Economic Outlook for 2021-2023

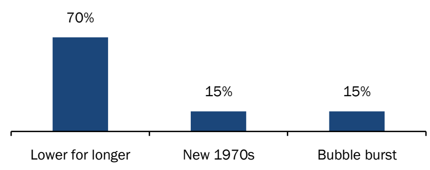
STRATEGY

A choice between falling behind and catching up

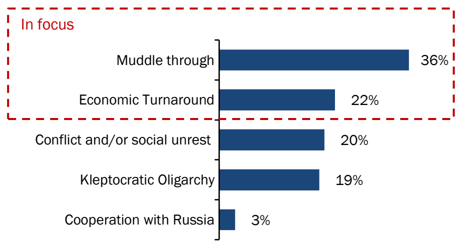
In 2020, the Ukrainian economy delivered a positive surprise amidst the worst global economic crisis since the Great Depression. Ukraine was relatively lucky to avoid a prolonged lockdown, as well as to face the most positive terms of trade since 2010. However, Ukraine's economic resilience was foremost rooted in one-off positive events, the absence of financial crisis on international markets (due to unprecedented policy response) and, to a certain extent, local macrofinancial stabilization achieved over 2016-2019. While rather responsible economic policies over 2014-19 allowed Ukraine to withstand the economic shock of 2020, they are not sufficient to set the country on a sustainable path of economic convergence with its peers and rivals. Our analysis suggests that maintaining a status quo is not enough to break the trend of economic underperformance, and there are significant socio-political risks if this path continues.

- In our view, **"*Muddle through*" remains the most likely socio-political scenario (36% probability) in the mid-term period.** In such a scenario, the structural reforms' agenda is not likely to get through social, institutional, and political barriers, resulting in lower economic growth and persistently high volatility. Average annual real GDP growth over 2021-23 is expected at 3.1% (vs 4.6% as World's average, 5.5% in EMs, and 3.8% in Emerging Europe). In contrast to previous recoveries, the growth is not expected to be driven by the devaluation-fueled net export. Instead, we expect that such sluggish though well-balanced economic growth will be driven by household consumption and investments against the mostly supportive external conditions over 2021-2023.
- **The economic growth achieved under our baseline scenario ("*Muddle through*") is not sufficient for economic convergence with more advanced countries** both over the forecast period and over the long run. This scenario lacks a sustainable determination in long-term geopolitical orientation and, subsequently, internal policies, though it is characterized by a marginal inclination towards the cooperation with Western partners.
- In our main alternative scenario ("Economic turnaround", 22% probability), the government is likely to support investment-led growth with the necessary structural reforms based on the development of efficient, fair, and competitive markets, with a required improvement in the state's institutional capacity. This scenario results in a 4.8% average annual real GDP growth over 2021-23.
- **Our baseline scenario and main alternative scenario are subject to the following risks:** *(1)* escalation of the military conflict with Russia and/or social unrest (with a combined probability of 20%), and *(2)* sliding into pure "Kleptocratic Oligarchy" with a Kuchma/Yanukovytch-like economic policy (19% probability).
- **Based on our analysis, we recommend to overweight short and mid-term USD-denominated sovereign bonds**, and to underweight both UAH-denominated bonds with maturity starting from August 2021 and USD-denominated bonds with maturity starting from mid-2024.

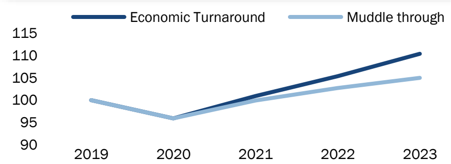
Expected probability of global economic scenarios



Probability of Ukraine's socio-political scenarios



Ukraine's GDP in % of 2019 GDP (in constant prices)



Key macroeconomic forecasts for Ukraine		Marginal Changes			Economic Turnaround		
	2020E	2021F	2022F	2023F	2021F	2022F	2023F
Real GDP growth, % y-o-y	-4.0	4.2	2.8	2.2	5.2	4.4	4.8
Consumer Price Index (UAH), % a-o-p	2.7	8.2	6.4	5.2	8.4	5.2	4.8
Consolidated budget balance, % of GDP	-5.4	-4.6	-3.4	-3.1	-4.2	-3.0	-2.8
C/A balance, % of GDP	4.0	-0.8	-2.1	-2.4	-1.5	-3.6	-4.2
FX rate, USD/UAH, a-o-p	27.0	28.2	29.1	30.1	27.5	28.1	28.6

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Ukraine's Economy in 2020: A Deserved Luck?

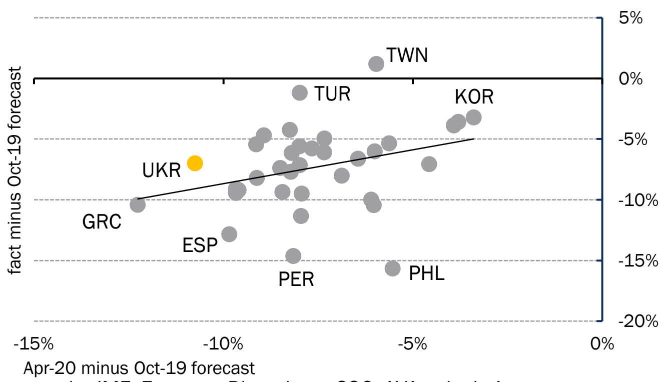
At the start of the global pandemic, Ukraine was expected to have a miserable economic performance in 2020. Instead, Ukrainian economy outperformed IFIs' and market expectations with a 4% decline of its real GDP. Based on current market forecasts, including our own forecast, economic output will reach the pre-pandemic level by the end of 2021. However, GDP will not return to the previous trend for several years, suggesting a better-than-expected, yet a dip recession in 2020.

Last year Ukraine has again underperformed its closests peers. Throughout the year, Ukraine was lucky to avoid prolonged total lockdown as well as to face the best terms of trade since 2010. At the same time, none of this would have brought such benefits in 2020 if there was a financial crisis on international markets, if there were no such positive one-off events like Gazprom's payment 2018 Transit Arbitration award, of if there were no responsible macroeconomic policies taken by successive governments during 2014-2020.

With the beginning of the global pandemic in March 2020, Ukraine found itself at the forefront of the negative revisions of economic growth forecasts. For instance, the IMF's 2020 Ukraine real GDP growth forecast was revised from about +3.5% to about -7.5% in April 2020. This was the second-largest growth downgrade among 81 countries in the IMF database filtered by nominal GDP (greater than USD 10B) and population (greater than 10m). The top five largest growth downgrades from October 2019 to April 2020 IMF World Economic Outlook (WEO) for countries' 2020 real GDP growth were as follows: Greece - 12.3%, Ukraine – 10.7%, Zimbabwe – 10.1%, Spain – 9.8%, Italy – 9.7%.

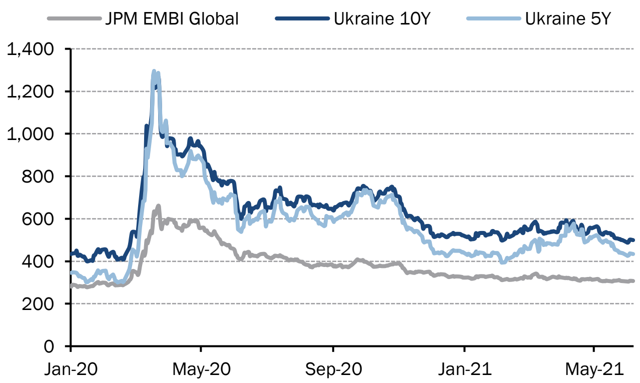
Financial markets were also increasingly skeptical about Ukraine's economic outlook and correspondingly increasingly wary of the country's risk. Figure 2 shows that the spread between Ukraine's and Emerging Markets' risk perception increased drastically since the start of the pandemic. The change in spreads also indicates that such a period of high pessimism was rather short-lived, as the disparity in risk assessment narrowed at the beginning of summer 2020 when the economic consequences of the pandemic became clearer. Even though the spreads did narrow following Ukraine's strong economic performance in 4Q'20, they did not return to pre-COVID-19 levels. Therefore, markets believe that Ukraine's risks relative to its peers did increase.

1. Real GDP change in 2020: Fact *vs* 2019 Forecast and Change in expectations (Apr'20 vs Oct'19)



Source: the IMF, Eurostat, Bloomberg, SSC, AYA calculations

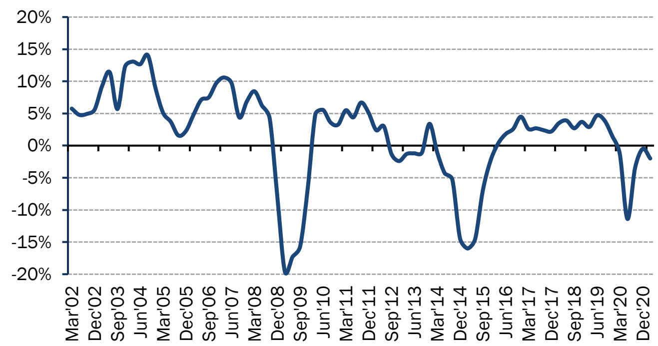
2. Market view of Ukraine's risk (spreads vs US Treasuries in basis points)



Source: Bloomberg, AYA calculations

Ukraine’s economy surprised to the upside, finishing the year with a loss of only 4% output, meaning that the difference between the actual 2020 growth and the IMF’s October 2019 WEO forecast was -7% rather than -10.7% (expected in April 2020). Even in terms of quarterly GDP growth, the worst hit Q2’2020 was not exceptionally bad by Ukraine’s recent historical “standards” (see Figure 3). Similarly, it is expected that Ukraine’s economic output will reach the pre-crisis level already in 2021. This makes 2020 recession very different from the previous episodes as the real GDP in 2019 was still 6% below its 2013 level and 12% below its 2008 levels (see Figure 4).

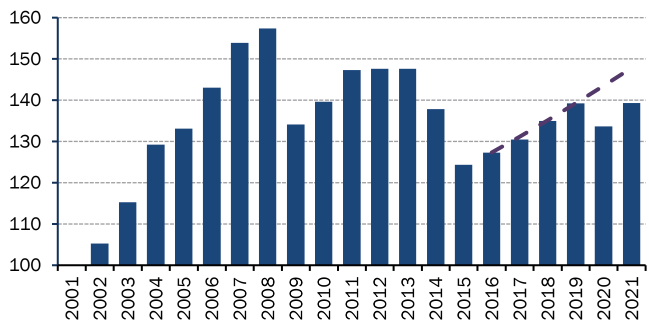
3. Real GDP change: quarter over the same quarter of previous year



Source: SSC

4. Indexed GDP in constant prices, 2001 – 2021’e

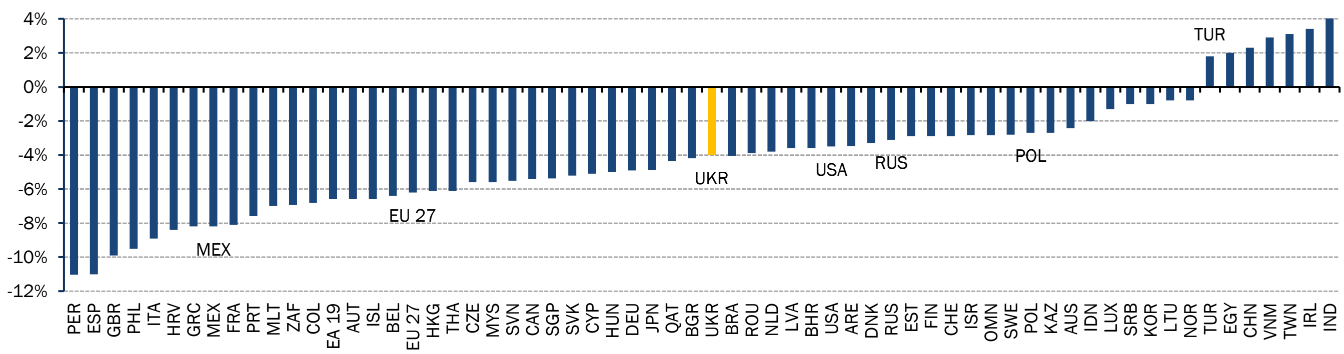
Index, 2001 GDP = 100



Source: SSC, AYA estimates and calculations. 2021 is based on our expectations for the baseline scenario.

At the same time, as Figure 1 shows, Ukraine was not the only country to outperform expectations. For instance, while countries such as Spain, surprised the market to the downside, countries such as Turkey and Taiwan delivered even larger positive surprises than Ukraine. Similarly, when it comes to the actual performance in 2020, in the group of 16 Emerging and Developing countries in the IMF classification, Ukraine has underperformed eight countries including Bulgaria, Russia, Poland, and Belarus. Therefore, the main conclusion from Ukraine’s performance in 2020 is that it was indeed better than expected, but it is still consistent with a thesis of Ukraine's chronic economic underperformance against its peers (Poland) and rivals (Russia). This is especially relevant given that Ukraine’s economic performance in 2020 would be even worse, if we adjust the growth rates for nonrecurring positive events, as described in this section below.

5. Real GDP change in 2020 (in %, y-o-y), selected countries



Source: Eurostat, Bloomberg, SSC

Technically, a better-than-expected GDP growth was driven by consumption, net exports, and government spending. Despite the pandemic already affected Q1'20 output data, private consumption still had a positive contribution to quarterly GDP growth in Q1. Similarly, private consumption contributed about 1% to the GDP growth in Q3. Strong wholesale and retail trade performance in Q4 (see Figures 6 and 7) also indicates a positive contribution of consumption to GDP growth. Secondly, net exports provided support for GDP in all three quarters of 2020 for which we have officially disclosed detailed data. In Q1 net exports' contribution was enough to offset the decline in government spending, in Q2 it was enough to fully cover the decline in private consumption, and in Q3 it lowered the quarterly GDP decline by almost two times. Finally, better than expected economic growth and macrofinancial stability allowed the growth of government consumption in Q3. Investments is the only GDP component that negatively contributed to GDP growth consistently throughout 2020. While the decline in investments was mostly driven by de-stocking, favorable monetary policy certainly cushioned further decline in private investments.

