



Focus
Ukraine

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

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Weekly Insight

Inflation slows to 4.1% YoY in 2019

Key messages of the today's comments

Domestic liquidity and bonds market

Foreigners still active in the market

So far this year, the bond portfolios of foreign investors slid UAH0.6bn (US\$25m), due to redemptions and the lack of primary auctions. With auctions starting today, this group's portfolios can increase.

NBU and Treasury increased liquidity in banking sector

Active absorption of the extra supply of hard currency at the end of last year, and an increase in budget expenditures caused a significant increase in banking-sector liquidity and will continue to have a similar impact this year. This week, liquidity will remain high, above UAH220bn (US\$9.2bn), with a possible increase.

Foreign exchange market

Hryvnia appreciation took a break

The hryvnia slightly weakened during recent weeks, partially due to the holidays and lower activity from foreign investors in the bond market. But with the holidays ending, exporters should become more active. The MoF is restarting its primary auctions today, providing an opportunity for further appreciation of the hryvnia.

Economics

C/A deficit fell to 2.3% of GDP in November

The C/A got support from lower natural gas prices and ongoing solid agricultural exports. These factors will keep supporting the C/A balance in the following months.

Inflation slows to 4.1% YoY in 2019

Lower world energy prices and a stronger UAH supported disinflation in 2019. This year, inflation will remain in the NBU's target range of 5±1%.

TUESDAY, 14 JANUARY 2020

Banks' reserves market (13 January 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	13.50	+0bp	-450bp
ON rate (%)	11.75	+38bp	-575bp
ON \$ swap (%)	10.26	-20bp	+0bp
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) (13 January 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	337,065	+0.00	-2.85
Banks	330,508	-1.32	-11.81
Residents	26,027	+0.68	+32.76
Individuals	9,826	+2.14	+62.36
Non-res ⁴	114,886	-0.51	+1,661.64
Total	818,312	-0.56	+8.61

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

FX market indicators (13 January 2020)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	24.1503	+1.98	-13.94
EUR/USD	1.1134	-0.17	-2.92
DX ²	97.345	+0.35	+1.75
UAH TWI ³	134.824	-2.22	+16.43

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

Gov't bond quotes¹ (14 January 2020)

Maturity	Bid	Ask
6m	13.00	11.00
12m	12.50	10.50
2y	12.50	10.25
3y	12.00	10.00
12m (\$)	4.00	2.75
2y (\$)	4.50	3.20

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

Domestic liquidity and bonds market

Foreigners still active in the market

So far this year, the bond portfolios of foreign investors slid UAH0.6bn (US\$25m), due to redemptions and the lack of primary auctions. With auctions starting today, this group's portfolios can increase.

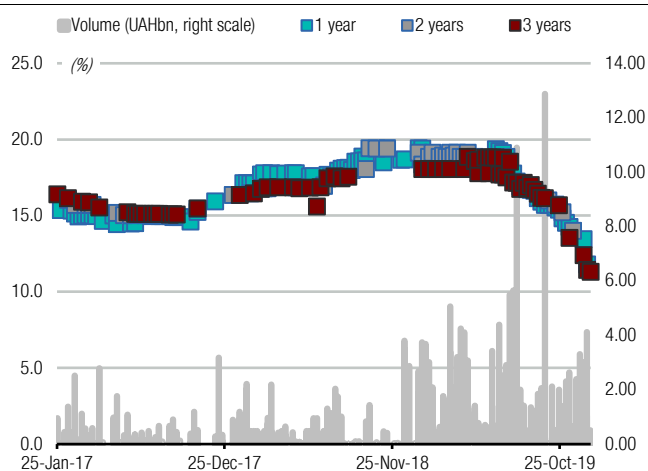
There was a large debt repayment on 8 January, which decreased the bond portfolios of foreigners by UAH1.4bn (US\$60m). However, during the next few days, foreigners become quite active in the secondary market, and purchased nearly UAH0.7bn (US\$30m) of local-currency paper. Most likely these bills were purchased from local banks.

ICU view: We expect that after today's primary auction, foreign investors' portfolios will continue to increase, as only part of the proceeds from debt repayments were reinvested in the secondary market. Also, as current interest rates are still at a level attractive to foreigners, they should keep buying government paper, especially due to expectations of a key policy rate decrease at the end of January.

