

# Ukraine. Monthly Market Overview

## August 2014



### Ukraine Sovereign Ratings

LCY rating	S&P	Moody's	Fitch
Long-term	B-	Caa1	B-
Short-term	B	-	-
Outlook	Stable	Negative	Negative
FCY rating			
Long-term	CCC	Caa3	CCC
Short-term	C	NP	C
Outlook	Stable	Negative	Negative
Latest assessment	11/07/14	04/04/14	07/02/14



Financial Markets team

# Ukraine. Monthly Market Overview. August 2014

## Major Macroeconomic Trends



### MACROECONOMIC INDICATORS - evolution

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014F*	2015F*
Nominal GDP (USDbn)	38.0	42.4	49.5	64.9	86.2	107.7	142.7	129.0	117.4	136.2	165	174	178	138	161
Real GDP growth (%)	9.2	5.2	9.4	12.1	2.7	7.3	7.9	2.1	-14.8	4.2	5.2	0.2	0.0	-6.3	0.8
Inflation CPI, eop (%)	6.1	0.6	8.2	12.3	10.3	11.6	16.6	22.3	12.3	9.1	4.6	-0.2	0.5	15.3	10.4
Industrial production (%)	14.2	7.0	15.8	12.5	3.1	6.2	10.2	-3.1	-21.9	11.0	7.6	-1.8	-4.7	-8.5	1.1
Producer prices index, eop (%)			7.6	20.5	16.7	9.6	19.5	35.5	6.5	20.9	19.0	0.3	1.7	21.0	5.5
Exports (USDbn)	20.1	23.4	28.9	41.3	44.4	50.2	64.0	78.7	39.7	51.4	68.4	68.8	63.3	62.3	67.2
Imports (USDbn)	17.7	21.5	27.7	36.3	43.7	53.3	72.1	92.2	45.4	60.7	82.6	84.6	77.0	68.1	70.3
Public debt (% of GDP)	37.1	33.5	29.0	24.8	18.0	14.8	12.0	13.7	32.2	39.7	36.2	36.6	41.0	50.4	47.7
Current account (% of GDP)	3.7	7.5	5.8	10.7	2.9	-1.5	-3.6	-7.1	-1.5	-2.2	-5.5	-8.5	-9.1	-5.9	-3.8
Net FDI inflow over year (USDbn) NBU methodology	0.8	0.7	1.4	1.7	7.5	5.7	9.2	9.9	4.7	5.8	7.0	6.6	3.3	1.8	3.4

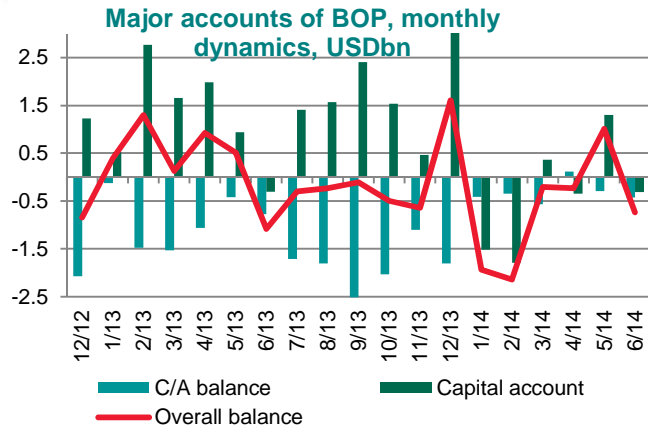
### EXCHANGE RATES - evolution

USD/UAH average	5.37	5.33	5.333	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	11.48	11.26
EUR/UAH average	5.1	5.02	6.02	6.61	6.38	6.26	6.92	7.78	10.88	10.52	11.09	10.31	10.81	15.30	14.41
UAH O/N average	16	3.5	6.5	5.3	3.5	4.0	3.5	11.3	8.4	1.5	5.7	11.9	2.7	5.7	3.5

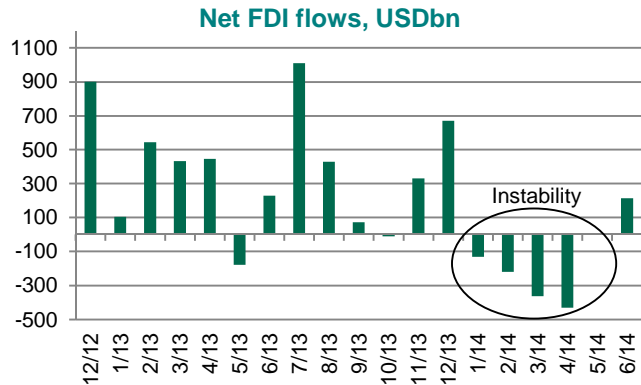
- **Geopolitical concern has remained the core factor for the dynamics of financial markets and performance of economic sectors in Ukraine in July.** Therefore, any positive structural changes are ruined by negative news from eastern Ukraine. In particular, the growing threat of a direct Russian invasion, the MH17 tragedy, as well as solid support of separatists in eastern Ukraine by its neighbour provides concern for domestic businesses regarding the near-term economic future.
- **The rather technical issue of the launch of the parliamentary re-election** (ie, dismissal of the coalition and technical resignation of the government) was a solidly negative argument for financial markets that required a few weeks for the situation to stabilise. However, political risks have not fully reduced back to normal due to uncertainty tied to geopolitical risks. In any case, we think this is **a movement in a right direction as early parliamentary elections are a potentially positive factor for accelerating economic reforms in Ukraine in the medium-term.**
- Any additional negative consequence of armed conflict in eastern Ukraine has worsened the Ukraine's economic performance as well as budget parameters. As a result the IMF technical mission extended its time in Ukraine in July. We think this may be a reason for the **delay in the provision of the second tranche for few weeks** (until late-August). At the same time, **the probability that the second tranche will be disbursed is rather high** as the IMF mission will recommend that the Fund's board provide Ukraine with the second tranche.

# Ukraine. Monthly Market Overview. August 2014

## Major Macroeconomic Trends



Sources: NBU, Credit Agricole



Sources: NBU, Credit Agricole

Forecast	GDP, YoY
Q314	-6.8%
Q414	-9.5%
Q115	-3.8%
Q215	1.1%

Source: Credit Agricole

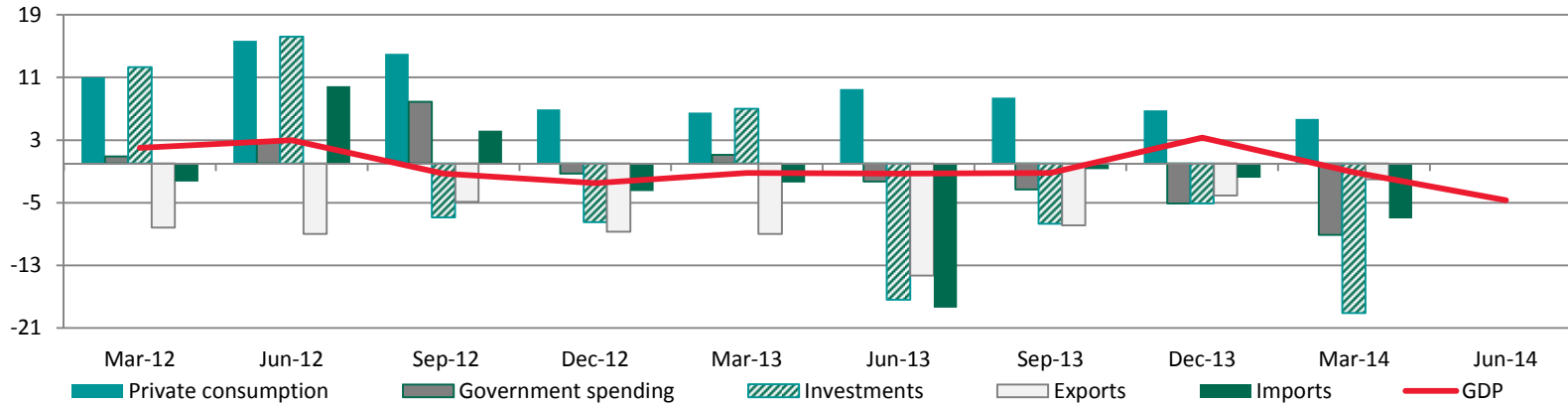
- An improvement in the rating outlook of Ukraine by S&P to Stable from Negative** is the first positive reaction from a rating agency on the improvements in Ukraine's ability to service its external debt – this improvement occurred about two months ago. However, **we are unlikely to see any rating upgrades until the armament conflict in eastern Ukraine is over**. We also do not even expect similar actions from other rating agencies in the near-term, as geopolitical risks are so high that they will negatively impact the macroeconomic outlook at least for this year.
- The performance of economic sectors worsened visibly in June**, with all of them showing a decline in YoY terms. Even though grain yields are estimated at their highest level since Ukrainian independence, the volume of harvest will be definitely lower in YoY terms due to a lesser harvesting area after the Crimea annexation as well as war conflict in some districts of eastern Ukraine. Additionally, the delay in harvesting season compared to the previous year created such a dramatic drop (17.6% YoY) in agriculture output in June. Hence, we should expect better agriculture performance figures in the coming months, while the **performance of other sectors (especially industrial and trade) may additionally worsen in H214**.
- Preliminary figures show GDP contracting by 4.7% YoY over Q214**. This is slightly better than our forecasts of -4.9%. We think the reason for such a decline in GDP is evident ie, more prolonged and dramatic effect of war conflict in eastern Ukraine than was initially expected. We also should point out the late agriculture harvesting season, weak private consumption and declining trade sector performance as the reasons for a GDP drop last quarter. All these factors became the reasons for a **more pessimistic outlook of Ukrainian economy in the near future**. This induced the wave of 2014 GDP downgrades, with the government being also in line with this trend. It expects to downgrade YoY GDP dynamics for 2014 to -6.0/-6.5%. **We also downgraded our forecast to -6.3%**.
- A worsening in the current account balance in June** (-USD0.42bn) versus May (-USD0.29bn) may not be fully explained by the weaker effects of hryvnia devaluation's adjustment but **rather by growing energy imports in June**. In fact, by threatening to face gas imports' cut from Russia, Ukraine strived to pump as much of it into underground storages as possible. We think this was a major reason for the worsening of the external trade balance. Of course, **a trade war with Russia also impacted the drop in Ukrainian exports, while this effect is still much weaker than a positive one from UAH devaluation**. Taking into consideration no gas imports from Russia and rather weak reverse gas supplies from Europe, we should expect **additional improvements in the CA in July**.
- Even though the capital account balance became negative again in June (-USD0.31bn) on lower inflow from international donors and negative financing flows into banking and corporate segments, **the situation is not dramatic enough to weaken hryvnia position in the near-term**.
- A turn in net FDIs inflow into positive figures (USD0.21bn) in June (for the first time this year)** is a quite positive signal for the market and a signal that investors are returning back to Ukraine after a resumption of cooperation with the IMF. At the same time, the active war conflict in eastern Ukraine will still limit FDIs flows into the country.