6. Real GDP (selected) components heatmap, y-o-y change

GDP component (selected)	2019 weight	1Q'18	2Q'18	3Q'18	4Q'18	1Q'19	2Q'19	3Q'19	4Q'19	1Q'20	2Q'20	3Q'20	4Q'20
Taxes on products	15.3%	0%	0%	3%	1%	1%	3%	2%	2%	-3%	-14%	-5%	-2%
Wholesale and retail trade	13.3%	5%	3%	6%	4%	1%	4%	4%	5%	5%	-6%	10%	11%
Manufacturing	11.3%	2%	2%	2%	-2%	0%	2%	3%	-1%	-3%	-14%	-5%	-1%
Agriculture	10.0%	-1%	20%	3%	14%	3%	7%	5%	-7%	-2%	-29%	-11%	-8%
Transportation and storage	6.4%	0%	2%	2%	0%	2%	4%	3%	4%	-10%	-30%	-13%	-12%
Public administration	6.1%	-1%	-1%	-2%	2%	6%	6%	6%	6%	-2%	-1%	5%	3%
Real estate activities	6.0%	10%	9%	9%	7%	6%	7%	8%	9%	3%	-6%	4%	4%
Mining and quarrying	5.7%	2%	1%	4%	3%	2%	3%	-2%	-8%	-5%	-9%	-1%	2%
Education	4.3%	0%	1%	0%	-1%	-3%	-1%	0%	-1%	-5%	-4%	-5%	-6%
Information and communication	4.1%	5%	6%	9%	6%	6%	7%	8%	9%	3%	-4%	5%	5%
Professional, scientific/technical services	3.3%	6%	6%	6%	7%	2%	5%	7%	8%	-1%	-22%	-12%	-11%
Electricity, gas, steam supply	2.9%	2%	8%	-1%	4%	-7%	2%	1%	-10%	-7%	-4%	2%	6%
Financial and insurance	2.8%	11%	-2%	14%	18%	6%	18%	4%	-10%	1%	-6%	5%	4%
Construction	2.7%	2%	8%	11%	9%	28%	22%	21%	24%	-4%	-5%	10%	13%
Health and social work	2.1%	-6%	-1%	-6%	-3%	7%	1%	2%	0%	-4%	3%	4%	4%

Source: SSC, AYA calculations

7. Ukraine's industry performance heatmap, y-o-y change

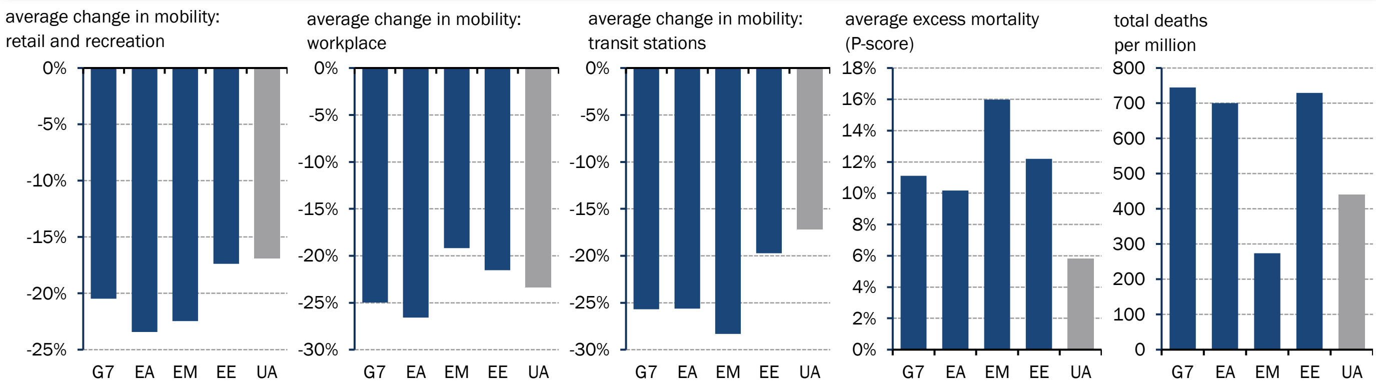
	2017	2018	2019	2020	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21
Agriculture	-2%	8%	1%	-12%	-1%	1%	-5%	0%	-4%	-41%	-6%	-6%	-19%	-18%	11%	26%	-6%	-7%	-2%	-5%
Construction	26%	9%	24%	4%	4%	-4%	-12%	-16%	-3%	0%	-1%	7%	13%	13%	9%	10%	-13%	-13%	-12%	13%
residential construction	16%	1%	5%	-19%	5%	-5%	-25%	-29%	-28%	-24%	-34%	-12%	-7%	-16%	-5%	-25%	-10%	6%	9%	40%
Retail trade	7%	6%	10%	8%	12%	16%	6%	-15%	-3%	1%	9%	9%	12%	15%	12%	13%	4%	6%	13%	34%
Wholesale trade	3%	4%	-1%	3%	-2%	-3%	-3%	-7%	2%	11%	-6%	7%	18%	4%	8%	6%	-1%	-1%	-6%	15%
Transportation	6%	-3%	2%	-14%	-21%	-11%	-13%	-27%	-26%	-18%	-15%	-4%	-13%	-10%	-8%	-6%	-1%	-9%	-7%	6%
transportation excl. pipelines	3%	-2%	1%	-6%	-4%	-3%	-7%	-19%	-20%	-11%	-6%	5%	-5%	-6%	4%	2%	-9%	-9%	-3%	11%
Passenger turnover	7%	5%	3%	-54%	0%	0%	-53%	-96%	-92%	-71%	-57%	-48%	-51%	-54%	-57%	-51%	-52%	-45%	15%	1092%
Key sectors output	3%	4%	2%	-4%	-3%	-1%	-6%	-15%	-9%	-10%	-5%	-2%	-7%	-8%	3%	9%	-4%	-4%	0%	18%
Mining	-4%	3%	-2%	-3%	-4%	-4%	-4%	-11%	-9%	-5%	-1%	0%	-3%	-2%	2%	6%	-3%	-4%	-2%	7%
Coal	-17%	6%	-3%	-14%	-19%	-15%	-19%	-35%	-44%	-13%	5%	3%	-6%	-12%	-3%	-2%	-5%	-7%	8%	45%
Oil & Gas	2%	3%	0%	-2%	-3%	0%	-4%	-4%	-3%	-2%	1%	1%	0%	-2%	-3%	-4%	-5%	-8%	-4%	-4%
Ore	-9%	4%	-3%	-2%	-2%	-6%	-3%	-16%	-4%	-5%	-5%	-4%	-8%	-2%	11%	20%	0%	1%	3%	12%
Manufacturing	5%	3%	1%	-7%	-3%	0%	-7%	-19%	-16%	-5%	-5%	-7%	-5%	-5%	-2%	3%	-7%	-7%	3%	18%
Food processing	6%	-1%	3%	-2%	4%	9%	0%	-5%	-4%	2%	6%	0%	-7%	-6%	-3%	0%	-8%	-13%	-6%	-3%
Coke and oil production	-7%	7%	3%	-2%	4%	2%	-3%	-1%	-1%	8%	-9%	6%	-8%	-13%	-9%	4%	-16%	-2%	-3%	0%
Chemicals	2%	15%	13%	5%	26%	24%	5%	9%	-5%	2%	15%	1%	6%	2%	-13%	3%	10%	14%	14%	9%
Pharmaceuticals	4%	-5%	4%	3%	-14%	0%	21%	17%	9%	-7%	-20%	14%	-5%	-2%	0%	25%	21%	0%	-18%	-10%
Basic metals	-3%	1%	-1%	-9%	-10%	-4%	-16%	-30%	-19%	-4%	-10%	-10%	-7%	-3%	9%	5%	-4%	-4%	5%	29%
Machinery & equipment	12%	12%	-2%	-19%	-13%	-12%	-15%	-35%	-32%	-21%	-20%	-22%	-8%	-18%	-14%	-2%	-10%	-7%	8%	41%
Industrial output	1%	3%	-1%	-5%	-5%	-1%	-7%	-15%	-13%	-5%	-3%	-4%	-3%	-4%	1%	5%	-4%	-5%	2%	13%

Source: NBU, AYA calculations

Multiple one-off factors supported the economic performance of the Ukrainian economy in 2020. These factors include such trivial aspects as a low comparison base in Q4'20 for some segments (e.g., agriculture and mining) and absence of financial crisis on international markets due to unprecedented policy response by various regulators (*see next section*). They also include a politically significant aspect of boosting construction spending using USD 3 bn funds received from the payment of the arbitration award from Gazprom to Naftogaz. But the most fundamental factors are the better-than-expected pace of pandemic for Ukraine, favorable international terms of trade, and, to a certain extent, macrofinancial stability.

Over the last decade, the share of private consumption has increased from about 65% to about 75% of GDP. While such an increase is driven mostly by the subpar investment activity, it still makes consumption by far the largest component of economic output. Since the pandemic was expected to hit employment, decrease households' income and increase households' precautionary savings, it was reasonable to expect a substantial decline in private consumption that, in turn, would significantly affect GDP performance in 2020. But this did not happen. We suppose that the main reason for better-than-expected consumption growth is better-than-expected pandemic outcomes.

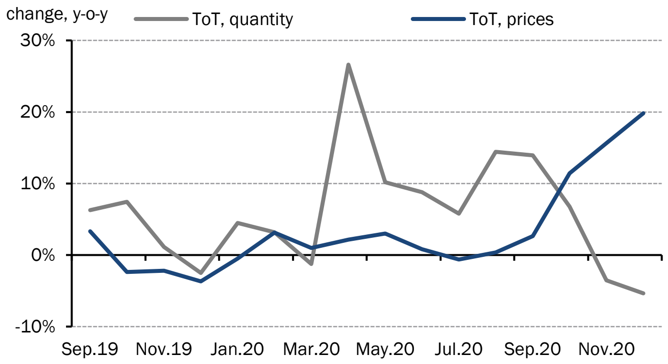
8. COVID-19 in 2020: change in population's mobility, excessive mortality and confirmed deaths per million



Source: COVID-19 Community Mobility Reports, OurWorldInData.org, AYA calculations

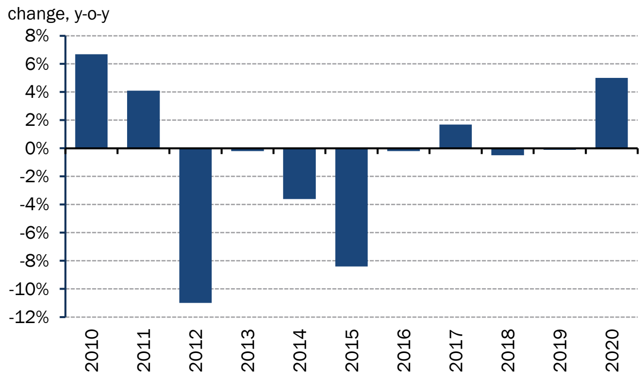
Indeed, Google community mobility data shows that the average decline in population mobility throughout 2020 in the three most important segments (retail and recreation, workplace, transit stations) was lower in Ukraine than in developed and in many East European countries. At the same time, this was unlikely driven by the government's failure to impose stricter lockdown measures when necessary due to political considerations or due to the state capacity constraints. If that would be the case, we would observe a higher average excess mortality and/or higher COVID-19 death rate in 2020. Instead, the data (see Figure 8) shows that Ukraine was lucky to get relatively better pandemic outcomes throughout 2020 that, in turn, allowed for a softer approach to lockdown measures. Correspondingly, fewer restrictions lead to better-than-expected economic performance.

9. Terms of Trade (ToT)



Source: SSC

10. Terms of trade, prices

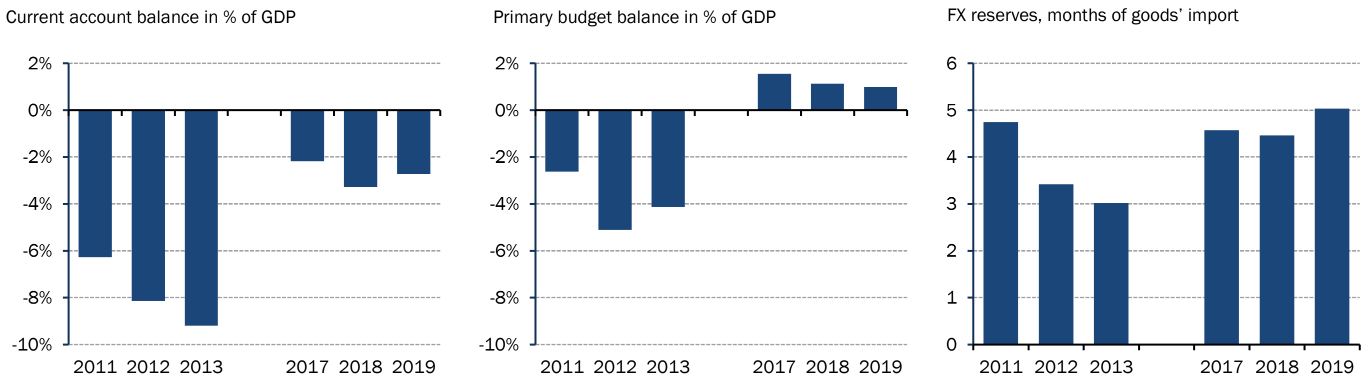


Source: SSC

The second explanation for better-than-expected economic performance also has little to do with Ukraine's internal factors. Instead, it results from a lucky external circumstance that positively affected Ukraine's net exports. Figures 9 and 10 show that in 2020 Ukraine experienced the most favorable terms of trade (ToT) since 2010, which contributed positively to GDP growth in Q4'20.

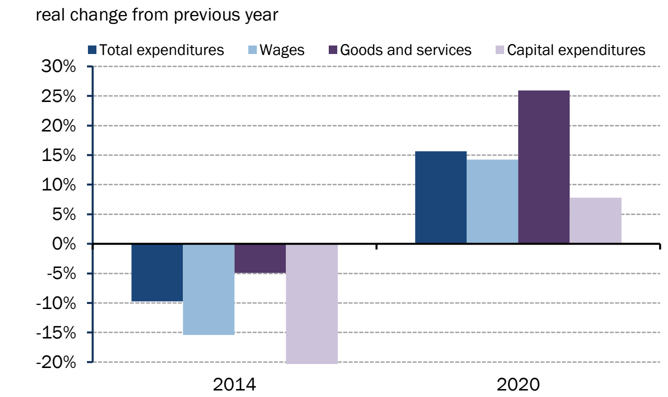
Finally, possibly the most important factor behind positive economic surprise in 2020 is macrofinancial stability. In contrast to previous recessions, Ukraine did not accumulate macroeconomic imbalances and, as a result, did not experience anything even slightly resembling a financial or banking crisis. Figure 11 clearly shows the difference between largely responsible economic policies before the pandemic and 'irresponsible' policies before 2013/2014. In turn, macrofinancial stability allowed for countercyclical fiscal and monetary policy during the pandemic (see Figures 12 and 13), the first-ever case of countercyclical policy in Ukraine's modern history.

