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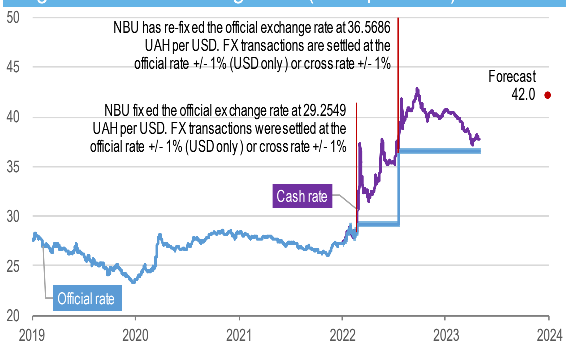
ECONOMICS | INTEREST RATES | FX MARKETS

5 May 2023

UKRAINIAN CAPITAL MARKETS REVIEW

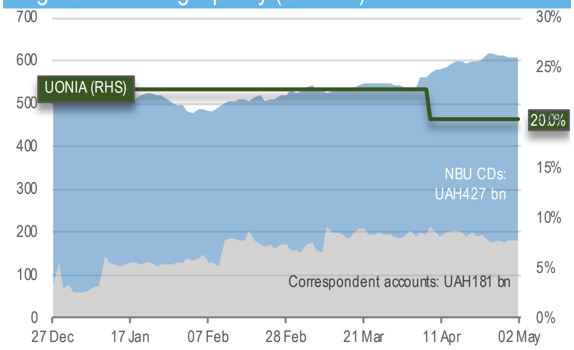
	Rating	Outlook	Last update
Fitch	CC	-	20.01.2023
S&P	CCC	NEGATIVE	06.04.2023
Moody's	Ca	STABLE	10.02.2023
R&I	CCC	NEGATIVE	27.07.2022

Figure 1. UAH exchange rate (UAH per USD)



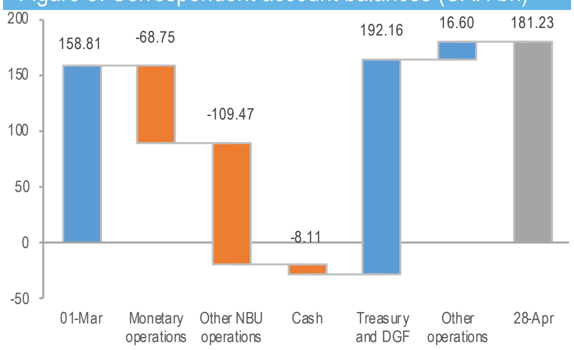
Sources: UKRSIBBANK, NBU, MinFin (media)

Figure 2. Banking liquidity (UAH bn)



Source: NBU

Figure 3. Correspondent account balances (UAH bn)



Source: NBU

This week in focus: Ukraine and the IMF – Will this time be different?

The IMF granted a 48-month financing package worth about USD15.6bn for Ukraine. None of Ukraine's previous bailouts were completed in terms of implementation of all the agreed-upon reforms and measures. To rebuild its track record, Ukraine has recently shown strong performance under the IMF-led monitoring program. But the road ahead looks tough.

FX and interest rates: Hryvnia benefits from subdued FX demand

Heightened FX supply, coupled with waning demand on the interbank market, has provided a favourable environment for the cash rate to appreciate. UAH gained more than 4% against the USD over the last two months on the cash market as FX sales by banks' clients most of time surpassed USD1bn per week, up by about 20% compared to sales in the first two months of the year.

Conversely, demand for FX exhibited a consistent downtrend, primarily driven by reduced offshore transactions by Ukrainian migrants. The decline in demand afforded the NBU the opportunity to curtail its market interventions, which decreased to approximately USD350mn per week during March and April, down from the previous months' levels exceeding USD650mn.

