Focus
Ukraine

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

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Weekly Insight

NBU cuts rate by 200 bps

Key messages of the today's comments

TUESDAY, 16 JUNE 2020

Domestic liquidity and bonds market

Tenor of new T-bills increases

Last week, the MoF successfully sold 1.5-year bills at 10.8% interest rate. They offer two-year and three-year instruments today.

Liquidity increases

The total amount of banking-sector liquidity was up to UAH201bn last week, and without scheduled large tax payments, it can increase further.

Foreign exchange market

Hryvnia holds the line

The hryvnia exchange rate fluctuated last week within the range of UAH26.5–27/US$ without attempts to move closer to UAH26/US$. This week, we do not expect any material changes in the FX market.

Economics

NBU cuts rate by 200 bps

An aggressive cut was expected as inflation hit a record low; nonetheless, the period of rapid rate decreases is over.

Consumer inflation keeps slowing

In May, the annual inflation fell to 1.7%, its lowest level since 2013. Looking ahead, inflation should remain subdued; we project a return to the NBU's target range only in 4Q20.

IMF Board approves US$5 bn SBA for Ukraine

The IMF increased the first tranche to US$2.1 bn and stressed the great risks for the programme due to the uncertainty about the direction of domestic economic policies.

ICU Macroeconomic Review - Gradual Reopening; Shaky Outlook

Last Thursday, we issued our updated macroeconomic review on Ukraine's economy.

Banks' reserves market (15 June 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	-200bp	-1,150bp
ON rate (%)	7.07	-35bp	-921bp
ON $ swap (%)	5.14	-124bp	-952bp
Reserves (UAHm)[2]	62,705	+38.06	+2.94
CDs (UAHm)[3]	137,951	-7.15	+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) (15 June 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	407,804	+4.10	+12.96
Residents	51,794	-2.43	+104.94
Individuals	7,688	-2.14	-20.87
Foreigners[1]	102,165	-3.16	+97.34
Total	**894,027**	**+1.28**	**+13.90**

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

FX market indicators (15 June 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	26.8240	+1.06	+1.45
EUR/USD	1.1273	-0.59	+0.58
DXY	97.005	+0.71	-0.58
UAH TWI[1]	126.909	-0.34	+2.60

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

Gov't bond quotes[1] (16 June 2020)

Maturity	Bid	Ask
6m	**10.50**	**7.00**
12m	**11.00**	**9.25**
2y	**11.25**	**10.00**
3y	**11.50**	**10.00**
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

Tenor of new T-bills increases

Last week, the MoF successfully sold 1.5-year bills at 10.8% interest rate. They offer two-year and three-year instruments today.

At last week's auction, demand was concentrated in the 1.5-year paper, which allowed the Ministry to borrow UAH5.3bn (US$0.2bn) at 10.8%. However, for three-month bills, the interest rate decreased to 9%, thanks to a limited offering. More details in our auction review.

Most of the bills sold last week were purchased by banks, both local and hard currency-denominated. Despite large redemptions, banks' portfolios rose UAH15.5bn (US$0.6bn), while other groups decreased their portfolios. Notable was the decline seen in foreigner's portfolios, as they decreased by UAH3bn (US$112m) last week.

ICU view: This week, we expect large demand for new bills, once more coming from banks due to the lower cost of NBU refinancing loans and new loans issued at UAH2.7bn last Friday. While we do not expect a material decline in the rates in bids; the Ministry can reject a large portion of demand to decrease rates following the NBU key policy rate decline (see comment below).

