

# Ukraine: Coping with the financing challenge

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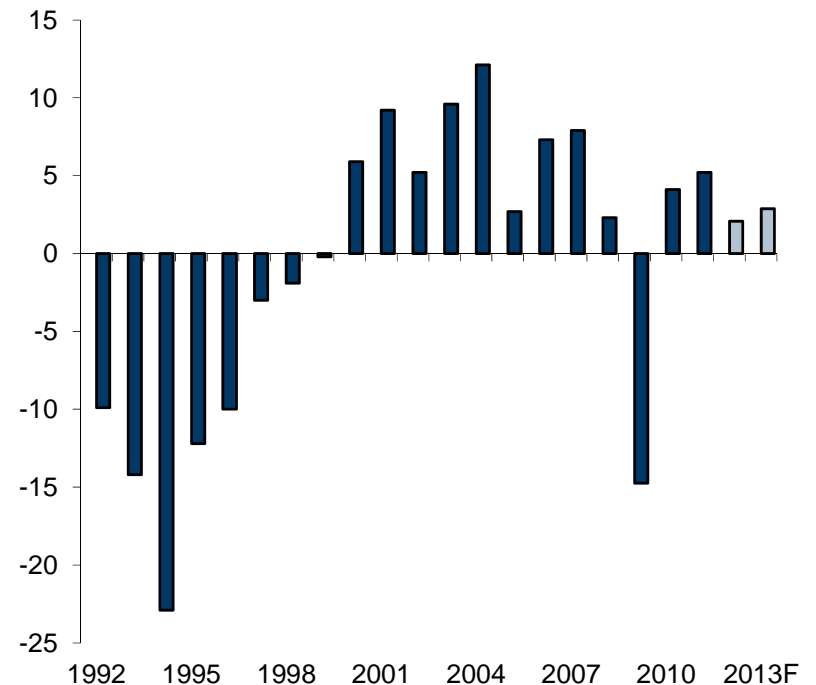
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# Ukraine's economic development has been very uneven

- Since independence in 1991, Ukraine has been prone to boom/bust cycles
- External accounts remain very sensitive to fluctuations of commodity prices
- Highest share of net fuel imports among EM countries (around 14% of GDP)
- Pro-cyclical policies in the run-up to the 2008-2009 crisis (a credit bubble, loose fiscal and income policies) led to a large current account deficit and high inflation
- Frequent spells of pegged exchange rate, typically followed by sharp corrections
- Despite a surge in expenditure last decade, infrastructure spending stayed low, social spending is poorly focused

**Ukraine: real GDP**  
% change year-on-year



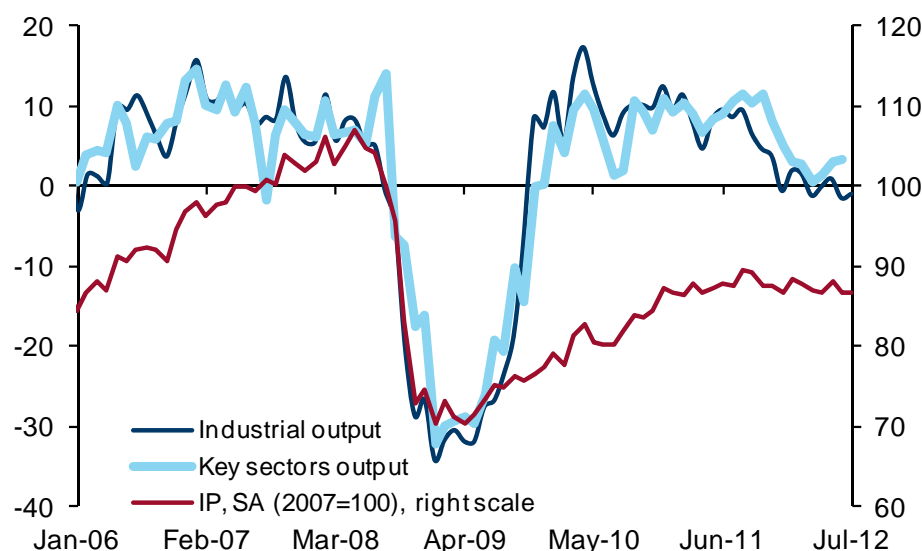
Source: State Statistics Committee, Credit Suisse forecasts

# Recent slowdown was led by weaker external demand

## Output indicators

% year-on-year change

Index (2007=100)



Note: The NBU's key sectors indicator covers 72% of GDP.

