ECONOMICS | INTEREST RATES | FX MARKETS

19 January 2023

UKRAINIAN CAPITAL MARKETS REVIEW

	Rating	Outlook	Last update
Fitch	CC	-	17.08.2022
S&P	CCC+	STABLE	19.08.2022
Moody's	Caa3	NEGATIVE	20.05.2022
R&I	CCC	NEGATIVE	27.07.2022

This week in focus: Surprising inflation brings but little good news

Ukraine's 2022 inflation came out lower than expected. That is the only good news, however. The surprising CPI growth mostly results from a temporary change in consumption pattern brought about by emergency power shutdowns. And as the latter adds to the challenges for producers, we see the risk of inflation reappearing in future months.

FX and interest rates: USD/UAH remains rangebound

The USD/UAH remains in extended sideways mode, helped by the central bank's actions on strengthening the fixed exchange rate regime Ukraine de-facto switched to following the Russian invasion. The pair is currently moving around the 40.5 mark on the cash market and remains fixed at 36.6 on the interbank one.

Reserve burning though, the fixed exchange rate more than the key rate lends itself to deal with inflation in the situation of elevated uncertainty, effectively anchoring both exchange rate and consumer price expectations, according to the NBU.

But for the USD1.1bn sale in the last week of 2022, which could be attributed to a seasonal rise in spending, NBU's FX interventions averaged at around USD0.64bn per week in December and early January, double the preceding month.

The central bank sees returning to the floating rate regime rather depending on the evolution of fundamental factors than some specific events or a certain calendar date. **We maintain our forecast of the USD/UAH sideways movement through the end of the winter followed by another refixing either late in 1Q or early in 2Q.**

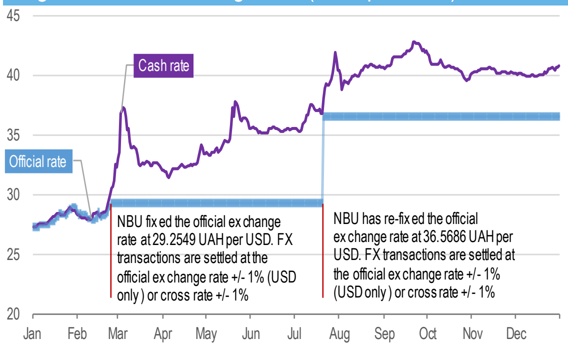
The banking hryvnia liquidity contracted to UAH506.6bn by the end of last week, after peaking above UAH534.1bn at the beginning of the year.

Apart from the state treasury operations and NBU's FX interventions, remaining correspondingly the major source and drain of hryvnia liquidity, it is worth noting the increasing return of cash into the banking system since year-start. More than UAH9bn of hryvnia was deposited over the first two weeks.

Besides, the balance of banks' correspondent account with the NBU doubled to UAH140.6bn on 11 January as new mandatory reserve requirements came into force. By the end of 13 January, the amount dropped to UAH121.4bn.

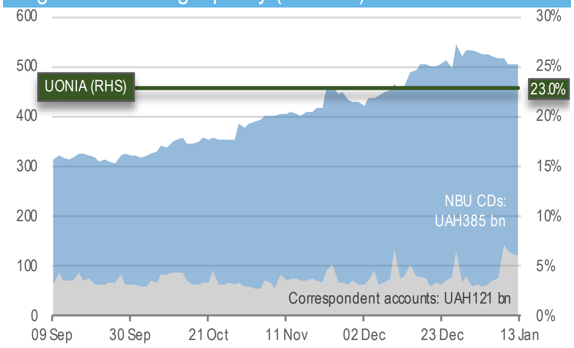
At the last monetary policy meeting, which took place on 9 December, the NBU lifted the mandatory reserves ratio for hryvnia and FX current accounts by 5pp. The central bank admits further ratio hikes going forward to deal with excess liquidity in the banking system, hindering monetary transmission to bank rates.

