



Focus
Ukraine

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

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Weekly Insight

Hryvnia fell below 27/USD

Key messages of the today's comments

Domestic liquidity and bonds market

Interest rates steady at 18%

After NBU increased the key rate, interest rates on short-term bonds rose to 18%. The MoF is attempting to keep rates from crossing this level, and will try to stay at 18% for the shortest bills.

NBU and Treasury absorbed liquidity

Liquidity in banking system declined due to FX selling by the NBU and absorption of funds by the Treasury. This week, liquidity could decline to UAH100bn.

Foreign exchange market

Hryvnia fell below 27/USD

We do not expect significant hryvnia fluctuations this week against the backdrop of relative balancing of demand and supply of foreign currency, but we still expect a slight weakening trend of the national currency.

Economics

C/A deficit at 2.3% of GDP in June

The annualized C/A deficit widened to US\$2.8bn in June due to the increasing merchandise-trade balance gap. Less favourable prices on Ukraine's exports and higher oil and gas prices will bring about further widening of both deficits.

TUESDAY, 7 AUGUST 2018

Banks' reserves market (6 August 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	17.50	+0bp	+500bp
ON rate (%)	N/A
ON \$ swap (%)	15.69	-46bp	+390bp
Reserves (UAHm) ²	44,699	-7.48	-11.53
DepCerts (UAHm) ³	58,063	-9.12	+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) (6 August 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	349,373	-0.27	-4.57
Banks	361,514	+1.37	+22.29
Residents	22,413	+0.01	+1.37
Individuals	4,072	+3.22	+464.66
Non-res ⁴	8,788	-4.88	+79,154.75
Total	746,160	+0.49	+8.95

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

FX market indicators (6 August 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	27.0500	+0.52	+4.56
EUR/USD	1.1554	-1.17	-1.86
DX ²	95.358	+0.85	+1.94
UAH TWI ³	118.063	+0.85	+4.21

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

Gov't bond quotes¹ (7 August 2018)

Maturity	Bid	Ask
6m	18.00	17.35
12m	18.25	17.40
2y	18.00	16.75
3y	18.00	16.75
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

Interest rates steady at 18%

After NBU increased the key rate, interest rates on short-term bonds rose to 18%. The MoF is attempting to keep rates from crossing this level, and will try to stay at 18% for the shortest bills.

Last week, the MoF held two auctions offering only hryvnia-denominated bills, and borrowed more than UAH3bn. In demand, interest rates on short-term bills were up to 18.5%, but the MoF's decision was to keep cut-off rates for three-month and six-month bills at 18%, and increase the rate for three-year bills to 16.85%, compared with the previous auction. For more information, see our overview of last [Tuesday](#) and [Thursday's](#) auctions. Bills were mostly purchased by local banks, which increased their local-currency bonds portfolios by UAH3.3bn last week.

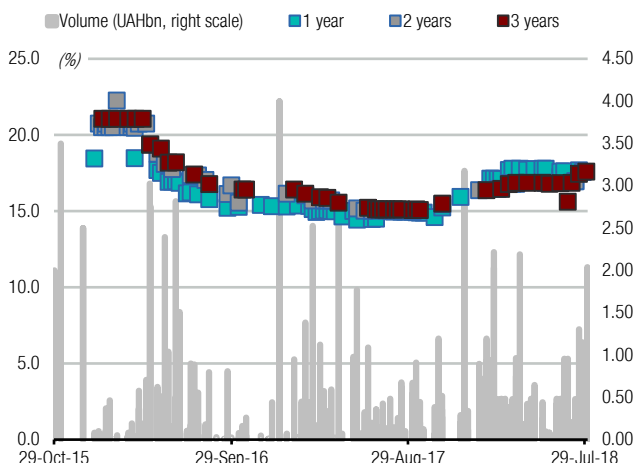
Foreign investors did not change their portfolios last week, which held steady at UAH8.8bn. Currently, these portfolios are just US\$325m at current rates. Compared with the recent high, they fell by about US\$235m. At the same time, in Kazakhstan, during the last four months, foreign investors' withdrawal of funds was larger, amounting to US\$0.9bn. Their portfolios fell by two-thirds to US\$0.45bn, according to Interfax. This outflow caused the tenge to weaken by 5% since the beginning of the year. But in Ukraine, the decline in foreign investors' portfolios did not cause hryvnia weakening; it has become stronger by 3.8% since January 2018.

