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

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Weekly Insight

GDP falls 11.4% YoY in 2Q20

Key messages of the today's comments

TUESDAY, 22 SEPTEMBER 2020

Domestic liquidity and bonds market

Foreigners accelerate selling T-bills

Due to the gradual weakening of hryvnia, foreigners have been more actively selling T-bills. This week, their portfolios declined again.

Liquidity increases

Fluctuations of banking-sector liquidity were low last week. Due to budget expenditures, liquidity slightly increased. This week, we expect the balance of budget operations to have a neutral impact on liquidity.

Foreign exchange market

Hryvnia weakens to above UAH28/US$

Expectedly, the hryvnia exchange rate continues to weaken, and reached UAH28.2/US$ at the end of last week. This week, the increase in hard-currency supply for month-end tax payments can stabilize the exchange rate above UAH28/US$.

Economics

ICU Macroeconomic Review – Bumpy recovery underway

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GDP falls 11.4% YoY and 9.9% QoQ SA in 2Q20

Ukrstat confirmed the flash estimates of a sharp fall in GDP for 2Q20 amid the COVID-19 pandemic and lockdown. Then the economy has started to recover, and for full-year 2020, we forecast a downturn of 5.7%.

Banks' reserves market (21 September 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	+0bp	-1,050bp
ON rate (%)	5.70	+39bp	-936bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	58,432	-5.71	-0.72
CDs (UAHm)[3]	109,147	+5.17	+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) (21 September 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.71
Banks	425,831	+1.07	+21.78
Residents	31,322	+10.62	+18.80
Individuals	8,267	+4.60	-19.03
Foreigners[1]	84,893	-1.44	-7.20
Total	**874,891**	**+0.76**	**+7.38**

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

FX market indicators (21 September 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	28.2307	+0.60	+15.67
EUR/USD	1.1771	-0.64	+6.84
DXY	93.656	+0.65	-4.93
UAH TWI[1]	120.836	+0.18	-10.84

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

Gov't bond quotes[1] (22 September 2020)

Maturity	Bid	Ask
6m	**10.00**	**8.00**
12m	**10.50**	**9.00**
2y	**11.00**	**10.00**
3y	**11.50**	**10.50**
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 accelerate selling T-bills

Due to the gradual weakening of hryvnia, foreigners have been more actively selling T-bills. This week, their portfolios will decline again.

Last week, foreigners decreased portfolios by UAH1.6bn (US$57m), the largest withdrawal over the last two months, after they decreased portfolios by UAH2.1bn in mid-July. In July they were very active due to hryvnia weakening to about UAH27.5/US$ from slightly above UAH26.5/US$ at the end of June.

Foreign portfolios slid below UAH85bn (US$3bn), and their share in total bonds outstanding declined to 9.7% last week.

ICU view: This week, the decline in foreigners' portfolios will continue. We expect that they can again withdraw more than UAH1bn (US$35m). This will happen due to selling bills since this week there are not any redemptions. The main reason will be weakening of the hryvnia. Foreigners will not wait for redemption at the end of the month.

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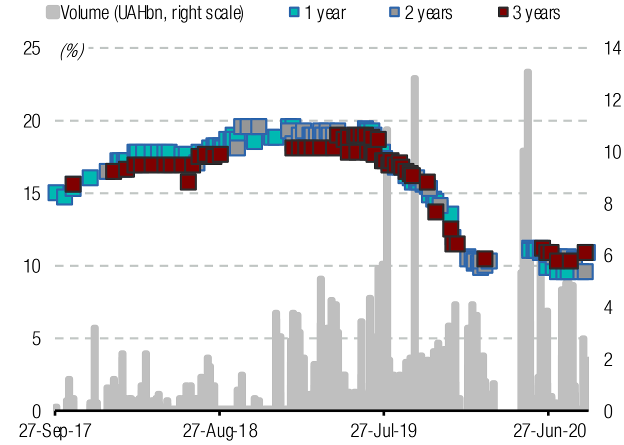
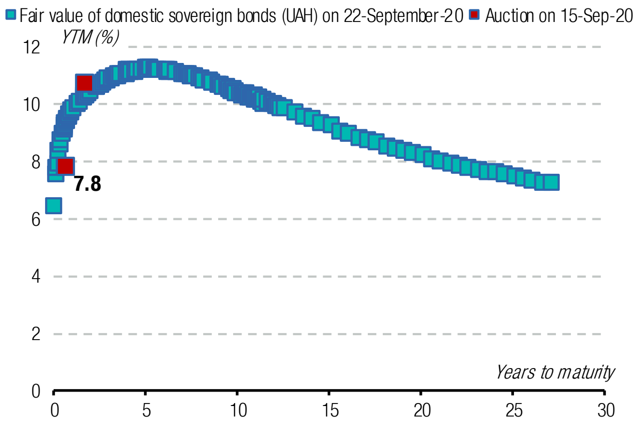
Chart 1. Local-currency bonds

