



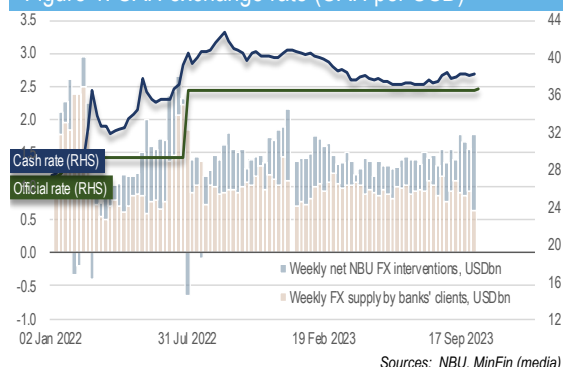
ECONOMICS | INTEREST RATES | FX MARKETS

9 October 2023

UKRAINIAN CAPITAL MARKETS REVIEW

	Rating	Outlook	Last update	This week in focus: From fixed to a semi-fixed
Fitch	CC	-	23.06.2023	The NBU transitioned to a managed flexibility of exchange rate. Under this new regime, however, the USD/UAH rate remains heavily influenced by FX restrictions and significant interventions by the central bank. We expect a limited rate movement in a short run. But a trending feature has been added to the rate. And it will manifest itself as the NBU proceeds along FX easing strategy.
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)

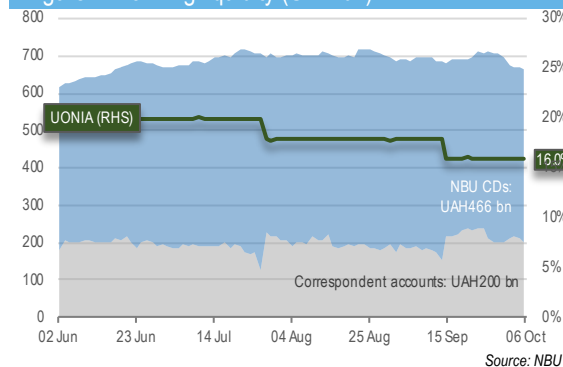


FX and interest rates: UAH remain supported by hefty FX interventions

After the implementation of the managed flexibility in the exchange rate regime on 3 October, the hryvnia demonstrated remarkable resilience in the market, thanks to the unwavering support from the NBU.

In the wake of this announcement, the interbank market experienced a substantial surge, with trade volumes soaring to USD540mn – a twofold increase from the previous day and surpassing the average level of the NBU's weekly interventions post-Russian invasion. Despite this heightened activity, the hryvnia experienced a marginal 0.06% depreciation against the US dollar, thanks to the NBU's firm commitment to "remain a key player" in the FX market, ensuring comprehensive coverage of market demand.

Figure 2. Banking liquidity (UAH bn)



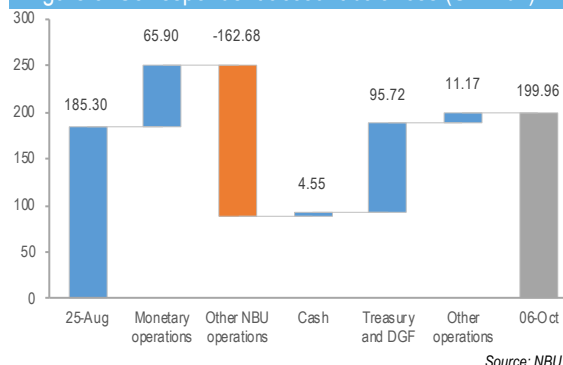
The subsequent days witnessed a decline in demand, with the USD/UAH rate ending week at the mark of 36.58, up 0.04% compared to the fixed level.

We expect market turbulence to subside in the coming weeks, with no significant shifts in the currency rate.

Looking forward, the movement of USD/UAH will likely be influenced by future policy easing measures, potentially adding to fundamental pressure on the rate. We maintain our year-end forecast of 40.0 hryvnias per US dollar.

Banking liquidity was relatively stable in September but dropped to UAH666.1bn after introduction of the managed flexibility. As of the end of last week (6 October), the balance of correspondent accounts stood at UAH200bn, no change over the week, while banks' positions in central bank's CDs contracted by 8% to UAH466.1bn.

Figure 3. Correspondent account balances (UAH bn)



Net NBU FX sales surged by 14% in September, reaching USD2.69bn. The increase largely followed the FX policy easing measures enacted by the central bank in late August. Back then, non-cash FX purchases by the population were authorized, and the monthly limit for 3-month FX deposits – a facility facilitating currency purchase at the official rate – was doubled.

Notably, net hryvnia withdrawals transformed into net cash inflows of UAH4.6bn in September. This shift is likely attributable to non-cash FX purchases by the population, along with the NBU's endeavors to lock in more hryvnia liquidity through term deposits.

