Focus

**Ukraine**

Markets

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

Research team

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# Weekly Insight

## Official FX reserves rose 1.3% MoM

**Key messages of the today's comments**

**TUESDAY, 8 MAY 2018**

### Domestic liquidity and bonds market

#### Government bond market

Today, the MoF will offer a series of local-currency bonds, but we do not expect large demand for this auction.

#### Liquidity increase continues

Last week, banking-sector liquidity remained at a high level with a slight increase. This week, we expect liquidity to remain steady.

### Foreign exchange market

#### UAH weakened slightly on the back of low trading volumes

This week, we expect supply and demand of FX on the local market to be balanced.

### Economics

#### Official FX reserves rose 1.3% MoM in April

Ukraine's official FX reserves rose by US$229m or 1.3% MoM, and amounted to US$18.4bn as of 1 May 2018. We expect that official FX reserves will rise to US$20bn by the end of 2018 thanks to the next tranche from the IMF and Ukraine's placement of Eurobonds.

#### C/A deficit expanded to 2% in 1Q18

The primary reason of increase in annualized C/A deficit to US$2.3bn or 2% of GDP was payment of interest on Eurobonds in the amount of US$0.6bn. The C/A deficit is to widen to 2.5% of GDP this year due to higher growth rates for imports and an expected decrease in commodity prices.

**Banks' reserves market (7 May 2018)**

| | Last | Weekly chg (%) | YTD chg (%) |
|---|---|---|---|
| NBU rate (%)[1] | 17.00 | +0bp | +400bp |
| ON rate (%) | 15.50 | -10bp | +410bp |
| ON $ swap (%) | 15.49 | -65bp | +320bp |
| Reserves (UAHm)[2] | 40,489 | -15.15 | -6.99 |
| DepCerts (UAHm)[3] | 55,189 | -14.92 | +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) (7 May 2018)**

| | Last | Weekly chg (%) | YTD chg (%) |
|---|---|---|---|
| NBU | 350,325 | +0.00 | -7.30 |
| Banks | 350,009 | -0.06 | +23.64 |
| Residents | 26,841 | -0.67 | +22.54 |
| Individuals | 2,583 | +0.87 | +795.31 |
| Non-res[4] | 11,898 | +0.16 | +124.17 |
| **Total** | **741,655** | **-0.05** | **+7.72** |

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

**FX market indicators (7 May 2018)**

| | Last | Weekly chg (%) | YTD chg (%) |
|---|---|---|---|
| USD/UAH | 26.2400 | +0.08 | -0.98 |
| EUR/USD | 1.1922 | -0.59 | +8.40 |
| DXY[2] | 92.749 | +0.32 | -5.98 |
| UAH TWI[3] | 120.470 | +0.32 | +8.62 |

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

**Gov't bond quotes[1] (8 May 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

## Government bond market

Today, the MoF will offer five series of local-currency bonds, but we do not expect large demand for this auction.

Last week, the MoF did not conduct a bond auction due to the public holiday on Tuesday. Bond portfolios remained steady, reacting mostly to hryvnia exchange rate movements.

Settlement for today's auction will be on Thursday due to the public holiday tomorrow. Demand for new bonds will be low, at April's levels, or below UAH1bn, since only local-currency bonds will be offered.

***ICU view: We do not anticipate any important movements in the bond market, as NBU's key policy rate remains at 17% for the third month (since 3 March) and the next monetary committee meeting is scheduled for 24 May. So, interest rates at the primary auction could be slightly volatile with changes around 10–20bp, depending on demand. The MoF can accept all demand submitted for the auction at levels close to recent auctions: above 17% for maturities less than one year, and at about 16% for longer-term bonds.***

