

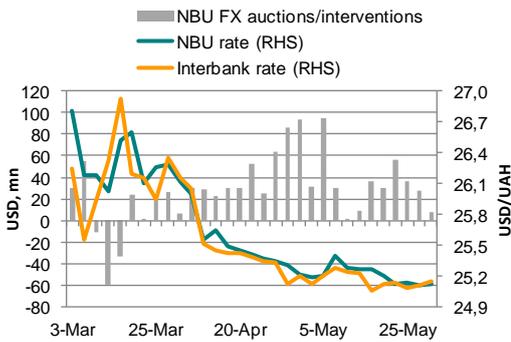


**This week in focus: The National bank of Ukraine cuts the key rate, more easing ahead**

The NBU commenced its intended policy easing firstly by cutting the key interest rate by 1% on May 26. Further policy decisions are on the cards with more substantial easing likely in July 2016. **Please see page 4 for more details.**

**Currency market: USD/UAH flattening right above 25**

Figure 1. UAH exchange rate (UAH per 1\$)



Source: NBU, Bloomberg

USD/UAH has kept its strengthening trend, albeit with a slower pace. **On May 27<sup>th</sup> USD/UAH closed at 25.13**, as the USD gained against almost all major peers after the Friday speech by FED Chairwoman J. Yellen.

Throughout last week the market has seen less sales of USD – average daily sale volumes decreased by USD 13mn comparing to the previous week (USD 186mn vs USD 199mn).

NBU intervened in the market 10 times so far in May with a total amount of USD 329.1mn. Cut-off rate have been decreasing with each auction beginning from its peak at 25.39 on May 17 down to 25.11 on May 27.

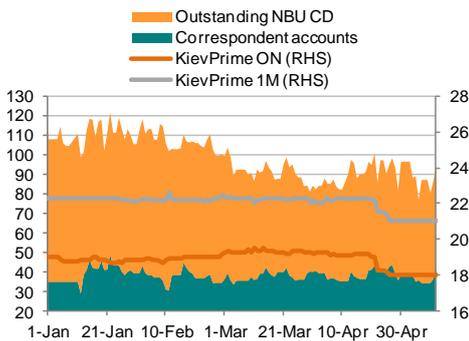
As it was revealed in an interview on May 27, the **EBRD decreased the amount of funds that it is going to allocate to Ukraine** in 2016 to below USD 1bn, effectively decreasing the amount of international inflows into the country's financial account. The exact amount of financial support is unspecified but among the stated **reason for the cut in finding is the government's impasse in 1Q 2016.**

Despite this, our projection is that **UAH will likely appreciate against USD to approximately 24.5** during the next 2-3 months, while the **outlook for the end of 2016 remains at bearish 27 level.** The outlook is based on medium-term expectations of a decline in steel prices (see *Weekly May 25, 2016 for more information*).

**EUR/USD has been depreciating for the past several weeks and closed at 1.111 on May 27.** Weak EUR results from the ECB's attempts to spur inflation via its stimulus measures while the markets remained sluggish in anticipation of G7 results and concerns over public sentiment regarding BREXIT. (*for more information please refer to Global Markets section*)

**Money market: Policy easing drives the money market rates down**

Figure 2. Banking liquidity (UAH bn) vs. KievPrime rates



Source: Bloomberg, NBU, UkrSibbank, MinFin

**Banking liquidity remains below UAH 100bn and landed on Friday the 27<sup>th</sup> at UAH 95.1bn level.** Lower levels of liquidity are attributed to settlements on new sales of sovereign bonds, as well as to month-end tax payments. Money market rates have declined, since the NBU Monetary Policy Committee decreased the key interest rate to 18% effective May 27<sup>th</sup>, pushing the interest rates downward. New cost of ON funds is around 15.5/16.5%, while indicative 1 week is 16/18% and indicative 1M is 18/20%, according to our data.

**The next meetings of the NBU Monetary Policy Committee are scheduled for 23<sup>th</sup> of June and 28<sup>th</sup> of July.** Monetary policy decisions could be anticipated on the latter after the tranche from the IMF will be secured.

The last OVDP auction was held on the 24<sup>th</sup> of May and the next one scheduled on the 31<sup>st</sup> of May. We expect the MinFin to keep driving the cut-off rates down the way it has been doing for the previous several weeks.

