Focus
Ukraine

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

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Weekly Insight

NBU estimates real GDP at +3.2% YoY in 2Q18

Key messages of the today's comments

Domestic liquidity and bonds market

Cost of borrowing increases

An increase in NBU's key rate and budget-financing needs forced the Ministry of Finance to be less conservative in accepting demand for new bonds last week. This could push demand to higher rates this week.

Treasury accumulates funds

After large budget expenditures in first half of July, last week, the Treasury accumulated funds in its accounts, which could be used for debt repayments and VAT refunds this week.

Foreign exchange market

Hryvnia depreciated 0.6%

This week, the hryvnia will be under pressure as a result of significant redemptions of government bonds and a period of VAT refunds, which will be somewhat offset by tax payments to the budget.

Economics

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Economic growth accelerated to 3.2% YoY in 2Q18, up from 3.1% YoY in 1Q18, per data from the NBU. In QoQ terms, growth was 0.8% QoQ SA (ICU's estimate as implied by NBU's 2Q18 year-on-year estimate).

Merchandise-trade balance deficit up 44.4% YoY in 5M18

The deficit expanded to US$2.1bn in 5M18, up compared with US$1.4bn in 5M17. High oil prices combined with solid consumer imports will bring about a further widening of the merchandise-trade balance deficit.

TUESDAY, 24 JULY 2018

Banks' reserves market (23 July 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	17.50	+0bp	+500bp
ON rate (%)	16.30	-40bp	+530bp
ON $ swap (%)	16.35	+76bp	+475bp
Reserves (UAHm)[2]	59,256	+12.97	+26.25
DepCerts (UAHm)[3]	50,015	-19.38	+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) (23 July 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	350,325	+0.00	-4.78
Banks	357,465	+0.78	+22.08
Residents	22,153	+0.77	+5.41
Individuals	3,655	+2.40	+438.99
Non-res[4]	9,723	-2.55	+790,368.29
Total	**743,321**	**+0.37**	**+8.92**

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

FX market indicators (23 July 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.4850	+1.09	+2.34
EUR/USD	1.1692	+0.27	+0.25
DXY[2]	94.632	-0.37	+0.82
UAH TWI[3]	119.138	-0.86	+4.48

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

Gov't bond quotes[1] (24 July 2018)

Maturity	Bid	Ask
6m	**18.00**	**17.35**
12m	**18.25**	**17.40**
2y	**18.00**	**16.75**
3y	**18.00**	**16.75**
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

Cost of borrowing increases

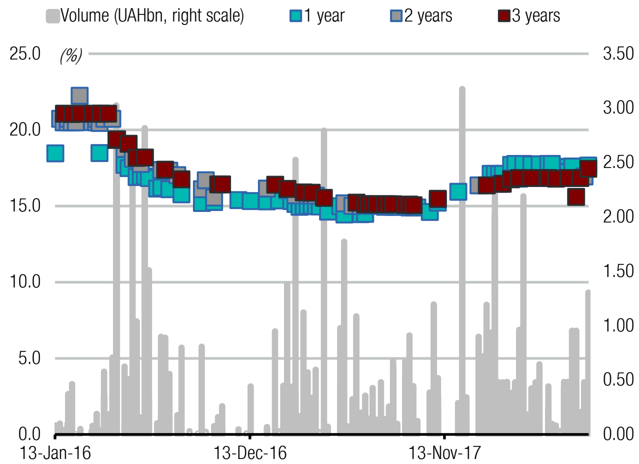
An increase in NBU's key rate and budget-financing needs forced the Ministry of Finance to be less conservative in accepting demand for new bonds last week. This could push demand to higher rates this week.

At its regular, primary auction last Tuesday, the MoF borrowed nearly UAH1.8bn, but to attract these funds, the MoF had to increase cut-off rates, which again increased the cost of new borrowings for the state budget. For three-month and six-month debt, cut-off rates were increased by 60bp, for 12-month bills by 45bp, and for three-year instruments 55bp. Only a few the most expensive bids were rejected at last week's auction. The Ministry received UAH1.83bn of demand, which was concentrated in three-month and three-year paper, which amounted to UAH1.36bn and UAH0.41bn, respectively.