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.

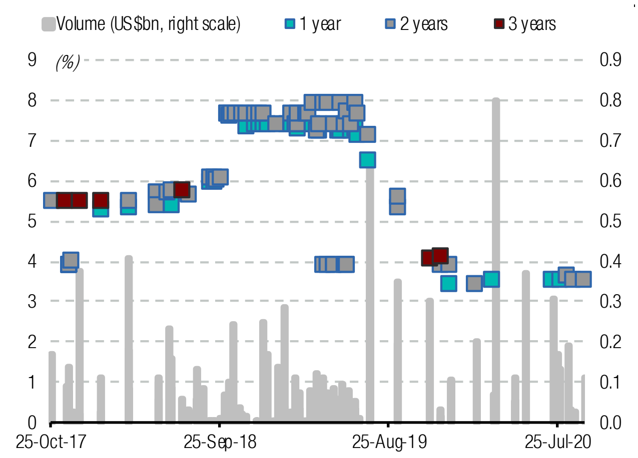
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

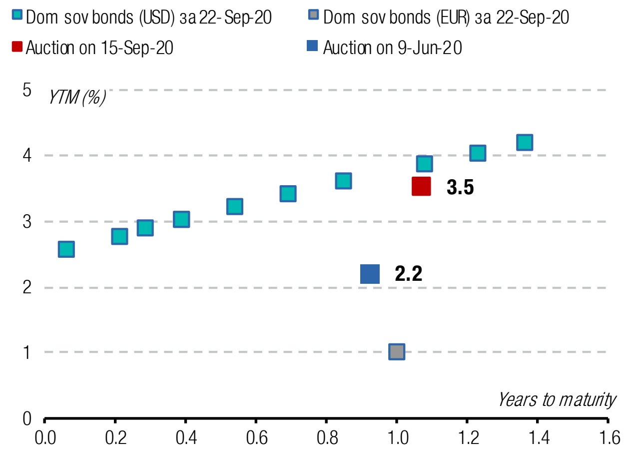
Chart 2. FX-denominated bonds

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 increases

Fluctuations of banking-sector liquidity were low last week. Due to budget expenditures, liquidity slightly increased. This week, we expect the balance of budget operations to have a neutral impact on liquidity.

Last week, budget expenditures increased thereby causing UAH8.8bn of inflows into the banking system. These funds were enough to cover outflows to other categories, as banks exchanged reserves in cash for UAH2.1bn, and the NBU absorbed an additional UAH2bn through the FX market.

Banks kept outstanding CDs slightly above UAH100bn, and more than UAH60bn was held in correspondent accounts with the NBU. Just last Friday, the amount of NBU CDs increased to UAH109bn, decreasing banks' correspondent account balances to UAH58.4bn.

ICU view: This week, we do not expect liquidity to increase due to more balanced Treasury operations. Yesterday started month-end tax payments, and banks will continue exchange reserves in cash. Additionally, the NBU can continue to sell hard currency to restrain weakening, absorbing new liquidity.