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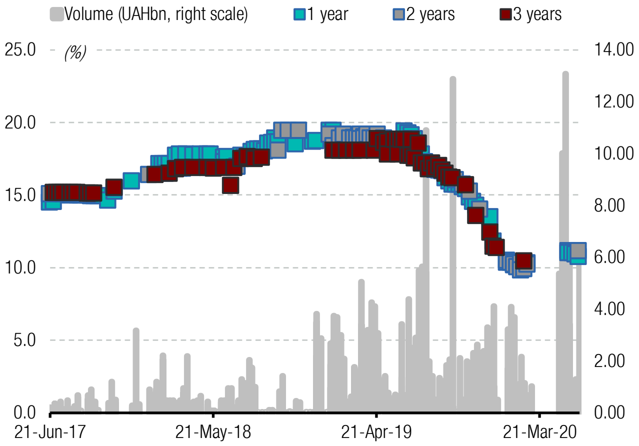
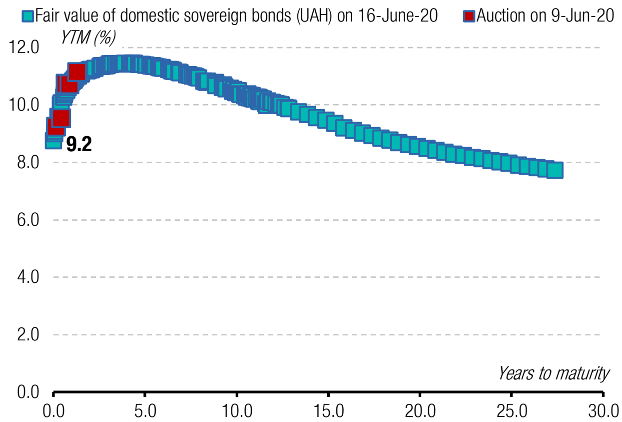
Chart 1. Local-currency bonds

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.

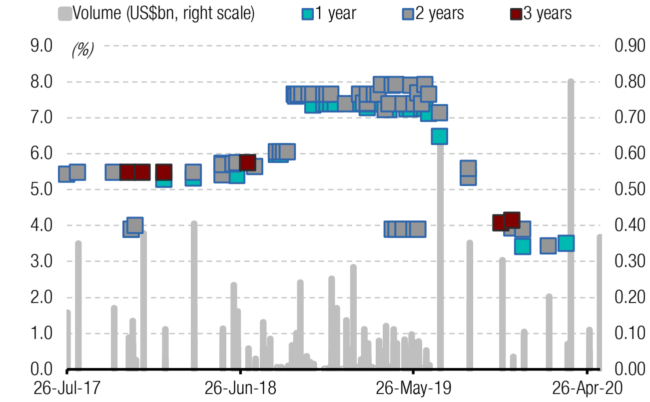
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

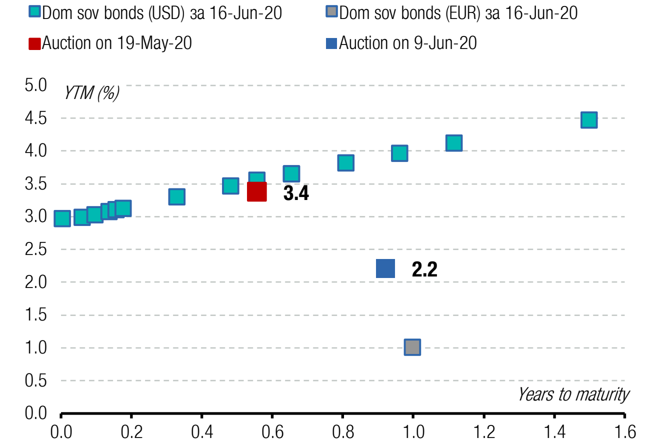
Chart 2. FX-denominated bonds

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 increases

The total amount of banking-sector liquidity was up to UAH201bn last week, and without scheduled large tax payments, it can increase further.

The FX market was rather steady last week with low NBU participation and impact on liquidity. Through hard currency purchases, the NBU injected into liquidity UAH1.1bn or ten times less than a week before. Additionally, the NBU issued for 13 banks UAH2.7bn of new loans last Friday for up to five years.

However, budget expenditures had the main impact on liquidity. The Treasury injected UAH10bn into liquidity, despite the low difference between debt repayments and new borrowings in local currency.

Only banks' reserves exchange in cash had a negative impact on liquidity of UAH6.2bn.

ICU view: This week, we do not anticipate a large outflow to budget accounts, while the government can increase expenditures after receiving a large amount of external financing. The NBU will likely purchase some hard currency to restrain fluctuations in the FX market, but without material impact on liquidity. Therefore, liquidity will remain above UAH200bn.

