



Focus
Ukraine

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

Research team
**Vitaliy Vavryshchuk
Alexander Martynenko
Taras Kotovych
Mykhaylo Demkiv**

Weekly Insight

NBU increases key rate to 25%

Key messages of the today's comments

MONDAY, 6 JUNE 2022

Ukrainian bond market

UAH bond market looks to reboot

The recent decline in borrowings and a sharp increase in the NBU key policy rate may lead to a reboot of the military bills' market very soon.

Eurobond prices stabilize

Information from the front did not change much last week, which led to a further moderate decline in Eurobond prices.

Foreign exchange market

UAH cash exchange rate stabilizes

Last week, the hryvnia's cash exchange rate stabilized and even strengthened somewhat after fairly significant volatility observed immediately after the NBU lifted the ceiling on the maximum allowed exchange rate for retail clients.

Economics

NBU increases key rate by 1,500 bps

NBU has decided against maintaining the key rate unchanged at 10% throughout the war and raised it to 25% in order to tackle the inflation and stabilize market FX rate.

Ukraine's public debt broadly unchanged YTD

In March, Ukraine's public debt increased by 0.8% MoM to an equivalent of US\$97.6bn, but this is marginally below the end-2021 level of debt.

Current account remains in hefty surplus in April

Ukraine's current account (CA) remained highly positive in April thanks to grants and humanitarian aid, but the financial account continues to deteriorate.

Banks' reserves market (3 June 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%) ¹	25.00	+1,500bp	+1,750bp
ON rate (%)	9.76	+0bp	+334bp
Reserves (UAHm) ²	99,982	+86.44	+93.75
CDs (UAHm) ³	117,820	-35.69	-21.49

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) (3 June 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU	428,606	-0.35	+34.45
Banks	542,449	+0.40	+6.60
Residents	74,011	+0.51	+61.98
Individuals	29,058	+2.21	+72.81
Foreigners ¹	72,402	+0.07	-27.69
Total	1,146,730	+0.15	+15.78

Source: NBU, ICU.

FX market indicators (3 June 2022)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	29.2500	-0.72	+7.14
EUR/USD	1.0719	-0.15	-11.61
DXY	102.140	+0.46	+12.85
UAH TWI ¹	137.616	+0.82	+12.74

Notes: [1] UAH trade-weighted index.

Source: Bloomberg, ICU.

Market gov't bond quotes¹ (6 June 2022)

Maturity	Bid	Ask
6m
12m
2y
3y
12m (\$)
2y (\$)

Source: ICU.

Ukrainian bond market

UAH bond market looks to reboot

The recent decline in borrowings and a sharp increase in the NBU key policy rate may lead to a reboot of the military bills' market very soon.

Last week, the Ministry of Finance attracted only UAH3.1bn for the budget, of which only UAH2.6bn was in local currency. At the same time, one of the two two-month bills offered last week was not military and, thus, cannot be resold in the secondary market. See details in the [auction review](#).

According to the NBU, foreigners bought a small portion of bills in the primary market, increasing their combined portfolio by almost UAH50m for the first time in three weeks. Most likely, they bought non-military paper. At the same time, the total volume of UAH bills traded on the secondary market declined to UAH0.9bn. The main reason was the expectation of the NBU Board meeting and a revision of the key policy rate for the first time since the beginning of the full-scale russian invasion.

