



Focus
Ukraine

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

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Weekly Insight

NBU keeps rate at 18%

Key messages of the today's comments

Domestic liquidity and bonds market

Domestic bonds outstanding increases

After last week's primary auction, total bonds outstanding increased to UAH758.9bn, and we expect the amount to continue to increase. Investments in domestic debt increased for all bondholder groups.

Liquidity remains high

Last week, banking-sector liquidity was around UAH120bn, despite low VAT refunds and month-end tax payments.

Foreign exchange market

Hryvnia appreciates

The return of foreign investors to the T-bill market and the minimum participation of the NBU in the FX market caused continued strengthening of the hryvnia. Last week the hryvnia finished at 27.495/US\$ and this week it could add another 10-20 kopecks.

Economics

C/A deficit at 3.6% of GDP in 2018

Thanks to lower world energy prices, lower volumes of dividends repatriation, and further economic growth, the C/A deficit will contract in 2019.

Sovereign debt rose in December

Last December, the total amount of sovereign debt rose by US\$3.6bn or UAH46bn in hryvnia equivalent, including an increase in both domestic and external debt. This amount of debt will likely remain stable in January, with a small increase in domestic debt.

NBU keeps rate at 18%

Despite the positive situation for the UAH and declining inflation, the NBU did not lower the rate in an effort to bring CPI growth to its 5% target in 2020. However, we still expect a gradual increase of the key rate to 16% by YE2019.

MONDAY, 4 FEBRUARY 2019

Banks' reserves market (1 February 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	18.00	+0bp	+200bp
ON rate (%)	16.34	+4bp	+134bp
ON \$ swap (%)	14.24	-64bp	-56bp
Reserves (UAHm) ²	50,869	-11.83	+10.98
DepCerts (UAHm) ³	65,867	+11.60	+26.36

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) (1 February 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU	342,124	-0.48	-4.59
Banks	374,956	+0.36	+7.09
Residents	22,945	+12.06	-0.07
Individuals	6,648	+0.32	+351.27
Non-res ⁴	12,211	+26.79	+45.45
Total	758,885	+0.63	+2.34

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

FX market indicators (1 February 2019)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	27.4950	-1.07	-1.33
EUR/USD	1.1456	+0.44	-8.43
DX ²	95.579	-0.22	+7.79
UAH TWI ³	117.576	+0.68	+10.28

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

Gov't bond quotes¹ (4 February 2019)

Maturity	Bid	Ask
6m	20.00	18.50
12m	20.00	18.50
2y	19.75	18.00
3y	19.50	17.50
12m (\$)	7.50	5.25
2y (\$)	7.50	5.50

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

Domestic liquidity and bonds market

Domestic bonds outstanding increases

After last week’s primary auction, total bonds outstanding increased to UAH758.9bn, and we expect the amount to continue to increase. Investments in domestic debt increased for all bondholder groups.

Refinancing debt repayments in FX-denominated bills, and large new borrowings in local currency (see [auction overview](#)) increased total bonds outstanding, despite a decline in NBU’s portfolio. All bondholder groups could continue to increase their portfolios this week, too, as the NBU’s key rate remains at 18%, which should stabilize interest rates at the current level.

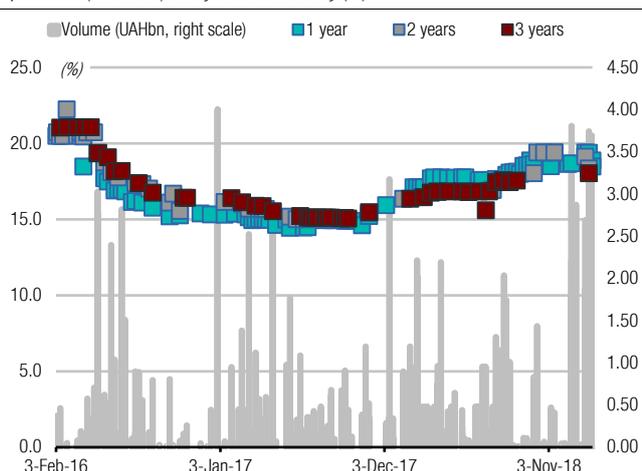
Last week, the largest increase was in foreign investors’ portfolios, as they purchased nearly UAH2.6bn of new bills. Non-bank investors increased portfolios by UAH2.1bn, banks by UAH1.6bn, and individuals kept their portfolios steady, reinvesting received repayments. Most of the increase was due to purchases of local-currency bills.

ICU view: High interest rates of local-currency bills, anticipation of seasonal hryvnia appreciation, and positive exchange-rate dynamics in 2018 created sufficient stimulus to increase investments in local-currency bills. So, this week, we expect an increase in investments from all groups, including foreigners, and they likely will prefer three-month bills with maturity prior to the president elections.

