



Focus
Ukraine

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

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Weekly Insight

Inflation accelerates

Key messages of the today's comments

Domestic liquidity and bonds market

Bond rates steady

Last week, the Ministry of Finance rejected part of demand for new government bonds, keeping cut-off rates unchanged. We expect that this week's auction will be similar, with low demand and unchanged rates.

Liquidity up, but could decline

At the end of last week, liquidity rose to UAH88.6bn, a record high for this autumn, but this week we could see a significant decline to about UAH80bn due quarterly tax payments.

Foreign exchange market

Hryvnia continues to appreciate

After a slight weakening at the end of October, the hryvnia began November with sufficient appreciation, which continued last week. We expect that this trend will continue this week, giving the hryvnia an opportunity to strengthen further.

Economics

Inflation accelerated to 9.5% YoY in October

Robust consumer demand, a gas price hike for population, and seasonal UAH weakening will continue to put upward pressure on inflation.

No decision on CET

The Parliamentary committee decided against a gradual implementation of a Capital Exit Tax (CET), which is now postponed.

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TUESDAY, 13 NOVEMBER 2018

Banks' reserves market (12 November 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	18.00	+0bp	+450bp
ON rate (%)	17.70	-10bp	+520bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	45,240	-12.73	+23.02
DepCerts (UAHm) ³	43,332	+35.89	+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) (12 November 2018)

	Last	Weekly chg (%)	YoY chg (%)
NBU	348,100	+0.00	-3.46
Banks	359,749	-1.25	+14.75
Residents	20,093	-1.16	-7.74
Individuals	5,413	+2.65	+501.49
Non-res ⁴	7,144	-0.94	+34.57
Total	740,498	-0.63	+5.47

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

FX market indicators (12 November 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	27.9155	-0.10	+5.30
EUR/USD	1.1218	-1.83	-3.83
DX ²	97.542	+1.27	+3.34
UAH TWI ³	118.521	+1.63	+2.93

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

Gov't bond quotes¹ (13 November 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

Bond rates steady

Last week, the Ministry of Finance rejected part of demand for new government bonds, keeping cut-off rates unchanged. We expect that this week's auction will be similar, with low demand and unchanged rates.

At the debut primary auction in November, the MoF rejected demand that was submitted with interest rates above the cut-off level seen during recent weeks. But this decreased budget proceeds just by 16% from what it would have been if this demand had been accepted. Total budget proceeds received amounted to UAH1.2bn last week. More details in our [auction review](#).

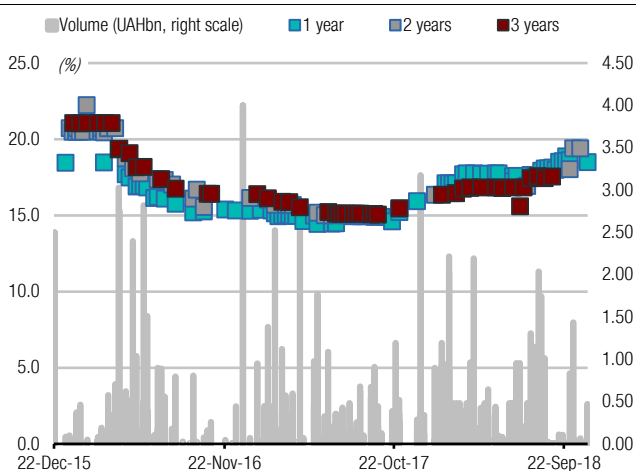
Such amounts of proceeds should allow the MoF to stay inside the financing limit set in the state budget for this year. But with new FX debt repayments scheduled for November and December, new borrowings in FX could be necessary. This current week is still very important for local-currency debt repayments, which in the first half of the month, will total UAH16.5bn. Last week, part of the repayments had already been paid, but this week, about UAH10bn should be paid to the NBU. So, without an inflow of funds into the banking system, we should not expect an increase in demand for new bills.

ICU view: The Ministry could continue to prefer borrowings in FX, and not agree to higher rates for local-currency bills. As a result, new borrowings will be small, and this month, the MoF will count on revenues from quarterly tax payments. This week budget will receive quarterly payments of corporate tax, which will support budget accounts and provide a source of funds for debt repayments and budget expenditures.