# Ukraine. Monthly Market Overview. August 2014

## Major Macroeconomic Trends

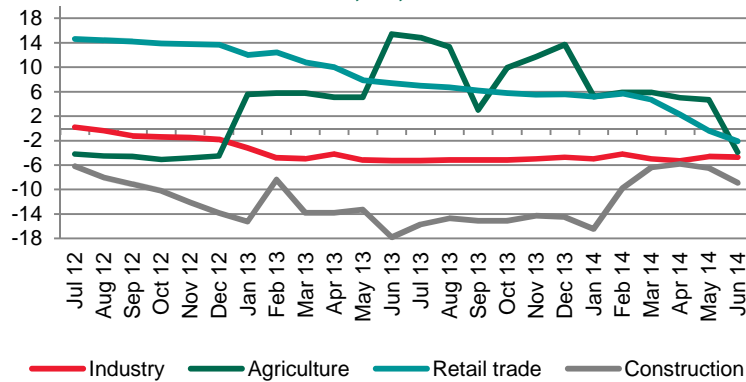


Quarterly GDP dynamics by expenditure components, %, YoY



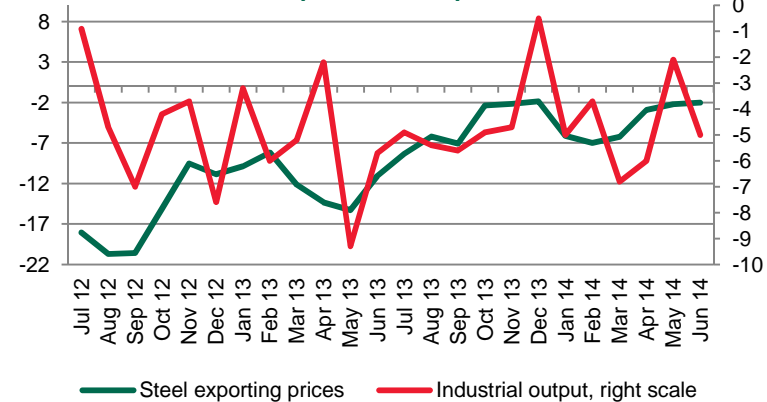
Sources: State Statistics Committee

Performance of major economic sectors, YTD, %, YoY



Source: State Statistics Committee

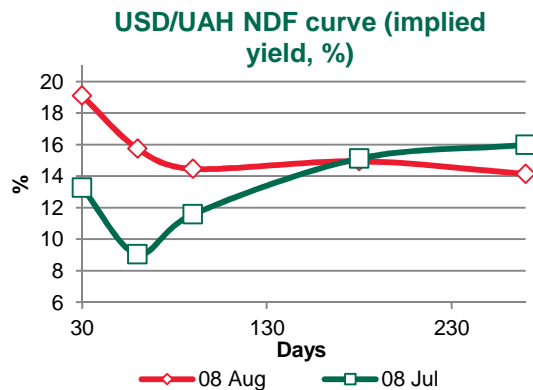
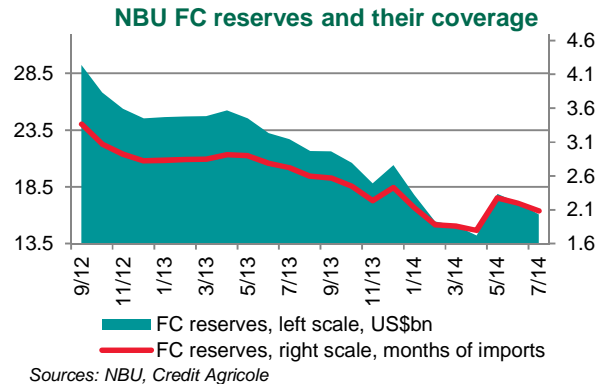
Industrial output and steel prices, %, YoY



Sources: State Statistics Committee, Bloomberg, Credit Agricole

# Ukraine. Monthly Market Overview. August 2014

## FX Market



Forecast, eop	USD/UAH	EUR/UAH
Q3'14	12.15	16.28
Q4'14	12.15	16.04
Q1'15	11.84	15.39
Q2'15	11.65	15.03

