Ukraine

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The economy showed higher than expected resilience to the past year's downturn and is going through a bumpy recovery. Sound and consistent macroeconomic policy making has been further cemented while some progress has been made in implementing structural reforms.

Country Risk Analysis

Summary

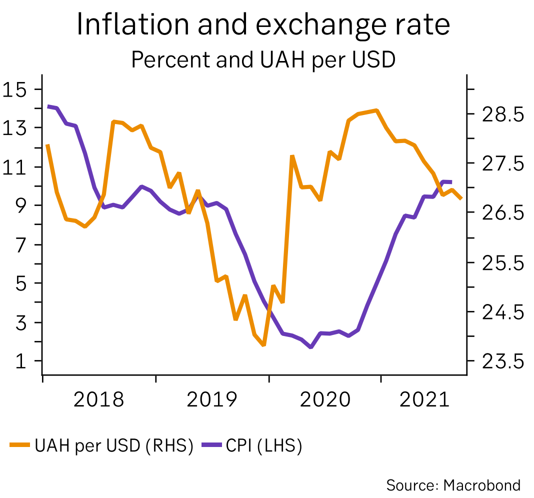
Ukraine showed higher than expected resilience to the past year's global downturn but have experienced a slightly slower recovery than regional peers. Consistent macroeconomic policies, including the inflation targeting framework and a flexible exchange rate, together with the past years' financial sector reforms, are among the factors that have contributed to this resilience.

External buffers to protect against a balance of payments difficulties have improved over the past year, helped by an improvement in the current account and the IMF's one-off SDR allocation. Despite constructive talks with the IMF and a gradual pace of reform, conditions have still not permitted the next loan disbursement under the Fund programme. Government funding needs are not acute and external debt obligations will be slightly lower over the next few years. However, Ukraine will need to tap international capital markets for refinancing and for financing a growing current account deficit. In the medium-term this can only be done on reasonable conditions if the authorities stick to the agreed conditions of its IMF programme. This remains a key country risk weakness.

The political situation remains challenging with vested interests holding back the government's pace of reform. Nevertheless, some progress have been made with judicial reform and strengthening the anti-corruption framework. Geopolitical risks, mainly relating to the conflict in the East, remain important.

Recent economic developments

Sluggish recovery following contraction last year. Following a contraction in real GDP of 4.2% last year, a recovery started in the fourth quarter. The pace of growth recovery has been sluggish and rocky, however, partly reflecting on and off in mobility restrictions. The vaccination rate is rising slowly but is among the lowest in Europe. Fuelled by robust consumer demand, the recovery and the global up-tick in food and energy prices has fuelled inflation. Consumer price inflation recently hit 10.2%, far surpassing the central bank's 5% (+/-1%) target.



Financing secured despite IMF programme on hold. The country's IMF programme which expires in December 2020 remains on hold as some key reform criteria have not been met. The last disbursement from the arrangement was in July 2020. Constructive talks are ongoing although the IMF's recent one-off SDR allocation may have reduced the authorities' sense of urgency. Meanwhile, financing needs have been met by new borrowing, mostly domestically. In addition, Eurobonds were successfully issued in the midst of last year's downturn, and more recently in April and July 2021. The latter was a USD 500 mn bond maturing in 2029 at a 6.3% yield. This reflects relatively solid investor sentiment and provides some comfort that that near-term financing needs can be met through alternative channels.

Surplus on the current account helped out. The sovereign's need to secure foreign currency was helped by a significant improvement in terms of trade in 2020. This and import compression contributed to shifting the current account into a surplus of 4.5% of GDP. In 2021, there was a still surplus in Q2 as exports remained surprisingly strong. Remittances, normally high in a global comparison, were resilient in 2020 and in the first half of 2021. Foreign direct investment (FDI) which were negative in net terms in 2020 have recovered in 2021.

External debt higher than average. Overall external debt as a share of GDP had been on a steady decline since the peak in 2015 but edged up to 82% by end-2020 on the back of increased government borrowing. By mid-2021 it had declined again. These levels are higher than among most country risk class peers. Non-financial private companies hold most of the debt. In net terms, Ukraine is an external creditor. External debt amortisations in 2021 have been significant, with a peak in Q3, although slightly lower than in 2020. Payments have been comfortably met.

