

December 24, 2014

Risky 2015 budget

IMF deal, currency stability under threat

The Cabinet of Ministers of Ukraine submitted its 2015 draft budget to the Rada (Ukraine's parliament) on Dec. 23 for its review after weeks of withholding details. It proved to be a disappointment, as the spending plan sloppily prepared with an unrealistic revenue target and heavy reliance on hryvnia printing by the National Bank of Ukraine (NBU). To make matters worse, the fiscal plan presumes UAH 88 bln of quasi-fiscal financing, with more currency printing being the only available source.

The general fiscal gap was proposed at 8.8% of GDP, above the 5.8% of GDP deficit target the IMF outlined for 2015. No doubt, the Fund might reconsider its requirements given the tough economic situation; however, it stated as early as September that it wanted to see a substantial fiscal gap reduction in 2015 and that does not look promising. Even setting aside the risk of IMF deal falling through, we see a high risk for hryvnia instability in case the budget isn't amended. The printing of up to UAH 190 bln of new hryvnia in 2015 (which is more than the UAH 150 bln printed in 2014) will only intensify the pressure on the local currency and render the budget plan even more irrelevant.

Overoptimistic tax revenue target

For the 2015 draft budget, the authorities outlined their revenue target at UAH 475.2 bln, which is a 31.6% yoy increase. A large part will come from personal income tax redistributed from local budgets and boosted NBU support. Net of those changes, the Cabinet plans a 27% yoy tax collection growth based on a series of tax hikes and the legalization of shadow-economy incomes. This assumption, however, wasn't reflected in the UAH 1.72 tln of planned nominal GDP for 2015, which implies just an 11% yoy increase. Given that tax pressure on the economy is already too high, we are very skeptical about potential tax revenue growth beyond nominal GDP (i.e. beyond 11% yoy). This means that nearly UAH 40 bln in tax collections are at risk.

Relying on NBU support

The spending plan presumes a substantial increase in direct NBU contributions to budget revenue. In particular, the Finance Ministry (MinFin) anticipates a UAH 65.4 bln wire from the NBU, which is almost triple than the UAH 22.8 bln provided in 2014. To make matters worse, the budget calls for these funds to be provided by May 2015, which means substantial hryvnia printing for fiscal support will be already in 4M15.

Continued heavy quasi-fiscal operations

On the top of an uncertain tax collections increase and heavy reliance on NBU support, the authorities outlined substantial support for quasi-fiscal operations. In particular, the budget presumes UAH 88 bln in quasi-fiscal support, which includes UAH 31.5 bln support for Naftogaz (a number that looks too low to us), UAH 36.5 bln for banking system refunding and UAH 20 bln for the Deposit Guarantee Fund. The government plans to issue UAH 88 bln in new local bonds, possibly to finance these needs, which implies they will be covered by hryvnia printing.

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State budget stats, UAH bln

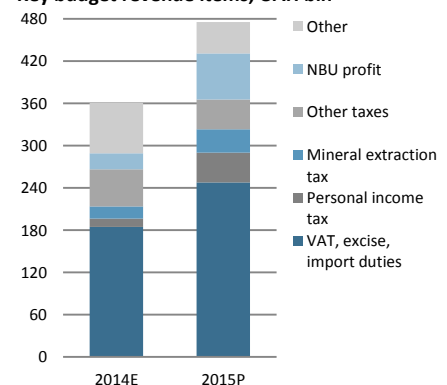
	2014E	2015 plan	yoy
Revenues	361.0	475.2	31.6%
Spending	429.6	527.2	22.7%
Deficit	68.6	63.7	-7.1%
% of GDP	4.4%	3.7%	-0.7pp

