Economics

10 October 2011 | 13 pages

# Ukraine Macro View

## Between a rock and a hard place

- **The NBU's reserves at US$35 are down US$3bn since last months** — This includes US$2bn on interventions to support the hryvnia.

- **Without an IMF program, a disorderly depreciation of hryvnia can't be ruled out** — We maintain our forecast for UAH at 8.25 in 2011/2012, assuming the IMF mission in end-October will reach a compromise with the authorities on the 2012 budget and gas price increase. Even if the REER does not appear overvalued now, external debt repayments, individuals' FX purchases, and Ruble depreciation pose risks for hryvnia.

- **US$53bn in scheduled external debt repayments make Ukraine vulnerable** — We estimate debt repayments to be about US$7bn in 4Q. While the rollover ratio for the corporates stood at above 100% earlier this year, bank were paying out their external debts (rollover ratio averaged 60% in 1H11). Meanwhile households will likely remain net buyers of FX (buying US$0.7-1bn per month), and current account deficit will reach about UAH$1bn in 4Q, according to our forecast.

- **Sovereign external debt repayment needs are US$2.6bn in 4q 2011 and US$1.9bn in 2012**— In addition, US$3.5bn is due to the IMF in 2012. It is possible that US$2bn VTB loan will be rolled or replaced by other financing from Russia.

- **For now domestic liquidity is tight, but budget is in need of financing** — The Ministry of Finance needs to repay UAH 3bn in treasury bills and UAH6bn in bonds in 4Q2011. Unwilling to offer high interest on domestic debt, the Ministry of Finance issued last week UAH2.5bn in FX-linked domestic paper at about 8-9%.

- **Banking system is still exposed, albeit less so than in 2008** — LTD ratio is still high at about 170% and FX loans account for 45%. Banking system assets to GDP are 86%, with state-controlled banks accounting for 20% of banking system assets and foreign banks for 40%.

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**Figure 1. Key economic forecasts**

| | 2011F | 2012F |
|---|---|---|
| Real GDP growth, % YoY | 4.7% | 4% |
| Investments, % YoY | 6% | 5% |
| Consumption, % YoY | 6.5% | 4% |
| CPI, % avg | 9.3% | 9.2% |
| UAH/USD, eop | 8.2 | 8.25 |

Source: Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

# Between a rock and a hard place

## BoP risks increase on global turmoil[1]

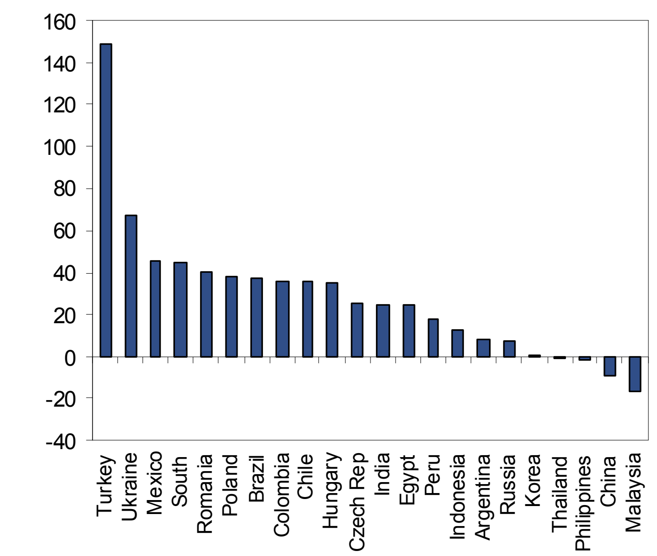
**Ukraine remains vulnerable to portfolio contagion risk due to high total external financing needs**. According to the NBU, US$53bn of external debt (including US$15bn of trade credits) is to be repaid between July 2011 and June 2012 as compared with about US$35bn of reserves as of the end of September (Bloomberg October4, 2011).

