Focus

**Ukraine**

Markets

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

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# Weekly Insight

# NBU raised the key rate to 17.5%

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

**TUESDAY, 17 JULY 2018**

## Domestic liquidity and bonds market

### Demand for bonds modest

Last week, the Ministry of Finance refinanced nearly half of debt repayments, but it had to increase the cut-off rates for local-currency instruments by 5-10bp.Today, interest rates could react to last week's key policy rate increase.

### Liquidity steady

The positive impact from Treasury operations and inflows from NBU supported liquidity keeping it above UAH110bn. These factors will be in place this week.

## Foreign exchange market

### UAH recovered losses

The hryvnia is set to be stable this week, as the NBU will continue to buy excess foreign currency proceeds from export.

## Economics

### Government updates economic outlook

The base-case scenario of the Ministry of Economic Development envisages real GDP growth of 3.2% and 3% in 2018 and 2019, respectively. Key growth drivers will be higher domestic consumer demand and investment activity.

### Inflation slowed to 9.9% YoY in June

Headline inflation remained unchanged in MoM terms, and decelerated to 9.9% YoY in June, down from 11.7% YoY in May. We improve our CPI forecasts to 10.2% YoY from 11.5% for the end of 2018, although inflationary risks remain high.

### NBU raised the key rate to 17.5%

Another increase in the key rate by the NBU indicates concern about the possibility of higher–than-expected prices, as well as the threat of disrupting the cooperation programme with the IMF.

### Rada fully met IMF terms on the anti-corruption legislation

Completing the process of establishing anti-corruption legislation was a big step taken by the Ukrainian Parliament towards receiving the next tranche from the IMF.

**Banks' reserves market (16 July 2018)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU rate (%)[1] | 17.50 | +50bp | +500bp |
| ON rate (%) | 16.50 | +70bp | +520bp |
| ON $ swap (%) | 15.73 | +49bp | +428bp |
| Reserves (UAHm)[2] | 53,555 | +34.22 | +24.42 |
| DepCerts (UAHm)[3] | 60,994 | -16.01 | +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 July 2018)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU | 350,325 | +0.00 | -5.57 |
| Banks | 354,712 | -0.62 | +21.02 |
| Residents | 21,987 | -0.80 | +5.28 |
| Individuals | 3,571 | +5.48 | +425.82 |
| Non-res[4] | 9,977 | -0.48 | +824,471.90 |
| **Total** | **740,573** | **-0.30** | **+8.01** |

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

**FX market indicators (16 July 2018)**

| | Last | Weekly chg (%) | YTD chg (%) |
|---|---|---|---|
| USD/UAH | 26.2500 | +0.17 | +0.90 |
| EUR/USD | 1.1711 | -0.28 | +2.10 |
| DXY[2] | 94.511 | +0.37 | -0.67 |
| UAH TWI[3] | 119.607 | +0.34 | +4.74 |

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

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

| Maturity | Bid | Ask |
|---|---|---|
| 6m | **17.75** | **17.00** |
| 12m | **17.95** | **17.25** |
| 2y | **17.75** | **16.75** |
| 3y | **17.50** | **16.50** |
| 12m ($) | **5.50** | **4.85** |
| 2y ($) | **5.70** | **5.00** |

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

# Domestic liquidity and bonds market

## Demand for bonds modest

Last week, the Ministry of Finance refinanced nearly half of debt repayments, but it had to increase the cut-off rates for local-currency instruments by 5-10bp.Today, interest rates could react to last week's key policy rate increase.

At the last auction, the MoF increased cut-off rates by 5bp to 17.4% for three-month and to 17.3% for six-month bills, and by 10bp to 16.25% for 1.5- and two-year paper. This allowed the MoF to borrow UAH1.3bn, which was nearly half of last week's debt repayments in local currency. Also, the MoF refinanced half of debt repayments in USD with the same level of cut-off rates as before, 5.65%.

According to information provided by the NBU, debt principal repayments last week mostly were received by banks and non-banks, and these two groups were the largest bidders at the auction. At the end of last week, the total amount of bonds outstanding slid to UAH740bn and was mostly distributed between these two groups of bondholders. Individuals increased portfolios slightly by UAH185m, while foreign investors' portfolios slid by UAH50m after redemption of USD-denominated bonds.

