Focus
Ukraine

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

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Weekly Insight

NBU kept key policy rate at 17%

Key messages of the today's comments

Domestic liquidity and bonds market

Low demand for bonds

At last week's auction, the Ministry of Finance received less than UAH0.5bn of demand. This week, the situation could be similar with only partial refinancing of debt repayments.

Liquidity recovers to above UAH100bn

Last week, the total amount of banking-sector liquidity rose above UAH100bn where it could stay until month-end tax payments.

Foreign exchange market

The hryvnia depreciated on controversial trade

After initial appreciation of the hryvnia, it couldn't break through the 25.9 UAH/USD threshold and slightly depreciated last week, as market conditions changed along with purchases of foreign currency by the NBU. To the end of the month, we expect moderate pressure on the hryvnia due to VAT refunds and redemption of UAH6.5bn of local bonds.

Economics

Headline inflation slowed to 13.2% YoY in March

Thanks to tighter monetary policy and a stronger hryvnia, the growth of consumer prices in March slowed to 13.2% YoY (1.1% MoM). High inflationary expectations and loosening fiscal policy will continue to put upward pressure on prices.

NBU kept key policy rate at 17%

The central bank believes that the current monetary policy is tight enough to bring inflation back to its target by mid-2019. Due to high inflationary risk, monetary policy will continue to be tight in 2018.

Steel output in Ukraine fell 3% YoY in 1Q18

The loss of steel mills in the temporarily occupied territory in March 2017 became the main factor in reducing steel production in 1Q18. However, thanks to improved raw material supplies and higher domestic demand steel output may rise 4-5% this year.

TUESDAY, 17 APRIL 2018

Banks' reserves market (16 April 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU rate (%)[1]	17.00	+0bp	+400bp
ON rate (%)	15.80	+0bp	+330bp
ON $ swap (%)	16.17	+20bp	+427bp
Reserves (UAHm)[2]	46,396	+4.57	+3.87
DepCerts (UAHm)[3]	55,594	+6.57	+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) (16 April 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU	350,325	+0.00	-7.78
Banks	349,278	+0.02	+22.50
Residents	27,239	-2.11	+19.21
Individuals	2,416	+0.38	+732.71
Non-res[4]	14,226	-0.85	+164.21
Total	**743,484**	**-0.08**	**+7.20**

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

FX market indicators (16 April 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.0900	+0.44	-2.72
EUR/USD	1.2380	+0.19	+16.59
DXY[2]	89.425	-0.18	-11.03
UAH TWI[3]	117.803	-1.05	+7.90

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

Gov't bond quotes[1] (17 April 2018)

Maturity	Bid	Ask
6m	17.50	16.50
12m	17.75	16.75
2y	17.50	16.50
3y	17.50	16.50
12m ($)	5.10	4.70
2y ($)	5.30	5.00

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

Domestic liquidity and bonds market

Low demand for bonds

At last week's auction, the Ministry of Finance received less than UAH0.5bn of demand. This week, the situation could be similar with only partial refinancing of debt repayments.

Last Tuesday, the Ministry refinanced less than one-third of last week's debt repayments, borrowing only UAH455.1m with interest rates for six-month bonds increasing to 17.1%. Demand for these bonds was just UAH17m, and the MoF accepted only three out of seven bids, receiving just UAH4.5m. We question this outcome of the MoF, since the weighted-average rate for 12-month bonds slid 5bp to 16.95%, and these bonds provided majority of last week's borrowings, UAH423.7m.

This week, the MoF has UAH3.5bn in debt repayments in local currency, including UAH2.2bn of principal repayments. The MoF's ability to refinance these payments will depend on demand and its decision on interest rates, which, given the NBU's decision to keep the key policy rate unchanged at 17%, may prove difficult.

ICU view: Bond rates this week should stay at recent levels with 5-10bp volatility, and the MoF will probably refinance about half of the debt repayments scheduled. Part of the funds from debt repayments could be spent on purchasing FX.

