USAID
FROM THE AMERICAN PEOPLE

FINREP
Financial Sector Development Project

FINREP Focus

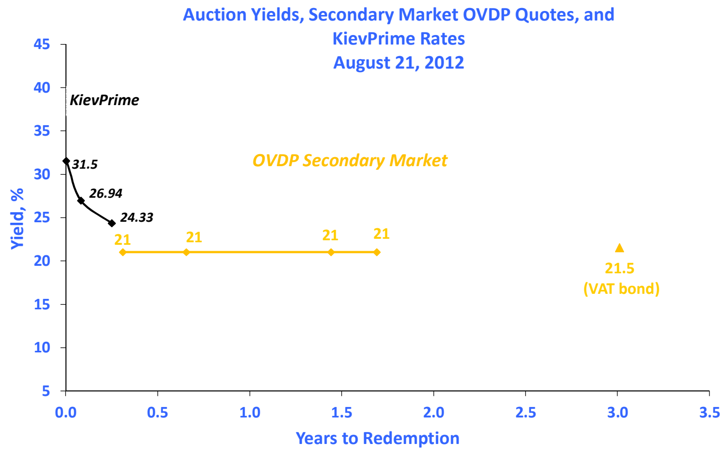
GOVERNMENT DEBT MARKET

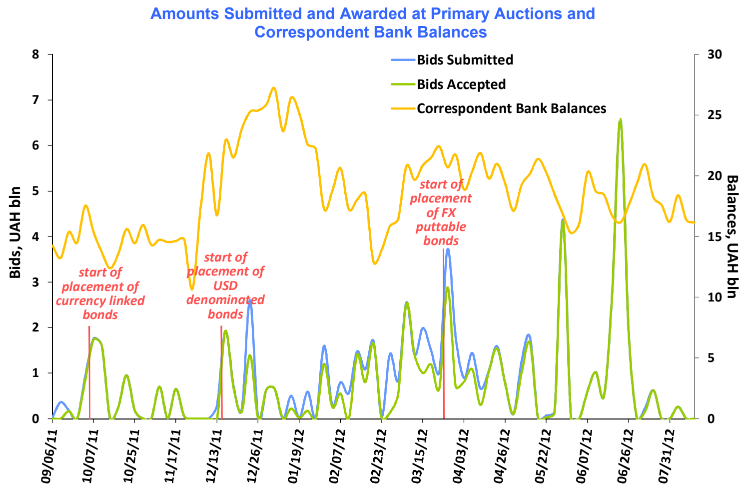
#32 (83)
August 20-23, 2012

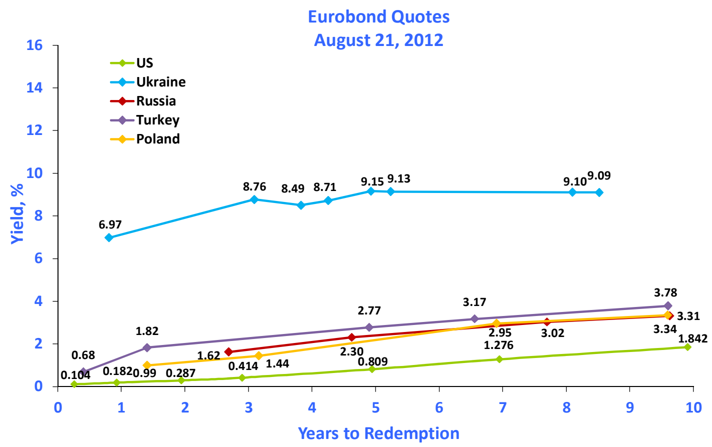
State Property Fund (SPF) reports privatization proceeds amounting to UAH 5.1 bln as of the end of July, which is nearly 51% of this year's budget target. In fulfilling the plan, the SPF relies on the successful sale of state shares in the regional gas companies. The Fund already announced holding of 5 such auctions in August and 12 in September, with the total starting price of all auctioned shares standing at UAH 0.32 bln. Also, based on the GoU decision taken earlier this month (Res.#713, dated 8/6/2012), five regional combined heat and power plants are planned to be sold by the end of this quarter. With the government borrowing plan fulfilled by 75% year-to-date and lack of activity in the primary market, failure to meet the privatization proceeds target of UAH 10 bln might not be easily compensated through increased borrowing. The average amount the MoF needs to raise monthly till year end to fulfill the budget plan is UAH 5.5 bln and its further increase will put significant pressure on the domestic market.