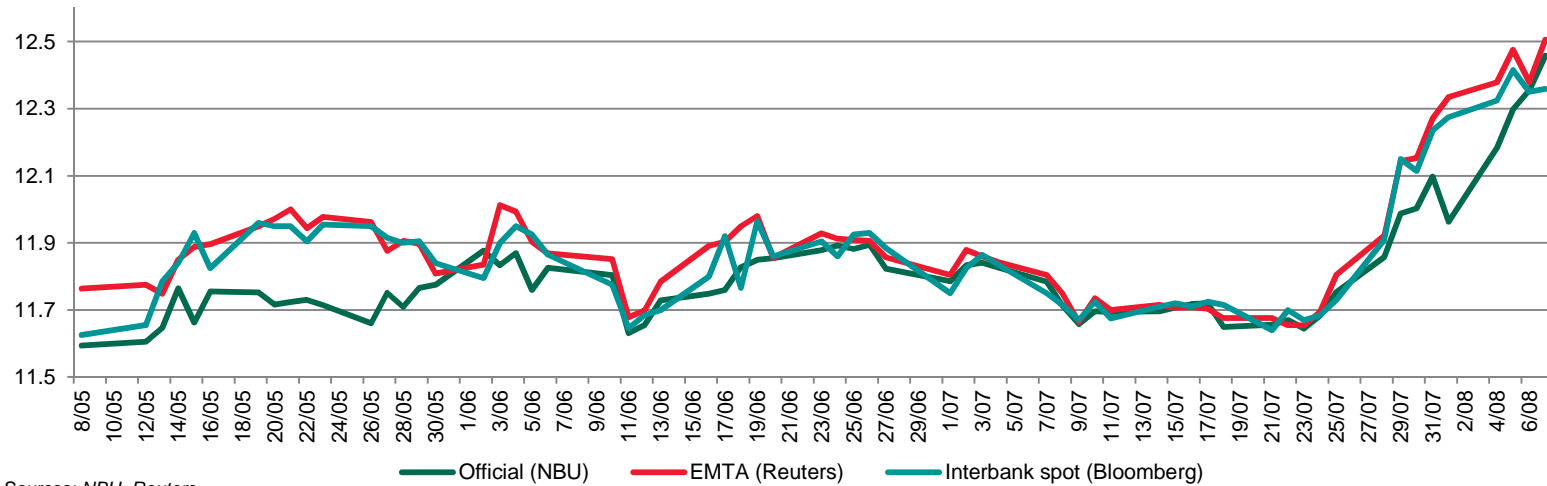
Source: Credit Agricole

- Political factors still heavily weights on exchange rate dynamics.** And even though harvesting season should have led to more visible hryvnia strengthening, the rate showed just a marginal and non-sustainable decline in July. At the same time, **market stability is not consistent. Thus any potential disruptions in domestic politics and geopolitical could easily breach so fragile a balance.** This happened in late July when the parliamentary coalition was broken and the PM resigned. The news rapidly reversed the dynamics on the FX market, thus moving USD/UAH rather quickly to a previous resistance level of 12.00. However, the absence of any reaction from the NBU pushed the USD/UAH to move in a new range of 12.20-12.60 in early August.
- The future dynamics of the exchange rate will be closely tied to the success of the military conflict between Ukraine and terrorists in eastern Ukraine, as well as any potential jitters tied to an upcoming pre-election campaign. Hence, **we doubt the hryvnia's ability to go behind the previous resistance level of 12.00 in the coming weeks.** At the same time, in case of no additional negative political and geopolitical news along with a strong attitude from the NBU to defend hryvnia in case of speculative attack, **we should not see any additional waves of hryvnia weakening.** Furthermore, the supply of foreign currency is still backed by the continuing agriculture season.
- Recent hryvnia weakening and a quick increase in the USD/UAH above the previous resistance level of 12.00 has not initiated any counter-actions from the NBU, thus proving its **strategy of a more flexible exchange rate regime.** This increased speculative movements on the market, thus forcing the NBU to act when the rate exceeded 12.50. First of all, the **NBU intervened with foreign currency sale.** Furthermore, the NBU increased its information pressure by explaining to the market that the current hryvnia devaluation has no economic ground and is rather a speculative one. This view is fully within our estimates. However, a one-time intervention has not calmed the market for any longer than just two days, thus **forcing the NBU to intervene again.**
- Recent FX market dynamics allow us to expect a **new temporary resistance level for the USD/UAH at 12.50.** At the same time, our **base forecast in the near-term is 12.15.** We think the **constant interventions of the NBU** (or just an intention to intervene) **in the coming week or two are required** to persuade the market of the low probability of further hryvnia weakening, thus inducing more foreign currency supply. And this should not require large interventions from the NBU as excessive demand is not strong, while most importers still postpone their purchases in hope of see hryvnia strengthen.
- Finance ministry downgrades its USD/UAH forecast in the budget from 10.80 to 12.00 this year.** We think a more prolonged war conflict in eastern Ukraine, quite solid disruptions in the economic activity of potential exporters (ie, still mills), as well as growing devaluation fears were major reasons for review of exchange rate forecasts towards a downgrade. On the back of the aforementioned reasons **we downgraded our year-end USD/UAH forecast to 12.15USD/UAH.**
- The drop in NBU FC reserves by USD1.01bn in July reflects the scheduled repayments. **New potential disbursement of IMF loan at end-August should replenish reserves soon.**
- As the **mandatory foreign currency sale** expires already on 20 August, we think **it will additionally be extended** due to the current market situation. We do not think it will be increased and should be left at its current 50%.

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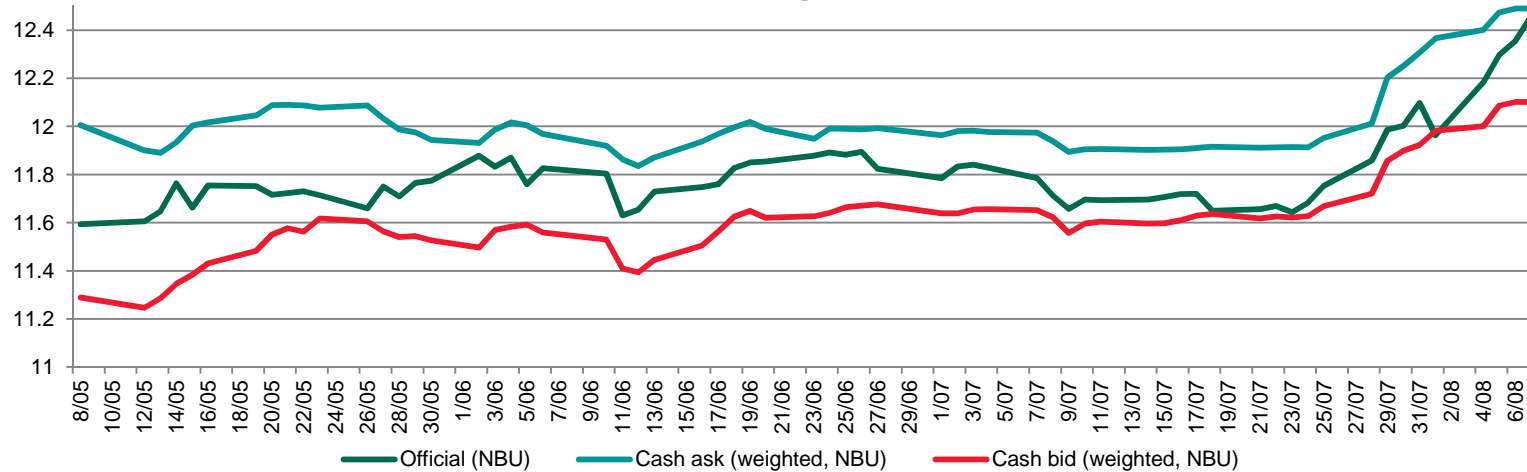
## FX Market

USD/UAH interbank exchange rate over last 3 months



Sources: NBU, Reuters

USD/UAH cash exchange rate over last 3 months



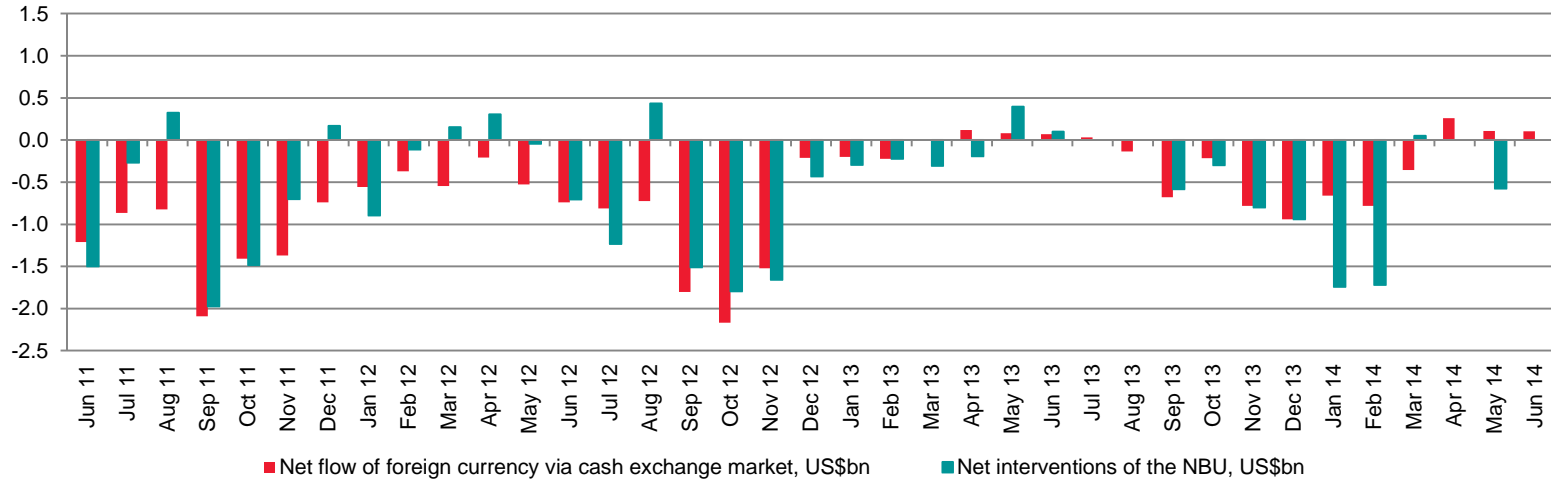
Source: NBU

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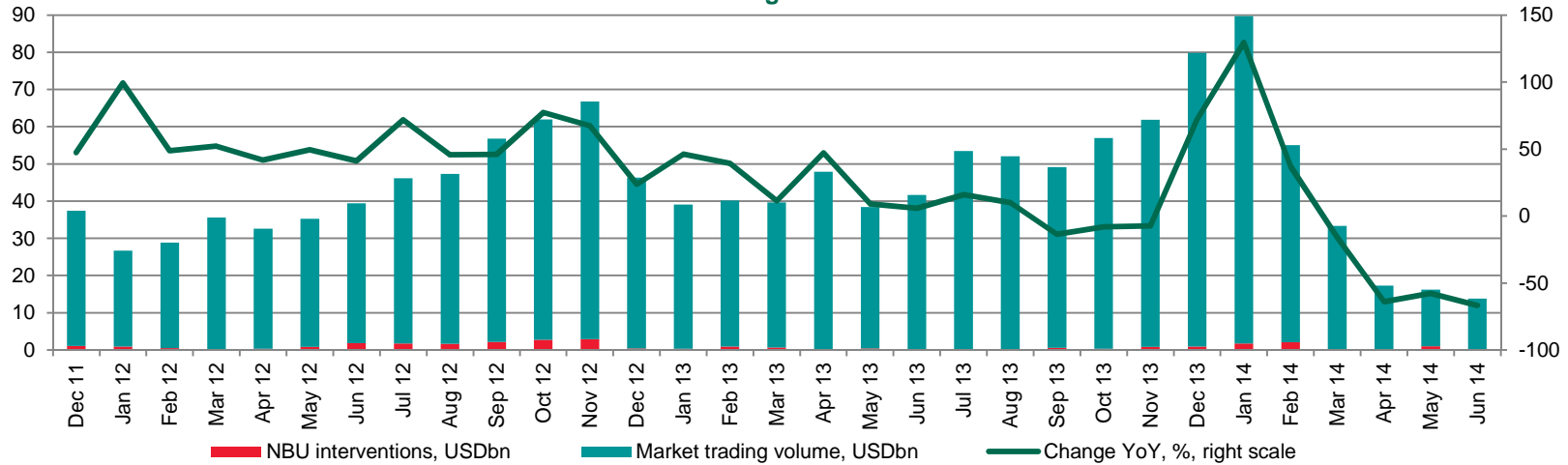
## FX Market



