Focus

Ukraine

Markets

Domestic liquidity, government bonds, FX market, and macro

Research team

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Weekly Insight

NBU keeps the rate on hold at 6%

Key messages of the today's comments

Domestic liquidity and bonds market

Eurobond issue: second attempt successful

Ukraine completed the offering of a new Eurobond issue and switch tender offer. This time, the amount was increased to US$2bn, and the rate was set at 7.25% compared with US$1.75bn at a rate of 7.3% three weeks ago.

Banks' share in bonds outstanding close to 50%

Last week, banks continued to increase investments in domestic bills both through new issues and purchases of bonds from foreign investors. This week, banks will again become the main buyers of new bills in both the primary and secondary market.

Liquidity declines again

The Treasury and NBU once again absorbed a large amount of liquidity, causing a decline to UAH149bn. However, this week, liquidity should stabilize and slightly recover.

Foreign exchange market

Smoothing interventions

Over three days last week, the NBU sold almost US$350m, halting the weakening of the hryvnia. This reassurance may be short-lived, and this week, the rate could again attempt to cross the UAH28/USD level.

Economics

Economic activity rebounds

Based on data published last week by UkrStat, we estimate the decline in GDP to slow to 8% YoY in June thanks to improvement in industrial production and trade. Factoring in the rather rapid recovery of domestic demand and the world economy, we consider risks to our June forecast of GDP this year (-6.7%) as skewed to the upside.

NBU keeps the rate on hold at 6%

At the first monetary meeting after the appointment of the new governor, NBU's Board decided not to change the rate after a cumulative decrease of 12 pp since April last year. The new NBU forecast envisages keeping the rate at the current level for the next 12 months and raising it to 6.5% in 3Q21.

TUESDAY, 28 JULY 2020

Banks' reserves market (27 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	+0bp	-1,100bp
ON rate (%)	5.67	+19bp	-1,003bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	59,026	+12.12	+20.75
CDs (UAHm)[3]	89,499	-18.96	+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) (27 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.72
Banks	425,653	+2.64	+22.35
Residents	29,078	-0.46	+11.34
Individuals	7,087	-4.43	-26.00
Foreigners[1]	93,039	-0.83	+21.25
Total	**879,434**	**+1.12**	**+10.28**

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

FX market indicators (27 July 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.6775	-0.16	+9.05
EUR/USD	1.1752	+1.95	+5.61
DXY	93.668	-1.52	-4.43
UAH TWI[1]	120.793	-0.57	-5.91

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

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

Maturity	Bid	Ask
6m	**12.50**	**9.00**
12m	**13.00**	**10.50**
2y	**13.25**	**10.75**
3y	**13.50**	**11.00**
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

Eurobond issue: second attempt successful

Ukraine completed the offering of a new Eurobond issue and switch tender offer. This time, the amount was increased to US$2bn, and the rate was set at 7.25% compared with US$1.75bn at a rate of 7.3% three weeks ago.

Yakiv Smoliy's resignation from the chairman of the NBU led to the cancellation of the Eurobond issue priced earlier this month. The Ministry's decision to cancel the issue was well taken. As it turned out, waiting created an opportunity to reconsider the terms of the deal.

Attracting US$6.3bn of demand, the bonds were priced at US$2bn par value with a 7.25% coupon rate. Of these funds, approximately US$0.85bn will be used to repurchase outstanding 2021 and 2022 Eurobonds.

ICU view: Overall, the changes from the first attempt in early July were an increase in the amount of the new issue and a switch tender offer from US$1.75bn and US$0.75bn, respectively. The interest rate decreased, although this should not be seen as an achievement of Ukraine, because the spread to the benchmark remained mostly unchanged. This time, it was 666bp, compared with about 663bp three weeks ago. The reduction in interest rates on US Treasury bonds during this time worked in favour of the rate. Settlement for the new Eurobonds is scheduled this week, so we expect a successful completion of the deal.

