



Focus
Ukraine

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

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Weekly Insight

Ukraine approves Anticorruption court

Key messages of the today's comments

TUESDAY, 12 JUNE 2018

Domestic liquidity and bonds market

Bonds portfolios steady

Last week, total bonds outstanding and bonds in portfolios saw slight changes due to debt redemption and its partial refinancing. This week, portfolios could see an increase with FX-denominated bonds purchased at primary auction.

Liquidity at new record high

During the first week of June, liquidity hit a new record high of UAH118bn. A similar high level of liquidity will be seen this week along with possible additional pressure on the hryvnia exchange rate.

Foreign exchange market

Quiet currency market

The hryvnia will remain at the current level with a slight appreciation trend in the absence of significant catalyst events.

Economics

Inflation slowed to 11.7% YoY in May

May's inflation reading came in at 11.7% YoY, the lowest rate since September 2016. Consumer prices remained flat in MoM terms. Solid consumer demand, loose fiscal policy, and rising energy prices will continue to put upward pressure on consumer prices.

Verkhovna Rada sacks Finance Minister

The appointment of Oksana Markarova as acting Finance Minister will ensure the continuation of the government's cooperation with the IMF. However, balancing the state budget in the pre-election year of 2018 remains a serious challenge for the MoF.

The parliament passes the law on the Supreme Anticorruption Court

Adoption of the Anti-corruption Law is a crucial step towards the implementation of the key conditions of the IMF financial aid programme. But the next tranche has not been secured yet.

International reserves drop by 1.6% MoM in May

International reserves continued declining due to sovereign debt repayments. To keep the international reserves above the current level, Ukraine needs to attract more external debt.

Banks' reserves market (11 June 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	17.00	+0bp	+450bp
ON rate (%)	16.00	+40bp	+500bp
ON \$ swap (%)	15.65	+26bp	+421bp
Reserves (UAHm) ²	43,554	-10.88	+10.07
DepCerts (UAHm) ³	74,032	+13.03	+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) (11 June 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	350,325	+0.00	-6.32
Banks	351,796	-0.80	+25.12
Residents	23,893	-3.66	+9.10
Individuals	2,967	+0.09	+348.36
Non-res ⁴	10,390	-3.77	+16,249.14
Total	739,371	-0.56	+9.09

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

FX market indicators (11 June 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.0850	-0.27	-0.23
EUR/USD	1.1784	+0.56	+5.26
DX ²	93.608	-0.29	-3.77
UAH TWI ³	122.358	+0.11	+8.03

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

Gov't bond quotes¹ (12 June 2018)

Maturity	Bid	Ask
6m	17.50	16.75
12m	17.75	17.00
2y	17.50	16.50
3y	17.50	16.50
12m (\$)	5.50	4.85
2y (\$)	5.70	5.00

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

Domestic liquidity and bonds market

Bonds portfolios steady

Last week, total bonds outstanding and bonds in portfolios saw slight changes due to debt redemption and its partial refinancing. This week, portfolios could see an increase with FX-denominated bonds purchased at primary auction.

At the last auction, the MoF borrowed UAH0.9bn, and refinanced less than one-third of local-currency debt repayments. Last Wednesday, the MoF also paid more than US\$110m in FX. After these repayments, bond portfolios mostly declined and total bonds outstanding slid UAH3.6bn. Most of the sell-off was from the portfolios of banks and non-banks, while individuals' portfolios remained steady at nearly UAH3bn. Non-residents' portfolios declined UAH0.4bn to UAH10.4bn.

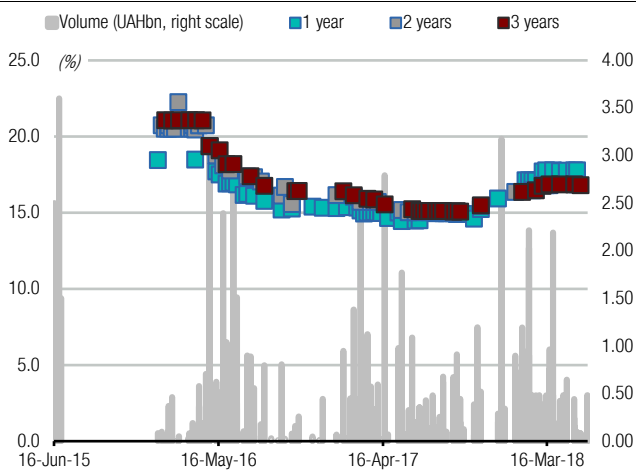
Today, the MoF will offer local-currency instruments with maturities from three months and up to three years, and USD-denominated bills maturing in January 2020. Most likely demand will be concentrated in FX-denominated paper, which will allow the MoF to decrease the cost off new borrowings in FX compared with May's auctions, depending on the level of demand.

