

Ukraine. Monthly Market Overview

October 2014



Ukraine Sovereign Ratings

LCY rating	S&P	Moody's	Fitch
Long-term	B-	Caa1	CCC
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	22/08/14



Financial Markets team

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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	135	133
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	-8.5	0.3
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	19.6	9.1
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	-12.5	0.4
Merchandise 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	60.7	64.2
Merchandise 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	66.3	67.3
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	60.9	67.4
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	-3.8	-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	0.5	2.6

EXCHANGE RATES - evolution

USD/UAH eop	5.30	5.33	5.33	5.31	5.05	5.05	5.05	7.70	7.98	7.96	7.99	8.04	8.24	13.50	13.70
USD/UAH average	5.37	5.33	5.33	5.31	5.12	5.05	5.05	5.32	7.79	7.93	7.97	8.02	8.16	11.90	13.60
EUR/UAH eop	4.70	5.05	6.70	7.20	6.00	6.70	7.42	10.86	11.45	10.57	10.30	10.54	11.04	17.15	16.71
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	16.93
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	6.1	3.5

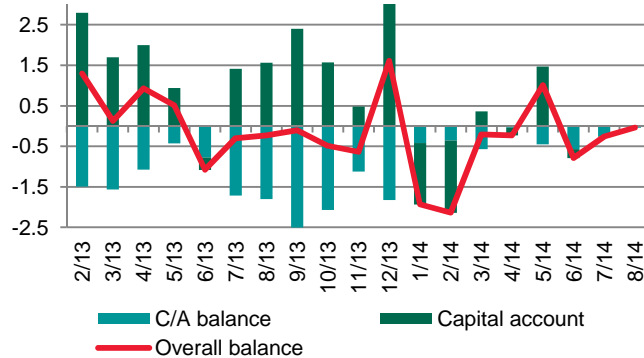
- Ukraine made additional step towards Euro integration in September. In particular, **both Ukrainian and European parliaments ratified simultaneously an association agreement**. And even though its full implementation is postponed till 2016, Ukraine still has some benefits. First of all, the EU will extend its duty-free regime for Ukrainian exports for an additional twelve months, while Ukraine will postpone the reduction of its duties for European imports for the same period. Additionally, Russian authorities promise not to impose additional duties against Ukrainian imports for a year. This definitely helps **smooth the external trade flow**.
- Ukrainian foreign partners consider worsening macroeconomic parameters for Ukraine this year because of the active conflict in eastern Ukraine. Hence, they are ready **to provide additional financial assistance**. In fact, in September Ukrainian president agreed on the possibility of providing an **additional USD1.0bn of financial guarantees through the US government**, while the **WB is ready to provide the second tranche (USD0.5bn) of its loan this year**. This should provide more inflow of foreign currency to stabilise the capital account of the BOP in 2014.
- Even though the ceasefire regime continues in eastern Ukraine, terrorists are still active in their attacks on Ukrainian armed forces, thus **keeping geopolitical risks elevated**. Hence, the probability of a renewal of an active war operation is quite high in the coming month or two.
- We consider **upcoming parliamentary elections (scheduled for 26 October)** as an important step towards reforming political structure in the country, thus allowing Ukraine to accelerate its Euro integration movement. This was a major goal of the recent revolution in Ukraine.

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Major Macroeconomic Trends

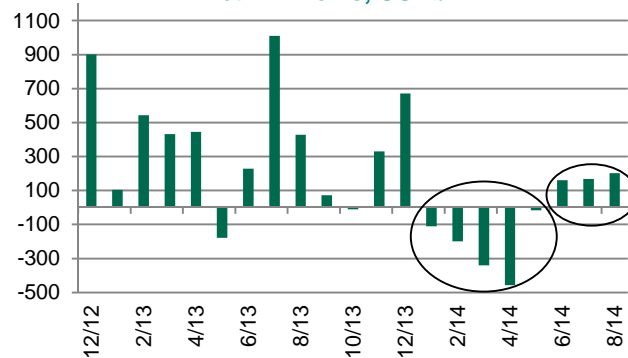


Major accounts of BOP, monthly dynamics, USDbn



Sources: NBU, Credit Agricole

Net FDI flows, USDbn



Sources: NBU, Credit Agricole

Forecast	GDP, YoY
Q314	-11.2%
Q414	-13.5%
Q115	-5.2%
Q215	0.9%

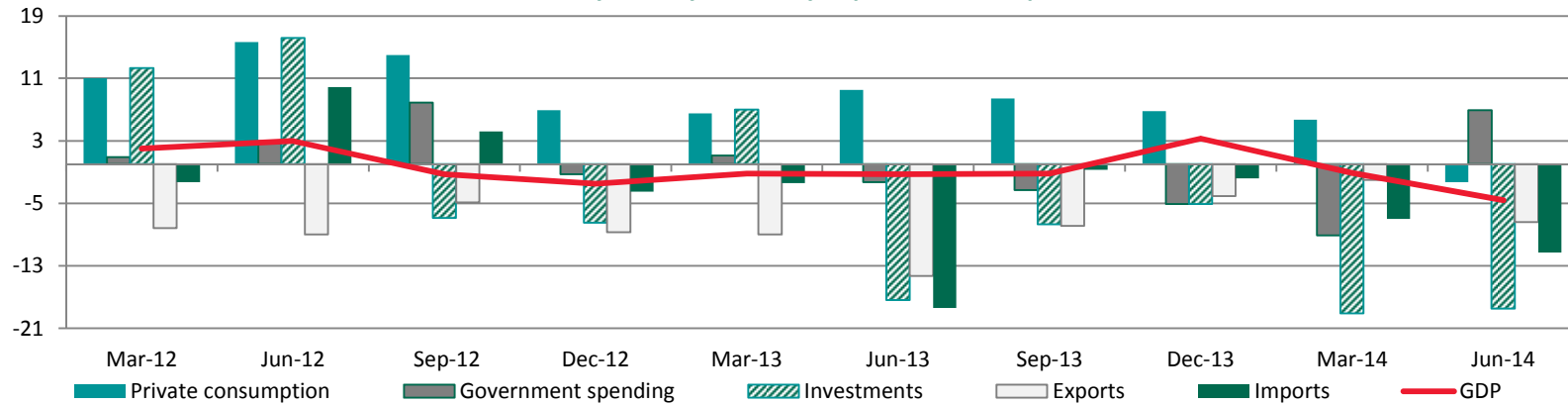
Source: Credit Agricole

- **Macroeconomic indicators showed the worst performance in most of sectors in August**, with the industrial sector recording the sharpest worsening in August (-21.4% YoY) compared to the previous month's figure (-12.1%). Other sectors have also suffered from the active conflict in eastern Ukraine, including trade (-17.1%) and construction (-37.1%). Agriculture remained the only bright spot in the domestic economy in August, by demonstrating an upturn of 13.6% YoY.
- **The decline in domestic economy will continue in the coming months.** However, **an increase in domestic steel output in September in MoM terms** (mostly because of growing output of steel mills not located in the zone of conflict) sends the first positive signal of a potential recovery.
- **Current account was almost fully balanced in August**, by showing just a USD0.04bn deficit. We can attribute the figure to a more significant drop in imports (-42.4% YoY) versus exports (-17.3%). A rather substantial decline in merchandise exports is entirely **tied to the active conflict in eastern Ukraine as well as the 'trade war' initiated by Russia.**
- **Capital account was fully balanced in August**, while the geopolitical situation and some strange NBU actions also affected the figure negatively. **In particular, the decision of the National Bank to increase the mandatory foreign currency sale to 100% has dramatically reduced the inflow of foreign currency under external loans.** As this measure was quite sensitive to the corporate segment, the roll-over ratio of external debt in this segment dropped to 61% in August from 86% the month before. On a positive note, the banking sector rollover ratio remained high (96%). Additionally, the **net FDI figure was positive in August (USD0.2bn) for a third month in a row**, thus reaching a three-month maximum.
- **We should see the improvement in the BOP in the near future.** In particular, the CA balance will remain rather balanced, while additional hryvnia devaluation recently should reduce imports further. In addition, the decline in mandatory foreign currency sale to 75% should improve the inflow of foreign currency in corporate segment.
- The quite strong negative effect of the active conflict in eastern Ukraine on domestic economic performance in August, as well as a grim outlook regarding the potential recovery of any economic activity in the conflict zone in the coming half a year **forced us to downgrade our whole-year GDP forecast to -8.5%. We also downgraded our forecast of GDP growth in 2015 to just 0.4%.**

