Ukraine Debt:

No cheap solutions for big fiscal gap

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Executive summary

Ukraine's budget requires debt financing of its deficit of about USD 16.4 bln in 2020-2021, according to our estimates. It will be a challenge to raise such debt, of which just USD 3.1 bln was attracted in 9M20. The remaining USD 13.3 bln in financing needs for the next 15M is equivalent to the amount that was raised in the previous 70 months.

The good news is that Ukraine's external debt repayment schedule for the next 15M is not tight (USD 3.8 bln), while most of the local debt (perhaps excluding USD 1 bln) can be easily rolled over.

What's negative is that Ukraine is going to cancel its limits on state guarantees for 2021 (as it did in 2020) and is coming back with debt issues for bailing out state companies.

Broadly speaking, **there are two mutually exclusive options** to finance the coming financial gap:

1. **Market & IFI financing**, via cooperation with Western financial partners (which can cover USD 1.4-3.4 bln of net needs), plus attractions from local banks (USD 2.4-3.1 bln) and foreign private creditors (up to USD 10 bln).
2. **Emission financing**, which looks like an alternative option that is not compatible with the first one. It will likely (but not necessarily) imply the loss of the NBU's independence and the spoiling of Ukraine's relationship with IFIs, thereby closing a window for international financing. If so, this will require emissions of the local currency in the equivalent of up to USD 15 bln (10% of GDP) or some combination of a lesser emission and debt restructuring.

The first option will require some steps that might be considered to be inappropriate by power brokers:

- The soon recovery of IMF cooperation, which is easier said than done:
  - Agree with the IMF and vote for the budget deficit for the next year (MinFIn has proposed 6.0% of GDP, while the recent IMF memorandum assumes 5.3%). The process itself might be time-consuming.
  - Resolve issues related to the rollback of anti-corruption reform (recall, the government has taken steps to undermine the legality of NABU director and select an anti-corruption prosecutor "inappropriate" for IFIs. So far, it's not clear what steps will be enough for the IMF and the EU officials to relieve their concerns.
- Remain consistent with IFI expectations on monetary policy, which is not very popular among power brokers.
- Be ready to increase rates on local and/or international bonds. This might be in conflict with the president's desire to see single-digit lending rates in the banking system.
- Be ready for revaluation pressure on the hryvnia, in case the local bond market will be reopened for foreigners (this is also in conflict with top power brokers' view on the market).

The second option requires less intellectual work in the short term and allows for fully removing the government's dependence on "external supervisors," which is a popular idea in and of itself. It will also allow to keep lending rates at low levels, at least in the nearest future, though the macroeconomic consequences of such a move could be negative. Also, such a move might imply the refusal of any external lending, which will automatically raise the question of the need to smoothly service external debts.

So far, we see that the first option is more likely, though time is working against this vision:

- Any delay in negotiations with IFIs increases the need to implement "simple moves" to finance the deficit.
- Nearly each week, the government makes another bold imprudent move that raises the concerns of Western partners.

Also, the entire fact that the state budgets for 2020 and 2021 assume domestic financing of the deficit for a fantastic sum of UAH 369 bln (or UAH 278 bln, based on our adjusted deficit numbers) – without clear straightforward sources of such financing (and the fact that only UAH 22 bln was raised net in 9M20) – speaks to the government leaving open an emission financing option.

Ukraine state debt, eop

	2019	9M20E	2020E	2021E
State debt USD bln	74.4	72.7	78.0	85.8
% of GDP	44%	52%	57%	55%
State & guaranteed, USD bln	84.4	82.7	88.0+	95.8+
% of GDP	50%	59%	64%+	62%+

State debt as of Sept. 30, 2020, USD bln

Domestic debt	30.9
- Local UAH bonds	26.7
- - Held by NBU	11.5
- - State banks (recap)*	6.9
- - "Free float" bonds	8.3
- - - State banks	2.8
- - - Private banks	1.7
- - - Nonresidents	2.9
- - - Other	0.9
- Local Eurobonds	4.1
- - - State banks	3.0
- - - Private banks	0.6
- - - Nonresidents	0.1
- - - Other	0.5
Other	0.1

External debt	41.8
- Internatinal bonds	22.7
- - US (AID) bonds	1.0
- - "Russian" bonds	3.0
- - Other bonds	18.7
- IFIs	14.4
- Other	4.7

