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

Weekly Insight

Current account remains in surplus

Key messages of the today's comments

MONDAY, 5 SEPTEMBER 2022

Ukrainian bond market

Bond-market activity remains low

Domestic borrowing increased last week. However, it remained at a low level that did not allow the full refinancing of current debt repayments.

Ukrainian Eurobonds under global sentiment pressure

Last week, Ukrainian Eurobond prices fell, reflecting the general bearish trend in bond markets.

Foreign exchange market

FX market maintains balance

Last week, the FX market remained in a shaky balance without large volatility both in the interbank and retail segments.

Economics

Ukraine's public debt declines in US$ equivalent

In July, Ukraine's public debt declined 8% MoM in US$ equivalent to US$96.8bn due to one-time hryvnia depreciation.

Huge current-account surplus in July due to grants

Ukraine's current account (CA) ended with a significant surplus of US$1.3bn in July (US$1.9bn over 12 months to July) as the government received sizable grants from international partners.

Banks' reserves market (2 September 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	25.00	+0bp	+1,700bp
ON rate (%)	9.76	+0bp	+233bp
Reserves (UAHm)[2]	60,632	-3.02	+12.91
CDs (UAHm)[3]	217,932	+6.71	+82.95

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) (2 September 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU	589,570	+0.00	+88.60
Banks	503,600	-1.94	+0.57
Residents	65,864	-0.86	+30.21
Individuals	30,294	-0.33	+50.65
Foreigners[1]	68,968	-1.86	-29.59
Total	**1,259,256**	**-0.92**	**+28.23**

Source: NBU, ICU.

FX market indicators (2 September 2022)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	36.8772	+0.34	+36.74
EUR/USD	0.9954	-0.12	-16.18
DXY	109.534	+0.67	+18.77
UAH TWI[1]	114.360	-0.36	-8.14

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

Market gov't bond quotes[1] (5 September 2022)

Maturity	Bid	Ask
6m	**21.00**	**16.00**
12m	**21.00**	**17.00**
2y	**23.00**	**18.00**
3y	**25.00**	**19.00**
12m ($)	**6.00**	**4.50**
2y ($)	**N/A**	**N/A**

Source: ICU.

Ukrainian bond market

Bond-market activity remains low

Domestic borrowing increased last week. However, it remained at a low level that did not allow the full refinancing of current debt repayments.

At the last auction of the summer, almost UAH4bn (US$107m) was raised for the budget, but only UAH323m (US$8.8m) was in local currency and the rest in hard currency. FX-denominated instruments with a put option were the most helpful in increasing borrowings. See details in the auction review.

The current level of proceeds does not allow the Ministry of Finance to refinance domestic debt repayments. In the first two months after the full-scale invasion, the government managed to attract more than it redeemed, and the rollover was above 100%. But since May, new borrowings fell short of redemptions, and every month since, the gap widened. Overall, the MoF failed to refinance UAH30bn (US$1.1bn) of redemptions in local currency in the first two months of this year due to investors' expectations of an escalation of hostilities in the east of the country. Then within six months of the full-scale russian invasion of Ukraine, this amount increased to UAH87bn (US$2.4bn). In addition, almost US$1bn and EUR78m of redemptions in hard currency have not been refinanced since the beginning of the year.

The inflow of investments in UAH government bonds decreased not only in the primary market, but also in the secondary market, especially in the segment of ordinary (non-military) government bonds. The volume of transactions with military bills on the secondary market slid from UAH359m (US$9.8m) to UAH328m (US$9m). In contrast, the volume of deals with ordinary bonds decreased from UAH3bn (US$82m) to UAH1.3bn (US$37m).

ICU view: Low rates for military bills in the primary market and the broader selection of bonds in the secondary market hamper budget borrowings. Refinancing of FX debt is also below 100%. So, in essence, the Ministry of Finance stopped relying on the domestic market as a source of financing the budget deficit. Through end of the year, the deficit will be financed through international financial assistance and the direct sale of government bonds to the National Bank.

