



Focus
Ukraine

Markets
**Domestic liquidity,
government bonds, FX
market, and macro**

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Weekly Insight

IMF requirements may be met soon

Key messages of the today's comments

Domestic liquidity and bonds market

Government bond market

Last week, the Ministry of Finance paid about UAH2bn in principal and interest debt repayments while it borrowed only UAH318m. This week's debt repayments to be refinanced will be also partial.

Liquidity remains high

Banking-sector liquidity remained steady most of last week, and only last Thursday started to decline. This week, liquidity could be volatile due to large, divergent cash flows.

Foreign exchange market

Stronger UAH on sufficient FX supply

The hryvnia may slightly strengthen against the US dollar this week thanks to April tax payments. In May-June, the hryvnia will continue its slight uptrend thanks to exporters' seasonal demand and prolonged adjustments of fiscal and monetary policies aimed at relatively stable exchange rate.

Economics

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The Verkhovna Rada's consideration of the law on the Anticorruption Court in the second reading may begin this week and be successfully completed in June. It is also possible to reach a compromise on gas tariffs.

Merchandise-trade-balance deficit rose 51.3% YoY in 1Q18

The trade balance deficit in goods amounted to US\$1.2bn in 1Q18, which is 51.3% higher compared with 1Q17. Due to higher oil prices and rising imports of consumer goods, the merchandise-trade-balance deficit will continue to increase in 2018.

Real GDP rose 3.1% YoY in 1Q18

Ukraine's economy expanded 3.1% YoY and 0.9 QoQ SA in 1Q18, per preliminary data from the State Statistics Service. Thanks to favourable external conditions, solid consumer demand, and rising investments, real GDP growth will be close to 3.5% this year.

Natural gas production in Ukraine in 4M18 declined 1% YoY

Despite this decrease, we expect that the steps taken to mitigate the regulation of the oil and gas industry will allow Ukrainian companies to increase extraction in 2018 by 4–6%, to 21.3–21.7bcm.

TUESDAY, 22 MAY 2018

Banks' reserves market (21 May 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU rate (%) ¹	17.00	+0bp	+400bp
ON rate (%)	16.30	+10bp	+410bp
ON \$ swap (%)	16.22	+20bp	+419bp
Reserves (UAHm) ²	50,298	-7.82	+7.22
DepCerts (UAHm) ³	53,473	-10.27	+0.00

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's short-term bonds.
Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (21 May 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU	350,325	+0.00	-7.30
Banks	347,952	-0.10	+24.32
Residents	25,512	-4.52	+18.77
Individuals	2,638	+2.20	+332.46
Non-res ⁴	11,194	-2.94	+108.41
Total	737,620	-0.25	+7.63

Notes: [1] non-residents
Source: NBU, ICU.

FX market indicators (21 May 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.0900	-0.44	-1.03
EUR/USD	1.1791	-0.40	+5.22
DXY ²	93.677	+0.49	-3.57
UAH TWI ³	121.946	+0.55	+10.81

Notes: [1] UAH trade-weighted index.
Source: Bloomberg, ICU.

Gov't bond quotes¹ (22 May 2018)

Maturity	Bid	Ask
6m	17.50	16.50
12m	17.75	16.75
2y	17.50	16.50
3y	17.50	16.50
12m (\$)	5.10	4.70
2y (\$)	5.30	5.00

Notes: [1] Actual quotes you can see at www.icu.ua.
Source: ICU.

Domestic liquidity and bonds market

Government bond market

Last week, the Ministry of Finance paid about UAH2bn in principal and interest debt repayments while it borrowed only UAH318m. This week's debt repayments to be refinanced will be also partial.