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

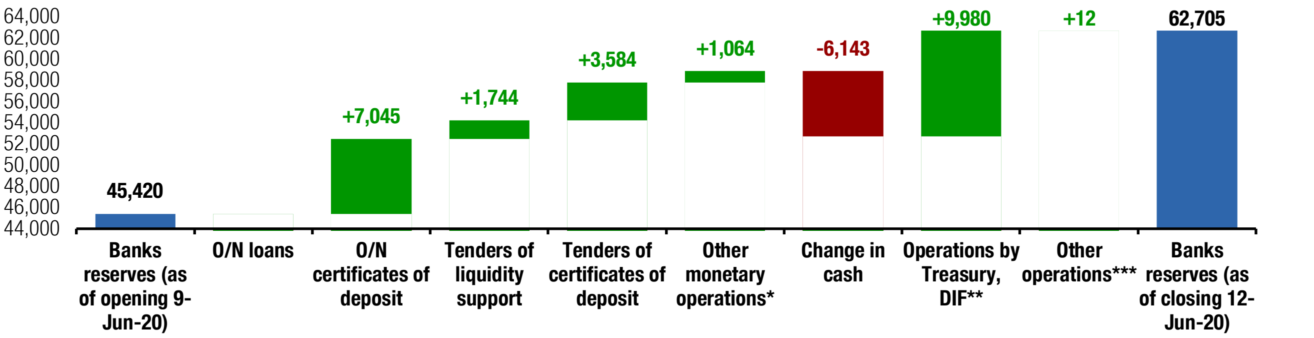
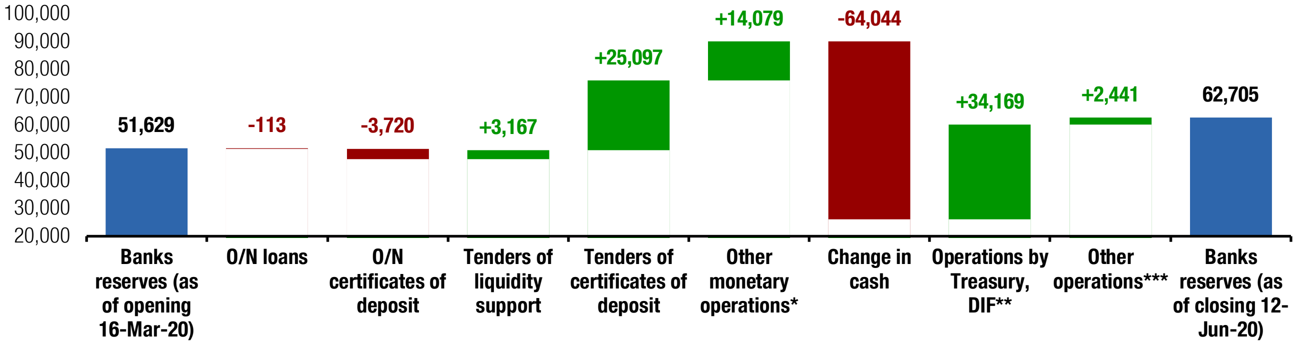


