Focus

**Ukraine**

Markets

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

Research team

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# Weekly Insight

# NBU increases key rate to 10%

**Key messages of the today's comments**

**MONDAY, 24 JANUARY 2022**

## Domestic liquidity and bonds market

### Borrowings in hryvnia minimal

Expectations of rising interest rates and a corresponding decline in asset prices on the back of general negative sentiment prompted domestic investors to reduce the purchase of UAH-denominate bills in the primary market to a minimum.

### The Eurobond market calms down slightly

The Eurobond market opened on Monday with a sharp rise in yields, but towards the end of the week, Monday's losses were partially offset. The yield curve remains inverted, with YTMs on most maturities exceeding 10%.

## Foreign exchange market

### The FX market stabilizes

Last week, the hryvnia exchange rate stabilized and fluctuated within the range of UAH28-28.5/US$, with the help and interventions from the NBU. Increased volatility will persist this week but we do not expect the situation to change dramatically.

## Economics

### NBU increases key rate to 10%

The NBU increased its key policy rate by 100 bps to 10% citing heightened inflationary risks. It also downgraded its 2022 macro forecast for Ukraine.

**Banks' reserves market (21 January 2022)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU rate (%)[1] | 10.00 | +100bp | +400bp |
| ON rate (%) | 8.51 | +21bp | +335bp |
| ON $ swap (%) | N/A | ... | ... |
| Reserves (UAHm)[2] | 77,830 | +40.19 | +17.65 |
| CDs (UAHm)[3] | 141,575 | -16.68 | +14.67 |

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) (21 January 2022)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| NBU | 310,106 | -0.80 | -4.46 |
| Banks | 550,816 | +1.54 | +4.86 |
| Residents | 83,007 | +1.27 | +42.37 |
| Individuals | 25,983 | +2.46 | +119.68 |
| Foreigners[1] | 84,709 | -4.12 | -6.49 |
| **Total** | **1,054,698** | **+0.37** | **+4.35** |

Source: NBU, ICU.

**FX market indicators (21 January 2022)**

| | Last | Weekly chg (%) | YoY chg (%) |
|---|---|---|---|
| USD/UAH | 28.2519 | +0.79 | +0.05 |
| EUR/USD | 1.1344 | -0.59 | -6.74 |
| DXY | 95.642 | +0.50 | +6.11 |
| UAH TWI[1] | 125.466 | -0.34 | +6.89 |

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

**Market gov't bond quotes[1] (24 January 2022)**

| Maturity | Bid | Ask |
|---|---|---|
| 6m | **12.50** | **10.75** |
| 12m | **13.00** | **11.75** |
| 2y | **14.00** | **12.75** |
| 3y | **14.50** | **13.25** |
| 12m ($) | **4.00** | **3.00** |
| 2y ($) | **4.50** | **3.25** |

Source: ICU.

# Domestic liquidity and bonds market

## Borrowings in hryvnia minimal

Expectations of rising interest rates and a corresponding decline in asset prices on the back of general negative sentiment prompted domestic investors to reduce the purchase of UAH-denominate bills in the primary market to a minimum.

Last week's primary bond auction provided the state budget with US$143m, which allowed it to refinance most of the USD-denominated redemptions a week earlier. However, borrowings in local currency amounted to only UAH119m. At the same time, the Ministry of Finance raised rates only on semi-annual bills, which had not yet been offered this year. See more details in the auction review. The main reason for low demand last week was the expectation of a revision of the NBU key policy rate on Thursday, as market participants mostly predicted its increase by at least 25-50bp.

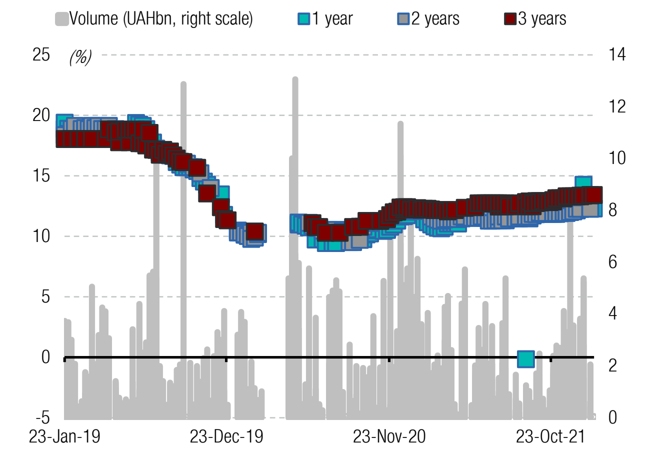
The total volume of trades in hryvnia-denominated bonds on the secondary market amounted to UAH9.7bn, where bonds maturing in 2025 were most actively traded. This issue is liquid and popular among foreign investors, and from the end of March, it will be included in the JPMorgan GBI index. The total volume of transactions with this paper amounted to UAH2.8bn last week, which is approximately 80% of the total decline in the foreign investors' portfolio last week. In total, foreigners reduced their portfolio by UAH3.2bn to UAH84.3bn during the week. Now their portfolios are less than 8% of the total volume of domestic bonds par value.

