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Desk Note

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State budget 2014

Spending Russian money

Alexander Paraschiy
ap@concorde.com.ua

The 2014 draft state budget submitted to parliament on Dec. 19 was predictably unrealistic. The state collection plan was overrated by at least UAH 20 bln, the privatization revenue plan of UAH 17 bln is not feasible given the approaching presidential elections, and the budgeted UAH 14.9 bln in financing of Naftogaz accounts for only covering its working capital needs, with no cash for repayment of its 2014 Eurobonds foreseen. However, the budget's shortcomings are irrelevant given the backing gained last week of up to USD 12 bln in loans from the Russian government, which will be more than enough to cover the 6% of GDP (more than UAH 100 bln) fiscal gap that we are projecting for 2014.

State budget stats, UAH bln

	2013E	2014 plan	yoy
Revenues	349.1	392.4	12.4%
Spending	408.3	447.3	9.6%
Deficit	59.2	59.5	0.6%
% of GDP	4.1%	3.6%	-0.5pp

Public debt, year-end, UAH bln*

	2013E	2014 plan	yoy
Total	573.1	616.2	7.53%
% of GDP	39.8%	37.3%	-2.5pp
External	272.1	279.0	2.5%
Internal	301.0	337.2	12.1%

Source: Verkhovna Rada, MinFin, Concorde Capital estimates

Tax base overrated by UAH 100 bln

The 2014 draft budget is built on optimistic assumptions. The projected 3% growth in real GDP (and 14.8% growth in nominal GDP) does not look feasible, given that growth this year will be negative (-0.8%, we estimate) and no solid recovery in external markets is expected. We project 1% GDP growth for Ukraine in 2014. Inflation (the Cabinet projects 4.3% CPI growth) also is not expected to speed up that strongly: a good grain harvest in 2013 will keep prices low, utility and electricity tariffs are frozen, and no hryvnia volatility is expected if Russia provides macro financing for Ukraine. As a consequence, the outlined tax base (UAH 1,653 bln nominal GDP) is at least UAH 100 bln above the realistic target (we project UAH 1,550 bln).

State collections target foresees UAH 20 bln shortfall

We expect state revenue to reach UAH 349 bln in 2013, or just 1% higher yoy (11M13 collections increased 1%) – a big contrast to the 2013 plan of +6.9%. yoy. The 2014 collection plan (UAH 392.4 bln), therefore, implies almost 12% yoy growth in revenue, which looks very ambitious given the tough economic situation. We expect that state revenue growth will be not higher than nominal GDP growth (or +6% yoy, based on our estimate). The 2014 state budget revenue, therefore, looks overestimated to us by at least UAH 20 bln.

Deficit to be covered from Russian loans

Despite the planned 2014 state deficit (UAH 59.5 bln) expected to be flat vs. the cash state deficit of UAH 59.2 bln expected in 2013, there is no realistic plan for its funding from internal sources. The Cabinet targets to generate UAH 17 bln from privatization in 2014, which will be hardly possible in view of it being a pre-election year (this year, privatization bought only UAH 1 bln, vs. the plan of UAH 10.9 bln). Such unrealistic deficit funding implies that authorities will heavily rely on Russian loans (up to USD 12 bln in 2014) to cover the outlined deficit and estimated revenue shortfall.

Naftogaz targets 1.0% GDP deficit, while its 2014 needs are 2x higher

The Cabinet estimated Naftogaz's deficit from low gas tariffs at UAH 14.9 bln in 2014 (and this already accounts for an expected 33% gas discount from Russia). The gap is planned to be traditionally covered by a state bond contribution to Naftogaz equity, and the company will likely pay for imported gas from these contributions. Interestingly, a month ago a MinFin official stated that the government will pump into Naftogaz UAH 14.8 bln in equity to enable it to repay its Eurobonds maturing in September 2014. As we understand, the latter payment is not included in the draft state budget.

Fiscal gap to exceed 6% of GDP
With the stipulated 2014 budget deficit of UAH 59.5 bln, Ukraine will likely have a final deficit of above UAH 100 bln (6% of GDP). That includes UAH 20 bln in an estimated state revenue shortfall, UAH 14.9 bln refunding for Naftogaz and UAH 5.0 bln refunding for the Ukrainian Bank of Reconstruction and Development. And this may also require an additional UAH 14.8 bln in funding for Naftogaz to help it repay its Eurobond.

Tax reform postponed
The tax reform earlier planned for 2014, consisting of a VAT tax rate cut (to 17% from 20%) and corporate income tax cut (to 16% from 19%) has been postponed in the budget plan. The Cabinet only agreed to a corporate income tax of 18% in 2014. Still, the cut does not offer any benefits due to peculiarity of the tax administration: corporate income tax is paid each quarter in advance and the size of the tax cannot be less than the amount paid for the same quarter a year before.

