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ECONOMICS | INTEREST RATES | FX MARKETS

3 March 2023

UKRAINIAN CAPITAL MARKETS REVIEW

	Rating	Outlook	Last update
Fitch	CC	-	20.01.2023
S&P	CCC+	STABLE	19.08.2022
Moody's	Ca	STABLE	10.02.2023
R&I	CCC	NEGATIVE	27.07.2022

This week in focus: Ukraine's record trade gap signals future challenges

Ukraine ended 2022 with an external deficit of USD2.9bn. Thanks to substantial foreign financial support, it was less than a quarter of the deficit in 2014, when Russia first invaded Ukraine. But considering the war consequences, stabilizing the balance of payments in the post-war period will require a comprehensive approach that addresses a range of economic, social, and political challenges.

FX and interest rates: Hryvnia strengthens, but will it last?

The hryvnia has displayed a positive performance at the onset of 2023, appreciating beyond the 40.0 threshold against the U.S. dollar on the cash market. While this is certainly good news, the reasons for the improvement are somewhat limited, making it difficult to predict whether the trend will continue for several months.

A decline in demand for imported fuels, owing to reduced outages and uninterrupted power supply lately, is among the primary factors contributing to the hryvnia's upswing.

Furthermore, NBU's enabling households to buy FX at a better than a "black market" rate with the obligation to place the bought FX on term deposit (3 -6 months), coupled with increased interventions, appears to have decreased cash market pressure, reallocating some demand to such FX deposits.

While the continuous inflow of foreign financial support enables the central bank to maintain its foreign exchange reserves, shoring up expectations on the hryvnia, **the recent improvement in the local currency looks unsustainable in the context of a continuously rising international trade gap**. Ukraine's trade deficit hit a record high last year and is prone to expand further this year.

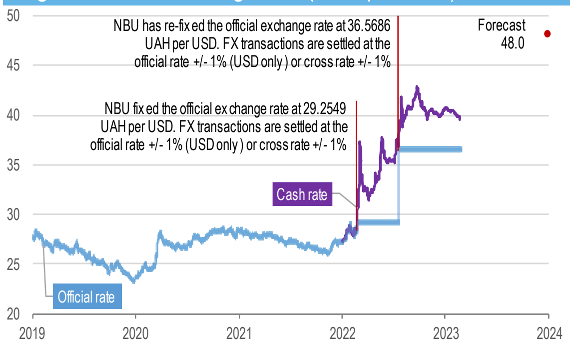
In addition, we believe that without some depreciation of the hryvnia, meeting this year's public revenue projections could be challenging for the government.

Banking liquidity apparently set to rewrite the all-time high, as the government increasingly injects fresh money. Because the central bank continue tightening mandatory reserve requirements, however, the share of funds tied on the correspondent accounts has notably increased.

As of 28 February, total funds in the system slightly exceeded UAH521bn, up 0.8% from mid-January. In the meantime, correspondent accounts' balance rose by a third to UAH168bn. And that is not counting more than UAH45bn increase in banks' position in local public debt after the NBU allowed banks partly meet increased required reserve rate with benchmark bonds.

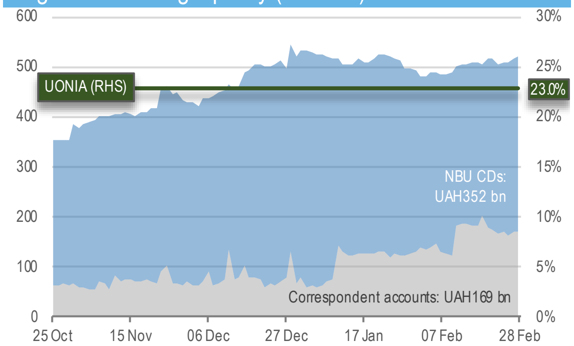
Worth also noting continuous inflow of cash money in the system, seemingly resulting from stabilized power supply. More than UAH28bn of paper hryvnia was deposited since mid-January.