11. Macroeconomic imbalances: 2011-2013 versus 2017-2019



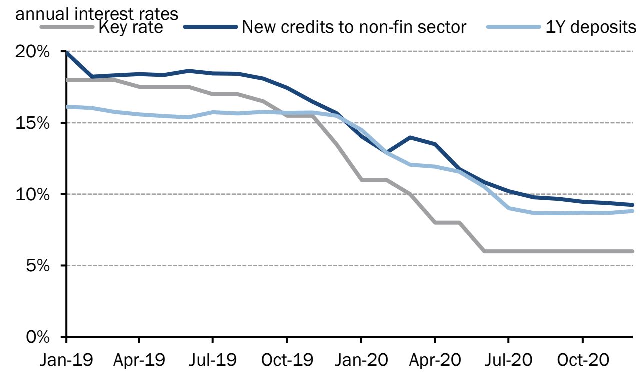
Source: SSC, NBU, AYA calculations

12. Fiscal response: budget expenditures



Source: NBU, AYA calculations

13. Monetary response in 2020: interest rates



Source: NBU

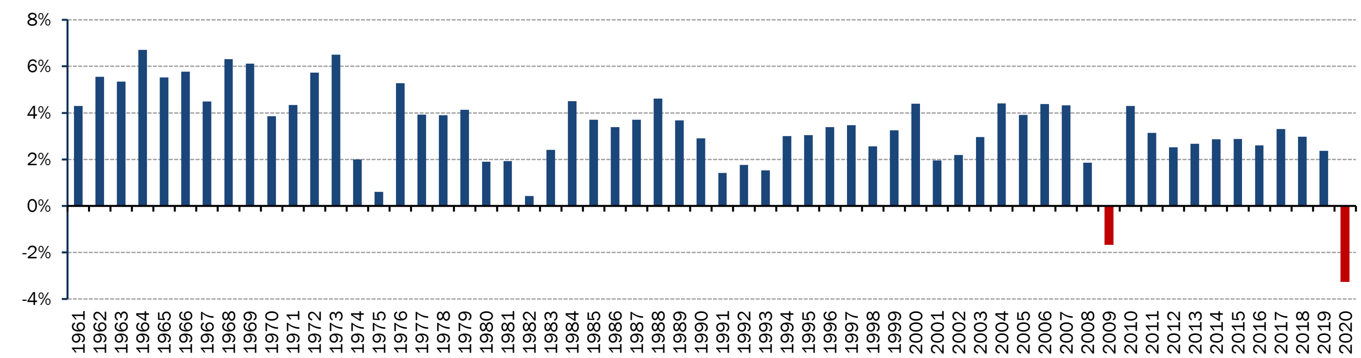
It is safe to say that neither fiscal/monetary stimulus nor a positive contribution of private consumption to GDP growth could be possible if Ukraine experienced a financial crisis in 2020. While the course of the COVID-19 pandemic and external trade environment were beyond the control of key Ukrainian institutions, the country still deserved to be lucky in 2020, at least to a certain extent. Mostly responsible macrofinancial policies that successive governments took over 2014-2019, together with a non-recurring support from significant increase in Naftogaz's contributions to the State budget created conditions for the relatively positive economic outcomes in 2020.

Global Economy: Again "Lower for longer"

The Great Lockdown surpassed the Great Recession and became the worst economic crisis since the Great Depression. Despite the historically unprecedented global policy response to the COVID-19 pandemic, the Global economy still contracted by 3.3% in 2020. The majority of market participants and economists continue to worry about long-lasting scarring effects on global growth going forward. Therefore, the main scenario for the global economy is consistent with the "lower for longer" investment thesis. While "*Lower for longer*" is by far the most likely scenario in our view, we assign a combined probability of 30% to two almost equally likely alternative scenarios: inflationary "*New 1970s*" and moderately deflationary "*Bubble Bursts*".

In 2020 the world experienced the largest economic crisis since the Great Depression. The global GDP declined by about 3.3%, only a second yearly decline since the 1960s. Obviously, some countries had it worse than others. For instance, China's GDP grew by 2.2%, which is still the lowest yearly increase since the beginning of market-oriented reforms in 1979, while UK GDP has plunged by 9.9%, the largest yearly drop since the beginning of the industrial revolution (the largest one-year decline since the "Great Frost" of 1709 when the economy declined by about 13%).

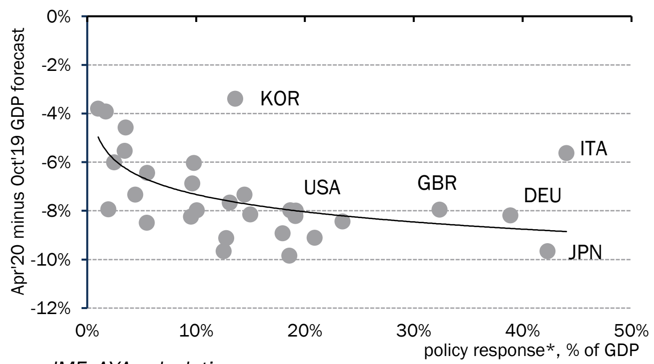
14. Global real GDP growth, % y-o-y



Source: World Bank

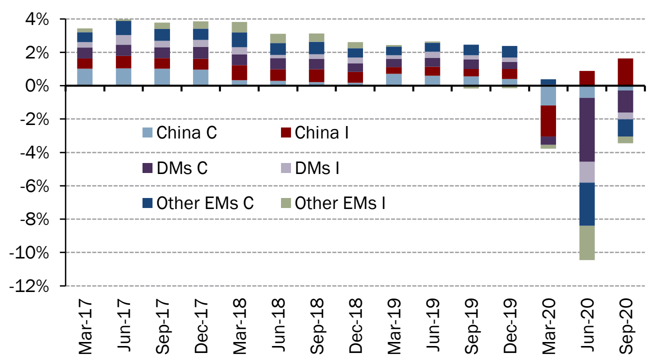
In such circumstances, the global policy response accounts for about 16% of the global GDP in fiscal stimulus alone, not including the effect from monetary easing and future expected fiscal expansion.

15. Policy response versus GDP forecast downgrade



Source: IMF, AYA calculations
** - including equity, loans, and guarantees*

16. Demand contribution to global GDP growth

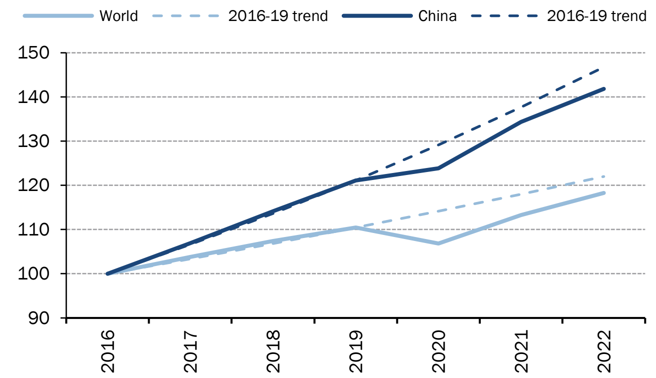


Source: IMF. C=Consumption, I=Investments.

The total policy response tends to be larger in the countries that are hit hardest (see Figure 15). At the same time, the unprecedented stimulus did not lead to a pick-up in demand, except in the case of Chinese domestic investments (Figure 16). We treat this observation as an indication that the magnitude of the economic stimulus should be treated in the context of a truly gigantic crisis.

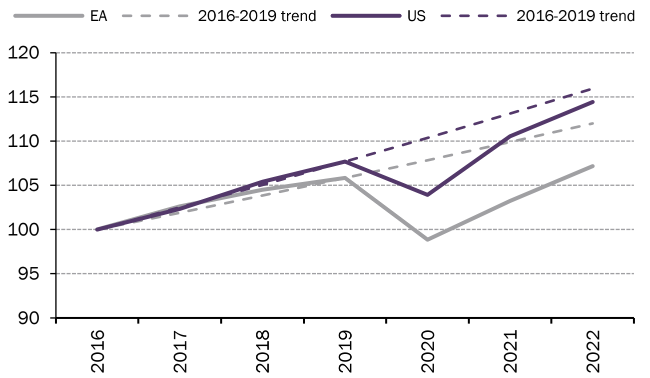
Indeed, neither the Global nor Chinese or European economies are expected to return to the pre-pandemic trend in the next two years. Even the US economy fueled by the approved Biden USD 1.9T fiscal stimulus is not expected to surpass the trend of economic growth by 2022. This means that despite the relatively fast economic recovery, COVID-19 is likely to inflict long-lasting economic scars. The IMF estimates that the cumulative per capita income loss to the pre-crisis projections by 2022 would range from 13% for developed economies to 22% for emerging economies excluding China[1].

17. Expected GDP growth vs trend over 2016-2019



Source: IMF, OECD, AYA calculations

18. Expected GDP growth vs trend over 2016-2019



Source: IMF, OECD, AYA calculations

The key question going forward is what are the long-lasting pandemic effects on the global economy. If the Great Lockdown is going to be similar to the previous exogenous economic shocks in its long-term economic consequences and leave virtually no economic scarring, then massive economic stimulus will inevitably lead to overheating and the return of inflation. We refer to such a scenario as the "New 1970s". However, if COVID-19 has the potential to leave scarring effects on the global economy, then, the recovery for the pandemic is likely to resemble what we used to since the Global Financial Crisis, namely, subpar economic growth, low inflation, and low interest rates globally. This scenario is commonly referred to as a "Lower for longer" investment thesis, which in turn represents a variation on the "secular stagnation" thesis, first popularized by Larry Summers in the mid-2010s.

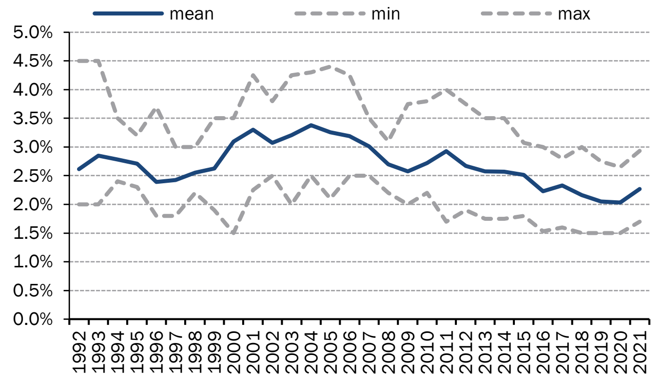
We analyzed long-term economic consensus forecasts for the United States[2] and found that leading US economists undoubtedly are in the "Lower for longer" camp. We treat the US as a proxy for the global economy as we believe that the US is the best positioned for a fast economic recovery. In other words, if the "lower for longer" thesis is relevant for the US, it is relevant for the EA and the EU.

Figures 19, 21, 23 below show the evolution of the next 10-year consensus forecast for the real GDP growth, inflation, and 10-year US treasury yield. Figures 20, 22, 24 show the uncertainty of these forecasts. While the most recent forecasts are definitely in line with the "lower for longer" thesis, what strikes us the most is the high level of agreement in the forecasts. For instance, survey participants were relatively more uncertain about the future path of economic growth in 2018 than they are in 2021. Similarly, the uncertainty about inflation and interest rates is well below the 2012 peak when a large fraction of market participants expected the early recovery from the 2008 crisis.

We understand such low uncertainty in the following way. We believe that the pandemic removed the excessive uncertainty about fiscal and monetary policy, which became larger as the US economy fully recovered from the negative effects of the balance sheet recession following the 2008 crisis.

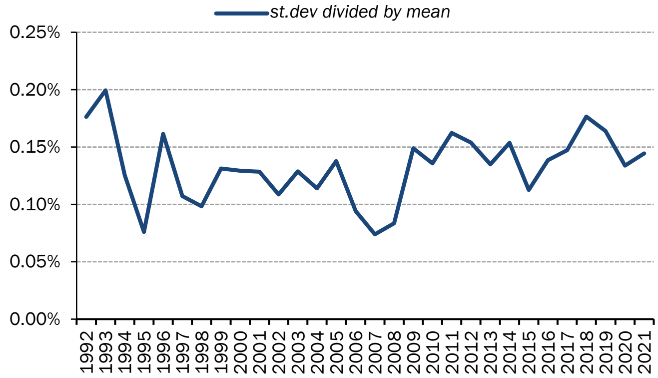
[1] The Great Divergence: A Fork in the Road for the Global Economy
[2] The data comes from the Q1'2021 Survey of Professional Forecasters (responses as of January 28th).