Taking into the account the NBU data about bondholders' portfolios, new bills at the abovementioned auction were purchased mostly by banks. Their portfolios saw the largest increase after settlement day last Wednesday. The portfolios of non-banks and private investors showed a small increase, where, the same as for banks, also had the effect of weakening the hryvnia. Additionally, banks purchased UAH255m of bonds from non-residents' portfolio last week. As a result, banks' share of total government bonds outstanding rose to 48.1% and non-residents' share slid to 1.3%.

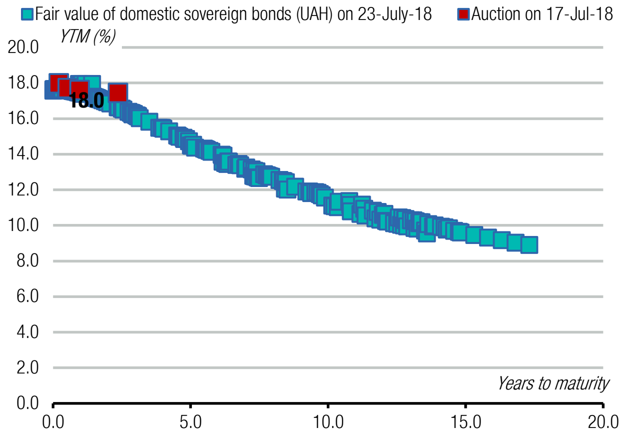
Chart 1. Local-currency bonds

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.

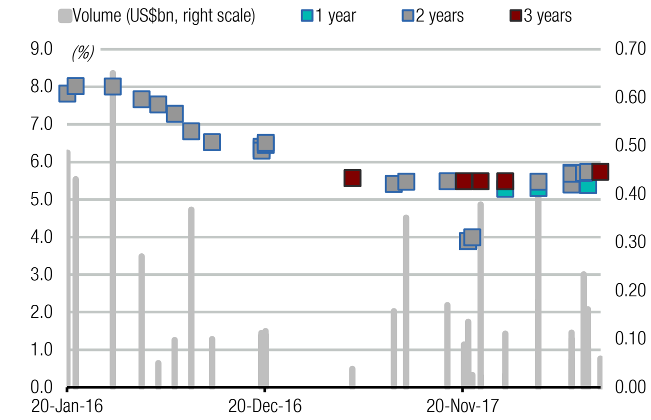
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

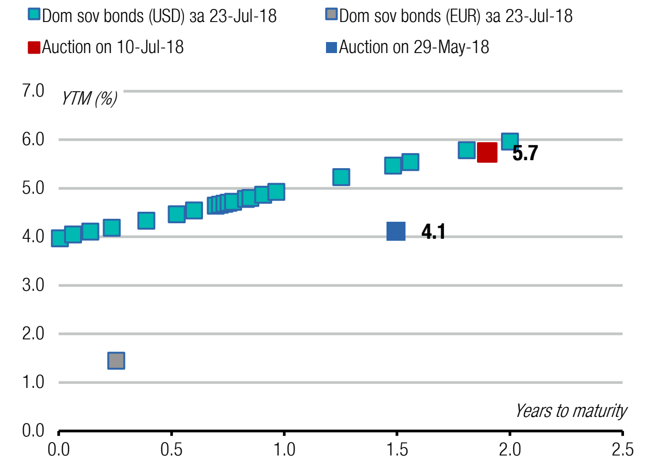
Chart 2. FX-denominated bonds

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.