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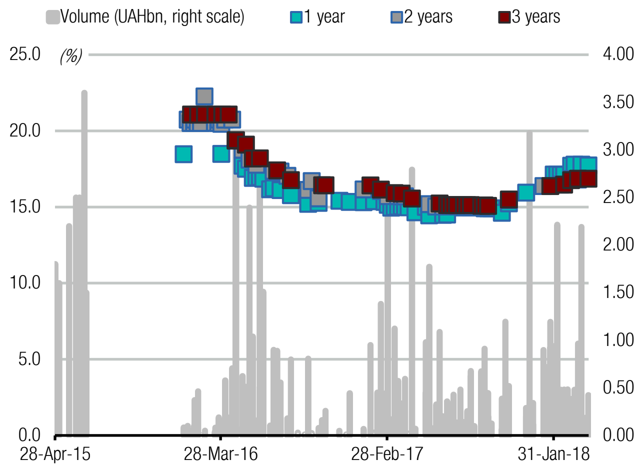
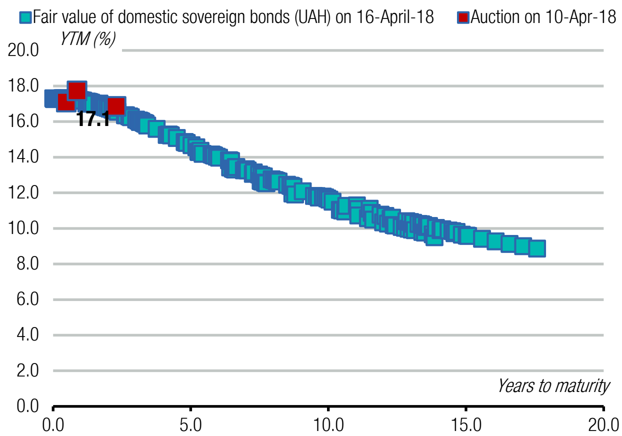
Chart 1. Local-currency bonds

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.

Liquidity recovers to above UAH100bn

Last week, the total amount of banking-sector liquidity rose above UAH100bn where it could stay until month-end tax payments.

The increase in liquidity was due to inflows from NBU's FX purchases and from the Treasury via a positive balance of its operations. NBU liquidity received about UAH1.5bn and the Treasury received more than UAH7bn. Outflows from liquidity via reserves exchange in cash declined to UAH3bn, which allowed inflows from NBU and Treasury to create liquidity above UAH100bn.

The liquidity structure last week was quite different from usual, with funds reallocation from CDs to reserves, as the NBU did not offer two-week CDs, and banks accumulated funds in reserves. Last week, total CDs outstanding fell to UAH40bn, while banks' correspondent accounts rose to about UAH60bn. After last Friday's meeting, the NBU offered two-week CDs, and the structure returned to its usual shape, with UAH46.4bn of reserves and UAH55.6bn of CDs outstanding.

ICU view: This week, liquidity should stay above UAH100bn, as month-end tax payments should start at the end of this week, and the Treasury will support liquidity with VAT refunds and large debt repayments.

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Chart 2. Banks reserves usages over last week(UAHm)

