



Focus
Ukraine

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

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Weekly Insight

Governor of NBU resigns

Key messages of the today's comments

Domestic liquidity and bonds market

Eurobonds: Successful pricing, but issue cancelled

Last week, Ukraine successfully priced new Eurobonds, but due to the resignation of National Bank Governor Yakiv Smoliy, the Ministry of Finance had to cancel the deal.

Foreigners' portfolios fall below UAH100bn

Foreign investors continued to decrease their bills' portfolios with a small correction due to revaluation of FX-denominated bills. Stabilization of the FX market and further selling and redemption of bills will continue to decrease portfolios.

Liquidity remains low

Keeping its negative impact on liquidity, Treasury caused a further decline in liquidity to UAH144bn. This week, we anticipate liquidity fluctuations at around UAH140-150bn.

Foreign exchange market

Hryvnia under pressure

The resignation of NBU Governor Yakiv Smoliy and the cancelation of the Eurobond issue had a negative impact on FX market, weakening the hryvnia to UAH27.19/US\$ last week. This week, the situation should steady, with hryvnia exchange stabilization slightly above UAH27/US\$.

Economics

Current account surplus for 5M20 jumped to US\$5.6bn

A significant current account surplus is the result of improving external trade and the NBU's revision of the methodology for reinvested earnings data compilation.

Governor of NBU resigns citing political pressure

Yakiv Smoliy resigned naming political pressure on him and top management of the NBU.

MONDAY, 6 JULY 2020

Banks' reserves market (3 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	6.00	+0bp	-1,150bp
ON rate (%)	5.77	+8bp	-1,032bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	45,536	-19.14	+12.15
CDs (UAHm) ³	98,628	-21.16	+73.31

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) (3 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	420,874	+0.90	+20.53
Residents	30,694	+0.97	+28.11
Individuals	7,774	+1.75	-16.36
Foreigners ¹	100,133	-0.83	+65.95
Total	884,052	+0.38	+13.35

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (3 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.1880	+1.84	+4.52
EUR/USD	1.1248	+0.26	-0.27
DXY	97.172	-0.27	+0.42
UAH TWI ¹	125.917	-1.50	+1.24

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (6 July 2020)

Maturity	Bid	Ask
6m	10.50	7.00
12m	11.00	9.25
2y	12.00	10.00
3y	12.00	10.50
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

Eurobonds: Successful pricing, but issue cancelled

Last week, Ukraine successfully priced new Eurobonds, but due to the resignation of National Bank Governor Yakiv Smoliy, the Ministry of Finance had to cancel the deal.

The deal included swapping Eurobonds due in 2021 and 2022 into new Eurobonds due in 2033. An additional amount in excess of the swap was for budget deficit financing. The initial target rate of 7.875% was decreased to 7.3% or 663bp spread to the benchmark. The new issue would have amounted to US\$1.75bn.

Unfortunately, just after the deal was priced, the Governor of the NBU announced his resignation. According to the Minister of Finance, negotiations with investors and legal advisers took all night. Ultimately, they decided not to proceed with the offering, so it was cancelled.

The Eurobond market's reaction was restrained. YTM of Ukrainian Eurobonds rose by about 20–30bp. Only the shortest bond with a maturity this September saw an increase in yield by 120bp. However, by Friday, the YTM for UKRAIN'20 declined to 4.3% or just 56bp above the level prior Smoliy's resignation.

ICU view: Cancellation of the deal was unusual. The MoF had a chance to review conditions and offer something better or not proceed with the deal as settlement was scheduled for 8 July, 2020. The MoF's decision was logical and after a new Governor of the NBU is appointed, the Ministry of Finance can reoffer the deal. In that case, we expect that new conditions will be not much different from the last week's pricing.

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Foreigners' portfolios fall below UAH100bn

Foreign investors continued to decrease their bills' portfolios with a small correction due to revaluation of FX-denominated bills. Stabilization of the FX market and further selling and redemption of bills will continue to decrease portfolios.

