

# Special Note

## UAH bonds – attractive again

TUESDAY, 23 FEBRUARY 2021

**We remain constructive on Ukrainian local debt.** Our view is supported by improved geopolitics, strong macroeconomic performance, solid external balances, and attractive risk-reward balance amid the global carry-friendly environment. Pushed by elevated fiscal needs, Ukraine's bonds offer relatively high yields against a background of relatively modest macro, credit, and FX risks, especially on a short-term horizon. Meanwhile, a slowdown in structural reforms and slow progress in negotiations with the IMF put a drag on economic performance and may deteriorate risk metrics in the medium term.

**High real rates, fast economic recovery, and favourable external conditions support the currency.** Ukraine's external balances continue to benefit from favourable terms of trade and restrained travel as well as from recovering portfolio inflows. This helps the NBU to further rebuild its FX reserves, which reached US\$29bn at the end of 2020, the highest level for the last eight years. Thanks to favourable seasonality and external conditions, and consistency of NBU's FX policy, by mid-2021, the hryvnia may strengthen even more than assumed in our forecast (UAH27/USD). By the end of the year, we see the currency close to current levels (UAH27.5–28/USD).

**Carry-friendly environment, high real rates, and improved FX outlook have rekindled foreign investors' interest in UAH bonds.** Given still light positioning, there is a potential for ongoing massive foreign inflows into UAH bonds. Moreover, local players have also accelerated buying since the end of 2020. Demand at the weekly auctions of the Ministry of Finance (MoF) remains strong, and oversubscription since mid-January led to a slight decrease in yields, most notable at the front end of the curve. Meanwhile, still elevated fiscal needs restrain the MoF from aggressive cutting of interest rates.

**Bonds with 1Y-2Y maturity look especially attractive from a risk-reward perspective.** By end-2021, we now see room for 1Y bond yields in Ukraine to lower slightly to 11% while 2Y bond yields should hover close to the current level of 11.7%. Even accounting for growing inflation expectations, such rates provide good opportunity for a carry trade given still manageable FX and credit risks.

**Main risks are currently associated with slowing reform momentum and uncertainty around the IMF programme.** These risks may worsen sentiment towards Ukraine and weigh on the hryvnia in the medium term. Also, the deteriorating inflation outlook may lead to delayed and, thus, aggressive tightening of monetary policy in the medium term, causing a pass-through to bond yields. We believe that the current spread between 5Y and 1Y bonds (around 120 bps) does not provide adequate premium for such risks.

**On the other hand, there are also upside risks stemming from foreigners' better access to the local bond market thanks to its improving infrastructure.** Establishing a link with Clearstream in 2019 substantially boosted foreign investors' interest to the Ukrainian bond market. Together with the favourable taxation regime, this remains a competitive advantage of UAH bonds compared with peers like Egypt. Moreover, last year,

the NBU introduced the mechanism of entering the Ukrainian government bond market via foreign nominee accounts. This should simplify the access to the market for foreigners, especially US-based funds that do not use Clearstream. Additional foreign inflows are likely if Ukrainian bonds are added into J.P. Morgan GBI-EM. One of the obstacles for bond index inclusion is the low level of participation of residents in longer-dated bonds placed in the market during the last couple of years. However, it is gradually improving thanks to support provided by the NBU via long-term refinancing and IRS instruments. We believe that the growing supply of government paper and involvement of domestic banks will improve the situation and push the inclusion of Ukrainian bonds into J.P. Morgan GBI-EM.

**Ukraine's local debt looks highly competitive versus emerging and frontier market peers.** The main high-yielding competitors of Ukraine are Egypt, Turkey, Georgia, Armenia and a few Sub-Saharan African countries such as Kenya and Uganda. However, except Egypt and Turkey, these are niche markets with low liquidity. Moreover, some of them impose a tax on interest payments, for instance, Uganda taxes 15% of revenues from bonds with maturities below 10Y and 10% above. Compared with Egypt, Ukraine has less overcrowded local bond market and better debt, fiscal and external account metrics, although lacks properly working IMF programme. Turkey offers a good investment opportunity in 5Y bonds; however, the case crucially depends on the central bank's ability to regain control over inflation and monetary stability, which was not the case in the last decade.

**The rest of the note presents charts supporting our main conclusions.**

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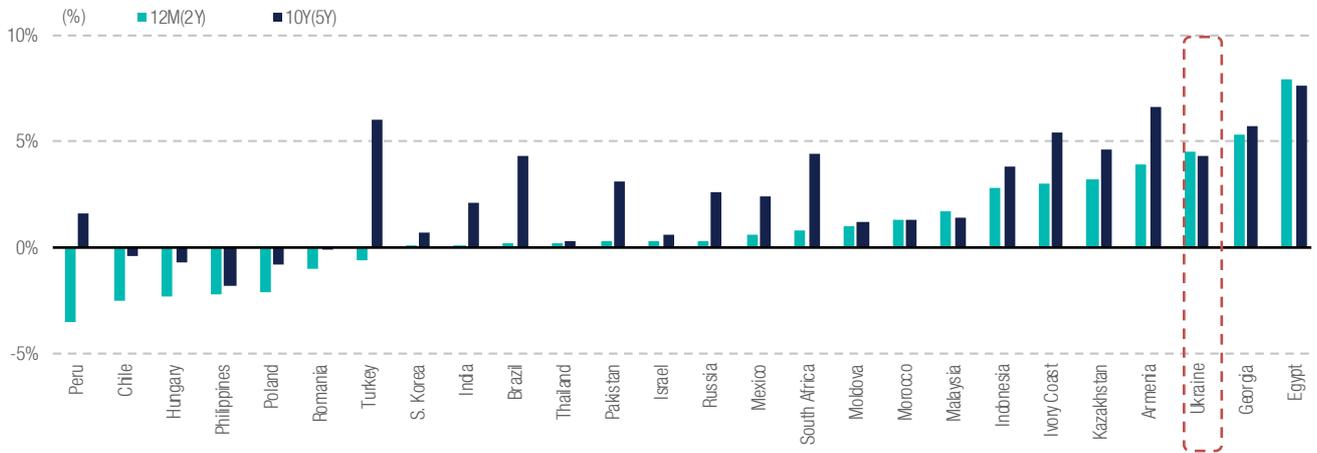
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# 1. UAH local debt in EM universe

- Real yields of Ukrainian bonds look attractive compared with peers, especially for bonds with 1Y maturity
- Aggregate risk score for Ukraine is moderate with some heightened measure of FX risk
- Even accounting for this aggregate risk score, real yields for 12m bills look very attractive while real yields for 5Y notes are in line with risk score

Chart 1. Real interest rates in selected EM countries

Real interest rates in Ukraine are among the highest among peers, especially for 12m yields



Note: for calculating real rates, we deflate nominal yields by the average between last 12-month CPI inflation rate and IMF forecast of average YoY CPI in 2021 for 12m rates and by the simple average between last 12-month CPI inflation rate and average YoY CPI in 2021-24 for 10Y(5Y) rates.

Source: Bloomberg, IMF WEO (October 2020), ICU

Table 1. Ukraine vs selected EM countries: Key metrics

Country	REWARD						DEBT RISK			LIQUIDITY RISK			FX RISK			MACRO RISK		
	Local currency				Hard currency	Public Debt to GDP	Fiscal Bal to GDP	Debt service to Revenues	Reserves to STD by RM	Eurobonds service to Reserves	Ext Debt service to Revenues	Reserves to ARA metric	CAB to GDP	REER to 5Y av	CPI	GDP	IP	
	Nominal Yield	Real Yield	CB rate	YTM														
	10Y(5Y)	12M(2Y)	10Y(5Y)	12M(2Y)	%	2021	2021	2021	%	%	%	%	%	%	2021	last data	last data	4q ma
Ukraine	10.0%	10.6%	4.4%	4.5%	6.0%	6.3%	63.8%	-7.8%	9.7%	89.0%	12.6%	8.4%	98.7%	-3.0%	3.6%	6.1%	-4.2%	-2.4%
Hungary	2.3%	0.8%	-0.7%	-2.3%	0.6%	2.8%	76.6%	-8.3%	4.7%	222.7%	n/a	n/a	129.5%	-0.9%	-4.0%	2.7%	-3.0%	-0.6%
Poland	1.3%	0.3%	-0.8%	-2.1%	0.1%	0.8%	60.1%	-10.5%	3.4%	93.8%	n/a	n/a	132.0%	1.8%	0.9%	2.4%	-2.7%	4.3%
Romania	2.7%	1.7%	0.0%	-1.0%	1.3%	2.2%	47.2%	-9.6%	4.8%	84.6%	n/a	n/a	107.6%	-4.5%	3.4%	3.0%	-2.2%	-2.1%
Israel	0.9%	0.1%	0.6%	0.3%	0.1%	1.6%	78.3%	-12.9%	6.4%	n/a	n/a	n/a	371.0%	3.5%	4.6%	-0.7%	-1.2%	2.0%
Turkey	18.1%	12.9%	6.1%	-0.6%	17.0%	5.2%	43.6%	-7.9%	9.6%	23.1%	24.4%	7.4%	32.6%	-0.9%	-18.6%	15.0%	1.9%	9.0%
Russia	6.5%	4.6%	2.6%	0.3%	4.3%	1.5%	19.0%	-5.3%	1.3%	370.5%	0.6%	0.6%	243.1%	1.8%	n/a	5.2%	0.0%	0.0%
Kazakhstan	10.0%	10.0%	4.6%	3.3%	9.0%	0.9%	23.8%	-5.3%	-1.3%	87.7%	2.4%	2.7%	65.0%	-2.8%	n/a	7.4%	-1.1%	-3.7%
Armenia	9.7%	6.8%	6.7%	4.0%	5.5%	3.9%	61.2%	-5.8%	11.4%	354.9%	2.3%	11.8%	71.2%	-7.3%	n/a	3.7%	n/a	-2.8%
Georgia	8.5%	8.0%	5.7%	5.3%	8.0%	2.2%	58.7%	-8.1%	6.1%	121.0%	13.3%	64.8%	102.8%	-8.5%	n/a	2.8%	-3.0%	2.0%
Moldova	6.2%	5.7%	1.2%	1.0%	2.7%	n/a	38.5%	-8.0%	3.4%	142.2%	0.0%	6.0%	226.9%	-10.6%	n/a	7.1%	0.0%	0.0%
South Africa	8.5%	4.3%	4.4%	0.8%	3.5%	4.3%	80.8%	-14.0%	17.5%	85.3%	6.2%	5.0%	60.7%	-1.8%	-3.5%	3.1%	-5.7%	-4.7%
Egypt	14.4%	13.2%	7.6%	7.9%	9.3%	6.1%	88.6%	-7.5%	46.5%	184.6%	4.7%	6.6%	57.2%	-4.2%	n/a	4.3%	n/a	-25.6%
Pakistan	10.1%	7.5%	3.1%	0.3%	7.0%	5.4%	86.6%	-8.0%	41.5%	124.7%	9.4%	19.8%	38.5%	-2.5%	-9.2%	5.7%	n/a	n/a
India	6.0%	4.0%	2.1%	0.1%	4.0%	n/a	89.6%	-13.1%	32.6%	190.8%	1.3%	2.8%	191.7%	-0.9%	-1.0%	4.1%	-6.1%	-2.3%
Indonesia	6.2%	4.4%	3.9%	2.9%	3.8%	2.0%	40.2%	-6.3%	15.4%	201.9%	9.0%	13.5%	121.3%	-2.4%	-1.6%	1.6%	-2.0%	n/a
Malaysia	2.8%	2.2%	1.4%	1.7%	1.8%	0.8%	66.8%	-6.5%	12.5%	85.5%	n/a	n/a	113.7%	1.8%	-3.1%	-1.4%	-5.6%	0.2%
Philippines	1.4%	1.4%	-1.8%	-2.2%	2.0%	1.8%	50.7%	-8.1%	12.0%	474.9%	2.2%	6.2%	252.7%	-1.5%	6.7%	4.2%	-9.3%	n/a
S. Korea	1.8%	0.9%	0.8%	0.1%	0.5%	1.3%	50.3%	-3.2%	-1.9%	226.0%	n/a	n/a	117.5%	3.4%	n/a	0.6%	0.0%	0.0%
Thailand	1.4%	1.0%	0.3%	0.2%	0.5%	n/a	53.4%	-5.2%	2.1%	316.0%	0.3%	0.9%	238.2%	4.6%	-0.3%	-0.3%	-6.2%	n/a
Brazil	7.8%	3.9%	4.4%	0.2%	2.0%	3.4%	102.1%	-16.8%	17.0%	208.4%	1.8%	2.3%	142.3%	0.0%	-24.7%	4.6%	-3.4%	1.6%
Chile	2.6%	0.3%	-0.4%	-2.6%	0.5%	1.8%	35.2%	-8.7%	3.1%	99.0%	n/a	n/a	83.3%	-2.9%	-3.0%	3.1%	-6.6%	-1.3%
Mexico	5.6%	4.1%	2.5%	0.6%	4.0%	2.6%	65.6%	-5.8%	15.7%	204.9%	14.0%	11.6%	116.0%	-0.1%	2.3%	3.5%	-8.3%	-5.9%
Peru	3.8%	-1.3%	1.6%	-3.5%	0.3%	2.0%	39.3%	-9.4%	8.1%	497.3%	1.0%	2.9%	266.3%	-0.3%	-6.9%	2.7%	-10.2%	-8.6%
Colombia	n/a	2.0%	n/a	0.1%	1.8%	2.7%	68.1%	-9.5%	12.7%	169.4%	9.6%	9.6%	147.7%	-3.9%	-5.7%	1.6%	-5.6%	-8.6%

Note: GDP 4q ma indicates GDP growth rate, moving average for the last four quarters; IP 6m ma indicates industrial production growth rate, moving average for the last six months.

