Ukraine: Just when things were picking up...

We expect GDP contraction in 2020 due to the Covid-19 pandemic. The deteriorating external environment will keep pressure on the hryvnia and dampen the NBU's interest rate cut(s) path. An IMF agreement just became a lot more than a nice-to-have

The sudden change in the external environment, with almost all European countries expected to experience a serious GDP contraction in 2020, is putting Ukraine's commodity-driven economy in a difficult position. The coronavirus outbreak will weaken the demand for Ukraine's commodity exports whose prices were already under downward pressure. On the internal front the range of social-distancing measures will have much of the same effect as in most of the other countries which imposed them: falling domestic demand and dramatically lower business activity in most of the economic sectors.

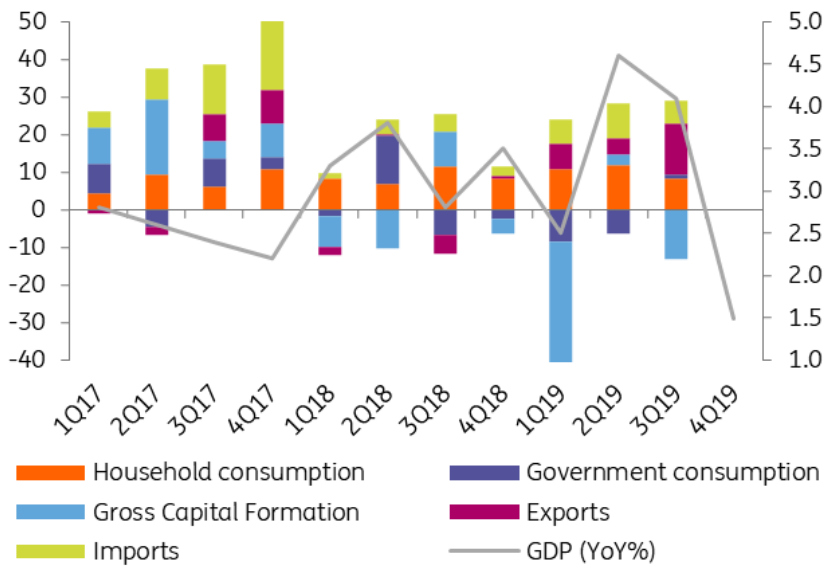
A lack of progress in securing the IMF programme, political uncertainties and substantial weakening of the external environment have seen a sudden reversal of fortunes and pose threats to weak fiscal and external balance sheets. This has put pressure on the hryvnia and UKRAIN bonds, the latter have underperformed substantially. Somewhat ironically, the recent fast-deteriorating conditions creates a new-found urgency for the Ukrainian government and

Parliament to push forward with the two main IMF's requests: land reform and the bank resolution framework. Our base case is that an agreement with the IMF will be reached in the next two months.

Growth

We are slashing our GDP growth forecast to -1.8% for 2020. Risks remain skewed to the downside, as the fiscal space to prop the economy is lacking (we estimate the budget gap in 2020 at -3.0% of GDP), while the NBU will probably not be able to lower the borrowing costs sufficiently to generate enough demand for local currency lending. We see a somewhat lagged effect of falling foreign demand and supply chain disruptions combined with a stockpiling in 1Q20, resulting in a -1.0% contraction in the first quarter versus 4Q19. The second quarter should feel the full-blown effects from lower consumer spending, investments and a chain-linked fall in production, all leading to a -2.5% quarterly sequential contraction. We believe that the – by then long expected– rebound in 3Q20 and 4Q20 (see here for detailed forecasts) will happen gradually rather than V-shaped due to the limited fiscal impulse to filter through the economy.

GDP dynamics per sector (YoY %)



Source: Datastream, ING

Inflation

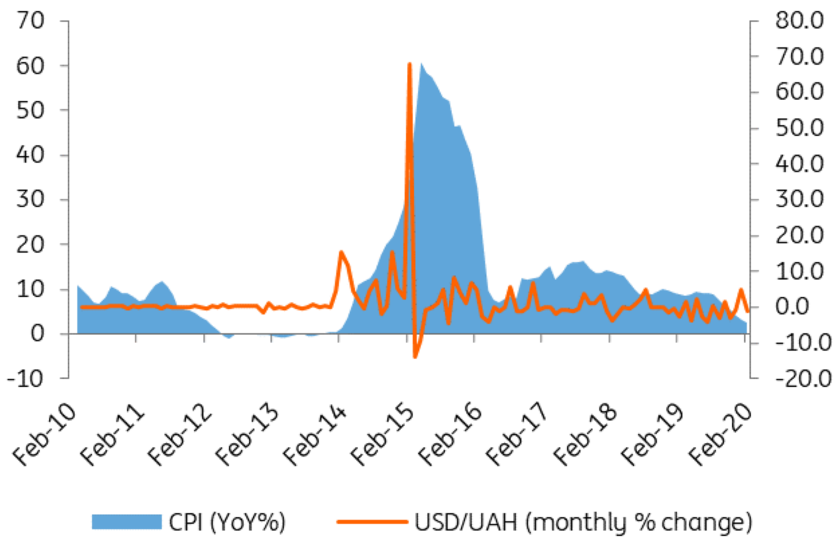
The significant decline in oil price puts additional downward pressure on an already below-target inflation. The oil-price effect will be offset to some extent by the weaker hryvnia, as the FX pass-through into prices remains very high in Ukraine (we estimate it to be around 0.3pp for every 1.0pp weaker hryvnia). We are therefore revising our **annual inflation forecast to 3.0%** from 3.5% previously. This will be one of the few positives for Ukrainian consumers these months, as the lower inflation means an increase in their real income.