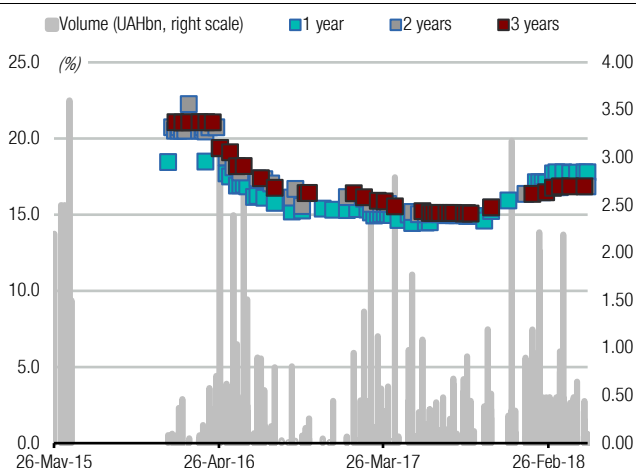
At last week's primary auction, 82% of total demand was accepted, but new borrowings allowed the refinancing of only a small portion of debt repayments. Receiving 22 bids, the MoF rejected only three, which could cause an increase in the cost of borrowings for all bonds. So, for bonds with maturities up to one year, the MoF kept cut-off rates unchanged, and for the two-year bond, the rate was increased by 5bp to 16.15%.

At the recent two auctions, the share of non-competitive demand rose rapidly. Using this type of bidding, investors hedge the risk of the MoF's sometimes unpredictable decisions about cut-off rates, and this also provides them with more opportunities to buy bonds. At the end of April, the share of non-competitive bids was 4-7%, but during the last two weeks, it was 25% and 36%, respectively. So far in 2018, this share was higher only at the beginning of April, when it was at 45% of total demand.

Last week, total bonds outstanding declined UAH1.3bn. Non-residents' portfolios slid UAH212m, while banks and individuals increased their portfolios by UAH160m and UAH54m, respectively. Last week, banks purchased local-currency bonds, while individuals increased ownership of both local and FX-denominated bonds. Only domestic-non-bank investors decreased their portfolios, and by UAH1.3bn.

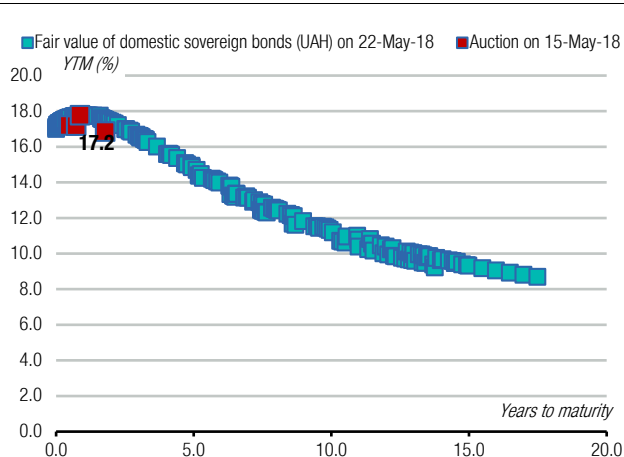
Chart 1. Local-currency bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: Ministry of Finance of Ukraine, ICU.

Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



Source: National Bank of Ukraine, Ministry of Finance of Ukraine, ICU.

ICU view: This week, the MoF will pay more than UAH5bn in domestic debt repayments in local currency, partially to the NBU. Also, US\$9m will be paid in FX. Our expectation is that demand at the primary auctions will be greater than during recent weeks. A few reasons include: 1) the MoF will offer three-month and three-year local-currency bonds and FX-denominated bonds with 1.5-2-year maturities; 2) demand for three-month bonds was postponed from last week; 3) there is a high level of banking-sector liquidity despite quarterly tax payments.

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Liquidity remains high

Banking-sector liquidity remained steady most of last week, and only last Thursday started to decline. This week, liquidity could be volatile due to large, divergent cash flows.

For most of last week, liquidity was steady at UAH114bn, and only last Thursday and Friday did it decline to UAH104bn, most likely due to quarterly tax payments.

The decline in liquidity last week was from the Treasury, which caused UAH10.2bn of outflows last week, mostly last Thursday and Friday. Also, UAH1.2bn of reserves were exchanged for cash during last week. Only the NBU provided UAH0.8bn of funds in banking system via operations in the FX market.

