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# Ukraine: Changes Are Real But So Are Challenges

By Natalia Gurushina, Chief Economist

*Economist Natalia Gurushina visited Ukraine and met with key policy makers in the public sector along with private sector analysts.*

## Key Takeaways:

- Ukraine's economy is stabilizing and the new government is making significant progress on the structural front in order to help secure the next installment from the International Monetary Fund ("IMF").
- However, the risk of another slippage in the reform drive is real and a potential political flare-up in the fall can complicate the situation and delay further IMF disbursements.
- Despite the recent improvements, Ukraine's economy is still in "intensive care" with a questionable growth outlook and a weak banking sector.
- Conditional upon the legislative approval of key reforms, we expect short-term funding from the official sector (IMF, U.S. guarantees, others) of at least $3 billion in the coming months. Ukraine 2019 bonds are currently trading 650 basis points ("bps") over 3-year U.S. Treasuries and given the increase in the National Bank of Ukraine ("NBU") international reserves and official funding forthcoming the spread looks very attractive with limited default risk. The valuation for longer duration exposure is less compelling due to long term growth and reform commitment concerns.

## Outlook

Changes in Ukraine are real. The economy shows signs of stabilization with much high-frequency data turning the corner, the devaluation spiral seems to be over, the international reserves are gradually increasing, and headline inflation is back in the single digits after skyrocketing to more than 60% year-over-year in the first half of 2015. The central bank has initiated the clean-up of the banking sector, formally adopted the inflation targeting regime, and started to shift to rule-based decision making.

Some political challenges seem to be eliminated (at least optically) after the government reshuffle in April 2016 and there is perception that decisions are being made from a single political center. It seems there is much optimism about the new government especially after Prime Minister Groysman's brave decision to go for a larger than expected (or required by the IMF) increase in the gas tariffs and appoint several "transparent" managers on key positions in major state-owned enterprises (SOEs).

It was clear from our visit that agents of change in the government do exist and they are pushing forward the reform agenda as much as they can. Most of the key bills required for the disbursement of the next IMF tranche have been passed by the parliament and the likelihood of getting the IMF Board's approval in the coming months is reasonably high.

However, this process will remain complicated due to internal conflicts, the dysfunctional parliament and a very fragmented political scene. In practical terms, this means that implementation risks are high for the already approved legislation and that outstanding structural issues (including pension reform and

privatization of largest SOEs) will likely have a bumpy ride in the parliament and other power structures potentially delaying the disbursement of the subsequent IMF tranches. Unfortunately, this visit failed to dissipate our concerns about another slippage in the reform drive – especially given a risk of snap elections in the fall. The Achilles Heel of the current presidency is that the coalition's majority in the parliament is slim and can easily fall below 226 votes. If the snap elections take place, the likely result will be more oligarch-driven and populist Rada.

Even though the economy started to shift to a new model, Ukraine is still in "intensive care" lacking a comprehensive transition program for the next few years. The viability of local sources of growth is highly uncertain. First, UAH (the national currency of Ukraine) devaluation eased pressure on the international reserves and improved the external imbalances but it also undermined household consumption and accentuated currency mismatches in the corporate sector reducing its ability to borrow. Second, political instability and a lack of privately-owned "investable" companies with low leverage limit foreign direct investment inflows and depress the investment growth. Third, the fiscal consolidation process is not over yet which means that the public sector spending will remain constrained in the foreseeable future.

Ukraine is effectively in the period of "monetary stagnation" with the banking sector not yet able to lend and many companies not yet able to borrow. The restructuring of the largest commercial bank, Privatbank, is taking longer than expected while the level of non-performing loans (NPLs) is close to 45%. We believe the NBU is not in a hurry to ease under the circumstances and wants to keep the real policy rate strongly positive in order to reduce inflation and gain credibility. One encouraging development is that the government is working with the U.S. Treasury and the European Bank of Reconstruction and Development ("EBRD") on a scheme to sell bad loans but it remains to be seen if and when it will be operational.

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