Ukraine economy in 2021

Bounce, but not a turnaround

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CONCORDE CAPITAL

Summary

As with most economies around the world, Ukraine's GDP will shrink in 2020 amid ever-increasing global uncertainty caused by the global coronavirus pandemic. We anticipate Ukraine's economy will decline 4.6% yoy with an expected plunge of gross fixed investment at 22% yoy. Meanwhile, private consumption will stay on a positive track, being fueled by growing real income. In 2021, Ukraine's economy will pick up 3.9% yoy amid this growth in household consumption and renewed investment.

For most of the year, consumer inflation stayed below 3% yoy, which is below the central bank's target range of 4-6%. Only in 4Q20, the growth of consumer prices started gaining momentum, and we forecast this should land the 2020 consumer inflation rate at 4.8% YTD. Fast growth of private consumption will be further heating inflation, bringing it to 6.1% YTD in 2021.

We estimate the current account (C/A) balance will go to surplus of USD 5.2 bln in 2020. The trade deficit will shrink to USD 2.0 bln as the corona-crisis turned out to be more harmful to Ukraine's imports than exports. In 2021, external trade growth will be restored, and imports are expected to grow faster than exports. Amid the enlarged trade deficit, the C/A will return to red, posting a deficit of USD 0.4 bln.

Meanwhile, the financial account will turn to a deficit in 2020, which we estimate at USD 6 bln. The increased outflow of foreign currency was a likely outcome for the period of swelled turbulence at the global financial market. However, these losses could be not that big should the Ukrainian government manage to secure another tranche of IMF financing in 2H20. We expect the financial account will turn to a surplus of USD 2.5 bln, supported by IMF financing and intensified borrowing at the external markets in 2021.

Unlike previous economic crises in Ukraine, the latest episode was not marked by a collapse of the national currency. In 2020, the Ukrainian currency depreciated around 4%, which is acceptable for Ukraine's thin forex. We expect the hryvnia to follow the track of moderate depreciation in 2021. We forecast the hryvnia's exchange rate in 2021 will average UAH 28.50/USD, while landing at UAH 29.50/USD at the year end.

After being downplayed for several years, fiscal issues popped up in 2020. The government faced the difficulty with financing swelled budget gap caused by ever-increased budget expenditures allowed by the amendments to the budget adopted amid COVID-related panic. We expect the government to finish the 2020 budget year with a deficit of UAH 200 bln (5% of GDP). In 2021, the budget will enlarge to UAH 220 bln (still remaining at 5% of GDP).

Key economic indicators

	2017	2018	2019	2020E	2021E
Real GDP, yoy	2.5%	3.4%	3.2%	-4.6%	3.9%
Nominal GDP, USD bln	112.2	130.9	153.8	147.8	153.8
CPI, year-end	13.7%	9.8%	4.1%	4.8%	6.1%
C/A balance, USD bln	-3.5	-6.4	-4.2	5.2	-0.4
Gross int'l reserves, USD bln	18.8	20.8	26.3	27.8	29.5
UAH/USD, average	26.60	27.20	25.85	26.95	28.50
UAH/USD, eop	28.07	27.59	23.69	28.50	29.50

Economy hit by corona crisis

Hit by falling global demand and the economic fallout, Ukraine's GDP will decline 4.6% yoy in 2020 after growing 3.2% yoy in 2019. The economy will be weighed down by gross fixed investments plummeting 22% yoy (vs. 14.2% yoy growth in 2019).

We expect industrial output to decline 5.5% yoy in 2020, accelerating from a 0.5% yoy slide in 2019. The output in metallurgy will decline around 10% due to weak external demand. Machinery will lose around 18% yoy amid weak investment demand, both within the country and abroad.

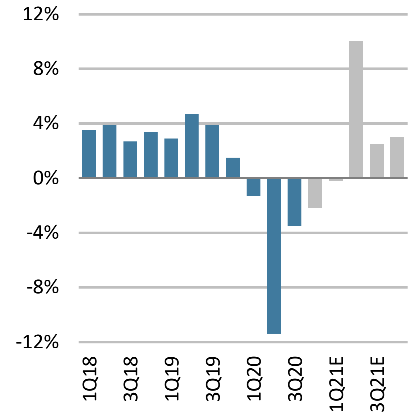
Agricultural output will contract 10% yoy as the grain crop will decline after consecutive record highs in 2018 and 2019. The drops in industry and agriculture will be somewhat offset by growth in trade and construction. In particular, real retail will increase 8.0% yoy (vs. 10.5% yoy growth in 2019) amid high consumer demand driven by continuing growth in household income. We also expect the construction sector to post growth of 1% yoy (vs. a 23.5% surge in 2019) amid increasing government spending on infrastructure projects.