Figure 1. UAH exchange rate (UAH per USD)



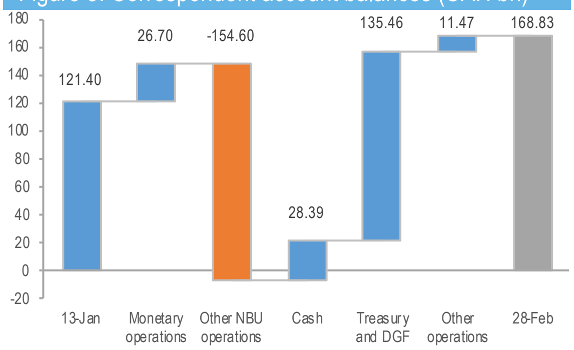
Sources: UKRSIBBANK, NBU, MinFin (media)

Figure 2. Banking liquidity (UAH bn)



Source: NBU

Figure 3. Correspondent account balances (UAH bn)



Source: NBU

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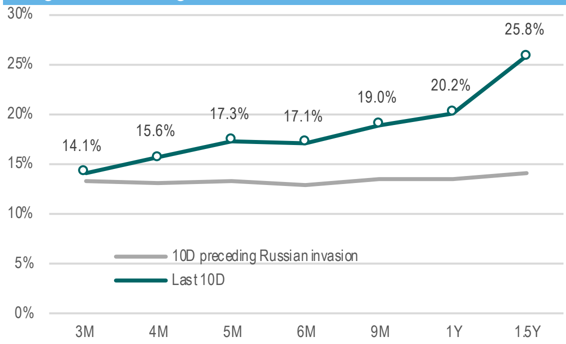
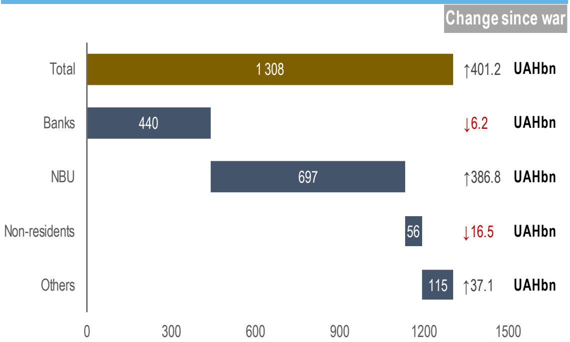
Figure 4. Local government bonds in UAH



Source: NBU

Figure 5. Position in local government bonds in UAH



Source: NBU

Government bond market

Primary debt market has a good start to 2023, thanks to concerted efforts with the NBU and the IMF to improve the public debt rollover rate.

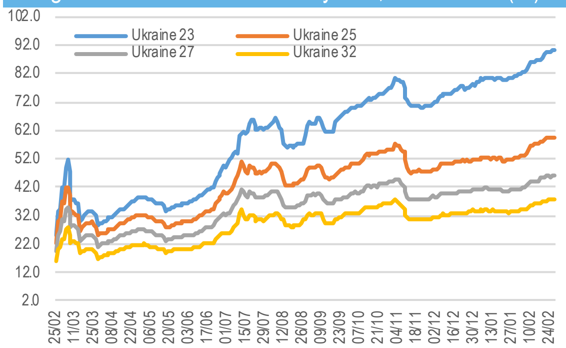
Since the beginning of 2023, FinMin has attracted some UAH83bn, EUR87mn, and USD314.5mn, while total local borrowings for the current year are projected at UAH90bn (in hryvnia equivalent).

Rollover rate for hryvnia-denominated bonds soared above 100% since late 2022 (when the NBU introduced the mandatory reserve tightening and allowed banks to partly meet the new requirement with benchmark bonds) from 50-60% in September-November.

Expectedly, the strongest bidding is seen in 2+ year hryvnia-denominated benchmark bonds (selected securities that can be used to meet the central bank's mandatory reserves requirement). To push rates down, volume caps of UAH7bn and UAH10bn have been imposed for 2-year and 2.5-year bonds correspondingly. As a result, at the last primary auction on 28 February, the cut-off rate for 2-year bonds was reduced below 19.0% per annum.