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

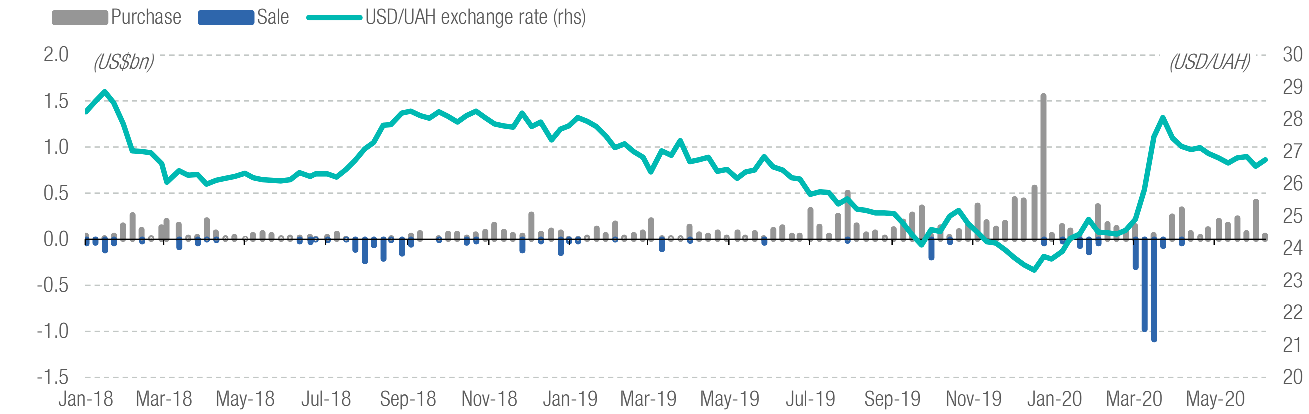
Hryvnia holds the line

The hryvnia exchange rate fluctuated last week within the range of UAH26.5–27/US$ without attempts to move closer to UAH26/US$. This week, we do not expect any material changes in the FX market.

Last week, the FX market was mostly self-balanced, and the hryvnia exchange rate stayed within the UAH26.5–27/US$ range. NBU purchased some extra supply, but decreased the amount of purchases to US$40m from US$411m a week before.

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.

However, last week the hryvnia ended at UAH26.75/US$, slightly weakened by 0.8% during last week.

ICU view: We do not expect hryvnia exchange rate volatility this week other than slight fluctuation within the same range of UAH26.5–27/US$. The market will be mostly self-balanced with the NBU only smoothing fluctuations. We do not anticipate any shocks caused by VAT refunds or large tax payments, which will be paid during the next week.

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Economics

NBU cuts rate by 200 bps

An aggressive cut was expected as inflation hit a record low; nonetheless, the period of rapid rate decreases is over.

The NBU decreased the key interest rate from 8.0% to 6.0%, which is the record low in the history of Ukraine. However, this move should not be viewed as a sign of the NBU turning extremely dovish. Considering the low CPI of just 1.7% YoY in May, the Ukrainian real rate remains one of the highest in the world.

NBU warned about the end of the cycle of sharp rate cuts in its communications and gave neutral "forward guidance", hinting at the possibility of a subsequent change in the key policy rate in either direction.

ICU view: We expect the key policy rate to decline by another 50 bps to 5.5 % by September and remain there until the end of 2020 when inflation will pick up. The NBU might start slowly increasing the rate in 2Q21 to avoid having the CPI move above the 5±1% target.

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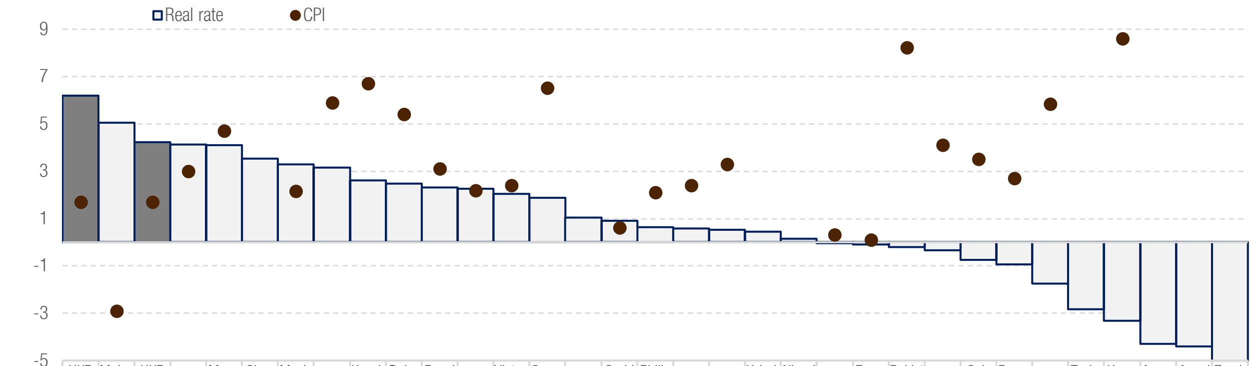
Chart 6. Real interest rates, selected countries