ICU view: The increase in cut-off rates and lack of limits for three-month bills allowed the MoF to borrow a large amount of funds, however, it increased the debt-servicing cost. Moving to higher rates will not improve budget execution, and will increase expenditures for debt service, especially with the hryvnia weakening. This is important because the MoF will extend its offering of FX-denominated bonds, which, most likely, will attract most of the demand this week. For this auction, the Ministry announced it will offer five FX-denominated bonds: four in US dollars with maturities from five to 19 months, and one in euros with a 10-month maturity.

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Treasury accumulates funds

After large budget expenditures in first half of July, last week, the Treasury accumulated funds in its accounts, which could be used for debt repayments and VAT refunds this week.

Last week, banking-sector liquidity tightened to UAH109.3bn. Most of the outflow was caused by the Treasury's negative balance of operations, which amounted to UAH5.7bn. Outflow via reserves exchange in cash was low, just UAH0.3bn during the week, which was mostly compensated by the NBU via FX purchases for a net UAH0.2bn.

Total CDs outstanding was high most of last week, with volatility around UAH60–63bn, and banks' correspondent accounts with the NBU at around UAH50bn. But last Friday, banks decreased investments in two-week CDs by allocating funds at accounts, so total CDs outstanding fell to UAH50bn and accounts' balances rose to UAH59.3bn.

ICU view: We could see a high level of liquidity volatility this week, as at the beginning of the week, liquidity could decline due to funds accumulation at the Treasury for budget expenditures later in the week. Usually at the end of the month, we see VAT refunds, and this Wednesday, the MoF will have to pay nearly UAH6bn in debt principal and interest repayments. Also, yesterday started the month-end tax payments period, which will be negative for liquidity. As a result, the discrepancy of these flows over time will increase liquidity volatility, although we expect it to stay at around UAH110bn.

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

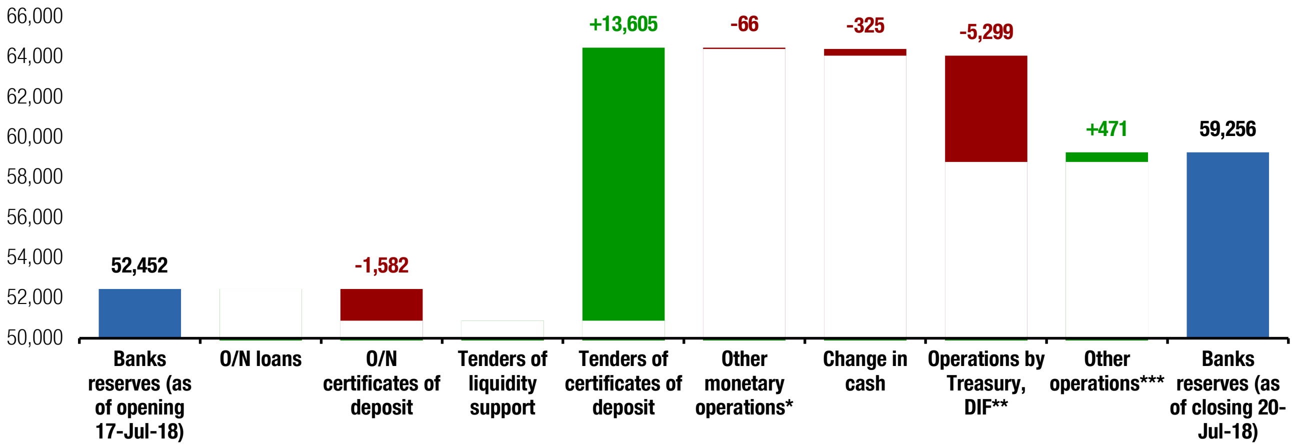
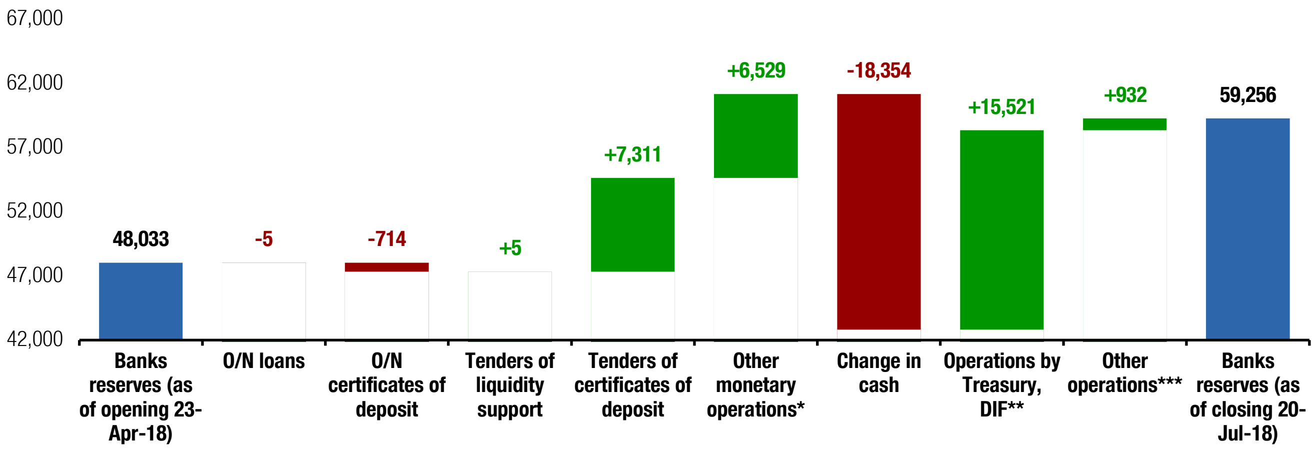