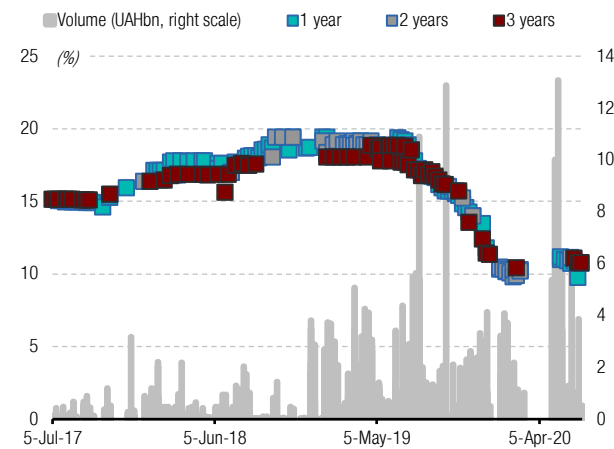
Last week, foreigners' sold UAH700m and by Wednesday, their portfolios had fallen below UAH100bn. Later in the week, the hryvnia weakened to UAH27.2/US\$, and portfolios rose due to FX revaluation. By the end of last week, foreign investors' portfolios declined to UAH99.9bn, the lowest level since October 2019.

ICU view: This week, the MoF will repay about UAH7bn in local currency and US\$670m in hard currency; foreigners will receive about UAH1bn in redemptions. Therefore, the decline in portfolios will continue with possible acceleration.

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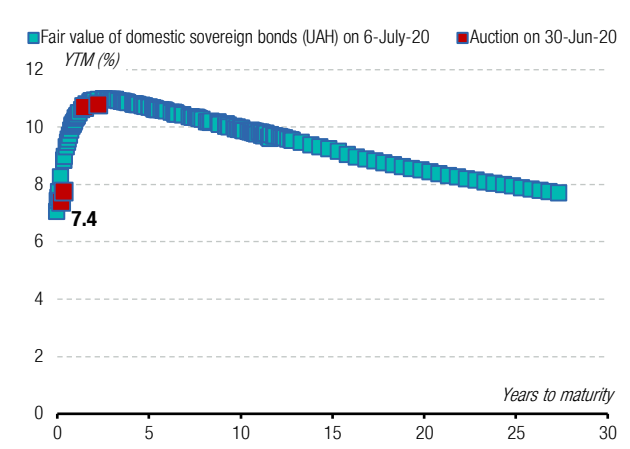
Chart 1. Local-currency bonds

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.

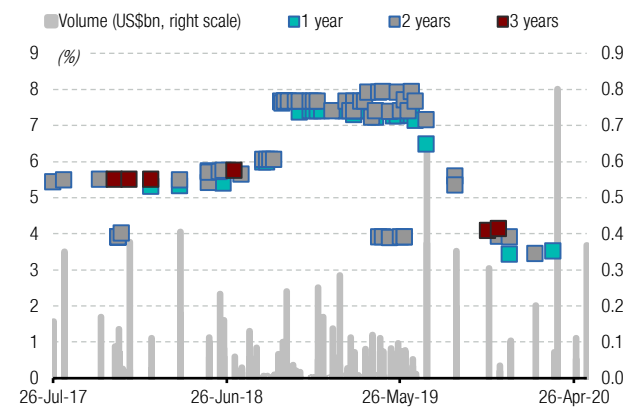
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

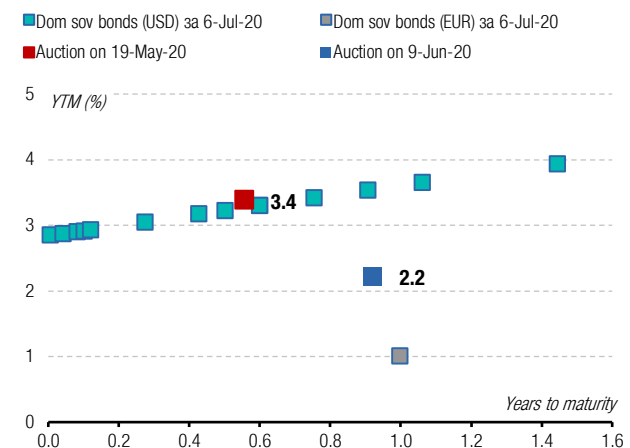
Chart 2. FX-denominated bonds

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 remains low

Keeping its negative impact on liquidity, Treasury caused a further decline in liquidity to UAH144bn. This week, we anticipate liquidity fluctuations at around UAH140-150bn.