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Banks' share in bonds outstanding close to 50%

Last week, banks continued to increase investments in domestic bills both through new issues and purchases of bonds from foreign investors. This week, banks will again become the main buyers of new bills in both the primary and secondary market.

New domestic bills sold in the primary market last Tuesday were mostly purchased by banks. Together with bonds purchased in the secondary market, banks increased their portfolios to UAH426bn (US$15.3bn). Last week, total portfolios grew due, in particular, to the revaluation of FX-denominated bills, increasing portfolios by UAH12.5bn (US$450m). The UAH-denominated portion of portfolios increased by UAH7.7bn (US$277m) to UAH324bn (US$11.7bn). UAH1.5bn (US$54m) of the increase could have been due to the purchase of bonds from foreigners.

ICU view: Banks continue to increase investments in government bills and decrease investments in NBU CDs. This week, they will probably prefer FX-denominated paper; therefore, banks' share in total bonds outstanding can rise very close to 50%.

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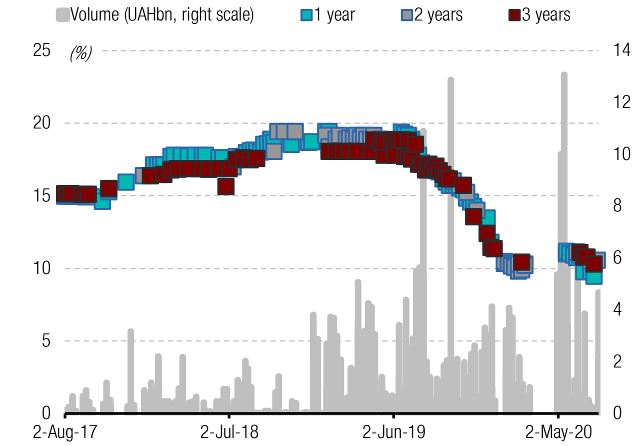
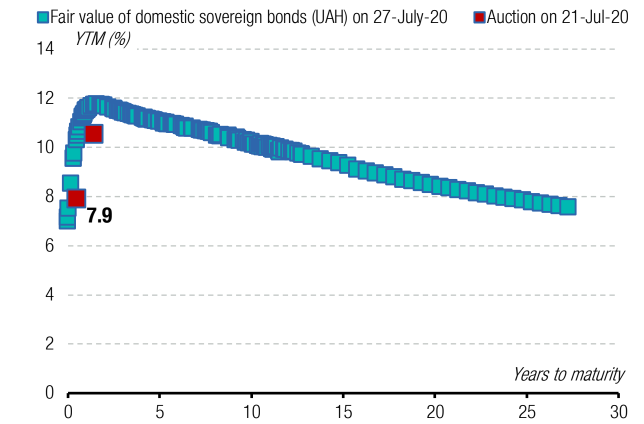
Chart 1. Local-currency bonds

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.

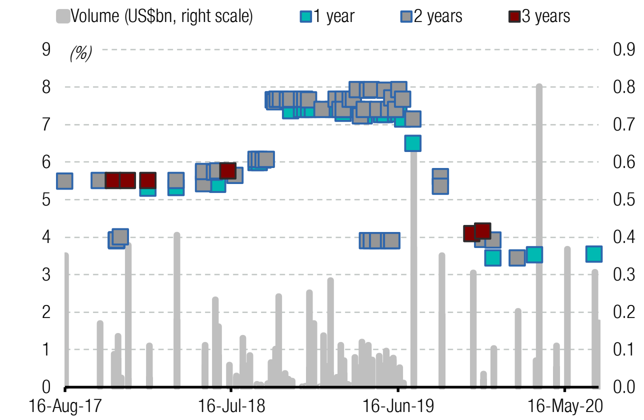
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

