

Weekly Insight

Inflation slowed to 9.8% in 2018

Key messages of the today's comments

Domestic liquidity and bonds market

Unexpected rates increase

Despite the MoF unexpectedly decided to increase cut-off rates at the end of last year, this year's debut auction provided a low amount of proceeds. However, the NBU's new regulations should soon boost banks' demand for MoF's bills.

Liquidity recovers above UAH100bn

The NBU's purchase of FX at the market, and an increase in budget expenditures supported liquidity, which rose above UAH100bn. However, liquidity is likely to be somewhat volatile at this level, although without a significant increase.

Foreign exchange market

Hryvnia weakens

Sufficient pressure from FX supply at the end of last year allowed the hryvnia to improve its position, but this year, the Ukrainian currency started to weaken. However, the recovery in economic activity of exporters should support the hryvnia, and keep it closer to UAH28/US\$ this week.

Economics

Inflation slowed to 9.8% in 2018

Consumer prices growth slowed to 0.8% MoM and 9.8% YoY in December, averaging 10.9% YoY in full-year 2018. Thanks to lower energy prices, as well as tight monetary and fiscal policies, inflation will continue to decelerate in 2019.

MONDAY, 14 JANUARY 2019

Banks' reserves market (11 January 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	18.00	+0bp	+350bp
ON rate (%)	17.40	-11bp	+360bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	N/A
DepCerts (UAHm) ³	N/A

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) (11 January 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU	346,943	-0.33	-3.78
Banks	374,033	+0.76	+3.63
Residents	19,730	-2.15	-9.71
Individuals	6,052	+1.77	+313.25
Non-res ⁴	6,539	+2.30	+25.25
Total	753,297	+0.20	+0.43

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

FX market indicators (11 January 2019)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	28.0620	+0.92	-1.43
EUR/USD	1.1469	+0.65	-4.68
DX ²	95.670	-0.53	+4.16
UAH TWI ³	115.799	-1.44	+9.12

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

Gov't bond quotes¹ (14 January 2019)

Maturity	Bid	Ask
6m	20.50	18.50
12m	20.50	19.00
2y	20.50	18.50
3y	20.50	18.00
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

Unexpected rates increase

Despite the MoF unexpectedly decided to increase cut-off rates at the end of last year, this year's debut auction provided a low amount of proceeds. However, the NBU's new regulations should soon boost banks' demand for MoF's bills.

In mid-December 2018's auction, the Ministry had to replace revenues from privatization and offered a wide range of three-month bills to attract additional funds. But demand for these bills was received with rates significantly higher than the last time they were offered, at 20.5%.

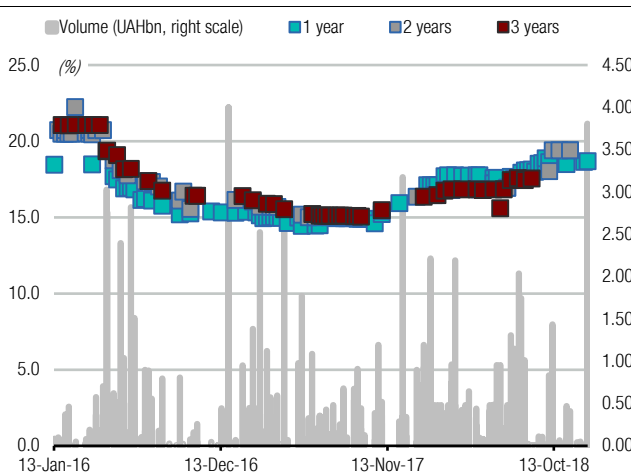
The MoF accepted these expensive bids, receiving UAH11.4bn of budget proceeds, but this decision also had a negative result. It created a new benchmark, and the market is starting to move yields closer to the last cut-off rate. This year's debut auction was with expectations that the MoF will keep the rate at 20.5%, and most demand was expensive. Out of UAH700m of demand, the MoF accepted only UAH44m, which had rates not higher than 19% for the three-month, and 18.5% for eight-month bills.

ICU view: New operational design of the NBU's monetary policy, launched last Friday, should increase the role of key policy rate. We think this will have a positive impact on local-currency funding costs, and will support the MoF in its attempts to keep the cut-off rate for three-month bills at 19%. So, in a few weeks, we could see an increase in demand for bills at rates that are more acceptable for the MoF.

