Focus	Markets	Research team
Ukraine	**Domestic liquidity, government bonds, FX market, and macro**	**Vitaliy Vavryshchuk** **Alexander Martynenko** **Taras Kotovych**

Weekly Insight

Ukraine's GDP grows 3.3% in 2021

Key messages of the today's comments

TUESDAY, 8 FEBRUARY 2022

Domestic liquidity and bonds market

Eurobond market gradually calming

Last week, the decline in Ukrainian Eurobond yields continued as investors' fears of a Russian invasion of Ukraine is gradually lessening.

Foreign exchange market

The hryvnia is on the way to appreciation

After reaching a seven-year low at the end of January, the hryvnia ended last week with the exchange rate at UAH28.12/US$. The situation in the FX market will continue to strengthen the hryvnia exchange rate.

Economics

Ukraine's GDP grows 3.3% in 2021

Ukraine's GDP growth accelerated considerably to 5.9% YoY in 4Q21, which implies full 2021 GDP growth rate of 3.3% according to our estimates.

Ukraine's C/A turns negative at 1.0% of GDP in 2021

Ukraine's current account (C/A) balance recorded a deficit of 1.0% of GDP ($2.1bn) in 2021, which is a deterioration from a 3.4% of GDP surplus in 2020.

Banks' reserves market (7 February 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	10.00	+0bp	+400bp
ON rate (%)	8.71	-58bp	+369bp
ON $ swap (%)	N/A	...	...
Reserves (UAHm)[2]	45,010	-30.93	-6.12
CDs (UAHm)[3]	157,900	+27.28	+0.00

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) (7 February 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU	310,106	+0.00	-4.46
Banks	540,776	-2.70	+3.59
Residents	80,769	-4.28	+35.25
Individuals	24,511	-5.41	+93.27
Foreigners[1]	79,157	-2.76	-18.42
Total	**1,035,500**	**-2.11**	**+1.90**

Source: NBU, ICU.

FX market indicators (7 February 2022)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	27.9262	-1.75	+0.78
EUR/USD	1.1442	+1.51	-5.01
DXY	95.399	-1.02	+4.79
UAH TWI[1]	125.931	+0.73	+4.70

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

Market gov't bond quotes[1] (8 February 2022)

Maturity	Bid	Ask
6m	**13.50**	**11.00**
12m	**14.50**	**12.00**
2y	**15.00**	**13.00**
3y	**16.50**	**13.50**
12m ($)	**4.00**	**3.00**
2y ($)	**4.50**	**3.25**

Source: ICU.

Domestic liquidity and bonds market

Eurobond market gradually calming

Last week, the decline in Ukrainian Eurobond yields continued as investors' fears of a Russian invasion of Ukraine is gradually lessening.

The Eurobond market is slowly calming, as more favourable information is received about diplomatic steps to decrease risks of Russian aggression. However, in general, the number of Russian troops gathered near the border is still quite large.

Last week, the Prime Minister of the UK and the President of Turkey visited Ukraine, and statements were made on the preparation of a tripartite alliance between Ukraine, Poland, and the United Kingdom. Also, the start of the Olympic Games and the visit of the President of Russia to Beijing significantly reduced the level of news regarding attacks on Ukraine.

Overall, the reduction in fears of active hostilities contributed to the yield on Eurobonds falling to 9.5-13.3% from 10.4-26.6% two weeks ago.

ICU view: This week, the world may be more focused on the Olympic Games than on Ukraine, and the level of negative news about Ukraine should decline. Although investors may still gradually reduce sales, it is possible that more of them will take the opportunity to buy Ukrainian Eurobonds with a very attractive yield. And as a result, YTMs may still decline.

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

Foreign exchange market

The hryvnia is on the way to appreciation

After reaching a seven-year low at the end of January, the hryvnia ended last week with the exchange rate at UAH28.12/US$. The situation in the FX market will continue to strengthen the hryvnia exchange rate.

