Focus
Ukraine

Markets
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Economic Insight

Takeaways from Local Government Debt Management Workshop

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ICU, in cooperation with the Ministry of Finance of Ukraine, the National Bank of Ukraine, and Clearstream, held the Local Government Debt Management Workshop on 8 June 2022. Participants discussed how ongoing macroeconomic developments, new regulations, the recent NBU key policy rate hike, and government debt management priorities affect the market for local government bonds.

Below we summarize the key points made by the speakers. We hope this information will be useful for you, our dear clients and partners, in planning your participation in the Ukrainian capital markets.

Yuriy Butsa (Government Commissioner for Public Debt Management)

- Ukraine has enjoyed a healthy interest from foreign investors for local bonds since 2019, when the Clearstream link was set up. The situation changed since the start of the full-scale war, but we would like to preserve the achievements in developing the local market and ensure its smooth functioning when the investor interest returns.
- Ukraine is experiencing a financing gap of about $5bn per month as revenues plummeted since the start of the war and the war-related expenditures are very high. Tax revenues fell by about 50% initially, but have been recovering lately as Ukraine managed to liberate many of its territories.
- The three sources of funding to cover the budget deficit are selling domestic bonds in the market, selling bonds to the NBU and concessional foreign funding.
- We have maintained the yields on our bonds at the pre-war level. We strongly believe that presently government bonds are an instrument to support the country rather than to maximize the market returns. We don't have a goal of exploring the market levels at this point and the price-discovery mechanism on the secondary market is not functioning. Therefore, our domestic market borrowings will remain a partly commercial and partly humanitarian exercise. There was not historically any strong correlation between yields on bonds and the NBU key policy rate beyond the shortest part of the curve, so the key policy rate decisions don't have an impact on our bond yields. We will keep the yield curve at the pre-war level and the last Tuesday's auction showed the demand remains significant.
- Most of our issues since the start of the war had a maturity of below one year, and we had nothing longer than 1.5 year. Before the war, we tried to extend maturities but now we don't have this possibility. Our priority now is to ensure full rollover of domestic debt, both in UAH and FX.

- We encourage investors to reinvest their proceeds into government bonds. The NBU has already announced that it would allow repatriation of proceeds from all bonds that mature since April 2023.
- MinFin is seeing very strong interest in government bonds from the retail segment. The largest institutional participants gave retail clients access to the market, and we now have about 85,000 individual investors.
- We try to limit reliance on funding from the NBU. We didn't sell bonds to the NBU before the war, and the bond portfolio held by central bank steadily decreased since 2016. We don't think the total volume of bonds on the NBU's balance sheet is critically large. We have also introduced a new instrument for the NBU purchases – an interest rate floater.
- We tried to de-dollarize our debt in the past. The currency structure of the public debt has not changed significantly since February. However, that is in part thanks to the sale of UAH bonds to the NBU.
- The external debt repayment schedule is relatively even and light. The government remains current on its debt. We have a crisis that is caused entirely by the war. It is important for us to maintain access to the international capital markets after the war, as we expect the private investors will take part in rebuilding the Ukrainian economy. So, the direction of our thinking now is to ensure that we are welcomed by the markets after the war.

Sergiy Nikolaychuk, NBU Deputy Governor

- The Ukrainian economy was hit severely by the crisis. Businesses cut operations and suffered significant damage to their assets. However, the economy is gradually recovering in the regions where there is no active fighting. According to the NBU estimates, GDP fell by 44% in March and narrowed the decline to 35-40% in May. However, one can only rely on indirect evidence to make GDP estimates.
- Consumer inflation was above 17% YoY in May, mainly due to disruption of supply chains and logistical problems. Inflation is highest in the Southern regions of Ukraine that currently are partly occupied. Inflation in the Western regions is the lowest, and it is, in fact, very close to the level of inflation in neighboring countries.
- The NBU adhered to inflation targeting and a flexible exchange rate before February, but the war changed everything. The economy stopped functioning based on market signals. We had to move to a completely different policy setting that includes a fixed exchange rate and strict capital controls. We also kept the NBU's key policy rate unchanged at the pre-war level until recently. Our priority was to ensure that the financial system is operating properly, and we managed to achieve this goal.
- Now that the first war-related shock is over, the economy is becoming increasingly driven by market signals, and we have to change our policy mode. That's why the NBU decided to hike its key policy rate to 25% from 10% recently. We believe the hike will spur investor interest in local UAH-denominated assets, will help ease pressures on international reserves, and help keep inflation under control.
- We had a number of policy options on the table, including a multi-step increase in the key policy rate. But we opted for a sharp hike as we believed a gradual approach would not produce the impact we expected on the market. We wanted to give a strong push to our monetary transmission mechanism. We also wanted to let the market know that we are very unlikely to increase the rate further in the future, and the most likely step looking ahead is only to cut the rate. We also expect the MinFin will revise rates on government bonds in response to the NBU's rate hike. The longer the MinFin delays the reaction, the longer we will need to hold our rate at an elevated level.

