Focus
**Ukraine**

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

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# Weekly Insight

## CPI inflation hits NBU target of 5%

**Key messages of the today's comments**

**MONDAY, 18 JANUARY 2021**

### Domestic liquidity and bonds market

#### Foreigners' buying activity increases

Foreigners' portfolios of Ukrainian local-currency bonds rose again last week. We expect they will rise once more this week due to offering of six-year notes.

#### Liquidity expectedly declines

The total amount of banking-sector liquidity expectedly declined last week due to outflows to budget accounts. This factor will be determinative for liquidity this week, too.

### Foreign exchange market

#### Hryvnia remains within the UAH28–28.5/US$ range

Active selling of hard currency by foreigners last week caused short-lived hryvnia appreciation, but this week the hryvnia can weaken a bit toward the top bound of UAH28–28.5/US$ range.

### Economics

#### CPI inflation hits NBU target of 5%

In December, headline inflation expectedly accelerated and hit the NBU target. We expect inflationary pressure to intensify in the near-term due to a surge of global energy and agri prices and a hike in the minimum wage. But in the medium-term, UAH appreciation amid robust external accounts and the pandemic-induced drag on demand should keep inflation close to the upper band of target range and restrain the NBU from the raising key rate in 1H21.

**Banks' reserves market (15 January 2021)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU rate (%)[1] | 6.00 | +0bp | -750bp |
| ON rate (%) | 5.21 | +43bp | -649bp |
| ON $ swap (%) | N/A | ... | ... |
| Reserves (UAHm)[2] | 52,665 | +21.10 | -13.67 |
| CDs (UAHm)[3] | 121,856 | -24.43 | -26.25 |

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) (15 January 2021)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU | 324,577 | +0.00 | -3.71 |
| Banks | 525,561 | +1.05 | +58.33 |
| Residents | 58,126 | +0.05 | +116.83 |
| Individuals | 11,439 | +1.97 | +13.86 |
| Foreigners[1] | 89,924 | +5.55 | -23.28 |
| **Total** | **1,009,814** | **+1.05** | **+22.68** |

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

**FX market indicators (15 January 2021)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| USD/UAH | 28.1450 | -0.41 | +17.04 |
| EUR/USD | 1.2082 | -1.11 | +8.36 |
| DXY | 90.772 | +0.75 | -6.64 |
| UAH TWI[1] | 118.263 | +0.92 | -12.64 |

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

**Gov't bond quotes[1] (18 January 2021)**

| 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

## Foreigners' buying activity increases

Foreigners' portfolios of Ukrainian local-currency bonds rose again last week. We expect they will rise once more this week due to offering of six-year notes.

Last week, foreigners purchased almost UAH4.5bn (US$160m) of local-currency instruments, and based on primary auction results, there were mostly half-year and one-year papers. Nonetheless, all rates at primary market remained steady. More details in auction review.

This year, foreigner's portfolios are up by UAH4.7bn (US$170m) and their share in domestic debt was up to 9%. Their portfolios now amount to UAH90bn (US$3.2bn), although that figure is UAH39bn less than the highest amount seen last February of UAH129bn (US$5.3bn).

The portfolios of domestic investors are near a maximum. Banks' portfolios are UAH525bn (US$18.7bn) or 52% of total outstanding, non-banks – UAH58bn (US$2.1bn), while individuals increased investments to a historical maximum of UAH11.5bn (US$0.4bn), which is just slightly above of 1% of total bonds outstanding.

