Focus	Markets	Research team
Ukraine	**Domestic liquidity, government bonds, FX market, and macro**	

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Weekly Insight

Government used guarantee from World Bank

Key messages of the today's comments

MONDAY, 4 MARCH 2019

Domestic liquidity and bonds market

New external borrowings

After finalizing new borrowings under the World Bank guarantee last week, the government received EUR529m on Thursday. These loans improved the FX balances in government accounts, and supported repayments of FX-denominated debt. However, they did not cover all needs for FX in 1H19.

Liquidity close to record high

Banking-sector liquidity rose to UAH120bn last week, close to this year's record high seen a month ago. This week, liquidity will stay high with a possible slight decline.

Foreign exchange market

Hryvnia appreciation continues

Despite the NBU purchasing about US$75m from the market last week, the hryvnia continued to appreciate. Last week, it exceeded UAH27/US$, and reached UAH26.84/US$ where it was at the end of the week.

Economics

Industrial production fell 3.3% YoY in January

Industrial production continues to decline—following a 3.5% YoY drop in December, it fell another 3.3% YoY in January. Thanks to still-solid consumer demand and an increase in the mining industry, the growth rate of industrial output in full-year 2019 will be positive.

Banks' reserves market (1 March 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	18.00	+0bp	+100bp
ON rate (%)	16.20	-58bp	+180bp
ON $ swap (%)	14.25	-38bp	-57bp
Reserves (UAHm)[2]	49,553	-10.44	-11.83
DepCerts (UAHm)[3]	67,313	+23.64	+32.50

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) (1 March 2019)

	Last	Weekly chg (%)	YoY chg (%)
NBU	337,107	+0.00	-4.86
Banks	362,342	-2.26	+5.31
Residents	23,733	-7.27	-11.29
Individuals	7,209	-4.19	+283.79
Non-res[4]	13,395	-0.52	-2.74
Total	**743,785**	**-1.41**	**+0.40**

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

FX market indicators (1 March 2019)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.8365	-0.62	+0.62
EUR/USD	1.1365	+0.26	-7.35
DXY[2]	96.527	+0.02	+6.87
UAH TWI[3]	121.107	+0.60	+6.57

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

Gov't bond quotes[1] (4 March 2019)

Maturity	Bid	Ask
6m	**20.00**	**18.50**
12m	**20.00**	**18.25**
2y	**19.75**	**18.00**
3y	**19.50**	**17.50**
12m ($)	**7.50**	**5.25**
2y ($)	**7.50**	**5.50**

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

Domestic liquidity and bonds market

New external borrowings

After finalizing new borrowings under the World Bank guarantee last week, the government received EUR529m on Thursday. These loans improved the FX balances in government accounts, and supported repayments of FX-denominated debt. However, they did not cover all needs for FX in 1H19.

According to the MoF, last Thursday, Deutsche Bank provided the government with EUR529m in two tranches: Tranche A amounted to EUR 240m for four years, and Tranche B amounted to EUR289m for 10 years. According to the Cabinet of Ministers resolution, the rate should be not higher than 5.9%, but actual rates for these loans have not been published yet. The World Bank guarantee covered US$375m of these loans.

According to our calculations, with these loans, the government should have enough FX for repayments until the end of March, and with new issues of FX-denominated domestic bills, until the end of April.

ICU view: These borrowings sufficiently improved the balances in FX accounts and decreased the impact from debt repayments on FX reserves. But future repayments, especially those scheduled for May, will require new FX borrowings, and a second tranche of EUR500m from the EU will not cover all budget needs in FX. So, FX-denominated domestic bills are still important and refinancing of domestic repayments in FX is still an issue.