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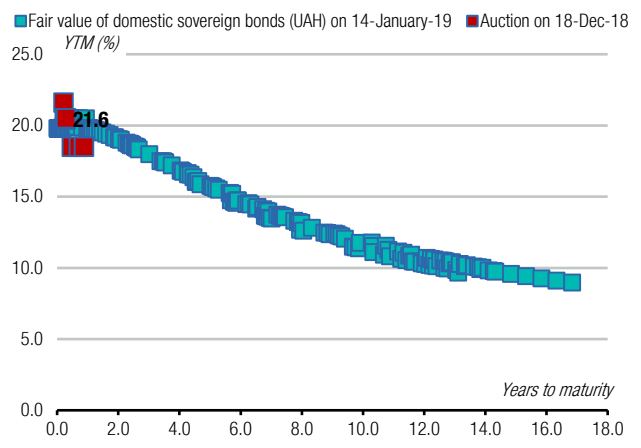
Chart 1. Local-currency bonds

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.

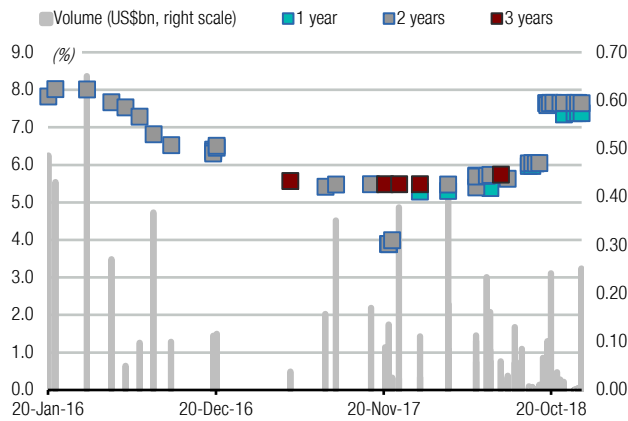
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

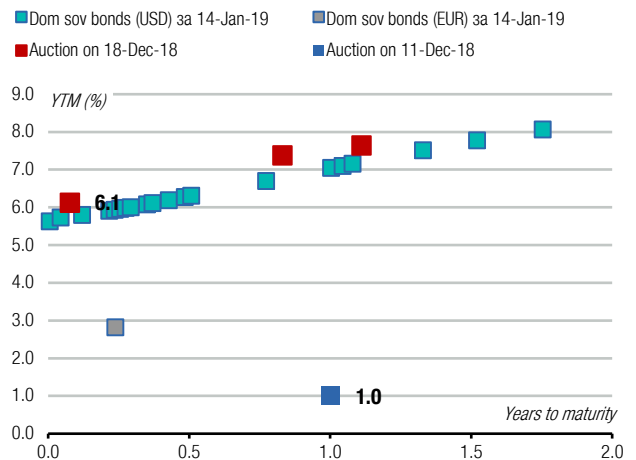
Chart 2. FX-denominated bonds

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 recovers above UAH100bn

The NBU's purchase of FX at the market, and an increase in budget expenditures supported liquidity, which rose above UAH100bn. However, liquidity is likely to be somewhat volatile at this level, although without a significant increase.

During December 2018, supply of FX required the NBU to make purchases in the market, which provided local-currency liquidity. In total, during December, the NBU paid a net UAH9.4bn for purchased FX. This year started with a negative balance between supply and demand, and the NBU absorbed UAH0.9bn, selling FX to satisfy extra demand.

The largest support for liquidity was provided by the Treasury via budget expenditures. The end of the budget year, and the need to use available funds caused an increase in budget expenditures. Last month, inflows from the Treasury and DGF amounted to UAH36bn. Actually, outflows last month were only via reserves exchange in cash to satisfy demand for cash prior to the holidays.

