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Ukrainian hryvnia

Soon & controlled or late & uncontrolled devaluation

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The NBU is clearly demonstrating its intention to keep the national currency under control at any price, while "control" does not mean a fixed exchange rate, in our view. The government has a reasonable chance to execute a steady hryvnia landing throughout 2013, provided that favorable conditions coincide. The control over hryvnia looks fragile and heavily depends on the ability to cooperate with IMF.

- The base scenario we see is a steady controlled devaluation to UAH/8.8 vs. USD till end-2013. We see this as a necessary condition to keep the NBU's fragile control over the domestic forex market and keep gross reserves safely above the USD 20 bln psychological level. Besides obvious macro reasons in favor of devaluation, new looming factors that can start the process are large IMF repayments and favorable timing on the temporarily calmed retail forex market.
- The most critical development to be watched is the IMF program, which has been widely assumed by creditors to restart after the October elections. If the IMF deal fails, investors would lose confidence and Ukraine will face a high risk that gross NBU reserves will shrink to a critical level already in spring 2013.
- Risk factors also include retail cash demand for dollars and Ukraine's worsening trade balance, but both appear to be under NBU control providing the IMF loan and devaluation happen in 1H13.
- Obvious global risks like failed quantitative easing, the U.S. fiscal cliff, deteriorated demand for steel and EU economic turmoil, as well as Ukraine's possible accession to the Custom Union, should also be kept in mind.
- Below we introduce a list of key checkpoints to control smoothness of our scenario, and key events that might become sensitive for the hryvnia outlook.

Key checkpoints for 1H13

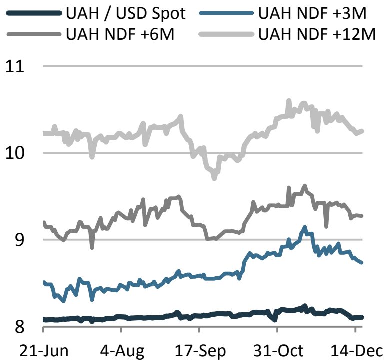
End-Jan:	No visibility in progress with the IMF
	UAH/USD rate < 8.1x
	No forex funds attracted to secure repayment of USD 1.32 bln to the IMF
End-Mar:	**No progress with the IMF**
	UAH/USD rate < 8.2x
End-Apr:	Net retail demand for dollar exceeds USD 2 bln in 1Q13
	UAH/USD rate < 8.3x
	No forex funds attracted to secure repayment of USD 1.32 bln to the IMF
	End-March NBU reserves < USD 23 bln
End-May:	Net retail purchase of dollar > USD 3.0 bln in 4M13
June:	No forex funds attracted to secure repayment of USD 1 bln Eurobond on June 11
	UAH/USD rate < 8.3x
	Ukraine's 5M12 trade deficit > USD 7.0 bln

Note: the most critical items are bolded

Watch list for encouraging events:
- Renewal of cooperation with the IMF (Jan-Feb)
- Devaluation of hryvnia by 4-5% (Jan-Mar)
- Eurobond placements (Feb, Apr, Jun, Oct, Nov)
- Ukraine's sovereign rating/outlook upgrades (Mar)
- Success in discount for Russian gas (Feb-Apr)

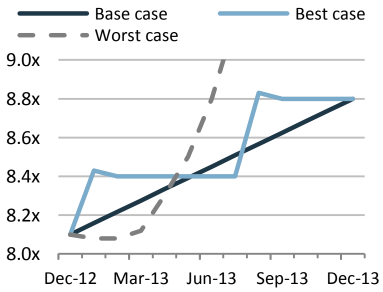
Watch list for discouraging events:
- Failure to negotiate with the IMF (Jan-Mar)
- Introduction of 10% tax on retail foreign currency sale
- Ukraine's sovereign rating downgrades (Mar)

UAH/USD market, last 6M



Source: Bloomberg

UAH/USD scenarios for 2013*



** Best and worst cases for the NBU's ability to control the hryvnia exchange rate. Worst case assumes failure to cooperate with the IMF*
Source: Concorde Capital research

All stars point at ~5% devaluation in early 2013

The ultimate goal of the current policy makers is to keep the hryvnia under control as part of securing the president's poll ratings before the early-2015 presidential elections. Our analysis suggests that this task is doable in the event that (1) IMF cooperation is resumed in early 2013, (2) a devaluation of about 10% occurs over 2013, and (3) the NBU will be able to cope with spikes in retail demand for dollars. This will allow the NBU to finish the year with gross reserves of USD 22 bln, safely above the psychological levels of USD 20 bln and two months of imports (USD 18 bln). The IMF cooperation and the devaluation look the most critical as they complement each other. Failure in at least two of the three areas could take the forex market out of NBU control already in spring 2013.

