Focus
Ukraine

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

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Weekly Insight

NBU keeps rate on hold at 6%

Key messages of the today's comments

MONDAY, 25 JANUARY 2021

Domestic liquidity and bonds market

Individuals' bond portfolios grow to record-high levels

Vast supply of a wide range of local-currency bonds allowed investors to increase their portfolios, and for individuals to reach a new record amount. This week, both foreigners and locals can increase their UAH bonds holdings.

Liquidity still high

Low collection of budget revenues and enough funds for expenditures caused inflow of funds from the Treasury to banking-sector liquidity, keeping it high. This week, liquidity will fluctuate due to month-end tax payments and VAT refunds.

Foreign exchange market

Hryvnia appreciates

The hryvnia will end the month with a self-balanced FX market, and this week can appreciate a bit, with a chance to cross the UAH28/US$ level.

Economics

Industrial production returning to a pre-pandemic trajectory

In December, industrial production surged by 4.8% YoY, showing positive YoY growth for the first time since September 2019. Indicators of agriculture and retail trade also improved significantly compared with last year. As a result, a GDP decline in 2020 should be much lower (4.2–4.4%) than previously estimated. In addition, growth momentum and favourable external conditions provide a solid basis for economic activity at the start of this year, even amid lockdown restrictions.

NBU keeps rate on hold at 6%

The NBU has been keeping the rate at 6% since June of last year. The NBU's new macroeconomic forecast envisages raising the rate at the next meeting in March. However, we see a high probability that the rate increase will be deferred, possibly even to 3Q21.

Banks' reserves market (22 January 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	6.00	+0bp	-750bp
ON rate (%)	5.16	-7bp	-631bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	67,044	+13.12	+7.15
CDs (UAHm)[3]	123,180	+0.21	-29.66

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) (22 January 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	324,577	+0.00	-3.71
Banks	524,544	-0.28	+60.58
Residents	58,925	+1.63	+144.36
Individuals	11,970	+4.42	+24.23
Foreigners[1]	90,910	+0.98	-25.13
Total	**1,011,113**	**+0.09**	**+23.46**

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

FX market indicators (22 January 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	28.1613	+0.06	+15.16
EUR/USD	1.2171	+0.74	+9.72
DXY	90.238	-0.59	-7.47
UAH TWI[1]	118.200	-0.05	-11.62

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

Gov't bond quotes[1] (25 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

Individuals' bond portfolios grow to record-high levels

Vast supply of a wide range of local-currency bonds allowed investors to increase their portfolios, and for individuals to reach a new record amount. This week, both foreigners and locals can increase their UAH bonds holdings.

Last week, the MoF offered local-currency paper with maturities from three months up to six years. Amid the redemption of UAH12bn (US$420m), the Ministry saw large demand and was able to refinance this redemption. With limited offering of three-month bills, the Ministry sharply decreased interest rates although they allowed the rates on some longer bills to increase slightly in order to receive greater proceeds. More details in auction review.

Some groups of bondholders increased portfolios of government bonds. Foreigners purchased an additional UAH0.9bn (US$32m) of bills, while non-banks purchased UAH0.9bn (US$32m). Individuals purchased UAH0.5bn (US$18m) of new paper, setting a record amount of bonds in their portfolios.

After a slight decline in portfolios in 2020, individuals once more increased investments and they now hold almost UAH12bn (US$430m) of government bonds. Included are UAH4.6bn of local-currency bonds, record large amount.

ICU view: This week, the Ministry will offer only maturities from five months up to three years, which may result in lower demand than earlier this year. In fact, the Ministry does not need large proceeds, as it has currently refinanced all local-currency repayments scheduled for January. On the other hand, demand from foreigners may increase, which could induce the MoF to borrow more and accumulate funds for the future repayments.

The Ministry may try to decrease the cost of borrowing, partially setting limits for short-term bills, and decreasing the premium to the NBU key policy rate. In addition, the Ministry can reject more bids and decrease rates by a few basis points for longer maturities.