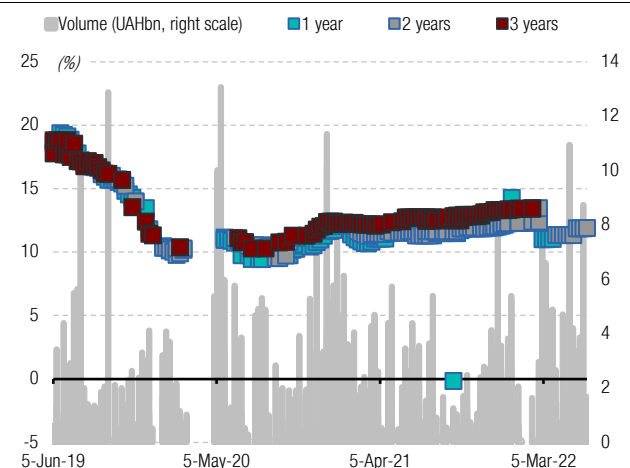
ICU view: The NBU's decision to raise the key policy rate to 25% (see [comment below](#)) came as a surprise to the Ministry of Finance. The Ministry decided not to react immediately and announced that interest rates at the primary auction tomorrow will remain unchanged. Thus, tomorrow's primary auction will reveal banks' and other investors' readiness to maintain their demand.

We think that the bond market is waiting for a reboot following the NBU's decision. Most likely the cost of new borrowings will increase soon. The Ministry of Finance will have to find a new level of interest rates that is acceptable to both investors and the budget. Interest rates on short-term bills can rise close to the key rate, while longer maturities can react less significantly as investors expect that NBU may start decreasing its key policy rate later this year or at the beginning of the next year. Therefore it will take some time for the market to decide where new fair yields for longer maturities might lie. The yield curve will thus become inverted.

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

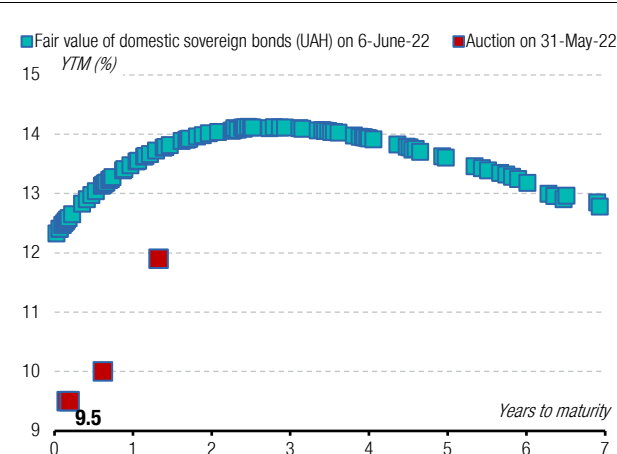
Chart 1. Local-currency bonds

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.

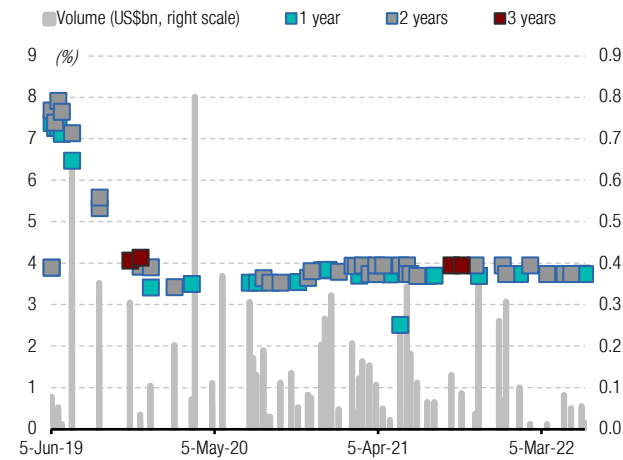
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

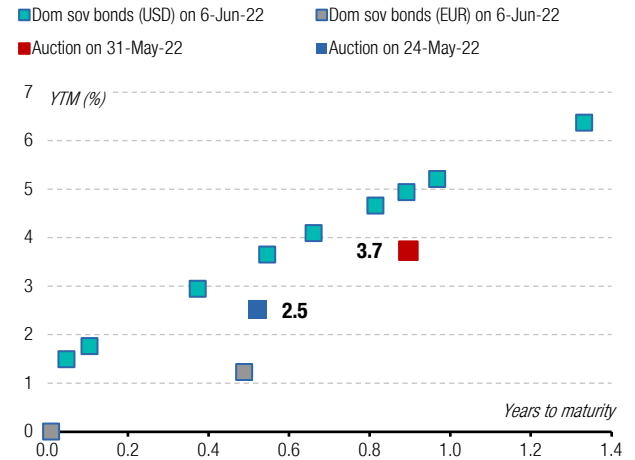
Chart 2. FX-denominated bonds

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.

