Focus
Ukraine

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

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Weekly Insight

NBU keeps the rate on hold at 6%

Key messages of the today's comments

TUESDAY, 8 SEPTEMBER 2020

Domestic liquidity and bonds market

Foreigners' share in T-bills falls to 10%

Foreigner's holdings in Ukrainian domestic bills continued to decline, and this week can fell below 10% of total bonds outstanding.

Liquidity remains steady

The total amount of banking-sector liquidity is still fluctuating around UAH160bn. This week, liquidity may decline to UAH155bn due to NBU interventions in the FX market and reserves exchange in cash.

Foreign exchange market

Hryvnia slightly weakens

With the beginning of a new month, the hryvnia exchange rate slightly weakens and this week, to satisfy extra demand, the NBU may sell hard currency from reserves. We expect the hryvnia exchange rate to fluctuate within the range UAH27.5–28/US$ during the week.

Economics

Current account surplus for 7M20 reaches US$7bn

In July, the C/A surplus decreased compared with previous months amid declining exports, but fundamental factors generally played in favour of Ukraine's external position. Instead, deteriorating devaluation expectations stimulated capital outflows.

NBU keeps the rate on hold at 6%

Expectedly, NBU Board decided to leave the key policy rate unchanged. We predict that by the end of the year, the NBU will keep the rate at 6% taking a wait-and-see approach. Next year, the NBU will be forced to raise the rate cautiously against the background of growing inflationary pressures.

Banks' reserves market (7 September 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	+0bp	-1,050bp
ON rate (%)	5.13	-6bp	-1,016bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	37,661	-35.43	-2.44
CDs (UAHm)[3]	112,236	+4.33	+136.06

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) (7 September 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	+0.00
Banks	418,838	+0.82	+7,463.10
Residents	28,105	+1.01	+1,667.67
Individuals	7,743	+1.08	+301,175.88
Foreigners[1]	86,924	-0.85	+3,705.20
Total	**866,187**	**+0.36**	**+9,087.84**

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

FX market indicators (7 September 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.7657	+0.65	+10.73
EUR/USD	1.1817	-0.80	+7.14
DXY	92.719	+0.41	-5.77
UAH TWI[1]	122.448	+0.40	-7.63

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

Gov't bond quotes[1] (8 September 2020)

Maturity	Bid	Ask
6m	**10.00**	**8.00**
12m	**10.50**	**9.00**
2y	**11.00**	**10.00**
3y	**11.50**	**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

Foreigners' share in T-bills falls to 10%

Foreigner's holdings in Ukrainian domestic bills continued to decline, and this week can fell below 10% of total bonds outstanding.

At last week's primary auction, new T-bills were mostly purchased by local banks, and their portfolio increased to UAH419bn (US$15bn) last week, which brought the share of banks to 48.4%. Due to these purchases, foreigners' share in bonds outstanding decreased to 10%, while they sold just UAH0.7bn of bills in the secondary market.

Additional impact came from hryvnia weakening, which inflated portfolios of local investors, as they held a large part of the FX-denominated instruments. Foreigners' portfolio consists 98% of UAH-denominated paper, so when the hryvnia weakens, their share declines.

ICU view: This week, we anticipate a further decline in foreigners' portfolios and, consequently, a lower share in bonds outstanding. The main impact will come from the primary auction and a further weakening of hryvnia.

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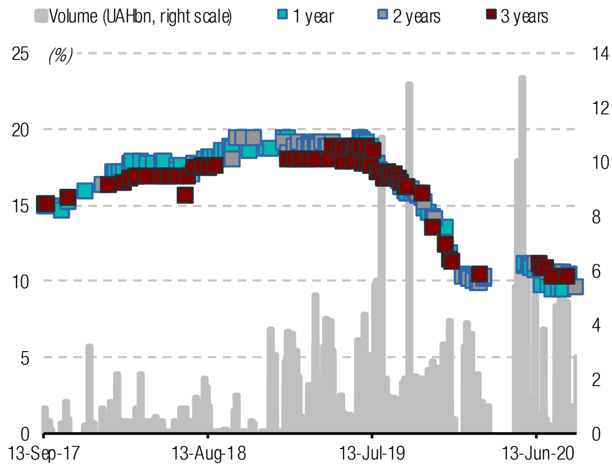
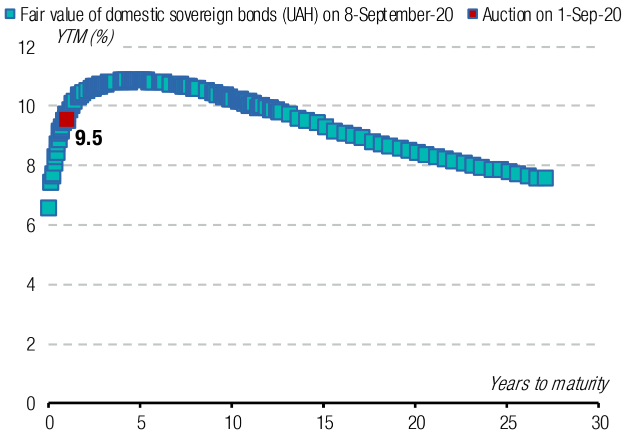
Chart 1. Local-currency bonds

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.