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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 (%)



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

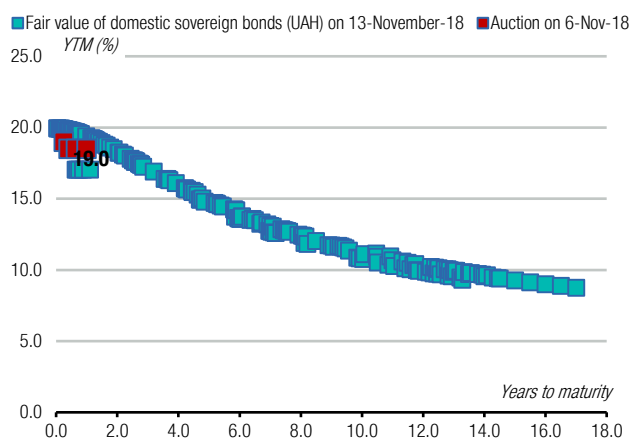
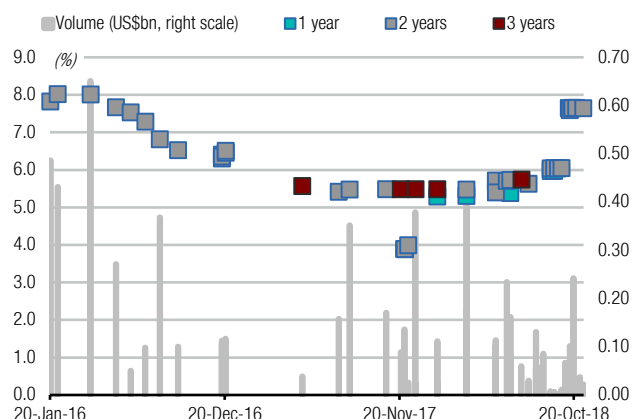


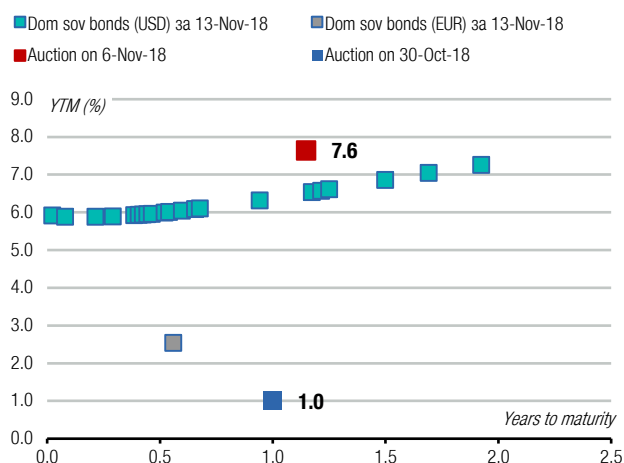
Chart 2. FX-denominated bonds

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 up, but could decline

At the end of last week, liquidity rose to UAH88.6bn, a record high for this autumn, but this week we could see a significant decline to about UAH80bn due to quarterly tax payments.

Last week, liquidity in the banking system—excluding government bond portfolios—was supported by budget expenditures and FX purchases by the NBU. Only last Thursday, the NBU made no purchases of FX, and, during last week, purchased US\$157.4m, providing the banking system with UAH4.4bn of liquidity. An additional UAH2.6bn of funds was received by banks through nonmonetary operations, as budget expenditures were decreased by outflows in cash.

At the same time, banks increased certificates of deposit. Last Thursday, they purchased an additional UAH6.6bn of CDs, which increased total CDs outstanding to UAH43.4bn, the largest amount since mid-August. But this purchase decreased the amount of banks' correspondent accounts balances with the NBU.

ICU view: This week, quarterly payments of corporate profit tax should require large amounts of funds and liquidity could decline, receiving mostly inflows from NBU via the FX market. At the same time, Treasury operations will have a mostly negative impact on liquidity, which could decline to about UAH80bn this week.