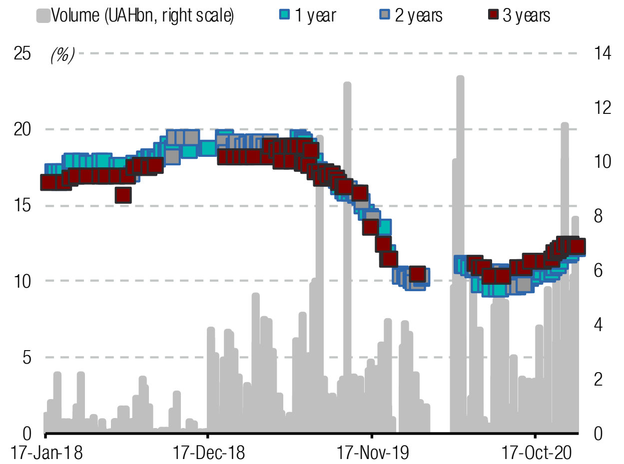
***ICU view: This week MoF will redeem almost UAH12bn (US$0.4bn) of bills, therefore, portfolios will see impact from both redemptions and new issues. However, we anticipate that foreigners will continue to increase investments in local-currency debt but at a slower pace. New investments will be lower during following weeks too, as investors will wait for progress in negotiations with the IMF regarding new tranche, especially amid the new government initiative to regulate natural gas prices.***

***This week, the MoF is starting to set limits for the shortest maturities, which will increase competitiveness for them and can allow the MoF to reduce interest rates. As for now, banks can get a 400bp premium between rates for the shortest, three-month maturity, to the NBU refinancing rate. Therefore, the Ministry will try to reduce this premium and get a lower cost of borrowing, especially at the beginning of the year, when financing needs can be limited.***

***Taras Kotovych, Kyiv, (044) 377-7040 ext.724***

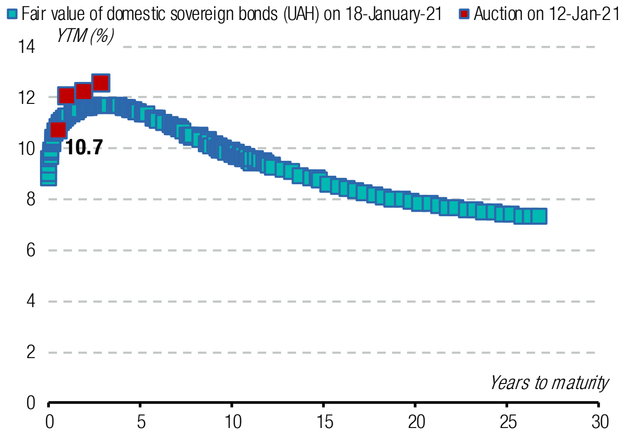
**Chart 1. Local-currency bonds**

*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.

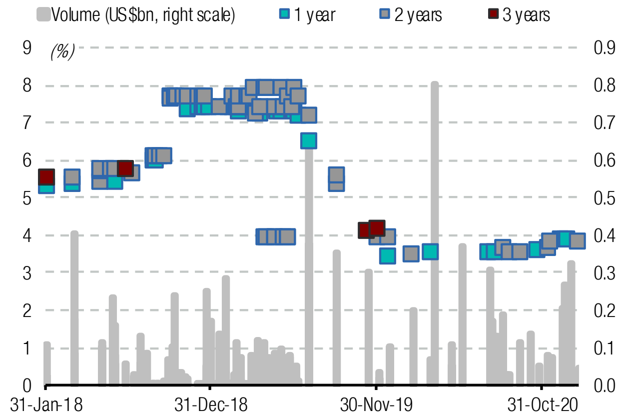
*Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions*




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

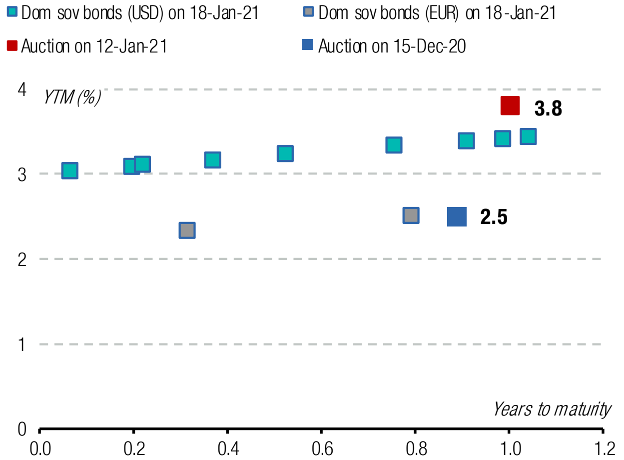
**Chart 2. FX-denominated bonds**

*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 expectedly declines

The total amount of banking-sector liquidity expectedly declined last week due to outflows to budget accounts. This factor will be determinative for liquidity this week, too.

