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Financial Sector Development Project

FINREP Focus

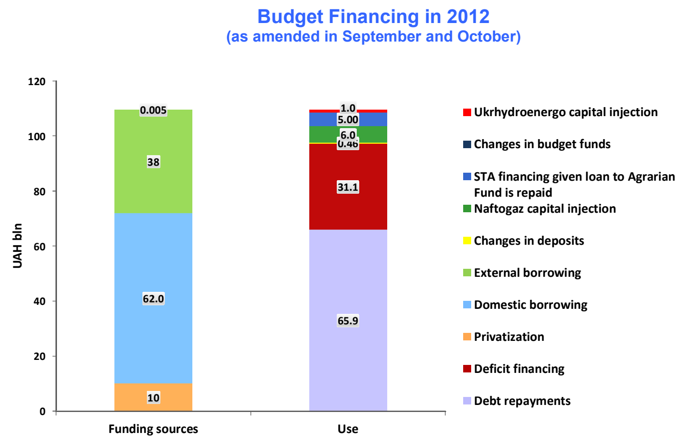
GOVERNMENT DEBT MARKET

SPECIAL ADDED FEATURE: *THIRD QUARTER BORROWING*

#38 (89)
October 1-5, 2012

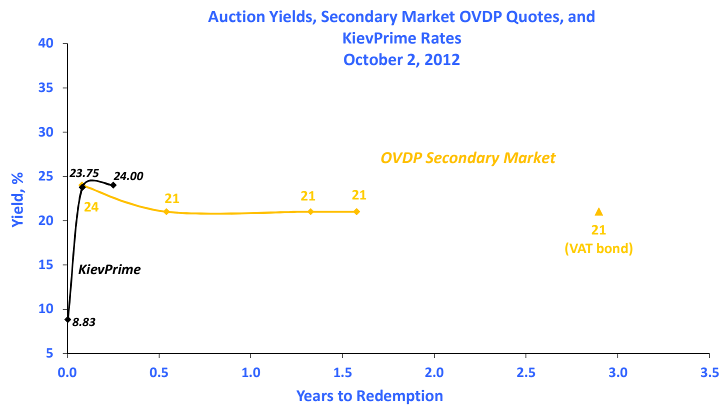
Past two weeks saw several amendments introduced to this year's budget, stipulating additional budget expenditures of UAH 2.1 bln (miners' salary increase) and 3.9 bln (direct financing of Naftogaz to compensate difference in tariffs). Also, it was decided not to proceed with the planned recapitalization of Naftogaz by another UAH 6 bln through the issuance of OVDPs. The borrowing target which included this issuance was not changed, so now these bonds will need to be issued in the primary market to get cash to cover the additional budget expenses. As a result, overall budget deficit increased from UAH 25.13 bln to 31.12 bln (2.07% of 2012 GDP est.). What brought about these decisions could be the fact that as of the end of 3Q the MoF already fulfilled this year's borrowing plan by almost 95% and had to borrow only about UAH 5 bln (including planned recapitalization of Naftogaz) for the general fund till year end. Thus, CabMin apparently decided to use this opportunity and borrow money for Naftogaz itself, freeing the company from additional costs related to doing repos with recapitalization bonds and saving budget funds in the long run. At the same time, with these changes CabMin leaves very little room for maneuver in case privatization proceeds, which currently stand at UAH 5.35 bln, fall short of the budget target of UAH 10 bln and need to be compensated through increased borrowing.

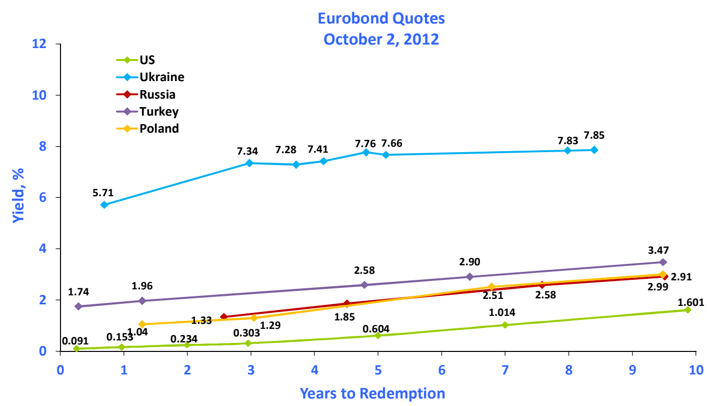
There were no scheduled or unscheduled auctions held on Tuesday as the MoF's placement schedule calls for the holding of just two weekly auctions on October 16 and 23, which could be explained by the current status of borrowing plan performance. These dates coincide with the two largest repayment dates scheduled for this month. The current schedule calls for issuance on both dates of intermediate maturities of 5 and 7 years notes denominated in hryvnia. The schedule is subject to changes and adverse effects on budget flow could see current schedule be amended. The month of October will also have the introduction of new 2-year retail bond sold through Oschadbank, in denominations of USD 500 with an interest rate of 9.25%. The target market for this issuance is retail bank depositors who have FX accounts.