Source: Bloomberg, IMF WEO (October 2020), IMF International Investment Position, WB International Debt Statistics, IMF Assessing Reserve Adequacy DataMapper ICU.

**Table 2. Ukraine vs selected EM countries: Risk scorecard**

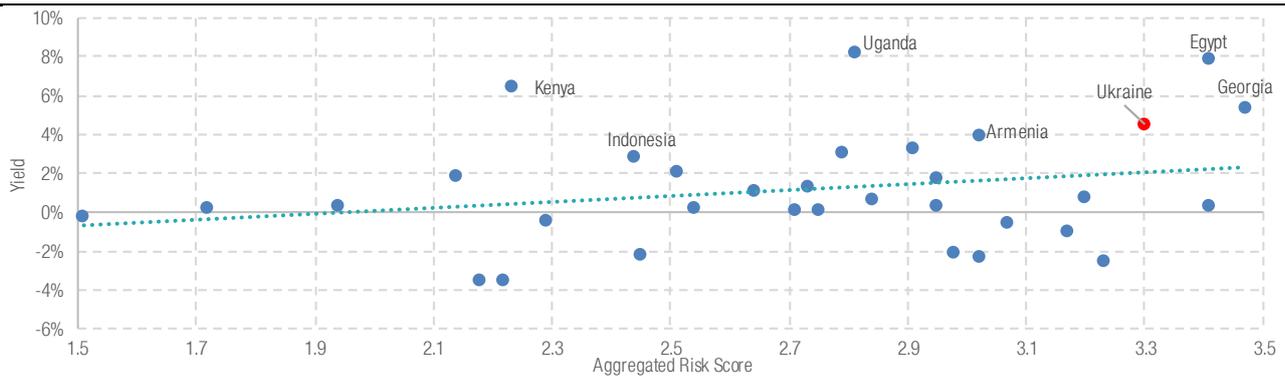
COUNTRY	DEBT RISK				LIQUIDITY RISK				FX RISK				MACRO RISK				OVERALL RISK
	Public Debt to GDP	Fiscal Bal to GDP	Debt service to Revenues	Average	Reserves to STD by RM	Eurobonds service to Reserves	Ext Debt service to Revenues	Average	Reserves to ARA metric	CAB	REER to 5Y av	Average	CPI	GDP (4qma)	IP (6mma)	Average	
Ukraine	3	4	2	3.0	3	4	2	3.0	3	4	4	3.7	2	5	4	3.5	3.3
Hungary	4	4	1	3.1	1	5	5	3.4	2	3	2	2.4	2	5	4	3.5	3.0
Poland	3	4	1	2.7	3	5	5	4.2	2	2	3	2.3	1	4	2	2.2	3.0
Romania	1	4	1	1.9	4	5	5	4.6	3	4	3	3.4	1	4	5	3.1	3.3
Israel	4	5	2	3.7	1	5	5	3.4	1	1	4	1.9	1	4	3	2.5	3.0
Turkey	1	4	2	2.2	5	5	2	4.1	5	3	1	3.0	4	3	1	2.8	3.1
Russia	2	3	1	2.0	1	1	1	1.0	1	2	5	2.6	2	3	3	2.6	1.9
Kazakhstan	2	3	1	2.0	4	2	1	2.5	5	4	5	4.6	3	3	5	3.6	3.1
Armenia	3	3	2	2.7	1	2	3	1.9	4	5	5	4.7	1	1	4	1.9	3.0
Georgia	3	4	2	3.0	2	4	5	3.5	3	5	5	4.4	1	4	1	1.9	3.5
Moldova	2	4	1	2.3	2	1	2	1.7	1	5	5	3.8	3	3	3	3.0	2.6
South Africa	4	5	3	4.0	3	3	1	2.4	5	3	3	3.6	2	5	5	3.8	3.4
Egypt	4	4	5	4.3	1	2	2	1.6	5	4	5	4.6	2	1	5	2.6	3.4
Pakistan	4	4	5	4.3	2	3	4	2.9	5	4	2	3.7	3	1	1	1.8	3.5
India	4	5	4	4.3	1	2	1	1.3	1	3	3	2.4	2	5	5	3.8	2.8
Indonesia	1	3	3	2.2	1	3	3	2.2	2	4	3	3.1	1	4	1	1.9	2.4
Malaysia	3	3	2	2.7	3	5	5	4.2	2	2	2	2.0	1	5	4	3.1	3.0
Philippines	3	4	2	3.0	1	2	2	1.6	1	3	4	2.7	2	5	1	2.6	2.5
S. Korea	3	3	1	2.4	1	5	5	3.4	2	1	5	2.5	1	3	3	2.2	2.7
Thailand	3	3	1	2.4	1	1	1	1.0	1	1	4	1.9	1	5	1	2.2	1.8
Brazil	5	5	3	4.4	1	2	1	1.3	2	2	1	1.7	2	5	4	3.5	2.6
Chile	2	4	1	2.3	3	5	5	4.2	3	4	2	3.1	2	5	4	3.5	3.2
Mexico	3	3	3	3.0	1	4	3	2.5	2	3	3	2.7	2	5	5	3.8	2.8
Peru	2	4	2	2.6	1	2	1	1.3	1	3	2	2.1	1	5	5	3.4	2.1
Colombia	3	4	2	3.0	1	3	2	1.9	2	4	2	2.8	1	5	5	3.4	2.7

Note: We assign a numerical score from 1 to 5 with higher numbers corresponding to greater vulnerability based on selected thresholds. Then we calculate an aggregated risk score for each country based on the weighted average of all available indicators. Weights are based on expert judgments regarding relative importance of factors and categories of factors. For instance, macro risk indicators have lower weights compared with ones from other categories.

Source: Bloomberg, IMF WEO (October 2020), IMF International Investment Position, WB International Debt Statistics, IMF Assessing Reserve Adequacy DataMapper ICU.

**Chart 2. Ukraine vs selected EM countries: Risk-reward ratio for 12m bonds**

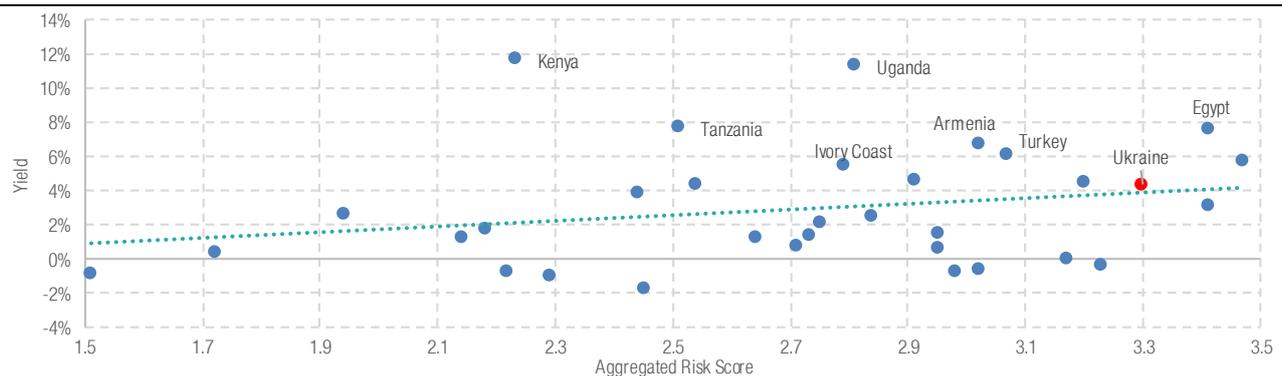
*Ukrainian yield for 12m bonds provides good premium to the level justified by risk metrics*



Source: Bloomberg, ICU

**Chart 3. Ukraine vs selected EM&FM countries: Risk-reward ratio for 5Y(10Y) bonds**

*Ukrainian yield for 5Y notes is relatively high compared with peers, but in line with risk indicators*



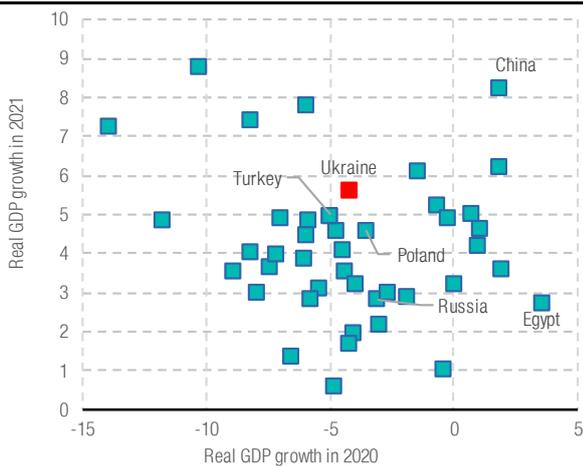
Source: Bloomberg, ICU

## 2. Macroeconomic developments

- After the lockdown-induced sharp decline in 2Q20, the Ukrainian economy swiftly went into recovery, exceeding expectations of nearly all economic forecasters. We currently estimate a GDP decline of 4.2% in 2020, and project a 5.6% rebound this year, which outperforms major peers.
- External accounts considerably benefit from COVID-19 crisis while deterioration in fiscal balances is moderate and much smaller compared with peers
- In December 2020, headline inflation expectedly accelerated and hit the NBU target of 5%. We expect inflationary pressure to intensify in the near term due to a surge of global energy and agri prices and a hike in the minimum wage; however, inflation should remain not far from the upper bound of the 5±1% target range as the ongoing food-price spike starts to unwind

**Chart 4. Real GDP in 2020-21 (YoY, %)**

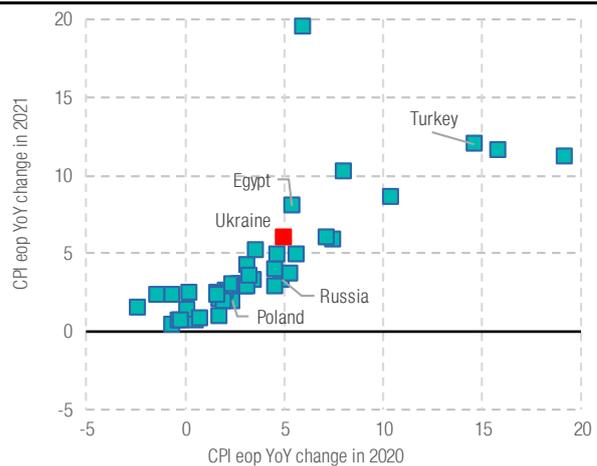
*Economic performance of Ukraine exceeds most peers while lagging behind selected Asian and African countries*



Source: IMF WEO (October 2020), ICU.

