



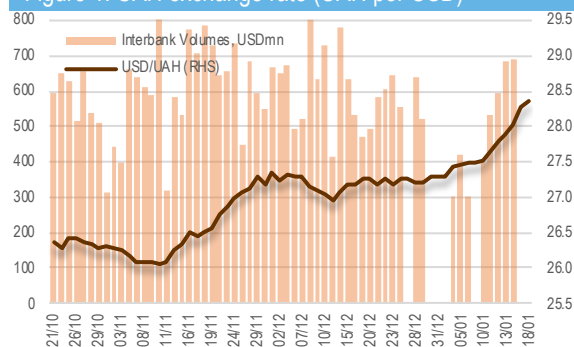
ECONOMICS | INTEREST RATES STRATEGY | FX

19 January 2022

**UKRAINIAN
CAPITAL MARKETS
WEEKLY**

	Rating	Outlook	Last update	This week in focus: Fiscal deficit is still small, but funding pressure will grow
Fitch	B	POSITIVE	06.08.2021	Ukraine enjoyed a lower than originally projected overall state budget deficit in 2022. The general fund revenue exceeded the plan by 2.8%, while expenditures fell short of projections by 11.5%. Because of growing fiscal challenges, a strong reforms commitment is of vital importance for Ukraine to stay in line with its 2022 fiscal deficit target of 3.5% GDP.
S&P	B	STABLE	12.03.2021	
S&P (N)	uaA	-	12.03.2021	
Moody's	B3	STABLE	12.06.2020	

Figure 1. UAH exchange rate (UAH per USD)



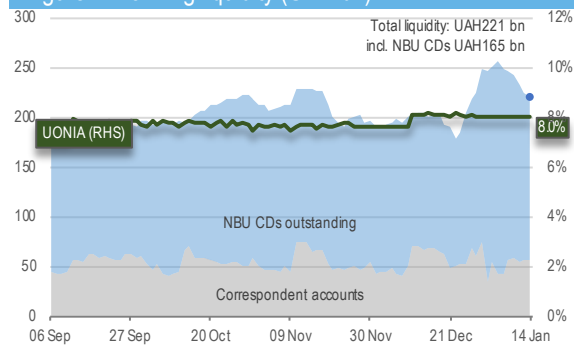
FX and interest rates: USD/UAH leaps above 28 on Russian invasion fears

The Ukrainian hryvnia has faced immense pressure since the beginning of the year, as an estimated 100,000 Russian troops massed on the country's northern and eastern borders fuels fears across the financial markets over a likely invasion.

The USD/UAH pair is now trading close to the 28.30 mark, down 3.7% from the level at the end of 2021. The key drivers of UAH weakness are high domestic banking sector liquidity, increased demand for hard currency in light of geopolitical events.

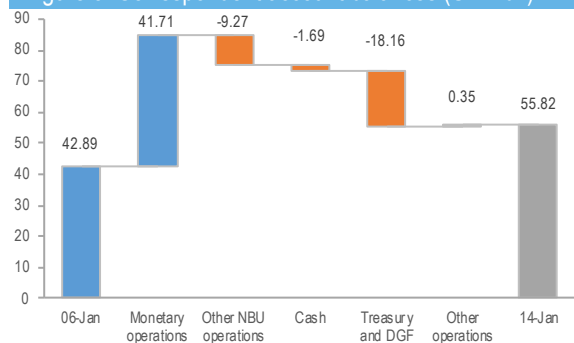
Provided limited pressures from sales of UAH government securities by international accounts, we believe the situation will remain manageable with UAH depreciation likely to lose steam. At the same time, demand for cash FX by population could become a significant game changer, with over UAH500bn cash liquidity being distributed across country. This could drastically change the situation if and when odds of a ground operation in Ukraine grow.

Figure 2. Banking liquidity (UAH bn)



It is important to follow how long the Russian troops will stay on the Ukrainian border, as a lengthy tense situation can erode economic recovery itself. Energy and fertilizers imports are likely to drain FX the most this year and are already coming into play. An elevated uncertainty regarding USD/UAH pair could make businesses cut their production plans. On the other hand, the pair could easily roll back below 28.00 level if any sign of Russia deescalating appears.

