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IMF talks

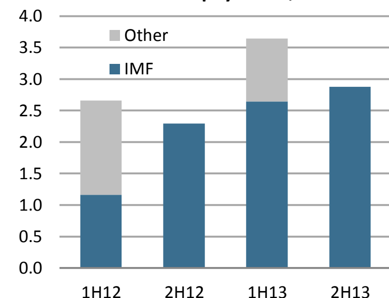
Strong commitments are hardly avoidable by May

Alexander Paraschiy
ap@concorde.com.ua

Record high external redemptions in 2013 and tiny NBU reserves have left no choice for the Ukrainian government but to struggle to secure a new program with its main creditor, the IMF. Besides its repeated requests – higher gas tariffs and tighter fiscal discipline – the Fund is expected to raise the issue of replenishing NBU reserves. That presumes hryvnia weakening as the most efficient measure. With the talks planned to start Jan. 29, Ukrainian authorities may try manoeuvring to minimize the political price of the potential IMF deal while keeping open their access to external debt markets. "Ongoing talks" with the IMF will be enough for Ukraine to cope with February's USD 1.3 bln repayments via attracting debt abroad. However, strong commitments will be crucial to bridge "constructive talks" with the Fund till May, when the next USD 1.3 bln payment comes.

Our brief analysis suggests meeting IMF requirements is the only apparent solution for decision makers to preserve stability over the next two years:

Ukraine's external repayments, USD bln



Source: NBU, MinFin

Ukraine standpoint:

- "Stability": stable currency and low utility bills are among the key pillars of the president's popularity. The next major election is in 2 years – there is still time for minor unpopular moves.
- Ukraine repays USD 6.5 bln external debt in 2013 (+USD 1.5 bln yoy), including USD 5.5 bln to the IMF.
- NBU reserves fell USD 7.3 bln in 2012 and they need to fall much less this year, despite the macro situation not improving. Reserves are just USD 6.5 bln above the critical 2M-import level. Replenishing reserves via new debt financing is a must.
- The IMF is the main creditor of Ukraine – its position on Ukraine will be a clear signal for "minority" creditors. If Ukraine fails to reach agreement, minor lenders will become more demanding and securing new loans from abroad would become a harder task.
- To make matters worse, Ukraine's standby agreement with the IMF officially expired on Dec. 31. A new deal will have to be drafted, virtually from scratch.

What to do:

⇨ Ukrainian authorities need critically to get a new agreement signed but an agreement will depend on a strong commitment to engage in politically painful policies.

⇨ Or at least, they need to generate jointly with the Fund encouraging messages for other Ukraine's creditors.

IMF standpoint:

- The Fund's mission is to help troubled economies to overcome hardships. Ukraine's case involves a weak BoP that has led to falling NBU reserves.
- The Fund newer comes to treat symptoms – it deals with the nature of the disease.
- As a creditor, the Fund needs clarity on how Ukraine is going to repay its debt. The 2012 NBU reserves decline calls into question Ukraine's ability to generate enough foreign F/X inflow under its currency peg, also calling into question Ukraine's ability to service external debt.
- Before entering a new deal, the IMF needs to see how Ukraine is going to:
  - replenish NBU reserves in the future (C/A deficit decline ⇔UAH devaluation)
  - comply with the standard IMF debtor requirements (budget deficit/GDP ⇔gas tariffs)

What to do:

⇨ Before starting a new program, it needs to see a realistic action plan that addresses key troubles.

But:

- The IMF's mission is also "not to harm"
- The IMF understands that a negative statement on Ukraine will worsen the nation's ability to get external debt.

⇨ In case of no reliable commitment from Ukraine, the Fund could continue a long dialogue.

Outcome:

Clear action plan signed:

- A reasonable UAH devaluation
- Residential gas rates up (?)
- IMF is happy, so are minor creditors – road to new loans is open

⇨ Relative "stability" till early 2015 looks manageable

"OK, let's go on the dialogue":

- Stable UAH … for how long?
- Minor debtors are nervous, but not frustrated … but for how long?

⇨ "Stability" is not secured even till end-2013

Key points

Ukraine is facing a severe need to resume cooperation with the IMF or at least create a series of positive messages about constructive talk with the Fund, which should be enough for the markets to rollover USD 1.3 bln due by Feb. 12.

We expect the IMF will insist on guarantees to engage in structural reforms and will not resume a standby program until a relevant action plan with strong commitments is presented.

The Ukrainian government does not meet the Fund's safety metrics on gross reserves and authorities will be asked to outline how reserves could be increased. Otherwise, the Fund faces the risk that the NBU will not have enough foreign currency to cover the first payment of the new standby loan.

