

Weekly Insight

NBU hikes the rate to 6.5%

Key messages of the today's comments

Domestic liquidity and bonds market

Decline in interest rates likely to fade

Last week, interest rates for three-month bills declined to 8.5%. However, the NBU's decision to increase the key policy rate can change the trend, at least as far as pulling up the decline in rates.

Slight liquidity fluctuations

Total amount of banking-sector liquidity continues to fluctuate around UAH190bn with low impact from all factors, which will continue this week, too.

Foreign exchange market

Hryvnia trends toward appreciation

Last week, the hryvnia strengthened and should maintain the overall trend to appreciation, while the NBU continues to restrain these movements.

Economics

NBU hikes the rate to 6.5%

After keeping the rate at the historically low level of 6% since June last year, the NBU Board started a new cycle of rate increases with a 50 bp move. In April, the rate is likely to be raised again, up to 7%.

TUESDAY, 9 MARCH 2021

Banks' reserves market (5 March 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	6.50	+50bp	-450bp
ON rate (%)	5.14	+14bp	-428bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	57,739	+4.95	-3.52
CDs (UAHm) ³	135,728	-2.77	-26.05

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 gov't bond holders (UAHm) (5 March 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	322,077	+0.00	-1.06
Banks	525,752	+0.07	+62.65
Residents	57,957	-3.30	+111.97
Individuals	14,213	+2.43	+62.64
Foreigners ¹	101,856	-0.80	-19.18
Total	1,022,094	-0.20	+26.03

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (5 March 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.7784	-0.69	+12.54
EUR/USD	1.1915	-1.33	+6.03
DXY	91.977	+1.21	-5.00
UAH TWI ¹	121.318	+1.49	-10.02

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (9 March 2021)

Maturity	Bid	Ask
6m	9.50	8.00
12m	11.50	10.00
2y	12.00	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

Decline in interest rates likely to fade

Last week, interest rates for three-month bills declined to 8.5%. However, the NBU's decision to increase the key policy rate can change the trend, at least as far as pulling up the decline in rates.

At the debut auction in March, interest rates for three-month paper fell to 8.5%, the lowest level since December 2020. Rates declined for bills with maturities up to 16 months, where the MoF capped the amount.

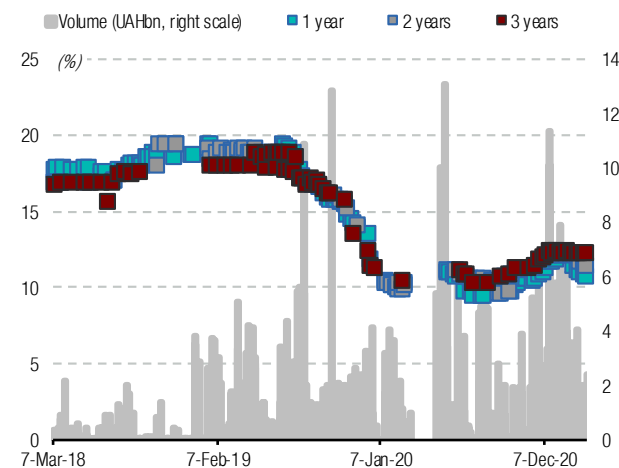
But after the NBU decided to increase the key policy rate last week to 6.5% (see comment below), the spread of UAH bills to the key rate tightened to 200bp; during the winter, it had been as much as 400bp. This decision can decrease competition among banks for new paper, and stop the decline in rates if not reverse it all together.

ICU view: Today, the MoF will offer bills with maturities starting from six months; therefore, a further decline is not likely, especially considering expectations of an additional increase in the key policy rate in April. Regardless, the MoF should be able to borrow enough to cover its needs and create a reserve for next week's debt repayment.

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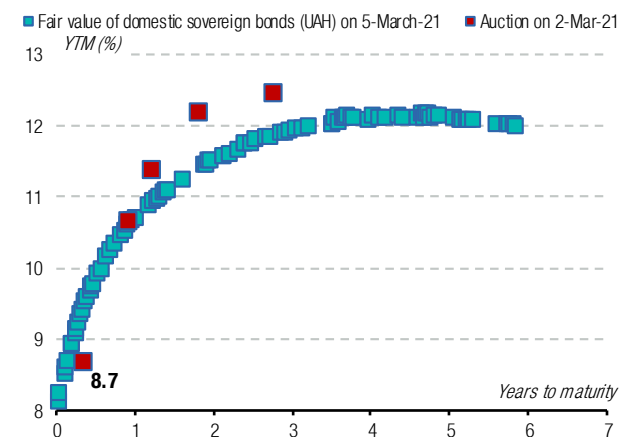
Chart 1. Local-currency bonds

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.