Figure 3. Correspondent account balances (UAH bn)



Banking liquidity shrank to UAH220bn since the beginning of the year. A UAH30bn drop (more than USD1bn) has mostly to do with fiscal flows and the central bank's FX interventions.

Some UAH18bn were transferred to the State treasury account over the last week. No details are available on the origin of these transactions.

Regarding the interventions, **the NBU sold in the market USD331mn last week**, hence draining UAH9.3bn. And because the market remains hot, about the same amount of FX is likely to be sold this week.

As of the end of last Friday, the balance of correspondent accounts with the NBU was UAH55.8bn, up 30.2% compared to a week before, and the amount of funds held in NBU's CDs dropped by 20% to UAH164.9bn.



Figure 4. Local UAH bonds market

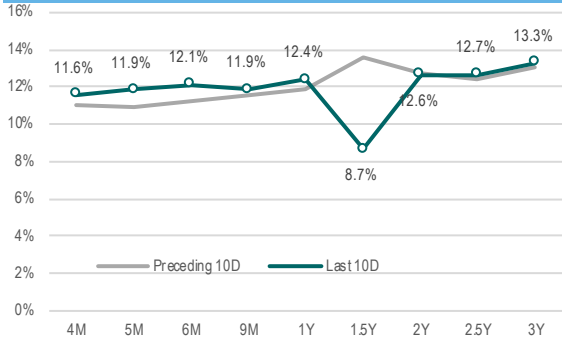
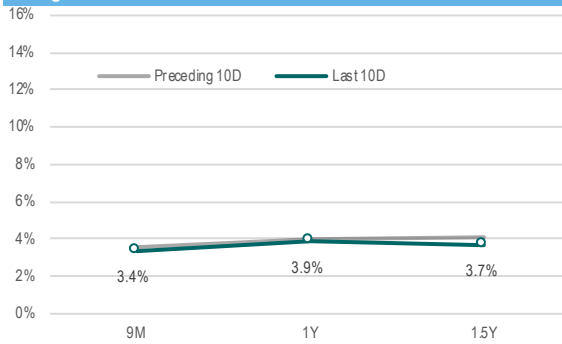


Figure 5. Local USD bonds market



Government bond market

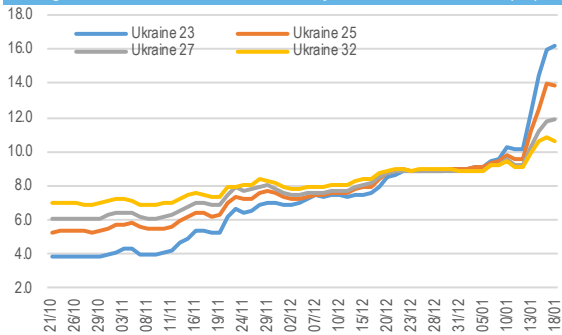
CCY	Maturity	Cut-off rate	WA rate	Max bid rate	Min bid rate	Number of bids	Bids accepted	Bid size, mn	Placement size, mn
UAH	5M	11.00%	10.99%	12.00%	10.95%	5	4	17.14	11.27
UAH	1Y	11.90%	11.90%	11.90%	11.90%	12	12	23.12	23.12
UAH	2Y	12.95%	12.95%	12.95%	12.95%	14	14	72.13	72.13
UAH	5.5Y	13.25%	13.25%	13.25%	13.25%	5	5	10.29	10.29
USD	5M	3.50%	3.50%	3.50%	3.50%	2	2	100.30	100.00
USD	9M	3.70%	3.70%	3.70%	3.70%	18	18	43.15	43.15

Tuesday's primary debt auction was nearly a failure for FinMin. The ministry offered a range of hryvnia-denominated bonds and two issues of short-term USD-denominated securities. And these were the FX bonds which drew some market bidding, while the UAH-denominated ones were out of interest.

According to FinMin, the USD100mn in five-month notes were sold at a marginal rate of 3.5%, and another USD43mn in nine-month notes were sold at a rate of 3.7%. But the auction in 5m securities looks like a deal with some state-owned bank for there were only two bids.

