Focus
Ukraine

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

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Weekly Insight

NBU accelerates monetary easing

Key messages of the today's comments

TUESDAY, 28 APRIL 2020

Domestic liquidity and bonds market

Bond portfolios steady

There were no material changes in government bond portfolios last week, just a minor reallocation of bills from foreigners' portfolios to Ukrainian banks. This week, we do not anticipate material changes in portfolios either, just another decline in foreigners' portfolios with bills reallocated to another groups.

Liquidity rose above UAH200bn

Due to a new wave of large budget expenditures, the total amount of banking-sector liquidity rose above UAH200bn, where it can stay this week due to NBU interventions and budget expenditures.

Foreign exchange market

Hryvnia remains steady

The hryvnia exchange rate was fluctuating near UAH27/US$ during last week, and this week, it should be the same. An exception could be a peak in hard currency selling for month-end tax payments causing short-lived appreciation.

Economics

NBU accelerates monetary easing

The NBU accelerated the easing cycle cutting the key policy rate by 200 bp to 8%. Also, NBU Governor Smolii announced additional monetary easing measures including extending the terms and the list of eligible collateral for standard liquidity support instruments and launching long-term refinancing loans with a floating interest rate.

Decline of industrial production deepens due to quarantine effects

In March, the fall in industrial production deepened to 7.7% YoY (from 1.5% YoY in February), while seasonally adjusted output declined by 1.3% compared with February's level.

Banks' reserves market (27 April 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	8.00	-200bp	-950bp
ON rate (%)	7.20	-166bp	-961bp
ON $ swap (%)	6.35	-225bp	-874bp
Reserves (UAHm)[2]	63,132	+5.36	+30.85
DepCerts (UAHm)[3]	138,318	+1.53	+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) (27 April 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	341,608	+0.40	-5.96
Residents	52,039	+0.00	+89.25
Individuals	8,542	+0.31	-2.51
Non-res[1]	113,501	-1.12	+196.22
Total	**840,265**	**+0.01**	**+8.42**

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

FX market indicators (27 April 2020)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	27.1250	+0.15	+2.75
EUR/USD	1.0829	-0.27	-2.89
DXY	100.041	-0.22	+2.08
UAH TWI[1]	129.981	-0.74	+4.56

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

Gov't bond quotes[1] (28 April 2020)

Maturity	Bid	Ask
6m	**16.00**	**12.00**
12m	**16.00**	**13.50**
2y	**16.00**	**13.50**
3y	**16.00**	**13.00**
12m ($)	**5.00**	**3.00**
2y ($)	**6.00**	**3.50**

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

Domestic liquidity and bonds market

Bond portfolios steady

There were no material changes in government bond portfolios last week, just a minor reallocation of bills from foreigners' portfolios to Ukrainian banks. This week, we do not anticipate material changes in portfolios either, just another decline in foreigners' portfolios with bills reallocated to another groups.

Foreigners continued to decrease investments in UAH-denominated paper, by UAH1.2bn (US$44m) last week, most of which was absorbed by Ukrainian banks. The total amount in foreigners' portfolio's in all currencies declined by UAH1.2bn (US$44m) to UAH113.5bn (US$4.2bn), while the UAH-denominated part of their portfolios slid by UAH1.2bn (US$44m) to UAH110.9bn (US$4.1bn).

Most of the bills were sold to Ukrainian banks, evidenced by their portfolios of local-currency paper being up UAH1.2bn (US$44) to UAH247.8bn (US$9.2bn). Individuals' portfolios remained steady, rising by just UAH37m (US$1.4m) to UAH3bnbn (US$111m).

ICU view: Market dynamics this week will remain the same with a slight reallocation of bills from foreigners to Ukrainian banks. The amount of selling can rise slightly due to fewer business days than usual and a decline in yields, with a positive impact on prices, which means foreigners' losses from selling bills will decrease. Therefore, we anticipate that the UAH-denominated part of foreigners' portfolio will decline below UAH110bn (US$4.1bn) and the monthly decline of portfolios will be at around UAH9bn (US$330m).

