

Weekly Insight

Parliament passes banking law

Key messages of the today's comments

Domestic liquidity and bonds market

Foreigners' exit from UAH bills slows

Last week, the decline in foreign investors' portfolios of UAH-denominated government bills slowed, but their exit from local debt continued. Steps toward the IMF programme can have a positive impact this week, but we do not expect portfolios to increase.

Budget absorbs liquidity

Banking-sector liquidity declined last week to UAH196bn due to outflows to the budget, which will continue this week due to quarterly and month-end tax payments and new T-bill issues.

Foreign exchange market

Hryvnia continues to appreciate

The hryvnia exchange rate appreciated throughout last week ending at UAH26.65/US\$ on Friday. This week, due to quarterly tax payments, the supply of hard currency will be high, creating positive pressure on the hryvnia, moving exchange rate to around UAH26.5/US\$.

Economics

GDP falls by 1.5% YoY in 1Q20

Unsurprisingly, the economy was hit hard by lockdown measures in March. However, Ukraine is still performing better than EU countries on average.

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TUESDAY, 19 MAY 2020

Banks' reserves market (18 May 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	8.00	+0bp	-950bp
ON rate (%)	7.31	+13bp	-872bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	66,283	+33.39	+18.69
CDs (UAHm) ³	130,034	-16.62	+0.00

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's certificates of deposit.

Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (18 May 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	370,122	+3.13	+1.16
Residents	51,560	+1.74	+103.77
Individuals	7,365	-12.80	-20.28
Foreigners ¹	109,163	-0.78	+160.16
Total	862,786	+1.20	+10.69

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (18 May 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	26.5650	-0.58	+0.70
EUR/USD	1.0913	+0.60	-2.20
DXY	99.665	-0.27	+1.70
UAH TWI ¹	131.543	+0.06	+5.34

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (19 May 2020)

Maturity	Bid	Ask
6m	12.50	11.00
12m	12.50	11.00
2y	12.50	11.00
3y	12.50	11.00
12m (\$)	5.00	3.00
2y (\$)	6.00	3.50

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

Source: ICU.

Domestic liquidity and bonds market

Foreigners' exit from UAH bills slows

Last week, the decline in foreign investors' portfolios of UAH-denominated government bills slowed, but their exit from local debt continued. Steps toward the IMF programme can have a positive impact this week, but we do not expect portfolios to increase.

Successful placement of new bills last week did not affect foreigners' portfolios, as new issues were mostly purchased by local banks. Out of UAH20bn (US\$0.8bn) of new bills sold at the auction (par value), about UAH17bn (US\$0.6bn) likely purchased by banks, and non-banks and individuals bought the other UAH3bn. Interest rates, set at 11.26-11.28% last Tuesday (see details in [auction review](#)), are not very attractive for non-banking investors, as they do not have access to NBU refinancing loans.

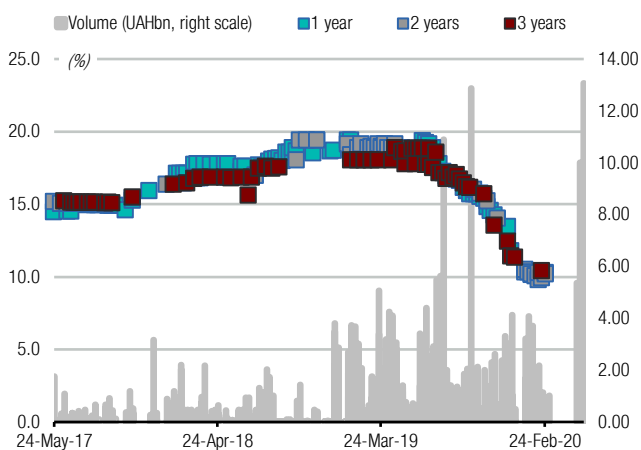
Although it does not appear that foreigners purchased new bills, they significantly slowed selling older bills. Last week, the portfolios of foreign investors declined just UAH0.8bn (US\$30m), or three times less than a week before. The lack of debt redemptions had low effect, as foreigners sold greater amounts earlier this month than they received in redemptions.

