Focus
Ukraine

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

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Weekly Insight

NBU keeps the rate on hold at 7.5%

Key messages of the today's comments

TUESDAY, 22 JUNE 2021

Domestic liquidity and bonds market

Banks decrease bond portfolios

Foreigners continued to increase investments in Ukrainian domestic debt, but at slower pace. Local banks took a break, probably waiting for the NBU's decision on monetary policy. Despite the aggressive rhetoric from the Fed, we expect steady interest from foreigners in UAH-denominated debt and renewed purchases of bonds by local banks.

Foreign exchange market

Hryvnia exchange rate corrects downwards

The hryvnia continued to appreciate at the beginning of last week. The NBU intervened by purchasing hard currency, and a correction started on Wednesday. Debt redemption, budget expenditures and recent refinancing loans, FED rhetoric, and the unchanged key policy rate in Ukraine were all these factors that caused the hryvnia to correct, along with the NBU selling hard currency last Thursday. These factors will keep pressure on hryvnia this week too.

Economics

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While market expectations were almost equally divided between expectations of a rate hike or keeping them on hold, the NBU decided to leave the key policy rate unchanged, in line with our forecast. Meanwhile, the NBU announced a phaseout of its anti-crisis monetary tools, thus tightening monetary conditions slightly. Looking ahead, we see the risks of the next rate move as tilted to the upside due to a more inflationary global environment and fast recovery of the domestic economy.

Banks' reserves market (18 June 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	7.50	+0bp	+150bp
ON rate (%)	7.11	+28bp	+103bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	67,025	+13.74	-3.39
CDs (UAHm)[3]	163,407	+15.13	+18.96

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) (18 June 2021)

	Last	Weekly chg (%)	YoY chg (%)
NBU	317,277	+0.00	-2.25
Banks	496,260	-1.86	+20.96
Residents	47,699	+0.71	-8.48
Individuals	17,461	+1.87	+128.31
Foreigners[1]	110,917	+2.25	+9.34
Total	**989,810**	**-0.64**	**+10.46**

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

FX market indicators (18 June 2021)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.2708	+1.11	+2.04
EUR/USD	1.1864	-2.02	+5.88
DXY	92.225	+1.84	-5.33
UAH TWI[1]	123.704	+0.58	-3.10

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

Gov't bond quotes[1] (22 June 2021)

Maturity	Bid	Ask
6m	**10.00**	**8.50**
12m	**12.00**	**11.00**
2y	**12.75**	**11.50**
3y	**13.00**	**12.00**
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

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Foreigners continued to increase investments in Ukrainian domestic debt, but at slower pace. Local banks took a break, probably waiting for the NBU's decision on monetary policy. Despite the aggressive rhetoric from the Fed, we expect steady interest from foreigners in UAH-denominated debt and renewed purchases of bonds by local banks.

The situation on the Eurobond market was ambiguous. On one hand, YTMs of Ukrainian sovereign Eurobonds rose by 18-33bp to 3.13-6.79% last week. This was partially due to the Fed's more hawkish rhetoric, which weighed on investor sentiment in EMs, but we expect this reaction to be short-lived. At the same time, Ukravtodor issued US$700m of government-backed bonds, which received US$2.4bn of demand. Demand of this size allowed Ukravtodor to decrease the interest rate to 6.25% from IPT 6.625%. So, interest in Ukrainian assets remains quite high.

In the domestic bond market, demand from foreigners for local-currency instruments declined, although the amount of proceeds was still significant for the MoF. With UAH14bn (US$0.5bn) due in local-currency debt redemptions, the MoF was able to sell just UAH5.8bn (US$214m) of new paper, about one-third of which was purchased by foreigners. As a result, only banks' local-currency bond portfolios declined, by UAH11bn (US$0.4bn).

In the secondary market, the most actively traded bonds were those due in 2023 and 2026. Trading was close to the level of newly issued paper, UAH1.3bn (US$48m) and UAH1.7bn (US$63m), respectively. In general, according to NBU data, weighted-average yields at the end of last week declined slightly to 8.3-12.4% range last Friday from 8.2-13.2% a week before.