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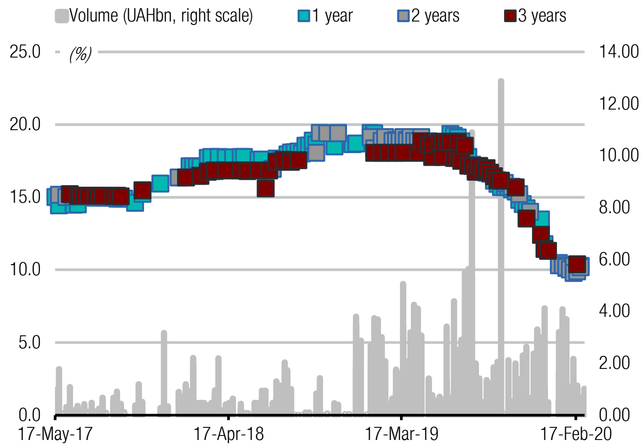
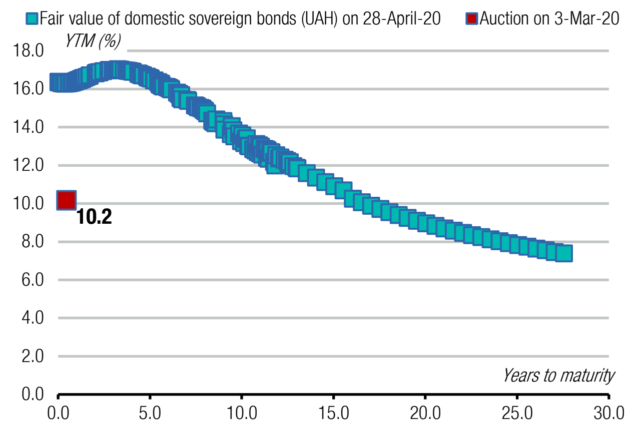
Chart 1. Local-currency bonds

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.

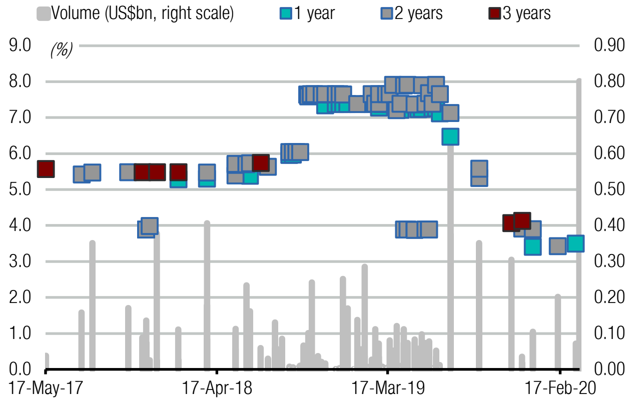
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

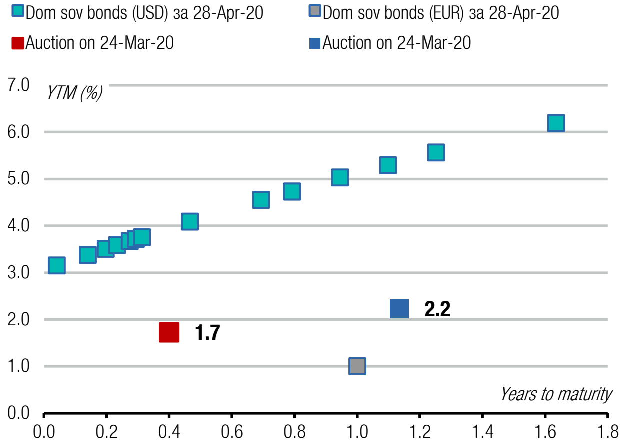
Chart 2. FX-denominated bonds

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 rose above UAH200bn

Due to a new wave of large budget expenditures, the total amount of banking-sector liquidity rose above UAH200bn, where it can stay this week due to NBU interventions and budget expenditures.

