14 July 2022

UKRAINIAN CAPITAL MARKETS REVIEW

	Rating	Outlook	Last update
Fitch	CCC	-	25.02.2022
S&P	CCC+	NEGATIVE	27.05.2022
Moody's	Caa3	NEGATIVE	20.05.2022
R&I	B-	-	28.02.2022

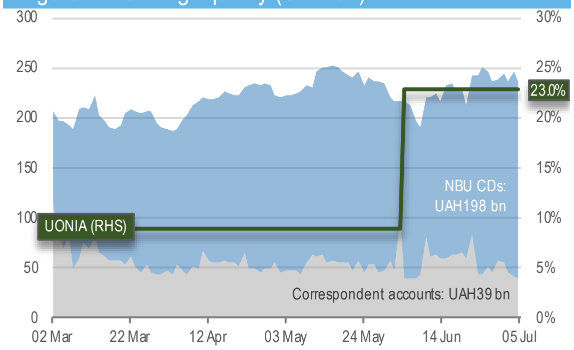
This week in focus: Inflation could extend well into 1H23

Ukraine has faced the new bout of inflation. So far, the major inflation drivers have been war-related panic buying, destruction of assets, and disruption of supply chains. Going forward, persistent problems with logistics, recovery in wages growth owing to a dramatic out-migration, as well as reaccelerated global inflation could keep pushing prices higher over the next 12 months.

Figure 1. UAH exchange rate (UAH per USD)

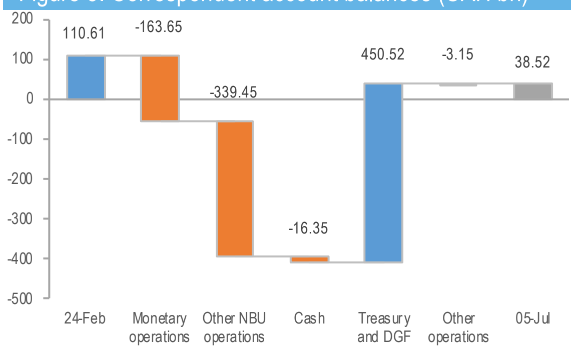
Source: NBU, MinFin (media)

Figure 2. Banking liquidity (UAH bn)



Source: NBU

Figure 3. Correspondent account balances (UAH bn)



Source: NBU

FX and interest rates: Ukrainian FX market operates in restricted mode

Ukraine de-facto switched to a fixed FX rate regime following the Russian invasion. The NBU suspended a number of FX market operations and most of cross-border FX payments to cope with war-related demand-supply imbalance.

The interbank market now operates with all transactions tied to the official rate, which has been fixed at 29.2549 UAH per USD since February 24. The daily turnover has dropped to around USD200mn from USD500-700mn before the war. At first offshore transactions by Ukrainians fleeing the country accounted for most of the turnover, followed by businesses involved in importing goods of critical importance. But the latter have increased their demand for FX over the last months following numerous amendments to the notion of critical, which now covers more than 90% of goods imported before the war.

Most of the FX demand at the interbank market is met by the NBU, which has doubled its interventions since mid-May to around USD1bn per week. Because of logistics problems and lost access to seaports, FX sales by exporters, but for IT, have dwindled to insignificant levels.

Cash market, being disconnected from the interbank one, is largely driven by situational factors. While at first it was a war-related shock, in April demand for FX cash started to rise again after the government allowed tax-free imports of cars from the EU, as well as because of some speculations.

We assume resetting of the official rate to the cash one when the NBU starts phasing out the fixed FX rate regime. June's key rate hike by the NBU, followed by reintroduction of import taxes and removal of restrictions related to critical import appears to be important steps in that direction. But the NBU also requires fair prices for government bonds for setting on the deregulation path.

Banking system remains full of liquidity. As of July 1, banks held UAH46bn on correspondent accounts, up 5.9% from February 24, and UAH191bn in NBU CDs, down 7.5%.

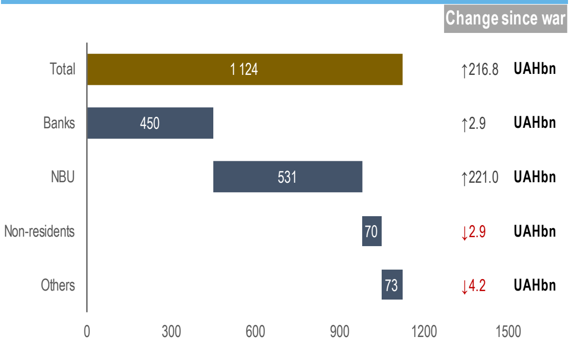
Typical in wartime cash outflow exceeded UAH60bn by mid-March. Because paper money has started returning into the system since then, and because most withdrawals occurred before the invasion, the drain narrowed to UAH16.4bn by the end of June.

