Focus
Ukraine

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

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Weekly Insight

NBU raises the key policy rate to 17%

Key messages of the today's comments

Domestic liquidity and bonds market

Non-residents continue to increase bond portfolios

Non-residents' portfolios of Ukrainian government bonds rose last week to UAH13.8bn, and show signs of increasing more.

Liquidity above UAH100bn

With a large VAT refund last week, total banking-sector liquidity, other than the government bond portfolio, was above UAH100bn, declining at the end of the week with the allocation of CDs.

Foreign exchange market

NBU's interest rate hike will support the UAH

Higher real interest rates will likely raise inflows from non-residents into local government bonds, increasing demand for the hryvnia and supporting its exchange rate.

Economics

NBU raises the key policy rate to 17%

The reason for the fourth consecutive increase is higher-than-expected inflation in January, as well as the absence of significant signs of weakening of inflationary risks. High inflation in the following months may result in a further interest rate hike.

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WEDNESDAY, 7 MARCH 2018

Banks' reserves market (6 March 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU rate (%)[1]	17.00	+100bp	+300bp
ON rate (%)	15.50	+130bp	+330bp
ON $ swap (%)	15.50	+140bp	+382bp
Reserves (UAHm)[2]	41,369	-25.60	-3.20
DepCerts (UAHm)[3]	38,989	-17.62	-43.05

Notes: [1] NBU's key policy rate; [2] stock of banks' reserves held at NBU; [3] stock of NBU's short-term bonds.
Source: NBU, Bloomberg, ICU.

Breakdown of govt bond holders (UAHm) (6 March 2018)

	Last	Weekly chg (%)	YTD chg (%)
NBU	354,320	+0.00	-7.57
Banks	342,857	-1.70	+35.04
Residents	26,641	-0.27	+11.98
Individuals	1,923	+3.75	+1,531.07
Non-res[4]	13,800	+4.99	+119.12
Total	**739,542**	**-0.71**	**+10.80**

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

FX market indicators (6 March 2018)

	Last	Weekly chg (%)	YTD chg (%)
USD/UAH	26.3000	-1.92	-2.54
EUR/USD	1.2404	+1.72	+17.22
DXY[2]	89.618	-1.10	-11.83
UAH TWI[3]	111.868	+1.26	+2.44

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

Gov't bond quotes[1] (6 March 2018)

Maturity	Bid	Ask
6m	**17.00**	**15.75**
12m	**17.00**	**15.75**
2y	**17.00**	**15.80**
3y	**17.00**	**15.90**
12m ($)	**5.10**	**4.70**
2y ($)	**5.30**	**5.00**

Notes: [1] Actual quotes you can see at www.icu.ua.
Source: ICU.

Domestic liquidity and bonds market

Non-residents continue to increase bond portfolios

Non-residents' portfolios of Ukrainian government bonds rose last week to UAH13.8bn, and show signs of increasing more.

Last week, the primary bonds market was quite steady. In anticipation of NBU's decision on the key policy rate, demand was less than one-third of debt repayments done last week. As a result, the proceeds of the auction for the budget amounted to UAH0.99bn. The greatest demand was for three-month bonds, as usual, and accepted interest rates remained steady at 16.00%. See our review of 28 February for details of the auction. Likely, non-residents were main bidders, and purchased the bulk of the May and August 2018 maturities, as yields were below fair value of bonds calculated by the NBU (see chart 1).

At the end of last week, portfolios of non-residents increased by UAH0.66bn to UAH13.8bn, as they continued to purchase local-currency bonds. To decrease short-term risks, the MoF has begun limiting offerings for bonds with maturities up to six months. The share of non-residents holdings of total bonds outstanding remained below 2%.

ICU view: Due to the increase of key policy rate to 17.00%, we expect an increase in the level of interest rates in bond bids at primary auctions. At the same time, the MoF will be conservative, and will try to keep bids down to a 20-50bp increase. Regardless, bonds will become more attractive to non-residents, who will likely take an interest in the secondary market for longer maturities since these offerings are limited at primary auctions. By the end of March, non-residents' portfolios could rise to as much as UAH15bn.