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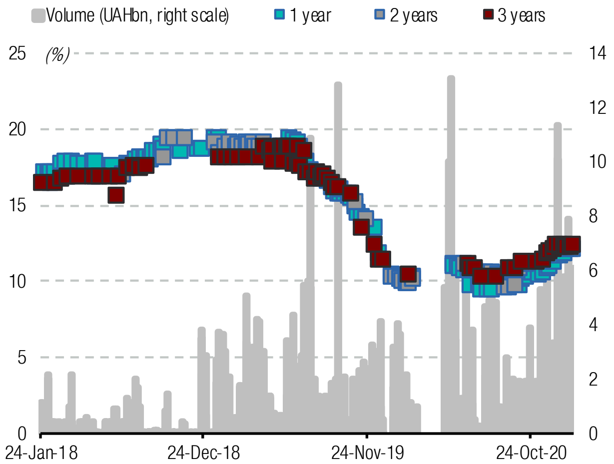
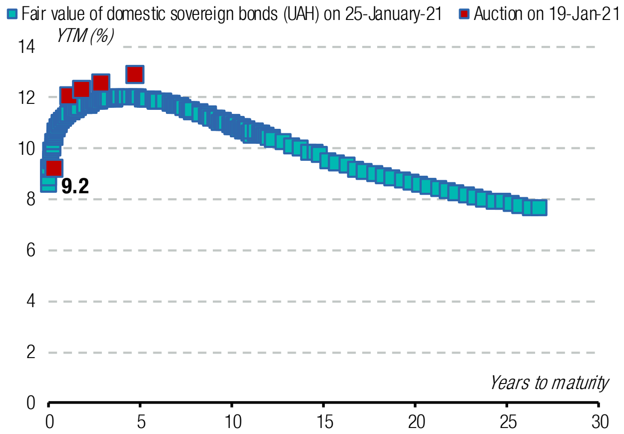
Chart 1. Local-currency bonds

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.

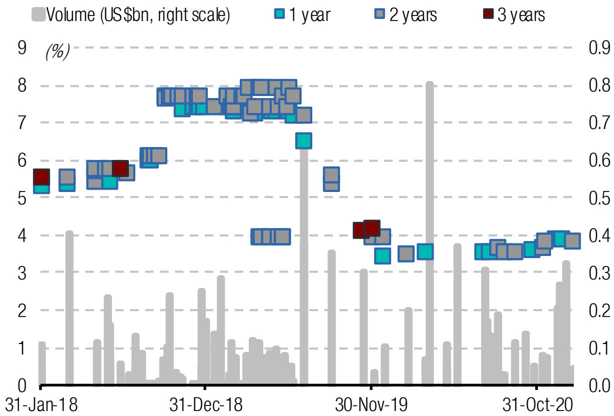
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

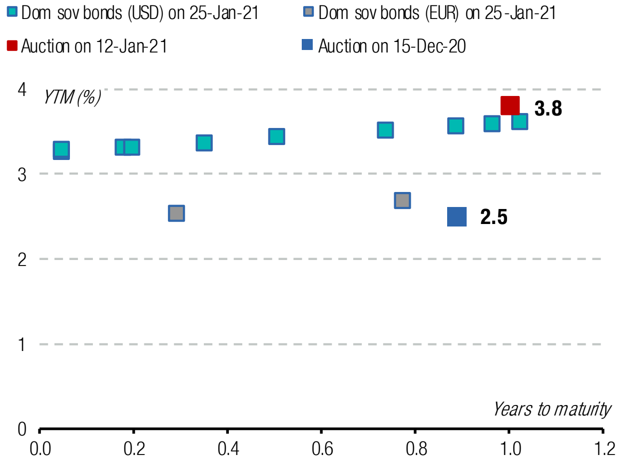
Chart 2. FX-denominated bonds

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 still high

Low collection of budget revenues and enough funds for expenditures caused inflow of funds from the Treasury to banking-sector liquidity, keeping it high. This week, liquidity will fluctuate due to month-end tax payments and VAT refunds.

