ECONOMICS | INTEREST RATES | FX MARKETS

1 September 2023

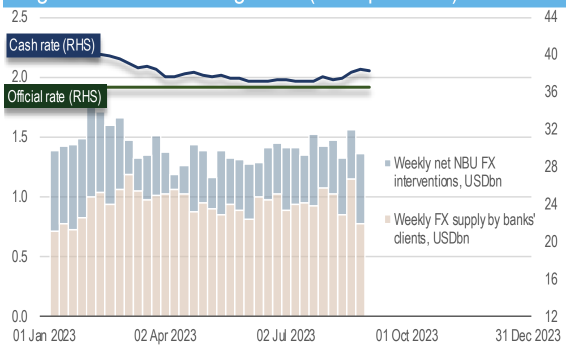
UKRAINIAN CAPITAL MARKETS REVIEW

	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: The fight against inflation isn't over yet

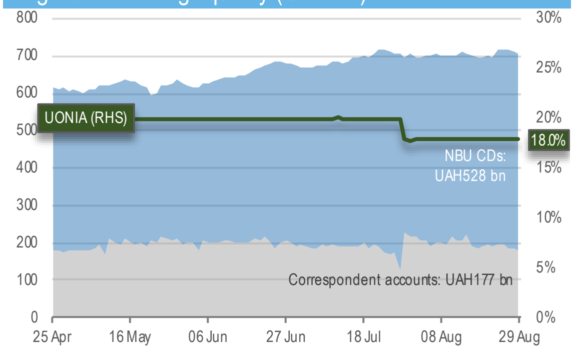
Despite rising public expenditures, consumer prices are firmly under control, thanks to remaining tight monetary policy and NBU's prudence in implementing FX policy easing. As this year's inflation sets a low base for the next year, however, pushing inflation to a single-digit zone may be no less challenging for the NBU than reversing consumer prices growth at the wartime.

Figure 1. UAH exchange rate (UAH per USD)



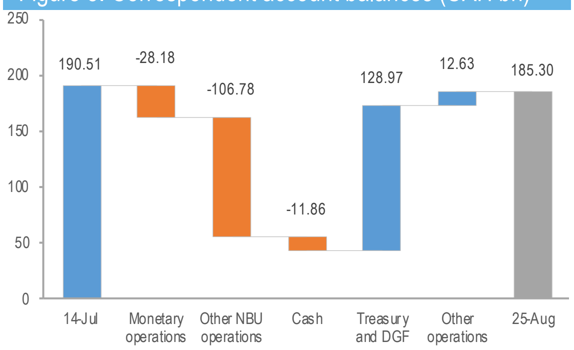
Sources: NBU, MinFin (media)

Figure 2. Banking liquidity (UAH bn)



Source: NBU

Figure 3. Correspondent account balances (UAH bn)



Source: NBU

FX and interest rates: NBU again steers speculative interest into banks

Hryvnia is again on a strong footing on the cash market, thanks to a deft response by the NBU to an apparently speculative trend.

The downward trajectory began to manifest in mid-August, with the USD/UAH rate reaching the 38.5 mark within a matter of days. The NBU has sold at the interbank market USD590mn last week, marking the fifth instance since Russian invasion where the FX interventions exceeded the USD500mn threshold.

We assume the market was primarily driven by speculative sentiment. The anticipation of an imminent seasonal surge in FX demand appears to have transformed into a self-fulfilling prophecy, eclipsing the lack of triggers for the seasonal pattern. Notably, the export of grains has dwindled below the 2mn ton per month in August. Prior to Russia's withdrawal from the "grain deal," monthly exports consistently exceeded 5mn tons, but for months when Russia sabotaged inspection of vessels. Given the limited scope for exports, agricultural producers, who directly contribute to the anticipated seasonal pattern, may be inclined to withhold their freshly harvested grains rather than partake in sales at lower prices. Fortuitously, unloaded during the "grain deal" stocks give a room for accommodating the storage of the new harvest.

