Focus
Ukraine

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

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Weekly Insight

Ukraine reaches new agreement with the IMF

Key messages of the today's comments

WEDNESDAY, 24 OCTOBER 2018

Domestic liquidity and bonds market

Domestic bond repayments refinanced

A difficult period with large FX domestic bond repayments in October will be over this week, as after holding an extra auction, the Ministry of Finance collected enough FX to fulfil its obligations.

Liquidity stays below UAH80bn

Last week, banking-sector liquidity remained under the negative impact from the Treasury. The NBU increased this pressure with FX selling at the end of last week, keeping liquidity below UAH80bn. This week, the FX market and month-end tax payments should continue to weigh on liquidity.

Foreign exchange market

VAT refunds and seasonally lower exports to weigh on UAH

Higher volumes of VAT refunds this week, as well as seasonally subsiding export revenues, will nudge exporters to retain foreign currency, which will reduce FX supply and weaken the UAH.

Economics

Ukraine reaches new staff level agreement with the IMF

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Merchandise-trade-balance deficit rises 46% YoY in 8M18

The merchandise-trade-balance deficit widened to US$5bn in 8M18. High world prices on energy products, gas prices and robust consumer imports will put pressure on the trade balance, but this will be offset by higher-then-expected metal prices.

Banks' reserves market (23 October 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	19.00	+0bp	+650bp
ON rate (%)	18.33	+21bp	+683bp
ON $ swap (%)	17.46	+38bp	+561bp
Reserves (UAHm)[2]	55,485	+1.51	+7.80
DepCerts (UAHm)[3]	21,898	-26.54	-8.69

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 October 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	N/A	...	...
Banks	N/A	...	...
Residents	N/A	...	...
Individuals	N/A	...	...
Non-res[4]	N/A	...	...
Total	**N/A**	**...**	**...**

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

FX market indicators (23 October 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	28.1580	+0.93	+5.90
EUR/USD	1.1471	-0.26	-2.37
DXY[2]	95.961	+0.40	+2.16
UAH TWI[3]	115.661	-0.70	+2.53

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

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

Maturity	Bid	Ask
6m	**19.75**	**18.50**
12m	**19.75**	**18.10**
2y	**19.50**	**18.00**
3y	**19.50**	**17.50**
12m ($)	**7.50**	**5.00**
2y ($)	**7.50**	**5.20**

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

Domestic liquidity and bonds market

Domestic bond repayments refinanced

A difficult period with large FX domestic bond repayments in October will be over this week, as after holding an extra auction, the Ministry of Finance collected enough FX to fulfil its obligations.

Last week, the MoF redeemed USD-denominated bills, having collected funds during the two weeks leading up to the repayments. Increasing the rates for these instruments helped attract investors. Maintaining them at this new level, the MoF collected an additional US$283m last week, most of it at the extra auction held last Thursday, which allowed it to raise enough funds for debt repayments in FX scheduled for this week. For additional information about last weeks' borrowings, please read our overviews of Tuesday's and Thursday's auction.

But this week debt repayments are scheduled in euros instead of US dollars. So, it was important for the MoF to refinance repayments and not exchange FX. Regardless, with only partial refinancing, the peak of domestic debt repayments in FX was met successfully. Currently, the MoF has refinanced 100% of October's FX debt principal repayments.

ICU view: At the beginning of October, the MoF hiked the cut-off rate for euro-denominated bills to 4.6%. So, the MoF fully refinanced October's FX redemptions which comprised the peak payments during these two weeks.

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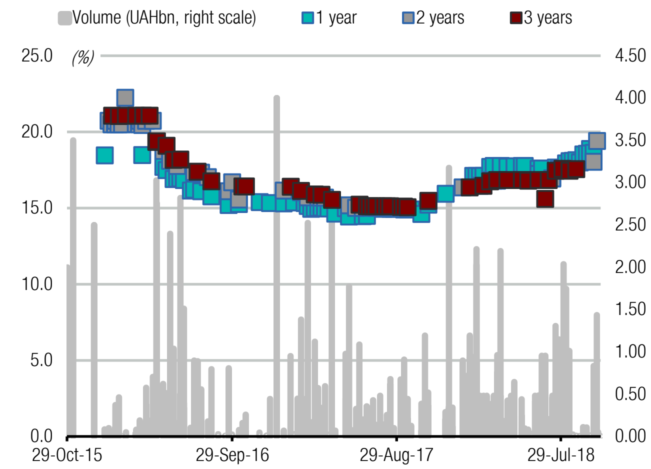
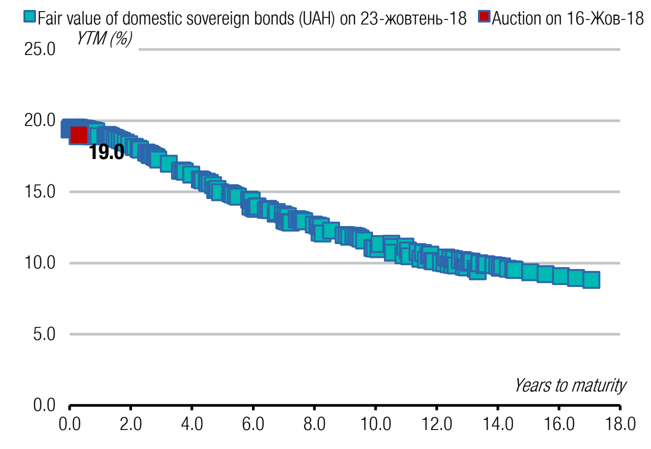
Chart 1. Local-currency bonds