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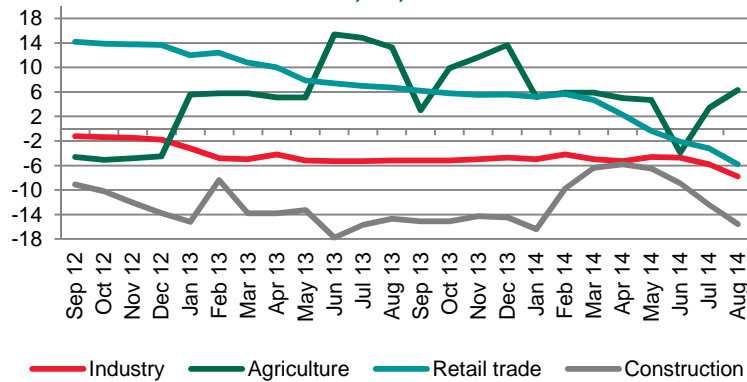
Major Macroeconomic Trends

Quarterly GDP dynamics by expenditure components, %, YoY



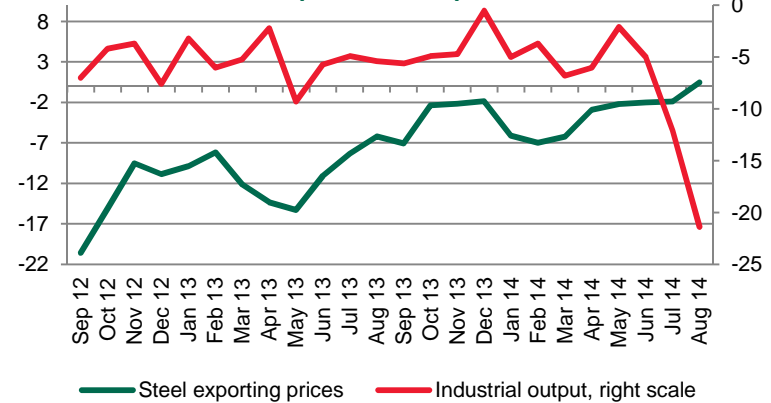
Sources: State Statistics Committee

Performance of major economic sectors, YTD, %, YoY



Source: State Statistics Committee

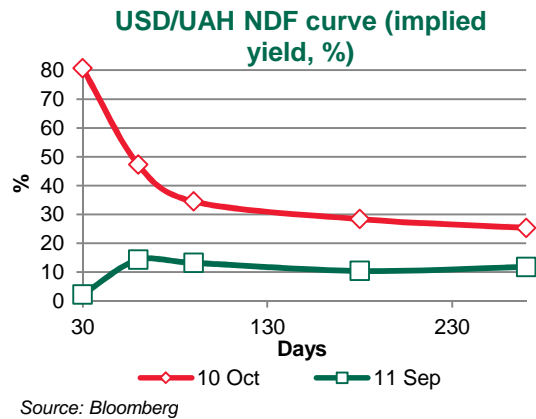
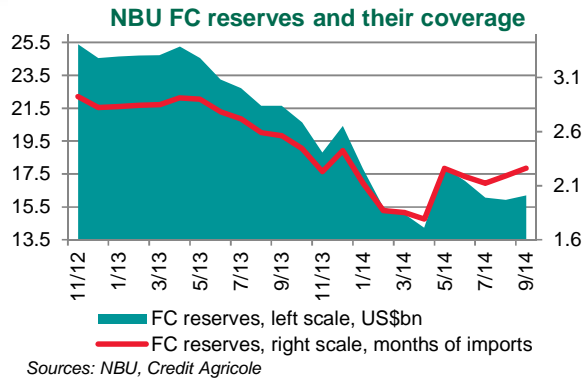
Industrial output and steel prices, %, YoY



Sources: State Statistics Committee, Bloomberg, Credit Agricole

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FX Market



Forecast, eop	USD/UAH	EUR/UAH
Q4'14	13.50	17.15
Q1'15	13.60	17.00
Q2'15	13.40	16.75
Q3'15	13.70	16.85

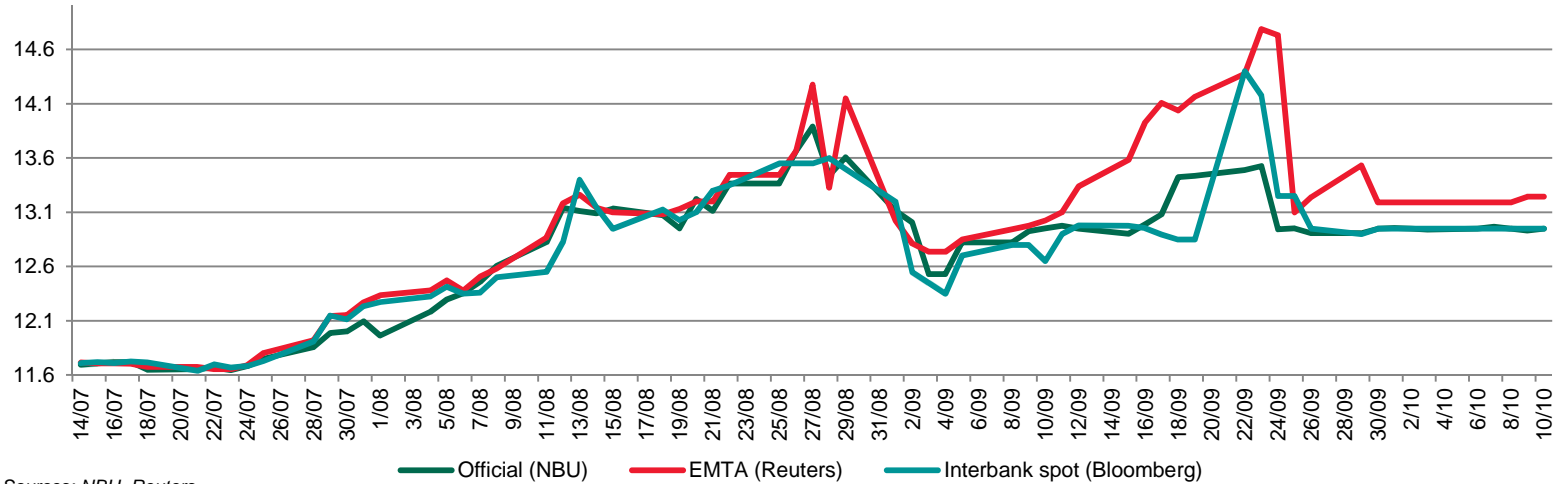
Source: Credit Agricole

- The FX market was quite volatile for the majority of days in September, despite new administrative restrictions of the NBU and foreign currency inflow from international donors. **The USD/UAH peaked at 14.7875 at the end of September, thus forcing the NBU to switch to an almost manual regime of currency regulation.** In particular, **the NBU ordered a USD/UAH of 12.95 as a temporary equilibrium**, by forbidding banks to quote any rates above the targeted one. The National Bank also imposed a ban on divestments abroad and reduced the limit on foreign currency sale to individuals via cash outlets, by trying to restrict potential foreign currency demand.
- NBU officials said new restrictive measures on the FX market were discussed with the IMF. Hence, **these measures should not reduce the probability of the new IMF loan tranche's disbursement.** At the same time, this definitely means they should be softened (or fully removed) as soon as market devaluation concerns are reduced. We also do not exclude the possibility of seeing new restrictive measures in the near-term.
- The National Bank recently corrected its previous foreign currency restrictions that negatively affected the inflow of foreign currency into the country.** This includes the reduction of mandatory foreign currency sale from 100% to 75% as well as no mandatory foreign currency sales on individuals' transfers from abroad. For example, the volume of transfers in August dropped sharply to just USD55m from USD137m in July as a reaction to imposition of their mandatory foreign currency sale.
- New administrative measures of the NBU and manual control over the rate moved most market indicators as well as banking deals to a USD/UAH of 12.95. Of course, **artificial restrictions created temporary market imbalances.** In fact, foreign currency supply is still weak due to both a reduction in export proceeds (mostly in steel and chemical sectors) and postponement of its sale by exporters. However, foreign currency demand was strengthened on the back of devaluation concerns. Hence, **excessive foreign currency demand remains unsatisfied and is constantly postponed for the next trading session.** We think the situation will improve as soon as devaluation concerns are reduced, while the NBU should show its constant support to the market.
- Among market instruments of hryvnia support the NBU decided to do both **FC auctions (mostly to replenish banking cash desks) and FC interventions (to satisfy bids of banking clients).** FC auction for cash replenishing proved to be effective for the cash FX market, thus inducing a gradual reduction of the USD/UAH rate there. However, **constant auctions for a few months in a row are needed in order to reduce devaluation concerns in this segment of the market.**
- NBU reserves increased by 1.7% to USD16.2bn in September** due to an inflow of loans from both the IMF and the WB. However, a purchase of foreign currency by Naftogaz on 1 October, as well as continuing NBU FC interventions, will **worsen this figure again in October.**
- Current interbank market sentiment, the dynamic of the unofficial cash FX market as well as worsening fundamentals due to the conflict in eastern Ukraine forced us **to downgrade our year-end USD/UAH forecast to 13.50.** This movement may be accompanied by a softening in some NBU administrative restrictions regarding the FX market by year-end. We also consider the inflow of additional financial assistance in the coming months that should stabilise the capital account of the BOP. At the same time, **we predict unchanged USD/UAH at 12.95 at least until after the elections** scheduled for late-October.