Financial market sentiment reasonably favourable. Portfolio flows started to recover in the second half of 2020, and the exchange rate has strengthened since early 2021. Another reflection of improved investor confidence is the increase in non-resident holdings of domestic bonds since early 2021. The share of foreign owners, however, is still lower than at the peak in early 2020.

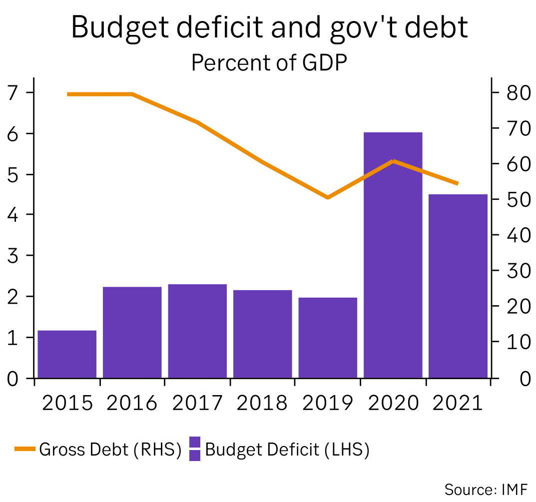
Reserves broadly stable. 18 months ago, IMF loan disbursements helped drive up foreign reserves to long-term highs. Since then, reserves have been broadly stable, in line with expectations but contrary to most emerging markets. The one-off IMF SDR allocation, equivalent to roughly 10% of the central bank's (NBU) reserves, largely coincided with foreign bond repayments. Hence, reserves are parked at roughly the same level as at the end of 2020 or USD 27 bn. This is equivalent to nearly 5 months of next year's imports and nearly 1.5 times the level of outstanding short-term external debt. These ratios have been strengthening since 2017.

Banking sector health is improving. The clean-up and downsizing of the banking system over the past years contributed to maintaining financial stability during downturn. Aggregate soundness indicators, such as capital adequacy and profitability have improved in the past year. This also includes non-performing loans which continued to decline to 37.2% of total loans in Q2 2021. The still very high level is mitigated by a high level of provisioning. The share of dollar deposits in the sector has also declined but remains high. Although the banking sector is relatively small, the large share of state-owned banks (roughly half of total bank assets) and their poor asset quality represents an important contingent liability for the government. The government aims to reduce its ownership in the sector to 25%, mainly via the sales of Privatbank and minority stakes in several other banks. This likely lies years down the road.

Sovereign ratings steady. Although the major sovereign credit rating agencies have left their ratings unchanged over the past year, one of them recently upped its outlook from stable to positive.

Economic policies

Temporary fiscal expansion. The process of consolidating public finances naturally came to a halt in 2020, but the general government deficit widened less than expected (6% of GDP). Budget balances subsequently improved in the first half of 2021, largely due to higher than expected revenues.



Government debt rose temporarily. The pandemic induced higher budget deficit temporarily reversed the decline in government debt seen in prior years. The general government debt rose to about 60% from 48.9% of GDP in 2019. This is moderate compared to peers. Meanwhile, contingent liabilities remain significant. Access to multilateral financing has kept debt affordability slightly stronger than peers. Interest costs/revenues are hovering around 8%.

High share of FX denominated debt has been stable. The share of government debt denominated in foreign currency has remained stable over the past year at about 60%. Much of this is owed to multilateral creditors. The share is relatively high and makes the debt burden vulnerable to a depreciation of the exchange rate.

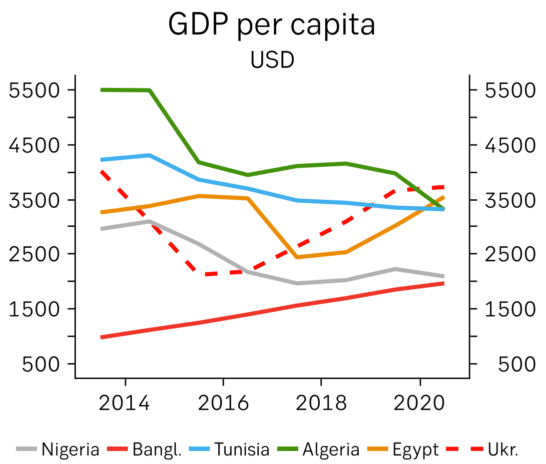
Monetary policy tighter as analysts are weary of the central bank's standing. Analysts are debating to what extent the NBU's position has weakened since the appointment of the new governor a little more than one year ago. Given that the bank has raised interest rates from 6 to 8.5% in 2021 in response to accelerating inflation rates, one may argue that its reaction function has not changed significantly. On the other hand, it is reported that nearly one third of senior management has left since the new governor's appointment. Several of them have referred to political pressure.

