UKRAINE

YOU REAP WHAT YOU SOW

Ukraine is usually quite prone to boom bust cycles. Yet high volatility has not allowed to stabilize growth towards a higher level, and fickle capital inflows have reinforced the importance of funding from foreign institutions, notably from the IMF and the European Union. Such official financing, coupled with the structural progress it has made in recent years, seem to have helped the country to cope with the Covid-19 crisis, at least for the moment, with fewer negative financial consequences than initially feared. Strong foreign demand for Ukraine's grain, lower oil prices and the foreign financing are all favourable factors that have helped the country weather the crisis, and raise hopes for a rapid economic recovery once the Covid-19 crisis is over.

WEATHERING THE COVID-19 SHOCK

In early 2020, Ukraine benefitted from lower risks than during previous recessions. Better policy management has limited the size of twin deficits (public and current account deficits) and helped to initiate (public and external) debt consolidation. Moreover, the disinflation process has reduced depreciation pressures on the UAH, despite recurrent political uncertainty.

Against this background, Ukraine was not hit by the Covid-19 pandemic as hard as its neighbours, with nearly 1000 cases per 1 million inhabitants, compared to nearly 4500 for Russia. Even so, the government imposed a strict lockdown from mid-March and gradually began to ease restrictions in mid-May. The drop of manufacturing output eased partially in May (-15.6% y/y), after -20.3% in April.

The authorities managed to avoid the sudden stop of capital flows faced in 2008 and 2014, so domestic demand did not contract as suddenly and sharply as before. The government secured financial packages from international institutions, as it was able to comply with necessary preconditions:

i/ a banking law allowing safeguarding the clean-up of the banking system, including notably the consolidation of doubtful loans

ii/ the end of a ban on farmland sales.

The Covid-19 pandemic caused a shift in household demand around the world, with a focus on essential goods. Ukraine's customers sought to secure the provision of commodities more than usual, which was a boost for Ukrainian grain exports. As a result, the decline of total exports was much lower in Ukraine compared to regional peers (-6% in April, compared to -30% in Poland).

In the meanwhile, Ukraine entered into recession during the 1st quarter (-1.3% year-on-year) and it should intensify in Q2. However, the GDP contraction should be less severe in 2020 as a whole (-4.2%) compared to regional peers.

Monetary policy is another explanation of the not so negative performance of Ukraine. The Central Bank was able to ease its policy rate by 750 basis points since the beginning of 2020, using the leeway created by the disinflationary process. Lower oil prices even magnified it, since inflation declined to 1.7% (y/y) in May 2020.

Moreover, Ukraine should be able to post a current account surplus of 1.5% of GDP in 2020 for the first time since 2005. This phenomenon and foreign capital inflows have helped to stabilize the exchange rate after some pressure in March and April. It should re-appreciate moderately as a result towards UAH 26 per USD by year-end (compared to UAH 24 in early 2020), buoyed by high yields on Ukrainian bonds (the yield on 3-year UAH government bonds is 10.75%).

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	3.3	3.4	-4.2	2.8
Inflation (CPI, year average, %)	11.0	7.9	1.7	3.7
Gen. Gov. balance / GDP (%)	-2.2	-2.3	-7.0	-5.0
Gen. Gov. debt / GDP (%)	60.2	55.0	63.0	65.0
Current account balance / GDP (%)	-3.3	-0.9	1.5	-1.0

TABLE 1 e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXPORTS CHANGE IN APRIL 2020 (Y/Y)

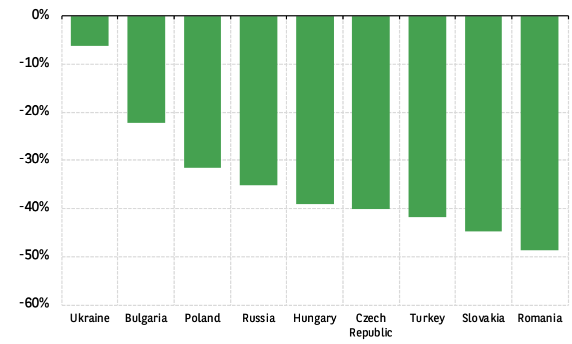

CHART 1 SOURCE: CEIC, BNP PARIBAS

POLICY SUPPORT: THIS TIME IS DIFFERENT

Ukraine had the leeway to ease its policy-mix this time, a situation that was not allowed by systemic crises in 2008 and 2014.

Fiscal policy support is strong, including through a moratorium on social security payments to the end of May, higher pensions and a financial package for the medical professions. A programme of subsidised and state-guaranteed loans was also expanded. Unemployment benefits were raised and a temporary unemployment benefit was created for quarantined jobs purposes.