Figure 1. UAH exchange rate (UAH per USD)



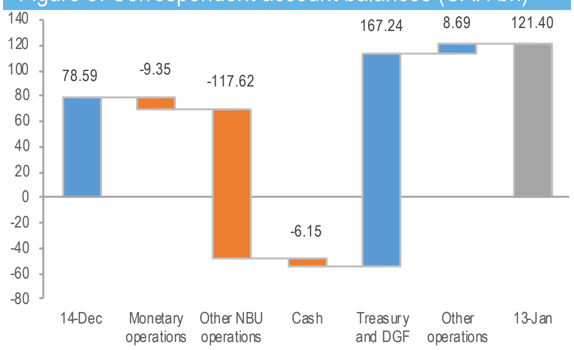
Source: NBU, MinFin (media)

Figure 2. Banking liquidity (UAH bn)



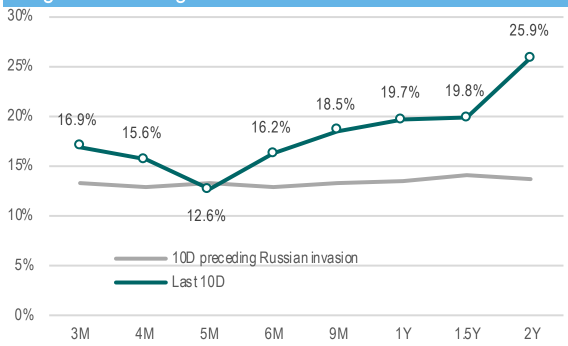
Source: NBU

Figure 3. Correspondent account balances (UAH bn)



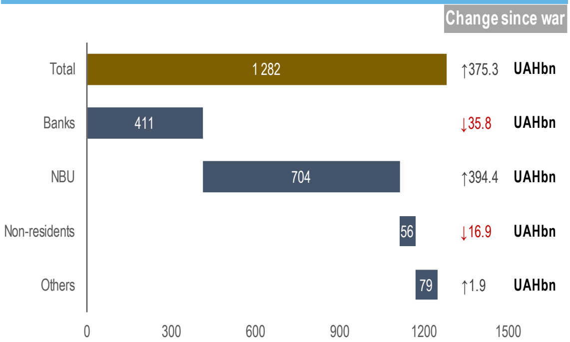
Source: NBU

Figure 4. Local government bonds in UAH



Source: NBU

Figure 5. Position in local government bonds in UAH



Source: NBU

Government bond market

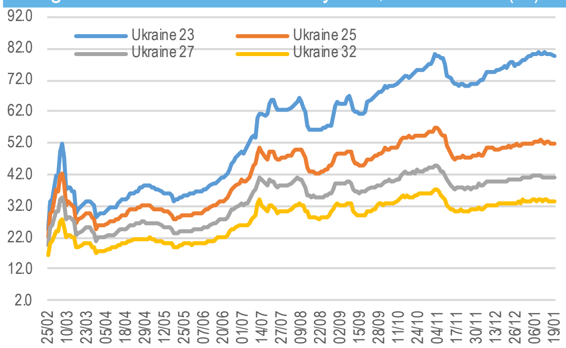
FinMin enjoys fresh demand for public debt, as improved communication with the central bank has begun to bear fruits. According to the IMF staff report, the two institutions have agreed on a need to improve the public debt rollover rate and to this end designed a multi-pronged strategy. It includes letting banks allocate half of the mandatory reserves in benchmark public debt securities, some adjustment in yields offered on the primary market, and a bank-by-bank analysis of liquidity conditions, preferences, and compliance requirements, to better understand market demand. The IMF reckons these steps could help the government to raise the debt rollover rate to 80% in 2023 (about USD7.3bn at the official rate, based on the actual public debt redemption schedule) from 63% in October last year when primary market yields ticked up.

Demand for UAH government bonds surged above UAH45bn (more than USD1.2bn at the official rate) at the last auction (10 January) before the new regulation allowing banks to include government bonds in mandatory reserves came into force (11 January). Most of the bids were concentrated in 1.5-year securities. While FinMin held the cut-off rate for these bonds unchanged at 19.25% per annum, the offer was capped at UAH19bn.

At the next auction (17 January), demand for UAH bonds rolled back to UAH5.7bn and investors' interest again shifted to short maturities.