Eurobond prices stabilize

Information from the front did not change much last week, which led to a further moderate decline in Eurobond prices.

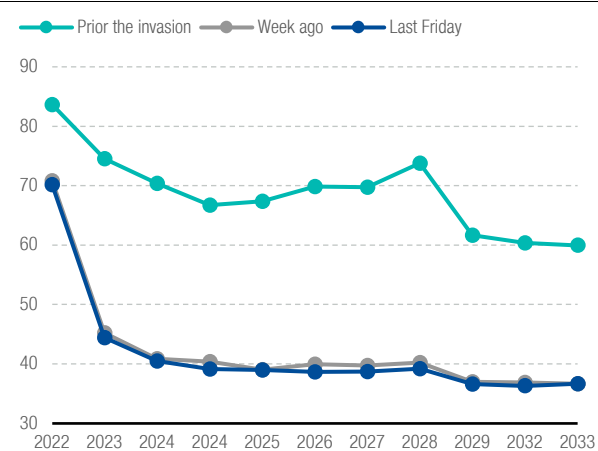
In general, the prices of Ukrainian Eurobonds were little changed on the week, fluctuating near the level of the previous Friday. Mostly, the decline was less than one cent. Only VRIs have risen by almost one cent to nearly 38.

ICU view: The lack of important positive news dampens investors' interest in Ukrainian Eurobonds. They will continue to closely follow the information about the hostilities and assess the prospects for a change in the situation on the frontline.

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

Chart 3. Ukrainian Eurobonds prices

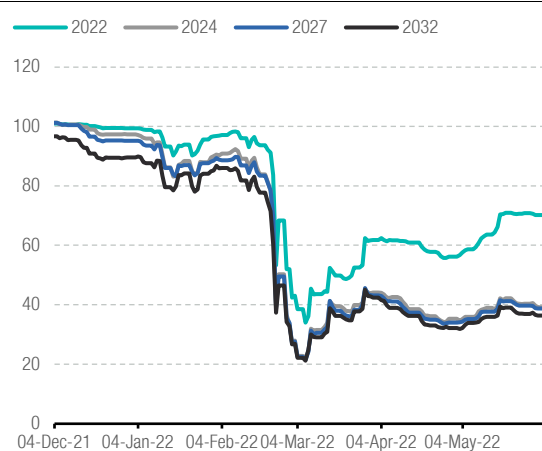
Prices of USD-denominated Eurobonds as of last Friday, a week ago and prior the Russian invasion



Source: Bloomberg, ICU.

Chart 4. Prices of selected Ukrainian Eurobonds

Last six-month historical data



Source: Bloomberg, ICU.

Foreign exchange market

UAH cash exchange rate stabilizes

Last week, the hryvnia's cash exchange rate stabilized and even strengthened somewhat after fairly significant volatility observed immediately after the NBU lifted the ceiling on the maximum allowed exchange rate for retail clients.

The hryvnia cash exchange rate in banks appreciated on average from UAH35.3–36.5/US\$ a week ago to UAH34.6–35.8/US\$ last Friday. However, the exchange rate for card transactions remained almost unchanged, in the range of UAH30–33/US\$.

ICU view: The FX market is gradually getting used to the new conditions and has found a relative temporary equilibrium. The hryvnia exchange rate should remain close to current levels with small fluctuations in the absence of negative news.

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

Economics

NBU increases key rate by 1,500 bps

NBU has decided against maintaining the key rate unchanged at 10% throughout the war and raised it to 25% in order to tackle the inflation and stabilize market FX rate.

