Ukraine

Favourable conjonction

Ukrainian growth accelerated rapidly in the first nine months of 2019, driven notably by the agricultural sector and household consumption, the latter being largely stimulated by borrowing. The appreciation of the hryvnia (UAH) triggered a sharp drop in inflation, which facilitated greater monetary policy easing. In the short term, monetary policy support should offset the impact of the global economic slowdown, which has already eroded industrial activity. At the same time, the announcement of a new IMF agreement is bound to reassure foreign investors. The central bank will have to deal with a classic dilemma: it needs to ease monetary policy to curb portfolio investment inflows, but doing so risks triggering a credit boom.

Since his inauguration in May 2019, President Volodymyr Zelensky has consolidated his position on the domestic political scene by winning a majority in the house of deputies while distancing himself from the oligarch Igor Kolomoisky, one of his main backers during the presidential campaign. Internationally, he proved he could be firm with his Russian counterpart on the Donbas and Crimea questions during the quadripartite summit, with France and Germany serving as mediators, while remaining open to dialogue. He has also benefited from the ongoing improvement in the economic situation. Lastly, healthy public accounts and his commitment to structural reform (draft law to lift the moratorium on the sale of farm land) convinced the IMF to grant the country another credit line.

Private demand fuels growth

In the first nine months of 2019, Ukrainian GDP rose 3.8% compared to the same period in 2018 (+4% in Q3, the most recently available quarter). On the supply side, all sectors contributed to growth, notably agricultural production – which accounts for about 10% of GDP, roughly the same as industrial output – with bumper grain harvests, thanks not only to favourable weather conditions but also to the improvement in sector productivity.

As to demand, growth has been fairly well balanced so far, buoyed by private demand: household consumption, investment and exports have all grown at roughly the same robust pace (10%, 13% and 9%, respectively). Over the same period, public spending declined by 5%.

Household consumption benefits from persistently strong real wage growth (9.7%, after 12.6% in 2018), falling unemployment (7.8% of the active population) despite an increase in the participation rate, and a sharp upturn in consumer credit (+19% in real terms). Investment, in contrast, was largely funded through cash flow as lending to companies eased after rebounding in 2018. The acceleration in GDP growth can also be attributed to vigorous exports, notably of farm produce.

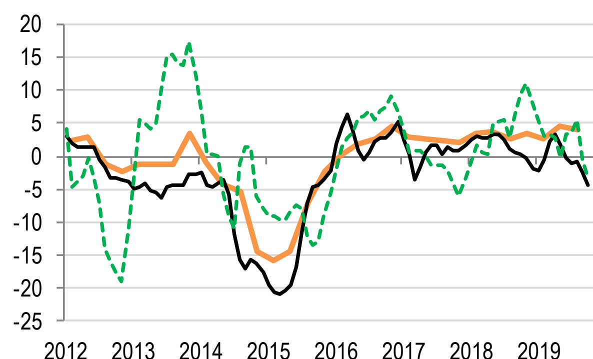
This momentum probably ran out of steam in Q4, as reflected by the slowdown in industrial output (chart 2). Yet monetary policy easing and the announcement of IMF financial support should trigger a sharper easing of domestic and external financing conditions, which should facilitate an upturn in investment lending. Although 2020 is likely to be a slow year compared to 2019, the country's macroeconomic fundamentals are improving (inflation, external accounts, public finances).

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	3.3	3.5	3.2	3.8
Inflation (CPI, year average, %)	10.9	7.9	5.0	5.2
Gen. Gov. balance / GDP (%)	-2.1	-2.2	-2.1	-2.0
Gen. Gov. debt / GDP (%)	61.9	50.0	48.0	47.0
Current account balance / GDP (%)	-3.3	-2.8	-3.2	-3.8
External debt / GDP (%)	87.7	80.1	76.1	75.0
Forex reserves (USD bn)	20,8	25,3	27,0	29,0
Forex reserves, in months of imports	3.5	4.0	3.8	3.8
Exchange rate USDUAH (year end)	30.0	26.6	27.0	28.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Stable growth since 2016



Source: Ukrstat, BNP Paribas

Liquidity swells

As the country's external liquidity continues to rise, official foreign exchange reserves reached USD 25.3 bn at the end of December, the equivalent of nearly 4 months of imports of goods and services. The current account deficit narrowed to USD 3.4 bn in Jan.-Nov. 2019, down from USD 4.2 bn over the same period in 2018, while net FDI flows amounted to USD 2.5 bn. The basic balance has thus improved, but continues to show a deficit. The consolidation of foreign reserves is mainly due to non-resident portfolio investment, which doubled to USD 5 bn in Jan-Nov 2019 compared to the year-earlier period, but also to Gazprom's USD 2.9 bn pay-out to

Naftogaz as part of the renegotiation of its natural gas supply contract.