On the expenditure side, the 2020 GDP decline will have been caused by the drop in investment of 22% yoy. Meanwhile, private consumption will inch up around 1% yoy (vs. 11.9% yoy growth in 2019) maintained by real income growth. The negative result of investment will be also set off by the positive contribution of the external sector, where the decline of imports outpaces the drop in exports.

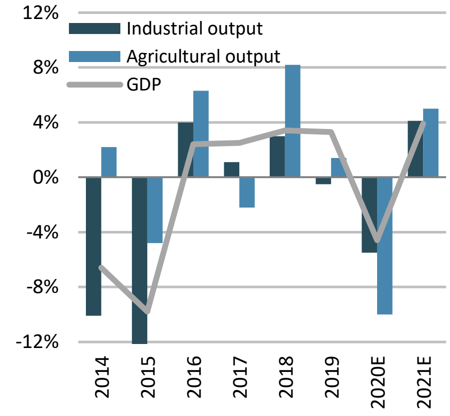
We expect Ukraine's economy will pick up 3.9% yoy in 2021 amid renewed investment and accelerated consumption. The negative influence of the COVID-19 pandemic on the world economy will endure Ukraine's restrained export opportunities. The renewed industrial output will be moderate in the absence of any structural changes, and the growth of 4.1% yoy will be largely due to the effect of the low comparative base. We expect agricultural output to pick up 5% yoy in 2021 amid a higher grain harvest.

We project that private consumption will improve 8.0% yoy, while the growth of gross fixed investment will pick up 10% yoy in 2021. The contribution of net exports will be negative.

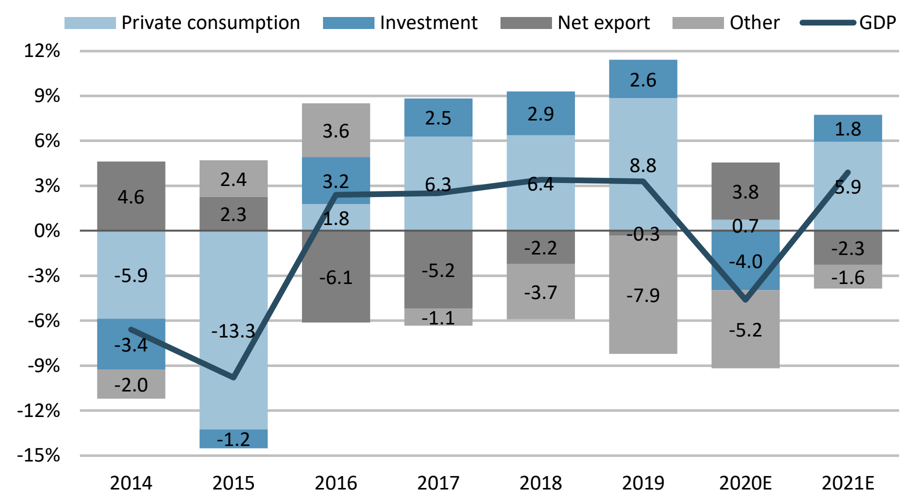
Real GDP



Key economic indicators, % yoy



Contribution to GDP growth, %



Source: UkrStat, Concorde Capital Research

Consumer inflation cooled in 2020

We expect consumer inflation to reach 4.8% YTD (on average 2.6% yoy) in 2020, compared to 4.1% YTD (7.9% yoy) in 2019. For the most of 2020, annual consumer inflation didn't exceed 3% yoy, staying below the NBU target range of 4-6%.