Policy easing and economic recovery are expected to increase the lending activities, which might be partially responsible for a decrease in liquidity, however, official data will be released with a lag.

Figure 3. OVDP auction schedule, 2Q 2016

Date	Currency	Maturity
31.05.16	UAH	3M, 6M, 9M, 1Y, 3Y
07.06.16	UAH	3M, 6M, 9M, 1Y, 2Y
14.06.16	UAH	3M, 6M, 9M, 1Y, 3Y
21.06.16	FX	3M, 6M, 9M, 1Y, 2Y



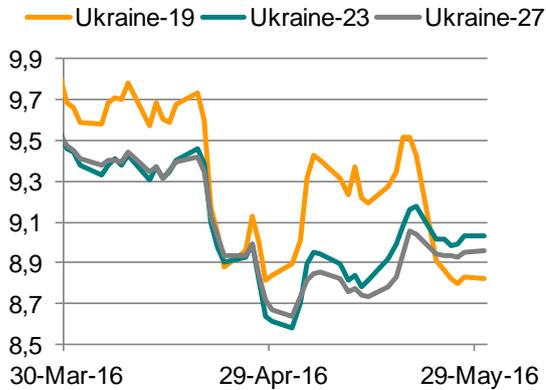
**Global markets: G7 meeting in Japan; EM countries bond placements**

**Figure 4. EUR/USD spot (mid)**



Source: Bloomberg

**Figure 5. Ukraine's sovereign Eurobond yields, bid/ask mids (%)**



Source: Bloomberg

The 42<sup>nd</sup> summit of G7 was held in Japan on May 26-27. A wide array of socioeconomic issues was on the agenda, among others the global growth slowdown and the declining price of oil. The summit is considered to be an important milestone in policymaking, especially concerning the application of “helicopter money” by central banks, which are running out of conventional tools to foster growth. However, **no palpable consensus has been reached** with the final declaration referring to “country specific circumstances”. The only imminent result is that Japan might postpone the sales tax hike till 2019, policy movements by the other summit participant are still to come.

Last week the **sovereign bond market was highly active**. After a somewhat botched USD 1.75bn bond issue by Russia, **Qatar surprised the market** with the size of its USD 9bn placement in three maturities, while the City of Buenos Aires, **following Argentina's bond placement in April 2016** sold USD 890mn of bonds with a 7.5% coupon on May 25. At the same time, Mozambique is struggling to restructure some of its debt, interest payments on which were due on the 23<sup>rd</sup> of May. The country had been downgraded by Fitch earlier this month while **the yields on its 2023 closed at a record 17.14%** on May 27.

The suspense regarding the **possible rate hike by the FED** keeps growing. In the last week's key speech FED Chairwoman J. Yellen said that **a rate hike is appropriate in the upcoming months**. The same day USD strengthened and Treasuries fell. Preceding to the Chairwoman's statement, several FED officials signaled in their speeches that the monetary policy tightening might happen in the nearest future, while US economic readings are mixed with the revised GDP figures showing that **the US economy expanded in 1Q faster than it was thought**, while the Expected one-year inflation rate is at the lowest point since 2010.

**Concerns of the Emerging markets' performance persist**, as the Chinese Yuan is losing its favorable position of strength versus the US dollar and weakness relative to the currencies its trading partners. **The yuan depreciated 1.3% MTD against the USD**. The Chinese government, which is under pressure to relax the monetary policy and prop up the economy, might impose new restriction to limit the outflow of capital. Intensified outflows will make it more expensive for companies to manage their USD-denominated debt and spur speculative trading. Under bearish scenarios, Chinese central bank's reserves will decline by USD 500bn and reach USD 2 700bn by the end of 2016.

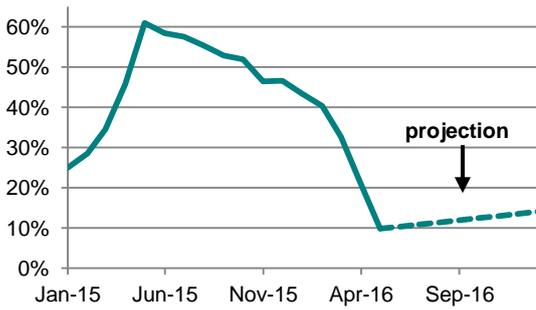
**European stock markets closed relatively flat**, with some benchmarks posting modest gains, on the week's last trading session on Friday due to investors' concerns over FED policies and the G7 summit.