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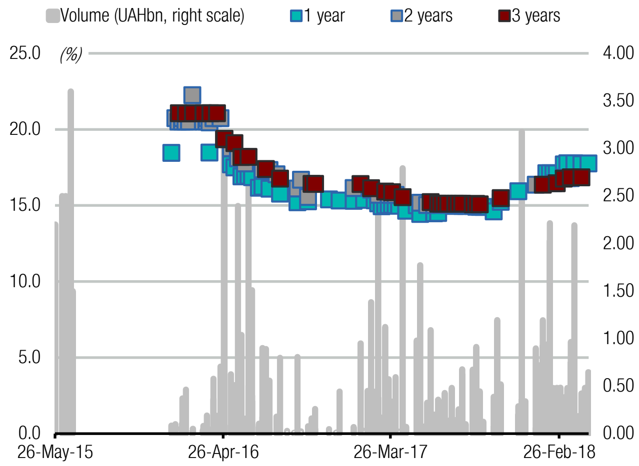
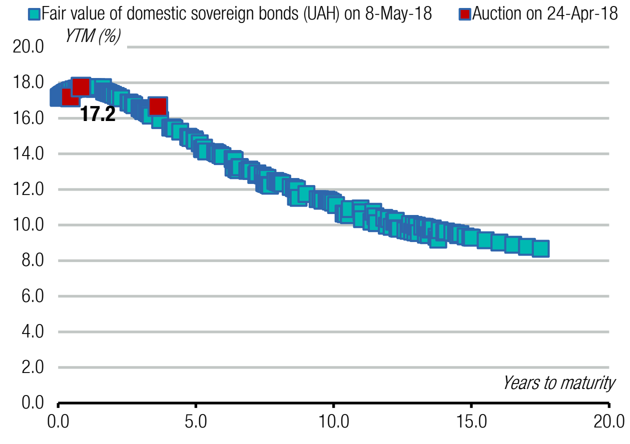
**Chart 1. Local-currency bonds**

*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.

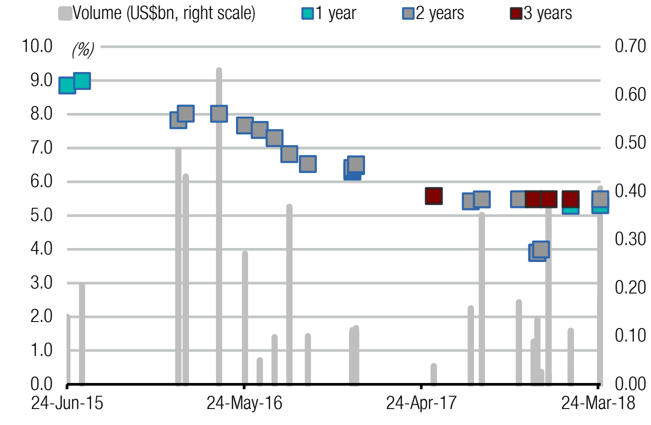
*Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions*




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

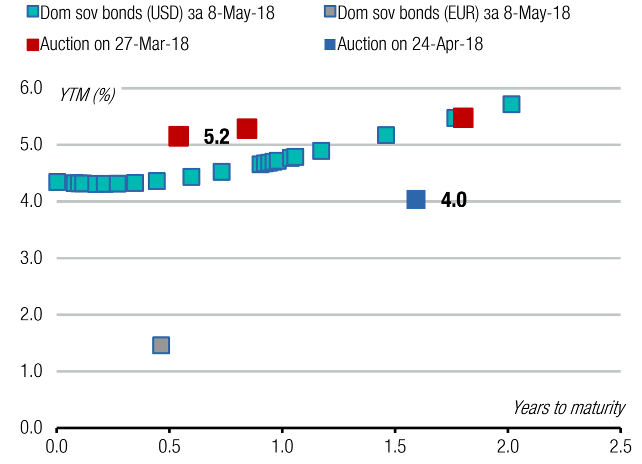
**Chart 2. FX-denominated bonds**

*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 increase continues

Last week, banking-sector liquidity remained at a high level with a slight increase. This week, we expect liquidity to remain steady.

The total amount of banking-sector liquidity set a new record high for the year last Thursday, rising to UAH114.4bn. Inflows were from cash exchange in reserves and small inflows from NBU via the FX market. The positive impact was partially offset by outflows via Treasury operations.

High liquidity levels and anticipation of outflows later this month forced banks to increase investments in CDs. Last Friday, banks increased outstanding of two-week CDs by 7.1bn, setting maturities to fulfil quarterly tax payments.

***ICU view: At the end of the week, quarterly tax payments should start and this could cause a slight decline in liquidity, but the total amount of banking-sector liquidity will stay above UAH100bn.***