ICU view: During June, the MoF has scheduled large debt repayments in FX that will have to be refinanced with new domestic borrowings, without new external borrowings. In total during June, the MoF has to pay at least US\$0.5bn in FX domestically. So, the MoF will likely prefer to borrow in FX, choosing the most acceptable level of cut-off rate.

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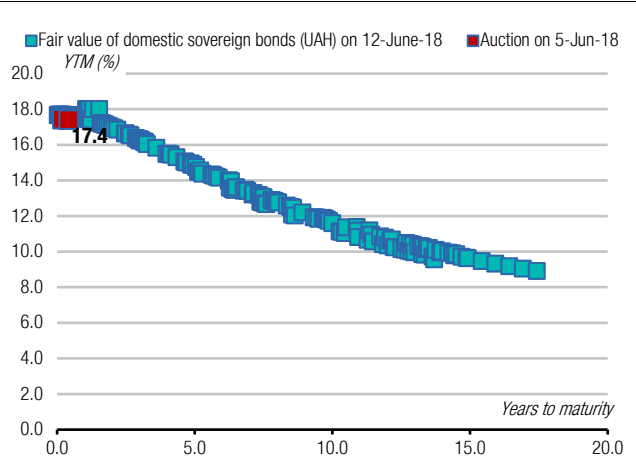
Chart 1. Local-currency bonds

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.

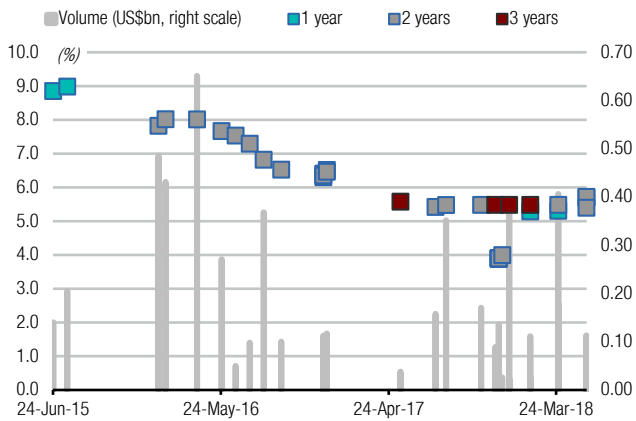
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

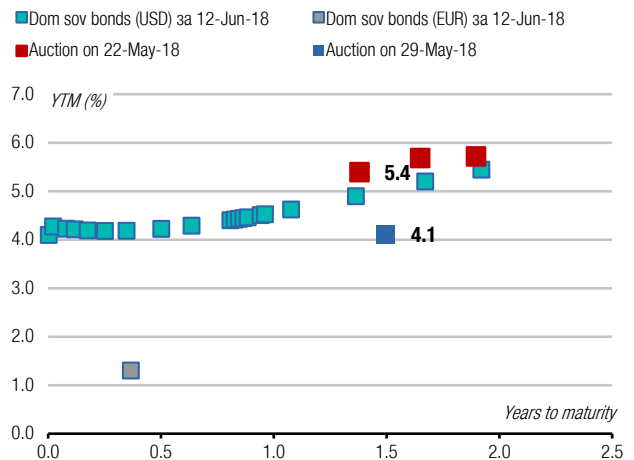
Chart 2. FX-denominated bonds

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.

Liquidity at new record high

During the first week of June, liquidity hit a new record high of UAH118bn. A similar high level of liquidity will be seen this week along with possible additional pressure on the hryvnia exchange rate.

After large redemptions of UAH-denominated debt last Wednesday, total banking-system liquidity rose to UAH118.6bn, a new record high since February 2016. Also, banks increased CDs in their portfolios for another new record amount over the last two years: total CDs outstanding rose to UAH78.3bn last week. At the same time, banks' correspondent account balances declined to UAH39bn, which was UAH5.3bn above the lowest amount of this year.

As the result, last week, liquidity support came mostly from the Treasury, at UAH6.5bn of net inflows. UAH0.5bn came from the NBU, while outflows were at UAH3.9bn via reserves exchange in cash. Finally, last week, banking-sector liquidity rose UAH2.8bn to UAH117.6bn.