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

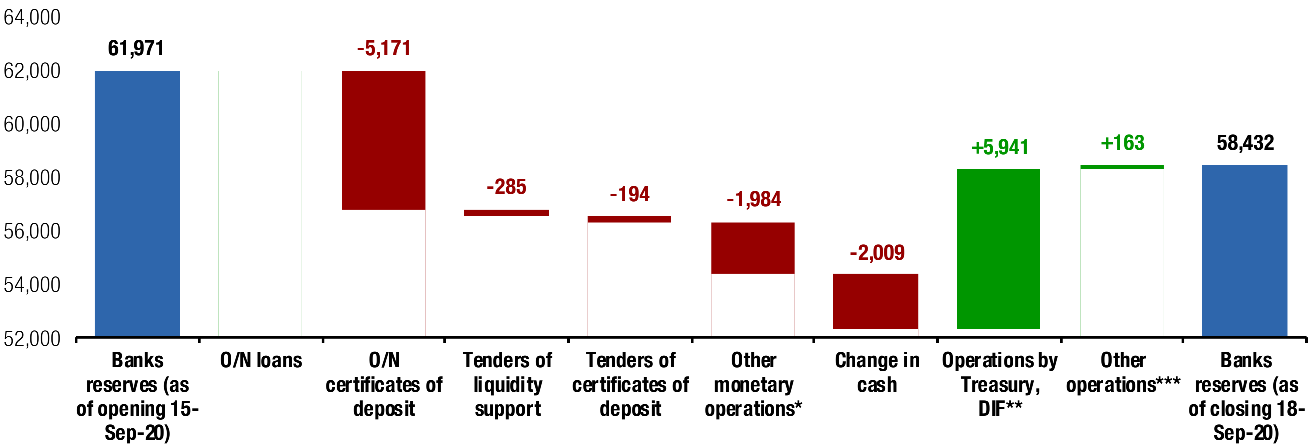
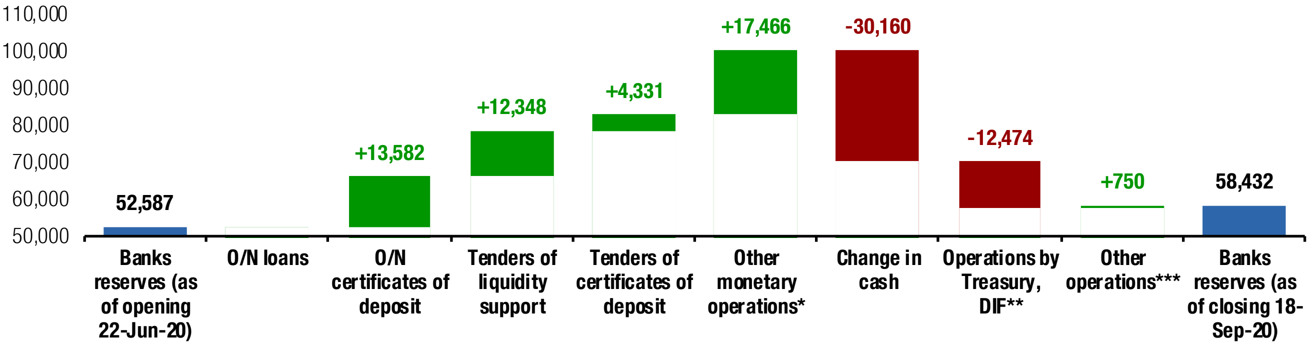


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 weakens to above UAH28/US$

Expectedly, the hryvnia exchange rate continues to weaken, and reached UAH28.2/US$ at the end of last week. This week, the increase in hard-currency supply for month-end tax payments can stabilize the exchange rate above UAH28/US$.

Demand for hard currency from foreigners to exchange funds from local-currency bills, low supply, and psychological expectations of hryvnia weakening, caused hryvnia exchange rate weakening to UAH28.14/US$ and induced the NBU to intervene in the market and sell hard currency from reserves. Last week, the NBU sold US$71m and slightly restrained weakening.

ICU view: Yesterday started month-end tax payments, forcing some exporters to sell hard currency and not wait for VAT refunds later this month. So, the balance in the FX market should improve, but foreigners' selling of T-bills will restrain hryvnia appreciation. Generally, the market can be self-balanced without NBU participation to satisfy extra demand.