The general decline in the severity of allegations of possible Russian aggression and the intensification of hard currency sellers allowed the hryvnia to appreciate by 2% over the past week. However, since the beginning of the year, the hryvnia weakened against the US dollar by a moderate 3.1%.

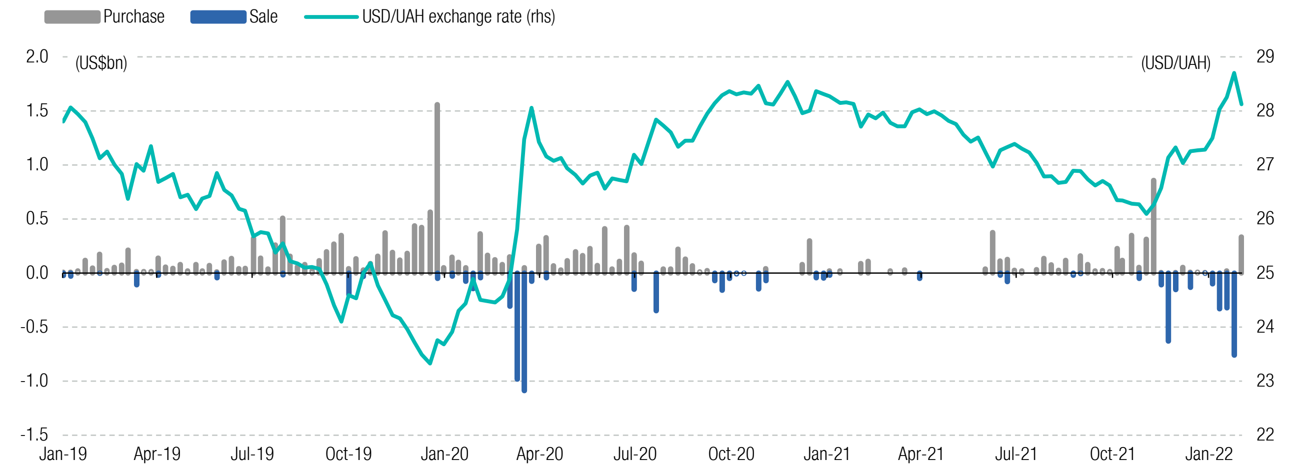
The balance of the FX market has improved as supply has increased, while the total amount of daily trading has decreased. This was especially noticeable on Monday, when the NBU bought US$178m in reserves from the market. In just one week, almost US$334m of hard currency was bought into reserves.

ICU view: An increase in supply with a general decline in daily trading indicates a decrease in fears of further escalation of Russia's aggression and lower expectations of further weakening of the hryvnia. Therefore, exporters have increased their presence in the FX market, while the demand from market players who aggressively purchased hard currency in January has already been met. Foreigners still exit from local-currency debt at the same pace, so their demand for hard currency did not increase either. Therefore, under current conditions, we expect that the hryvnia will continue to gradually move towards strengthening this week.

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

Chart 1. 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

Ukraine's GDP grows 3.3% in 2021

Ukraine's GDP growth accelerated considerably to 5.9% YoY in 4Q21, which implies full 2021 GDP growth rate of 3.3% according to our estimates.

The GDP growth came in above our projection of 5.0% for 4Q21 and 2.9% for full 2021. Detailed breakdown of GDP components will be available at the end of March.

ICU view: Even though economic growth turned out stronger than expected, we still believe it was unimpressive given that GDP contracted 3.8% in 2020 and the comparison base was extremely favourable. According to our estimates, agriculture alone contributed above 1.5pp to 3.3% GDP growth last year via direct and indirect effects thanks to a bumper harvest.