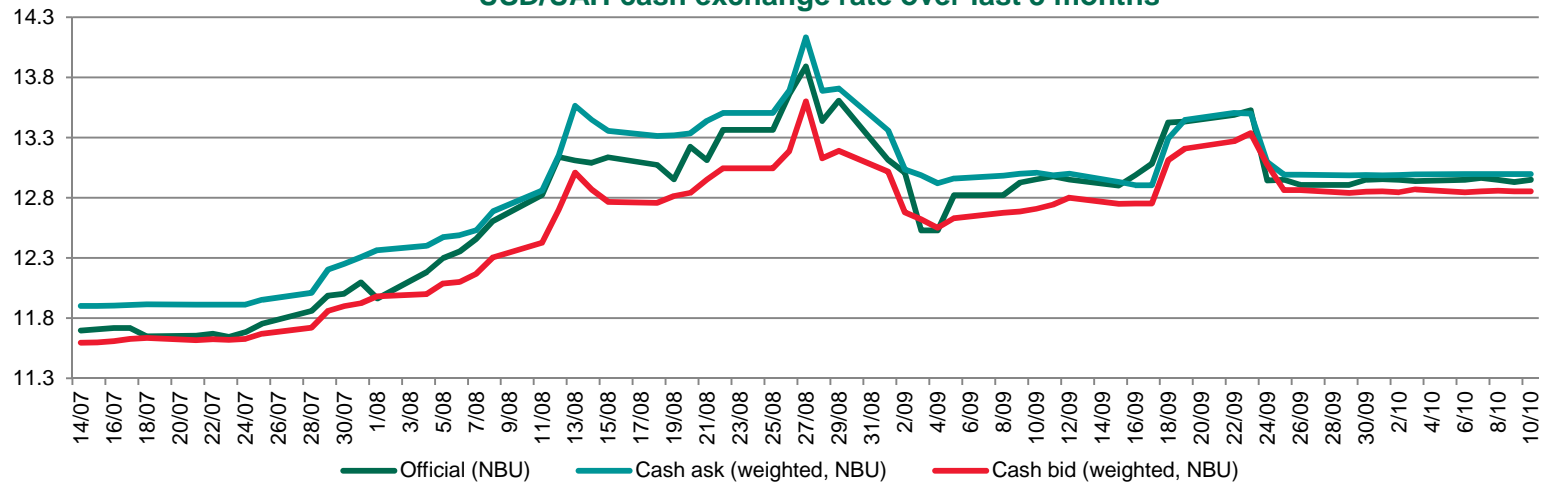
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FX Market

USD/UAH interbank exchange rate over last 3 months

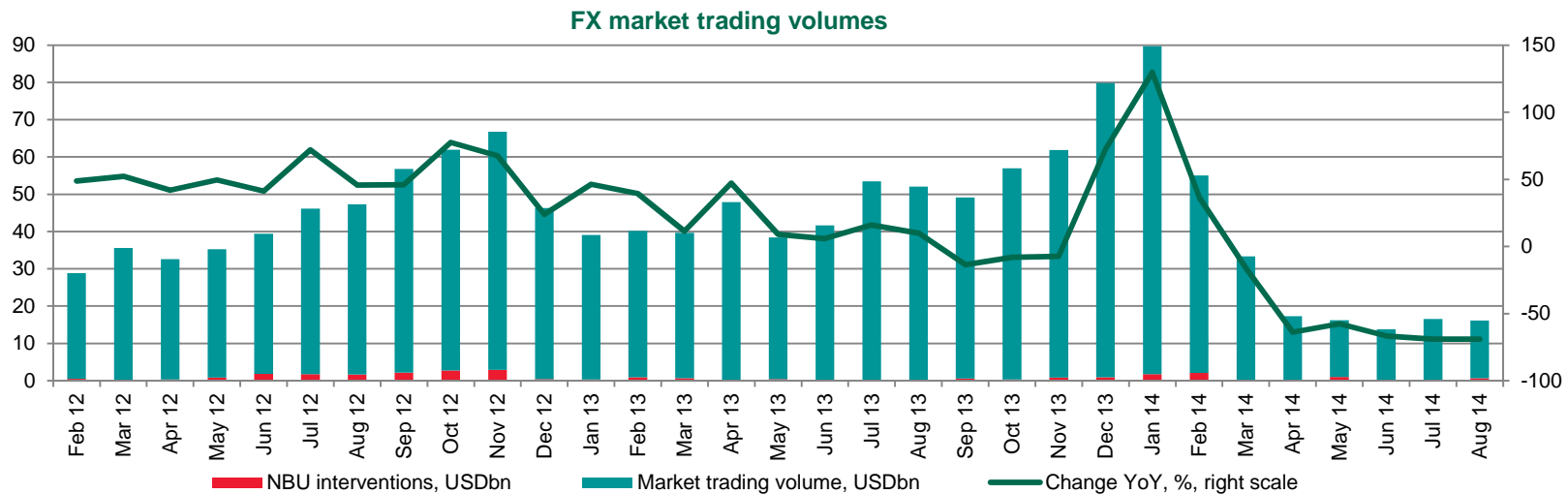
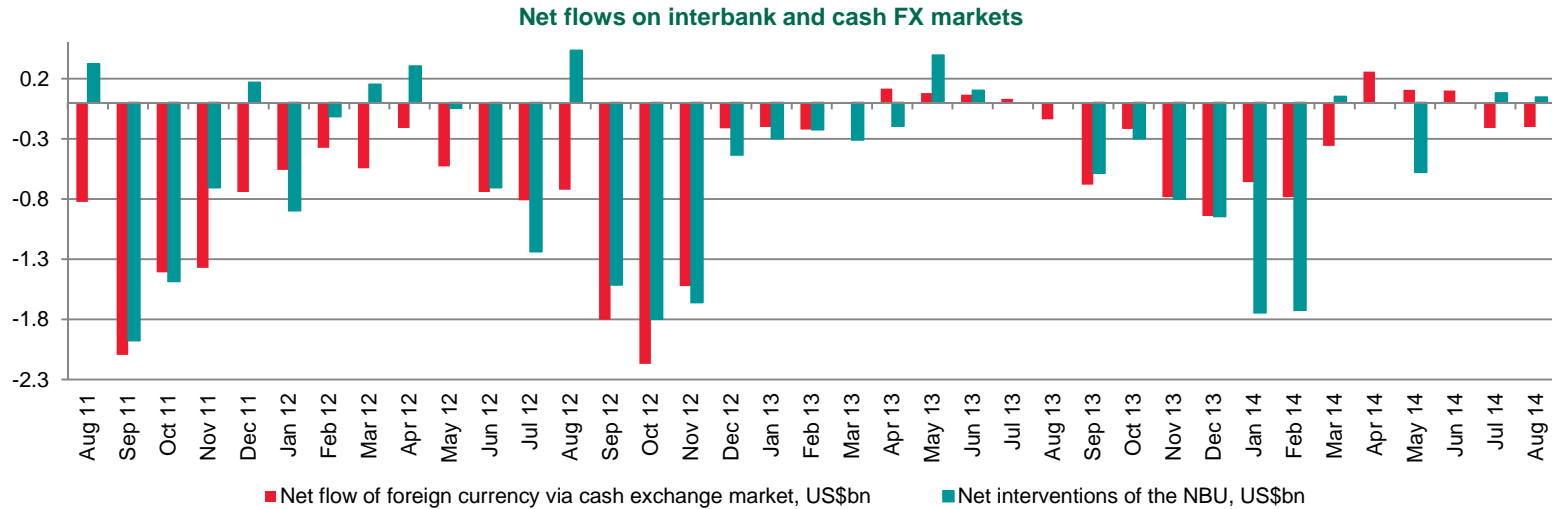