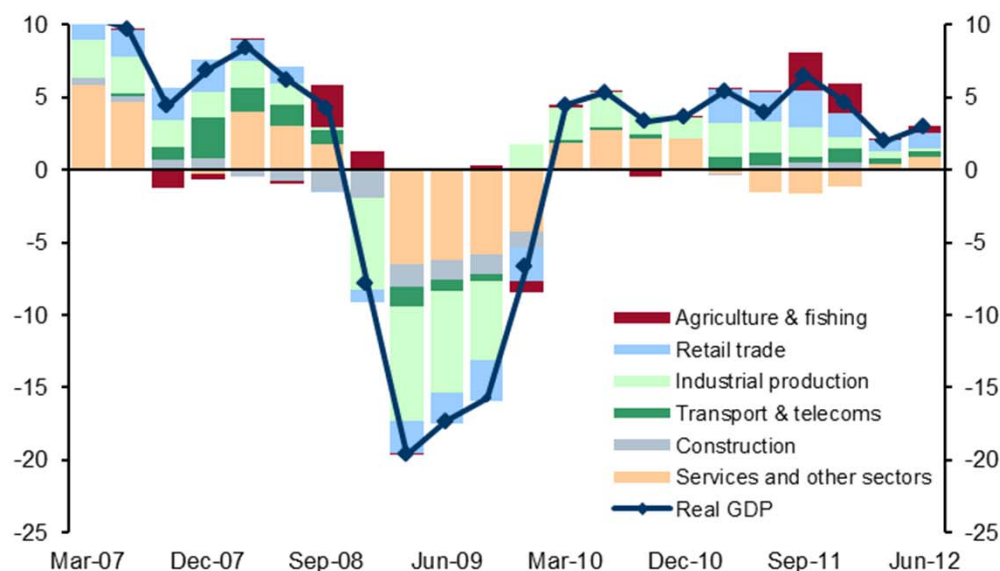
Source: State Statistics Committee, NBU, Credit Suisse

- Industrial output has stagnated recently, reflecting weak external demand. In seasonally adjusted terms, on our estimates, IP was flat in July, having dropped 1.5% mom sa in June. Performance of key export-oriented sectors has been deteriorating, with metals output down 8.6% yoy in July (vs. -0.8% yoy in June) and food industry output up 0.4% yoy (vs. 3.0% yoy in June).
- Demand-side GDP data pointed to consumption-led growth until recently, while the performance of fixed investment has been uneven. Most of investment growth in 2011-2012 was related to Euro 2012 projects.

# Agriculture supported GDP growth over past 4 quarters

## Contributions to real GDP growth, quarterly

pps, except for % year-on-year change in real GDP



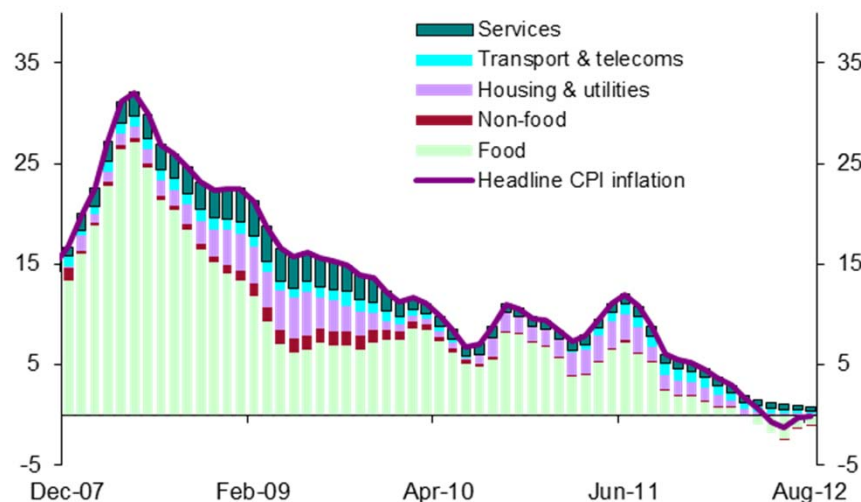
Source: State Statistics Committee, Credit Suisse