The following factors contributed to inflation cooling in 2020:

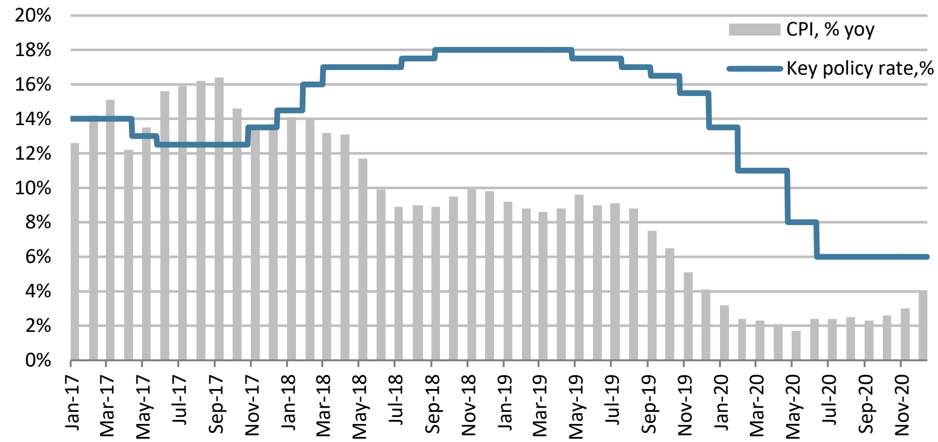
- Hard quarantine restrictions suppressed consumer demand during March-May.
- The decline of global prices for natural gas resulted in lower administratively regulated tariffs for household utilities.
- Prices in transportation dropped due to reduced demand and lower global prices for gasoline during the pandemic.
- The robust 2019 harvest and abundant supply of vegetables in 2020 restrained price growth for food.
- Quarantine restrictions affected the public's mobility and consumption patterns, resulting in lower demand for consumer goods.

Amid the cooling inflation, the NBU reinforced monetary softening that started in April 2019. In 2020, the NBU cut its key policy rate to 6.0% from 13.5%.

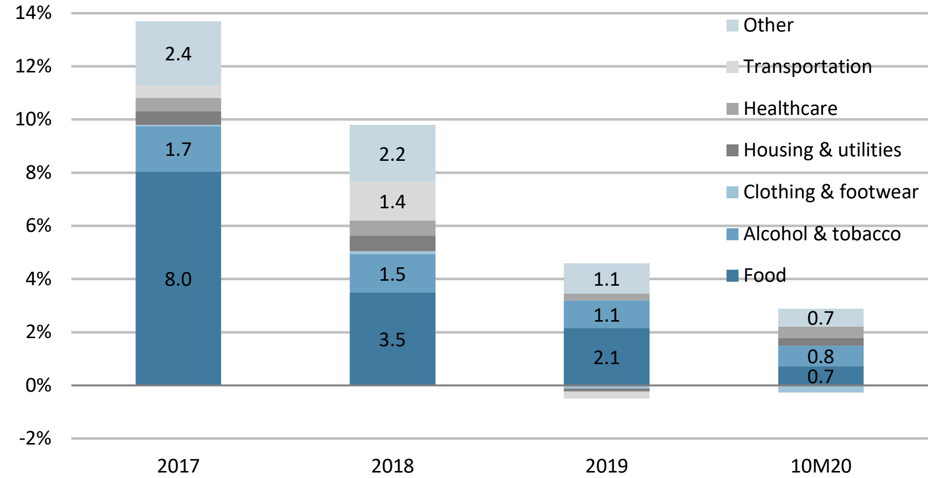
We expect consumer inflation to reinforce itself in 2021, heated up by growth of wages and a turnaround of prices for energy resources. Annual inflation will slightly exceed the NBU target range at the end of 2021, causing the NBU to tighten its monetary policy in response.

We expect consumer inflation to reach 6.1% YTD (5.2% yoy) in 2021. However, this estimate might be too high if the effect of pandemic-related restrictions on consumer behavior will be more powerful than we expect. In which case, the growth of wages won't result in noticeable growth of consumer demand.