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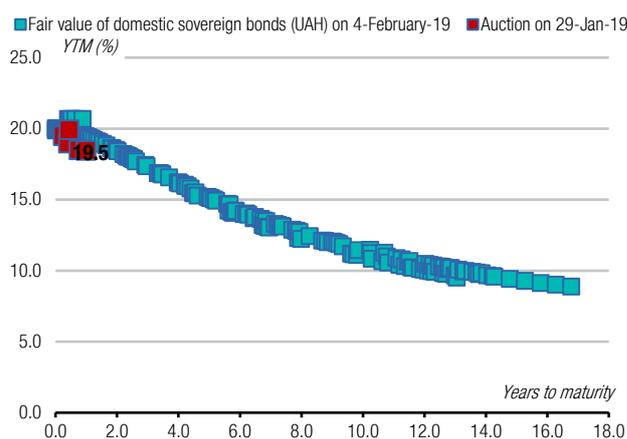
Chart 1. Local-currency bonds

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.

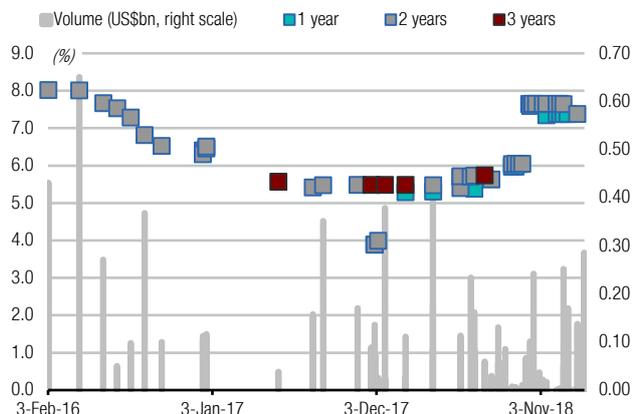
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

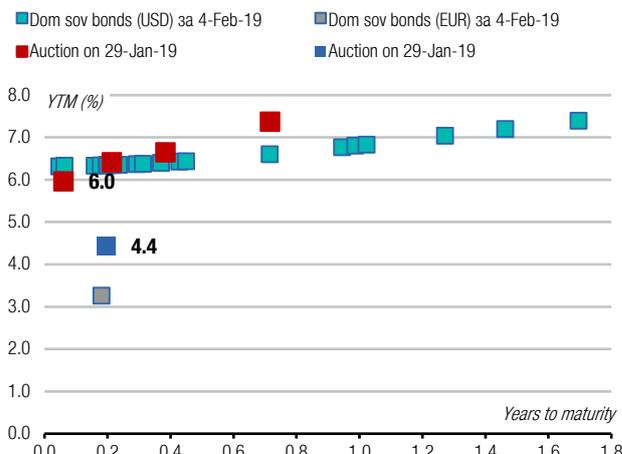
Chart 2. FX-denominated bonds

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 remains high

Last week, banking-sector liquidity was around UAH120bn, despite low VAT refunds and month-end tax payments.

Last week, liquidity received insufficient support from the NBU, as it purchased about US\$45m of FX from the market, and banks repaid loans to the NBU. So, the net balance of NBU operations was negative for liquidity. Non-monetary operations also had a negative impact on liquidity. The Treasury's positive impact changed to negative, and last week, it absorbed UAH15bn, the main negative impact on liquidity, as cash exchange in reserves amounted to UAH6.8bn, compensating only part of outflows.

ICU view: Despite a lack of support and mostly negative impact, liquidity was high, and it declined only to UAH115.1bn. The beginning of a new month could change the direction of Treasury operations to provide support for liquidity. So, liquidity should remain at a high level at least to the end of this week, to be ready for quarterly tax payments that start next week.