- Real GDP growth slowed sharply in Q1 2012 (to -0.3% qoq in seasonally adjusted terms, from 1.0% qoq sa in Q4 2011), mainly due to much weaker external demand, before bouncing to 1.9% qoq sa in Q2 2012. With agricultural output contributing strongly to GDP growth in the four quarters through mid-2012, the performance of the non-agricultural part of the economy over this period was fairly lackluster, in our view.
- Near-term GDP growth prospects are uncertain due to weak external demand and a projected decline in agricultural output compared to last year (as a result of a lower harvest). Latest IFI growth projections for 2012 are in the 2.5%-3.0% yoy range; we currently expect 2% growth this year.

# How sustainable is Ukraine's recent disinflation?

## Contributions to headline year-on-year CPI inflation

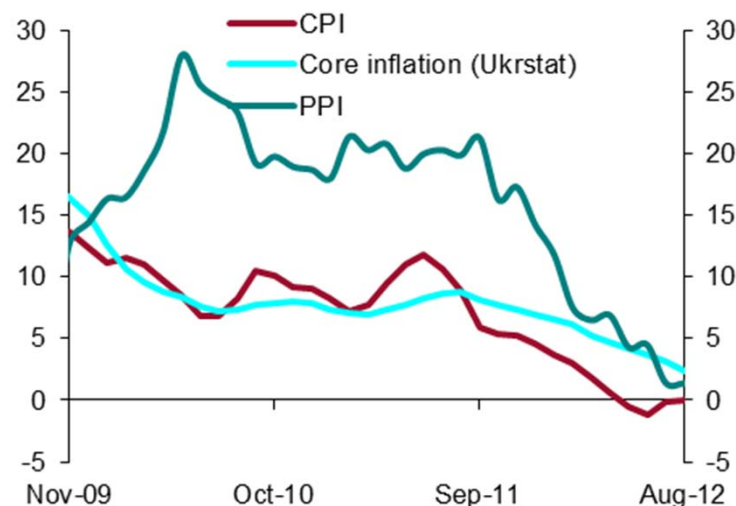
pps, except for % yoy change in CPI



Source: State Statistics Committee, Credit Suisse

## Consumer and producer prices and core inflation

% year-on-year change



Source: State Statistics Committee, Credit Suisse

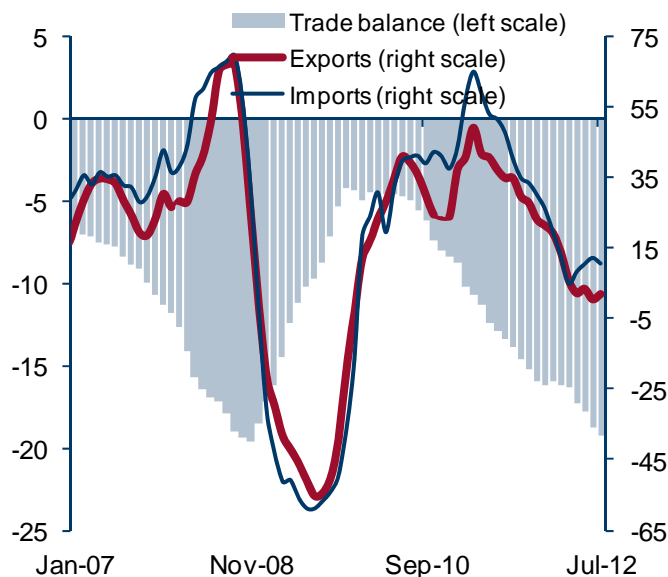
- Inflation continued to decline sharply in 2012, hitting an all-time low of -1.2% yoy in June and staying subdued since then, almost entirely due to lower food prices. The unfavorable base effects, spending pressures ahead of parliamentary elections in October, and possible exchange rate depreciation thereafter are likely to cause inflation to rebound to about 6% by year-end, on our estimates.
- The steep decline in inflation recently was due at least in part to new CPI basket weights that reduced the share of food products but also increased the weight of imported goods in the CPI. This should lead to a higher pass-through effect from changes in the exchange rate, increasing the impact on inflation of potential currency depreciation.

