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

MONDAY, 26 OCTOBER 2020

Domestic liquidity and bonds market

Foreigners' outflow slows

Last week, the portfolios of domestic bills rose for most of bondholder groups, while foreigners slowed selling bills. Since only UAH-denominated instruments will be offered this week, activity will be mostly among banks.

Liquidity outflows to the budget

The total amount of banking-sector liquidity declined last week, mostly due to outflows to the budget accounts. This week, the increase in budget expenditures and VAT refunds may have a stabilizing effect on liquidity.

Foreign exchange market

FX market self-balanced

After five weeks of NBU interventions to sell hard currency, last week, NBU did not participate in the market. The need for local-currency liquidity for month-end tax payments stimulated the supply side in the market, and supported the hryvnia exchange rate.

Economics

Economic recovery loses steam

The economic situation in September deteriorated compared with August based on most indicators, except trade. However, due to the rapid recovery during the summer months, the fall in GDP in 3Q20 slowed to around 5% YoY (est.) compared to 11.4% in 2Q20. The risks to our forecast of a 5.7% decline in GDP in 2020 look to be balanced.

NBU keeps the rate on hold at 6%

For the third time in a row, the NBU Board decided to keep the rate at 6% after a cumulative decrease of 12pp since April of last year. The NBU's new macroeconomic forecast envisages raising the rate to 7.5% next year to counter accelerating inflation.

Banks' reserves market (23 October 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	+0bp	-1,050bp
ON rate (%)	5.37	+0bp	-978bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	56,859	+10.81	+3.34
CDs (UAHm)[3]	110,304	+0.97	+66.47

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) (23 October 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.71
Banks	446,176	+1.11	+28.29
Residents	31,843	+7.15	+19.99
Individuals	8,256	+4.46	-24.51
Foreigners[1]	79,971	-0.24	-19.92
Total	**890,823**	**+0.82**	**+8.35**

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

FX market indicators (23 October 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	28.3167	-0.08	+13.77
EUR/USD	1.1860	+1.21	+6.56
DXY	92.768	-0.98	-4.84
UAH TWI[1]	120.182	-0.87	-8.86

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

Gov't bond quotes[1] (26 October 2020)

Maturity	Bid	Ask
6m	**10.00**	**8.00**
12m	**10.75**	**9.75**
2y	**11.50**	**10.25**
3y	**11.75**	**10.50**
12m ($)	**4.50**	**3.00**
2y ($)	**5.00**	**3.25**

Notes: [1] Actual quotes you can see at www.icu.ua.
Source: ICU.

Domestic liquidity and bonds market

Foreigners' outflow slows

Last week, the portfolios of domestic bills rose for most of bondholder groups, while foreigners slowed selling bills. Since only UAH-denominated instruments will be offered this week, activity will be mostly among banks.

At last week's primary auction, the MoF sold UAH5.7bn (US$200m) of local-currency bills and UAH1.5bn (US$52.7m) of FX-denominated paper. See details in our latest auction review. Actually, FX-denominated bills were key to increasing the portfolios of domestic investors and slowing the decline in foreigners' portfolios.

According to NBU statistics on bondholders' structure, new bills were mostly purchased by banks, but all domestic investors increased their portfolios using USD-denominated bills. Banks increased portfolios by UAH4.8bn to UAH446bn (US$170m and US$15.8bn, respectively), non-banks by UAH2.1bn to UAH31.9bn (US$74m and US$1.1bn, respectively), and individuals by UAH0.3m to UAH8.3bn (US$11m and US$0.3bn, respectively).

Meanwhile, foreigners slowed the decline in their portfolios to UAH150bn (US$5.3m) last week, almost six times lower than a week before, while in UAH-denominated part of portfolio decline was UAH325m (US$11.5m).

ICU view: This week, we will not see material changes in portfolios. Without debt redemptions, most portfolios will change after the primary auction and due to secondary-market trading. As the hryvnia exchange rate should be rather steady, the revaluation of FX-denominated bills will have low impact on portfolios. Therefore, it will mostly be banks that increase portfolios, while other groups of investors may reduce their holdings.

