement issues during periods when consumers dramatically change their spending patterns. As CPI weights are not updated accordingly, the resulting official CPI numbers underestimate the actual changes in the cost of living. For instance, households dramatically lowered their expenditures on clothes and footwear during the pandemic, but the drop in prices was accounted in the CPI calculation with the weights based on distribution of household expenditures in 2018. Using NSA data, we tried to roughly evaluate the corresponding effect comparing the spending patterns in 1H19 and 1H20 and adjusting the weights used for CPI calculations accordingly. Our findings show that the true inflation should be about 0.14 pp higher than the official CPI figure, which is slightly lower compared with average estimates of 0.23-0.32 pp that Reinsdorf (2020) received for 83 countries. The lower number for Ukraine can be attributed to an unusually low food inflation, while in 69 out of 83 countries in Reinsdorf (2020) food prices rose faster than the overall CPI. In addition, we relied on heavily aggregated data while using more disaggregated indicators may expose an even higher discrepancy between the "true" and official CPI.

Chart 40. Changes in CPI components in Oct-2020 (YoY, %) and changes in share of HH spending in 1H20 (YoY, pp)

Goods and services, which households started to consume more, saw larger prices increases



Source: State Statistics Service of Ukraine, ICU

Inflation is close to upper band of target range in 2021

Both headline CPI and core CPI will grow at an annual pace close to 6%

Inflation is likely to continue to edge higher over the coming months, and we expect it will hover around 6%, the upper bound of the target range, for the most of 2021. For this rise of inflation we factor in not only the fading effects of low MoM inflation prints at the beginning of 2020, but also a fast rebound of real wages and retail sales, a 20% minimum wage hike in January, a surge in global commodity prices including those for foods, and the ongoing upturn of energy prices along with their pass-through to domestic prices for fuel, gas and utilities.

On the other hand, there are several reasons why our current projection of inflation in 2021 is slightly lower compared with September when we expected inflation to exceed the NBU target range. First, stricter lockdown measures in 4Q20 and 1Q21 will restrain prices growth, especially for contact services and clothes and footwear. Second, we improved our estimates on the UAH exchange rate to account for more benign global financial conditions for EMs and more favorable terms of trade. Third, not disbursed official financing and limited ability to borrow domestically restrain the government from massive fiscal spending at the end of the year, at least compared with amounts envisaged by the Budget Law. Fourth, the government delayed the next round of minimum wage hike to UAH6,500 to December 2021 from July. And finally, we note the prudent stance of the NBU's monetary policy and the lower chances of strong monetary accommodation next year. The latter fact is also confirmed by relatively anchored inflation forecasts and expectations of different groups of economic agents.

External position: To stay solid

- **We reiterate expectations of strong C/A surplus of 4.3% GDP in 2020 due to the favourable terms of trade and weak internal demand for imports**
- **2020 C/A surplus should turn into a moderate 1.2% GDP deficit in 2021, as surge in imports will be only partly compensated by recovering exports**
- **F/A shows return of capital inflows, primarily thanks to recovery of public borrowings, FDI, and lower capital flight**
- **Reserves to reach US$31bn and exceed 100% of IMF ARA metric in 2021**
- **UAH so far is beating expectations and is likely to strengthen to UAH27–27.5/USD by mid-2021 and then will end 2021 within UAH27.5–28/USD**

C/A outlook remains strong

Ukraine looks now not only able to retain a high C/A surplus by the end 2020, but also finish 2021 with a relatively low C/A deficit. Strong prices for key metal and agri commodities, steady private remittances, and a relatively moderate recovery in imports look to play the key role in C/A robustness.

