Focus
Ukraine

Markets
Government bonds, FX market, and macro

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Weekly Insight

Parliament approves 2024 budget

Key messages of the today's comments

MONDAY, 13 NOVEMBER 2023

Ukrainian bond market

Bond yields decrease further

The Ministry of Finance has reduced interest rates at the primary auctions for all offered instruments for three consecutive weeks, which has also led to lower rates in the secondary market.

Moderate price volatility on lack of significant news

Ukrainian Eurobonds remain mainly under the influence of global sentiment towards emerging markets.

Foreign exchange market

Hryvnia strengthening yet further

Last week, the NBU strengthened the official exchange rate of the hryvnia even more, which also had a significant impact on the cash market.

Economics

Inflation plummets on food prices

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NBU reserves decline third month in a row

The NBU gross international reserves were down 1.9% MoM in October to US$39bn, which marked the third straight month of reserves decline.

Parliament approves 2024 budget

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Banks' reserves market (10 November 2023)

	Last	Weekly chg (%)	YoY chg (%)
NBU rate (%)[1]	16.00	+0bp	-900bp
ON rate (%)	9.76	+0bp	+0bp
Reserves (UAHm)[2]	192,138	-7.66	+240.86
CDs (UAHm)[3]	509,479	+6.21	+47.42

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) (10 November 2023)

	Last	Weekly chg (%)	YoY chg (%)
NBU	690,693	+0.00	+7.16
Banks	607,125	+1.03	+22.73
Residents	127,962	+1.66	+90.84
Individuals	48,341	+4.21	+58.44
Foreigners[1]	45,617	+0.09	-23.99
Total	**1,521,326**	**+0.69**	**+17.27**

Source: NBU, ICU.

FX market indicators (10 November 2023)

	Last	Weekly chg (%)	YoY chg (%)
USD/UAH	36.1404	-0.34	-2.14
EUR/USD	1.0686	-0.42	+4.67
DXY	105.861	+0.80	-2.17
UAH TWI[1]	116.647	+0.50	+2.30

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

Market gov't bond quotes (13 November 2023)

Maturity	Bid	Ask
6m	**17.50**	**15.00**
12m	**18.50**	**17.00**
2y	**19.50**	**18.00**
3y	**20.00**	**18.75**
12m ($)	**5.00**	**4.50**
2y ($)	**N/A**	**N/A**

Source: ICU.

Ukrainian bond market

Bond yields decrease further

The Ministry of Finance has reduced interest rates at the primary auctions for all offered instruments for three consecutive weeks, which has also led to lower rates in the secondary market.

Last week, the MoF lowered rates for the seven-month paper to 17% and for a new three-year note that will become a "reserve" bond to 18.9% (by 29 bps in three weeks). Last week, demand twice exceeded the supply, including a 4x oversubscription for the shortest, seven-month bills. See details in the auction review.

Trading in the secondary bond market decreased by approximately 30% last week, with a reduction in UAH bond yields by approximately 20–30bp. The most traded were two USD-denominated bills due next year. At the same time, trading in UAH bonds concentrated on several instruments maturing in 2025 (approximately half of all trades in UAH bonds).

With no scheduled redemptions, investors' portfolios increased last week.

ICU view: The MoF started to cut rates in mid-October, taking advantage of market expectations for a key policy rate cut and limiting the amount of bonds on offer. In anticipation of a further NBU key rate reduction in December, the Ministry of Finance set caps for each bond offering and lowered rates by 20–30 bps for a few weeks. The offer of seven-month bonds attracted great demand in the auctions, and the competition for this instrument was high.

Tomorrow, the Ministry of Finance plans to issue the same bonds as last week for UAH11bn. Due to the limited supply of these securities, they will likely remain oversubscribed. Therefore, the reduction of rates may continue, which will also immediately affect the yield in the secondary market.