19. Consensus forecast: US Real GDP annual rate of growth in next 10 years: average, max, min



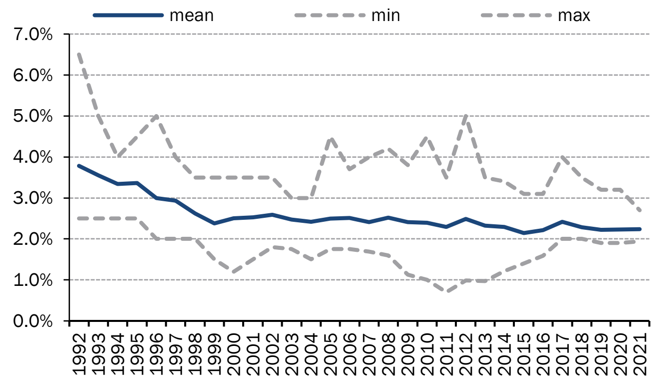
Source: Survey of professional forecasters, AYA calculations

20. Consensus forecast: US Real GDP annual rate of growth in next 10 years: forecast uncertainty



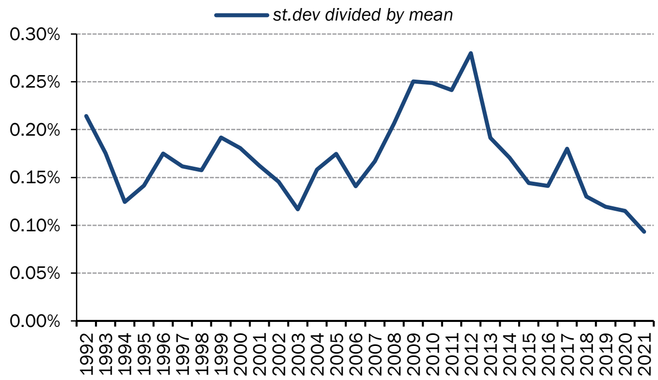
Source: Survey of professional forecasters, AYA calculations

21. Consensus forecast: US CPI annual rate of change in next 10 years: average, max, min



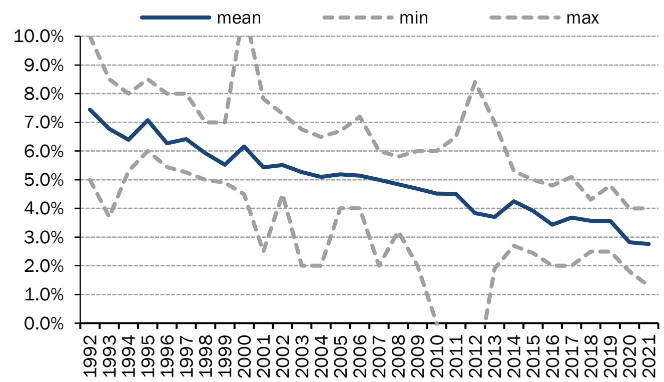
Source: Survey of professional forecasters, AYA calculations

22 Consensus forecast: US CPI annual rate of change in next 10 years: forecast uncertainty



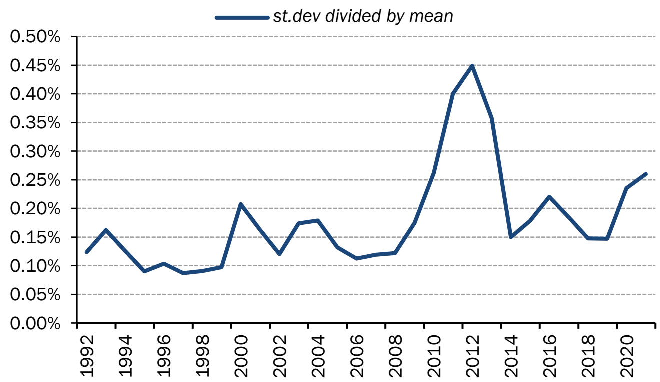
Source: Survey of professional forecasters, AYA calculations

23. Consensus forecast: US 10-year average annual bond yield in next 10 years: average, max, min



Source: Survey of professional forecasters, AYA calculations

24. Consensus forecast: US 10-year average annual bond yield in next 10 years: forecast uncertainty



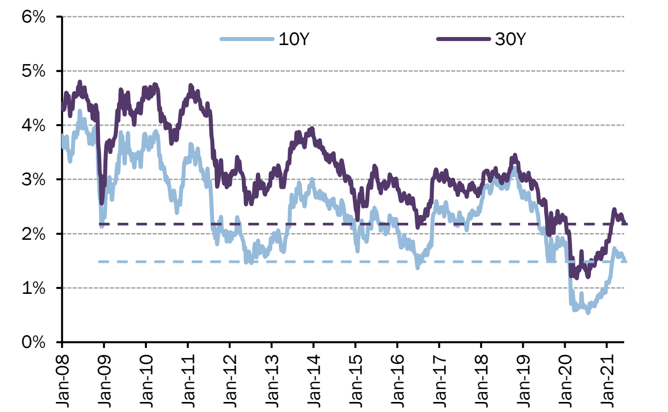
Source: Survey of professional forecasters, AYA calculations

In our view, “Lower for longer” is the most likely scenario for the global economy for now.

Research suggests that COVID-19 is likely to leave long-lasting economic scarring on the global economy. For instance, Fuentes and Moder (2021)[3] clarify that exogenous economic shocks in the past did not cause permanent economic damage - however, financial crises did. While the Great Lockdown would not leave scarring on the demand side of the global economy, it has the potential to negatively affect the potential level of output through several supply-side channels.

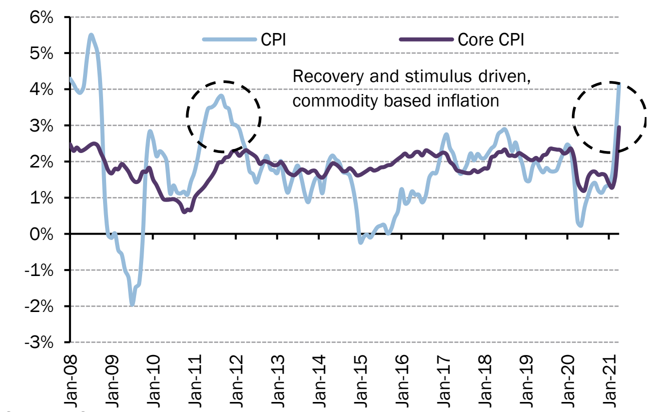
Recent market developments do not reject the “lower for longer” thesis. As a result of the impressive rally in the US treasury yields, the rates still stay at historically low levels, close to the average minimum levels of 2009-2019. Similarly, the uptick in the US CPI is still well below the levels that could be expected for the temporary recovery and commodity-driven increase in inflation. We also conclude that the recent increase in the US inflation expectation is well consistent with the “lower for longer” thesis. While inflation expectation derived from treasury-inflation protected securities (TIPS) suggested about 2.4% to 2.6% inflation rate in the next five years (the highest since mid-2008), 10-year expectations are at 2.3%, (2.7% and 2.5% correspondingly as of early May) which is reasonably close to the January 28th consensus forecast and to the post-2008 average. To be inconsistent with “lower for longer”, the US core inflation should gain a foothold above 3%.

25. US treasury yields since 2008



Source: Bloomberg

26. US consumer inflation



Source: St. Louis FED

At the same time, we also believe that the existing policy took-kit has evolved to deal with demand-side challenges. Effectively, both fiscal and monetary policies are less well equipped to tackle supply-side issues and more likely to result in accelerated inflation than in the case of structurally weak demand. Similarly, we believe that especially in the US the fiscal stimulus is used to soften the negative effects of increased inequality and, thus, poorly targeted. In contrast to the post-financial crisis environment, households are less likely to save due to precautionary motives and less likely to constrain spending in favor of deleveraging. Therefore, the current fiscal stimulus will have a higher multiplier and the probability of an inflationary scenario should be considered seriously.

Finally, we acknowledge a relatively high chance for the substantial stock market correction both in the US and globally following the broad loss of confidence in the current level of stock market valuation. The global liquidity is likely to worsen then, and interest rates for risky and high-risk borrowers, including EM governments, are likely to rise. In such a scenario we also expect capital outflow from EMs and relatively low commodity prices.

A short description of the global economic scenarios and their probability breakdown is presented in Figure 27. Given the current consistency of consensus forecasts (presented above), we expect that “Lower for longer” is by far the most likely scenario with a 70% probability.

[3] The scarring effects of COVID-19 on the global economy

27. Perceived probabilities of global economic scenarios

"Lower for longer"
Probability: 70%

- low inflation in the US over the next 10 years (about 1.5-2%) and subdued economic growth (about 2-2.5%)
- accommodative monetary and fiscal policy, both in the US and the EU/EA
- long-term interest rates at the 2010-2020 average level
- high valuation ratios, moderate capital inflows into emerging markets

"New 1970s"
Probability: 15%

- high inflation in the US over the next 10 years (above 4% on average), high commodity prices
- high real GDP growth in the US (above 3% on average), acceleration of GDP growth in the EU/EA
- accommodative monetary policy, accommodative/neutral fiscal policy, both in the US and EU/EA
- 10-year US treasury yield is at least 4%; lower valuation ratios, moderate capital outflows from emerging markets

"Bubble bursts"
Probability: 15%

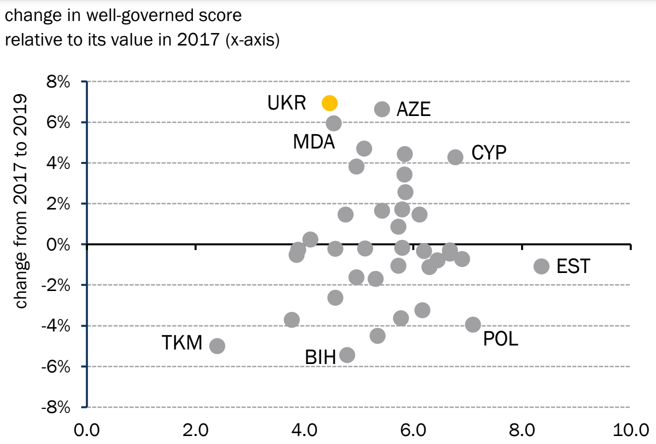
- more than 35% decline in the main US stock market indexes at some point over next 2-3 years
- low inflation in the US (about 1.5-2%) and subdued economic growth (about 2-2.5%) over the next 2-3 years
- lower commodity prices, low global growth, low liquidity, high interest rates for emerging market countries

Political Economy: Continuing to muddle through

Seven years since the Revolution of Dignity, Ukraine continues to find itself in the situation when business as usual is not sufficient for a steady economic growth going forward. In this section, we discuss the chances for a positive change. Unfortunately, a volatile mix of weakened political position, paternalistic request from objectively poor population, increased resistance to reforms from vested interests, and a stalemate between proponents of radical "state regulation" and radical "libertarianism" favor the high probability of "Muddle through" scenario. This scenario implies the absence of a strong commitment to any alternative economic model, where the State balances between populism, oligarchs and its desire to increase own power. In turn, such scenario will result in marginal progress towards institutional integration with the EU against a largely preserved status quo, with explicit cycles of progress and setbacks.

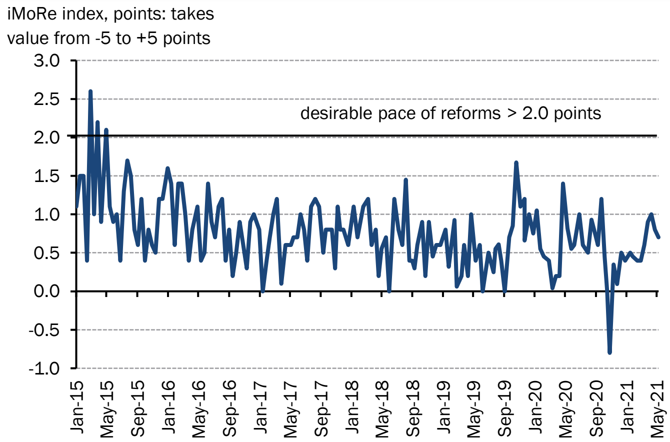
Ukraine has underperformed in the domain of structural reforms since gaining its independence[4]. Similarly, and most likely because of this, Ukraine also has failed to catch up in terms of living standards with comparable countries after the disastrous economic decline of the early 1990s. Unfortunately, Ukraine has largely missed a unique chance for drastic institutional changes following the Revolution of Dignity (2013-2014). While important progress has been made in several domains including state governance (see Figure 28), the overall pace of structural reforms was disappointing.

28. Progress in state governance, 2017-2019



Source: EBRD transition indicators, AYA calculations

29. iMoRe index: pace of reforms



Source: VOX Ukraine

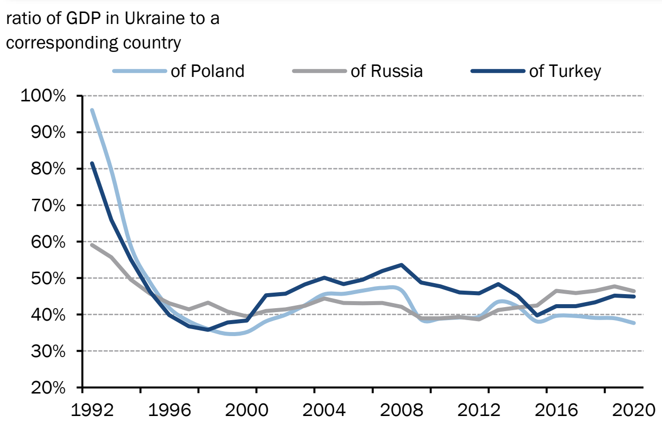
As a result, Ukraine's GDP per capita (at PPP) did not converge to the level of its partner and rival countries (see Figure 30). While there is some progress in comparison with Russia since 2014 (mostly due to the dismal performance of the latter), there is no real progress relative to Poland. Ukraine's GDP per capita (at PPP) remained at the level of 40% of Poland's GDP since mid-1990s.

Moreover, as Figure 31 shows, international partners have stopped expecting any economic convergence of Ukraine with Emerging Market economies in the medium term. For example, in the 2019 World Economic Outlook, the IMF expected that over the next five years the ratio of Ukraine's GDP to EMs' GDP would stay flat at about 75%. While such forecast did change in the IMF's WEO as of April 2021, this change is driven by a one-off reversal of fortunes caused mostly by changes in the PPP exchange rate, and just as before the standards of living are not expected to converge further.

[4] See Strategy of economic reforms, AYA special report (2015) for details

In other words, to start catching up, the Ukrainian government must do something differently. Despite the positive effect of somewhat reasonable economic policies over 2014-2020, it is not enough. More of the same type of economic policies is unlikely to end economic underperformance.

30. Evolution of Ukraine GDP per capita (at PPP) relative to partner and rival countries



Source: IMF, AYA calculations

31. Evolution of the GDP per capita (PPP) forecast for Ukraine compared to Emerging market countries.

Source: IMF, AYA calculations

Below we discuss the current political situation, recent trends, and resulting political scenarios.

February and March 2021 have brought some positive news for the presidential administration on account of the sanctions against the pro-Kremlin politician and businessman Viktor Medvedchuk. President Zelenskiy's political ratings were on the rise, according to all latest public opinion surveys:

- the Kyiv International Sociology Institute reported that 45% of Ukrainians trust Zelenskiy, compared with 39.5% earlier same month;
- the Razumkov Center noted a similar uptick in Zelenskiy's ratings as of mid-March, with 31% of respondents saying they trust the President, up from 26.5% back in February;
- Sociological Group Rating has reported that Zelenskiy's approval ratings increased from 41% in January to 44% in February.

However, a closer look at such marginal improvements shows that the political rating of the President stays nearly at the lowest level if compared with mid-2019 (see Figure 32), even despite a small improvement during April and May. Therefore, our estimate of the public support necessary for the implementation of the reform agenda is from very low to virtually absent.

On top of that, we see several negative developments: such as increased fragmentation of the ruling party and strengthened political influence of Ukrainian oligarchs in the Parliament (at least some of whom are explicitly in the opposition to structural reforms). In the meantime, the Russian-Ukrainian conflict has not disappeared from the scene – on the contrary, over the last several months the military conflict became more active. In addition, international experts note weak progress in improving institutional capacity, uneven application of the rule of law, and a high level of corruption.