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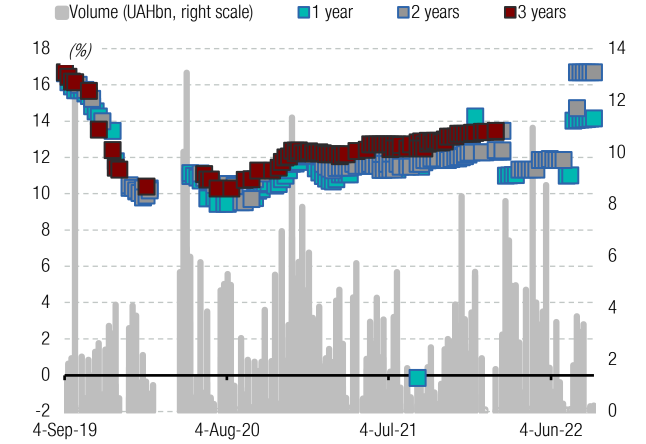
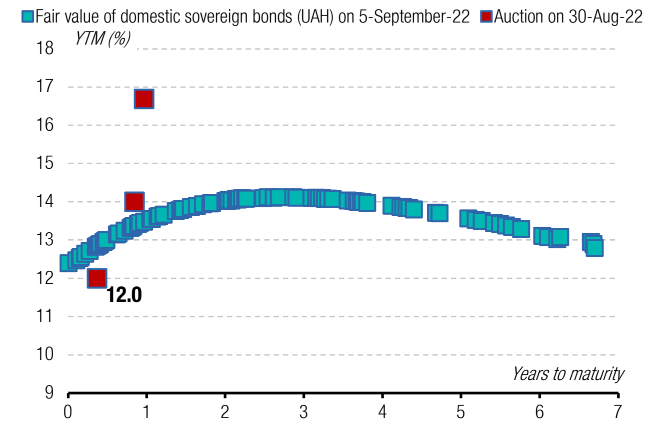
Chart 1. Local-currency bonds

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.

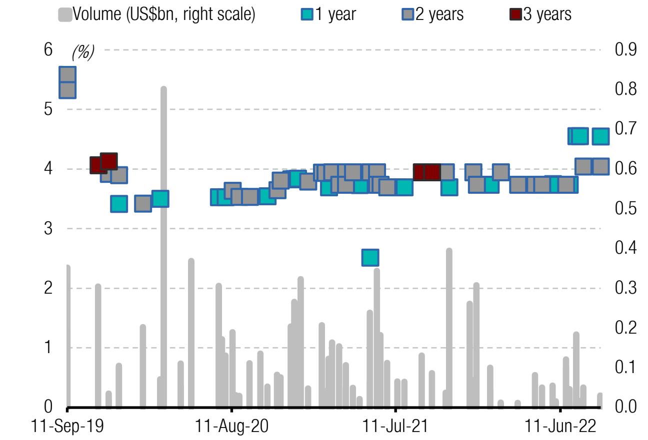
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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

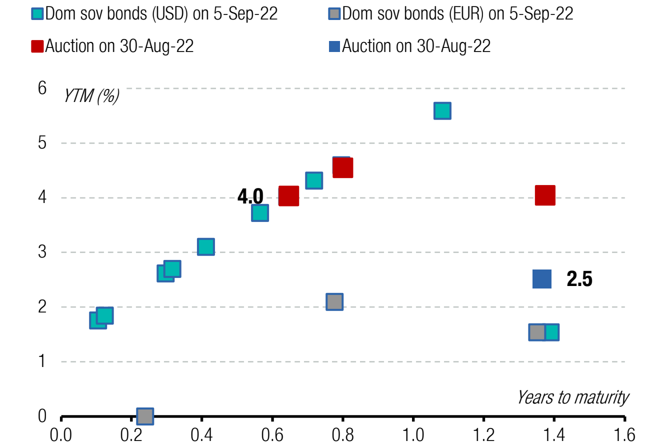
Chart 2. FX-denominated bonds

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.

Ukrainian Eurobonds under global sentiment pressure

Last week, Ukrainian Eurobond prices fell, reflecting the general bearish trend in bond markets.

Anticipation of rate hikes by central banks caused a decrease in bond prices on the global market, and the trend also spread to developing countries, including Ukraine. Even though country-specific factors for Ukraine prevail, there was no material country news last week.