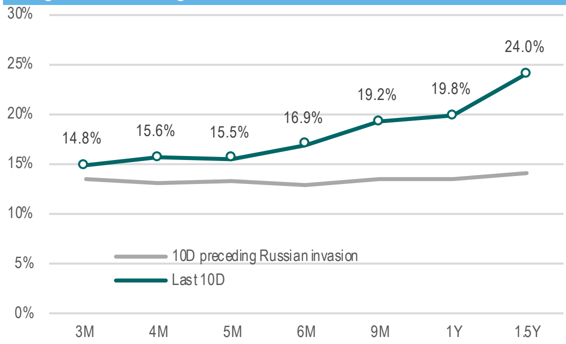
Presently, the USD/UAH rate on the cash market has stabilized near the 38.00 mark. However, it is worth noting that FX supply on the interbank market has slipped below USD1 billion since the beginning of May. This development may be attributed to temporary disruptions in the export of agricultural products.

Considering the convergence of the cash market rate with the official rate, **we revised our year-end forecast for the official rate to 42 hryvnias per US dollar** from the initial projection of 48 hryvnias. We reckon the NBU is unlikely to implement additional rate adjustments until it unveils a conditions-based strategy aimed at facilitating a gradual shift toward a more flexible exchange rate regime and the easing of FX controls. According to the IMF-Ukraine memorandum, this roadmap is anticipated to be presented by the end of June .

Total hryvnia liquidity in the banking system stabilized above UAH600bn, up by UAH85bn from the end of February. The growth in liquidity has been primarily fueled by public expenditures, predominantly financed by foreign donors. Notably, net State treasury transactions have exceeded UAH192bn in the past two months. A significant portion of these funds was absorbed through FX interventions and CDs placements.

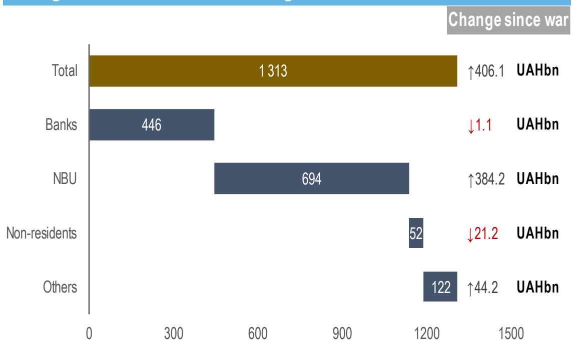
An important aspect to consider is the recent decline in the balance of correspondent accounts, which has dropped by about 10%. This adjustment likely reflects an increased share of term deposits in banks' liabilities. Such a development is significant as it enables the NBU to mitigate FX risk associated with the rising hryvnia liquidity, ultimately contributing to the overall resilience of the banking system.

Figure 4. Local government bonds in UAH



Source: NBU

Figure 5. Position in local government bonds in UAH



Source: NBU

Government bond market

Sustainable demand boosts sovereign curve extension. The Finance Ministry has successfully extended the sovereign curve, benefiting from sustainable demand for government bonds.

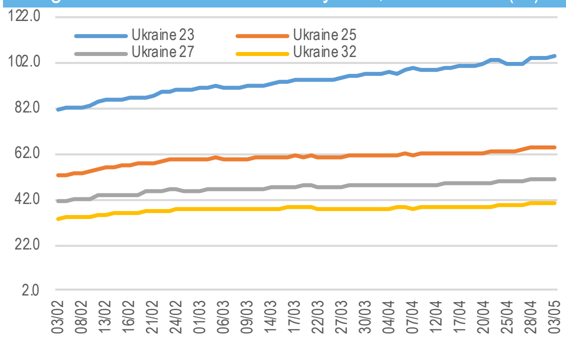
At the recent primary auction held on 2 May, the ministry offered a range of bonds, including 3-year and 2.5-year bonds in UAH, as well as 9-month securities in both UAH and USD. Notably, the auction marked the return of the longest issue since the Russian invasion in February 2022, fetching UAH3bn despite being a modest seller. State-owned banks were presumed to be the main purchasers, as only three bids were submitted and all three were accepted at the cut-off rate of 19.75%, 5bp higher than the 2.5-year bonds.

The 2.5-year bonds attracted seven bids totalling UAH4.2 billion.