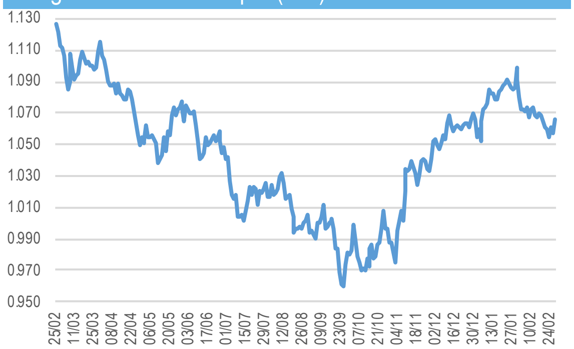
Non-benchmark securities with similar tenure have also received strong reception lately, albeit with a yield premium of 1pp over the benchmark ones.

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



Source: Bloomberg

Figure 7. EUR USD spot (mid)



Source: Bloomberg

Euro bounces back on hawkish ECB outlook

Euro recovers against the U.S. dollar after briefly piercing the 1.06 psychological barrier. On Wednesday, 1 March, the EUR/USD pair was heading toward the 1.07 key level.

Markets are betting for additional jumbo interest rate hikes by the ECB in the coming months. The expectations were lifted by signs of rebounding inflation in France, Spain, and Germany - the Eurozone's three biggest economies.

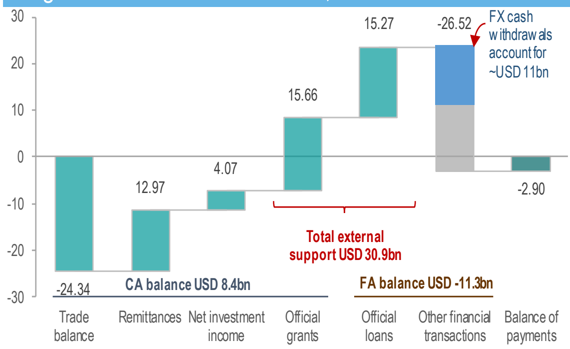
Besides, recession fears in the Eurozone seem to have receded, which has boosted the ongoing recovery in the single currency, as well as the hawkish narrative from the ECB.

Across the pond, the U.S. 4Q22 GDP reading came out below market expectations, as well as 3Q22's figure, indicating that the U.S. economy is slowing at a faster rate than anticipated and stoking fears that rising borrowing costs could adversely impact growth.

But the greenback still remains buoyed by hawkish expectations, which have helped to support U.S. Treasury bond yields, keeping them close to their year-to-date peak.

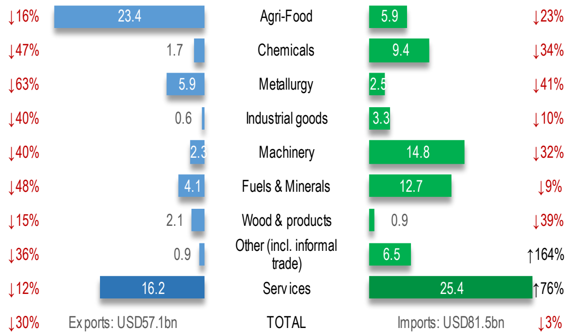
The benchmark 10-year Treasury yield topped 4% on Wednesday, for the first time since November, but has shortly retreated to 3.996%.

