Focus	Markets	Research team
Ukraine	**Domestic liquidity, government bonds, FX market, and macro**	**Sergiy Nikolaychuk** **Alexander Martynenko** **Taras Kotovych**

Weekly Insight

Ukraine continues active borrowings

Key messages of the today's comments

MONDAY, 28 DECEMBER 2020

Domestic liquidity and bonds market

Ukraine continues active borrowings

The Ministry of Finance continued to actively borrow in the local and international markets to cover the state budget deficit. This week, the MoF will attract at least UAH10bn (US$350m) from the primary bonds auction.

Liquidity up at year end

Banking-sector liquidity was volatile last week, falling to UAH150bn on Wednesday and recovering to almost UAH180bn last Thursday. This week, we expect active budget expenditures causing liquidity increase, only partially restrained by new bond purchases and reserves exchange in cash.

Foreign exchange market

Hryvnia exchange rate returns in the expected range

The hryvnia continued to weaken last week within the expected range of UAH28–28.5/US$. This week, despite increased demand for hard currency, the exchange rate will fluctuate near the upper band of this corridor until the end of the year, as we expected.

Economics

Industry rebounds, retail sales remain elevated

Despite the COVID-19 outbreak, economic activity continued to be resilient in November. Moreover, the improvement in the external environment, especially in the iron ore and steel markets, helped to revive the industry, which also stimulated freight transport. Domestic consumer demand remained robust, leading to elevated retail sales and a recovery in wholesale trade.

Banks' reserves market (24 December 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	+0bp	-750bp
ON rate (%)	5.65	+49bp	-535bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	52,135	-19.59	-12.71
CDs (UAHm)[3]	98,371	+6.56	-12.70

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) (24 December 2020)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.71
Banks	507,827	+3.60	+54.72
Residents	43,365	+10.29	+67.96
Individuals	10,653	+6.06	+10.62
Foreigners[1]	84,368	+2.83	-28.05
Total	**970,977**	**+2.64**	**+18.79**

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

FX market indicators (24 December 2020)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	28.3647	+1.28	+21.97
EUR/USD	1.2187	-0.57	+9.90
DXY	90.323	+0.34	-7.51
UAH TWI[1]	117.219	-0.59	-16.80

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

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

Maturity	Bid	Ask
6m	**10.50**	**9.00**
12m	**12.00**	**10.50**
2y	**12.25**	**11.00**
3y	**12.50**	**11.25**
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

Ukraine continues active borrowings

The Ministry of Finance continued to actively borrow in the local and international markets to cover the state budget deficit. This week, the MoF will attract at least UAH10bn (US$350m) from the primary bonds auction.

Last week, the Ministry borrowed UAH22bn (US$784m) through new domestic bond issuance, most of which was in local currency. These funds were provided mostly by local banks, but a small part of borrowings was from foreigners. As a result, there were issues mostly with short-term maturity. Despite foreigners becoming active in the local market, interest rates continued to rise for some bonds. See details in the auction review.

The government continued to attract funds externally, too. Last week, the Cabinet of Ministers adopted a resolution to take a six-month loan from Deutsche Bank, AG up to US$350m priced at three-month LIBOR plus 5.75%. With the current level of LIBOR at 0.24%, the cost of this loan is about 6%.

The government will have an early redemption option, e.g., at the time when it is able to again issue Eurobonds. Conditions of this early redemption option should be included in the loan agreement.

ICU view: The MoF is doing its best to obtain budget financing and borrow the maximum amount of funds this year. This should allow it to finance budget expenditures and to accumulate sufficient funds for the beginning of the New Year, to cover budget expenditures during the first half of January. However, we assume that net budget financing this year will be lower than planned, about UAH300bn (US$11bn), and will amount to UAH250bn (US$9bn).