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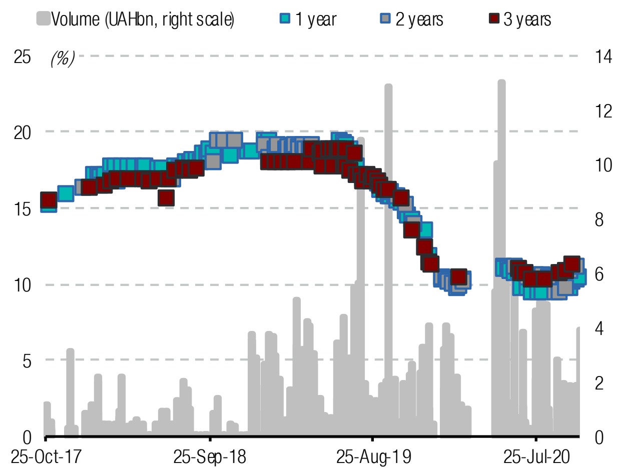
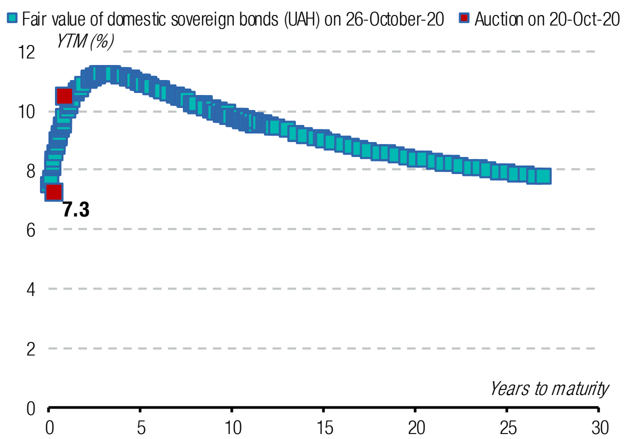
Chart 1. Local-currency bonds

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.

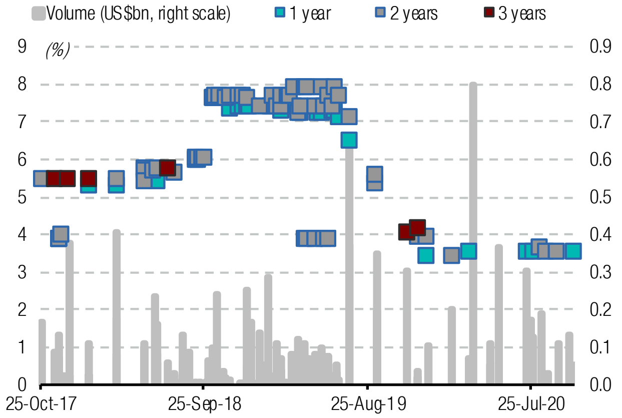
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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.

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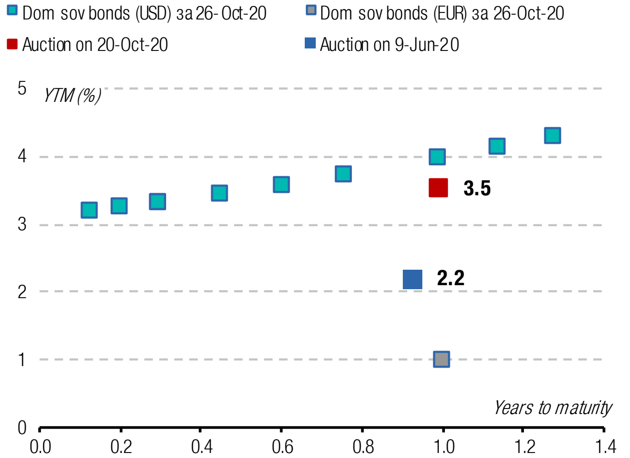

Source: National Bank of Ukraine, Ministry of Finance of Ukraine, ICU.

Liquidity outflows to the budget

The total amount of banking-sector liquidity declined last week, mostly due to outflows to the budget accounts. This week, the increase in budget expenditures and VAT refunds may have a stabilizing effect on liquidity.

