Focus
Ukraine

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

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Weekly Insight

NBU keeps rate at 25%

Key messages of the today's comments

MONDAY, 25 JULY 2022

Ukrainian bond market

MoF raises yields to test demand

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Ukraine seeks to postpone payments on Eurobonds

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Foreign exchange market

NBU allows one-off deep hryvnia depreciation

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Economics

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Banks' reserves market (22 July 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	25.00	+0bp	+1,700bp
ON rate (%)	9.76	+0bp	+290bp
Reserves (UAHm)[2]	68,742	+9.12	-6.11
CDs (UAHm)[3]	155,424	+2.46	+7.75

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) (22 July 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU	543,606	+2.84	+71.33
Banks	526,348	+1.25	+4.18
Residents	65,618	+0.28	+36.00
Individuals	30,875	+10.32	+65.52
Foreigners[1]	71,360	-0.13	-33.58
Total	**1,238,348**	**+2.03**	**+24.24**

Source: NBU, ICU.

FX market indicators (22 July 2022)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	36.7172	+24.31	+35.40
EUR/USD	1.0213	+1.32	-13.24
DXY	106.730	-1.23	+14.98
UAH TWI[1]	113.152	-20.05	-9.55

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

Market gov't bond quotes[1] (25 July 2022)

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

Source: ICU.

Ukrainian bond market

MoF raises yields to test demand

In a somewhat daring move, the Ministry of Finance raised the interest rate on UAH bills, which resulted in increased local-currency borrowing. However, activity in the secondary market slowed even further against this background.

At last Tuesday's auction, the Ministry of Finance increased the interest rate on 12-month bills from 11% to 14%—the first increase since February. This decision resulted in almost UAH1.8bn (US$61m) being raised for the budget. However, almost 2/3 of the demand for this instrument came in with rates above 14%, so it was rejected. The demand for other local-currency bills was minimal, as it was for FX-denominated instruments, which resulted in the state budget raising ten times less in terms of proceeds than the previous week. See details in the auction overview.

Relatively low rates for UAH bills, which have remained unchanged since February, are increasingly discouraging domestic investors from buying new bonds. Increase in demand for one-year government paper in the primary market did not lead to better trading in the secondary market. The turnover of hryvnia-denominated securities decreased to the lowest level since the government started placements of military bonds in early March. In total, 4,138 deals worth UAH209m (US$6m) were concluded.

ICU view: The hopes of market participants that the Ministry of Finance will review the terms of new bills have only partially come to pass. However, a first step has been made, and the rates on 12-month bills were increased. Therefore, it is reasonable to expect a further upward revision of interest rates. Last week, the NBU announced that the discount rate would not go lower than 25% until at least 2Q24. Such guidance further strengthens banks' and other domestic investors' belief that the rates offered by the Ministry of Finance are too low and do not provide adequate compensation for risk. Therefore, the demand for UAH bills is unlikely to recover at the current level of yields. We believe that a further increase in rates at primary auctions is only a matter of time.

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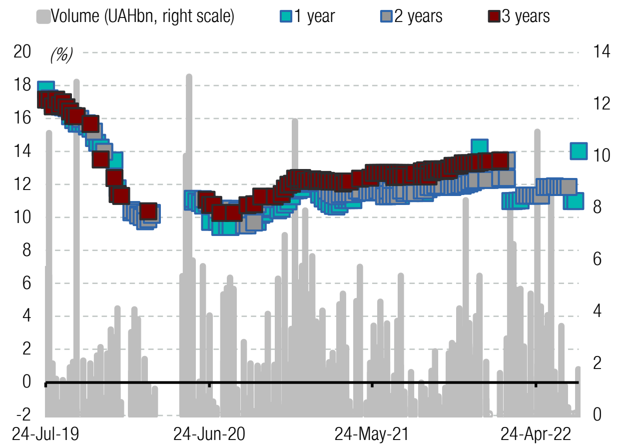
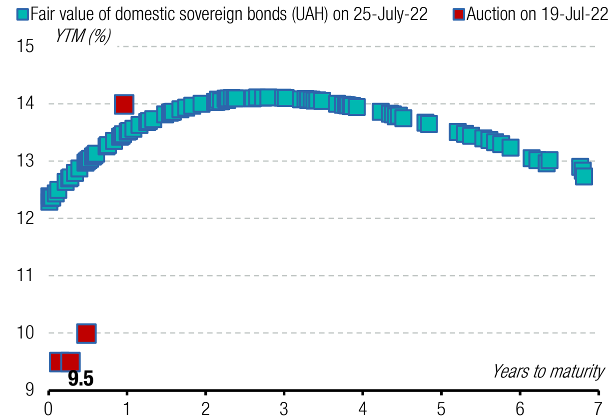
Chart 1. Local-currency bonds