Despite the aggressive cut, Ukraine's real rate remains one of the highest in the world



	UKR (bef)	Malaysia	UKR (aft)	AZE	Mongolia	Ghana	Mexico	Egypt	Kazakh.	Belarus	Russia	Indon.	Vietnam	Georgia	Tajik.	Serbia	Philipp.	Brazil	China	Uzbek.	Nigeria	USA	Eurozone	Pakistan	RSA	Colombia	Romania	India	Turkey	Kyrgyz.	Argent.	Angola	Zambia
Real rate	6.19	5.05	4.23	4.13	4.11	3.53	3.28	3.16	2.62	2.47	2.33	2.26	2.05	1.88	1.04	0.89	0.64	0.59	0.53	0.44	0.14	-0	-0.1	-0.2	-0.3	-0.7	-0.9	-1.7	-2.8	-3.3	-4.3	-4.4	-6.3
CPI	1.7	-2.9	1.7	3	4.7	10.6	2.15	5.9	6.7	5.4	3.1	2.19	2.4	6.5	10.6	0.6	2.1	2.4	3.3	14.5	12.3	0.3	0.1	8.22	4.1	3.51	2.7	5.84	11.4	8.6	44.2	20.8	16.6

Source: Trading Economics, ICU..

Consumer inflation keeps slowing

In May, the annual inflation fell to 1.7%, its lowest level since 2013. Looking ahead, inflation should remain subdued; we project a return to the NBU's target range only in 4Q20.

In May, consumer prices grew by 0.3% MoM, and annual growth slowed to 1.7% from 2.1% in April. This result completely coincided with our estimates and was slightly lower than the Bloomberg consensus forecast (1.9%). Core inflation amounted to 3.0% YoY, remaining almost unchanged since January. Both headline and core indicators remained below the NBU's target range of 5% +/- 1 pp for the fifth month in a row.

Such result was mostly determined by very low inflation (or even deflation for headline CPI) during the period from Sep-19 to Feb-20. In March-May, prices resumed growth at a rate close to the 5% inflation target when measured by the MoM seasonally adjusted annualized rate (SAAR). At the same time, core inflation slowed to 1% MoM SAAR in May.

The decomposition by components shows a slight acceleration of food inflation to 2.8% YoY, due to a sharp rise in prices of eggs and fruits against the background of lower meat prices. Meanwhile, gas and fuel prices fell sharply again, and their annual decline deepened.

ICU view: So far, our expectations about the prevailing effect of the contraction in aggregate demand on slowing inflation have been confirmed.

In the coming months, given a relatively stable exchange rate and still depressed demand amid a gradual easing of containment measures, we expect inflation to remain low. Inflationary pressure is expected to increase in the fall due to a weakening exchange rate, rising global energy prices, and a gradual recovery in domestic demand, mainly for food. Thus, we expect consumer inflation to return to the NBU target range only at the end of 2020, rising to 4.2%.

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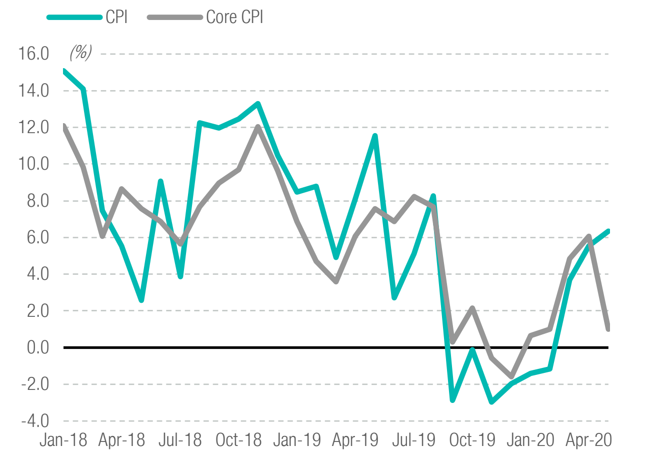
Chart 7. CPI and Core CPI, MoM SAAR, %