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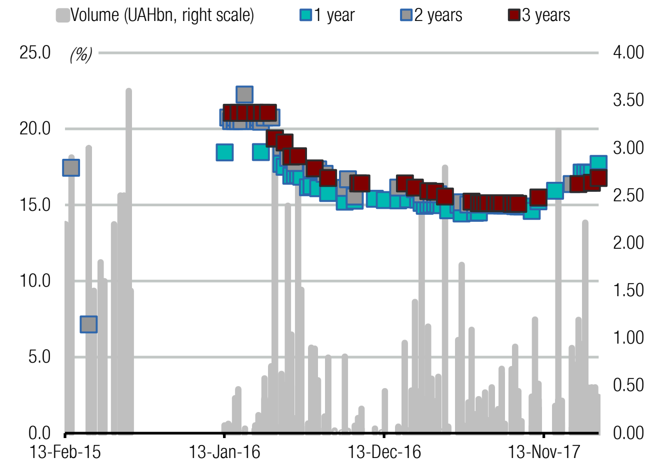
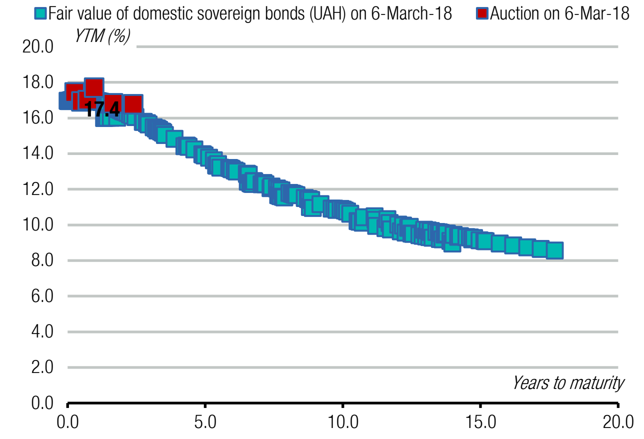
Chart 1. Local-currency bonds

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.

Liquidity above UAH100bn

With a large VAT refund last week, total banking-sector liquidity, other than the government bond portfolio, was above UAH100bn, declining at the end of the week with the allocation of CDs.

Liquidity received a positive impact from low outflows to the budget due to the anticipation of NBU's decision on key policy rate, which was held last Thursday. On that day, NBU offered only ON CDs, which are not suitable for banks, which prefer two-week CDs. When they were offered last Friday, banks purchased UAH21bn at the new 17% interest rate, increasing outstandings by UAH6bn after redemption of older CDs the previous day. As the result of this mismatch in redemption and new issue, banks' correspondent account balances with the NBU set a new high from the end of January (the record high of UAH71.46bn in banks' accounts was seen on 26 January, the day previous to the key rate increase). Consequently, the following day, banks' account balances fell to UAH44.00bn after new CD purchases.

ICU view: Liquidity was the highest last Thursday when banks received large debt repayments but postponed buying new government bonds. Instead, they purchased new CDs, which had become more attractive. We expect a similar liquidity structure over the next weeks, as banks will not see a decline of liquidity, therefore, they will increase CD or bond purchases, and decrease their FX positions.

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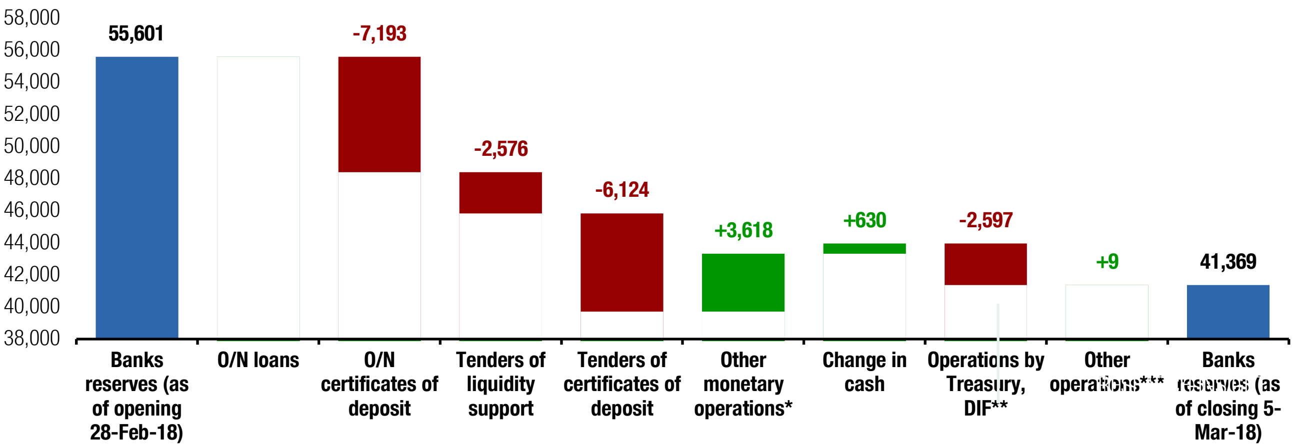
Chart 2. Banks reserves usages over last week(UAHm)