Recent FX policy easing measures, permitting the purchase of non-cash FX at banks by households and expanding the limit for FX deposits, sent the cash USD/UAH rate back below the 38.0 mark. The seasonal pattern might still manifest itself shortly. Yet it might be muted by uneven export sales.

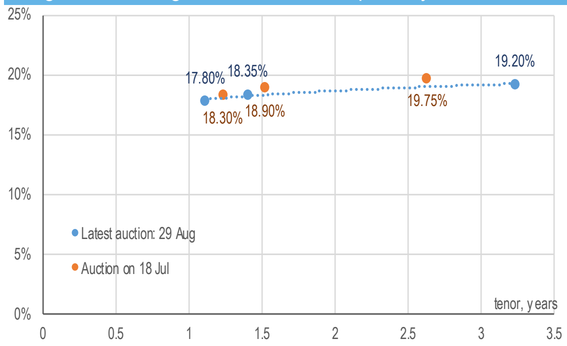
Looking forward, **we maintain our forecast of UAH devaluation to the level 40.0** per USD by the year-end on the back of rising fundamental demand for FX.

Banking liquidity has stabilized around the UAH700bn mark. Hand in hand with continuing fiscal injections, the NBU effectively absorbs fresh liquidity through FX interventions and monetary operations (CDs auctions).

As of the end of last week (25 August), the banking sector's exposure to NBU CDs amounted to UAH532.9bn, up by more than 5% over the last month. And 3-month CDs constituted 39% of this amount, exhibiting a rise of 4pp.

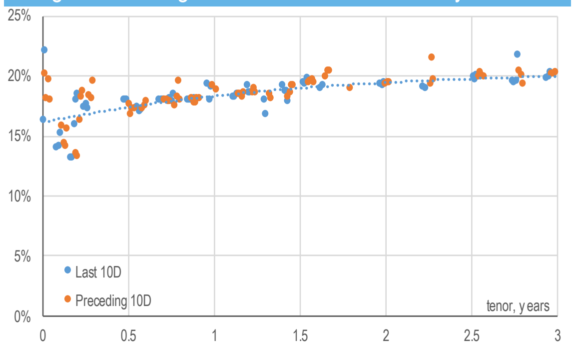
The recent reversal in the demand for cash hryvnia may be attributed to FX exchange operations. The trend may intensify in the coming weeks following the NBU's permission for non-cash FX purchase by population.

Figure 4. UAH government bonds primary market



Source: FinMin

Figure 5. UAH government bonds secondary market



Source: NBU

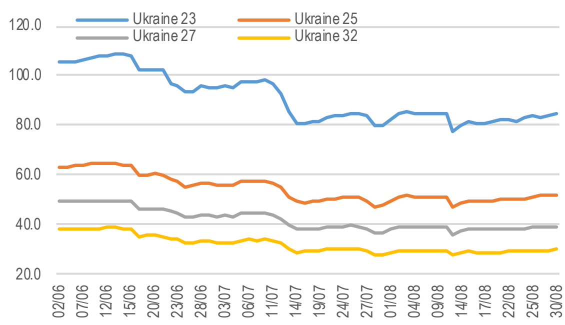
Government bond market

FinMin continues leveraging its price power. As inflation consistently declines, allowing for more key rate cuts ahead, FinMin keeps bargaining down public debt yields. The local government bonds' yield has already dropped by approximately 50bp across the curve since the NBU embarked on its monetary policy easing policy last month.

At the last primary auction (29 August) the ministry offered UAH-denominated bonds only with tenures of 1 year, 1.5 year, and 3.2 years. The latter represents the longest UAH bond offering since the Russian invasion of Ukraine in February 2022. Remarkably. the aggregated demand for these bonds exceeded UAH8bn, or 1.73 when expressed in the bid-to-cover ratio, which measures the total amount of bids versus the total amount of bonds actually auctioned. While bid rates ranged from 19.00% to 19.25%, FinMin set cut-off rate at 19.20%.

