



Focus
Ukraine

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

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Weekly Insight

Inflation rises sharply

Key messages of the today's comments

Domestic liquidity and bonds market

Foreigners increase activity in UAH bond market

After two weeks without making new investments in UAH-denominated debt, last week, foreigners came back to the market and increased their portfolios. However, due to redemptions this week, we expect activity to be less visible.

Liquidity outflows to budget

Large amounts of tax collections and new bill purchases caused larger fluctuations in liquidity than earlier this year. This week, we expect the slight recovery in the total amount of banking-sector liquidity.

Foreign exchange market

The hryvnia exchange rate tends toward strengthening

The hryvnia exchange rate continued to appreciate, but very slowly. Therefore, for this week, we keep our forecast of gradual appreciation within the UAH27.5–28.0/US\$ range.

Economics

Inflation rises sharply

The further rise in Ukraine's inflation to 7.5% YoY in February was primarily driven by higher food and fuel prices. This fast-paced trend of price growth is likely to continue in the coming months, which will lead to a further increase in the key policy rate by the NBU.

MONDAY, 15 MARCH 2021

Banks' reserves market (12 March 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	6.50	+0bp	-350bp
ON rate (%)	5.74	-4bp	-554bp
ON \$ swap (%)	N/A
Reserves (UAHm) ²	54,160	-6.20	+4.92
CDs (UAHm) ³	117,170	-13.67	-26.09

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) (12 March 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	322,077	+0.00	-0.77
Banks	529,448	+0.70	+59.51
Residents	57,116	-1.45	+107.21
Individuals	14,375	+1.14	+62.13
Foreigners ¹	103,602	+1.71	-17.42
Total	1,026,857	+0.47	+25.47

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (12 March 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.7135	-0.23	+6.15
EUR/USD	1.1953	+0.32	+6.87
DXY	91.679	-0.32	-5.94
UAH TWI ¹	121.169	-0.12	-7.60

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (15 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

Foreigners increase activity in UAH bond market

After two weeks without making new investments in UAH-denominated debt, last week, foreigners came back to the market and increased their portfolios. However, due to redemptions this week, we expect activity to be less visible.

Since last December, the total amount of UAH-denominated bonds in foreigners' portfolios rose gradually, and reached a local high on 19 February of UAH102bn. But later in the month, in reaction to uncertainty regarding cooperation with the IMF and an increase in rates for less risky assets, they started to draw down their portfolios, albeit marginally.

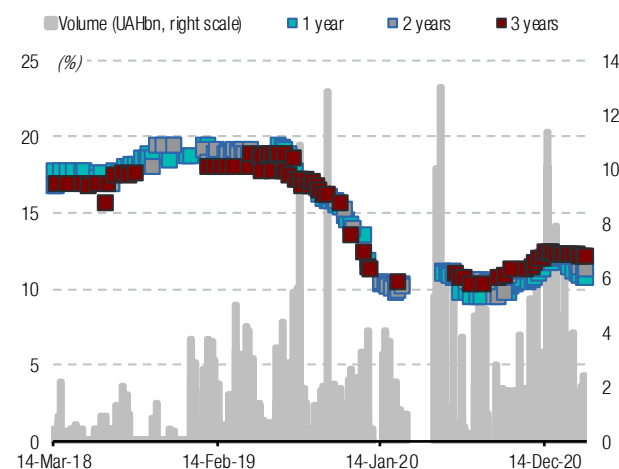
Last week, however, portfolios rose once more, exceeding UAH103bn, setting a new record for 2021. Last week, foreigners purchased UAH1.9bn of new bills. The purchases were fueled by a new wave of demand for EM assets, but most compelling for investors could be renewed appreciation of the hryvnia, and the NBU's decision to increase the key policy rate to fight inflation.

ICU view: Large debt redemptions are scheduled for the next several weeks, which will distort an actual picture of investors' activity due to their rotation. However, in overall, we expect further marginal increase of non-residents' portfolios. MoF is going to set a cap just for the three-month bills and offer bonds with maturities up to six years. This should attract extra demand from foreigners who are looking for higher yields amid still not too strong UAH exchange rate.

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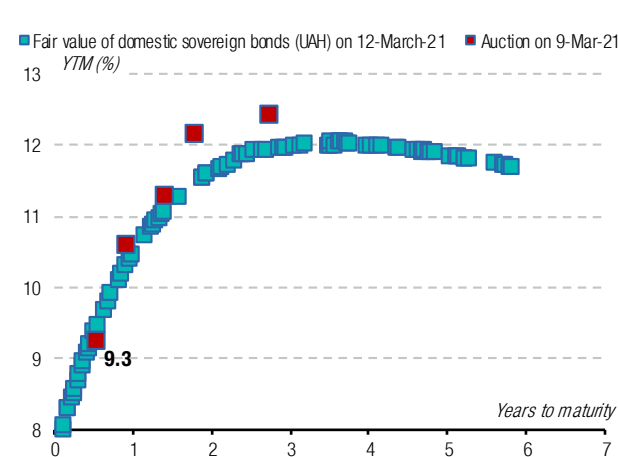
Chart 1. Local-currency bonds

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.