Despite beginning a new month, the total impact of Treasury operation was negative, with absorption of UAH6.5bn. However, outflows to the budget were not compensated by the NBU deals with hard currency, as previously. Last week, the NBU bought just US\$19m with a mere impact on liquidity.

ICU view: Instability in the FX market will force the NBU to smooth volatility to restrain hryvnia weakening. The impact on liquidity will be mostly negative, where only budget expenditures can compensate outflows. We expect liquidity to stay around UAH140–150bn this week.

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

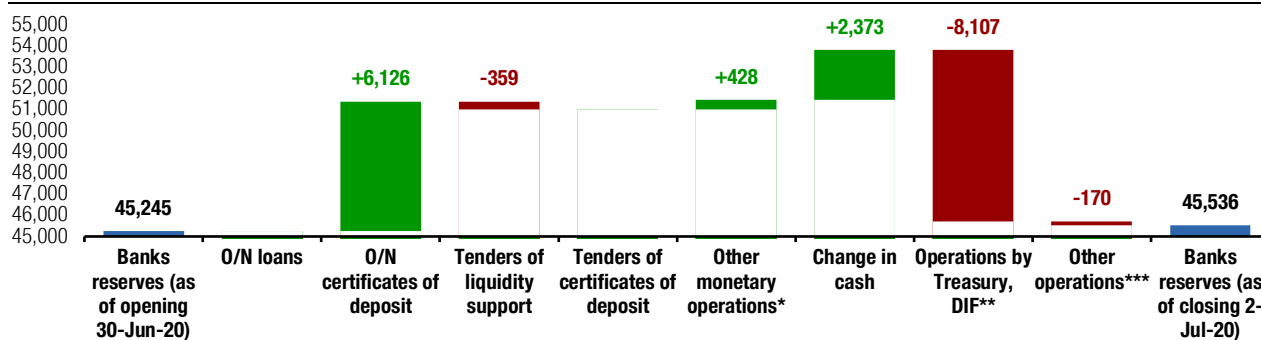
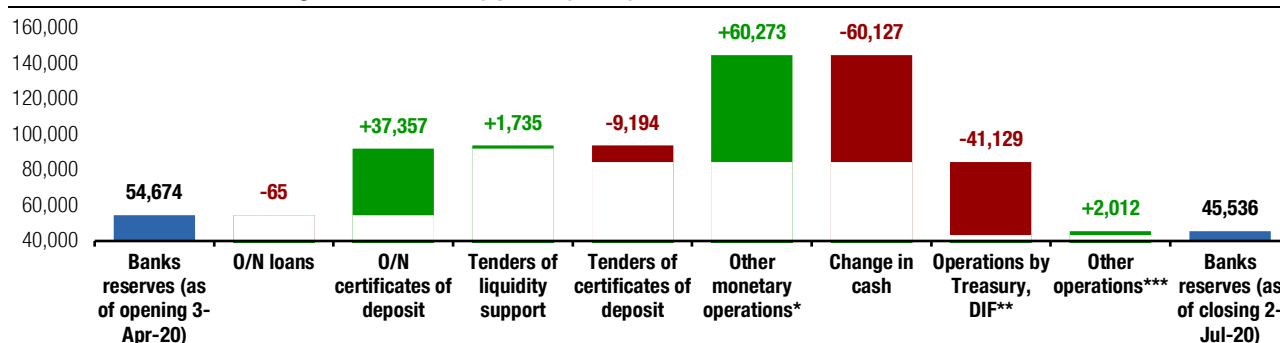


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 under pressure

The resignation of NBU Governor Yakiv Smoliy and the cancelation of the Eurobond issue had a negative impact on FX market, weakening the hryvnia to UAH27.19/US\$ last week. This week, the situation should steady, with hryvnia exchange stabilization slightly above UAH27/US\$.

