Ukraine Watch: weekly update - economy in war (week 16)

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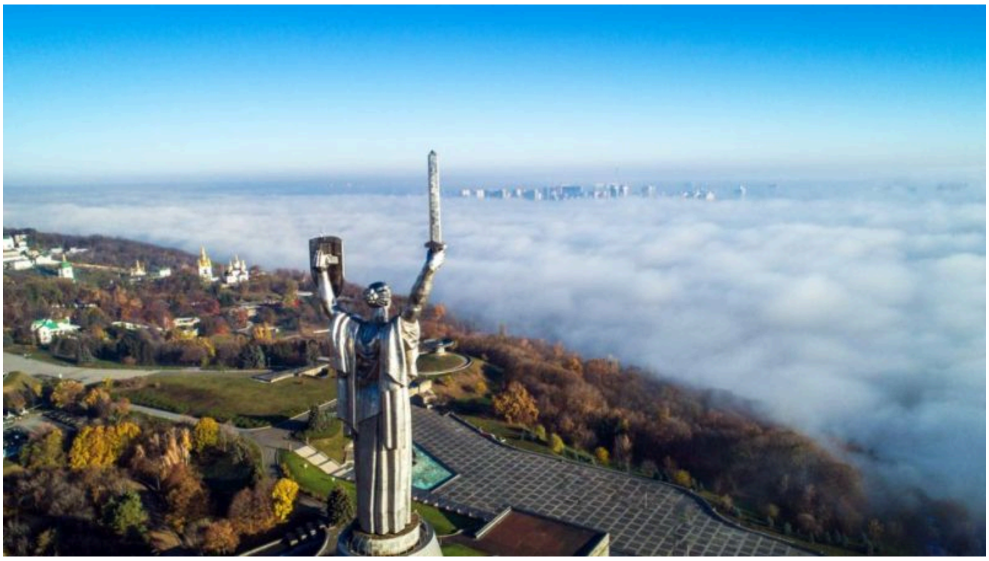
The sixteenth week of the war has already gradually transformed into a regular process, while we expect more news soon on Ukraine's international integration. We also have positive news regarding military cooperation. In parallel mode, the government is trying to help businesses through different support programmes. Banks very slowly adjust to the NBU policy rate decision, but the regulator continues finding ways to switch to a flexible exchange rate regime, while this transformation may take additional weeks.



A solid step towards Ukraine's integration into the Western community is expected

The key point here is the potential **granting of candidate status to Ukraine for EU membership**. The final decision on this issue will be taken by the EU Council **next week** through a direct vote by representatives of all 27 member states at the EU Summit on June 23-24. However, before that, there was a "signal" voting in the European Parliament, which has only an advisory status, and the vast majority of deputies voted in favour of the decision. **The recent statements of Albania, Montenegro and Northern Macedonia** in support of the decision to grant Ukraine a candidate status in the EU also provide optimism, especially considering that these countries already have such a status and have intended to become full members of the EU for a long time. The views of these countries provide a good counterargument to opponents of Ukraine's status regarding the "queue" of countries still in the process of EU accession. In related news, **the first joint visit of the leaders of the three largest states of "Old Europe"** - Germany, France and Italy - this Thursday is perceived as a strong positive signal from the perspective of granting Ukraine the status of the candidate quite soon.

Even though we remain quite optimistic regarding the candidate status of Ukraine for EU membership, the next step**. i.e. EU membership, could take more than ten years**, especially considering similar processes in other candidate countries or those that have already joined. However, **we consider this time lag as rather a benefit** than a drawback because Ukraine will be able to prepare better for the accession. In particular, Ukraine will have plenty of time to harmonise its legislation to European standards and implement new practices and reforms in its economic policy. For Ukraine, this would be mostly concentrated on forming a market economy, protecting property rights and restarting anti-corruption institutions. Additionally, the EU may choose the most appropriate time

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to accept new members when it would be at the peak of its economic cycle, which also may take several years.

We also noticed quite good progress this week in the defence cooperation between Ukraine and its Western partners. Earlier this week, the USA representative to NATO stated that they **support the creation of a defence alliance between the UK, Poland, Ukraine and the Baltic states**. The idea of this alliance is not new, and it initially appeared even before Russia invaded. We could consider this alliance as a temporary substitute for the membership of Ukraine in NATO. The data regarding military support suggests that this alliance de-facto exists: As of mid-June, volumes of arms supplied to Ukraine from Poland (USD 1.8 bn) and the UK (USD 1.1 bn) were second after supplies from the USA (USD 2.1 bn). The volume of military supplies from Baltic states is not quite significant so far, but it is the highest in terms of the GDP of these countries.