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 depreciated 0.6%

This week, the hryvnia will be under pressure as a result of significant redemptions of government bonds and a period of VAT refunds, which will be somewhat offset by tax payments to the budget.

Last week, the hryvnia weakened against the US dollar despite the key rate hike by the NBU. Apparently, the main reasons were the mood on the local currency market and expectations of a difficult week ahead. This prompted some market participants to buy here and now, rather than postpone purchases and risk that the hryvnia could weaken even more. Thus, despite sufficient supply, the situational increase in demand for foreign currency pushed the hryvnia downward, although the rate stayed below 26.5 UAH/USD. Accordingly, the national currency fell by 0.6% last week and finished trading at 26.45 UAH/USD.

The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries trade partners of Ukraine) decreased 0.6% to 119.3 for the period. In year-on-year terms, real trade-weighted indices (CPI and PPI based) increased 4.8% and decreased 0.8%, respectively.

ICU view: This week, the hryvnia will be under pressure, as there will be significant repayments of government bonds (almost UAH6bn, of which 4bn is redemption) and VAT refunds, which will increase the supply of hryvnia in the market and allow exporters to sell less foreign currency. Additionally, pressure may be caused by the last phase of dividend payments abroad this month. However, the compensation for the abovementioned factors will be demand for the hryvnia for tax payments to the budget.

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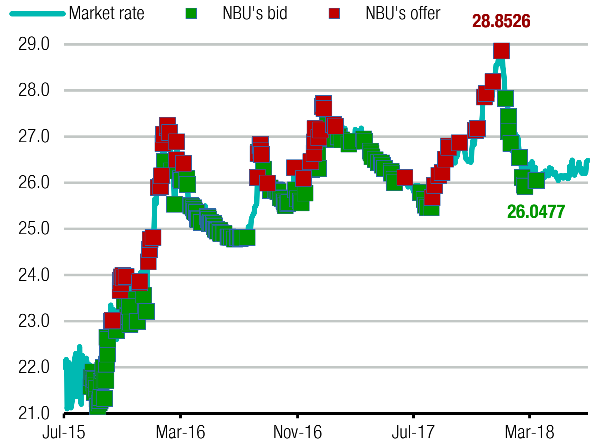
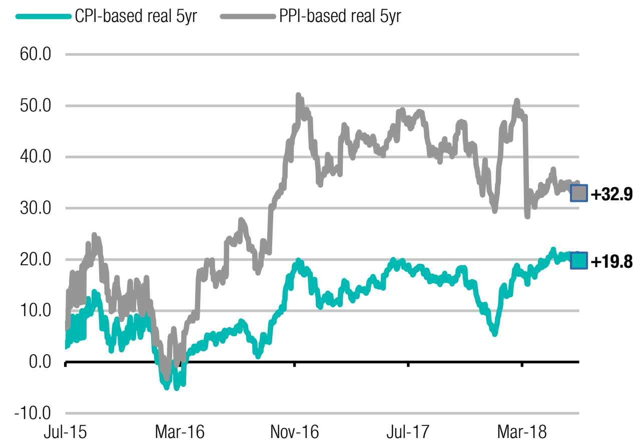
Chart 5. FX market indicators, 3-year history