ICU view: Most likely, foreigners will not change their view on Ukrainian local-currency debt and will not increase their portfolios. However, the selling of local-currency bills has slowed, probably at the same pace as last week. New issues most likely will be purchased by banks, as they provide higher interest rates than NBU's CDs, and can be used for new NBU loans.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

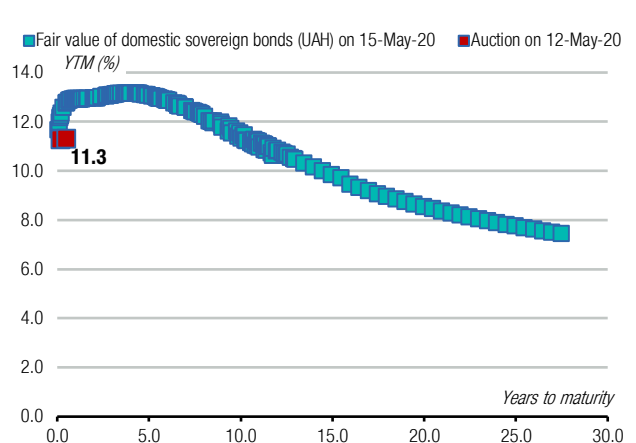
Chart 1. Local-currency bonds

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.

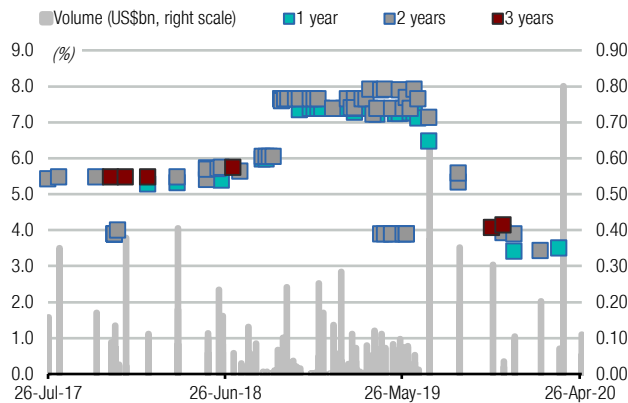
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

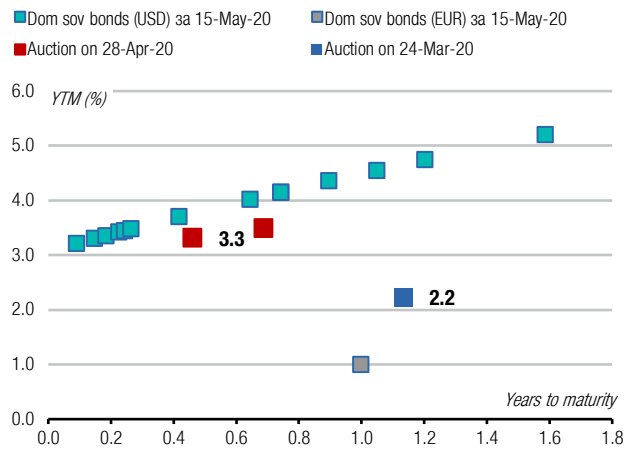
Chart 2. FX-denominated bonds

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.

Budget absorbs liquidity

Banking-sector liquidity declined last week to UAH196bn due to outflows to the budget, which will continue this week due to quarterly and month-end tax payments and new T-bill issues.

Settlement of new UAH-denominated bills was decisive in liquidity changes last week. Last Wednesday, outflows to the budget was UAH14.8bn, and in total last week, UAH8.9bn. Additionally, last week, banks exchanged UAH5.2bn of reserves in cash, usual transactions for the first half of the month. In total, the negative impact from non-monetary operations was UAH13.8bn last week.

However, the NBU continued to purchase extra supply of hard currency, spending UAH4.3bn last week. Nevertheless, this inflow was not enough to compensate outflows through non-monetary operations.

