Focus
Ukraine

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

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Weekly Insight

NBU keeps rate, increases reserve requirements

Key messages of the today's comments

Ukrainian bond market

MoF continues to raise interest rates selectively

Last week, the Ministry of Finance again raised rates on UAH bills, but selectively.

Eurobond price correction continues

Prices of Ukrainian Eurobonds continued to slide gradually, most by no more than 4%.

Foreign exchange market

Hryvnia strengthens in cash segment

The cash rate of the hryvnia against the US dollar strengthened significantly last week to the level last seen in mid-October.

Economics

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The regulator left the key rate unchanged at 25%, as expected. It has also increased reserve requirements to improve the effectiveness of the transmission mechanism.

November brings first signs of slowing inflation

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MONDAY, 12 DECEMBER 2022

Banks' reserves market (9 December 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	25.00	+0bp	+1,650bp
ON rate (%)	9.76	+0bp	+233bp
Reserves (UAHm)[2]	65,290	+4.46	+60.56
CDs (UAHm)[3]	383,322	+4.09	+148.94

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) (9 December 2022)

	Last	Weekly chg (%)	YoY chg (%)
NBU	674,570	+0.00	+115.79
Banks	488,085	+0.24	-4.81
Residents	72,634	+1.07	-8.31
Individuals	31,610	+2.82	+29.29
Foreigners[1]	58,051	+0.91	-36.90
Total	**1,325,971**	**+0.25**	**+29.87**

Source: NBU, ICU.

FX market indicators (9 December 2022)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	36.7800	-0.19	+35.79
EUR/USD	1.0540	+0.05	-6.67
DXY	104.810	+0.25	+8.87
UAH TWI[1]	112.737	+0.11	-13.59

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

Market gov't bond quotes[1] (12 December 2022)

Maturity	Bid	Ask
6m	23.00	18.00
12m	24.00	19.00
2y	28.00	20.00
3y	25.50	21.00
12m ($)	6.00	4.50
2y ($)	N/A	N/A

Source: ICU.

Ukrainian bond market

MoF continues to raise interest rates selectively

Last week, the Ministry of Finance again raised rates on UAH bills, but selectively.

At last Tuesday's auction, four UAH bills were offered with maturities from seven months to two years and a six-month EUR-denominated bill. The largest demand was for 1.5-year instrument with one bid for UAH3bn (US$82m). However, accepting it would have required the Ministry of Finance to raise the interest rate by 25bp to 19.25%, so they ignored the bid. Therefore, UAH 3.1bn (US$83M) was borrowed, including EUR54.7m in euros and UAH0.9bn (US$24.9m) from two-year bills. For the latter, the Ministry agreed to raise the rate by 25bp to 19.5%. See details in the auction review.

The rejected demand only partially moved to the secondary market, increasing trading volume from Wednesday till Friday compared with the first two days of the week. Thus, on Wednesday-Friday, trading totalled UAH2.3bn (US$62m) in contrast to only UAH0.3bn (US$8m) on Monday and Tuesday. During the week, trading activity was little changed: the number of deals with UAH bonds decreased by 98 to 4,769, and the volume was up by UAH275m (US$8m) to UAH2.6bn (US$70m).

ICU view: Last Tuesday, the MoF unexpectedly rejected bids with significant volumes but accepted smaller bids, even though both required a 25bp rate hike. Both issues are comparable in terms of maturities and were redeemable in 2024. Such a selective approach may be confusing to the market and reduces the potential for new borrowings. Tomorrow's auction can again result in only partial refinancing of this week's repayments of UAH14.4bn (US$0.4bn).

