Focus
Ukraine

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

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Weekly Insight

MoF resumes primary auctions

Key messages of the today's comments

Domestic liquidity and bonds market

Primary auctions resume

Despite the resumption of primary auctions last week with a reasonable increase in interest rates, foreigners' portfolios continued to decline. This week, local banks can purchase new T-bills and try to get higher interest rates.

NBU supports liquidity

Last week, the largest inflow of funds into banking-sector liquidity was provided by the NBU trough new refinancing loans to banks and buying hard currency. As a result, liquidity was close to UAH200bn. This week, the Treasury can support liquidity and keep it at about UAH200bn.

Foreign exchange market

Hryvnia's short-lived appreciation

A break in VAT refunding and the need for local-currency liquidity to pay month-end tax payments caused an increase in hard-currency supply and hryvnia appreciation to below UAH27/US$. However, this week, demand for hard currency will rise, and we expect the hryvnia exchange rate to move back to the UAH27–27.5/US$ range.

Economics

Initial effects of quarantine on construction

Construction contracted due to complications in transportation and organizing employees to work under lockdown as well as from subdued investment demand under increasing uncertainty.

Current-account balance improves thanks to fall in imports

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MONDAY, 4 MAY 2020

Banks' reserves market (30 April 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	8.00	+0bp	-950bp
ON rate (%)	7.04	-16bp	-977bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	66,865	+64.26	+38.58
CDs (UAHm)[3]	134,484	-16.54	+0.00

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's certificates of deposit.
Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (30 April 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	341,816	+0.23	-5.92
Residents	52,063	+0.31	+89.75
Individuals	8,553	+0.51	-2.38
Foreigners[1]	112,478	-1.00	+193.76
Total	**839,486**	**-0.02**	**+8.33**

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

FX market indicators (30 April 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	26.9408	-0.70	+2.07
EUR/USD	1.0955	+1.22	-2.32
DXY	99.016	-1.36	+1.58
UAH TWI[1]	129.899	-0.09	+4.76

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

Gov't bond quotes[1] (4 May 2020)

Maturity	Bid	Ask
6m	**15.00**	**12.00**
12m	**15.00**	**13.50**
2y	**15.00**	**13.50**
3y	**15.00**	**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

Primary auctions resume

Despite the resumption of primary auctions last week with a reasonable increase in interest rates, foreigners' portfolios continued to decline. This week, local banks can purchase new T-bills and try to get higher interest rates.

The MoF sold nearly UAH5.4bn of UAH-denominated bills last week, and additionally sold US$164m of FX-denominated paper, which improved budget financing prior to debt repayments. The Ministry had to increase rates for local-currency instruments by 190bp to 11.30% for three-month paper. However, for USD-denominated bills, interest rates remained steady. For more details, see in our auction review.

Most likely, UAH-denominated papers were purchased by banks to obtain NBU refinancing loans. This auction had an unusual settlement date, the same when the NBU held a tender for liquidity support.

Of some note, the Ministry of Finance used this auction to obtain additional budget financing, and probably to create reserves prior to debt redemptions scheduled for this week of UAH5.9bn.

ICU view: The increase in rates for local-currency bills enhanced their attractiveness for local banks, as they can use them to receive long-term liquidity loans from NBU with a significantly lower interest rate, at 8% instead of 11.3% from bills. On the other hand, the Ministry took a step toward the market, and this week we expect to see new demand not only from banks since a large debt repayment is due this Wednesday. Nevertheless, there is low probability that the Ministry will increase rates further, and will attract less funds than at the auction last week. At the same time, foreigners will continue to decrease portfolios through sales in the secondary market, as well as through redemptions, so their portfolios may slid by about UAH2bn this week.