Net flows on interbank and cash FX markets

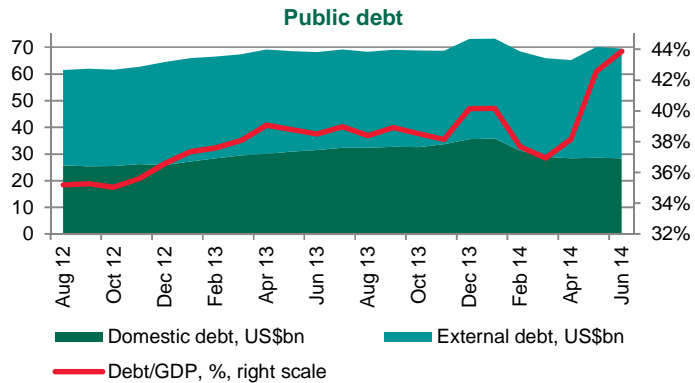


FX market trading volumes

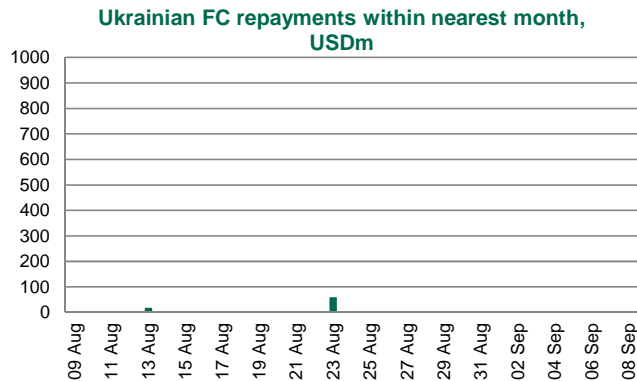


# Ukraine. Monthly Market Overview. August 2014

## Debt indicators



Sources: Finance Ministry, Credit Agricole



Sources: Finance Ministry, Credit Agricole

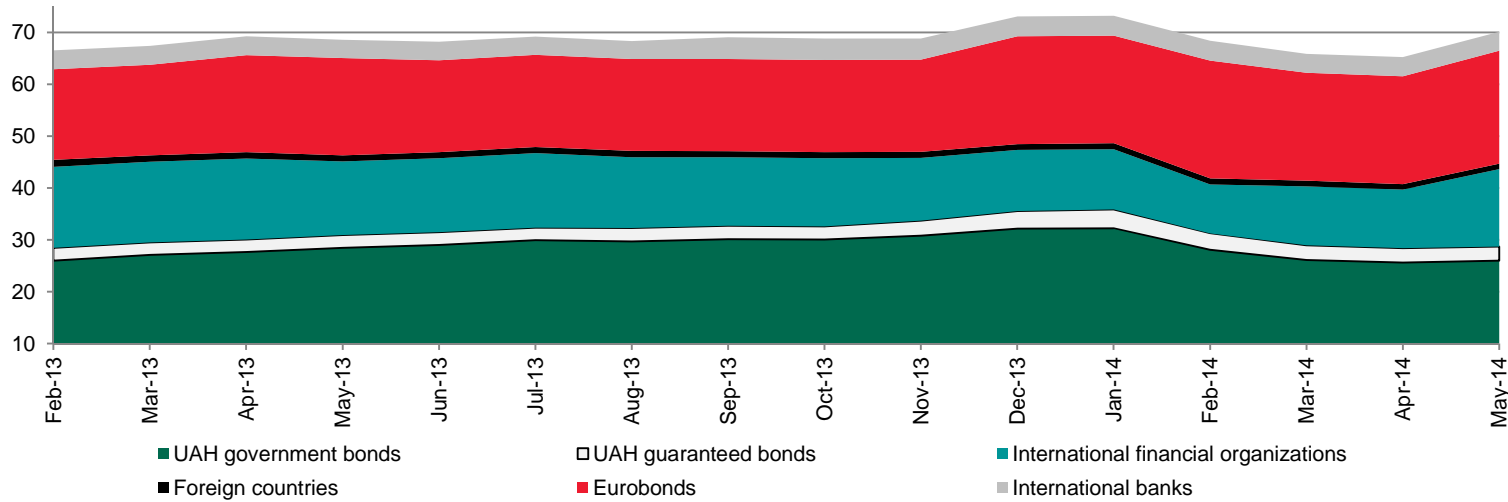
- **Public debt reduced slightly over June (by 0.8% MoM) to USD69.5bn.** The dynamics reflect lower inflow of foreign currency from international donors, with simultaneous redemption of Eurobond worth USD1.0bn. This affected a reduction in external public debt by 0.7%.
- Due to the postponement of the second IMF tranche's provision, **the government and NBU had to pay their existing obligations of USD1.11bn** (USD0.66bn to IMF, USD0.33bn on foreign currency local government bonds and USD0.12bn on Eurobonds' coupons) **in July by themselves.** With the lack of any external inflow of external debt, we think **public debt will again show a small decline in July.**
- Despite a decline in public debt, a more solid drop in **GDP additionally increased the debt-to-GDP ratio to 43.9% in June**, compared to 42.6% the month before. And even though we expect a further reduction in public debt in July, debt-to-GDP should still remain on a growing track.
- **The government was not quite as active in domestic borrowings in July**, thus borrowing local currency resources (UAH5.42bn) that were just enough to make the necessary repayments over the month (UAH5.38bn). **The government also partially refinanced its obligation on foreign-currency local bonds** by borrowing USD0.2bn from the market and paying USD0.33bn the next day.
- By following IMF requirements **the government issued a second tranche of VAT bonds** (UAH2.17bn) in late-July. On one side, the potential demand for VAT-bonds is quite large taking into consideration the absence of attractive bonds on the market. At the same time, as the first tranche of VAT-bonds of UAH3.58bn has not been fully absorbed by the market yet, **we expect wider discounts on new issue in the coming weeks.**
- The approval of core budget amendments by parliament in late July, stipulating additional revenues and cuts in expenditure (in order to be resilient to worsening economic environment due to the conflict in eastern Ukraine) **removed any significant obstacles to receive the second tranche of IMF stand-by loan.** However, due to some delays in the process of review, assessment and implementation of programme requirements, **the disbursement of the second tranche will be delayed for about a month.** Hence, a second tranche worth USD1.4bn may be received in the second half of August. In particular, NBU governor stated that the decision of the IMF board is expected on 29 August. In any case, both representatives of the IMF technical mission and IMF management positively assessed the progress of Ukraine in following IMF obligations. Hence, **the probability of receiving the second tranche is rather high currently.**
- **The government continued its policy on increasing external borrowing, that will allow it to cover current redemptions and stabilise the capital account of the BOP.** In particular, a new agreement was signed in mid-July with the World Bank on the provision of a USD0.30bn loan on the modernisation of social framework, while in early-August the WB approved a provision of USD0.5bn to Ukraine for banking sector development.