Apart from defence assistance from the potential military alliance, the most noteworthy news in this segment was **the Ramstein-3 meeting on June 15**, which has expanded by three more states to a total of 50 defence ministers, including Moldova and Georgia. As a result, defence ministers decided to **provide new weapons shipments** (including additional US supplies by USD 1.0 bn) to Ukraine quite soon, thus simultaneously decreasing the time between the decision and physical shipment of arms to Ukraine. It was also announced the intention to **continue arms deliveries over an extended period** and gradually rearm the Ukrainian army in accordance with the standards of NATO.

NBU keeps active discussions as to conditions for floating exchange rate

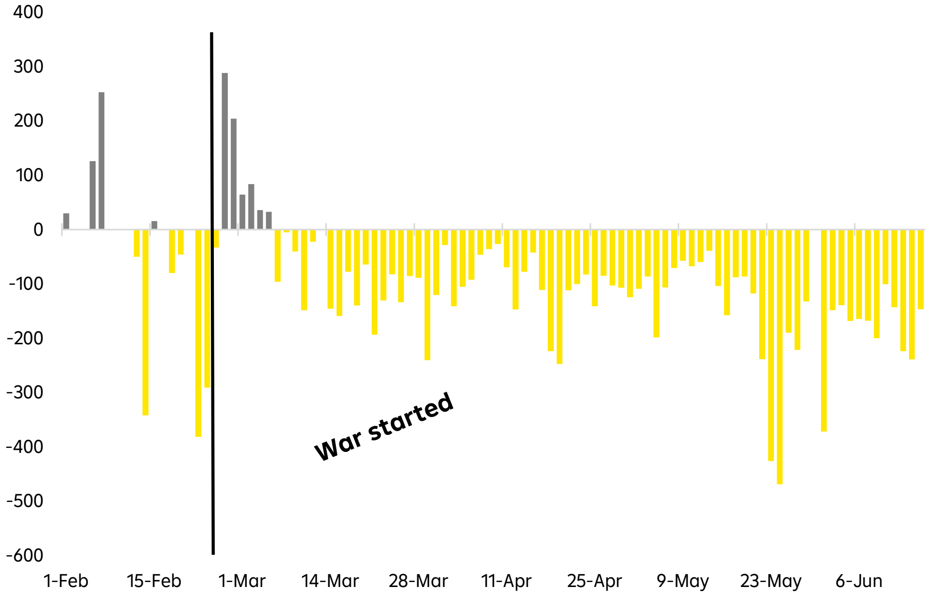
It was logical to see additional comments and clarifications from NBU officials regarding the potential switch from the current exchange rate regime after the regulator returned to the classical method of targeting inflation through the policy rate. Unsurprisingly, the bulk of the discussion in the **minutes of NBU Monetary committee members** was directed to exchange rate issues. The main message there is that the **economy is not yet ready to return to a flexible exchange rate**, where the major criteria for a flexible rate should be the ability of the FX market to self-balance. One of the main problems here is increasing volumes of imports that are strengthened by recent tax and custom simplifications. On the other side, the difference in exchange rates in multiple market segments creates incentives for exporters to avoid foreign currency sales through official channels.

NBU officials, in their comment, do not reject the possibility (and the necessity) of moving to a flexible exchange rate regime. But they refer to several preliminary conditions that should be met, while the majority of them are mainly in the competence of the government. The most important pre-condition is the **return to the charge of import duties**, which was abolished within the first few weeks of the war in order to stimulate import flows under disrupted supply chains and the lack of domestic production after direct invasion and damage of production facilities. However, the preservation of this system for a longer time harmed the restoration of domestic output due to tightening competitiveness from imported supplies. This caused additional pressure on FC demand. So the idea of restoring import duties (and imposing additional charges on non-priority imports) looks rational in terms of restoring the competitiveness of domestic producers and weakening pressure on the FX market. The latter seems to be the major argument for the NBU to prepare the market for a floating exchange rate. However, **the voting in the parliament on the return of import charges has been postponed this week** for a later time for unknown reasons, while deputies still expect to vote on it by the end of June. In any case, the delays in the return of import taxation **could postpone the return to a flexible exchange rate**.

