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GOVERNMENT DEBT MARKET

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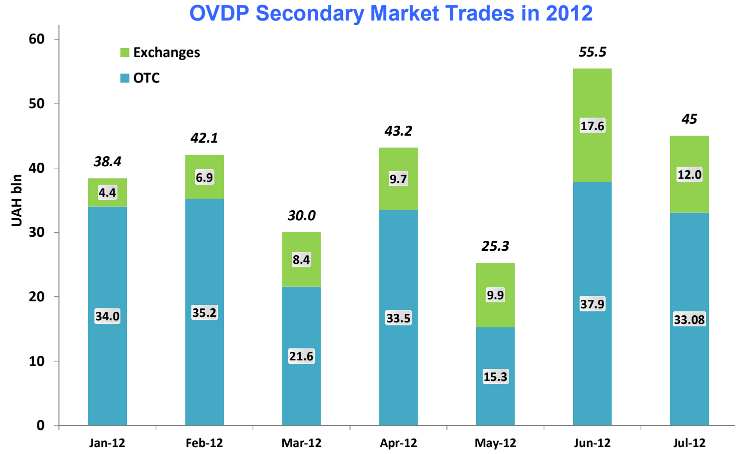
Judging from the primary auctions schedule for August, posted on the MoF web-site, the Ministry does not aim to raise meaningful amounts for the state budget through OVDP placements this month. At the four auctions scheduled, only hryvnia denominated bonds with maturities of 5 and 7 years will be offered. *Reference*: five auctions held in July resulted in UAH 0.77 bln raised to the budget, but all were the sale of FX linked and FX denominated bonds.

In the meantime, the focus of the NBU and MoF is on FX denominated retail bonds which may be issued in late September – early October. According to the NBU, their yield will be in the range 8%-10% and the total volume issued may amount to USD 200 mln. The purchase of FX retail bonds of under UAH 150,000 will not require buyer's identification. Based on recent amendment to the Tax Code, income on such bonds, both interest income and capital appreciation, is not subject to taxation. If successful, introduction of this instrument may further increase the portion of FX government debt, which as of the end of June already amounted to 58% of total direct public debt (including FX linked bonds).

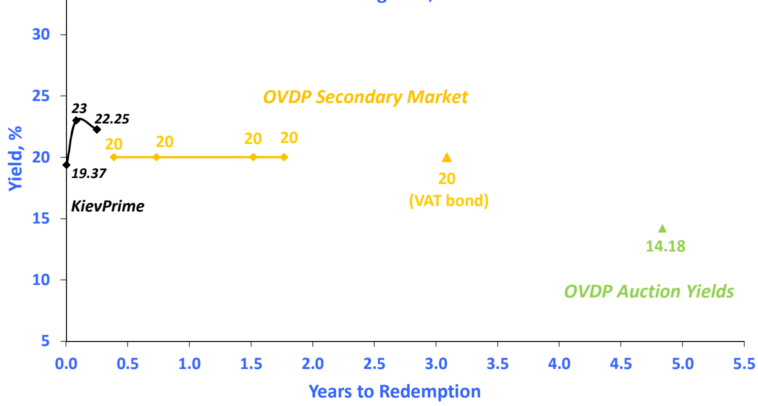
The secondary market for OVDPs saw a slight decrease in activity in July, with the total volume of trades standing at UAH 45 bln, as compared to UAH 55.5 bln in June. The portion of trades done on exchanges also decreased from 32% to 27%, as compared to June, but still is the third highest this year. According to market participants, the secondary market activity was concentrated mostly on FX denominated bonds and, to a lesser extent, on 1-year hryvnia bonds and VAT bonds.

This week's auction was marked by the reappearance of the friendly bidder or bidders. The MoF decided to solicit bids for 5- and 7-year hryvnia denominated notes and received three bids ranging from 14% to 14.30% and average weighted yield of 14.18%. Total amount of funds to the state budget amounted to UAH 267.8 mln. This gives the Ministry a start on next week's repayment which amounts to UAH 0.83 bln in principal. The central bank was active in providing liquidity, however correspondent accounts dropped due to payments to Gazprom from Naftogaz. Interest rates in both the money market and secondary hryvnia denominated market remained elevated, and offering of only longer dated maturities at the auction lessened investor and traders' interest.