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

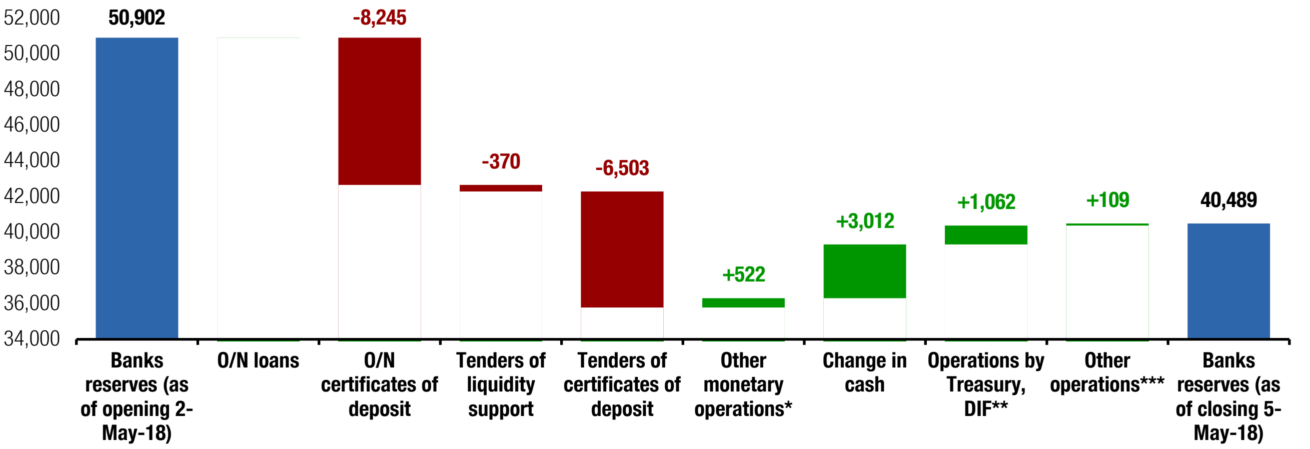
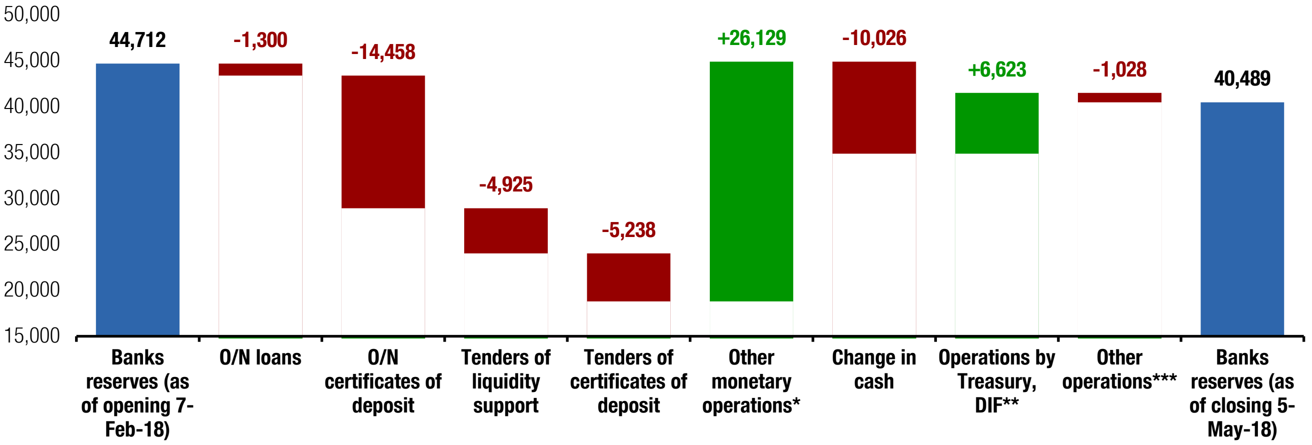


**Chart 4. Banks reserves usages over last 90-day period (UAHm)**




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

## UAH weakened slightly on the back of low trading volumes

This week, we expect supply and demand of FX on the local market to be balanced.

A short work week and low trading volumes, as well as the globally stronger US dollar, brought about an imbalance of supply and demand for FX currency on the local market. Thus, last week, the hryvnia fell 0.4% in nominal terms, to 26.33 UAH/USD.

The hryvnia's CPI-based, real trade-weighted index rose 0.8% to 119.6 for the period. In year-on-year terms, real trade-weighted indices (CPI- and PPI-based) increased 7.6% and 12.8%, respectively, which implies faster prices growth in Ukraine compared with its main trade partners.

***ICU view: This week, we don't expect large amounts of VAT refunds or repayments of UAH-denominated domestic government bonds. Hence, given high interest rates in Ukraine and a stronger USD globally, which balance each other, we expect that supply of and demand for FX currency will be balanced, which implies a stable UAH exchange rate. For more details regarding the influence of the domestic government bonds market on the UAH exchange rate read our blog (in Ukrainian).***