**Chart 5. CPI (eop) in 2020-21 (YoY, %)**

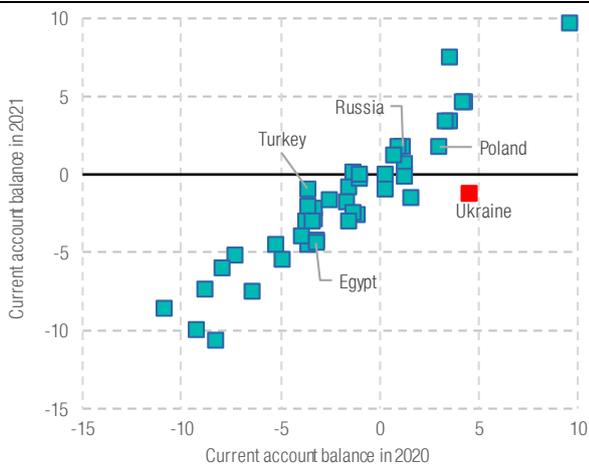
*Ukrainian inflation remains close to 5% target avoiding deflation or inflation soaring as in selected peers*



Source: Bloomberg, IMF WEO (October 2020), ICU

**Chart 6. CA balance in 2020-21 (% of GDP)**

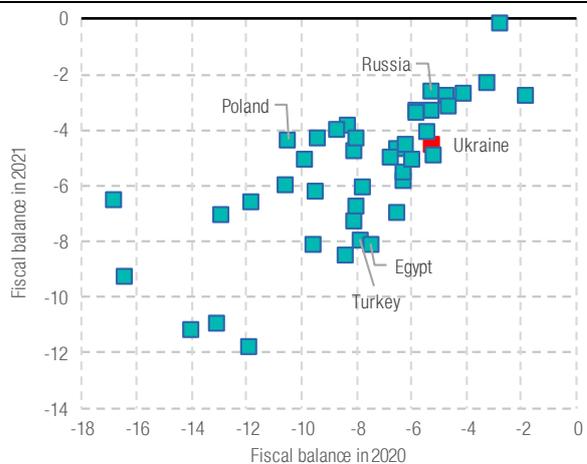
*After surprising positively in 2020, current account balance is expected to worsen the most in 2021 while still remaining at a sustainable level*



Source: IMF WEO (October 2020), ICU.

**Chart 7. Fiscal balance in 2020-21 (% of GDP)**

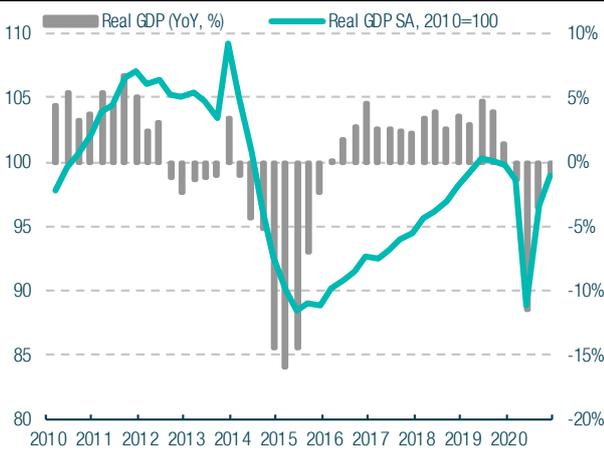
*While deteriorating due to the pandemic and infrastructure projects, fiscal stance in 2020-21 is one of the most prudent in EM universe*



Source: IMF WEO (October 2020), ICU

**Chart 8. Real GDP**

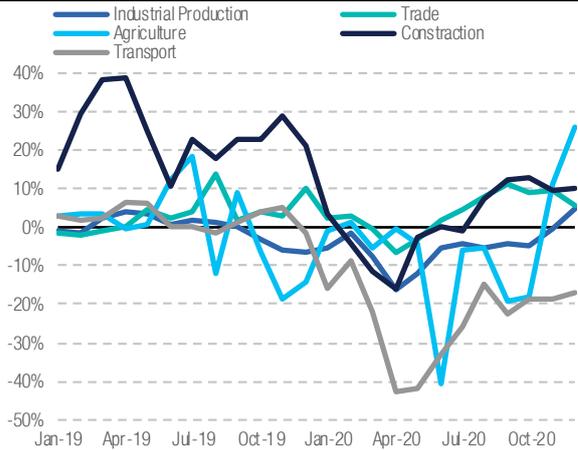
After sizable pandemic-induced fall in 2Q20, the economic activity almost completely recovered in 2H20



Source: Ukrstat, ICU.

**Chart 9. Key economic indicators (YoY, %)**

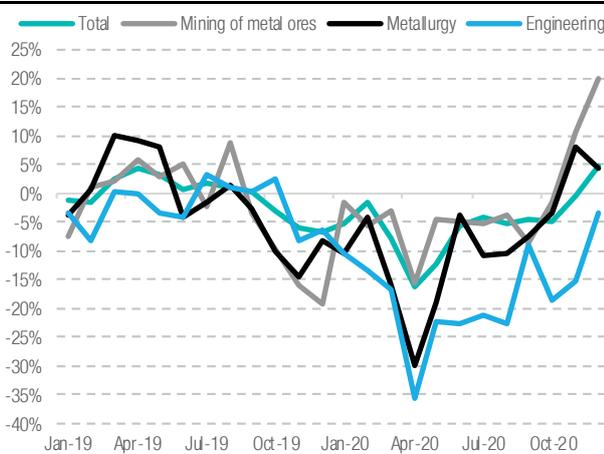
Trade and construction returned to positive YoY growth in mid-20 while industrial production only did so at the end of the year



Source: Ukrstat, ICU.

**Chart 10. Industrial production (YoY, %)**

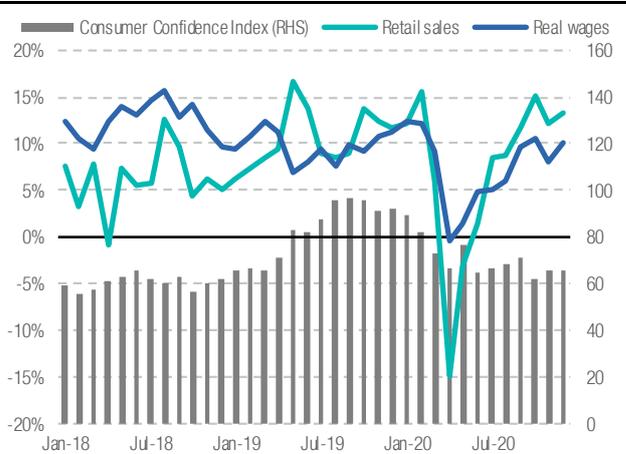
Industrial production benefits from favourable conditions on global markets for iron ore and steel as well as from robust domestic demand



Source: Ukrstat, ICU.

**Chart 11. Retail sales and real wages (YoY, %)**

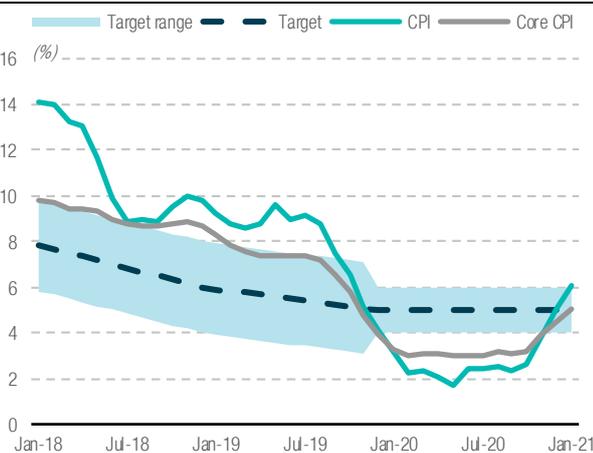
Retail sales came back to pre-pandemic trend in mid-20 amid fast recovery of income and switching expenditures to spending domestically



Source: Ukrstat, Info Sapience, ICU

**Chart 12. CPI, Core CPI and targets (YoY, %)**

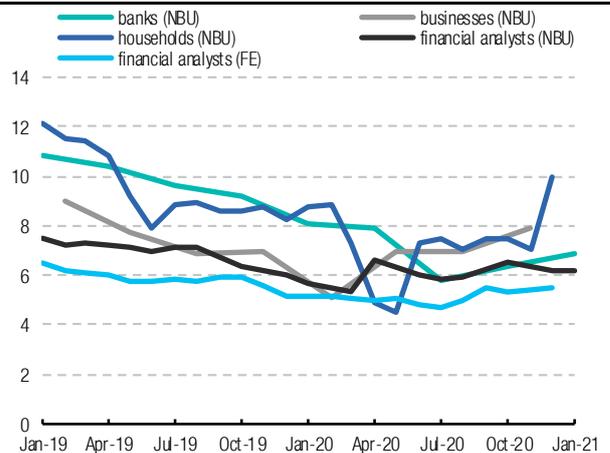
Consumer inflation hit 5% target in December 2020 as monetary easing and food and supply-side factors fuelled price growth at the end of the year



Source: NBU, Ukrstat, ICU.

**Chart 13. Inflation expectations (YoY, %)**

While deteriorating slightly at the end of 2020 amid raising food and energy prices, inflation expectations remain relatively well anchored



Note: presented are expectations of price changes during the next 12 months collected by the NBU and Focus Economics consensus for CPI eop in 2021

Source: NBU, Focus Economics, ICU

### 3. Public debt overview

- Ukraine’s debt burden is relatively moderate. After four years of rapid decline, the debt-to-GDP ratio surged to 63% in 2020, reflecting a 4% fall of real GDP and UAH real depreciation amid high share of FX denominated debt
- In recent years, the outstanding amount of UAH bonds grew sizably and reached US\$30bn at the end of 2020. Still, their share in public debt just barely exceeded 39% in January, indicating strong potential for future growth and replacement of FX debt
- Banks accumulated the major part of UAH bonds while the NBU continues its gradual quantitative squeezing as the bonds in its portfolio are redeemed. The share of foreigners after their gradual exit in 2020 is moderate compared with peers
- Government has ambitious plans for borrowings via UAH bonds this year. We believe that these plans have a high chance to be fulfilled if bond buying keeps the pace of January–February

**Chart 14. Ukraine’s debt-to-GDP ratio, %**

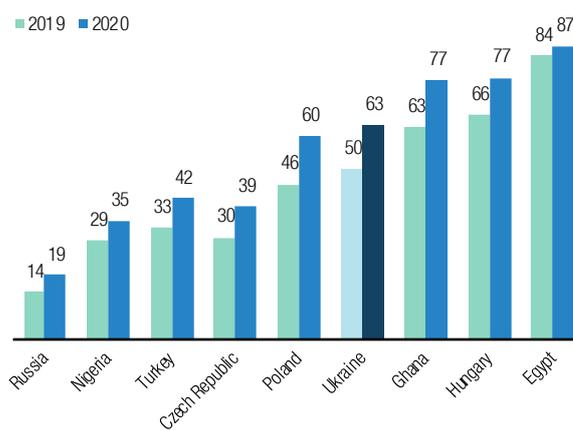
*Strong downward trend was reversed in 2020 amid pandemic effects while we project the ratio to decline as soon as this year*



Source: Bloomberg, IMF, ICU.