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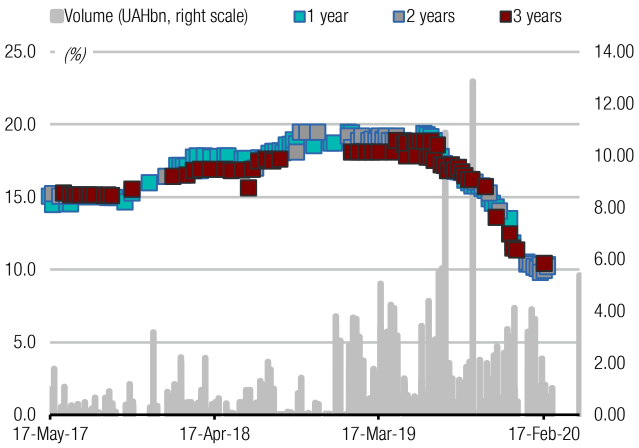
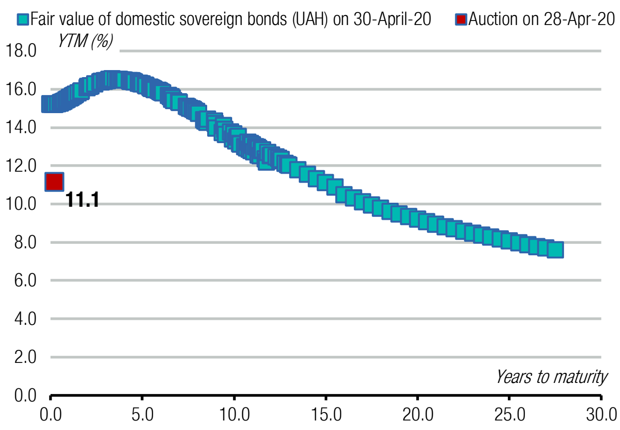
Chart 1. Local-currency bonds

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.

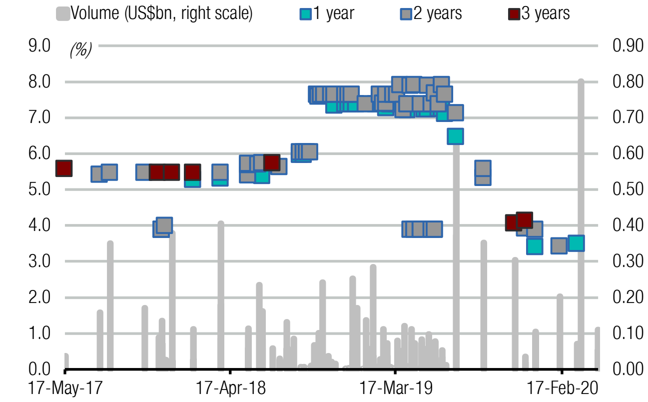
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

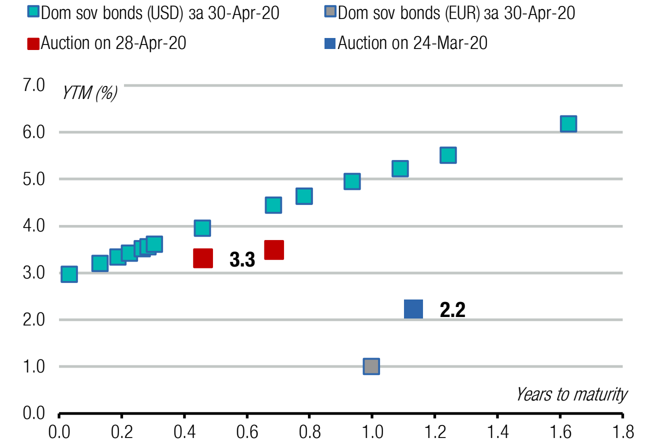
Chart 2. FX-denominated bonds

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 supports liquidity

Last week, the largest inflow of funds into banking-sector liquidity was provided by the NBU trough new refinancing loans to banks and buying hard currency. As a result, liquidity was close to UAH200bn. This week, the Treasury can support liquidity and keep it at about UAH200bn.

The NBU was the largest provider of liquidity last week, issuing UAH6.9bn of loans to nine banks through a three-month tender, and UAH3.1bn through the FX market. These inflows were enough to compensate most of outflows through non-monetary operations amounted to UAH14.2bn.

Due to the high level of banking-sector liquidity, ON interest rates (UIIR) declined to about 7%, with banks still keeping most free liquidity in NBU CDs. At the end of last week, they had invested UAH118bn in seven-day CDs and UAH20.5bn in ON CDs.

ICU view: This week, we anticipate that the NBU will sell some hard currency to satisfy extra demand from foreigners who sell T-bills or receive T-bill redemptions. As a result, the NBU will have a balanced impact on liquidity, probably with inflows only on Friday due to three-month and five-year loan tenders. However, the Treasury may increase expenditures again, especially due to debt redemptions on Wednesday. As a result, liquidity will stay close to UAH200bn, with short-term funds available at a rate below the NBU key rate.