The next pre-condition from the NBU for the floating regime is **separating foreign currency purchasers**, which represent the public sector and allowing them to buy foreign currency directly from the NBU at a special rate. This rate would be equal to the one the government sells foreign currency resources to the NBU. This procedure would keep some critical purchases of the state budget at a special rate (that may be fixed), thus separating them from the market and lowering the pressure on the exchange rate there. **All other foreign currency operations would be done at market conditions with an equilibrium exchange rate**. The NBU applied this approach in 2015, which also allowed to stabilize the FX market then. Same as for import charges, the government's decision could implement this procedure. In any case, the analysis of NBU pre-conditions for floating exchange rate and prospects for their implementation, especially on the side of the government and the parliament, allows us to **estimate delays in the switch to a flexible exchange rate regime for an additional four to six weeks**.

As soon as the FX market remains in its current mode with a multi-currency environment, we notice **a slight widening in the spread** between the official exchange rate and the average rate in an unofficial segment of the market this week to 21.3-21.5% (i.e. increasing the average USD/UAH on the unofficial market to 35.26-35.51) from 20.1-20.5% the week before. We do not see any specific fundamental reasons for this dynamic, thus attributing it mainly to some speculative factors. However, in case the dynamic of the widening spread continues, this could create additional negative incentives for exporters to postpone their FC sales and to find ways of selling their proceeds at a rate closer to unofficial market quotes. The NBU remained a net foreign currency seller this week, with the volumes of interventions almost the same as the week before (i.e. close to USD 0.85 bn). **We expect to see neither substantial changes in NBU interventions nor substantial movements in the exchange rate on the unofficial market** within the coming week. However, **a slight upward adjustment** in the exchange rates on the unofficial market could persist due to a potential decline in the volume of FX sales by exporters at the official rate and attempts to be involved in operations with a better rate.

Chart 1 - Net NBU interventions, USD mn equivalent



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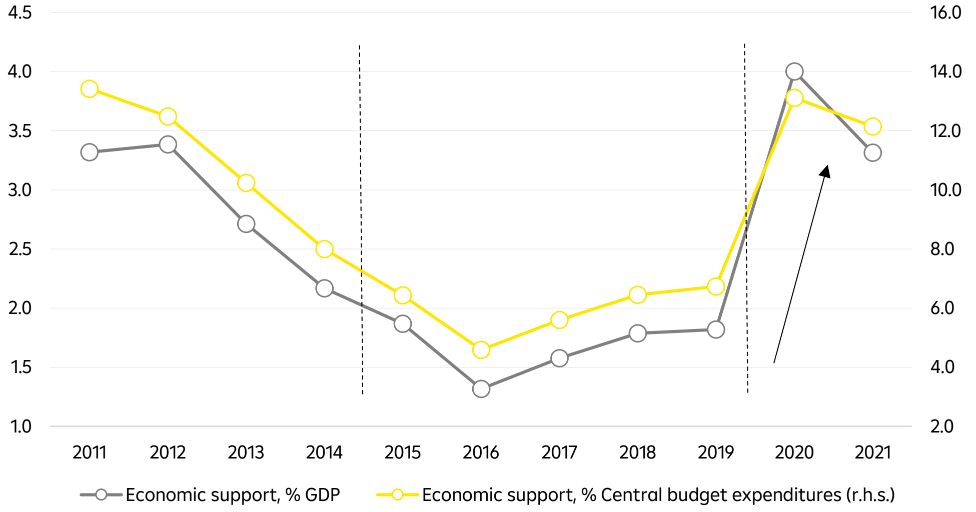
The government announces new programmes of business support under war conditions

The absence of any prospects for the end of the war within the nearest months raises the necessity of stimulating the economy, minimisation of the negative impact of the war and preventing further deterioration in the business environment in Ukraine. Even though **recent estimates from NBU officials reveal a slight improvement in GDP dynamic to a decline of 35-40% in May** from a 40-50% drop in March-April, it is still worrisome enough to think of urgent stimulating measures for the economy. Therefore, it was **a rational decision for the government to announce a "new economic strategy" under war conditions**. The government would offer eight state programmes, which should stimulate employment and business activity through the provision of benefits to businesses, assistance to the unemployed, and participation in government contracts and construction programmes. The goals of all programmes look logical, but the uncertainty of their outcome and efficiency under the classical model of cost-benefit analysis still could be a problem. In order to increase efficiency, the government intends to use **two state programmes that have already proven their effectiveness**: the online-service portal "Diya" and the "5-7-9%" program. This aggregation can reduce transaction costs to some extent, but the budget will still incur additional charges due to raising potential volumes of financial flows under the programmes. In case of proven efficiency and urgent needs, the government can expand the number of programmes in the future.