Outflows to the Treasury last week amounted in total to UAH1.1bn, which was the key reason for the decline in liquidity. Banks exchange of reserves in cash had low impact, while the NBU did not purchase hard currency, instead injecting liquidity through its operations with just UAH148m of new funds.

ICU view: At the end of the month, liquidity declined slightly, and can stabilize due to large VAT refunds and a likely increase in budget expenditures. However, if these inflows are low, liquidity will continue to decline below UAH170bn.

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

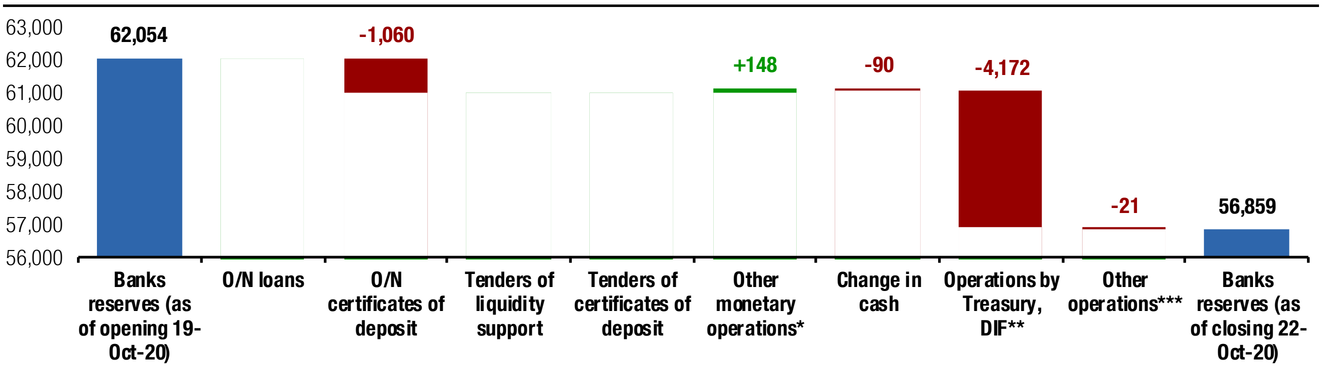
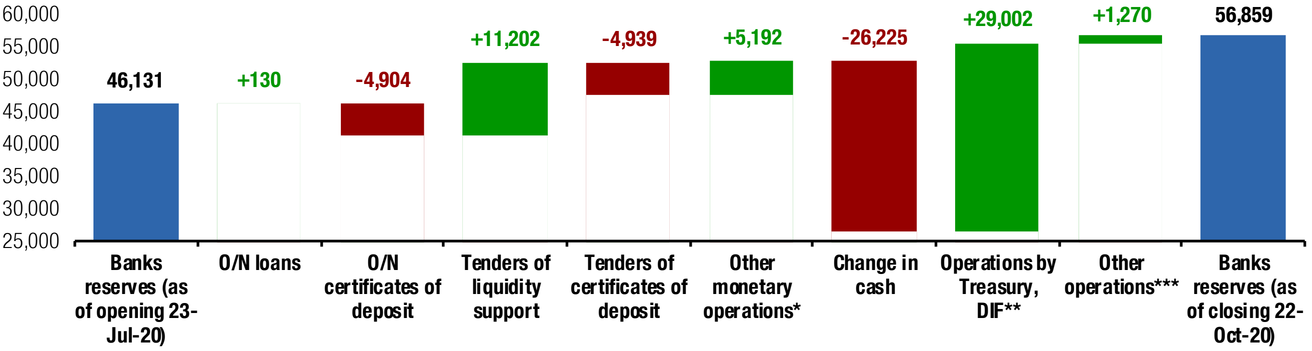


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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

FX market self-balanced

After five weeks of NBU interventions to sell hard currency, last week, NBU did not participate in the market. The need for local-currency liquidity for month-end tax payments stimulated the supply side in the market, and supported the hryvnia exchange rate.