ICU view: This week, liquidity will be under the impact from usual factors: Treasury operations, which will collect month-end tax payments and pay VAT refunds, MoF debt repayments (will be done through the Treasury), reserves exchange into cash or back, and NBU's operations in the FX market. Divergency of these cashflows will cause an increase in liquidity and volatility, but it should stay above UAH100bn.

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Chart 2. Banks reserves usages over last week(UAHm)

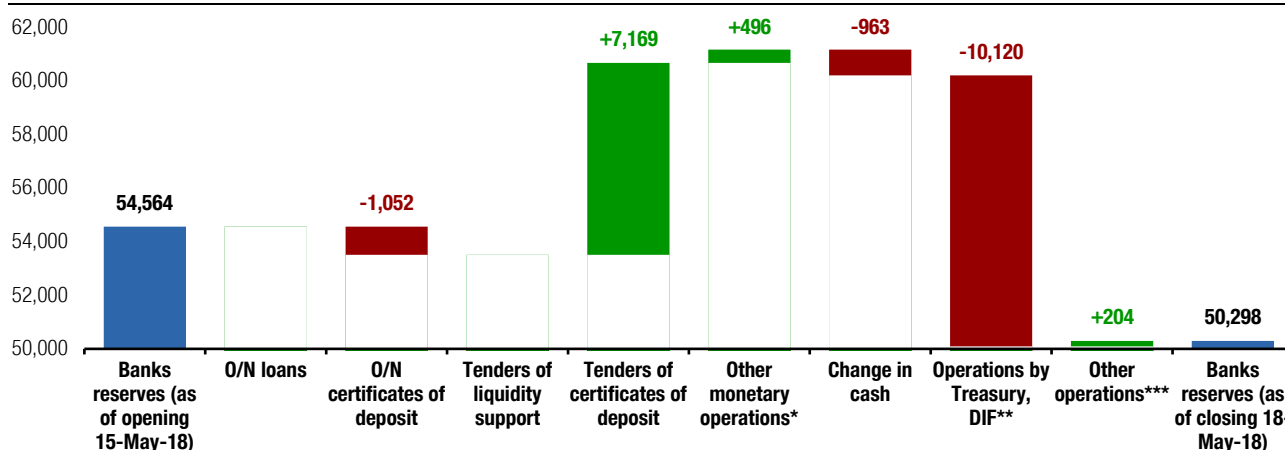
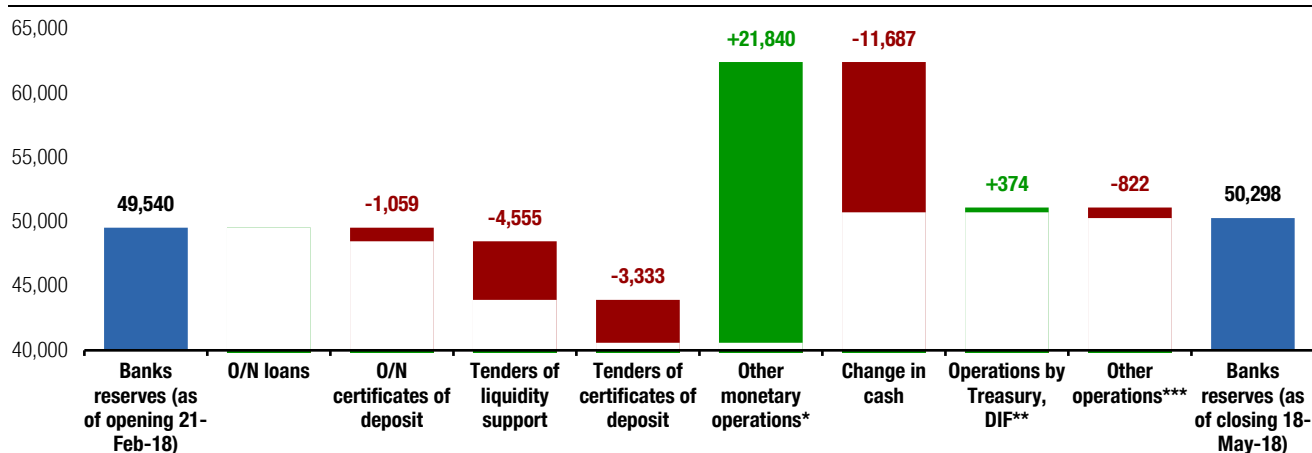