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

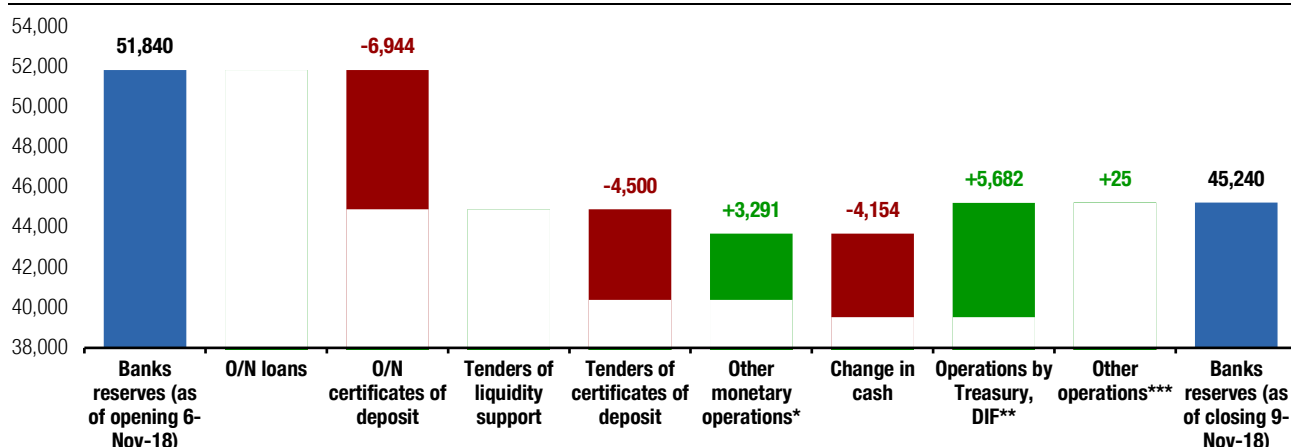
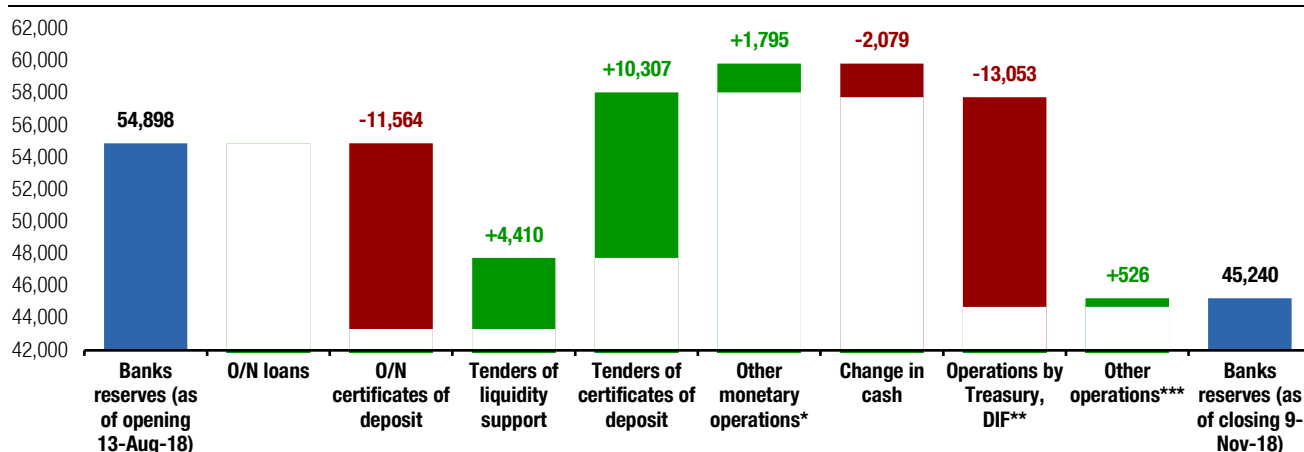


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 continues to appreciate

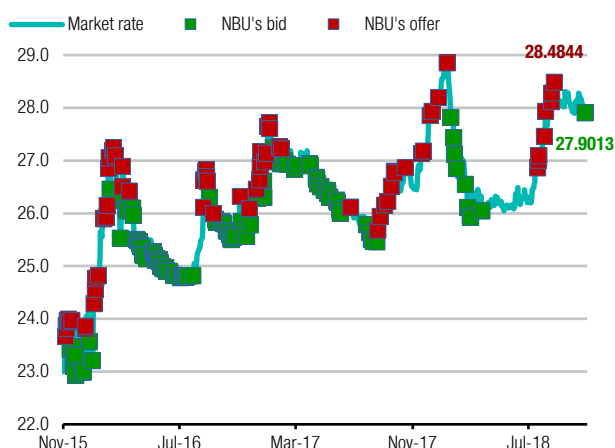
After a slight weakening at the end of October, the hryvnia began November with sufficient appreciation, which continued last week. We expect that this trend will continue this week, giving the hryvnia an opportunity to strengthen further.

Over the past week, the hryvnia strengthened by 0.7% to UAH27.86/USD, a level seen in mid-October and the end of August. With attempts to restrain hryvnia appreciation, the NBU purchased US\$157.4m and also held a FX auction after a long break.