Despite the NBU providing UAH8.7bn of new refinancing loans, the total amount of liquidity did not return to the previous week's level.

The main reason for the decline was outflow to budget accounts amounting to UAH121bn. Most likely, given large borrowings and collection of UAH19.8bn of revenues to the state budget, the government is not hurry to make expenditures. This is due to needs to adopt new budget programmes for this year, but, regardless, the Treasury absorbed UAH20.8bn of funds this year.

However, demand from individuals for cash declined, causing banks' exchange of cash in reserves at UAH1.3bn last week.

***ICU view: This week, liquidity will be under the impact of Treasury operations. Investors will not be able to refinance debt repayments in full as short-term bills***

***offering is limited. Therefore, new borrowings will likely be lower than repayments, causing inflow into liquidity. On the other hand, month-end tax payments can concentrate next week, and will meet VAT refunds. Thus, this week outflows will be low, while still causing a slight decline in liquidity.***

***Taras Kotovych, Kyiv, (044) 377-7040 ext.724***

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

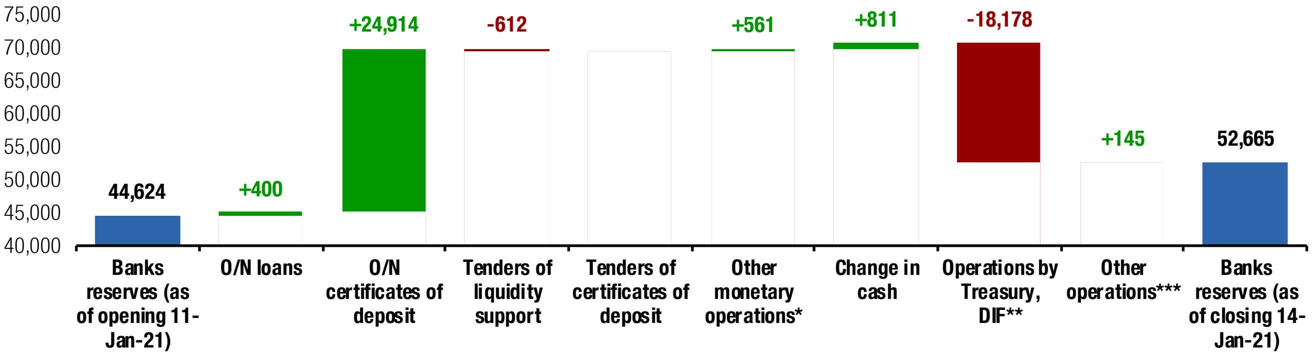
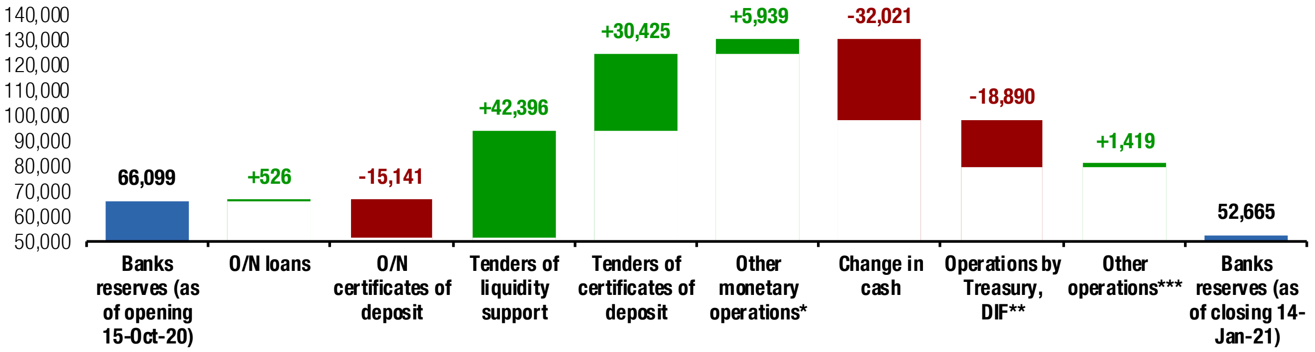



**Chart 4. Banks reserves usages over last 90-day period (UAHm)**




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 remains within the UAH28–28.5/US$ range

Active selling of hard currency by foreigners last week caused short-lived hryvnia appreciation, but this week the hryvnia can weaken a bit toward the top bound of UAH28–28.5/US$ range.