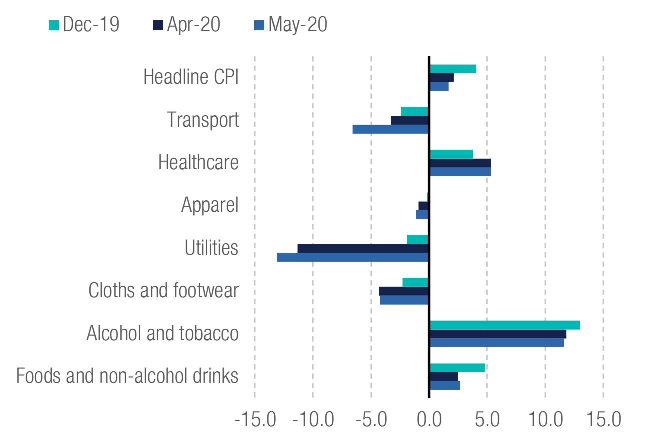
Seasonally adjusted annualized rate of growth compared with the previous month



Source: Ukrstat, ICU.

Chart 8. CPI and its main components, YoY changes, %

In April, inflation deceleration was determined by gas and fuel components



Source: Ukrstat, ICU.

IMF Board approves US$5 bn SBA for Ukraine

The IMF increased the first tranche to US$2.1 bn and stressed the great risks for the programme due to the uncertainty about the direction of domestic economic policies.

The IMF Board has approved an 18-month US$5 bn SBA for Ukraine.

The IMF also stressed very large risks to the new programme, especially highlighting the severity and length of the global downturn and the uncertainty about the direction of domestic economic policies.

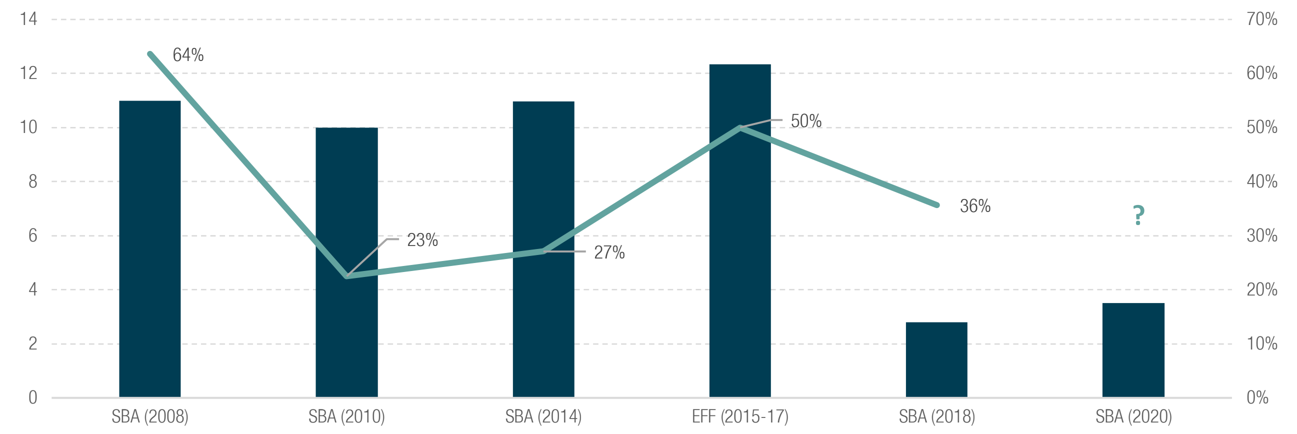
The first tranche of the programme was increased to US$2.1 bn compared with the previously expected US$1.8–1.9 bn, which was fully transferred to the budget. The next tranches are scheduled based on two quarterly reviews this year and two more reviews next year.