ICU view: This week will not see significant changes in liquidity, as there will be neither large outflows via tax payments or inflows via VAT refunds, nor large debt payments. At the primary market, demand will be concentrated in FX-denominated bonds. At the same time, extra liquidity could be spent for purchasing FX or FX-denominated bonds, which are becoming more attractive compared with local-currency bonds.

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Chart 3. Banks reserves usages over last week(UAHm)

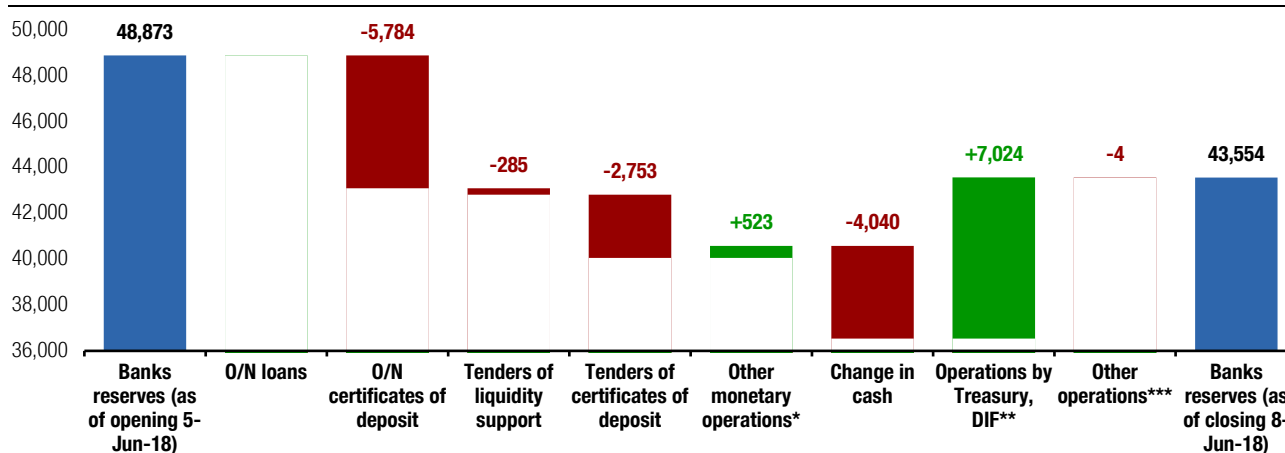
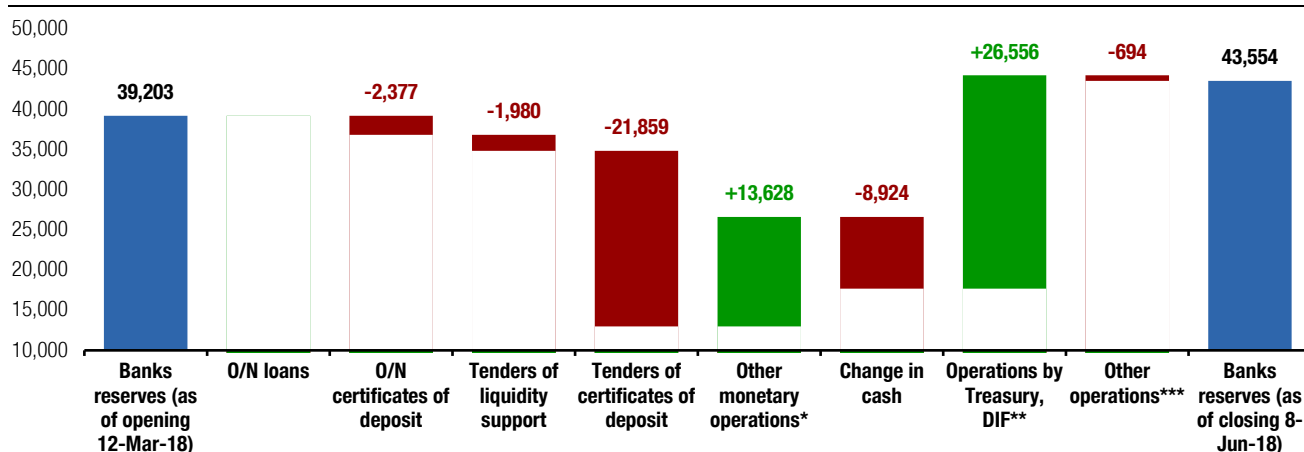


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

Quiet currency market

The hryvnia will remain at the current level with a slight appreciation trend in the absence of significant catalyst events.