Purchases of UAH4.5bn of new local-currency bills by foreign investors determined extra supply of hard currency in the market and caused the hryvnia to appreciate to UAH28.02/US$ last Wednesday. Later in the week, the hryvnia weakened a bit and by the end of week was UAH28.15/US$, but still stronger by 0.4% compared with the previous week.

For the most part, the NBU did not participate in the FX market and purchased just US$20m to international reserves.

***ICU view: Demand for hard currency can rise slightly this week, especially due to large debt repayments, where some local investors will decide to partially exchange funds in hard currency, and importers can increase purchases of hard currency for new goods after the holidays. However, supply from foreigners will be lower, while supply from locals for tax payments will also be low, as exporters will prefer to wait for VAT refunds.***

***Therefore, despite the global situation in commodities markets still positive for Ukraine, large selling of FX will not take place. Therefore, we expect the hryvnia exchange rate will stay within the same range of UAH28–28.5/US$ with slight weakening toward its upper bound. Later, we expect prevailing seasonal appreciation pressure with support from foreign investors in local-currency debt and high global prices for the traditional Ukrainian exports.***

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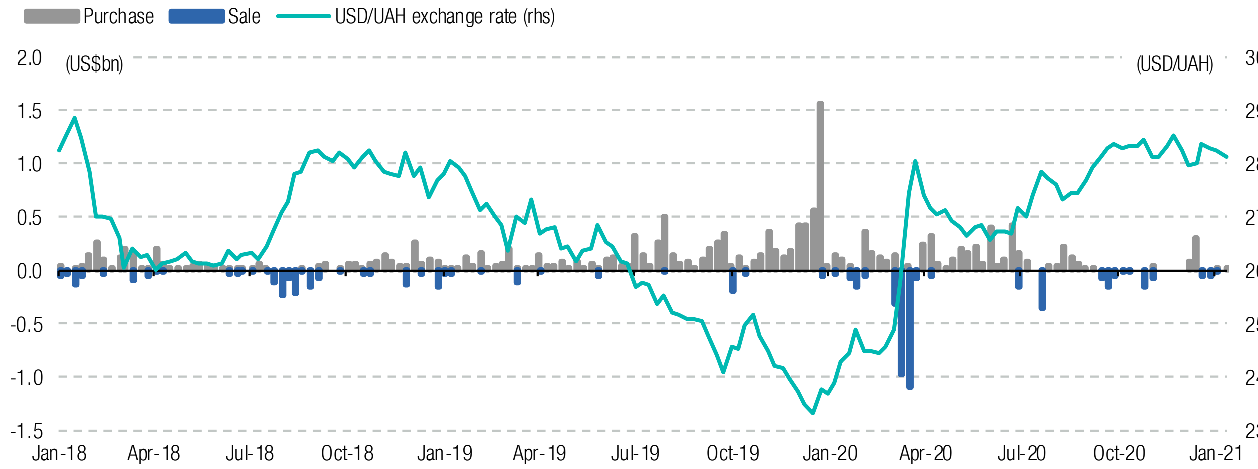
**Chart 5. FX market indicators, 3-year history**

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




Source: NBU, Bloomberg, ICU.

# Economics

## CPI inflation hits NBU target of 5%

In December, headline inflation expectedly accelerated and hit the NBU target. We expect inflationary pressure to intensify in the near-term due to a surge of global energy and agri prices and a hike in the minimum wage. But in the medium-term, UAH appreciation amid robust external accounts and the pandemic-induced drag on demand should keep inflation close to the upper band of target range and restrain the NBU from the raising key rate in 1H21.

In December, consumer prices grew by 0.9% MoM and annual inflation accelerated further to 5.0% YoY from 3.8% YoY in November. The outturn was higher than Bloomberg consensus (4.8%), our nowcast (4.5%), and NBU's October forecast (4.2%).