***ICU view: Demand for bonds remains modest, similar to 2Q18, with a notable lack of demand from foreign investors. This group of bondholders just received redemption as opposed to having sold bonds in the market. So, this week, demand will be mostly generated by domestic investors looking for higher interest rates. At the same time, the MoF will try to keep rates unchanged to keep cost of borrowing at the current level.***

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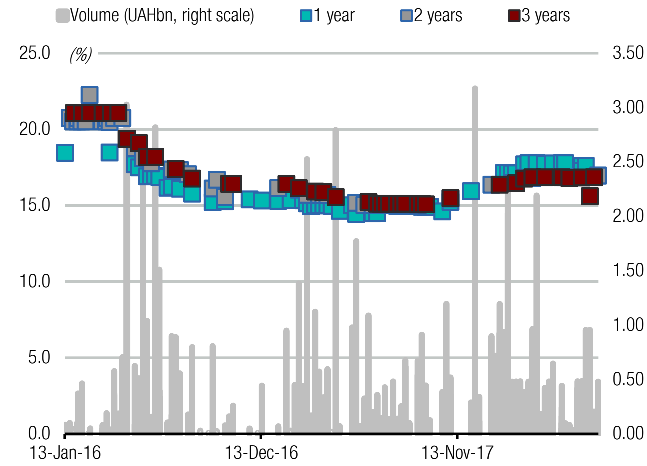
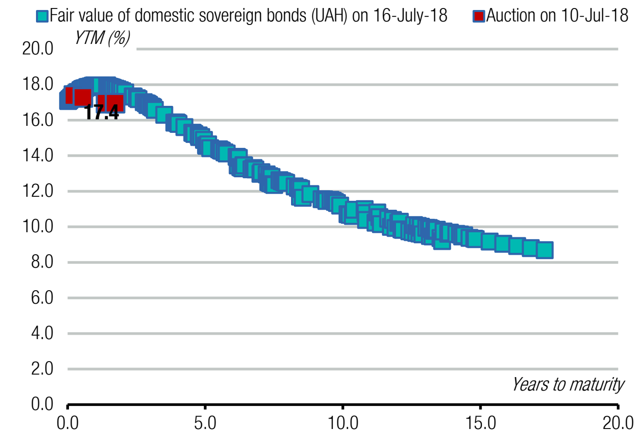
**Chart 1. Local-currency bonds**

*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.

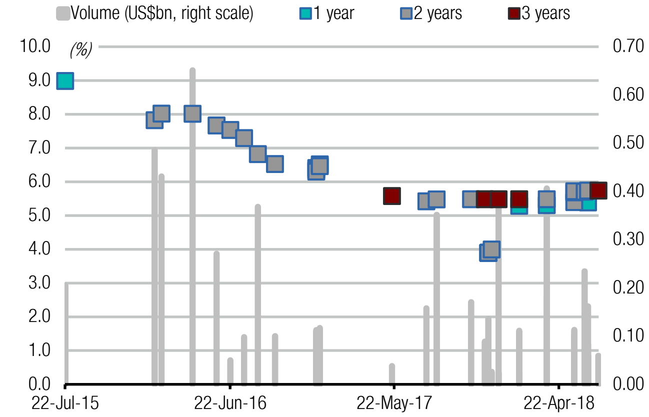
*Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions*




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

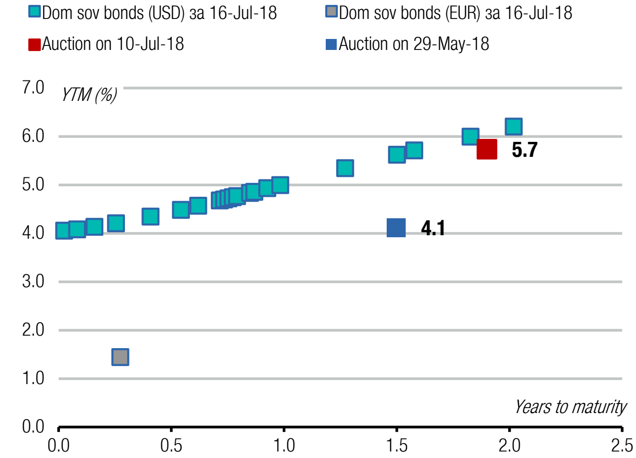
**Chart 2. FX-denominated bonds**

*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 steady

The positive impact from Treasury operations and inflows from NBU supported liquidity keeping it above UAH110bn. These factors will be in place this week.