Finally, banking-sector liquidity declined to UAH196bn, without material impact on interbank interest rates, keeping ON interest rates slightly below the NBU key policy rate.

ICU view: The last days of quarterly tax payments are this week. Later this week, month-end tax payments will begin. Therefore, outflows to budget accounts will continue, and will be larger with the settlement of new bills. As a result, banking-sector liquidity can decline below UAH190bn, causing a short-lived increase in interbank rates.

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

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

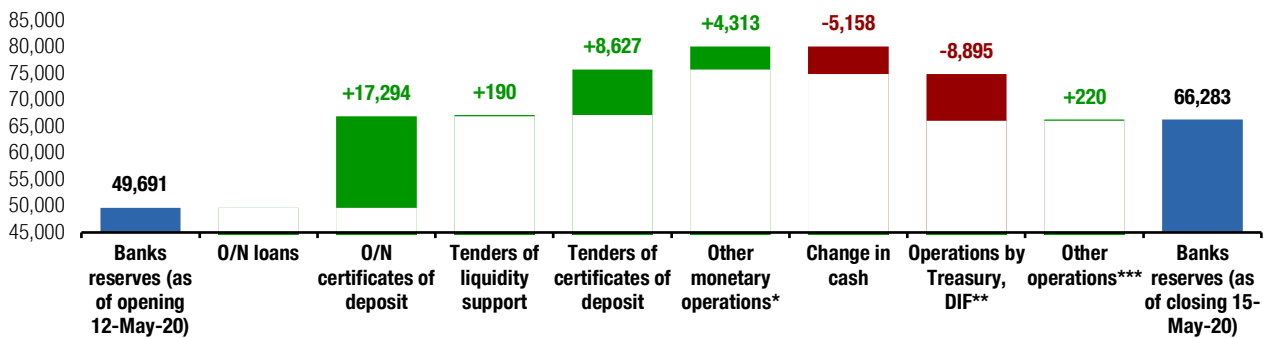
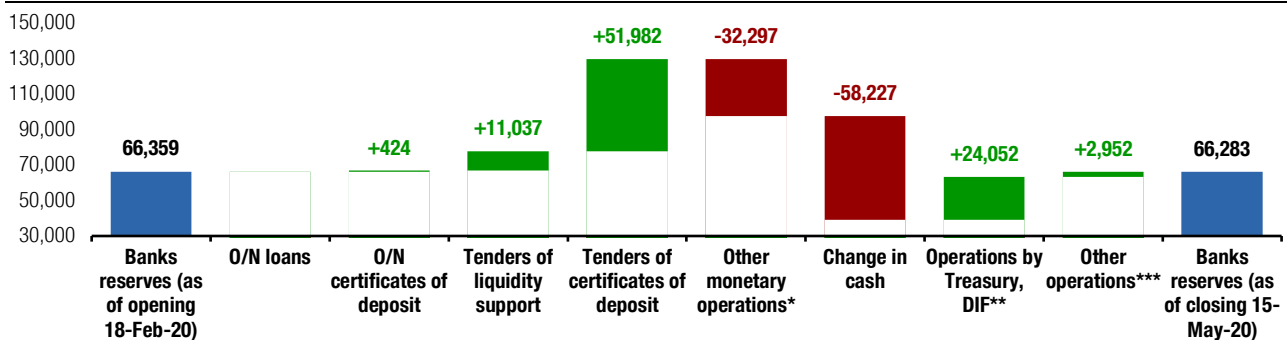


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 continues to appreciate

The hryvnia exchange rate appreciated throughout last week ending at UAH26.65/US\$ on Friday. This week, due to quarterly tax payments, the supply of hard currency will be high, creating positive pressure on the hryvnia, moving exchange rate to around UAH26.5/US\$.