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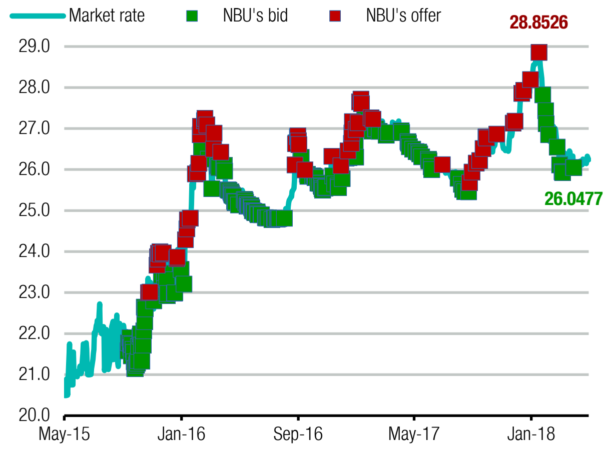
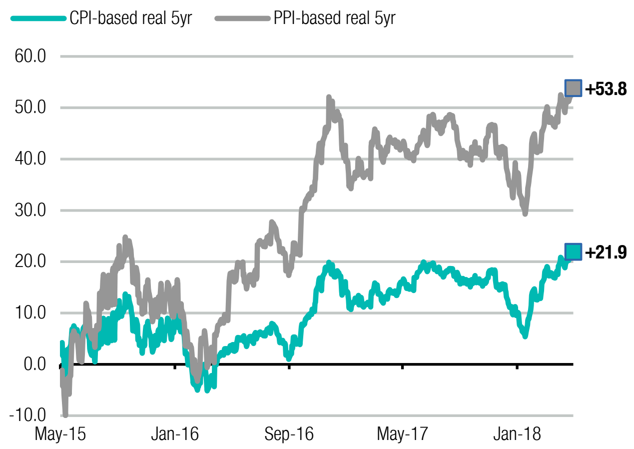
**Chart 5. FX market indicators, 3-year history**

*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 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

## Official FX reserves rose 1.3% MoM in April

Ukraine's official FX reserves rose by US$229m or 1.3% MoM, and amounted to US$18.4bn as of 1 May 2018. We expect that official FX reserves will rise to US$20bn by the end of 2018 thanks to the next tranche from the IMF and Ukraine's placement of Eurobonds.

The NBU continued to purchase the FX currency on domestic interbank market thanks to higher supply of foreign currency compared with demand for it. In April, the NBU bought US$326m, while it sold only US$24m. Thus, net purchases on the interbank market amounted to US$303m. At the same time, EUR83.6M were received from the domestic placement of government bonds denominated in foreign currency.

On the flip-side, Ukraine paid US$127.4m to service state and guaranteed debt, including US$30.8m to service FX-denominated domestic government bonds. Now, official FX reserves are covering 3.3 months of future imports.

***ICU view: Our in-house calculations show that this year, the NBU and the MoF have to pay approximately US$4.4bn (including both principle and interest) to meet their FX liabilities (i.e. FX-denominated domestic government bonds, Eurobonds and payments to the IMF). However, thanks to 1) the planned Eurobond placement, 2) another tranche from the IMF, 3) placements of domestic government bonds denominated in foreign currency, 4) NBU's purchase of FX currency on the domestic interbank market, and 5) possible macro-financial assistance from the EU, we expect FX reserves will increase to US$20bn by the end of 2018.***

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## C/A deficit expanded to 2% in 1Q18

The primary reason of increase in annualized C/A deficit to US$2.3bn or 2% of GDP was payment of interest on Eurobonds in the amount of US$0.6bn. The C/A deficit is to widen to 2.5% of GDP this year due to higher growth rates for imports and an expected decrease in commodity prices.

Another booster of growth of C/A deficit was higher volumes of merchandise imports, which increased US$7.8bn or 18.3% YoY in March in annualized terms and totaled US$50.4bn. Import of machinery and equipment (account for 27.8% of total imports) rose 24.9% YoY, while import of mineral goods grew 29% YoY, accounting for 23.6% of total imports.

Growth of annualized merchandise exports slowed to 12.2% YoY in March (16.1% YoY In February) and totaled US$40.5bn. The slowdown was due to deceleration in growth rates of export of food products to 6% YoY, down from 12% YoY in February, while this particular category accounts for 43.3% of total exports. In addition, growth rates of metallurgical exports slowed to 18.7% YoY (20.4% YoY in February), accounting for 25.8% of total exported goods.

The negative impact on the C/A balance was to some extent mitigated by higher primary income balance (+78.5% YoY, totaling US$3bn) and a twofold YoY increase in the services trade balance surplus to US$0.9bn.

***ICU view: Our base-case scenario envisages that imports will continue to increase at higher growth rates compared with those of exports, while commodity prices will gradually decrease; hence, we expect the C/A deficit will widen further towards US$3bn this year (2.5% of GDP).***

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