Last week, the hryvnia exchange rate in the interbank market has fluctuated within the range of UAH28.17-28.47/US$, ending last week at UAH28.32/US$ or just 0.1% stronger than a week before. Since the market was self-balanced, it was not necessary for the NBU to intervene.

ICU view: Month-end tax payments continue this week, which means larger hard-currency supply from exporters who need local-currency liquidity to pay taxes. Therefore only VAT refunds can decrease supply and balance the FX market without NBU interventions.

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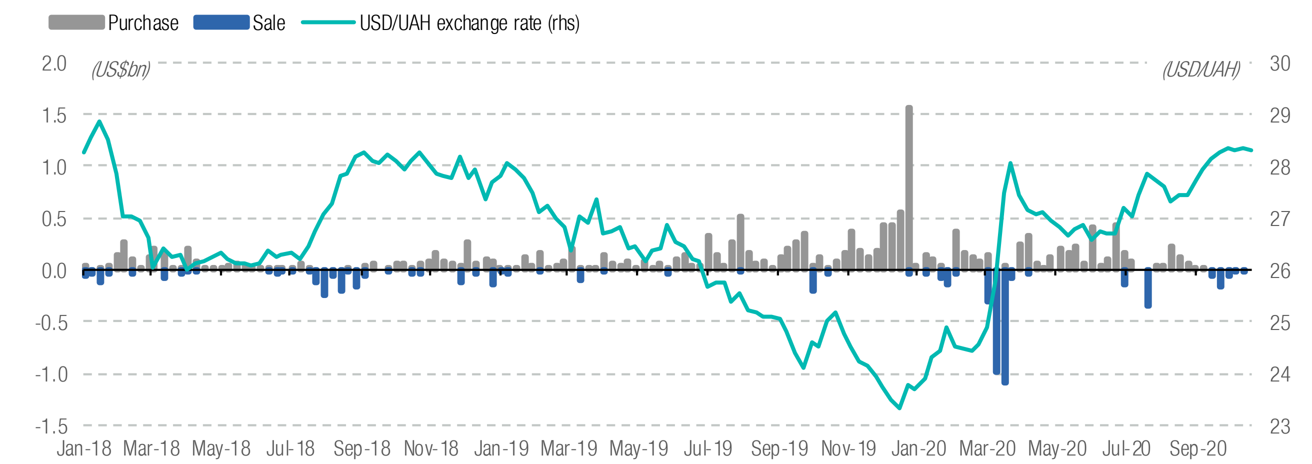
Chart 5. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

Economic recovery loses steam

The economic situation in September deteriorated compared with August based on most indicators, except trade. However, due to the rapid recovery during the summer months, the fall in GDP in 3Q20 slowed to around 5% YoY (est.) compared to 11.4% in 2Q20. The risks to our forecast of a 5.7% decline in GDP in 2020 look to be balanced.

In September, the decline in industrial production decelerated to 4.4% YoY from 5.3% YoY in August; however, compared with August, industrial output contracted by 1.1% MoM SA. This result was mostly determined by worsened performance of food production and the extractive industry. In 9M20, industrial production decreased by 7.0% YoY. The largest contribution to the decline came from a decrease in the output of metallurgy by 12.6% YoY and machinery by 20.6% YoY, coal mining by 16.3% YoY, and electricity generation by 5.3% YoY. At the same time, the output of the chemical industry grew by 7.3% YoY and pharmaceuticals by 1.4% YoY.

Agricultural production fell by 19.2% YoY in September, while in 9M20 the decline deepened to 13.1% YoY. First of all, this decline is due to the later start of harvest and lower yields of early cereals. In addition, livestock volumes continued to decline, by 2.4% over 9M20.

Also, after several months of post-lockdown recovery, transport indicators deteriorated. In September, the fall in passenger and freight turnover deepened to 50.3% and 12.8%, respectively, from 45.8% and 4.2% in August. Mainly, there has been a decrease in passenger traffic by rail and air, most likely reflecting the impact of the increased Covid-19 cases. The decrease in freight turnover occurred primarily on railways due to lower harvest volumes and reduced transportation of construction materials, as well as in pipeline transport after the resumption of gas transit in August.