Low demand for hryvnia bonds came a no surprise. Although the local debt market has hardly responded to the heightened tension along the Ukrainian border, market participants took a wait-and-see stance before another NBU MPC meeting on January 20.

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



EUR/USD retreats below 1.1400 barrier

The EUR/USD pair turned to the bearish move soon after hitting the new 2022 high of 1.1480 earlier in the month, as safe-haven flows took a dominant position at the financial markets.

Higher U.S. yields driven by **rising speculation that the Federal Reserve will accelerate further its tightening pace** are underpinning the positive sentiment in the greenback.

The 10-year U.S. Treasury yield soared to a fresh two-year high of 1.856% from less than 1.50% seen in the last week of 2021.

The U.S. central bank is having its first meeting of the year next week and is not expected to change rates or the rest of the monetary policy. But investors will be looking for confirmation that the first rate hike will take place not sooner than in March, as the pace at which policymakers will raise rates is critical.

ECB officials have been quite vocal lately and now acknowledge that high inflation could last longer in the euro area, sparking fresh speculation of a move on rates by the central bank by the end of 2022.

Yet, the unabated advance of the coronavirus pandemic remains the exclusive factor for economic growth prospects and investors' sentiment in the region.

Figure 7. EUR USD spot (mid)

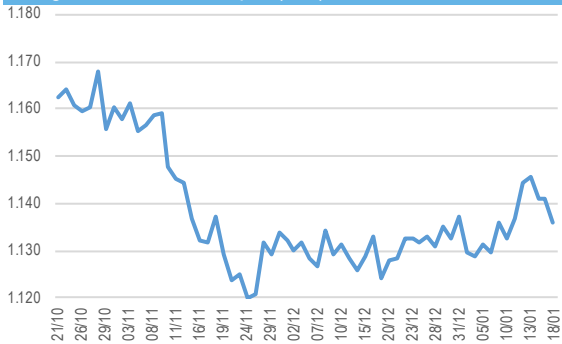
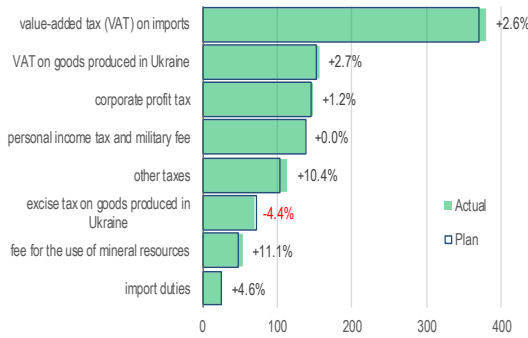


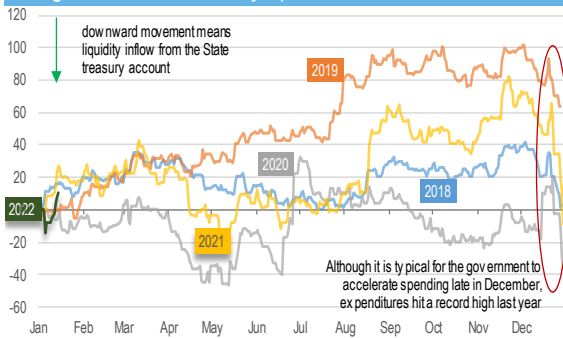
Figure 8. State budget general fund revenue, UAHbn



Fiscal deficit is still small, but funding pressure will grow

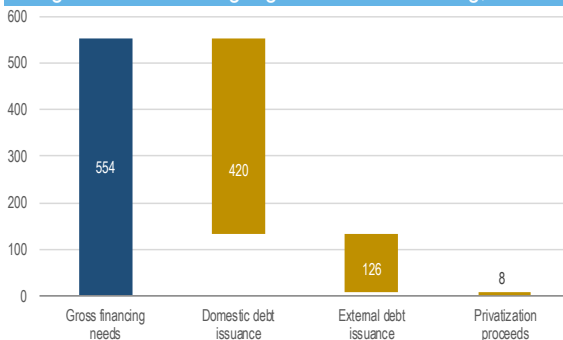
Ukraine enjoyed a lower than originally projected overall state budget deficit in 2022. The general fund of the state budget received UAH1.08tn in 2021 (+0.7% y/y), 2.8% above the plan, according to the preliminary data of the State Treasury Service of Ukraine. Bolstered by a swift recovery in cross-border trade, value-added tax and corporate profit tax were the major contributors. Ukraine enjoyed record high prices for steel products and iron ore for the most of the year and this was followed by record domestic harvest, coupled with strong domestic demand.