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.

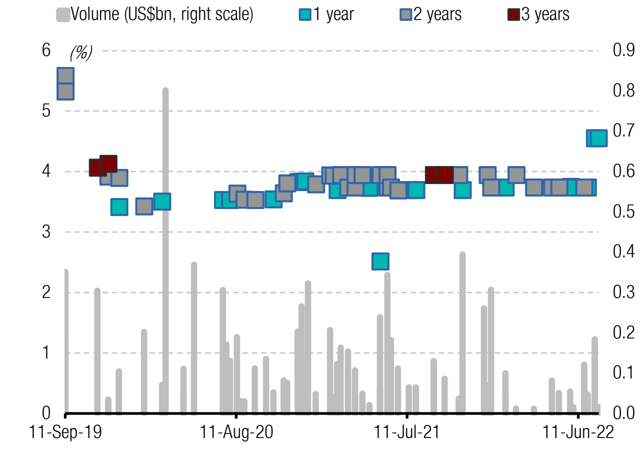
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

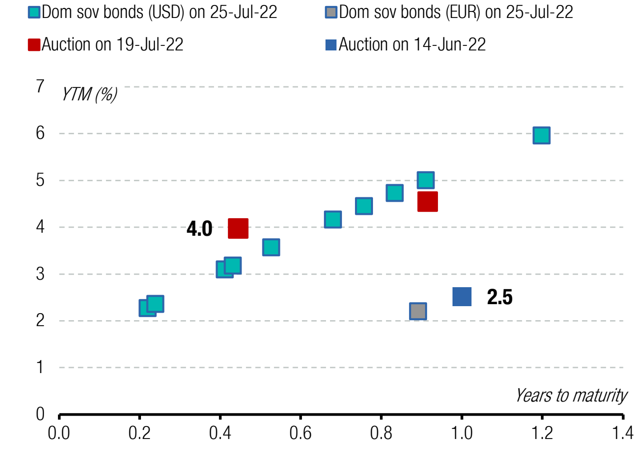
Chart 2. FX-denominated bonds

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 seeks to postpone payments on Eurobonds

Last week, Ukraine announced consent solicitation with investors to defer all payments on all of its Eurobonds for two years.

About a month before a US$0.9bn Eurobond matures, the government decided to request from investors a review of the terms of all issues of Eurobonds and defer the maturity of each of them by 24 months. This proposal covers Eurobonds worth US$17.3bn and EUR2.3bn. The only pay-out that will be made before the full suspension of payments is the coupon on Eurobonds maturing in 2024, which is scheduled for 1 August.

The government also intends to stop making coupon payments on Eurobonds for the next two years, although coupons will be accrued. In addition, during the deferral period, the accrued-but-not-paid coupons shall bear interest (interest on interest) at the fixed rate applicable for each Eurobond. Ukraine reserves the right to pay coupons accumulated during the deferral period partially or in full at any time during the two-year period. At the same time, the government wants to reserve the right, if necessary, to convert accrued coupons into new bonds after the two-year period is over.

Also last week, creditors from the G7 countries and the Paris Club announced that they will defer principal and interest repayments from Ukraine until the end of 2023, with the possibility of extending the grace period until the end of 2024. The countries from the Paris Club also asked Eurobond holders to agree to the restructuring terms presented by Ukraine.