ICU view: Taking into the account the structure of foreign investors' portfolios, where 75% are invested using CLN and 72% of their portfolios are in Ukrainian bills with maturities in 2019-2023, a significant decline is not expected. Also, we will see demand for local-currency bills with concentration at the shortest maturities and with interest rates at 18% this week. We also expect demand for FX-denominated bills with short-term maturities, which were announced for this week also.

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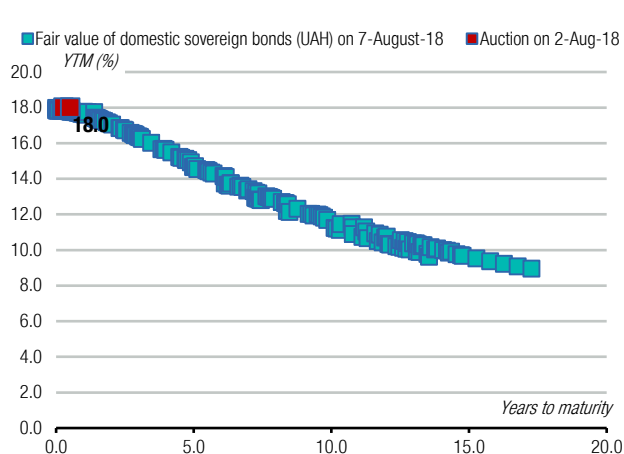
Chart 1. Local-currency bonds

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.

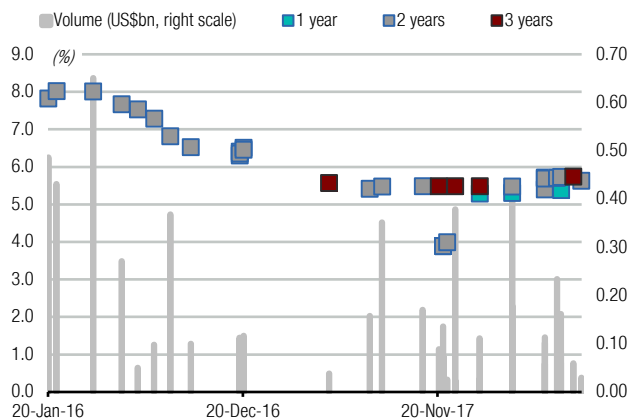
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

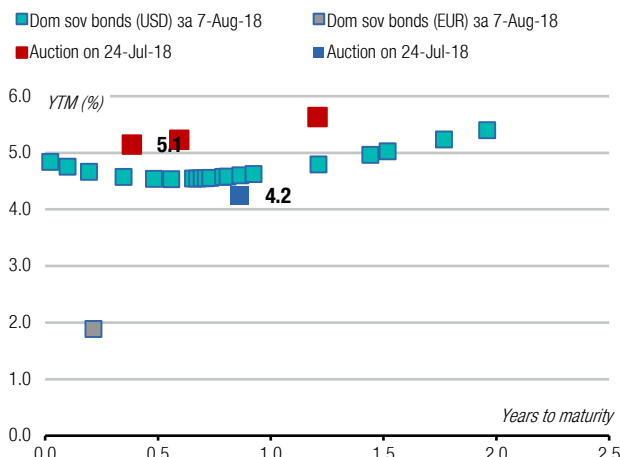
Chart 2. FX-denominated bonds

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.

NBU and Treasury absorbed liquidity

Liquidity in banking system declined due to FX selling by the NBU and absorption of funds by the Treasury. This week, liquidity could decline to UAH100bn.

Liquidity outflow was very fast last week, which could continue this week hitting the UAH100bn level, which will be neutral although larger than last years' level in August and this year's level in March. Most outflows were to the NBU via the FX market where the NBU sold US\$240m of FX and absorbed about UAH6.5bn of liquidity. The negative balance of Treasury operations amounted to UAH5.3bn. Unexpectedly for the beginning of the month, only cash exchange in reserves slightly compensated outflows by about UAH2.2bn.

At the same time, total CDs outstanding declined by UAH3.3bn last week to UAH57.7bn while banks' correspondent accounts with the NBU declined to UAH44.7bn. Local-currency debt repayments that took place last week, including UAH1bn of principal repayments, which were mostly paid to the NBU without impact on liquidity. But debt repayments increased the need for funds in budget accounts, and the NBU paid an additional UAH5.3bn of its extra revenues from last year.

ICU view: This week, liquidity will continue to decline due to outflows via the FX market to the NBU. Additionally, the Treasury will have a negative balance of operations with slow expenditures due to the low level of funds in its accounts. As a result, liquidity could decline to about UAH100bn this week.