Figure 9. State treasury operations, UAHbn



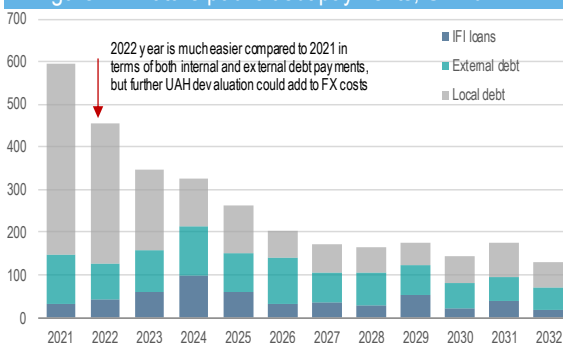
The total expenditures of the general fund fell short of projections by 11.5% and amounted to UAH1.26tn. As a result, the state budget was executed with a deficit of UAH168.4bn versus UAH220.9bn provided by the latest financial plan. This roughly corresponds to 3.4% of GDP according to our calculations and is below the figure of 5.1% originally stipulated in the budget. Significant part of spending was traditionally made in December. During the last month, the state injected more than UAH78bn (net flow) to the banking sector, pushing overall banking sector liquidity to a record high of UAH257bn and creating soft monetary conditions at the beginning of the year. This abundant liquidity, against the backdrop of heightening geopolitical risks contributed to UAH weakness observed during the first weeks of January.

Figure 10. 2022 budget general fund financing, UAHbn



Price spikes across various markets impose growing fiscal challenges in 2022. As the inflation-fighting agenda comes into the foreground of global policy efforts, Ukraine may find its macroeconomic assumption laid out in the 3-year state budget declaration being out of date. Starting from the 3.8% annual real GDP growth forecast, although it meets our expectations for the current year, we now see reasons to put on revision our forecast. A crop's damage because of a sharp increase in price for fertilizers, global prices correction for iron ore and steel products, and remaining out of control energy prices pose a severe threat to the recovery. While modest inflation expectation of 6.2% could give some hope for better than expected VAT collection, Ukraine might fall short of income tax revenue if production costs remain elevated. And this is not to mention still low vaccination rates, which pose a risk to the near-term growth outlook in case of the Covid spread reacceleration.

Figure 11. Future public debt payments, UAHbn



A strong reforms commitment is of vital importance for Ukraine to stay in line with its 2022 fiscal deficit target of 3.5% GDP. The country is pursuing its cooperation with the IMF under the SBA. While the programme expires at the end of June 2022, the government has already announced its intention to extend cooperation further on. Announced by the authorities lending proposals (soft loans, loan guarantees, and grants) to stimulate economic activity could be futile against the introduced fiscal tightening. Such an approach makes the government's policy more redistributive than stimulative and could increase its fiscal burden later on as new lending programs are launched. Cooperation with the IMF is important not only to keep a check on budgetary sources but also to preserve the country's access to global capital markets, as it remains an important benchmark for foreign investors.

We believe FinMin will be forced to cut maturities in the primary auctions and also will be looking for non-standard solutions to tap international capital markets (like bridge loans) until the situation allows for placement of sovereign Eurobonds. With USD2.2bn of the loan remaining undrawn under the SBA, the government may also press ahead with implementation of performance criteria agreed with the IMF. The next review of the IMF programme is scheduled for March 4, with SDR500mn (circa USD700mn) available for withdrawal.