ICU view: *This week, we expect to see liquidity slightly above UAH100bn. The key impact will be from NBU's participation in the FX market, purchasing or selling FX to smooth hryvnia volatility. The budget will have a low impact with low expenditures, but an increase in VAT refunds could be positive for liquidity.*

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

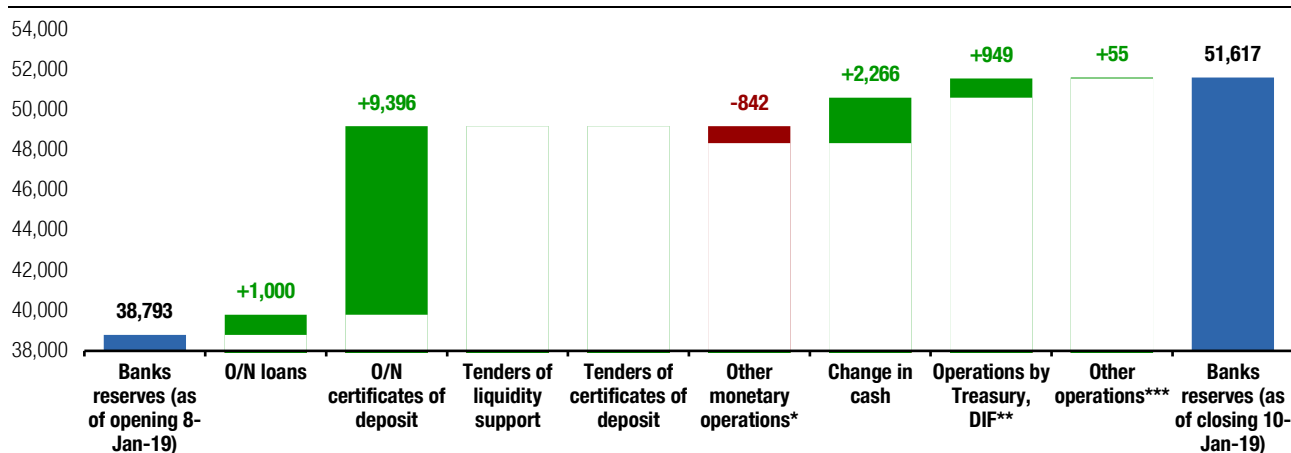
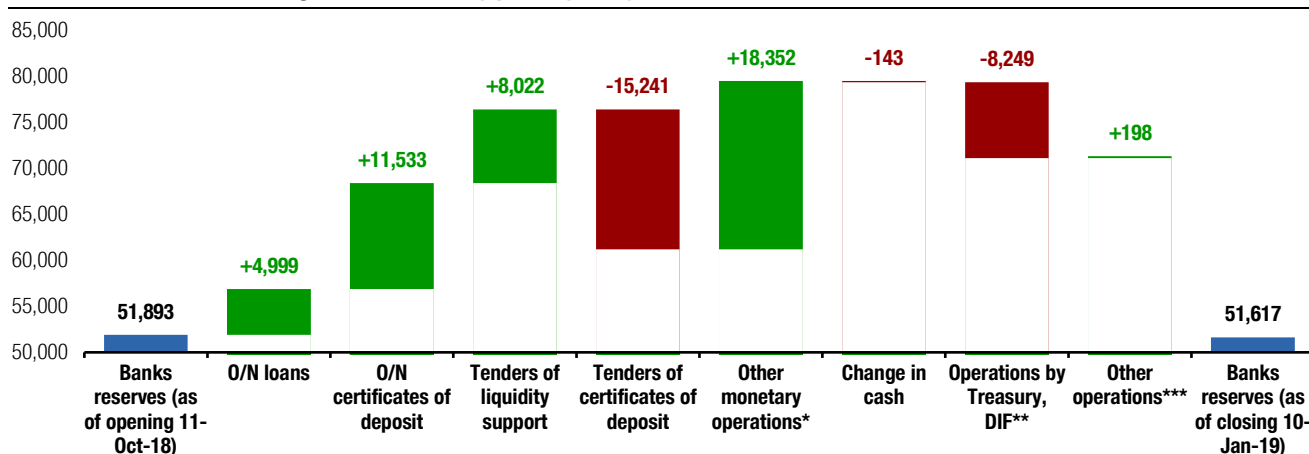


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 weakens

Sufficient pressure from FX supply at the end of last year allowed the hryvnia to improve its position, but this year, the Ukrainian currency started to weaken. However, the recovery in economic activity of exporters should support the hryvnia, and keep it closer to UAH28/US\$ this week.