IMF mission plans to visit Ukraine on August 29 – September 5 to discuss 2013 budget issues, energy reform and social assistance programs. According to the budget forecast for 2013-2014, approved by CabMin in April (Res.#318, dated 4/5/2012), next year's budget deficit is planned at UAH 13.9 bln, down from this year's UAH 25 bln. Unlike previous years, the main source of deficit financing will be the privatization proceeds (UAH 10.9 bln), not the borrowings which will be made only for debt repayments (UAH 78.7 bln) and special fund (UAH 3 bln). Current dynamics of the privatization process calls into question the viability of such approach, raising the possibility of next year's borrowings increasing above the planned level.

The interest payments due this week on government obligations were most likely met with funds generated as a result of quarterly tax payments that were paid on Monday. There was, however, one bid placed at the auction at 23.9% for UAH 10 mln 5-year OVDPs, obviously rather as a statement as to where real interest rates are than any expectation of being awarded. The MoF faces approximately UAH 2 bln in amortization and interest payments on VAT bonds over a three day period next week. It remains to be seen if it will seek funding in the market or if monthly tax revenue due at the month's end will be sufficient to meet government obligations.



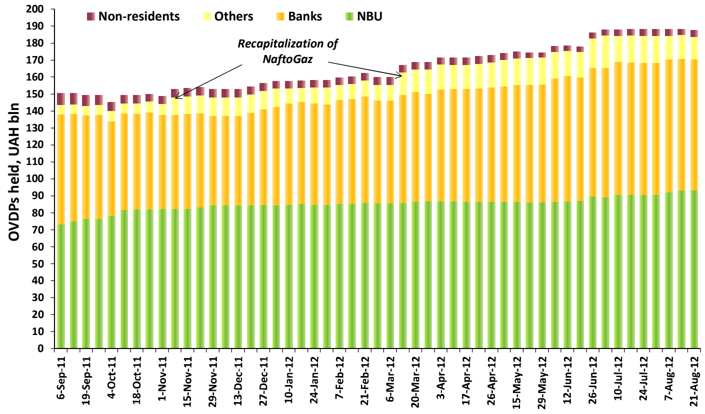




Dynamics of Domestic Government Bond (OVDP) Holders

UAH bln

Date	Bonds Held by				Total
	NBU	Banks	Others	Non-residents	
8/14/12	93.08	77.68	13.89	3.5	188.14
8/21/12	93.08	77.3	13.18	3.79	187.36



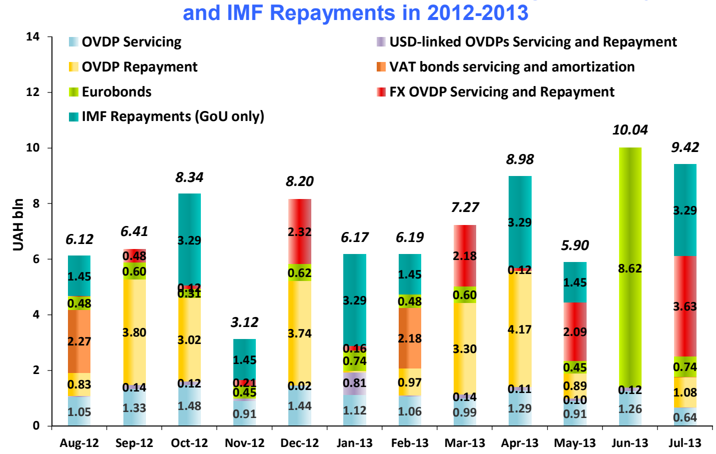
Top 10 Banks by OVDP Holdings (as of the end of July'12)