Inflow from the Treasury last week was UAH3.8bn as debt repayments were mostly refinanced, while budget revenues collection was low with just UAH9bn of revenues last week and UAH29bn this year. With low demand for cash, banks increased reserves by UAH0.4bn last week. The NBU provided banks with just UAH256m of new loans, while banks repaid UAH0.7bn of loans.

Liquidity rose by UAH3.6bn to UAH191bn last week.

ICU view: Liquidity declined and will stay at around UAH190bn with slight fluctuations, due to unmatched tax payments and VAT refunds. NBU will have low impact on liquidity through the FX market (see comment below). Liquidity dynamic will depend on the amount of tax payments, VAT refunds, the amount of NBU injections through

the FX market, and new loans for banks. Likely only NBU transactions will be able to keep liquidity steady.

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

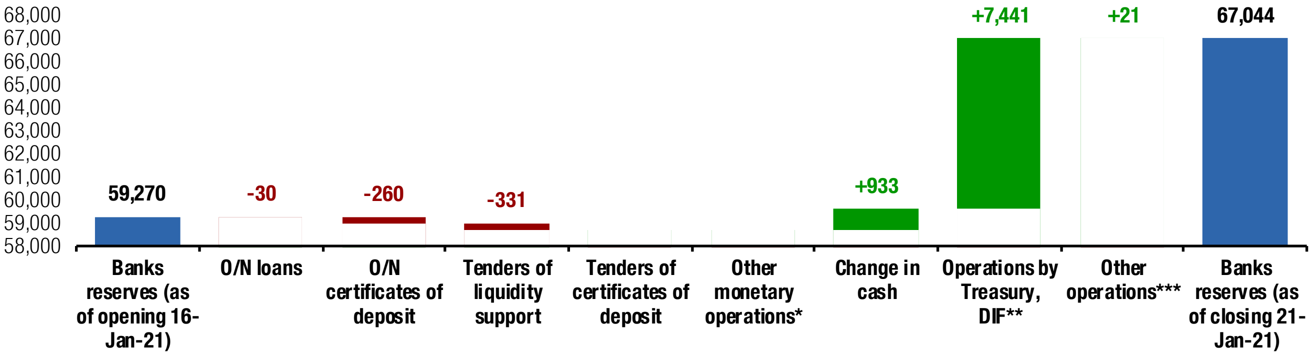
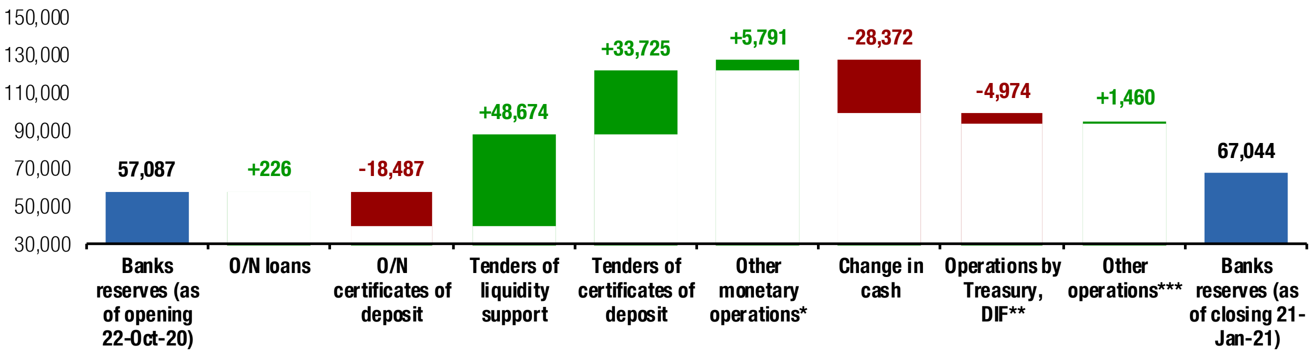


Chart 4. Banks reserves usages over last 90-day period (UAHm)



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 appreciates

The hryvnia will end the month with a self-balanced FX market, and this week can appreciate a bit, with a chance to cross the UAH28/US$ level.