Inflation and NBU key rate



Contribution of CPI components



Source: UkrStat, NBU, Concorde Capital Research

External accounts: C/A shifts to surplus in 2020

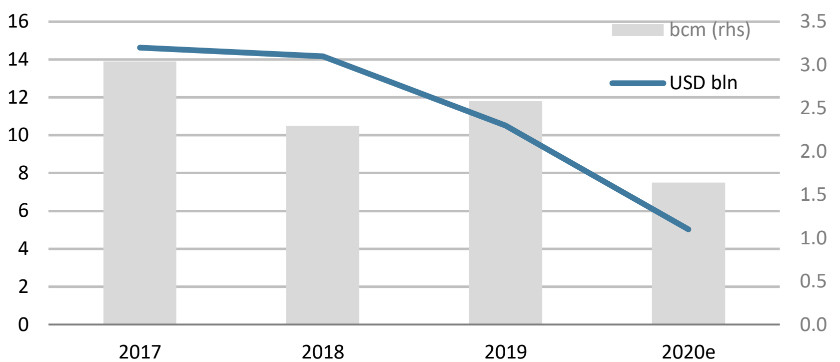
We expect Ukraine's C/A surplus will reach USD 5.2 bln in 2020 (vs. a deficit of USD 4.1 bln in 2019). The C/A switched to a surplus amid a decline of the trade deficit, which we estimate at USD 2.0 bln in 2020 (vs. USD 12.5 bln in 2019). In particular, the goods trade deficit will shrink to USD 6.7 bln from USD 14.3 bln in 2019, while the surplus of services trade will increase to USD 4.7 bln from USD 1.8 bln in 2019.

The corona crisis had a more negative effect on Ukraine's imports than exports. Goods exports fell 5.2% yoy in 2020 (vs. 6.3% yoy growth in 2019), according to our estimates. The exports decline was mostly due to weak exports of metals amid the drop of global demand. Meanwhile, the robust 2019 grain crop helped to maintain export receipts from food products in 2020 at levels close to those in the previous year.

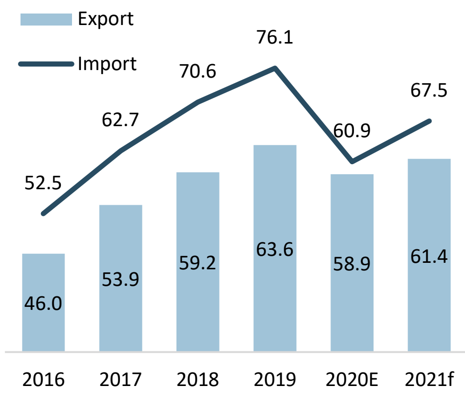
We expect goods import to plunge 16.5% yoy in 2020. In particular, imports of mineral products dropped by around 40%, mostly due to low imports of natural gas. In addition, machinery imports slid around 12% yoy amid plummeted investment demand. At the same time, food imports jumped around 15% yoy, driven by growing consumer demand.

The C/A will switch to a USD 0.4 bln deficit in 2021 amid an enlarged trade deficit, according to our forecast. We expect goods imports to jump 10% yoy amid higher global prices for energy products, as well as increased investment demand, which has been particularly spurred by government-financed investment projects. Ukraine's goods export will largely depend on the renewal of the world economy and the price trend on key export commodities – grains and ferrous metals. We expect goods exports to pick up 4% yoy in 2021.