USD/UAH cash exchange rate over last 3 months



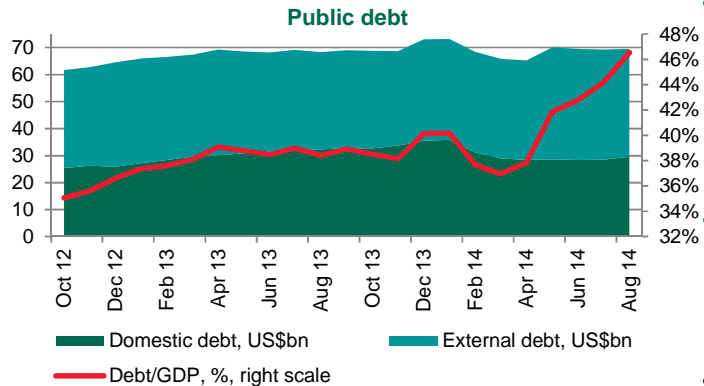
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FX Market

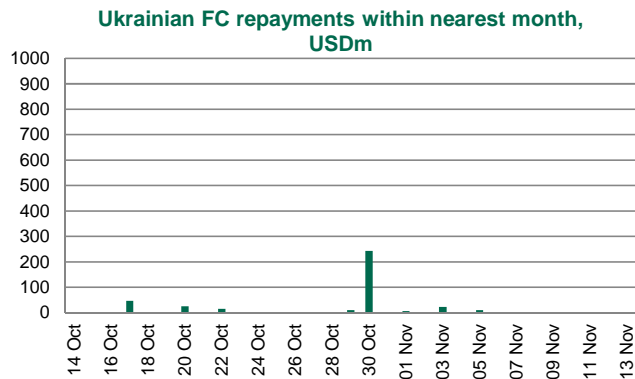


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Debt indicators



Sources: Finance Ministry, Credit Agricole



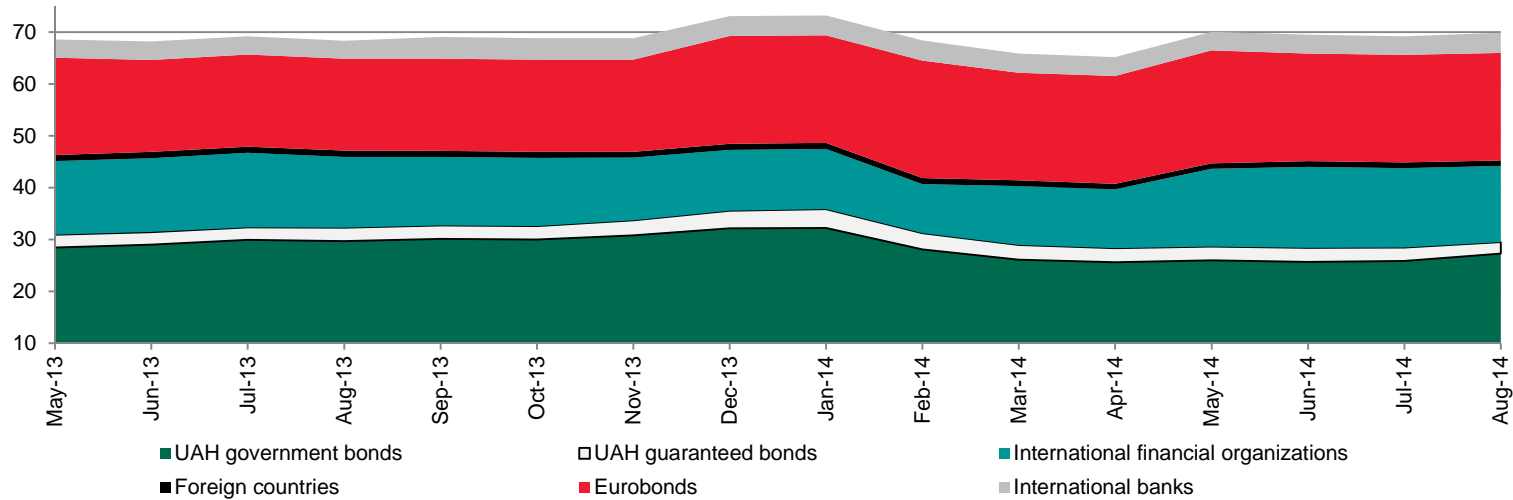
Sources: Finance Ministry, Credit Agricole

- Public debt expanded moderately in August** (by 1.70% MoM to USD69.5bn) on more active domestic borrowings. However, the increase in domestic debt (by 3.6% to USD29.5bn) was not yet tied to a bountiful interest of private investors to domestic government bonds. Instead, this was **rather technical issuance of government bonds worth UAH46.7bn to finance Naftogaz** in order to prepare the company ahead of paying its Eurobonds at the end-September. We also think Naftogaz will use the funds borrowed as repayment for its gas arrears to Russia (in case of successful gas negotiations). External public debt faced a modest slide in August 1.8% mostly due to a repayment of the IMF loan.
- We expect rather flat dynamics in public debt in September** due rather small volumes of hryvnia borrowed through the domestic bonds auction. **External debt should also remain mostly unchanged over the month** even though there had been large fluctuations of it throughout the month. In particular, the IMF has disbursed its second-tranche (USD1.4bn) of a stand-by loan in early September, while the government repaid USD1.6bn on Naftogaz Eurobonds at the end of September.
- A sharp contraction in the domestic economy continues to hamper the **debt-to-GDP ratio, which surged to 46.5% in August** from 44.2% the month before. We think the trend will continue, at least for this year. Constant worsening in the domestic economy, as well as additional external borrowings **will drive debt-to-GDP further up to 60.6% of GDP for the whole year**, in our view.
- Continuing escalation of the conflict in eastern Ukraine and a corresponding contraction in Ukrainian exports **forced Ukraine to appeal to foreign partners to increase the volume of financial assistance** this year. In particular, the US government is ready to provide an additional USD1.0bn as a financial guarantee. Hence, we can see new a Eurobonds issue in the coming months. The government also issued Eurobonds in CAD, we attribute that to the readiness of Canadian investors to purchase this issue. The WB also considered the possibility of a disbursement of its second tranche (USD0.5bn) of a financial loan this year. **Even though all these flows are already excessive in terms of planned debt repayments this year they should support the BOP**, thus reducing some concerns for further UAH devaluation.
- The debt repayment schedule for the coming 12 months is rather mild** for the government with the total amount to be paid at USD6.9bn. A quarter of these repayments to IMF (with a rather high probability to be refinanced), while half is represented by payments for local FC bonds. As most FC bonds are owned by domestic banks (including state-owned ones), we think they will have rather a high rollover ratio. Hence, **the risk of a public default is tiny in the coming 12 months**. Moreover, the **risk of any restructuring efforts of the government may be rather small currently**. Even in case there will be such ideas, the government probably will have to receive approval from the IMF on any restructuring deals.
- In case Ukraine renews gas negotiations with Russia, we think the top priority for the government will be **the redemption of a USD3.1bn gas debt to Gazprom until year-end**, including USD2.0bn until October (according to preliminary agreement). However, **this should not be a huge problem for the government as it already has a bulk of this amount (around UAH26bn) on Naftogaz accounts**.

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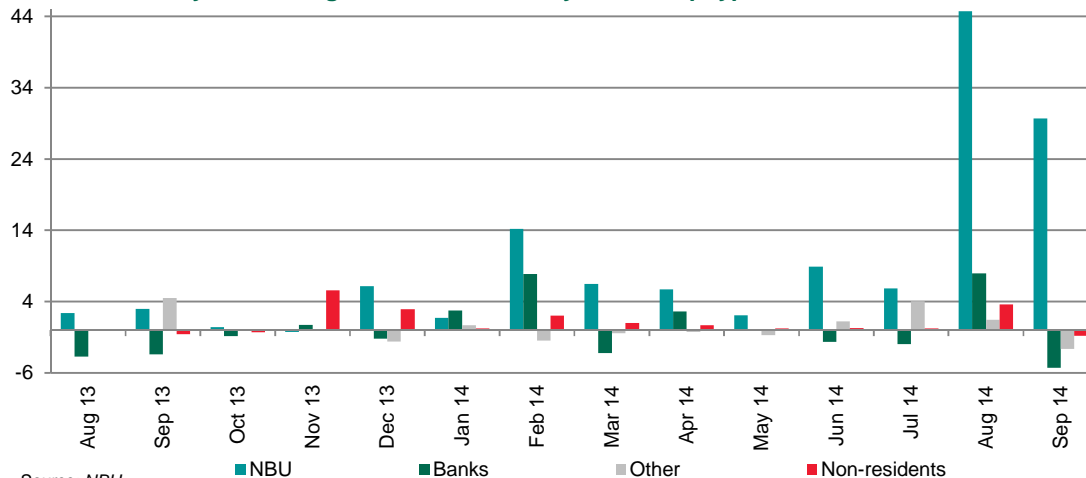
Debt indicators