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

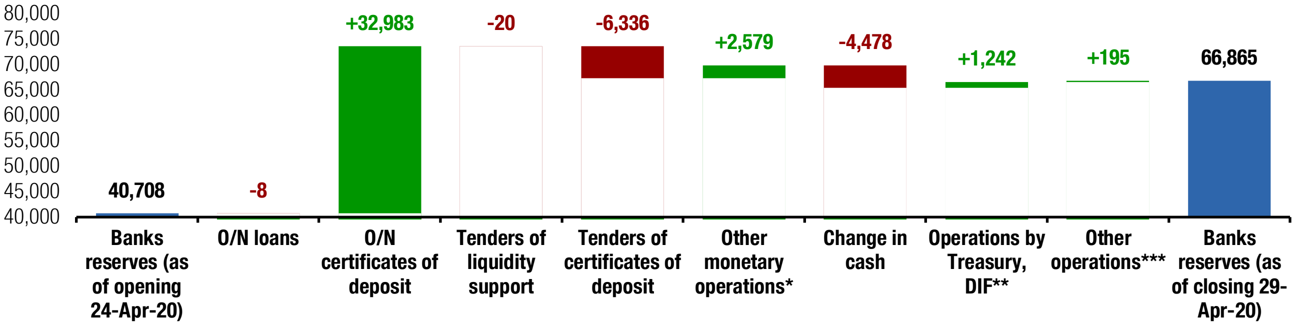
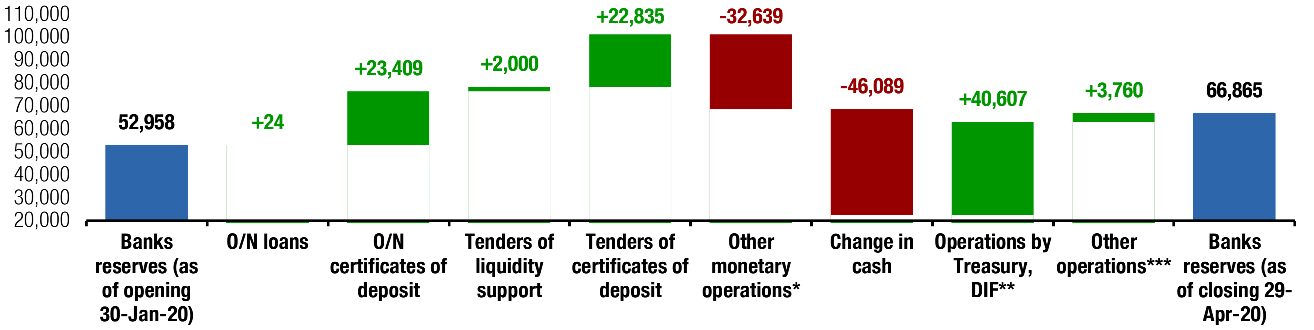


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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's short-lived appreciation

A break in VAT refunding and the need for local-currency liquidity to pay month-end tax payments caused an increase in hard-currency supply and hryvnia appreciation to below UAH27/US$. However, this week, demand for hard currency will rise, and we expect the hryvnia exchange rate to move back to the UAH27–27.5/US$ range.

There was a five-day break in VAT refunds at the end of April, which caused not only volatility in banking-sector liquidity, but also an increase in hard-currency supply. As a result, the hryvnia appreciated to UAH26.94/US$ by the end of last week. This happened despite the NBU's efforts to restrain appreciation by purchasing US$115.5m from the market and the Treasury's payment of UAH6.4bn in VAT refunds last Wednesday. So, last week, the hryvnia appreciated by 0.7%/US$.

ICU view: After last week's appreciation, we anticipate the hryvnia to depreciate slightly and return to the range of UAH27–27.5/US$ this week. This will happen due to the pressure of demand from foreigners who buy hard currency after selling UAH-denominated bills in the secondary market and receiving redemptions. This may result in the NBU's USD-selling interventions to satisfy extra demand. However, for the most of the week, the market will be self-balanced. Positive news about steps toward a new IMF programme will add some positive support to the hryvnia later this week.