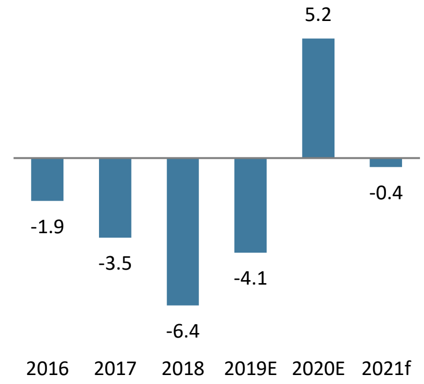
Natural gas imports



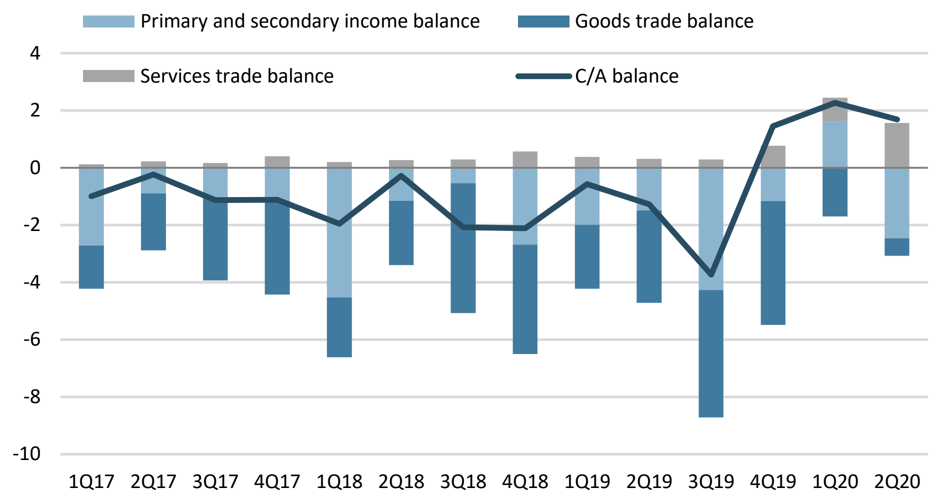
Goods & services trade, USD bln



C/A balance, USD bln



C/A structure, USD bln



Source: NBU, UkrStat, Concorde Capital research

External accounts: Financial account slides to deficit

We expect the financial account will slide to a deficit of USD 5.2 bln (vs. a surplus of USD 10.1 bln in 2019). The currency outflow was caused by significant debt repayments by the government, the sale of local Eurobonds by nonresident investors, capital outflow from the private sector and swelled demand for cash foreign currency outside the banking sector amid increased uncertainties.

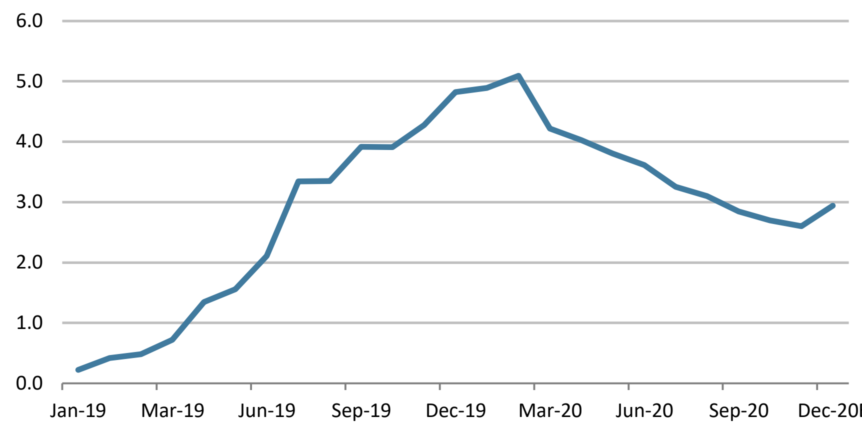
The redemptions and buybacks of government and corporate Eurobonds exceeded new issues in 2020. The government didn't secure its planned IMF tranche in 2H20 after failing to keep commitments related to the anti-corruption agenda, as well as financial and fiscal sustainability.

In 2020, Ukraine faced foreign currency outflow related to the sale of local bonds by nonresidents. This run of investors was caused by both external and internal factors:

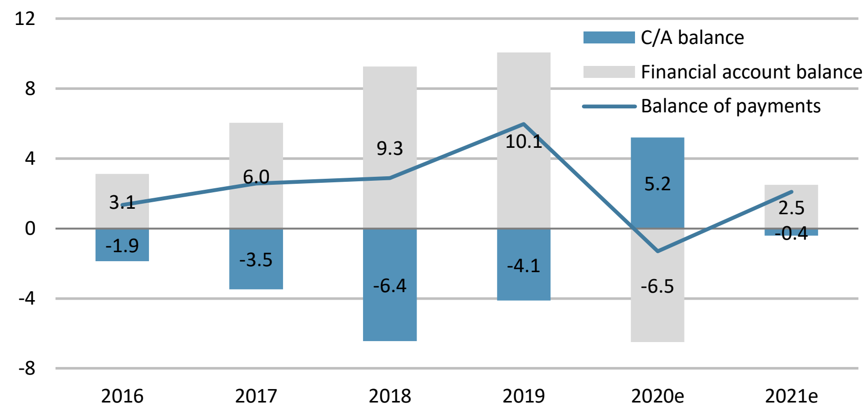
- High turbulence at the global markets – spurred by the evolving pandemic – made international investors less prone to holding EM assets in general.
- The falling popularity of the Zelensky administration – owing to a series of unfulfilled election promises – have worsened the assessments of Ukraine's political risks.
- Exchange rate exposure has increased amid higher hryvnia volatility.

In 2021, the inflow to the financial account will depend on the government's ability to get IMF financing. Our base-case scenario assumes Ukraine will secure the next IMF loan tranche in 1Q21. The IMF financing – along with related loans from the World Bank and the EU – will amount to around USD 2.5 bln. In turn, this will facilitate access to the international bond market. We expect the placement of Ukraine's Eurobonds will raise around USD 4 bln in 2021. We project the 2021 financial account surplus will amount to USD 2.5 bln.