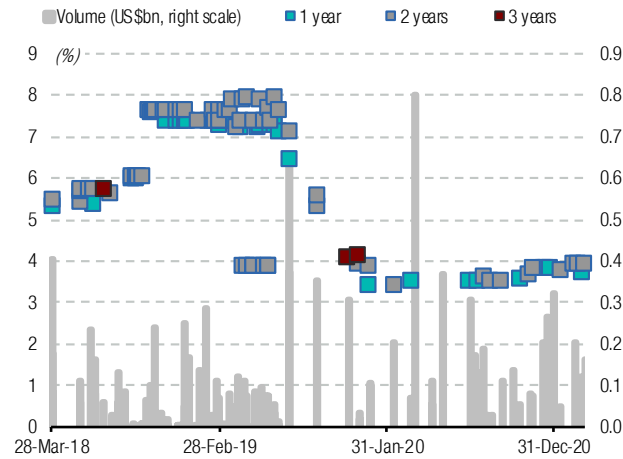
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

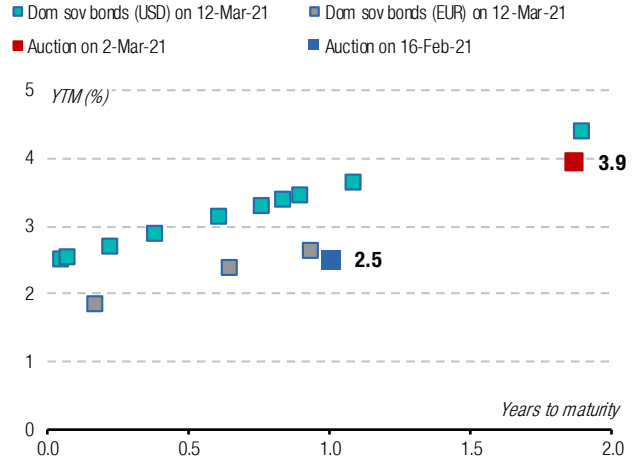
Chart 2. FX-denominated bonds

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 outflows to budget

Large amounts of tax collections and new bill purchases caused larger fluctuations in liquidity than earlier this year. This week, we expect the slight recovery in the total amount of banking-sector liquidity.

Budget accounts last week absorbed UAH15bn through tax collection of UAH18bn and new bond purchases of UAH5.2bn vs UAH1bn of interest repayments. As the result, liquidity in the banking system fell by UAH15bn to UAH176bn, as the NBU did not intervene in the FX market and provided just UAH2.5bn of new loans to 12 banks while banks exchanged reserves in cash of the same UAH2.5bn.

ICU view: This week, the MoF has to redeem UAH15bn of UAH-denominated bonds, which likely will be not refinanced in full, since it would require an increase in interest rates. Therefore, with this payment and a bit more active budget expenditures, liquidity should continue recovery, started last Friday.

