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Q&A on Ukraine's balance of payments & hryvnya

Challenges linger, but no major shocks in sight

First Deputy Prime Minister Valeriy Khoroshkovsky admitted last week the country's standby loan facility with the IMF can only be unlocked after October's parliamentary election. In addition, little progress on negotiations with Russia implies a new gas deal is unlikely in the next couple of months. Our conservative base case macro scenario "no gas deal, no IMF money this year" is turning into a reality. We projected that in 2012 Ukraine will face an external financing gap of USD ~7.1 bln (3.8% of GDP) due to weak external commodity and debt markets. The NBU should still be able to keep the hryvnya stable vs. the US dollar via the sale of reserves. We note that 1Q12 data on NBU reserves (which declined a mere 2% qoq) were better than we expected and we think that the risks to our aforementioned projections are to the upside. We provide our view on the 2012 balance of payments, the hryvnya, the effects of the IMF program being frozen and other related issues in Q&A form.

What is your base case scenario for balance of payments (BoP) and exchange rate for 2012?

We project Ukraine's current account (C/A) deficit will widen to 6.3% of GDP (USD 11.9 bln) in 2012 while Ukraine's external financing needs (combined C/A and financial account balances) will amount to USD 7.1 bln this year. The NBU will step in to defend the hryvnya at the current level via the sale of reserves and will manage to keep the hryvnya broadly stable through 2012. With no new IMF money expected this year, NBU reserves can decline to USD 22 bln (-30% yoy) by end-2012, according to our projection.

Balance of payments and NBU reserves, USD bln

	2008	2009	2010	2011	2012E
C/A balance	-12.8	-1.7	-2.9	-9.0	-11.9
% of GDP	-7.1%	-1.4%	-2.1%	-5.5%	-6.3%
Financial account balance	9.7	-12.0	7..9	6.6	4.8
% of GDP	5.4%	-10.2%	5.7%	4.0%	2.6%
External financing needs*	-3.1	-13.7	5.0	2.4	-7.1
NBU reserves	31.5	26.5	34.6	31.8	22.1

** Positive numbers indicate an external financing surplus*

Source: NBU, Concorde Capital

Wouldn't a meltdown in NBU reserves to USD 22 bln instigate capital flight, adding risks to your projections?

This is indeed the key risk to our projections (though hardly quantifiable) that we highlighted previously. The economy's vulnerability to external and domestic shocks will stay high through 2012 and any major event against the backdrop of melting reserves is likely to trigger capital flight. However, after 1Q12, we are much more optimistic about the remainder of 2012 – we now see our base estimate of a 30% fall in reserves as a worst case scenario only. The NBU has demonstrated its ability to restrain large-scale FX speculation and keep cross-border capital flows under control, even though that involves administrative measures.

What is distinguishing about 1Q12 data?

1Q12 data was better than we expected – the FX market was broadly balanced in 1Q12, suggesting the C/A deficit was almost offset with capital inflows so far. NBU reserves were down a reasonable 2.1% (USD 0.6 bln) over 1Q12. Moreover, in March, the NBU saw its reserves grow for the first time since August despite a USD 1.3 bln gas bill paid by Naftogaz.

What has supported the financial account so far?

In 2M12 (latest available data), the financial account was supported by strong debt capital inflows into the corporate sector (which more than covered redemptions of external debt by banks) and hefty FDI (+82% in 2M12). Also in 1Q12, a new instrument emerged for replenishing government FX holdings (and NBU reserves), local FX-denominated bonds. The new papers turned out a success, with the government raising net USD 0.9 bln YTD via their sale.

What is the further potential to raise FX-denominated debt domestically?

We think the potential is vast and the government should be able to sell another net USD 1.3-1.7 bln in FX-denominated debt locally by end-2012. With the ban on FX lending still in place, banks are channeling part of raised FX deposits into local FX bonds, given that yields remain attractive (1.5-year bonds yield 9.3%).

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What are the risks to your C/A deficit projection?