We see the rates on Ukraine sovereign bonds will increase in the near future:

- **If the first option works, the supply of new bonds will be massive. Also, foreign private creditors will have a chance to take advantage of being the biggest hope in financing the state gap, by demanding higher rates on new placements.**
- **As the second option should not be ruled out, this raises Ukraine's sovereign risk, requiring higher rates.**

What to expect in the near future:

- A likely delay of an IMF deal might force MinFin to issue a new Eurobond and downgrade its budget expenditure plan to reduce the 4Q20 financing gap.
- MinFin to increase rates on short-term local bonds, in order to increase demand from banks (if the NBU does not cut the key rate) and to significantly increase rates on mid-term local bonds to make them attractive again for nonresidents.
- Watch for possible changes in NBU monetary policy.

** Bonds that state banks received from MinFIn as contribution to their equity.*
Source: NBU, MinFin, Concorde Capital estimates

Summary of state budget gap financing

Ukraine's **state financing gap**, based on budget plans, is USD 20.0 bln for 2020-2021, which we estimate can be realistically reduced to USD 16.4 bln, of which **USD 13.3 bln** needs to be raised in **4Q20-2021**.

However, it will be a challenge to finance such a gap, especially taking into account that in 9M20, the potential two-year gap had been financed by only USD 3.1 bln (or 19%).

- **External debt plan looks easy**. The plan implies net USD 4.5 bln **(gross USD 8.3 bln)** borrowing in 4Q20-21:
    - **USD 2.5 bln** has been "nearly secured" to be taken from the **IMF, World Bank** and **EU**.
    - Being able to raise another IMF tranche (**USD 0 to 0.7 bln**) and other conventional debts for **USD 0.7-2.0 bln**, Ukraine will need to finance a gross amount of **USD 3.1-5.1 bln** (or net USD 1.1-3.1 bln) from **Eurobond** placements in the next 15M (in the last 15M, gross Eurobond placements were USD 4.4 bln).
- **But its timing could be challenging** as the government relies on the IMF/EU/WB as its sole external source to finance the budget deficit for the remainder of 2020. But to get disbursed the "nearly secured" amounts, Ukraine will have to agree with the IMF on two painful items: anti-corruption reform and the next year's budget. This could be time-consuming, so it might happen that Ukraine will have to seek urgently for alternative sources by end-2020
- **Local debt plan looks challenging.** The remaining **USD 8.8 bln** of the 15M gap is implicitly planned to be financed internally (with a local bond issue). Among the key local bond holders, the NBU and nonresidents are not buying now, with at least USD 0.4 bln and USD 0.3 bln of bonds they hold maturing in the next 15M.
    - The potential of local banks to buy bonds is limited to UAH 70-90 bln (**USD 2.4 – 3.1 bln**), we estimate.
- **To cover the remaining net USD 5.7- 6.4 bln gap in 4Q20-2021**, the government will have to:
    - A - reduce the budget deficit, which will be politically hard to implement.
    - X - issue more international bonds.
    - Y - attract foreigners to local bonds.
    - Z - secure support from the central bank (a kind of QE).

If options A and Z are excluded, the part of "internal debt" in the amount of USD 5.7-6.4 bln (plus the NBU's USD 0.4 bln in bonds that won't be rolled over) should be financed by private foreign creditors. If so, the **total 15M supply of local & international bonds to private foreign creditors could reach a net amount of USD 7.2-9.9 bln (gross USD 9.5-12.2 bln).**

Foreign creditors, therefore, can become the most critical contributors to Ukraine's budget financing.

The most dangerous alternative option to finance the budget's gap is a purchase of local bonds by the NBU, either **directly on the secondary market** (which will question the NBU's independence and could spoil Ukraine's relationship with the IMF) or **indirectly via state banks** (which could be even worse, as that will raise questions on the independence of not only the NBU, but also of state banks, illustrating a reversal of their corporate governance reform).

- If so, IFI money is unlikely to come, nor will other international creditors. Total financing via "QE" might increase up to USD 15 bln (if non-residents won't be able to sell local bonds) or more in the next 15M. As a sub-option here, Ukraine can decide to avoid repaying some of its international debt.