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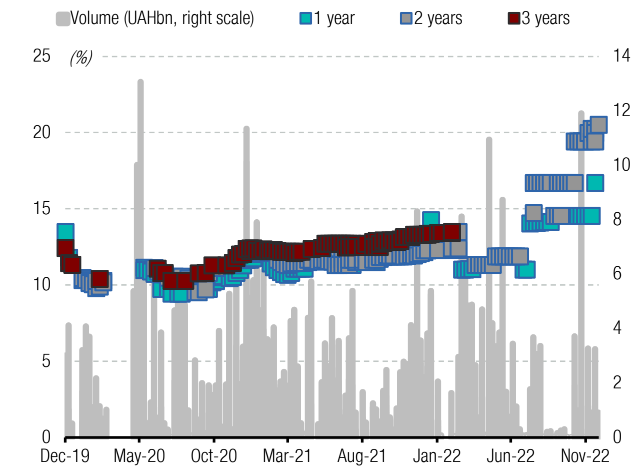
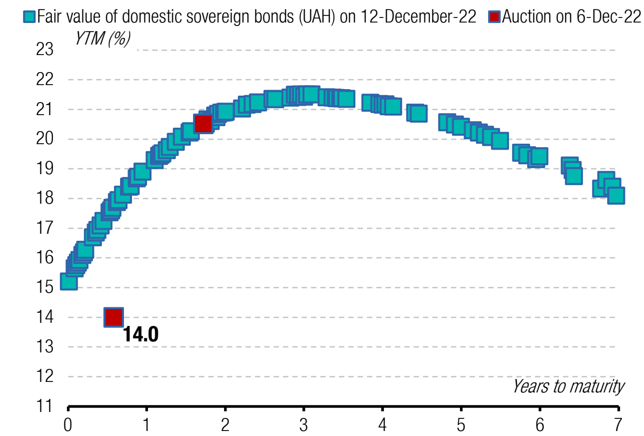
Chart 1. Local-currency bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: MFU, ICU.

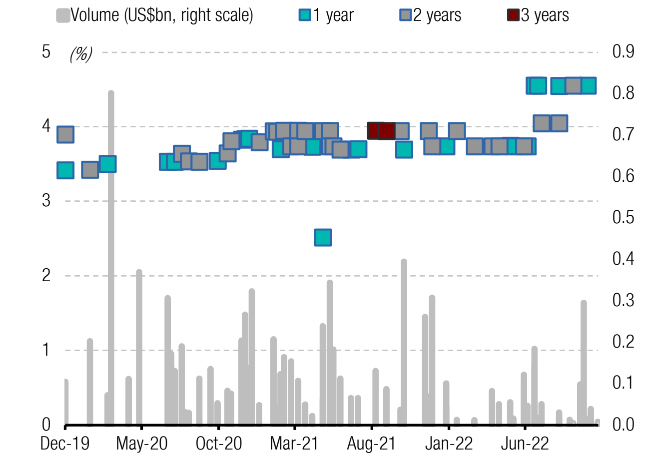
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



Source: NBU, MFU, ICU.

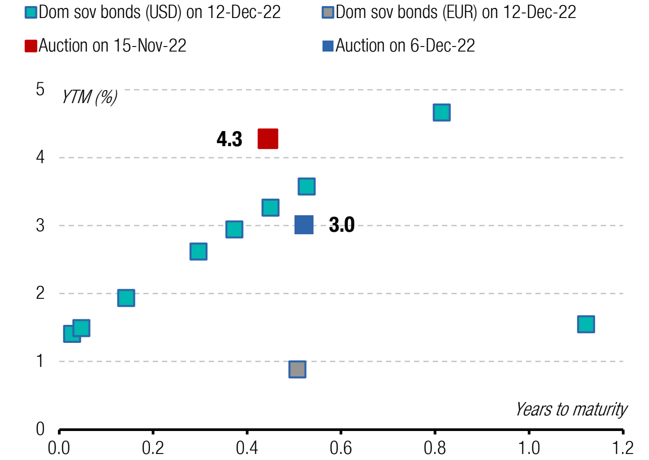
Chart 2. FX-denominated bonds

Three-year history of domestic government bond placements at primary market: proceeds (in billions) and yields-to-maturity (%)



Source: MFU, ICU.

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



Source: NBU, MFU, ICU.

Eurobond price correction continues

Prices of Ukrainian Eurobonds continued to slide gradually, most by no more than 4%.

Spreads of Ukrainian Eurobonds to the benchmark widened again, pushing yields up and prices down. During the week, prices slid mostly by one cent per dollar or 3–4%, but several issues fell by 8–9% or 2 cents. Generally, the price range shifted from 21–27 cents to 20–26 cents. The price for VRIs fell below 30 cents per dollar of notional value.