The government will try to play the Hungarian game by avoiding any strong commitment on (politically) painful policies but building up a dialogue with the Fund to make investors believe that standby program will be resumed at some stage. This kind of behavior would be enough for the start (till February payments are done), but patience of minority creditors could likely come to end till April-May, when Ukraine is facing another USD 1.3 bln redemption.

The IMF is unlikely to report a formal agreement by February. But Ukrainian authorities will show readiness to engage in reforms and most likely will make a few commitments to the least painful policies, which should bridge the "constructive talk" mood till April-May.

IMF to demand solution plan

The IMF mission will reportedly arrive in Ukraine on Jan. 29. These critical talks will occur just as the Ukrainian government faces peak external debt redemptions in 2013 and the country's macroeconomic fundamentals are getting worse. Against this backdrop, we analyzed how the negotiations might unfold and what their results could be.

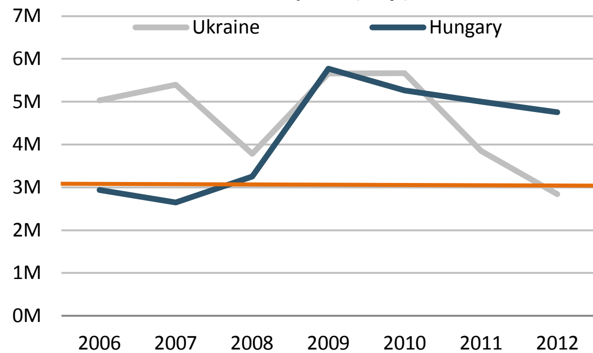
Till this day, the IMF did not have among its clients a problem-free country. The main role of the Fund is to help those with hardships but, apparently, the creditor wants to see how the applicant will fix the source of the problem and safely payback the loan. That is why there has never been a deal with IMF until government strongly committed for reforms.

Gross reserves ceiling will be an issue

According to the IMF metrics, Ukraine does not satisfy two out of three traditional criteria of reserves coverage:

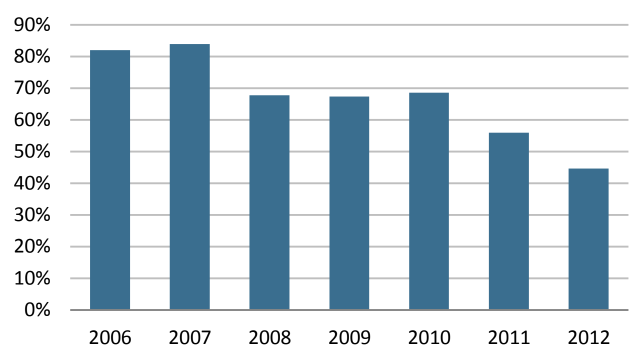
- NBU reserves are below 3 months of imports (2.8M as of end-2012);
- Gross reserves do not cover total short-term external liabilities (coverage is estimated at nearly 44% as of end-2012). This means that even temporal hardships with external debt rollover endangers currency stability and gross reserves might not be enough to defend from speculative attacks.

Gross reserves, months of imports (eop)



Source: NBU, Central Bank of Hungary

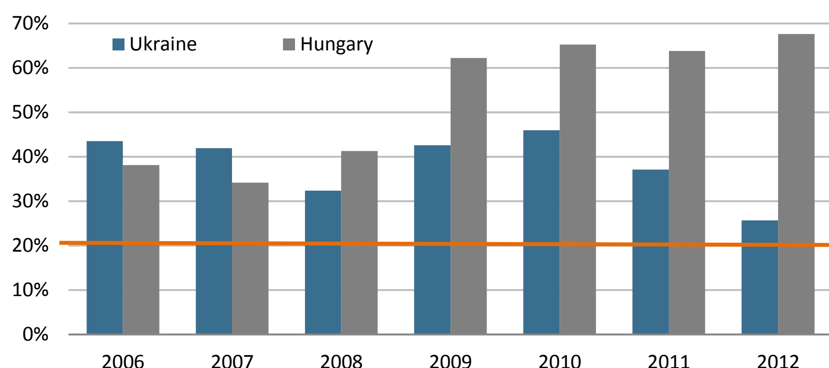
ST* external debt coverage by gross reserves, Ukraine (eop)



**Short-term; Source: NBU*

The only good news about Ukraine's foreign currency reserves is that they still cover more than 20% of broad money, the M2 indicator (25.7% as of end-2012). This means that economy is relatively well-protected against unexpected capital flight or deposit outflow. Yet even on this criterion we are very close to the critical level, especially if we consider the intention of authorities to relax monetary policy and increase money aggregates.