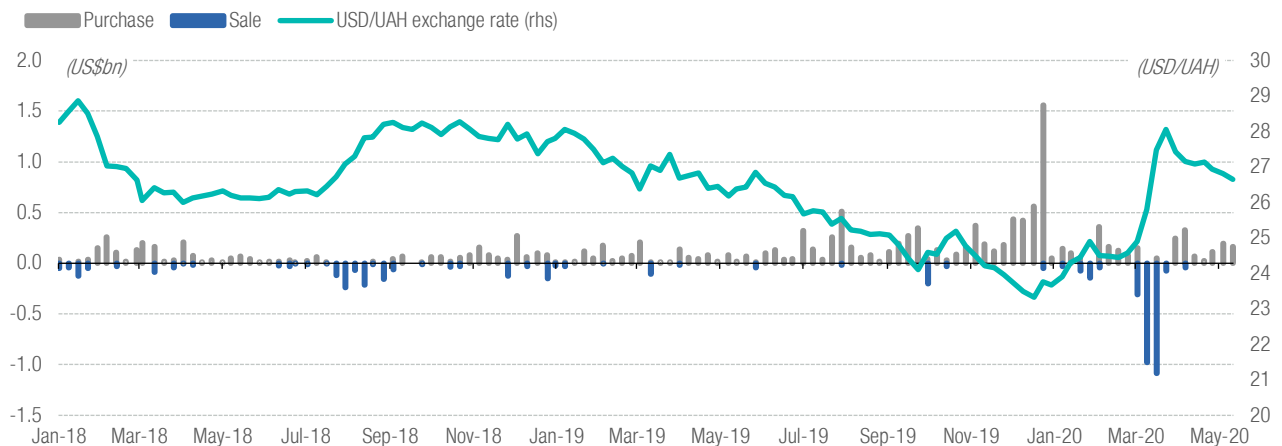
Last week, banks purchased a large portion of new bills, but the need for local-currency funds remained high due to tax payments. There was an oversupply of hard currency in the FX market and the hryvnia appreciated. NBU interventions just restrained hryvnia appreciation. During the week, the NBU purchased US\$161m from the market.

ICU view: *Supply of hard currency will be huge this week, too, due to quarterly tax payments and switching to month-end taxes. Therefore, the hryvnia will remain strong with slight appreciation to around UAH26.5/US\$. This should happen despite NBU participation in the market purchasing of extra supply. Parliament voting on the banking law (see comment below) should add positive sentiment and add some psychological support for the hryvnia.*

Taras Kotovych, Kyiv, (044) 377-7040 ext.724

Chart 5. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market and NBU interventions (weekly data)



Source: NBU, Bloomberg, ICU.

Economics

GDP falls by 1.5% YoY in 1Q20

Unsurprisingly, the economy was hit hard by lockdown measures in March. However, Ukraine is still performing better than EU countries on average.

As expected, flash GDP estimates for 1Q20 showed that the containment measures implemented in March negatively affected the economy: GDP contracted by 0.8% QoQ SA and 1.5% YoY. The result for the quarter was determined by poor economic performance in March, while GDP contraction in January-February was estimated by the Ministry of Economy to be minor, 0.2% YoY. UkrStat will publish the breakdown for GDP and the nominal values on 19 June.