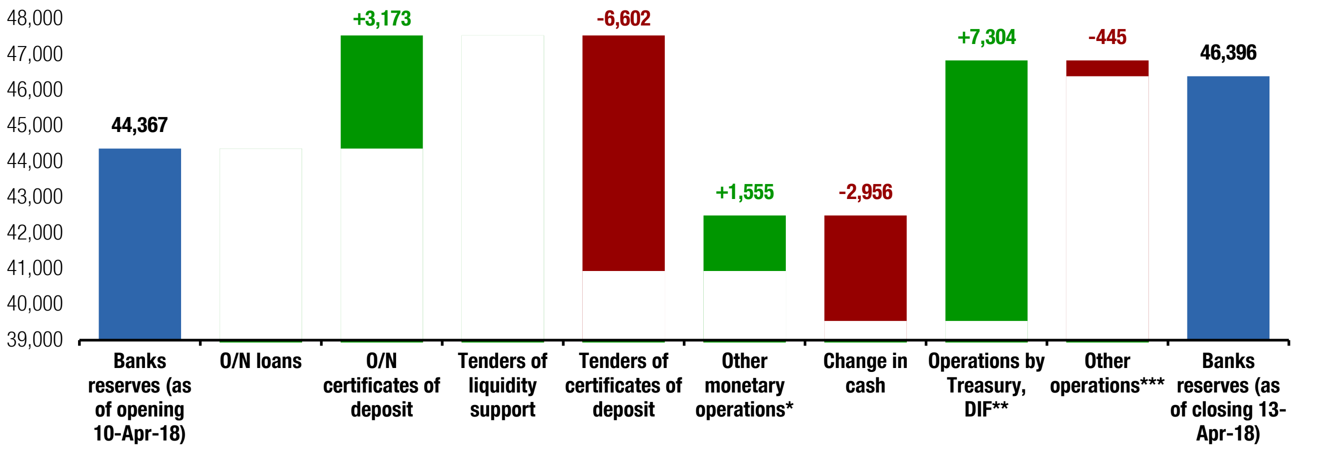
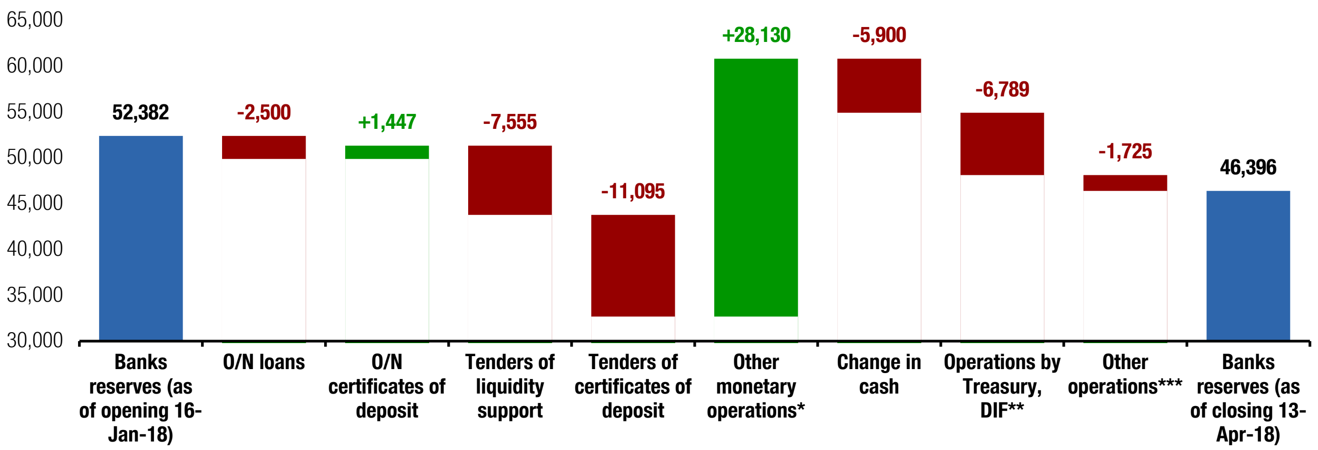


Chart 3. Banks reserves usages over last 90-day period (UAHm)



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

The hryvnia depreciated on controversial trade

After initial appreciation of the hryvnia, it couldn't break through the 25.9 UAH/USD threshold and slightly depreciated last week, as market conditions changed along with purchases of foreign currency by the NBU. To the end of the month, we expect moderate pressure on the hryvnia due to VAT refunds and redemption of UAH6.5bn of local bonds.