The hryvnia remained mostly unchanged in the past week and was influenced mostly by foreign-currency demand from large importers and related currency selling by exporters. Foreign currency was also in demand from affiliated foreign companies for dividend payments abroad. Adoption of the law for the anticorruption court was positively assessed by market participants and allowed the hryvnia to appreciate on the last day of the previous week. Due to relatively balanced supply and demand, the national currency depreciated insignificantly and finished the week at 26.14 USD/UAH.

The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries trade partners of Ukraine) decreased 0.9% to 121.9 for the period. In year-on-year terms, real trade-weighted indices (CPI and PPI based) increased 7.6% and 14.4%, respectively, which implies faster prices growth in Ukraine compared with its main trade partners.

ICU view: This week, the hryvnia's rate will be in a tight range with an appreciation trend, as we expect supply and demand on the local currency market to be balanced.

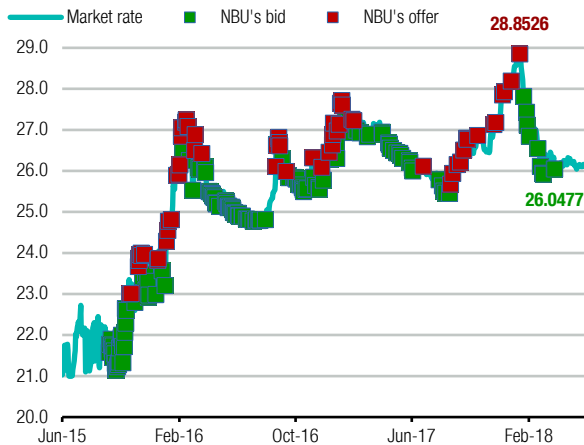
However, IMF comments related to the adoption of the law on the anticorruption court may affect the market. On the other hand, high level of liquidity in the banking sector may cause additional pressure on the hryvnia.

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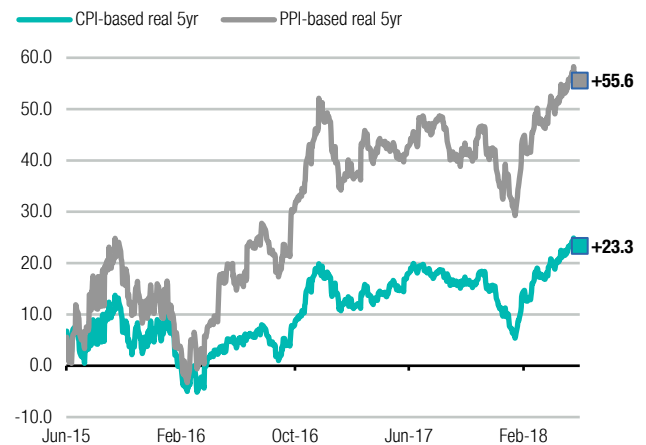
Chart 5. FX market indicators, 3-year history

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

Inflation slowed to 11.7% YoY in May

May's inflation reading came in at 11.7% YoY, the lowest rate since September 2016. Consumer prices remained flat in MoM terms. Solid consumer demand, loose fiscal policy, and rising energy prices will continue to put upward pressure on consumer prices.

The inflation slowdown was caused primarily by a deceleration of growth rates in prices for food products to 13.7% YoY in May, down from 17.2% YoY in April. The contribution of this particular category decreased by 1.5ppt to 5.8ppt out of the total reading of 11.7%. In addition, there was a slowdown in the growth rates of prices on alcoholic beverages and tobacco products to 19.4% YoY, and utilities to 4.9% YoY. Core inflation decreased by 0.1ppt to 9.3% YoY. The NBU forecasts CPI at 8.9% YoY for the end of 2018.

ICU view: The slowdown in growth rates of food-products prices was thanks to the good harvest of early fruits and vegetables, and moderate decline in prices for meat. However, this will be constrained by limited supply of some food products (e.g. meat, and milk products), while prolonged draughts are raising the risks of weaker grain crops this year. In addition, consumer prices will remain under pressure from solid domestic demand against the backdrop of an increase in consumer lending and rising wages as well as rising oil prices. Thus, we keep our inflation forecast unchanged at 11.5% for the end of 2018.

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Verkhovna Rada sacks Finance Minister

The appointment of Oksana Markarova as acting Finance Minister will ensure the continuation of the government's cooperation with the IMF. However, balancing the state budget in the pre-election year of 2018 remains a serious challenge for the MoF.