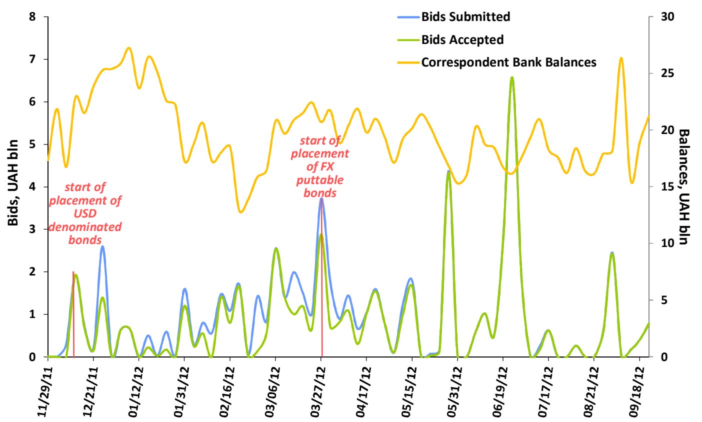
OVDP Placement Schedule for October 2012

Placement Dates and Maturities	
Oct. 16	**Oct. 23**
5 and 7-year	5 and 7-year





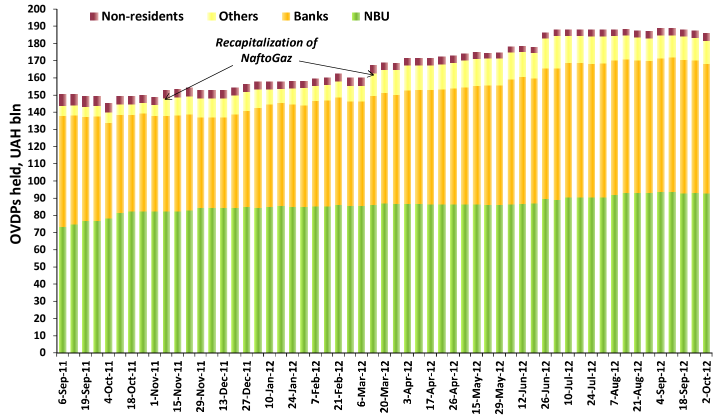
Amounts Submitted and Awarded at Primary Auctions and Correspondent Bank Balances



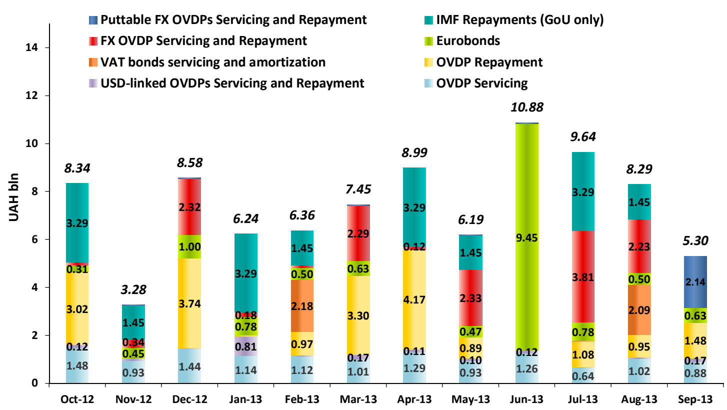
Dynamics of Domestic Government Bond (OVDP) Holders

UAH bln

Date	Bonds Held by				Total
	NBU	Banks	Others	Non-residents	
9/25/12	93.04	77.08	13.00	4.19	187.32
10/2/12	92.91	75.4	13.21	4.19	185.72



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



The European debt crisis returned to center stage as Spain, expected to request an official bailout either at this week's ECB meeting or next week's Euro Zone/ Finance Ministers meeting, announced the request was not imminent. The Spanish request was opposed by Germany's Merkel, coming so soon after the Bundestag's approval of EUR 100 bln bailout of Spanish banks. Spanish Prime Minister Rajoy was able to declare the request premature after receiving assurance from Spain's 17 regions that they would abide by deficit targets set by central government. The appeal for financial assistance by several of Spain's regions along with threat of secession by Spain's most prosperous region, Catalonia, had market participants expecting the official request a *fait accompli*.

Several aspects of the ECB's Open Market Transaction, OMT, had to be elucidated for market participants after confusing and conflicting remarks by Belgian Central Bank Governor, Coene. The purchase will consist of bonds that have 3 or less years to maturity and governments will not be able to manipulate their issuance to take advantage of the new buying program. Conditionality will stipulate that the debt maturity profiles not be changed, thus precluding governments from frontloading their debt structures. There will be an implicit limit on the amount of bonds to be bought through the OMT. Assurances were made that OMT will not be restricted in buying only those bonds in existence prior to a government request for an OMT/ESM program. This would also eliminate the possibility of a two-tier market developing, within the requesting countries debt market, between new and old issuance. The rationale for restricting buying in the front end of yield curve was supported by the economic rationale that peripheral countries feared re-denomination most in short end of issuance and also where the transmissions of ECB policy rates were most misaligned.