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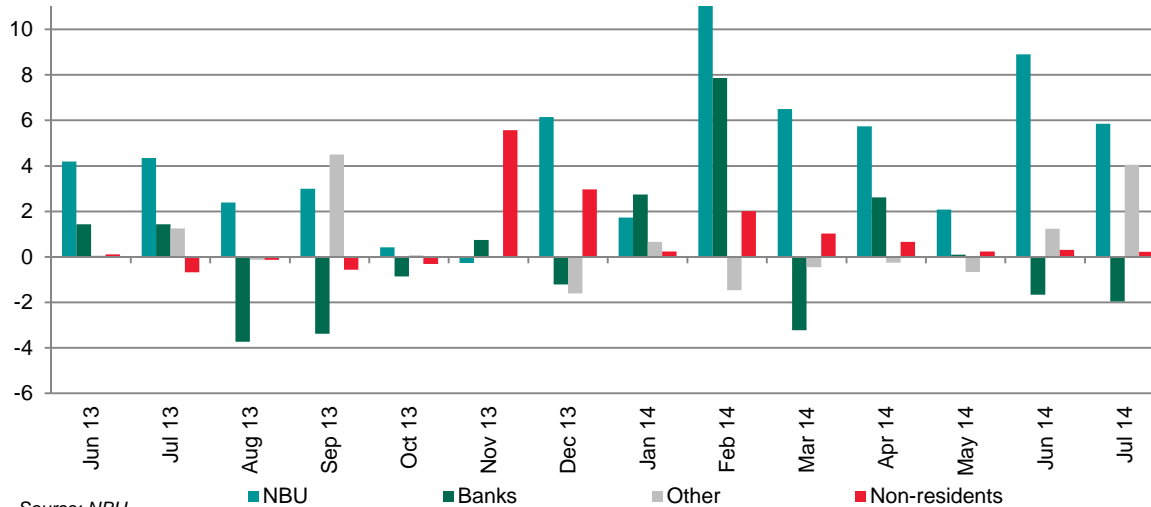
## Debt indicators

USD nominated public debt by components, USDbn



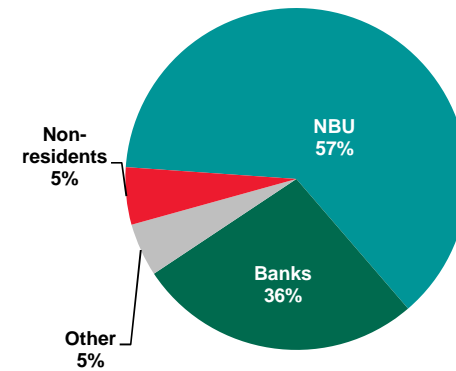
Source: Finance Ministry

Dynamics of government bonds by ownership types, MoM, UAH bn



Source: NBU

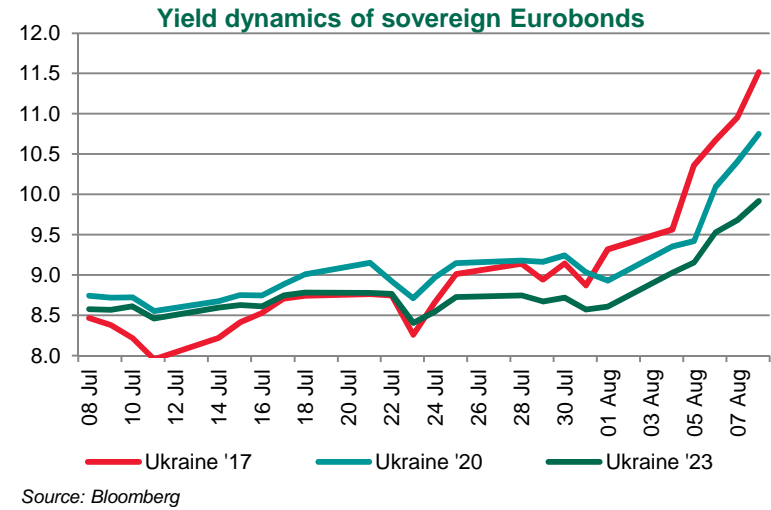
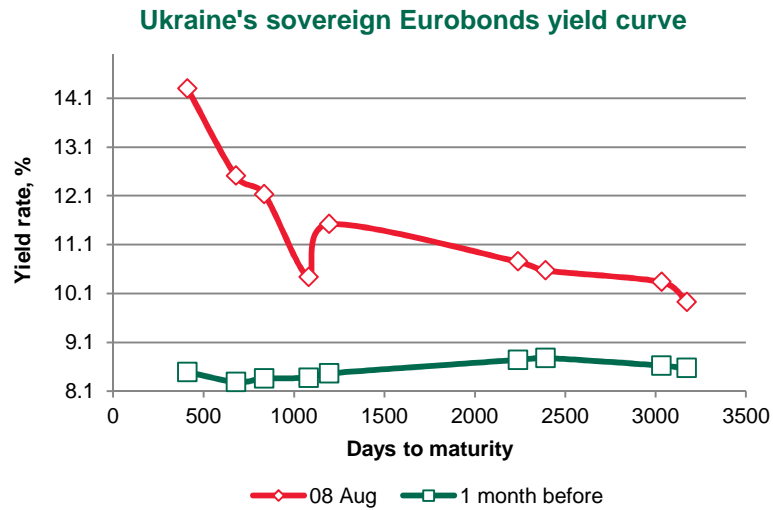
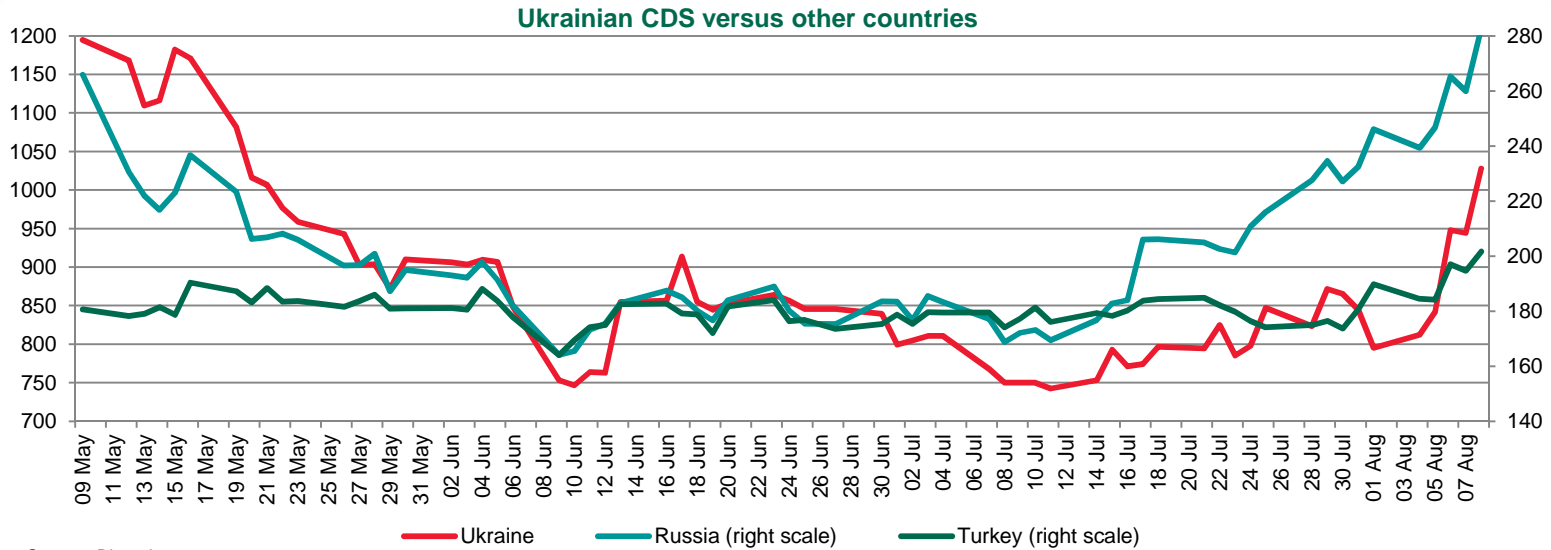
Breakdown of OVDP by owners (as of 8 Aug)  
Total volume - UAH306bn



Source: NBU

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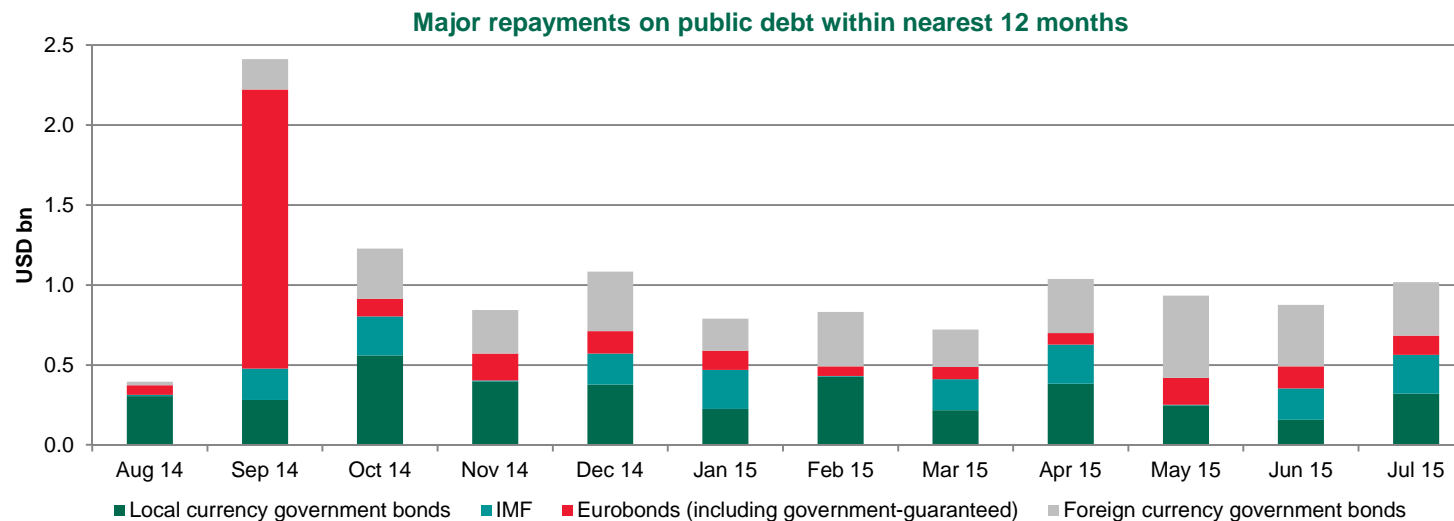
## Debt indicators