**Oil slipped again** after touching the threshold of USD 50 per barrel on Thursday the 26<sup>th</sup>, after Canadian producers had resumed production.



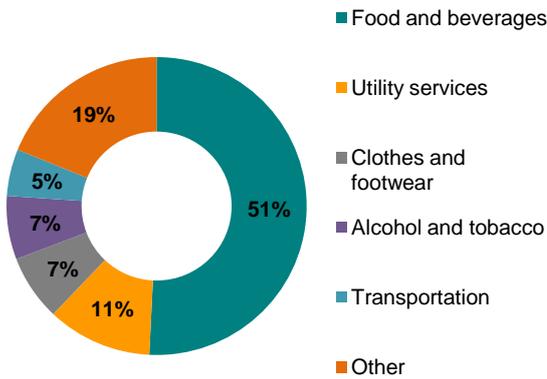
**This week in focus: The NBU cuts the key rate, more easing ahead**

**Figure 6. Inflation rate 2015-2016 y/y change, %**



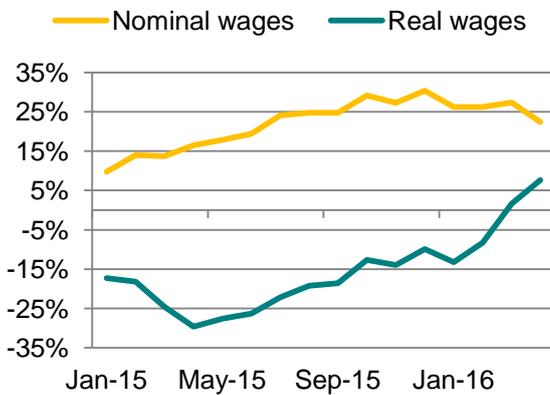
Source: NBU, UkrSibbank

**Figure 7. CPI calculation basket weights, %**



Source: State statistics service

**Figure 8. Nominal and Real salaries, y/y change %**



Source: State statistics service

The NBU cut the key interest rate by 1% on Thursday the 26<sup>th</sup>. **The new rate of 18% is effective May 27.** The central bank has already cut the key rate by 4% since the beginning of 2016. The regulator aims to put the interest rate in line with **the rate of inflation, which plummeted in April to 9.8% y/y, beating expectations.** The central bank officially stated that its **inflation targets are 12% +/-3% and 8% +/-2% for the end of 2016 and 2017** respectively. Among the major factors that caused the disinflation in 1Q 2016 are weakening domestic demand, tight monetary policy of the regulator and external appreciation pressures on UAH.

**Real wages showed an increase of 7.6% y/y in April 2016**, for the first second month in a row, while nominal wage increased by 22% y/y. Although the NBU previously assumed that the growth of real wage is moderate and not sufficient enough to trigger upward pressures on inflation, the latest developments demonstrate that the possibility for inflation acceleration is increasing. Time lag and somewhat outdated methodology of the CPI calculations are hampering analysis. It might be prudent to exercise caution and account for factors that might cause an unexpected surge in inflation.

**CPI in 2016 is expected to receive upward pressure from administered prices**, since the government implemented an increase in retail gas prices at the beginning of May and announced an upward adjustment of tariffs for heating and hot water. Therefore, administered prices are expected to be a major component of the CPI in 2016, but less so in 2017. Nevertheless, **the NBU doesn't expect that further monetary tightening will be necessary to keep in check their further adjustment to cost-recovery levels.**

**In mid-term these adjustments are expected to eliminate distortions in price-setting mechanisms**, whereas on the longer time horizon they are expected to exert downside pressure on inflation, countering the effective demand of households.

**The new interest rate is 9% above the inflation rate as of April and 5-6% above the expected inflation rate as of year-end.** Such a sizeable gap erodes the current account and subdues economic activity. It is likely that **the NBU will have to use its FX reserves to avoid the untimely UAH appreciation** till the funds begin to flow into the capital account with the IMF tranche in July.