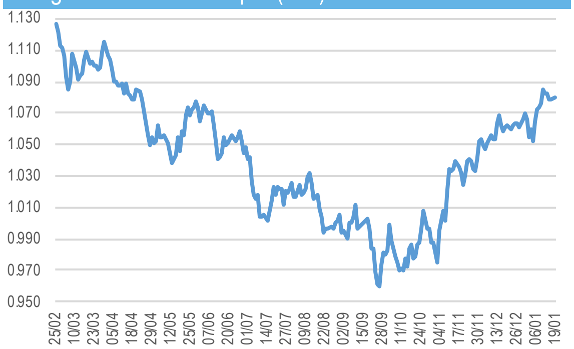
The NBU admits another mandatory reserve rate hike going forward. According to the central bank's estimates, these increases along with letting banks fulfil up to half of their reserve requirements with benchmark bonds could generate a one-time increase in demand for public debt of about UAH40bn.

Figure 6. Ukraine's Eurobond yields, bid/ask mid (%)



Source: Bloomberg

Figure 7. EUR USD spot (mid)



Source: Bloomberg

Euro gains support as Europe looks to hold off a recession

The euro recovers against the US dollar, regaining the 1.0800 hurdle and beyond midweek.

Economic officials from the European Union on Monday (16 January) offered a rosier vision for the bloc's economic future, with the latest data showing Europe may avoid a recession that had been predicted several months ago.

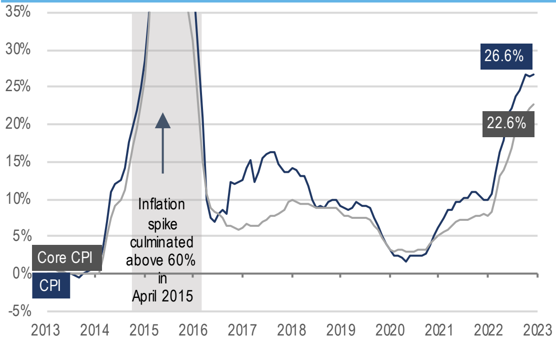
The economic threat posed by sky-high energy prices in the eurozone has also faded amid an unseasonably mild winter in much of northern Europe.

But, as the Federal Reserve (Fed) made it clear the central bank won't flinch in the battle to curb inflation, speculations turned to the European Central Bank (ECB) monetary policy actions. And rumors the ECB could slow the pace of quantitative tightening amid improved economic expectations weigh on the single currency.

US Treasury yields have little changed over the last month. The yield on the benchmark 10-year Treasury note dropped 5bp to 3.43%. Yields move inversely to prices.

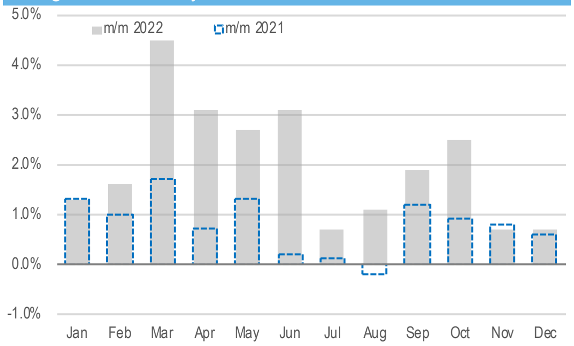
Bond investors remain concerned that the pace of the rate hikes implemented by the Fed so far in its fight against high inflation could drag the US economy into a recession.

Figure 8. Annual inflation evolution



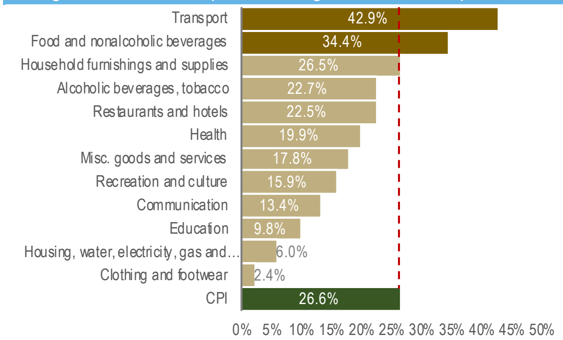
Source: Ukrstat

Figure 9. Monthly inflation evolution



Source: Ukrstat

Figure 10. Annual price changes in CPI components



Source: Ukrstat

Surprising inflation brings but little good news

Ukraine's 2022 inflation came out lower than expected. That is the only good news, however. The surprising CPI growth mostly results from a temporary change in consumption pattern brought about by emergency power shutdowns. And as the latter adds to the challenges for producers, we see the risk of inflation reappearing in future months.