Structural policies and institutions

Some progress on reform in the midst of the pandemic. In mid-2021, important progress was made with judicial reform and measures to strengthen the anti-corruption framework. Parliament also adopted new legislation relating to the banking sector, including the central bank. The privatisation process has picked up pace, with revenues rising more than threefold in 2020, albeit from low levels, and continued up in 1H 2021 too. At the same time, there have been signs that corporate governance reform in the state-owned enterprises may not have progressed as far as expected. The World Economic Forum's global competitiveness index puts Ukraine at 85th of 141 countries. The ranking balance strengths such as infrastructure, the level of education and market size against the poor quality of institutions and innovative capabilities.

Governance standards is a weakness but gradually improving. On the quality of governance and institutions, Ukraine scores poorly compared to country risk peers. Corruption related indicators and measures of political stability, in particular, are weak. This being said, several World Bank indicators have been improving somewhat over the past few years. Transparency International's corruption perception rankings has also been on an improving trend since 2013, recently putting Ukraine at 117 place of 180 countries. On the business climate, the World Bank's (nowadays much questioned) Ease of Doing Business index has improved in the past five years and puts Ukraine ahead of most country risk class peers and 64th of 190 countries.

Per capita incomes above most country risk peers. Given that the population is shrinking, GDP per capita has been growing at a slightly higher rate than real GDP over the past few years. Although PPP adjusted per capita incomes declined slightly in 2020, a rise in nominal incomes puts the country above most country risk peers.



Source: World Bank

Political and security situation

Strong parliamentary position versus strong vested interests. A relatively challenging political and institutional environment remains a country risk weakness. President Zelensky's Servant of the People party holds an unprecedented and comfortable majority in parliament but vested interests continue to work against necessary reforms. New efforts have recently been made to deal with the influence of oligarchs, most notably those with links to Russia. While positive, these may increase tensions further with affected parties. Western political support remains strong and creates incentives to move forward on economic reforms.

Geopolitical risk remains elevated. On the military conflict with Russia, little progress has been made relating to the Minsk treaty. Instead, Ukraine has been trying alternative paths and recently launched the Crimea Platform. The forum, with high level international attendance mainly sent the message that Crimea belongs to Ukraine. Taking the opposite view, President Putin has repeated that Ukraine's borders are fake and that Russians and Ukrainians are one people. The message is old but some observers concluded that this was as an escalation of his ahistorical rhetoric. In parallel, Russia recently pushed Belarus forward in the process of creating a "union state" with Putin as President. Separately, Russia amassed about 100000 troops on Ukraine's Eastern border earlier this year and blockaded parts of the Black Sea. The snap exercise showed the speed by which Russia can concentrate forces to the area. The forces withdrew in early May but left significant amounts of equipment behind showing that Russia is not willing to let the Ukrainian conflict getting too cold.

Outlook

Economy facing bumpy near-term recovery. Our house forecasters Oxford Economic have recently cut their growth forecasts for 2021-2022. They pointed to a slower than expected start of 2021 and see tighter economic policies ahead amplified by significant risks of further mobility restrictions. Forecasts for 4% and 3.5% real GDP growth are broadly in line with those of the central bank.

Medium-term economic growth to settle at around 3%. Recent years' reforms may have improved prospects for higher longer-term growth. Most recently, several observers welcomed new legislation aimed at loosening oligarchs hold of parts of the economy arguing that such steps are key to any material improvement in long-term economic growth. This being said, most analysts are expecting medium-term economic growth to settle around 3%. Achieving higher levels will still be challenging given relatively low investments and demographic pressures, recently aggravated by the outflow of labour to neighbouring economies.