**Chart 15. Debt-to-GDP ratio, Ukraine and selected EM countries, end of 2019 and 2020, %**

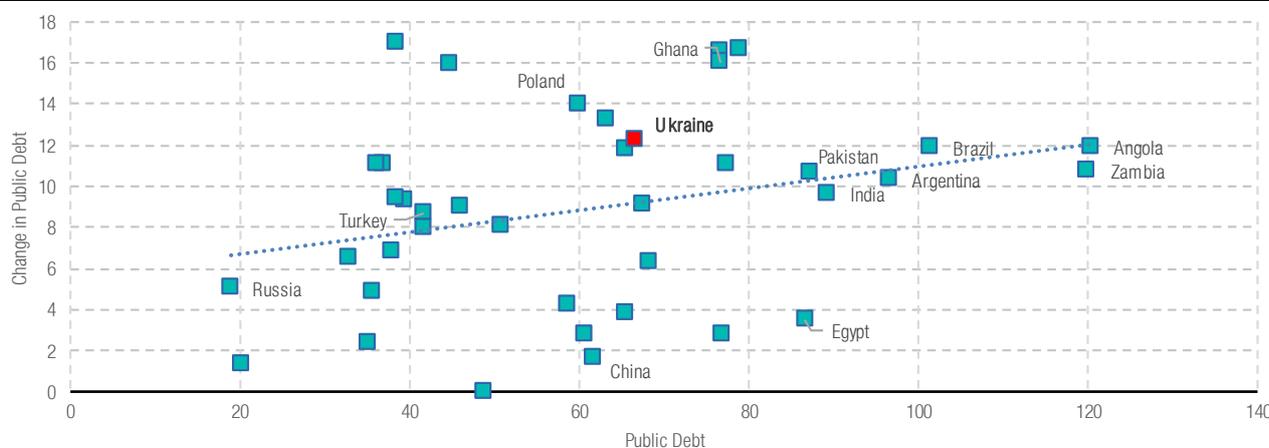
*As deteriorating debt metrics in 2020 were a common trend in all EMs, Ukraine does not look like an outlier*



Source: Bloomberg, ICU.

**Chart 16. Ukraine vs selected EM countries: Public debt and change in public debt in 2020 (% of GDP)**

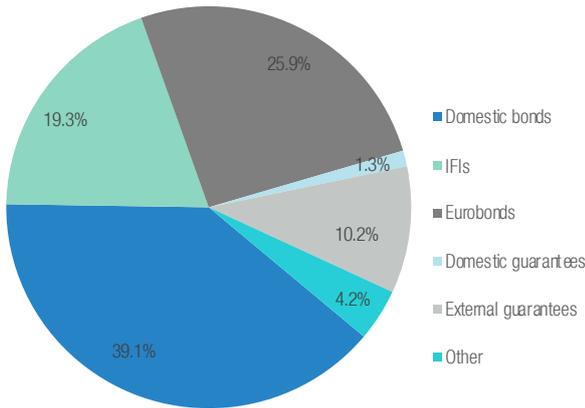
*In 2020, an increase in debt-to-GDP ratio in Ukraine was relatively large due to real depreciation amid high FX debt share*



Source: IMF WEO (Oct 2020), MFU, ICU.

**Chart 17. Debt structure by type (as of 1 January, 2021)**

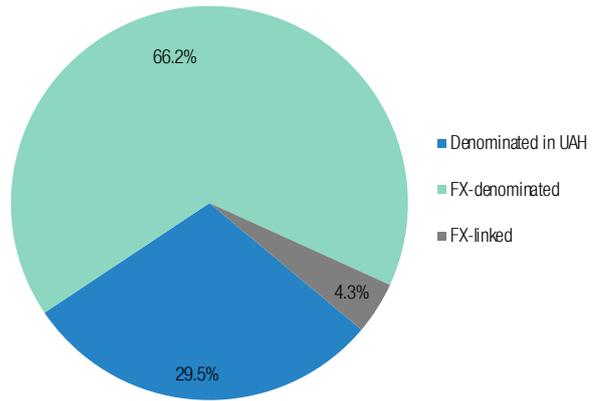
About a quarter of public debt comes from external market sources while concessional financing from IFIs is approximately of the same size



Source: MFU, ICU.

**Chart 18. Debt structure by currency (as of 1 January, 2021)**

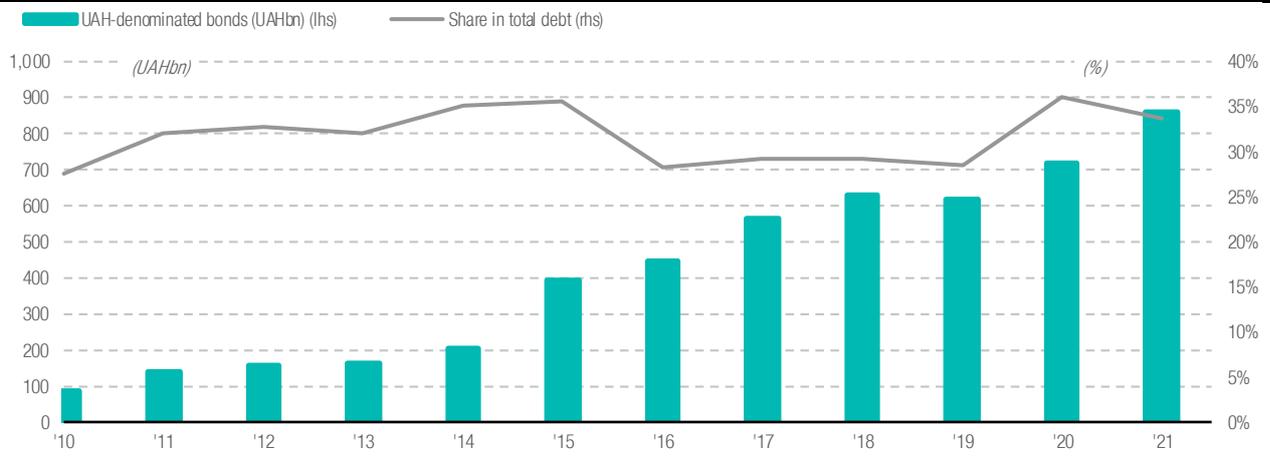
Less than 30% of Ukrainian public debt is in national currency indicating the potential for UAH bonds replacing the external debt gradually



Source: MFU, NBU, ICU.

**Chart 19. UAH bonds: Volumes and share in overall debt**

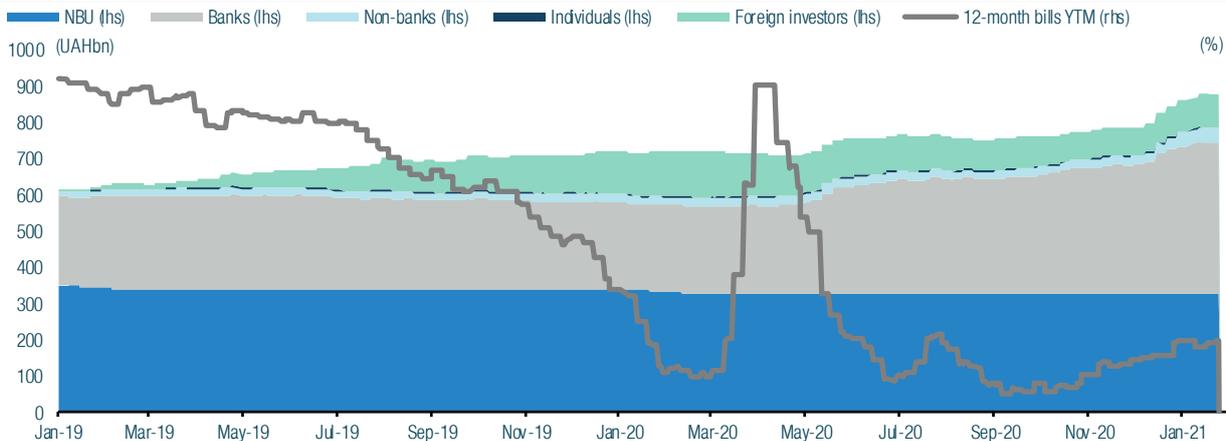
In recent years, outstanding amount grew fast and reached US\$30bn at the end of 2020. However, UAH bonds share in public debt only occasionally exceeds 35%



Source: MFU, ICU.

**Chart 20. UAH bonds portfolios (UAHbn) and 12M bills' YTM (%)**

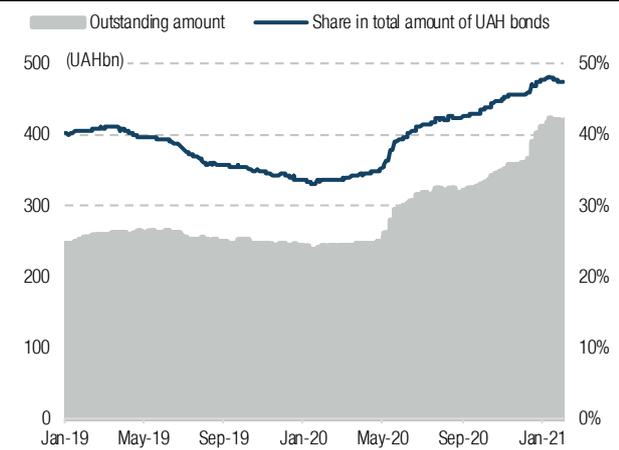
In 2019-20, NBU's share declined from 57 to 38%, while banks increased their holdings 67%. Foreigners are active players since 2019, when link with Clearstream is established



Source: NBU, ICU.

**Chart 21. UAH bonds held by local banks**

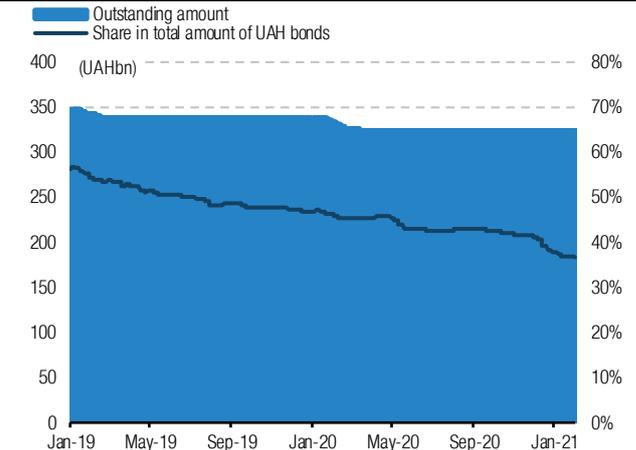
Local banks increased their portfolios of UAH almost by 70% since May 2020, using liquidity support from the NBU



Source: NBU, ICU.

**Chart 22. UAH bonds held by the NBU**

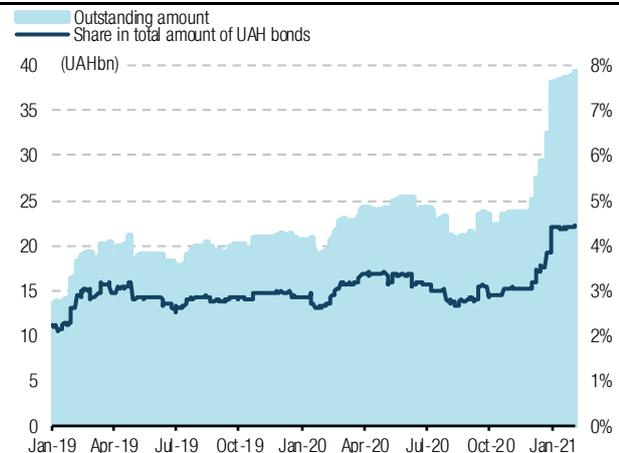
NBU's portfolio contracts gradually as the bonds are redeemed



Source: NBU, ICU.

**Chart 23. UAH bonds held by non-banks**

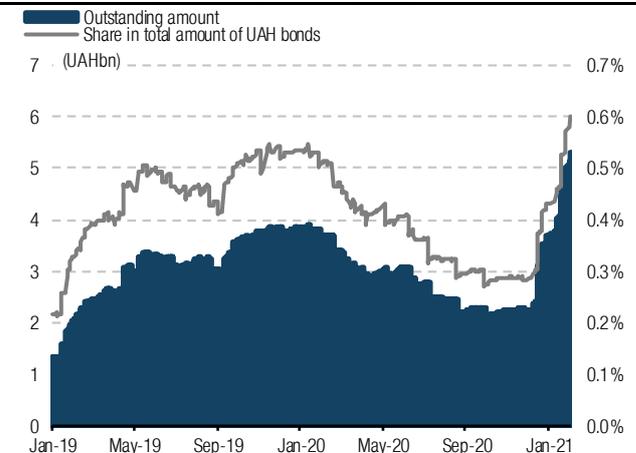
In November–December 2020, non-banks increased their UAH bonds holdings by 60%



Source: NBU, ICU.