Our broad conclusion is that authorities do not have much time for lingering with the hryvnia decline. The best time to smoothly cope with the three tasks listed above is January-February 2013. A fast devaluation will solve many problems for the NBU, the government, and the president including:

- IMF cooperation and smooth external borrowing. As we highlight below, the smoothness of cooperation with the IMF will be the main factor in securing external lending in line with the 2013 budget plan. A signal that the government can allow for some devaluation will increase Ukraine's leverage in talks with the IMF. Moreover, devaluation could allow ratings agencies to upgrade Ukraine's profile, while failure will surely cause a downgrade. It's critical for this to happen by end-January since Ukraine is scheduled to repay USD 1.32 bln by Feb. 12. It's even more important by end-April, on the eve of another USD 1.32 bln transfer.
- Residential demand for cash dollars. Recent experience suggests that household demand for cash dollars (and therefore NBU reserves) is very sensitive to hryvnia stability – in case of any UAH move, demand for dollars would increase 2-3x. So far, the NBU has been able to scare away individuals from the purchase of cash dollars by submitting a bill to charge 10% on the cash sale of foreign currency. The bill is unlikely to be passed by parliament, and the NBU has limited time to use this scarecrow for control of retail dollar demand. In 1-2 months, it will simply stop working and the NBU will have to invent another demand-limiting measure.
- Elections: devaluation is a very unpopular move for citizens. The campaign for the presidential elections will start in less than two years and an earlier devaluation raises the chances that the electorate would forget/forgive this unpopular development.
- Early (actually, any) devaluation would soften further devaluation expectations, thus decreasing the dollar-demand pressure.
- C/A deficit. Our analysis suggests that letting the hryvnia to fall to 8.5/USD in the 2013-average would save about USD 4 bln in the C/A balance compared to a sticky hryvnia scenario. The later it happens, the higher the devaluation pressure from the widening C/A deficit will be and the more effort will be required for control.

While the latter two reasons were in place as early as a year ago, the increasing pressure from the former three should eventually lead to a decision in favor of devaluing the hryvnia in January-February. Moreover, we won't be surprised if a reasonable devaluation takes place during the long Christmas/New Year holidays, or right after them.

BASE CASE: CONTROLLED DEVALUATION

Devaluation: tools and complications

Devaluation is seen as critically important for Ukraine's image, as there is a clear consensus that the currency is being kept artificially high - both Moody's and S&P highlighted this in their December statements.

The short-term goal of policy makers, therefore, is to:

1. ***Satisfy external demand for devaluation which will result in:***

- A better position in talks with IMF (critical for February already)
- A better ability to attract external financing (critical for February too)
- An ability to cope with deterioration of C/A balance (critical in mid-2013)

2. ***Keep hryvnia under tough control to secure only a minor devaluation, as:***

- Radical forex moves are spoiling policy makers' ratings in Ukraine
- A minor devaluation keeps safe Ukraine's dollarized banking system

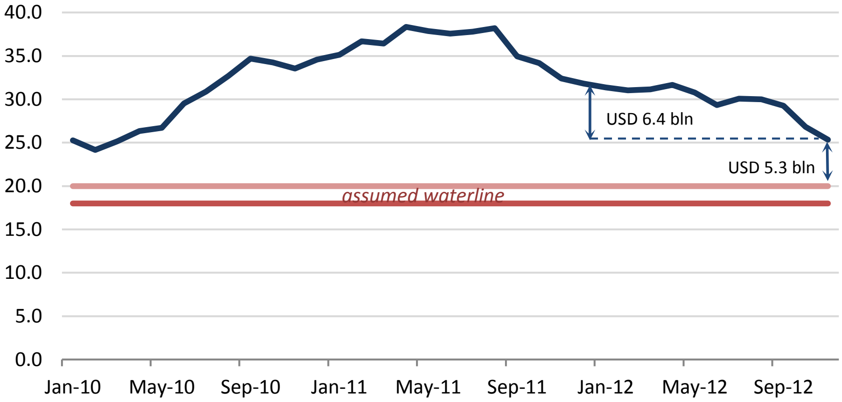
Matching the two targets is not trivial in Ukraine, where everything is complicated by the citizenry's habit of keeping savings in the foreign currency in the times of uncertainty – even a small devaluation generates abnormal demand for dollars from individuals, as the November and September cases suggest (refer to page 8 for more details).

