CEEMEA Views – Ukraine
Foreign Investor Interest is Picking Up

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- Robust growth has returned, driven by consumption.
- Non-resident inflows have led the Hryvnia to appreciate.
- A new IMF program is expected by the end of the year.
- The key risk to the outlook is potential for policy inaction.
- Public debt appears sustainable, assuming FX stability.

ROBUST GROWTH RETURNED

Following the economic collapse in 2014-15 when real GDP declined by cumulative 18% (2015Q2 relative to 2013Q4), ***robust growth has returned*** in recent years (Exhibit 1).

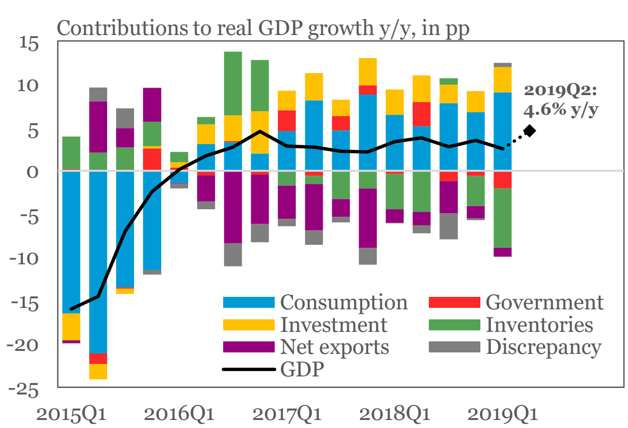
- After a relatively muted first quarter (2.5% y/y), ***the flash estimate for 2019Q2 surprised on the upside*** at 4.6% y/y and 1.6% q/q (sa). As a result, even if growth came to a halt in H2, the reading for the full year would exceed 3.0%.
- Realistically, ***we expect growth to come in at around 3.5% for 2019***, enough to trigger the warrants which were part of the 2015 debt restructuring (Exhibit 2).
- ***Strong domestic consumption*** after a long period of suppressed demand ***has been driving growth***, together with a reorientation of exports towards the EU. Consumption is supported by positive consumer sentiment and substantial remittances.
- ***Early parliamentary elections have likely prevented a slowdown in investment*** in Q2, but further explanations of the pickup will require the release of the full GDP breakdown.

FAVORABLE FINANCIAL CONDITIONS

Global financial conditions have been favorable in recent months as central banks, among them the Fed and ECB, started loosening monetary policy once again. As a result, external financing pressure has eased.

- **Non-resident holdings of domestic Ukrainian bonds have increased dramatically** since late-2018, reaching a share of 10.9% by mid-August. Excluding the NBU, non-residents now hold 18.9% of total domestic government bonds (Exhibit 3).
- As of mid-August, ***non-residents hold a total of UAH87.3 bn in domestic government bonds***, compared to just UAH6.3 bn in January.
- Overall, ***non-resident flows have picked up significantly and created appreciation pressure*** on the Hryvnia, creating concerns about declining competitiveness of Ukrainian exports.
- As a result of strong demand for Ukrainian debt, ***borrowing by the government is ahead of schedule*** according to the Ministry of Finance, with only around 20% of the originally planned issuance remain.

Exhibit 1. Growth surprised on the upside in 2019Q2.



Source: Haver, IIF

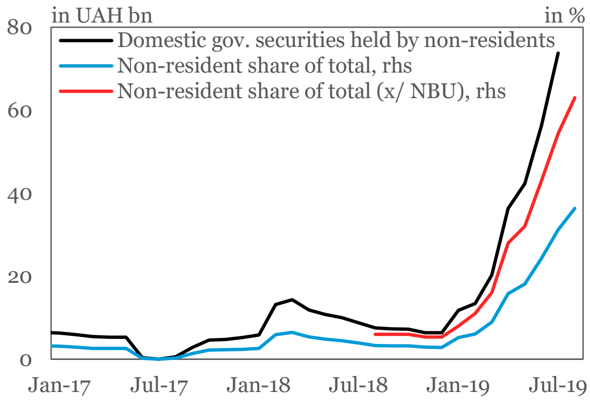
Exhibit 2. Full-year growth will likely lie around 3.4-3.5%.