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

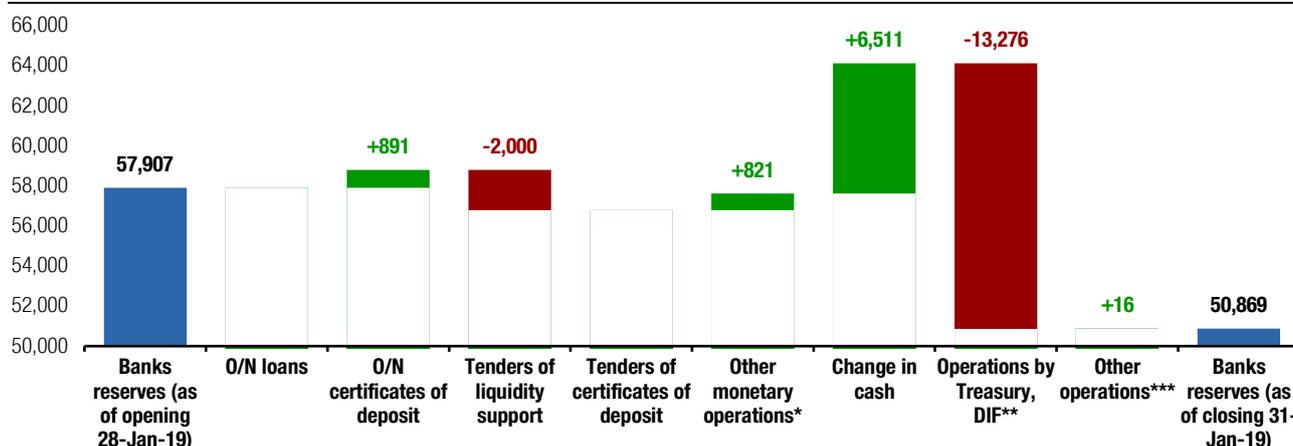
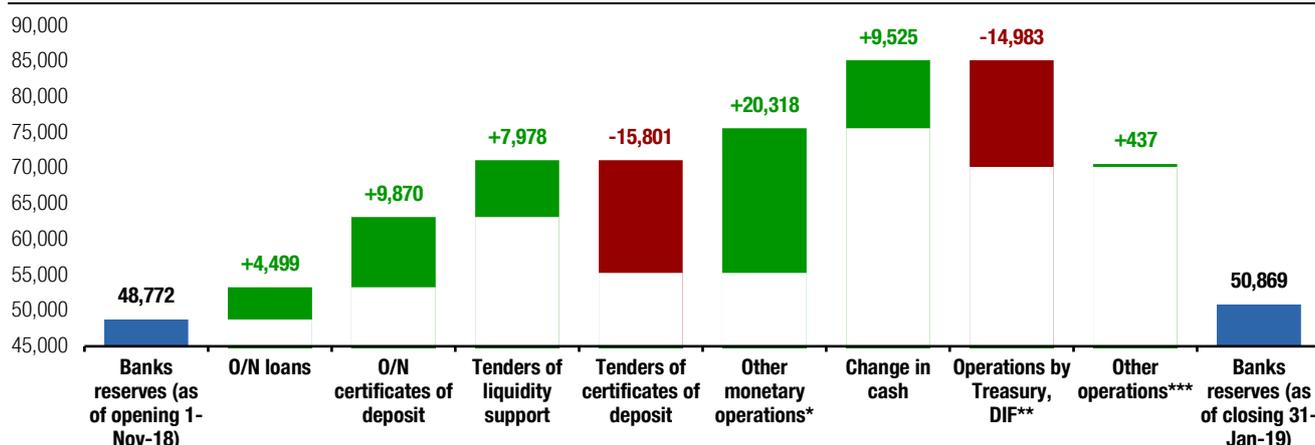


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 appreciates

The return of foreign investors to the T-bill market and the minimum participation of the NBU in the FX market caused continued strengthening of the hryvnia. Last week the hryvnia finished at 27.495/US\$ and this week it could add another 10-20 kopecks.

Last week, foreign investors purchased UAH2bn of new local-currency bills and UAH0.4bn of bills denominated in FX, increasing total portfolios outstanding to UAH12.2bn. Therefore, total FX inflow in Ukraine amounted to US\$80m during the week, with most of the FX sold at the market. As the result, last week, supply exceeded demand and pressured the exchange rate, decreasing the cost of FX.

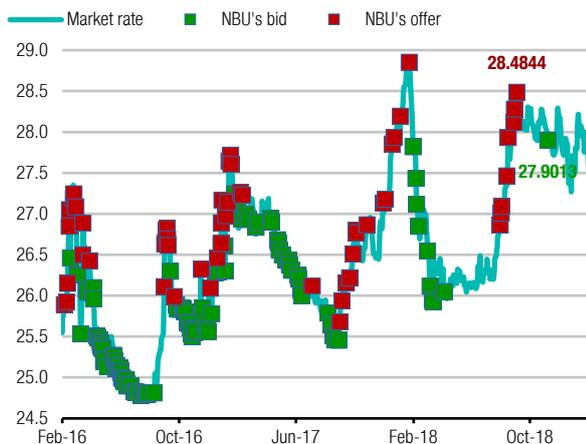
Finally, last week, the hryvnia appreciated by 1.1%, and by 1.3% YoY. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) rose 0.68% to 117.6 while in YoY terms, it was up 10.3%.