Ukraine state budget deficit

	Deficit	Financing of deficit		
	2020-21	2020-21	9M20 fact	4Q20-21
Planned, UAH bln	569	560		
Planned, USD bln	20.3	20.0		
- Incl. external debt, USD bln		6.8		
Adjusted, UAH bln	486	469	82	387
Adjusted, USD bln	17.3	**16.4**	**3.1**	**13.3**
- Incl. external debt, USD bln		6.8	2.3	4.5

Sources of budget gap financing, USD bln

	2019	9M20	4Q20 - 2021 Implied needs	4Q20 - 2021 Possible sources
Net state debt raised	**2.9**	**3.1**	**13.3 - A**	**6.2…6.9 + X + Y + Z**
gap				**7.1…6.4** - A - X - Y - Z
External	**-0.4**	**2.3**	**4.5**	**4.5 + X**
IMF	-0.7	1.6		0.0…0.7
Other	0.5	0.5		1.4… 2.7
Eurobonds	-0.2	0.2		3.1…1.1 + X
Internal (local bonds)	**3.3**	**0.8**	**8.8**	**1.7…2.4 + Y + Z**
Other	0.4	0.1		0.0
Banks	-0.9	2.5		2.4…3.1
NBU	-0.4	-0.5		-0.4 + Z
Nonresidents	4.2	-1.2		-0.3 + Y

Possible contributors to gap financing (if A & Z = 0), USD bln

	2019	9M20	4Q20 - 2021E
Domestic banks (local bonds)	-0.9	2.5	2.4…3.1
IMF	0.0	1.6	0.0…0.7
NBU, EU & other	-0.6	0.0	1.0…2.3
Foreigners (local & int'l bonds)	4.0	-1.0	9.9…7.2
Total	**-0.4**	**3.1**	**13.3**

Possible contributors to gap financing (if A =0. & Z > 0), USD bln

	2019	9M20	4Q20 - 2021E
IMF	-0.7	1.6	-0.7…0.0
Other external	0.5	0.5	-1.1…0.7
Banks & nonresidents (local bonds)	3.3	1.3	-0.3…1.3
NBU	4.0	-1.0	15.4…11.3
Total	**-0.4**	**3.1**	**13.3**

Source: MinFin, NBU, Concorde Capital estimates

Unprecedented budget deficits and planned sources of their financing

After planning a record-high budget deficit of UAH 298 bln (USD 11 bln, or 7.5% of GDP) in 2020, Ukraine's government has planned another sizeable deficit for the next year, or UAH 270 bln (USD 9 bln, or 6.0% of GDP).

The recent history of budget planning, as well as recent improvements in economic activity, allows us to estimate that the actual budget deficit for 2020 and 2021 will be smaller, or 6.2% and 5.3% of GDP, respectively:

- The total amount of the budget deficit, therefore, will likely reach UAH 486 bln in 2020-2021, of which it's possible to finance about UAH 16 bln from privatization proceeds, while the rest – UAH 469 bln, or USD 16.4 bln – can only be financed by raising state debt.
- This is an unprecedented amount, which is equal to aggregate debt financing for the previous six years, in USD terms.

Out of total expected financing needs of UAH 244 bln (USD 8.5 bln) in 2020, Ukraine has secured financing for only UAH 82 bln (USD 3.1 bln) in 9M20. This suggests that:

- In 4Q20, Ukraine will have to seek additional financing of the upcoming budget gap of UAH 162 bln (USD 5.6 bln), which exceeds annual financing for 2015-2019.
- In 2021, Ukraine will have to seek additional financing of UAH 226 bln (USD 7.8 bln).

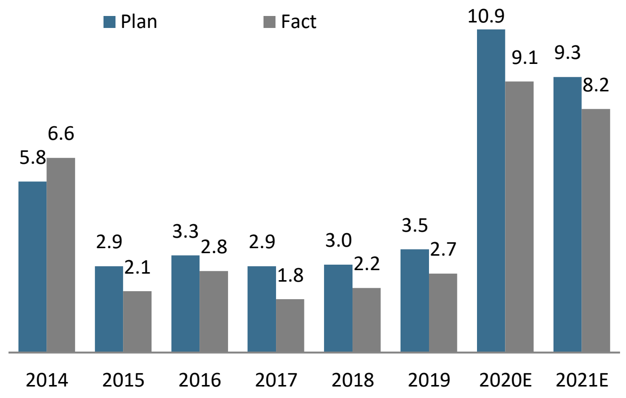
Total budget financing needs for the next 15 months, therefore, amount to USD 13.3 bln.