USD nominated public debt by components, USDbn



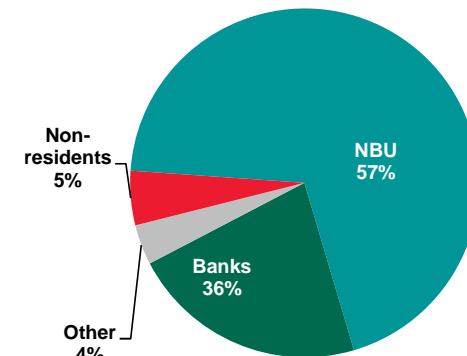
Source: Finance Ministry

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



Source: NBU

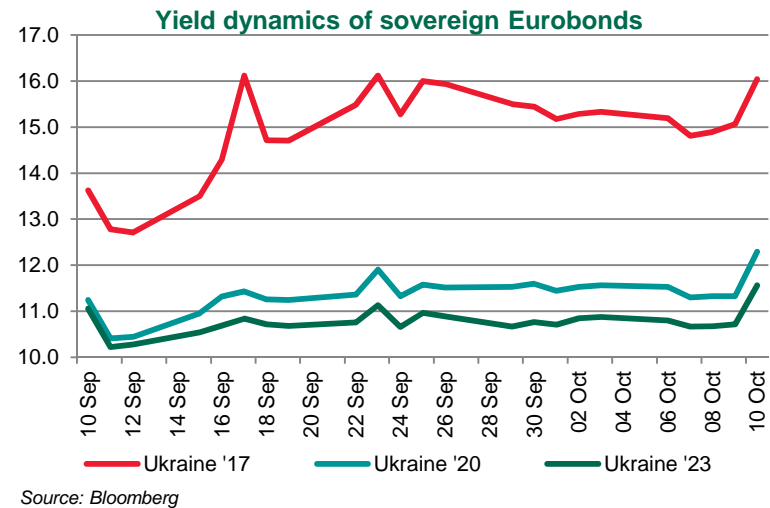
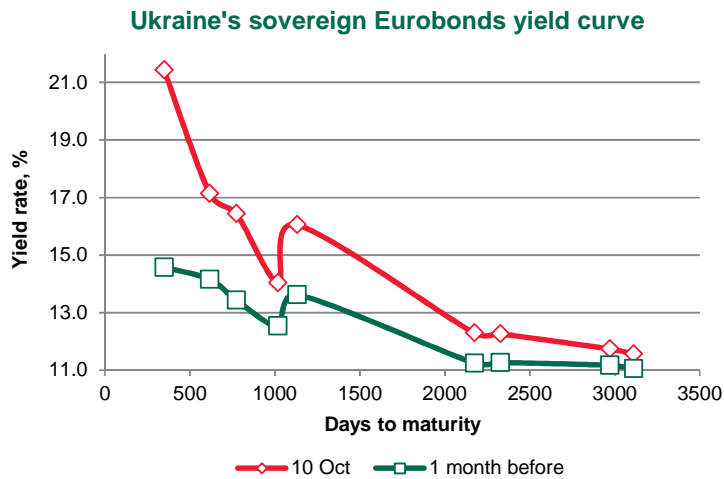
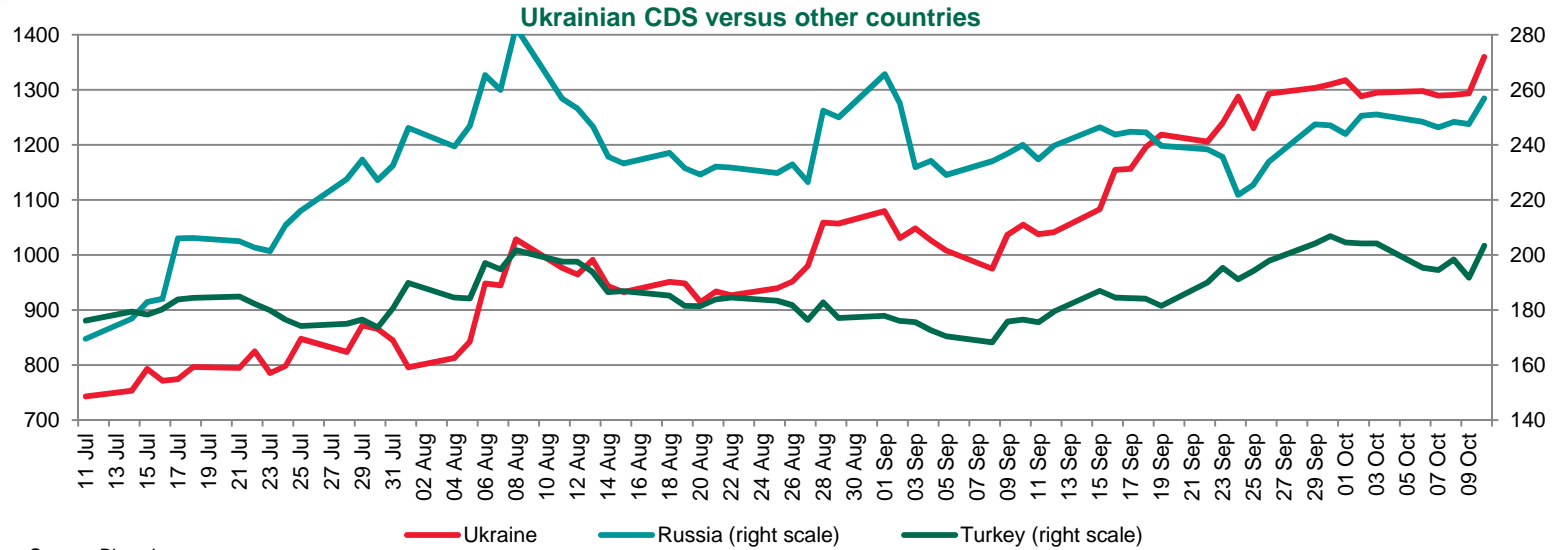
Breakdown of OVDP by owners (as of 10 Oct)
Total volume - UAH386bn



Source: NBU

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Debt indicators



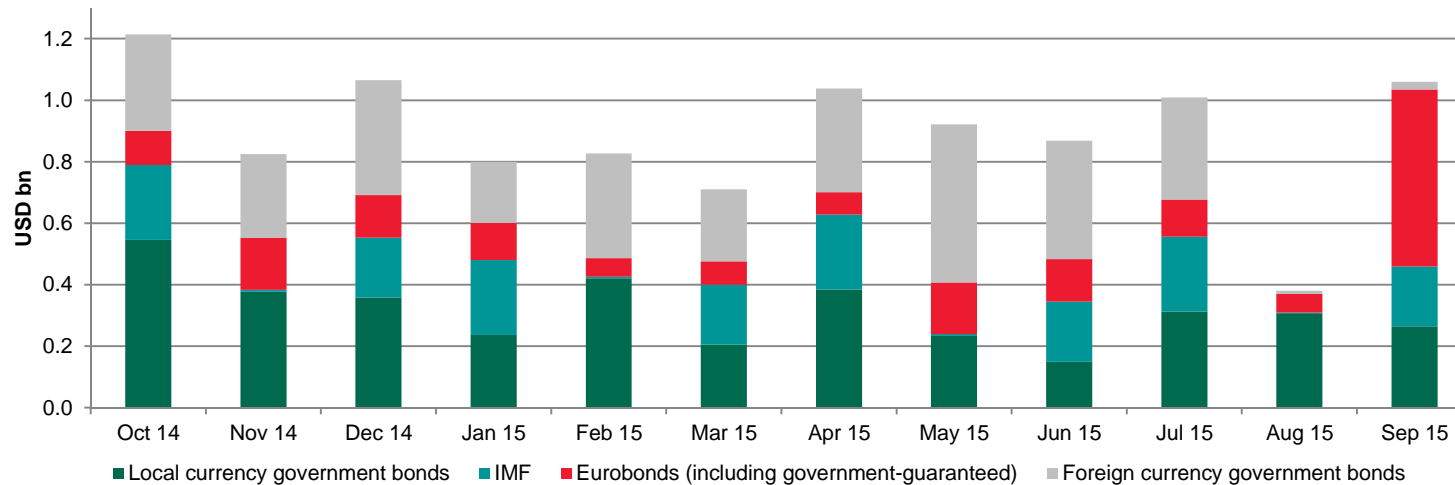
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Debt indicators