At the moment two major factors defining the amount of liquidity in the system are government expenditures, which are majorly financed by international donors, and FX sales by the NBU.

Figure 4. Local government bonds in UAH

Source: NBU

Figure 5. Position in local government bonds in UAH



Source: NBU

Government bond market

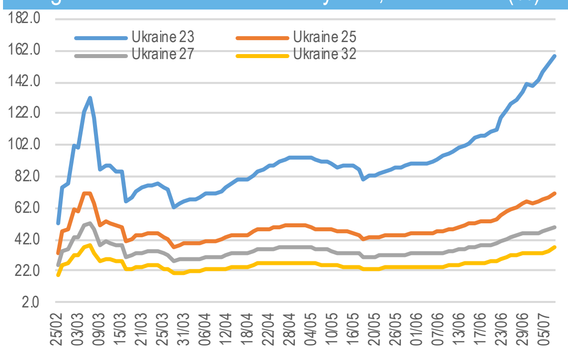
Having lost access to commercial funds with the Russian invasion, **Ukraine has implemented a war finance policy** to meet its funding needs. The ministry of finance has offered citizens, businesses, and foreign investors to support the state budget by investing in so-called "war bonds", which are issued in the local market only. And to avoid establishing "unmanageable" postwar debt securities, these bonds pay much lower interests than traditional ones. The cut-off yield for 3m UAH bonds has been fixed at 9.5%, for 6-9m - at 10%, for 1y bonds - at 11%, and 1.5y ones - at 11.5% per year.

With annual inflation running almost twice as high as the yield for 1y UAH bonds, FinMin can barely find demand to cover its current debt servicing needs. FX-denominated bonds, though typically receive better reception, do not help much.

Foreign financial aid and the NBU are currently the two major sources of financing for Ukraine. As of July 5 (starting from February 24), the government received circa USD11bn (in USD equivalent) from external donors and USD7.7bn (in USD equivalent) from the NBU. In comparison, FinMin raised some USD3.7bn (in USD equivalent) via sale of war bonds.

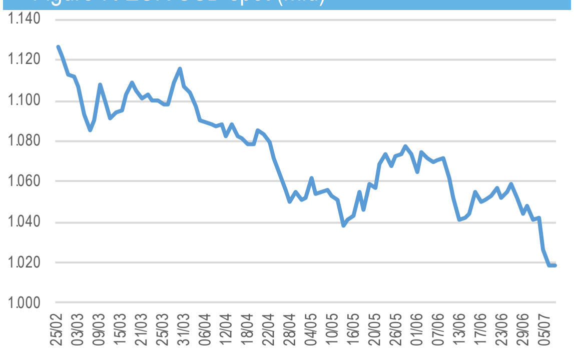
Despite the fact that the central bank continues publicly piling pressure on FinMin to raise interest rates for war bonds to a market level, we do not expect any changes in the yield curve until the economy is back to normal.

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



Source: Bloomberg

Figure 7. EUR USD spot (mid)



Source: Bloomberg

Euro reaches US dollar parity as recession fears build

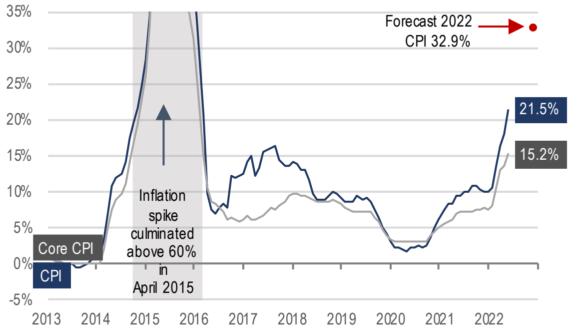
The EUR/USD has fallen to its lowest level in two decades as fears of a recession in the Eurozone have ramped up. The pair was trading at 1.0029 on Thursday (July 14), losing more than 10% over the last four months.

Eurozone inflation hit a record 8.6% in June, prompting the ECB to give markets advance notice of its intention to hike interest rates for the first time in 11 years at its July meeting. A rate hike looks likely as the ECB has already done with the Asset Purchase Program (APP) and is left with interest rate policy measures only.

The US consumer price index soared 9.1% from a year ago in June, up 0.5% on May. But **the US Fed has come way ahead of ECB in taming inflation**, raising its key short-term interest rates by 75 basis points in June – its largest hike since 1994 – to a range of 1.5% to 1.75%. And the market expects at least two more hikes ahead this year.