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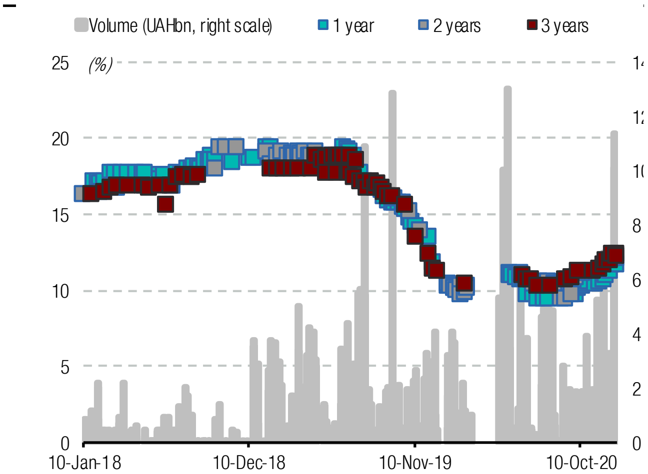
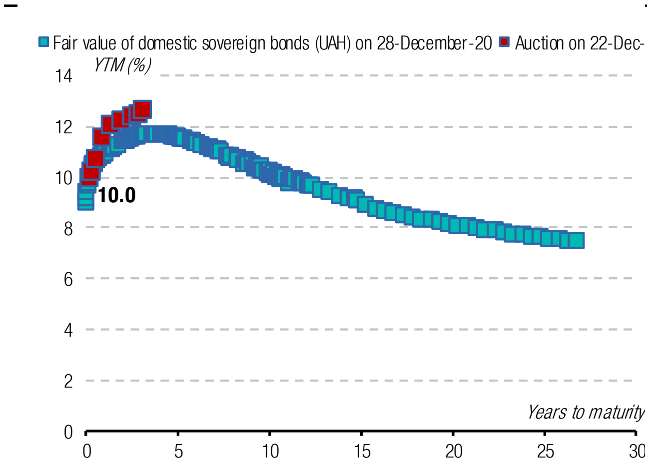
Chart 1. Local-currency bonds

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.

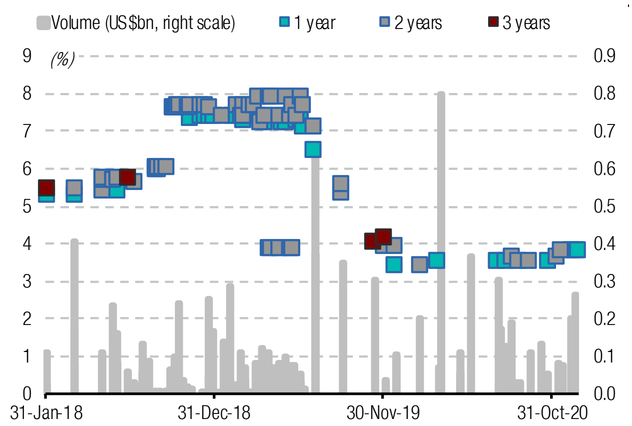
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

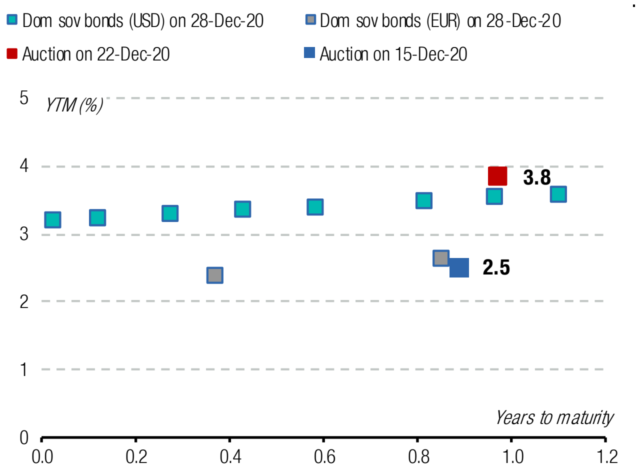
Chart 2. FX-denominated bonds

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 up at year end

Banking-sector liquidity was volatile last week, falling to UAH150bn on Wednesday and recovering to almost UAH180bn last Thursday. This week, we expect active budget expenditures causing liquidity increase, only partially restrained by new bond purchases and reserves exchange in cash.