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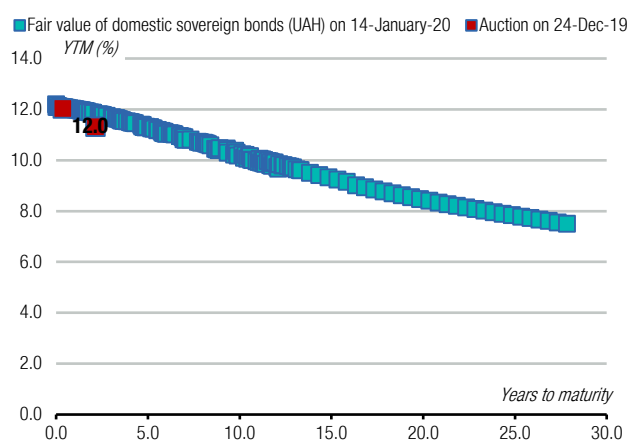
Chart 1. Local-currency bonds

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.

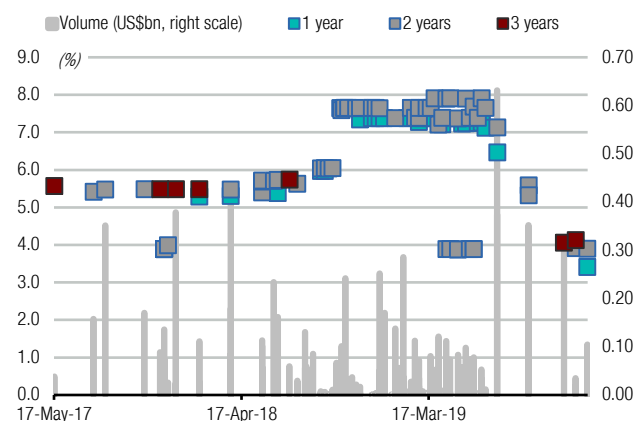
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

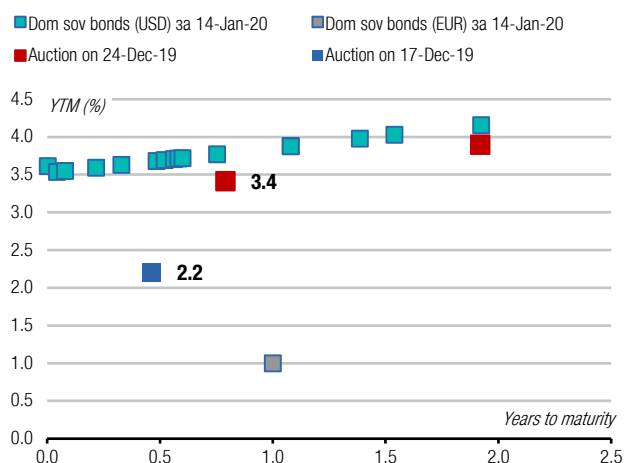
Chart 2. FX-denominated bonds

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.

NBU and Treasury increased liquidity in banking sector

Active absorption of the extra supply of hard currency at the end of last year, and an increase in budget expenditures caused a significant increase in banking-sector liquidity and will continue to have a similar impact this year. This week, liquidity will remain high, above UAH220bn (US\$9.2bn), with a possible increase.

During the last 10 days of 2019, the NBU purchased hard currency in the amount of UAH31.3bn (about US\$1.3bn), while the positive impact from Treasury operations was UAH17.7bn. So, outflow from reserves via exchange in cash of UAH10.7bn did not decrease liquidity. As a result, last year, liquidity rose above UAH200bn to UAH204.4bn (US\$8.5bn), and started this year from that level.

During the first two weeks of January 2020, liquidity rose more than by UAH20bn. This increase was caused by the same inflows from NBU via FX purchases and the Treasury, as expenditures exceeded revenues, by UAH5.2bn and UAH5.6bn, respectively. Additionally, unusual for the beginning of the month, banks started exchange of cash in reserves, increasing liquidity by UAH11.1bn.

ICU view: This week we anticipate inflows of FX from foreigners for new bills, which will be mostly purchased by the NBU. Also, banks will continue to exchange cash in reserves, while the Treasury can once again receive less revenue than it will make in expenditures. So, liquidity will stay above UAH220bn with a possible increase.

