

Weekly Insight

NBU raises key rate to 8.0%

Key messages of the today's comments

Domestic liquidity and bond market

Ukrainian bill market in lull

Last week's large redemption of bonds was only partially refinanced, and the volume of trading in the secondary market remained almost unchanged. Both indicate low activity of investors, in particular, due to the revision of the NBU key policy rate. We do not expect any important changes in market activity this week, as the market will react to the MoF's decisions tomorrow and the NBU's decision to raise the key policy rate last Thursday.

Ukraine taps 2029 Eurobonds

Last week, the Ministry of Finance tapped Eurobonds maturing in 2029. This borrowing improves the hard currency balance in government accounts, but does not cover needs for hard currency for external debt payments that peak this September.

Foreign exchange market

Hard currency supply prevails

Despite the easing of FX-market regulations, the hryvnia exchange rate strengthened due to the predominance of the hard currency supply in the market. This week, the positive trend may be maintained through the payment of month-end taxes and the sale of currency by the agri sector.

Economics

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An above-forecast CPI has led to a 50 bps rate hike, which was not expected until September.

MONDAY, 26 JULY 2021

Banks' reserves market (23 July 2021)

| | Last | Weekly chg (%) | YoY chg (%) |
|------------------------------|---------|----------------|-------------|
| NBU rate (%) ¹ | 8.00 | +50bp | +200bp |
| ON rate (%) | 6.87 | +6bp | +120bp |
| ON \$ swap (%) | N/A | ... | ... |
| Reserves (UAHm) ² | 76,294 | +33.49 | +65.38 |
| CDs (UAHm) ³ | 139,526 | -10.47 | +38.89 |

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) (23 July 2021)

| | Last | Weekly chg (%) | YoY chg (%) |
|-------------------------|----------------|----------------|---------------|
| NBU | 317,277 | +0.00 | -2.25 |
| Banks | 504,809 | -1.35 | +19.57 |
| Residents | 48,496 | -1.54 | +70.54 |
| Individuals | 18,771 | -1.27 | +165.82 |
| Foreigners ¹ | 107,445 | -1.03 | +15.34 |
| Total | 996,798 | -0.90 | +13.86 |

Notes: [1] non-residents

Source: NBU, ICU.

FX market indicators (23 July 2021)

| | Last | Weekly chg (%) | YoY chg (%) |
|----------------------|---------|----------------|-------------|
| USD/UAH | 27.0457 | -0.66 | -2.57 |
| EUR/USD | 1.1771 | -0.37 | +1.51 |
| DXY | 92.912 | +0.36 | -1.88 |
| UAH TWI ¹ | 125.517 | +0.73 | +3.59 |

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Gov't bond quotes¹ (26 July 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 bond market

Ukrainian bill market in lull

Last week's large redemption of bonds was only partially refinanced, and the volume of trading in the secondary market remained almost unchanged. Both indicate low activity of investors, in particular, due to the revision of the NBU key policy rate. We do not expect any important changes in market activity this week, as the market will react to the MoF's decisions tomorrow and the NBU's decision to raise the key policy rate last Thursday.

Demand at the primary auction last Tuesday was quite restrained. The Ministry of Finance managed to borrow only UAH7.5bn in local currency and refinance less than half of last week's repayments. The reasons for such a low level of refinancing may be that market participants were waiting for the NBU's decision on the key policy rate on Thursday, and in addition, foreigners continued to reduce their portfolios of hryvnia bonds.

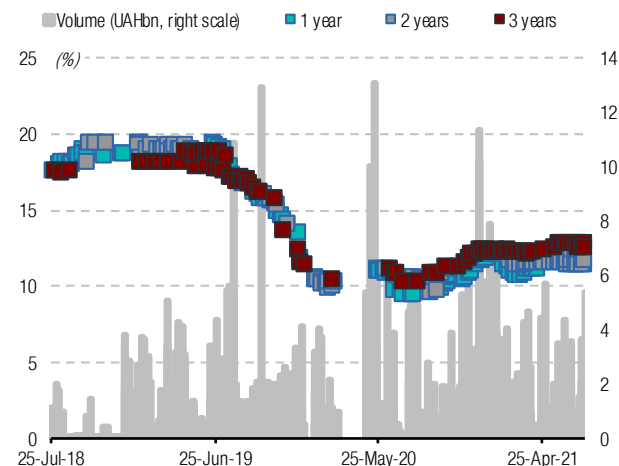
As a result, the volume of trade in UAH-denominated bonds on the secondary market did not change much, slid by only UAH0.2bn to UAH4.9bn, while the weighted average rates on concluded agreements did not see material changes. Again, the most traded were bills due July 2022, which amounted to approximately 30% of the total turnover on the secondary market.