Local government bonds held by nonresidents, USD bln



External accounts, USD bln



Source: NBU, Concorde Capital research

Exchange rate: Moderate devaluation with higher volatility

After gaining value by 5.3% against U.S. dollar and becoming recognized as the most appreciated currency in the world in 2019, the Ukrainian hryvnia returned to the more familiar pattern of moderate depreciation observed in 2017-2018. The hryvnia will have depreciated 4.1% in 2020 with an average exchange rate of UAH 26.95/USD (vs. UAH 25.85/USD in 2019), according to our estimates.

In 2020, the volatility of Ukraine's forex intensified, resulting in more NBU interventions during the year. The growing uncertainty in the world – related to the COVID-19 pandemic and subsequent recession – caused excessive demand for foreign currency in spring, prompting the typical pattern in uncertain times of U.S. dollar purchases by both businesses and the public. In March, the NBU had to spend USD 2.2 bln of reserves in order to keep the exchange rate from uncontrollable depreciation.

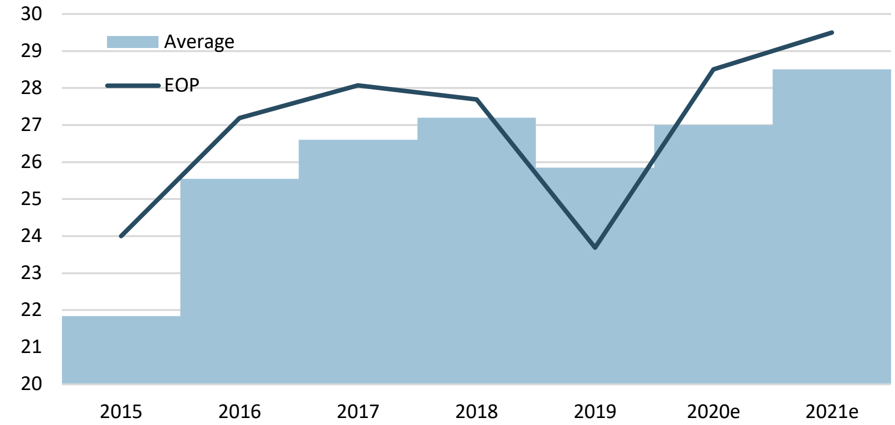
In addition to the negative external environment, some domestic developments added negative informational background affecting the foreign currency exchange market. Firstly, the Zelensky administration reshuffled the top managers of the NBU, a move viewed by the market as a potential threat to the regulator's independent status. Secondly, the failure to secure the second IMF loan tranche increased uncertainty at the market in 2H20.

On top of that, the trend of nonresident investors selling their Ukrainian local bonds, which lasted for the most of the year, created additional demand for foreign currency.

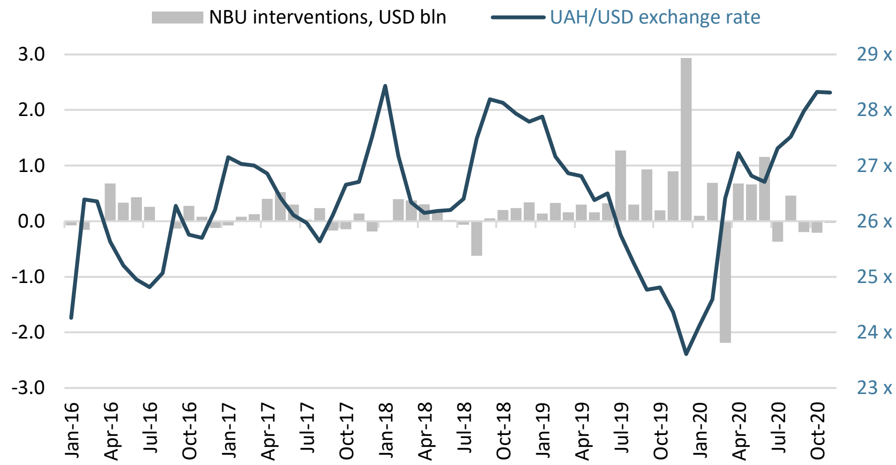
We view moderate hryvnia depreciation as the most likely trend at Ukraine's forex in 2021. The market's increased volatility related to the various pandemic effects is likely to remain. We also don't expect any noticeable achievements of the Zelensky administration in fighting systemic corruption and fostering economic reforms. This means that accessibility to external sources of financing will remain limited, and this will keep the hryvnia's exchange rate under devaluation pressure. At the same time, relatively high international reserves will enable the NBU to limit excessive volatility of the exchange rate.