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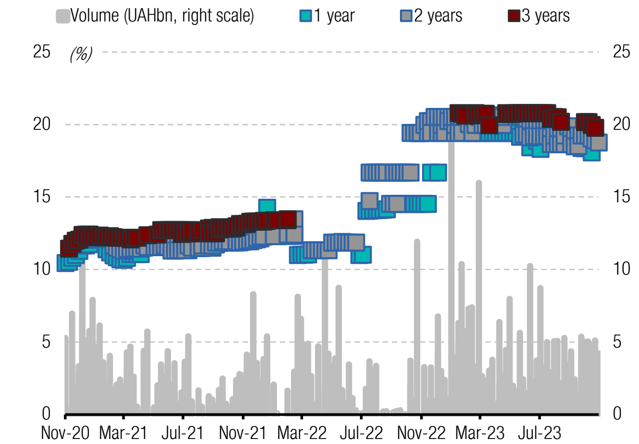
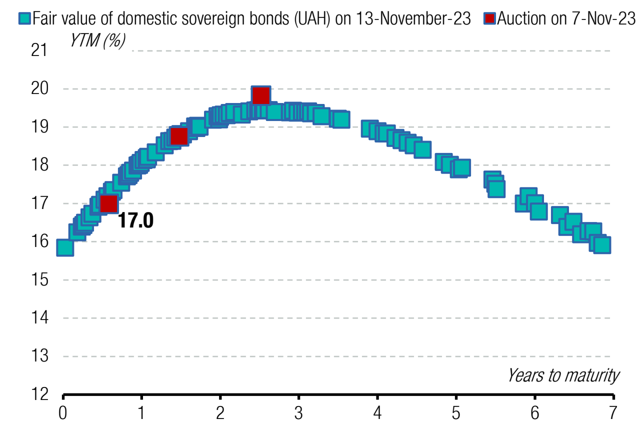
Chart 1. Local-currency bonds

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



Source: MFU, ICU.

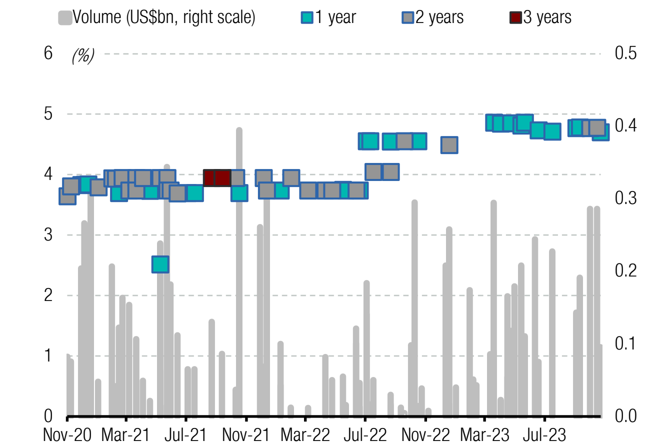
Fair value of domestic government bonds as calculated by NBU versus placements via primary market auctions



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.

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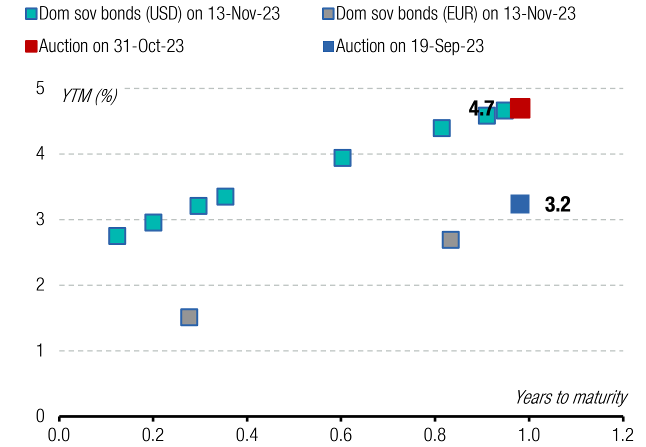

Source: NBU, MFU, ICU.

Moderate price volatility on lack of significant news

Ukrainian Eurobonds remain mainly under the influence of global sentiment towards emerging markets.

Eurobond prices fell slightly last week, by about two per cent, mainly remaining in the range of 26–32 cents per dollar. The price range for instruments with different maturities widened to 11.6%. VRIs are still quoted slightly above 42 cents per dollar of notional value. The EMBI index slid by 0.7%.

ICU view: Eurobond prices continue to align with global sentiment. Last Friday late evening, the IMF announced it completed its second review of the EFF program for Ukraine and a staff-level agreement was reached. Therefore, positive sentiment may prevail in the market this week. On the other hand, the lack of news about progress in approving a new aid package from the US could weaken positive signals about Ukraine's progress with the IMF program.