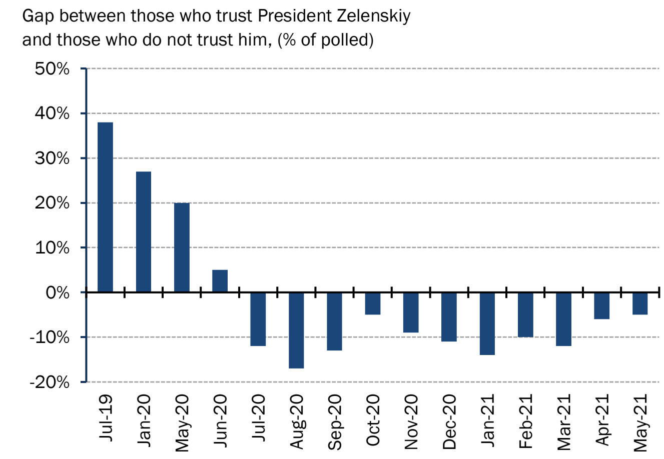
Among the abovementioned political problems, we see significant short-term risks resulting from the fragmentation of the ruling party, because the increased influence of oligarchs on Ukrainian MPs could lead to early Parliament's dissolution. We describe this risk below.

In principle, after the 2019 parliamentary elections, the ruling party "Servant of the People" was able to disregard a coalition with any other party (see Figure 33). In other words, it had 'mono-majority', making it possible to pass legislation without consent from MPs from other factions.

However, local experts say that since the Parliamentary elections in 2019 the oligarchs started to actively 'invest' in deputies to get lucrative laws, knock off undesired officials, and even attack government institutions that are dangerous to them. With a risk of further Constitutional Court policy reversals, this also threatens to undermine previous institutional reforms such as the bank resolution framework and other aspects of the anti-corruption agenda.

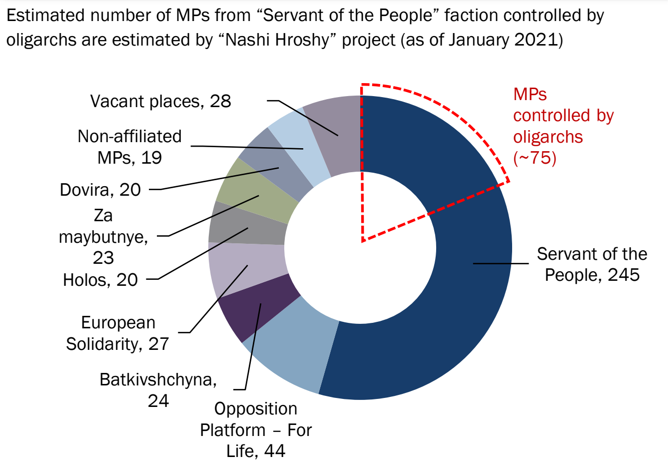
For example, "Nashi Hroshy" project has estimated that in mid-2019 the wealthiest Ukrainian oligarch R.Akhmetov controlled just 7 MPs, and as of now, this number has increased to approximately 50 MPs, with 30 of them in the "Servant of the People" faction ("Pavlyuk's group"). Another 45 MPs from the same faction are supposed to be controlled by oligarch I.Kolomoysky.

32. Balance of trust to President Zelenskiy



Source: Sociological Group Rating

33. Current composition of Ukrainian Parliament



Source: rada.gov.ua, "Nashi Hroshy"

If the abovementioned estimates are true, the oligarchs have influence over enough deputies to make it difficult for Zelenskiy to secure 226 votes without oligarchs' direct support. Another indication of the ruling party's fragmentation is that only about 50% of laws proposed by the presidential administration were supported by this Parliament (and about 20% of laws proposed by the Government). Recent internal scandals within the ruling party, related to the US sanctions against several Ukrainians, as well as related to the appointment of some ministers, also confirm this. On the one hand, this makes it harder to implement changes, proposed by the presidential administration. On the other hand, the situation might be about to change. We see the signals that such a situation increases the level of the President's frustration about the stand-off within his party (especially after he delivered a tough speech about oligarchs on March 12th). Given that the President sometimes acts rather emotionally, there is a risk that he will decide to dissolve Verkhovna Rada any time soon. He has already signaled about the possibility of such scenario[5].

Based on the recent poll data (Figures 34 and 35), we conclude that a snap parliamentary election will bring a less stable and potentially more dangerous composition of Verkhovna Rada. This coalition might take several forms:

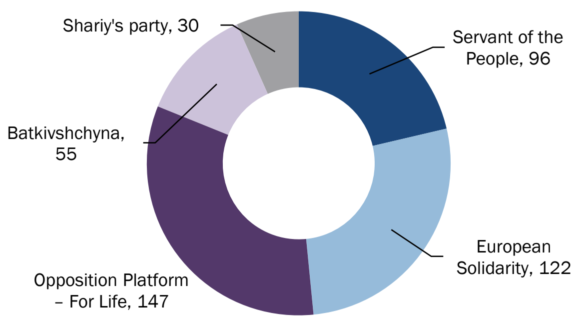
a) Due to the increase in the popularity of pro-Russian politicians such as "Opposition Platform - For Life", there is a risk that such parties will hold a majority in the parliament if they form a coalition with the populistic "Batkyvschyna" party (Figure 35).

b) If the number of pro-Russian MPs will fail short of 226, another possible compositions include:

[5] https://news.rbc.ua/rus/politics/zelenskiy-prigrozil-nardepam-rospuskom-rady-1614068698.html

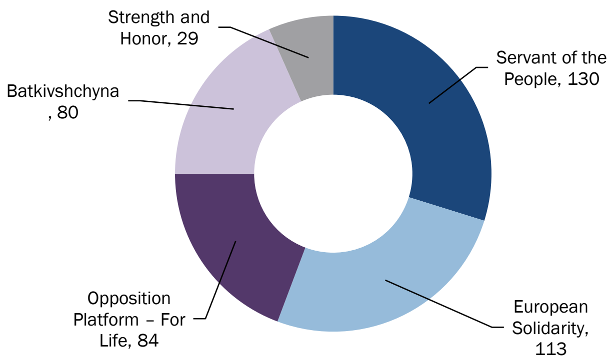
- *Coalition of the "Servant of the People" and "European Solidarity":* this scenario is likely only if the personal ambitions of their respective leaders become subdued, and they stop the long-lasting personal confrontation. Such scenario would be the most beneficial for the continued and even faster integration into EU institutions (in comparison with other likely outcomes). It will also help to fill a competence gap in the current 'mono-majority'.
- *Coalition of the "Servant of the People", "European Solidarity" and "Batkyvschyna":* that will be a poisonous mix, where Y. Tymoschenko would try to play the leading role by becoming the Prime Minister (recurrence of 2007–2010 period).
- *Coalition of the "Servant of the People" and "Opposition Platform - For Life":* this scenario is moderately likely given 2019 pro-ceasefire rhetoric of President Zelenskiy. But this outcome will lead to high chances for reliance on 'soft' cooperation with Russia through some shady deals, a high level of paternalism, and fragile economic growth.
- *Coalition of the "European Solidarity" and "Opposition Platform – For Life":* unlikely scenario given the political programs of these parties. If such coalition becomes a reality, there is a high risk of social unrest, initiated by the supporters of the "European Solidarity" (veterans of the conflict in Donbass, in particular).

34. Expected composition of Ukrainian Parliament after re-election as of March 11-14, 2021



Source: KISMI

35. Expected composition of Ukrainian Parliament after re-election as of May 28 – June 3, 2021



Source: KISMI

Another factor that should be considered in terms of political scenarios for Ukraine, is a policy of a newly elected US President. Starting from the first days in the office, President Biden's team has sent rather obvious signals about their concerns regarding Ukraine's anti-corruption policies, including through personalized sanctions against some odious Ukrainian citizens. As far as we understand, anti-corruption policies were also among several questions that concerned the IMF.

Notably, right after such signals from the Western counterparties, President Zelenskiy has given a strong speech, covering anti-corruption policies, particularly concerning oligarchs and relations with Russia, including the status of Crimea, and references to his presidential predecessors. His speech was based on the "Ukraine Fights Back"[6] narrative. The following lines have struck us the most:

> *"While you and I believed that justice existed, and tried unsuccessfully to find it, some appropriated state resources, subsoil, strategic enterprises, pipelines, and even, as it turned out, the Constitutional Court of Ukraine. In a word - everything in sight. Restoring justice in Ukraine was one of my key promises. People say you have to wait three years for the promised. We started a little earlier."*

[6] https://www.president.gov.ua/en/news/zvernennya-prezidenta-ukrayini-shodo-ostannih-rishen-rnbo-67109

The obvious question is what will come out of the speech in terms of anti-corruption and de-oligarchisation successes, relations with Russia, and relations with the West. Recently almost all top Ukrainian oligarchs have felt the impact of related State's efforts. Legal actions against V.Medvedchuk, a battle against the abuse of dominance by gas supply companies in Q1'21 (where ~70% of market is controlled by D.Firtash), changes in management of some state-owned energy companies (where ousted administration was suspected in shady deals with I.Kolomoyskiy), and proposals about the increase in tax rates for industries related to R.Akhmetov indicate that the President's abovementioned narrative could be sincere. If it is true and if the State will develop its capacities to make complex decisions, these intentions will be positive for the rollout of market reforms. On the other hand, there is a risk that the State will use popular de-oligarchisation agenda to unproportionally increase its own economic power: in combination with weak efforts to develop state's capacities in making complex decisions, it could lead to gradual transition to state capitalism.

Another possible explanation behind recent de-oligarchisation initiatives might be that Zelenskiy wants to deflect the public's attention from Ukraine's failures in fighting the COVID-19 pandemic and the disappointing pace of vaccination (one of the slowest in the world). Alternatively, it could be a maneuver to deflect the society from recent tariff protests, which appeared at the beginning of this year (especially given that many people associate high tariffs with benefits for the oligarchs). Or this narrative could have been used to neutralize the effect from active protests in Q1'21 related to people's dissatisfaction with Ukraine's judicial power and internal affairs forces. In other words, there is a risk that de-oligarchization policy is only a short-lived situational initiative that allowed the State to keep its power and to calm down a potential social unrest.

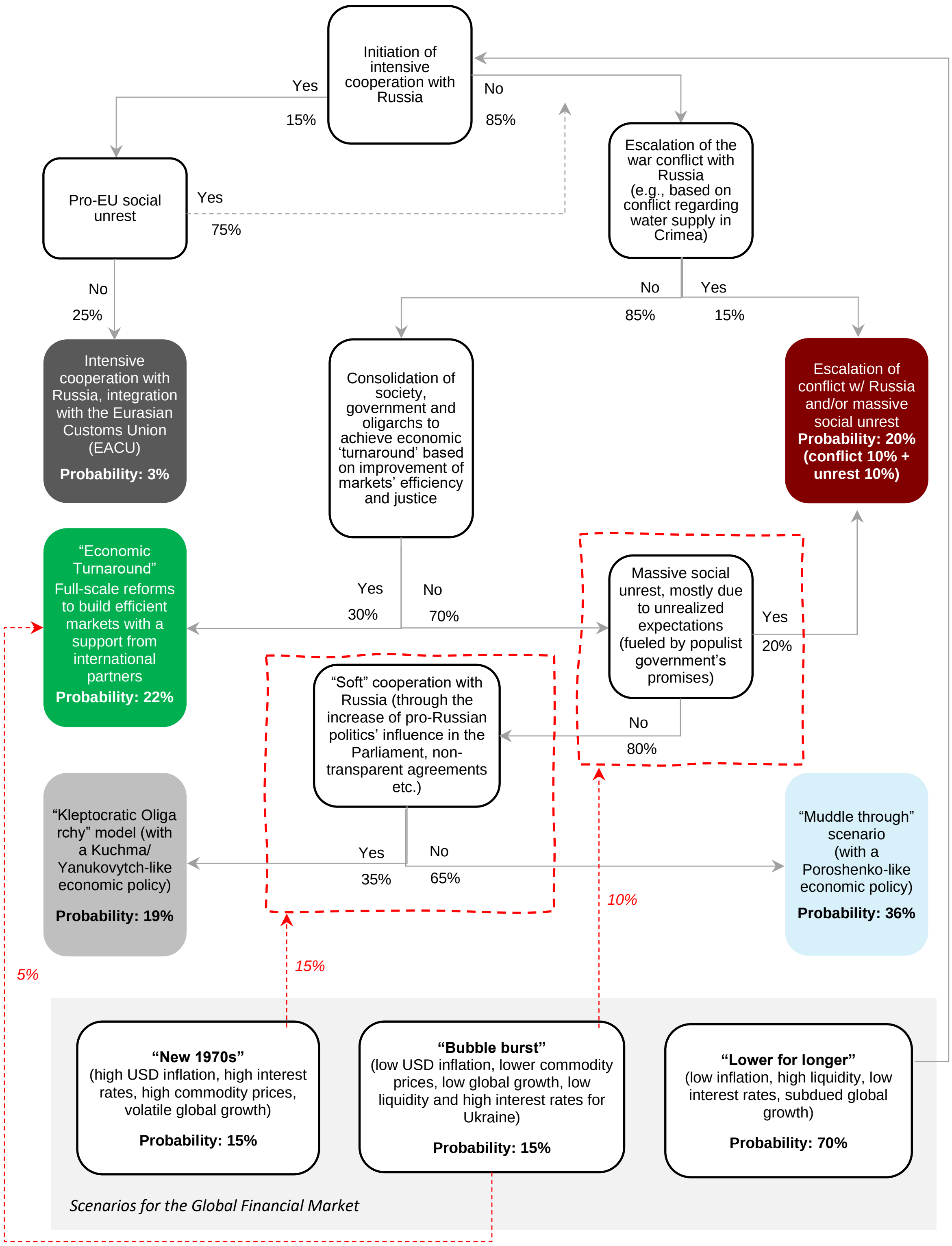
On top of that, one should not rule out the possible actions of oligarchs if Zelensky starts a confrontation with them. For instance, we could witness negative campaigning against Zelenskiy, his team, and the current government. Or we can see attempts of nudging the President towards any emotional actions for the decrease of his public support or, ultimately, to his impeachment or resignation.

Bearing in mind that Russia was also mentioned in abovementioned speech and Putin's friend Medvedchuk has suffered from recent Ukrainian State's actions, we should not forget about their possible reaction. In general, given such rhetoric from the President regarding the Russian-Ukrainian conflict, substantial near-term progress towards its resolution is unlikely, in our view.