The IMF also released a new macroeconomic forecast for Ukraine. In particular, the IMF worsened its forecast for GDP decline this year to 8.2% (from 7.7% in April WEO) and recovery next year to 1.1% (from 3.6%). At the same time, the CPI growth forecasts remained high, on average by 4.5% this year and by 7.2% next year. The current account deficit is projected at 1.7% of GDP this year and 2% of GDP next year. At the same time, the IMF projects a sharp reduction in international reserves this year, down to US$19.3 bn this year and only a gradual recovery next year of up to US$23.4 bn

ICU view: The approval of the programme was long-awaited, but some decisions came as a surprise. On one hand, increasing the volume of the first tranche to US$2.1 bn makes it marginally easier for the government to finance the budget deficit and external debts repayments this year. On the other hand, in its communications, the IMF placed unusual emphasis on the risks of the programme. In particular, it stressed the uncertainty about domestic economic policy, the potential impact of vested interests, and populist decisions replacing sound structural reforms.

After auditing previous programs, the IMF paid tribute to the success in macroeconomic stabilization, while highlighting significant problems with the implementation of structural reforms. Usually, after receiving the first tranches and restoring macro-financial stability, interest in reforms' implementation decreased significantly. That is why this time a significant part of the conditionality for the programme took the form of prior actions and future structural benchmarks for planned reviews, which do not look problematic.

Chart 9. Ukraine's IMF programmes since 2008: allocated volumes (SDR bn) and disbursed share (%)



Source: IMF, ICU.

However, given the previous experience of programmes with the IMF, sharing the risks outlined by the IMF and forecasting the maintenance of macro-financial stability in 2H20, we do not expect new tranches from the SBA this year. However, the government's sizable financial needs against the backdrop of a still-high budget deficit and external debt repayments next year will ensure one or two successful reviews of the programme.

The published IMF forecast looks very conservative in most respects, both compared with our estimates and consensus (see details in next section). We consider it more as a stress-testing scenario rather than a baseline scenario.

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ICU Macroeconomic Review - Gradual Reopening; Shaky Outlook

Last Thursday, we issued our updated macroeconomic review on Ukraine's economy.

While the national economy starts to reopen after two months of strict lockdown, we believe its recovery will be gradual due to subdued demand and the negative toll from remaining quarantine restrictions on potential output rebound and its further growth. We forecast Ukraine's real GDP to fall by 6.7% in 2020, and recover by 5.7% in 2021. Thus, we are more pessimistic than consensus for 2020, but expect a more rapid rebound next year.

Inflation to rise gradually and the NBU will stay dovish End-year CPI of 4.2% in 2020, and 5.3% in 2021, will allow the NBU to continue easing monetary policy, however only marginally after the decisive step it took last Thursday. We forecast the central bank will cut its key policy rate to 5.5% by September. It seems that we are in the camp that are projecting subdued inflation and aggressive reaction of the NBU this year. However, after the May CPI release and the last move of the NBU, many others may join this camp.

Larger stimulus is expected from the budget We forecast an expansion of the state budget deficit this year to 6% of GDP, slightly lower than plan at 7.5% of GDP due to cutting back on certain expenditures as resources are scarce. Despite the sizable increase in the budget deficit this year, public finances appear to be sustainable. We project only a moderate increase in the public debt-to-GDP ratio of up to 57%.

External accounts proved resistant to the coronacrisis thanks to a sizable improvement in terms of trade and a sharp contraction of imports. We expect the C/A surplus will amount to around 1% of GDP in 2020, and then turn to a moderate deficit of 1.2% of GDP in 2021. Here, we are among the most optimistic, as many others still project a C/A deficit this year.

Accounting for secured official financing, the government's return to the international capital markets, and a rebound of private capital inflows, we project that international reserves will increase to almost US$28.5bn or 100% of the IMF Aggregate Reserve Adequacy metric by the end of 2022.

Return to a current account deficit together with further monetary policy easing will cause a moderate weakening of the hryvnia by the end of the year to as much as UAH28–29/USD. In 2021, we do not expect sizable changes in the exchange rate, as the current account deficit will be more than offset by capital inflows under the financial account. Our forecast for the exchange rate is broadly in line with market consensus.

Please see our new Macroeconomic Review for more details.

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