Keeping all these complications in mind, we see there is a reasonable chance for Ukraine to pursue this scenario with just up to a 10% weakening of the national currency in 2013.

USD 20 bln gross NBU reserves is a critical point

The controlled hryvnia scenario looks manageable until the point gross NBU reserves are kept above a psychological level of USD 20 bln, or 2.2 months of future imports (vs. USD 25.3 bln, as of end Nov-2012). If this level is passed, we believe the NBU will have to do extremely hard work for the reserves to not fly to an even more dangerous threshold of USD 18 bln (2 months of imports).

Gross NBU reserves, USD bln



Source: NBU, Concorde Capital research

Against this backdrop, we assume USD 20 bln gross reserves as a waterline for our analysis beyond which there is an ocean of uncertainty. The Belarusian 2011 currency shock is indicative: its ruble fell by almost three times as soon as gross reserves reached a month of imports. For Ukraine, a 3x larger and less toughly controlled economy, the threshold would be bigger but the devaluation effect on the threshold's arrival would be smaller, we believe.

The task of not losing USD 5 bln in reserves over 2013 does not look trivial, at first glance, taking into account that the NBU has spent USD 6.4 bln in 11M12. Ukraine's economy is not looking better next year, and Ukraine's sovereign rating is lower now.

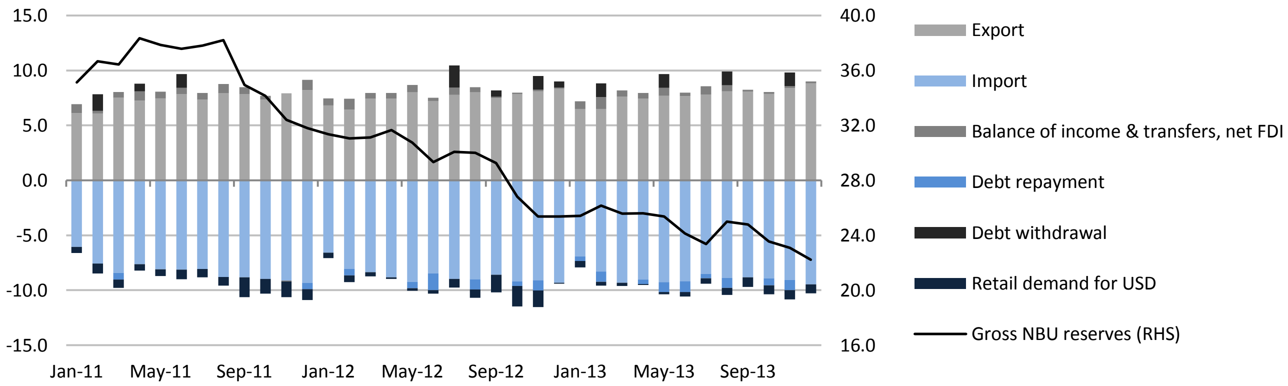
Our base-case: NBU reserves to be above USD 22 bln in 2013

Our key assumptions for full-year 2013 that validate this scenario are the following:

- The government allows for a 5% currency devaluation no later than May 2012
- The C/A deficit will grow to USD 14.0 bln (from USD 13.6 bln in 2012E) on a near 2% yoy increase in imports and 2% growth in exports
- Access to external markets for debt rollovers will be in line with the government's plan to raise USD 5 bln via Eurobonds and/or cooperation with IMF
- The NBU is able to control household demand for cash dollars and spend no more than USD 6.0 bln to feed retail needs (vs. USD 8.8 bln in 11M12)

Under this set of assumptions, the controlled devaluation would cost about USD 3.0 bln in gross NBU reserves in 2013, which will let them remain in a safe zone of USD 22 bln by end-year.

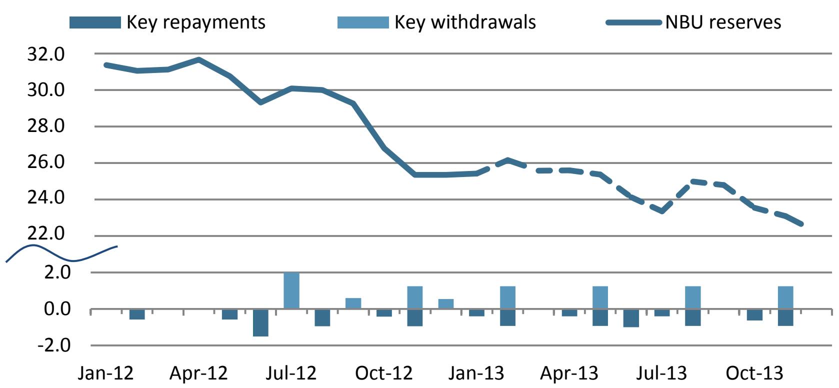
Key BoP items and NBU reserves, USD bln



Source: UkrStat, NBU, Concorde Capital research

Detailed assumptions behind the scenario are presented in the appendices.