# Rising current account deficit is Ukraine's Achilles' heel

## Merchandise trade

12m rolling, \$bn

% yoy change in USD values, 3mma

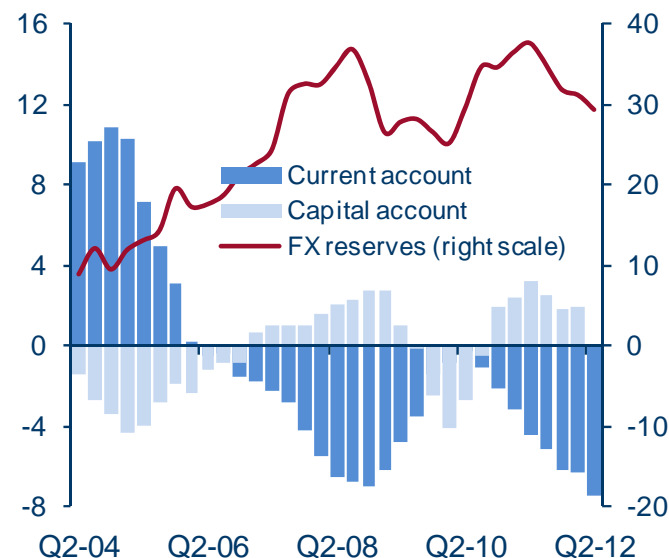


Source: National Bank of Ukraine, Credit Suisse

## Current and capital account , gross FX reserves

% of GDP, 12m rolling

US\$ bn



Source: National Bank of Ukraine, Credit Suisse

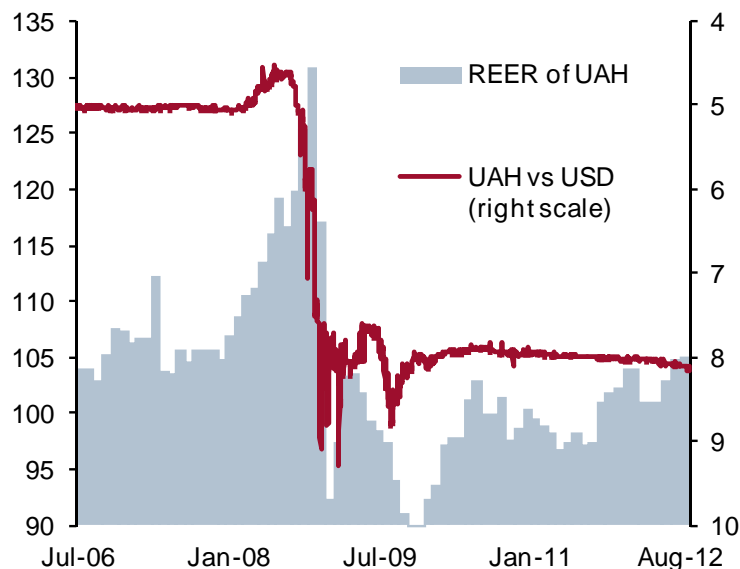
- After a sharp decline post the 2008-2009 crisis, the current account has been widening steadily again, from 2.1% of GDP in 2010 to 5.5% of GDP in 2011, due mainly to steep increases in the value of energy imports. The c/a deficit was relatively stable in early 2012, thanks mainly to a sharp decline in the volume of imported gas, but has been widening rapidly recently, reaching \$13.1bn (7.4% of GDP) in July 2012 on a 12-month rolling basis.
- The 12-month goods trade deficit was 8.4% of GDP in 2011 and 11.6% of GDP in July 2012. The main prospects for narrower trade and c/a deficits next year are associated with a possible deal with Russia involving sharply lower gas prices, in return for equity in the pipeline and possibly Ukraine's membership in the Customs Union.
- The high and rising c/a deficit represents Ukraine's key credit vulnerability, in our view.