ICU view: Overall, the terms of the offer are quite friendly for Eurobond holders. The government chose the least painful form of restructuring possible at this stage. Eurobond holders will receive the full amount of all payments, albeit with a delay. As compensation for delaying payments, they will get additional interest.

We expect that the restructuring terms proposed by Ukraine will be accepted by the largest holders of Ukrainian Eurobonds. The fact that the Paris Club countries have already made concessions on their own loans to Ukraine is an additional argument in favour of a positive decision on the Eurobond restructuring. After all, both official and commercial creditors make similar concessions and are on an equal footing. In addition, Ukraine seeks to obtain similar concessions from all international financial organizations. The results of the Eurobond holders' vote will be known on 10 August.

We do not rule out the government may seek a second restructuring at the end of the two-year period. The government's stance will depend on developments in the battlefields, the state of economy and public finances, and the country's debt burden.

Prices of Eurobonds have likely hit a bottom, as they barely reacted to the government's restructuring proposal. After the postponement is agreed to, prices may even rise slightly as one of the factors of uncertainty that weighed on prices since February will have been eliminated. At the same time, prices will remain sensitive to developments on the frontlines and any progress Ukraine makes would be taken very positively.

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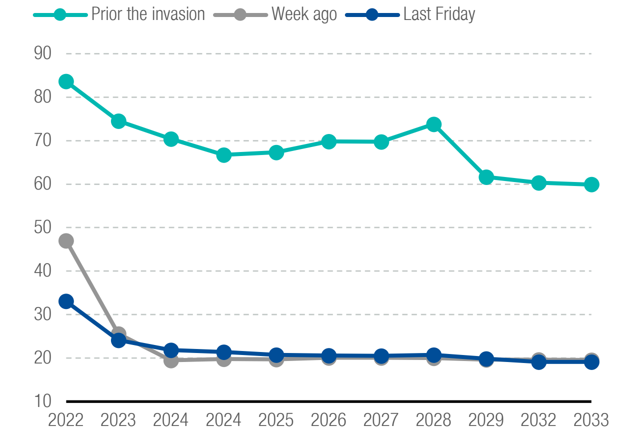
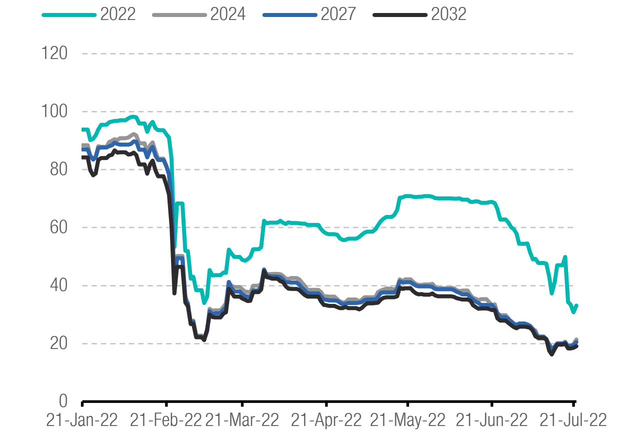
Chart 3. Ukrainian Eurobonds prices

Prices of USD-denominated Eurobonds as of last Friday, prior the russian invasion and the lowest prices seen on 7 March, 2022



Source: Bloomberg, ICU.

Last six-month historical data



Source: Bloomberg, ICU.

Foreign exchange market

NBU allows one-off deep hryvnia depreciation

On Thursday, the NBU weakened the official exchange rate of the hryvnia to the US dollar and changed several regulations for retail clients that caused turbulence in the FX market.

The NBU raised the US dollar exchange rate by 25% to UAH36.6/US$ on Thursday morning, and, accordingly, reset the official exchange rates on other foreign currencies. This is the first decision to change the official exchange rate since the start of russia's full-scale war against Ukraine. The official exchange rate is the rate at which importers buy and exporters sell hard currency in the interbank market.