Public finances to gradually improve in the near-term. This year's general government budget deficit is likely to decline to about 4.5% of GDP, despite continued pandemic related spending and another hike in minimum wages. This would be a slightly faster pace of reduction than targeted by the government, largely due to higher than planned revenues. The government's budget for 2022 targets a 3.5% of GDP deficit, in line with IMF expectations. The IMF projects a steady decline in government debt/GDP to 44.8% of GDP by end-2025.

Financing needs remain high. Following large debt repayments in 2H 2021, external debt payments will be slightly lower in 2022. Nevertheless, they still amount to well above 10% of GDP. Together with the expected budget deficit in the order of 3% this means that government financing needs will remain high also in 2022. In order to maintain access to external financing on reasonable conditions, continued close cooperation with the IMF will be necessary. We assume this will happen, either through an extension of the current SBA into 2022 or, more likely, that a new more ambitious EFF arrangement will be negotiated.

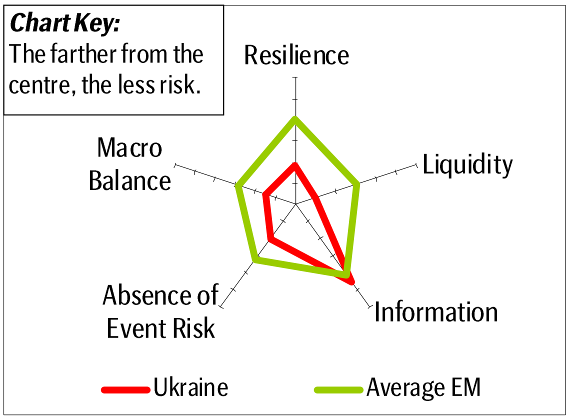
Risks relating to IMF agreement and to the near-term growth outlook. First, the assumption of a continued cooperation with the IMF naturally comes with a risk. Indeed, the country has a relatively poor track record in implementing Fund programmes. Discontinued IMF cooperation would most importantly squeeze the supply of external financing, making the sovereign dependent on more expensive domestic financing from the country's underdeveloped capital market. In such a scenario there is also a risk that the country's heavy external debt repayments could divert funds away from public investment and other growth enhancing measures.

Second, uncertainty over the pace of economic recovery is significant, largely due to the development of the pandemic. Infection rates are rising rapidly at the time of writing and vaccinations rates remain very low.

Military conflict still poses risks. A downside risk to our main macroeconomic scenario is an intensification of geopolitical tensions. In particular, should the military conflict in the East spread or intensify it would risk dampening sentiment and reducing economic activity. It would also pose risks to public finances.

Ukraine: Risk Profile

Key ratios	2021
Population (Mn)	41,5
GDP/capita (USD)	4 229
Real GDP (% chg)	4,0
Inflation (%)	9,2
Current Account (% of GDP)	-3,2
Reserves/imports (months)	5
Budget balance (% of GDP)	-4,5
Government debt (% of GDP)	54



External Ratings:
Fitch: B (pos)
Moody's: B3 (sta)
S&P: B (sta)

Peers:
Tanzania
Turkey
Egypt

Graph: Ukraine shows some strength on macro balance but is generally weaker than the average emerging market country as illustrated by the red line mostly falling inside the green one.