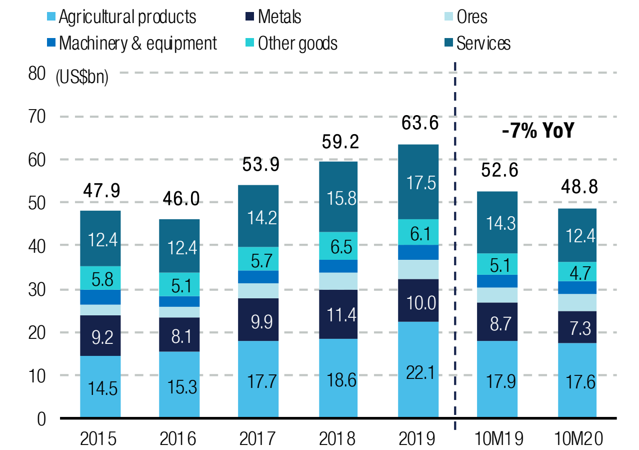
Favourable external trade, resilient private remittances and subdued internal demand determine C/A surplus of 4.3% GDP in 2020

We expect C/A surplus to reach US$6.4bn or 4.3% GDP in 2020, due to elevated prices for grains and iron ore, depressed prices for crude oil and natural gas, resilient private remittances, and overall subdued internal demand. Moreover, the weekend lockdown and sharply raising COVID-19 cases amplify the risk of an additional drop in imports and even larger 2020 C/A surplus.

In 10M20, the C/A surplus reached US$5.1bn versus the US$6.2bn deficit in 10M19, while the trade deficit amounted to just US$1bn compared with US$10bn for 10M19. Exports in 10M20 declined by 7.3% YoY, driven mostly by lower prices and sales volume of steel, as well as by depressed transportation services and travel. Meanwhile, export of IT services grew by an impressive 21% YoY and took 8.3% share in overall exports.

Chart 41. Exports (US$bn)

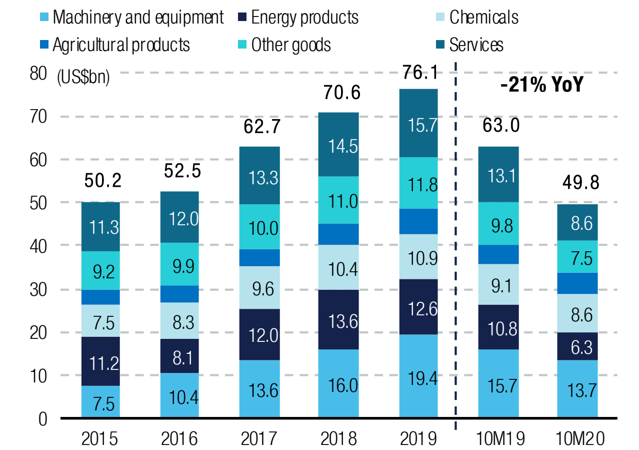
Ukraine's 10M20 exports fell 7.3% YoY to $49bn, driven mostly by decline in steel (-16% YoY), travel services (-79% YoY), pipeline transit (-21% YoY), and other transportation services (-23% YoY)



Source: NBU, ICU

Chart 42. Imports (US$bn)

Lower purchases in energy products (-41% YoY), machinery and equipment (-13% YoY), and travel services (-49% YoY) contributed most to the 21% YoY decline in 10M20 imports



Source: NBU, ICU

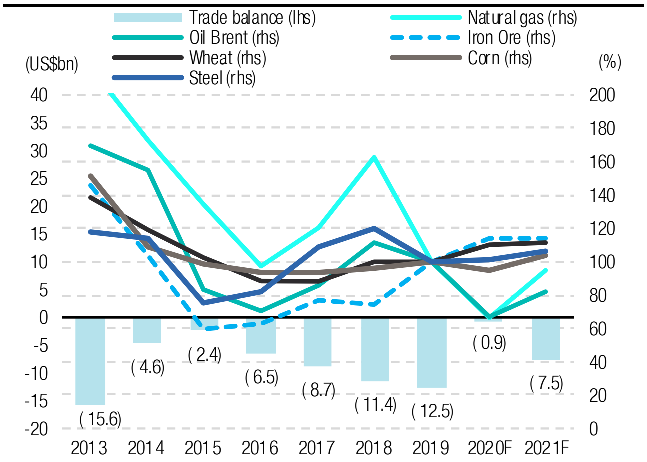
The 10M20 decline in imports was much sharper, by 21% YoY. Slump in imports of energy products, machinery and equipment, and travel services made the greatest contribution to the decline in imports. In addition, investment income payments fell by US$3bn due to weak financial results of Ukrainian companies with foreign capital. Meanwhile, private remittances remained surprisingly steady as they declined only 2.3% YoY.