The surge was partly due to unwinding of base effects. In addition, December's annual inflation was mostly driven by food and energy components reflecting global trends. Namely, food inflation continued its acceleration to 5.2% YoY from 1.4% YoY in September. While it was relatively broad-based, the main contribution was provided by accelerated prices of sunflower oil to 22% YoY, eggs to 30% YoY, and sugar to 48% YoY. Sharp recovery of global oil and gas prices caused the acceleration of prices growth for fuel (by 6% in November–December) and utilities (to 13.6% YoY).

Meanwhile, fundamental inflation pressure is stabilizing. Core inflation rose to only 4.5% YoY; a MoM SA increase in core CPI was close to 5% in annualized terms last months. Outbreak of COVID-19 cases kept the price growth for many nonessential goods and services muted, while the exchange rate was stronger than anticipated.

***ICU view: Looking ahead, further moves of food and energy prices, an average electricity tariff hike, and a 20% increase in minimum wage will probably put additional upward pressure on inflation. As a result, the headline rate is likely to edge higher in the coming months and exceed the upper bound of target range as soon as February.***

***However, there are still reasons to think that this year headline inflation will hover not far from the upper bound of the target range as the ongoing food-price spike starts to unwind. Moreover, the economy's large output gap is likely to keep underlying inflation pressure stable, and the recent and expected strengthening of UAH exchange rate will provide an additional drag on prices growth.***

***With that said, we expect the NBU to maintain a slightly accommodative policy stance, tolerating headline inflation exceeding the target range amid prevailing supply-side factors. Sure, there is some bias for an earlier hike should inflation expectations start to decelerate or demand recover faster. But we believe that such hikes are unlikely until the NBU sees strong evidence of robust recovery of economic activity and underlying inflation pressure. Thus, we maintain our view that the NBU will keep the rate on hold at the next meeting on Thursday and start a new tightening cycle not until 2H21.***

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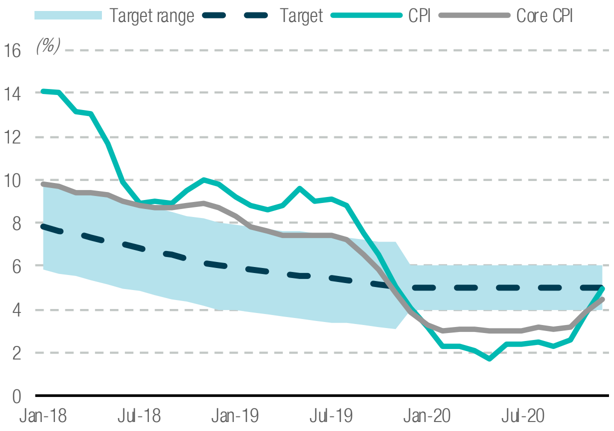
**Chart 6. CPI, core CPI and target, YoY, %**

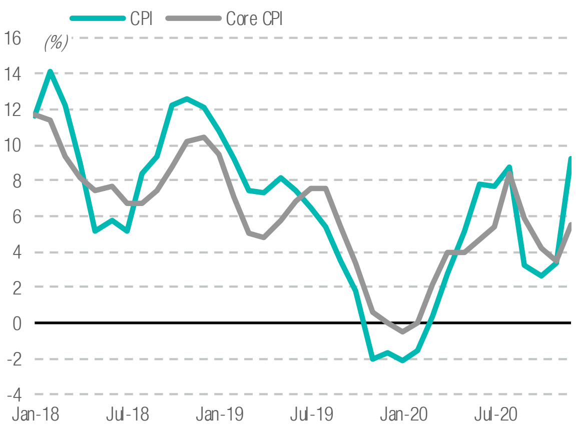
*(In December, both headline and core inflation returned to target range after being below the range since the beginning of the year)*




Source: Ukrstat, NBU, ICU.

**Chart 7. CPI and Core CPI, 3MA MoM SAAR, %**

*(Three-month moving average of seasonally adjusted annualized rate of growth compared with the previous month)*




Source: Ukrstat, ICU.

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