Usually, we see a decline in economic activity during the holidays with an increase in demand for FX from importers to use extra revenues for import new goods. So, in the first few weeks of the year, we usually see the hryvnia weakening and attempts to find a new record high, after which we see seasonal appreciation until summer.

Last week, the exchange rate started to depreciate, and was UAH28.2175/US\$ on Thursday. On Friday, the balance moved to supply, and allowed hryvnia to become a bit stronger.

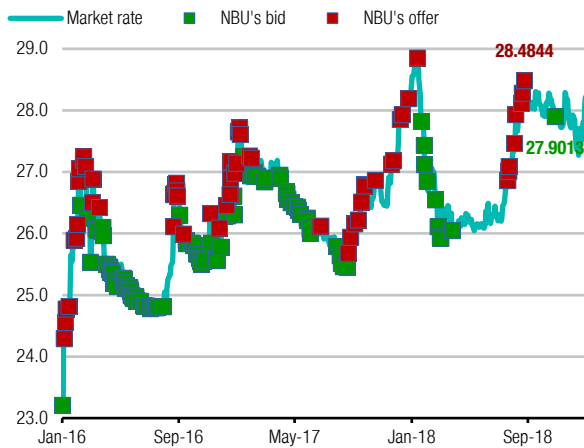
In total this year, the hryvnia lost 1.29%, weakening to UAH28.062/US\$. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) declined 1.44% to 115.8 while in YoY terms, it was up 9.1%.

ICU view: Volatility in the hryvnia exchange rate will continue this week, but an increase in export revenues and NBU interventions can help the market to meet extra demand for the hard currency, and thus support the hryvnia. As a result, we could see the exchange rate below last year's record high, and hryvnia will be stronger than UAH29/US\$ in January.

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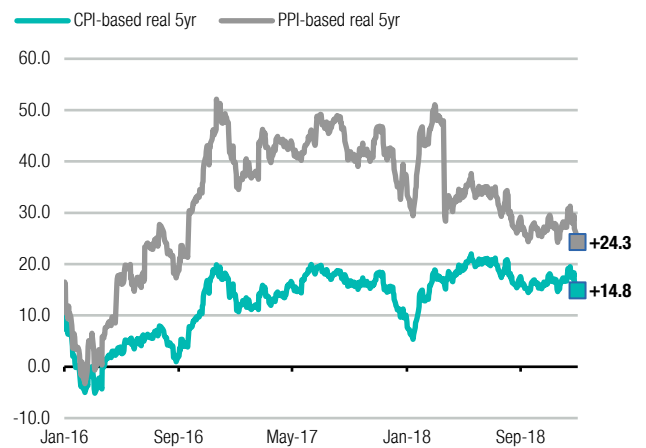
Chart 5. FX market indicators, 3-year history

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

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Consumer prices growth slowed to 0.8% MoM and 9.8% YoY in December, averaging 10.9% YoY in full-year 2018. Thanks to lower energy prices, as well as tight monetary and fiscal policies, inflation will continue to decelerate in 2019.

The inflation slowdown in December was primarily thanks to decelerated growth rates in transport prices to 12.9% YoY (vs. 16.8% YoY in November) against the backdrop of stronger UAH and plunged world oil prices. The contribution of this particular category fell to 1.5ppt out of 9.8% in December (vs. 2ppt out of 10% in November). On the flip-side, prices on food products (+7.8% YoY), tobacco products, and alcoholic beverage (+17.9% YoY) continued to increase for the third consecutive month, accounting for 51% of the total basket. Core inflation inched down by 0.2ppt to 8.7% YoY. The NBU forecasts headline CPI at 6.3% YoY for the end of 2019.

ICU view: The end-year 2018 inflation came in slightly below our and updated NBU's forecasts (10.2% and 10.1%, respectively) primarily due to an unexpected slowdown in growth rates of transport prices. For 2019, we expect inflation to decelerate to 8.5% YoY thanks to lower prices for oil and natural gas, tight monetary and fiscal policies, and slowing economic growth. Still, consumer prices will still be supported by solid consumer demand, high inflationary expectations, and rising nominal wages.

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