In 2021, the trade deficit will expand together with recovering energy prices and demand for imports, while growth of exports will be moderate

We maintain our expectations of Ukraine's C/A balance turning to deficit in 2021. The key factor will be the expanding trade deficit, as mobility recovery, removal of most logistical disruptions, and postponed domestic consumer and investment demand should lead to a 17% surge in imports. Exports will grow as well, but at a much slower pace, 6% YoY. Poor 2020/21 grain harvest, bumpy recovery of European and MENA steel markets, and declining iron ore prices should become the key hurdles to exports' growth. However, this growth, together with a moderate 4% recovery in private remittances, will be enough to leave the 2021 C/A deficit at a relatively low level of 1.2% of GDP. There is a high risk of a bigger-than-expected C/A deficit due to the effect of postponed demand for imported goods and services, particularly foreign travel, as well as due to a rapid growth in energy prices. These two factors may accelerate expansion of the trade deficit in 2H21.

Chart 43. Ukraine's trade balance (US$bn) and commodity prices (2019=100)

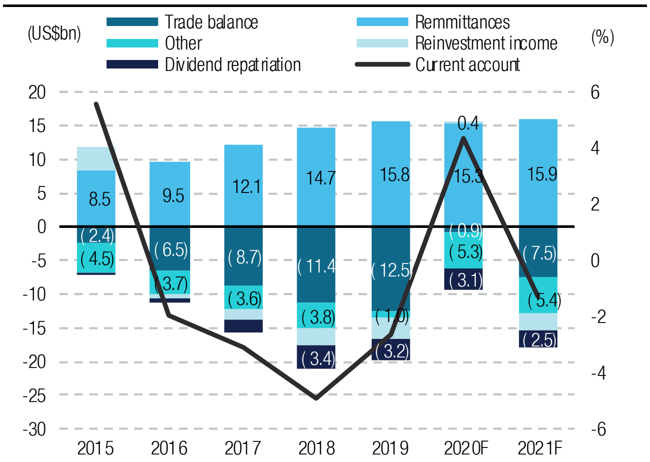
Higher prices for iron ore and lower prices for oil and natural gas contribute significantly to the contraction of Ukraine's trade deficit in 2020



Source: Bloomberg, NBU, ICU

Chart 44. Ukraine's current account (US$bn, % of GDP)

Ukraine's C/A surplus in 2020 will turn into a 1.2% GDP deficit in 2021, mostly due to the more than tripling trade deficit



Source: NBU, ICU

Improved global sentiment to reverse capital flows

Capital flight into hard currency assets, including FX cash, continues

F/A continued to show capital outflows this year mimicking similar trends in many other countries. In 10M20, capital outflows reached US$5.9bn versus the US$8.3bn net inflows in 10M19. As in 2019, capital flight to foreign assets, including the conversion into FX cash by the population, remained elevated and reached US$6.1bn in 10M19. Meanwhile, unlike in the previous years, the acquisition of foreign debt and investment capital almost disappeared. In 10M19, FDI and private debt inflows were close to zero, and the government repaid $1.7bn more than it borrowed.

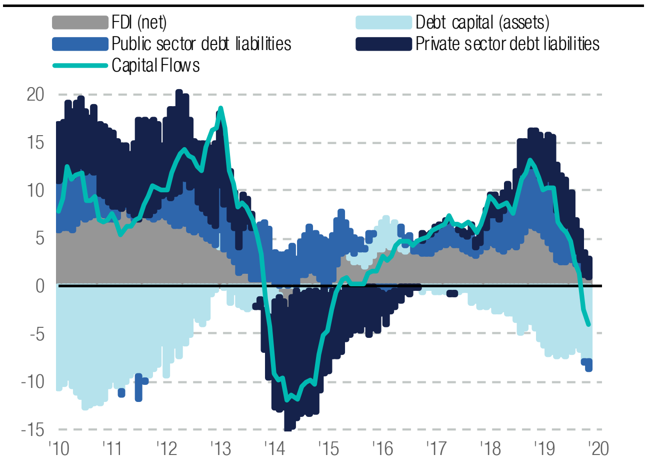
Return of FDI inflows and slide in accumulation of FX assets delayed until 2021