Aggressive bidding was witnessed for the 9-month securities, with 71 bids for USD-denominated bonds amounting to USD123mn and 29 bids for UAH-denominated bonds totalling UAH611mn.

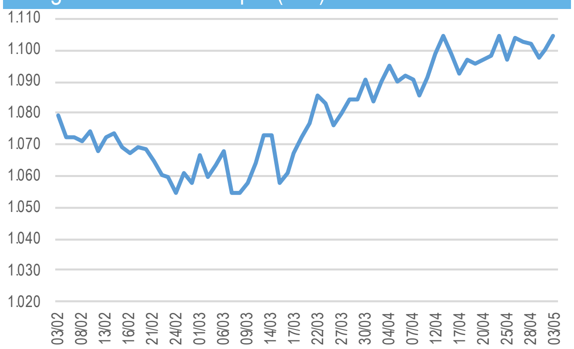
Bids for USD-denominated bonds were allotted in full, while one bid for UAH-denominated bonds was rejected due to a bid rate exceeding the accepted yield of 18.5% per annum.

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



Source: Bloomberg

Figure 7. EUR USD spot (mid)



Source: Bloomberg

EUR/USD holds firm above 1.1000 amid diverging central bank policies

The EUR/USD pair has settled above the significant level of 1.1000, driven by the contrasting policy stances of the Fed and the ECB.

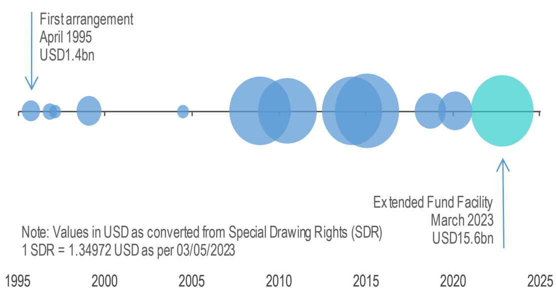
The Fed expectedly raised interest rates on Wednesday (3 May) by 25bp and suggested this rate hike may be the last. In particular, the central bank appeared to soften its language about future rate increases by dropping the line from the March statement that said, "the committee anticipates that some additional policy firming may be appropriate."

Jerome Powell, head of the Fed, commented to the press after the statement’s release that dropping that language was a "meaningful change" and that the central bank’s June decision would be driven by incoming data. So far, headline inflation in the US economy is continuously declining, thanks to lower gasoline prices, while core inflation remains persistently resilient due to robust consumer spending.

The ECB yesterday (4 May) also matched consensus. The central bank raised rates on the main refinancing operations, the interest rate on the marginal lending facility and the deposit facility by 25bp to 3.75%, 4.00% and 3.25%, respectively.

But, in contrast to the Fed, the European central bank stressed that underlying inflation in the Eurozone remains strong despite the loss of momentum seen in past months. In addition, the lags and strength of transmission of past rate raises to the real economy remain uncertain. The ECB also noted that future decisions will make rates sufficiently restrictive. Some ECB policymakers reportedly see 2-3 rate hikes ahead.

Figure 8. History of Lending Arrangements



Source: IMF

Figure 9. Schedule of reviews and available funds

Availability Date	Millions of USD	Conditions
31 Mar 2023	2 707.59	Board approval of the EFF
15 Jun 2023	893.50	1st review and end-April 2023 performance criteria
13 Oct 2023	893.50	2nd review and end-June 2023 performance criteria
29 Feb 2024	895.94	3rd review and end-December 2023 performance criteria
15 Jun 2024	2 253.43	4th review and end-March 2024 performance criteria
01 Sep 2024	1 126.68	5th review and end-June 2024 performance criteria
01 Dec 2024	1 126.68	6th review and end-September 2024 performance criteria
01 Mar 2025	921.22	7th review and end-December 2024 performance criteria
31 Aug 2025	921.22	8th review and end-June 2025 performance criteria
01 Mar 2026	1 296.82	9th review and end-December 2025 performance criteria
31 Aug 2026	1 296.82	10th review and end-June 2026 performance criteria
10 Mar 2027	1 291.24	11th review and end-December 2026 performance criteria
Total	**15 624.64**	

Source: IMF

Ukraine and the IMF – Will this time be different?