ICU view: Last week's global sentiment in the debt markets was fairly neutral for developing countries. The prices of Eurobonds did not change significantly, apparently driven by country-specific news. Prices for Ukrainian Eurobonds continued to slide against the backdrop of lack of major news on the warfront.

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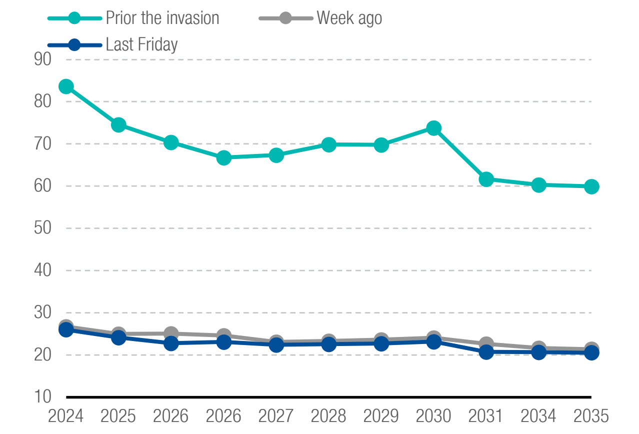
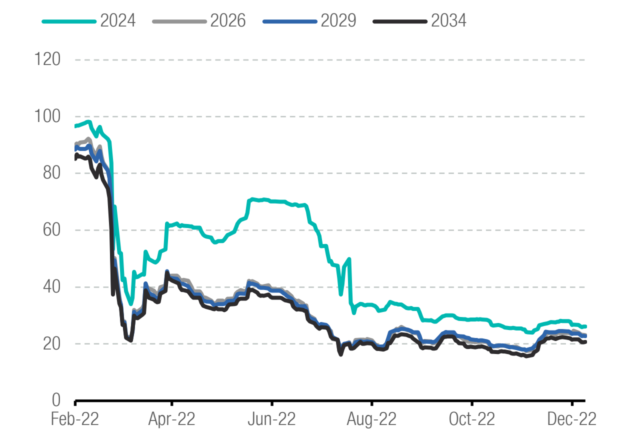
Chart 3. Ukrainian Eurobonds prices

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



Source: Bloomberg, ICU.

Last eight-month historical data



Source: Bloomberg, ICU.

Foreign exchange market

Hryvnia strengthens in cash segment

The cash rate of the hryvnia against the US dollar strengthened significantly last week to the level last seen in mid-October.

The supply of hard currency on the cash FX market outweighs demand. Over the past week, the hryvnia exchange rate in leading retail banks appreciated by approximately 0.6% to UAH39.3–40.1/US$ from UAH39.6–40.3/US$ a week before. The current exchange rate is very close to levels last seen in mid-October.

On the interbank market, demand continued to prevail significantly. Therefore, the NBU's weekly interventions increased to US$583m, the maximum since mid-October.

ICU view: With the coming Christmas and New Year holidays, hard currency supply may increase further in the cash segment, leading to further strengthening of the hryvnia exchange rate. NBU interventions in the interbank market will remain large in December as customers buy FX to make end-of-year settlements of trade contracts. However, high interventions are unlikely to put excessive pressure on international reserves thanks to regular inflow of international financial aid.