ICU view: Investors' activity declined for two reasons. With quite high inflation in May, the market put a high probability on the NBU's increasing the key policy rate, which would cause an increase in rates for local-currency debt. In addition, foreigners could slow investments due to hryvnia appreciation and less attractive local-currency debt.

Therefore, with the hryvnia weakening slightly (see comment below) and the key policy rate kept unchanged, we could see foreigners accelerating investments, in particular in longer-dated paper. Especially as the MoF will offer the two-year and five-year instruments which were the most actively traded last week in the secondary market.

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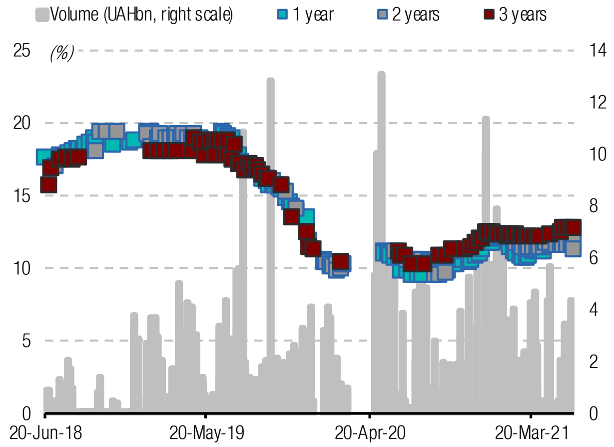
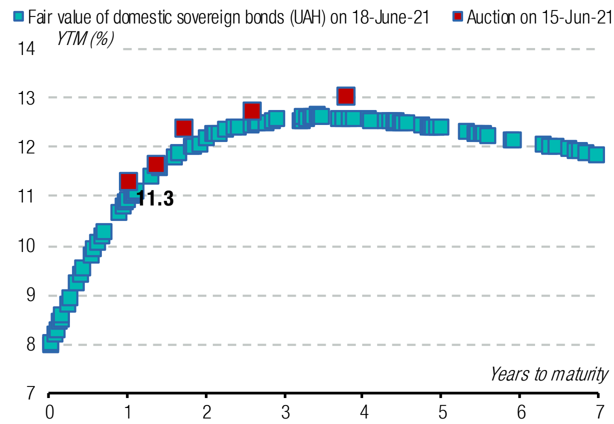
Chart 1. Local-currency bonds

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.

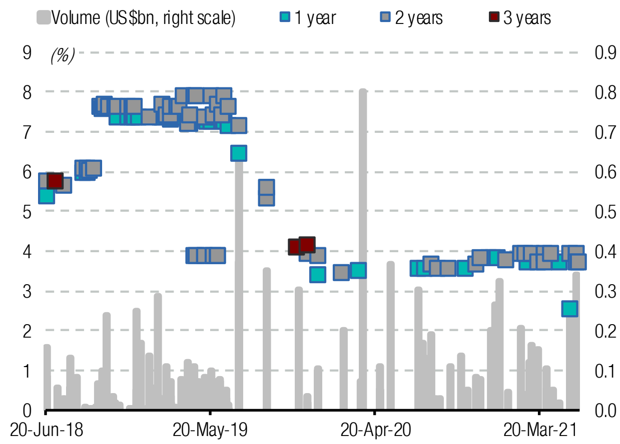
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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 (%)



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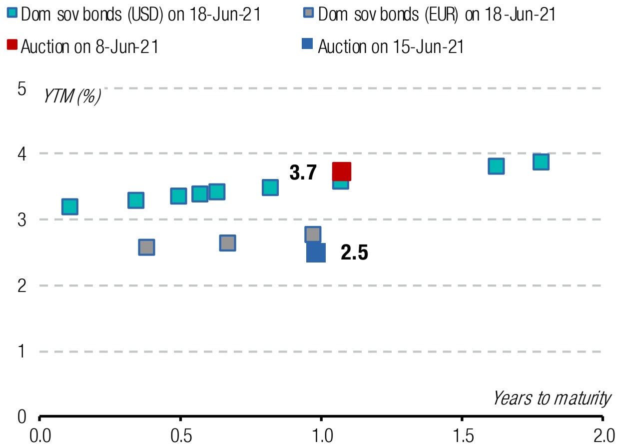

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Prior to the primary auction, foreigners sold about US$100m, which supported the hryvnia. But by the late Tuesday, the hryvnia started to weaken after the NBU purchased at least US$93m that day and US$114m last week.