NBU reserves and key debt moves, USD bln



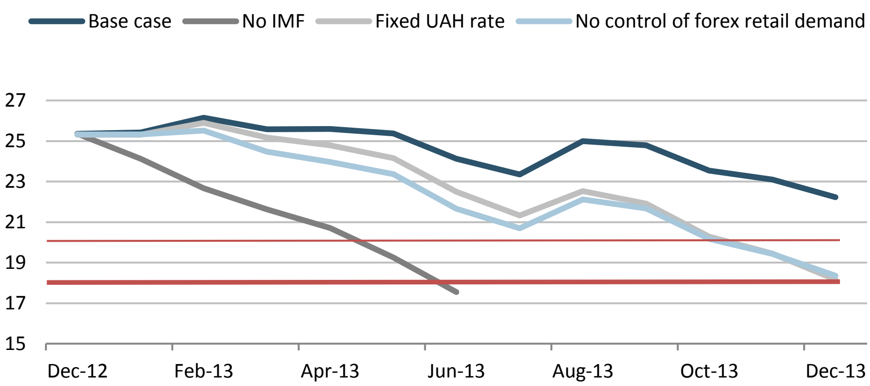
Source: UkrStat, NBU, Concorde Capital research

KEY RISK FOR "SAFE UAH LANDING" SCENARIO

Any sidestep could trigger loss of control

Running a sensitivity study of NBU reserves for deviations from our key assumptions, we conclude that the stability that we have designed is shaky: the achievement of a waterline of USD 20 bln would be a matter of time if something would go wrong, with the IMF factor being the most critical. A summary of key underlying assumptions for each deviation from the base-case scenario can be found in Appendix II.

NBU reserves - sensitivity to deviation from base-case, USD bln



Source: UkrStat, NBU, Concorde Capital research

The "no-IMF" deviation from our base case also includes a "no forex control" scenario, though it looks powerful in it of itself. To put it plainly, our further discussions in this report are useless if Ukraine fails to cooperate with the IMF.

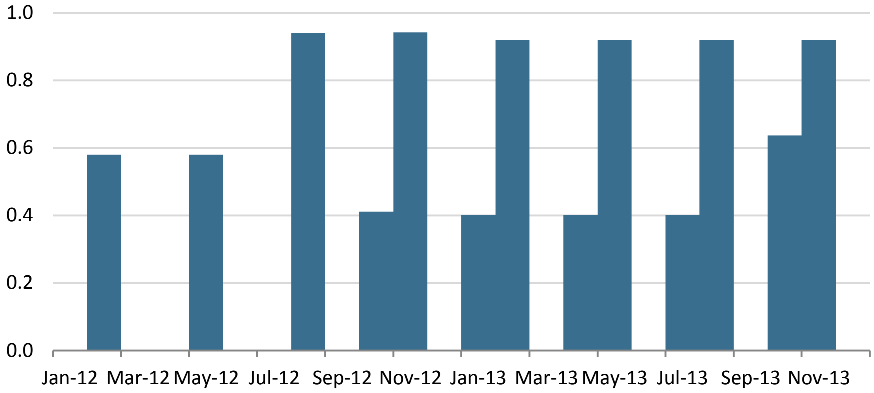
The scenarios of "fixed UAH rate" and "no forex control" seem to be similar by their individual effects. Taking into account that a UAH devaluation is most likely to trigger the NBU losing control over the forex market (as was the case in November 2012), that might lead to a conclusion that it's better to keep hryvnia stable to maintain control. However, that's unlikely to work as a stable hryvnia will exaggerate devaluation expectations and could lead to an unexpected loss of forex market control at any time. Instead, a well-prepared devaluation will allow the NBU to set tough temporary restrictions on the forex market (e.g. a new phase of discussions on a need to tax forex operations) until expectations of a further devaluation would vanish.