# UAH/USD peg fuels volatility of FX reserves, interest rates

## Hryvnia's exchange rates

UAH REER\* (2001 = 100)

UAH per USD, spot

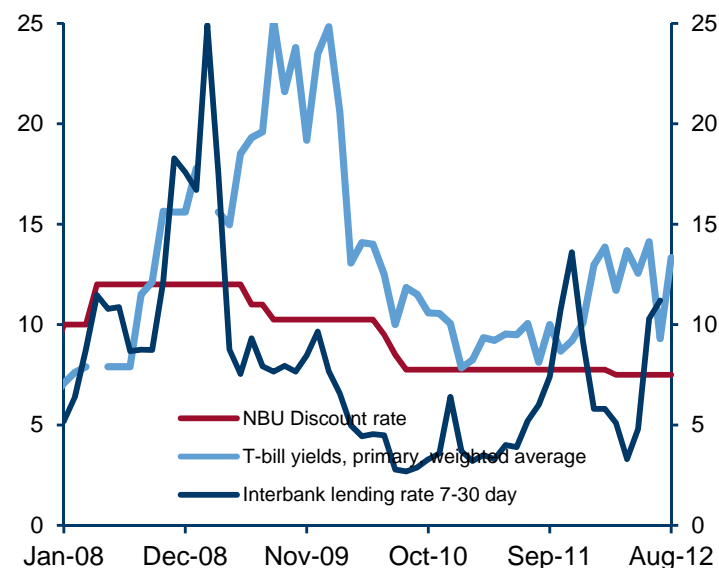


\*Real effective exchange rate; an increase denotes appreciation.

Source: the BLOOMBERG PROFESSIONAL<sup>TM</sup> service, Credit Suisse

## Interest rates

% p. a.



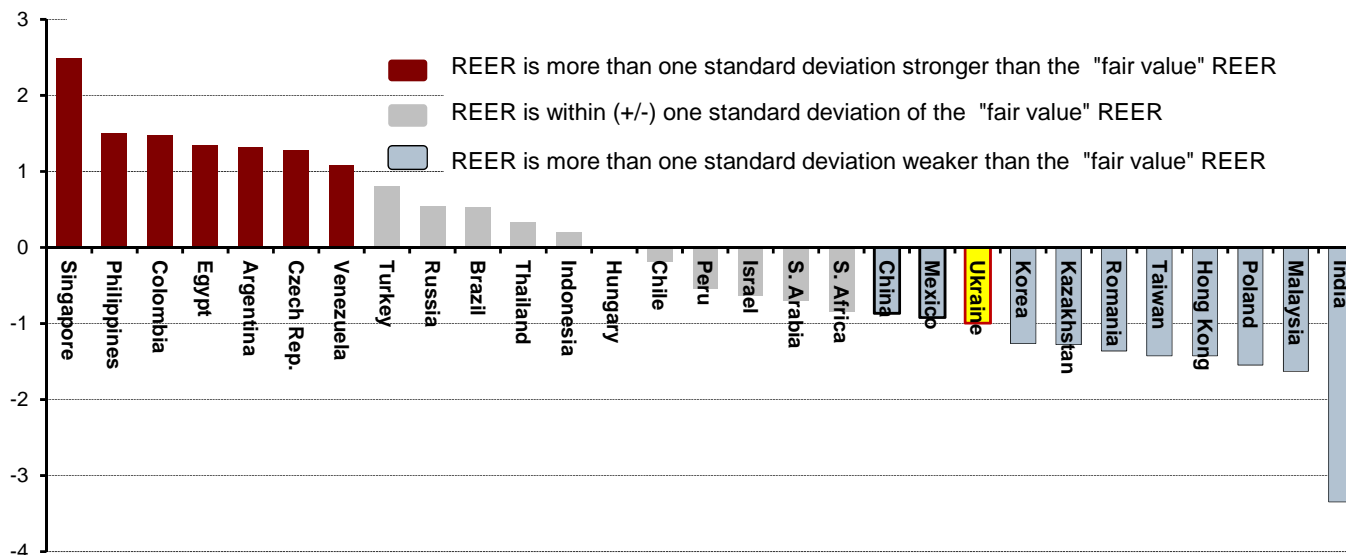
Source: National Bank of Ukraine, Credit Suisse.

- The central bank's determination to maintain the currency's peg (to USD) in the face of weaker demand for key export products has contributed to a \$8.5bn decline in the stock of its non-gold reserves in the 12-month period through end-August 2012 (to \$28.1bn, just over three months of import cover). At the same time, market interest rates have remained volatile.
- Since the beginning of 2012, the central bank has cut some of its policy rates by 75bps and the refinancing rate by 25bps to 7.50% (in March 2012), the first such moves since 2009.