Last Thursday, the Treasury paid almost UAH10bn in VAT refunds, which compensated the outflow seen last Wednesday due to new bond purchases and tax collection. With active expenditures, the Treasury can cause large inflow of funds in liquidity this year, which is now just UAH2bn of inflows.

Reserves exchange in cash was still the largest outflow from banking-sector liquidity during 2020. Last week outflow amounted to UAH5.8bn and in total, cash exchanged was UAH127bn or almost twice the amount as during the previous three years combined.

Hryvnia weakening (see comment below) induced the NBU to intervene in the FX market by selling hard currency. Therefore, last week, the NBU absorbed UAH1.2bn through the FX market, but provided two banks with UAH5.2bn of three-month loans.

ICU view: Last week, banking-sector liquidity rose UAH16bn to UAH177bn, and with active budget expenditures, it should increase further. We do not expect that all budget expenditures will be made this year in full, but part of funds borrowed in local currency recently should return to the banking system this week.

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

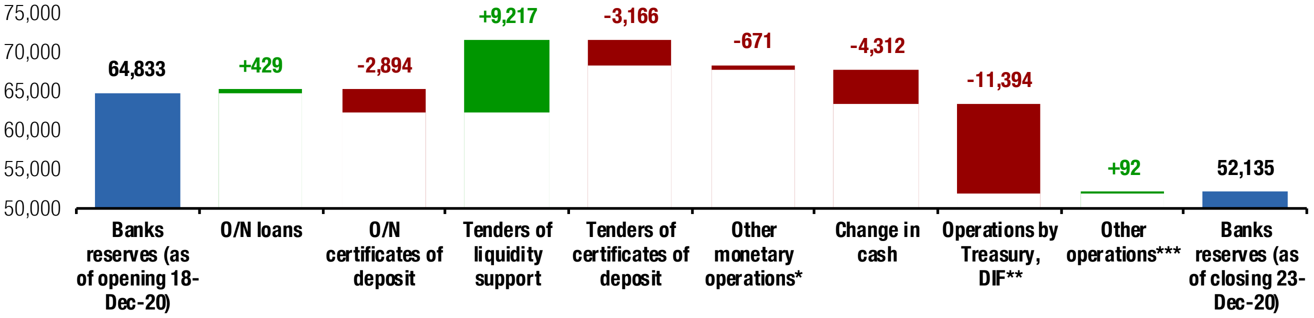
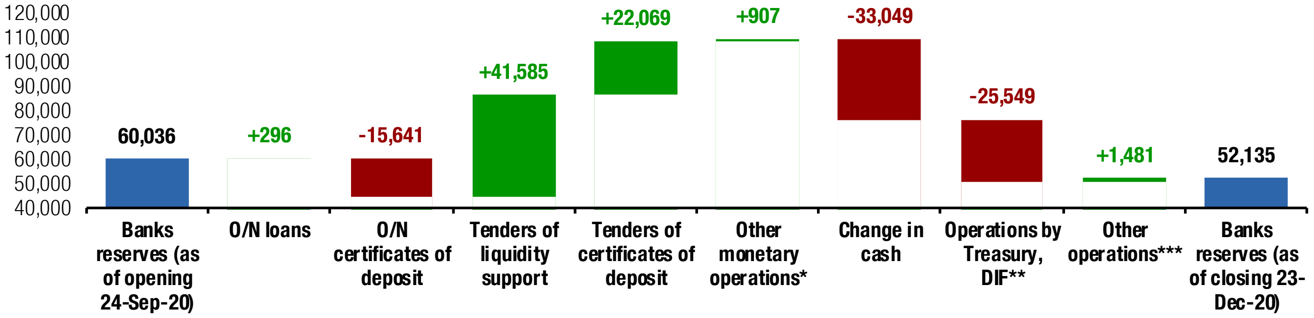


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 exchange rate returns in the expected range

The hryvnia continued to weaken last week within the expected range of UAH28–28.5/US$. This week, despite increased demand for hard currency, the exchange rate will fluctuate near the upper band of this corridor until the end of the year, as we expected.