Ukraine: Key Economic Indicators

	2017	2018	2019	2020	2021	2022	2023	2024
Macroeconomic								
GDP (% chg)	2,4%	3,5%	3,2%	-4,0%	4,0%	3,5%	2,7%	2,6%
GDP (USD bn)	112	131	154	155	175	190	209	234
GDP/capita (USD)	2 632	3 088	3 651	3 711	4 229	4 614	5 117	5 781
Investments/GDP	18%	20%	21%	17%	17%	19%	19%	19%
Trade/GDP (%)	92%	88%	80%	72%	67%	67%	64%	60%
Money & Prices								
CPI inflation (%)	14,4%	10,9%	7,9%	2,7%	9,2%	6,7%	5,4%	5,0%
Money supply, M2 (% chg)	75%	63%	56%	92%	112%	118%	124%	140%
Interest rates, short-term	14,5%	18,0%	13,5%	6,0%	7,0%	7,0%	7,0%	7,5%
Oil price (Brent)	$44	$54	$71	$64	$42	$62	$60	$60
Government Finances								
Budget balance/GDP	-2,2%	-2,1%	-2,2%	-6,1%	-4,5%	-3,5%	-2,4%	-2,4%
Govt debt/GDP	72%	60%	49%	61%	54%	52%	49%	46%
Interest costs/revenues	10%	8%	8%	7%	8%	7%	7%	7%
Balance of Payments (USD bn)								
Current account	-3,5	-6,4	-4,1	5,3	-5,5	-7,4	-7,6	-9,9
as % of GDP	-3,1%	-4,9%	-2,7%	3,4%	-3,2%	-3,9%	-3,6%	-4,2%
Export of goods	48,9	48,2	51,7	48,8	47,9	52,6	55,4	58,4
Imports of goods	62,0	63,8	67,4	61,0	66,9	71,5	74,5	76,9
FDI, net	3,7	4,5	5,2	-0,1	4,2	4,6	5,2	5,8
Loan repayments	9,4	11,0	9,9	20,7	22,9	25,1	27,4	29,6
Other capital flows, net	-24	-12	-6	-5	-4	-4	-10	-15
External Debt & Liquidity (USD bn)								
Total debt	123	121	124	138	153	167	182	197
as % of GDP	109	92	80	89	87	88	87	84
short-term debt	22,3	20,7	22,0	24,5	23,5	24,9	26,3	27,9
Reserves (ave.)	15,6	19,8	24,1	27,5	30,2	30,5	30,8	29,9
months of imports	3	4	5	5	5	5	5	5
Exchange rate vs USD	26,6	27,2	25,8	27,0	27,3	28,7	29,4	29,5

Source: Oxford Economics, IMF and SEB estimates

Rating history (end of year)				
Fitch	B-	B-	B	B
Moody's	Caa2	Caa1	Caa1	B3
S&P	B-	B-	B	B

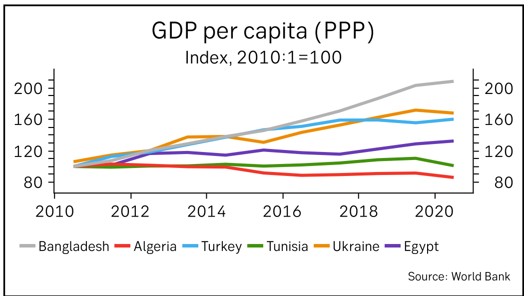
Type of government: **Democracy**

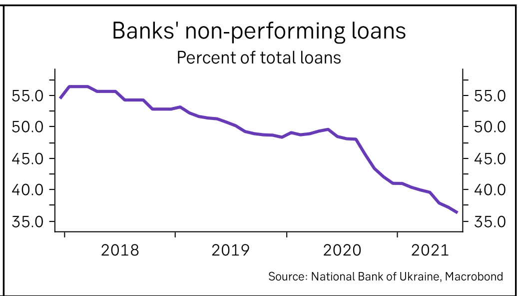
Next elections: Legislative elections 2023, presidential elections 2024

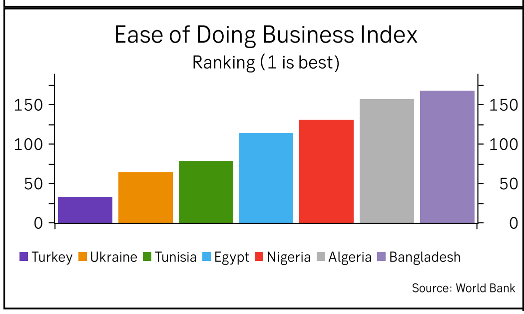
Other:

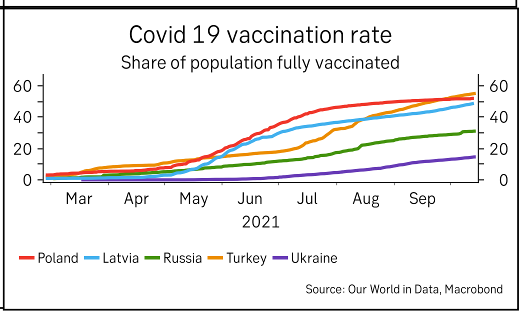
Latest PC deal: Rescheduled debt 1994, 1995 and 2015.

Latest IMF arrangements: USD 5 bn. 18-month Standby Arrangement, exp in December 2020









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