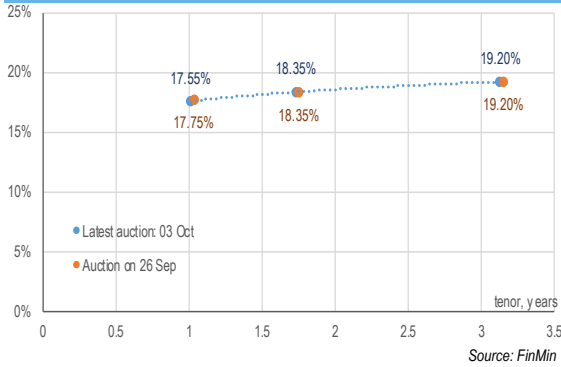
In the first week of October NBU sold USD1.1bn to ease market anxiety over the new currency regime.



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Figure 4. UAH government bonds primary market

Government bond market



The Ukrainian government bonds appear to have encountered a plateau, particularly noticeable in mid- and long-term securities, where the decline in yield has halted in the past month. This stagnation runs counter a policy rate cut in mid-September and a sustained deceleration in inflation.

During the latest primary auction on 3 October, the FinMin offered bonds across the standard range of maturities, including 1-year, 1.5-year, and 3-year securities.

While the yield on 1-year bonds dropped to 17.55%, a decrease of 20bp over the last month, the yields on 1.5-year and 3-year bonds remained stable at 18.35% and 19.2%, respectively. This lack of change might indicate growing market uncertainty regarding the long-term prospects of economic recovery amid ongoing military operations.

Additionally, the government recently unveiled the draft of the state budget for the next year. While the projected income appears feasible, questions arise when looking at outlined expenditures and their funding sources. This potential fiscal ambiguity might have weakened the FinMin's bargaining power, contributing to the prevailing market uncertainty.

Figure 5. UAH government bonds secondary market

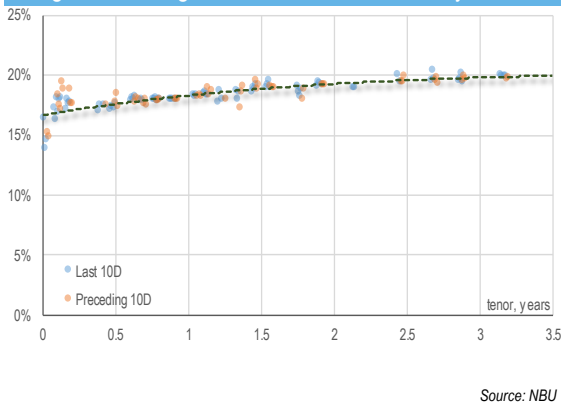
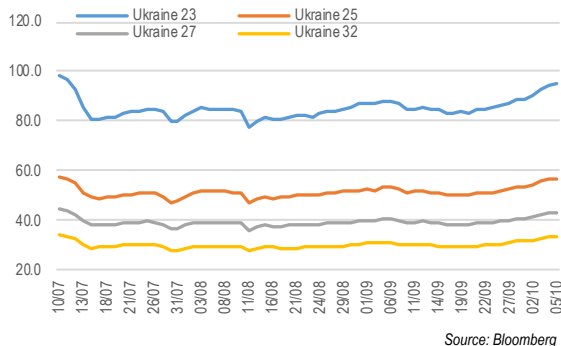


Figure 6. Ukraine's Eurobond yields, bid/ask mid (%)

EUR/USD slips to mid-1.0500s on rising worries around Euro area economy

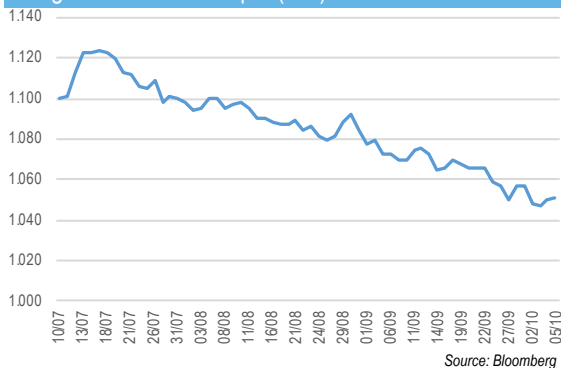


The Euro has been facing downward pressure against the US dollar due to persistent disappointments in Eurozone economic data, contrasted by positive surprises in US statistics.

The decline started in late August, sparked by uncertainty from the ECB regarding rate decisions, leading to discussions about potential stagflation in the region.

European concerns deepened with lacklustre GDP figures for the 2Q, where the economy's meagre 0.1% growth fell below market expectations of 0.3%. Moreover, slowing business activity and a drop in industrial production, combined with a hawkish stance from ECB policymakers, have raised fears of an imminent economic stagnation in the Eurozone.

Figure 7. EUR USD spot (mid)



During the first Autumn meeting, despite a 25bp rate hike and what appeared to be a dovish tone – the ECB hinted that the current cycle of rate hikes might have peaked – market attention focused on the central bank's acknowledgment of existing downside risks within the Eurozone, further weighing on the Euro.