Chart 3. Banks reserves usages over last 90-day period (UAHm)



Notes: [1] data from the NBU's daily reporting https://bank.gov.ua/control/uk/publish/article?art_id=38643651&cat_id=40807142 ;

* operations repo, purchase and sale of government bonds, FX market interventions, stabilisation loans, FX swap agreements; ** DIF – deposit insurance fund;

*** interest payments on NBU's loans and on NBU's certificates of deposit, other operations. Source: NBU, ICU.

Foreign exchange market

Stronger UAH on sufficient FX supply

The hryvnia may slightly strengthen against the US dollar this week thanks to April tax payments. In May-June, the hryvnia will continue its slight uptrend thanks to exporters' seasonal demand and prolonged adjustments of fiscal and monetary policies aimed at relatively stable exchange rate.

The hryvnia remained stable last week with some strengthening on Friday on the back of the quarterly tax payments. The NBU bought US\$60m for four days on the local interbank market, which implies that the FX supply exceeded demand. Thus, last week, the hryvnia strengthened 0.2%, to 26.13 UAH/USD.

The State Treasury performs the function of withdrawing monetary reserves from bank accounts -- this implies that primary budget surplus, which was close to 2% at the end of 1Q18 is also preserved in 2Q18, but its size may be somewhat different. At the same time, the price of reserve money, which is currently determined by the NBU at 17%, is unlikely to be lowered in the near future. These factors make UAH-denominated assets attractive and serve as 1) a preventive measure to avoid escaping from less liquid to the most liquid assets, and eventually 2) support the UAH exchange rate.

The hryvnia's CPI-based, real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) increased 1.5% to 121.0, while the DXY index rose 1.2% to 93.64 last week. In year-on-year terms, real trade-weighted indices (CPI and PPI based) increased 10.1% and 15.4%, respectively, which implies faster prices growth in Ukraine compared with its main trade partners.

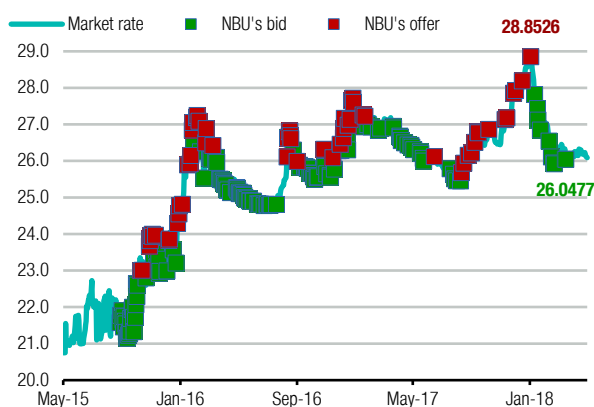
ICU view: This week we expect the VAT refund in the amount of UAH4.5bn, and repayments of domestic government bonds (more than UAH5bn). However, we expect the FX supply and demand to be balanced, as the large amount of abovementioned funds will be used for April tax payments. Thus, the hryvnia may slightly strengthen this week. In May-June, the hryvnia should continue its slight uptrend thanks to strong demand for UAH from Ukrainian exporters and the authorities' commitment to determined fiscal and monetary policies.

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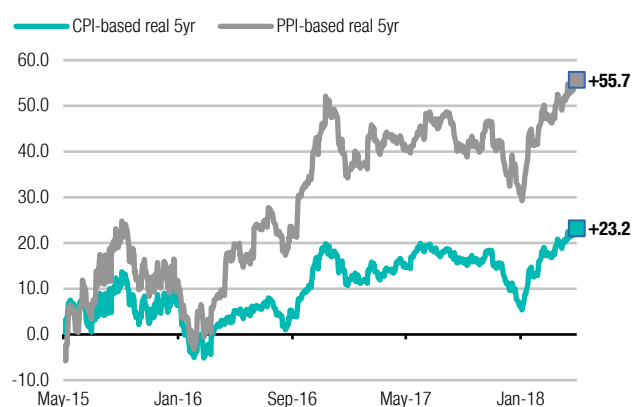
Chart 4. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market



Notes: the chart provides labels for the average exchange rate at last two NBU auctions (one on buying FX from the market and one on selling it). Source: NBU, Bloomberg, ICU.

