UKRAINE

CAPPED GROWTH

The Ukrainian economy has suffered an accumulation of external and domestic shocks: the pandemic (vaccination rates are still low), the ongoing geopolitical risk, and domestic political tensions. Adding to these factors, inflation has accelerated over the past year. However, the Covid-19 crisis has been much better absorbed than was the case for the crises of 2008 and 2014. The current account balance has recovered and foreign currency reserves have increased, thanks in particular to higher commodity prices (cereals and metals). International support (mainly from the IMF and European Union) provided the required complement, allowing fiscal support to the economy. However, the country remains exposed to a sudden stop of capital flows. As a result, Ukraine still remains dependent on financing from international financial institutions.

BRAKES ON THE RECOVERY

Ukrainian economic growth was disappointing throughout 2021, with an unexpected recession in the first half followed by a relatively modest recovery. However, the country has come through the Covid-19 episode without a financial crisis, in contrast to 2008 and 2014. One notable difference lies in the increase in prices for commodity exports (which fell in 2008 and 2014); this made a substantial contribution to improving the current account, despite the drop in agricultural production seen in 2020 and the first half of 2021. Alongside the support of international financial institutions (mainly the IMF and EU), this helped protect foreign currency reserves, stabilise the exchange rate and, ultimately, ensure the country's solvency.

However, the private capital inflows have dried up. The fickleness of this flows affects the financing of growth and continues to limit its potential. The local economic situation has been difficult. Manufacturing production has not returned to its pre-Covid level and was still 6% below it in November 2021. The acceleration in inflation (with energy prices rising, particularly as the result of higher taxes) since the end of 2020 has hit household spending. Fortunately, production and exports of agricultural products probably bounced back in the second half of 2021, thanks to a good cereal harvest.

The health risk remains substantial, following several waves of infection, of which the most recent (in the autumn of 2021) was also the biggest both in the number of cases (25,000 per day at the peak) and of deaths (700 per day at the peak). Vaccination levels remain low, with only one-third of the population covered, which has resulted in severe restrictions being maintained.

Lastly, political risk remains significant and takes two forms: the difficulty in implementing reforms, notably to the judiciary (which is a condition of international aid), and the conflict with Russia (tensions in March 2021 and again since the end of the year). The continuation of these risks has resulted in the freezing of investment, despite a law introduced in early 2021 designed to encourage foreign investment.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	3.2	-4.0	2.0	2.8	2.8
Inflation (CPI, year average, %)	7.9	2.7	9.3	9.0	6.2
Gen. Gov. balance / GDP (%)	-2.0	-6.0	-4.5	-4.0	-3.0
Gen. Gov. debt / GDP (%)	50.5	60.8	62.0	63.0	63.0
Current account balance / GDP (%)	-2.8	4.0	-0.8	-2.5	-3.0
External debt / GDP (%)	79.1	84.0	80.0	76.0	74.0
Forex reserves (USD bn)	25.3	29.1	30.9	27.5	26.5
Forex reserves, in months of imports	4.0	5.6	5.0	4.3	4.1

e: ESTIMATE & FORECASTS
TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

GDP: CONSTANT PRICES SEASONALLY ADJUSTED

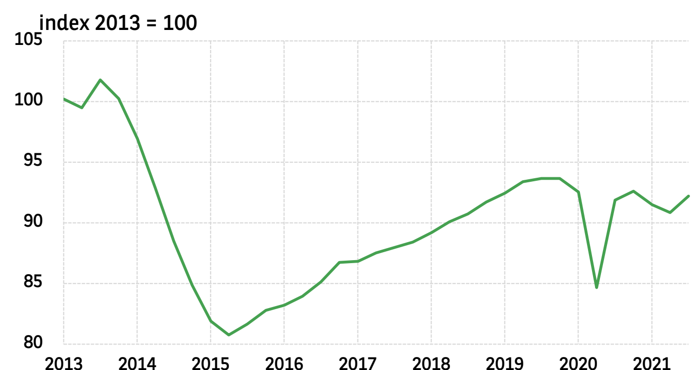

CHART 1 SOURCE: REFINITIV, BNP PARIBAS

SUPPORT FROM ECONOMIC POLICY IS CONSTRAINED

Initially, the policy mix helped support the Ukrainian economy. International financing supported this by funding the budget directly rather than payment being made to the central bank as in a traditional programme. A stable exchange rate and low inflation at the time the pandemic hit allowed the central bank to cut its policy rate. The shock of the pandemic was therefore cushioned and the recession in 2020 was fairly modest.