Quasi-fiscal operations, UAH bln

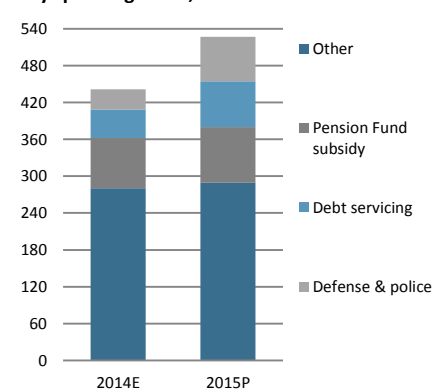
	2014E	2015 plan	yoy
Naftogaz subsidy	96.9	31.5	-67.5%
% of GDP	6.3%	1.8%	-4.4pp
Bank recapitalization	-	36.5	-
% of GDP	-	2.1%	-
Deposit Guarantee Fund	10.1	20.0	98.0%
% of GDP	0.7%	1.2%	0.5pp
Total	107.0	88.0	-

Source: Verkhovna Rada, Concorde Capital estimates

Key budget revenue items, UAH bln



Key spending items, UAH bln



Source: Verkhovna Rada, Concorde Capital estimates

War and debt servicing - core spending growth factors

The draft budget suggests increasing spending by 22.7% yoy to UAH 527.2 bln, concentrating on debt-servicing expenses (up to UAH 74.7 bln from UAH 46.3 bln), the military (up to UAH 40.2 bln from UAH 15.2 bln), and law enforcement, which includes police, Border Guard Service and National Guard (up to UAH 32.5 bln from UAH 17.9 bln).

At the same time, social spending increased by only UAH 11.4 bln, primarily due to the boosted Pension Fund deficit (up to UAH 90.7 bln from UAH 81.7 bln in 2014). To the government's credit, subsidies to the inefficient coal sector are to be cut drastically to UAH 1.2 bln from UAH 11.0 bln in 2014.

9% of GDP fiscal gap threatens IMF cooperation

The quasi-fiscal financing (UAH 88 bln), coupled with the targeted deficit (UAH 63.7 bln), will comprise 8.8% of GDP (UAH 151.7 bln) of the general fiscal gap. It's very probable the potential revenue shortfall might result in a 10% of GDP figure in 2015. Against the backdrop of the previously declared IMF benchmark of 5.8% of GDP for the general state and Naftogaz deficits in 2015, we see a high risk posed to Ukraine's further cooperation with the Fund. For sure, the Fund, when outlining the deficit benchmark, did not mention support for the banking system, and there is a chance the conditions might be revised. However, the IMF anticipated the authorities to narrow down fiscal gap anyway but even that is unlikely under the suggested spending plan.

If the IMF says "no" to the suggested spending plan, Ukraine will default, pure and simple. Thus far, the government has a chance to both fit the budget parameters to IMF requirements and gain concessions in order to extend the standby program. Despite these negative indicators, we see a high chance that IMF cooperation will continue in 2015 and Ukraine will be able to receive at least the earlier planned USD 11.4 bln next year.

Currency to fall further on large-scale hryvnia printing

Putting the IMF factor aside, we expect further hryvnia depreciation on the back of generous budget financing from the NBU. The draft budget assumes a UAH 17/USD currency exchange rate in 2015. The market exchange rate of the hryvnia is already in the UAH 18-19 UAH/USD range and can strengthen only under tightened fiscal and monetary policy. Unfortunately, the budget draft does not give us grounds to assume any fiscal tightening – even under the scenario of continued cooperation with the IMF and other donors, Ukraine will have to print UAH 133–190 bln of hryvnias in 2015 (refer to the next page for more information on that).

If the suggested budget is approved as it is, then further devaluation is predetermined. Recall, heavy hryvnia printing (UAH 149.5 bln, year-to-mid-December) was one of the factors that led to its devaluation by more than 50% this year. And this is despite Ukraine spending about USD 5.2 bln of its gross international reserves to support the local currency – a luxury that the central bank won't be able to afford in 2015, given its gross reserves as of the year start will be about USD 7.5 bln (or slightly more than one month of Ukraine's future imports).

No one has a clear vision what the average exchange rate will be in 2015. However, comparing the projected depth of hryvnia printing with previous years, we believe the hryvnia will fall far below the UAH 20/USD mark if the bill passes parliament as it looks now.

How much hryvnia should be printed if the budget is approved?