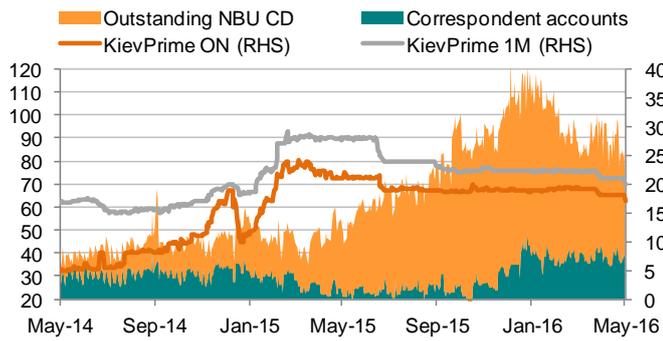
Monetary policy easing is expected to support domestic demand, increase business activity and accelerate economic growth. However, to reiterate once again, **we expect the next substantial policy move from the NBU**, most likely a key rate cut of several percentage points, **to be made in July 2016.** Before that time the central bank, while clearly aiming for easing of the regulations, may lack the ground necessary to carry out the policy changes.

In the end of the year we expect **the NBU interest rate target to be in range of 14-16%**, which is approximately 2% higher than our projected inflation rate (and 4% higher than the NBU target).



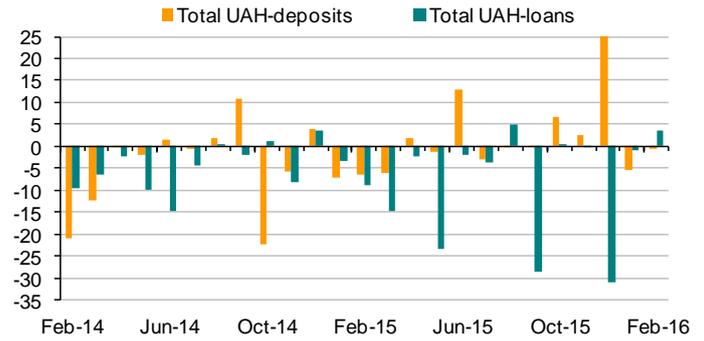
**Money market**

**Banking liquidity vs. money market rates, %**



Source: Bloomberg, NBU, UkrSibbank estimates

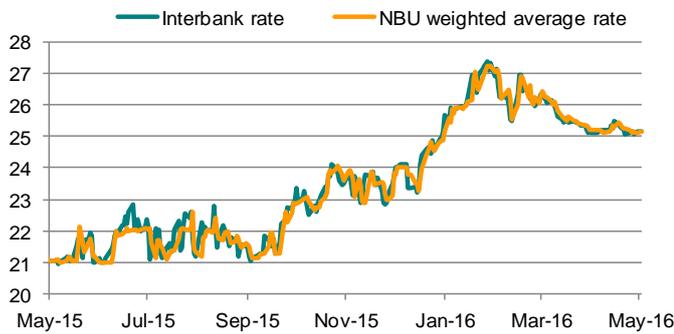
**Change in local currency loans and deposits, UAHbn**



Source: the NBU

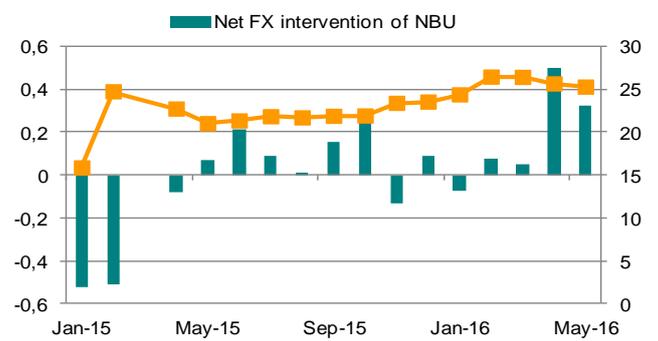
**Currency market**

**UAH exchange rate, UAH/\$1**



Source: Bloomberg

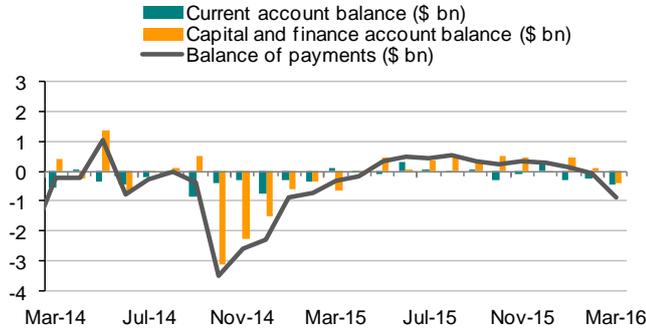
**Net retail FX interventions of the NBU in 2015-2016, USDbn**