**Chart 24. UAH bonds held by local individuals**

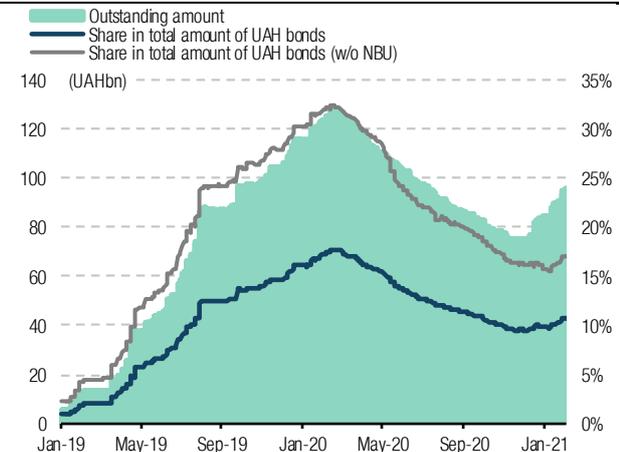
Since December 2020, individuals express high interest in local bonds due to attractive yields compared with deposits and improving trade infrastructure



Source: NBU, ICU.

**Chart 25. UAH bonds held by foreigners**

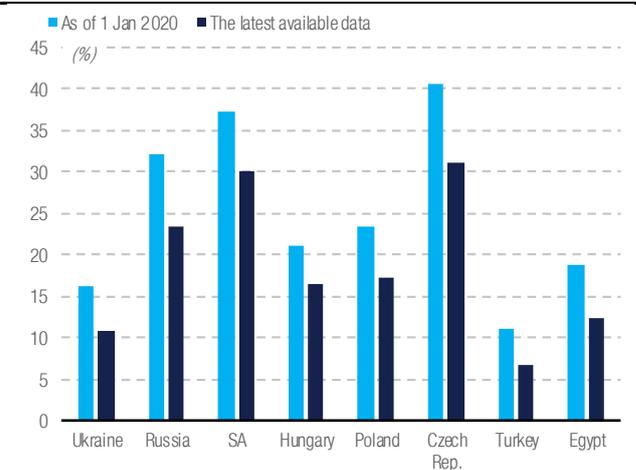
Foreigners have been building up UAH bonds holdings again, although their portfolios are still below the peak in February 2020 by more than US\$1bn



Source: NBU, ICU.

**Chart 26. Share of local bonds held by foreigners**

There is a potential for further increase of foreigners' share as Ukraine lags behind many peers by this indicator



Source: NBU, countries data, ICU.

**Chart 27. UAH bonds structure by residual maturity, UAHbn**

Bonds with maturities longer than 7Y are not traded; paper is held by the NBU and SOBs



Source: NBU, ICU.

**Chart 28. Bond issues' structure by maturity, UAHbn**

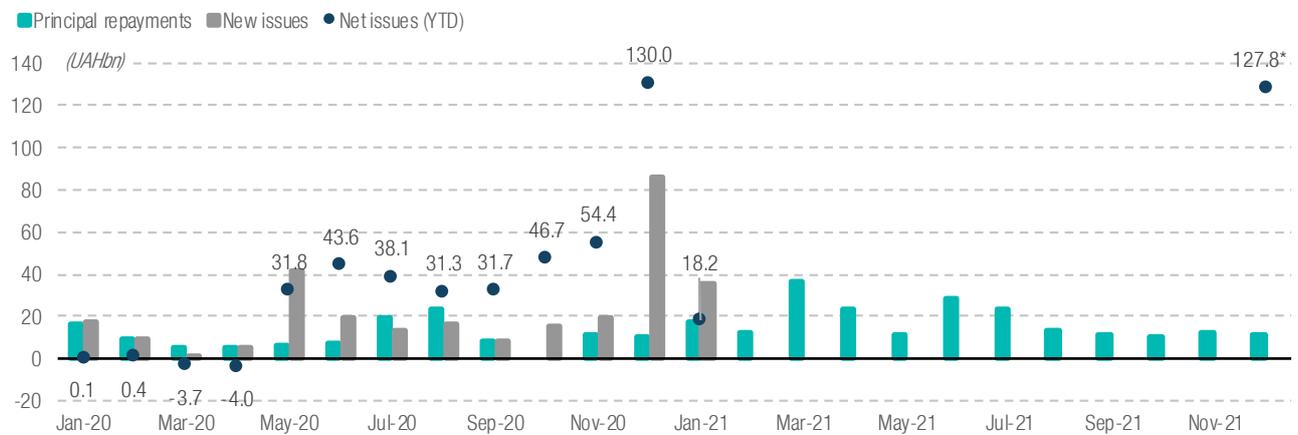
In 2020, the MoF was prone to issue short-term paper, but this year supply is more focused on 1Y-2Y maturities



Source: MFU, ICU.

**Chart 29. UAH bonds: Principal repayments and new issues, UAHbn**

We project that government will finance the fiscal deficit with net issue of UAH bonds in the amount close to 2020 volume (UAH130bn); however, the net supply of UAH bonds should be more equally distributed in time



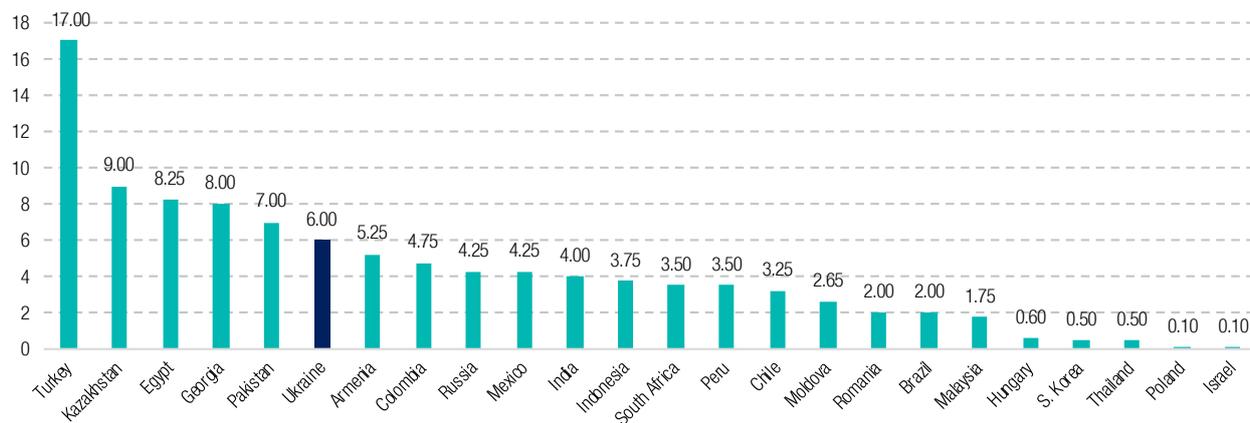
Source: MFU, ICU.

## 4. NBU monetary policy

- Both the NBU and we see an increase of the key policy rate by 100bp to 7% this year. However, we expect that the NBU will postpone the hikes amid inflows of foreign portfolio investments and corresponding UAH appreciation
- We assess the current monetary policy stance as relatively dovish. Even though the key rate remained unchanged since June 2020, the ex-post real rate has fallen to just 1% as the end of 2020. Meanwhile, ex-ante real rate deflated by our 12M ahead CPI forecast hovers around zero since mid-2020
- Moreover, while the NBU continued its gradual quantitative squeezing as bonds from its portfolio are redeemed, the additional supply of liquidity went to government accounts via banks, which substantially increased their UAH bond portfolios by UAH166bn (+68%) since the start of 2020
- Investments in local bonds considerably boosted excessive liquidity of the banking sector (credit to NBU less the debt to the NBU) that reached UAH250bn at its peak in 2020. Last six months excessive liquidity hovered around UAH90bn keeping short-term interbank rates close to the floor of NBU interest rate corridor

**Chart 30. Key policy rate in selected EM countries, %**

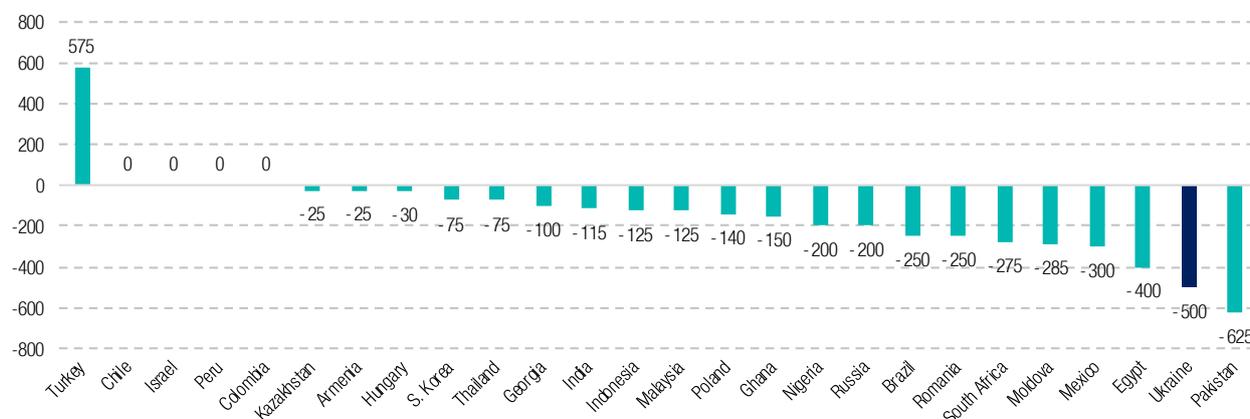
*While Ukraine remains a country with one of the highest key policy rates across the EM universe...*



Source: Bloomberg, ICU.

**Chart 31. 12M change in key policy rate in selected EM countries, bps**

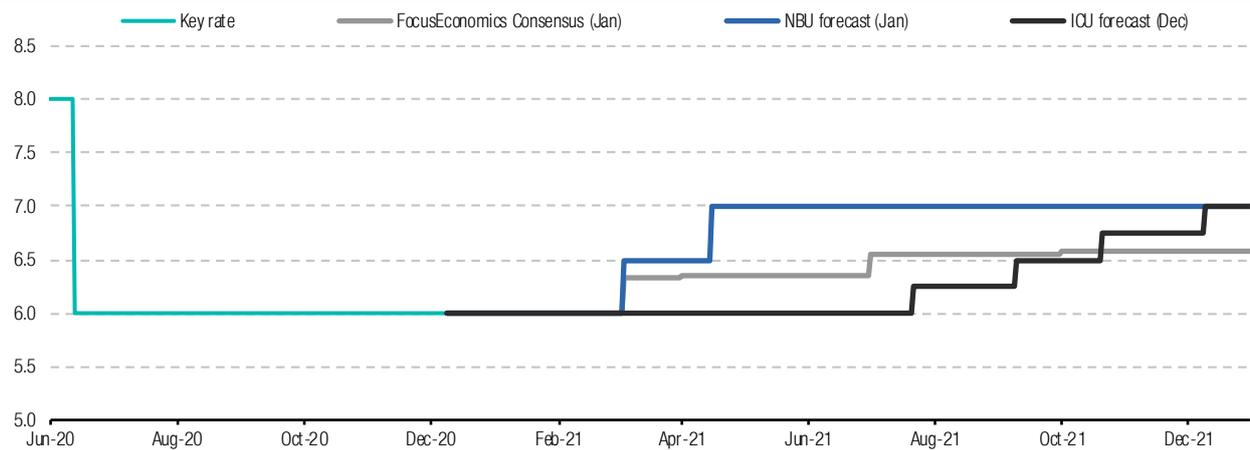
*... despite being one of the biggest rate cutters in last 12M period*



Source: Bloomberg, ICU.