ICU view: *In general, the situation with budget financing does not look catastrophic, but after raising the key policy rate (see comment below), the Ministry of Finance will have to raise rates on new borrowings to maintain at least the same level of premium—and to increase the amount of borrowings, probably even more. This will be especially relevant for foreigners, who have paused making new investments. With the hryvnia's recent appreciation, current yields become even less attractive to them.*

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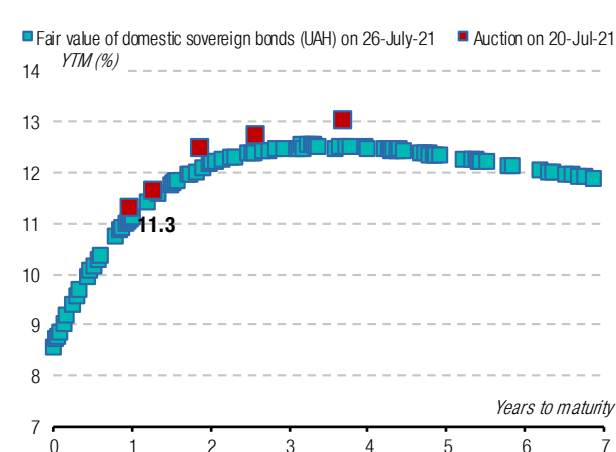
Chart 1. Local-currency bonds

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.

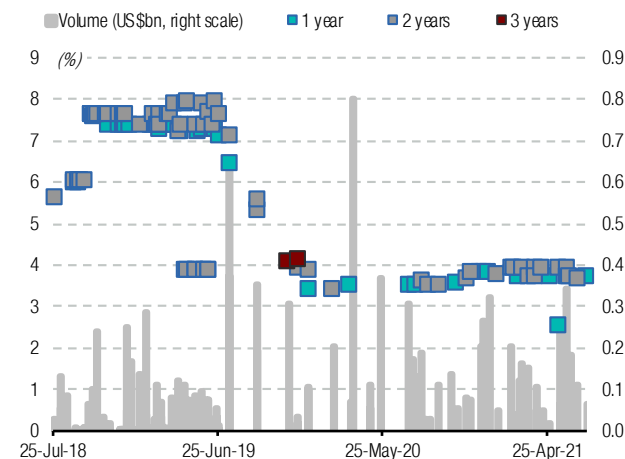
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

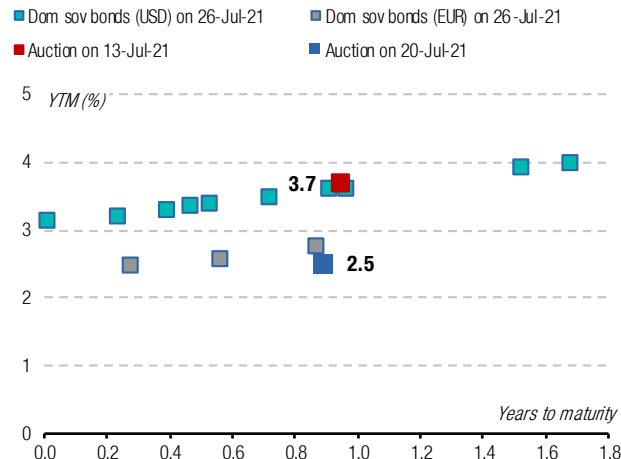
Chart 2. FX-denominated bonds

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.

Ukraine taps 2029 Eurobonds

Last week, the Ministry of Finance tapped Eurobonds maturing in 2029. This borrowing improves the hard currency balance in government accounts, but does not cover needs for hard currency for external debt payments that peak this September.

Last Thursday, the Ministry of Finance reopened Eurobonds denominated in US dollars due 2029, and sold an additional US\$500mn. The additional issue was priced at a rate of 6.3%, which is in line with market quotes at the time of the announcement of the deal plus a small premium of about 10-20bps.