Over the past week, the prices of Eurobonds lost more than 10% and closely approached the minimum values seen on the eve of the announcement of the results of investors' vote to defer payments. However, for some Eurobonds, prices fell even lower. Most Eurobonds of Ukraine were priced last Friday at 18-28 cents.

ICU view: Currently, Ukraine is mainly under the influence of global markets, as restructuring has been finalized and the risk of default has not materialized. News from battlefields is no longer decisive for investors. Therefore, we expect that prices may further decrease in the near future until investors' appetite for high-risk assets begins to recover.

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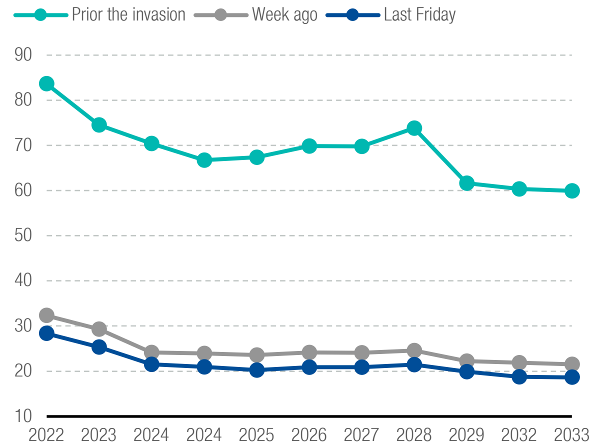
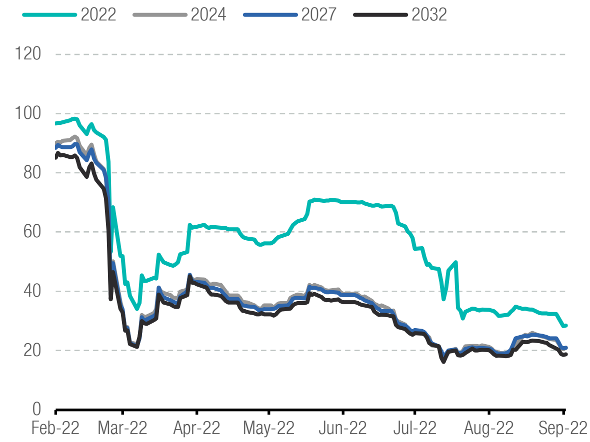
Chart 3. Ukrainian Eurobonds prices

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



Source: Bloomberg, ICU.

Last six-month historical data



Source: Bloomberg, ICU.

Foreign exchange market

FX market maintains balance

Last week, the FX market remained in a shaky balance without large volatility both in the interbank and retail segments.

The National Bank reduced interventions to US$239m last week as supply from bank clients increased, probably again due to the sale of hard currency by the Ministry of Finance to finance current budget needs. Also, the increase in supply was probably facilitated by the recovery of the export of grain and oil crops through the Black Sea ports.

The cash FX market was also fairly balanced, with slight fluctuation and insignificant changes in the cash exchange rate. The hryvnia exchange rate to the US dollar in the leading retail banks remained almost unchanged at close to UAH40/US$.

ICU view: The interbank FX market still requires the NBU's interventions or the sale of hard currency by the Ministry of Finance and is far from being balanced on its own. Instead, for the second consecutive week, the cash market is quite balanced, with minimal fluctuations. If the current relatively stable situation in the country is maintained, we do not expect any particular changes in the FX market.