Source: NBU

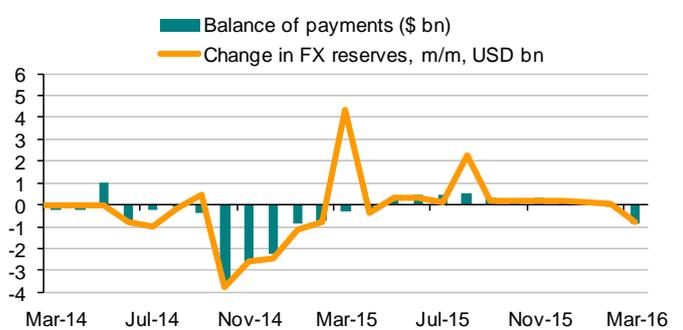
**Balance of payments**

**Major BoP accounts, USDbn**



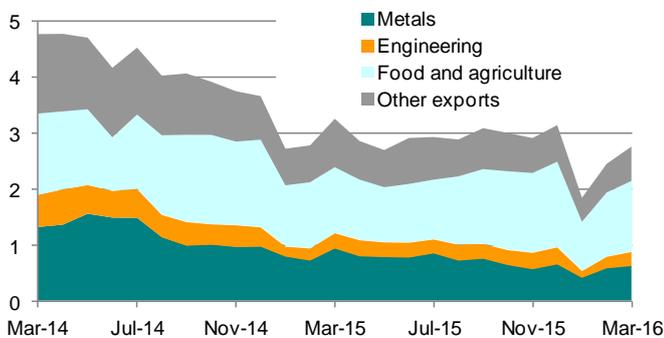
Source: NBU

**BoP vs change in foreign reserves, USDbn**



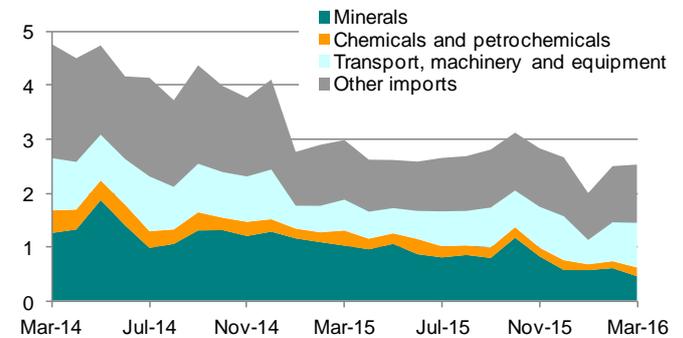
Source: NBU

**Exports components dynamic, USDbn**



Source: NBU

**Imports components dynamic, USDbn**



Source: NBU



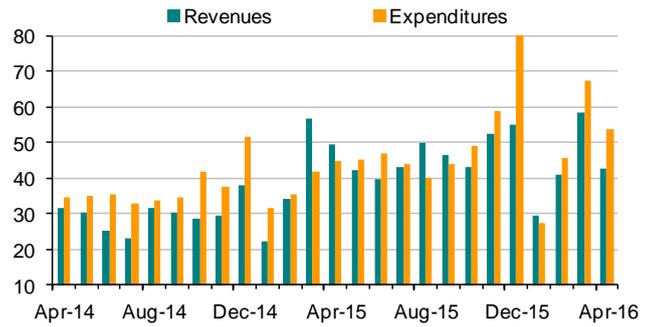
**Budget performance**

**Budget performance, UAHbn**

	Jan-Apr 2015	Jan-Apr 2016
<b>Budget revenues</b>	<b>162.64</b>	<b>171.94</b>
VAT proceeds	41.37	54.26
Corporate income tax	17.41	15.82
<b>Budget expenditures</b>	<b>153.30</b>	<b>193.67</b>
Deficit / Surplus	+9.34	-21.73

