Kyiv
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Ukraine:
Macroeconomic Radar

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Last months, economic activity forecasts are being regularly deteriorated amid a reassessment of the effects of the pandemic and the lockdown. Recently, the IMF and the World Bank have almost simultaneously published their updated forecasts, however, with radically different positions. The IMF forecasts GDP to fall by 8.2% this year and grow by 1.1% next year, meanwhile, the World Bank predicts a decline of 3.5% and growth of 3.0%, respectively. If the former forecast can be considered rather as a stress scenario, then the optimism of the second one is difficult to explain. Instead, balance of payments, exchange rate and inflation expectations are gradually improving. The same applies to the forecasts of lowering the NBU key policy rate, although they traditionally lag behind the decisions of the NBU.

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Economy and GDP forecasts

The national economy starts to reopen after two months of strict quarantine. However, the prevailing number of forecasters expect the recovery to be gradual due to the weak demand and negative effect of other post-pandemic constraints on productivity. Most of the organizations project Ukraine's real GDP to fall by 5-6% in 2020 and grow by 4-5% in 2021. The forecasts of the Government and the NBU, in general, fit into this picture. Real GDP is projected to fall by 4.8-5% in 2020 and grow by 4.3% in 2021 (NBU). Notwithstanding, NBU noted in its communications on the latest monetary policy decision that "consumer and investment demand are highly likely to remain subdued longer than it was projected in April... and the fall in the Ukrainian economy may be deeper than expected." Thus, forecasts are likely to be deteriorated slightly in the coming months.

The IMF's and the World **Bank's** positions mismatch

The IMF and the World Bank have almost simultaneously published their updated forecasts at the beginning of June. At the same time, the projections of these organizations, whose headquarters are located straight opposite each other in Washington, D.C., were radically opposite. The IMF, from its side, has published a scenario that, according to key indicators, can be used rather for stress testing. In particular, the IMF has downgraded its forecast to 8.2% GDP decline this year (from 7.7% in April WEO) and 1.1% recovery next year (from 3.6%). Instead, the World Bank expects GDP to fall by only 3.5% this year and grow by 3.0% next year.

Inflation

Consumer inflation continued to slow down and updated its 2013 minimum by falling to 1.7% YoY in May. Weak demand and fall of global energy prices maintained their effects and prevailed among other factors. However, recovery of demand and prices for energy products, as well as, weakening of the hryvnia exchange rate are expected by the end of the year. According to consensus estimates, these factors will cause inflation acceleration to 5.5-5.7%. It looks like forecasts will be revised downwards in the upcoming months, as Dragon Capital and ICU recently did. For example, in April, the NBU projected 6% for 2020. But it is already clear that inflation will stay below the target for a longer period than expected in April. The Government and IMF inflation forecasts (11.6% and 7.7%, respectively) seem genuinely surprising against this low inflationary background. Overall, most forecasters set inflation close to the NBU's target of 5% by 2021, which to some extent is evidence of confidence in the monetary policy of the central bank.

NBU’s key policy rate

Low inflation allowed NBU to take another decisive step and reduce the key policy rate to 6% last week, which is historically lowest level. This became a surprise to most forecasters, who on average projected the key policy rate of about 6.5% at the end of this year with a marginal cut next year. Back in April, the NBU itself expected that the rate will be reduced to 7% and will remain at this level until the end of 2021. At the same time, in its communications NBU warned about the end of the cycle of sharp rate cuts and gave neutral forward guidance, hinting at the possibility of further change of policy rate in both directions. This makes the NBU’s new policy rate forecast, which is to be published at the end of July, even more interesting to see.

Budget execution

To a large extent, this forecast will depend on the budget execution. So far, despite the lack of revenue and high shortfall in expenditures, most forecasters project budget deficit for the year to be close to the plan - about 7% of GDP. While the IMF and the NBU forecast 7.7% and 8% of GDP, respectively. Next year, a moderate fiscal consolidation is expected with a reduction of the deficit to 3.6% of GDP. At the same time, the IMF's forecast of the budget deficit at the level of 5.3% of GDP gives reason to expect a more gradual reduction of the budget deficit.

Despite a significant increase in the budget deficit this year, public finances appear stable. The growth of public debt to GDP ratio is expected to be quite moderate - up to 63% of GDP this year with a return to the downward trend next year.

Current account

The external position of Ukraine's economy proved to be quite resistant to the effects of the coronacrisis due to a significant improvement in terms of trade and a sharp reduction in imports. However, despite the formation of a rather significant current account surplus for the first 4 months, most forecasters expect a deficit at 0.6-1.7% of GDP for this year and its expansion to 1.6-2.2% of GDP next year. The revision of forecasts of the current account balance of this year is likely in the upcoming months, as it was recently done by Dragon Capital and ICU, which now synchronously forecast a surplus of 1% of GDP.