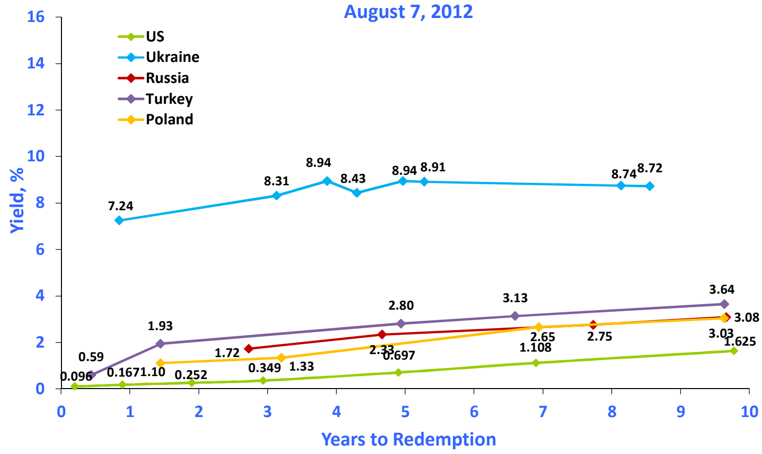
OVDP Secondary Market Trades in 2012



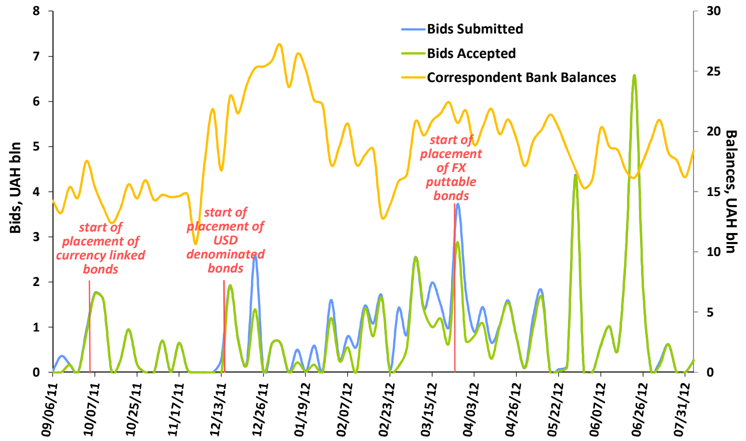
Auction Yields, Secondary Market OVDP Quotes, and KievPrime Rates
August 7, 2012



Eurobond Quotes
August 7, 2012



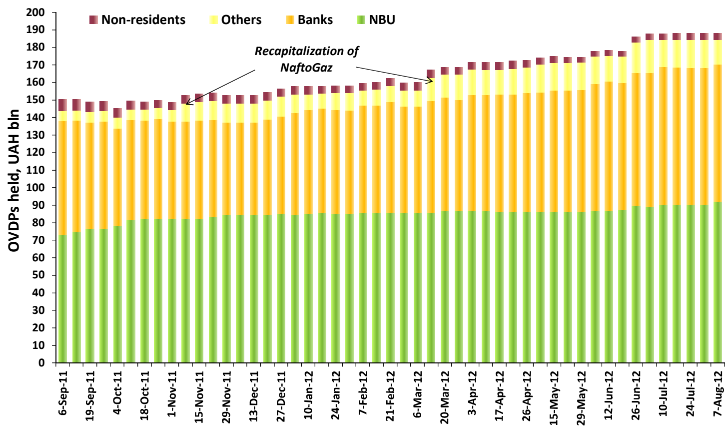
Amounts Submitted and Awarded at Primary Auctions and Correspondent Bank Balances