During the first half of the week, the hryvnia appreciated against the US dollar, as there was oversupply of foreign currency at the local market due to excessive supply from the agricultural sector to finance its spring seed campaign. Additionally, supply of the foreign currency was supported by obligatory cash selling by importers. At the same time, on Tuesday-Wednesday, the NBU bought excessive foreign currency from the market of around UAH2bn (although net sales for the week accounted for UAH1.5bn). Thus, the hryvnia depreciated to the end of the week.

The hryvna depreciated 0.6% in the past week to 26.15 UAH/USD. Its CPI-based real trade-weighted index increased 1% to 118.6 for the period. In year-on-year terms, real trade-weighted indices (CPI- and PPI-based) increased 8.7% and 11.6%, respectively, which implies faster prices growth in Ukraine compared with its main trade partners.

ICU view: By month-end, we expect a decline of the national currency, as the period of VAT refunds and significant volumes of government debt securities repayment will create pressure on the hryvnia.

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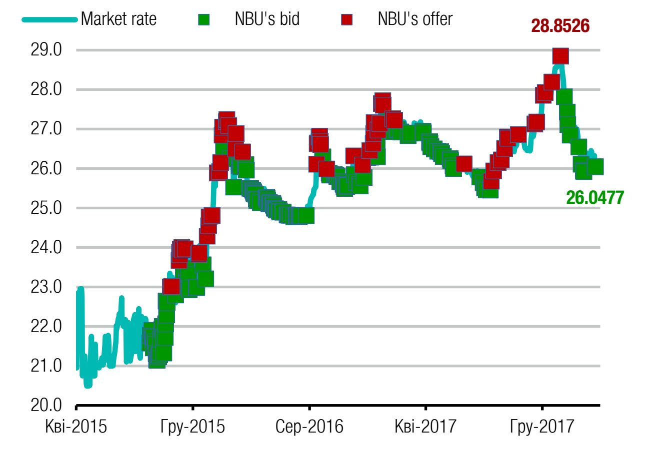
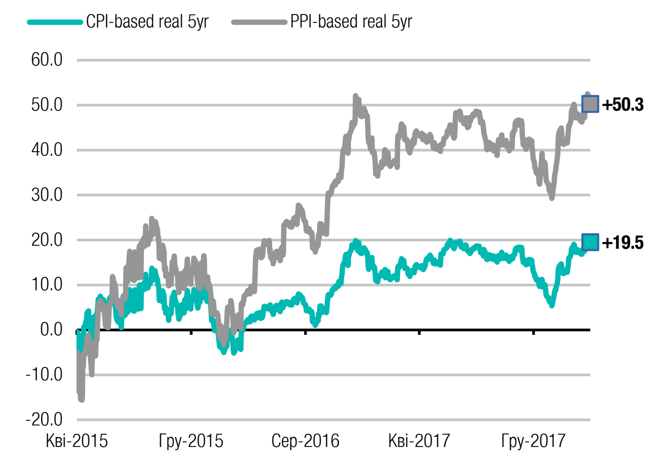
Chart 4. FX market indicators, 3-year history

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 misalignment[1] from fundamental level[2] (%)



Notes: [1] "+" overvalued, "-" undervalued; [2] based on the UAH's CPI- and PPI-based real TWIs. Source: ICU.

Economics

Headline inflation slowed to 13.2% YoY in March

Thanks to tighter monetary policy and a stronger hryvnia, the growth of consumer prices in March slowed to 13.2% YoY (1.1% MoM). High inflationary expectations and loosening fiscal policy will continue to put upward pressure on prices.

The main source of inflation in March traditionally was the growth of food and soft-beverage prices (+ 17.3% YoY); their contribution to the overall figure was 7.4ppt out of the total 13.2%. Significant growth (+ 20.2% YoY) was seen in prices for alcoholic beverages and tobacco products with a contribution of 1.7ppt.