The IMF granted a 48-month financing package worth about USD15.6bn for Ukraine. Additionally, the agreement is supposed to unleash a USD115bn total support package for the war-battered country. None of Ukraine's previous bailouts — 11 since 1995 — were completed in terms of implementation of all the agreed-upon reforms and measures. To rebuild its track record, Ukraine has recently shown strong performance under the IMF-led Program Monitoring with Board Involvement. But the road ahead looks tough: apart from the painful requirements and high uncertainty related to the war, the program is supposed to survive through the parliament and presidential elections.

Key program's parameters. Ukraine and the IMF have agreed on a USD15.6bn loan package at the end of March. The loan program will run for the next four years.

Because of exceptionally high uncertainty, a two-phased approach is envisioned. At first, the program will be focused on helping Ukraine close its massive budget deficit and easing the pressure to print money to use for spending. This phase is supposed to last 12-18 months, depending on the evolution of the situation on the battlefield. In the second phase, the focus of the program is projected to shift to more expansive reforms to entrench macroeconomic stability, support recovery and early reconstruction, and promote economic growth.

The first tranche under the new IMF program of USD2.7bn has already been obtained. Ukraine can receive this year some USD4.5bn in total, provided the authorities timely meet the program's requirements (the first two reviews are scheduled for 15 June and 13 October 2023).

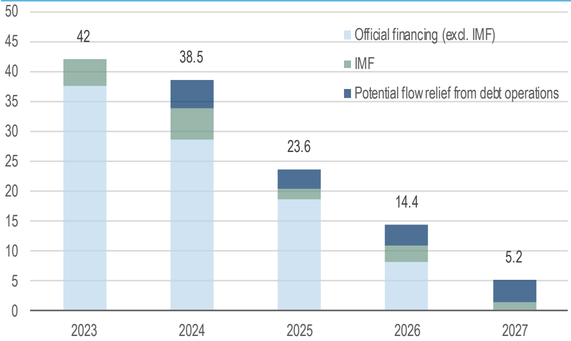
We skip other details and focus on the program's risks instead.

The history of half-wins. Ukraine has had multiple programs with the IMF since the 1990s. While the country has made progress in some areas and has implemented some reforms, albeit with varying degrees of success, it has struggled to fully implement all the agreed-upon reforms and measures. Some programs were interrupted due to unforeseen circumstances (such as political instability, COVID, etc.), but most of the programs were not completed due to a lack of political will to deliver reforms.

High inflation and large public deficit are among the issues Ukraine most frequently failed to address. The two issues, in particular, resulted from loose monetary and fiscal policy. While the local authorities insisted on the need to stimulate economic growth, the IMF saw a chase for quick wins behind such management, with continuous increases in money supply rather stimulating FX outflow than investment activity.

Even though the NBU adopted inflation targeting in early 2016 – one of Ukraine's successes under the cooperation with the IMF – the central bank's independence, which is an essential part of effective fighting inflation, requires a permanent defence. And this may well be tested as soon as in 2H23. Inflation pressure has been declining since the beginning of the year. It might reappear in the coming months because of the risk of utility tariffs hike, but not for long, considering the high base of the last year. If this is the case, debates on the timing and the extent of future monetary policy easing may spread beyond the central bank's walls. Slow progress on the development of the post-war economic recovery program might add fuel to the fire

Figure 10. Financing Gap and Sources, USDbn



Source: IMF

Worst-case scenario is unlikely

Regarding fiscal policy, the government's heavy spending on utility tariffs subsidies may generate a risk. The IMF does not stand against such support. But the Fund would like to see a well-targeted resources allocation to protect vulnerable households, while wholesale and retail electricity and gas markets are supposed to find balance through restored and enhanced competition.

Considering the political implications of the issue, the recent government's decision to put off the electricity tariff hike for another month could be related to ongoing local negotiations on the matter.