Treasury operations continue to have a large positive impact on liquidity. Last week, UAH7.8bn flowed into liquidity, causing an overall increase.

The negative impact of reserves exchange in cash declined to UAH2bn, supporting a liquidity increase to UAH202bn due to Treasury operations on Friday. However, banks repaid some loans to the NBU, causing the total NBU impact on liquidity to be negative. Despite the injection of UAH0.8bn through hard currency purchases, NBU absorbed about UAH2.4bn through loans redemption, and its impact on liquidity was a negative UAH1.6bn last week.

ICU view: Month-end tax payments will come in the next several days, but expenditures will be greater. Making tax payments will require additional local-currency liquidity, which taxpayers will try to obtain through hard currency selling. Additional liquidity can provide banks exchange of cash in reserves, but probably with less significance than before the lockdown. Therefore, liquidity will fluctuate around UAH200b, and probably will be above this level.

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

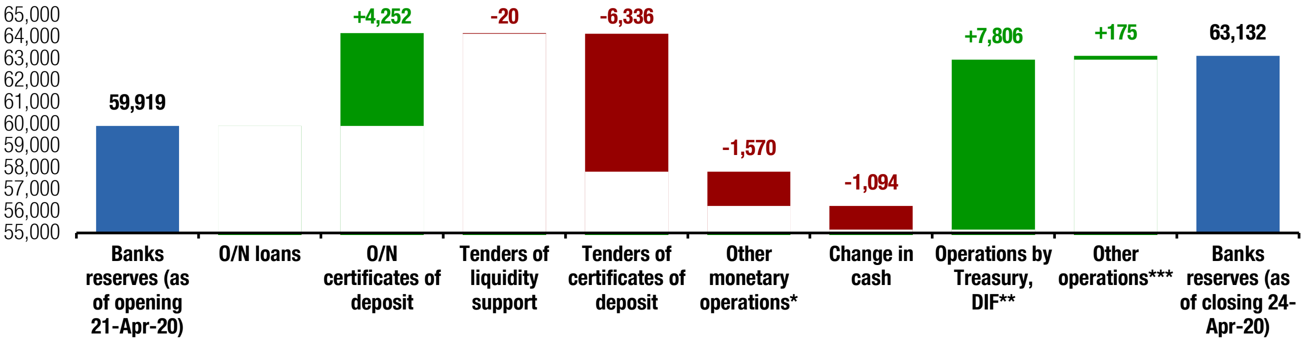
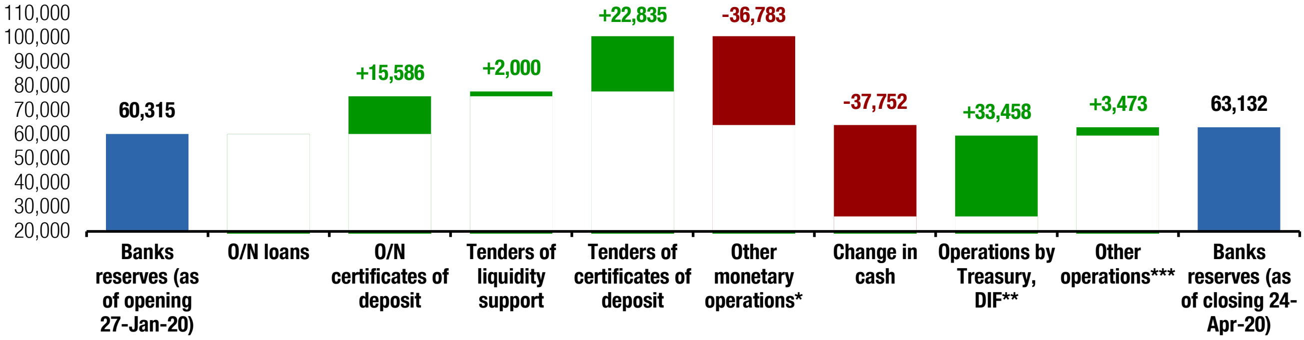


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 remains steady

The hryvnia exchange rate was fluctuating near UAH27/US$ during last week, and this week, it should be the same. An exception could be a peak in hard currency selling for month-end tax payments causing short-lived appreciation.