Last Wednesday, the market reversed and the hryvnia weakened. The key reason was an increase in demand for hard currency after the huge inflow of liquidity into the banking system from the state budget. Expenditures had become active at the end of the previous week, but last weak accelerated due to bond redemption on Wednesday and inflows from the budget, which amounted to UAH15.3bn.

Changes in the market balance forced the NBU to sell US$20m last Thursday to decrease pressure on hryvnia. As the result, hryvnia weakened by 1.1% to UAH27.27/US$.

ICU view: This week FX market will stay under the influence of large liquidity in the banking system and foreigners trading with local-currency bonds. Overall, we anticipate that hryvnia will remain under the pressure despite month-end tax payments and probable purchases of new bonds today by foreigners, fluctuating within the range of UAH27-27.5/US$.

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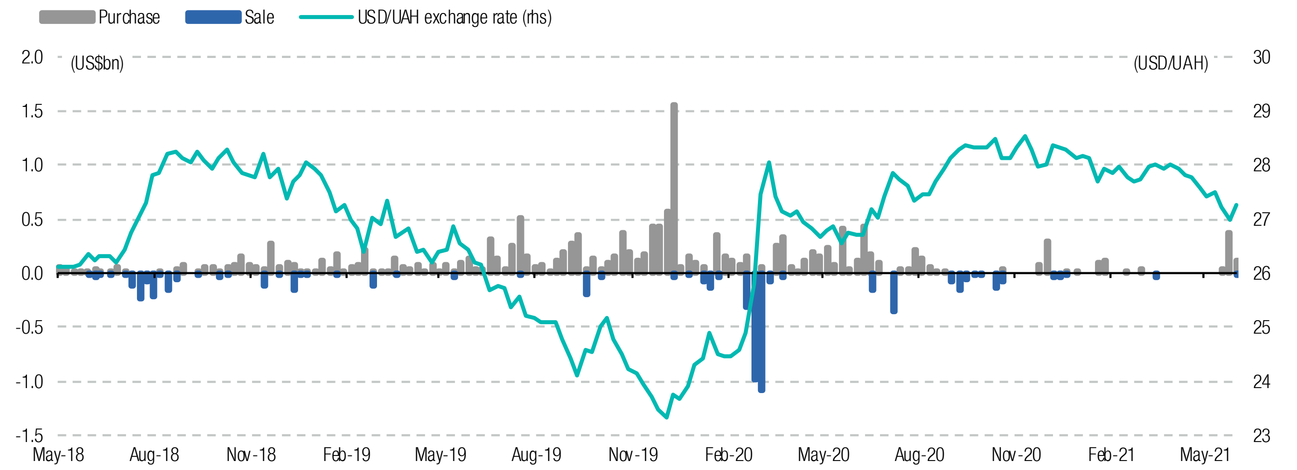
Chart 3. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

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The NBU downplayed the recent elevated CPI numbers (9.5% YoY in May), highlighting the predominance of temporary factors and no signs of an increase in underlying inflationary pressures above the forecast. Moreover, the NBU pointed out still well-anchored inflation expectations. Such position completely coincided with our assessment, while about a half of the respondents in different surveys voted for an additional hike mostly based on high inflation prints.

Forward guidance remained very hawkish and explicitly linked further hikes with threats to meet the 5% inflation target in 2022, rising from stronger underlying inflationary pressures and worsening expectations. So far, the NBU considers monetary conditions as appropriate to lower inflation to the target next year accounting for the normalization of global commodity prices and the new, larger harvest coming to the market.