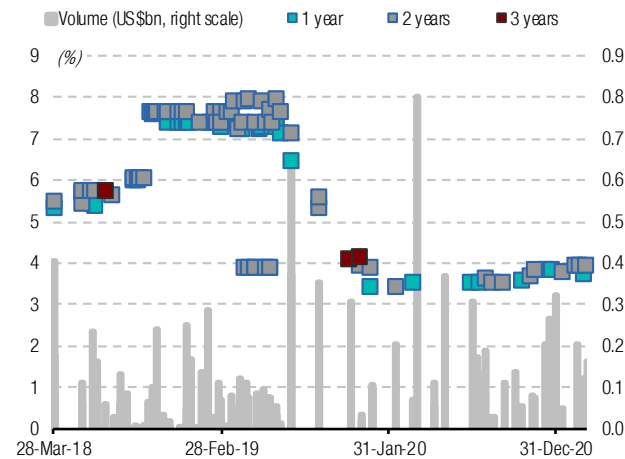
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

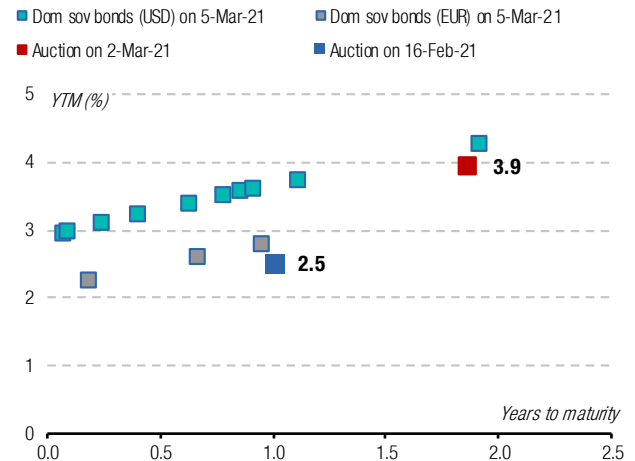
Chart 2. FX-denominated bonds

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.

Slight liquidity fluctuations

Total amount of banking-sector liquidity continues to fluctuate around UAH190bn with low impact from all factors, which will continue this week, too.

Last week, total banking-sector liquidity was down by UAH2.8bn to UAH191bn. The key impact was from cash exchange in reserves of UAH3.8bn. On the other hand, here were inflows from budget accounts of UAH0.3bn and the NBU returned to the FX market and intervened, paying UAH0.6bn for hard currency.

ICU view: Overall, banking-sector liquidity remains steady at around UAH190bn. This level was supported by partial refinancing of debt repayments and NBU purchases of hard currency. This week, liquidity can remain steady without material changes and NBU support through loans.