Double elections challenge. The legal regime of the current martial law prohibits national and local elections (the next parliament elections are scheduled for October 2023, and the next presidential elections are to be held in March 2024). Proceeding from the program's assumption that the situation in the country allows for economic recovery and reconstruction at the second phase, national elections call is likely at that stage.

The political instability and frequent changes in government in Ukraine have often undermined the ability to carry out reforms. Corruption and resistance from vested interests have also hindered progress under the IMF programs. Caused by the war large-scale social and demographic changes in the country, with a huge number of internally and externally displaced persons and amplified polarity in sentiments, can much aggravate political issues and challenges.

The risk of Ukraine getting off track of the IMF-supported reform agenda is low. The admit pathway forward may well be imperfect, but good enough to buttress fiscal and external stability.

Worth noting, however, that the IMF's loan is as a part of a USD115bn package of external support over 2023–27 involving sizable official financing in the form of grants and concessional loans, as well as debt relief. The slow progress may well undermine prospects not only for these financial resources, but also for foreign investment, and broad international market access. All these will define the speed of Ukraine's recovery from the tragedy of war.

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	-29.1	-5.0
Industrial production (%YoY)	4.0	1.1	3.0	-0.5	-4.5	1.9	-36.9	NA
Retail sales (%YoY)	4.3	6.5	6.2	10.3	8.4	10.7	-21.4	NA
Unemployment rate end of year (ILO, working age)	9.3	9.5	8.8	8.2	9.5	9.8	NA	NA
Nominal GDP (UAH bn)	2 385	2 984	3 561	3 975	4 222	5 460	5 191	NA
Nominal GDP (USD bn)	93	112	131	155	157	201	161	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	17.6	NA
Total public debt (% of GDP)	81.0	71.8	61.0	51.6	60.8	48.9	78.4	NA
External balance								
Exports of goods and services (USD bn)	46.0	53.9	59.2	63.6	60.7	81.5	57.1	NA
Imports of goods and services (USD bn)	52.5	62.7	70.6	76.1	63.1	84.5	81.5	NA
Current account balance (USD bn)	-1.9	-3.5	-6.4	-4.1	5.3	-2.1	8.4	NA
Current account balance (% of GDP)	-2.0	-3.1	-4.9	-2.7	3.4	-1.0	5.2	NA
Net FDI (USD bn)	3.8	3.7	4.5	5.2	-0.1	6.0	0.6	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	42.0
Exchange rate (EUR/UAH) end of year	28.4	33.5	31.7	26.4	34.7	30.9	39.1	44.5

**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
01.05.2023	02.05.2023	03.05.2023	04.05.2023	05.05.2023	06.05.2023	07.05.2023
IMF SDR 107.2mn FGB % USD 78.0mn		LGB* % UAH 535.0mn LGB % UAH 2 061.4mn Fed: FOMC	ECB: MPC	LGB* % UAH 203.1mn		NBU: FX Reserves (deadline - 7th day)
08.05.2023	09.05.2023	10.05.2023	11.05.2023	12.05.2023	13.05.2023	14.05.2023
LGB* % UAH 3 300.0mn	NBU: Minutes	LGB* % UAH 116.7mn LGB P UAH 7 542.0mn	LGB* % UAH 1 100.0mn NBU: Monetary Statistics	LGB* % UAH 1 100.0mn	LGB* % UAH 141.3mn	
15.05.2023	16.05.2023	17.05.2023	18.05.2023	19.05.2023	20.05.2023	21.05.2023
LGB* % UAH 431.8mn		LGB* % UAH 557.6mn LGB % UAH 692.9mn	LGB* % UAH 195.6mn		LGB* % UAH 238.0mn	
22.05.2023	23.05.2023	24.05.2023	25.05.2023	26.05.2023	27.05.2023	28.05.2023
LGB* % UAH 313.6mn	LGB* % UAH 261.0mn	LGB* % UAH 922.1mn LGB % UAH 4 996.1mn LGB P UAH 19 046.3mn	LGB* % UAH 506.3mn LGB % USD 5.8mn LGB P USD 312.3mn	LGB* % UAH 251.3mn	LGB* % UAH 245.6mn	

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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