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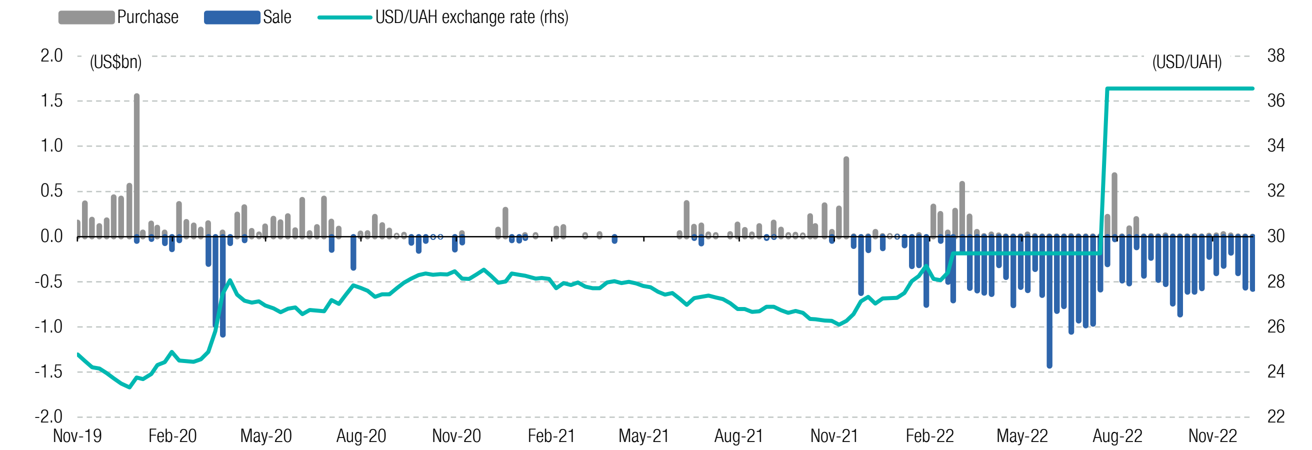
Chart 4. FX market indicators, 3-year history

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 unchanged, increases reserve requirements

The regulator left the key rate unchanged at 25%, as expected. It has also increased reserve requirements to improve the effectiveness of the transmission mechanism.

The regulator has kept the key rate unchanged at 25%, in line with expectations. The CPI, albeit continuing to grow, was slightly below the NBU's forecast. However, excessive liquidity in the banking sector has prevented the full effect of monetary transmission. Other interest rates in economy have increased only marginally compared with the NBU rate. To address this issue and achieve higher commercial interest rates, NBU is hiking the reserve requirements by 500 bps, effective January 2023. Instead of the current requirements of 0% for UAH deposits and 10% for FX deposits, the regulator introduces a 5% requirement for current accounts in UAH, while term deposits will remain at 0%. For FX deposits, banks will have to keep 15% for current accounts and 10% for term deposits.

Banks will be able to keep up to 50% of their reserve requirements in government bonds. The NBU will determine the eligibility criteria for such inclusion after consultations with the Ministry of Finance.

ICU view: New reserve requirements can almost double the amount of reserves banks will have to keep. It means that up to UAH65bn of additional reserves will be kept in the form of government bonds. While the exact details are yet to be announced, NBU will likely allow some existing bonds to be included in the reserves. Banks likely will choose to increase their bond portfolios thus creating additional demand in the tens of billions of hryvnias at the primary auctions in 1Q23. They will also be compelled to roll over maturing bonds from their "reserve portfolios," assuring elevated demand for bonds.

Banks will have a stimulus to encourage their clients to keep more of their funds in term deposits versus current accounts, as it will reduce their reserve requirements.

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November brings first signs of slowing inflation

Annual headline inflation decelerated marginally to 26.5% YoY in November from 26.6% in October. Yet, core CPI still accelerated to 22.1% YoY from 21.5%.

Food prices growth slowed in November on both a MoM and YoY basis thanks to better supply of vegetables and, thus, reversed the accelerating CPI trend. The trend across the board was mixed with the YoY pace of growth in tariffs for transportation services and utilities remaining broadly unchanged while prices for many other less significant components accelerated marginally.

ICU view: Deceleration of annual prices in November was a positive surprise and signalled that inflationary pressures started to weaken against the backdrop of depressed household demand. November data imply end-2022 CPI will be below our expectation of 29.5%. Still, it is almost certain that annual inflation will be accelerating during the winter months from the end-November level and a sustainable decelerating CPI trend will only emerge in March.

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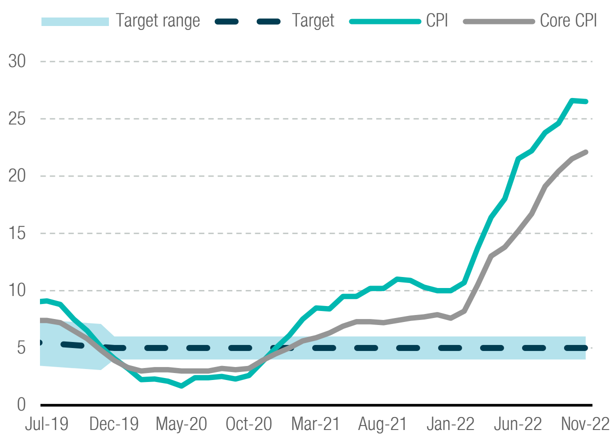
Chart 5. CPI, core CPI and target, YoY, %