Inflation closed out 2022 with a 26.6% annual reading, as measured by the consumer price index. That's down from our forecast of 32.9%. (see details on CPI components' growth in Figure 10)

The soaring inflation is an immediate effect of Russia's war of aggression against Ukraine, causing much of the Ukrainian economy to be physically destroyed, and triggering the biggest global energy price shock since the 1970s. Not much new here. What is more interesting is that last year's inflation looks quite moderate for a war-battered country.

As we warned in our report of 14 July, **the headline figure much underestimates the real burden on consumers' pockets** because the war caused uneven price pressure across products and regions.

Triggered by the mass urban-rural migration consumer price adjustment in rural areas nearly fully played out by mid-summer. In turn, **the difference in readings for price growth across products increased again following Russian missile attacks on Ukraine's energy infrastructure in 4Q22**. Consumption in Ukraine has skewed towards essentials amid emergency power shutdowns. Besides, electricity shortage spurred demand, and correspondingly prices, for products that might not even count in CPI.

Besides, **moderate inflation came on the back of NBU's efforts to get its grip on the cash FX market**. That not only helped to avoid another official rate adjustment but also tamed imported inflation.

In spite of slower-than-expected inflation in 2022, consumer **prices are likely to continue growing in 1H23 and remain in the double-digit zone high through the end of 2023.**

The major inflation drivers are expected to be:

Rise in production costs owing to continuing problems with power delivery

Expected in 2023 utility tariffs hike, driven by a substantial gap between government-supported and market prices for energy commodities

Further hryvnia devaluation

On top of that, assuming Ukraine gets on the recovery path in 2H23, an expected increase in imports might add to growth in consumer prices.

That said, **thanks to the tight monetary policy and the government's assurances of avoiding monetary financing of state budget expenditures in 2023, we currently regard the risk of inflation spiraling out of control as negligible.**

Key Macroeconomic Indicators								
	2016	2017	2018	2019	2020	2021	2022	2023F
Real sector								
Real GDP (%YoY)	2.4	2.5	3.4	3.2	-3.8	3.4	-40.0*	-5.0
Industrial production (%YoY)	4.0	1.1	3.0	-0.5	-4.5	1.1	NA	NA
Retail sales (%YoY)	4.3	6.5	6.2	10.3	8.4	10.7	NA	NA
Unemployment rate end of year (ILO, working age)	9.3	9.5	8.8	8.2	9.5	9.3*	NA	NA
Nominal GDP (UAH bn)	2 385	2 984	3 561	3 975	4 222	5 460	NA	NA
Nominal GDP (USD bn)	93	112	131	155	157	201	NA	NA
Prices								
CPI (average %YoY)	14.9	14.4	11.0	7.9	2.7	9.4	20.0	29.7
CPI (end of year %YoY)	12.4	13.7	9.8	4.1	5.0	10.5	26.6	22.1
Real average wage growth (%YoY)	9.0	19.1	12.5	9.8	7.4	11.9	NA	NA
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	2.9	1.6	2.4	1.8	5.2	3.6	NA	NA
Total public debt (% of GDP)	81.0	71.8	61.0	51.6	60.8	48.9	NA	NA
External balance								
Exports of goods and services (USD bn)	46.0	53.9	59.2	63.6	60.7	81.5	NA	NA
Imports of goods and services (USD bn)	52.5	62.7	70.6	76.1	63.1	84.5	NA	NA
Current account balance (USD bn)	-1.9	-3.5	-6.4	-4.1	5.3	-2.1	NA	NA
Current account balance (% of GDP)	-2.0	-3.1	-4.9	-2.7	3.4	-1.0	NA	NA
Net FDI (USD bn)	3.8	3.7	4.5	5.2	-0.1	6.0	NA	NA
Foreign exchange reserves (end of year)	15.5	18.8	20.8	25.3	29.1	30.9	28.5	22.0
Imports coverage (months of imports of goods)	3.7	3.6	3.5	3.9	4.8	4.1	3.0*	2.0
Interest and exchange rates								
NBU discount rate (% end of year)	14.0	14.5	18.0	13.5	6.0	9.0	25.0	15.0
Exchange rate (USD/UAH) end of year	27.2	28.1	27.7	23.7	28.3	27.3	36.6	48.0
Exchange rate (EUR/UAH) end of year	28.4	33.5	31.7	26.4	34.7	30.9	39.1	50.9