**Ukraine needs about US$8-10bn to cover CA deficit and capital outflows in 4Q, we think.** We estimate debt repayments to be about US$7bn in 4Q (vs about US$5bn in 2Q and 3Q). While rollover ratio for the corporates stood at above 100% earlier this year, banks were paying out their external debts (rollover ratio averaged 60% in 1H11). Meanwhile households will likely remain net buyers of FX (buying US$0.7-1bn per month), and the current account deficit will reach about UAH$1bn in 4Q, according to our forecasts.

**Sovereign external debt repayment needs are US$2.6bn in 4Q 2011 and US$1.9bn in 2012. In addition, US$3.5bn is due to the IMF in 2012.** The government will need to repay US$2bn VTB loan and a US$0.6bn Eurobond in December. It is possible that VTB loan will be rolled or replaced by other financing from Russia; however, further financing is still needed, in our view.

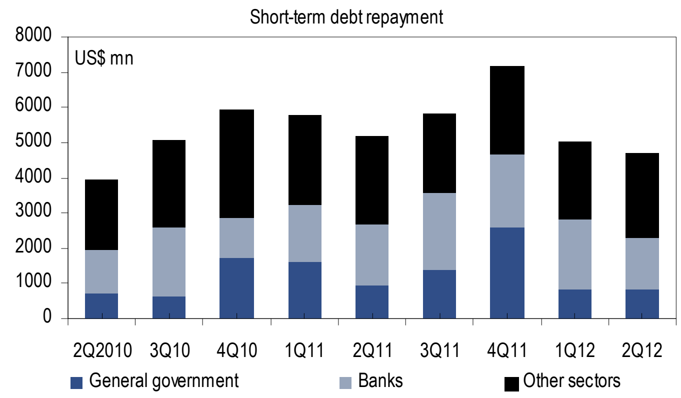
**We estimate that about US$1-2bn was spent on interventions to support hryvnia in September.** Should capital inflow disappoint due to tight financial conditions on the external markets, the NBU will need to spend reserves accumulated earlier this year and the IMF loan would be helpful to limit the pressure on reserves.

**Figure 2. Ukraine remains vulnerable to portfolio contagion due to large external financing requirements (debt repayments and current account deficit as a share of reserves)**




Source: Bloomberg, Citi Investment Research and Analysis

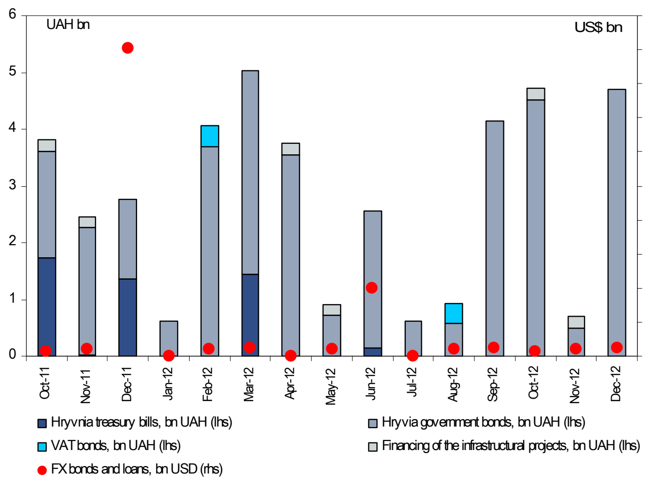
**Figure 3. 4Q2011 looks difficult given about US$7bn of external debt maturing …**




Source: NBU, Citi Investment Research and Analysis

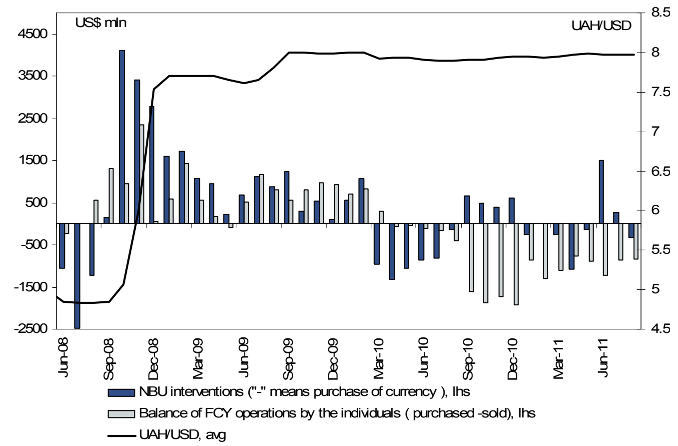
[1] Please see also Emerging Markets Macro and Strategy Outlook, September, 2011