Source: NBU

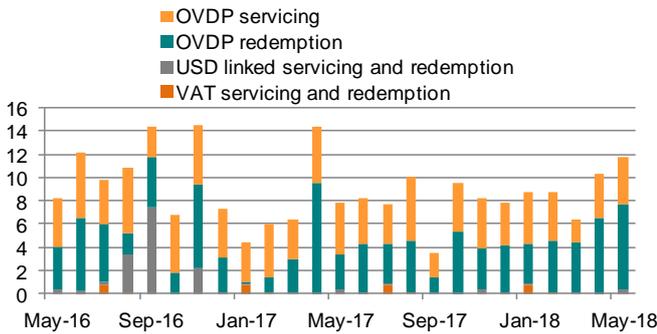
**General budget revenue and expenditures, UAHbn**



Source: NBU, State Treasury

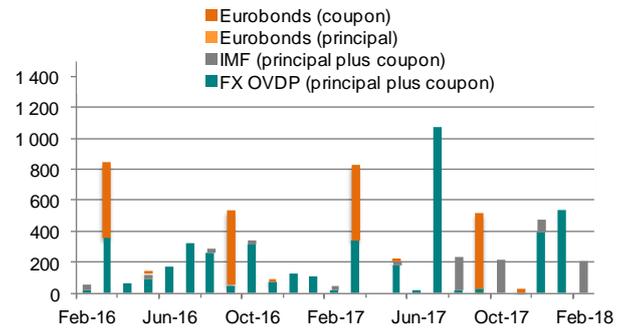
**Sovereign debt**

**UAH- denominated debts' repayments schedule, UAHbn**



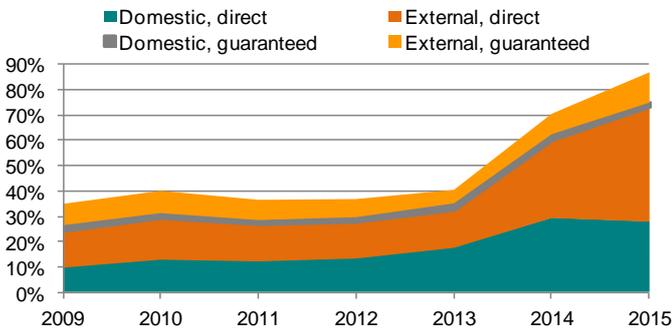
Source: NBU, UkrSibbank estimates

**FX-denominated debts' repayments schedule, USDmn**



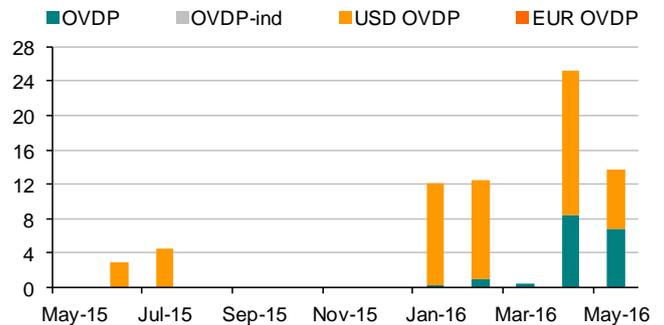
Source: NBU, UkrSibbank estimates

**Total government debt, % GDP**



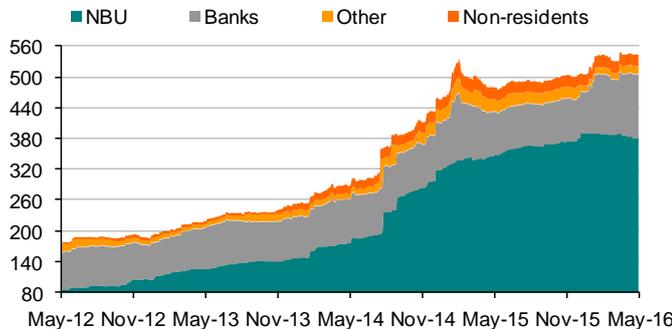