Six new programmes are based entirely on grants, i.e. the recipients would not have to repay the money back. The grants would be provided for: 1) opening new business; 2) development of processing enterprises (purchase of equipment); 3) partial compensation of the cost of greenhouses (in cooperation with banks); 4) partial compensation of planting new fruit and berry orchards (in cooperation with banks); 5) partial buyout of newly established IT-companies through the Ukrainian Startup Support Fund; 6) grants for training in IT-courses. Thus the emphasis is placed on stimulating the development of small and medium-sized enterprises and **support for three key areas: processing industry, agricultural production and IT**. We consider these sectors as potential growth drivers for the economy in the medium term. The government also included them in the list of priorities in March.

Taking into account the fact that the implementation of these programmes will start in a few months, and some of them involve a lengthy procedure of agreement and approval, as well as banks' decisions, **the additional burden on the budget in 2022, will be minimal** with the bulk of expenditures to be moved into next year. When making appropriate changes to the state budget for 2022, budget expenditures will likely be reallocated from other state programmes that provide for a similar funding scheme but were not fully implemented in war conditions. Implementing the government initiatives presented above **will not lead to a significant increase in the state budget deficit in 2022** but may still cause additional expenditures up to UAH 20 bn in 2023. Perhaps their implementation in 2022 will partially come at the expense of reducing the funding for other state programmes or special foreign aid. Overall, state budget spending on economic activity has increased sharply since 2020, from 1.8% of GDP in 2018-2019 to 4.0% of GDP in 2020 and declined slightly to 3.3% of GDP in 2021, due primarily to the implementation of the Big Construction programme.

Chart 2 - Chart. Central budget expenditures on economic supporting (%)



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All NBU Monetary committee members supported the policy rate hike

After the rather unexpected decision of the NBU to hike the policy rate from 10% to 25% in one movement at the beginning of June, the release of the minutes of the Monetary committee meeting was especially important for the market to understand the sustainability of the recent decision and to find hints for further policy rate decisions of the NBU for the medium-term period. In particular, NBU Monetary committee members understand **the temporary negative impacts of policy rate decision on some segments**, including a potential increase in the costs of local borrowing for the budget, because the government would have to raise bonds' yields in order to keep them attractive on local markets. However, this burden would not be increased this year but will be passed chiefly for 2023, thus having the potential to be refinanced through new issues under milder conditions then. The **major potential drawback** of the policy rate decision is expected in the segment of **banking loans**, while NBU officials consider **this effect as limited** due to gradual adjustment in loan rates to the new policy rate and provision of the majority of new loans at privileged rates subsidized by the budget. Therefore, NBU officials consider these **negative effects as acceptable** if considering estimated support of macro-financial stability and pre-conditions for economic recovery.

We consider most of the aforementioned NBU's arguments and primary goals **reasonable under current circumstances**, while a substantial portion of policy actions is dependent on the simultaneous decision of the government. On the contrary, the government already mentioned its different approach to the sale of local war bonds by not expecting to increase their placement yields. This already caused a sharp drop in investors' participation in the primary auctions in early June to the lowest volumes since the war started, while a moderate outcome of the auction this week (UAH 3.6 bn) is attributed entirely to solid bonds' redemption on Wednesday worth UAH 18.2 bn and corresponding partial refinancing of this volume. Therefore, we still see the low attractiveness of war bonds among investors, which would finally **force the government to start adjusting placement yields upwards** within the coming weeks.

The decision of the NBU regarding the policy rate hike was supported by the majority of Monetary committee members, **with nine out of ten members considering a hike in the policy rate to 24-25%.** The estimates of the markets that a small and gradual rate hike would not eliminate expectations of further hikes was the core rationale behind such a solid hike in one decision. The core message from the Monetary committee's minutes was the view of the majority of its members that **a policy rate hike to 25% is the last movement within the cycle of monetary tightening**. This fully fits our forecasts that the NBU can switch to the cycle of monetary easing already by the end of this year in order to send the signal on the short-term nature of the current cycle. Therefore, **we maintain our year-end policy rate forecast at 20% for 2022**. However, this would happen only in case of **no additional worsening** in the war conflict and its end this year. Otherwise, the NBU may keep its current policy rate unchanged (or even additionally increase it). We also support the view of NBU officials that active financial flows on reconstruction and country support after the war ends would require rather substantial downward adjustments to the policy rate within a short period of time. Therefore, **in case of no long-term war, we preserved our forecast of a policy rate at 12% by the end of 2023**.