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

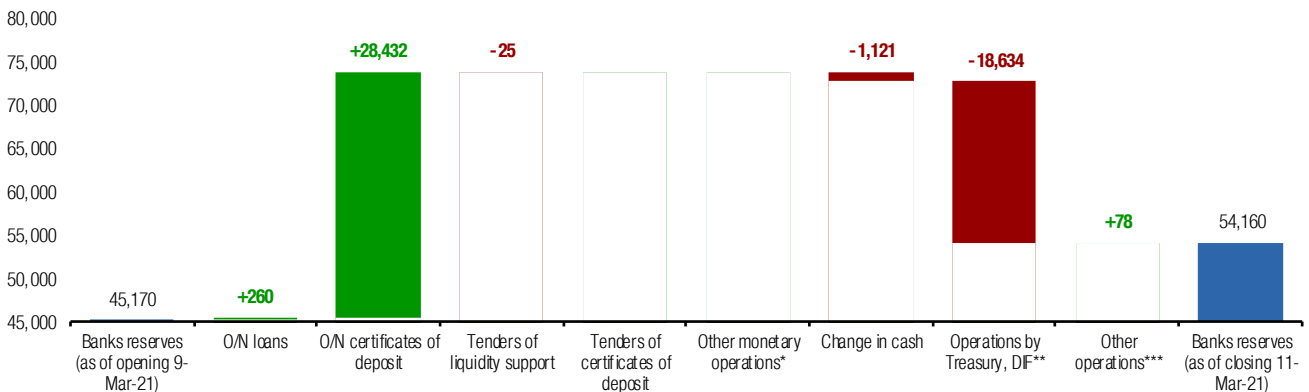
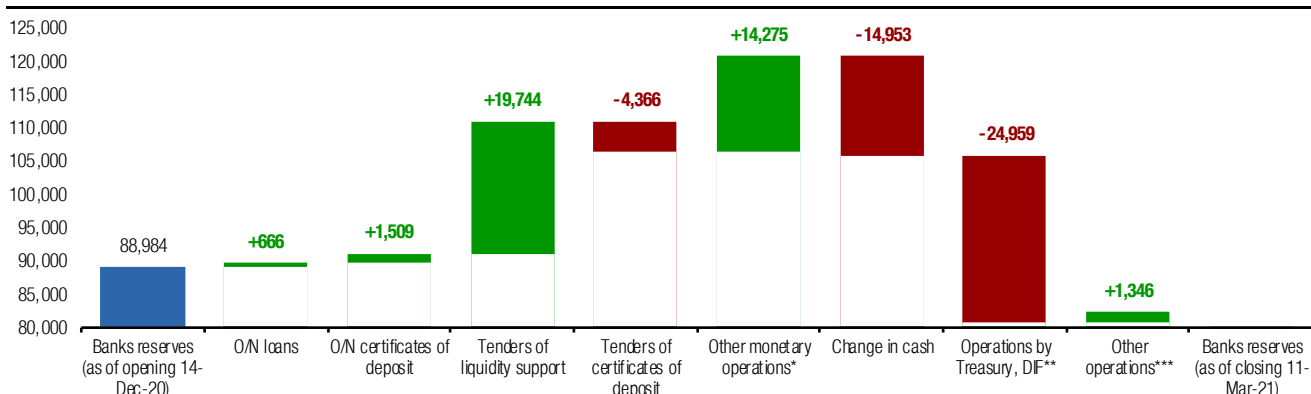


Chart 4. Banks reserves usages over last 90-day period (UAHm)


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

The hryvnia exchange rate tends toward strengthening

The hryvnia exchange rate continued to appreciate, but very slowly. Therefore, for this week, we keep our forecast of gradual appreciation within the UAH27.5–28.0/US\$ range.

A gradual increase in foreigners' activity in the bond market, large tax payments, and lack of NBU interventions in the FX market allowed the hryvnia to continue gradual appreciation. However, it was very slow, just 0.2% to UAH27.71/US\$.

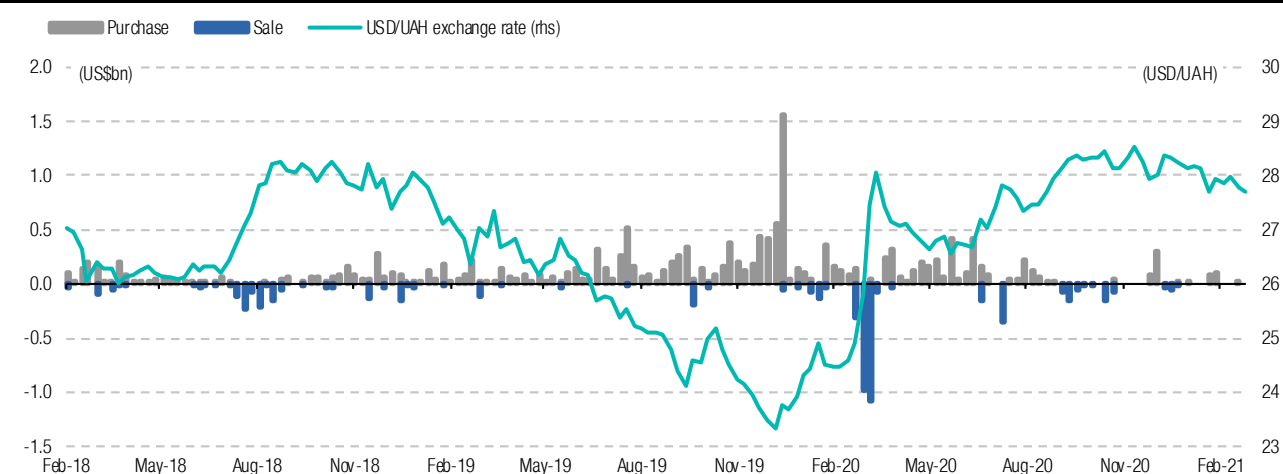
The FX market was self-balanced with increased demand from importers and larger supply from foreigners for buying new UAH-denominated bills. In addition, agrarians financing spring planting most likely supported the supply of hryvnia hard currency.

ICU view: We do not anticipate material changes in the hryvnia exchange rate behaviour, with gradual appreciation within the UAH27.5–28.0/US\$ range, under the same factors of impact. On the one hand, the supply of hard currency from foreigners and the agri-sector will increase, while on the other, the demand for hard currency will rise from importers and foreigners who will be interested in withdrawing investments. This can cause larger fluctuations in exchange rates and more NBU interventions, but in general, it will not affect the current trend in hryvnia appreciation.