**Chart 32. Key policy rate forecast**

We expect the NBU to delay an increase in the key policy rate until July as foreign inflows will cause UAH appreciation and contain inflation pressure



Source: NBU, FOCUS ECONOMICS, ICU

**Chart 33. Key policy rate and inflation**

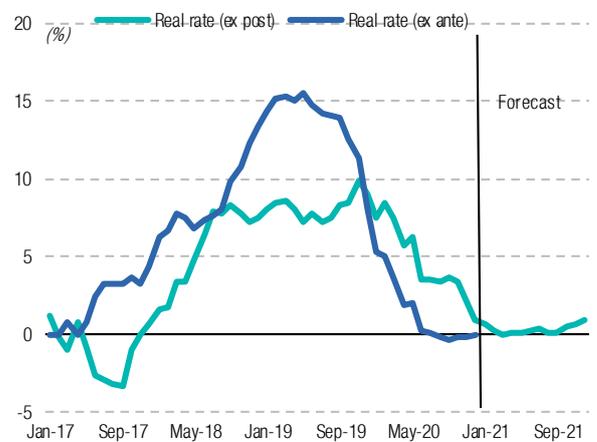
NBU has kept the key policy rate unchanged despite the rise in inflation factoring in the slump in the economy caused by the pandemic



Source: NBU, Ukrstat, ICU

**Chart 34. Ex-post and ex-ante real rates**

Monetary policy stance switched from very hawkish to moderately dovish as a response to pandemic drag on economy and low inflation in mid-2020

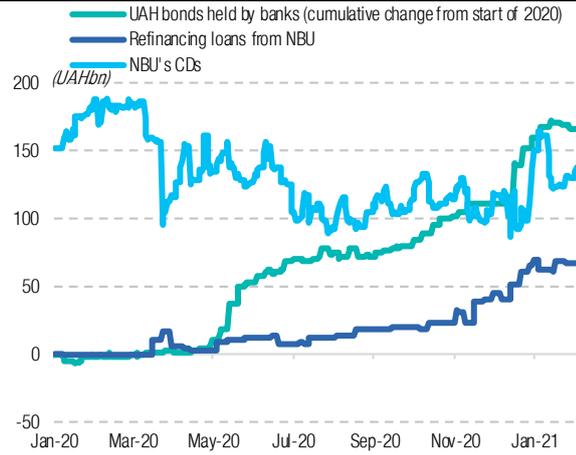


Note: ex-post real rate is deflated by actual CPI YoY, while ex-ante real rate is deflated by ICU's 12m ahead forecast of CPI YoY

Source: NBU, Ukrstat, ICU.

**Chart 35. Selected banks' assets and liabilities**

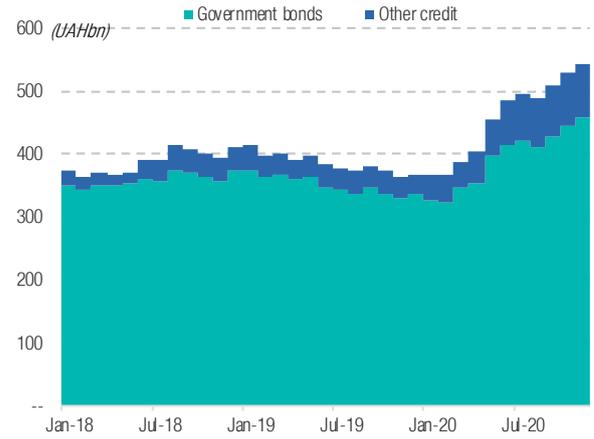
*Lower rates made banks switch their liquidity from CDs to bonds*



Source: NBU, ICU.

**Chart 36. Banks exposure to the public sector**

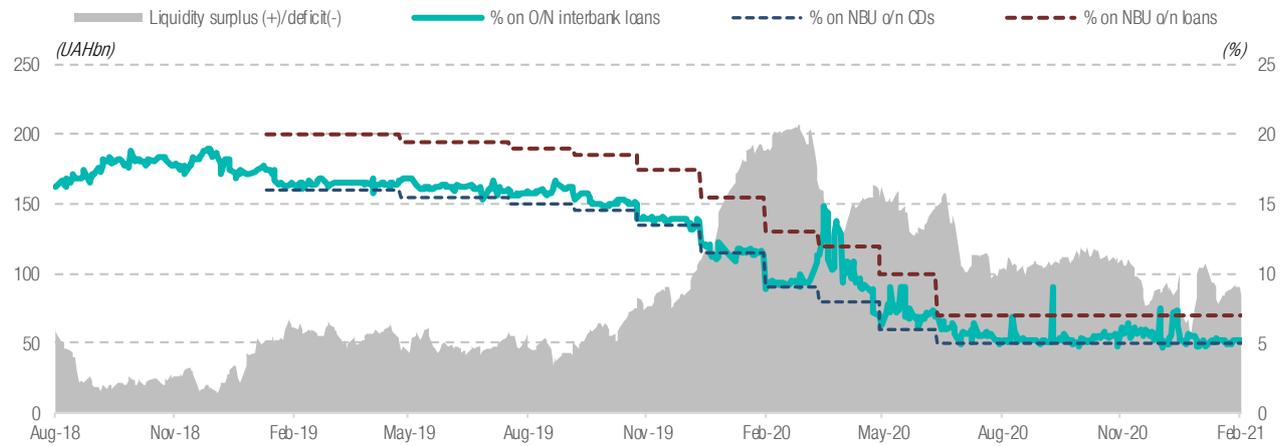
*Banks increased their holdings of government and government-related debt*



Source: NBU, ICU.

**Chart 37. UAH liquidity surplus (+) / deficit (-) in Ukrainian banking system**

*Structural liquidity surplus keeps the interbank O/N rates close to the lower bound of NBU's rate corridor*



Note: liquidity stance is determined as a difference between banks' claims on the NBU (corresponding accounts at the NBU and holdings of NBU's CDs) and debt to the NBU on refinancing loans

Source: NBU, ICU

# 5. UAH bond yield outlook

- UAH yield curve steepened recently with long-term yields rising and short-term yields falling
- NBU's intention to keep rate at 6% and abundant liquidity are behind the falling yields at the front end of the curve. These factors also play at the long end, but to a far lesser extent. Rising inflation expectations and uncertainty around the IMF are more important issues at the long end
- By end-2021, we see room for 1Y bond yields in Ukraine to slide to 11% and 2Y bond yields to stay close to the current level of 11.7%

Table 3. Benchmark UAH government bonds

Maturity	Coupon rate, %	Outstanding amount, UAHbn	Issued amount (YTD), UAHbn	YTM, %	YTM 1m cchange, bps	YTM YTD cchange, bps	YTM 12m cchange, bps
19-May-21	10.97	0.8	0.8	9.24	-100	-129	-
11-Aug-21	16.00	9.7	0.5	10.02	-79	-97	-26
05-Jan-22	17.25	10.9	5.1	10.79	-45	-59	52
03-Aug-22	16.06	6.9	0.0	11.33	-16	-22	107
12-Oct-22	14.91	9.4	0.0	11.43	-12	-14	118
23-Aug-23	10.00	10.4	0.0	11.73	-7	14	147
22-Nov-23	11.67	11.0	0.0	11.76	-8	19	149
22-May-24	9.99	4.4	5.3	11.83	-10	31	-
26-Feb-25	15.84	41.1	0.0	11.84	-12	42	156
26-May-27	9.79	5.2	2.4	11.65	-13	74	143

Source: MFU, NBU, ICU.

Chart 38. Bonds rates in primary market (%)

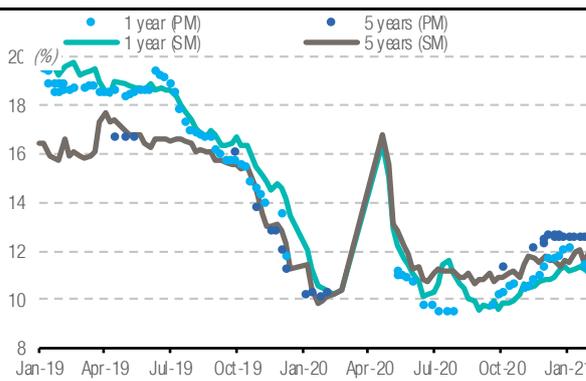
Normal yield curve points out to expectations of rising short-term rates and additional premium for long maturity



Source: NBU, ICU.

Chart 39. Primary and secondary YTM (%)

Until recently, the MoF provided an additional premium at the primary market to meet high financing needs



Source: NBU, ICU.

Chart 40. Yields on 1Y bonds, secondary market (%)

Yields are lower slightly to 11% by the end of 2021



Source: NBU, ICU

Chart 41. Yields on 2Y bonds, secondary market (%)

Yields are expected to hover around current level of 11.7% through 2021



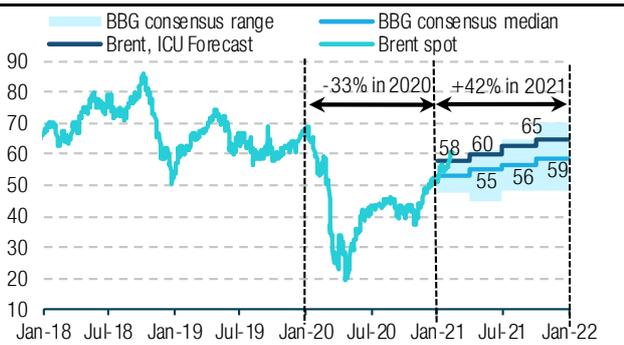
Source: NBU, ICU.

# 6. FX outlook

- Prices for Ukraine’s key exports—metals, ores, and grains—will remain elevated compared with 2018–20, despite likely decline towards the end of 2021
- While surging oil and gas prices and rebounding expenditures for transportation and travel abroad may result in tripling the trade deficit, strong remittances will help keep C/A deficit below 2% of GDP in 2021
- Elevated export prices imply high upside risks for our C/A balance and FX forecasts
- Recovering capital inflows result in continuation of FX reserves growth to US\$31bn
- UAH is likely to further strengthen to UAH27–27.5/USD by mid-2021 amid favourable terms of trade and supportive seasonality, and end 2021 within UAH27.5–28/USD

**Chart 42. Oil prices (US\$/bbl)**

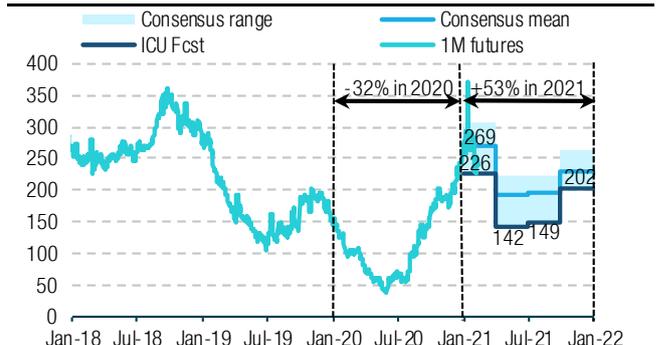
*Oil prices will continue to grow due to recovering global demand, high supply discipline of OPEC+, slow recovery of non-OPEC production*



Source: Bloomberg, Refinitiv, ICU.

**Chart 43. Natural gas prices in Europe (US\$/tcm)**

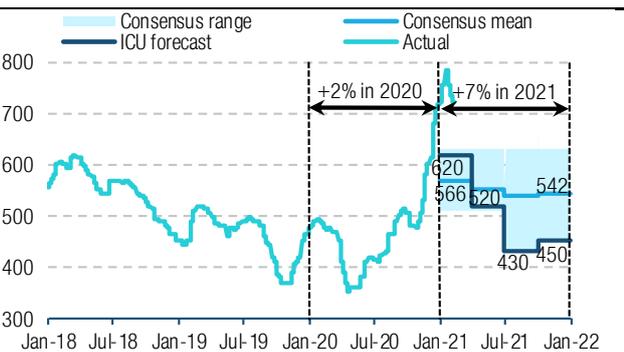
*Gas prices are supported by rising oil prices, recovering economies, lower inventories, and slower LNG supply growth*



Source: Bloomberg, Refinitiv, ICU.

**Chart 44. Steel HRC price in Black Sea region (US\$/t)**

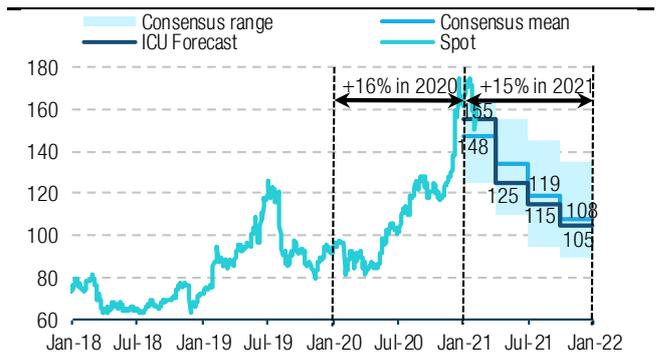
*Steel prices should quickly drop from their current levels due to rising ex-China steel output and lower iron ore prices, but on average will be higher YoY in 2021*



Source: Bloomberg, Refinitiv, ICU.