# Among other EM currencies, hryvnia still looks “cheap”

Deviation of real effective exchange rates (REER) from our model-based fair value estimates as of 07 September 2012

Number of standard deviations



Source: Credit Suisse

- Ukraine's hryvnia appears to be among the “cheaper” EEMEA currencies, by one standard deviation from our “fair value” estimates for the currency's REER.
- However, the rapid widening of Ukraine's current account deficit underscores the need for the central bank to allow for the exchange rate to cushion at least some of the impact of the worsening external position.
- The apparent political preference for a rigid peg raises the risk of further FX reserve losses and a large-scale exchange rate adjustment after the parliamentary elections (in late October 2012).



# Delayed policy response to large funding needs

## ➤ Ukraine has very significant financing needs in 2012-2013:

We estimate that Ukraine needs to cover 8% of GDP in budget financing needs and \$33bn (19% of GDP) in balance-of-payments needs (excluding short-term FX debt amortizations) in 2012.

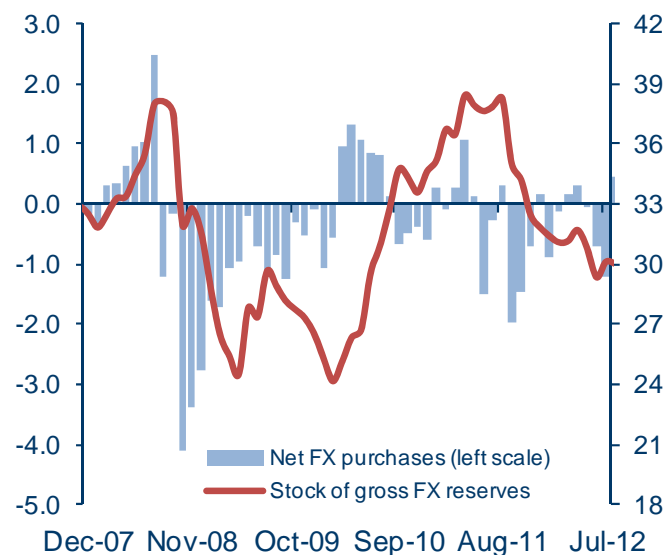
## ➤ However, political constraints on policy flexibility have complicated Ukraine's ability to cope successfully with the financing challenges:

- parliamentary elections (in October 2012) are an overriding focus and appear to have constrained the ability of the government and the central bank to address the risks to macroeconomic stability in a timely manner;
- commitments to the IMF on raising gas tariffs have not been met; IFI financing has been on hold since early 2010;
- social spending has been hiked, by 2.4 pps of GDP above the 2012 budget;
- a peg to USD contributed to a decline in FX reserves between end-August 2011 and end-August 2012 of \$8.5bn (or by 23%).