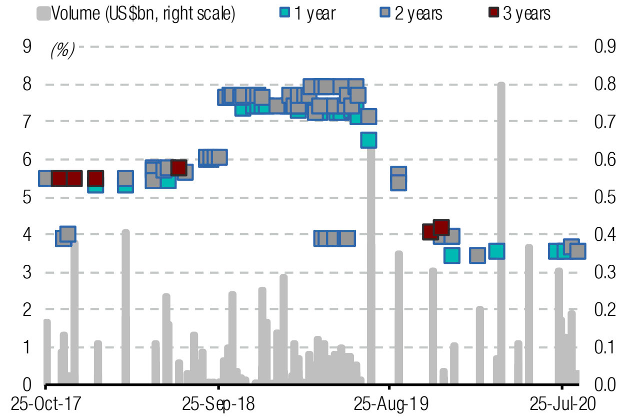
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

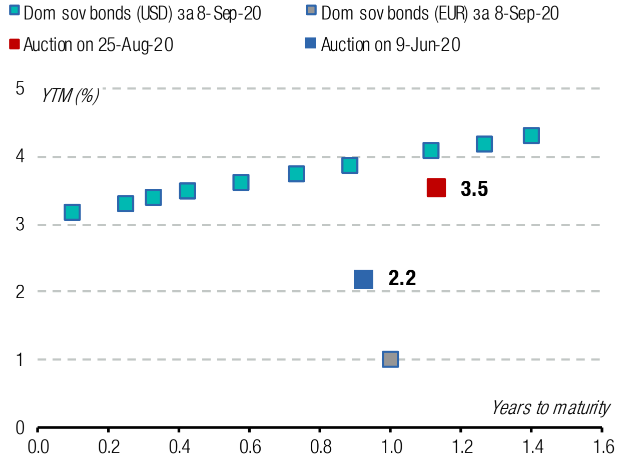
Chart 2. FX-denominated bonds

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 steady

The total amount of banking-sector liquidity is still fluctuating around UAH160bn. This week, liquidity may decline to UAH155bn due to NBU interventions in the FX market and reserves exchange in cash.

Last week, banks decreased the amount of NBU CDs to UAH107.5bn for one day only, and increased their balances in correspondent accounts with the NBU. But later in the week, they increased the amount of CDs above UAH110bn.

Generally, fluctuations were low with only slight impact from the NBU and mostly neutral impact from non-monetary operations. Banks, finally, did not impact liquidity with reserves in cash exchange, while the Treasury impact on liquidity was low. Therefore, the banking sector ended last week with liquidity at UAH164bn, or UAH4bn more than a week before.

ICU view: This week, banks can increase reserves exchange in cash while the NBU is expected to absorb liquidity through sale of hard currency. Additionally, the liquidity may be absorbed to Treasury accounts.