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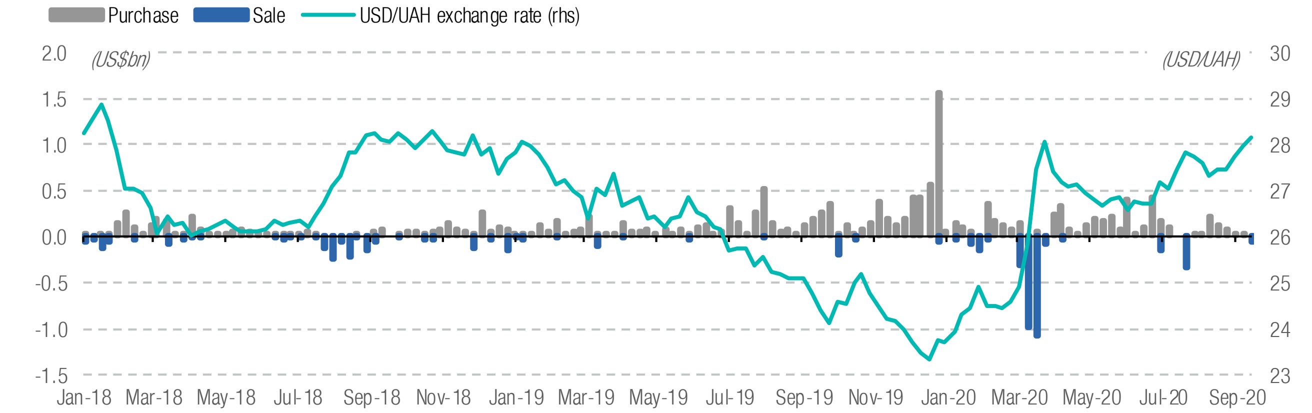
Chart 5. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

ICU Macroeconomic Review – Bumpy recovery underway

Last week, we issued our updated macroeconomic review on Ukraine's economy.

During the summer, the Ukrainian economy was rapidly recovering after the lockdown. However, new outbreaks of coronavirus globally and in Ukraine will slow further growth. While we do not expect another severe lockdown, the negative effects of the pandemic will be felt on both potential output and aggregate demand.

Still, we improve our 2020 GDP forecast to a decline of 5.7% from 6.7%. This upgrade was caused primarily by the rapid "turn-on" of the economy in the summer and better terms of trade as iron ore prices surged. As we have assessed before, the Ukrainian economy is weathering the global crisis quite well due to its structural characteristics and macro-financial stabilization accomplished in previous years.

However, the results could be better if more monetary and fiscal stimulus were applied, which is constrained by uncertainty over obtaining official financing amid limited market access. We continue to expect another tranche from the IMF, but not before early 2021 due to the last judicial decisions, uncertainty around anticorruption authorities, and the start of parliamentary discussion of the budget not yet agreed with the IMF.

We leave almost unchanged our forecast for GDP growth in 2021 at 5.6%. Minimum wage hikes will provide an additional boost to consumer spending while putting a drag on investment. Nevertheless, we expect a rebound in investment, factoring in the recovery of the global economy, easing credit conditions, and some monetary accommodation. As a result, we are more optimistic on economic growth rates next year compared with consensus.

Inflation surges above the target range in 1Q21 and reaches 6.5% YoY in 2021. Pent-up demand in some sectors, cost-push effects from minimum wage hikes, UAH depreciation, and recovery in energy prices will keep the CPI growing at a slightly accelerated pace.

Higher-than-target-range inflation will also be a result of muted NBU response. We expect that first, the NBU will take a wait-and-see approach keeping the rate unchanged at 6% to YE2020. Then, reacting to growing inflationary pressure, it will deliver two 50 bps hikes to 7%, still leaving the monetary stance slightly accommodative.

The hryvnia will depreciate slightly despite better fundamentals. We improve our 2020 C/A outlook and raise the projected surplus to US$6.2bn, or 4.2% of GDP, as COVID-19 depresses demand for imports, constrains travel, and lowers investment income payments more than was earlier expected, while remittances prove resilient. Although fundamentals for the hryvnia remain solid, effects of worsening sentiment have prevailed so far. Factoring in exaggerated devaluation expectations, domestic consumption recovery, expected worsening global conjuncture, unsupportive capital flows, and a surge in fiscal spending, we project the hryvnia to depreciate by the end of the year to the range of UAH29–30/US$. In 2021, recovering capital flows will partly compensate the negative impact of C/A turning to deficit (US$3.7bn or 2.4% of GDP). As a result, the hryvnia should slide into the UAH29.5–30.5/US$ range by the end of 2021.