**Figure 4. …though government likely to get Russian financing for US$2bn repayments due in December**




Source: Bloomberg, Citi Investment Research and Analysis

**Figure 5. Population continue to invest in FX**



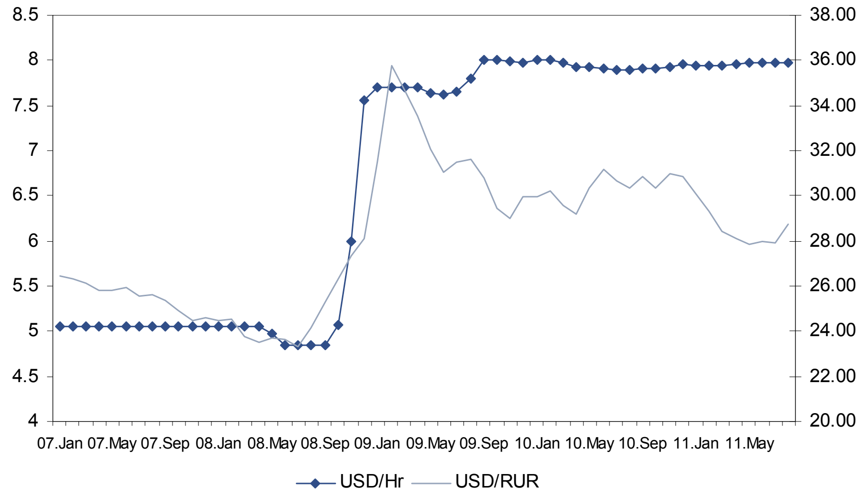

Source: NBU, Citi Investment Research and Analysis

**We maintain our forecast for UAH at 8.2-8.3 in the end of 2011-mid 2012, assuming the IMF mission in end-October will reach a compromise with the authorities** on the 2012 budget and gas price increase. Headline inflation plunged even below our forecast to 5.9%YoY in September,[2] and this provides an opportunity for the government to minimize the negative impact of the hike in retail gas prices.

**Even if the REER does not appear overvalued now, external debt repayments, individuals' cash purchases, and Ruble depreciation pose risks for the hryvnia**. We expect the current account deficit will reach about 5% GDP (over US$8.4bn) next year and the hryvnia will continue to depreciate in 1H 2012. Current account deficit was US$4.5bn January-August in 2011, increasing to US$1bn in August (compared to $557mn in July), partially as a result of the 2012- soccer-championship-related imports. Roughly 30% of exports go to Russia and another 30% to EU countries. Commodities dominate exports, with metals accounting for 34%, food and agricultural exports accounting for 20%, and fuel and energy 13%. In some products, Ukraine competes directly with Russia.

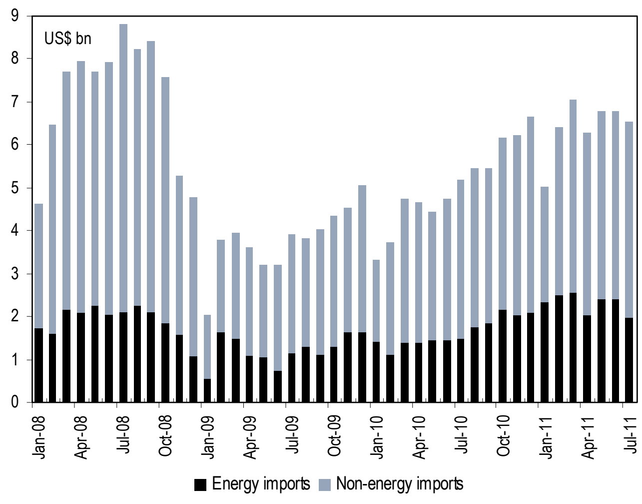
[2] Ukraine Macro View: Inflation Probably Close to Peak (July 24, 2011).