Looking ahead, we predict against the background of positive news about the vaccines and Biden's victory in the US presidential election that the appetite of foreign investors for EM assets will sharply improve. First of all, amid its elevated financial needs government should benefit and borrow in net terms more than $3bn in 2021, exploiting both official sources and market funding. Due to post-pandemic uncertainty, we expect that the private sector will behave more cautiously and inflows of investment and debt capital will be rather moderate, below pre-pandemic amounts.

As before, we predict that an increase of foreign assets will slow sharply as the accumulated amounts will be spent actively, for example, on informal imports and foreign tourism. As a result, net capital inflows will become positive again and reach US$5.6bn.

Chart 45. Capital flows (US$bn, 12m trailing)

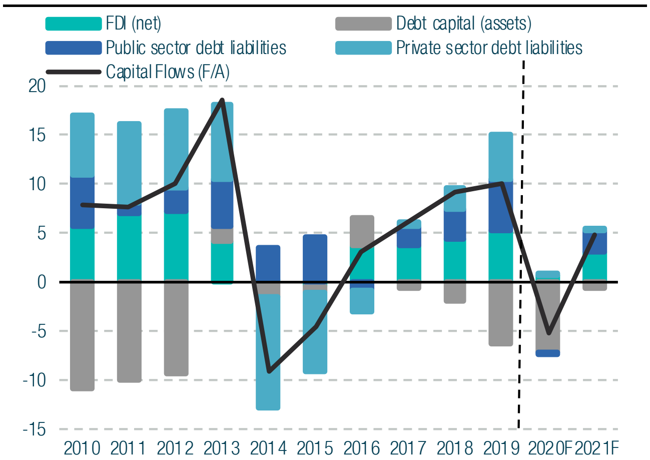
In 2020, acquisition of foreign debt and investment capital almost disappeared while capital flight into FX assets remained elevated



Source: NBU, ICU.

Chart 46. Capital flows of private sector (US$bn)

2021 sees a return to net capital inflows as capital flight fades out while FDI and official borrowings come back



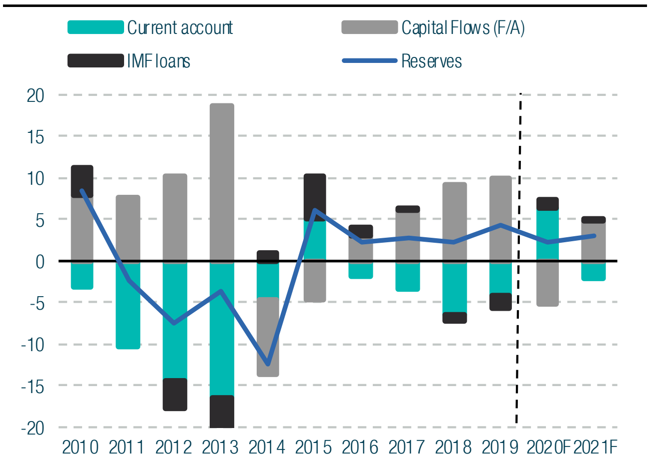
Source: NBU, ICU

Reserves to exceed 100% 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 marginally, compared with a BoP surplus about US$3bn on average during 2016–19. Next year, we expect the return to a US$3bn BoP surplus amid recovering capital inflows. Factoring in disbursements from the IMF, we project further growth of reserves to US$31bn. As a result, they should exceed 100% of the IMF Aggregate Reserve Adequacy metric for the first time since the GFC.