No IMF – no stability

Worrying signals:
Failure to attract financing to repay February tranches to the IMF
No progress in cooperation with the IMF by March 2012

A 60% more intense repayment schedule to the IMF in 2013 is self-telling for the importance of renegotiating with the Fund.

IMF payback schedule, USD bln



Source: MinFin, NBU

Ukraine's success in attracting USD 3.85 bln of debt financing in 2012 was a result of investors' expectations on closer contacts with the IMF. Ukraine should not miss the expectations as next year's lending plan is more aggressive.

Both S&P and Moody's highlighted they will look closely for the government's progress in this area and any failure would cause a downgrade of Ukraine's sovereign rating, thus limiting its ability to secure adequate refinancing. Against this backdrop, the rollover of USD 5.5 bln in IMF debt throughout 2013 and a USD 1 bln Eurobond scheduled for June 2013 are under risk.

To date, the government hasn't been very communicative with IMF representatives, and less than two months are left to the first set of tranches to repay USD 1.3 bln.

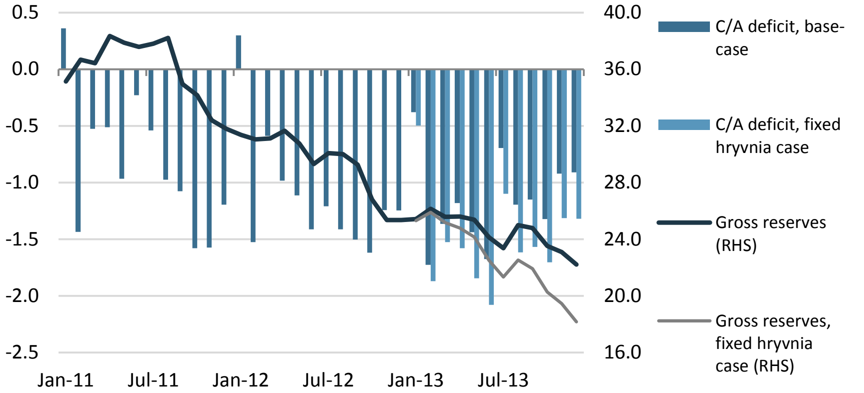
Devaluation matters itself

Worrying signal:
UAH/USD <8.2 in March 2013

Our base case scenario assumes the NBU will run a steadily controlled devaluation to 8.8 UAH/USD by end-2013. Subdued non-energy imports – due to import product and service price increases – and flat energy imports (see Appendix I for more details) – allow for a relatively modest C/A deficit at USD 14 bln in 2013 (some 3% higher yoy).

In the alternative scenario, if the authorities decide to play "hryvnia stability" one more year, the C/A deficit is expected to reach USD 18 bln in 2013 (+33% yoy) or 9.4% of GDP 2013E. Against this backdrop, nothing would guarantee hryvnia stability. In this case, gross NBU reserves could approach the USD 20 bln mark in October, at the latest.

C/A deficit and NBU reserves: base case vs. "stable UAH", USD bln



Source: UkrStat, NBU, Concorde Capital research

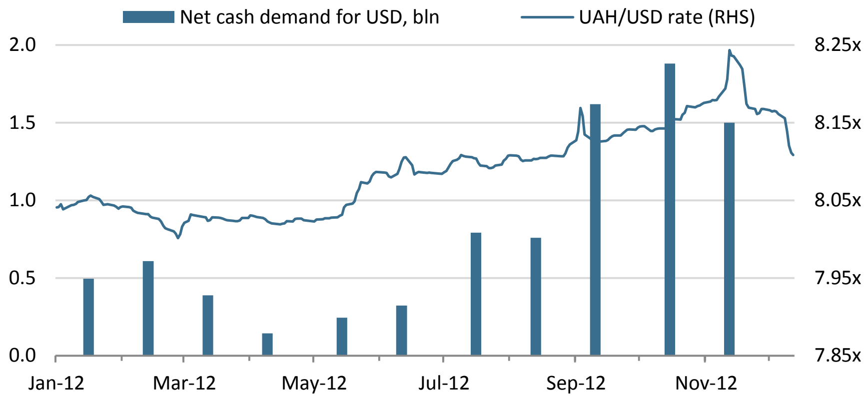
Our analysis suggests that earlier devaluation can lead to an even smaller growth of C/A deficit compared to our base-case - please refer to Appendix I for more details on C/A sensitivity to timing of devaluation.