Of this amount:

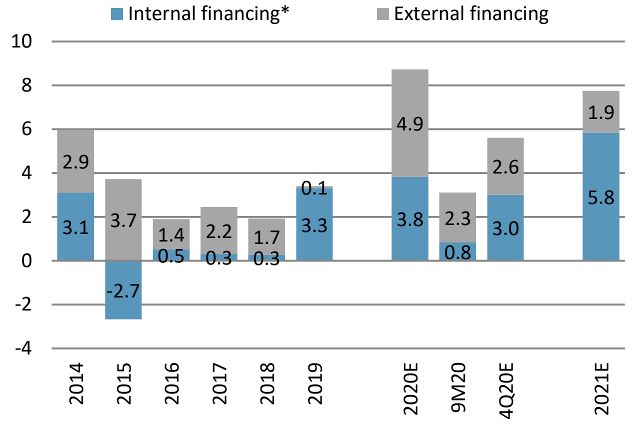
- Only net USD 4.5 bln (or about USD 8.3 bln, including refinancing needs) is planned to be raised on external markets. This is not a big challenge, as majority of such financing can come from the IMF, EU and World Bank. The only challenge here is to find common ground with the IMF as soon as possible, in order to secure planned external financing for USD 2.3 bln by the end of 2020.

- The rest, or USD 8.8 bln (based on our estimates), should to be raised on domestic markets via placement of local bonds. This will be a challenge, taking into account that the key local bond buyers of the past years, the National Bank and international funds, are no longer buying. If they will be passive (not selling), their bonds for at least USD 0.7 bln will mature in the next 15M. That means other potential buyers (local banks) will have to secure demand for at least USD 9.5 bln of local bonds. This is simply impossible, meaning support from non-residents (and in an emergency, the central bank) will be vital. Alternatively, the government may decide to borrow more on international markets (or cut its spending plan).

Ukraine state budget deficit, USD bln



Debt financing of general budget gap, USD bln



* Including local bonds purchased by non-residents
Source: NBU, MinFin, IMF, Concorde Capital estimates

External deficit financing: The plan looks easy, if not for political risk

Unlike the government's plan to finance the deficit via issues of local bonds, the external financing plan looks easy:

- The plan assumes just USD 4.5 bln in net financing in 4Q20-2021.
- Over this period, the government is scheduled to repay USD 3.8 bln of debt…
- … Meaning the total amount to finance the deficit and repay external debt is USD 8.3 bln. This is comparable to the gross amount raised in 9M20 (USD 7.5 bln).

Out of the total amount to be raised, Ukraine has a real chance to get:

- Up to USD 3 bln from the IMF, or more realistically **USD 0.7-1.4 bln** (one or two of the scheduled four SBA tranches).
- EUR 1.2 bln (**USD 1.4 bln**) from the EU under its macro-financial assistance program and **USD 0.4 bln** from the World Bank that is nearly agreed upon.
- About **USD 0.7 bln** (and up to USD 2 bln) of other conventional financing (other multilateral and bilateral loans).

The remainder of external needs for the next 15 months, gross USD 3.5-5.2 bln (net USD 1.5-3.2 bln), can be financed from market placements of international Eurobonds.

The key risk: an IMF deal

A fly in the ointment of such an "easy" plan is that MinFin is "planning" to receive in 4Q20 a lot of funds from external lenders (about USD 2.3 bln), and all this money is related to an IMF deal (USD 0.7 bln IMF tranche, USD 1.4 bln EU loan, plus USD 0.35 bln World Bank financing).