We expect the average exchange rate to reach UAH 28.50/USD in 2021. A greater depreciation might occur in case of significant changes of NBU policy (e.g. withdrawing from the floating exchange rate, unreasonable interventions). At the same time, we don't rule out the appreciation scenario if nonresident investors will massively return to Ukraine's local debt market, attracted by high interest rates, as this will secure continuing inflow of foreign currency to the market.

Annual UAH/USD exchange rate



NBU interventions and exchange rate



Source: NBU, Concorde Capital research

Budget: The deficit you cannot finance

Amid the COVID-related panic, Ukraine's government amended the budget to include a targeted deficit of UAH 298 bln (or 7.5% of GDP) in 2020. While the budget revenue is likely to slightly exceed plan, public expenditures are likely to be much lower than targeted by the amended plan, leading us to expect the 2020 budget deficit to be around UAH 200 bln (5% of GDP).

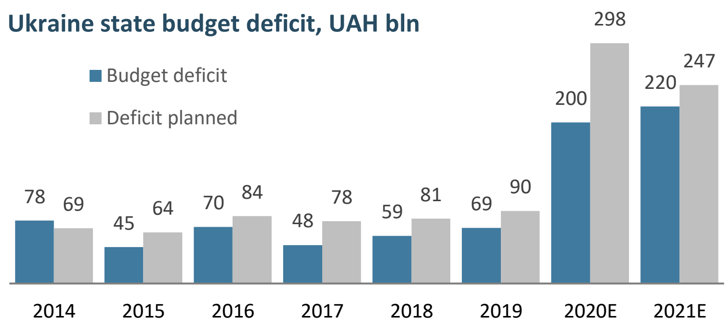
During the year, Ukraine's government faced the difficulty of raising both external and internal debt for financing the budget deficit. Nonresidents lost their interest in the Ukrainian domestic bond market. Domestic players also reduced their activity at the bond market amid the increased economic and political risks in the country. Moreover, the flight of nonresident investors from the Ukrainian debt market increased the supply of domestic bonds at the secondary market, which offered higher interest rates than at the primary market. That prompted some domestic investors to move their resources towards the secondary market.

The Ukrainian government failed to secure the second IMF loan tranche in 2H20, coupled with some connected lending from other IFIs. The apparent difficulties with the IMF talks hampered the ability of the Ukrainian government to make new issues of international Eurobonds.

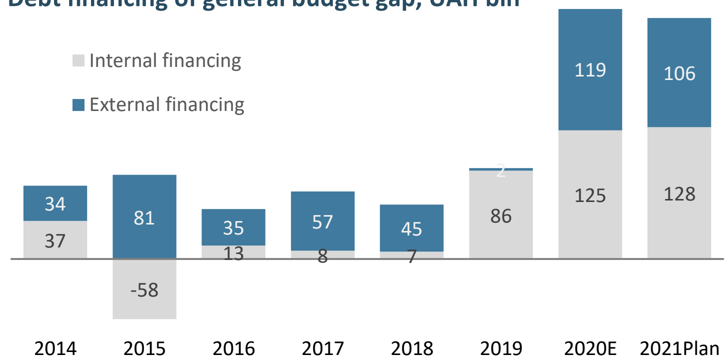
The 2021 budget assumes the deficit of UAH 246.6 bln (5.5% of GDP). We expect the Ukrainian government is likely to face similar difficulties with financing budget expenditures, like in 2020. History will repeat itself, and we expect the actual deficit in 2021 will be around UAH 220 bln (5% of GDP).

In our view, it is a counterproductive practice to adopt the budget with a deficit above a generally accepted "safe" level when emergency spending is not expected. In a country with notorious corruption, weak institutions and government propensity for populism, increased budget expenditures are not likely to create an additional safety net for a vulnerable public and/or new economic incentives. Instead, it is likely to create new areas of corruption and undermine fiscal discipline.