Rank	Name of the Bank
1	Oshchadbank
2	UkrEximBank
3	Raiffeisen Aval
4	VTB Bank
5	First Ukrainian International Bank (FUIB)
6	Delta Bank
7	Erste Bank
8	Citibank
9	OTP
10	Sberbank of Russia, Subsidiary

State-owned banks
Non-primary dealers

Source: *Erste Bank*

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



This week, holdings of non-residents registered their biggest increase this year of UAH 0.3 bln, recovering to the mid-May levels. This positive trend may, however, be affected next week by the scheduled amortization payment on VAT bonds of UAH 1.6 bln. This may reduce the non-residents portfolio by nearly a quarter of that amount, based on market participants' estimate of the amount of VAT bonds held by foreign investors (20%-25%).

An old concept - capping interest rates on sovereign debt of the peripheral countries at spreads off of German bunds - was resurrected last weekend by an article in *Der Spiegel*, only to be quickly undercut by the Bundesbank saying that moves to shore up solvency risk were a decision by governments not the ECB. The ECB quickly responded that proposed capping was only one of many measures under consideration to address the debt problem. The ECB seemed to intimate that the idea was to provide more of a guide to bond investors to suggested levels of yields, rather than explicitly stated caps. The ECB, at its September 6 meeting, must clarify three main issues to satisfy market participants: whether it intends to restrict intervention to short maturities; what conditionality it will expect/ demand from countries requesting assistance; and the matter of subordination, rights of private sector bond investors versus those of the ECB in case of hard and or soft defaults. The ECB, in order to be able to satisfy the markets must find a method to move debt from troubled banks' portfolios of to its own, through either direct purchases or the ESM as a part of a monetary policy operation and not of financing sovereign debt. Those tasks must be accomplished with the help of private capital crowding in. Past policy attempts by the ECB, IMF and EU provided a means of exiting the capital markets of the troubled countries, undermining policies designed to aid the troubled countries.

The summer holidays have proven not to be a respite for issuers or investors in the high yield corporate bond market as the YTD issuance tops USD 184 bln, with August issuance to date at USD 25 bln. The flow of funds into high yield mutual funds and ETFs totals USD 20 bln YTD with 9 bln of that total coming in the last 8 weeks. The impact of this quest for high yield is staggering when the rate of interest offered on new debt, is looked at on a historical basis. The average yield of non-investment grade debt for the last 30 years has averaged 11% according to Reuters; while 45% of the 25 bln sold in August has come to market with less than a 6% coupon/interest rate.

FOCUS has often called readers attention to spreads between the U.S. and German 10-year debt, and recent movements warrant an update. On July 26, the above spread stood at 11bps in favor of the U.S. bond, 1.43% vs. 1.32%. on August 15, mostly as a result of a 38.7 bps rise in the U.S. 10-year, U.S. 1.817% vs. German 1.492%, as any fear of the American economy sliding into recession appeared to be close to nil and subsequent retreat from safe haven sovereign debt to equities; as of the market close of August 21, the spread has narrowed to 26 bps with German debt increasing in yield and German 2-year note moving to a positive yield after a two plus weeks of trading with a negative reading. The spread then migrated to 32.5 bps, an increase of 6.5 bps.

CONTACTS
Paul Roberti, Senior Sovereign Debt Advisor
PRoberti@finrep.kiev.ua
Volodymyr Vysotskyi, Sovereign Debt Expert
VVysotskyi@finrep.kiev.ua
Alina Chernomaz, Sovereign Debt Analyst
AChernomaz@finrep.kiev.ua
Tel: +38 (044) 379 1375
www.finrep.kiev.ua