Broad money (M2) coverage by gross reserves, (eop)



Source: NBU, Central Bank of Hungary

No doubt, the IMF mission will indicate the safety buffer on foreign reserves is slim. Even in the case of Hungary (gross reserves 4.8 months of imports), the Fund posed the need to increase gross reserves to avoid currency risks. Against this backdrop, Ukraine's gross reserves issue is expected to be named among the key impediments to resuming cooperation.

'Disease' dictates remedy: BoP problem takes the lead for Ukraine

The list of commitments the IMF requires from applicants has very strong reasoning. For instance, Hungary had been running a very high state debt before the crisis (67% of GDP in 2007). Apparently, the main IMF requirements (on the top of banking sector problem-solving) have been related to managing this debt and fiscal austerity.

Ukraine's picture is a bit different. State debt is at quite safe levels (36.1% of GDP in 2012). The balance of payments problem (with the 2012 C/A deficit being at 7.6% of GDP) and fast-shrinking gross reserves became the key issue.

At this backdrop, we should expect the IMF will update its remedy for Ukraine's bottlenecks by repeating the recommendations ignored till now (gas rates, monetary policy) and adding a requirement to find a way to cope with the shrinking C/A deficit and replenish gross reserves.

Currency peg not a problem for IMF, except in Ukraine's case

The IMF does not have any preferences on exchange rate regimes its debtors employ. If Western economists had been previously more sympathetic to floating currency rates, the 2008-09 experience shows that pre-determined depreciation on the heels of shrinking world trade (like in Hungary and Ukraine) does not necessarily bring noticeably better results than in the case of a currency peg (like with Latvia and Bulgaria).

Against this backdrop, the IMF considers each situation separately and is flexible to authorities' preferences, as long as it sees a realistic problem-solving plan to agree on a suggested policy choice. For instance, the IMF accepted a currency peg for Latvia because the country aimed to join the euro zone, which meant that it would eventually have a free-floating currency.

For Ukraine, the Fund will not insist on changing the exchange rate regime only in case the government explains in what way (if not with the exchange rate) the balance of payment problem will be solved and what is the plan to replenish gross reserves. Allowing the hryvnia to fall looks like the only solution within the given time constraints.

Ukraine can hardly avoid strong commitments

Ukrainian authorities will be seeking to have external funds for rollover 2013 redemptions with the minimum possible reform commitments to the IMF. With the steps necessary for Ukrainian authorities outlined below, we are considering only the February IMF talks:

- **Check risk appetite:** The first obvious step is to check how sufficient demand will be for Ukraine's Eurobonds if no IMF deal results in February. Our own investigation showed that there will be some demand but it will narrow once no progress with the IMF is observed. We expect the authorities reached a similar conclusion when probing the market (Deputy PM Serhiy Arbuzov visited the US to talk to at least one private fund two weeks ago);
- **Prepare positive messages:** Drawing some surprise, Prime Minister Mykola Azarov stated in January the Cabinet of Ministers is ready to raise natural gas tariffs on the wealthier to reach an IMF agreement. The goal of such statements is to build a dialogue with the IMF and to give Eurobonds holders a positive signal about potential cooperation. This simple move against the backdrop of high risk appetite globally should secure the government's access to debt market for till the next visit of the IMF mission (March-April, we believe);
- **Commitments:** Since the macroeconomic situation is unlikely to improve that fast and IMF redemptions are scheduled for every quarter, the Cabinet is doomed to commit to a few painful policies the IMF is requesting. Unfortunately for Ukrainian authorities, public statements about possible policy decisions are not the same as strong commitments to engage in these policies.

In this respect, merely general positive messages about the government's readiness to engage in policies would be sufficient for the market in February. But to keep the parties satisfied, the IMF will ask the Cabinet to commit on some "structural benchmarks" that should be met already by April.

Playing the Hungarian game
As a benchmark for analyzing Ukraine's case, we took recent examples from the IMF negotiations with the Hungary government, which applied for IMF funding again in late 2011 to rollover its IMF peak redemptions (USD 4.8 bln due in 2012 and USD 5.7 bln in 2013). Despite a delay in concluding the new standby program in 2012, Hungary managed to keep "constructive talk" going with the Fund in what was received positively by the market. As a result, the Hungarians managed to arrange a few successful Eurobond placements (EUR 1.0 bln in November 2012 and EUR 0.5 bln in January 2013). We believe Ukraine might try to deal similarly with the Fund.

But Ukraine is not Hungary…
To a large extent, the positive story of Hungary was defined by a resumed quantitative easing policy in the US. Abundant liquidity made investors turn a blind eye on the long, drawn-out "constructive talks." Ukraine benefited from improved liquidity in 2012 as well, despite holding no talks with the IMF at all.