The NBU intervened moderately last week. In total, the NBU purchased US$28.6m, which restrained appreciation last Wednesday. The NBU did not participate on the other days when the market self-balanced.

As a result, last week, the hryvnia slightly weakened by 0.2% to UAH27.13/US$. The hryvnia's CPI-based real trade-weighted index (which includes currencies of 27 countries that are trade partners of Ukraine) rose 0.3%, while in YoY terms, it was up 5.8%.

ICU view: The end of month usually brings demand for local-currency liquidity for month-end tax payments. Despite there have been introduced some tax breaks and loan benefits for business during the lockdown, total needs in local-currency funds remain large. Therefore, supply of hard currency can rise and for some time cause hryvnia appreciation. However, the hryvnia exchange rate will stay close to UAH27/US$ as demand for hard currency will be the same as last week. But next week will see a new wave of demand in the FX market due to the redemption of local-currency bills including additional demand from foreigners, who will buy hard currency for funds withdrawal.

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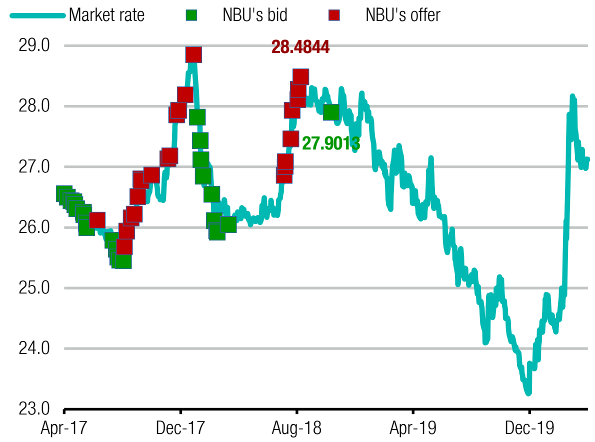
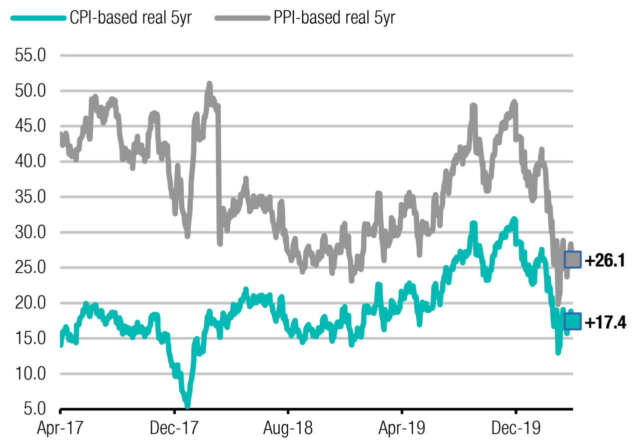
Chart 5. FX market indicators, 3-year history

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

NBU accelerates monetary easing

The NBU accelerated the easing cycle cutting the key policy rate by 200 bp to 8%. Also, NBU Governor Smolii announced additional monetary easing measures including extending the terms and the list of eligible collateral for standard liquidity support instruments and launching long-term refinancing loans with a floating interest rate.