In addition, the NBU announced a decision to phase out the use of anti-crisis monetary instruments, such as long-term refinancing and interest rate swaps. Thus, from 1 July 2021 and on, the maximum maturity of long-term refinancing loans will be reduced from five to three years. Auction volumes will also decrease: to UAH 5bn from July, UAH 4bn from August, and to UAH 3bn from September. At the same time, starting on 1 July, the frequency of interest rate swap auctions will be reduced from two times per month to once per month, with the maximum maturity decreasing from five to three years. Given that there are no significant shocks to the financial markets, long-term refinancing and interest rate swaps will be fully phased out on 1 October 2021.

ICU view: We find such NBU's decisions as well balanced and justified. The NBU started to raise the rate earlier and stronger than many other EM central banks, and the previous hikes have already contributed to the inflows of portfolio investments into the country and exchange-rate strengthening. It is unlikely that an additional stimulus through this monetary transmission channel is currently needed. Rather, the NBU may allow the exchange rate to strengthen more, only marginally smoothing currency appreciation through FX interventions.

In addition, the reaction of bank rates to previous key policy rate hikes has been rather sluggish. Probably, there is a potential for an increase in deposit rates without further hikes of the NBU rate. We consider the phaseout of the anti-crisis monetary measures as a much more appropriate tool in the current conditions, especially, accounting for the "crisis nature" of these monetary tools and their distorting impact on the monetary system.

Looking ahead, we share the NBU's hawkish forward guidance, considering the risks of additional hikes as prevailing compared with the turn to an easing cycle. However, a potential rate hike will be related not so much to the pass-through of global food and energy prices into domestic ones, but to increasing fundamental inflationary pressure resulting from a more rapid economic recovery after the recent lockdowns. But for the new decisive moves, the NBU must receive more strong signals from the real sector and the labour market than just an increase in sunflower oil prices and the introduction of annual natural gas tariffs.

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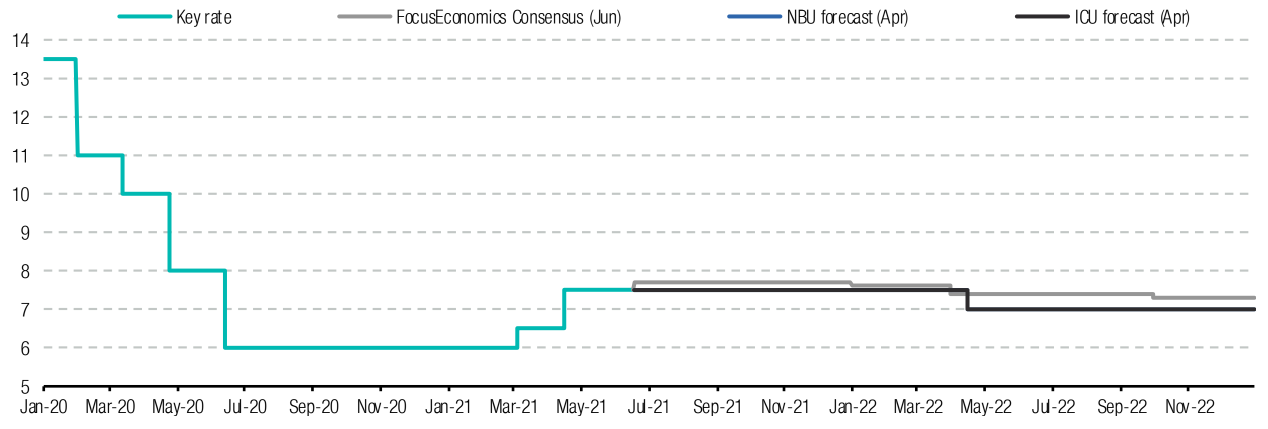
Chart 4. NBU key rate (%)



Source: NBU, FOCUSECONOMICS, ICU

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