UKRAINE

TAKING ADVANTAGE OF A FAVOURABLE ENVIRONMENT

The country weathered the difficulties of 2020 relatively well, notwithstanding the recession that Covid-19 produced and the drying up of private capital inflows. Thanks to the improvement in the terms of trade, the current account surplus was sufficient to balance the existing gap. Over recent years, Ukraine has been able to improve its fiscal management, which helped to secure the support of international financial institutions. The challenge for the months ahead lies in a resumption of capital inflows and in the planned reforms to encourage investment and increase potential growth. It will be important to keep an eye on reforms in the banking sector, which relate both to the consolidation of the sector and to the improvement of the prudential and supervisory framework.

FINANCING NEEDS ARE LIKELY TO BE COVERED

Facing a massive shock, the Ukrainian economy has demonstrated an unusual level of resilience. Indeed, Ukraine saw its currency reserves increase in 2020, despite private capital inflows' sudden stop. This is a new phenomenon in the country's recent history. It has helped ensure that the Covid crisis has been weathered better than previous crises, such as those of 2008 and 2014.

Although the country has not avoided recession and the public finances have come under pressure, it has managed to meet its financing needs. It was mainly done through the current account balance, which went from a deficit of USD 4.1 billion in 2019 to a substantial surplus of USD 6.6 billion (an improvement of nearly USD 11 billion). This improvement offset the drop in net inflows of private capital in 2020 compared to 2019, which was of a similar amount. Meanwhile, payments from international financial institutions came to only USD 3 billion, net of repayments of earlier loans.

The improvement in the terms of trade and the structure of exports played a key role in the shift in the current account. The fall in exports was held at only 2%, whilst imports fell by nearly 11%, in part due to the fall in oil prices. Exports benefited in H1 2020 from strong demand for agricultural products (particularly cereals). After this, the industrial recovery seen throughout Europe in the second half of 2020 resulted in very strong growth in steel exports in volume terms, made even stronger in value terms as prices soared.

However, the fragile nature of the balance of payments remains a significant topic for 2021. The current account surplus is likely to shrink, under the effect of falling cereal exports (drop in volumes) and rising oil prices. Meanwhile, even if private capital inflows resume, they will be partly offset by relatively substantial debt repayments, most notably the USD 4 billion debt maturing in the third quarter. Against this background, the country will require the continued support of the IMF.

However, it is possible that the planned USD3 billion will only be partially disbursed, with the February tranche already having been delayed. Given that the country will have to repay USD 1.5 billion to the IMF, net receipts could be limited. Even so, the prospect of an allocation of Special Drawing Rights (SDRs) by the IMF could more than cover the shortfall: given Ukraine's quota in the IMF, nearly USD 4 billion could be allocated (even before taking into account the possibility that advanced economies could forego their share in favour of emerging economies). This would help address the challenge of covering financing needs and suggests a fresh increase in foreign currency reserves over time.

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	3.2	-4.0	4.4	3.8
Inflation (CPI, year average, %)	7.9	2.7	7.5	5.7
Gen. Gov. balance / GDP (%)	-2.0	-7.5	-5.5	-2.5
Gen. Gov. debt / GDP (%)	50.1	64.5	66.0	64.0
Current account balance / GDP (%)	-2.7	4.6	1.1	-0.3
External debt / GDP (%)	78.7	83.4	77.3	73.9
Forex reserves (USD bn)	25.3	29.1	31.4	30.0
Forex reserves, in months of imports	4.0	5.7	5.6	5.1

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

TERMS OF TRADE (EXPORT PRICES OVER IMPORT PRICES): Y/Y CHANGE

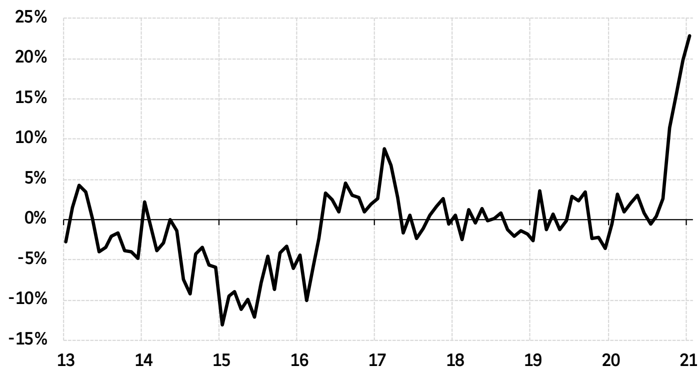

CHART 1 SOURCE: CEIC, BNP PARIBAS

If IMF payments resume as planned, and the allocation of SDRs comes rapidly, the modest rise in the hryvnia since the beginning of the year could continue despite a growing inflation differential. Inflation accelerated to 7.5% year-on-year in February 2021 (from 2.6% in October 2020), due mainly to the prices of food, electricity and gas. Monetary policy may be tightened beyond the 50bp increase in interest rates implemented in 21Q1 (from the record low level of 6%).