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.

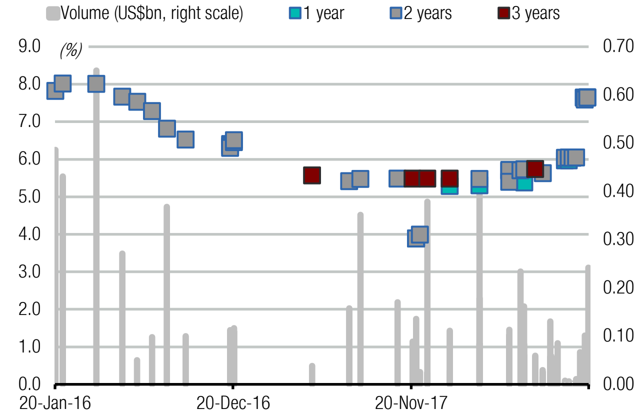
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

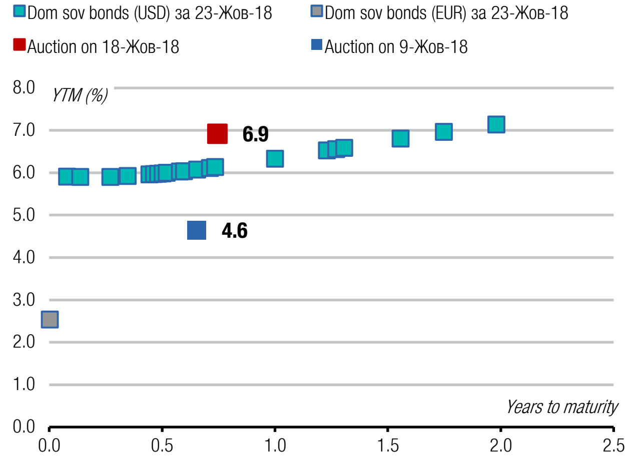
Chart 2. FX-denominated bonds

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 stays below UAH80bn

Last week, banking-sector liquidity remained under the negative impact from the Treasury. The NBU increased this pressure with FX selling at the end of last week, keeping liquidity below UAH80bn. This week, the FX market and month-end tax payments should continue to weigh on liquidity.

The Treasury started to accumulate funds in its accounts in preparation for a very difficult November, when a large amount funds in local currency will be required for debt repayments. Total debt repayments will amount to UAH26bn, with nearly half owed to the NBU. So, the MoF and Treasury have to be ready for these payments, a large part of which is scheduled for the beginning of the month. As a result, this week, the Treasury will continue to negatively impact liquidity, which will be somewhat offset by VAT refunds.

ICU view: Liquidity will stay below UAH80bn and should decline close to this years' low although most likely not below UAH70bn. Support for liquidity will provide VAT refund and cash exchange in reserves. But these inflows will be insufficient to increase liquidity significantly.