The magnitude of this decision came unexpectedly as the market anticipated a much more modest rate hike. The regulator expects interest rates on UAH government bonds and deposits to increase in order to prevent economic agents from converting local currency into FX and reduce consumption. Interest on NBU CD's will be equal to 23%, while interest on refinancing loans will be equal to 27%.

ICU view: Such a drastic move indicates the seriousness of the situation in the economy, which is yet to live through the lengthy war. This decision creates challenges for the Ministry of Finance, which now will have to increase the yields on its bonds. Should they go for a substantial raise of the yields, it will encourage larger demand from both individual investors and corporate sectors. Banks will enjoy a greater interest income on CDs and are likely to engage in price competition for the deposits. However, the amount of liquidity is going to shrink as banks will be repaying loans with floating interest rates that they obtained from the NBU during the COVID crisis.

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

Ukraine's public debt broadly unchanged YTD

In March, Ukraine's public debt increased by 0.8% MoM to an equivalent of US\$97.6bn, but this is marginally below the end-2021 level of debt.

Local debt was up 4.3% MoM, and the growth was mainly driven by UAH50bn worth of bonds that the NBU directly purchased from the government. External debt was slightly down, as the amount of new foreign loans was relatively small in April vs March.

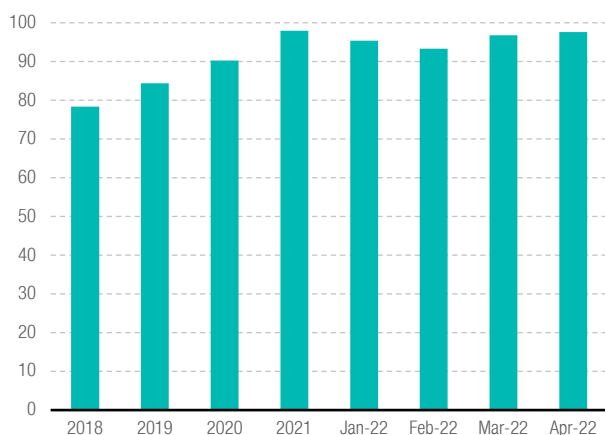
ICU view: We estimate the debt also remained little changed in May, but it is likely to start to grow significantly in June largely on new external borrowings. An average monthly increase in public debt till the end of 2022 may be up to US\$2.0-3.0bn, as G-7 countries started gradual disbursement of their US\$19.8bn aid package (about 60% of it is reportedly in the form of loans), and the EU is finalising its EUR9.0bn macro-

financial loan. Ukraine's public debt is thus expected to increase significantly through to the end of the year.

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

Chart 5. Ukraine's public debt, \$bn

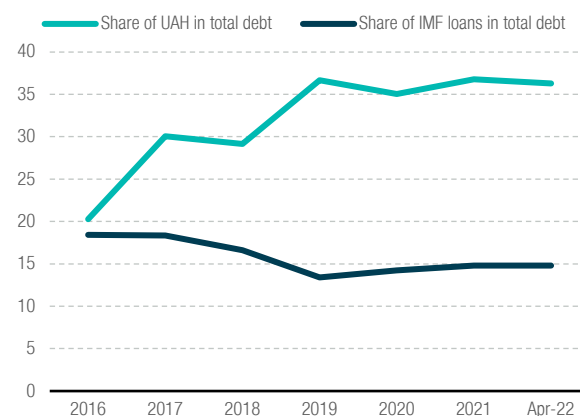
Public debt largely unchanged YTD



Source: MoF, ICU.

Chart 6. Share of UAH and IMF loans* in total debt, %

The share of hryvnia debt slightly down YTD



* includes IMF SDR allocation

Source: MoF, ICU.

Current account remains in hefty surplus in April

Ukraine's current account (CA) remained highly positive in April thanks to grants and humanitarian aid, but the financial account continues to deteriorate.