**Chart 45. Benchmark iron ore prices (US\$/t)**

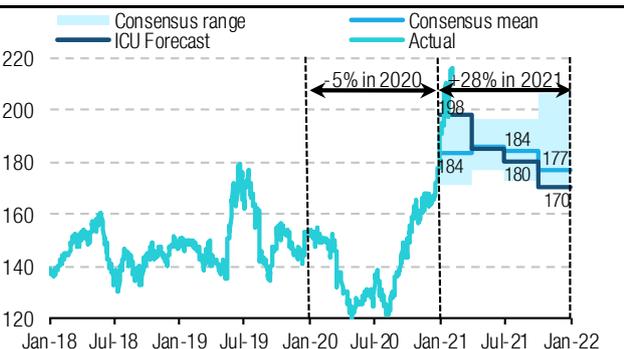
*Although iron ore prices may drop 45% by YE21 due to strong seaborne supplies and slowing China demand, on average they will gain 14% YoY in 2021*



Source: Bloomberg, Refinitiv, ICU.

**Chart 46. Corn prices (US\$/t)**

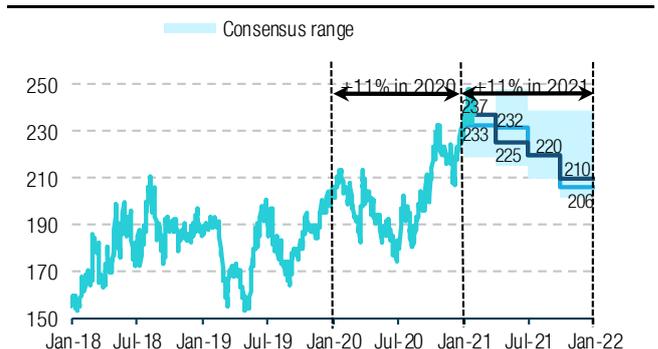
*Corn prices should remain elevated in 2021, supported by higher oil prices, China demand, and lower 2020/21 production affected by droughts*



Source: Bloomberg, Refinitiv, ICU.

**Chart 47. Wheat prices (US\$/t)**

*Wheat prices should moderately decline due to high stocks and ample supply; however, they are poised for an average 10% YoY growth in 2021*



Source: Bloomberg, Refinitiv, ICU.

**Chart 48. Exports (US\$bn)**

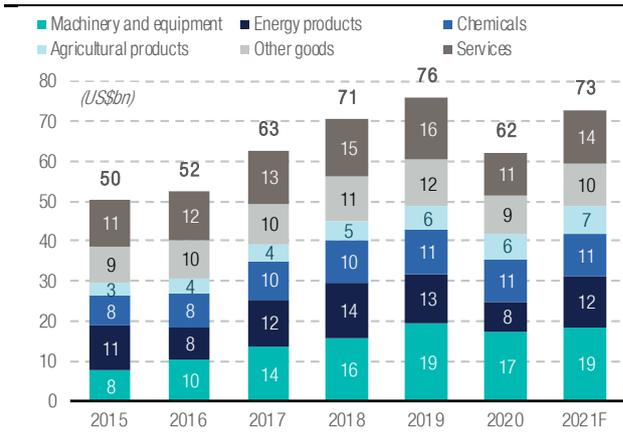
While volumes of steel products, transportation, and travel services were most affected and drove exports down 5% in 2020, they should also help exports to recover the same 5% in 2021, aided by favourable steel, ore, and grain prices



Source: NBU, ICU

**Chart 49. Imports (US\$bn)**

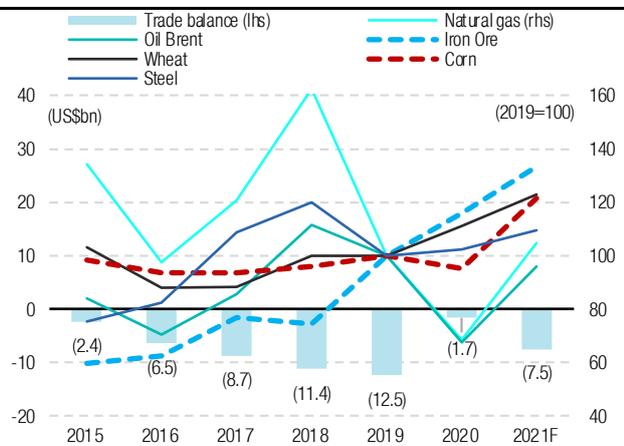
Mostly due to crisis-hit oil and gas prices, foreign travels and transportation services, and deteriorated demand for investment goods, imports fell 18% in 2020. Fast recovery of the same drivers should help imports to grow 15% in 2021



Source: NBU, ICU

**Chart 50. Trade balance (US\$bn) and commodity prices (2019=100)**

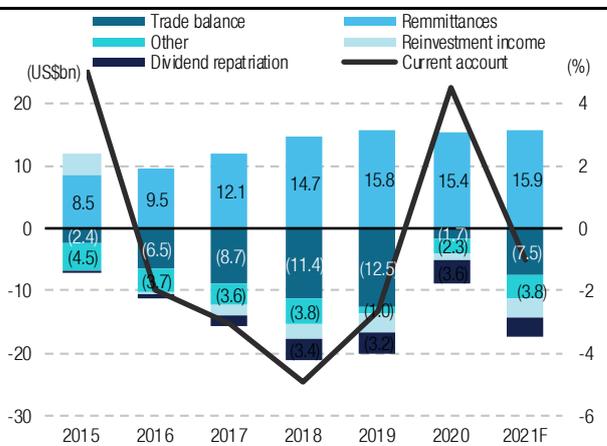
Historically strong drivers of import costs, oil and gas prices will catch up with grains and metals in growth in 2021; hence, the trade deficit will quickly expand



Source: Bloomberg, NBU, ICU

**Chart 51. Current account (US\$bn, % of GDP)**

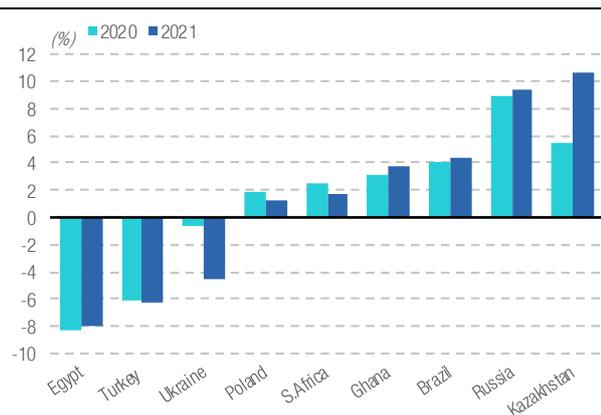
Despite more than tripling trade deficit, the current account deficit should still be a moderate 1.2% of GDP, as private remittances should remain strong



Source: NBU, ICU

**Chart 52. Ukraine's trade balance vs selected EM countries (% of GDP)**

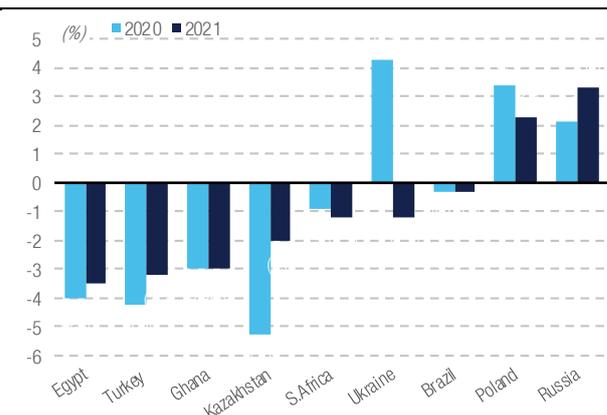
Highly dependent on energy imports, Ukraine should be among EM countries which will see the fastest expansion of their trade deficit in 2021



Source: Bloomberg, NBU, ICU

**Chart 53. Ukraine's C/A balance vs selected EM countries (% of GDP)**

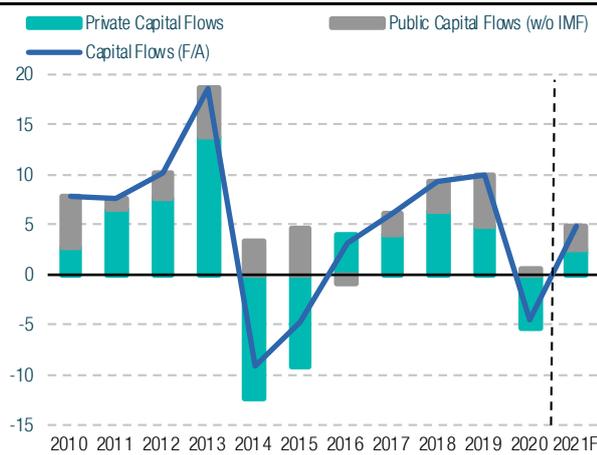
Significant migrant labour force and their cash remittances home make Ukraine's 2021 current account deficit one of the lowest among EMs



Source: Bloomberg, NBU, ICU

**Chart 54. Capital flows (US\$ bn)**

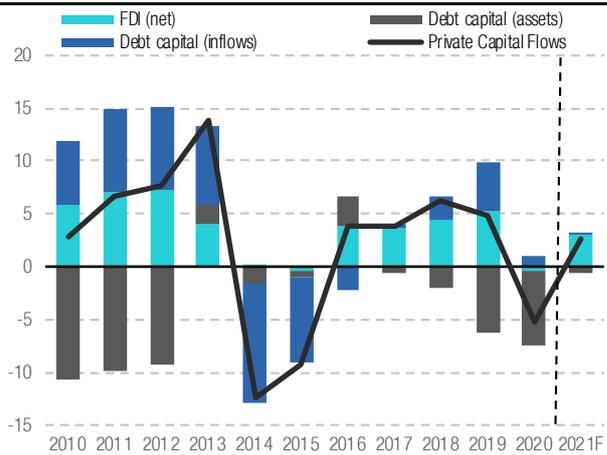
While private sector showed a net capital outflow in 2020, the situation should reverse in 2021



Source: NBU, ICU.

**Chart 55. Capital flows of private sector (US\$ bn)**

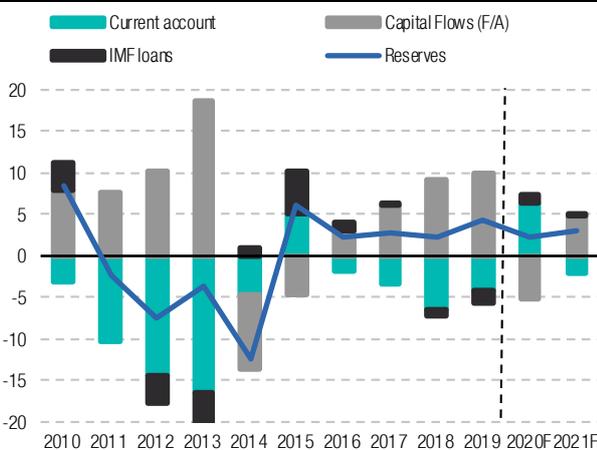
In 2021, capital flight from the private sector should fade out while FDI will recover, albeit still 40% below pre-pandemic levels



Source: NBU, ICU

**Chart 56. Changes in Reserves (US\$ bn)**

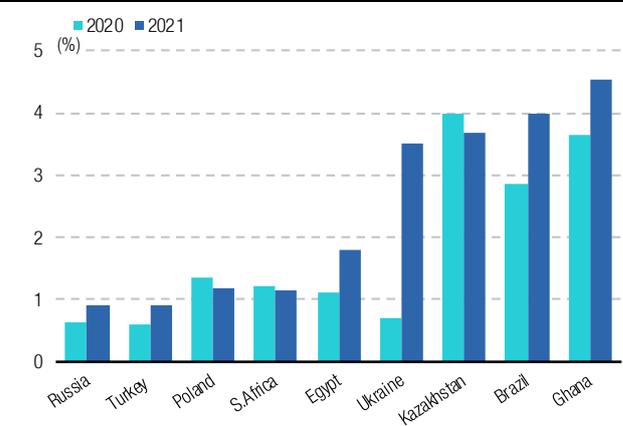
We expect IMF financing will help Ukraine to continue accumulating FX reserves



Source: NBU, ICU.