FX and Rates

The lower inflation profile will not be a game-changer for the NBU in our view. We think that the main determinant of the future path of interest rates is not inflation, but rather FX. Should the UAH depreciation pressures continue, we believe that the NBU will protect the currency at the expense of interest rates. To this, we add the still incipient but growing fiscal concerns which will need to be balanced by a relatively tighter monetary policy - or at least less relaxed than initially envisaged. In any case, the NBU will need to walk a tight rope between rates and FX. **We expect the current interest rate cut cycle to stop at 8.0%** this year (currently is at 10%), with risks skewed to the upside due to FX weakness.

Speaking of FX, the rapidly deteriorating external environment has led to the re-emergence of worries regarding Ukraine's ability to fund itself in the markets. Overlapping this, the long-awaited IMF agreement is still a work-in-progress, while internally a somewhat typical behaviour of people increasing dollar-cash demand is resurfacing.

FX pass-through at work



Source: Datastream, ING

As expected, the NBU has acted quite aggressively to contain hryvnia losses, selling more than USD2bn in March-to-date while in parallel allowing for FX swap yields to spike above 20%, which makes bets against hryvnia very expensive. We previously targeted 27.00 as a line in the sand for the UAH, but given the unusual strong outflows seen everywhere in EM we think that spikes above 28.00 could be temporary allowed by NBU.

In the end, we believe that it all comes down to finding an equilibrium level which balances the demand for hard currency with the goal of preserving some of the important achievements the stronger hryvnia generated throughout 2019: lower inflation, lower and relatively well anchored inflation expectations, improving debt metrics, capital inflows, increased confidence in local currency, etc.

Ratings

No longer than two-three weeks ago we were still quite confident that we will see at least one rating upgrade for Ukraine this year, namely from Moody's which still has the country at 'Caa1' positive, two notches below S&P ('B' stable) and Fitch ('B' positive). While we still believe that chances for this to happen are reasonable, they are definitely not as high as they were. Besides the disruptions that the Covid-19 pandemic has created and will still generate, the recent government reshuffle has added to uncertainties about the reform path and pace, while the long-awaited and discussed IMF agreement has not been concluded yet.

On the IMF topic – a key rating driver we believe - having an agreement in place means a lot more than it meant a month ago. As we speak, Ukraine would find it probably quite difficult to fund itself from the international markets at reasonable rates, if at all. Hence, the importance of the financial component of the agreement has noticeably increased. Derived from this one, the agreement would also open the door for EC/World Bank funding and – last but not least – the reform agenda that such an agreement would put forward will be seen as an anchor for future governments as well. We are aware that Ukraine's track record of working with the IMF is less than impressive (none of the previous four agreements was completed) but even partial reform accomplishments are better than reform reversals.

Rating drivers/Factors that could lead to an upgrade or downgrade

Agency (review date)	Upgrade Drivers	Downgrade Drivers
Moody's Caa1 pos (22/05/2020)	• Sustained reduction in sizeable external vulnerability (ie, maintaining or further increasing FX reserves in relation to external payments) • Conditionally on reaching an IMF agreement and remaining in broad compliance with the conditions of a new programme (material progress on implementing the ambitious reform agenda is not a requirement) • Evidence that spillovers to Ukraine's economic and fiscal performance from the conflict in eastern Ukraine remains contained	For outlook to return to stable: Improvements to Ukraine's external vulnerability will not be sustained, eg: • Material delays in accessing new financing (eg, failure to agree new IMF programme or inability to remain in broad compliance with new agreement) • Notable reduction in FX buffer, accompanied by an outflow of foreign investors from domestic market • Further escalation of geopolitical tensions that would have a negative spillover on Ukraine's economic and fiscal profile
S&P B sta (11/09/2020)	• Progress on reform agenda while preserving earlier achievements (incl. NBU independence) • External liquidity outperforms projections	• Disruptions to funding from concessional programs or capital markets over the next year (e.g. driven by backtracking on key reforms)
Fitch B pos (04/09/2020)	• Reduction in external financial vulnerabilities (eg, strengthened external balance sheet and greater financing flexibility) • Increased confidence that progress in reforms will lead to improvement in governance standards and higher growth prospects while preserving the improvements in macroeconomic stability • Further declines in government indebtedness and improvements in the debt structure	For outlook to return to stable: • Re-emergence of external financing pressures or increased macroeconomic instability (failure to agree an IMF programme or delays to disbursements from it) • External or political/geopolitical shocks that weaken the macroeconomic performance and Ukraine's fiscal and external position • Failure to improve standards of governance, raise economic growth prospects or reduce the public debt-to-GDP ratio

Source: Moody's, S&P, Fitch Ratings, ING

Author

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

Disclaimer