Such multipolarity in probabilities and a wide range of involved stakeholders leads us to develop several political-economic scenarios, also taking into account global economic scenarios discussed in the section above (as the global economic factors will have an impact on domestic politics). Below we present a tree with political-economic scenarios (Figure 36), and a short description of each scenario (Figure 37).

As of today, our analysis of possible outcomes gives us reasons to estimate the high probability of the "Muddle through" scenario (36% probability). However, both "Economic turnaround" scenario (considering anti-corruption rhetoric) and "Kleptocratic Oligarchy" with softening relations with Russia" (considering the outcome of possible parliamentary reelections) are quite likely as well.

36. Perceived probabilities of socio-political scenarios for 2021-2023



Source: AYA Securities' estimations of scenarios' probability
Notes: The probability is estimated by way of assessment of business communities' expectations (mass media analysis, personal discussions etc.)

37. Perceived probabilities of political scenarios for 2021-2023

“Muddle through” scenario
(with a Poroshenko-like economic policy)

Probability: 36%

- Marginally EU-oriented regime, but with a further decrease in confrontation with Russia and slow pace of pro-Western reforms. Finding compromises with paternalistic requests and local oligarchs, which could be not consistent with European vector.
- Objectively poor population, increased fragmentation of the ruling elite, political influence of Ukrainian oligarchs in the Parliament and explicit opposition to reforms at least from some of them gives us reasons to estimate high probability of this scenario.
- High reliance on financing from international capital markets creates risks of transition either to “Extend-pretend” scenario and/or to “Social unrest” scenario in case of external shocks and global liquidity squeeze (reflected by red dotted line from the “Bubble burst” global scenario).

“Economic Turnaround”
Full-scale reforms to build efficient markets with a support from international partners

Probability: 22%

- The government is expected to actively implement the reforms to change the economic system under this scenario. These reforms should not fundamentally contradict both the ideology of IFOs (to keep receiving the funding and technical assistance from Western governments and institutions) and principles of Western markets’ functioning in general.
- This scenario requires consolidation of key local stakeholders to achieve economic ‘turnaround’ based on improvement of markets’ efficiency and justice. For example, that is possible if the communication about resulting beneficial changes for the oligarchs is made efficiently, or if there is a fundamental disruption in the leadership of oligarchic groups (e.g., a transition of power to more pro-Western successors).
- This scenario is also possible only with the appointment of pro-EU professional non-populist Government, with adequate capabilities to implement and communicate reform agenda. We see a problem with finding and appointing such candidates for this role, therefore we’ve assumed significantly lower probability for this scenario.

Escalation of conflict w/ Russia and/or massive social unrest

Probability: 20% (conflict 10% + unrest 10%)

- If Russian internal problems related to Ukraine increase (e.g., in respect of water supply in Crimea), Putin may provoke an escalation of the military conflict in new regions. The likelihood of this scenario will increase if Russia is sure about a lack of military competence of Ukrainian Government and about a decrease in support to Ukraine from the US.
- Social unrest is also probable amid (i) unrealized 2019 public expectations fueled by promises of the ruling populist elite (with a possible transition to Venezuela-like social unrest); (ii) sharp decrease in the standards of living in case of severe external shock (“Bubble burst” global scenario) and negative economic effect from next quarantine waves with inefficient vaccination rollout; (iii) in case of war with Russia – amid incompetence and poor coordination in the military campaign that leads to fast growing death toll in the army.

“Kleptocratic Oligarchy” model
(with a Kuchma-like economic policy)

Probability: 19%

- Klepto-oligarchic model, with high chances for reliance on ‘soft’ cooperation with Russia through some shady deals. The model leaves Ukraine with high level of paternalism, inequalities, and fragile economic growth.
- High risks that the IMF program is not implemented. Pro-EU direction will gradually fade out, being replaced by policies and agreements friendly to Russian financial interests (e.g., in exchange for “peace” or through the increase of pro-Russian politics influence in case of snap elections in the Parliament).
- High reliance on commodities growth in conjunction with populistic policies can also lead to this scenario (reflected by red dotted line from the “New 1970s” global scenario). For example, decrease of regulated energy prices below fair market price will increase government spending for hidden subsidies, and ruling elites will be motivated to increase cooperation with Russia to buy energy at lower prices in exchange for political concessions (for instance, transition to gradual recognition of Crimea as Russian territory).

Intensive cooperation with Russia, integration with the Eurasian Customs Union (EACU)

Probability: 3%

- According to our expectations, such scenario is very unlikely in the short- to medium-term period:
  (a) As of now external funding from IFOs is potentially available in the periods of high debt redemptions, and Russia’s own financial possibilities are limited (cooperation with IFOs should be preferred by Ukrainian authorities).
  (b) Ukrainian political elite probably realizes that such direct cooperation will highly likely lead to a massive social unrest (though we understand that Russia can push for such scenario at least to increase political volatility in Ukraine, as implied in other branches of our scenario tree).

Source: AYA Securities’ estimations of scenarios’ probability
Notes: The probability is estimated by way of assessment of business communities’ expectations (mass media analysis, personal discussions etc.)

Figure 38 shows our economic forecasts for two scenarios:

(1) our main scenario "*Muddle through*" and (2) the main alternative scenario "*Economic Turnaround*". We do not model either "*Escalation of conflict with Russia*" or "*Massive social unrest*" due to the impractically high uncertainty as to how such scenarios would affect economic outcomes. We do not model the scenario of "*Kleptocratic Oligarchy*" as it is a special case of the "*Muddle through*" scenario with a marginally worse economic outcome. Finally, we refrain from modeling the scenario of the "*Intensive cooperation with Russia*" due to its low probability.

38. Key Macroeconomic Forecast Indicators

Key macroeconomic forecasts for Ukraine		Marginal Changes			Economic Turnaround		
	2020E	2021F	2022F	2023F	2021F	2022F	2023F
Real GDP growth, % y-o-y	-4.0	4.2	2.8	2.2	5.2	4.4	4.8
Consumer Price Index (UAH), % a-o-p	2.7	8.2	6.4	5.2	8.4	5.2	4.8
Consolidated budget balance, % of GDP	-5.4	-4.6	-3.4	-3.1	-4.2	-3.0	-2.8
C/A balance, % of GDP	4.0	-0.8	-2.1	-2.4	-1.5	-3.6	-4.2
FX rate, USD/UAH, a-o-p	27.0	28.2	29.1	30.1	27.5	28.1	28.6

Source: AYA Securities' estimates

Our political analysis and scenario tree are closely linked with the framework of strategic choice between socio-economic models, developed by our team in 2014-2015[7]. In 2014 we have formulated the following strategic alternatives for Ukraine:

- Retaining the social contract within the framework of the "Kleptocratic Oligarchy".
- Transition to "Capital Markets" model, based on the development of efficient, fair, and competitive markets (with a required improvement in State capacity).
- "Export-oriented model" – an attempt to reload the present model by orientation on signals from the export markets as a substitute for the development of efficient internal markets ("Capital Markets" model).

We updated our analysis in a separately published side-note *"Alternative Economic Models for Ukraine: Lessons from the Past"* by answering the following questions:

Q1. There are no pure economic models in the real world. How the commitment to different economic models has been changing in Ukraine over time?

Q2. If there are changes in the inclinations towards specific models in Ukraine over time, what were the reasons behind such changes?

Q3. What are our current long-term expectations?

Q4. What could secure a commitment to the "Capital Markets" model in the future?

The above-mentioned sidenote could be of interest to policy-makers, think-tanks and professional investors that sometimes omit institutional factors in their analysis.

One of the conclusions resulting from our analysis of these questions is that a weak and fragmented society in Ukraine (in a combination with a weak state and significant influence of Russia) results in the volatility of Ukraine's commitment to the "Capital Markets" model – we named it as "Muddle through" scenario.

Based on our analysis under "Muddle through" scenario, we do not see the probability of sustainable political changes necessary for the transition from economic underperformance towards catching-up as high. **We describe the implications for bondholders from this scenario in the last section of this report.**

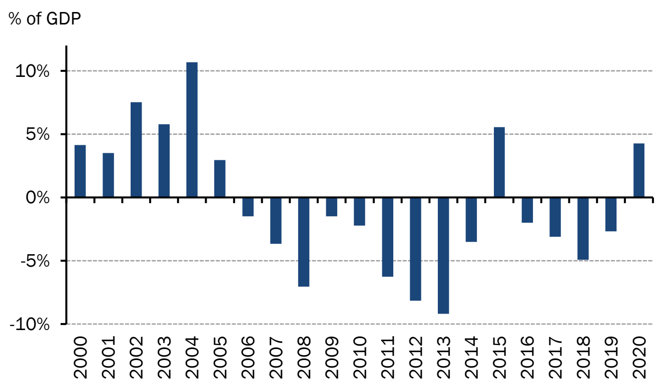
[7] Strategy of economic reforms, AYA special report (2015)

External Sector: Supportive, yet not a key driver

In 2020 the external sector provided major support for the Ukrainian economy. This had happened due to the combination of unique circumstances that are not expected to persist into 2021-2023. Overall, both CA balance and trade balance are expected to be healthy by historical standards due to relatively high export prices and increasing share of export services. In our baseline scenario, we expect that average CA account deficit will be at 1.8% of GDP in 2021-'23, starting from 0.8% CA deficit in 2021. In our main alternative scenario (structural reforms), CA deficit is expected to widen to an average of 3.1%, starting from a deficit of 1.5% of GDP in 2021 and increasing to a deficit of 4.3% in 2023 due to higher imports of investment goods.

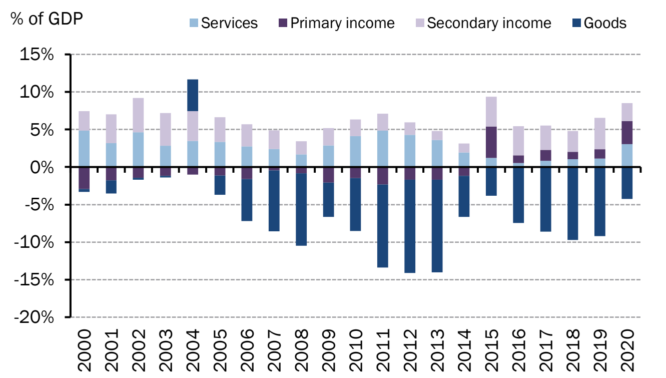
2020 was not a typical year for the Ukrainian economy in many respects, including the external sector. While many factors that have contributed to the positive CA balance are rather one-off events, such as a decline in the imports of consumer goods due to the pandemic, other positive factors are here to stay. For example, while the negative contribution of travel to the balance of services is likely to increase from 3% of GDP in 2020 to about 5%, such increase is likely to be offset by the positive contribution from IT services export, from 3% to 6% of GDP by the end of 2023. Similarly, we expect a further increase in remittances and a slow increase in the share of remittances sent via official channels, not to mention a continued decline of a relative share of remittances from Russia.

39. C/A Balance in % of GDP



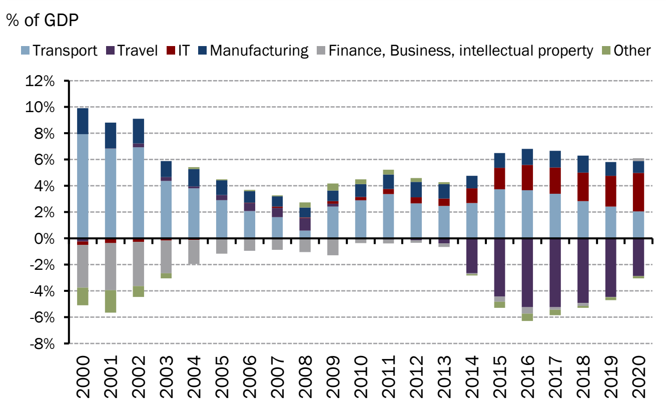
Source: NBU, AYA calculations

40. C/A Balance structure in % of GDP



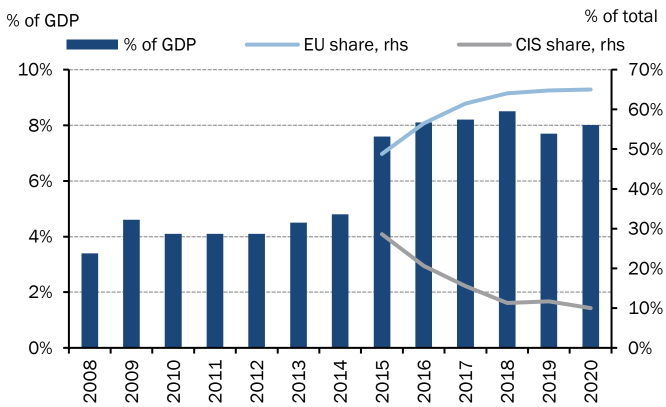
Source: NBU, AYA calculations

41. Balance of Services' structure in % of GDP



Source: NBU, AYA calculations

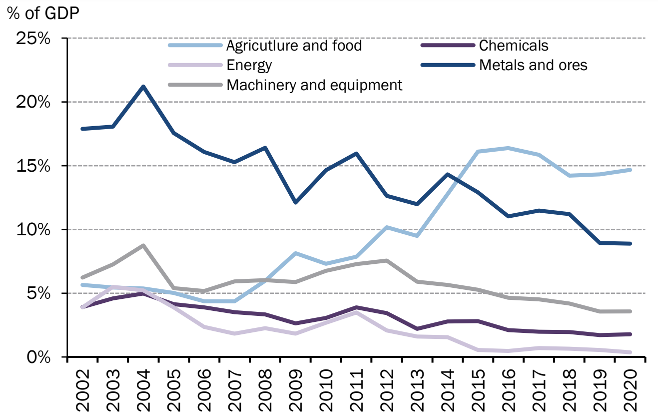
42. Private remittances to Ukraine from abroad



Source: NBU, AYA calculations

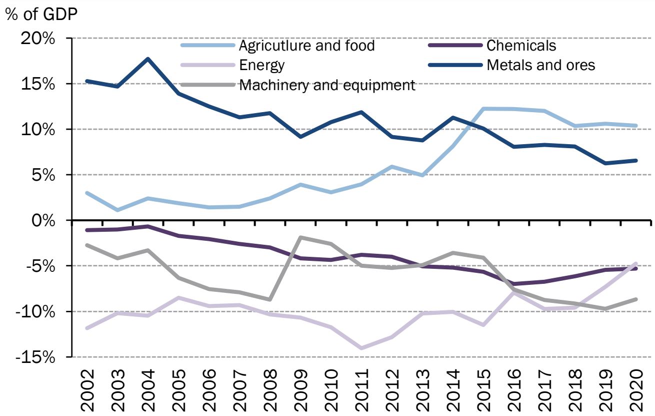
We also expect that the share of agriculture and food in both exports and net exports will continue to increase due to the relatively better outlook for agriculture commodities. While the increased reliance on agriculture has its risks, it also promises increased stability of trade balance as agriculture commodity prices tend to be less volatile than basic metals (mostly iron ore) prices.