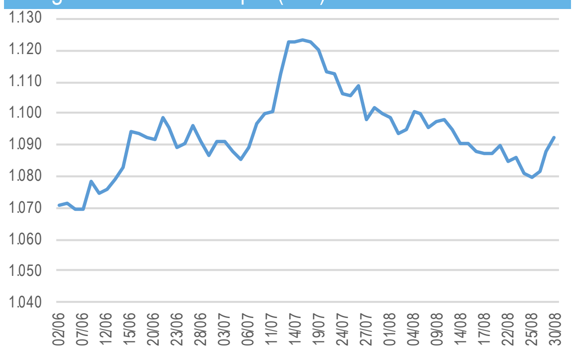
Auctions for shorter-dated bonds persistently witness lackluster demand, with bid-to-cover ratio below 1. But FinMin seems to be not very interested in increasing exposure in a short-term debt. At the last auction the cut-off rate for 1 -year bonds was held at 17.80% and for 1.5year bonds – at 18.35%

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



Source: Bloomberg

Figure 7. EUR USD spot (mid)



Source: Bloomberg

EUR/USD dives below the 1.0900 barrier

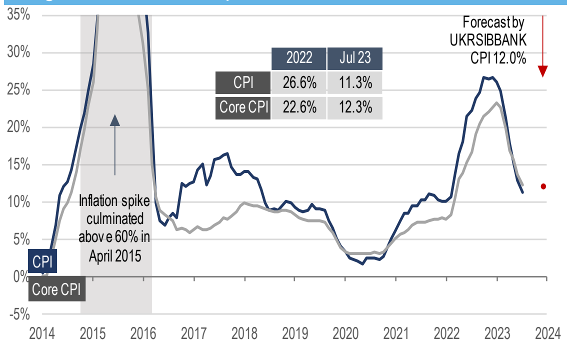
The Euro has yielded some ground against the US Dollar, slipping beneath the pivotal 1.0900 threshold on Thursday (31 August).

The driving force behind this development can be attributed to the absence of any significant updates around the ECB regarding its potential decision on rates once the summer season is over. Inflation in the Eurozone, as measured by the change in the Harmonized Index of Consumer Price (HICP), held steady at 5.3% on a yearly basis in August. According to Reuters, the probability of the ECB raising key rates by 25bp in September declined below 40% after this data.

But USD also lacks reasons for growth. The narrative surrounding the Fed tighter-for-longer stance appears to have dwindled in the wake of recent economic indicators that fell short of projections. Released on Thursday (31 August) the personal consumption expenditures price index (PCE) - one of the Fed's preferred gauges for inflation – came in largely in line with market estimates, providing no fresh clues regarding central bank's future monetary policy actions.

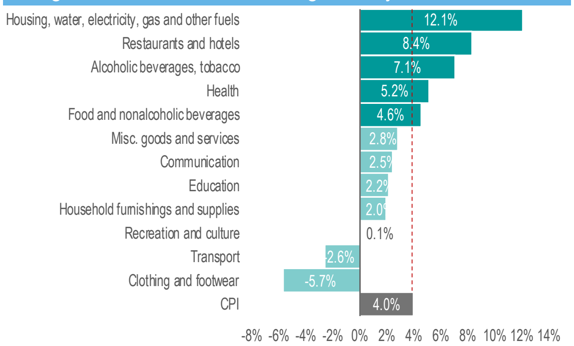
But US Treasury bond yields advance, boosting the USD. Bond traders assess mixed signals from the latest US jobs report. While average hourly earnings fell short of expectations, the US added more jobs than anticipated. The 10-year Treasury yield recovered by 10bp to 4.184% on Friday (1 September) after sliding from multi-year peak of 4.25%, reached a week ago, to 4.09% on Thursday.