***ICU view: This week, the market will wait for the decision of the Ministry of Finance on interest rates on hryvnia-denominated bonds after the NBU increased the key policy rate to 10% last week (see comment below). Foreigners will seize the moment and continue to withdraw funds from local-currency debt, reducing Ukrainian risk in their portfolios, primarily due to the escalation of potential hostilities on the border with Russia.***

***Taras Kotovych, Kyiv, (044) 377-7040 ext.724***

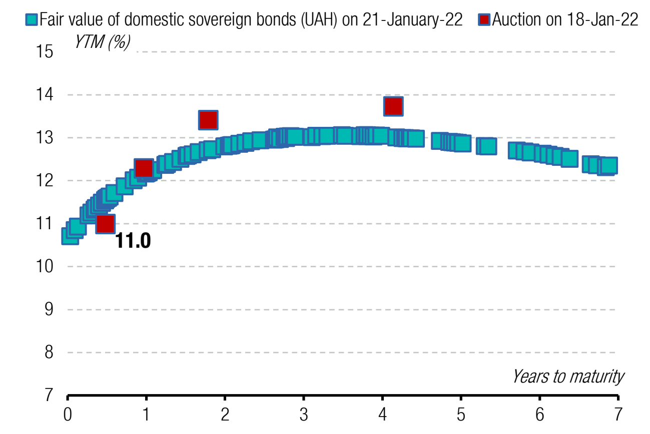
**Chart 1. Local-currency bonds**

*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.

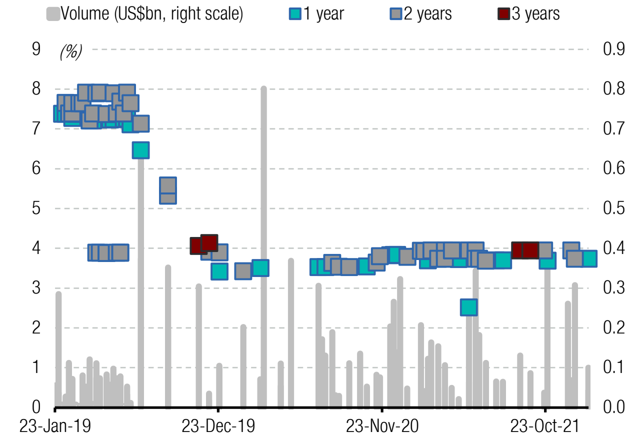
*Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions*




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

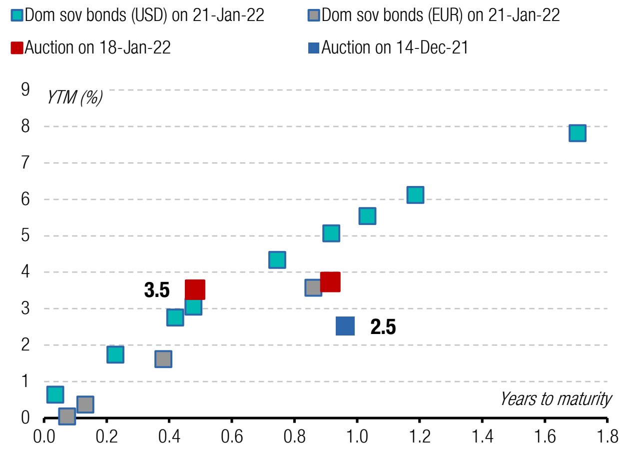
**Chart 2. FX-denominated bonds**

*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.