Last week, the impact from non-monetary operations was neutral, with a small positive impact on liquidity, which amounted to UAH2.3bn. Usually during the first half of the month, outflows are caused by reserves exchange in cash, which amounted to UAH5.1bn, but this outflow was compensated by budget expenditures, providing net inflow at UAH7.3bn. Additionally, the NBU provided UAH1.6bn of liquidity via the FX market.

At the same time, banks decreased CD portfolios prior to the monetary committee decision on the key police rate, and started to purchase new two-week CDS last Friday. Last week, banks decreased CDs outstanding by UAH2.7bn, which were at a low of UAH53.1bn last Thursday, and recovered last Friday to UAH61bn.

***ICU view: This week will not see liquidity volatility. We could see a different direction of Treasury operations with increased collection of taxes and other revenues, in addition to new borrowings, which could exceed insufficient repayments. But, in the end, these cash flows will have insufficient impact on liquidity with new inflows from the NBU via FX purchase in the market (see comment below).***

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

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

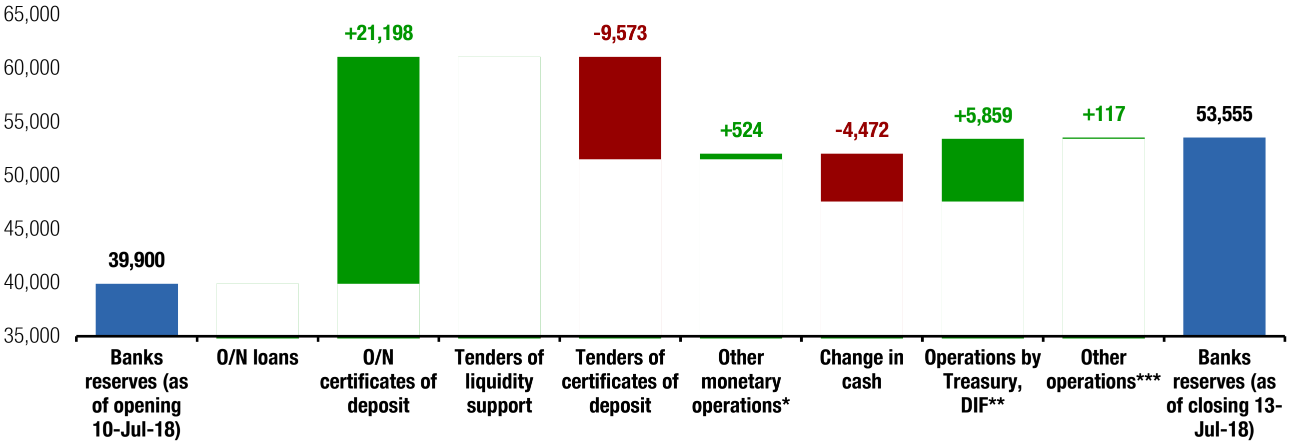
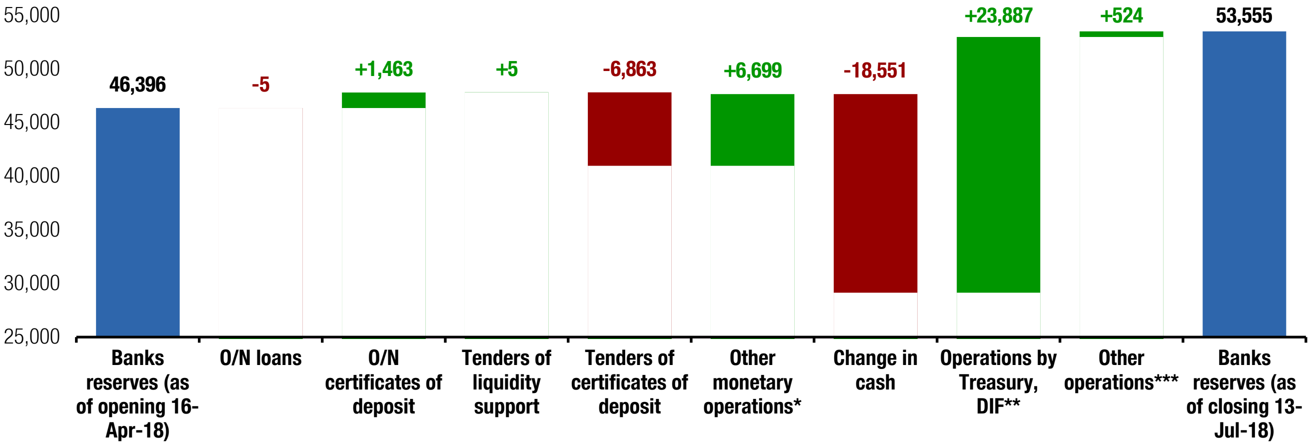