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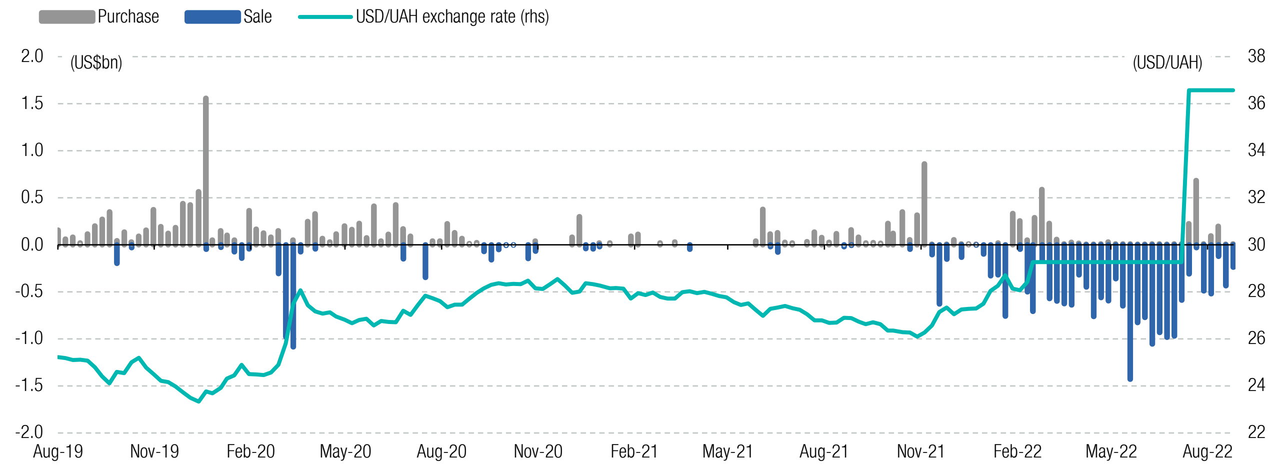
Chart 4. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

Ukraine's public debt declines in US$ equivalent

In July, Ukraine's public debt declined 8% MoM in US$ equivalent to US$96.8bn due to one-time hryvnia depreciation.

Ukraine didn't have any significant external borrowings in July, as the vast majority of international financial assistance came in the form of grants. Local borrowings were heavily dominated by sale of government bonds to the NBU, which totaled UAH30bn.

A one-time hryvnia depreciation that the NBU carried out in late June (US dollar became more expensive by 25%) was the factor behind the significant change in the total debt stock—it increased 15% MoM in UAH equivalent, but declined 8% MoM in US$ equivalent. The share of UAH-denominated debt declined to 33.9% from 38.5% in June.

ICU view: The ratio of end-July public debt to Ukraine's 2022E GDP is close to 78%. We expect the debt-to-GDP ratio will move up further close to 90% by the end of 2022.

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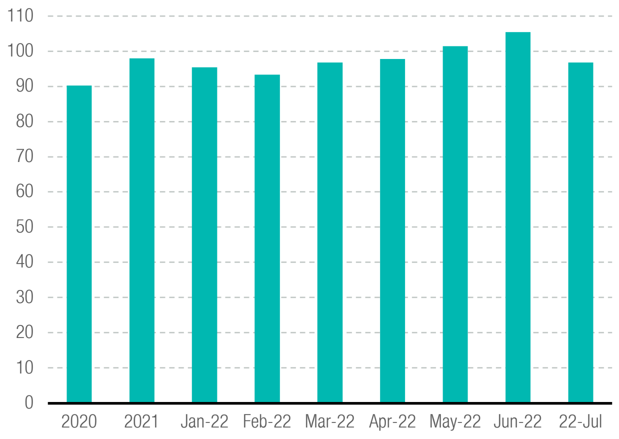
Chart 5. Ukraine's public debt, $bn

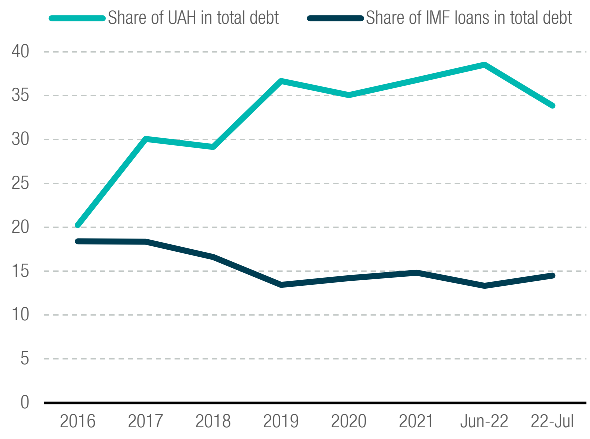
Public debt declines in US$ equivalent due to hryvnia depreciation



Source: MoF, ICU.