Figure 8. 2022 BoP breakdown, USDbn



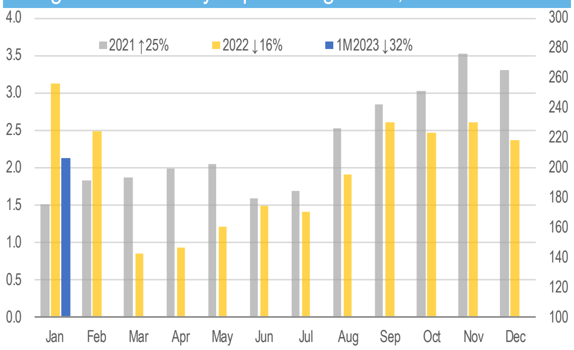
Source: NBU

Figure 9. 2022 exports & imports breakdown, USDbn



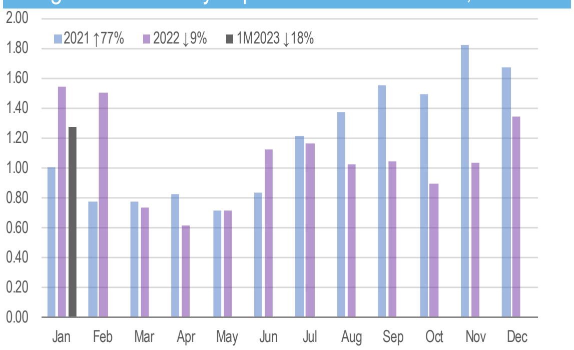
Source: NBU

Figure 10. Monthly export of agri-food, USDbn



Source: NBU

Figure 11. Monthly import of fuels & minerals, USDbn



Source: NBU

Ukraine's record trade deficit signals future economic challenges

Ukraine ended 2022 with an external deficit of USD2.9bn. Thanks to substantial foreign financial support, it was less than a quarter of the deficit in 2014 - the last time Ukraine's balance of payments was in the red - when Russia first invaded Ukraine. But the country faced more severe economic disruption this time, with many assets being destroyed, a number of supply chains cut, and millions of people displaced. Stabilizing the balance of payments in the post-war period will require a comprehensive approach that addresses a range of economic, social, and political challenges. Rebuilding and diversifying exports, stimulating foreign investments, promoting fiscal discipline, and strengthening institutions are all critical measures to regain external balance sustainability.

Ukraine's trade balance has never been more deeply in the red. The international trade gap reached USD24.3bn in 2022. Although there have been some monster trade deficits in the past, the one notched up in 2022 trumped them all. Most of the trade deficit drivers, laid out in our report from 15 September 2022, remain actual. Briefly, these are the loss of a number of production assets, disruption in supply chains, an increase in the import of energy commodities (again due to the destruction of Ukraine's own refinery facilities), and a two-fold rise in the import of services due to the dramatic outmigration.

Late in the year, Ukraine also increased import of contingency equipment, fuels, and various home-use devices (lanterns, lithium batteries, etc.) in response to intensified Russian missile attacks on Ukraine's energy infrastructure.

Outlook for 2023 remains grim. Hopes for electricity exports – once expected to be an important contributor after Ukraine joined ENTSO-E (European Network of Transmission System Operators for Electricity) - were dashed after Russian missile attacks put Ukraine on the brink of an energy market collapse.

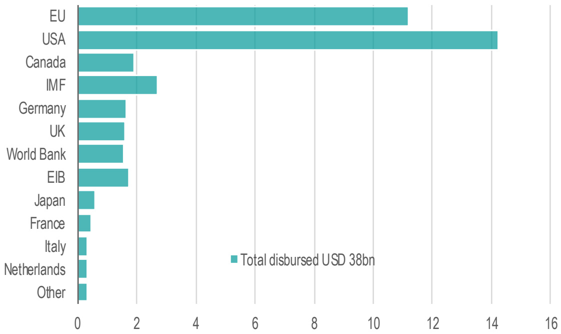
On the contrary, the country has become dependent on import of electricity and foreign energy commodities in general. The latter is expected to account for most of the foreign currency spending this year.

Ukraine's agriculture – the leading export industry - lost 16% of its FX revenues last year. Thanks to the UN-brokered grain deal, which was extended until 20 March 2023, the drop looks mild compared to other industries. But recovery is out of sight yet, even assuming positive developments on the battlefield. Many lands have suffered drastic ecological degradation owing to the war. Because of rolling power cuts in the aftermath of Russian attacks on the local energy infrastructure, some crops were left unharvested in 4Q, as the producers had no means to process or store them. With remaining actual security risks, shortage of inventories, and continuous decline in global prices for food, the agriculture industry is likely to see another drop in export revenue this year.

The potential for recovery in steel and iron ore products export, assuming Ukraine regains full access to seaports, is seen as limited. Many enterprises have been severely damaged, while others, such as the steelmaker Azovstal in Mariupol, have been totally destroyed.