Last week, foreigners' activity in the bond market was good, but without impact to the FX market due to the high level of reinvesting ratio or investor rotation. Therefore, the hryvnia exchange rate stayed close to UAH28.25/US$ and appreciated only at the end of last week when it moved to UAH28.16/US$ or 0.06% weaker than the previous week.

NBU has not intervened in the market since 12 January. NBU sold hard currency just once this year, on 4 January, and twice purchased hard currency on the 6th and 12th of January. Each intervention was for US$20m. There has been almost two week break since the last intervention, allowing market to become self-balanced.

ICU view: The last week of the January will see an extra supply of hard currency, despite exporters reducing supply due to VAT refunds. But additional support for the

hryvnia will come from foreigners investing in local-currency debt. The IMF has not made negative statements about gas price regulations, and the government does not immediately need the next tranche from the Fund. The government has a large amount of hard currency in its accounts, while large debt repayments are scheduled for March. Therefore, we anticipate that the hryvnia will appreciate this week to about UAH28/US$ or cross this level.

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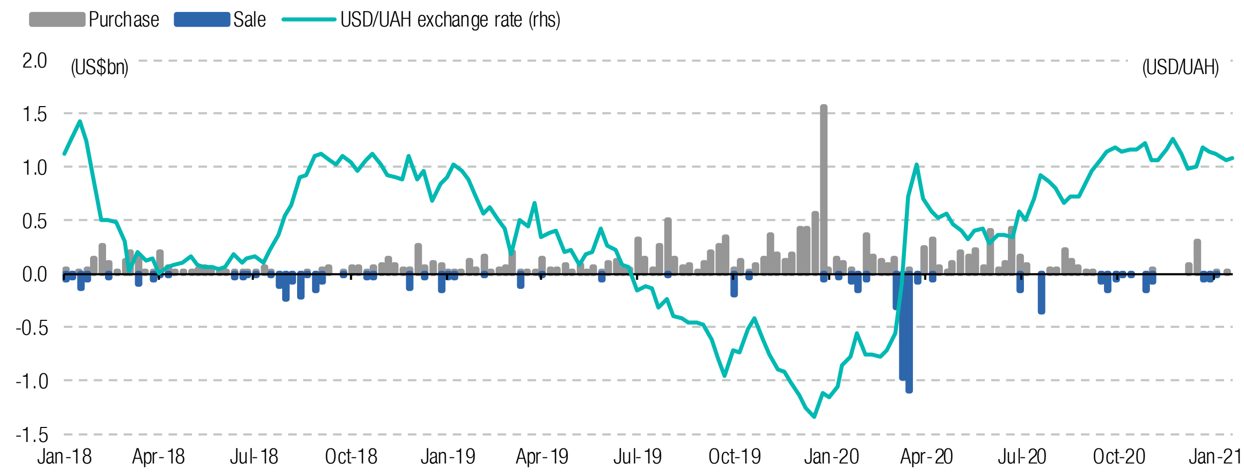
Chart 5. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

Industrial production returning to a pre-pandemic trajectory

In December, industrial production surged by 4.8% YoY, showing positive YoY growth for the first time since September 2019. Indicators of agriculture and retail trade also improved significantly compared with last year. As a result, a GDP decline in 2020 should be much lower (4.2–4.4%) than previously estimated. In addition, growth momentum and favourable external conditions provide a solid basis for economic activity at the start of this year, even amid lockdown restrictions.

In December, a YoY decline in industrial production, which has lasted since 4Q2019, was replaced by an increase of 4.8% YoY, while compared with November, output increased by 1.1% MoM SA. The surge in prices on global markets stimulated iron ore mining (+20% YoY) and metallurgical production (+4.3% YoY). Due to stable domestic demand, the output of the machine-building industry slowed significantly, and the production of textiles, pharmaceuticals, and chemicals increased sizably. In addition, weather conditions led to a sharp increase in energy production by 15.8% YoY.