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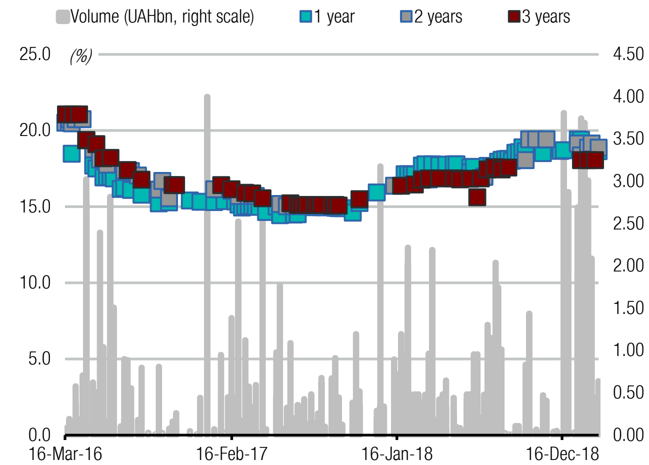
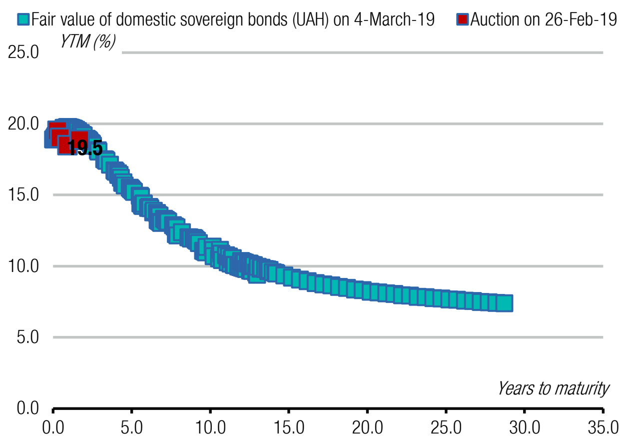
Chart 1. Local-currency bonds

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.

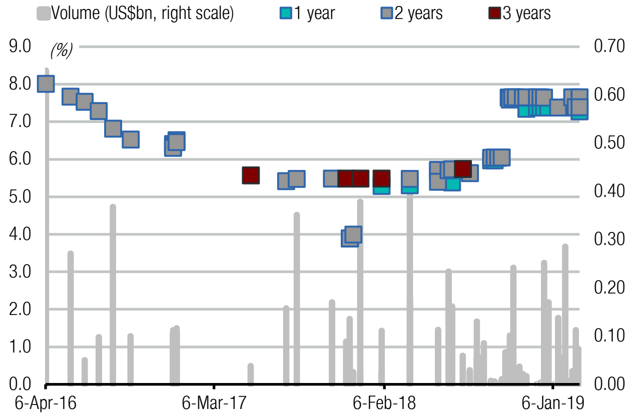
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

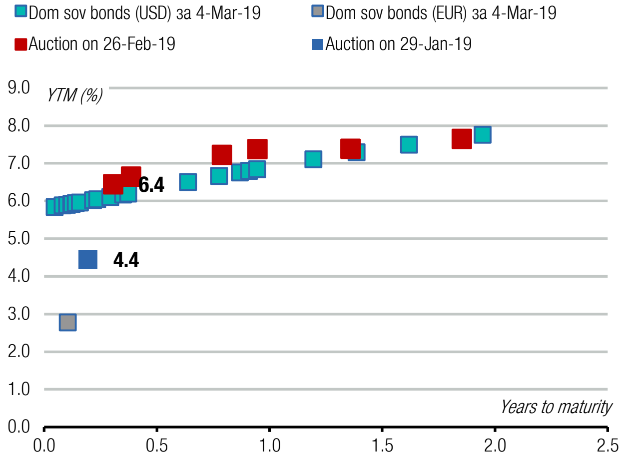
Chart 2. FX-denominated bonds

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 close to record high

Banking-sector liquidity rose to UAH120bn last week, close to this year's record high seen a month ago. This week, liquidity will stay high with a possible slight decline.

As is usual for the end of month, last week was active with VAT refunds, and the government paid about UAH10bn in refunds, covering most of outflows to budget accounts. In addition, the NBU purchased FX, and banks exchanged cash in reserves. In total, the banking system received UAH6.1bn, including 4.9bn from cash, and UAH1.5bn from the NBU via the FX market.

Balances in banks' correspondent accounts were mostly above UAH50bn, and slightly declined below this level at the end of week. At the same time, total CDs outstanding rose to UAH70bn.