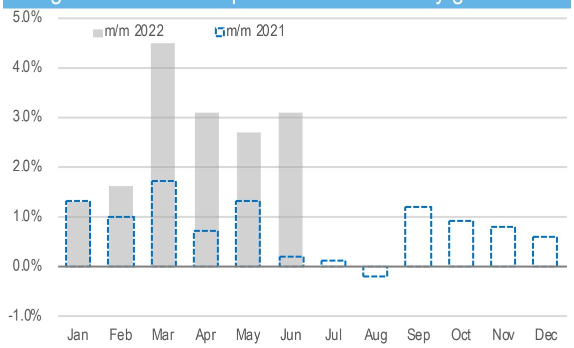
Fears of a recession in the eurozone have also intensified on the back of rising uncertainty about energy supply to the bloc, with Russia threatening to further reduce gas supplies to Germany and the broader continent. This, along with the prospect of an economic slowdown casts a specter of doubt over whether the ECB will be able to tighten monetary policy sufficiently to rein in record-high inflation.

Figure 8. Consumer prices indices' annual growth rate



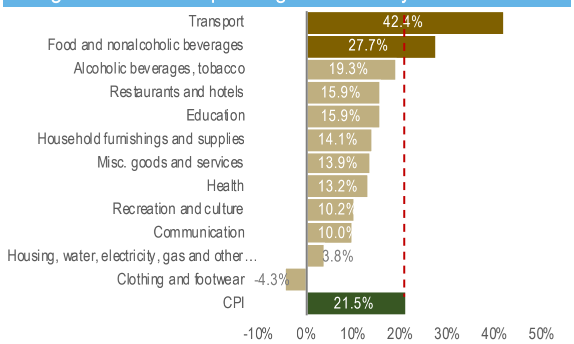
Source: Ukrstat

Figure 9. Consumer prices index's monthly growth rate



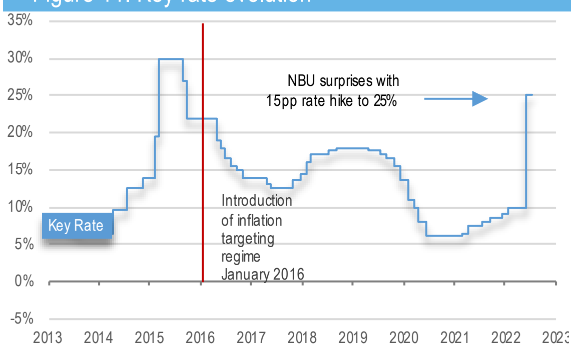
Source: Ukrstat

Figure 10. Annual prices growth in May



Source: Ukrstat

Figure 11. Key rate evolution



Source: NBU

Inflation could extend well into 1H23

Ukraine has faced a new bout of inflation. Prices climbed 21.5% in the year through June, and a steeper rise looms ahead. So far, the major inflation drivers have been war-related panic buying, destruction of assets, and disruption of supply chains. Going forward, persistent problems with logistics, expected later recovery in wages growth owing to a dramatic out-migration, as well as reaccelerated global inflation could keep pushing prices higher over the next 12 months.

Inflation is likely to exceed 30% in 2022… The Consumer Price Index climbed 3.1% from May, with the escalating cost of food and transport contributing the most to the rising cost of living. While price growth at the beginning of the war had mostly to do with panic buying, now it is the continuous destruction of assets along with disruption of supply chains that drives inflation. Destruction of the country's major refinery and oil storage facilities coupled with the global steep rise in energy and fuel costs could pile further pressure on businesses by adding to the costs of final products.

…and keep rising in 1H23. Assuming active hostilities end in 2H22, the next stage in the inflationary process will happen when the economy is set on the path of recovery. Reaceelerating around the world inflation has had a limited effect on local prices so far, thanks to import restrictions introduced by the government following the Russian assault. The situation will change, however, as soon as the government starts taking steps towards import liberalization.

Another source of inflation could result from dramatic out-migration. Currently, the local labour market is experiencing a glut resulting from the destruction of many businesses. But recovery would require much more labour than it is available now, giving rise to competition for skilled workers.

Finally, yet importantly, the government remains highly reliant on money emission. The state budget monthly funding needs amount to USD5bn, according to FinMin. Foreign donors cover about half of the amount and the rest comes from local sources, and chiefly from the NBU. Reintroduction of import duties in July is likely to cut down on the NBU's contribution, yet they apparently will not fully eliminate further expansion of money supply. Because of war shocks, the effects of money emission have been dim so far, but they may become more perceptible later in the year as the offensive campaign starts abating and consumer confidence improves.