We see three major risks:

- Strong growth in household income. Retail trade surged 13% in real terms in 2M12, pointing to continued strength in domestic demand. Yet, we think growth in real income is likely to subside moderately by end-1H12 as the economy slows.
- Higher-than-projected gas imports. We expect Ukraine will counterbalance a 34% yoy hike in the price for gas by slashing imports 24% yoy to 34 bcm in 2012 (and using leftovers from the previous period) to keep its full-year bill broadly unchanged at USD ~14.5 bln. We do not exclude that the government will purchase larger volumes to maintain a hefty stock in storage ahead of the 2012/13 heating season.
- Weakness in the steel market. We assume prices for Ukraine's steel will be 5-10% yoy lower in 2012 and current developments are in line with our projections so far. However, given lingering weakness in EU markets, a further correction in steel prices should not be ruled out completely.

Is renewal of Ukraine's IMF program critical given the sizable external financing gap projected for 2012? What are the consequences if the program remains frozen?

Resumption of the program is highly desirable. The key benefit of renewal of the IMF program would be an improvement in investor perception of Ukraine and a related decline in the cost of new borrowing for both the government and the private sector. We think that even without an active IMF program, the government should still be able to raise debt on international markets or attract bilateral loans, albeit with a hefty risk premium to lenders. Recent news of Naftogaz raising a USD 2.0 bln facility at 11% p.a. from Russia's Gazprombank clearly illustrates the case – new money is available but only at punitive rates.

Does hryvnya stability hurt exporters?

Yes. While the hryvnya has stayed broadly stable vs. the US dollar in nominal terms since early 2009, it has appreciated 7% vs. the basket of currencies of Ukraine's key trading partners (based on NBU calculations) over the last three years. At the same time, the real effective exchange rate (REER) of the hryvnya (the metric that accounts for changes in nominal exchange rates and differences in inflation in Ukraine and its partner economies) appreciated 13% over the period, thus almost fully reversing the 15% fall over 2008. Needless to say, local producers became less competitive internationally on pricing.

What would the effect of hryvnya depreciation be on the BoP?

A weaker hryvnya should quickly help narrow the C/A gap. We also think the hryvnya's fall would trigger inflows of debt capital into Ukraine's corporate sector and local government bonds. Interest on UAH-denominated debt (both sovereign and corporate) is attractively high but investors are held back by fears of FX losses and remain in a "wait and see" mode. Hryvnya depreciation of 10-15% would likely create a "the worst is behind" perception of the Ukrainian economy and alleviate many concerns.

So why have the NBU and government been prioritizing hryvnya stability?

The legacy of the Ukraine's pre-crisis lending boom is that most retail loans are still FX-denominated while household income is mostly in hryvnyas. Depreciation will hurt leveraged households and the need to protect them seems to be the NBU's key rationale for defending the hryvnya, especially given this is an election year. Also the current government apparently wants to demonstrate it is much more effective in keeping the hryvnya stable than its predecessors, who did not prevent a 40% fall in late 2008. For right or wrong reasons, the hryvnya's stability vs. US dollar has traditionally been a domestic economic policy priority – any major fluctuations in the UAH:USD exchange rate have been treated as NBU failures. A weaker hryvnya would also imply significantly higher costs of external public debt servicing and a surge in Naftogaz's financial gap – but these considerations are of lesser importance at this point, in our view.

What are exchange rate expectations domestically?

Expectations of hryvnya depreciation in Ukraine have faded considerably in the last couple of months: net monthly purchases of foreign currencies by the population averaged USD 0.5 bln in 2M12, down 60% from 4Q11. Another sign that confidence in the hryvnya remains robust is that growth in hryvnya retail deposits has been notably outpacing growth in FX facilities YTD.

What could be the key short-term drivers of hryvnya volatility in 2Q12?

FX outflow from banks into the cash market has usually been a major factor behind FX market instability. Thus, abrupt changes in the sentiment of the population or business might spur an upsurge in demand for FX cash, prompting higher exchange rate pressure. However, we do not see any such major triggers emerging in the coming months. Also the FX cash market should be supported with spending by tourists during the Euro-2012 football championship to be held in June.

What is the most likely post-election exchange rate scenario?

We do not believe in a pre-determined post-election scenario for the hryvnya. At the same time, it is highly likely that the NBU will take a step toward greater hryvnya flexibility after the election by widening the UAH:USD fluctuation band to 4-5% around the 8.0 level from an effective +/-0.5% now. We see high chances of the hryvnya remaining stable in 4Q12 should the global commodity and debt markets improve by that time.

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