Source: MinFin

**Local borrowings, UAHbn**



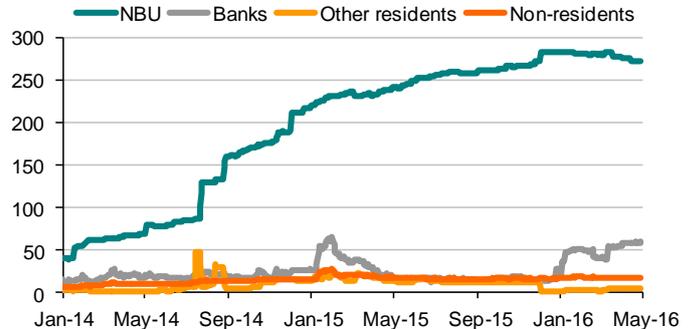
Source: NBU

**Outstanding OVDP owners structure, UAHbn**



Source: NBU

**Outstanding OVDP changes in holding since start 2013, UAHbn**

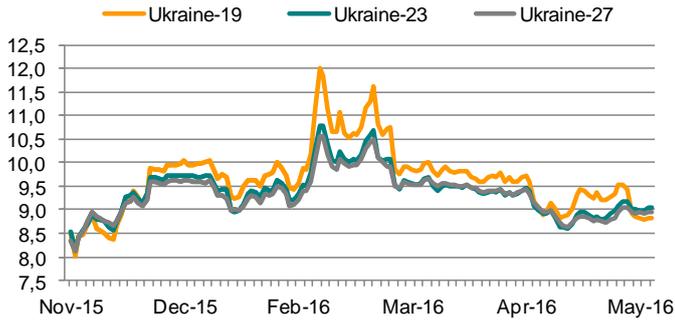


Source: NBU



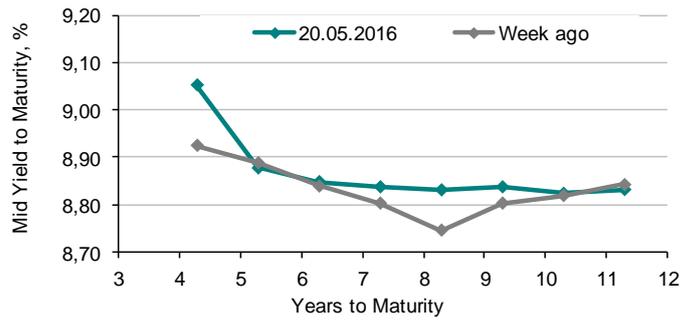
### Eurobond market

Ukraine's sovereign Eurobond yields, %



Source: Bloomberg

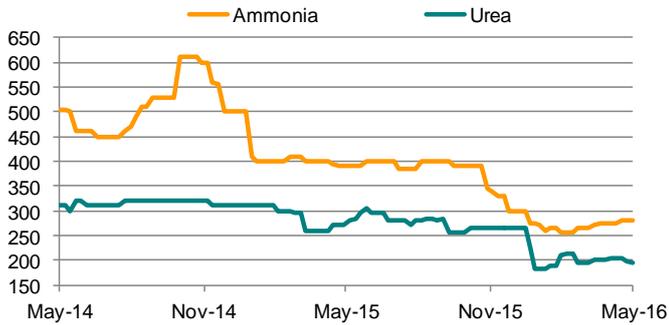
Ukraine's sovereign Eurobond yield curve, %