However, fiscal support remained more modest than in other emerging economies, with a primary government deficit (i.e. before interest costs) of 3.1% of GDP in 2020 and 1.2% of GDP in 2021 (compared to an average for emerging economies of 7.5% and 4.7% respectively). This gap can be explained by Ukraine's more limited leeway. The country had a payment default in 2014 and debt service costs increased to 3.3% of GDP in 2021.

In particular, monetary support proved temporary. The acceleration in inflation (from 2.6% in October 2020 to 6.1% three months later and 10.9% a year later) led the central bank to act at the beginning of 2021 (more than 6 months before those in other emerging economies did so). Overall, the policy rate was increased by 300 basis points, to 9%, by the end of 2021. Ukraine's exposure to inflationary risk is structural; monthly inflation figures have been above 10% half of the time since 2014. Imperfections in the transmission channels of monetary policy reduce the level of control the central bank has over these trends.

Moreover, international support has run up against persistent deficiencies in governance. The World Bank's government effectiveness indicator is amongst the lowest amongst emerging economies. This suggests that government reforms do not always feed through into facts on the ground (notably due to problems of implementation and rule of law).

The judicial reform that the government introduced was intended precisely to reduce the risk that funds invested or loaned (whether by banks or by international funders) are not misused. The high level of non-performing loans (30.1% of loans by volume at the end of 2021) demonstrates the extent of this risk.

However, internal political conflict, notably between the country's president and the constitutional court, have disrupted the adoption of these reforms. These are the symptoms of the existence of special interest groups that are delaying necessary structural changes.

The many limits on the support that economic policy could provide explain why the recovery in activity in 2021 was disappointing.

LIMITED SAFETY NETS IN THE EVENT OF AN EXTERNAL LIQUIDITY SHOCK

In a largely dollarised economy such as Ukraine, the interruption of foreign currency inflows needs to be closely monitored. A shortage, whether as the result of a shock to steel exports or to capital flows, would affect the day-to-day functioning of the economy. Repeated shortages hit growth and improvements in standards of living. In the shorter term, the risk is clearly that currency reserves could become insufficient to cover net currency outflows.

Currency reserves have increased over the past few years. The current account went from a deficit of USD 4.2 billion in 2019 to a surplus of USD 6.2 billion in 2020 and a modest deficit of USD 1.5 billion in 2021. Part of the improvement appears to be structural, with an increase in migrant remittances. Another element, linked to sales of commodities, looks more vulnerable to a downturn. Volume effects could become more positive in the short term on the back of a good cereal harvest and strong demand for metals. However, the price effect has largely been wiped out by increases in the price of imported hydrocarbons since the summer of 2021.

International financing has made a significant contribution to the increase in currency reserves. However, this effect is reversible to the extent that the loans received will need to be repaid. Ukraine's net reserves (i.e. with future repayments deducted) are much smaller than the gross figure. This highlights the importance of continued support from international institutions in the absence of a durable alternative source of financing (notably FDI).

FOREIGN RESERVES IN % OF A METRIC

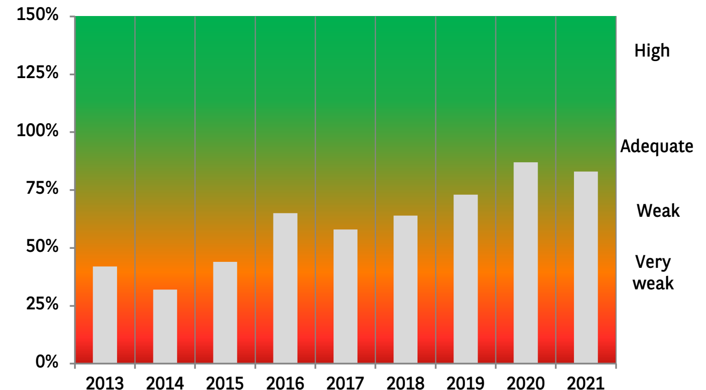

CHART 2 SOURCE: BNP PARIBAS

To assess whether or not foreign currency reserves are adequate, it is useful to quantify the threats to reserves, here summarised as follows[1]: an abrupt drop in exports (as the potential percentage reduction), potential capital outflows (as a percentage of gross liabilities to non-residents), and a sudden conversion of resident UAH assets into USD (as a percentage of M2 money supply). The first two of these percentage measures are assessed on the basis of the 2014 shock, with the conversion of M2 estimated at 5% (the standard figure used for a currency with a floating exchange rate). Adding these figures gives a metric representing the risks that currency reserves might need to cover. However, reserves remain below this figure, despite their marked increase since the 2014 crisis. External vulnerability remains high in the event of an internal or external shock, such as those seen in 2008 and then in 2014. The support of international financial institutions is essential in dealing with this liquidity risk.

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1 A method similar to that used by the IMF, Assessing Reserve Adequacy, Policy Paper (2011).