Chart 47. Changes in Reserves (US$ bn)

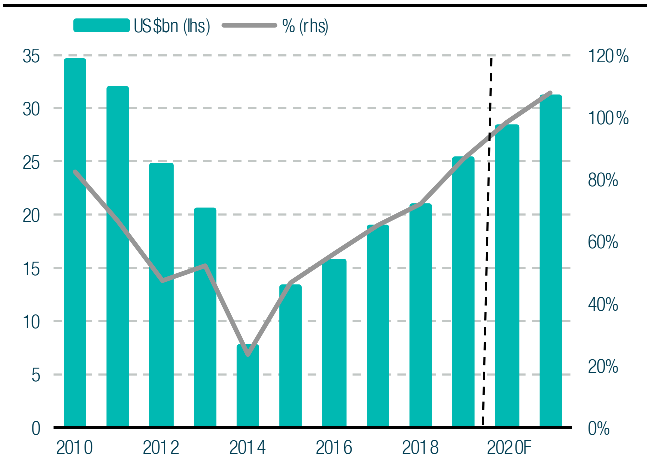
The pace of reserves accumulation is surprisingly stable since 2015



Source: NBU, ICU.

Chart 48. 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: stronger in line with external accounts

The hryvnia so far is beating expectations and is likely to be within the band of UAH28.0–28.5/USD by YE20, as merchandise imports and foreign travel remain largely depressed by COVID-19 and related constraints. After a nervous summer, devaluation expectations stabilized in August–October, as state officials became more cautious in their public comments about FX priorities.

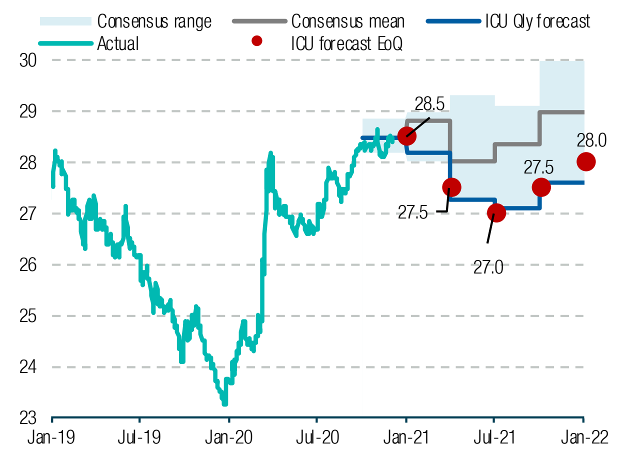
UAH is likely to strengthen to UAH27–27.5/USD by mid-2021 and then will end 2021 within UAH27.5–28/USD

In the short-term, we see the FX risk balance 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 surging fiscal payments and high devaluation expectations.

In 1H21, UAH is likely to moderately strengthen, supported by exporters' higher activities and larger inflows of external capital amid improved domestic sentiment. In 2H21, the market balance should tilt towards more UAH depreciation pressure from an expanding C/A deficit. Ultimately, the national currency should end 2021 in the range of UAH27.5–28/USD.

Chart 49. UAH/USD forecast

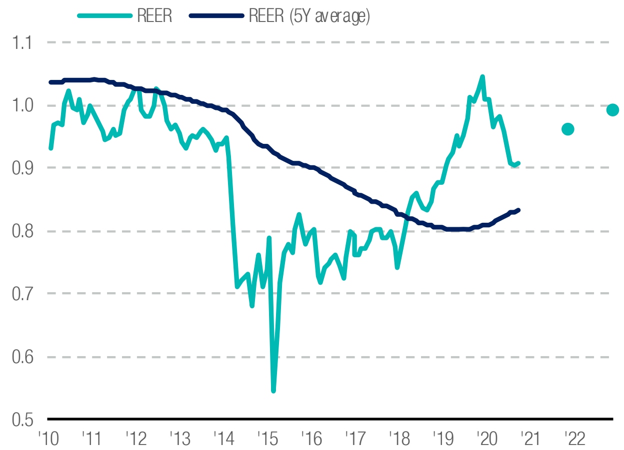
UAH should depreciate to 28–28.5/USD range by end-2020 and then fluctuate within UAH27–28/USD during the most of 2021



Source: NBU, Bloomberg, ICU.