## Ukraine. Monthly Market Overview. August 2014

### Debt indicators

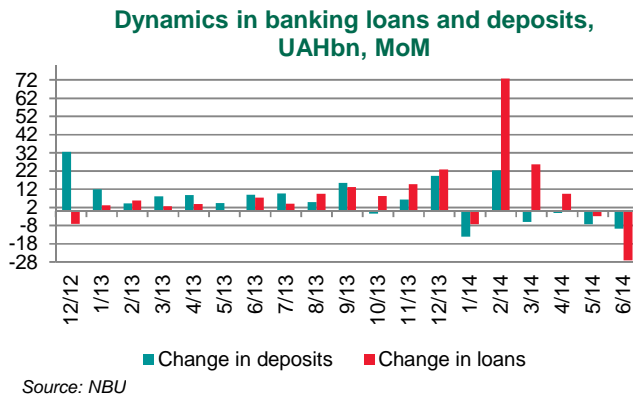
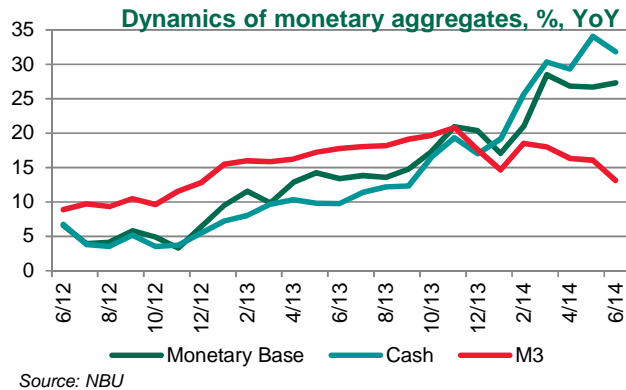
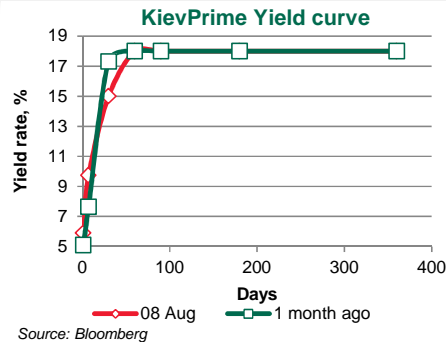
USDbn	Q314	Q414	Q115	Q215	2014
<b>Repayment of FC-denominated public debt</b>	<b>3.7</b>	<b>1.9</b>	<b>1.7</b>	<b>2.3</b>	<b>11.0</b>
Foreign currency local government bonds	0.5	1.0	0.8	1.2	2.2
IMF debt	0.9	0.4	0.4	0.4	3.7
Eurobonds (including state-guaranteed)	1.9	0.4	0.3	0.4	4.1
Other	0.3	0.1	0.2	0.3	1.0



Source: Credit Agricole

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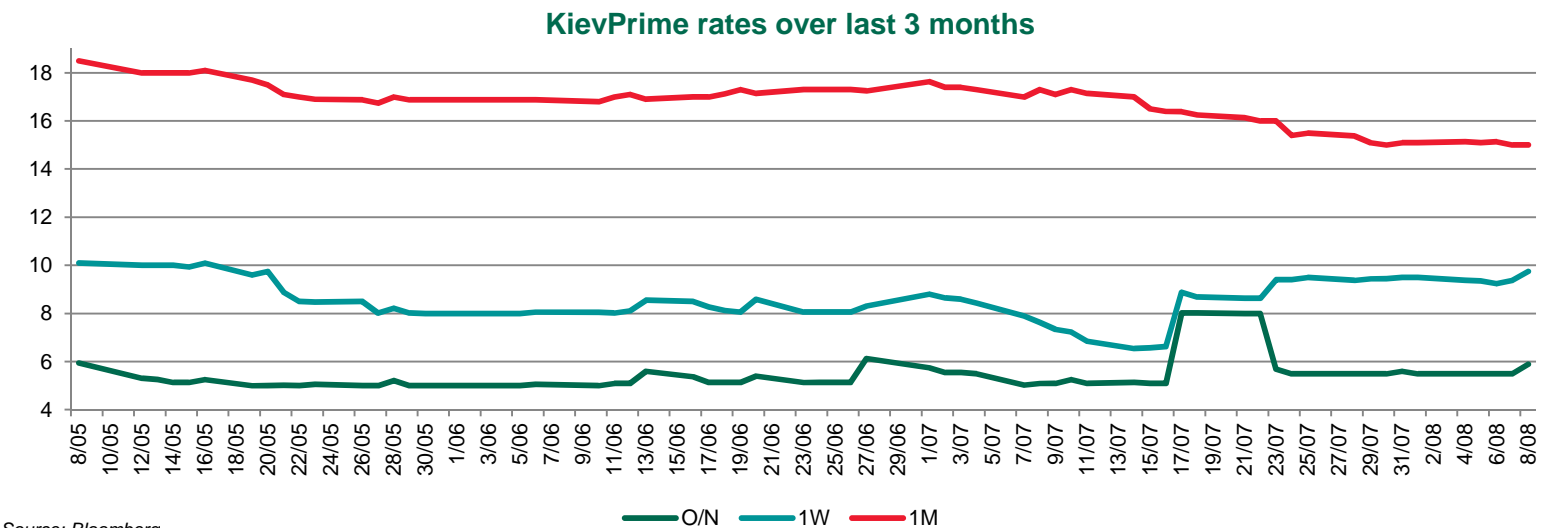
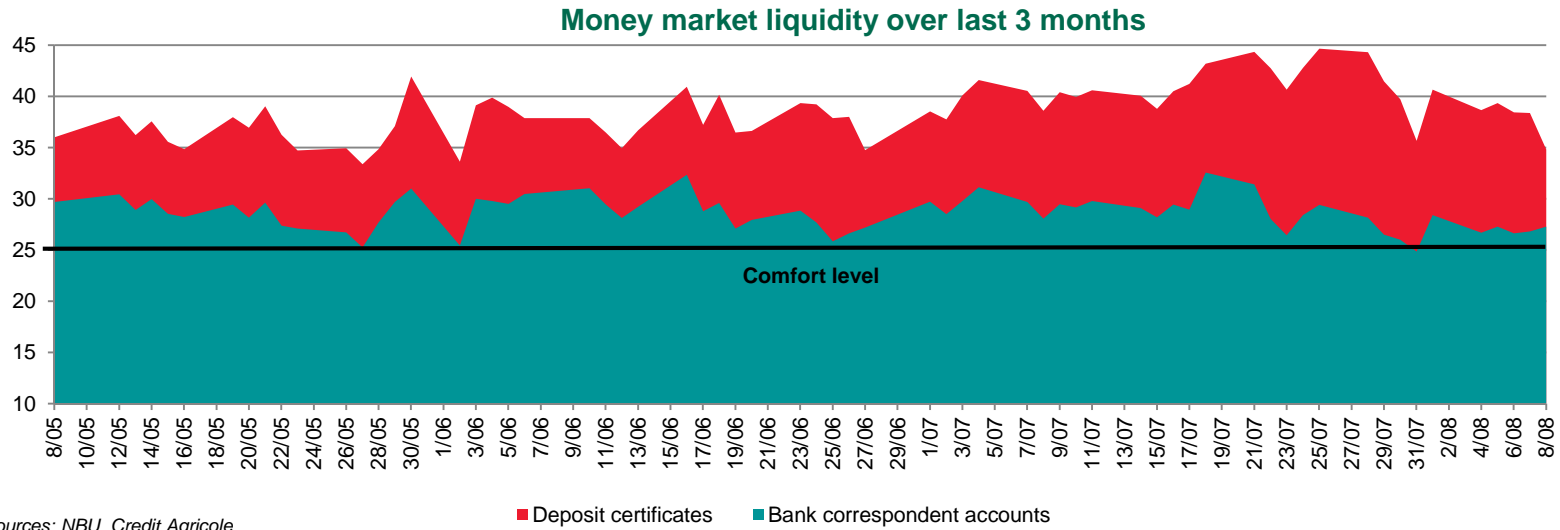
## Money Market