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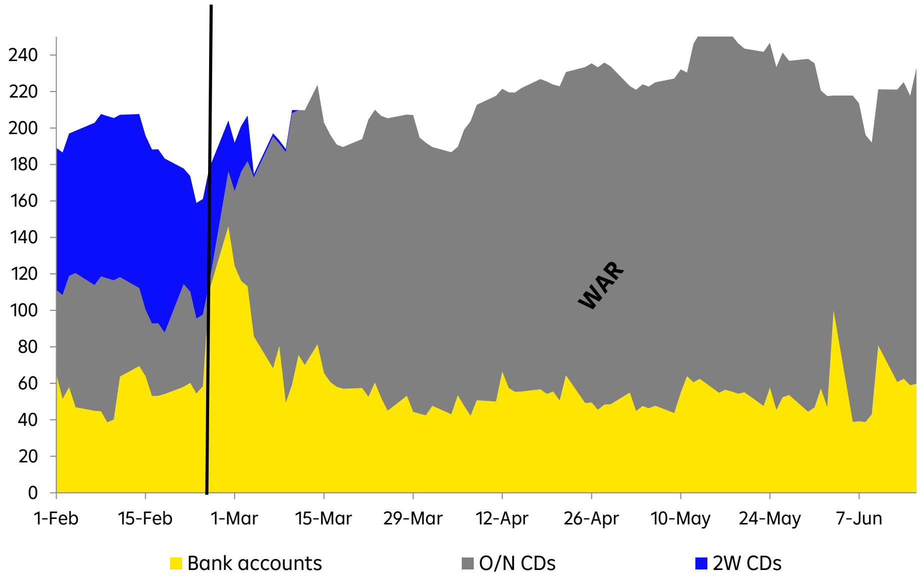
Over the last two weeks, **the biggest outflow of liquidity from the banking sector** has come from the NBU foreign currency interventions. Outflows from the NBU's reserves amounted to USD 1.4 bn, which is the standard picture under the significant limitation of export flows. On the other side, this outflow **is fully offset by the operations of the State Treasury** (UAH 67.4 bn), which is directly related to the purchase of the military bonds worth UAH 70 bn past week by the NBU. On the positive side, the outflow of the cash hryvnya has stopped, we have even seen some inflow of cash money into the banking sector recently, which may indicate that the initial panic of the population has cooled off.

Money of banks on the correspondent account with the NBU has stabilized and fluctuates on the pre-war levels of UAH 54 bn. Monetary operations of the NBU with banks had a slightly negative effect on liquidity. This is directly related to the **continuous purchase of O/N deposit certificates from the NBU** due to the very restricted provision of new loans after the substantial hike in the NBU policy rate and a corresponding adjustment in the rate for NBU CDs. As the war started in February, the banks are gradually increasing their assets in the form of deposit certificates reaching a record high of UAH 180-190 bn by the end of May. **The volume of refinancing loans from the NBU posted a moderate decline** (by 10%) since NBU's decision on the policy rate hike. We think the floating rate on some NBU refinancing loans and increasing their costs after the policy rate decision stimulated banks to get rid of expensive resources by switching instead to cheaper deposits, which do not demonstrate a solid increase in their rates yet.

Even though banks started the adjustment of deposit rates to the new level of the key rate, this process is not homogenous, with **small banks facing the necessity to increase deposit rates more substantially**, while the majority of large banks still preferred to wait for the market reaction and not increase their rates visibly. In particular, **the UIRD index of deposit rates has adjusted upwards by 42-60bp over the week**, with a more visible increase recorded in six-month rates to 7.73%. Surprisingly, the hike in the rate of three-month deposits was the lowest over the week (by 42bp to 6.62%). We still attribute such dynamics in rates to the higher time lag between NBU policy rate decision and the corresponding reaction of the market under conditions of martial law.

Chart 3 - Liquidity in the Banking system, UAH bn



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