**estimates, no official data yet available*

FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
16.01.2023	17.01.2023	18.01.2023	19.01.2023	20.01.2023	21.01.2023	22.01.2023
		LGB* % UAH 285.9mn LGB % UAH 136.4mn LGB P UAH 2 358.4mn		Fitch Sovereign Credit Rating Review		
23.01.2023	24.01.2023	25.01.2023	26.01.2023	27.01.2023	28.01.2023	29.01.2023
		LGB % UAH 87.8mn LGB* % UAH 377.8mn LGB* P UAH 2 500.0mn	LGB % USD 1.0mn NBU: MPC	FGB % EUR 54.7mn		
30.01.2023	31.01.2023	01.02.2023	02.02.2023	03.02.2023	04.02.2023	05.02.2023
		IMF SDR 116.7mn LGB* % UAH 700.3mn LGB % UAH 32.5mn LGB* P UAH 2 500.0mn FGB % USD 33.7mn Fed: FOMC	LGB P USD 347.3mn LGB % USD 6.8mn ECB: MPC	IMF SDR 98.5mn		
06.02.2023	07.02.2023	08.02.2023	09.02.2023	10.02.2023	11.02.2023	12.02.2023
NBU: Minutes		LGB* % UAH 448.0mn		Moody's Sovereign Credit Rating Review		

MOST COMMON TERMS AND ABBREVIATIONS

GDP	Gross domestic product
CPI	Consumer price index
FDI	Foreign direct investment
BoP	Balance of Payments
CA	Current account
FA	Financial account
IIP	International investment position
VAT	Value-added tax
CD	Certificate of deposit
FX	Foreign exchange, foreign currency
UAH	Ukrainian hryvnia
USD	U.S. dollar
EUR	Euro
SDR	Special drawing rights
UONIA	Ukrainian OverNight Index Average
WA	Weighted average
DGF	Deposit Guarantee Fund
Ukrstat	State Statistics Service of Ukraine
NBU	National Bank of Ukraine
ECB	European Central Bank
Fed	Federal Reserve System
FOMC	The Federal Open Market Committee
MPC	Monetary policy committee meeting
Minutes	Summary of MPC meeting
IMF	International Monetary Fund
IFI	International financial institutions
LGB	Local government bonds
FGB	Foreign government bonds (Eurobonds)
P	Principal due
%	Interests due
*	government bonds held by NBU or issued for recapitalization of state-owned banks

bp	basis point
pp	percentage point
y/y	in annual terms; year-on-year change
m/m	in monthly terms; month-on-month change
TTM	trailing twelve months
RHS	right-hand scale

Contacts

Investment Business Group

Viktoriia Nebeska
Market Making Government Bonds
(+38044) 201-22-74
viktoriia.nebeska@ukrsibbank.com

Mykhailo Kharchuk
Market Analysis
(+38044) 537-49-75
mykhailo.kharchuk@ukrsibbank.com

FX Business
Kostiantyn Rupchev
Head of FX Sales
(+38044) 537-50-04
kostiantyn.rupchev@ukrsibbank.com

Corporate Business
Ievgen Kulikov
Head of MNC team
(+38044) 201-22-43
ievgen.kulikov@ukrsibbank.com

Distribution:
macro@ukrsibbank.com

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