- The draft assumes a budget deficit of UAH 63.7 bln;
- The quasi-fiscal deficit would amount UAH 88.0 bln;

This results in a **UAH 151.7 bln** in budget funding needs for 2015, under the best-case scenario.

- The government's net international borrowing (from the IMF and other donors) is UAH 83.4 bln, according to the plan.

If received in full, these international funds will decrease the government's financing gap to **UAH 68.3 bln**, which, most likely, will be covered by the NBU.

- On top of that, the NBU will print an additional **UAH 65.4 bln** to contribute to budget revenue.

In the best-case scenario, therefore, the total amount of printed money for budget support will amount to UAH 133.7 bln.

In the event of deviation from the best case (which is very likely), the NBU will have to cover up to UAH 190 bln, which would also consist of:

- Up to UAH 17 bln in unreceived privatization proceeds (this year, the government got only UAH 0.5 bln of the UAH 17.0 bln plan, and the next year could prove just as weak);
- Up to UAH 40.0 bln of underreceived tax collections, as outlined on the first page of our note.

Key budget stats

Quasi-fiscal operations, UAH bln

	Target 2014	Target 2015	2015 Draft / 2014E
Naftogaz subsidy	96.9	31.5	-67.5%
% of GDP	6.25%	1.83%	-4.4pp
Refunding banks	-	36.5	-
% of GDP	-	2.12%	-
Deposit guarantees fund	10.1	20.0	98.0%
% of GDP	0.65%	1.16%	0.5pp
Total	107.0	88.0	

Source: Verkhovna Rada, MinFin, UkrStat, Concorde Capital estimates

Budget revenues and expenditures, UAH bln

	Target 2014	2014 Expected	Target 2015	2015 Draft / 2014E
State budget revenues	377.8	361.0	475.2	31.6%
% of GDP	24.38%	23.29%	27.61%	4.7pp
State budget spending	441.6	429.6	527.2	22.7%
% of GDP	28.49%	27.71%	30.63%	3.3pp
State budget deficit	68.6	68.6	63.7	-7.1%
% of GDP	4.42%	4.42%	3.70%	-0.7pp
Tax revenues	299.6	266.4	365.6	37.2%
% of GDP	19.33%	17.19%	21.24%	4.3pp
Personal income tax	14.2	11.7	42.3	261.8%
% of GDP	0.92%	0.75%	2.46%	1.7pp
Enterprise profit tax	40.3	40.0	33.6	-16.1%
% of GDP	2.60%	2.58%	1.95%	-0.6pp
VAT	150.0	128.7	156.1	21.3%
% of GDP	9.67%	8.30%	9.07%	0.9pp
Rent on minerals' extraction	21.3	17.4	33.4	92.2%
% of GDP	1.37%	1.12%	1.94%	0.8pp
Import duties	15.6	11.9	31.5	164.5%
% of GDP	1.01%	0.77%	1.83%	1.1pp
Excise duties	44.9	44.0	60.0	36.4%
% of GDP	2.90%	2.84%	3.49%	0.7pp
Non-tax revenues	69.4	66.9	99.9	49.3%
% of GDP	4.48%	4.32%	5.80%	1.6pp
Transfer from the NBU	22.8	22.8	65.4	186.8%
% of GDP	1.47%	1.47%	3.80%	2.4pp

Selected expenditure items

Pension Fund subsidy	81.7	81.7	90.7	10.9%
% of GDP	5.27%	5.27%	5.27%	0.1pp
Debt servicing	46.3	46.3	74.7	61.3%
% of GDP	2.99%	2.99%	4.34%	1.4pp
Defense Ministry	15.2	15.2	40.2	165.7%
% of GDP	0.98%	0.98%	2.34%	4.3pp
Internal Affairs Ministry	17.9	17.9	32.5	81.8%
% of GDP	1.16%	1.16%	1.89%	1.7pp
Coal subsidy	11.0	11.0	1.2	-89.1%
% of GDP	0.71%	0.71%	0.07%	1.1pp

Source: Verkhovna Rada, MinFin, UkrStat, Concorde Capital estimates

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