Modest populism returns
Social outlays will increase and the government even added an overtly populist, pre-election maneuver of UAH 6 bln in compensation of deposits lost during the Soviet collapse. Still, we can see that the acceleration in social spending is quite modest: the minimum wage and the subsistence levels will both increase 8.1%, vs. their growth of 5.0% and 6.8% respectively in 2013. This limited social spending boost is only a provisional plan and will likely be revised upwards if state collections are better, or Russian loans are secured as promised.

Promissory notes to be used
The draft budget outlines the possibility to cover state liabilities with promissory notes. There is no clear number on possible limits of promissory note use. However, we noticed that the Cabinet cut its 2014 VAT refunding plan by UAH 6.1 bln despite the declared official intention to increase exports. Most likely, the plan for the heavy use of promissory notes can justify such numbers.

Pension fund deficit almost unchanged
The pension fund subsidy increased modestly, only 5.0% yoy (up to UAH 87.4 bln) vs. 29.1% yoy a year ago. That’s a positive development in terms of fiscal prudency; however, it is not typical to see such parsimony during a pre-election year. Most likely, we should expect a revision to boost pension spending closer to the year end.

Russia’s support might be much smaller than announced
Russian President Vladimir Putin said on Dec. 17 that he could arrange for a loan of up to USD 15 bln for Ukraine, stating that the funds could be drawn from the National Welfare Fund. In his turn, Russian Finance Minister Anton Siluanov said the Fund cannot invest more than 10% of its NAV into Ukrainian bonds. Given that the Fund’s official NAV is USD 86.9 bln as of Dec. 1, 2013, and taking into account that Russia has already allocated USD 3 bln into Ukrainian bonds this year, the maximum amount that Russia’s Fund can provide to Ukraine next year is USD 5.7 bln. That might not be enough for Ukraine to address all its macro challenges in 2014. Most likely, Russia will have to find other sources to finance Ukraine’s government, and Ukraine will have to give some tangible (economic or political) concessions to secure the financing from “other” Russian sources.

Key budget stats

Revenues and spending, UAH bln

	Target 2013	2013 Expected	Target 2014	2014 Target / 2013E
State budget revenues	370.0	349.1	392.4	12.40%
% of GDP	23.48%	24.24%	23.74%	-0.5pp
State budget spending	419.3	408.3	447.3	9.55%
% of GDP	26.61%	28.35%	27.06%	-1.3pp
State budget deficit	50.6	59.2	59.5	0.58%
% of GDP	3.21%	4.11%	3.60%	-0.5pp
General budget revenues	488.2	451.5	499.0	10.51%
% of GDP	30.98%	31.35%	30.18%	-1.2pp
General budget spending	549.6	523.7	562.9	7.49%
% of GDP	34.87%	36.37%	34.05%	-2.3pp
General budget deficit	61.4	72.2	59.5	-17.48%
% of GDP	3.90%	5.01%	3.60%	-1.4pp
Pension Fund subsidy	83.2	83.2	87.4	4.96%
% of GDP	5.28%	5.78%	5.28%	-0.5pp
Incl. Pension Fund deficit coverage	21.8	21.8	22.1	1.49%
% of GDP	1.38%	1.51%	1.34%	-0.2pp

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

Deficit financing, UAH bln

	2013E	Target 2014	yoy
State budget deficit	57.9	54.9	-5.20%
State loans	1.3	1.2	-7.69%
Total deficit to cover	59.2	59.5	0.58%
% of GDP	4.11%	3.60%	-0.5pp
External funding, net	-4.1	6.9	-270.13%
- New loans	48.6	43.2	-11.19%
- Repayments	52.7	36.3	-31.10%
Internal funding (net)	43.4	55.7	28.29%
- New loans	88.9	114.9	29.27%
- Repayments	45.5	59.2	30.20%
Privatization proceeds	1	17	17x
Public debt, year-end	573.1	616.2	7.53%
% of GDP	39.80%	37.28%	-2.5pp
External debt, year-end	272.1	279.0	2.53%
% of GDP	18.90%	16.88%	-2.0pp
Internal debt, year-end	301.0	337.2	12.05%
% of GDP	20.90%	20.40%	-0.5pp

Source: Verkhovna Rada, MinFin, UkrStat, 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

Andriy Gerus ga@concorde.com.ua
Alexandra Kushnir ak@concorde-group.eu
Yuri Tovstenko ytovstenko@concorde.com.ua
Alisa Tykhomirova at@concorde.com.ua

RESEARCH

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

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

Machinery
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