Instead, indicators of trade turnover were unexpectedly high in September. Thus, the growth of retail sales accelerated to 11.6% YoY. According to our estimates, retail trade turnover grew 2.5% MoM SA. In 9M20, retail sales grew by 6.7% YoY. In addition, in 9M20 wholesale trade turnover grew 1.9% YoY compared with a decrease of 0.2% in 8M20.

ICU view: Based on monthly indicators, we estimate the fall in GDP at about 6% YoY in September after less than 5% YoY in June–July. As a result, in 3Q20, the decline in GDP is estimated to slow to about 5% YoY compared with 11.4% YoY in 2Q20 and 6% YoY in our September forecast. At the same time, a significant contribution (about 1.5pp) to this drop in 3Q20 was provided by weak agricultural performance due to the later start of corn harvesting.

And although this factor will be partially offset in 4Q20, in general, expectations for the harvest of grain and other crops worsen over the year due to adverse weather conditions. Also, due to the increase in COVID-19 cases in Ukraine and neighbouring countries, the risks to further recovery of domestic and external demand are growing.

At the same time, the robust growth of domestic trade indicates that the impact of surging Covid-19 cases has been offset by weak social distancing and ignorance of tightening restrictions on the local level together with flowering of e-trade. Moreover, robust growth of real wages (6% YoY in August) and recovery of the labour market fueled some improvement of consumer sentiment, especially related to the assessment of their own financial stance.

As a result, we estimate the risks to our forecast of a 5.7% GDP decline in 2020 as balanced in both directions. To a large extent, the outcome will be determined by the severity of the government's response to the spread of coronavirus after local elections. Although we expect additional measures to be introduced, their negative

impact on the economy should be much weaker than it was in the spring. However, it is likely that the growth of economic activity in 4Q20 compared with 3Q20 will be weaker than we set in our September forecast (2% QoQ SA). Additional impetus is expected only from agriculture due to the change of seasonality.

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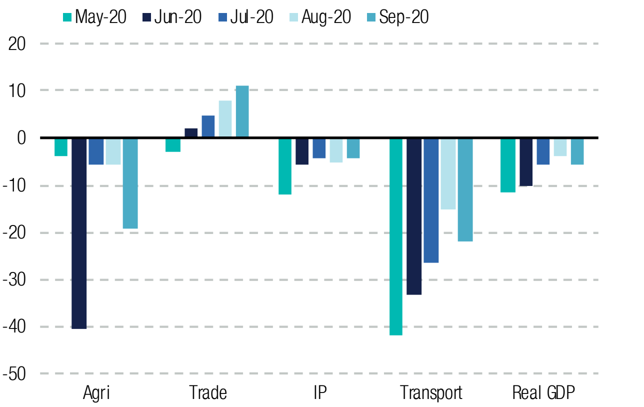
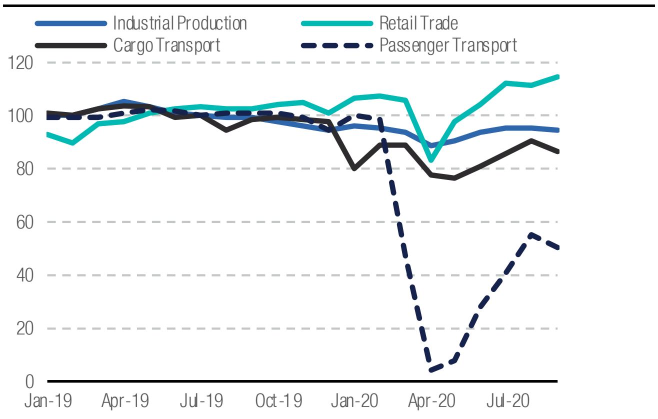
Chart 6. Real GDP and output of by activity, % YoY



Source: Ukrstat, ICU.

Chart 7. Real GDP and output of by activity, SA levels, 2019=100



Source: Ukrstat, ICU.

NBU keeps the rate on hold at 6%

For the third time in a row, the NBU Board decided to keep the rate at 6% after a cumulative decrease of 12pp since April of last year. The NBU's new macroeconomic forecast envisages raising the rate to 7.5% next year to counter accelerating inflation.