# Twin deficits underscore the dearth of financing sources

## FX reserves, interventions

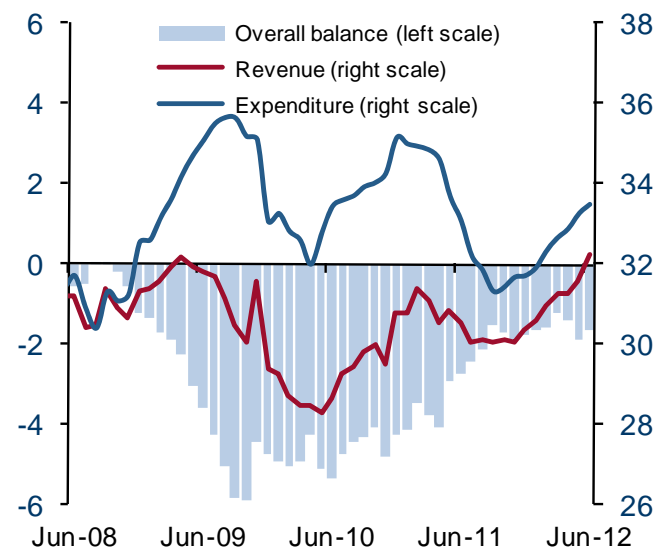
\$bn



Source: National Bank of Ukraine, Credit Suisse

## Consolidated budget operations

% of GDP, 12-month rolling



Source: Finance Ministry, Credit Suisse

# Ukraine is facing very challenging external financing needs

## Ukraine: balance of payments financing needs and sources

UKRAINE'S BALANCE OF PAYMENTS FINANCING					
\$bn	2008	2009	2010	2011	2012F
Funding need (including short-term debt amortization)	46.0	40.6	41.3	59.7	69.3
Funding need (excluding short-term debt amortization)	22.9	19.3	22.9	34.1	31.9
Current account deficit	12.8	1.7	3.0	10.2	13.5
External debt amortization	9.7	17.4	19.2	23.7	23.2
Public	0.9	3.0	3.3	5.1	6.3
Private	8.8	14.4	15.9	18.6	16.9
FDI outflows	0.4	0.2	0.7	0.2	0.5
Short-term debt	23.1	21.3	18.4	25.6	32.1
Funding sources (including gross short-term borrowing)	46.0	40.6	41.3	59.7	69.3
FDI inflows	10.4	3.6	6.5	7.2	8.5
Portfolio investments	0.3	0.3	0.3	0.5	0.5
Medium- and long-term borrowing	10.1	4.5	14.9	17.9	17.5
Short-term borrowing	21.3	18.4	25.6	32.1	35.0
Other flows (including multilateral financing)	5.0	8.1	2.5	-0.4	0.0
Change in net international reserves (- indicates increase)	-1.1	5.7	-8.5	2.5	7.8
Memo items:					
Nominal GDP (\$ bn)	179.4	113.7	128.4	164.5	166.7
Source: IMF, NBU, Credit Suisse estimates					

- The public sector was due to repay some \$3.8bn to the IFIs in 2012, besides the \$2bn loan from VTB (50% refinanced in June 2012) and a \$0.5bn Eurobond (paid in June). The private sector needs to roll over \$17bn.
- The government had to refinance \$2.5bn of external market debt in 2012. It has so far repaid \$1.5bn and raised \$2.0bn from the capital markets. In 2013, total service of IMF-related liabilities is close to \$6bn, of which half is due from the NBU and half from the government (in addition to a \$1bn Eurobond maturity), further increasing the significance of an IMF agreement or a deal with Russia early next year.

# Fiscal policy has to tighten in order to contain funding needs

## Ukraine: government funding needs and sources

UKRAINE	2009		2010		2011E		2012F	
	\$ bn	% of GDP	\$ bn	% of GDP	\$ bn	% of GDP	\$ bn	% of GDP
<b>Total borrowing requirement</b>	<b>14.4</b>	<b>12.7</b>	<b>13.2</b>	<b>10.3</b>	<b>11.4</b>	<b>6.9</b>	<b>13.2</b>	<b>7.7</b>
Overall fiscal deficit*	5.6	4.9	7.0	5.5	2.9	1.8	4.7	2.7
Primary fiscal deficit	3.8	3.3	5.0	3.9	0.0	0.0	0.9	0.5
Interest payments	1.7	1.5	2.0	1.6	2.9	1.8	3.8	2.2
Total amortization payments	5.8	5.1	4.3	3.4	5.7	3.5	7.6	4.4
Domestic debt	3.3	2.9	3.5	2.7	4.0	2.4	3.8	2.2
External debt	2.5	2.2	0.8	0.6	1.7	1.0	3.8	2.2
Naftogaz operational deficit	3.0	2.6	1.9	1.5	2.8	1.7	0.9	0.5
<b>Funding sources</b>	<b>14.4</b>	<b>12.7</b>	<b>13.2</b>	<b>10.3</b>	<b>11.4</b>	<b>6.9</b>	<b>13.2</b>	<b>7.7</b>
External	6.2	5.5	5.5	4.3	3.4	2.1	3.5	2.0
Domestic financing sources, of which	8.0	7.0	7.3	5.7	6.5	4.0	8.3	4.8
Gross domestic borrowing	2.1	1.8	5.4	4.2	6.7	4.1	7.5	4.4
Drawdowns on fiscal deposits	5.7	5.0	-1.9	-1.5	-0.2	-0.1	0.8	0.5
Privatization	0.2	0.2	0.4	0.3	1.4	0.9	1.4	0.8
<b>Memo item:</b>								
GDP (\$bn)	113.7		128.4		164.5		166.7	
*Excluding bank recapitalization costs.								

Source: National Bank of Ukraine, Finance Ministry, Credit Suisse estimates

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