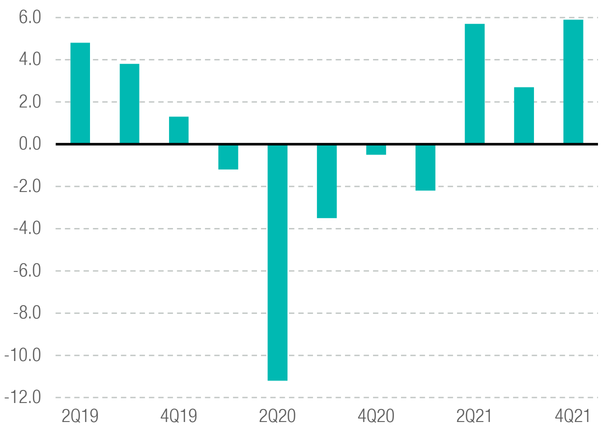
Real GDP growth above 3.0% implies Ukraine will make a VRI payment in 2Q23. Our tentative estimates imply that 0.1% of GDP growth above 3.0% (but below 4.0%) means a VRI pay-out in the range of $27-29m in 2023 depending on the final number for the 2021 GDP deflator and the exchange rate before the payment. This implies a yield just above 2.5% based on nominal value of the portion of the Eurobonds that were converted into VRIs.

Looking forward, we expect economic growth will remain muted in 2022 given a number of headwinds, including high energy prices, slowing domestic demand, and slowing growth of Ukraine's key trading partners. Ongoing tensions with Russia are yet another risk factor that heavily undermines business and investor confidence and may delay large investment projects. We expect GDP will grow 3.2% in 2022.

Vitaliy Vavryshchuk, Kyiv, (044) 377-7040 ext.721

Chart 2. Real quarterly GDP change, YoY, %

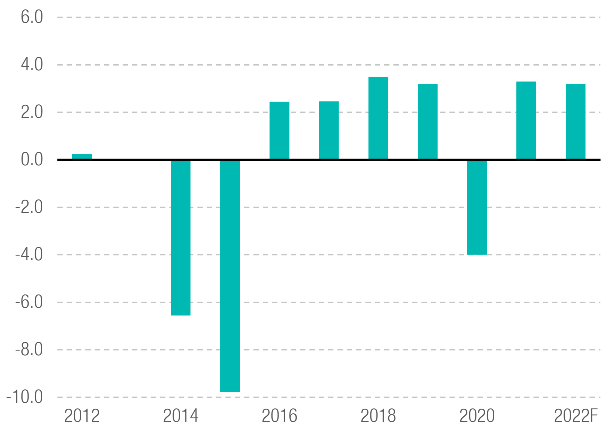
GDP growth accelerated considerably in 4Q21



Source: Ukrstat, ICU.

Chart 3. Real yearly GDP change, YoY, %

We estimate that Ukraine's GDP increased by 3.3% in 2021



Source: Ukrstat, ICU.

Source: Ukr

Ukraine's C/A turns negative at 1.0% of GDP in 2021

Ukraine's current account (C/A) balance recorded a deficit of 1.0% of GDP ($2.1bn) in 2021, which is a deterioration from a 3.4% of GDP surplus in 2020.

The deterioration was primarily driven by a rapidly growing income that non-residents earned on their foreign direct investments into Ukraine (a part of primary income of C/A). Total earnings surged to $15.2bn in 2021, from $3.9bn in 2020. This growth in investment income came on the back of surging commodity prices and a related improvement of companies' financials. Meanwhile, the deterioration in FDI income balance was partly offset with a robust 28% YoY increase in migrant remittances to $15.0bn (7.5% of 2021F GDP). The trade balance deficit remained largely unchanged at 1.5% of GDP as rapid growth in export revenues was offset with a surging imports of consumer and investment goods.