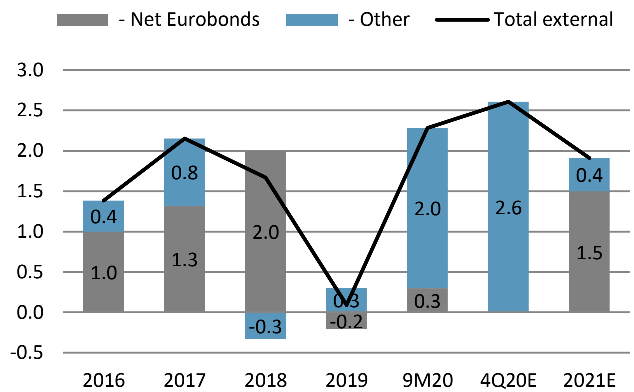
Currently, there are two impediments to a successful IMF deal:

- The 2021 budget plan has not been agreed upon with the IMF. The fund earlier saw Ukraine's 2021 budget deficit at 5.3% of GDP, while the latest budget draft assumes a 6.0% deficit. According to Ukraine's PM, the government is currently discussing with the IMF the ways to reduce the deficit plan. The decrease is technically possible, but politically it's a difficult and time-consuming task. That means the 2021 budget will be approved by parliament later rather than sooner in 2020, and so will be the IMF's positive conclusion on the deal.
- An even more politically painful issue is Ukraine's attempts to step back from anti-corruption reform. In this area, the IMF is likely to wait until the government conducts a transparent selection of the new specialized anti-corruption prosecutor and resolve a deadlock with a status of NABU director (no timing for that is clear).

In case Ukraine is not able to secure a soon IMF deal, it will have to (either or both):

- Significantly downgrade its 2020 budget expenditures
- Try issuing a new Eurobond in late November or December, possibly on distressed conditions.

Government net external financing, USD bln



Scheduled repayments of external debt, USD bln

	4Q20	2021
Int'l Eurobonds		1.96
IMF	0.23	0.48
Other	0.18	0.94

Source: NBU, MinFin, Concorde Capital estimates

Domestic deficit financing: The plan looks tough

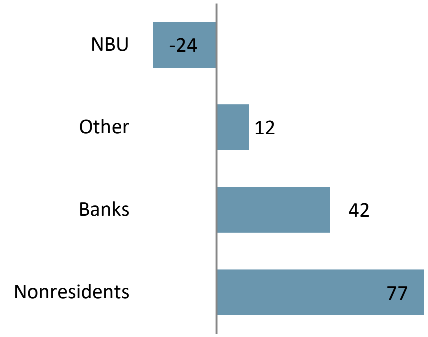
Based on the budget deficit outlook and the government's plan to finance the deficit abroad, we estimate MinFin will have to raise domestically net UAH 278 mln in 2020-2021 (the budget plans for the same period imply UAH 369 bln).

Out of this amount, MinFin raised only UAH 22 bln in 9M20 (8% of all its needs for two years).

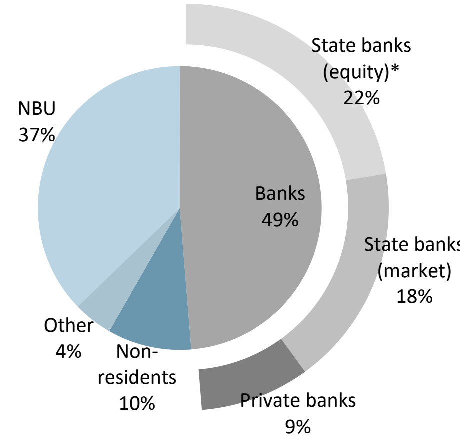
In the next 15 months, it will have to:
- raise net UAH 256 bln and
- rollover ~ UAH 236 bln of the bonds maturing.

Possible sources of financing are:

Net purchase of local bonds, 2019-9M20 UAH bln



Holders of Ukraine local bonds, end-3Q20



NBU:

Not buying currently
The NBU was the most active buyer of local bonds in 2013-2015, purchasing net UAH 284 bln during this period. However, the central bank has not bought state bonds since 2017.

In 2017-9M20, UAH 57 bln of bonds held by the NBU matured, with no rollover.

Will reduce bonds by ~UAH 12 bln
In the next 15 months, at least UAH 12 bln of NBU-held bonds will mature. If the NBU does not change its policy, this amount should be refinanced by other sources.

The NBU needs to change its policy to become a buyer of the bonds. A kind of QE is being actively discussed by the NBU Council. But so far, the management of the central bank opposes the idea.

Non-residents:

Are selling actively
Non-residents were the most active buyers of local bonds in 2019, purchasing net UAH 109 bln.