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

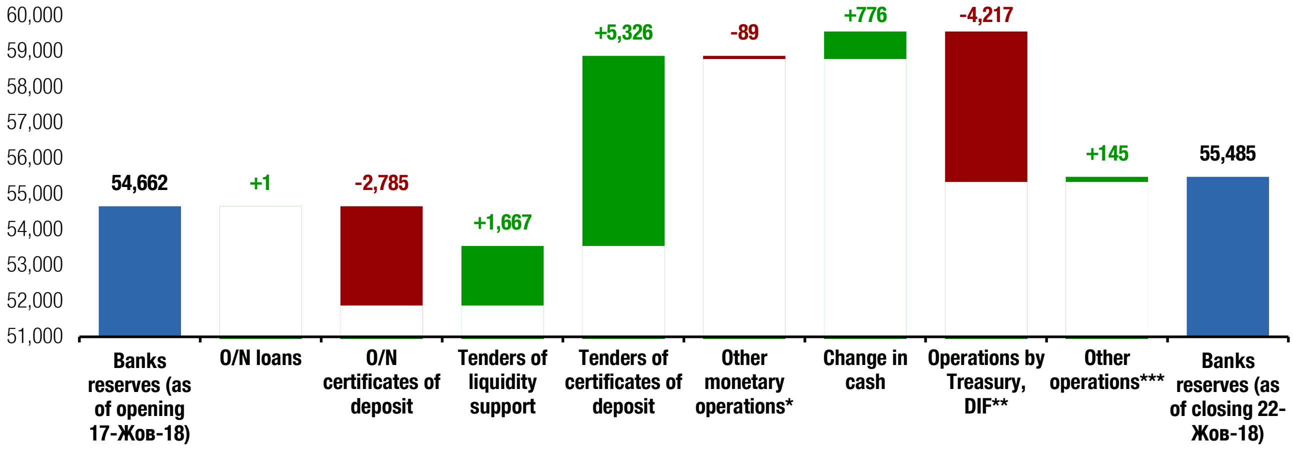
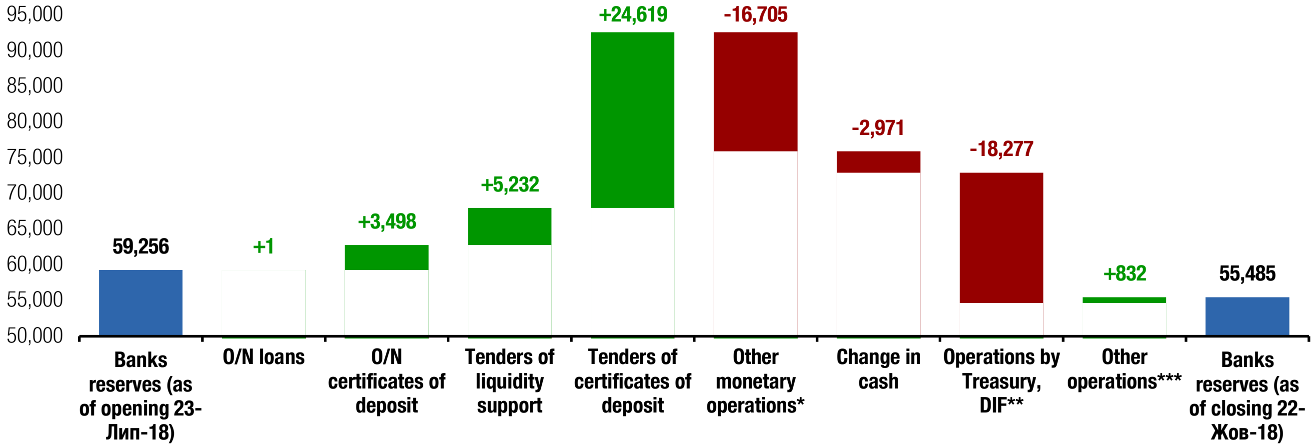


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

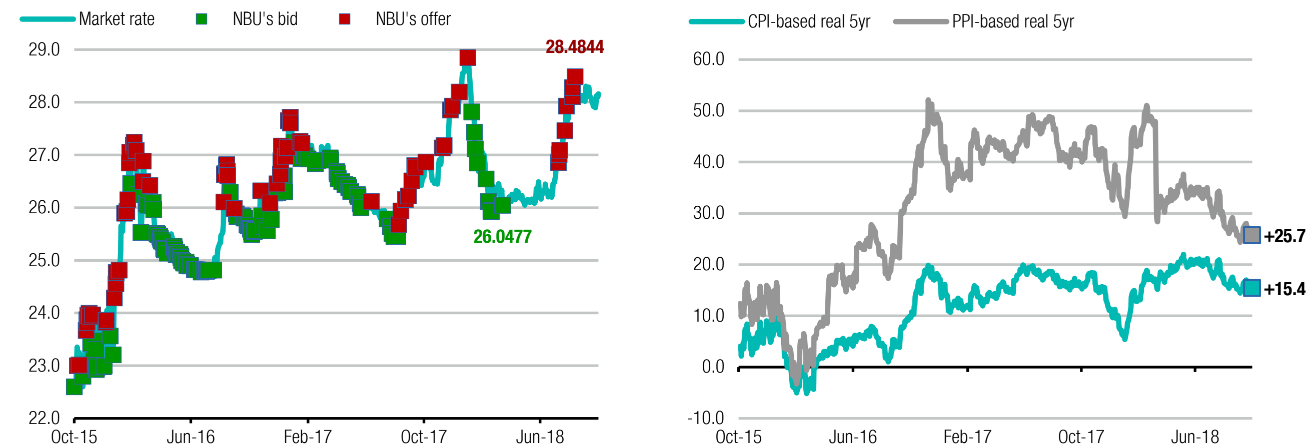
VAT refunds and seasonally lower exports to weigh on UAH

Higher volumes of VAT refunds this week, as well as seasonally subsiding export revenues, will nudge exporters to retain foreign currency, which will reduce FX supply and weaken the UAH.