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

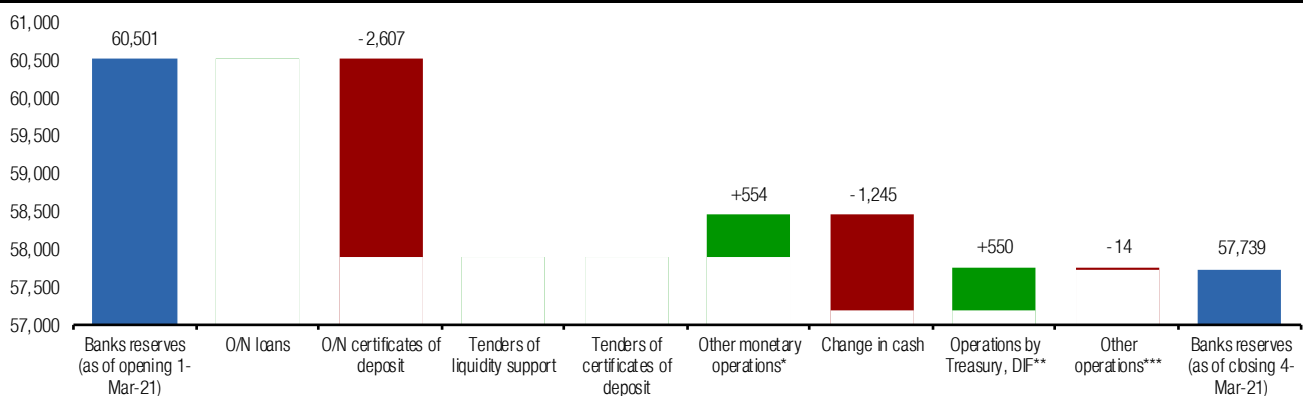
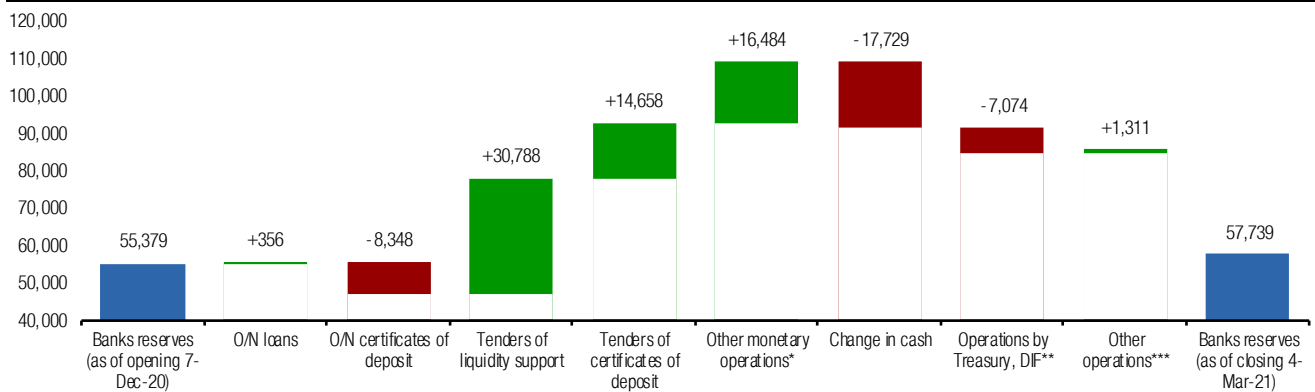


Chart 4. Banks reserves usages over last 90-day period (UAHm)


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 trends toward appreciation

Last week, the hryvnia strengthened and should maintain the overall trend to appreciation, while the NBU continues to restrain these movements.

Actually, the NBU did not intervene in the FX market for three consecutive weeks, only returning to the market last Friday with a purchase of US\$20m. This restrained further appreciation at the time, but did not reverse the trend.

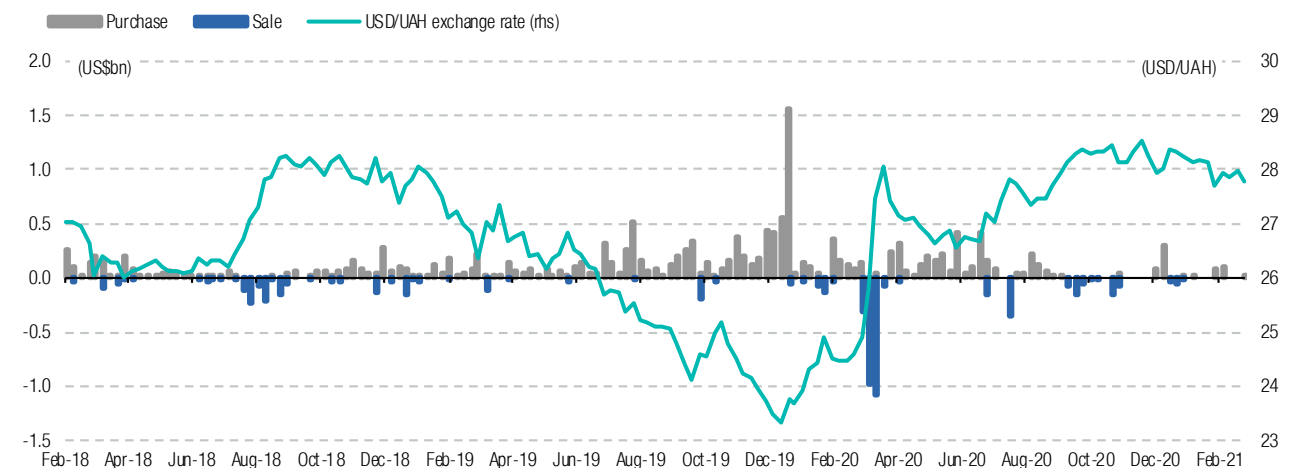
Finally, the hryvnia appreciated by 0.7% last week to UAH27.78/US\$ without inflows of hard currency from foreigners as their portfolio of local-currency bonds remained steady last week.