Figure 8. Consumer price indices



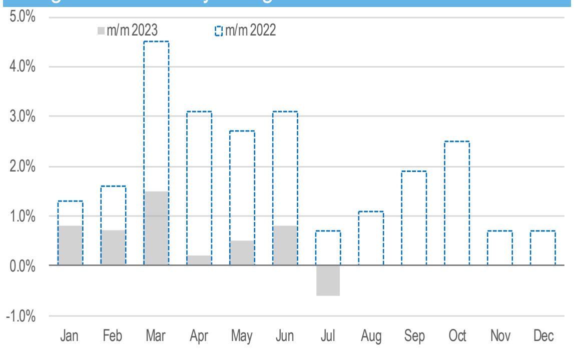
Sources: Ukrstat

Figure 9. Breakdown of CPI growth, year-to-Jul 2023



Source: Ukrstat

Figure 10. Monthly CPI growth



Sources: Ukrstat

The fight against inflation isn't over yet

Despite rising public expenditure, inflation is firmly under control, thanks to remaining tight monetary policy and NBU's prudence in implementing FX policy easing. While a marginal acceleration in consumer price growth is likely this year, there appears to be no compelling factors indicative of a shift in the downward trend in inflation.

Ukraine's headline inflation in July dropped by 1.5pp to 11.3% y/y, once again surpassing expectations. Core inflation, which excludes energy, food, alcohol and tobacco prices, slowed to 12.3% y/y in July from 13.7%. y/y a month earlier.

This considerable dip in the consumer price index's growth is predominantly attributed to the government's imposition of a ban on tariff hikes for utility services, but for electricity. While such administrative intervention will considerably curtail the CPI growth in the latter half of 2023, this move may come at the cost of potential inflationary pressure in 2024, as adjustments to tariffs remain pending.

We improved our inflation forecast for 2023 to 12.0% y/y from 18.4% y/y. We do not dismiss the likelihood of renewed acceleration in consumer price growth in the latter half of 2023, driven by elevated fuel prices and the potential devaluation of the hryvnia toward the year's end. Besides, many businesses have not factored in new electricity tariffs in their costs yet. That said, it is important to emphasize that no compelling evidence supports a deviation from the current downward trend in inflation within a 9-month horizon.

Despite the backdrop of rising public expenditures, buttressed by a continuous inflow of foreign assistance earmarked for the restoration of war-damaged energy and civil infrastructure, the prudence exhibited by the NBU in its monetary and FX policies keeps inflation well-managed.

The fight against inflation isn't over. As this year's inflation sets a low base for the next year, steering inflation to a single-digit zone may be no less challenging for the NBU than reversing consumer prices growth at the wartime. The necessity of maintaining a tight monetary stance to uphold control over consumer prices beyond the 9-month horizon cannot be understated. The looming inflation risks in 2024 encompass likely utility tariff hikes, the anticipated devaluation of the hryvnia, and the emerging resurgence of real wages.

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	3.0	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	16.0	11.6
CPI (end of year %YoY)	13.7	9.8	4.1	5.0	10.5	26.6	12.0	10.0
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	18.0	10.0
Exchange rate (USD/UAH) end of year	28.1	27.7	23.7	28.3	27.3	36.6	40.0	46.0
Exchange rate (EUR/UAH) end of year	33.5	31.7	26.4	34.7	30.9	39.0	44.8	54.3

**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
28.08.2023	29.08.2023	30.08.2023	31.08.2023	01.09.2023	02.09.2023	03.09.2023
		LGB % UAH 3 253.6mn	NBU: BoP			
04.09.2023	05.09.2023	06.09.2023	07.09.2023	08.09.2023	09.09.2023	10.09.2023
		LGB % UAH 24.0mn	NBU: FX Reserves (deadline - 7th day)	Ukrstat: GDP S&P Sovereign Credit Rating Review Ukrstat: Price indices		
11.09.2023	12.09.2023	13.09.2023	14.09.2023	15.09.2023	16.09.2023	17.09.2023
IMF SDR 187.5mn NBU: Monetary Statistics		IMF SDR 295.5mn LGB % UAH 72.1mn LGB % UAH 1 274.7mn	LGB P USD 388.9mn NBU: MPC ECB: MPC	IMF SDR 59.7mn FGB % USD 94.3mn		
18.09.2023	19.09.2023	20.09.2023	21.09.2023	22.09.2023	23.09.2023	24.09.2023
		IMF SDR 125.0mn LGB % UAH 162.5mn LGB P UAH 5 000.0mn Fed: FOMC				

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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