Yet in each case investors had additional reasoning (except abnormal liquidity) to continue buying state securities:

- In the case of Hungary, the macro situation was already quite stable: C/A surplus (1.6% of GDP in 2012), sufficient gross reserves (4.8 months of imports as of end-2012), declining state debt (down to 75.5% of GDP from

77.7% a year ago). This made investors optimistic about the country's solvency.

- In the case of Ukraine, there was a strong assumption that the IMF program will be resumed shortly after parliamentary elections. Sliding industrial production (-1.8% yoy in 2012), an expanded C/A deficit (to 7.6% of GDP) and melting gross reserves (to 2.8 from 3.9 months of imports during the year) made it logical to expect that an IMF deal was inevitable after the elections.

At this backdrop, we can hardly expect Ukraine enjoying unlimited access to financial markets if its talks with the IMF fail.

IMF has a "not to harm" position

The strategic mission presumes that the Fund "*secures financial stability … promotes sustainable economic growth and reduces poverty around the world*". In this respect, overarching economic hardships made the Fund adjust it traditional problem-solving tools and treat creatively every specific case.

Also taking on the role of a careful surgeon, the IMF has been trying, firstly, not to harm, and only after that to encourage a country towards conducting structural reforms, sometimes painful.

No deal for nothing

The Fund's flexibility shouldn't be overestimated. From various countries' experience (including Ukraine), we see that the IMF can listen to reasonable arguments as to why some painful policies cannot be implemented in full. Still, the Fund will request a doable but ambitious plan for solving existing problems and will not agree "for deal" just for nothing.

Key macro indicators, Ukraine vs. Hungary

	2006	2007	2008	2009	2010	2011	2012*
GDP, USD bln*							
Hungary	112.5	135.9	154.5	126.7	127.8	138.8	126.0
Ukraine	107.8	142.7	180.0	117.2	136.4	165.2	178.8
Exchange rate							
HUF/USD	210.5	183.8	171.8	202.3	208.1	200.9	225.4
UAH/USD	5.1	5.1	5.3	7.8	7.9	8.0	8.1
Gross reserves, USD bln							
Hungary	21.6	24.0	33.9	44.2	45	48.8	44.7
Ukraine	22.4	32.5	31.5	26.5	34.6	31.8	24.5
Gross reserves, months of import							
Hungary	2.9	2.6	3.2	5.8	5.3	5.0	4.8
Ukraine	5.0	5.4	3.8	5.7	5.7	3.9	2.8
C/A balance, USD bln*							
Hungary	-8.3	-9.9	-11.3	-0.3	1.4	1.2	2.1
% of GDP	-7.4%	-7.3%	-7.3%	-0.2%	1.1%	0.9%	1.6%
Ukraine	-1.6	-5.3	-12.8	-1.7	-3.0	-10.3	-13.6
% of GDP	-1.5%	-3.7%	-7.1%	-1.5%	-2.2%	-6.2%	-7.6%
Public debt, % of GDP*							
Hungary	65.5%	67.0%	72.9%	79.7%	81.3%	77.7%	75.5%
Ukraine	14.8%	12.3%	20.0%	34.7%	39.9%	35.9%	35.8%
Gross external debt, % of GDP*							
Hungary	90.4%	104.6%	116.8%	149.9%	141.7%	140.6%	136.7%
Ukraine	50.6%	56.0%	56.5%	88.2%	86.0%	76.4%	74.1%

** - estimates for 2012*

Source: IMF, NBU, UkrStat, Central bank of Hungary, Concorde Capital estimates

Contacts

CONCORDE CAPITAL
2 Mechnikova Street, 16th Floor
Parus Business Centre
Kyiv 01601, Ukraine
Tel.: +380 44 391 5577
Fax: +380 44 391 5571
www.concorde.ua
Bloomberg: TYPE CONR <GO>

CEO
Igor Mazepa im@concorde.com.ua

SALES

Sales & Trading
Rostyslav Shmanenko rs@concorde.com.ua
Andriy Gerus ga@concorde.com.ua
Yuri Tovstenko ytovstenko@concorde.com.ua
Maksym Slobodskiy sm@concorde.com.ua
Katerina Shevchenko ksh@concorde.com.ua

RESEARCH

Head of Research
Alexander Paraschiy ap@concorde.com.ua

Agriculture, Consumer, Utilities
Alexander Paraschiy ap@concorde.com.ua

Machinery, Oil & Gas
Roman Dmytrenko rd@concorde.com.ua

Metals & Mining
Roman Topolyuk rt@concorde.com.ua

Economics, Fixed income
Alexander Paraschiy ap@concorde.com.ua

Politics
Zenon Zawada zzawada@concorde.com.ua

Editor
Zenon Zawada zzawada@concorde.com.ua

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