However, they have been selling the bonds since late February. In 9M20, they reduced their position by UAH 33 bln (of which about UAH 10 bln in bonds matured).

Will reduce bonds by at least UAH 8 bln
If non-residents stop selling their bonds, their position will decrease by about UAH 8 bln in the next 15 month due to bonds' maturity.

MinFin needs to boost the yields of its new mid-term bonds to get non-residents interested.

Ukrainian banks:

Are buying, but capacity is limited
Local banks were the most active buyers of state bonds over 9M16, purchasing net UAH 66 bln.

However, even their theoretical capacity to buy the bonds (cash position plus investments into central banks' certificates of deposit, which are between UAH 195 and 215 bln) is smaller than MinFin's needs for the next 15 months.

In practice, it would be a wonder if these banks invest additionally UAH 90 bln into local bonds.

MinFin needs to raise the rates of its new bonds to make private banks interested, or to force state banks to purchase more bonds, possibly with the NBU's involvement. But even this won't allow it to count solely on banks in its bond issue plan.

Therefore:

If no changes in NBU policy on state debt happen, and if MinFin does not raise the interest rates on its new bonds, its unfilled gap can be as high as UAH 165-195 bln in the next 15 months, including:

- Total gap of UAH 255-275 bln
- Filled by domestic banks by UAH 80 – 90 bln.

** Bonds that state banks received from MinFIn as contribution to their equity*
Source: NBU, MinFin, Concorde Capital estimates

Domestic deficit financing: Local banks already beat annual record in 9M20

Since March 2020, the only net buyers of local bonds were Ukrainian banks, while non-residents and the NBU reduced their holdings.

As a result of this, the banks purchased net bonds for UAH 66 bln in 9M20, which is more than any historical annual result.

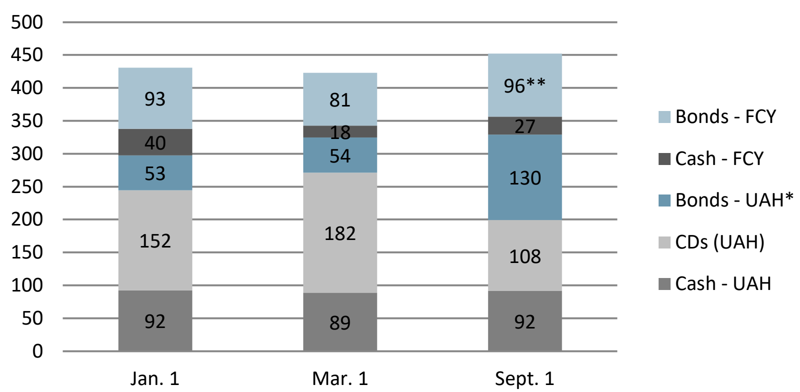
An additional supply of new bonds, based on our analysis of the budget and its financing plan, is UAH 86 bln in 4Q20 and UAH 170 bln in 2021 (plus about UAH 12 bln of bonds in hands of the central bank that will mature in 2021).

Banks are unlikely to afford to buy such an amount:

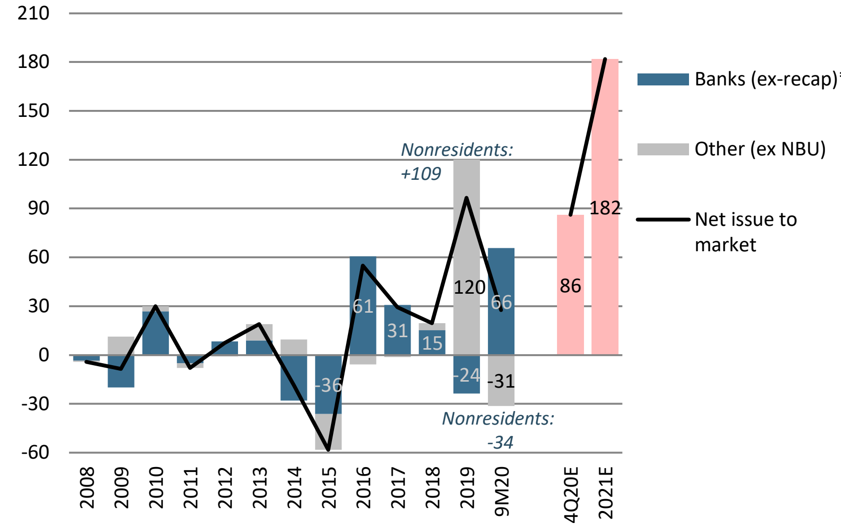
- Their current liquidity is about UAH 205-215 bln, of which they are placing UAH 105-115 bln into the central bank's certificates of deposit (CDs).
- In March-August 2020, the banks reduced the amount of CDs by UAH 75 bln, and increased their holdings of local currency state bonds by UAH 76 bln (since then, bonds were not actively placed).
- Very theoretically, the banks can increase their exposure to local bonds by the current amount of CDs they hold (UAH 105-115 bln), plus convert into bonds some of the new deposits they can raise. Though, some of the foreign-owned banks have strict limits on exposure to Ukraine's debt, while state banks are unlikely to be active. In practice, it would be positive if UAH 80-90 bln of the banks' current liquidity is converted into local bonds in the next 15 months.