Please see our new [Macroeconomic Review] for more details.

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GDP falls 11.4% YoY and 9.9% QoQ SA in 2Q20

Ukrstat confirmed the flash estimates of a sharp fall in GDP for 2Q20 amid the COVID-19 pandemic and lockdown. Then the economy has started to recover, and for full-year 2020, we forecast a downturn of 5.7%.

On the expenditures side, the fall of investments in fixed capital by 22.3% YoY, household consumption by 10.4% YoY, and exports by 9.0% YoY played the major role. Meanwhile, demand for imports fell the most by 23.4% YoY.

Among sectors, expectedly, the main losses were registered for HORECA with a value added (VA) decline of 58.1% YoY, transportation VA down 26.9% YoY, and other services VA by 27.1% YoY. In addition, the later start of the grain harvest caused the fall in VA of the agricultural sector by 29.1% YoY. No sector showed positive YoY growth. Even VA in IT and healthcare felt by 4.2% YoY and 2.3% YoY, respectively.

ICU view: The main factor for such a sharp decline in GDP was the containment measures, which in Ukraine were one of the toughest in the world during April–May. However, in June, restrictions were eased rapidly and economic activity recovered. At the same time, about 1.2 p.p. in the quarterly GDP decline was due to a later start of the grain harvest.

Despite the severity of quarantine restrictions, relatively limited fiscal stimulus, and the late harvest factor, the decline in GDP was not as steep as the EU average of 13.9% YoY. However, Ukraine was behind most countries of Central and Eastern Europe.

The rapid lifting of quarantine restrictions in the summer caused a sharp economic rebound. However, new outbreaks of coronavirus and a return of social distancing will slow further growth. As a result, we project a GDP decline of 5.7% for full-year 2020.

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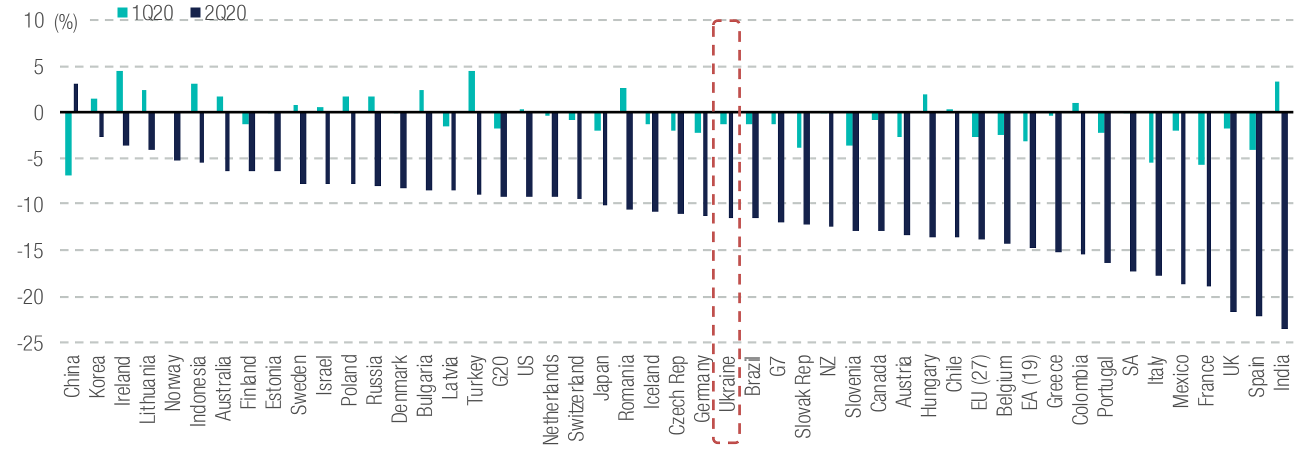
Chart 6. Real GDP (YoY, %)



Source: OECD, Ukrstat, ICU.

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