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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

Inflation rises sharply

The further rise in Ukraine's inflation to 7.5% YoY in February was primarily driven by higher food and fuel prices. This fast-paced trend of price growth is likely to continue in the coming months, which will lead to a further increase in the key policy rate by the NBU.

In February, consumer prices grew by 1.0% MoM, while annual inflation accelerated to 7.5% YoY (compared with 6.1% YoY in January) and moved even further from NBU's target of 5%. The outcome exceeded the estimates of the overwhelming majority of experts (Bloomberg consensus – 7.2% YoY, ICU estimate – 6.9% YoY). At the same time, the acceleration of core inflation to 5.6% YoY (from 5.0% YoY in January) was almost in line with our expectations.

The main factor in accelerating inflation was the sharp rise in prices for food, which is observed not only in Ukraine, but throughout the world. In particular, the FAO food price index rose by almost 17% YoY in February, which is the highest rate since 2012. Given the high share of food products in the consumer basket (41%) and the openness of the economy, domestic inflation is extremely sensitive to these global trends. In particular, the highest rates of price growth are shown by eggs (85% YoY), sugar (62% YoY), and sunflower oil (35%).

In addition, fuel prices have risen sharply in recent months, and for the first time since mid-2019, the annual price change has become positive (4.4% YoY).

Instead, the gradual strengthening of the UAH exchange rate and the economy's capacity underutilization induced by COVID-19 pandemic contained fundamental inflationary pressures. In addition, inflation was affected by the government's restriction on the gas price for households, which was reflected in the CPI.

ICU view: Looking ahead, we expect further increases in food and energy prices to keep fueling inflationary pressures. At the same time, the ongoing strengthening of the UAH exchange rate and more precautionary behaviour of the population against the background of a growing likelihood of new lockdown restrictions will be important deterrents. In addition, we still expect that the ongoing food price spike should unwind in the second half of the year. Thus, the annual changes in the headline CPI and the core CPI will increase slightly in the coming months (by 0.5–1.0 pp) and will hover at

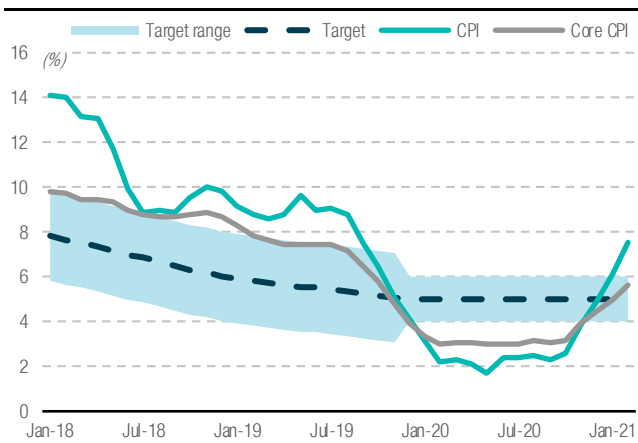
these levels (about 8% and 6%, respectively) until the end of the year, slightly higher than our December forecasts.

Given such inflationary trends and the gradual economic recovery, the NBU is highly likely to raise the key policy rate again, to 7%, but then take a wait-and-see attitude. At the same time, if the current surge in inflation, even against the background of a certain strengthening of the UAH exchange rate, will hurt inflation expectations, the NBU will be forced to act more aggressively. Moreover, the current rise in US Treasury yields, the global deterioration in risk appetite, and the lack of significant progress in negotiations with the IMF have significantly tilted the risks toward a tighter response from the NBU.

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

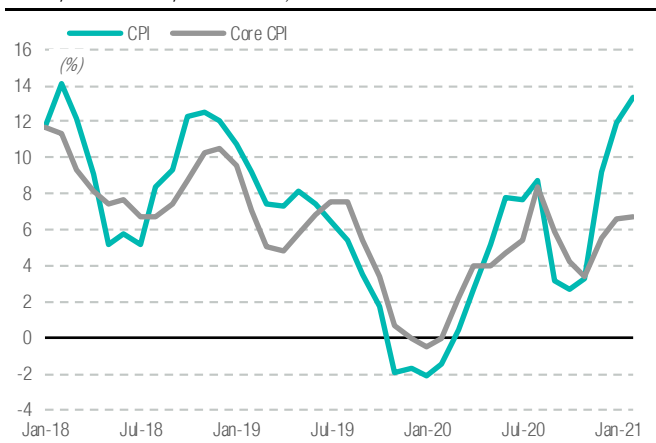
(Both headline and core inflation accelerate sharply since October 2020)



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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