The NBU revised down the inflation forecast for this year to 4.1% YoY from 4.7% YoY in the July forecast due to an increase in the food supply. Instead, the NBU raised its inflation forecast for next year to 6.5% YoY from 5% in the July forecast, given a stronger increase in the minimum wage than in the previous forecast. The NBU predicts a return to the 5% target in 2022.

To achieve this, the forecast envisages raising interest rate next year to 6.5% in April, then 7% in July, and to 7.5% in September, with a further decrease in 2022 to 6.5%.

Communication regarding future decisions has remained balanced. The NBU noted the opportunity to support the economy through a further reduction in the rate if an increase in Covid-19 cases leads to a slowdown in the recovery of domestic demand. At the same time, the NBU has warned of a rate hike next year, focusing on the approved parameters of fiscal policy.

The GDP forecast remained almost unchanged, namely 6% decline this year, and growth of 4.2% next year, and 3.8% in 2022. Also, the NBU released the main parameters of the balance of payments projection, envisaging transition from the current account surplus of about 3% of GDP this year to a deficit of 2% of GDP next year and 5% of GDP in 2022. Accounting for continued cooperation with the IMF, reserves are projected at $29-30 bn in the next years.

ICU view: The NBU's decision came as no surprise to the market and was expected by the vast majority of analysts, including us. However, some concerns arose that against the background of the low September inflation print and deteriorating prospects of IMF funding, the new leadership of the NBU will move to more substantial monetary policy easing, focusing more on political considerations.

However, the new NBU forecast fully corresponds to the "technocratic status" of the institution and is an acceptable balance between the NBU's goals of achieving inflation targets and supporting the economy in the current environment. Although in September we predicted that the NBU would be forced to raise rates in 1Q21, new information, such as an increase in Covid-19 cases and low September inflation, are strong arguments for postponing this step to April. Moreover, the NBU currently sees a more aggressive policy than expected by us in September (7% rate at the end of 2021) and consensus (the rate only marginally higher than 6% at the end of 2021). Of course, the implementation of this plan, other things being equal, will also be an important check on the consistency of the new NBU leadership in conducting monetary policy.

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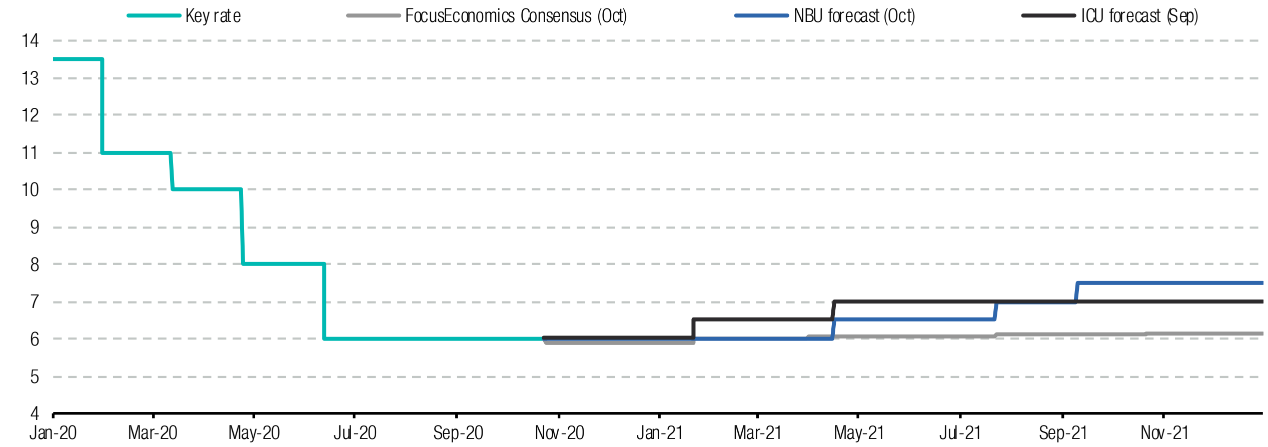
Chart 8. Key rate forecast (%)



Source: NBU, FOCUSECONOMICS, ICU

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