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

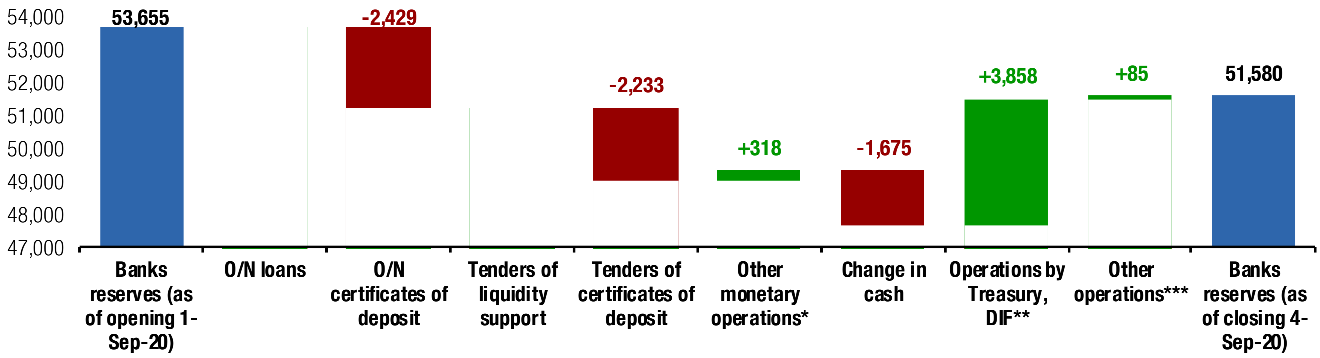
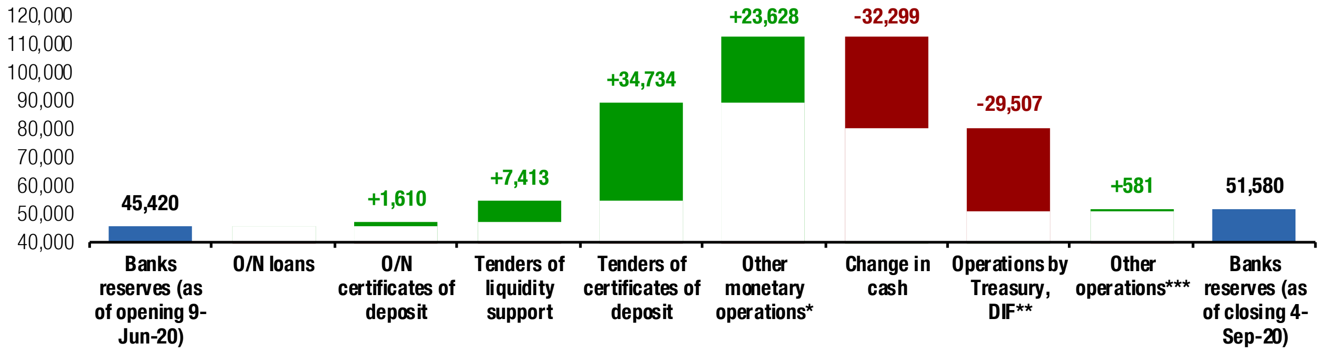


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 slightly weakens

With the beginning of a new month, the hryvnia exchange rate slightly weakens and this week, to satisfy extra demand, the NBU may sell hard currency from reserves. We expect the hryvnia exchange rate to fluctuate within the range UAH27.5–28/US$ during the week.

September started with large interest payments due on five-year local-currency notes, mostly paid to foreigners. This payment caused extra demand for hard currency and slight weakening of the hryvnia to UAH27.71/US$.

NBU purchased just US$11.5m last Friday, the lowest amount during any one week this year, except weeks when the NBU did not purchase hard currency at all. The same amount of intervention was seen at the end of May 2019.

ICU view: This month's demand for hard currency likely will come from importers, as they will replenish their goods' reserves at the beginning of new school year and in anticipation of seasonal business activity. Therefore, we expect the NBU to intervene in the FX market, selling hard currency to restrain weakening. We expect a weakening trend in the hryvnia, but also expect the NBU to keep it within the range of UAH27.5–28/US$.

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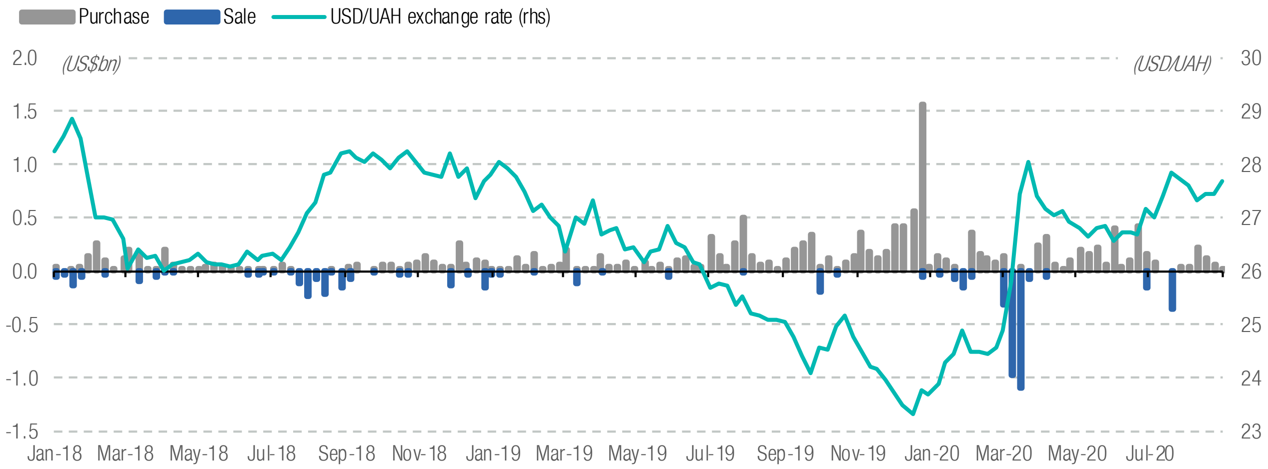
Chart 5. FX market indicators, 3-year history