ICU view: *The Ministry has taken an important step to replenish hard currency accounts, especially in the absence of an agreement with the IMF to receive the next tranche in the near future along with a later receipt of the SDR allocation than scheduled external debt payments. The market seems to have taken the additional placement calmly, and although the initial price target was set quite high (at 6.625%), the final level of yield turned out to be close to the level of market quotes.*

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Foreign exchange market

Hard currency supply prevails

Despite the easing of FX-market regulations, the hryvnia exchange rate strengthened due to the predominance of the hard currency supply in the market. This week, the positive trend may be maintained through the payment of month-end taxes and the sale of currency by the agri sector.

Over the past week, bank customers have sold more hard currency than they bought, which has added support for the hryvnia and even forced the NBU to buy US\$32mn in reserves on Friday. It is very likely that the key sellers of hard currency were both exporters who needed hryvnia liquidity to pay month-end taxes, and agri companies who receive hard currency earnings and also need hryvnia funds within the country.

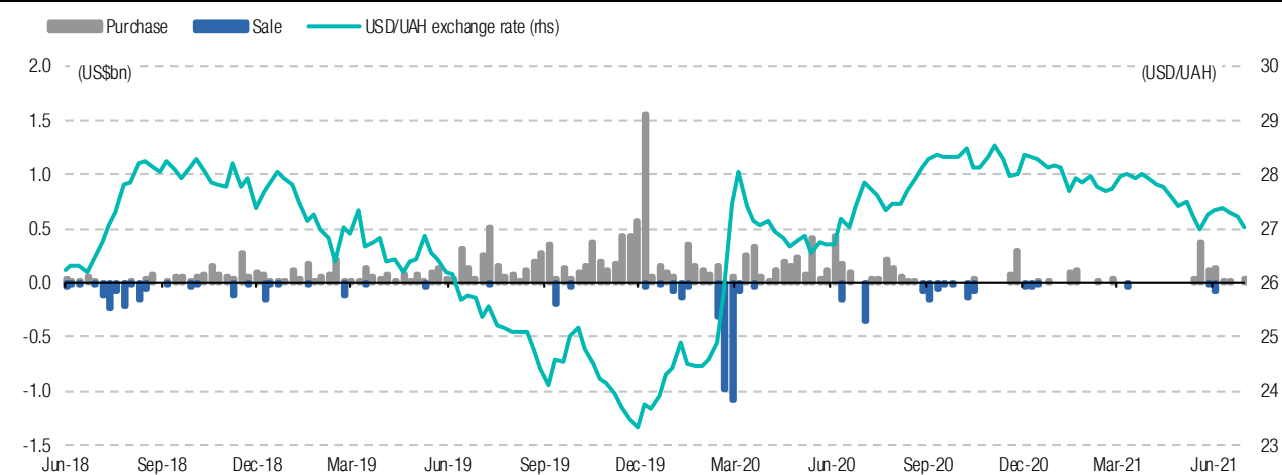
As a result, the hryvnia strengthened over the week by 0.7% to UAH27.05/US\$.

ICU view: Even without hard currency inflows from foreign investors in UAH-denominated debt in July, the hryvnia appreciated and should be able to maintain this trend, crossing the level of UAH27/US\$ to the range of UAH26.5–27/US\$ this week. The key impact will be from the same factors as last week, which was keeping the balance in the market on the supply side.

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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.

Economics

NBU raises key rate to 8.0%

An above-forecast CPI has led to a 50 bps rate hike, which was not expected until September.

Inflation rose to 9.5% YoY in both May and June. This was well above the $5\pm 1\%$ target and exceeded the NBU's forecast. It is very likely that the CPI will reach double-digits later this year. The regulator is expected to address this likelihood by increasing the key rate by another 50 bps to 8.5% at the next meeting in September. In addition, NBU has increased the interest rate it charges banks on refinance loans from being equal to the key rate to the key rate plus 100 bps. The regulator decreased the FX intervention amount from US\$20m to US\$5m.

ICU view: The rate hike was expected given the CPI dynamics, but many have feared that the political turbulence around the NBU may prevent its management from making the increase. The regulator is also tightening monetary policy by cutting the refinancing that helped banks increase the amount of government bonds on their balance sheets by around UAH100bn in 2020.

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