In total, industrial production decreased by 5.2% YoY in 2020, while output increase was observed only in the chemical and pharmaceutical industries, by 4.7% YoY and 3.0% YoY, respectively.

In recent months, agriculture performance has also improved due to the late harvest of corn. As a result, in December, output increased by 26% YoY. However, in total, agricultural production decreased by 11.5% YoY in 2020.

Meanwhile, domestic demand has remained robust since July. Growth in retail trade amounted to 13.4% in December. And in total for 2020, it came to a solid 8.4%. As in previous months, the deteriorating situation with the COVID-19 pandemic did not meaningfully affect the purchasing power of consumers against a background of continued strong income growth. However, consumer sentiment remained quite depressed.

ICU view: The strong performance of the economy in December led to an improvement in GDP estimates for 2020. We currently estimate a decline of 4.2–4.4%, which is a fairly good result by international comparison in the coronacrisis year. The resilience of the domestic economy is determined by its structure, the macro-financial stabilization in previous years, and the rapid adjustment of the population and business to new operating conditions.

The same factors, in our opinion, will continue to positively influence economic activity this year. In addition, the very favourable situation in the global markets for iron ore, steel, and agri products will continue to stimulate production and generate vast FX inflow into the country in 1H21. The recovery of the global economy from 2Q21 against the background of large-scale vaccination in AEs should provide an additional impetus to exports.

Domestic demand must also remain robust. In addition, although vaccination in Ukraine is likely to lag behind neighbouring countries and will not be as large-scale, it will help to avoid severe lockdowns during the next flu season.

As a result, we confirm our estimate of economic growth this year at 5.6%.

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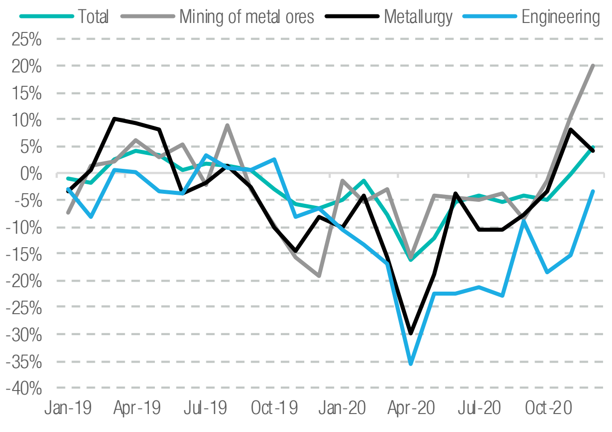
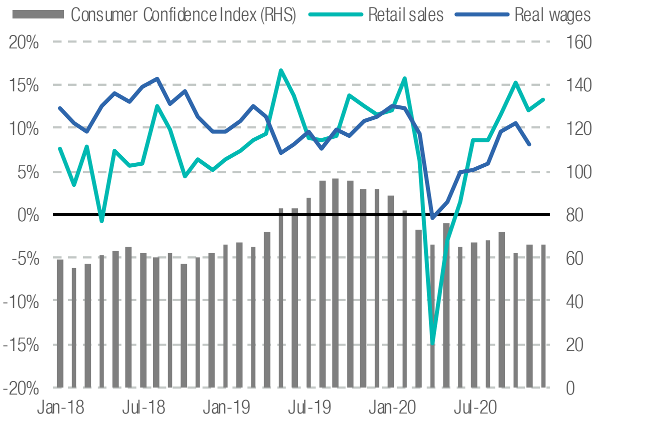
Chart 6. Industrial output, % YoY



Source: UkrStat, ICU.

Chart 7. Retail sales and real wages (% YoY), and consumer sentiment



Source: UkrStat, Info Sapience, ICU.

NBU keeps rate on hold at 6%

The NBU has been keeping the rate at 6% since June of last year. The NBU's new macroeconomic forecast envisages raising the rate at the next meeting in March. However, we see a high probability that the rate increase will be deferred, possibly even to 3Q21.

