ECONOMICS | INTEREST RATES | FX MARKETS

20 July 2023

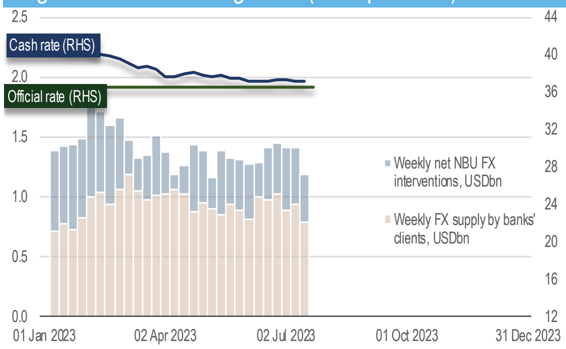
UKRAINIAN CAPITAL MARKETS REVIEW

	Rating	Outlook	Last update
Fitch	CC	-	23.06.2023
S&P	CCC	NEGATIVE	06.04.2023
Moody's	Ca	STABLE	10.02.2023
R&I	CCC	NEGATIVE	27.07.2022

This week in focus: Balancing Between Macro and Financial Stability Risks

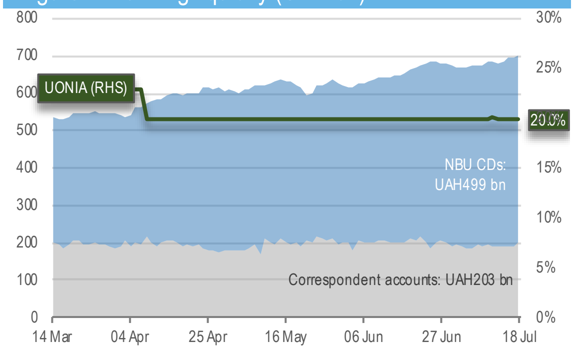
The NBU has unveiled its comprehensive strategy aimed at easing FX restrictions, transitioning to greater exchange rate flexibility, and returning to inflation targeting. Implementation of the strategy is contingent upon specific conditions. And we see limited opportunities for the NBU to implement the primary stage's measures before the end of the summer.

Figure 1. UAH exchange rate (UAH per USD)



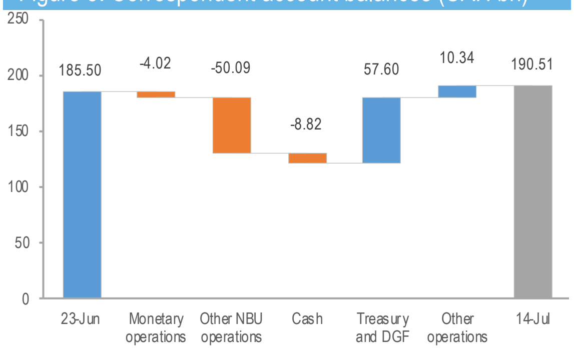
Sources: NBU, MinFin (media)

Figure 2. Banking liquidity (UAH bn)



Source: NBU

Figure 3. Correspondent account balances (UAH bn)



Source: NBU

FX and interest rates: FX strategy yields minimal impact on USD/UAH rate

The USD/UAH cash rate has exhibited minimal fluctuations since the beginning of the month, remaining less than 2% above the official rate.

Despite the introduction of the NBU's FX strategy on transitioning to greater exchange rate flexibility, and returning to inflation targeting, the impact on the currency pair has been limited so far, primarily due to the persistence of most of restrictions and the absence of a defined timeline for future easing measures.

Nonetheless, we caution against viewing the current stability as a long-term trend. We assume the ongoing conflict has added to demand for cash FX transactions, bringing back to the market seasonal patterns associated with the agricultural production cycle. This was evident from the significant surge in FX supply observed during the spring months, when agricultural producers were selling their FX reserves to finance sawing campaign.

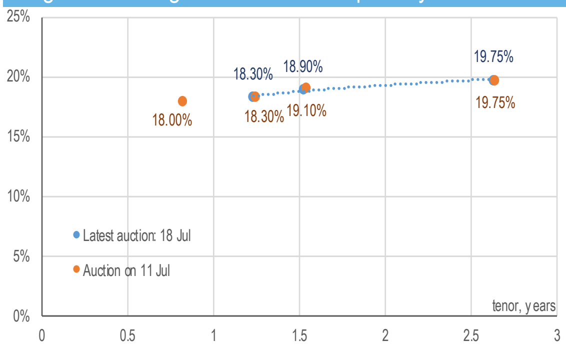
If our assumption holds true, there is a potential risk of an upswing in demand for cash FX towards the end of August, when the agricultural sector is deep in the harvesting campaign and producers seek to convert their freshly earned revenues into foreign currency.