At year-end 2019, the normalisation of relations between Naftogaz and Gazprom had a positive impact on the balance of payments in the short term. In late December, the two companies signed an agreement under which Gazprom pledged to deliver a cumulative total of USD 7 bn in natural gas through the end of 2024. In exchange, Naftogaz agreed to write off Gazprom's arrears, with the exception of a USD 2.9 bn pay-out in late December. This pay-out will largely offset the decline in Naftogaz's transit revenues in 2020.

Considering that the hryvnia's appreciation was due more to speculation than to a fundamental improvement in the balance of payments, the central bank made major net currency purchases (USD 7.9 bn), which facilitated the payment of external debt servicing charges for the government and the central bank.

Looking beyond these positive short-term trends, the improvement in external liquidity makes the country more vulnerable to foreign investors who hold now 14.5% of total domestic debt compared with only 1% at end-2018. The announcement of the IMF's USD 5.5 bn Extended Fund Facility surely reassured investors. But foreign reserves are still relatively low compared to the annual external debt servicing charge (USD 15 bn excluding trade debt and intra-group debt in 2020). Fragile external accounts require fiscal austerity, which the authorities have maintained so far.

Public finance targets met

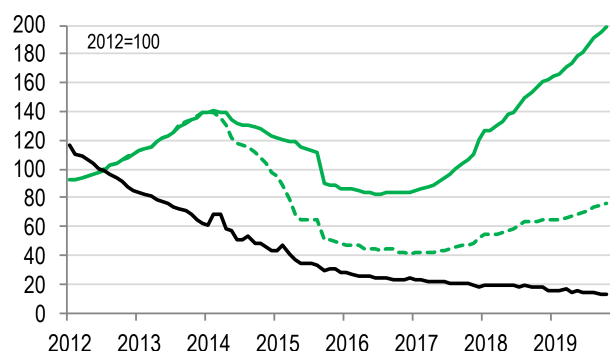
In Jan-Oct 2019, the central government deficit was capped at 2% of GDP, below the target of 2.3%, the primary surplus narrowed slightly to 1.1% from 1.5% in 2018, and interest payments shrank from 3.3% to 3.1%.

For the year 2020, parliament adopted a budget with a projected deficit of UAH 94 bn (USD 3.5 bn), or 2.1% of GDP. For the government, the big risk is not in underestimating spending but in overestimating revenues, due to the appreciation in the exchange rate: 30% of revenues are denominated in USD, compared to only 5% for spending (all other factors being the same, a stronger currency increases the deficit). Yet the budget was based on a conservative assumption of a USDUAH exchange rate of 27, compared to 24 currently. This is another argument for curbing the hryvnia's appreciation. Yet the risks of budget overruns are very small, and the IMF will be keeping a close watch.

Currency appreciation triggered a share decline in the central government's debt ratio, from 62% of GDP at year-end 2018 (including guaranteed debt) to 50% in November 2019 (nearly 60% of which is denominated in foreign currency).

The financing plan is very cautious. The government intends to issue USD 5 bn in international bonds solely to cover the payment of its external debt. Given the expected pay-outs by the IFIs and the EU, the need for international bond issues should be limited to USD 2 bn.

3- Consumer credit boom



Source: NBU, BNP Paribas

Monetary policy dilemma

The hryvnia's appreciation against the dollar since early 2019 has fuelled disinflation: consumer price increases fell back to 4.1% yoy in December, from 9.8% at the end of 2018. The central bank was able to lower its key policy rate to 13.5%, from 18% at year-end 2018, and this trend has accelerated since October (the key policy rate was cut by a cumulative total of 300 bp). Until mid-2019, monetary policy was very conservative with a key rate of more than 10% in real terms. This policy was justified by the political uncertainty that reigned ahead of legislative elections.

Now that this uncertainty has been lifted, the central bank has more manoeuvring room, but it will soon be faced with a classic dilemma for the emerging countries: with further monetary easing, the economy risks overheating, notably via a credit boom, but maintaining a very positive domestic interest rate spread risks attracting portfolio investment, which could lead to an overvalued currency.

Even the central bank believes that consumer credit is catching up too quickly. Fortunately, lending has become highly de-dollarized in recent years. Moreover, as of 2021, the central bank intends to require banks to apply a higher weighting to consumer loans when calculating the weighted average assets used in capital adequacy ratios.

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