Excess USD retail demand may spoil the party

Worrying signal:
More than USD 3.0 bln in retail demand in 4M13

Only a tranquil hryvnia decline will allow the NBU to stay above the USD 20 bln red line. The success of the base-case scenario heavily depends on the NBU's ability to run a controlled devaluation without sparking panic on the retail forex market. The experience of 2012 is indicative: a series of attempts to stimulate devaluation processes in September and November led to an unnecessary withdrawal of foreign currencies from the banking system into household coffers.

Hryvnia spot and retail demand for dollars



Source: UkrStat, NBU, Concorde Capital research

If the NBU is be able to extinguish the fire, lower net foreign currency purchases would allow for remaining in a safe zone. Smaller cash demand of USD 2.5 bln than in 2012 should suffice for playing a safe lending scenario.

A remedy for retail demand control is invented, though it's short-lived

The NBU's recently invented remedy to cope with risk is a legislative initiative to introduce a 10% tax (15% earlier) on cash sales of foreign currency. According to the regulator, just the news on the tax's possible introduction, circulating since late November, has reversed the 2:1 ratio of retail dollar demand/supply in mid-November to 1:2 in early December. We believe the NBU will not be able to introduce the tax as the initiative will have little support in parliament. Most likely, NBU officials will remind the public of this initiative whenever necessary, but it's obvious that the effect from this scarecrow will diminish with time – yet another reason to do the devaluation sooner.

Intensified discussions on this type of taxation could mean the NBU is ready to start a steady devaluation, though adopting this law would have extremely bad implications for the hryvnia: a negative reaction from the IMF and rating agencies is the least evil that we can expect in this case.

NBU emissions can stimulate USD demand

Another factor that can stimulate internal demand for cash dollars is the NBU's expected hryvnia emission through the purchase of T-bills. For instance, the monetary base declined 0.5% during 11M12 despite NBU injections that included UAH 21.0 bln of direct T-bills purchases. All injections went ultimately into the forex market and were neutralized through NBU dollar purchases. Given the preserved devaluation sentiments, we expect a similar story in 2013 if the NBU keeps purchasing T-bills directly. The 2013 budget presumes a UAH 47.2 bln net T-bills issue, which promises up to USD 5 bln in extra cash demand unless enough purchases of T-bills are made by commercial banks.

Other risk factors include, but are not limited to:

- Current account balance: Russian gas, decline in global steel demand, poor 2013 harvest, no economic revival in 2H13.
- External liquidity: QE3, fiscal cliff in USA, resurrected Eurozone crisis, etc.

Customs Union alternative is unlikely

Ukraine's aggravating external account position and reluctance to comply with the IMF requirements pushed state authorities to searching for support from the Russian Federation. Ukrainian President Viktor Yanukovych was scheduled to visit Moscow on Dec. 18 and was reportedly on the verge of signing a historic deal for Ukraine to join the Customs Union, in exchange for cheaper natural gas and other offers, such as loans from the Eurasian Bank at reduced rates. The meeting was canceled when both sides appeared to be unable finding common ground.

Some experts have estimated that the Customs Union will save up to USD 9.0 bln for Ukraine in 2013, which probably sounds lucrative for the ruling group given that the alternative is quite tough. In this respect, it's very likely some declarative agreements might happen in the near future.

At the same time, we see very low chance for the Customs Union to become a full-fledged scenario. Firstly, large business groups do not see Ukraine's future in this formation, which assumes the creation of super-national body at some stage. Secondly, joining the Customs Union requires parliamentary approval, an almost impossible scenario in its current shape. Finally, Moscow is unlikely to give advances on this deal which means that no concession is possible unless the Kremlin has clear evidence that Kyiv would indeed join as a full member.

APPENDICES

APPENDIX I

Key assumptions of base-case scenario, 2013

UAH will gradually devalue to 8.8/USD by year-end

For modeling purposes, we assume the local currency will gradually depreciate from the current level of 8.1/USD to 8.8 rate by the end of 2013.