The hryvnia started last week strengthening thanks to higher FX supply from exporters and lowed FX demand because of the holiday on Monday in Ukraine. However, after this effect had exhausted, the trend changed, not least due to a globally stronger USD. Thus, last week, the UAH weakened 0.7% to 28.12 UAH/USD.

Chart 5. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market *UAH exchange rate misalignment[1] from fundamental level[2] (%)*



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.

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

The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) decreased 1% to 115.5 for the period, while in YoY terms, it was up 2.7%.

ICU view: This week, we expect higher UAH volatility due to increased pressure from higher volumes of VAT refunds, which will allow exporters to retain FX currency, thus reducing FX supply. At the same time, last week, the NBU reduced the hryvnia's volatility first by buying excess FX supply and then selling FX at the end of the week. It will likely continue to conduct such policy this week.

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Economics

Ukraine reaches new staff level agreement with the IMF

The current EEF programme is replaced by a new 14-month Stand-By Arrangement in the amount of US$3.9bт. The new deal will allow Ukraine to unlock financing from other international financial institutions for repaying and servicing FX debt in 4Q18 and 2019.

Ukraine's government increased gas tariffs by 23.5% on Friday following Parliament's approval of the 2019 budget in the first reading the day before.

Shortly after the government's announcement on the gas tariff hike, the IMF announced that it had reached a staff level agreement on a new financial aid programme. The new Stand-By Arrangement (SBA) will replace the existing Extended Fund Facility (EFF) that is due to expire in March 2019. The amount of the new 14-month SBA is equivalent to US$3.9 bn. The agreement is subject to further IMF approval and will be conditioned on passing the 2019 budget in the final reading.

ICU view: The announcement of the new deal with the IMF is a very positive sign for Ukraine since the country is facing an approximate $1bn financing gap for its FX debt payments before YE2018, and peak FX debt repayments in 2019. Securing a staff-level deal with the IMF may be sufficient to unblock EU (EUR1bn) and World Bank ($800m) loans, as well as it gives the Ministry of Finance a greater chance of successfully placing Eurobonds (the government expects to attract $2bn). The main condition is parliament's passing the 2019 government budget in the final reading.

We see two major remaining threats to the approval of budget, and, therefore, the IMF deal. The primary issue is the Capital Exit Tax (CET) that should replace the income tax. The IMF sees it as a threat to financial stability since income tax revenues (UAH90bn for 2019) amount to 2.3% of GDP or 7% of consolidated budget revenues. We believe that the compromise solution will suggest gradual replacement of the income tax with CET. The other possible problem might be lack of parliamentary support of a budget with spending, which does not satisfy MPs' election-year appetites due to the IMF criteria. We believe that such a scenario is possible, but not plausible. In the base-case scenario, Parliament supports the deal. We expect final voting on the budget to take place either on 8 November or between 20–22 November.

For more details, please see our separate note.

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Merchandise-trade-balance deficit rises 46% YoY in 8M18

The merchandise-trade-balance deficit widened to US$5bn in 8M18. High world prices on energy products, gas prices and robust consumer imports will put pressure on the trade balance, but this will be offset by higher-then-expected metal prices.

Exports of goods rose 12.4% YoY or US$3.4bn, to US$30.9bn, per data from the State Statistics Service. The largest contribution to this increase was made by base metals and products made from them (+28% YoY), which account for 26% of total exports, electric machines (+22% YoY), and wood and articles made from wood (+35% YoY).

Imports of goods amounted to US$35.9bn, having increased by 16.1% YoY or US$5bn. The growth was primarily due to higher energy imports (+14.3% YoY), which account for 23% of total imports, electric machines (+27% YoY), and products of the chemical and allied industries (+11% YoY).

ICU view: Imports of goods will continue to rise faster than exports due to solid consumer demand and higher volumes of energy imports against the backdrop of high energy prices. At the same time, the growth rate of exports will be supported by higher-than-expected steel prices and a better harvest this year, which will constrain widening of the merchandise-trade-balance deficit.

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