Demand for hard currency continues to be greater than supply, and last week's large VAT refund will decrease supply of hard currency as well. Probably, only the NBU will support the supply side to restrain hryvnia weakening, as last week's note purchases by foreigners only marginally supported the hryvnia.

In total, foreigners purchased new bonds at a US$50m equivalent or just one-fourth of the amount they bought a week before. This supply of hard currency was insufficient to satisfy demand, and the NBU had to intervene in the market and sell US$43m from reserves. Thanks to the NBU, the hryvnia weakened just by 1.3% last week to UAH28.37/US$.

ICU view: Active budget expenditures and closing contracts will increase hryvnia-denominated liquidity in the banking system, causing an increase in demand for hard currency. This extra demand can be satisfied by the NBU and partially by foreigners. Therefore, the hryvnia exchange rate will fluctuate close to UAH28.5/US$ this week, as we expected in our Macro Review.

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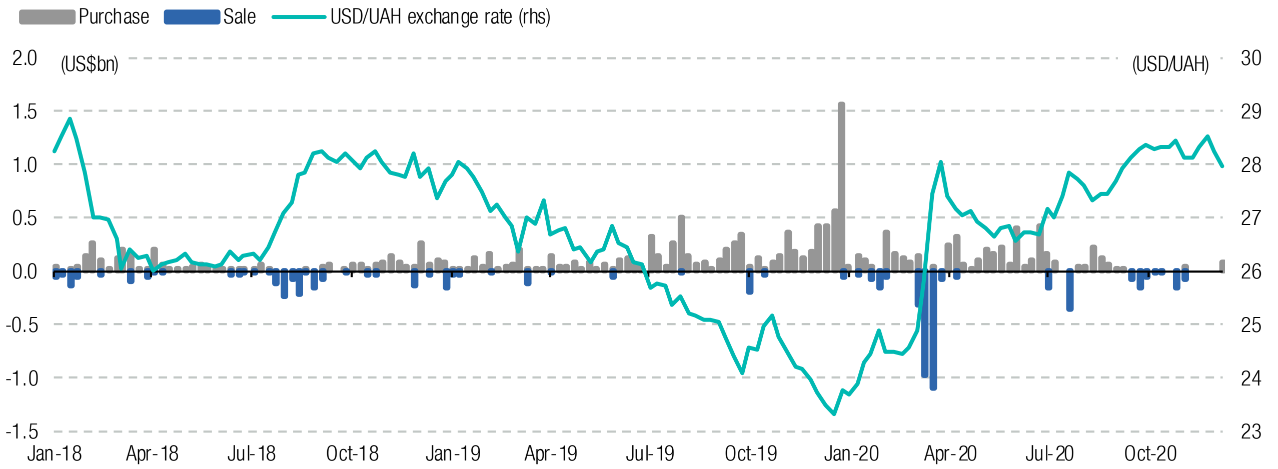
Chart 5. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

Industry rebounds, retail sales remain elevated

Despite the COVID-19 outbreak, economic activity continued to be resilient in November. Moreover, the improvement in the external environment, especially in the iron ore and steel markets, helped to revive the industry, which also stimulated freight transport. Domestic consumer demand remained robust, leading to elevated retail sales and a recovery in wholesale trade.