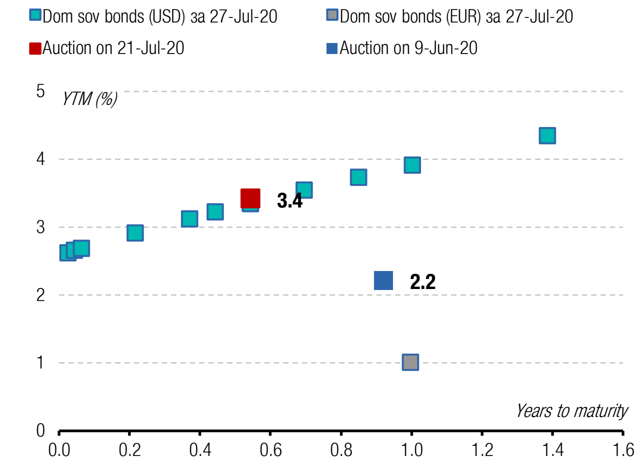
Chart 2. FX-denominated bonds

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 declines again

The Treasury and NBU once again absorbed a large amount of liquidity, causing a decline to UAH149bn. However, this week, liquidity should stabilize and slightly recover.

The NBU was active in the FX-market again, intervening with the sale of hard currency, which significantly increased the outflow of liquidity caused by operations of the Treasury. Only UAH4.2bn was absorbed into the budget last week from new borrowings and the collection of month-end tax payments. The NBU sold almost US$350m and withdrew another UAH9.7bn from liquidity. But banks' need for cash decreased, and they slowed down reserves exchange in cash to UAH1.2bn last week, compared with UAH4bn a week before.

ICU view: This week, month-end tax payments will continue, and the MoF will offer new local-currency bills. These outflows will have two sources of compensation that can cause liquidity to increase: redemption of UAH13bn of local-currency bills and VAT refunds, which this month has been slow. Therefore, the total amount of liquidity should stabilize at or rise above UAH150bn.

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

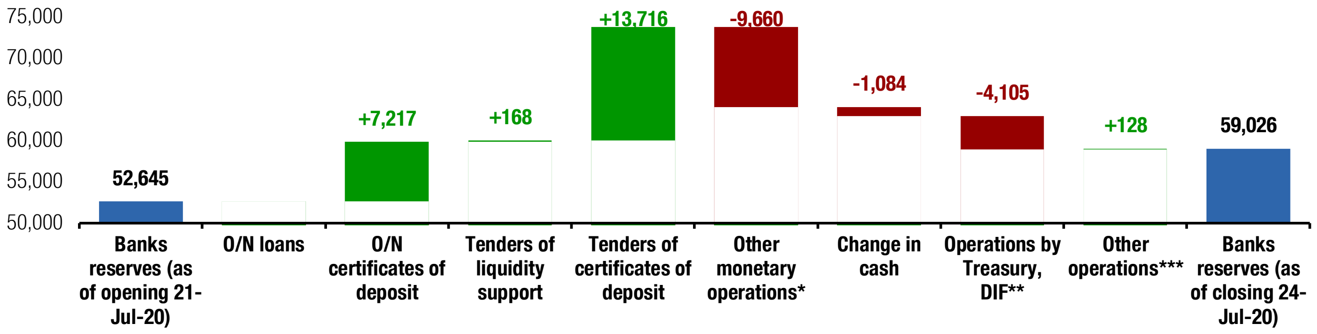
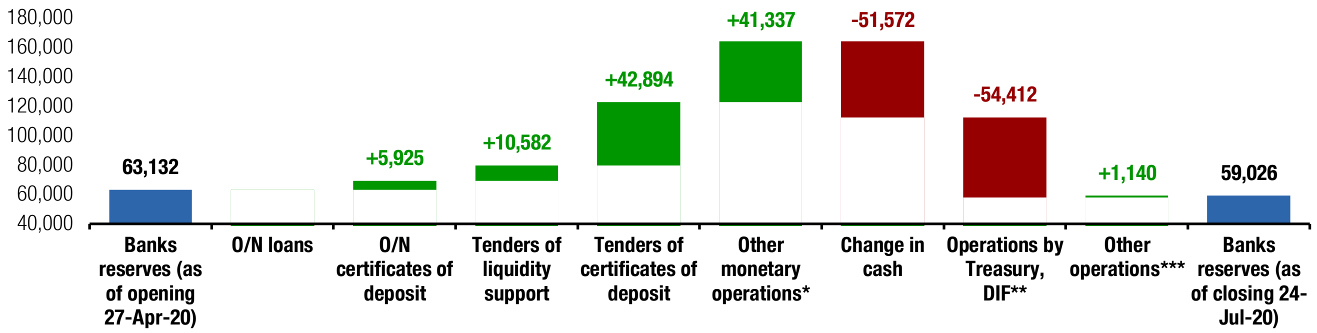