Chart 50. Real Effective Exchange rate (Dec 1999 = 1)

After sizable weakening this year UAH REER has to appreciate in the medium term



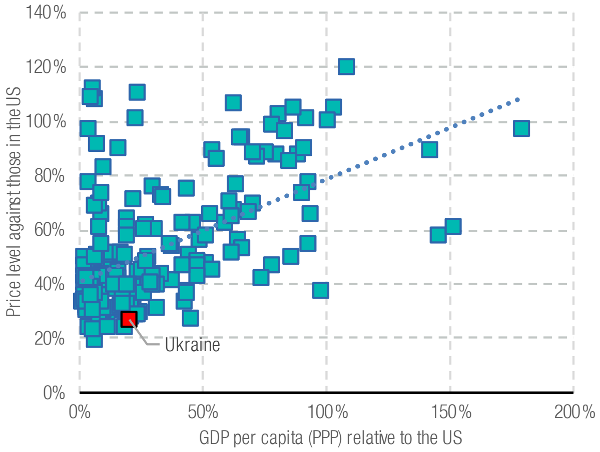
Source: NBU, ICU

UAH REER is to strengthen in the medium term

Moreover, despite still prevailing depreciation expectations among residents, we assess medium-term risks for UAH as tilted upwards as currency looks undervalued in real terms. During 10M20, the UAH real effective exchanged rate weakened 13% in 10M20 after surging by 35% in 2018-19 and still remained c.9% above its 5y average. However, if we consider the IMF's estimates of the purchasing power parity, prices in Ukraine are only 27% of the level in the US based on the GDP basket. Even adjusting for productivity levels (GDP per capita in the US is five times higher than in Ukraine), the Ukrainian currency has a sizable potential for real appreciation. And even conservative IMF projections assume a gradual shrinking of these gaps in price levels and productivity between Ukraine and the US.

Chart 51. Price levels and GDP per capita relative to the US

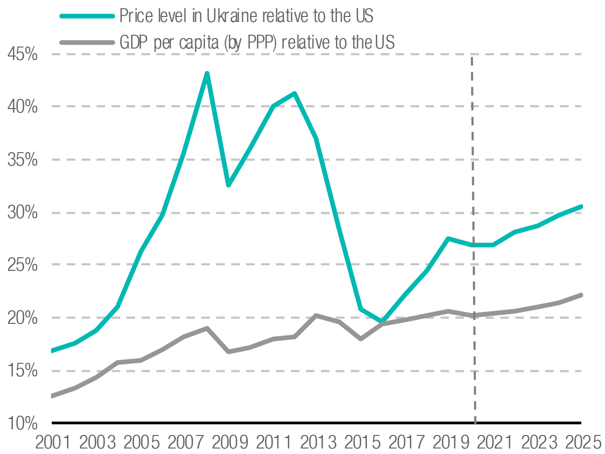
UAH looks strongly undervalued, even accounting for the gap in productivity



Source: IMF WEO (October 2020), ICU.

Chart 52. Price level and productivity: Ukraine vs US

IMF predicts slow convergence of Ukrainian prices and productivity to US levels



Source: IMF WEO (October 2020), ICU

Besides, the medium-term fundamentals provide evidence of potential real appreciation of Ukrainians currency. First of all, the main arguments are solid external accounts represented by a large current account surplus this year (and still low and sustainable current account deficit next year), and improved reserves position over the last five years. Second, public finance metrics exceed those of most peers. And last, but not least, improved global sentiment towards EMs provide the basis for UAH real strengthening.