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 7M20 reaches US$7bn

In July, the C/A surplus decreased compared with previous months amid declining exports, but fundamental factors generally played in favour of Ukraine's external position. Instead, deteriorating devaluation expectations stimulated capital outflows.

In July, the C/A surplus of US$0.4bn was much lower compared with the previous three months as the trade deficit grew to US$0.6bn, the highest monthly level so far this year. That was caused by a rapid decrease in merchandise exports, in particular that of mining and metallurgical products, grain, and sunflower seeds.

In 7M20, the C/A surplus reached US$7bn versus the US$2.9bn deficit in 7M19, while the trade deficit amounted to just US$0.4bn compared with US$6.3bn for 7M19. Ukraine's 7M20 exports declined by 8% YoY, driven mostly by lower prices and sales volume of steel, as well as by depressed transportation services. However, the 7M20 decline in imports was much sharper, by 21% YoY, with a fall of imports of energy products, machinery and equipment, and travel services having made the greatest contribution. In addition, investment income payments fell 88% due to weak financial results of Ukrainian companies with foreign capital. Meanwhile, private remittances were surprisingly steady as they declined only 5% YoY.

In July, the financial account saw a return to capital outflow of US$0.4 bn. First of all, this reflected a deterioration in devaluation expectations, which led to an increase in foreign asset holdings by residents of US$0.9 bn. FDI continued to shrink due to losses of companies with foreign capital. However, for the third month in a row, the private sector has attracted foreign debt capital, and this month, the government joined by placing Eurobonds.

The overall balance of payments ran a small deficit. However, as gold and other reserve currencies appreciated against the US dollar, international reserves continued to grow, to US$28.8 bn.

ICU view: Fundamental factors keep playing in favour of Ukrainian external accounts. Thus, favourable terms of trade, the resilience of remittances and IT services proceeds, and a sharp decline in imports and investment income payments continue to call a C/A surplus. In the coming months, we still expect imports to resume amid

economic recovery and iron ore prices to lower, which will return the C/A to deficit. However, for the full year of 2020, the C/A surplus will be quite sizable.

Instead, worsening devaluation expectations will continue to put pressure on the financial account. Over the remainder of the year, amid a recovery of debt capital inflow, we expect the net capital flow to be close to zero, maybe even switching to small positive values.

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NBU keeps the rate on hold at 6%

Expectedly, NBU Board decided to leave the key policy rate unchanged. We predict that by the end of the year, the NBU will keep the rate at 6% taking a wait-and-see approach. Next year, the NBU will be forced to raise the rate cautiously against the background of growing inflationary pressures.

The NBU's decision was in line with our expectations and those of consensus, while approximately a third of respondents bet on a cut, most often by 50 bp.

According to the NBU, a rate of 6% is an attempt to strike a balance between maintaining moderate inflation and stimulating the economy. In its communication, the NBU paid considerable attention to the recovery of consumer demand and the resultant increase in social standards, considering them as factors of accelerating future inflation. Forward guidance was balanced; namely, the NBU cited factors for possible monetary policy easing (increased negative impact of the coronavirus on domestic demand and business activity) and tightening (likely increase in inflation risks in 2021).

ICU view: So far, despite only two out of six members of NBU Board remaining in their positions over the last two months, the NBU has not significantly changed its monetary policy reaction function. The decision to keep the key rate on hold seems justified as balancing the risk of inflation with the need to support economic recovery.

The NBU's July forecast envisages keeping the rate at 6% to mid-2021 and raising it to 6.5% afterwards. This forecast does not take into account the government's plans to increase the minimum wage by an average of 30% next year, which will certainly have a significant pro-inflationary impact.

Given the still low current inflation and the fragility of the economic recovery from the coronacrisis, the NBU is likely to take a wait-and-see attitude and keep rates on hold until the end of the year. But early next year, raising the minimum wage and accelerating inflation will make a monetary-policy response inevitable. Therefore, the NBU will be forced to raise rates earlier and more than projected in its July forecast. At the same time, in our opinion, steps to raise the rate will be quite cautious, given the NBU new leadership's greater focus on restoring lending and supporting the economy.

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