ICU view: Active VAT refunds during a short period, and a new wave of hryvnia appreciation supported an increase in liquidity and a decline in interbank rates. This can force the NBU to undertake a new attempt to absorb liquidity, probably together with the government using outflows to budget accounts. Also, at the beginning of month, banks usually increase exchange of reserves in cash, which should also be negative for liquidity.

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

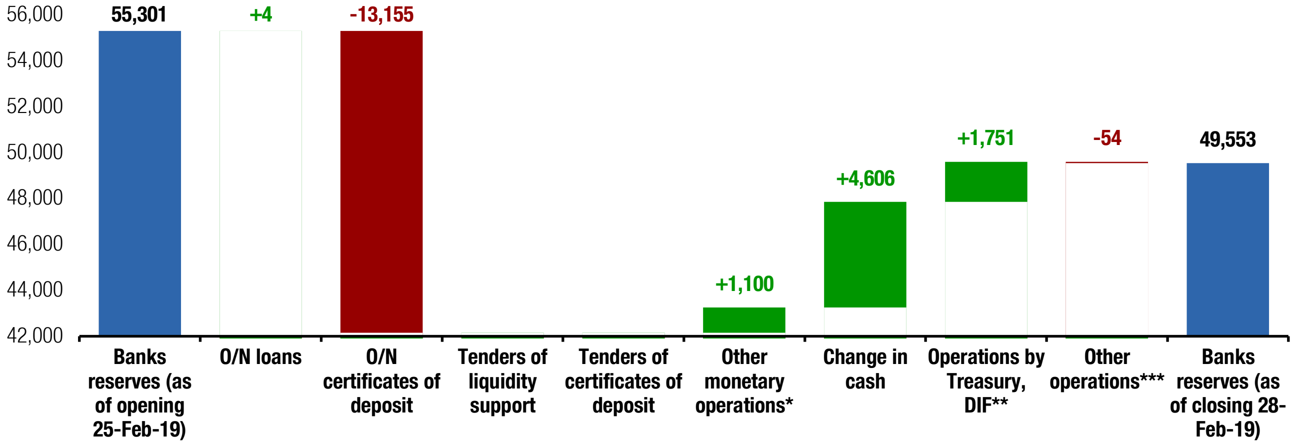
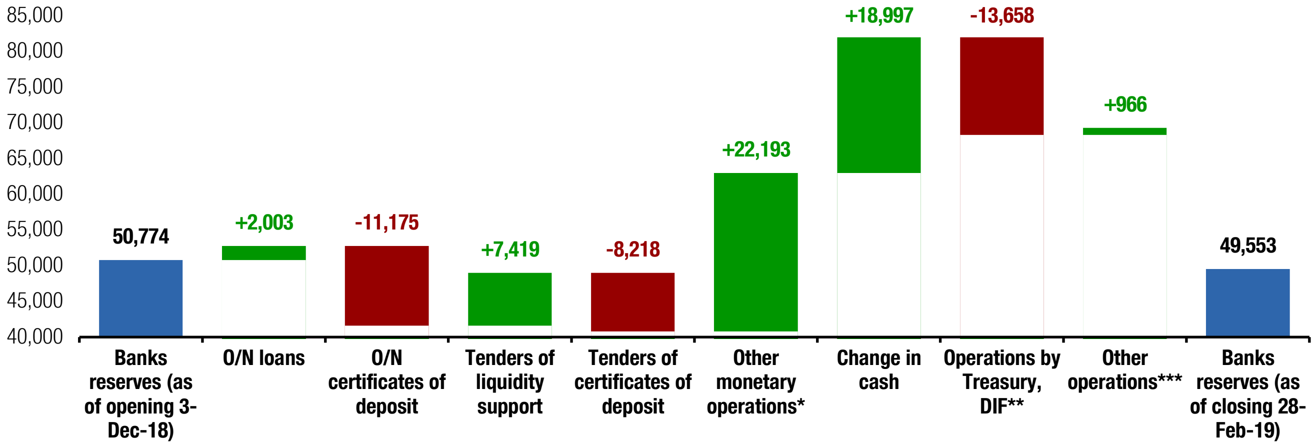


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 appreciation continues

Despite the NBU purchasing about US$75m from the market last week, the hryvnia continued to appreciate. Last week, it exceeded UAH27/US$, and reached UAH26.84/US$ where it was at the end of the week.