UKRAINIAN CAPITAL MARKETS WEEKLY

Key Macroeconomic Indicators								
	2015	2016	2017	2018	2019	2020	2021	2022E
Real sector								
Real GDP (%YoY)	-9.8	2.4	2.5	3.4	3.2	-4.0	3.1*	3.8
Industrial production (%YoY)	-12.3	4.0	1.1	3.0	-0.5	-4.5	1.5*	1.0
Retail sales (%YoY)	-19.8	4.3	6.5	6.2	10.3	8.4	9.2*	10.0
Unemployment rate end of year (ILO, working age)	9.1	9.3	9.5	8.8	8.2	10.1*	9.3*	8.5
Nominal GDP (UAH bn)	1 989	2 385	2 984	3 561	3 975	4 194	5 007*	5 820
Nominal GDP (USD bn)	90	93	112	131	155	156	184*	204
Prices								
CPI (average %YoY)	48.5	14.9	14.4	11.0	7.9	2.7	9.4	9.0
CPI (end of year %YoY)	43.3	12.4	13.7	9.8	4.1	5.0	10.5	8.9
Real average wage growth (%YoY)	-20.2	9.0	19.1	12.5	9.8	7.4	8*	3.0
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	2.3	2.9	1.6	2.4	1.8	5.2	5*	3.5
Total public debt (% of GDP)	79.4	81.0	71.8	61.0	51.6	60.9	64.6*	61.5
External balance								
Exports of goods and services (USD bn)	47.9	46.0	53.9	59.2	63.6	60.6	62.6*	65.0
Imports of goods and services (USD bn)	50.2	52.5	62.7	70.6	76.1	62.3	72.5*	78.0
Current account balance (USD bn)	5.0	-1.9	-3.5	-6.4	-4.1	6.6	-0.6*	-3.2
Current account balance (% of GDP)	5.6	-2.0	-3.1	-4.9	-2.7	4.2	-0.3*	-1.6
Net FDI (USD bn)	-0.5	3.8	3.7	4.5	5.9	-0.4	5.5*	3.0
Foreign exchange reserves (end of year)	13.3	15.5	18.8	20.8	25.3	29.1	30.9	32.5
Imports coverage (months of imports of goods)	3.4	3.7	3.6	3.5	3.9	4.8	4.1	5.0
Interest and exchange rates								
NBU discount rate (% end of year)	22.0	14.0	14.5	18.0	13.5	6.0	9.0	9.5
Exchange rate (USD/UAH) end of year	24.0	27.2	28.1	27.7	23.7	28.3	27.3	29.8
Exchange rate (EUR/UAH) end of year	26.2	28.4	33.5	31.7	26.4	34.7	30.9	32.5

*estimates, no official data yet available



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UKRAINIAN CAPITAL MARKETS WEEKLY

FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
17.01.2022	18.01.2022	19.01.2022	20.01.2022	21.01.2022	22.01.2022	23.01.2022
		LGB* % UAH 462.1mn LGB* P UAH 2 500.0mn LGB % UAH 944.8mn	NBU: MPC			
24.01.2022	25.01.2022	26.01.2022	27.01.2022	28.01.2022	29.01.2022	30.01.2022
Ukrstat: Retail trade		LGB % UAH 87.8mn LGB* % UAH 554.0mn Fed: FOMC	FGB % EUR 54.7mn	Ukrstat: Nominal & Real Wage		
31.01.2022	01.02.2022	02.02.2022	03.02.2022	04.02.2022	05.02.2022	06.02.2022
Ukrstat: Industrial Production NBU: Minutes NBU: BoP	IMF SDR 43.6mn FGB % USD 33.7mn NBU: Cost of Real Sector External Debt	LGB* % UAH 700.3mn LGB % UAH 1 279.2mn LGB P UAH 11 504.3mn	LGB % USD 13.0mn LGB P USD 367.9mn ECB: MPC	IMF SDR 98.5mn Ukrstat: GDP flash estimate		
07.02.2022	08.02.2022	09.02.2022	10.02.2022	11.02.2022	12.02.2022	13.02.2022
NBU: FX Reserves (deadline - 7th day)		LGB* % UAH 448.0mn Ukrstat: Price indices				

MOST COMMON TERMS AND ABBREVIATIONS

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



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