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

NBU's interest rate hike will support the UAH

Higher real interest rates will likely raise inflows from non-residents into local government bonds, increasing demand for the hryvnia and supporting its exchange rate.

The hryvnia started last week with a slight weakening against the US dollar, but during the following days, it strengthened. Key drivers were increased demand among non-residents who sold foreign currency for the purchase of local government bonds (almost UAH660m), as well as the decision by the central bank to raise the key policy rate to 17%.

Last week, the hryvnia strengthened by 1.7% in nominal terms, to 26.5359 UAH/USD. Its CPI-based real trade-weighted index rose 0.67% to 109.39; in year-on-year terms, it is up 2.67% from 106.55 last year.

ICU view: This month, the UAH will be supported by a number of factors, with the key ones being: 1) inflows from non-residents into local government bonds, which will increase demand for the hryvnia, 2) a globally weaker greenback, 3) lower oil prices, 4) seasonality—agrarians are to sell foreign currency for financing their needs during the new sowing season, and 5) seasonally increasing demand for steel on world commodity markets. Thus, these are all preconditions for further hryvnia appreciation.

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Economics

NBU raises the key policy rate to 17%

The reason for the fourth consecutive increase is higher-than-expected inflation in January, as well as the absence of significant signs of weakening of inflationary risks. High inflation in the following months may result in a further interest rate hike.

In January, growth in consumer prices exceeded the forecast trajectory of the NBU, accelerating to 14.1% YoY as a result of higher fuel and food prices, and a weakening of the hryvnia. In addition, according to preliminary data, inflation remained elevated in February.

The NBU kept its inflation forecast at 8.9% YoY by year-end but reiterated what it sees as the inflationary risks it stressed earlier: 1) high inflationary expectations, 2) robust domestic demand (retail sales rose 9.6% YoY in January), and 3) delay in the IMF tranche.

ICU view: The 450 bps increase in the key policy rate since October 2017 caused a significant inflow of non-residents into local government bonds, which resulted in the strengthening of the UAH. In turn, a stronger hryvnia restrains growth in consumer prices to some extent. The National Bank of Ukraine warns that it does not exclude raising rate at subsequent meetings, but we believe that the NBU has practically exhausted the opportunities for further interest rate hikes. However, before declining, the inflation trend may still persist for the next three months, so we do not rule out the possibility of raising the rate at the next meeting.

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Naftogaz wins US$4.63bn over the Gazprom transit dispute in Stockholm court

Gazprom is obliged to pay compensation for the failure to meet gas transit obligations but intends to appeal the court decision.

Taking into account the outstanding debt to Gazprom for gas received by Ukraine in 2014 and 2015, Naftogaz should eventually receive US$2.56bn. In addition, since February 28, 2018, Gazprom has a daily penalty of US$0.5m until full payment of the debt is received.

Gazprom confirmed its obligation to pay US$2.56bn in favor of Naftogaz, but said it did not agree with the court's decision because of the court’s asymmetrical approach to the supply and transit cases and intends to "protect its rights by all legal means".

In addition, Gazprom initiated the termination of the contract with Naftogaz for the supply and transit of gas and returned to it a prepayment for March deliveries. Naftogaz regards Gazprom's refusal as a breach of contract and failure to comply with the court decision.

ICU view: According to our estimates, the US$2.56bn compensation accounts for about 75% of the required natural gas imports in 2018, or 4% of Ukraine's expected total imports of this year. However, we do not exclude another long legal litigation with Gazprom for Naftohaz; thus, the prospect of obtaining compensation may be quite remote or may become the subject of intensive bargaining.

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