Conversely, the US dollar has maintained its strength on the back of robust US economic data. Although the Fed kept rates steady at 5.5%, it updated its Summary of Projections (SEP) with central bank's officials now expecting the interest rate to reach 5.1% by the end of 2024, up from the previous projection of 4.6%. This adjustment bolstered the US dollar further.

The yield on the 10-year Treasury hit a 16-year high this week, reaching 4.884% before retreating slightly to 4.744% by Friday.

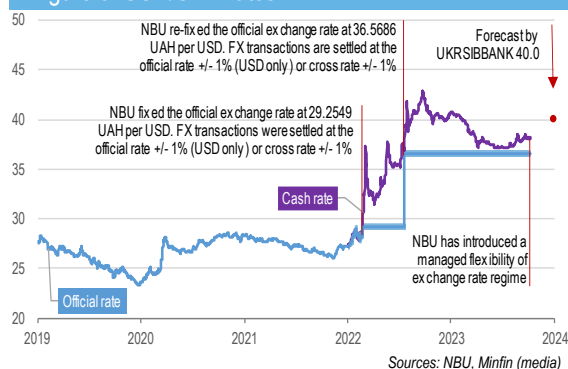


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Figure 8. USD/UAH rates



From fixed to a semi-fixed

The NBU transitioned to a managed flexibility of exchange rate regime, effective from 3 October. This move, although employing measures slightly different from our initial assumptions, aligns with our expectations as outlined in our report from 20 July. Under this new regime, the USD/UAH rate remains heavily influenced by FX restrictions and significant interventions by the central bank. But for speculative fluctuations, which may trigger some rate adjustment, we expect a limited rate movement in a short run. With the new regime, however, a trending feature has been added. And it will manifest itself as the NBU proceeds along FX easing strategy.

The decision logically follows the FX easing policy initiated by the central bank earlier this summer. The more restrictions the NBU removes, the more currency risks it expects market participants to take themselves.

It is important to note that at this stage the move appears more preparatory than an actual change in the currency regime. Further easing in FX regulations governing market demand is necessary for a complete shift.

This aligns with the central bank commitment to restrain from market disbalance regulation with a rate at this stage. The first trades after the announcement, resulting in a 0.06% hryvnia depreciation against the US dollar despite a doubled demand for foreign currency, support this stance. The half measure approach seems to assures, that the NBU recognizes the challenges posed by logistic and security issues amid ongoing military operations, limiting opportunities to address the structural deficit of foreign currency.

Before the NBU announces new FX easing measures, we expect no material fluctuations in USD/UAH rate.

The NBU's past measures and efforts to restructure banking liquidity will also help limit fluctuations in the USD/UAH rate in the short run. Thanks to these initiatives, the central bank is now confident in its ability to "remain a key player" on the FX market, compensating for the structural deficit of FX.

With the new regime, however, a trending feature has been added to the rate. At this stage, a contrasting statement that hryvnia rate under the new regime "will be determined by transactions in the interbank FX market" seems like a cautionary note for speculative moves on the market. The more FX the NBU will need to sell, the deeper hryvnia will depreciate.

But it will start to strongly manifest itself later, as the NBU proceeds along FX easing strategy.

Looking ahead, the NBU it is about to complete the first stage of the strategy, involving liberalization of trade transactions and facilitation of new loans and investments.

Additionally, the central bank has signaled of its readiness to discuss with market participants reintroduction of FX derivatives. While hedging instruments are projected at the third stage of FX easing strategy, the NBU do not rule out an earlier authorization if this contributes to currency stability.

Both actions, however, might entail FX control tightening.

In total, **while expecting relative stability in the currency market in the short run, we maintain our year-end USD/UAH forecast of 40.0**, as any potential policy easing measure are likely to add to fundamental demand for FX.

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



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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	44.0	52.9

*estimates, no official data yet available

NA – data is not available because of continuing military operations



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FOUR WEEKS AHEAD

Mon	Tue	Wed	Thu	Fri	Sat	Sun
09.10.2023	10.10.2023	11.10.2023	12.10.2023	13.10.2023	14.10.2023	15.10.2023
Ukrstat: Price indices	NBU: Monetary Statistics					
16.10.2023	17.10.2023	18.10.2023	19.10.2023	20.10.2023	21.10.2023	22.10.2023
23.10.2023	24.10.2023	25.10.2023	26.10.2023	27.10.2023	28.10.2023	29.10.2023
		LGB % UAH 244.7mn LGB P UAH 4 255.2mn	LGB P USD 352.6mn NBU: MPC ECB: MPC			
30.10.2023	31.10.2023	01.11.2023	02.11.2023	03.11.2023	04.11.2023	05.11.2023
	NBU: BoP	IMF SDR 96.1mn FGB % USD 78.0mn LGB % UAH 997.9mn LGB P UAH 18 227.1mn LGB % UAH 1 312.9mn Fed: FOMC				

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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