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

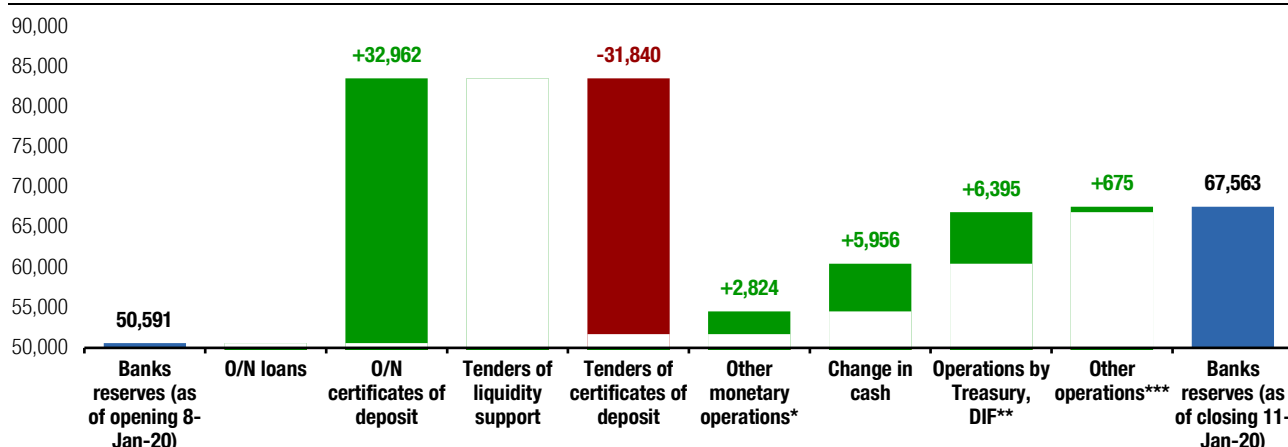
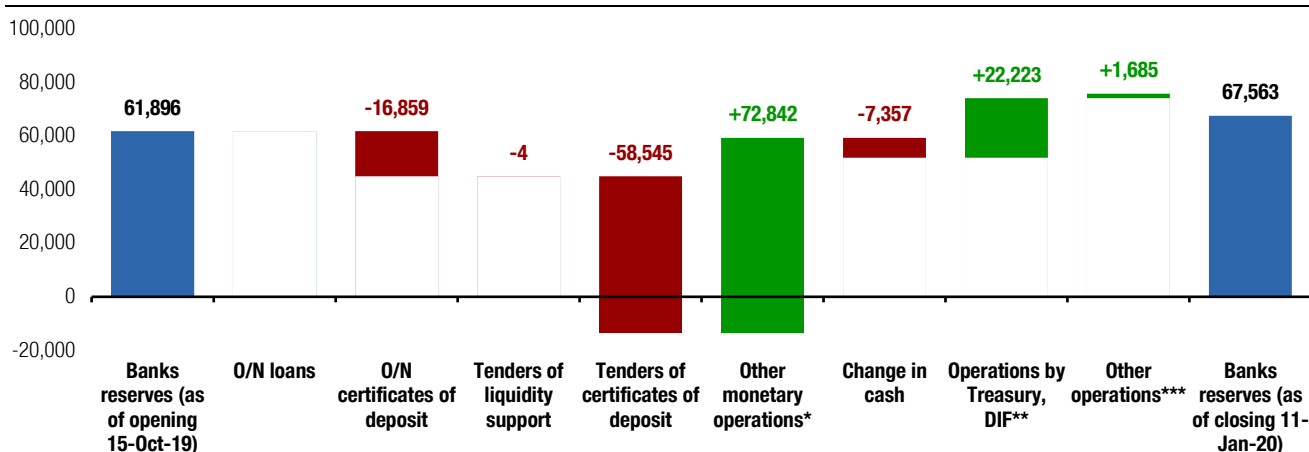


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 took a break

The hryvnia slightly weakened during recent weeks, partially due to the holidays and lower activity from foreign investors in the bond market. But with the holidays ending, exporters should become more active. The MoF is restarting its primary auctions today, providing an opportunity for further appreciation of the hryvnia.

After reaching UAH23.26/USD on 24 December 2019, low activity of foreigners in the bond market, together with lower exports, weighed on the hryvnia. Another negative impact was from the large amount of FX purchased by the NBU. So, according to Bloomberg, the hryvnia ended last year at UAH23.76/USD, having appreciated during 2019 by 16.6%.

The same factors kept the hryvnia under pressure in January. No primary auctions, and last week there was a large debt repayment, which probably caused additional demand for hard currencies. As a result, during the debut weeks of this year, the hryvnia was volatile, so far losing 1.6%, and weakening to UAH24.15/USD yesterday.