The headline figure may underestimate the real inflation. Because of uneven price pressure across products (consumption is skewed towards essentials) and regions (prices in rural areas adjust to those in big cities amid urban-rural migration in the first month of the war) we see the risk of official inflation running below what consumers are suffering in their pockets.

NBU lifted the key rate to 25% from 10% on June 2. The action came as a surprise, considering preceding assurances of unchanged rate until monetary transmission channels are effective again and the fact that the current inflation has mostly to do with rising cost rather than demand.

The NBU signalled its expectations that "a significant rise" in the key policy rate "will be sufficient to ease pressures on the FX market and stabilize inflation expectations". The action, however, has not been followed by the correspondent rise in rates for public debt, which NBU's expectations rest on. Due to that, **the risks of another hike should not be ruled out.**

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	-3.8	3.4	-40.0
Industrial production (%YoY)	-12.3	4.0	1.1	3.0	-0.5	-4.5	1.1	NA
Retail sales (%YoY)	-19.8	4.3	6.5	6.2	10.3	8.4	10.7	NA
Unemployment rate end of year (ILO, working age)	9.1	9.3	9.5	8.8	8.2	9.5	9.3*	NA
Nominal GDP (UAH bn)	1 989	2 385	2 984	3 561	3 975	4 222	5 460	NA
Nominal GDP (USD bn)	90	93	112	131	155	157	201	NA
Prices								
CPI (average %YoY)	48.5	14.9	14.4	11.0	7.9	2.7	9.4	19.9
CPI (end of year %YoY)	43.3	12.4	13.7	9.8	4.1	5.0	10.5	32.9
Real average wage growth (%YoY)	-20.2	9.0	19.1	12.5	9.8	7.4	11.9	NA
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	2.3	2.9	1.6	2.4	1.8	5.2	3.6	NA
Total public debt (% of GDP)	79.4	81.0	71.8	61.0	51.6	60.8	48.9	NA
External balance								
Exports of goods and services (USD bn)	47.9	46.0	53.9	59.2	63.6	60.7	81.5	NA
Imports of goods and services (USD bn)	50.2	52.5	62.7	70.6	76.1	63.1	84.5	NA
Current account balance (USD bn)	5.0	-1.9	-3.5	-6.4	-4.1	5.3	-2.1	NA
Current account balance (% of GDP)	5.6	-2.0	-3.1	-4.9	-2.7	3.4	-1.0	NA
Net FDI (USD bn)	-0.4	3.8	3.7	4.5	5.2	-0.1	6.0	NA
Foreign exchange reserves (end of year)	13.3	15.5	18.8	20.8	25.3	29.1	30.9	NA
Imports coverage (months of imports of goods)	3.4	3.7	3.6	3.5	3.9	4.8	4.1	NA
Interest and exchange rates								
NBU discount rate (% end of year)	22.0	14.0	14.5	18.0	13.5	6.0	9.0	25.0
Exchange rate (USD/UAH) end of year	24.0	27.2	28.1	27.7	23.7	28.3	27.3	42.0
Exchange rate (EUR/UAH) end of year	26.2	28.4	33.5	31.7	26.4	34.7	30.9	NA

**estimates, no official data yet available*

FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
11.07.2022	12.07.2022	13.07.2022	14.07.2022	15.07.2022	16.07.2022	17.07.2022
		LGB* % UAH 223.7mn LGB* P UAH 2 500.0mn LGB P UAH 139.8mn	LGB % USD 11.4mn LGB P USD 618.6mn			
18.07.2022	19.07.2022	20.07.2022	21.07.2022	22.07.2022	23.07.2022	24.07.2022
		LGB* % UAH 285.9mn LGB % UAH 995.6mn LGB P UAH 15 342.2mn	NBU: MPC ECB: MPC	Ukrstat: Retail trade		
25.07.2022	26.07.2022	27.07.2022	28.07.2022	29.07.2022	30.07.2022	31.07.2022
		LGB % UAH 87.8mn LGB* % UAH 554.0mn LGB* P UAH 2 500.0mn LGB P UAH 6 403.2mn Fed: FOMC	Ukrstat: Nominal & Real Wage	NBU: BoP		
01.08.2022	02.08.2022	03.08.2022	04.08.2022	05.08.2022	06.08.2022	07.08.2022
IMF SDR 38.2mn FGB % USD 33.7mn Ukrstat: Industrial Production NBU: Minutes		LGB* % UAH 700.3mn LGB % UAH 1 279.2mn LGB P UAH 15 526.1mn	IMF SDR 98.5mn LGB % USD 6.5mn Ukrstat: GDP flash estimate			NBU: FX Reserves (deadline - 7th day)

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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