**Figure 6. Ruble depreciation if preserved may start hurting Ukraine's trade balance**



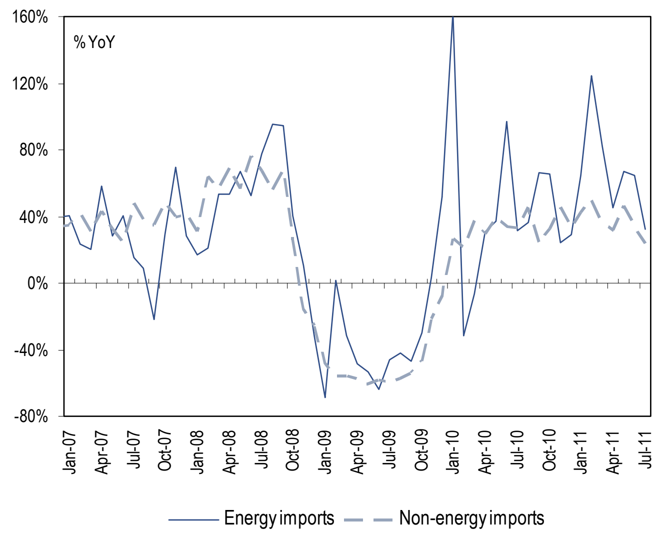

Source: NBU, CBR, Citi Investment Research and Analysis

**Figure 7. While high gas prices were behind sharp growth in energy imports, …**



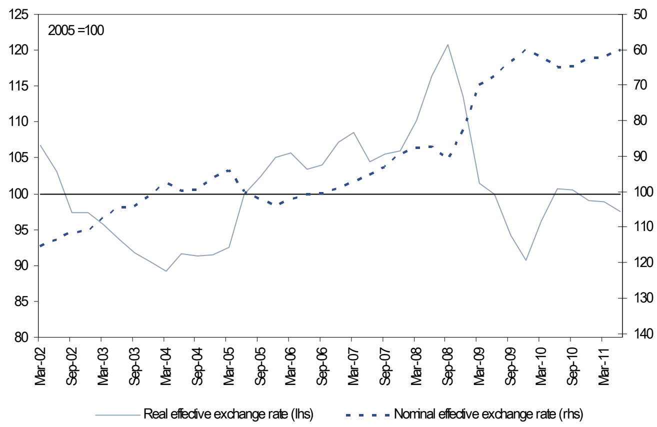

Source: NBU, Citi Investment Research and Analysis

**Figure 8. high income growth together with budget capital spending led to fast recovery in non-energy imports and widening CA deficit**