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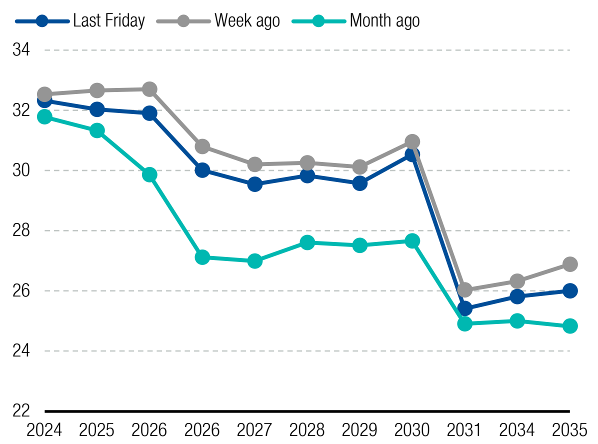
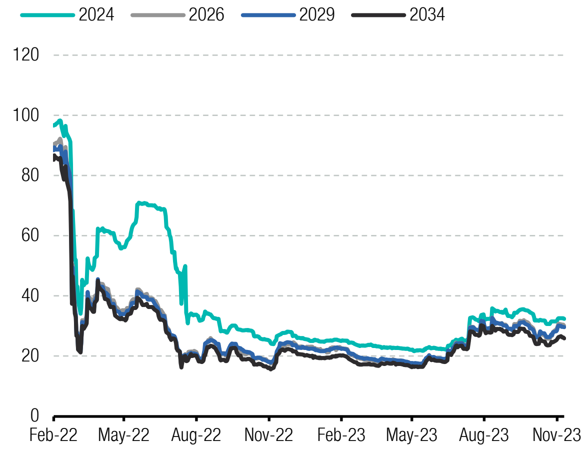
Chart 3. Ukrainian Eurobonds prices

Prices of USD-denominated Eurobonds as of last Friday, a week and a month ago



Source: Bloomberg, ICU.

Historical data since February, 2022



Source: Bloomberg, ICU.

Foreign exchange market

Hryvnia strengthening yet further

Last week, the NBU strengthened the official exchange rate of the hryvnia even more, which also had a significant impact on the cash market.

On the interbank market, the imbalances in the operations of bank clients (legal entities) decreased significantly. In four business days, the sale of hard currency increased by 8% and the purchases fell by 10%. Therefore, the NBU reduced the weekly volume of interventions to US$389m, the lowest amount since the beginning of September. The hryvnia's official exchange rate is set UAH36.08/US$ for today, which is 1.3% less than fixed rate at the beginning of October.

In systemically important banks, the cash exchange rate strengthened by an average of 0.4% to UAH37.1–37.7/US$.

ICU view: The imbalance in the clients' (legal entities) transactions in the interbank market has decreased significantly. As expectation of hryvnia depreciation faded in the past two weeks, bank clients now buy or sell currency largely based on their current liquidity needs. The NBU sold a significantly smaller amount of hard currency from reserves last week than in the previous few weeks. However, this substantial reduction in interventions may be temporary, and they may increase next week. Banks continued to strengthen the hryvnia cash rate in the retail market largely replicating the trend of the official rate.

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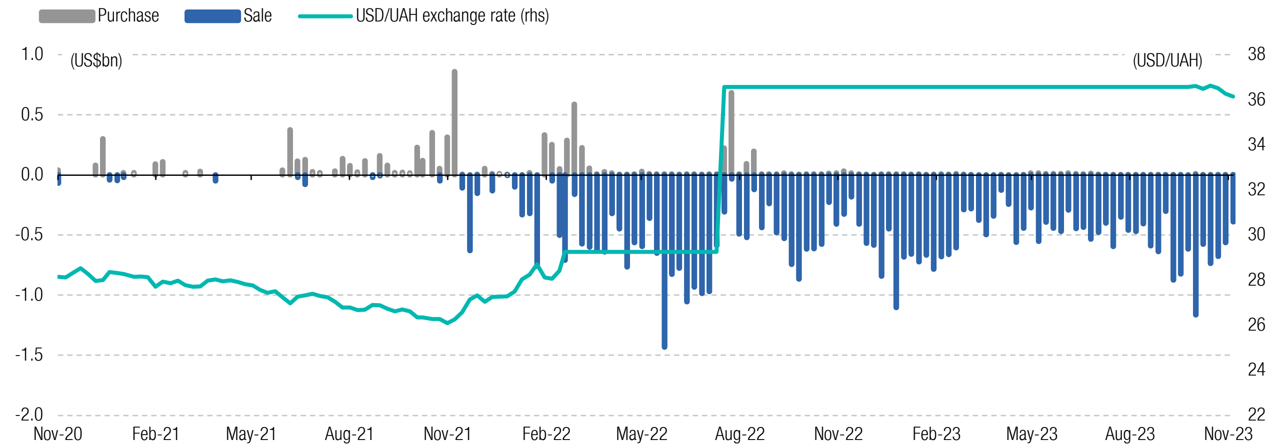
Chart 4. FX market indicators, 3-year history

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



Source: NBU, Bloomberg, ICU.