As a result, the public deficit is expected to swell to 7% of GDP in 2020, and then to remain significant at 5% of GDP in 2021. This implies another increase in public debt. The sharp reduction in the public debt ratio in recent years (to 55% of GDP in 2019) is a key strength. The increase in debt should be financed by disbursements from the IMF (USD 2 bn paid out in June, out of a total allocation of USD 5 bn by year-end 2021) and other international institutions, mainly the European Commission and EBRD. It is also expected to support foreign currency reserves to USD 27 bn at end-2020 (compared to USD 25 bn at end-2019).

The Central Bank also eased reserve requirements for banks, thus freeing up liquidity in hryvnia. Liquidity supply was increased through new instruments and by expanding the range of eligible collateral in order to include municipal bonds and state-guaranteed corporate loans. The introduction of various capital additional buffers (notably for systemic risk and capital conservation) was postponed at least until October 2020. Moreover, loan defaults during the Covid-19 crisis and debt restructuring before September 2020 will not be considered as non-performing loans.

The law simplifying the restructuring and recapitalisation procedures for Ukrainian banks was also postponed until August 2024. This is an important decision because the banking system has still a very high volume of non-performing loans on its balance sheet, inherited from the late resolution of the 2014 crisis. Although part has already been forgiven, non-performing loans still accounted for 49% of total loans outstanding in Q3 2019 (even though this is lower than the Q2 2017 peak of 58%).

REDUCE GROWTH VOLATILITY AND INCREASE THE POTENTIAL

At a time when the coronavirus continues to cause new victims in numerous countries, it is still too early to imagine the return to a stable growth trajectory without the risk of new setbacks. Yet Ukraine has weathered the Covid-19 crisis without severe financial instability, which could make another attractive investment argument for international investors.

However, there are risks to this kind of situation such as:

i/ capital flows triggering an exchange rate appreciation thereby weighing on growth rather than supporting it,

ii/ an increased vulnerability through a high share of short-term and foreign currency inflows.

Financial reforms are needed mainly to fix the financial dollarization of the economy. There is still a high share of public debt in foreign currencies (60%). Household deposits in foreign currencies account for 42.8% of bank liabilities, and net open foreign currency positions account for 47.4% of the capital of banks, a currency mismatch that exposes them to significant balance sheet risk in case of a sharp depreciation of the exchange rate.

Monetary policy effectiveness is limited by the low liquidity on long-term maturities. This incomplete yield curve also exposes borrowers to either borrow in local currency and short-term maturity (maturity mismatch) or in foreign currency (currency mismatch). In parallel, the government needs to stick with a long-term strategy to reduce its debt ratios, since there is still a USD 3 bn bond with Russia (4 bn in net present value) that matured in 2015 and was not repaid.

INFLATION AND POLICY RATE

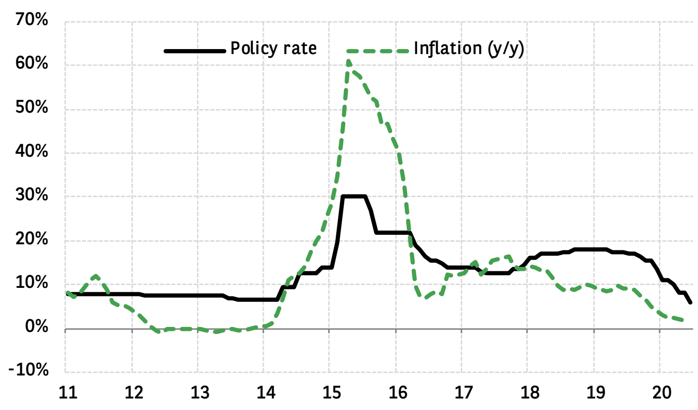

CHART 2

SOURCE: CEIC, BNP PARIBAS

Finally, Ukraine should improve its debt resolution procedures. Resolving insolvency is still long and costly, and the recovery rate is low. The country ranks 146th in this index of the World Bank's Ease of Doing Business report.

Looking beyond financial reforms, Ukraine also needs to avoid a Dutch disease: the risk to see a specialization on commodities (grains and industrial metals in Ukraine), thus triggering early deindustrialization. Human capital is key but, in our view, the problem is more the attractiveness of the local labour market than the skills of the Ukrainian labour force, since Ukrainian migrants are currently working in neighbouring economies, such as the Polish industrial sector.

Ukraine needs to improve its attractiveness towards investors in order to develop its industrial base. Economic stability (lower country risk, insolvency resolution) is a necessary precondition, but is not enough. There were already some reforms implemented during recent years that went in the right direction. As a result, it became easier to get credit, to deal with construction permits and to register property.

However, Ukraine needs more stability in order to nurture an investment cycle. Its physical infrastructure is ageing and in volume terms is lower than before: the overall capital stock has eroded by more than 20% in volume since the country's independence, according to the Penn World Tables.

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