USDbn	Q414	Q115	Q215	Q315	2014
Repayment of FC-denominated public debt	1.9	1.7	2.3	1.9	11.0
Foreign currency local government bonds	1.0	0.8	1.2	0.4	2.2
IMF debt	0.4	0.4	0.4	0.4	3.7
Eurobonds (including state-guaranteed)	0.4	0.3	0.4	0.8	4.1
Other	0.1	0.2	0.3	0.3	1.0

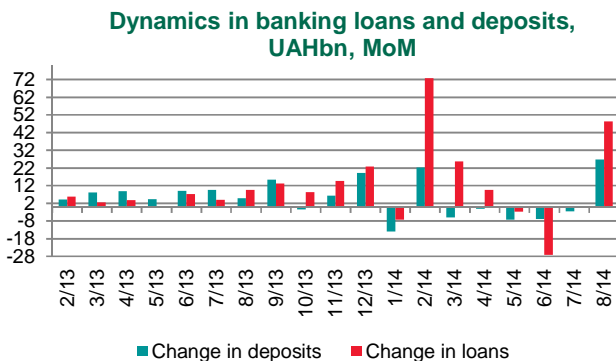
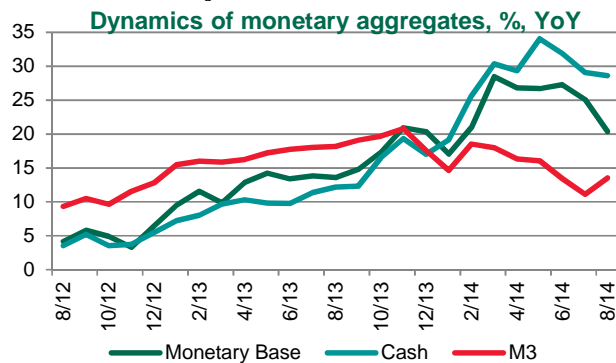
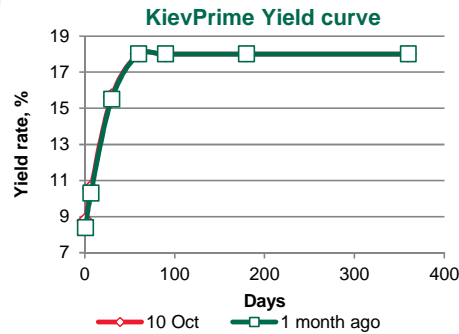
Major repayments on public debt within nearest 12 months



Source: Credit Agricole

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Money Market

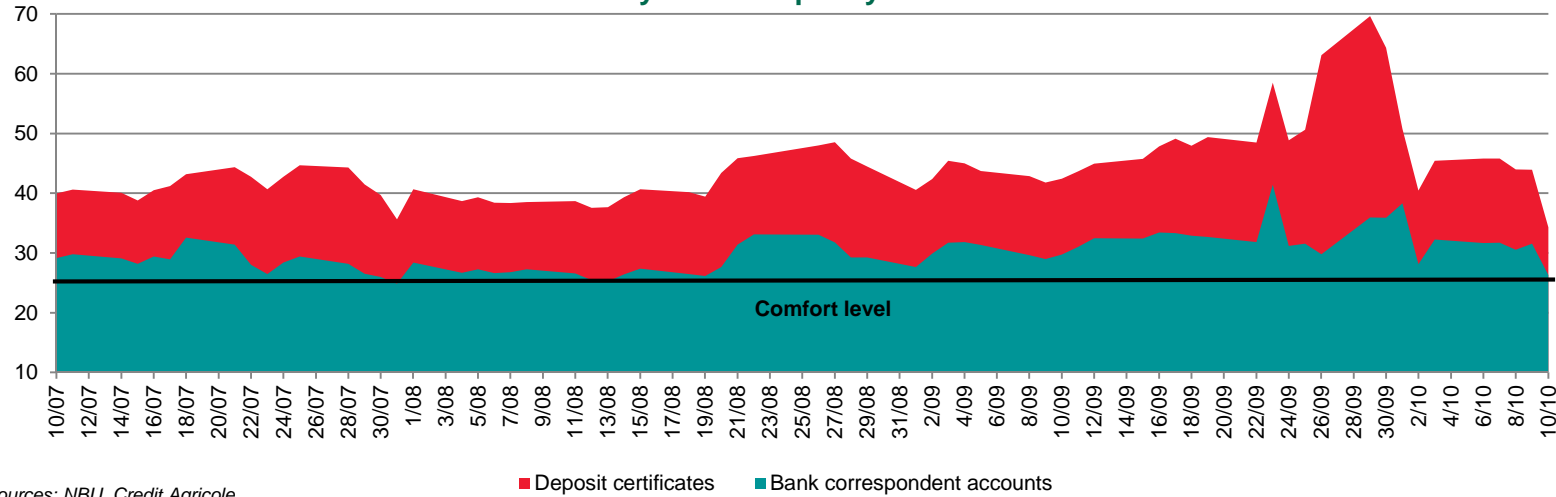


- **Banking system quick liquidity was quite volatile over the last month**, this volatility is entirely tied to operations between state institutions and thus did not involve the money market dynamic. In turn, the money market was quite excessive in hryvnia. The average volume of banking balances with the NBU did not drop below UAH27bn in September, while UAH25bn is still a minimum comfort level for the banking system. This allowed **rates to remain relatively flat over the whole month** (O/N at 8.0-8.8%, 1W at 10.1-10.8%).
- **The volume of money supply growth is quite significant this year.** In particular, the volume of NBU refinancing under government bonds' collateral has been increased by UAH80.2bn over Q314. And the deduction of a net increase in the stock of NBU CDs of UAH20.9bn, as well as a payment for Naftogaz Eurobonds, still leaves the inflow of hryvnia into the banking system at UAH35bn over the last quarter.
- **NBU estimates recapitalisation needs for nine out of the top 15 banks at UAH56bn.** The estimate was done after stress-testing checks implemented by both the NBU and IMF over the summer. The list of banks facing liquidity problems was not disclosed. In case owners of certain private banks will not be able to recapitalise them, we think the government will have to do this, according to an IMF memorandum. We think this may be done, as usual, through a OVGZ issue. This **should additionally increase liquidity in the banking system**, thus theoretically preventing rates from any sharp hikes in Q414.
- Even though there are few arguments for any sharp hikes in interest rates in the coming months, the **rather dangerous situation on FX market still provides a solid reason for potential monetary tightening by the NBU in the near-term.** Because existing administrative instruments to control exchange rate stability are not fully effective in keeping hryvnia stable, **the probability of monetary tightening is growing** as this should be a solid instrument for reducing potential foreign currency demand. In this case, we can still see a sharp increase in the cost of short-term monetary resources.
- **Banking deposits are still on a declining track** due to geopolitical concerns, the bankruptcy of small banks as well as due to high devaluation fears on FX market. As **we still expect the trend to persist at least in the coming month or two**, this should keep short-term PI deposit rates high.
- **Headline CPI made a rather unexpected hike in September (2.9% MoM, 17.5% YoY)** versus consensus forecasts of 2.1% MoM and 16.0% YoY. We think **the second wave of hryvnia devaluation, a seasonal increase in food prices, as well as a hike in excise duties for tobacco products** have been the core reasons behind the increase in consumer prices last month.
- **The start of the heating season may provide an additional hike in inflation** in October or November due to the increase in heating tariffs. As a result, **we had to downgrade our year-end CPI forecasts to 19.6%.** The current inflation dynamic and the grim outlook for it in the coming two to three months provides a solid signal for the NBU **to tighten its monetary policy in the medium-term.**