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

The share of hryvnia debt fell significantly due to hryvnia weakening



* includes IMF SDR allocation

Source: MoF, ICU.

Huge current-account surplus in July due to grants

Ukraine's current account (CA) ended with a significant surplus of US$1.3bn in July (US$1.9bn over 12 months to July) as the government received sizable grants from international partners.

July's deficit of trade in goods was at a record high since the start of the war at US$2.0bn, while the deficit of trade in services remained broadly flat from June at US$1.2bn. The hefty trade deficit was more than offset with US$1.3bn in migrant remittances (a component of primary income) and US$2.9bn in official grants to government (a component of secondary income).

Meanwhile, the financial account ended with a deficit of US$1.6bn on the back of a build-up in trade credits and FX cash withdrawal from hryvnia accounts by population abroad. The stock of trade credits was up by US$0.8bn. It nearly halved vs. June but was still substantial. FX cash outflows from banks stayed flat at US$1.0bn. There were no significant inflows of debt to the government sector in July.

Since the deficit of the financial account was nearly equal to the surplus of the current account, NBU reserves were only marginally down in July (-2% MoM to US$22.4bn).

ICU view: July's numbers indicate Ukraine's economy remains heavily dependent on external financial assistance, which came in substantial volumes in the form of grants. Meanwhile, July numbers are not fully indicative of the BoP trends through end-2022 for two reasons. Firstly, the economy operated under the pre-war exchange rate in the first three weeks of July before the NBU reset it (the US dollar became 25% more expensive) at the end of the month. Weaker hryvnia likely played a role in improving the trade balance already in August. Also, it could decelerate the build-up of trade credits as exporters could temporarily have more incentives to repatriate hard currency to Ukraine to sell it at a more favourable exchange rate. Secondly, Ukraine managed to restart the export of grains and vegetable oils thanks to a UN-brokered deal that unblocked some of the Black Sea ports. Higher exports also could help narrow the trade deficit, probably in a sustainable manner. Indirect indicators show the external imbalances were smaller in August than in July.

We expect the outflows through the financial account to be roughly equal to the C/A surplus in the months to the end of 2022, with the balance again ensured thanks to the

international support. The NBU end-2022 reserves are thus likely to be close to July's level.

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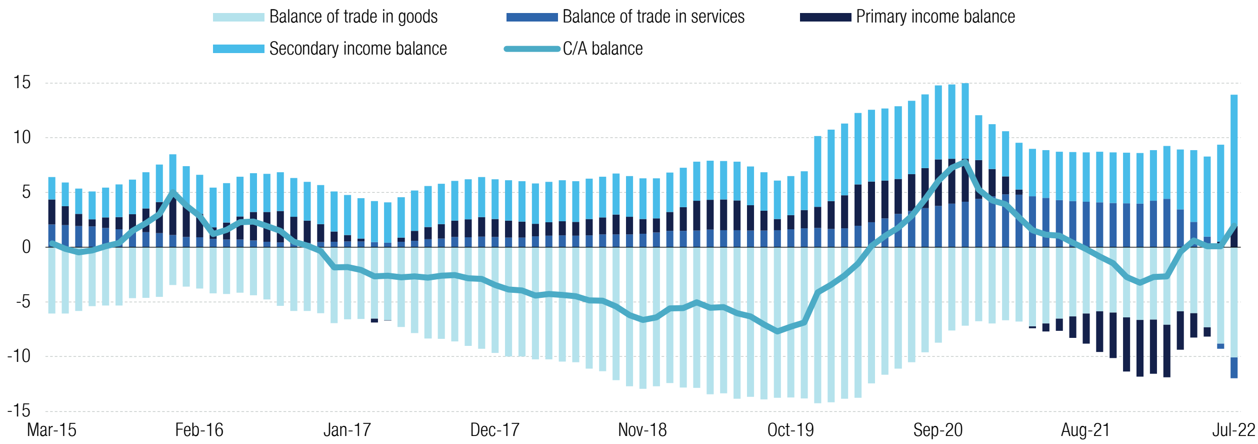
Chart 7. Current account, 12-month trailing, $bn

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



Source: MoF, ICU.

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