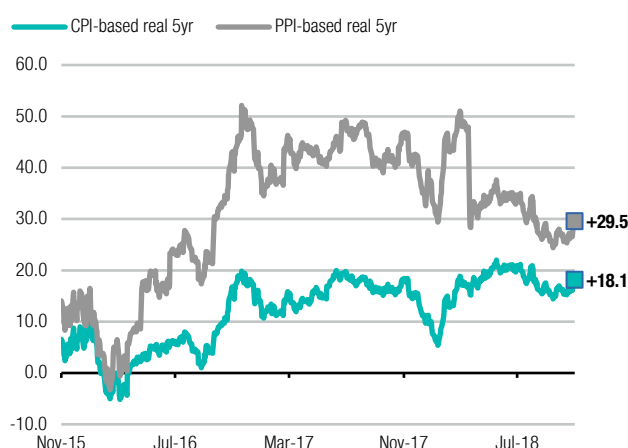
Significant FX supply over lower demand was probably the result of a combination of factors. With lower demand for dividend payments abroad, we could have an increase in FX selling by agricultural companies for autumn field work due to quite warm weather, and also by corporates that collect funds in local currency for corporate tax payments this week.

ICU view: This week, the hryvnia is likely to stay at the same level as last week. On the other hand, the hryvnia could appreciate to UAH27.8/USD due to FX supply. We're seeing a repeat of the dynamic with the hryvnia seen last November, meeting the same impact from similar factors.

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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 misalignment¹ from fundamental level² (%)

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

Economics

Inflation accelerated to 9.5% YoY in October

Robust consumer demand, a gas price hike for population, and seasonal UAH weakening will continue to put upward pressure on inflation.

In October, the State Statistics Service of Ukraine registered growth in all major components of inflation, with the exception of education and healthcare. The key contributors to inflation acceleration were higher prices on transport (+18.5% YoY), alcoholic beverages, and tobacco products (+16.9% YoY), communication (+13.6% YoY), and food products and alcoholic beverages (+7% YoY). Each added 0.1ppt MoM to the total reading of 9.5% YoY in October (vs. 8.9% YoY in September). Core inflation rose 8.8% YoY. According to updated-in-October forecasts, the NBU expects headline CPI at 10.1% YoY for the end of 2018.

ICU view: Consumer-price growth is set to accelerate in the following months, and remain under pressure from 1) seasonal UAH weakening, 2) a gas price hike for the population beginning in November, 3) high world oil prices, and 4) robust consumer demand. Thus, we maintain our CPI forecast at 10% YoY for the end of 2018.

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No decision on CET

The Parliamentary committee decided against a gradual implementation of a Capital Exit Tax (CET), which is now postponed.

The full-scale implementation of CET will significantly reduce government revenues as the proceeds from corporate tax in 2019 are expected at UAH90bn or 7% of the consolidated budget revenues. Therefore, the Ministry of Finance submitted a compromise proposal for a gradual implementation of the tax and payments in advance to ensure that changes in taxation will not dramatically increase the budget deficit. Despite the IMF having agreed with this solution, the Rada committee decided that a parallel existence of two systems for taxation of corporate income is not desirable, and postponed voting until a better solution is found.

ICU view: Abandoning the idea of replacing the corporate income tax with CET will be positive for the new IMF programme, as the Fund was very skeptical of the idea in the first place. However, the sunk cost for the President and his fraction in Parliament are already high, as he promised it to the business community on numerous occasions. Finding a better compromise may take time, and delay the budget process. We expected it to be adopted on November 20-22nd but there is a good chance we can see the voting on 4-6th of December. If no deal is reached by that time, Ukraine is highly unlikely to get an IMF tranche in 2018, as there would only be a few more voting days in the Parliament (December 18-20th) but the IMF board will be unable to meet immediately after that period due to the Christmas holidays.

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Ukraine's FX reserves grew after the Eurobond placement

Ukraine FX reserves grew to US\$18.1bn after the Eurobond placement.

Proceeds from the most recent Eurobonds allowed Ukraine to increase its reserves to US\$18.1bn as of 5 November. This brings the country's reserves back to 3.0 months of future import. Apart from that, the hryvnia enjoyed a period of strengthening that allowed NBU to make net purchases of FX to accumulate more reserves.

ICU view. Despite the positive developments, Ukraine is still has yet to receive the first tranche of the new IMF programme, which is linked to budget adoption, and money from the EU and World bank that, in turn, is linked to a stance of cooperation with the IMF.

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