**Chart 57. FDI in Ukraine vs selected EM countries (% of GDP)**

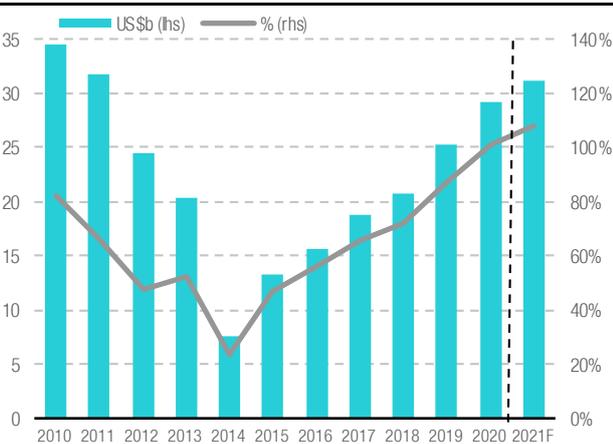
Ukraine's FDI recovery in 2021 is expected to be one of the strongest in EMs



Source: NBU, ICU

**Chart 58. Reserves (US\$ bn) and the ratio to IMF ARA metric (%)**

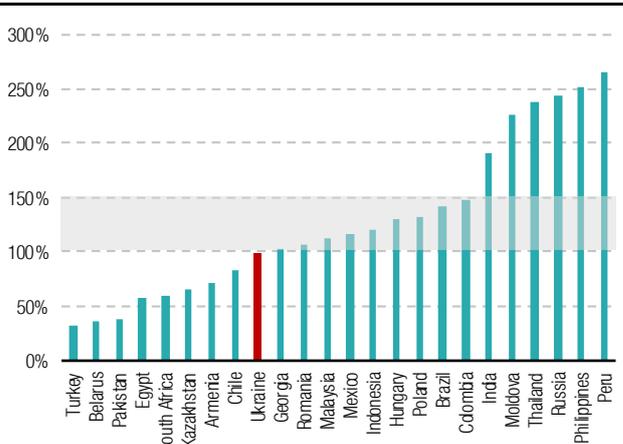
Reserves reached 100% of IMF ARA metric in 2020



Source: NBU, ICU.

**Chart 59. Reserves in Ukraine vs selected EM countries (% to IMF ARA metric)**

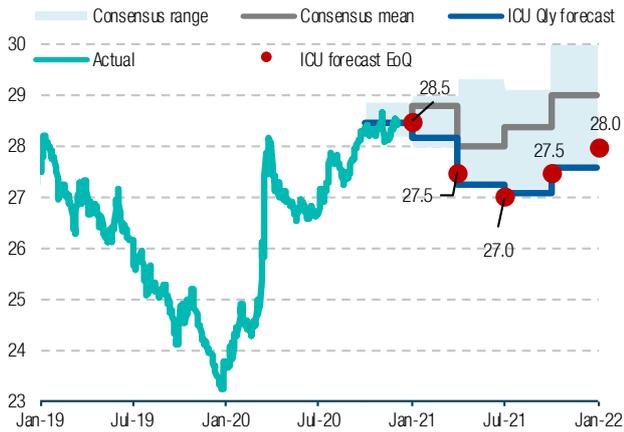
Ukraine outperforms peers like Turkey and Egypt



Source: Bloomberg, IMF, NBU, ICU

**Chart 60. UAH/USD forecast**

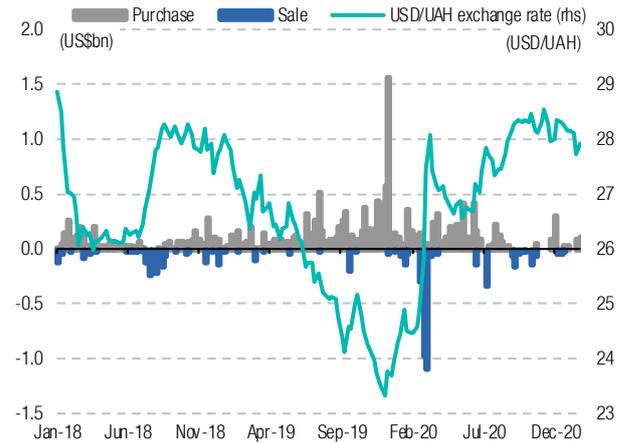
UAH is likely to further strengthen to UAH27–27.5/USD by mid-2021 and then end 2021 within UAH27.5–28/USD



Source: NBU, Bloomberg, ICU.

**Chart 61. UAH/USD and NBU FX interventions**

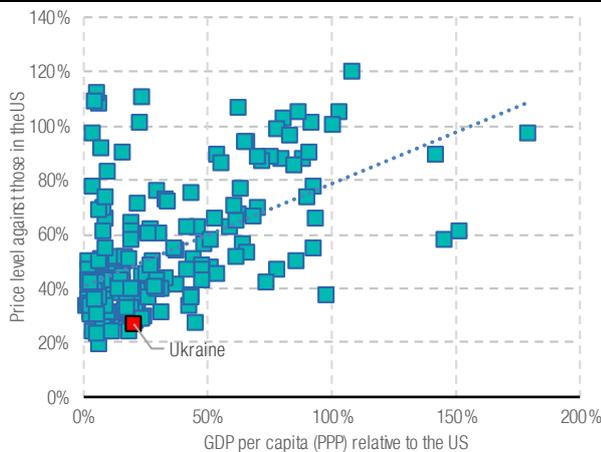
The NBU will stick to floating exchange rate regime, but smoothening role of FX interventions may be enhanced



Source: NBU, ICU

**Chart 62. Price levels and GDP per capita relative to the US**

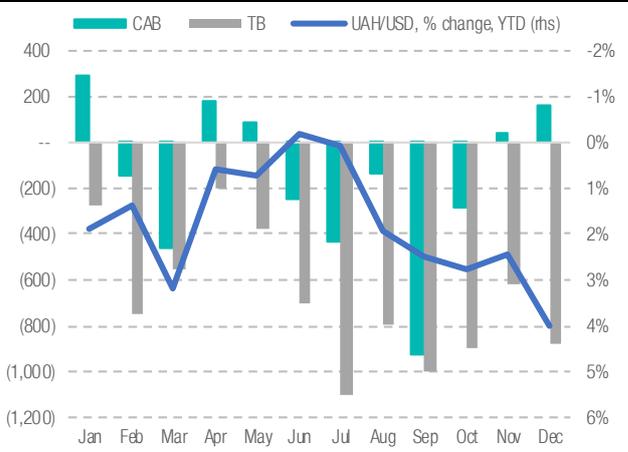
UAH looks strongly undervalued, even accounting for the gap in productivity



Source: IMF WEO (October 2020), ICU.

**Chart 63. Average C/A and trade balance (US\$ m) and change of UAH/USD (% YTD) by months in 2016–20**

UAH tends to appreciate sizeably amid seasonal improvement of trade in 2Q



Source: NBU, ICU

**Chart 64. Devaluation expectations in Ukraine**

Devaluation expectations started improving since November



Source: InfoSapiens, ICU.

**Chart 65. EoP change in FX rates of selected EM countries (%)**

Ukraine's slowdown of local currency depreciation on 2021 should be among the sharpest in EM



Source: Bloomberg, Refinitiv, ICU

# Macro forecast summary

	Historical data for 2010-19									Forecast by ICU		
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020E	2021F
<b>Activity</b>												
Real GDP (% YoY)	4.2	5.5	0.2	(0.0)	(6.6)	(9.8)	2.4	2.5	3.4	3.2	(4.2)	5.6
Nominal GDP (UAHbn)	1,079	1,300	1,405	1,465	1,587	1,989	2,385	2,984	3,561	3,975	4 032	4 596
Nominal GDP (US\$bn)	136	163	174	180	133	90	93	112	131	155	149	167
Unemployment (%)	8.2	8.0	7.6	7.3	9.3	9.1	9.3	9.5	8.8	8.2	10.0	9.5
<b>Inflation</b>												
Headline inflation (% YoY, e.o.p)	9.1	4.6	(0.2)	0.5	24.9	43.3	12.4	13.7	9.8	4.1	5.0	6.0
Headline inflation (% YoY, avg.)	9.4	8.0	0.6	(0.3)	12.1	48.7	13.9	14.4	10.9	7.9	2.7	6.4
GDP deflator (% YoY)	13.5	14.2	7.8	4.3	15.9	38.9	17.1	22.1	15.4	8.1	5.9	8.0
<b>Exchange rates</b>												
UAH/USD (e.o.p.)	7.94	8.04	8.05	8.24	15.82	24.03	27.30	28.10	27.72	23.81	28.32	28.00
UAH/USD (avg.)	7.95	7.98	8.08	8.15	12.01	21.95	25.55	26.61	27.19	25.80	26.97	27.52
<b>External balance</b>												
Current account balance (US\$bn)	(3.0)	(10.2)	(14.3)	(16.5)	(4.6)	5.0	(1.9)	(3.5)	(6.5)	(4.1)	6.6	(2.0)
Current account balance (% of GDP)	(2.2)	(6.3)	(8.3)	(9.2)	(3.5)	5.6	(2.0)	(3.1)	(4.9)	(2.7)	4.4	(1.2)
Trade balance (US\$bn)	(2.7)	1.7	0.8	0.5	(0.7)	(0.6)	(0.4)	(1.0)	0.1	(12.5)	(1.7)	(7.5)
Trade balance (% of GDP)	(2.0)	1.0	0.4	0.3	(0.6)	(0.7)	(0.5)	(0.9)	0.1	(8.1)	(1.1)	(4.6)
Exports (US\$bn)	(0.6)	(0.3)	(0.3)	0.6	(0.3)	0.3	(0.2)	0.0	(0.0)	63.6	60.6	63.9
Imports (US\$bn)	11.2	9.1	10.3	12.3	(8.0)	(3.5)	(3.0)	2.5	5.2	76.1	62.3	71.4
Capital flows (F/A) (US\$bn)	7.9	7.7	10.1	18.6	(9.1)	(4.6)	3.1	6.1	9.3	10.1	(4.6)	4.9
FDI (US\$bn)	5.8	7.0	7.2	4.1	0.3	(0.4)	3.8	3.7	4.5	5.2	(0.4)	3.0
FDI (% of GDP)	4.2	4.3	4.1	2.3	0.2	(0.5)	4.1	3.3	3.4	3.4	(0.3)	1.9
Reserves (US\$bn)	34.6	31.8	24.5	20.4	7.5	13.3	15.5	18.8	20.8	25.3	29.1	31.1
Reserves % of ARA metric	82	67	48	52	24	46	56	65	72	86.7	101.2	107.9
<b>Interest rates</b>												
NBU's key policy rate (% e.o.p.)	7.75	7.75	7.50	6.50	14.00	22.00	14.00	14.50	18.00	13.50	6.00	7.00
<b>Fiscal balance</b>												
Budget balance (% of GDP)	(5.9)	(1.8)	(3.8)	(4.4)	(5.0)	(2.3)	(2.9)	(1.5)	(2.4)	(2.1)	(5.3)	(4.5)
Public debt (% of GDP)	40.1	36.4	36.7	39.9	69.4	79.0	80.9	71.8	60.9	50.6	63.3	56.9
<b>Wages</b>												
Average nominal wage (UAH)	2,247	2,639	3,032	3,274	3,475	4,207	5,187	7,105	8,867	10,504	11,597	13,999
Real wage (% YoY)	7.6	8.8	14.3	8.2	(5.2)	(18.5)	7.8	19.7	12.6	9.9	7.4	13.5

Source: Ukrstat, NBU, MoF, ICU.



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