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

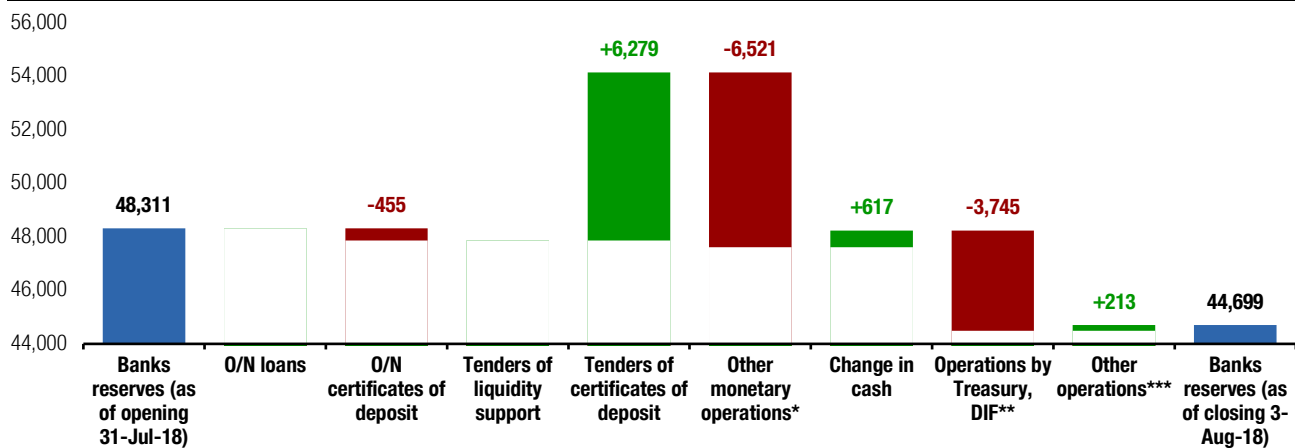
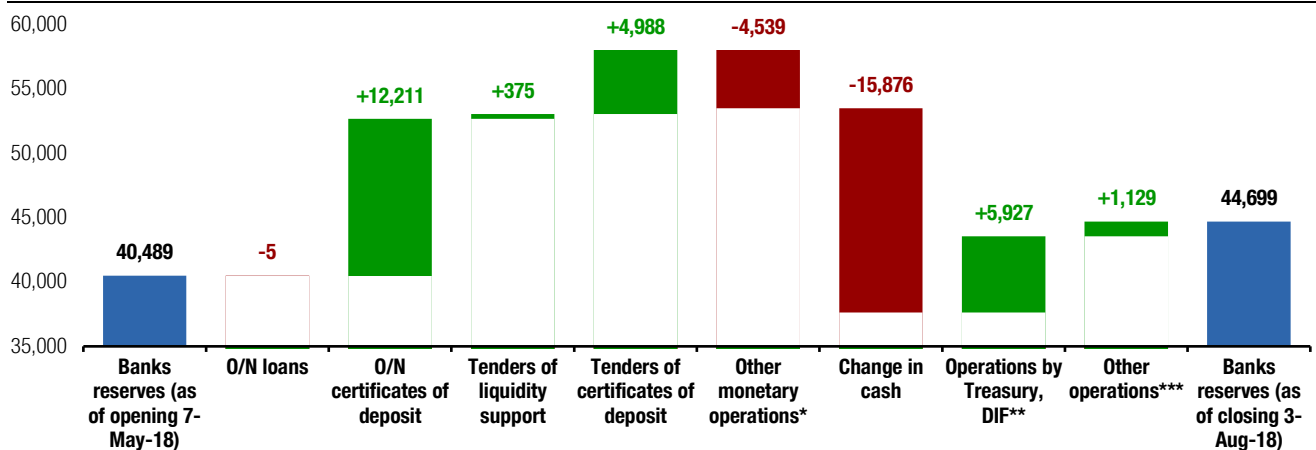


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

Hryvnia fell below 27/USD

We do not expect significant hryvnia fluctuations this week against the backdrop of relative balancing of demand and supply of foreign currency, but we still expect a slight weakening trend of the national currency.

Last week turned out to be very difficult for the Ukrainian currency, since the hryvnia was under pressure from buyers of foreign currency during the entire week. Firstly, there were final payments for VAT refunds, which increased hryvnia liquidity and curbed foreign currency sales by exporters. Secondly, affiliated companies bought currency for the payment of dividends abroad, which added pressure on the hryvnia. This situation forced the NBU to enter the market with the sale of foreign currency at auction (three times last week) for the first time since the end of January. Thus, the National Bank sold through this mechanism US\$178m. This deterred a further decrease of the hryvnia exchange rate. However, according to the results from last week, the national currency depreciated by 1.3% to 27.082 UAH/USD.