Q3 growth q/q (sa); rows: Q4 growth q/q (sa)

Q4 \ Q3	0.0	0.1	0.2	0.3	0.4	0.5	0.6	0.7	0.8	0.9	1.0
0.0	3.0	3.0	3.1	3.1	3.2	3.2	3.3	3.4	3.4	3.5	3.5
0.1	3.0	3.0	3.1	3.2	3.2	3.3	3.3	3.4	3.4	3.5	3.6
0.2	3.0	3.1	3.1	3.2	3.2	3.3	3.4	3.4	3.5	3.5	3.6
0.3	3.0	3.1	3.2	3.2	3.3	3.3	3.4	3.4	3.5	3.6	3.6
0.4	3.1	3.1	3.2	3.2	3.3	3.4	3.4	3.5	3.5	3.6	3.6
0.5	3.1	3.2	3.2	3.3	3.3	3.4	3.4	3.5	3.6	3.6	3.7
0.6	3.1	3.2	3.2	3.3	3.4	3.4	3.5	3.5	3.6	3.6	3.7
0.7	3.1	3.2	3.3	3.3	3.4	3.4	3.5	3.6	3.6	3.7	3.7
0.8	3.2	3.2	3.3	3.3	3.4	3.5	3.5	3.6	3.6	3.7	3.7
0.9	3.2	3.3	3.3	3.4	3.4	3.5	3.5	3.6	3.7	3.7	3.8
1.0	3.2	3.3	3.3	3.4	3.5	3.5	3.6	3.6	3.7	3.7	3.8

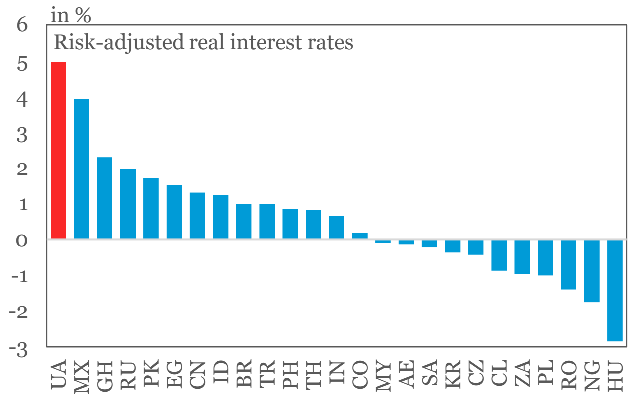
Source: Haver, IIF

Exhibit 3. Non-resident interest picked up sharply.



Source: Haver, IIF

Exhibit 4. Ukrainian real interest rate is highest among EM.



Source: Haver, IIF

- ***Total issuance will decline*** in upcoming auctions. Furthermore, the maturity profile is expected to change and become less attractive to foreign investors. Thus, ***growth of non-resident portfolio investment is expected to slow***.
- Considering a policy rate of 17%, inflation around 5-6% in the medium term, and a CDS spread around 500bps, ***the risk-adjusted real interest rate lies around 5.0%***, the highest among major emerging markets (Exhibit 4).
- Despite favorable global financial conditiones, ***Ukraine is at risk to a change in market sentiment***. A new IMF program would represent another positive signal to the markets. However, as investors expect a new program to be agreed upon relatively quickly, delays could change market sentiment and cause capital outflows. We do not see this as a likely scenario as both sides appear to be interested in an agreement.
- The ***relative illiquidity of the local market and relatively long maturity of bonds*** should stand in the way of sudden and dramatic changes.
- ***Market access for non-residents has improved*** dramatically since Ukraine was connected to Clearstream in May of 2019.

NEW IMF PROGRAM EXPECTED SOON

As a result of early parliamentary elections and the clear majority for President Zelensky's party, ***negotiations with the IMF over a new program are expected to start*** as soon as a new government is in place (likely September).

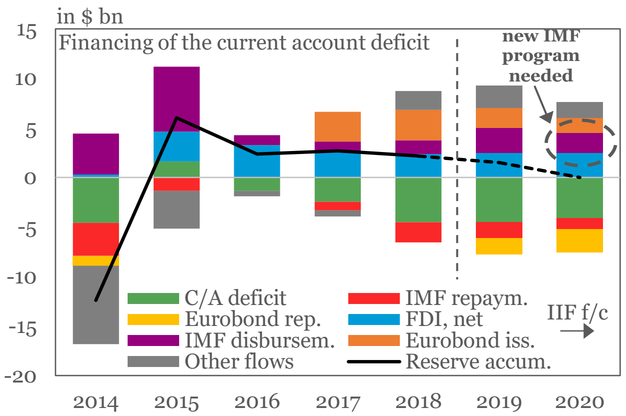
- The ***IMF is expected to visit Kyiv soon***, possibly in the week of August 26. Talks at the technical level are reported to have already begun.
- ***Four candidates are being discussed for the position of Prime Minister***: Vladyslav Rashkovan (IMF Executive Director), Andriy Kobolev (CEO of Naftogaz), Yuri Vitrenko (Naftogaz Executive Director), and Oleksy Honcharuk (deputy head of Zelensky's office). At this time, Honcharuk is considered the tentative favorite due to his close relationship with the president.
- The NBU expects that ***a 3-to-4-year Extended Fund Facility (EFF) could be agreed upon before the end of the year*** to replace the December 2018 SBA, which was intended to carry Ukraine through the presidential and parliamentary elections in 2019.
- The external financing picture has improved markedly, and ***Ukraine does not urgently require liquidity*** to meet its external obligations. Specifically, liquidity is sufficient to get past the September peak in FX debt repayments (close to $2 bn, of which more than $0.5 bn consist of repayments to the IMF).
- Thus, the new program will not require any frontloading and is primarily needed to fulfil obligations to the IMF. A ***program size of around $2 bn*** per year is being discussed, which aligns with our analysis (Exhibit 5).
- The fact that ***negotiations can build on past programs*** might speed up the process.