IMPLEMENT FURTHER BANKING REFORMS

The monetary policy easing in the first half of 2020 (500bp cut in the policy rate) allowed bank lending rates to be reduced to record lows. This helped bolster lending growth in 2020, over and above the existing subsidised loan schemes (the so-called 5-7-9 plan), which, despite being expanded, accounted for only 0.5% of GDP. Bank lending to the non-financial private sector increased by 9% based on a constant perimeter (see next paragraph). However, this lending growth against the background of a recession suggests new non-performing loans to come, for which banks have made provisioning. This situation led the central bank to introduce various measures. It extended into 2021 a programme that in 2020 had resulted in the restructuring of 10% of consumer loans and 7% of business loans. The risk weighting associated with consumer loans should be increased in 21H2 from 100% to 150%. Convergence towards Basel and EU standards is likely to resume, after marking time in 2020. Lastly, an asset quality review and stress test exercise will involve the 30 biggest banks.

These stricter rules look necessary given that the banking system has in the past generated significant volumes of non-performing loans, with a lengthy resolution. Thus in 2020, banks were still restructuring non-performing loans that appeared in 2015-16. These still stood at 41% of total loans by the end of the year, from 48.4% in 2019. Moreover, the final average recovery rate remains low (9% according to the World Bank).

The reduction of the frequency of non-performing loans and the effectiveness of the restructuring of those that do arise are the driving forces behind the legal reforms that the government wants to introduce in order to improve the legal security of loans issued and the transparency of financing in general. These reforms also form part of the IMF's conditions for the next tranche of aid to Ukraine. The difficulties experienced in introducing them also explains the disbursement delay of the February 2021 tranche of the IMF's loan to Ukraine.

INCREASE FISCAL SPACE THROUGH LOWER DEBT

In the recent past, the cleaning up of the banking system has created a substantial cost and contributed to the deterioration of the public finances. After the 2015-16 crisis, the country's main bank, PrivatBank, had to be nationalised. Now, the constraints that Ukraine faces in financing its needs make it necessary to look towards reducing government debt in future. The high level of interest rates on the hryvnia, reflecting the level of risk, is a drag on this process as it incentivises external borrowing denominated in currencies with lower interest rates. However, it exposes to a risk of an increased debt service in the case of hryvnia depreciation.

In parallel, government debt is likely to continue to rise in 2021, towards 66% of GDP. The continuation of the Covid-19 epidemic, with a 3rd wave observed in March 2021, and the slow roll-out of vaccinations in Ukraine, suggests that the bulk of the stimulus programme will remain in place in 2021. The government deficit will remain high, at 5.5% of GDP, from 7.5% in 2020. Moreover, whilst IMF support in 2020 served directly to finance the budget, an allocation of SDRs can only benefit the central bank. This would suggest that until IMF support payments resume, the government will have to finance itself on the domestic market at higher interest rates. The scale of interest expenditure, at 3.5% of GDP in 2021, shows the need to reduce borrowing in order to increase fiscal space.

YIELD CURVE

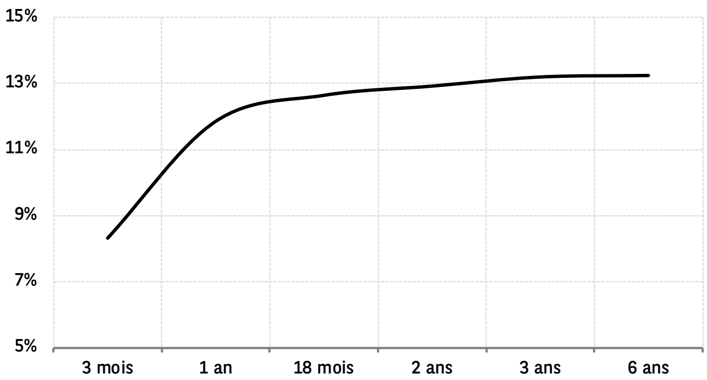

CHART 2

SOURCE: REFINITIV, BNP PARIBAS

INCREASING POTENTIAL GROWTH

Ukraine also needs to focus on attracting Foreign Direct Investment (FDI), in order to limit its external debt (83.4% of GDP in 2020) but also to enhance potential growth. FDI inflows recovered in 2016 but dried up again in 2020. In order to attract future investment, the government has passed a new law in 21Q1 guaranteeing the stability of the legal framework (rule of law). It is also giving foreign investors tax breaks, exemptions from import duties, and preferential property taxes. The aim of this law is to move up the value chain, by making industrial sectors eligible and including businesses in the extractive industries (e.g. iron ore) only if processing and enrichment takes place in Ukraine.

Recent years have brought early successes, notably in the field of IT services, but Ukraine needs sustained investment in its physical and human capital, which has been held back by a series of crises. Thus total factor productivity only regained its 2008 level in 2019. At the same time, the capital stock (notably infrastructure) has dwindled steadily over recent years, when measured at constant prices. Lastly, the number of people employed has also fallen over the past few years, with the emigration of more highly-trained workers. The net result of all this is the limiting of potential growth that now needs to be addressed.

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