After inflation rose to 5% in December, the NBU forecasts that inflation will exceed the target range in 1Q21, then will hover at 8–9% during the year, and fall to 7.0% by the end of the year (compared with 6.5% in the October forecast). Higher inflation than previously expected is explained by a faster recovery in consumer demand and higher prices for food and energy products, amid growing business costs of labour. A return to the target range is expected in 1H22.

Keeping the rate unchanged amid rising inflation was justified by the NBU due to the temporary nature of pro-inflationary factors, weak investment activity, and depressed business sentiment amid quarantine restrictions, as well as a balance of risks, among which the NBU highlighted a potential inflow of portfolio investments and a resulting strengthening of the exchange rate.

Looking ahead, the NBU forecast envisages raising the interest rate in March to 6.5% and in April to 7%, and then keeping the rate at this level for two years. In the previous forecast, the NBU expected to increase the rate to 7.5% this year with a further decrease to 6.5% in 2022.

However, in its communication regarding forward guidance, the NBU noted the possibility of not raising the rate at future meetings, if the impact of fundamental pro-inflationary factors on consumer demand and deterioration of inflationary expectations are offset by capital inflows.

In addition, the NBU improved the GDP estimate for the last year to a 4.4% decline. Given the latest industry and trade data for December (see the previous section), this even looks pessimistic. The forecast for GDP growth of 4.2% in 2021 and 3.8% in 2022 remained unchanged.

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, recent surveys have already shown an increase in the expectations of a rate hike, which was reflected in the NBU forecast.

At the same time, we still see a relatively high probability that the rate increase will be deferred to 2Q21, and possibly even to 3Q21. According to our estimates, in the coming months, the inflow of portfolio investments will continue at a fairly significant amount, which will stimulate the strengthening of the exchange rate and, accordingly, will restrain inflation. Given the temporary nature of the current surge in inflation and core inflation still below 5%, this will provide the NBU the arguments to continue to keep the rate on hold. And only in a middle of a year, when the recovery of economic activity is on more solid footing against reduced pandemic risks, and the inflow of portfolio investment slows down, will the NBU start a cycle of hiking rates

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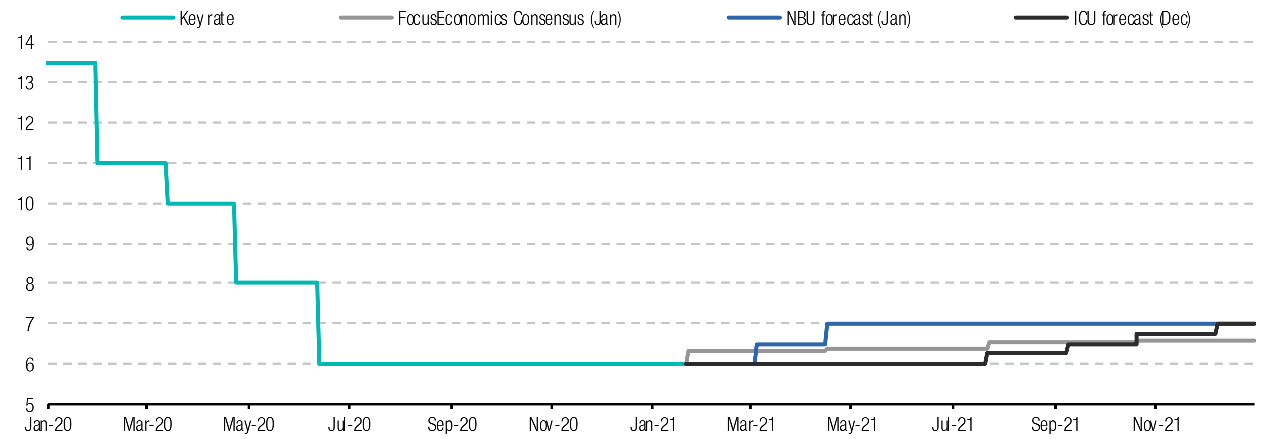
Chart 8. Key rate forecast (%)



Source: NBU, FOCUSECONOMICS, ICU

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