The central bank underscored its commitment to support the economy during the period of the pandemic as the main reason for such an aggressive cut. Meanwhile, according to the NBU's new forecast, inflation remains in the target band this year accelerating to only 6% from the current 2.3% amid the lagged effects of recent weakening of the hryvnia. At the same time, the GDP forecast was revised to 5% contraction this year (vs 3.5% growth in January's forecast) and then it will rebound by 4% in 2021.

The interest rate forecast underpinning this macroeconomic framework envisages a cut by 100 bp to 7% during next the MPC meeting (11 June) and then the key rate remaining on hold. In addition, the central bank highlighted its intention to cut even more aggressively if weak domestic demand puts stronger downward pressure on inflation.

ICU view: The reaction of the NBU on the pandemic's effects on domestic economic activity and inflation was more aggressive than we and other market participants expected (consensus was for a 100 bp cut). In addition to factors mentioned by the NBU, we would highlight last weeks' FX market stabilization and deeper fall in energy prices as well as the progress in adoption of legislation (land market and banking laws) opening the way for the new deal with the IMF and the support from the IFIs.

Also, it is worth highlighting the changes in rhetoric of the central bank, which moved to a more dovish tone and focused more significantly on supporting the economy compared with the past few years when the central bank has been strongly concerned about inflation.

In addition, we see strong downward risks for economic activity and inflation this year. First, NBU's forecast for a decrease in GDP looks more optimistic compared with ours (6-8%) and the IMF's (7.7%). Second, the recent decline in global energy prices may put an additional drag on inflation via direct and second-round effects. Third, despite

the sizable decrease, the real interest rate in Ukraine remains one of the largest among peers.

Given the rising likelihood of lower inflation and more dovish policy of the NBU, we see prevailing downside risks for our current projection of the key policy rate at the end of the year (7.5–8%).

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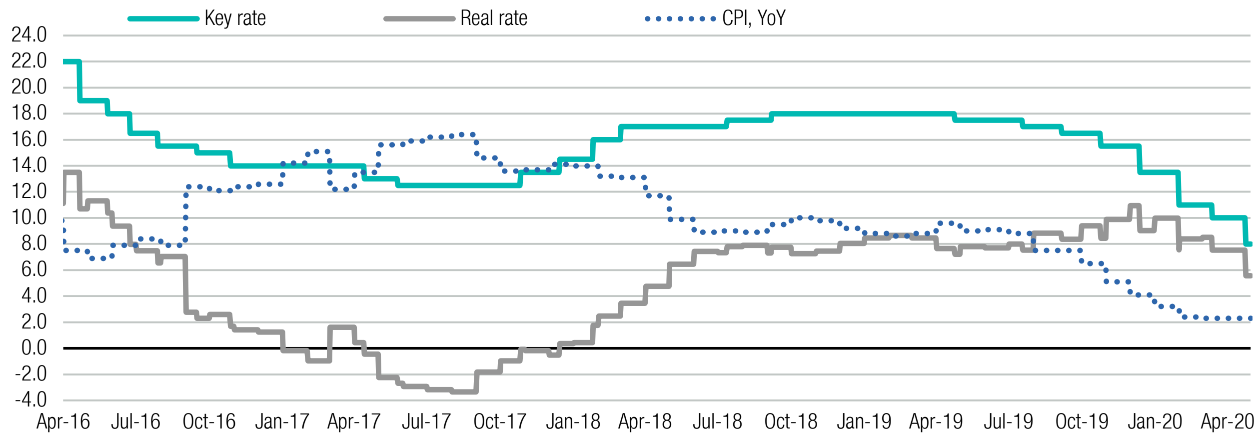
Chart 6. NBU key policy rate (nominal and real) and consumer inflation



Source: National Bank of Ukraine, State Statistics Service of Ukraine, ICU.

Decline of industrial production deepens due to quarantine effects

In March, the fall in industrial production deepened to 7.7% YoY (from 1.5% YoY in February), while seasonally adjusted output declined by 1.3% compared with February's level.