AMBITIOUS REFORM AGENDA

Many reforms have already been implemented under previous programs, including gas market liberalization and a clean-up of the banking sector. However, the ***new government appears committed to an ambitious reform agenda***.

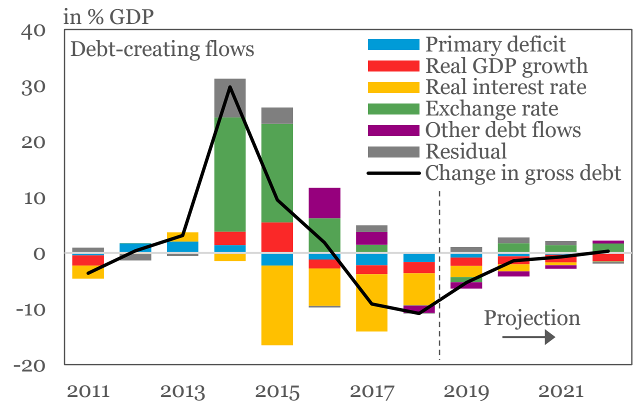
- President ***Zelensky seems to be planning for a quick implementation of land reform*** and the Finance Ministry has already drafted a bill in cooperation with the World Bank. We see passage of land reform as fairly likely before the end of the year.
- ***Liberalization of the gas market has been a contentious issue*** during previous IMF programs. However, the decline in gas prices in the global market

Exhibit 5. A new IMF program will be needed in 2020.



Source: Haver, IIF

Exhibit 6. Public debt is set to decline further.



Source: Haver, IIF

has reduced the burden on consumers for the time being. An increase in gas import prices would bring this issue back to the forefront as a specific formula for future price adjustments has not been determined.

- Anti-corruption efforts have been an integral part of past programs and will remain in focus. An ***anti-corruption court was established*** in April 2019 after parliament had approved the respective law in 2018.
- The previous government approved the ***split of the State Fiscal Service into two seperate bodies***: tax service and customs service. Reform of the revenue administration was a structural benchmark in previous programs, but implementation was delayed repeatedly. Both entities are expected to be fully operational soon.
- ***Parliament also has to adopt the so called "split" laws,*** which regulate the division of the National Commission for Regulation of Financial Services Markets between the NBU and the National Commission on Securities and Stock Market.
- The ***reform of state-owned enterprises (SOEs)*** will also be an important part of any new program.
- We believe that the ***government will be interested in implementing major reform efforts soon*** to demonstrate to the IMF its willingness and ability to address structural challenges.
- The ***new parliamentary majority could be less interested in preserving the status quo***, as it includes fewer allies of entrenched interests (oligarchs).
- Despite positive signals, local analysts expect some delays since ***conflicts will surface once policy details come into focus***, as opposed to a broad commitment to certain objectives.

PUBLIC DEBT IS SUSTAINABLE

The ***fiscal outlook appears positive*** (Exhibit 6) and faster growth will lead to smaller deficits.