In November, the decline in industrial production slowed to 0.3% YoY (from 5% YoY on average over the previous five months); in seasonally adjusted terms industrial output increased by 1.5% MoM. First, the performance of metal ore mining and metallurgical production improved significantly, as output surged by 10.6% YoY and 8.2% YoY, respectively. On the one hand, last year's base of comparison was very low, on the other, strong demand from China and extremely high prices have contributed to a further increase in domestic production.

Also, in November, volumes of agricultural production were higher than last year, by 11.3% YoY, and in 11M20, the decline slowed to 12.4% YoY. This was primarily due to the acceleration of maize harvesting.

The improvement in industry and agriculture stimulated freight transport, where the decline slowed to 7.9% YoY compared with 9.8% YoY in October. At the same time, the performance could be much better if pipeline transport did not show a decline by almost a third. In addition, the growth of wholesale trade accelerated to 2.6% YoY for 11M20, compared with 2.1% YoY for 10M20.

Further, despite the COVID-19 outbreak, the growth rate of retail sales remained high—12.1% YoY in November. However, the spread of the coronavirus has caused some decline in social mobility. Thus, in November, passenger turnover was only 45% of the level of last year, which was the lowest ratio since July. Rail transport decreased the most compared with previous months.

ICU view: As we expected earlier, the autumn Covid-19 outbreak caused a sharp slowdown in economic recovery, primarily due to increased social distancing. At the same time, in contrast to the spring lockdown, GDP losses are quite insignificant as

both businesses and the population have already adapted to the new norms. In addition, a favourable external environment has given additional impetus to the economy. Therefore, we see more upside risks for our GDP forecast for 4Q20 and for FY2020 (current estimate is a decline of 4.8%).

In 1Q20, we anticipate an additional positive effect for economic activity from the growth of government spending at the end of this year, which was made possible by active borrowing by the government from both official sources and the market.

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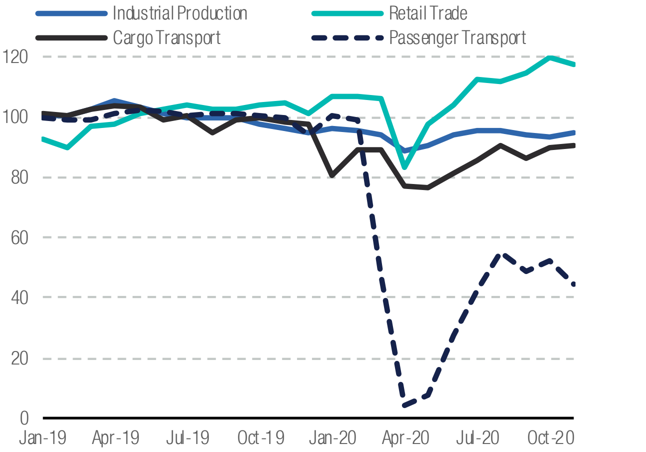
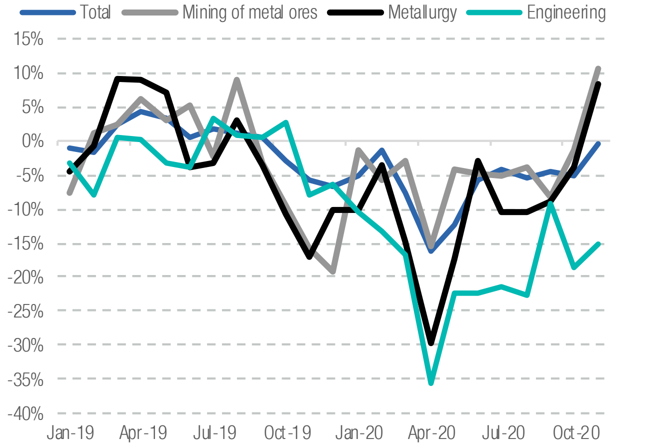
Chart 6. Real GDP and output of activities, SA levels, 2019=100



Source: Ukrstat, ICU.

Chart 7. Industrial output, % YoY



Source: Ukrstat, ICU.

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