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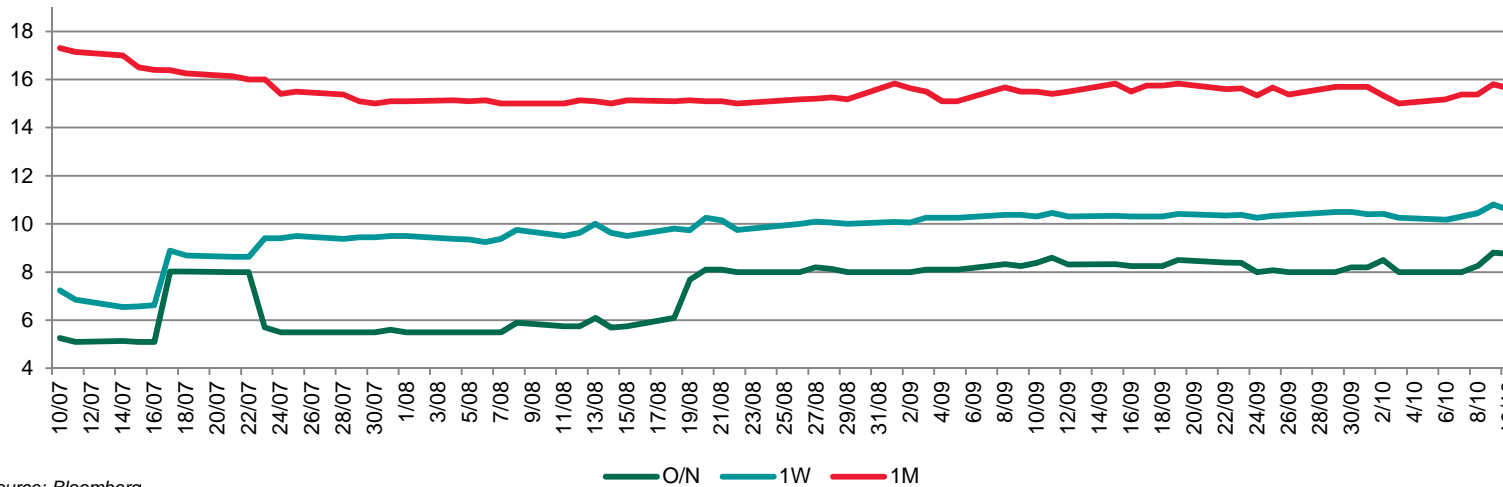
Money Market

Money market liquidity over last 3 months



Sources: NBU, Credit Agricole

KievPrime rates over last 3 months

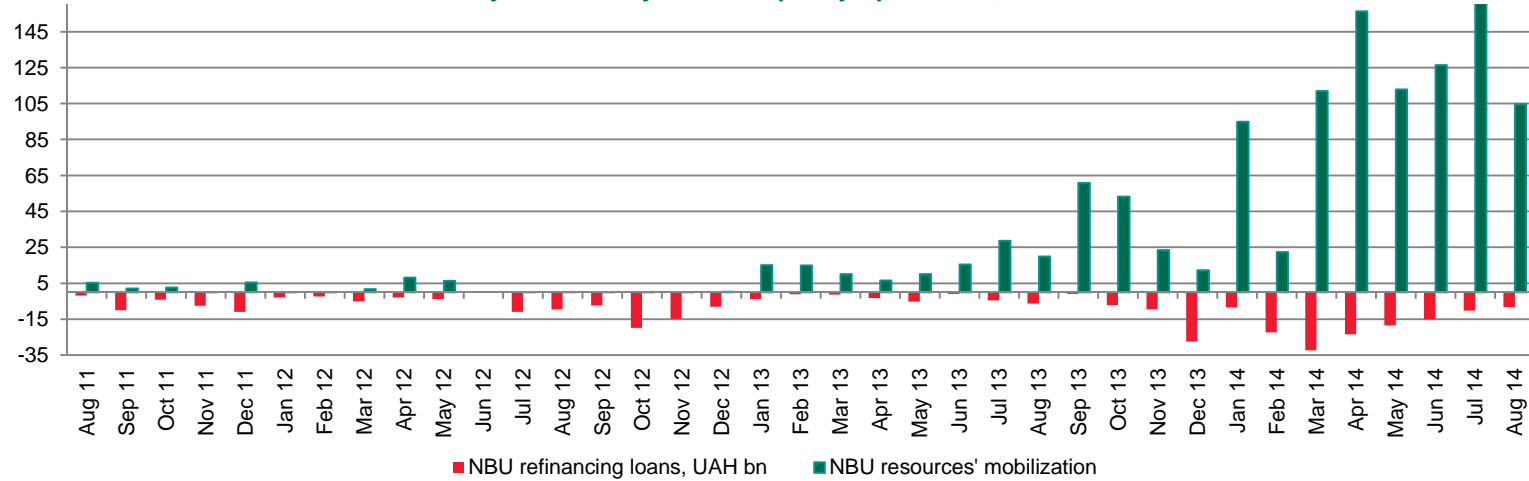


Source: Bloomberg

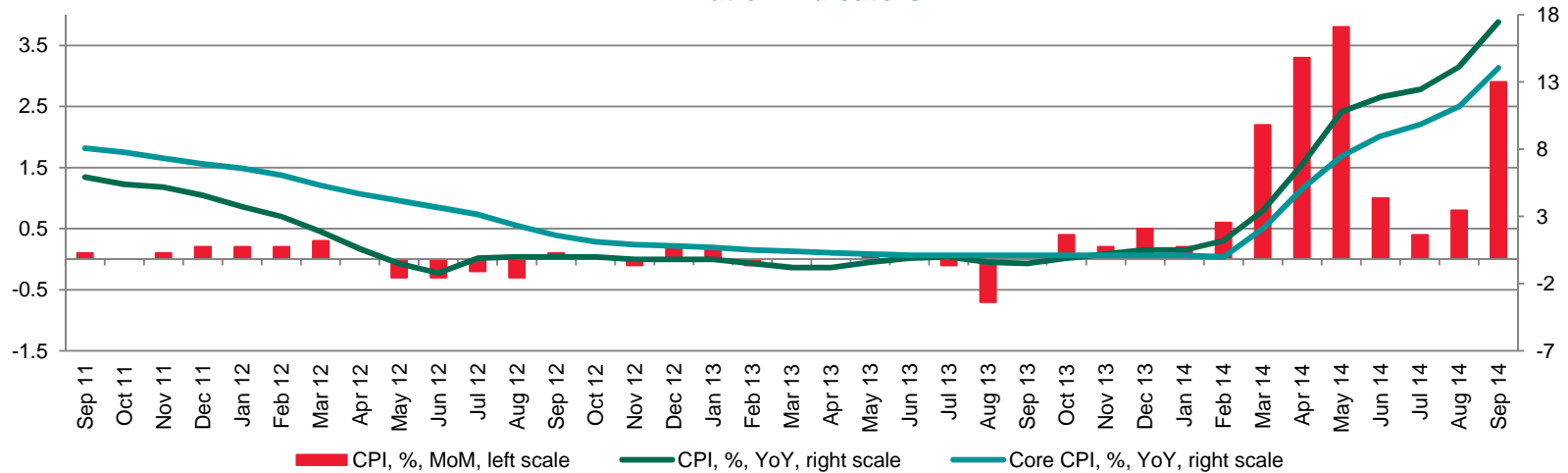
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Money Market