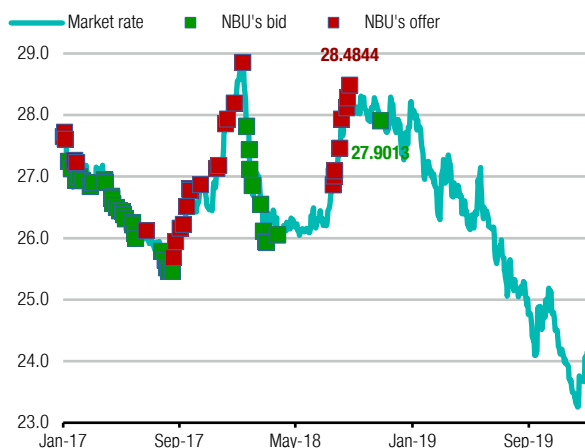
ICU view: This week, the hryvnia exchange rate can change direction, and move back to the level seen at the end of last year. Foreigners will play an important role if they become more active in the bond market. At the same time, demand for FX from

importers and NBU's purchases of additional hard currency should restrain appreciation, keeping the exchange rate slightly below UAH24/USD by the end of the week.

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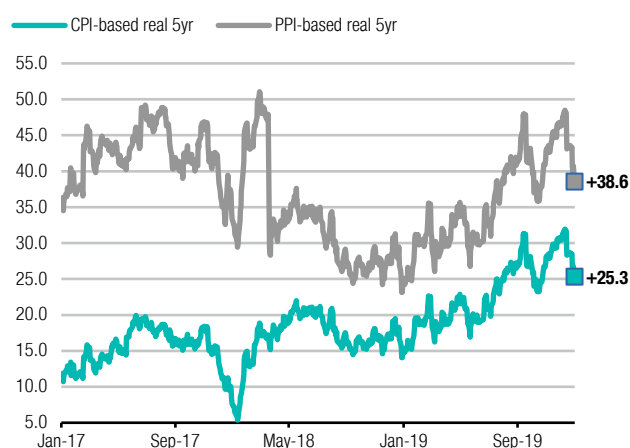
Chart 5. FX market indicators, 3-year history

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

C/A deficit fell to 2.3% of GDP in November

The C/A got support from lower natural gas prices and ongoing solid agricultural exports. These factors will keep supporting the C/A balance in the following months.

In 11M19, the C/A deficit fell 19% YoY to US\$3.4bn, while in annualized terms, it declined 29% YoY to US\$3.6bn (est. 2.3% of GDP), per data from the NBU. In November, merchandise exports declined 3.4% YoY, mainly due to a 15% YoY drop in exports of metals and a 19% YoY plunge in exports of ores. In 11M19, exports of goods rose 6.8% YoY to US\$42.3bn. Imports of goods fell 1.9% YoY driven primarily by a 27% YoY plunge in energy imports. In 11M19, imports of goods rose 7% YoY to US\$54.8bn, while energy imports declined 6.6% YoY. On a 12-month trailing basis, the merchandise-trade-balance deficit was US\$13.6bn (+5% YoY, 8.9% of GDP) in November, while the services-trade-balance surplus soared 51% YoY to US\$1.8bn.

ICU view: Natural gas prices below our expectations against the backdrop of warm winter and ongoing solid agricultural exports allowed the C/A to contract to an est. 2.3% of GDP in November, and given the current dynamics, the C/A deficit will likely be lower than our forecast of 2.7% of GDP in full-year 2019. Further decrease in prices for steel and ores as well as lower transit volumes of Russian gas will cause trade-deficit widening this year. This should be partially compensated by lower imports of natural gas and a further decline of prices for energy products, which combined with economic growth, will result in the C/A deficit slightly widening to 2.7% of GDP.

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Inflation slows to 4.1% YoY in 2019

Lower world energy prices and a stronger UAH supported disinflation in 2019. This year, inflation will remain in the NBU's target range of $5\pm 1\%$.

In December, headline inflation slowed to 4.1% YoY from the 5.1% YoY seen in November, which is the lowest reading since March 2014, while in MoM terms, prices fell 0.2%. Growth rates of consumer prices slowed in all major subcategories, but the main positive impact on inflation slowdown was deceleration of growth on food prices to 4.8% YoY, which accounted for 0.8ppt out of overall 1ppt inflation decrease. The other important driver was a 1.9% YoY decline in utilities prices, while prices for transport fell for the third month (-2.4% YoY). Core inflation fell to 3.9% YoY in December. In full-year 2019, consumer prices increased 7.9%.

ICU view: The inflation reading outperformed both our (4.9% YoY) and the NBU's (6.3% YoY) forecasts mainly thanks to the UAH's appreciation, lower-than-expected energy prices, and a record 2019 grain harvest. The stronger YoY hryvnia and lower YoY natural gas prices will continue to constrain consumer prices growth in the following months. Absent any shock, inflation will remain in the NBU's target range of $5\pm 1\%$ in 2020.

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