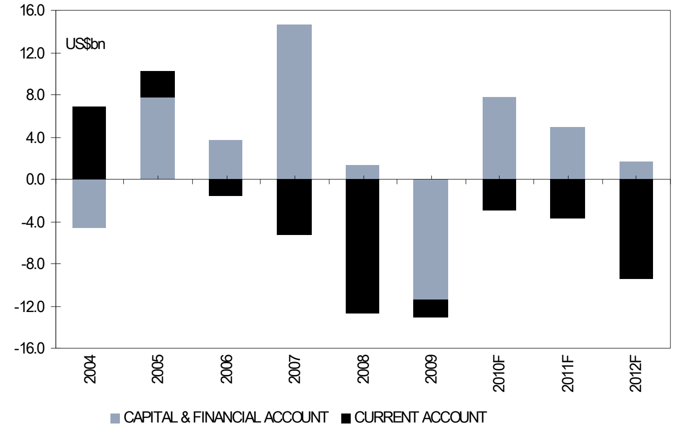

Source: NBU, Citi Investment Research and Analysis

**Figure 9. REER does not appear overvalued…**




Source: NBU, Citi Investment Research and Analysis

**Figure 10. but widening CA deficit and large debt repayments to put pressure on hryvnia in 2012**

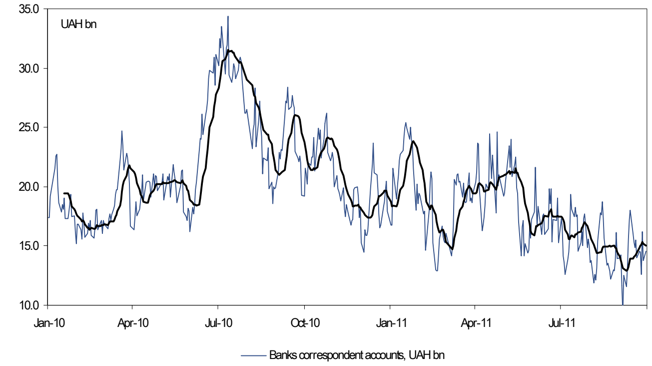



Source: NBU, Citi Investment Research and Analysis

# Domestic liquidity is tight for now

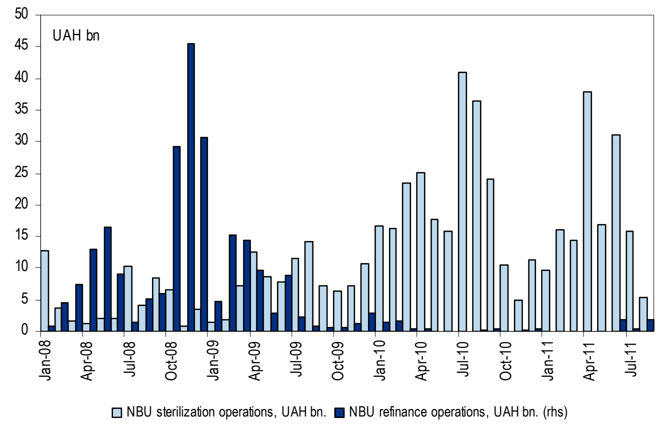
**Regulatory restrictions and tight domestic liquidity limited pressure on the hryvnia.** Correspondent accounts fell to an all-time low despite 20% nominal GDP growth yoy in 1H2011. Discount rate with the NBU is 7.75%, overnight credits are available at 9.25% (using government T-bills as collateral) and 11.25% (uncollateralized). However, the NBU have not been providing any refinancing in recent months. Interbank rate is currently 13-14%. The Ministry of Finance has not placed any debt in domestic currency over the last few months as it has been unwilling to offer higher interest rates. However, the Ministry of Finance issued last week UAH2.5bn in fx-linked domestic paper at about 8-9%.[3]

**Figure 11. Correspondent accounts are at all time low despite about 20% nominal GDP growth in 1H2011**




Source: NBU, Citi Investment Research and Analysis

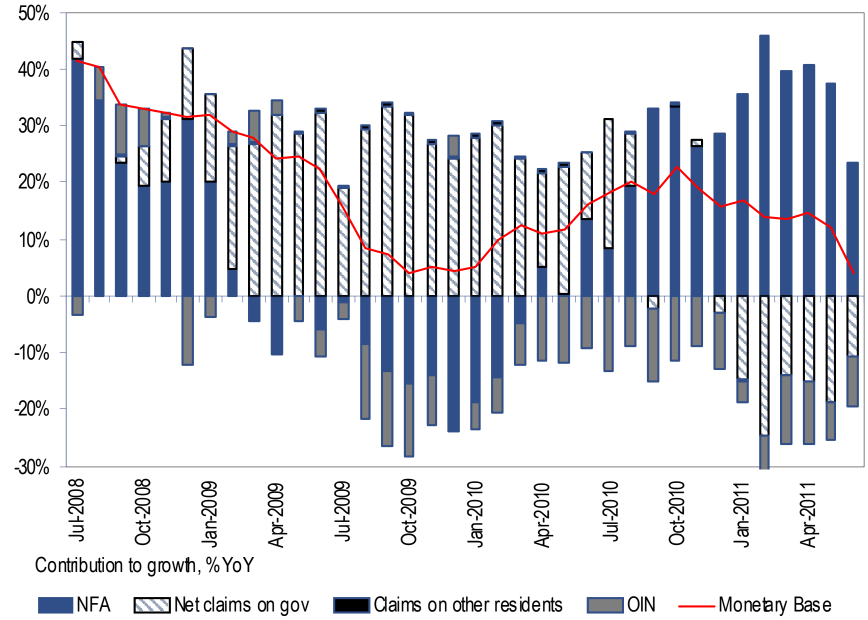
**Figure 12. While the NBU limits refinancing**