Immediately after Smoliy's resignation, the FX market reacted with the hryvnia weakening to UAH27.2/US\$. The NBU's interventions restrained the weakening and stabilized the exchange rate at about UAH27.2/US\$. The NBU had to sell US\$151m last Thursday.

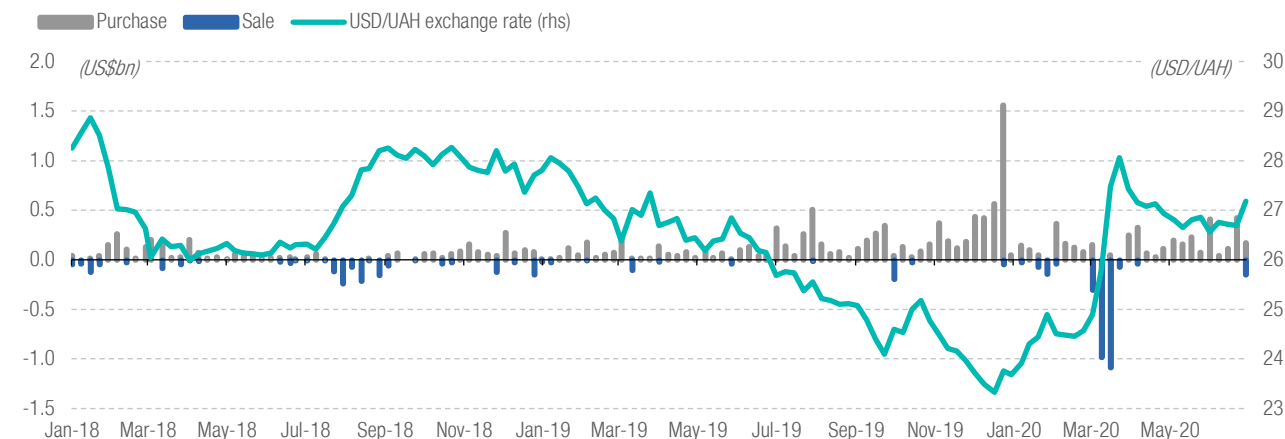
Thanks to NBU's support, last week the hryvnia weakened just by 1.8%.

ICU view: *Even without a Governor, the NBU team will continue to work as before, so we do not expect any changes in their FX policy. We expect that the market will become calmer, and with NBU interventions, the exchange rate will stabilize slightly above UAH27/US\$.*

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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

Current account surplus for 5M20 jumped to US\$5.6bn

A significant current account surplus is the result of improving external trade and the NBU's revision of the methodology for reinvested earnings data compilation.

In May, Ukraine's current account (C/A) ran a significant surplus of US\$1.4bn (compared with a deficit of US\$136m in May 2019). That led to a C/A surplus of US\$5.6bn in 5M20 (compared with US\$1.1bn deficit in 5M19). Such a sharp improvement in the C/A balance to a large extent is explained by the NBU's update of the methodology for accounting reinvested earnings of companies with foreign direct investments. This led to a revision of primary income in C/A and FDI statistics since 2015. Thus, the 2019 C/A deficit was increased from US\$1.3bn to US\$4.2bn, while the 4M20 C/A surplus was revised from US\$1.8bn to US\$4.2bn. Mirror changes were reflected in FDI flows.

Meanwhile, the trade balance improvement also contributed into the swing of the C/A balance. In May, trade in G&S recorded a surplus US\$373m (compared with a deficit of US\$770m in May 2019), leading to an external trade surplus of US\$305m for 5M20 (compared with a deficit of US\$3.5bn for 5M19). The trade surplus was ensured by favourable terms of trade and better resilience of exports compared with imports.

In May, the decline in remittances deepened significantly: by 21% YoY to US\$805m (in April, the decline was 13%). For 5M20, remittances decreased by 2.1% YoY to US\$4.5bn.