- It was not a surprise that the **NBU decided in mid-July to hike its policy rate by 300bp to 12.5%**. This is a clear signal that the NBU has started to fight inflation and is gradually moving its monetary policy in line with IMF requirements regarding a inflationary targeting regime. Rather rapidly growing inflation as well still high inflationary risks in the near-term are rather strong arguments for the action of the NBU. And even though policy rate is not directly tied to money market rates, they still adjusted upwards as NBU automatically increased both its refinancing rates and deposit certificates' rates. However, **the adjustment occurred in short-term rates (up to one week) only, as rates of resources with longer maturity already included the risk of an acceleration in inflation**. Consequently, the decision of the NBU regarding the key rate was to leave it unchanged.
- A hike in NBU O/N CDs and refinancing rates has not lasted for long**. And in few days it reduced the rates by 250bp, while additionally hiking the 1W rate by 25bp and 2W rate by 50bp. We think this was **a decision to correct the yield curve to make it steeper** as rather attractive O/N CDs rates raised demand for them among banks, thus causing growing costs for the NBU to sterilise O/N hryvnia.
- We can also expect an additional hike in NBU policy rate in the coming two to three months** in case of the further risk of an acceleration in inflation. In any case, a decision of the NBU regarding its policy rate is clear **evidence of more monetary tightening in the medium-term**, thus supporting our estimates of an increase in interest rates around September-October.
- Even though one of the goals of the NBU decision to hike its key rate is to curb inflation, we think this should **not have an immediate effect on inflation**. In fact, money transmission mechanism are still rather weak, while the bulk of inflation is happening due to non-monetary factors, ie, an administrative increase in prices.
- The imposition of a 15% tax on PI deposits should not induce a new wave of deposits outflow from banks** as there are no investment alternatives for households currently.
- The weaker effect of exchange-rate adjustments has not stopped inflation in July. At the same time, **inflation in July of 0.4% MoM (12.5% YoY) was considerably behind our forecasts of 0.9%**. We can explain the difference through the lesser effect of the increase in hot water and heating tariffs (by 6.9%) effective since July, while the actual hike was much higher. We think the Statistics office will postpone the inclusion of a hike in heating tariffs into CPI until heating season in October. **We expect rather mild inflation in August**, where the effect of an adjustment to hryvnia devaluation will counterbalance a seasonal decline in food prices. Hence, we do not see a small increase in CPI this month.
- Rather modest inflation in July may **delay for three to four weeks the decision to switch NBU policy to monetary tightening. This should keep medium- and long-term interest rates unchanged**, while short-term rates may show an additional slight decline for most of August. And despite weak headline CPI, core inflation is still strong, thus supporting our view of **more monetary tightening in the coming two months**.

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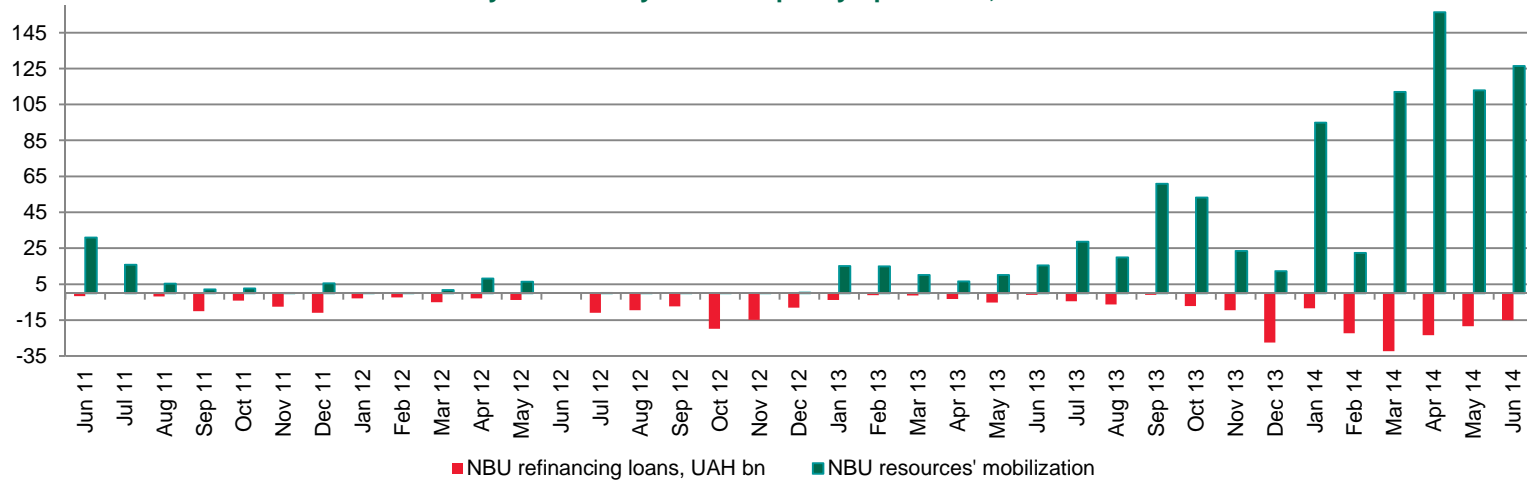
## Money Market



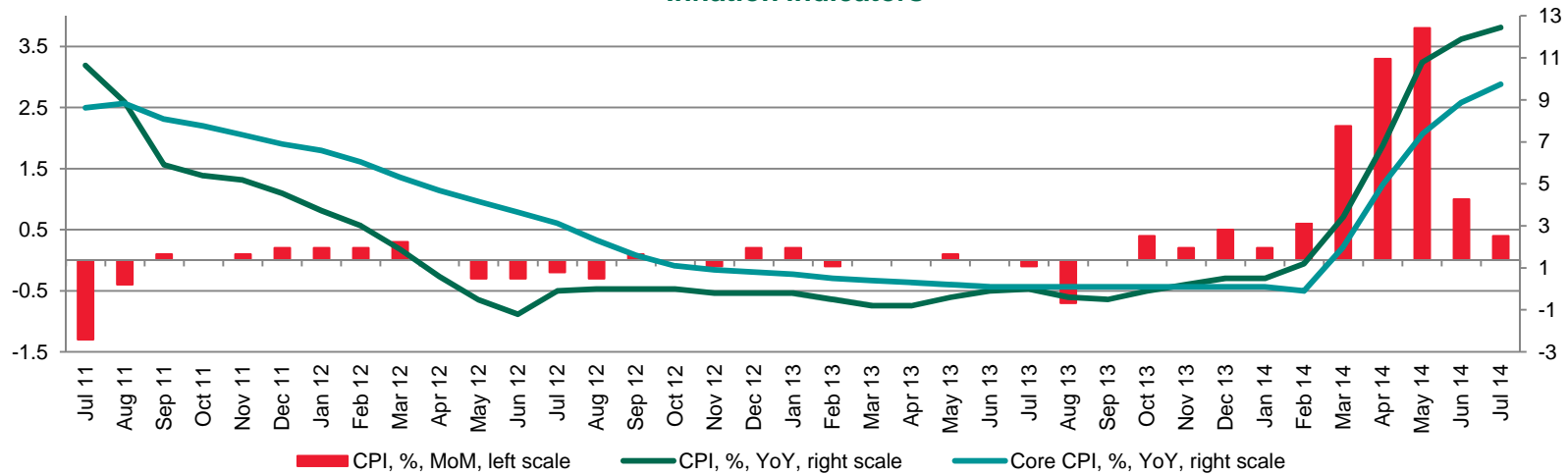
# Ukraine. Monthly Market Overview. August 2014