43. Exports structure in % of GDP



Source: SSC, AYA calculations

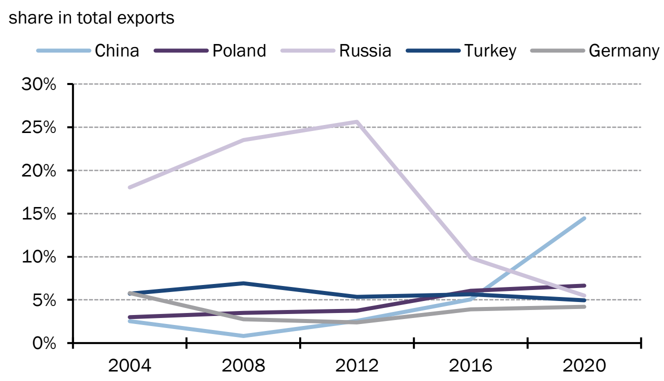
44. Net Exports structure in % of GDP



Source: SSC, AYA calculations

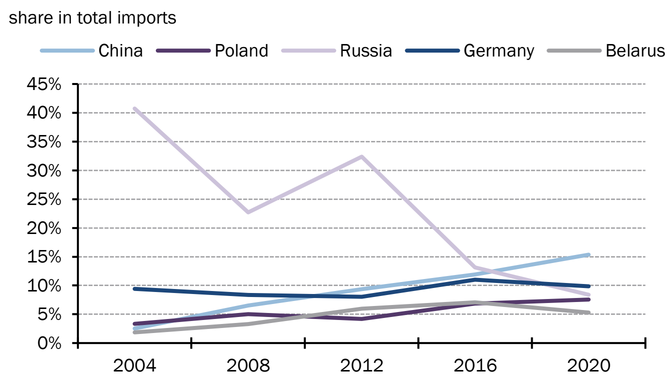
In terms of geographical structure, we note a further decrease in the trade with Russia, in terms of both exports and imports. In 2020 and for the first time, Russia dropped to third place in the list of countries ranked by the highest volume of Ukraine's exports. While in recent years the EU became the major trading partner for Ukraine, we also note the increased importance of China, especially in terms of exports. In the last five years, the share of exports to China increased from 5% to about 15%.

45. Main export countries for Ukraine



Source: SSC, NBU, AYA calculation

46. Main import countries for Ukraine



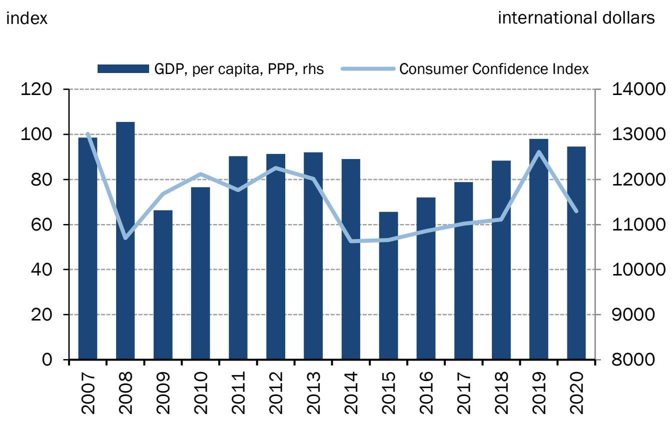
Source: SSC, AYA calculations

Domestic Consumption: Moderate growth

In contrast to the pre-pandemic years, we expect a slowdown in the rate of growth of private consumption from an average of 8.3% p.a. during 2016-2019 to an average of 4.5% p.a. during 2021-2023. The main drag on growth in private consumption is a slower pace of real wage increases relative to recent years, driven by the acceleration of commodity inflation and relatively slower growth of USD nominal wage due to relatively high base effect. We expect that the government will continue to commit to macrofinancial stability and, thus, run a relatively moderate fiscal deficit of 3.7% of GDP in 2021-2023 (3.3% of GDP in our alternative scenario). Therefore, the government consumption will not compensate for the weaker consumer demand.

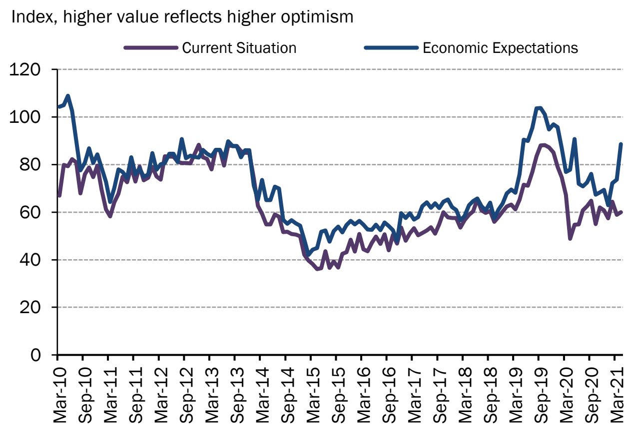
By the end of 2019, both GDP per capita (PPP) and households' economic expectations have reached the highest level since the peak of 2008, also slightly surpassing the local peak of 2011-2013. However, despite a relatively small GDP decline and a 7.4% increase in the real wage, economic expectations substantively declined in 2020, with no signs of a sustainable recovery in 2021. On the contrary, worsened pandemic in Q1'2021 together with relatively high unemployment expectations is likely to drag on the growth of private consumption beyond the first half of the year.

47. Consumer confidence index vs GDP per capita



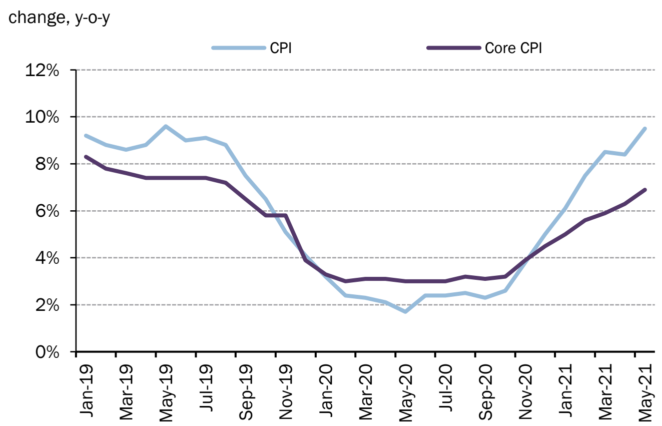
Source: Info Sapiens, IMF, AYA calculations

48. Consumer expectations indexes



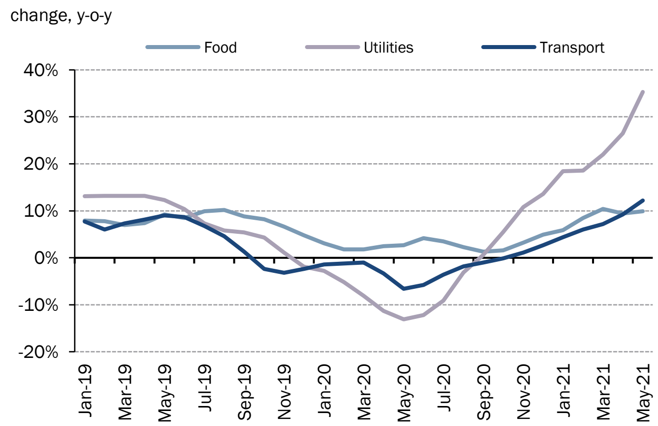
Source: Info Sapiens

49. Consumer inflation, y-o-y change



Source: NBU

50. Consumer inflation, change in selected components

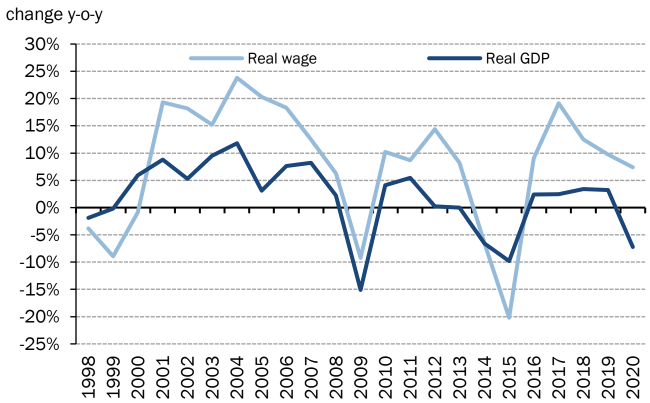


Source: NBU

Acceleration of consumer inflation relative to the low price base of 2020 is also likely to negatively affect consumption growth, at least in 1H'21. Both higher inflation and COVID-19 restrictions (that are likely to be in place in the autumn of 2021 due to a slow pace of vaccination) are likely to affect most vulnerable consumers, i.e., those with the highest marginal propensity to consume. As a result, the drag on private consumption growth in 2021 is likely to be higher than currently anticipated.

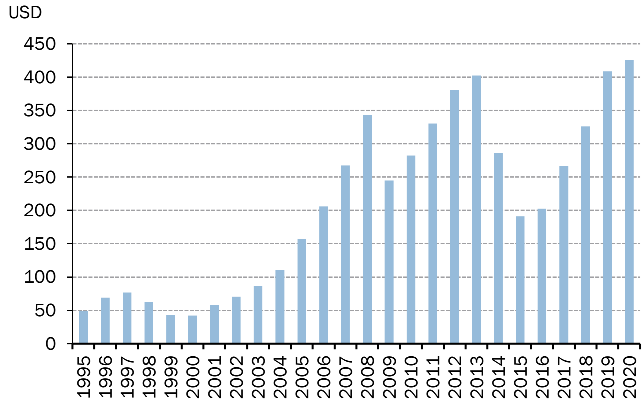
During 2016-2020, the real wage has gone up by 72%, while the growth in USD terms was even more impressive (at 123%). As a result, the average USD-denominated wage has surpassed its 2013 peak by 6% in 2020. It is likely that the growth in labor productivity over the last eight years has exceeded the growth in USD wage. Therefore, the current level of average wage will unlikely undermine Ukraine's competitiveness. However, given the magnitude of the increase in recent years, the economy and the labor market might require additional time for the adjustment. This means that the increase in both real and USD denominated wages is likely to slow down in 2021-2023.

51. Change in real wages vs change in real GDP



Source: SSC, AYA calculations

52. Average nominal wage in Ukraine, USD equivalent



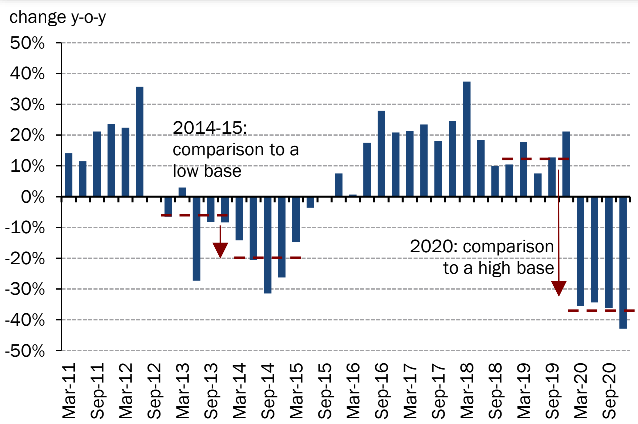
Source: SSC, NBU, AYA calculations

Investments: Leveraging macrofinancial stability

We expect a comparatively quick recovery of investments after a sharp drop in 2020. Due to the positive effects of macrofinancial stability and record low interest rates on loans in domestic currency, we expect that investments will grow on average by 12% in our baseline scenario (18% in the case of the "Economic turnaround" scenario) per year over 2021-2023. The forecast is conditional to the government commitment to macrofinancial stability, specifically to responsible fiscal policy (including removing the potential strain on government finances by unlocking cooperation with the IMF), as well as maintaining the independence of the National Bank. In our view, the key indicator of progress towards this goal is the stability of inflation expectations.

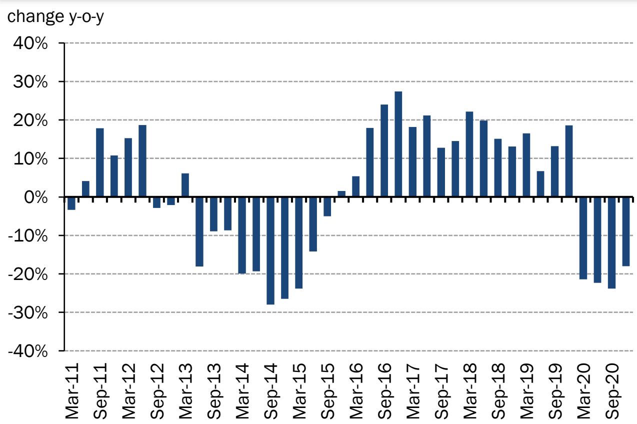
In contrast to Ukraine's economic and financial crisis of 2014-2015, the global pandemic came during the active phase of economic growth. The average annual growth in fixed capital formation over 2016-2019 was 16.8% (14.2% in 2019), while it stood at 1.7% during 2011-2013 (-8.4% in 2013). This difference in comparison base overestimates the true magnitude of the 2020 decline.