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

Smoothing interventions

Over three days last week, the NBU sold almost US$350m, halting the weakening of the hryvnia. This reassurance may be short-lived, and this week, the rate could again attempt to cross the UAH28/USD level.

The appointment of a new head of the NBU did not help to stabilize the hryvnia exchange rate. The NBU intervened in the market on Tuesday selling almost US$100m. On Wednesday, sales of hard currency doubled, and in just three days, the NBU sold US$347.8m.

These interventions were supported by a number of events. On Thursday, the NBU kept its key policy rate at 6% despite market expectations for a reduction. In addition, a new EUR1.2bn financing agreement was signed with the EU. The second attempt to place Eurobonds and switch tender offer were successfully completed.

ICU view: The stabilization of the hryvnia exchange rate may be short-lived, as this week there will be significant debt repayments in local currency, part of which will be directed to the FX-market. Month-end tax payments will not match VAT refunds. This may cause further fluctuations in the exchange rate and require NBU intervention. Therefore, we expect the hryvnia exchange rate will continue to fluctuate and attempt to cross UAH28/USD toward weakening.

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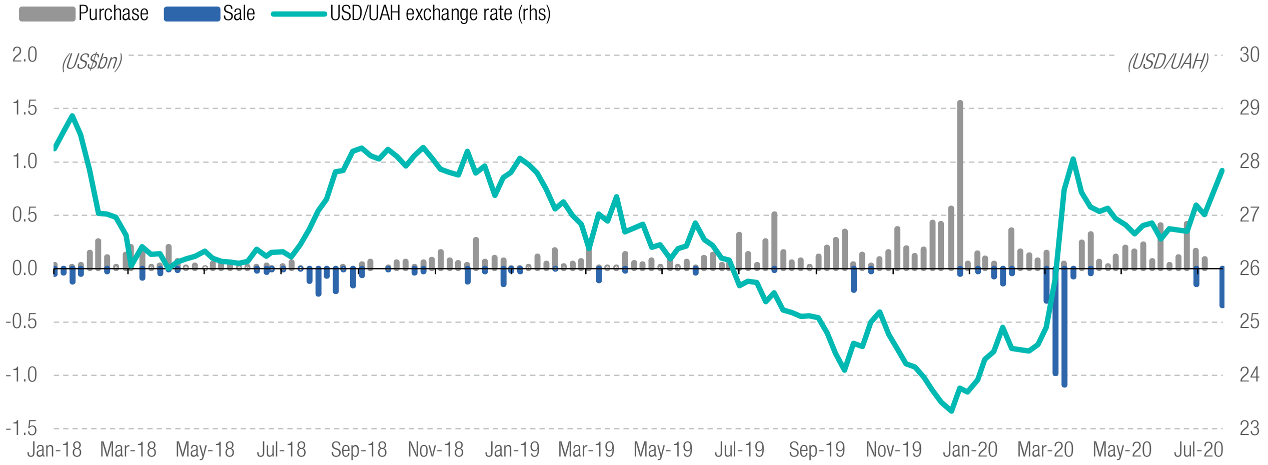
Chart 5. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

Economic activity rebounds

Based on data published last week by UkrStat, we estimate the decline in GDP to slow to 8% YoY in June thanks to improvement in industrial production and trade. Factoring in the rather rapid recovery of domestic demand and the world economy, we consider risks to our June forecast of GDP this year (-6.7%) as skewed to the upside.