## Money Market

Monthly NBU money market liquidity operations, UAHbn



Inflation indicators



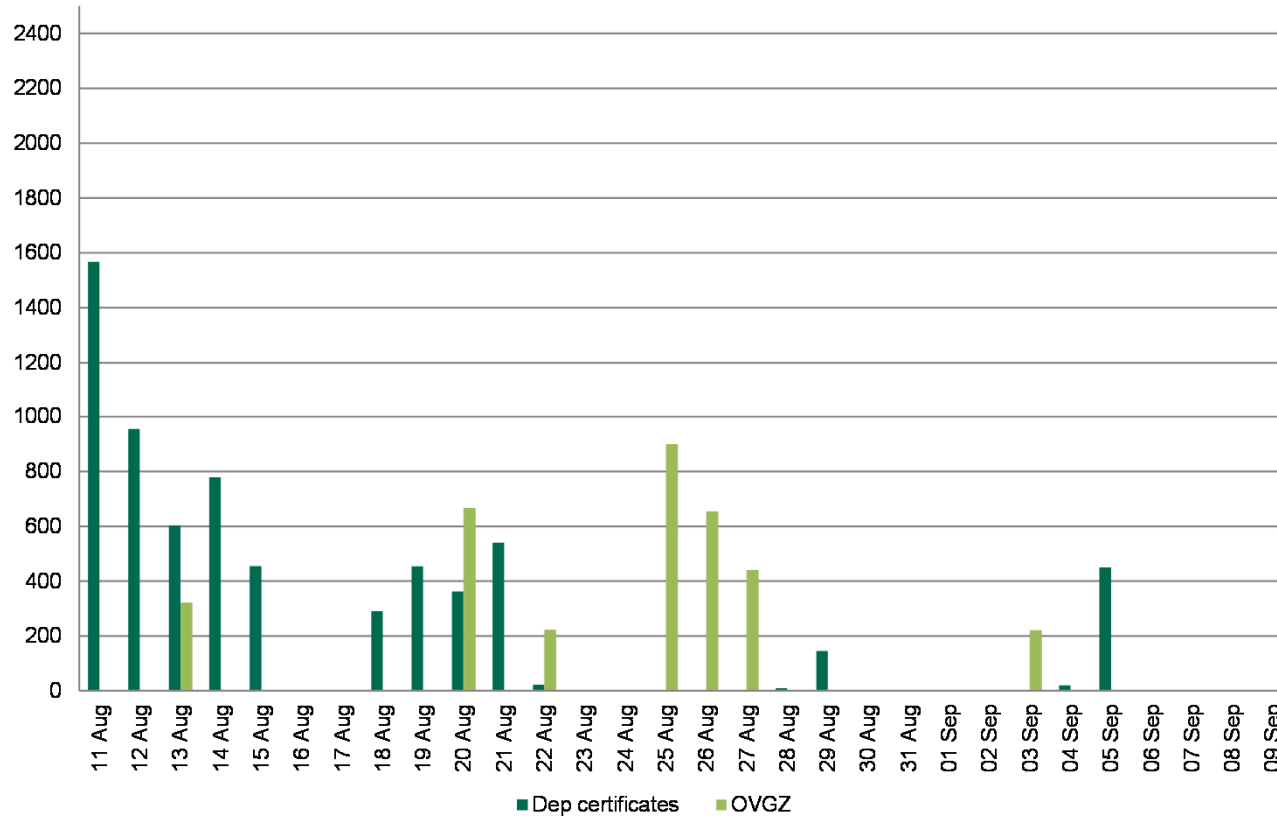
Source: State Statistics Committee

# Ukraine. Monthly Market Overview. August 2014

## Money Market

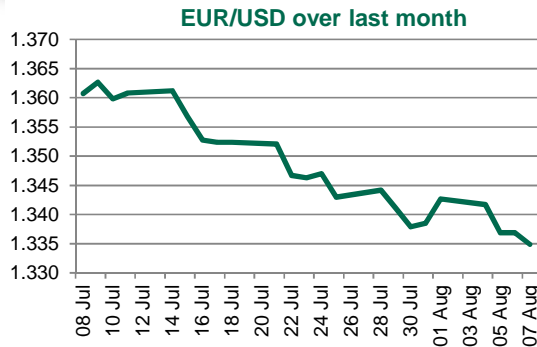


Liquidity inflow during upcoming month, UAH mn

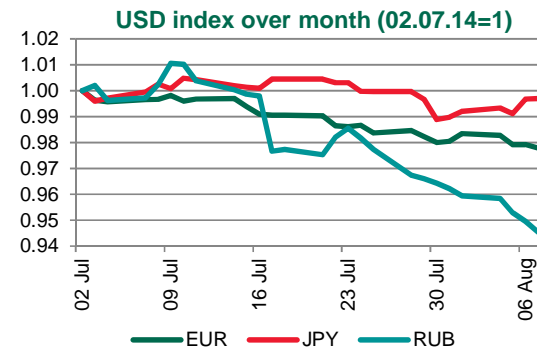


Sources: NBU, Finance Ministry, Credit Agricole

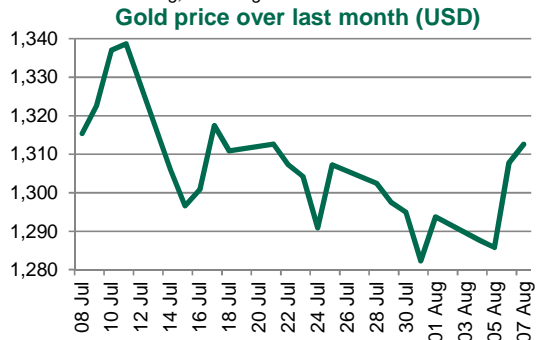
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Source: Bloomberg



Sources: Bloomberg, Credit Agricole



Source: Bloomberg

- The EUR/USD weakened to 1.3384 towards the end of the month. Eurozone headline inflation surprised once again on the downside in July, dropping to 0.4% YoY, its lowest reading since October 2009. The annual inflation rate could face further downside risk over the next two months as food and energy prices remain subdued.
- The USD is showing broad-based strength, supported by an improved economic outlook in the US coupled with firming inflation and labour market indicators that are shifting the focus toward monetary policy normalization at the US Federal Reserve. US yields have responded, providing for a fundamentally-driven USD rally on the back of interest rate differentials. Additionally, heightened tensions in the Middle East (linked to Israel's offensive into Gaza), deeper joint economic/financial sanctions against the Russian Federation by both the US and the European Union, and increasing violence in Syria have escalated geopolitical factors in the global risk equation, placing selective asset classes (emerging markets) on the defensive. Relative growth and structural liquidity provided by the deepest capital markets in the world are the primary factors supporting a bullish trend for the US currency. The US economy expanded by 4% on a quarter-to-quarter annualised basis.

The following are adjusted market forecasts:

**Crédit Agricole CIB EUR/USD forecast:**

Q314	Q414	Q115	Q215
1.3700	1.3200	1.3000	1.2900

**Consensus forecast (Bloomberg FC Poll by 91 strategists average)**

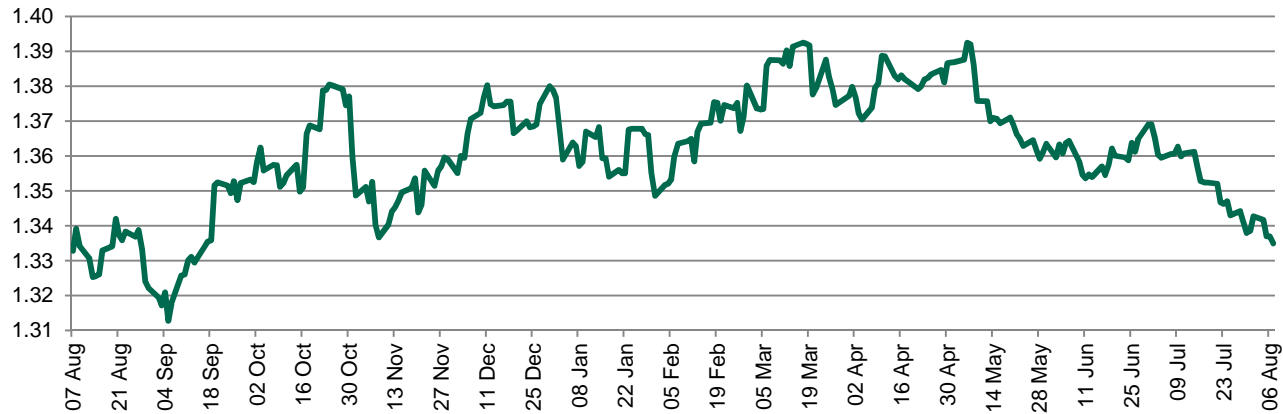
Q314	Q414	Q115	Q215
1.3400	1.3200	1.3000	1.2800



# Ukraine. Monthly Market Overview. August 2014

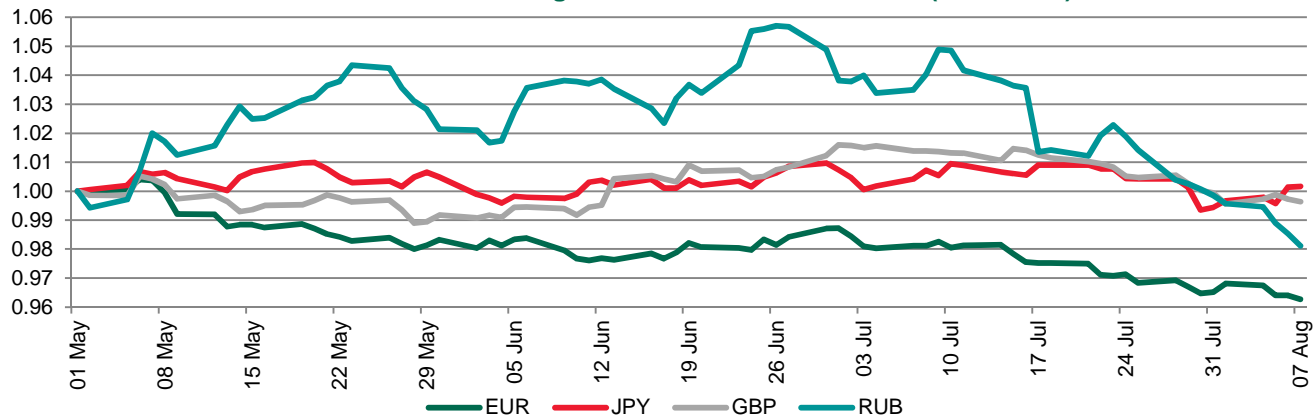


EUR/USD over last 12 months



Source: Bloomberg

Index of currencies against USD over last 3 months (01.05.14=1)



Sources: Bloomberg, Credit Agricole

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