On Thursday, 7 June, Ukraine's parliament with 254 votes accepted the proposal of Prime Minister Volodymyr Groisman to remove Oleksandr Danyliuk from the post of Finance Minister.

On the same day, the Cabinet of Ministers appointed Oksana Markarova as acting head of the Finance Ministry. Previously, Mrs. Markarova had occupied the post of first deputy Finance Minister since April 2016. Upon her appointment, Markarova stated that she was looking forward to deepening cooperation with the IMF and announced higher budgetary efficiency, macroeconomic stability, and reducing fiscal risks to be her main priorities (sources: TV Channel 112 Ukraine, Interfax-Ukraine).

Danyliuk, in turn, said in a Hromadske TV broadcast that he leaves the MoF together with his advisors and the majority of deputies, in particular, Yuriy Butsa and Sergei Marchenko, who were responsible for debt and budgetary policy, respectively.

ICU view: Assigning Markarova to the position of acting Minister of Finance is a positive step. We do not expect a change in the budget and the debt policy of the Ministry. Markarova has a good reputation among Western investors and lenders. As acting Finance Minister, Markarova has enough authority to manage cooperation of the MoF with the IMF for the existing EFF program. In addition, Markarova had been in charge of budgetary policy for a considerable amount of time. However, it is the budget balance that is one of the most critical challenges for the Finance Ministry amid the ongoing under-fulfilment of the revenue part of the budget. Together with creating the anti-corruption court and raising natural gas tariffs for the population, balancing the state budget is the key pre-condition for Ukraine's obtaining an IMF tranche this year.

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The parliament passes the law on the Supreme Anticorruption Court

Adoption of the Anti-corruption Law is a crucial step towards the implementation of the key conditions of the IMF financial aid programme. But the next tranche has not been secured yet.

The Verkhovna Rada passed the Law on the Supreme Anticorruption Court of Ukraine (SACC). Establishing and the launch of the SACC was one of the key requirements of the IMF financial aid programme, together with hiking tariffs for gas for the population. Voting for the bill was preceded by months of negotiations in search of a compromise, with the main debates around the procedure for the election of SACC judges and the role of international experts. In the end, the law granted the Council of International Experts (CIE) substantial authority in appointing and vetoing candidates to the SACC.

The President of the Venice Commission, Gianni Buquicchio, stated that the law fully complies with the Commission's guidelines. However, some observers are cautious in assessing how fully the law takes into account the recommendations of the Commission and the IMF (sources: Ekonomichna pravda, Dzerkalo tyzhnia, DSnews). The IMF published the statement of the Fund's Permanent Representative in Ukraine Goesta Lungman about the need to analyse the law to determine its compliance with the existing agreement. Also, a number of experts emphasized that to begin to establish the SACC, parliament has to adopt two laws: the first one to actually create the SACC, and the second one bringing the SACC Law into conformity with the law on The Judicial System and Status of Judges.

ICU view: The adopted law on the SACC is likely to satisfy the IMF. But to fully comply with requirements of the IMF programme, Parliament must ensure the full functioning of the SACC by passing laws for its creation and the enforcement of compliance with judicial legislation. However, these procedures—unlike the SACC law itself—should require much less time and debate. The adoption of the SACC law increases the chance of Ukraine to receive the next IMF tranche in the fall. However, the final IMF approval of the law, as well as other key IMF conditions such as raising natural gas tariffs for the population and the balanced budget, are still required to secure the next tranche.

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International reserves drop by 1.6% MoM in May

International reserves continued declining due to sovereign debt repayments. To keep the international reserves above the current level, Ukraine needs to attract more external debt.

The volume of international reserves decreased in May by 1.6% MoM to US\$18.1bn due to repayments on public debt, out of which US\$455m was paid to the IMF. International reserves shrunk by more than US\$2bn YTD as a result of government FX debt and interest repayments. Net purchase of US1.2bn by the NBU during the five months of 2018 helped to replenish FX reserves. Foreigners invested in UAH government bonds in the equivalent of US\$200m YTD, which helped the regulator increase net purchases of FX. Ukrainian residents, mostly banks, made net investments in FX-denominated government bonds (both USD and EUR) in the amount of US\$0.2bn. International reserves have decreased by US\$689m (3.7%) since the beginning of the year as a result of these transactions.

ICU view: Given that the second half of the year is traditionally less favourable for the hryvnia, the National Bank will be limited in its ability to continue replenishing FX reserves. Therefore, in order to keep the amount of reserves above the current level (i.e. more than three months of import), Ukraine will need to raise funds from official lenders and/or in foreign markets.

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