UkrStat data on trade, transport, and industrial production in June reaffirmed our expectations for continued recovery of economic activity as quarantine restrictions and social distancing are eased.

In particular, trade is rebounding rapidly. After two months of decline, the growth rate of retail trade returned positive, 1.4% YoY. According to our estimates, in June, the seasonally adjusted level of retail trade was only 3% lower than the maximum level in January. To a large extent, the high figure for June can be explained by the realization of deferred demand and an increase in the purchase of fuel for personal transport (by 11% YoY). At the same time, consumer sentiment remains depressed and even worsened compared with May.

The decline in wholesale trade slowed to 0.5% YoY for 6M20 from 2.8% YoY in January-May. According to our estimates, in June, wholesale trade turnover increased by 12% YoY. Its seasonally adjusted level was higher than at the beginning of the year, before the pandemic.

Industrial production is also recovering rapidly and in June, the seasonally adjusted level was 6.3% higher than in April and only 1.5% lower than in January–February. In annual terms, the decline slowed to 5.6% YoY compared with 12.2% YoY in May, bringing the 1H20 outcome to -8.3% YoY. The rebound of domestic demand played the major role as the production of consumer durables grew by 5% YoY and the production of consumer non-durables fell only by 1.1% YoY in June. Among the activities, the main contribution to the rebound was delivered by metallurgy (+7.5% MoM; -3.9% YoY), chemical industry (+10.1% MoM; +1.1% YoY), and coal mining (+ 51.7% MoM; -12.7% YoY).

At the same time, the efficiency of the economy was still significantly constrained by the limited mobility of population. Thus, passenger turnover, although significantly improved compared with April–May, in June was only 27% of last year's level. In particular, for public transport in cities, this ratio was 55–60%. For passenger turnover of rail and air transport, it amounted to only 16% and 2%, respectively.

In addition, the aggregated indicator of economic activity was negatively affected by the later start of grain harvesting compared with last year. As a result, in June, agricultural production decreased by 40.6% YoY.

ICU view: Based on monthly indicators, we estimate the fall in GDP in 2Q20 by 10–11% YoY (compared with 10% YoY in our June forecast). At the same time, more than 1 pp of this decline is due to the later start of the grain harvest campaign, which should be compensated in the next quarter. In contrast, in many other areas, economic recovery is faster than previously expected.

Given the significant lowering of social distancing requirements and return to traditional formats of work and leisure, the active recovery of the world economy, especially in Southeast Asia and Central and Eastern Europe, and still quite favourable terms of trade, faster economic growth in the coming quarters and upward revision of our forecast of GDP decline this year (6.7%) are likely. However, the risks of further recovery remain high due to new waves of coronavirus infection in some regions of the world and the possible deterioration of expectations about the prospects for economic development by consumers and businesses.