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

NBU estimates real GDP at +3.2% YoY in 2Q18

Economic growth accelerated to 3.2% YoY in 2Q18, up from 3.1% YoY in 1Q18, per data from the NBU. In QoQ terms, growth was 0.8% QoQ SA (ICU's estimate as implied by NBU's 2Q18 year-on-year estimate).

Solid consumer demand and high fixed investment will continue to push up real GDP growth. The main driver of growth was solid domestic demand thanks to 1) high business expectations of enterprises, 2) acceleration of current and capital budget expenditures, and 3) higher incomes because of increased wages, pensions, and further growth of remittances. In addition, real GDP growth was supported by a low base of comparison due to the severance of economic ties with the temporarily occupied territories last year. Thus, the growth of production volumes in the energy and mining sectors made a significant contribution to economic activity.

In general, the NBU has kept its forecast for economic growth at 3.4% in 2018, and reduced the forecast for 2019 to 2.5% (the previous forecast was 2.9%) due to the diminishing effect of a sharp increase in social standards in previous years, and tight monetary conditions that are necessary to return inflation to the target, according to the NBU in its July inflation report.

ICU view: Our estimate of real GDP growth in 2Q18 is somewhat more optimistic: 3.5% YoY and 0.9% QoQ SA. But growth drivers are in line with the NBU's position: higher consumer demand, a low base of comparison related to the trade blockade of non-

controlled area of Donbass, and higher investment activity. However, in our view, real GDP growth will not exceed 2% in 2019, as external refinancing needs increase and there is a less steep rise of wages and social security payments than in 2017-18.

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Merchandise-trade balance deficit up 44.4% YoY in 5M18

The deficit expanded to US$2.1bn in 5M18, up compared with US$1.4bn in 5M17. High oil prices combined with solid consumer imports will bring about a further widening of the merchandise-trade balance deficit.

In 5M18, export of goods amounted to US$19.5bn. Food products accounted for 37.5%, metals and products made from them 26.4%, machinery and equipment 10.1%, mineral products 8.9%, and 17.1% was other products. In YoY terms, exports increased by 12.9% or US$2.2bn. The largest contributors to this increase were metals at 55% (US$1.2bn), electric machines at 11.6% (US$0.3n), and wood and articles of wood at 8.6% (US$0.2bn).

Merchandise imports totaled US$21.5bn, of which 22.7% were mineral products, machinery and equipment 20.2%, products of chemical and allied industries 14.3%, means of transport 8.3%, and other products 35.5%. In 5M18, imports increased 15.3% YoY or US$2.8bn. The largest contribution to this increase was made by machinery and equipment 28.3% (US$0.8bn), products of chemical and allied industries 14.2% (US$0.4bn), and metals and articles of them 8.4% (US$0.2bn).

ICU view: Imports of goods will continue to rise faster than exports due to high oil prices, solid consumer imports, and lower steel prices, the main driver of Ukrainian exports. Our view is that the merchandise-trade-balance deficit will widen from US$6.3bn in 2017 to US$9.8bn in 2018.

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