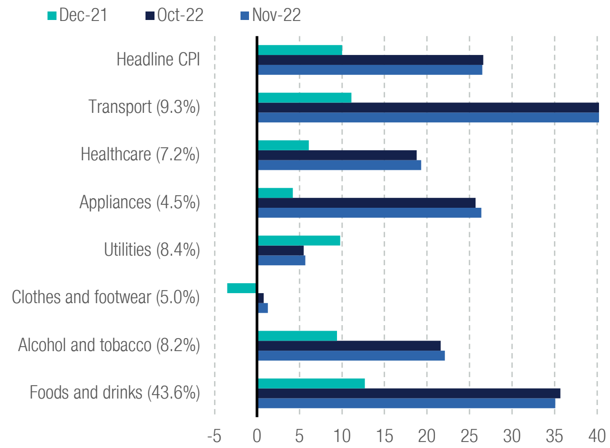
Inflation surprisingly decelerates in November



Source: Ukrstat, NBU, ICU.

Chart 6. CPI and its main components, YoY, %

Prices for food decelerated on better supply of vegetables



Source: Ukrstat, ICU.

NBU reserves exceed pre-war level in November

NBU gross international reserves surged 11.7% in November to $27.95bn and exceeded the pre-war level thanks to inflows of international financial aid.

Last month, Ukraine received an EUR2.5bn loan from the EU and a US$1.5bn grant from the US. Meanwhile, the NBU spent a net US$1.6bn on sale interventions.

ICU view: NBU reserves were boosted thanks to intensified inflows of financial assistance from Ukraine's allies. In December, Ukraine expects to receive another US$3.0bn grant from the US. This should be enough to offset the FX sales interventions by the NBU, which are likely to increase substantially in December from November's US$1.6bn due to larger imports of goods on the back of frequent and lengthy power blackouts. We thus expect the NBU's end-2022 reserves to stay close to the end-November level.

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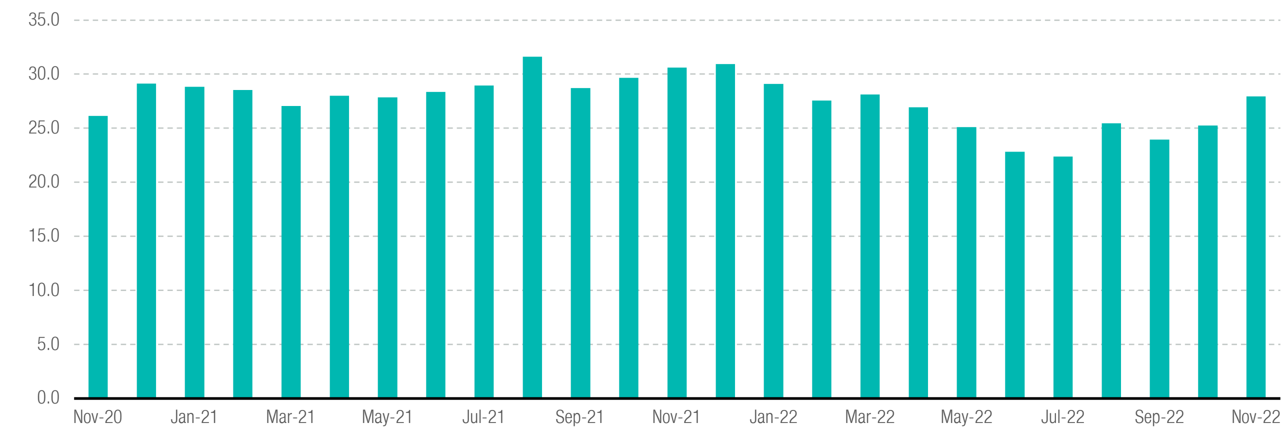
Chart 7. NBU gross international reserves, US$bn

NBU reserves surge on aid from the EU and the US



Source: NBU, ICU.

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