Chart 4. Banks reserves usages over last 90-day period (UAHm)




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

## UAH recovered losses

The hryvnia is set to be stable this week, as the NBU will continue to buy excess foreign currency proceeds from export.

The UAH began last week with a strengthening and recovered losses that it suffered the week before due to a holiday in the US, and excess FX demand due to dividend payments to foreign investors. However, the NBU did not allow the UAH to strengthen much, as it bought excess FX (US$62m) on the interbank market. Thus, last week, the hryvnia strengthened 0.4%, to 26.21 UAH/USD.

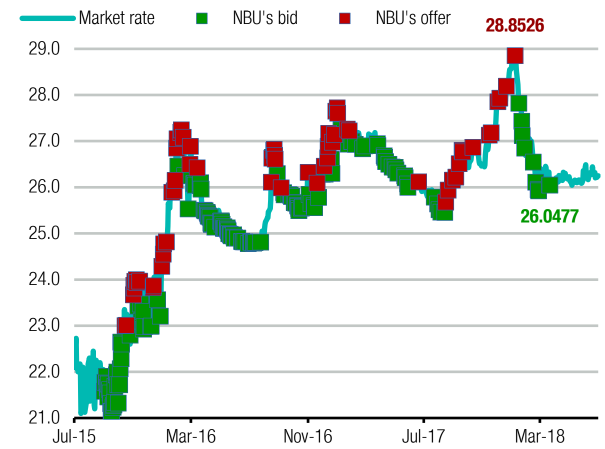
The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries trade partners of Ukraine) increased 0.7% to 119.9 for the period. In year-on-year terms, CPI based real trade-weighted index increased 4.3%, while PPI based index declined 1.3%.

***ICU view: This week, we expect the UAH to be stable as VAT refunds and domestic government bond payments will be insignificant, implying that UAH supply will not increase. On the flip side, FX supply will be sufficient thanks to FX revenues of exporters. The NBU will probably continue to buy excess FX currency to prevent the UAH exchange rate from high volatility.***

*Dmytro Dyachenko, Kyiv, (044) 377-7040 ext.738*

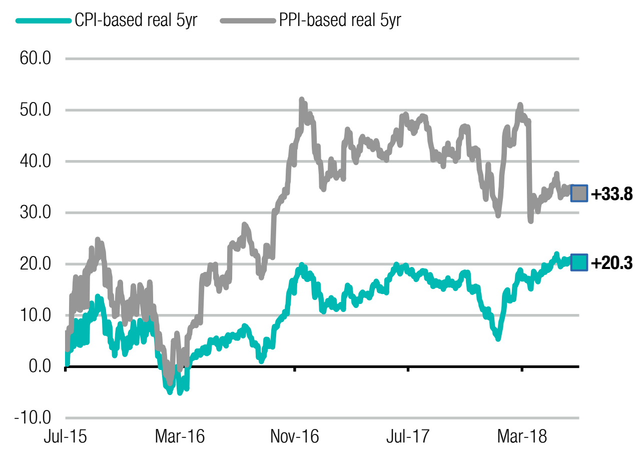
**Chart 5. FX market indicators, 3-year history**

*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

## Government updates economic outlook

The base-case scenario of the Ministry of Economic Development envisages real GDP growth of 3.2% and 3% in 2018 and 2019, respectively. Key growth drivers will be higher domestic consumer demand and investment activity.

According to the Ministry's forecast, Ukraine's economy won't reach pre-crisis levels until 2021, when it expects real GDP to rise to 101.6% compared with the 2013 level. Inflation is set to slow further to 9.9% in 2018 and 7.4% in 2019, which exceeds the NBU's forecasts of 8.9% and 5.8%, respectively. At the same time, according to Economichna Pravda, the Ministry of Economic Development forecasts the year-average UAH exchange rate at 29.4/USD in 2019, and 29.7/USD and 30.4/USD in 2020 and 2021, respectively. The baseline scenario is the least risky and the Ministry expects it will be used for 2019 budget planning.