- When deciding on the size of the increase, we also kept in mind the market's inflationary expectations, which are now close to 20%. Having a rate of 25% should make the yield on assets positive in real terms and ease inflationary pressures.
- We continue to see pressures in the FX market, and the NBU keeps selling hard currency to keep the market balanced. The situation was relatively stable in March and April, and the NBU sold nearly $2bn in each month. The sale of reserves was fully offset with the inflows of international assistance. But the situation worsened in May when the NBU sold $3.4bn, and we did not receive sufficient international aid to offset the decline. So, the reserves were down by about $2bn to $25.1bn. This is still a relatively high level, the equivalent of five months of imports (based on volumes in April and May). We expect international assistance in the coming months will be enough to prevent a decline in NBU reserves.
- The government agreed to reintroduce import taxes and submitted the corresponding draft Law to Parliament. The cost of imports will become higher, and this will ease pressures on the FX market and bring new revenues to the budget.
- There are no near-term plans to move to a flexible exchange rate—we must wait until certain preconditions are in place. Taxation of imports is only one of such preconditions. At this point, we believe that a fixed exchange rate is the preferable option as it serves as a nominal anchor, helps keep inflation under control, and is critical to price and financial stability.
- Capital controls remain tough, but we plan to ease them gradually when the situation improves. It is going to be a gradual liberalization, a process similar to the one we saw in 2016–2020, and it is going to be conditions-based rather than time-based.

Jan Willems, Head of Product Management Global Markets at Clearstream

Serge Christ, Global Market Head of Network Management Americas, CEE, CIS at Clearstream

- Clearstream represents over 70% of non-resident investors into UAH government bonds. The link was not frozen at the start of the war, and Clearstream continued to support the local bond market to the extent local regulations allow it to do so.
- All UAH government bonds issued prior to 24 February can be settled internally in Clearstream with transfer of ownership in UAH or any other currency.
- No local secondary market transactions are possible for pre-24 February issued bonds.
- UAH government bonds issued after 24 February can be settled internally in UAH or any other currency and Free of Payment with the local Ukraine secondary market.
- All UAH government bonds continue to pay UAH income into Clearstream.
- No FX income is possible until April 2023.
- UAH can be withdrawn from Clearstream and moved into the investors' own UAH onshore cash account or to UAH cash accounts of primary dealers to participate in bond auctions.
- A new feature added recently: local Ukraine financial institutions can now hold UAH government bonds in Clearstream, directly or indirectly, further widening trading and settlement counterpart opportunities.
- It's very beneficial to consider reinvesting cash into new bonds.

Konstantin Stetsenko, ICU Founding Partner

- Since the beginning of the war, trading on the secondary market was suspended. The decrease in bonds held by non-residents is only due to redemptions. But in Clearstream, bonds are still allowed to trade. The price is close to 55% of par for 2025 bonds. With current FX restrictions, local and international markets are entirely detached from each other.
- All amounts already paid by the MoF sit in the Clearstream account in Ukraine. Until 1 April 2023, it will not be possible to repatriate funds from Ukraine due to FX restrictions. So, it is reasonable for foreign investors to use UAH liquidity, earn some carry, and repatriate funds after 1 April 2023.
- Local retail investors are very active in the bond market and want to support the country financially. Local brokers and banks allowed clients to purchase bonds. ICU alone made it possible for about 10,000 retail investors to buy bonds.
- We are also working on an IT solution and a related legal mechanism to allow foreign investors to invest in local instruments. The vast majority of transactions are done locally on a fully automated basis, and we expect foreign investors will also have this convenience soon.

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