Economics

Inflation plummets on food prices

Ukraine's annual inflation fell to 5.3% YoY in October, the lowest level since December 2020, on a sharp deceleration in food prices.

Consumer prices were up 0.8% MoM in October, significantly slower than 2.5% MoM in October last year, pushing down annual inflation. The slowdown was primarily driven by food as favorable weather conditions and a good harvest led to a decline in prices for vegetables (-20.2% YoY), fruits (-7.6%), eggs (-15.0%), and sunflower oil (-11.4%). Practically all other major components of the consumer basket saw a deceleration in prices.

ICU view: The recent sharp slowdown in consumer prices apparently results from abundant harvest that exceeded all beginning-of-the-year expectations. Stability of the exchange rate and regulated utility tariffs is also making a positive contribution to the trend. We see inflation picking up slightly from the current level by the end of the year and remaining mostly in the range of 6–7% in 1H24. However, we believe it will accelerate in 2H24 and end up just above 10% at the end of 2024, on normalization of agricultural harvest and pass-through effects of hryvnia exchange rate weakening. With inflation remaining relatively low in the coming quarters, we expect the NBU will deliver another 100bp cut in the key policy rate and overnight rate.

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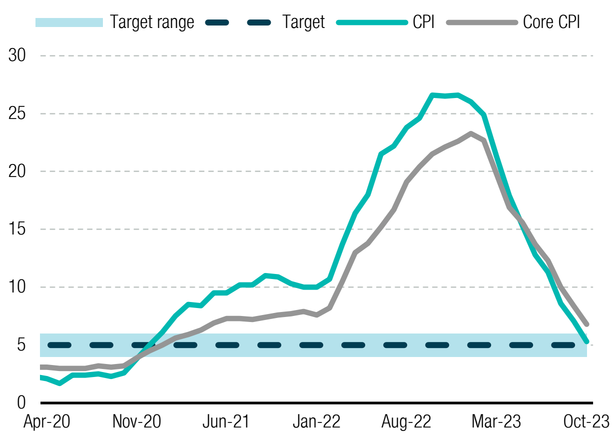
Chart 5. CPI, core CPI and target, YoY, %

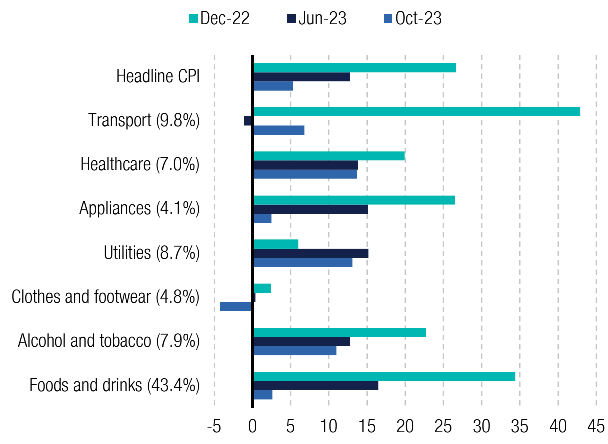
Annual inflation keeps falling



Source: Ukrstat, NBU, ICU.

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

Price for food decelerated considerably



* numbers in brackets indicate the share of the component in consumer basket

Source: Ukrstat, ICU.

NBU reserves decline third month in a row

The NBU gross international reserves were down 1.9% MoM in October to US$39bn, which marked the third straight month of reserves decline.

The decline in reserves last month reflects an upsurge in NBU interventions through the month following an announcement of the NBU abandoning the fixed exchange rate of the hryvnia vs US dollar and moving to a managed flexible exchange-rate regime. Households and businesses expectedly increased FX purchases, and the NBU had to sell net US$3.3bn in the market, the third largest monthly amount since the start of the full-scale war. Inflows of foreign financial aid that replenished NBU reserves were significant last month, including a EUR1.5bn loan from the EU and a US$1.2bn grant from the US. However, foreign aid fell short of what the NBU and government needed for interventions and repayment of debt.