UAH exchange rate misalignment¹ from fundamental level² (%)



Notes: [1] "+" overvalued, "-" undervalued; [2] based on the UAH's CPI- and PPI-based real TWIs. Source: ICU.

Economics

IMF requirements may be met soon

The Verkhovna Rada's consideration of the law on the Anticorruption Court in the second reading may begin this week and be successfully completed in June. It is also possible to reach a compromise on gas tariffs.

According to Interfax-Ukraine, IMF official spokesman Jerry Rice in Washington last Thursday stressed the critical importance of the Anticorruption Court Law for the further progress in Ukraine's implementation of the EFF program. Rice emphasized that the law should fully comply with Ukraine's commitments under the IMF program, the Venice Commission and Council of Europe recommendations.

Rice recalled the need to bring domestic gas tariffs to market levels, while protecting the poorest sections of the population. The Ukrainian News' interlocutor said that the IMF did not approve the plan proposed by Naftogaz of Ukraine for a differentiated increase in gas tariffs depending on monthly consumption volumes.

At the same time, Prime Minister Volodymyr Groysman and Speaker of the Verkhovna Rada Andriy Parubiy predicts that parliament will begin to consider the bill on the Anticorruption Court this Tuesday. According to Parubiy and deputy head of the faction BPP Serhiy Berezenko, now there is an active discussion of representatives of the executive and legislative branches within the IMF regarding the harmonization of the most controversial provisions of the law. Moreover, 13 out of 14 controversial provisions have already been agreed upon, except the provision on the veto rights of the public council for candidacy of the anticorruption judges. Berezenko noted that the law should be adopted no later than June, while Parubiy awaits the possible adoption of the law on Thursday (Source Censor.net Interfax-Ukraine).

ICU view: Statements by authorities last week indicated that they are determined to accelerate efforts to meet the key requirements of the IMF in the near future. And this increases the chances of Ukraine receiving the IMF tranche in 2H18. At the same time, bringing the law on the anticorruption court in line with the requirements of the IMF is key. Taking into account the complexity of the discussion and the large number of amendments proposed by deputies, the law is most likely to be adopted in June.

The rejection of the Naftogaz's offer to increase gas tariffs for the population through their differentiation was anticipated, since the IMF has traditionally been negatively positioned to any difference in gas prices as to a source of corruption. More likely, in our opinion, is a gradual alignment of tariffs with import parity with the use of compensatory mechanisms.

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Merchandise-trade-balance deficit rose 51.3% YoY in 1Q18

The trade balance deficit in goods amounted to US\$1.2bn in 1Q18, which is 51.3% higher compared with 1Q17. Due to higher oil prices and rising imports of consumer goods, the merchandise-trade-balance deficit will continue to increase in 2018.

Imports of goods continued to increase faster than exports. In 1Q18, merchandise imports rose 13.2% YoY to US\$12.6bn. Significant contribution to imports' growth was made by machinery and equipment (+20.2% YoY), and chemical products (+16.4% YoY). At the same time, imports of mineral products declined 3.5% YoY.

Merchandise exports rose 10.3% to US\$11.4bn. The key drivers of growth were metals and products made from them (+23% YoY) and machinery and equipment (+21.8% YoY). However, exports of plant products fell 3.8% YoY.

Taking into account a 16% YoY increase in the services-trade-balance surplus to US\$1.5bn, Ukraine's total trade balance recorded a deficit of US\$135m in 1Q18.

ICU view: The merchandise-trade-balance deficit is to expand further over the course of 2018 due to 1) high oil prices, 2) declining steel prices, and 3) a further increase in imports of consumer goods. We expect the trade-balance deficit in goods to expand to US\$7.7bn or 6% of GDP, up from 5.7% of GDP as of the end of 1Q18.