In Q1, industrial output decreased by 5.1% YoY. The largest contribution to the decrease was made by the production of metallurgy (by 10.3%), machinery (by 14.5%), coal (by 17.9%), and utilities (by 8.1%).

ICU view: The deepening of industrial decline in March in YoY terms mostly reflected the statistical effect of the base of comparison from the previous year. At the same time, the first impact from the national quarantine introduced in mid-March was relatively weak. That was evidenced by a moderate decline in industrial production compared with February.

As expected, the main negative impact from the quarantine and reduction in aggregate demand was reflected in the production of capital goods and durable consumer goods, where the fall in output deepened to 19.1% YoY and 21.5% YoY in March. However, the shares of these groups in the sales of mining and processing industrial goods were only 10.1% and 1.3% last year.

Given the sharp slump in demand for both capital and durable consumer goods, production of machinery, textiles, and furniture fell the most (by 17–18% YoY) in March. In addition, the fall in output in metallurgy has deepened – to 16% YoY, but here the impact of low global demand had been felt for several months. Similar trends are observed in mining and utilities, where the slump is primarily caused by the sharp decline in domestic demand due to the warm winter.

Instead, expectedly, production of pharmaceutical products jumped by 22% YoY in March. The food industry remains resilient, although a slight drop in output was recorded in March. Mainly, it was a reflection of the complications in transportation and organization of employees to work under quarantine and in the delivery of finished products to consumers both within the country and abroad.

In Q2, the quarantine's negative impact on industry will intensify due to a further decline in disposable income, an increase in the propensity of households and businesses to save, and growing production costs due to various constraints stemming from the quarantine. Meanwhile, with the gradual easing of quarantine restrictions in line with the government's five-stage plan announced on 24 April, the slump in industrial production should be much smaller than during the 2008 and 2014–15 crises.

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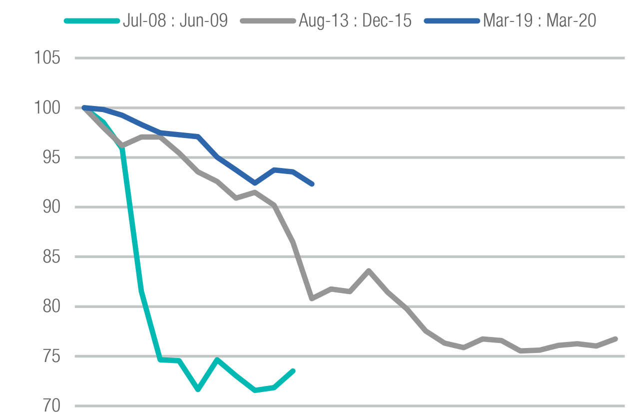
Chart 7. Industrial production (first month = 100)

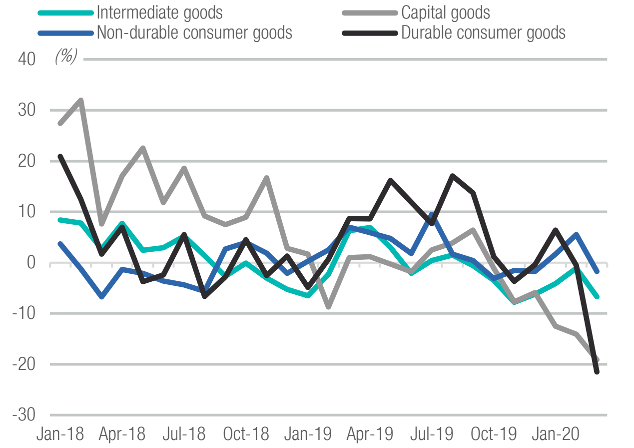
Three crisis episodes are shown where the maximum level of production on the eve of crisis equals 100%



Source: State Statistics Service of Ukraine, ICU.

Chart 8. Industrial production in 2018-2020

By main industrial groupings, YOY change



Source: State Statistics Service of Ukraine, ICU.

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