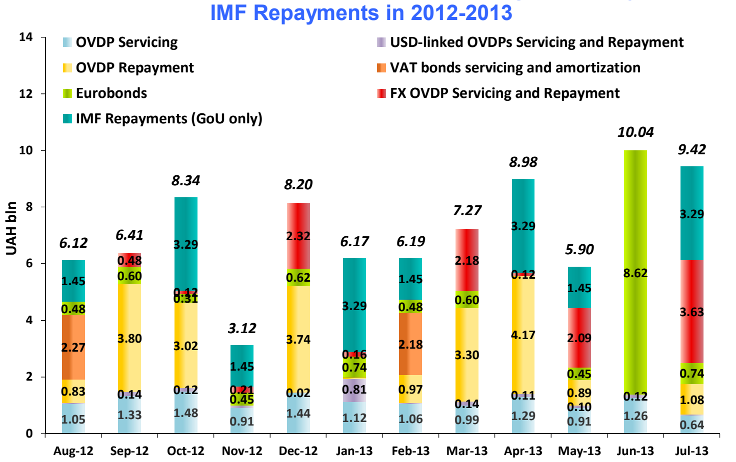
Dynamics of Domestic Government Bond (OVDP) Holders

UAH bln

Date	Bonds Held by				Total
	NBU	Banks	Others	Non-residents	
7/31/12	90.36	78	15.99	3.5	187.86
8/7/12	91.98	78.34	14.08	3.5	187.89



Domestic and External Government Bonds Servicing and Repayment and IMF Repayments in 2012-2013



This week's changes in OVDP holdings could be attributed to the sale by Naftogaz of its recapitalization OVDPs to banks which then used these bonds to obtain refinancing from the NBU.

Although initially disappointed by the lack of direct action by the Federal Reserve and the ECB, global markets have adopted a wait-and-see attitude with a positive bias. This can be seen both in yesterday's close of the S&P 500 stock average over 1400 (approaching yearly high of 1420) and the major index of non-investment grade bonds closing below a 7% yield. Investors remember the initial negative reaction to the long term refinancing operations (LTRO) and the positive snap back markets enjoyed once the operation was fully understood. The ECB's announced choice to concentrate its intended operation in the front end of the yield curve can be justified as classic monetary policy, and appears to provide liquidity rather than solvency. Targeting shorter maturities matches the ECB's aim of trying to repair monetary transmission mechanism which allows the central bank's policy rates to have influence on other borrowing costs in the economy. An operation in the front end of the curve also mitigates criticism from some quarters that if purchases were concentrated in the longer end of the curve, 10-year maturities, it would alleviate pressure on some members to maintain budget austerity. German opposition to ECB bond buying brought a revival of the 60/40 plan also known as "red and blue". This plan would allow for the mutualization of 60% of sovereign debt, while the remaining 40% would be the responsibility of the individual countries. The main objection to this plan is the creation of a two tier sovereign Euro debt market. The revamping of the governing board of the ECB was put forward by Jürgen Stark who resigned from the ECB over bond buying tactic. Under his plan, the board would be reduced to 9 members from current 23 with the largest contributors having permanent seats and the others rotating among the smaller members. This type of action requires changes in both the Maastricht Treaty and the statutes that created the ECB.

The Federal Reserve said all the right things but there was no policy action taken. The last time the FRB initiated quantitative easing the break even points on inflation for both 5- and 10-year expectations were lower than where they currently stand, which may have inhibited further policy moves for now. The recent improvement in the employment measure along with the ISM non-manufacturers survey may also have caused the FRB to adopt a wait-and-see posture.

The U.S. Treasury announced plans to issue its first floating rate note in FY'13 in order to attract new investors and reduce reliance on issuance of short term T-Bills and the necessity for constant rollovers. The Treasury is also engaged in its August refunding operation, auctioning USD 72 bln comprised of 3-, 10- and 30-year maturities. This represents USD 54.2 bln rollover and USD 17.18 bln of new money raised.

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