This leaves the potential unsatisfied demand for new local bonds at UAH 166-176 bln in the next 15M (or at least UAH 178-188 bln, including the refinancing needs of bonds in hands of the NBU that will mature) **that cannot be covered by local banks.**

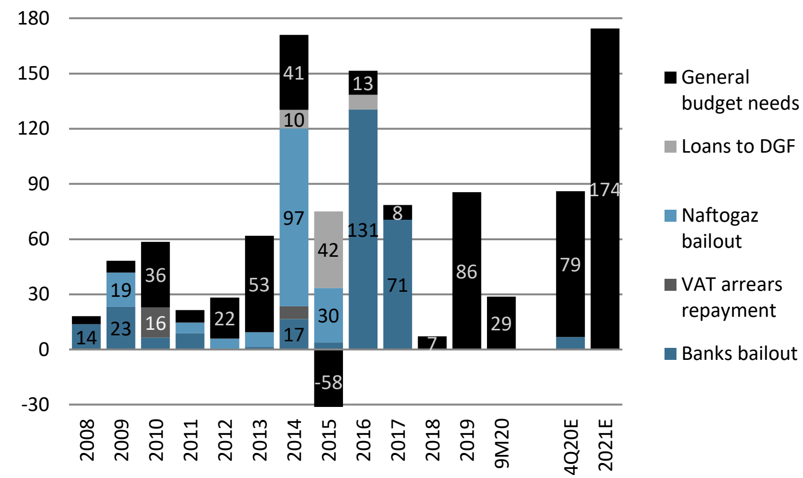
Liquid assets and state bonds on banks' balance in 2020, UAH bln



Net placement of local bonds to market, UAH bln



Purpose of local bond issues (net proceeds), UAH bln



** State bonds in excess of what the banks received as capital contribution. ** The increase is solely due to UAH devaluation.*
Source: NBU, MinFin, Concorde Capital estimates

Domestic deficit financing: State banks are unlikely to buy more

State banks were the banking system's key buyers of local bonds in 2020 as they purchased net **UAH 58 bln** of UAH-denominated bonds **in March-July**, the period of the most activity on the bond market:

- This is more than a 3x increase of their UAH bond exposure* since March 1.
- The increase was due to the banks' net divestment of the NBU's CDs (UAH 35 bln) and the attraction of additional liquidity from other sources (about UAH 20 bln). The potential to fund new bond purchases by divesting CDs is limited to state banks (less than UAH 20 bln in CDs are being held currently).
- Their local currency cash remained nearly unchanged in 2020, suggesting there is no room for decline.
- Moreover, the state banks will have to repay about UAH 25-28 bln in external debt in the next 15 months:
  - Oschadbank Eurobond amortization: USD 120 mln in 2021
  - Ukreximbank amortizations: USD 63 mln in 4Q20, as well as UAH 4 bln and USD 483 mln in 2021.
  - Privatbank: about USD 100-250 mln in compensation to bailed-in bondholders.