The policy of the Federal Reserve aimed at increasing bank liquidity and restoring balance sheets by keeping rates lower for longer has now, with the assistance of global quantitative easing, spread to all facets of the economy. Corporations have been able to shed their balance sheets of costly debt by refunding bonds with significantly lower borrowing costs through new issuance. This has enabled many corporations to continue to operate successfully while awaiting stronger economic growth. The impetus behind this in most cases has been the FRB ability to force large intuitional investors further along the yield curve and increase their debt and risk profiles. This was especially evident in mid-September, when several non-investment grade issuers were successful in issuing 10-year debt at 4.375%, the lowest rate in history for that maturity and credit category. The market for non-investment grade debt in September recorded issuance of USD 29 bln, largest total since 1995. The 3Q overall had non-investment grade issuance at USD 94 bln, three times that of a like period in 2011. The high grade market for corporate debt likewise had issuance which dwarfed that of 2011 by 64%. The negative aspect to this trend is that the unabated drive by investors for yield is leading to little or no differentiation among good credits and average credits, which has proven in the past to be a harbinger of future market dislocations.

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DEBT FINANCING OF STATE BUDGET IN 3Q 2012

GOVERNMENT BORROWING

	Actual, in UAH bln	Planned, in UAH bln	Quarterly Plan Performance, %	Annual (Budget) Plan Performance 1Q-3Q, %
Total government borrowing (funds raised for the **general fund of the state budget**)	35.3*	18	196%	94.6%
- Domestic borrowing	6.5*	10	65%	97.8%
- External borrowing	28.8	8	360%	89%

GOVERNMENT BOND ISSUANCE

	1Q		2Q		3Q	
	UAH bln	% of total issuance excl. Naftogaz recapitalization bonds	UAH bln	% of total issuance	UAH bln	% of total issuance excl. recap. bonds
Total government bond issuance (at par value)	23.3	-	26.12	*100%*	35.2*	-
- out of which maturing in 2012	5.5	*31.8%*	0	*0%*	0	*0%*
- Domestic bond issuance:	23.3*	-	26.12*	-	6.4*	-
- *Primary market issuance*:	17.3*	*100%*	26.12*	*100%*	5.4*	*15.8%*
• UAH denominated bonds	10.23	*59.1%*	11.08	*42.4%*	3.9	*11.4%*
• Currency-linked bonds	0.7	*4%*	1.47	*5.6%*	1.3	*3.8%*
• USD denominated bonds (13 mos. to 3 yrs)	4.18	*24.2%*	11.03	*42.2%*	0.18	*0.5%*
• EUR denominated puttable bonds	2.18	*12.6%*	1.14	*4.4%*	0	*0%*
• USD denominated puttable bonds	-	-	1.4	*5.4%*	0	*0%*
- *Naftogaz recapitalization*	6	-	-	-	-	-
- *Ukrhydroenergo recapitalization*	-	-	-	-	1	-
- External bond issuance	0	*0%*	0	*0%*	28.8	*84.2%*
- *Primary market issuance*	-	-	-	-	20.8	*60.8%*
- *VTB loan refinancing (private placement)*	-	-	-	-	8	*23.4%*

** difference in amounts raised for the budget and par value of bonds issued is due to short-term bonds being placed at a discount to their par value and accrued coupon interest affecting the price of reopened issues.*

MATURITY PROFILE OF PRIMARY MARKET ISSUANCE

Maturities:	1Q		2Q		3Q	
	UAH bln	% of total issuance	UAH bln	% of total issuance	UAH bln	% of total issuance
- 3-month bills	4.2	*24.4%*	-	-	-	-
- 6-month bills	1.3	*7.3%*	-	-	-	-
- 9-month bills	0	*0.0%*	-	-	-	-
- 1-year bills	3	*17.6%*	8.2	*31.5%*	0.2	*3%*
- 18-month notes	4.2	*24.4%*	0.6	*2.3%*	2.2	*41.3%*
- 2-year notes	3.8	*21.9%*	2.9	*11.1%*	-	-
- 3-year notes	0.8	*4.4%*	7.3	*28%*	1.3	*24.9%*
- 5-year bonds	-	-	3.4	*13.1%*	1.1	*19.8%*
- 7-year bonds	-	-	3.7	*14%*	0.6	*11.1%*

NET DEBT FINANCING

		UAH bln
	3Q	**1Q-3Q**
Funds borrowed	35.3	84.5
Funds repaid (principal only)	-17.4	-49.5
Net financing	17.9	35

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