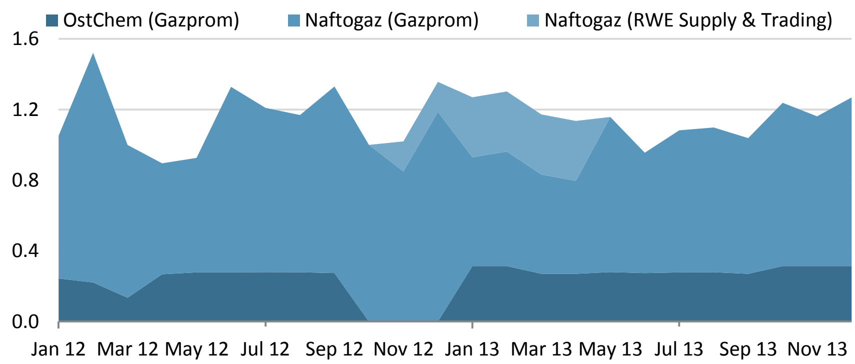
Underlying assumption for UAH/USD rate

Source: Bloomberg, Concorde Capital estimates

Import: energy bill fixed in USD

Ukraine will have to import nearly 33 bcm of gas and fuel and has no alternatives at the moment. Against this backdrop, the US dollar-denominated energy bill will be the same at any hryvnia rate. In 2012, the general energy bill is expected to be USD 26.5 bln, while for 2013 we expect a reduction to USD 25.5 bln on the back of a continued oil and coal import decline.

Gas import, USD bln

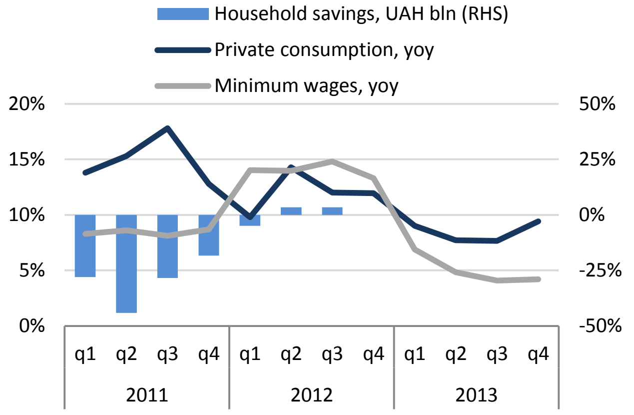


Source: Naftogaz, Concorde Capital estimates

Import: non-energy bill to be +8.4% yoy in USD terms

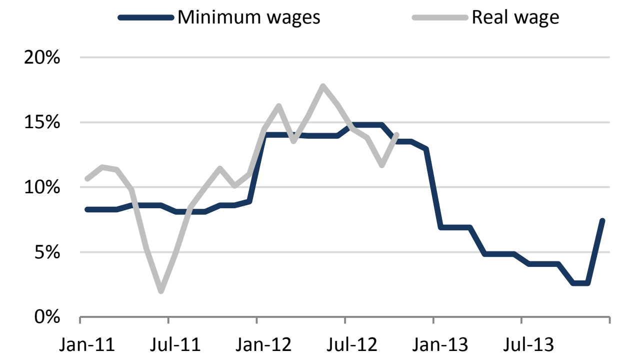
Private consumption, the main driver of non-energy imports, is expected to grow 12.5% yoy in hryvnia in 2013. The main factors are a potential household savings decline and a modest minimum wage increase. The last two years showed household consumption was quite resilient despite a slowdown in real income growth, and the trend is most likely to continue in 2013.

Sources of private consumption growth



Source: UkrStat, Concorde Capital research

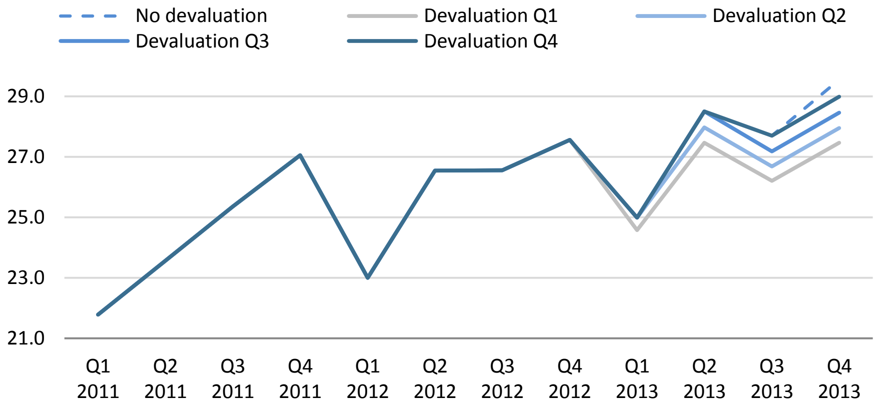
Residential income growth assumptions



Source: UkrStat, Concorde Capital research

Based on our exchange rate assumption, the USD-denominated non-energy import spending will grow 8.4% yoy in 2013.