## The Eurobond market calms down slightly

The Eurobond market opened on Monday with a sharp rise in yields, but towards the end of the week, Monday's losses were partially offset. The yield curve remains inverted, with YTMs on most maturities exceeding 10%.

On Monday, the YTMs on Eurobonds denominated in US$ rose to record levels, and for bonds maturing in September 2022, exceeded 25%. However, after the statements of the Russian representatives that Russia does not plan military aggression against Ukraine and the appointment of talks between Russian Foreign Minister Sergei Lavrov and US Secretary of State Antony Blinken for last Friday, the markets calmed down slightly and YTMs declined. Last Friday, after these negotiations ended and statements were that negotiations went well, yields declined moderately to 9.6-19.0%.

***ICU view: The change in YTMs over the next few weeks will be driven mainly on the dynamics and outcome of negotiations between NATO and Russia. In particular, the United States plans to provide a response to Russia on its request of so-called security guarantees. Risks to Eurobond prices remain symmetrical and YTMs volatility high. A sustained positive trend in yields can only be seen if real steps are taken to de-escalation in the Ukrainian eastern border and tensions between Russia and the United States and NATO will be reduced.***

***Taras Kotovych, Kyiv, (044) 377-7040 ext.724***

# Foreign exchange market

## The FX market stabilizes

Last week, the hryvnia exchange rate stabilized and fluctuated within the range of UAH28-28.5/US$, with the help and interventions from the NBU. Increased volatility will persist this week but we do not expect the situation to change dramatically.

Over the past week, the supply of hard currency from bank customers has been growing gradually, but demand increased even more, requiring significant interventions by the NBU. On Tuesday, the NBU sold about US$300m, although half of last Monday deals were with settlement next day due to the holiday in the US on Monday. The NBU sold additional

US$18m on Wednesday, and in total last week, the NBU interventions on hard currency sales amounted to US$321m, or just US$10m less than a week earlier.

The pressure in the market fell last Friday after talks between US Secretary of State Antony Blinken and Russian Foreign Minister Sergei Lavrov were completed followed by the rather positive tone of their statements. Immediately after positive news was published, sellers appeared in the market, but there was mostly low demand. Therefore, the NBU bought US$20m of extra supply, and hryvnia ended the week at UAH28.25/US$, a mere appreciation compared with Wednesday, but for the week it still weakened by 0.8%.

***ICU view: This week the hryvnia will be under the pressure from both external and internal factors. On the one hand, Russia will maintain its pressure on Ukraine and high risks of further escalation of the conflict will continue to create nervousness in the FX market. On the other hand, the period of month-end tax payments to the budget has begun, which will last until the end of this week. Exporters' needs of hryvnia funds to pay taxes may encourage them to increase hard currency sales, if such a need is not offset by the VAT refunds from the budget.***

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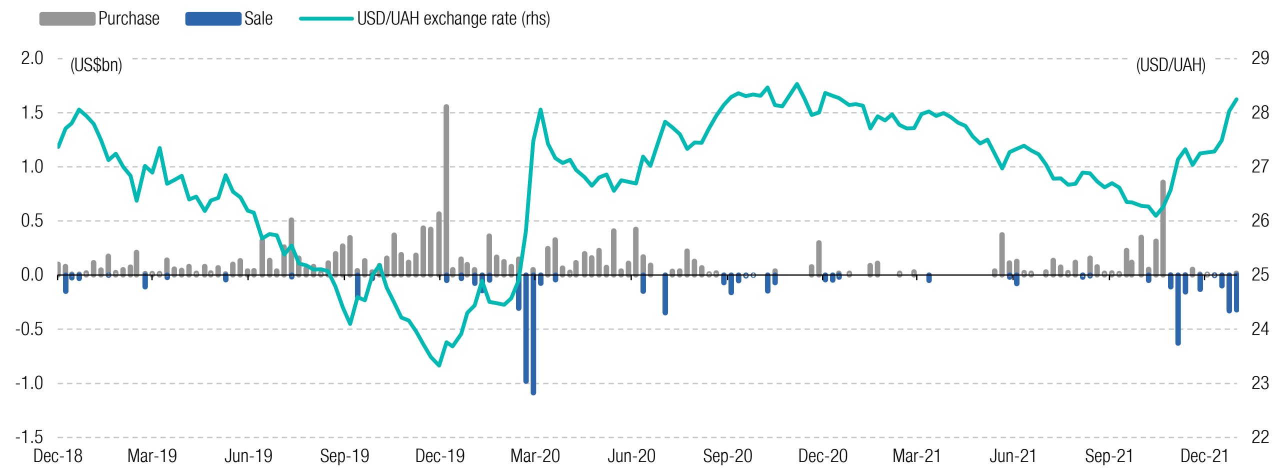
**Chart 3. FX market indicators, 3-year history**

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




Source: NBU, Bloomberg, ICU.