The change in the official exchange rate also led to heightened fluctuations in the cash market. The cash exchange rate at the largest retail banks weakened from UAH35.75–37.14/US$ last Monday to UAH37.44–38.83/US$ on Friday. Banks also updated card exchange rates; they were reset closer to the new official rate. Among the 10 banks having about 95% of active payment cards in Ukraine, the average exchange rate of the US dollar for card transactions weakened during the week from UAH32.5–34.9/US$ to UAH36.6–37.05/US$.

In addition to weakening the hryvnia, the NBU imposed stricter capital controls for retail clients. The limit for withdrawal of FX cash from hryvnia cards is now UAH12,500 (US$341) per week rather than UAH50,000 (US$1,366) per month, and the limit for transfers to cards in foreign banks was reduced to UAH30,000 (US$820) from UAH100,000 (US$2,732) per month. In addition, a limit has been set on the amount of payments abroad to UAH100,000 per month per one client. In the meantime, the NBU allowed banks to sell non-cash currency to retail clients, placing it on deposit for three months or more.

ICU view: The NBU was forced to carry out a significant one-time devaluation of the hryvnia to reduce the imbalances in the FX market during the war and reduce pressure on international reserves. There was no alternative to this decision because maintaining the pre-war USD/UAH exchange rate required significant intervention, which in recent weeks stood at almost US$1bn per week. Please read more about details of the NBU's decision and its impact on the FX market in our last week's review "NBU Takes Bold Decision to Protect Reserves."

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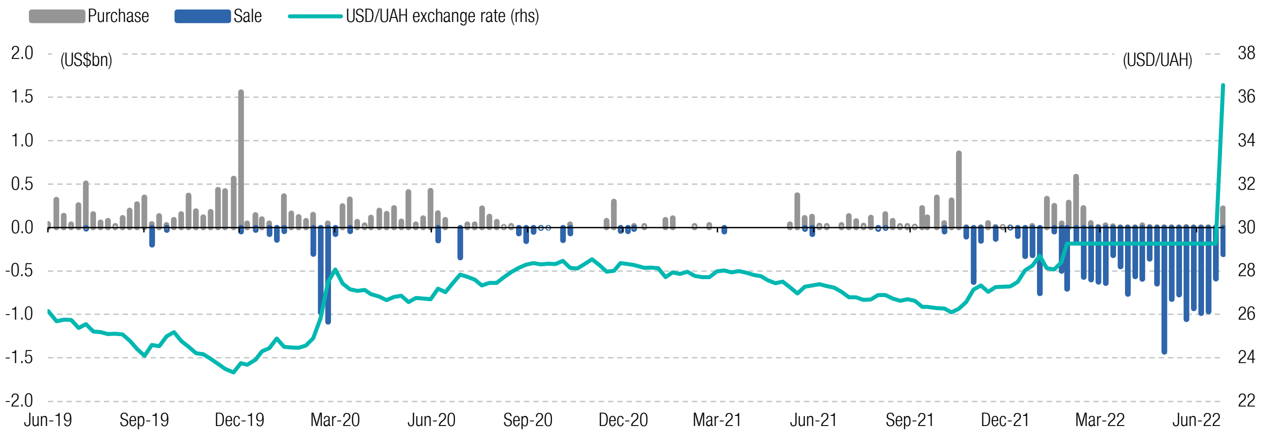
Chart 4. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

NBU keeps rate at 25%

The NBU abstained from changing the key rate, in line with the expectations, and indicated it expects the rate to stay at 25% until at least 2Q24.

This decision came as no surprise after inflation reached 21.5% YoY in June. At the same time, large banks were reluctant to meaningfully increase rates on deposits while the Ministry of Finance waited until 19 July to start increasing rates in the primarily auctions. With all this, the effect of the June hike is yet to be fully seen, therefore, leaving little doubt other than to keep rate unchanged.

NBU has given a grim but realistic forecast of a 30% YoY CPI in 2022, and 20.7% YoY CPI in 2023. It has also indicated that the key rate is expected to remain at this level at least until 2Q24.

ICU view: The macro forecast indicates the regulator's expectation of a lengthy period of high interest rates as the toll of war increases every day. Despite the forecast, the NBU should be ready to further increase rates if necessary. At the moment, there is a greater possibility of another rate hike rather than an early rate cut.

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