ICU view: The lingering uncertainty regarding the fate of US financial aid to Ukraine is the key unknown when it comes to projections of NBU reserves at end-2023. We continue to assume that the issue will be resolved in favor of Ukraine, and we'll see an inflow of another US$3.3bn to NBU reserves. In that case, we expect NBU will hold about US$42bn before the start of 2024. A lack of new US financing for another couple of months will be an unfortunate development, but will not create significant problems for strength of the NBU reserve position and the FX market.

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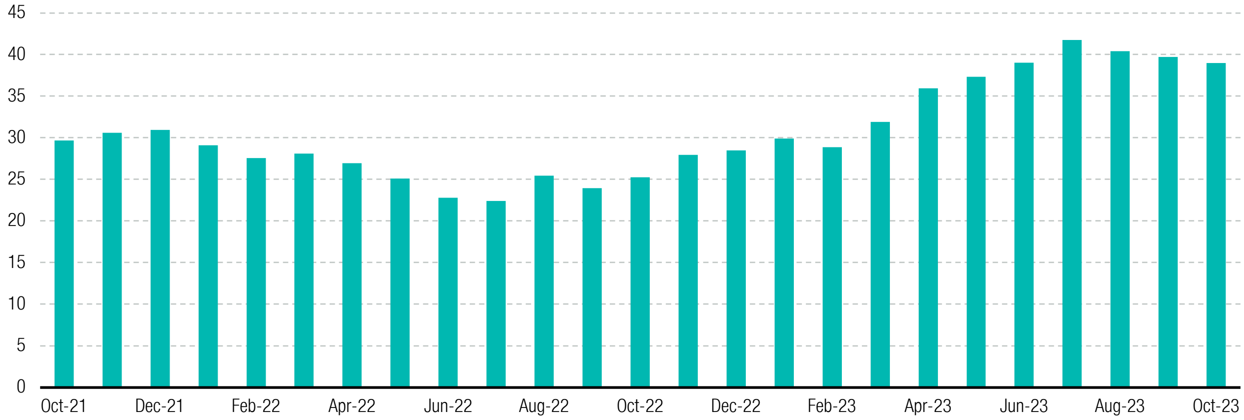
Chart 7. NBU gross international reserves, US$bn

NBU reserves down third month in a row



Source: NBU, ICU.

Parliament approves 2024 budget

Last week, the Ukrainian parliament approved the state budget for 2024. The plan sees a significant reduction of the budget deficit in relation to GDP, but the borrowing plan still remains very ambitious.

Next year's central budget plan shows budget expenditures will remain elevated, close to 43% of GDP. This is significantly above 27% of GDP in pre-war 2021, but substantially below 50%+ in 2022 and 2023. Total revenues are expected to grow 25% next year, including a 32% growth in tax revenues. Budgeted tax and non-tax revenues are expected to cover 53% of expenditures, which is a substantial improvement from 2022 and 2023. The budget draft law envisages a state budget deficit of UAH1.6bn (US$39bn based on the average projected official exchange rate). This is an equivalent of 20% of the expected nominal GDP in 2024, which is considerably narrower than in 2022 and 2023. The state budget is supposed to be primarily funded with external loans and grants with net domestic borrowings being equivalent to only 5% of total needs.

ICU view: The budget law broadly assumes that expenditures will remain little changed in 2024 vs 2023. The key risk here is that if russia's war against Ukraine continues through 2024, the numbers may be subject to substantial revisions, similar to 2023. We believe the government's plan to raise US$41bn in external funding in 2024 looks quite ambitious, but if sources are confirmed, this will provide significant support for the economy. The key external funding risk at the moment is continued delays in the approval of financial aid from the US, Ukraine's key ally. The funding from the EU is likely to remain little changed in 2024 vs the current level of EUR1.5bn/month.

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Table 1. Key parameters of state budget, US$bn

	2021	2022	2023 (budget plan)	2024 (budget plan)
Total revenues (before grants)	47.5	40.4	38.7	43.5
incl. tax revenues	40.6	29.4	32.7	38.7
Expenditures	54.7	83.6	92.7	81.3
Net lending	0.2	-0.1	0.9	0.8
Budget deficit (before grants)	-7.3	-43.2	-54.9	-38.6
Total revenues / expenditures	87%	48%	42%	53%
Tax revenues / expenditures	74%	35%	35%	48%
Total revenues / GDP*	24%	25%	21%	23%
incl. tax revenues / GDP*	20%	18%	18%	20%
Expenditures / GDP*	27%	52%	51%	43%
Deficit / GDP*	-4%	-27%	-31%	-20%

* 2023 and 2024 numbers are based on ICU projections of nominal GDP

Source: MFU, ICU.

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