Focus
Ukraine

Markets
Economics

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Macro Insight

NBU Abandons Fixed Exchange Rate

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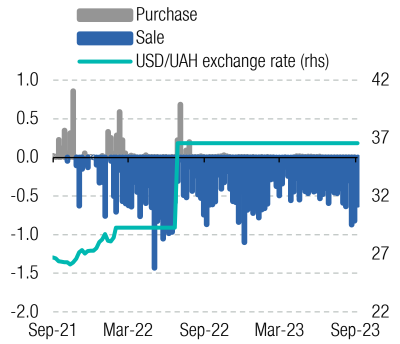
In a much-expected move, the NBU announced yesterday that the 18-month-long period of fixed-exchange-rate regime is over, and they introduced a "managed flexible" exchange-rate regime. The new regime implies the official exchange rate will change daily, and the NBU will ensure that the rate fluctuates in both directions. We expect the hryvnia exchange rate will remain little changed in the next couple of months, but a managed, gradual depreciation is inevitable over the longer term in 2024 and 2025. We maintain our end-2024 projection of the exchange rate at UAH42/US$. Yields on hryvnia deposits should, thus, be largely sufficient to compensate for possible depreciation risks.

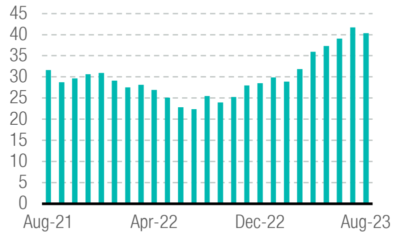
- The NBU announced it has abandoned the fixed exchange rate of the Ukrainian hryvnia vs the US$ starting today. The new, flexible, exchange-rate regime implies the official exchange rate will fluctuate daily depending on market rates. The NBU will, effectively, remain the key player in the market.
- The NBU fixed the exchange rate at UAH29.25/US$ on Feb 24, 2022, the first day of russia's full-scale invasion of Ukraine and then re-fixed it at UAH36.56/US$ in mid-2022. By fixing the exchange rate, the NBU provided a nominal anchor for the economy and a much-needed comfort for businesses and households. It played a key role in bringing inflation back to single digits since August 2023. The NBU had to spend from its reserves an average US$500mn per week in 2022 and 9M23 to cover excess demand in the interbank market and maintain the fixed-exchange-rate regime.
- While the fixed exchange rate was instrumental in ensuring macroeconomic stability, it implied the hryvnia has been significantly overvalued. This led to an accumulation of substantial imbalances in external accounts. The deficit of trade in goods is likely to reach an all-time high of 16–17% of GDP in 2023, as Ukrainian exports stagnate while robust domestic demand drives imports up. Another pressing issue for the balance of payments is a deficit of external trade in services that emerged since the start of the full-scale war due to expenditures of refugees abroad. Also, withdrawals of FX cash by the population domestically and abroad remain a significant drag. These imbalances have so far been safely covered with inflows of foreign financial aid in the form of loans and grants. Generous foreign aid also allowed the accumulation of reserves by the NBU.
- The NBU made it clear it does not plan to adjust the exchange rate in the near future so as to eliminate imbalances of external accounts. This, though, may become their goal over the longer-term horizon, but the timing for achieving this goal is hardly possible to specify at the moment. The NBU assured the market that in the short-term, a significant deviation of the exchange rate from its current

FX market weekly indicators (UAH exchange rate and NBU interventions)



Source: NBU

Gross NBU reserves, US$bn



Source: NBU

level is not desirable, and this is not what the central bank will allow.

- The NBU reiterated its intention to maintain a presence in the FX interbank market and preserve significant FX sale interventions that are designed to alleviate a "structural FX deficit." NBU officials provided little guidance about how the size of the structural deficit will be estimated saying it's important to maintain constructive ambiguity on the matter. The NBU also gave no indication what size of FX interventions they believe is acceptable under the new exchange-rate regime. Their guiding principles for the future exchange-rate trajectory will not be disclosed.
- We believe that despite a switch from a fixed-exchange-rate regime, the NBU will prioritize stability of the hryvnia over other goals in the next couple of months. A significant and rapid depreciation of the hryvnia or substantial volatility of the official exchange rate could undermine market trust in the national currency and provoke massive FX purchases by importers and households. We, thus, expect only marginal weakening of the hryvnia exchange rate by the end of the year. This will create no risk to macroeconomic stability while letting market adjust to new realities.
- The market is likely to see some nervousness in the coming weeks, as it will be adjusting to the new exchange-rate regime. The cash exchange rate may see larger-than-usual volatility while FX demand in the interbank market may temporarily increase prompting the need for higher FX sale interventions by the NBU. But the situation is very likely to normalize within a couple of weeks.
- Looking longer-term, in 2024 and 2025, we expect gradual, managed hryvnia weakening with the pace of depreciation being comparable to yields on UAH hryvnia deposits. This way, the NBU will make profitability of FX and UAH instruments nearly comparable and prevent massive conversion of hryvnia savings into FX. This implies the NBU will need to keep its key policy rate relatively high in real terms in the coming years. We maintain our current end-2024 exchange-rate projection of UAH42/US$.
- The NBU is fully equipped to keep the situation in the FX market under full control. The central bank's reserves currently stand at close to US$40bn, much above the pre-war level. This is an equivalent of over five months of future imports. Possible disruptions to inflows of international financial aid from the US will prevent further accumulation of reserves, but it is unlikely to result in a significant reduction of existing reserves (providing inflows from other allies remain intact).
- The NBU did not provide any additional information about further FX liberalization measures, but we expect it will remain extremely cautious in the coming quarters, taking only symbolic steps that facilitate cross-border trade operations. We are skeptical about rapid liberalization of flows related to external private debt and FDI.

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