New FX regulations that took effect on 7 February 2019, stopped the hryvnia's appreciation. Attempts to weaken in mid-February have been replaced by a strengthening. The NBU purchased about US$75m last week, but this participation in the market was insufficient to keep exchange rate around UAH27/US$.

VAT refunds did not have a negative impact on the hryvnia. Foreign investors remained inactive in the market, with stable portfolios of government bills.

As the result, the hryvnia appreciated by 0.62% to UAH26.84/US$ last week. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) rose 0.6% to 121.1 while in YoY terms, it was up 6.6%.

ICU view: This week could see a new wave of exchange-rate volatility, as the mandatory rate of FX selling for businesses will be decreased from 50% to 30%, and

could result in a decline in the supply of FX. At the same time, changes in weather conditions could increase selling of FX by agrarians to finance their seasonal expenditures. As the result, this week, the hryvnia could weaken to above UAH27/US$, but with low probability of about 25%, and for a short period of time.

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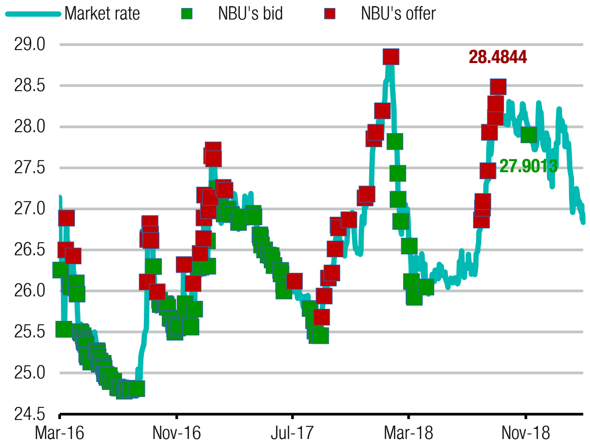
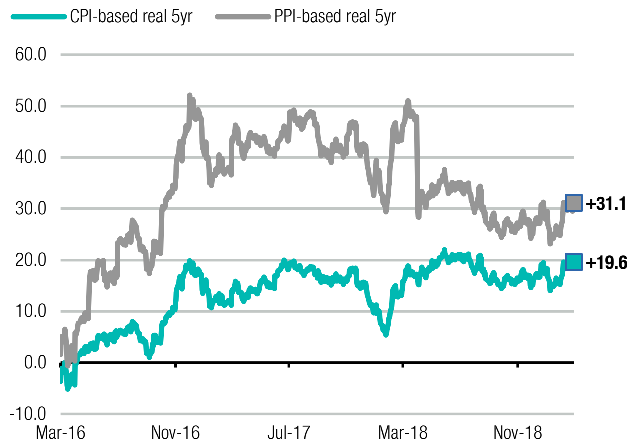
Chart 5. FX market indicators, 3-year history

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

Industrial production fell 3.3% YoY in January

Industrial production continues to decline—following a 3.5% YoY drop in December, it fell another 3.3% YoY in January. Thanks to still-solid consumer demand and an increase in the mining industry, the growth rate of industrial output in full-year 2019 will be positive.

In SA terms, industrial output fell 0.5% compared with December. The processing industry, which accounts for 57% of total industrial output, dropped 5.5% YoY, mainly due to decreased output in the chemical industry (-14.9% YoY), engineering (-11.9% YoY), and metallurgy (-4.5% YoY).

The mining industry fell 1.6% YoY in January after 1.8% YoY growth in December, due to a 7.1% YoY decrease in mining of metal ores. The utilities sector expanded 1.3% YoY in January, but the growth rates slowed from 11.1% YoY seen in December. Meanwhile, the State Statistics Service revised upward full-year 2018 industrial production growth to 1.6% vs. the previous estimate of 1.1% growth. The revision was broad based.

ICU view: This year, industrial production will be supported by still-solid consumer demand and higher growth rates in the mining industry thanks to expanding gas extraction and higher world prices on iron ore because of the tragedy in Brazil. Our baseline scenario envisages industrial production growth of 1.9% in full-year 2019.

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