Monthly NBU money market liquidity operations, UAHbn



Inflation indicators



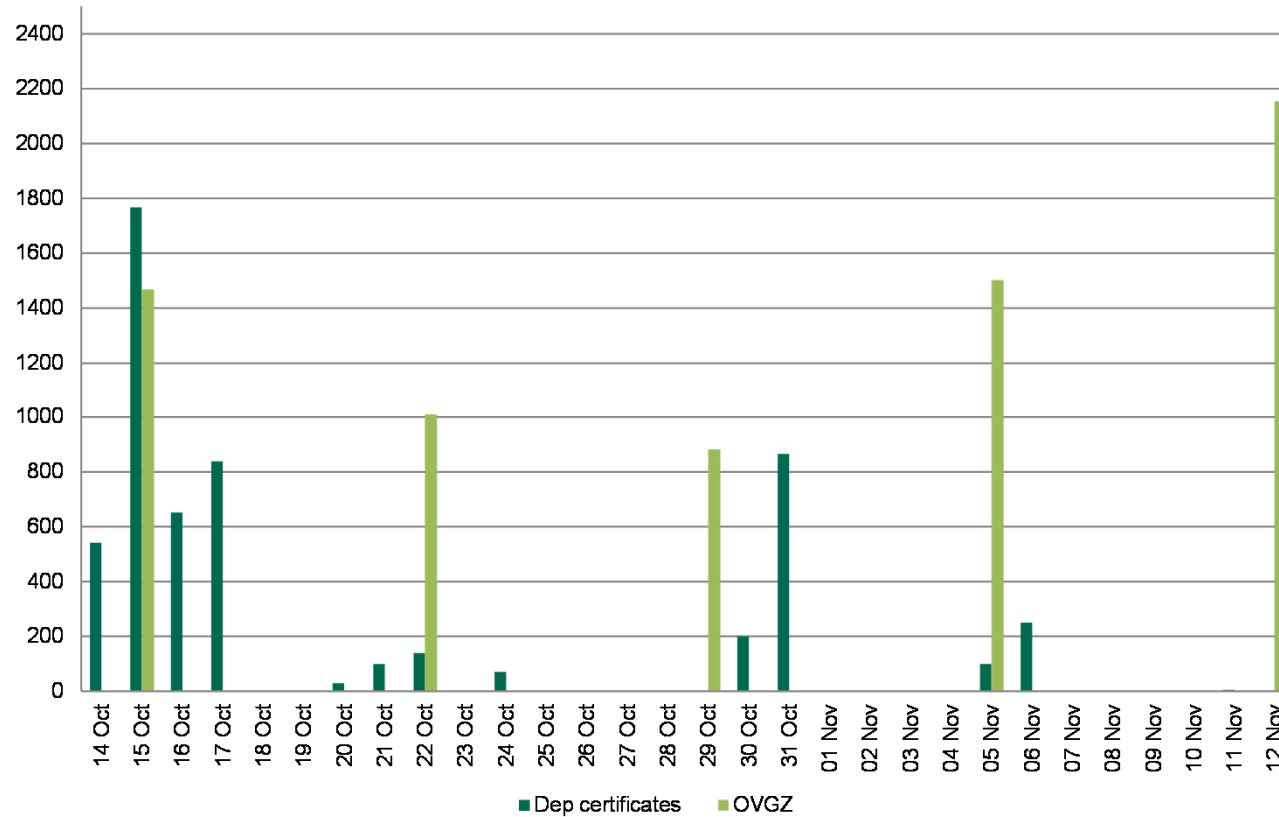
Source: State Statistics Committee

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Money Market

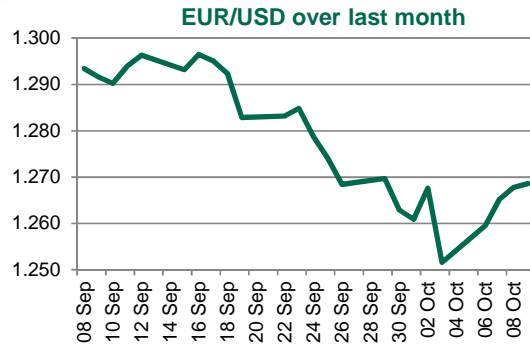


Liquidity inflow during upcoming month, UAH mn

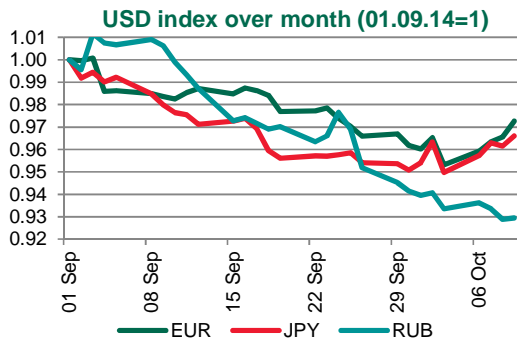


Sources: NBU, Finance Ministry, Credit Agricole

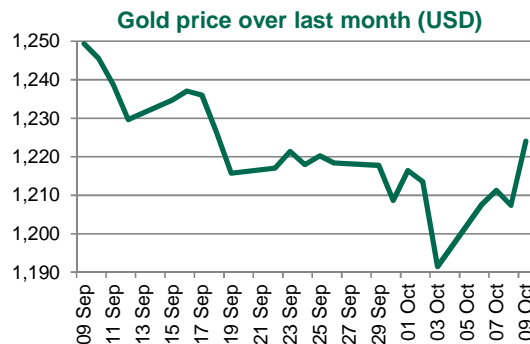
Ukraine. Monthly Market Overview. October 2014



Source: Bloomberg



Sources: Bloomberg, Credit Agricole



Source: Bloomberg

- From the current levels we see limited room of any further increase in ECB easing expectations. Although central bank President Draghi is keeping all options regarding additional policy easing open, he also stressed that the latest measures may be sufficient in order to reach price stability anew. It must be noted too that Governing Council member Weidmann just recently indicated that inflation is unlikely to fall further from current levels. All of the above suggests that more aggressive policy measures, such as quantitative easing, are unlikely anytime soon. Accordingly ECB rate expectations have stabilised and appear poised for a further reassessment in the coming week.
- In the US, the Fed has finally acknowledged that the past months' USD appreciation is starting to have a larger impact on US inflation expectations. Already several FOMC members have reacted stressing that further currency upside will weaken growth and price developments to the detriment of their ability of reaching their two goals (price stability, employment). With the Fed at the end of its QE-taper, such rhetoric appears aimed at forging more realistic tightening expectations and thus a more measured USD-response in the coming weeks.
- Given these emerging ECB/Fed policy differences amidst significant short positioning, it should not be surprise if EUR/USD is at risk of a short-term correction. Indeed with the aforementioned move in ECB/Fed interest rate differentials providing the necessary catalyst, many traders nerves about securing year-end profits may capitulate, fuelling a move higher.
- Given such risks we advise buying EUR/USD with target of 1.31 and a stop at 1.2350. Once again, however, we reiterate that our long-term view still favours EUR/USD downside in 2015 in line with our forecast profile.

The following are adjusted market forecasts:

Crédit Agricole CIB EUR/USD forecast:

Q414	Q115	Q215	Q315
1.2800	1.2800	1.2700	1.2500

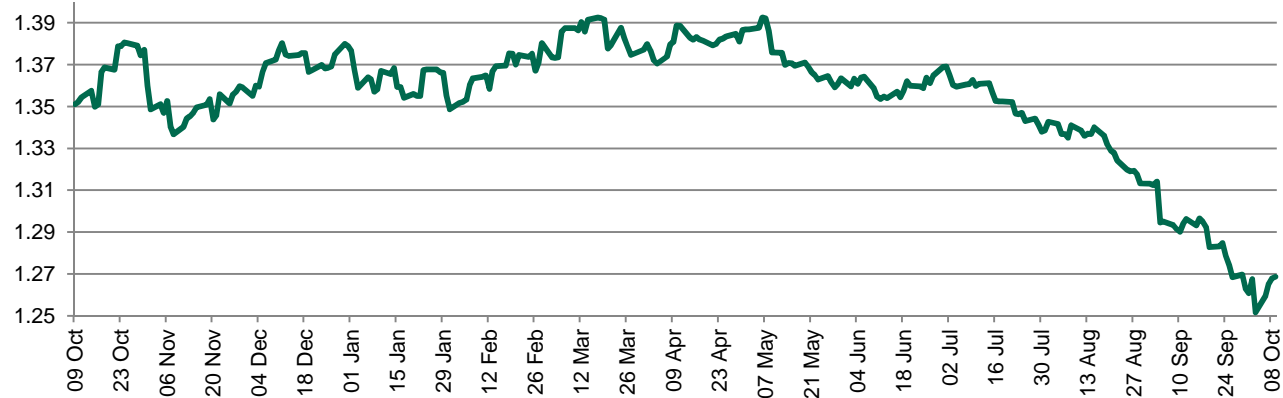
Consensus forecast (Bloomberg FC Poll by 91 strategists average)

Q414	Q115	Q215	Q315
1.2700	1.2500	1.2500	1.2300

Ukraine. Monthly Market Overview. October 2014

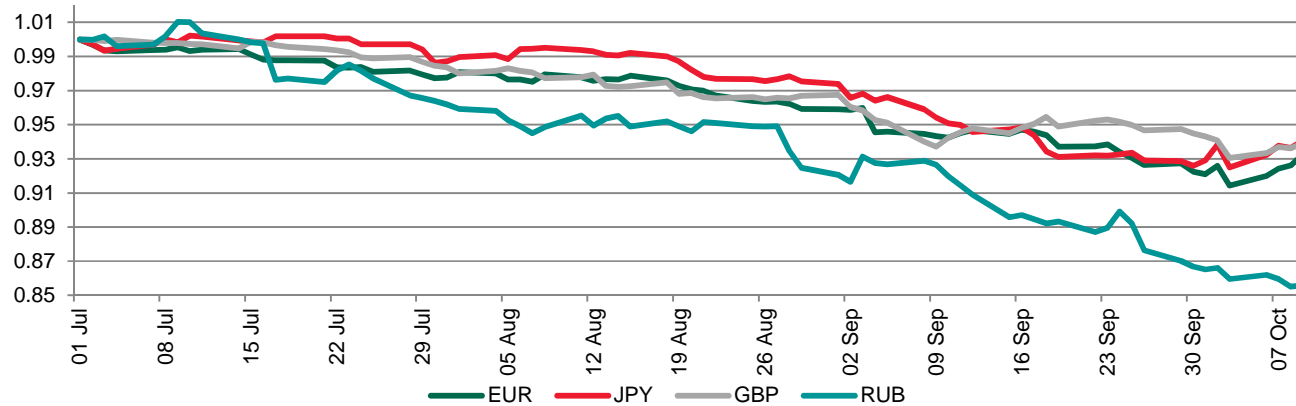


EUR/USD over last 12 months



Source: Bloomberg

Index of currencies against USD over last 3 months (01.07.14=1)



Sources: Bloomberg, Credit Agricole

Certification

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