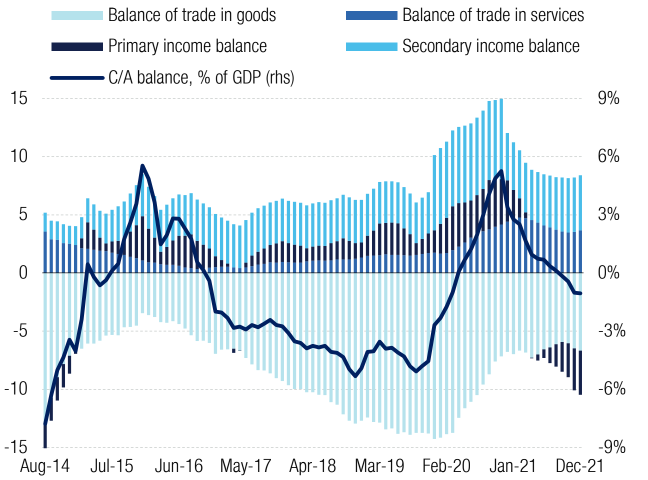
The financial account balance came in positive at $2.6bn largely thanks to net FDI inflows ($6.0bn, 3.0% of GDP). More than 80% of such inflows were nothing but reinvestment of the FDI income by non-residents. While the financial account inflows fully compensated for the C/A gap, Ukraine's external accounts were additionally supported by the IMF money ($2.7bn in SDR allocation minus $0.7bn net outflow of the IMF loans).

ICU view: We expect the C/A will deteriorate in 2022 due to persistently high energy prices and weaker YoY prices for Ukraine's key export commodities. We currently project a 2022 C/A gap of 2.3% of GDP with downside risks to this projection. The financial account is also at significant risk as risk premia for Ukraine-related assets grew significantly in recent months due to Russia's threat of military invasion. We, nevertheless, believe that any lack of funding from private capital markets will be fully offset with concessional funding from IFIs and Western governments, which indicated they are prepared to provide a substantial package of financial support to Ukraine. The chances are still high that this way Ukraine will be able to cover the larger C/A gap and alleviate external sector-related pressures on the local FX market.

Vitaliy Vavryshchuk, Kyiv, (044) 377-7040 ext.721

Chart 4. Current account and its components, 12-month trailing, $bn and % of GDP

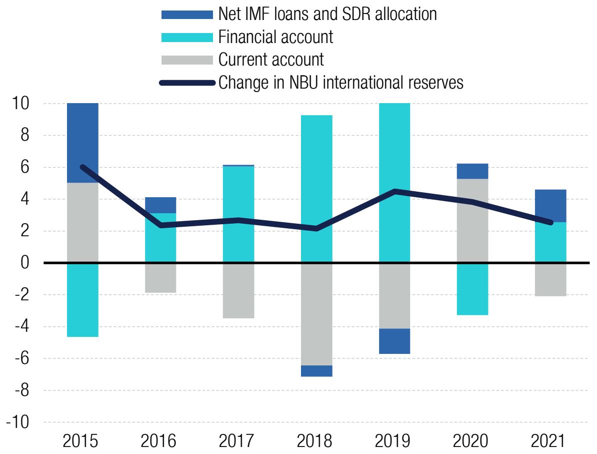
C/A turned to deficit in 2021



Source: NBU, ICU.

Chart 5. Balance of payments flows and NBU reserves, $bn

BoP inflows were positive thanks to F/A and money from the IMF



Source: NBU, ICU.

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11th floor, LEONARDO Business Centre
19-21 Bogdan Khmelnytsky Street
Kyiv, 01030 Ukraine
Phone/Fax +38 044 3777040

WEB www.icu.ua

RESEARCH

Vitaliy Vavryshchuk
Head of macro research
vitaliy.vavryshchuk@icu.ua

Taras Kotovych
Senior financial analyst (Sovereign debt)
taras.kotovych@icu.ua

Dmitriy Dyachenko, CFA
Financial analyst
dmitriy.dyachenko@icu.ua

Alexander Martynenko
Head of corporate research
alexander.martynenko@icu.ua

Mykhaylo Demkiv
Financial analyst (Banks)
mykhaylo.demkiv@icu.ua