# Economics

## NBU increases key rate to 10%

The NBU increased its key policy rate by 100 bps to 10% citing heightened inflationary risks. It also downgraded its 2022 macro forecast for Ukraine.

Inflationary risks are primarily driven by high energy prices, rapid growth of salaries and robust domestic consumer demand. Also geopolitical tensions with Russia resulted in a selloff for Ukrainian assets, including UAH weakening, that threaten the current disinflationary path.

The NBU signaled it may increase the key rate by another 100 bps to 11% in March and it will remain in double digit territory until 1H23. The updated forecast implies a longer period of elevated rates and CPI compared to the October figures. According to the revised forecast, the CPI will decelerate from the current 10% YoY to 7.7% at the end of the year. The 2022 GDP growth forecast is downgraded to 3.4% from 3.8% previously.

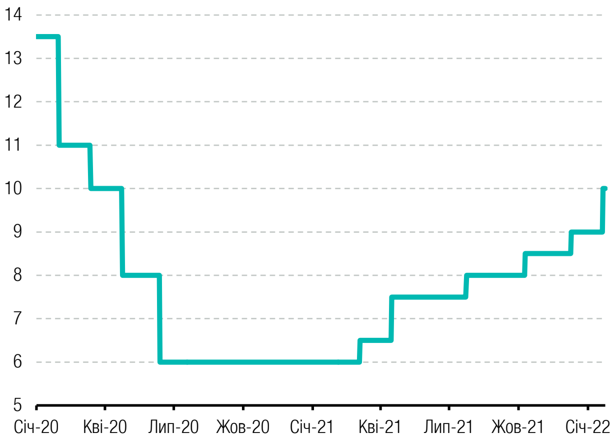
NBU has also announced other changes to its policy design. Regulator abandoned daily purchase of FX in the amount of US$5m for the sake of reserves replenishment. In addition, NBU in February will raise by 2 pp the required reserve ratio for UAH current accounts and FX deposits (both current and term).

***ICU view: The key policy rate increase by the NBU was above our expectations. In our view the key factor behind the move is the increase in risks due to escalation of Russia's military pressures and a related fall in the price of Ukrainian assets and the hryvnia. Further NBU actions will largely depend on degree of the impact that the ongoing conflict has on the local financial market. The NBU announced it may tighten monetary policy further if geopolitical risks increase. In our view, if the situation worsens significantly, the NBU may be ready to hike the key policy rate at an extraordinary board meeting.***

***Mykhaylo Demkiv, Kyiv, (044) 377-7040 ext.723***

**Chart 4. NBU key policy rate, %**

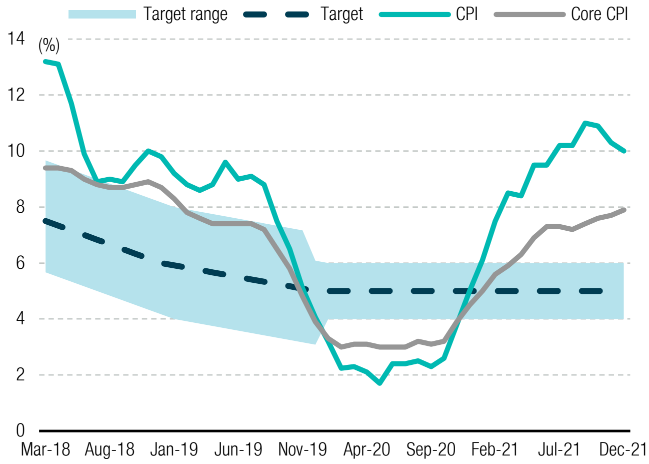
*Key policy rate hiking trend continues as inflation stays significantly above the NBU target band*




Source: NBU, ICU.

**Chart 5. CPI, core CPI and target, YoY, %**

*While headline inflation continued to decelerate, the core CPI was up again in December underscoring the persistence of inflationary pressures*




Source: Ukrstat, ICU.

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