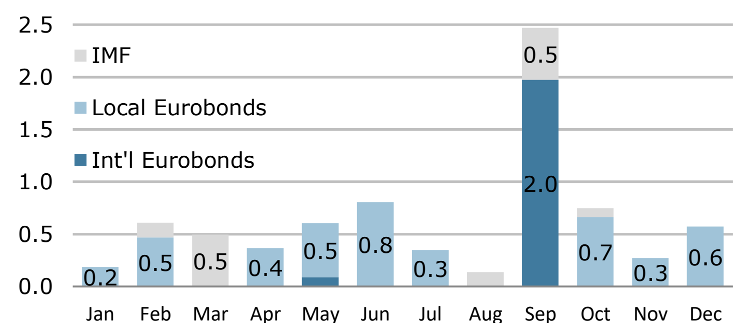
Ukraine state budget deficit, UAH bln



Debt financing of general budget gap, UAH bln



Key foreign currency debt repayments in 2021, USD bln



Source: MinFin, NBU, IMF, Treasury, Concorde Capital research

Key macro indicators

	2013	2014	2015	2016	2017	2018	2019	2020E	2021E
Economic activity									
Real GDP, yoy	0.0%	-6.6%	-9.8%	2.4%	2.5%	3.4%	3.2%	-4.6%	3.9%
Household consumption, yoy	6.9%	-8.3%	-19.8%	2.7%	9.5%	9.3%	11.9%	1.0%	8.0%
Investments in fixed capital, yoy	-8.4%	-24.0%	-9.2%	20.4%	16.1%	16.6%	14.2%	-22.0%	10.0%
Nominal GDP, UAH bln	1,465	1,587	1,989	2,385	2,984	3,561	3,975	3,984	4,383
Nominal GDP, USD bln	183.3	133.5	91.0	94.6	112.2	130.9	153.8	147.8	153.8
GDP per capita, USD	4,030	3,116	2,133	2,225	2,651	3,087	3,645	3,605	3,967
Industrial output, yoy	-4.3%	-10.1%	-12.3%	4.0%	1.1%	3.0%	-0.5%	-5.5%	4.1%
Inflation									
CPI (eop)	0.5%	24.9%	43.3%	12.4%	13.7%	9.8%	4.1%	4.8%	6.1%
CPI average	-0.3%	12.1%	48.7%	13.9%	14.4%	10.9%	7.9%	2.7%	5.9%
PPI (eop)	1.7%	31.8%	25.4%	35.7%	16.5%	14.2%	-7.4%	9.5%	6.8%
External accounts									
Current account balance, USD bln	-16.5	-4.6	5.0	-1.9	-3.5	-6.4	-4.2	5.2	-0.4
% GDP	-9.0%	-3.4%	5.5%	-2.0%	-3.1%	-4.9%	-2.7%	3.5%	-0.3%
Financial account balance, USD bln	18.6	-9.1	-4.6	3.1	6.0	9.3	10.1	-5.2	2.5
% GDP	10.1%	-6.8%	-5.1%	3.3%	5.3%	7.1%	6.6%	-3.5%	1.6%
Gross NBU reserves (eop), USD bln	20.4	7.5	13.3	15.5	18.8	20.8	26.3	27.8	29.5
State debt									
Total state debt, USD bln	73.2	69.8	65.5	71.0	76.3	78.3	74.4	77.0	81.0
% GDP*	35.2%	69.4%	79.1%	80.9%	71.8%	60.9%	50.3%	52.1%	52.7%
State external debt, USD bln	37.6	38.8	43.4	45.6	49.0	50.5	49.0	52.6	54.6
% GDP*	20.5%	38.6%	52.4%	52.0%	46.1%	39.3%	29.2%	35.7%	35.5%
Gross external debt, USD bln	142.1	125.3	117.7	112.5	115.5	114.7	121.7	123.0	125.0
% GDP	77.5%	124.5%	142.0%	128.3%	108.6%	89.3%	79.1%	83.3%	81.3%
Exchange rate									
UAH/USD exchange rate (eop)	7.99	15.77	24.00	27.19	28.07	27.59	23.69	28.50	29.50
UAH/USD exchange rate (avg)	7.99	11.89	21.85	25.55	26.60	27.20	25.85	26.95	28.50

** Based on UAH value of debt and GDP*
Source: UkrStat, NBU, MinFin, Concorde Capital research

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