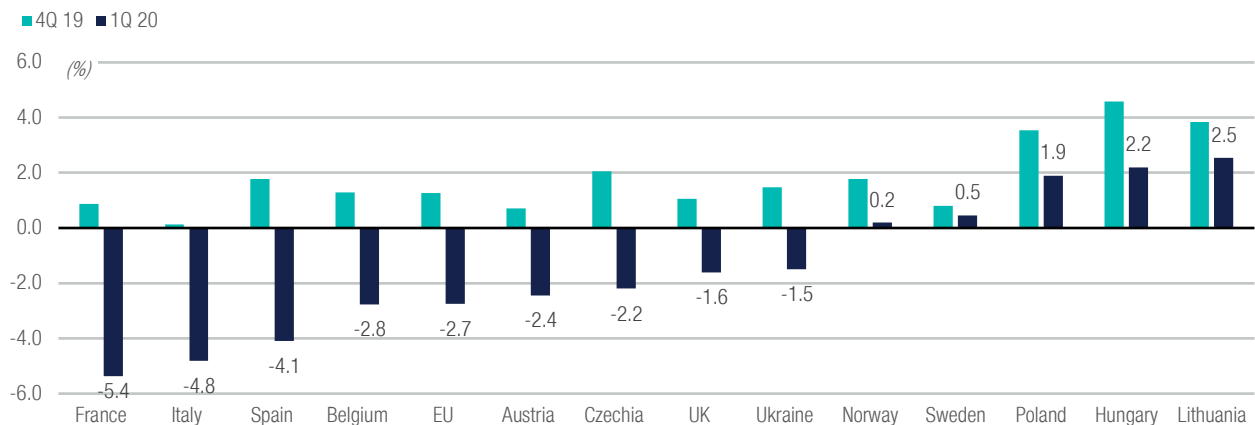
ICU view: *The flash GDP reading was slightly worse than our estimate and the Bloomberg consensus forecast (both a YoY decline of 1.0%). After growth for 16 consequent quarters, a contraction was expected because of the more challenging external environment, lower demand for energy thanks to warm weather, lower volumes of gas transportation, and last but not least, the initial impact of containment measures. Larger-than-expected contraction can be explained by the deeper impact of the lockdown on performance of the services sectors where data is not observed on a monthly basis (education, healthcare, accommodation and food services, arts and entertainment, etc.)*

Meanwhile, thanks to the lower share of services in GDP and relatively modest number of COVID cases, the contraction in Ukraine was slightly milder compared with average figures in Europe (in the EU, GDP fell by 2.7% YoY in 1Q 20). However, most CEE economies (except of the Czech Republic) continued to grow although at a decelerating rate compared with previous quarters.

Looking ahead, 2Q20 economic activity figures are likely to reveal the full extent of the crisis. We currently expect GDP to start recovery from 3Q20, but at a slow pace due to lower incomes and precautionary behavior of consumers and investors which could cause full-year GDP contraction of 6-8%.

Sergiy Nikolaychuk, Kyiv, (044) 377-7040 ext.721

Chart 6. Real GDP (YoY, %)



Source: OECD, State Statistics Service of Ukraine, ICU.

Parliament passes banking law

The IMF saga could finally come to an end with payment of the tranche in June.

Despite fierce opposition from within the ruling party and with the help of the de jure opposition, Verkhovna rada passed the law on banks, which is a condition for the IMF programme. It addresses the loopholes in the existing legislation that allowed insolvent banks to be brought back to life by court decisions. The new law prevents any insolvent bank from that kind of resuscitation. Former shareholders will be entitled to compensation only in the case of wrongdoing from the regulator, but their ownership of the bank will not be reinstated. It applies both to banks in liquidation and nationalized banks. The law also requires a reputable audit firm to assess the equity of the bank at the moment it was deemed insolvent.

ICU view: There will be another round of voting on the motion to cancel the results of Wednesday's vote. Given the fact that the law received 270 votes in favour and 153 against (including absentees and those who abstained), it is extremely unlikely that this motion will get the necessary 226 votes. In fact, this will be another technical obstacle aimed at postponing the signing of the bill by another week or two.

We expect a positive decision on the first tranche of the IMF programme and its disbursement by the end of June. This law will be challenged by the various political forces in the constitutional court. While it is hard to predict the outcome of the court's decision, any ruling is possible after the first tranche is disbursed.

Mykhaylo Demkiv, Kyiv, (044) 377-7040 ext.723

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11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kyiv, 01030 Ukraine
Phone/Fax +38 044 3777040

WEB www.icu.ua



RESEARCH

Sergiy Nikolaychuk

Head of macro research
sergiy.nikolaychuk@icu.ua

Taras Kotovych

Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Dmitriy Dyachenko

Junior financial analyst
dmitriy.dyachenko@icu.ua

Alexander Martynenko

Head of corporate research
alexander.martynenko@icu.ua

Mykhaylo Demkiv

Financial analyst (Banks)
mykhaylo.demkiv@icu.ua

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