Source: NBU, Citi Investment Research and Analysis

[3] http://www.kommersant.ua/pda/kommersant.html?id=1787894

**Figure 13. Money base growth slowed as a result of smaller debt-financed budget deficit**




Source: NBU, Citi Investment Research and Analysis

## But budget needs money…

**Government 2012 forecast of 2.5% of GDP deficit and US$3.5bn in net borrowings from external markets in our view is overly optimistic.** The government has prepared a draft of the 2012 budget and the final version will be adopted in November. According to the plan, the deficit will fall to UAH24bn or 2.5% GDP, in line with IMF requirements. Assuming 5% GDP growth and average inflation of about 7.9%, the government forecasts 13% growth in revenues (to UAH338bn/US$42bn) next year. It plans to limit the growth in expenditures to 7% (to UAH362bn/US$45bn). The government plans to borrow about US$3.5bn net on external markets and UAH10bn net in national currency.

**Figure 14. Consolidated budget (including Pension Fund deficit), UAH bn**

| | | 2011F | 2012F |
|---|---|---|---|
| Revenues | | 299 | 338 |
| | (%GDP) | 23% | 22% |
| | Tax revenues | 306 | |
| | Non-tax and other revenues | -6 | |
| Expenditures | | 338 | 362 |
| | (%GDP) | 26% | 24% |
| | Deficit (including Pension fund) | 38 | 24 |
| | %GDP | 3.0% | 1.6% |
| Financing (excluding bank recapitalization) | | 38 | 24 |
| | Domestic borrowing | 8 | 10 |
| | Disbursement | 45.09 | 54.34 |
| | Amortization | 37.52 | 44.24 |
| | External borrowing | 18 | 22 |
| | Disbursement | 43 | 37.53 |
| | Amortization | 25 | 15.05 |
| | Change in cash balances | 2 | -9 |
| | Privatization | 10 | … |
| Memo items | | | |
| | GDP, UAH bn | 1291 | 1505 |
| | CPI, YoY % | 8.9 | 7.9 |
| | UAH/USD | 7.95 | 8.1 |

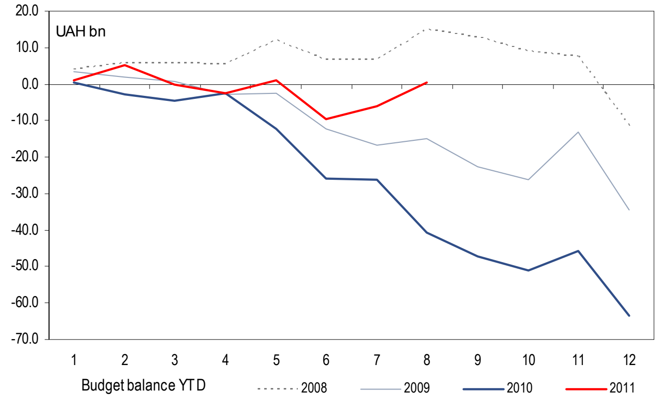
Source: MoF, Citi Investment Research and Analysis

**The Ministry of Finance needs to repay UAH3bn in treasury bills and UAH6bn in bonds in 4Q2011.** However, limited local liquidity makes it difficult for the government to borrow on the local market.

**Budget performance so far has been strong.** Improving tax discipline and a pick-up in domestic consumption helped to boost budget revenues. The consolidated budget deficit fell about 3 times to UAH8bn and the pension fund deficit was down almost 50% to UAH13bn (US$1.6bn) in January-July. The Budget, updated during the summer, anticipated additional budget revenues of US$1.8bn (UAH14bn), which should finance US$1.4bn (UAH11.5bn) of spending increases, including raising public sector wages. Meanwhile, spending may underperform by UAH20bn. The government may limit expenditure to statutory spending and EURO 2012.