ICU view: The hryvnia exchange rate remains oriented toward appreciation even without foreigners' participation in the bond market. Therefore, this week the exchange rate should stay within the range of UAH27.5–28/US\$ with gradual movements toward the bottom of this range. The NBU will continue to restrain fast appreciation through 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

NBU hikes the rate to 6.5%

After keeping the rate at the historically low level of 6% since June last year, the NBU Board started a new cycle of rate increases with a 50 bp move. In April, the rate is likely to be raised again, up to 7%.

According to NBU estimates, this rate path is consistent with the return of inflation to the target range of 5% +/- 1 pp in 1H22. Also, among the factors justifying the rate hike, the NBU noted the acceleration of inflation in February, worsened inflationary expectations, rising prices in world commodity markets, in particular for agricultural products and energy, the solid recovery of the global economy and domestic consumer demand, and the effects of last year's UAH weakening. As a key risk to future inflation behaviour, the NBU pointed to a further change in lockdown restrictions in the response to the spread of the pandemic, seeing the likelihood of both improvement and deterioration.

NBU's forward guidance was quite hawkish and focused on its readiness to continue raising interest rates to limit fundamental inflationary pressures, stabilize expectations, and bring inflation to the target.

ICU view: *Even though such an increase in the rate was envisaged in the NBU's January forecast, about half of the respondents, according to various surveys, expected that the NBU would again leave the rate at 6%. First of all, such expectations against the background of accelerating inflation were based on the probable pass-through of an increase in the key rate on government-bond yields and bank-loan interest rates, as well as on the situation with vaccinations and the pandemic in Ukraine.*

In our December Macroeconomic Review, we also predicted that the NBU would postpone the rate hike until July. Our key assumption was that the strengthening of the exchange rate at the beginning of the year, as a result of favourable terms of trade and inflows of portfolio investments, should restrain inflationary pressures. However, the NBU's FX interventions in mid-February significantly slowed the strengthening of the hryvnia.

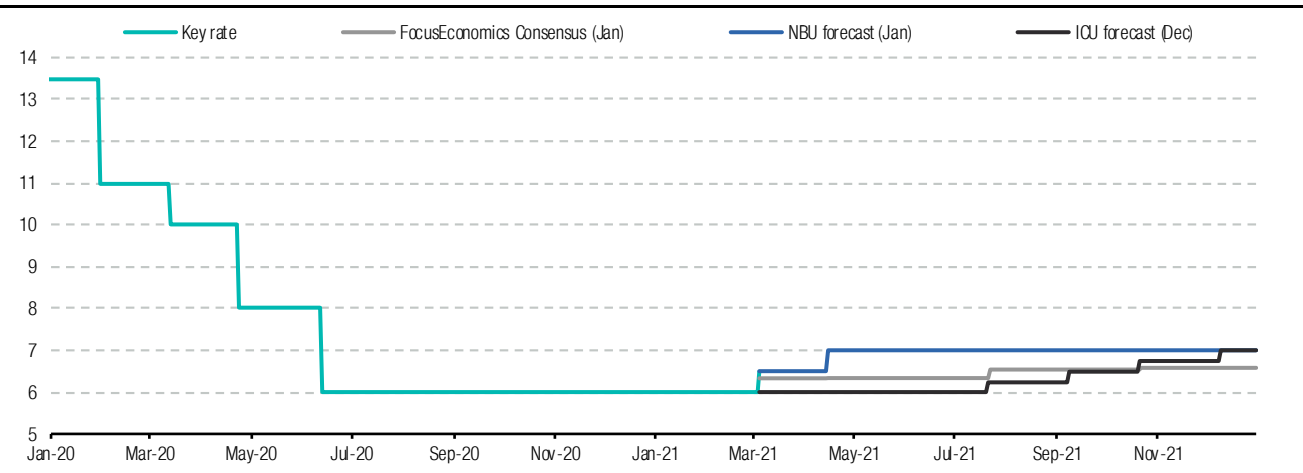
In our opinion, the rate hike will give additional impetus to non-residents' portfolio investments and, correspondingly, will support the strengthening of the exchange

rate. Therefore, we still expect movement to the level of UAH27/US\$ in the coming months.

At the same time, even in the context of UAH strengthening, given pro-inflationary factors mentioned by the NBU and its hawkish rhetoric, the rate is likely to be raised to 7% in April. This decision is also supported by the continuing rise in commodity prices, deteriorating inflation expectations globally, rising interest rates on long-term US Treasuries, and a decrease in the likelihood of receiving IMF funding this year. Given the risk of official funding shortage, the NBU may be forced to raise the rate even more. However, so far, just like the NBU, we expect the rate at the end of the year to stay at 7%.

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Chart 6. NBU key rate (%)



Source: NBU, FOCUS ECONOMICS, ICU

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