Source: Bloomberg

### Commodity markets

Fertilizers (Black Sea), USD per ton



Source: Bloomberg

Steel CIS export HR coil (Black Sea/Baltic Sea), USD per ton



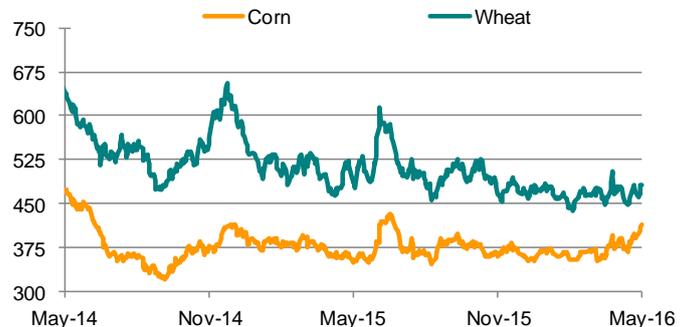
Source: Bloomberg

WTI oil (nearest active future at NYMEX), USD per barrel



Source: Bloomberg

Corn and wheat (nearest active future at CBT), USD per bushel



Source: Bloomberg



Key Macroeconomic Indicators									
Ratings (M/S&P/F) Ca/B-/RD	2008	2009	2010	2011	2012	2013	2014	2015	2016F
<b>Real sector</b>									
Real GDP (%YoY)	2.3	-14.8	4.1	5.2	0.3	0.0	-6.8	-10.0	1.2
Industrial production (%YoY)	-5.2	-21.9	11.2	8.0	-0.7	-4.3	-10.7	-6.0	1.0
Retail sales (%YoY)	17.3	-20.9	10.1	13.2	12.3	6.1	-11.0	-25.0	0.4
Unemployment rate end of year (ILO, working age)	6.9	9.6	8.8	8.6	8.1	7.7	9.7	11.5	10.3
Nominal GDP (UAHbn)	948.1	913.3	1082.6	1302.1	1411.2	1454.9	1566.7	2031.3	2394.1
Nominal GDP (\$bn)	178.9	112.8	135.3	162.8	174.2	177.4	131.3	88.7	86.0
<b>Prices</b>									
CPI (average %YoY)	25.2	15.9	9.4	8.0	0.6	-0.2	12.1	48.7	18.0
CPI (end of year %YoY)	22.3	12.3	9.1	4.6	-0.2	0.5	24.9	43.3	14.0
Real average wage growth (%YoY)	6.3	-9.2	10.2	8.7	14.4	8.2	-6.5	-35.0	5.0
<b>Fiscal balance (% of GDP)</b>									
State budget deficit (without Naftogaz)	1.3	3.9	5.9	1.8	3.8	4.4	5.0	3.0	2.5
Total public debt	20.0	34.8	39.9	36.3	36.5	40.2	70.3	91.4	96.4
<b>External balance</b>									
Exports of goods (\$bn)	67.7	40.4	52.2	69.4	70.2	65.0	50.5	35.4	33.2
Imports of goods (\$bn)	-83.8	-44.7	-60.6	-85.7	-89.7	-84.6	-56.7	-38.7	-38.1
Current account balance (\$bn)	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-5.2	-0.2	-2.1
Current account balance (% of GDP)	-7.1	-1.5	-2.2	-6.3	-8.2	-9.2	-4.0	-0.2	-2.5
Net FDI (US\$bn)	9.9	4.7	5.8	7.0	7.2	4.1	0.3	2.3	3.9
Foreign exchange reserves	31.5	26.5	34.6	31.8	24.5	20.4	7.5	13.3	16.4
Imports coverage (months of imports of goods)	4.5	7.1	6.8	4.5	3.3	2.9	1.5	4.4	5.3
<b>Interest and exchange rates</b>									
NBU discount rate (% end of year)	12.00	10.25	7.75	7.75	7.50	6.50	14.0	22.0	14.0 *
Exchange rate (UAH/\$) end of year	8.1	8.0	7.9	8.0	8.1	8.2	15.8	24.0	27.0 *
Exchange rate (UAH/EUR) end of year	10.9	11.5	10.5	10.4	10.6	11.3	23.0	26.2	30.7 *

Source: UkrStat, NBU, MinFin, UkrSibbank

\* Broad estimate

Economic calendar 2016												
Source:	UkrStat								NBU			State Treasury
	GDP growth	Fixed capital investments	Industrial production	Retail trade	Construction works	Agricultural output	Inflation rate	Jobless rate	Balance of payments	NBU reserves	Monetary / FX statistics	Balance of Treasury account
Date of release (actual / indicative)	act	act	act	act	act	act	act	act	ind	ind	ind	act
<b>May</b>												
May 2												V
May 6							V					
May 9										V		
May 10										V		
May 11										V	V	
May 12											V	
May 13						V					V	
May 16	V											
May 17								V				
May 19				V								
May 26			V		V							
May 27												
May 30		V							V			
May 31									V			
<b>June</b>												
June 3										V		
June 4										V		
June 5							V			V		
June 10											V	
June 11											V	
June 12											V	
June 16				V		V						
June 17					V							
June 18			V									
June 19	V											
June 23								V				
June 29									V			
June 30									V			V



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