At the same time, the growth of utilities prices slowed to 6% YoY (in March 2017 there was an increase in electricity tariffs), while their contribution to headline inflation decreased to 0.4ppt (in February it was 0.7ppt). In addition, against the backdrop of a stronger hryvnia and lower fuel prices, the growth of transport prices decelerated to 14.9% YoY, while their contribution was 1.8ppt. (in February it was 2ppt). Core inflation slowed to 9.4% YoY.

Despite the March headline inflation (13.2% YoY) was higher than projected, the NBU maintained its CPI forecast at 8.9% YoY for the end of 2018.

ICU view: Consumer prices will continue to be under pressure due to the following factors: 1) the recovery of consumer demand against the backdrop of rising wages (currently wages' share is around 40% of GDP, and we expect it to increase to 43-45% by the end of 2018 and 45-47% by the end of 2019); 2) transition of manufacturing costs to prices, as private businesses will strive to defend their profits at the previous levels (currently profits account for 44% of GDP, which is 1ppt higher than the historical average), and 3) high inflationary expectations. Inflationary pressure will be mitigated to some extent by tight monetary policy. We expect a gradual inflation slowdown over the course of the year. Despite high inflationary risks, we keep our inflation forecast at 12.5% for the end of 2018.

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NBU kept key policy rate at 17%

The central bank believes that the current monetary policy is tight enough to bring inflation back to its target by mid-2019. Due to high inflationary risk, monetary policy will continue to be tight in 2018.

In spite of higher-than-projected March inflation (13.2% YoY), the NBU kept its inflation forecast at 8.9% for the end of 2018, with a gradual deceleration toward 5.8% and 5% in 2019 and 2020, respectively.

Inflation will decelerate thanks to tight monetary policy, decreasing impact of imported inflation, and increasing supply of food products.

The NBU also updated its key monetary projections: 1) real GDP will grow by 3.4% in 2018, and by 2.9% in 2019-2020, while household consumption will remain the main drivers of growth; 2) official FX reserves will increase to US$21.6bn by the end of the year thanks to the next tranche from the IMF (US$2bn), the placement of Eurobonds (US$2.5bn), and loans from the EU, and the World Bank. In addition, the government is expected to issue US$1.5bn in Eurobonds in 2019.

The NBU's forecasts are based on the following: 1) the government will continue to implement reforms, and 2) Ukraine will continue to cooperate with the IMF.

ICU view: We believe that due to existing inflationary risks (see the previous comment), monetary policy will continue to remain tight. At the same time, along with the gradual deceleration of inflation to 12.5% by the end of the year (our baseline scenario), we continue to expect the key policy rate will be reduced by 100-150 bps this year.

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Steel output in Ukraine fell 3% YoY in 1Q18

The loss of steel mills in the temporarily occupied territory in March 2017 became the main factor in reducing steel production in 1Q18. However, thanks to improved raw material supplies and higher domestic demand steel output may rise 4-5% this year.

According to Ukrmetalugprom, steel production in Ukraine declined by 3% YoY to 5.2mt in 1Q18. Because of the same factors, rolled iron output fell to 4.6mt, which is 2% less compared with 1Q17. At the same time, in March, steel production increased by 6% YoY to 1.7mt, while rolled iron output rose 7% YoY to 1.5mt.

Pig-iron production grew by 8% YoY in 1Q18, to 5.3mt. The main drivers of growth were stabilization of supplies of coke and iron ore to the steel mills in Mariupol and Dniprovsky Steel, as well as the relaunching part of the capacities of Zaporizhstal after reconstruction, Ukrmetalurgprom reported.

ICU view: This year, we expect growth of steel output to be 4-5% to 22.2mt against the following factors: 1) improvement and stabilization of raw-materials supply to metallurgical plants in Mariupol (Azovstal and Illich Steel); 2) renewal of supply of raw materials, and restoration of production at the Dniprovsky Steel in July 2017; and 3) increasing domestic demand for steel thanks to the acceleration of economic growth and the implementation of infrastructure projects.

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