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	(4.8)	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	3,976	4,535
Nominal GDP (US$bn)	136	163	174	180	133	90	93	112	131	155	147	165
Unemployment (%)	8.2	8.0	7.6	7.3	9.3	9.1	9.3	9.5	8.8	8.2	10.0	9.5
Inflation												
Headline inflation (%, YoY, e.o.p)	9.1	4.6	(0.2)	0.5	24.9	43.3	12.4	13.7	9.8	4.1	4.5	6.0
Headline inflation (%, YoY, avg.)	9.4	8.0	0.6	(0.3)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	6.0
GDP deflator (%, YoY)	13.5	14.2	7.8	4.3	15.9	38.9	17.1	22.1	15.4	8.1	5.1	8.0
Exchange rates												
UAH/USD (e.o.p.)	7.94	8.04	8.05	8.24	15.82	24.03	27.30	28.10	27.72	23.81	28.50	28.00
UAH/USD (avg.)	7.95	7.98	8.08	8.15	12.01	21.95	25.55	26.61	27.19	25.80	27.02	27.52
External balance												
Current account balance (US$bn)	(3.0)	(10.2)	(14.3)	(16.5)	(4.6)	5.0	(1.9)	(3.5)	(6.5)	(4.1)	6.4	(2.0)
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)	4.3	(1.2)
Trade balance (US$bn)	(2.7)	1.7	0.8	0.5	(0.7)	(0.6)	(0.4)	(1.0)	0.1	(12.5)	(0.9)	(7.5)
Trade balance (% of GDP)	(2.0)	1.0	0.4	0.3	(0.6)	(0.7)	(0.5)	(0.9)	0.1	(8.1)	(0.6)	(4.6)
Exports (US$bn)	(0.6)	(0.3)	(0.3)	0.6	(0.3)	0.3	(0.2)	0.0	(0.0)	63.6	60.0	63.9
Imports (US$bn)	11.2	9.1	10.3	12.3	(8.0)	(3.5)	(3.0)	2.5	5.2	76.1	60.9	71.4
Capital flows (F/A) (US$bn)	7.9	7.7	10.1	18.6	(9.1)	(4.6)	3.1	6.1	9.3	10.1	(5.2)	4.9
FDI (US$bn)	5.8	7.0	7.2	4.1	0.3	(0.4)	3.8	3.7	4.5	5.2	0.6	3.0
FDI (% of GDP)	4.2	4.3	4.1	2.3	0.2	(0.5)	4.1	3.3	3.4	3.4	0.4	1.9
Reserves (US$bn)	34.6	31.8	24.5	20.4	7.5	13.3	15.5	18.8	20.8	25.3	28.2	31.1
Reserves % of ARA metric	82	67	48	52	24	46	56	65	72	86.7	98.0	107.9
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)	(5.0)	(4.5)
Public debt (% of GDP)	40.1	36.4	36.7	39.9	69.4	79.0	80.9	71.8	60.9	50.6	62.7	56.9
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	11,597	13,838
Real wage (%, YoY)	7.6	8.8	14.3	8.2	(5.2)	(18.5)	7.8	19.7	12.6	9.9	7.6	13.0

Source: Ukrstat, NBU, MoF, 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)	(3.5)	(3.0)	(1.3)	12.2	5.0	6.3
Nominal GDP (UAHbn)	706	810	995	1,050	815	933	1,112	1,115	846	868	1,127	1,136	901	1,051	1,278	1,304
Nominal GDP (US$bn)	26	31	36	38	30	35	44	46	34	32	41	40	32	39	47	47
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	2.3	4.5	6.1	5.7	6.4	6.0
Headline inflation (%, YoY, avg.)	13.8	11.5	8.9	9.7	8.9	9.1	8.5	5.2	2.6	2.1	2.4	3.6	5.7	5.9	5.9	6.3
GDP deflator (%, YoY)	15.1	17.4	16.0	13.5	12.2	9.9	7.6	4.7	5.1	5.0	5.0	5.0	8.0	8.0	8.0	8.0
Exchange rates																
UAH/USD (avg.)	27.28	26.18	27.37	27.92	27.31	26.52	25.21	24.22	25.10	26.87	27.57	28.46	28.17	27.25	27.08	27.58
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	27.59	28.50	27.50	27.00	27.50	28.00
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	6.00	6.00	6.50	7.00

Source: Ukrstat, NBU, ICU.

Disclosures

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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

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