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Real GDP rose 3.1% YoY in 1Q18

Ukraine's economy expanded 3.1% YoY and 0.9 QoQ SA in 1Q18, per preliminary data from the State Statistics Service. Thanks to favourable external conditions, solid consumer demand, and rising investments, real GDP growth will be close to 3.5% this year.

The key drivers of economic growth were retail sales (+7.6% YoY) against the backdrop of rising real incomes and an increase in industrial production by 2.4% YoY.

Taking into account weak performance of other real sectors of economy—agriculture decreased by 0.5% YoY, construction by 0.3% YoY, and transport turnover by 3.8%—we suggest that significant growth will be posted in fixed investment (the data will be released on 25 May) and the services sector.

ICU view: 1Q18 real GDP growth well exceeded both the ICU forecast (+2.5% YoY) and the NBU's estimate (+2.3% YoY), which, in our view, can be linked to robust investment activity. We expect economic growth to accelerate thanks to the following: 1) robust consumer demand against the backdrop of rising real incomes, and further expansion in consumer lending (+47.4% YoY in March), 2) a further increase in private and government investment, and 3) favourable external conditions. We maintain our forecast of 3.5% real GDP growth for 2018.

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Natural gas production in Ukraine in 4M18 declined 1% YoY

Despite this decrease, we expect that the steps taken to mitigate the regulation of the oil and gas industry will allow Ukrainian companies to increase extraction in 2018 by 4–6%, to 21.3–21.7bcm.

According to Ukrtransgaz, in 4M18, natural gas production in Ukraine declined by 1% YoY to 6.77bcm.

Average daily production volumes of state-owned companies UkrGasVydobuvannya and Ukrnafta in April decreased to 44.1mcm, i.e. by 2% compared with January 2018, and by 1% compared with April 2017.

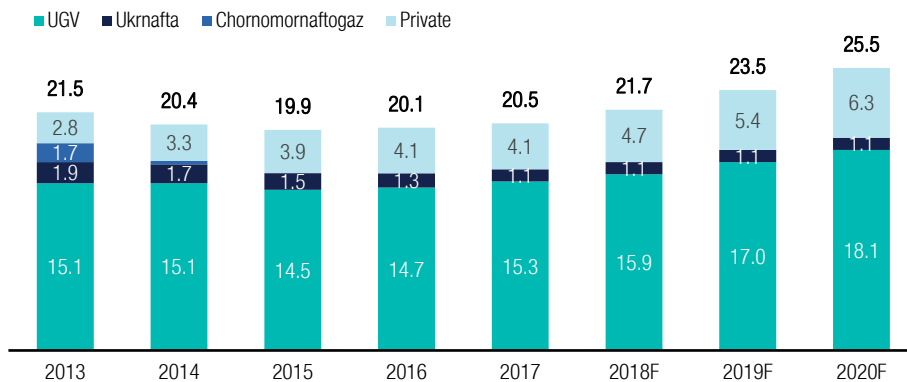
At the same time, average daily production volumes of private Ukrainian companies in April dropped to 11.5mcm, i.e. by 6% compared with January 2018, and by 4% compared with April 2017.

ICU view: Ukrainian gas production is experiencing a negative impact from the over-regulation of the industry. The jumps in fees for the use of the resources in recent

years, and the bureaucracy and the complexity of the licensing system, frightened investments in capital-intensive production. At the same time, it is becoming increasingly difficult to restrain the natural decline of extraction in Ukrainian deposits, most of which have a long lifetime.

But we expect that positive changes in the regulation of the industry that have occurred over the past few months will be able to significantly revive activity of gas production this year. We expect that gas production in Ukraine may increase by 4 to 6% in 2018 to 21.3–21.7bcm and reach 25–26bcm in 2020. For a more detailed analysis see the [blog](#).

Chart 5. Production of natural gas in Ukraine, bcm



Sources: Energybusiness, Naftogaz Ukraine, ICU

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