Such dynamics could prompt the NBU to consider widening of the corridor for foreign exchange transactions and introducing amendments to the FX interventions mechanism, to effectively respond to the evolving market conditions.

Banking liquidity has stabilised at approximately UAH687bn. As of 14 July, the balance of correspondent accounts amounted to UAH190.5bn, experiencing a decrease of UAH12.7bn over the past three weeks, the position in NBU CDs exceeded UAH505bn, because of a UAH30.2bn increase in holdings of 3-month CDs, reaching a total of UAH175.4bn.

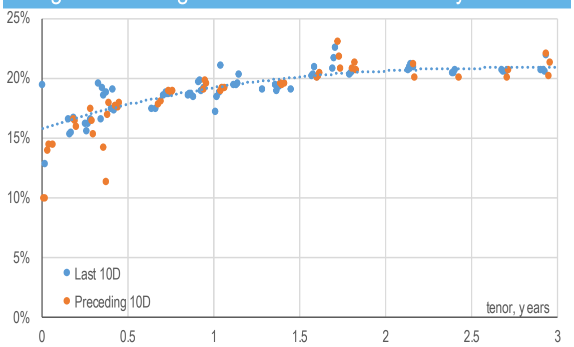
State treasury operations and FX interventions nearly offset each other, surpassing UAH50bn. But there remained a persistent demand for cash hryvnia, resulting in an outflow of approximately UAH9bn from the system over the past three weeks.

Figure 4. UAH government bonds primary market



Source: FinMin

Figure 5. UAH government bonds secondary market



Source: NBU

Government bond market

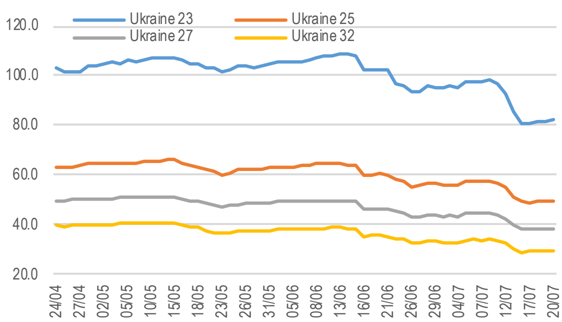
The FinMin continues to refine its public debt offering strategy by reducing the volume of securities available. In the latest auction, the ministry exclusively offered 1-year, 1.5-year, and 2.5-year hryvnia-denominated bonds. While the volume limits for 1-year and 1.5-year bonds were maintained at UAH4bn and UAH5bn, respectively, the offering for the longest maturity bond was reduced by UAH2bn to UAH3bn. Having accumulated sufficient FX reserves to meet its immediate debt payments, the ministry has refrained from offering FX bonds since the beginning of the month.

Notably, the longest maturity bond garnered the highest demand, with a bid-to-cover ratio surpassing 2.0. Despite the robust demand, the ministry decided to maintain the cut-off rate at 19.75%, refraining from any adjustments.

The 1.5-year bonds experienced lackluster demand, with bids covering only a half of the proposed volume. This subdued demand could be attributed to the FinMin's decision to lower the marginal rate by an additional 20bp to 18.9%, resulting in a 40bp decline in yield over the past month. The ministry strongly believes that the NBU may start monetary policy easing cycle as soon as at the forthcoming committee meeting scheduled for 27 July, given a persistent slowdown in inflation. It is important to note, however, that the government's tax revenue collection is trailing behind projections. While the situation appears manageable now, the persistence of this issue over several months could potentially give the market some leverage in the future.

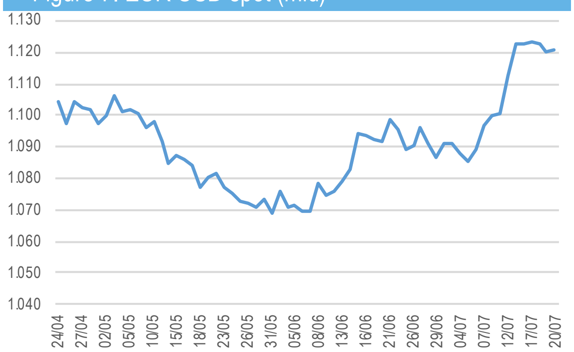
The auction of 1-year bonds went by largely unnoticed, despite the yield remaining unchanged at 18.3%.

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



Source: Bloomberg

Figure 7. EUR USD spot (mid)



Source: Bloomberg

EUR/USD pierces 1.1200 from below

The EUR/USD seared above the 1.1200 barrier, reaching its highest point since February 2022. The upward movement emerged in early July following the release of disappointing U.S. payrolls data, making investors to believe Federal Reserve may not be as hawkish as expected. The Fed had previously indicated the likelihood of further rate hikes to address inflation and achieve the 2% target range.