***ICU view: Our 2018 real GDP forecast is slightly more optimistic. We expect economic growth will be close to 3.5% boosted by solid consumer demand against the backdrop of rising real incomes and retail lending. However, in our view, real GDP growth will not exceed 2% in 2019, as external refinancing needs increase and less steep rise of wages and social security payments than in 2017-2018.***

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## Inflation slowed to 9.9% YoY in June

Headline inflation remained unchanged in MoM terms, and decelerated to 9.9% YoY in June, down from 11.7% YoY in May. We improve our CPI forecasts to 10.2% YoY from 11.5% for the end of 2018, although inflationary risks remain high.

The key contributor to slowing inflation in June was a decrease in growth rates of prices on food products to 9.5% YoY, down from 13.7% YoY in May. The contribution of this particular category declined 1.8ppt to 4ppt out of the total reading of 9.9% in June. Growth of prices of alcoholic beverages and tobacco products slowed to 18.3% YoY (vs. 19.4% YoY in May), but this was counterbalanced by accelerated growth of prices on transport to 14.6% YoY (vs. 13.7% YoY in May). Core inflation slid to 9% YoY. Last week, the NBU confirmed its inflation forecast of 8.9% YoY by the end of 2018.

***ICU view: Inflation slowdown was expected because of the good harvest of fruits and vegetables this year, lower world prices on meat, and UAH appreciation in February and June, which showed up in prices of imported goods. However, significant inflationary risks—solid consumer demand, high world energy prices, seasonal weakening of the UAH in 2H18, and possible increase in gas prices for the population—will continue to put pressure on consumer prices. Nevertheless, with respect to 1) an increase of the key policy rate by the NBU to 17.5% (see the next comment), 2) amendments to the Anti-Corruption Court law, which were one of the key requirements from the IMF for unlocking the next tranche, and 3) the positive forecast for the grain harvest—despite this year's draught, the Ministry of Agrarian Policy expects the harvest to be close to last year's reading—we improve our inflation forecast to 10.2% YoY from 11.5% YoY by the end of 2018.***

***Dmytro Dyachenko, Kyiv, (044) 377-7040 ext.738***

## NBU raised the key rate to 17.5%

Another increase in the key rate by the NBU indicates concern about the possibility of higher–than-expected prices, as well as the threat of disrupting the cooperation programme with the IMF.

The National Bank Board decided to raise the key rate to 17.5%. As noted by the NBU, this decision was taken to return inflation to the target range for 2019.

The cycle of raising interest rates has been ongoing since October 2017. During this time, the regulator raised the key rate five times by five percentage points each.

***ICU view: Despite the slowdown in inflation to 9.9% (YoY) and to 0 MoM in June, there is a likelihood of re-acceleration. This could be brought about by growth of demand caused both by rising wages, and by increasing the size of transfers of labor migrants from abroad.***

***We expect the increase in rates to enhance the attractiveness of hryvnia instruments, and, thus, reduce pressure in the medium term. We do not rule out further increases in 2018 in case of failure of the programme of cooperation with the IMF. At the same time, the National Bank will be very careful and unlikely to begin a cycle of lowering the key rate in 2018.***

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

## Rada fully met IMF terms on the anti-corruption legislation

Completing the process of establishing anti-corruption legislation was a big step taken by the Ukrainian Parliament towards receiving the next tranche from the IMF.

Last Thursday, the Ukrainian Parliament passed amendments to the law on the judicial system and status of judges in order to bring it into compliance with the law on the High Anti-corruption Court (ACC).

Also, Parliament amended the law on the ACC according to the recommendations of the IMF, excluding other courts from consideration of appeal concerning corruption cases transferred by the National Anticorruption Bureau.

***ICU view: The Ukrainian Parliament has met all of the recommendations of the IMF with regard to anti-corruption legislation, and made a big step towards unlocking the next***

***tranche of the IMF's macrofinancial aid. Although the IMF has not yet expressed its final official assessment of the adopted anticorruption laws, approval of the law package is highly likely. Ukraine still has to fulfil the IMF's other two key conditions: hike tariffs for natural gas for the population to the level of import parity, and balance the 2018 state budget at a deficit level of not more than 2.5% of GDP. We maintain our view that Ukraine will successfully receive the IMF tranche in 2018.***

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