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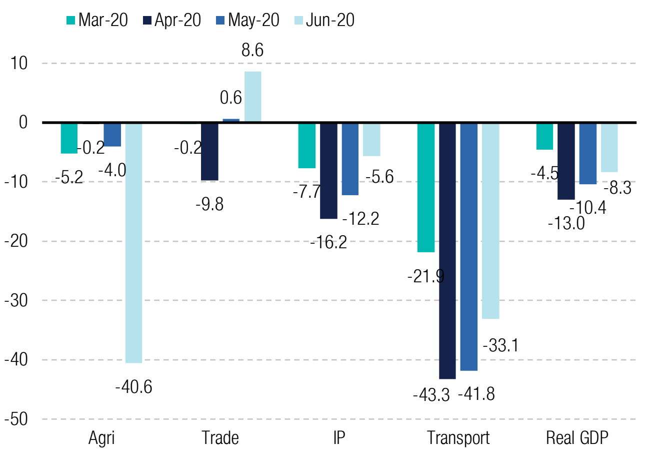
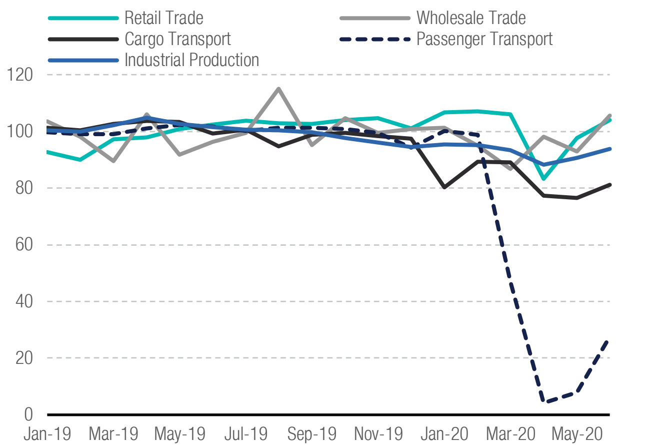
Chart 6. Real GDP and output of activities, % YoY



Source: Ukrstat, ICU.

Chart 7. Real GDP and output of activities, SA levels

2019=100



Source: Ukrstat, ICU.

NBU keeps the rate on hold at 6%

At the first monetary meeting after the appointment of the new governor, NBU's Board decided not to change the rate after a cumulative decrease of 12 pp since April last year. The new NBU forecast envisages keeping the rate at the current level for the next 12 months and raising it to 6.5% in 3Q21.

According to the NBU, this rate path is consistent with the achieving the inflation target (5% +/- 1 pp) in the coming years. In particular, the NBU lowered its forecast for the CPI change to 4.7% for the end of this year and raised it to 5.5% for the end of next year, approaching our estimates (4.2% and 5.3%, respectively). Similarly, the NBU brought its forecasts closer to our estimates of the pace of GDP decline this year, revising it to 6% from 5% in the April forecast.

In its communication on forward guidance, the NBU highlighted the changes in social standards, including the minimum wage, and the pace of economic recovery. Meanwhile, the NBU left an easing bias, pointing to the possibility of providing additional impetus in the case of a slower recovery of consumer and investment demand.

ICU view: NBU's decision came as a surprise, as consensus estimates tended to a slight reduction of rate (by 25 bp). Financial journalists and market participants predicted an even more aggressive cut, by 50–100 bp. Such expectations were primarily caused by the rhetoric of the new NBU Governor Kyrylo Shevchenko before his appointment on the need to stimulate the economy and increase lending through lower interest rates.

At the same time, although we, too, previously expected a rate cut of 25 bp (and to 5.5% by the end of this year), new information last week fully justified the decision to keep the rate on hold. First, data published by the Ukrstat on industrial production and retail trade in June showed that domestic demand is recovering quite rapidly. Second, the foreign exchange market had been under significant stress. The hryvnia exchange rate devalued steadily even with the NBU's rather significant foreign exchange interventions. In addition, the Ministry of Finance has returned to the Eurobond market, and a significant easing of the NBU's monetary policy the day before could hinder the successful issue.

In the future, the rate path will strongly depend on the reaction of the revamped NBU Board. On Thursday, after the monetary decision, former Deputy Finance Minister Yuriy Geletiy replaced Oleg Churiy as NBU Deputy Governor in charge of market operations. Last week, Kyrylo Shevchenko communicated his intention to maintain the focus of the NBU's monetary policy on achieving inflation targets. The NBU's decision on the rate was a logical confirmation. If this focus is maintained and taking into account economic factors such as stronger economic recovery, and faster exchange-rate weakening, the policy rate is likely to remain at 6% by the end of the year as in the NBU forecast, rather than being cut to 5.5% as in our June projection. Next year, if the government rapidly increases the minimum wage, the NBU will be forced to raise rates more aggressively than currently set in the NBU and ICU forecasts (both at 6.5%).

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