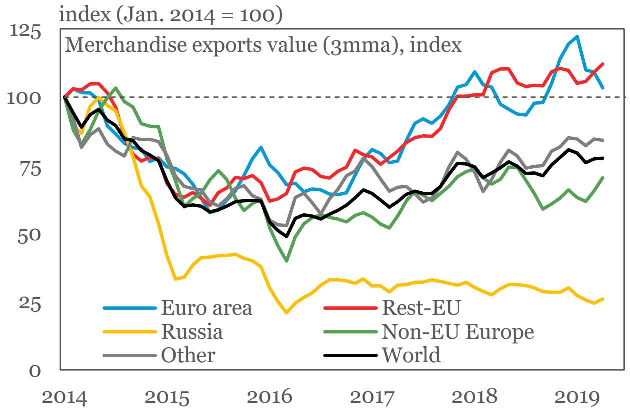
- Ukrainian budgets are typically based on fairly conservative assumptions, frequently leading to ***overperformance relative to fiscal objectives***.
- Over the first half of 2019, ***both the revenue and expenditure side of the budget have been underperforming***, the former partially due to lower-than-expected import tax payments as a consequence of the stronger exchange rate.
- The 2020 budget will be submitted to Parliament on September 15 and ***the planned deficit is in line with previous commitments*** to the IMF.
- ***Hryvnia depreciation is the most important risk*** to the sustainability of public debt as our analysis shows. In the near term, the stronger Hryvnia will help with debt service payments, as around 60% of debt is in FX.
- ***We expect the Hryvnia to remain broadly stable***, between 25.5-26.5 UAH/USD in the near term.
- Medium term, ***high interest rates and slowing inflation will likely attract more interest in UAH-denominated bonds*** and shift the composition of external debt.
- Another important goal is a ***to smoothen the debt repayment schedule*** to avoid peaks such as in September of this year.

EXTERNAL ENVIRONMENT COULD WEAKEN

Export reorientation towards the EU following the establishment of the Deep and Comprehensive Free Trade Area (DCFTA) has supported the current account, in the context of strong import growth as a result of rising disposable incomes (Exhibit 7).

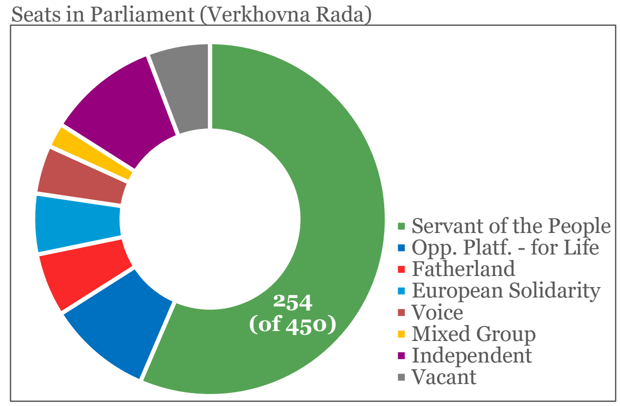
- So far, ***favorable terms of trade***, partially a result of falling energy prices, ***have supported Ukraine's trade balance***.

Exhibit 7. Exports to the EU have increased in recent years.



Source: Haver, IIF

Exhibit 8. Zelensky's party has a clear majority.



Source: Haver, IIF

- Despite the slowdown in the Euro area, ***exports have proven to be fairly resilient***. This is a result of the large share of agricultural products, which tend to be less prone to cyclical swings.
- Medium and long term, the large dependence on commodities and agricultural products leads to a ***substantial exposure to price swings and weather events.***
- The overall slowdown of the world economy could lead to lower demand for agricultural goods and thereby ***weigh on prices for Ukraine's agricultural exports***. This would cause a deterioration of the current account. Furthermore, prices for iron ore, another important export, could be further hit by US-China trade tensions.
- Currently, remmitances from abroad essentially cover Ukraine's trade deficit and ***emigration is expected to continue*** due to the large demand for labor in Poland, the Czech Republic, and other CEE economies. If Ukrainians resettle permanently, remittances could fall and weaken domestic demand.

POLITICAL RISK REMAINS

The ***main risk to Ukraine's outlook is political***, despite the presidential party's significant majority in the new parliament (Exhibit 8).

- While the government will have a clear mandate to implement reforms, ***euphoria will likely not last for more than a year***, if history is any guidance.
- In addition to the eventual decline in public support, ***the president's party in parliament could fracture***, as it was created in a relatively hasty fashion before the snap election.
- Furthermore, while the president's team has been saying the right things, ***it remains unclear what specific policies Zelensky is planning to pursue***.
- Therefore, the new government should attempt to ***pass the most important pieces of legislation by the end of the year***.
- The fact that many of the president's allies will remain in parliament rather than joining the adminstration could lead to an ***improved ability to pass legislation***.
- Some local analysts have ***concerns about a replacement of NBU governor Smoliy***, which would send a very negative signal to the markets as well as the IMF. Furthermore, NBU deputy governors are expected to resign if Smoliy is ousted.

RELATED PUBLICATIONS

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