The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries trade partners of Ukraine) increased 0.85% to 118.1 for the period. In year-on-year terms,

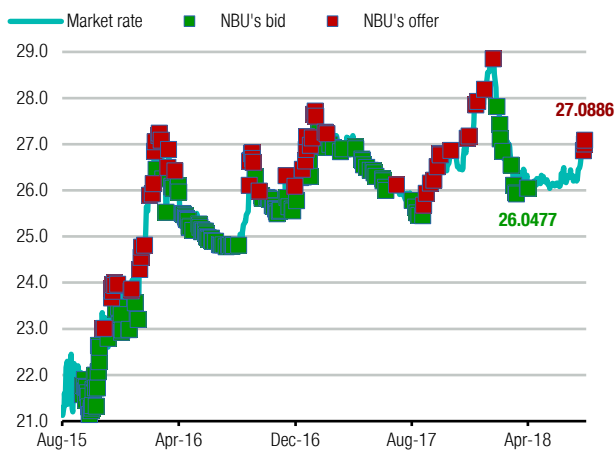
real trade-weighted indices (CPI and PPI based) increased 3.9% and decreased 2.7%, respectively.

ICU view: The hryvnia exchange rate should stabilize this week in the absence of important events. However, purchasing foreign currency for dividend payments abroad may continue this week, which will put pressure on the hryvnia exchange rate until the beginning of quarterly tax payments and, accordingly, the national currency may slightly weaken.

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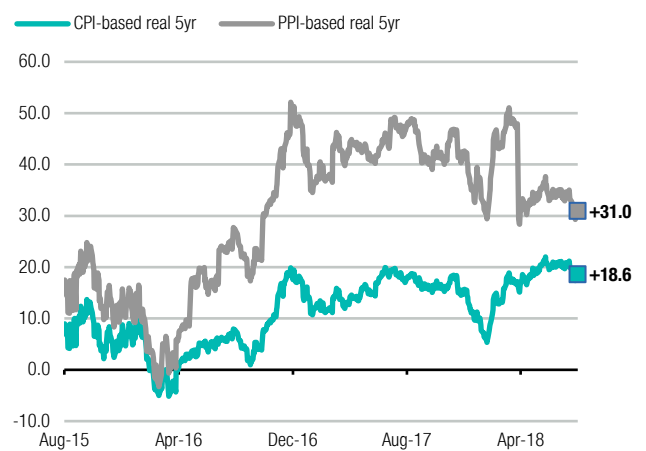
Chart 5. FX market indicators, 3-year history

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

C/A deficit at 2.3% of GDP in June

The annualized C/A deficit widened to US\$2.8bn in June due to the increasing merchandise-trade balance gap. Less favourable prices on Ukraine's exports and higher oil and gas prices will bring about further widening of both deficits.

The C/A deficit amounted to US\$613m (+2.2x YoY), while the merchandise-trade balance deficit widened to US\$4.3bn (+27% YoY) in 1H18, per data from the NBU. Exports of goods rose 11.7% YoY or US\$2.2bn, and totaled US\$21.2bn. The largest contribution to this increase was made by metallurgical exports (accounted for 67% from the total US\$2.2) thanks to both increased prices (HRC average price rose 25% YoY in 1H18, to \$583/t) and physical volumes (+14.2% YoY in 5M18, ICU's estimate is based on the data from the State Statistics Service of Ukraine). Other sources of increase were chemicals, and timber and wood products, which accounted to 13% and 11% respectively.

At the same time, Ukraine imported goods in the amount of US\$25.5bn (+14% YoY) in 1H18. In US dollar terms, imports rose US\$3.1bn: machinery and equipment accounted to 27% from this amount, chemicals 18%, and goods products and mineral products were each 15%. Here it should be noted that imports of mineral products surged 19.6% YoY in 2Q18 after a decline of 1.4% YoY in 1Q18, which was explained by resumed imports of gas against the backdrop of higher world prices. The negative impact on the C/A balance was, to some extent, mitigated

by higher primary and secondary income balances (+14.3% YoY, totaling US\$3.2bn in 1H18), and an increase of 59% YoY in the services-trade-balance surplus to US\$0.5bn.

ICU view: The C/A deficit will continue to widen in 2H18 due to higher volumes of energy imports against the backdrop of higher prices, a further increase in consumer and investment imports, and less favourable prices for steel and iron ore. We expect the C/A to widen to US\$3.8bn or 3% of GDP in 2018.

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