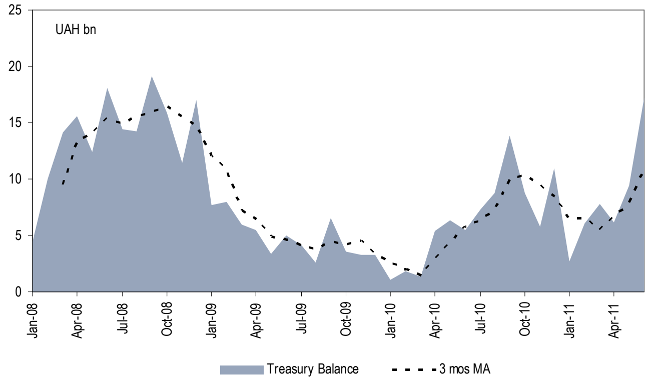
**However the Naftogaz deficit is a key concern as Ukraine postpones hikes in gas tariffs**. Ukraine failed to meet its obligation to hike gas prices by 20% in April and by another 10% in July, creating risks of breaking another requirement under the IMF SBA to keep the budget deficit, including the deficit of the national oil and gas company Naftogaz, within 3.5% this year. Budget transfers to Naftogaz and compensation for the difference in tariffs to local budget amounted to UAH6.2bn (US$0.8bn). In addition, the government injected US$8.5bn (US$) into Naftogaz's capital this year.

**Figure 15. According to MoF statistics headline deficit is not large so far…**




Source: MoF, Citi Investment Research and Analysis

**Figure 16. …and there has been an accumulation on the treasury cash account**




Source: MoF, Citi Investment Research and Analysis

# IMF mission expected in end-October

**The IMF program negotiations on the US$15bn stand-by arrangement (SBA) broke-down earlier this year.** Out of the four prior-actions agreed to in December 2010,[4] utility price increase and budget (now for 2012) remain outstanding. An IMF mission is expected in Ukraine in end-October.

1. Submit to Parliament a 2011 budget consistent with a general government deficit of 3.1 percent of GDP and the commitments included in the MEFP, paragraph 6.

2. Submit to Parliament legislation on pension reforms consistent with commitments in the MEFP, paragraph 11.

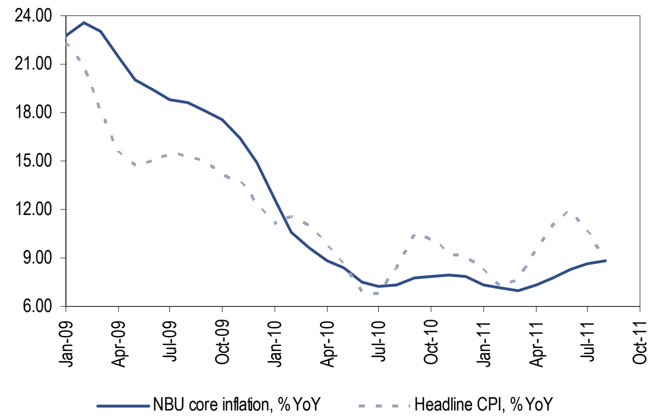
3. Pass legislation to revoke the Law "On Temporary Ban to Levy Penalties on Ukraine's Citizens for Overdue Payments of Utility Bills" (MEFP, paragraph 14).

4. NERC will issue (by December 16, 2010) instructions to communal utility companies to raise end-user heating tariffs (effective January 1, 2011) to reflect the August increases (MEFP, paragraph 15).

**We believe that IMF and Ukraine are likely to reach an agreement this year.** Low inflation presents an opportune moment for Ukraine to increase domestic utility prices. Furthermore, a sharp movement on hryvnia, in our view likely without an IMF program, would be far more politically costly, than an increase in inflation to about 10% from 5.9%YoY in September. Budget assumptions are also likely to be revised towards lower growth. Originally four tranches of SDR1bn each were scheduled for 2011; the authorities believe they could secure two tranches in 4Q2011.