Imports response to hryvnia devaluation, USD bln*

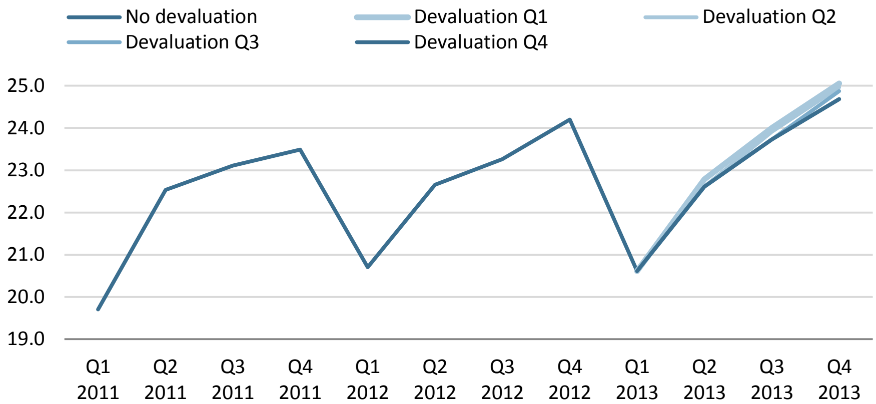


**Assuming a steady devaluation by 2.4% for the quarter starts in Q1, Q2, Q3 or Q4.*
Source: UkrStat, Concorde Capital research

Exports react marginally on hryvnia weakening

For exports, we assume a 0.15 ppt increase for every percent of devaluation of the national currency.

Export response to hryvnia devaluation, USD bln*

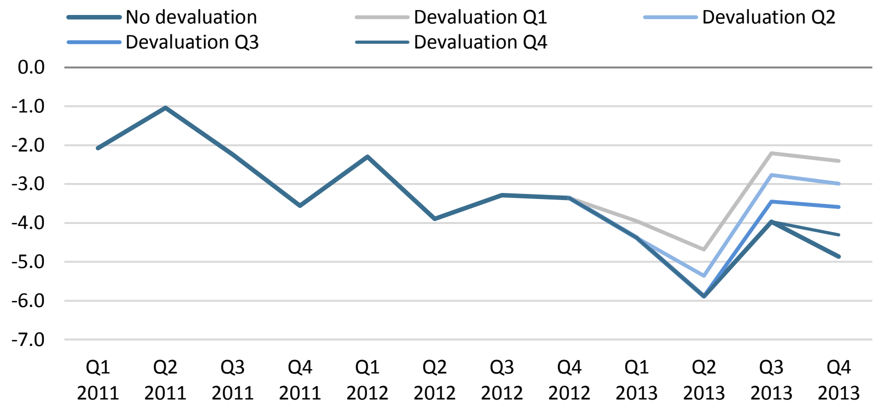


**Assuming a steady devaluation by 2.4% for the quarter starts in Q1, Q2, Q3 or Q4.*
Source: UkrStat, Concorde Capital research

Imports to determine trade balance

All in, the import of non-energy goods and services is the most exchange-rate-sensitive item of Ukraine's trade balance. Cumulative effect for the year ranges from a USD 13.3 bln trade deficit with a 1Q devaluation to a USD 19.1 bln trade deficit with no devaluation at all.

Trade balance response to hryvnia devaluation, USD bln*



**Assuming a steady devaluation by 2.4% for the quarter starts in Q1, Q2, Q3 or Q4.*
Source: UkrStat, Concorde Capital research

APPENDIX II
Scenario sensitivity details

Gross NBU reserves: base case and key deviations, USD bln

	2011	2012E	2013E			
			Base-case	No IMF deal	No devaluation	No dollar demand control
C/A balance	-10.2	-13.5	-14.0	-14.0	-18.0	-14.0
Avg. UAH/USD rate	8.0	8.0	8.6	8.6	8.1	8.6
Exports	88.8	90.9	92.5	92.5	91.8	92.5
Imports	-99.0	-103.7	-105.7	-105.7	-109.1	-105.7
Balance of income, transfers, net FDI	6.9	5.3	5.9	5.9	5.9	5.9
Loan repayments (IMF, Eurobonds)	-1.2	-5.0	-6.5	-6.5	-6.5	-6.5
New loans	3.4	4.4	5.0	2.0*	5.0	5.0
Household demand for cash	-11.4	-8.9	-6.4	-8.8*	-6.4	-8.8*
Other capital flow	9.6	10.5	12.1	10.5	12.1	12.1
Gross NBU reserves, eop	31.8	25.4	22.2	15.2	18.2	19.8

** Least certain items. Source: NBU, UkrStat, Concorde Capital research*

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