NBU reserves

Given the agreements on official financing, the possible return of the Government to the international capital market, and the resumption of private capital inflows, international reserves are projected at US$25-26bn at the end of this year and US$26.4-27.3bn at the end of 2021. NBU forecasts are traditionally slightly higher. However, the new IMF forecast is frankly surprising. Reserves are projected to fall to US$19.3bn this year and recover only to US$23.4bn next year.

And this is despite the fact that the IMF takes into account the official funding as planned. Such an outcome is possible only due to a significant outflow of private capital, with much higher volumes than observed in March. As mentioned above, this forecast can be seen as the stress test rather than as a baseline scenario.

Exchange rate

It is clear that under such conditions the hryvnia exchange rate should weaken sharply. The IMF does not publish its exchange rate forecast, but calculations based on other indicators confirm this. However, most forecasters expect only a moderate weakening of the exchange rate - up to 28 UAH/USD at the end of this year and up to 28.3-28.9 UAH/USD next year.

Conclusions

The macroeconomic situation is relatively stable. Inflation is low, the balance of payments is improving, the budget deficit is within acceptable limits, taking into account the crisis caused by coronavirus pandemic. Realization of crisis scenarios in the financial sector (significant capital outflow, national currency devaluation, bank system crisis) is possible only under the development of political crisis or dramatic worsening of economic activity indicators.

A political crisis can be caused by political struggle or sharp and unexpected problems in the economy. In turn, such problems may arise due to thoughtless recruitment decisions. For example, the collapse of the NBU's independence or further changes in the Government's financial and economic bloc that will worsen the quality of the Cabinet of Ministers and related Ministries. Irresponsible economic policies and acceleration of corruption at state owned enterprises can also facilitate the political crisis. Overall, the probability of such scenarios remains low, in our opinion, although it has increased recently

Annex. Forecasts of key macroeconomic indicators of Ukraine

		2018	2019	2020						2021					
				Cons	Gov	NBU	IMF	WB	EBRD	Cons	Gov	NBU	IMF	WB	EBRD
					29.03.20	23.04.20	09.06.20	08.06.20	13.05.20			23.04.20	09.06.20	08.06.20	13.05.20
Activity															
Real GDP	YoY, %	3,4	3,2	-5,3	-4,8	-5,0	-8,2	-3,5	-4,5	4,4		4,3	1,1	3,0	5,0
Nominal GDP	UAHbn	3 561	3 975	3 956	3 986	3 970	3 908			4 450		4 360	4 277		
Nominal GDP	US$bn	130,8	155,2	146						158					
Unemployment	%	8,8	8,2	10,7	9,4	9,5	12,6			9,6		8,6	12,0		
Inflation															
Headline inflation	YoY, %, e.o.p.	9,8	4,1	5,5-5,7	11,6	6,0	7,7			5,0-5,5		5,0	5,9		
Headline inflation	YoY, %, avg.	10,9	7,9	3,9	6,8	4,3	4,5			6,0		5,8	7,2		
GDP deflator	YoY, %	15,4	8,1	5,1	5,3	5,1	7,1			7,7		5,1	8,2		
Exchange rates															
UAH/USD	e.o.p.	27,7	23,8	27,9-28,1						28,3-28,9					
UAH/USD	avg.	27,2	25,8	27,05						28,15					
External balances															
C/A balance	US$bn	-4,4	-1,3	-2,4		-2,5	-2,2			-3,4		-5,3	-2,9		
C/A balance	% of GDP	-3,3	-0,9	-1,7 - -0,6			-1,7			-2,2 - -1,6			-2,0		
Trade balance	US$bn	-11,4	-12,4	-11,1	-8,3	-12,4	-7,5			-13,6			-12,9		
Exports	US$bn	59,1	63,4	58,9	59,9	63,4	56,1			61,9		61,6	63,2		
Imports	US$bn	70,5	75,8	70,0	68,2	75,8	63,6			75,4		75,3	76,0		
Reserves	US$bn	20,8	25,3	25-26		27,2	19,3			26,4-27,3		28,6	23,4		
Interest rates															
NBU's key policy rate	%, e.o.p.	18,0	13,5	6,5		7,0				6,1-6,3		7,0			
Fiscal Balance															
Budget balance	% of GDP	-2,4	-2,1	-6,9		-8,0	-7,7			-3,6		-2,8	-5,3		
Public debt	% of GDP	60,9	50,6	63,1			65,4			61,1			62,7		

Do you have comments or questions?
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