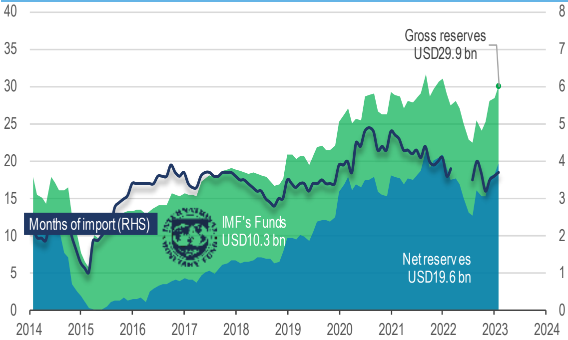
The import of services, another source of pressure on the country's FX reserves, stabilized at around USD2.4bn per month in 2H22, but for December. We reckon a USD2.4bn monthly FX outflow, which is about twice as high as before the war, is a peak value, while another pickup in December to USD2.8bn could be attributed to a seasonal spike in purchases by households. It doesn't include FX cash withdrawals, draining an extra USD0.8-1bn per month. That said, we expect both figures to go down this year, as Ukrainian migrants increasingly find new jobs abroad.

Figure 12. External aid received since 24 Feb, USDbn



Source: FinMin

Figure 13. Ukraine's FX reserves, USDbn



Source: NBU

Comprehensive reforms are required to regain external balance sustainability

It is clear **Ukraine will continue living beyond its means this year**, dependent on inflows of foreign capital to cover its needs in foreign currency.

Foreign official creditors pledged some USD31bn this year. Another USD15bn is expected to be provided by the IMF. The country has successfully passed the final review under the Program Monitoring with Board Involvement (PMB), paving the way to a fully-fledged program. The local authorities hope to secure a 5-7-year loan worth about USD15bn. The new arrangement could be approved as soon as within few weeks, according to the head of the IMF.

The expected this year financial support is one and a half times as much as last year. But it looks sufficient only in the context of remaining foreign currency restrictions in place. Future economic recovery, which is likely to entail a gradual regulatory easing, may well overshadow the current import in spending, further deepening the external deficit.

National bank of Ukraine is virtually the only source of foreign currency at the local market now. But for IT segment, which has little alternatives to pay salaries but convert its external revenue, business prefer hold back currency sales now due to remaining high uncertainty, both in terms of economy, including future local currency rate, and security risks.

Stimulation of investments, promoting fiscal discipline, and strengthening institutions are all critical measures to boost foreign currency inflow in the country, rebuild and diversify its exports, and regain external balance sustainability.

While the IMF's support is usually conditional on comprehensive reforms, Ukraine has a track record of foot-dragging when it comes to meeting structural benchmarks. Without an open and proactive approach to addressing the foregoing issues, they will come back to haunt the country later.

Key Macroeconomic Indicators	2016	2017	2018	2019	2020	2021	2022	2023E
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	23.6
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	3.7	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*

NA – data is not available because of continuing military operations

FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
27.02.2023	28.02.2023	01.03.2023	02.03.2023	03.03.2023	04.03.2023	05.03.2023
		LGB* % UAH 125.8mn LGB % UAH 3 253.6mn FGB % USD 257.6mn LGB P UAH 27 072.8mn		LGB* % UAH 135.0mn		
06.03.2023	07.03.2023	08.03.2023	09.03.2023	10.03.2023	11.03.2023	12.03.2023
LGB* % UAH 2 200.0mn		LGB* % UAH 682.7mn LGB % UAH 24.0mn		S&P Sovereign Credit Rating Review		
13.03.2023	14.03.2023	15.03.2023	16.03.2023	17.03.2023	18.03.2023	19.03.2023
IMF SDR 295.5mn Ukrstat: GDP		LGB* % UAH 199.6mn LGB % UAH 345.6mn FGB % USD 94.3mn	IMF SDR 59.7mn NBU: MPC ECB: MPC			
20.03.2023	21.03.2023	22.03.2023	23.03.2023	24.03.2023	25.03.2023	26.03.2023
IMF SDR 125.0mn		LGB % UAH 162.5mn LGB* % UAH 900.2mn Fed: FOMC			FGB % USD 110.6mn	

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

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