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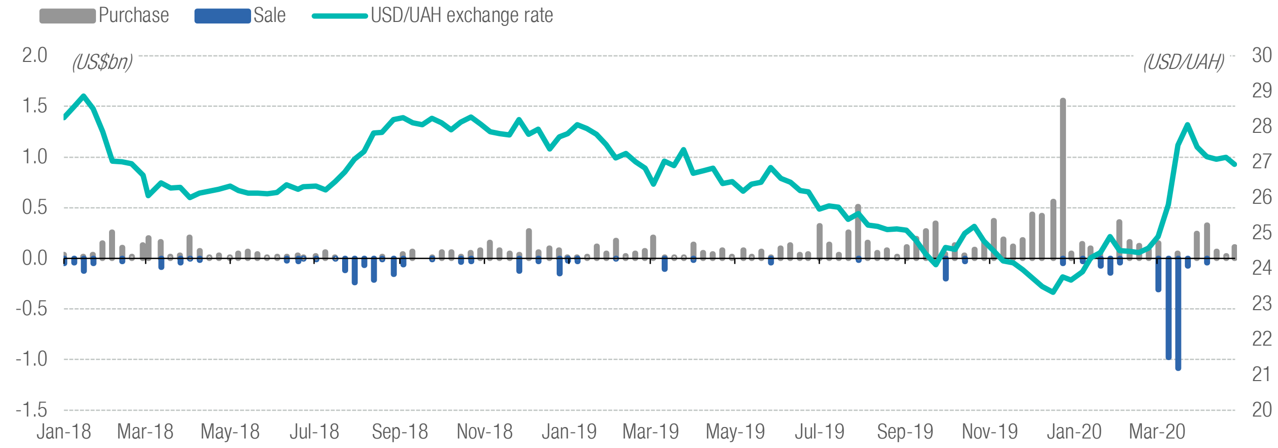
Chart 5. FX market indicators, 3-year history

Ukraine hryvnia UAH exchange rate per US dollar at the interbank market and NBU interventions (weekly data)



Source: NBU, Bloomberg, ICU.

Economics

Initial effects of quarantine on construction

Construction contracted due to complications in transportation and organizing employees to work under lockdown as well as from subdued investment demand under increasing uncertainty.

In March, construction declined by 11.6% YoY (compared with 0.6% YoY in January-February). In 1Q20, construction contracted by 5.5% YoY against a 29% YoY surge in 1Q19. The 1Q20 outcome was determined by a decrease in construction of infrastructure facilities (by 10.3% YoY) and residential construction (by 10.4% YoY), while non-residential construction continued to grow (by 7.0% YoY).

ICU view: The sharp decline in March can be explained by the introduction of preventive measures from 17 March and the emergency regime throughout Ukraine on 25 March to combat the pandemic. While there were no direct restrictions on constructions works, the activity in the sector suffered from complications in transportation and organization of employees to work under lockdown as well as from subdued investment demand under increasing uncertainty. Meanwhile, these negative effects were partially offset by a surge in capital expenses of the general government (by 38% YoY).

We expect that construction will decelerate further in the coming months amid subdued investment demand from the private sector. Meanwhile, public expenditures under "Great Construction" projects should provide support for construction this year.

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Current-account balance improves thanks to fall in imports

A decrease in the import of energy and machinery and robust growth of food, iron ore, and IT services exports so far exceed any decline of metallurgical export.

In March, the current account (C/A) deficit shrank to US$389m (compared with US$526m in March 2019). That led to a C/A surplus of US$244m in 1Q20 (compared with US$150m deficit in 1Q19).

In 1Q20, exports of goods and services grew by 1.3% YoY benefiting from the increase in the export of foods (5.9% YoY), iron ore (11.2% YoY), and IT services (33.9% YoY). However, the decline in the export of metallurgical products (by 15.1% YoY) and pipeline transportation (by 23.1% YoY) put a drag on overall exports. Meanwhile, imports of goods and services decreased by 4.4% YoY amid low global energy prices, subdued machinery imports, and a decline in travel abroad.

According to our estimates per data from the NBU, remittances decreased slightly by 1.6% YoY in March, but in 1Q20 grew by 7.9% YoY to US$2.9bn..

As a result, the C/A deficit for the last 12 months declined to US$0.9bn (est. 0.6% of GDP), or to US$3.8%bn (est. 2.4% of GDP) when adjusted for a US$2.9bn payment from Gazprom received in December 2019. On a 12-month trailing basis, the merchandise trade deficit shrank to US$13.8bn (est. 8.7% of GDP), while the services trade surplus rose to US$2.4bn (est. 1.5% of GDP), and remittances were flat at US$12.2bn (est. 7.7% of GDP).

ICU view: So far, favourable terms of trade and high demand for food and IT services amid robust remittances benefited the Ukrainian C/A. We expect that in coming months, the C/A will be supported by resilience of agricultural and IT services exports, a fall in energy prices, weak domestic demand for import of investments and durable consumer goods, and restrictions on travel abroad. These factors will allow an offset of the expected fall in remittances and metallurgical exports.

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