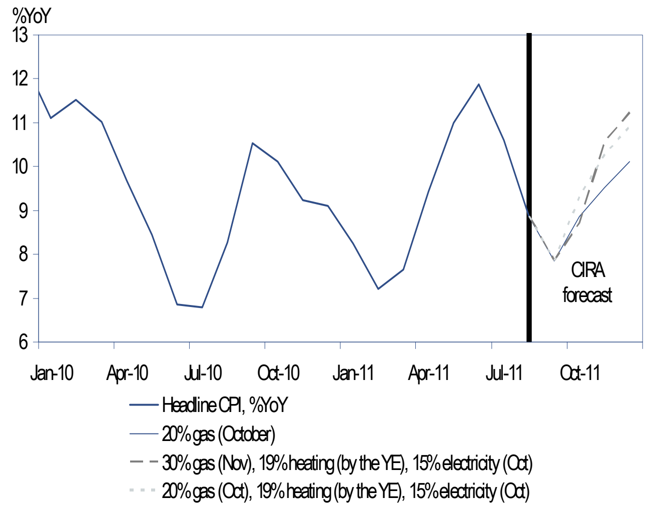
[4] Ukraine: Letter of Intent, and Technical Memorandum of Understanding December 10, 2010, p.10

**Figure 17. Inflation is at an all-time low**




Source: NBU, Citi Investment Research and Analysis

**Figure 18. Utility price hikes would increase inflation to about 10% yoy.**

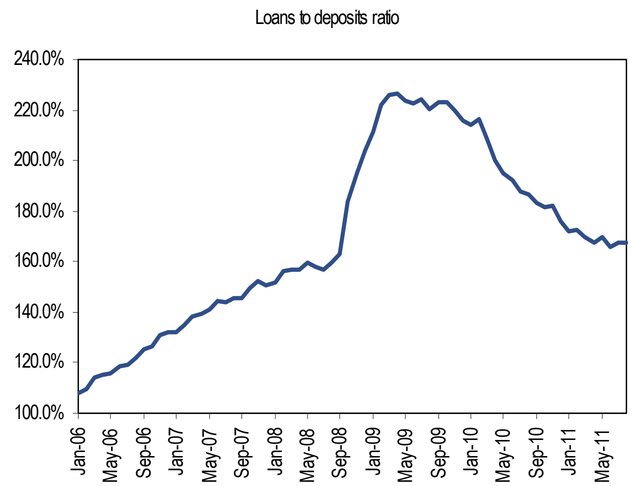



Source: NBU, Citi Investment Research and Analysis

# Banking system is exposed, but less

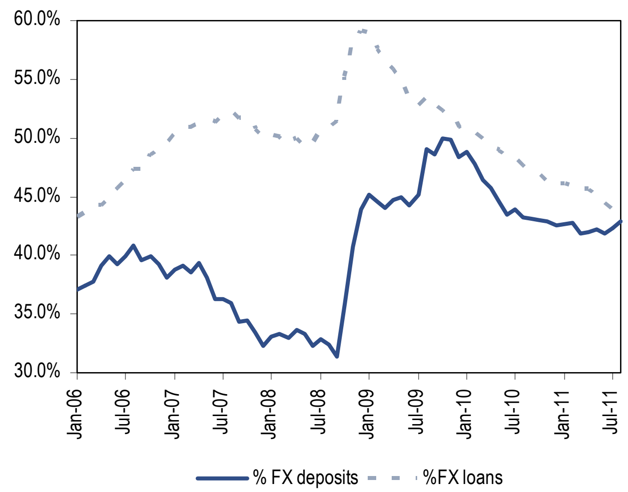
**High share of loans in FX to unhedged borrowers and exposure to European banks make the system vulnerable.** Banking system assets to GDP are about 86%. State-controlled banks account for 20% of banking system assets and foreign banks for about 40%. We estimate that vulnerable European banks account for about 10% of banking system assets in Ukraine and might step-up withdrawal of funds. LTD and dollarization ratios, while lower than pre-crisis, remain elevated.

**Figure 19. Loan-to-deposit ratio is still elevated…**




Source: NBU, Citi Investment Research and Analysis

**Figure 20. … And dollarization levels are high**




Source: NBU, Citi Investment Research and Analysis

# Appendix A-1

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