The job statistics was followed by the lower-than-expected U.S. consumer price index data, suggesting that the monetary policy measures implemented so far are yielding the desired effect.

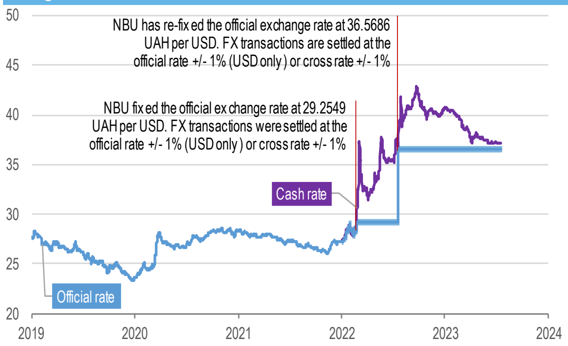
The Federal Reserve is due to meet and make fresh policy decisions on July 25-26.

The pattern of U.S. Treasury yields closely follows the movement of the U.S. dollar. The 10-year Treasury yield has experienced a decrease of nearly 20bp since early July.

However, **there appears to be uncertainty among investors regarding the sustainability of support for the euro**. This uncertainty seems to be driven by a divergence of opinions among ECB officials regarding the central bank's future moves.

Despite the mixed sentiments surrounding the euro, the final readings of the Eurozone inflation data for June and the U.S. housing market indicators for the same month could potentially influence trading dynamics in favor of the single currency.

Figure 8. USD/UAH rates evolution



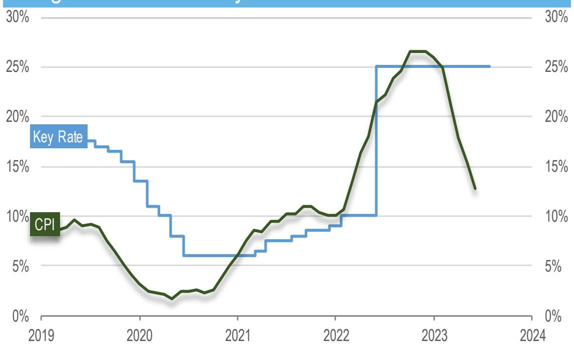
Sources: NBU, MinFin (media)

Figure 9. The strategy three-stage implementation plan

The primary stage	Focus on minimizing the complexity arising from multiple exchange rates, liberalizing trade transactions, and facilitating new loans and investments.
The second stage	Various measures related to the liberalization of trade finance, effective management of currency risks faced by banks, and enabling the repatriation of interest income accrued from "old" debt liabilities and investments.
The final stage	The NBU plans to consider allowing payments on loans and investments, liberalizing household transactions and transactions involving derivatives, as well as permitting lending to non-residents and investments abroad.

Source: NBU

Figure 10. CPI vs Key rate evolution



Sources: Ukrstat, NBU

FX Easing Strategy: Balancing Between Macro and Financial Stability Risks

The NBU has unveiled its comprehensive strategy aimed at easing FX restrictions, transitioning to greater exchange rate flexibility, and returning to inflation targeting. It is important to note that the implementation of the strategy is contingent upon specific conditions and does not adhere to a fixed timeframe. Besides, the strategy prioritizes transactions related to trade of goods and services over capital transactions, and transactions with own FX over transactions with purchased FX.

The strategy acknowledges that increasing exchange rate flexibility requires the removal of most restrictions on cross-border trade transactions and eliminating factors contributing to the existence of multiple exchange rates.

We skip the former, as most of trade transactions are currently allowed, but for some services trade. As for the latter a crucial area of focus is the exchange transactions involving cash FX by households. To facilitate the lifting of restrictions in this area, the NBU has implemented measures to enhance the attractiveness of hryvnia assets. By providing banks with limited access to 3m CDs with an annual interest rate equal to the key rate of 25%, 5pp higher than overnight CDs, the central bank incentivizes banks to offer higher deposit rates to encourage households to place their savings in term deposits. This, in turn, should help the NBU mitigate the risk of sudden hryvnia withdrawals and their impact on the cash FX market.

Progress in this regard has as yet been limited. According to our calculations, total hryvnia deposits held by the population with a tenure of 3m or more increased by approximately UAH26.5bn to UAH185.4bn between April and June (the real figure could be marginally higher, as not all banks having such deposits applied for 3m CDs). In comparison, households' current accounts in hryvnia have witnessed an increase of UAH23.5bn during April-May. Furthermore, hryvnia cash withdrawals have exceeded UAH40bn between April and June.