ICU view: The market should continue to receive enough supply of FX, which should cause additional hryvnia appreciation. However, at the end of this week, new, easier regulations for the FX market will go into effect, and demand for FX could rise. Despite this easing of regulations, we expect further hryvnia appreciation to UAH27.3-27.4/USD.

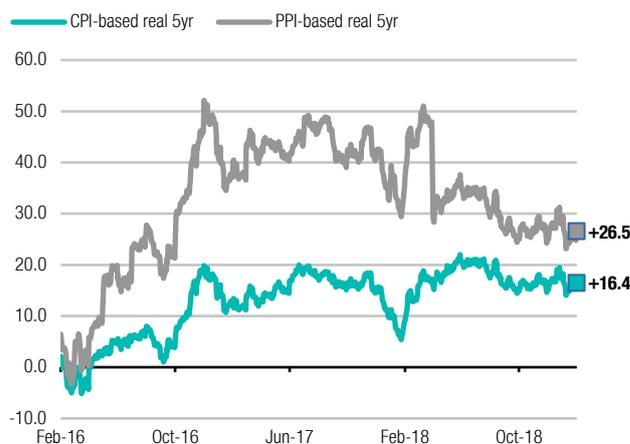
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Chart 5. FX market indicators, 3-year history

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 3.6% of GDP in 2018

Thanks to lower world energy prices, lower volumes of dividends repatriation, and further economic growth, the C/A deficit will contract in 2019.

The annualized C/A deficit contracted to US\$4.7bn in December, down from US\$5.1bn in November, bringing the full-year 2018 reading to a deficit of 3.6% of GDP.

The merchandise-trade-balance deficit amounted to US\$13bn (+34% YoY) or 9.9% of GDP. In 2018, imports of goods in Ukraine rose 14% YoY to US\$56.3bn. Key growth drivers were machinery and equipment (+18% YoY), energy imports (+14% YoY), and chemical products (+9% YoY). Exports of goods rose 9.2% YoY to US\$43.3bn, thanks to metallurgical exports (+15% YoY), which accounted for 42% of total increase, and food products (+5%). The services trade balance surplus rose 44% YoY to US\$1.5bn. Remittances from abroad increased by 20% YoY to US\$11bn.

ICU view: The full-year 2018 C/A deficit slightly exceeded our estimate of 3.8% of GDP mostly due to lower trade balance deficit (US\$11.5bn vs. our estimate of US\$11.9bn) against the backdrop of lower energy imports and higher exports of food products. Our baseline forecast envisages the C/A deficit contracting to 3.3% of GDP in 2019 (US\$4.8bn) thanks to 1) lower volumes of energy imports supported by decreased world energy prices, 2) lower volumes of dividends repatriation this year, and 3) further growth of Ukraine's economy.

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Sovereign debt rose in December

Last December, the total amount of sovereign debt rose by US\$3.6bn or UAH46bn in hryvnia equivalent, including an increase in both domestic and external debt. This amount of debt will likely remain stable in January, with a small increase in domestic debt.

During December 2018, Ukraine received the first tranche from the IMF according to the new SBA programme, in the form of government-guaranteed debt, causing external guaranteed

debt to increase by US\$1.4bn. State external debt rose by US\$0.8bn due to macro-financial aid from the EU and borrowings under the WB guarantee.

Domestic debt rose, too, as in December the MoF became active with new borrowings and on 18 December 2018 borrowed UAH20bn. Additionally, an increase of domestic debt in US\$ equivalent was due to hryvnia appreciation. In local currency, debt rose by UAH20bn, while in US\$, the increase was greater.

However, according to the MoF's assumption of nominal GDP, the ratio of total debt to GDP declined to about 62%, below that of the previous four years.

ICU view: During January, we saw high activity of the MoF in the primary bond market, and we anticipate an increase in domestic debt by UAH700-800m or about US\$30m. External debt should decline due to a lack of new borrowings. Therefore, total debt outstanding should decline slightly with a larger decline in external debt and a slight increase in domestic debt.

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NBU keeps rate at 18%

Despite the positive situation for the UAH and declining inflation, the NBU did not lower the rate in an effort to bring CPI growth to its 5% target in 2020. However, we still expect a gradual increase of the key rate to 16% by YE2019.

Despite earlier rhetoric, the NBU did not change its end of year 2019 and 2020 inflation forecast from 6.3% YoY and 5.0% YoY, respectively. However, in order to achieve this goal, the regulator has to keep the rate at 18% at the moment. NBU sees the potential for easing monetary policy under the base-case scenario of Ukraine continuing its cooperation with the IMF and a further decline in inflation.

ICU view: Despite the numerous challenges laying ahead for the Ukrainian economy in the upcoming year, we expect a gradual decrease of the key policy rate to 16% by the end of the year.

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