Ukraine’s central bank to cut rates as IMF loan is approved

As Ukraine gets its IMF loan today, we think things are aligning for Ukraine's central bank to push the key rate into the lower single digits. In bond markets, we believe these developments could make way for a “second wave” of inflows, after 2019

Ukrainian President Volodymyr Zelensky attends an extraordinary session of parliament as Ukrainian lawmakers try to vote draft laws, whose adoption is required to obtain a loan from the IMF

Source: Shutterstock

Why we are cautiously optimistic on Ukraine

Ukraine's central bank will hold its monetary policy meeting on 11 June. We expect the bank to cut the key rate by at least 100 basis points to 7.00% and by another 100 basis points at the following meetings, most likely in two consecutive steps of 50bp each. Therefore, we maintain our key-rate forecast of 6.00% for year-end.

Two days prior to the central bank meeting, on 9 June, the IMF Board is expected to approve a USD 5bn loan to Ukraine.

In bond markets, we believe these developments could make way for a “second wave” of inflows, after 2019. Strong external market sentiment and the all but certain IMF deal have already seen a strong rally in EUR and USD-denominated UKRAIN bonds (130-150bp tighter over the week) and we believe that this should also be supportive for local currency bonds. The inflows are unlikely to come close to what we saw last year, but nevertheless, we believe it is worth flagging.

On the FX side, we were never too bearish on UAH, but still, see room to become even more constructive. Our current forecasts see the FX rate at 27.00 in 4Q20 and 26.5 in 4Q21. We maintain these but acknowledge that risks for a stronger hryvnia have increased.

Our cautious optimism on bond inflows and upside in FX is based on the following:

1 Anticipated new inflows into local bonds due to:

- **Limited supply in the long-end and diminishing outflows**
  The ministry of finance issuance has been focused in the short part of the curve in recent months, which slowly led to a flatter curve. Moreover, expectations of the IMF deal have seen a deceleration in non-resident bond outflows. It's not all one way of course, as the lower yields and slightly improved liquidity are also encouraging selling from those who couldn't exit by now, but on balance, we think that the outflows will diminish and could even reverse in the upcoming months.

- **The key rate at lower than expected levels by the year-end**
  The central bank has room to cut the key rate this year below its initially pencilled 7.00%. Inflation is low and previous UAH weakening didn't transmit into higher core inflation. As the demand recovery will take some time and hryvnia looks unlikely to weaken, we aren't expecting meaningful upside pressures in either core or headline inflation. We maintain our below-consensus forecast for 2020 average inflation at 3.50%.

- **IMF loan to allow for more opportunistic issuance**
  The government is clearly in a more comfortable position now when it comes to financing the budget deficit. Excluding the short-term T-bills which will be rolled over, we estimate total funding needs for the June-December 2020 period at USD16bn, roughly split into USD 9.5bn budget deficit and USD 6.5bn redemptions.

  We think that international financial institutions funding will cover around 50% of the total 2020 budget deficit (which we estimate at 7.5% of GDP or USD10bn). This means USD3.5bn from IMF and USD1.5-2bn from other sources, mainly EU.

  A key point for this year's financing will be the eventual re-tap of the external markets. We think that this is quite likely to happen after the IMF loan approval. Ukraine already placed EUR1.25bn in 10-year Eurobonds in January and we believe that the targeted amount could be even higher now (e.g. USD1.5- 2bn).
  If successful, this will allow for more opportunistic – and probably longer-term - issuance on the local market.

2 Positive current account developments

We've been constantly optimistic about the prospects of seeing a current account surplus this year and it looks that things are going our way.

Considerable trade and services balance improvements and a lower than expected drop in remittances are making us quite comfortable with our 1.0% of GDP current account surplus this year. Coming from a 2.3% deficit in 2019, this means around USD 5bn improvement of the current account position.

3 Improved FX reserves resilience

We think that the current account improvements, smaller than expected capital outflows and expected external borrowings will maintain the FX reserves levels at least at last year's USD 25.3bn level (vs currently USD25.4bn).

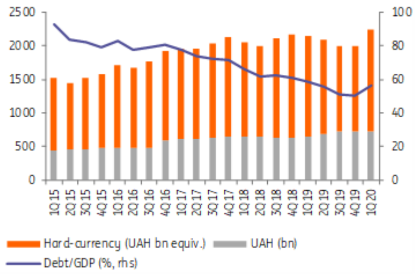
Given the lower GDP and trade numbers, the reserve adequacy metrics will in fact improve in 2020.

4 Stable rating prospects

In the aftermath of the virus outbreak, Fitch on 22 April revised the outlook on Ukraine's B rating to stable from positive. With the IMF deal improving the external financing outlook, we believe Ukraine's ratings are solidified.

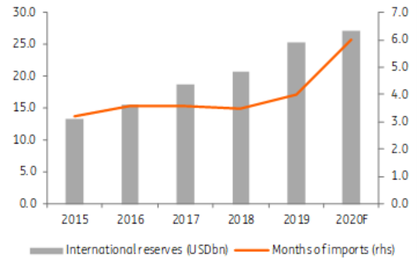
In fact, we see a reasonably good chance that Moody's ('Caa1' pos - two notches below S&P and Fitch) will upgrade Ukraine to 'B' space in its November review.

Fig 1 Public debt dynamics



Source: NBU May 2020 Inflation Report

Fig 2 Improving reserve coverage



Source: NBU, ING

Author

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com