Regarding the enhancement of exchange rate flexibility, the NBU may consider widening of the corridor for interbank FX transactions. Additionally, the NBU may revise its FX interventions mechanism, potentially introducing an auctioning system or establishing an informal corridor. However, **given the persistent demand for paper hryvnia and the reemergence of seasonality in the FX market due to the ongoing conflict, the NBU's options to implement the primary stage's measures before the end of the summer may be limited**.

Another signal sent by the NBU is its commitment to "maintain a tight monetary stance via appropriately high real interest rates, which will support sufficient attractiveness of hryvnia assets and thereby help minimize risks to FX stability".

In 2018-19 it was real policy interest rate above 10% that helped the NBU to curb inflation. In light of reduced inflation risks but persistent uncertainties resulting from the ongoing war, we assume central bank's maintaining a real policy rate ranging from 5% to 10%. Based on the NBU's inflation forecasts, this implies a key rate of 16% to 20% by the end of this year and 10% to 15% by the end of the following one.

The NBU has also provided insight into the factors that will influence future FX easing actions. Alongside general macroeconomic parameters, the NBU's considerations include financial stability risks. While specific details are not provided, it is likely that these risks relate to ensuring the stability of the banking system during the ongoing conflict and the potential nationalization of financial institutions failing to meet the NBU's requirements.

Key Macroeconomic Indicators	2017	2018	2019	2020	2021	2022	2023E	2024F
Real sector								
Real GDP (%YoY)	2.5	3.4	3.2	-3.8	3.4	-29.1	-0.5	5.0
Industrial production (%YoY)	1.1	3.0	-0.5	-4.5	1.9	-36.9	NA	NA
Retail sales (%YoY)	6.5	6.2	10.3	8.4	10.7	-21.4	NA	NA
Unemployment rate end of year (ILO, working age)	9.5	8.8	8.2	9.5	9.8	NA	NA	NA
Nominal GDP (UAH bn)	2 984	3 561	3 975	4 222	5 460	5 191	NA	NA
Nominal GDP (USD bn)	112	131	155	157	201	161	NA	NA
Prices								
CPI (average %YoY)	14.4	11.0	7.9	2.7	9.4	20.0	22.6	11.6
CPI (end of year %YoY)	13.7	9.8	4.1	5.0	10.5	26.6	18.4	7.0
Real average wage growth (%YoY)	19.1	12.5	9.8	7.4	11.9	NA	NA	NA
Fiscal balance (% of GDP)								
State budget deficit (without Naftogaz)	1.6	2.4	1.8	5.2	3.6	17.6	NA	NA
Total public debt (% of GDP)	71.8	61.0	51.6	60.8	48.9	78.4	NA	NA
External balance								
Exports of goods and services (USD bn)	53.9	59.2	63.6	60.7	81.5	57.1	NA	NA
Imports of goods and services (USD bn)	62.7	70.6	76.1	63.1	84.5	81.5	NA	NA
Current account balance (USD bn)	-3.5	-6.4	-4.1	5.3	-2.1	8.4	NA	NA
Current account balance (% of GDP)	-3.1	-4.9	-2.7	3.4	-1.0	5.2	NA	NA
Net FDI (USD bn)	3.7	4.5	5.2	-0.1	6.0	0.6	NA	NA
Foreign exchange reserves (end of year)	18.8	20.8	25.3	29.1	30.9	28.5	32.0	30.0
Imports coverage (months of imports of goods)	3.6	3.5	3.9	4.8	4.1	3.7	4.2	3.8
Interest and exchange rates								
NBU discount rate (% end of year)	14.5	18.0	13.5	6.0	9.0	25.0	20.0	14.0
Exchange rate (USD/UAH) end of year	28.1	27.7	23.7	28.3	27.3	36.6	42.0	50.7
Exchange rate (EUR/UAH) end of year	33.5	31.7	26.4	34.7	30.9	39.0	47.9	59.8

**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
10.07.2023	11.07.2023	12.07.2023	13.07.2023	14.07.2023	15.07.2023	16.07.2023
Ukrstat: Price indices	NBU: Monetary Statistics		LGB % EUR 3.1mn			
17.07.2023	18.07.2023	19.07.2023	20.07.2023	21.07.2023	22.07.2023	23.07.2023
		LGB % UAH 690.2mn	LGB P USD 314.5mn			
24.07.2023	25.07.2023	26.07.2023	27.07.2023	28.07.2023	29.07.2023	30.07.2023
		LGB % UAH 87.8mn LGB P UAH 2 700.0mn Fed: FOMC	LGB % USD 1.6mn NBU: MPC ECB: MPC			
31.07.2023	01.08.2023	02.08.2023	03.08.2023	04.08.2023	05.08.2023	06.08.2023
NBU: BoP	IMF SDR 105.2mn FGB % USD 33.7mn	LGB % UAH 32.5mn LGB P UAH 1 000.0mn		IMF SDR 98.5mn		

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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