53. Change in capital investments, y-o-y



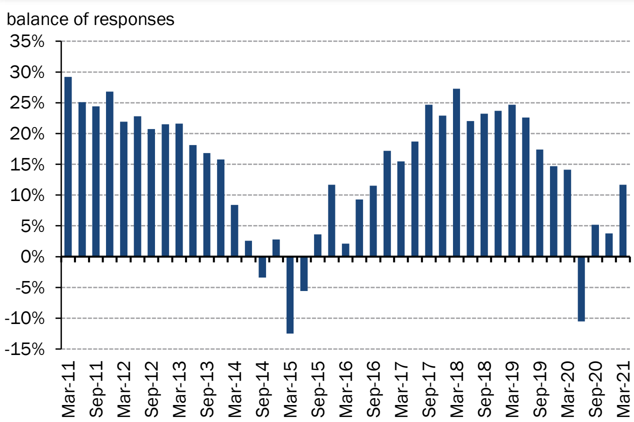
Source: SSC, AYA calculations

54. Change in fixed investments, y-o-y



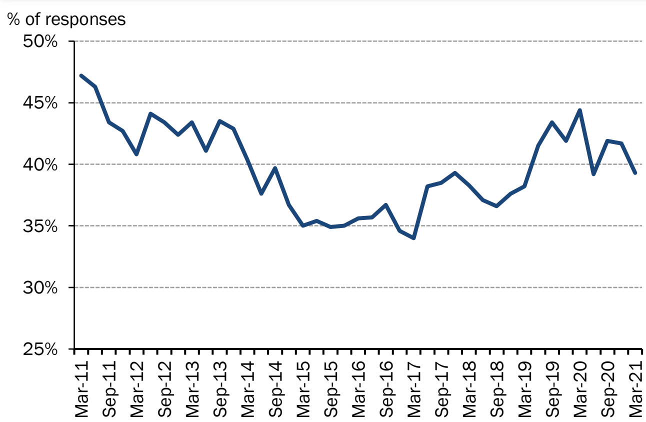
Source: SSC

55. Business Outlook Survey: Is capital spending (ex. Construction) expected in the next 12 months?



Source: NBU

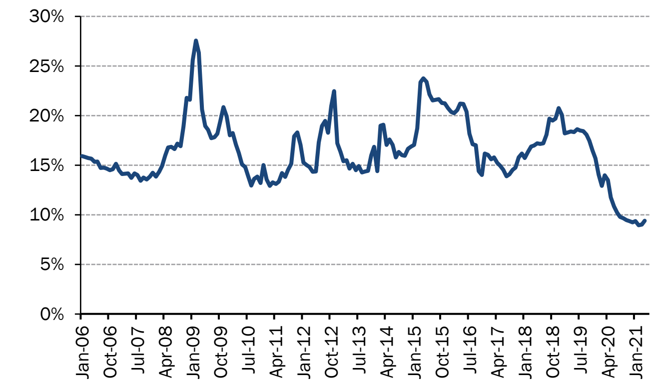
56. Business Outlook Survey: Do you expect to take bank loans in the next 12 months?



Source: NBU

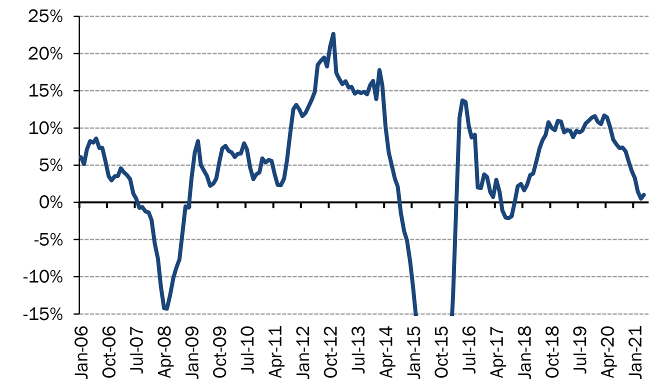
The data from the business outlook survey (Figures 55, 56) confirm that during the recent recession business maintained a rather positive outlook about investments in the next 12 months. At the same time, the share of respondents in the NBU business outlook survey who plan to take new loans declined in the first three months of 2021. We assume that such responses follow naturally from the worse than expected pandemic situation and corresponding activity restrictions. The sensitivity of businesses' plans to COVID-19 developments is factored in our investments growth forecast.

57. Interest rates on loans to nonfinancial corporations



Source: NBU

58. Real interest rate on loans

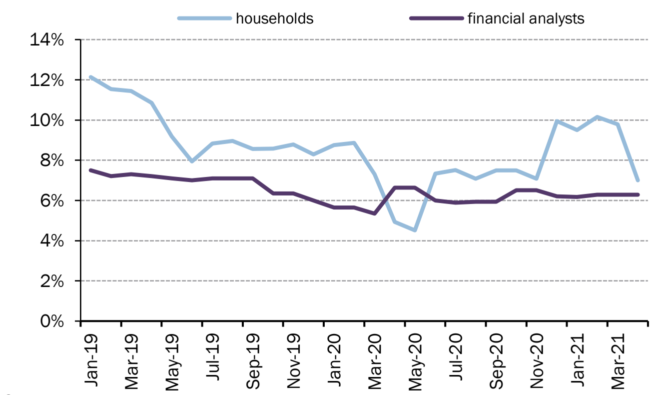


Source: NBU, AYA calculations

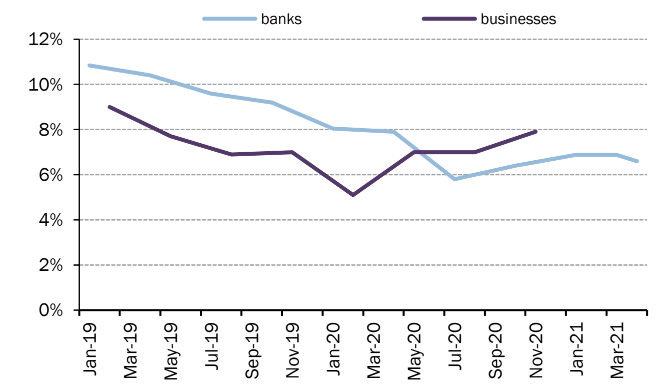
Beside the fact that the 2020 recession is less severe than the 2014-2015 crisis, the key feature of the present moment is historically low interest rates on loans in domestic currency (Figure 57). Importantly, the current level of nominal rates is achieved when inflation is expected to stay at the single digits for a foreseeable future (Figure 59). This makes the current interest rate environment unprecedented as a virtually zero real interest rate is achieved during period of moderate inflation.

In our view, despite such supporting conditions, market participants do not fully trust that the government can maintain the achieved macrofinancial stability beyond 1H'2021. Confirming the support of the National Bank's independence while it navigates the policy response to the transitionary inflationary pressure, as well as reaching a compromise in negotiations with the IMF could convince both financial markets and the real sector that the current lax monetary conditions will persist. This, in turn, will support the investment-driven economic recovery over 2021-2023.

59. Inflation expectations: expected change in CPI over next 12 months



Source: NBU



Source: NBU

So far, actions of both government and the National Bank of Ukraine were reassuring despite the anti-financial stability rhetoric of a small group of legislators (that includes MPs from the ruling party) Given that y-o-y change in CPI since February was substantially above the 5%±1% target, NBU increased its key policy rate to 7.5% (a total hike of 150 bps in 2021). As a result, the inflation expectations remain well-anchored (Figure 59), further supporting macrofinancial stability.

However, a recent acceleration in CPI to 9.5% y-o-y means that both headline and core inflation will exceed the National Bank forecast as of the end of 1H'21. Therefore, to maintain macrofinancial stability, NBU should increase its key policy rate further to reassure financial markets. Given this, we believe that NBU is likely to increase the key policy rate by another 100 bps before the end of July.

Despite the headline inflation can briefly exceed 10% y-o-y, we believe that National Bank is rather close to the end of tightening cycle. Therefore, we do not expect that the key policy rate will be higher than 8.5-9.0% during 2021 as the high base of comparison for commodity prices in the 2H'2021 will help to slow down the inflation pressure in year-over-year terms. The main risk comes from the fiscal space, specifically from a possibility for politically motivated fiscal expansion.

Implications for Bondholders

Though there is a moderate risk that Ukrainian government can face a small-scale funding crisis in the coming months, we expect that even in such case the government is likely to secure the required funding using administrative levers. If such risk materializes, there is high probability of 10-15% UAH devaluation. We believe that this risk is most material for the holders of UAH bonds.

In our opinion, current term structure of Ukraine's USD bond curve may underestimate long-term risks (e.g., a risk of state's failure in the next possible round of intensified conflict with Russia) resulting from the absence of Ukraine's strong commitment to the "Capital Markets" model of economic development.

Overall, we recommend to overweight short and mid-term USD-denominated sovereign bonds, and to underweight both UAH-denominated bonds with a maturity starting from August 2021 and USD-denominated bonds with a maturity starting from 2024.

In the sections above, we presented our medium-term forecasts that extend only to the end of the current political cycle, i.e., until the next presidential elections scheduled for March 31, 2024.

Our relatively optimistic economic forecasts are mostly driven by: (a) favorable terms of trade due to high commodity prices and market expectations of the new "commodity super-cycle" peak (with which we do not fully agree); (b) achieved macrofinancial stability and policymakers' perceived commitment to its continuation (still supported by regulatory actions). Therefore, one of the key drivers of our forecasts is the presumption that macrofinancial stability persists over the forecasted period. However, by the end of the current political cycle the risks that macrofinancial stability can be sacrificed for the short-term political gains could increase, just as it had happened before in Ukraine's modern history.

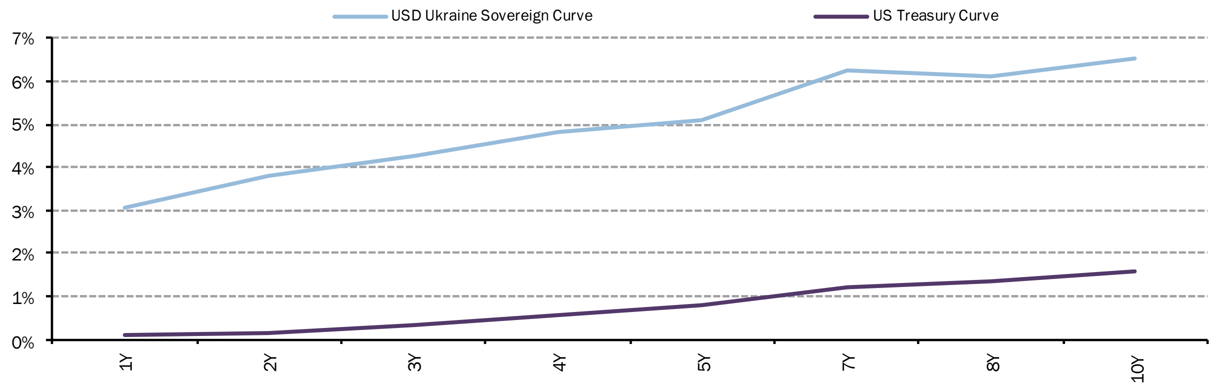
Therefore, while our mid-term view is rather optimistic, we remain cautious about Ukraine's long-term economic prospects, especially given the absence of a strong commitment to the "Capital Markets" model of economic development. As we describe in a sidenote *"Alternative Economic Models for Ukraine: Lessons from the Past"*, our current base case long-term expectations include Ukraine's inability to catch up with its peers in terms of economic development, no integration into the EU, and high risks of state's failure in the next possible round of intensified conflict with Russia (especially in case of gradual losing of adequacy by the aging V. Putin). In our opinion, current term structure of Ukraine's USD bond curve may underestimate all these long-term risks. Since these risks are long-term and the difference between Ukraine's and US term spread[8] is only 198 bps we conclude that Ukrainian yield curve is not steep enough, mostly due to overpriced long maturities (risks not taken into account) but also to some degree underpriced short term maturities (since we forecast continuation of the macro financial stability until the end of the current political cycle).

While we do not expect that short-term risks will negatively impact short end of USD yield curve, there are risks to UAH yield curve. In the short run, Ukraine's government's ability to secure the funds necessary for debt repayment and servicing remains the most important risk to macrofinancial stability. The government has less than three months to secure USD 3 bn before September 2021. Therefore, it is feasible that Ukrainian government can face a small-scale funding crisis in the coming months if several of the following preconditions take place: (1) substantial decline in global risk

[8] Term spread is calculated as a difference between 10Y mid yield-to-maturity and 1Y mid yield-to-maturity.

appetite (for instance, due to a price correction on global financial markets); (2) larger than expected correction of Ukraine's export commodity prices; (3) a continued increase in tensions with Russia beyond what we have seen in March-April 2021; (4) a failure to secure prolongation of the current agreement with the IMF or to sign a new program. In such a case, the government is still likely to secure the required funding using administrative levers in the domestic borrowing market as well as by cutting back spending. However, we expect that such scenario will cause a hit to financial markets' confidence, leading to 10-15% currency depreciation. In turn, this will likely result in up to 200 bps increase in the NBU key policy rate as a response to the corresponding acceleration of inflation (following devaluation). This reasoning leads to the recommendation to underweight UAH-denominated bonds with a maturity starting from August 2021, at least on a temporary basis.

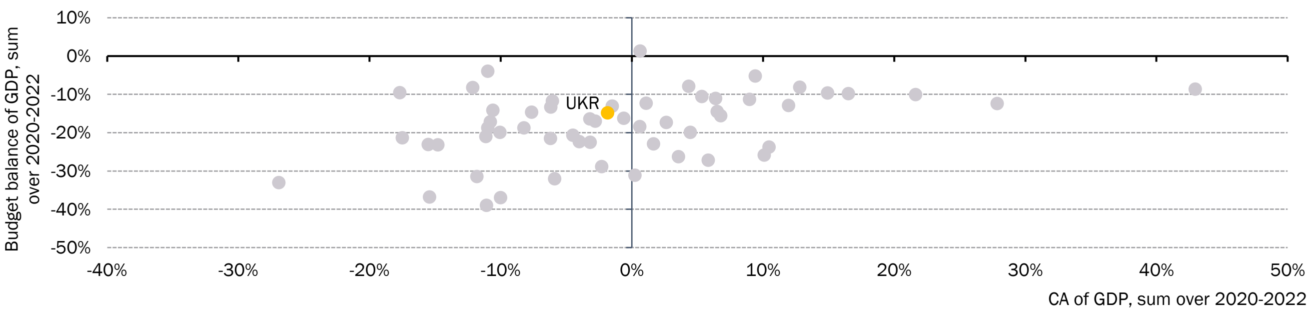
60. Ukraine's and US sovereign bond curves (USD-denominated)



Source: Bloomberg (as of June 8, 2021)

At the same time, we further note that despite the short-term risks to financial stability discussed above, and in contrast to the most previous historical episodes, Ukraine finds itself in a relatively stable position in the mid-term, at least in contrast to many comparable countries. Figure 61 shows that, according to IMF WEO forecast, Ukraine has a relatively low expected accumulated current account and budget deficits over 2020-22. This, in turn, implies relatively stable fundamentals. Therefore, the key risk to macrofinancial stability lies in the domain of potential policy mistakes.

61. Expected Current Account and Budget deficits, sum over 2020-2022



Source: the IMF's WEO forecast

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