As a result, the C/A surplus for the last 12 months grew to US\$2.5bn (est. 1.7% of GDP). Over the past 12 months, the merchandise trade deficit decreased to US\$11.7bn (est. 7.8% of GDP), while the services trade surplus increased to US\$2.9bn (est. 1.9% of GDP), and remittances were almost unchanged at US\$12bn (est. 7.9% of GDP).

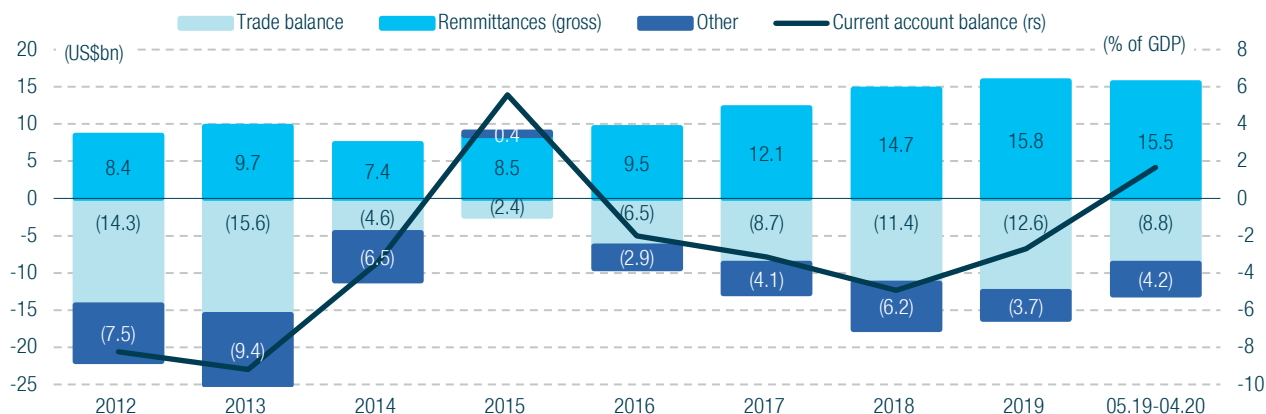
In May, capital outflows under the financial account remained significant (US\$1.7bn) against the background of sizable repayments of external debt by the public sector (US\$1.2bn) and FX cash accumulation (US\$0.5bn). In addition, due to the change in methodology, the outflow was recorded in FDI (US\$323m), reflecting the assessment of losses in corporates with foreign investment and the corresponding reduction of reinvested earnings in their capital. Instead, after two months of outflows, private debt capital turned to inflows (US\$343m).

ICU view: In the coming months, we expect imports to recover amid the reopening of the economy and the C/A to return to deficit.

However, given the revision of the methodology for accounting of reinvested earnings and the improvement in foreign trade, we see significant upside risks to our projection of a C/A surplus of US\$1.5bn (1.0% of GDP) for 2020. Meanwhile, most other analysts are still projecting a C/A deficit.

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Chart 6. Current account balance



Source: NBU, UkrStat, ICU.

Governor of NBU resigns citing political pressure

Yakiv Smoliy resigned naming political pressure on him and top management of the NBU.

This resignation came as a surprise despite numerous and lengthy calls to fire the central bank top management within the ruling party. Smoliy named several conflicts including attempts to stop the banking law in Constitutional court shortly after the IMF deal was struck. In addition, parliament was due to issue a political statement that could have given the President the power to fire Smoliy.

ICU view: Smoliy's resignation creates a huge uncertainty around what the policy of the new Governor will be and how that person will be able to cooperate with the remaining Board members. The latter will remain in their positions unless they, too, decide to resign or their term ends. There are three major concerns:

- **Monetary policy. Excessively tough monetary policy was named as the main problem by most of NBU's critics. It is very likely that the new NBU Governor will lean to more dovish monetary policy. The question remains how dovish.**
- **Willingness to continue the crusade against the former shareholders of the insolvent banks and the political will to recover bad debts in courts.**
- **Potential reversal of the reforms including the ban on insider lending.**

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