Trade in goods balance turned marginally negative, as imports recovered fast narrowing its YoY decline to 46% in April vs 66% in March. Exports remain depressed being only half of last year's volumes. Trade in the services balance turned hugely negative since March and remained such in April, the key explanation being an upsurge in expenditures of Ukrainian refugees abroad. Migrant remittances (a component of primary income) hold up fairly well and were down by only 15% YoY. The largest positive contributor to the CA surplus was grants from foreign governments and humanitarian aid. Overall, Ukraine's CA surplus totaled US\$1.1bn in April and US\$1.6bn over 12 months to April.

Meanwhile, net capital outflows reached US\$1.9bn in April driven by capital flight from the private sector. The largest contributor was the build-up of trade credit, as Ukrainian exporters delayed transfer of revenues, and importers made prepayments for future imports. The second most important contributor to capital outflow was the withdrawal of FX cash by Ukrainians abroad from their hryvnia card accounts. The total amount of such operations increased to US\$1.0bn in April from US\$0.9bn in March. Net capital inflows to the state sector was positive thanks to new loans from Ukraine's international partners.

ICU view: April numbers show rapid recovery of imports, which we expect to continue in the coming months. We thus expect the trade balance will continue deteriorating through end-2022. Still, the CA will remain in surplus thanks to generous grant support provided to Ukraine by foreign governments. Such support is going to be upscaled in the coming months. Financial aid from foreign governments and IFIs in the form of loans will also support Ukraine's financial account. The latter, however, will remain negative as capital flight from the private sector continues despite strict capital controls imposed by the NBU since the start of the war.

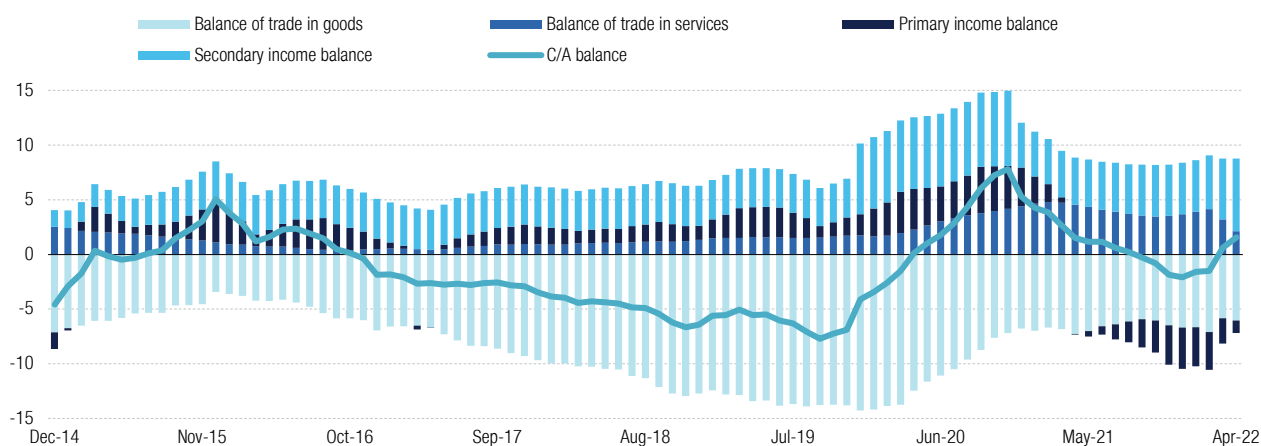
So far, significant misbalances in external accounts caused by the war have been largely compensated with international financial aid. This situation is hardly sustainable and the authorities may be forced to let hryvnia exchange rate also play its role in balancing the market.

Noteworthy as a side comment, the overall quality of the trade in goods balance remains quite poor due to gaps in import registration procedures. BoP data should be interpreted carefully in that respect.

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

Chart 7. Current account, 12-month trailing, \$bn

Current account remains in hefty surplus thanks to grants from foreign governments



Source: MoF, 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

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