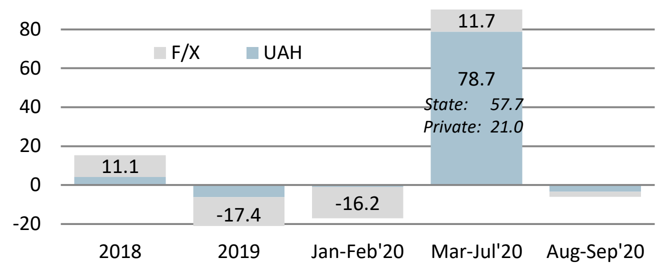
That means state banks may have to reduce their foreign currency bonds. Also, they will have to finance ambitious quasi-fiscal infrastructure (road) projects, so their total holding of local bonds is unlikely to increase.

To further boost bond purchases, state banks should use funds from deposits, NBU refinancing, or loan recoveries.

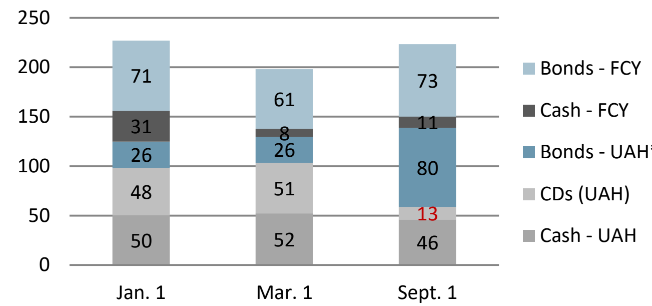
Private banks were less active in bond purchases (UAH 21 bln in March-July) as they seem to prefer keeping their liquidity in CDs rather than invest in longer and illiquid government bonds. Most likely, they took advantage of non-residents' exits in May-June, having purchased bonds at significant discounts.

- Private banks' theoretical potential to purchase bonds is high (amount of CDs is about UAH 90 bln currently).
- But to fulfill this potential, the **government may need to hike the rates on the bonds**, especially those with **shorter maturity**. Also, further cuts in the NBU's key rate (and thus CD rates) would be helpful.

Net purchase of bonds by Ukrainian banks, UAH bln

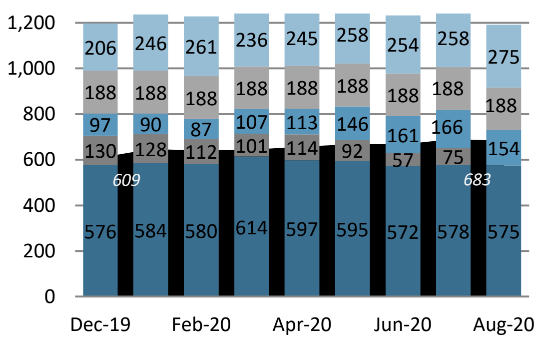


State banks: liquid assets and state bond balance, UAH bln

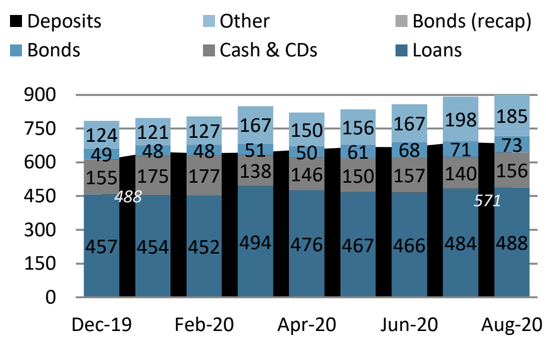


Gross assets and deposits eop, UAH bln:

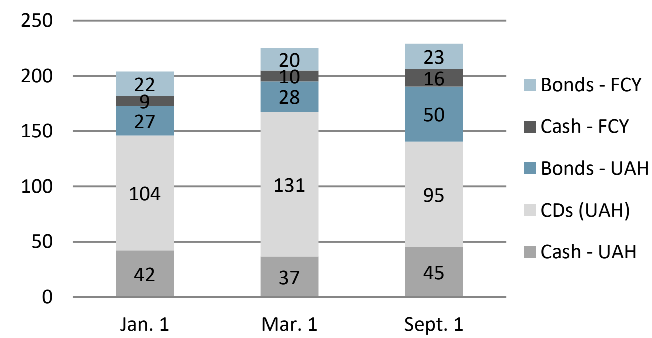
State banks



Private banks



Private banks: liquid assets and state bond balance, UAH bln



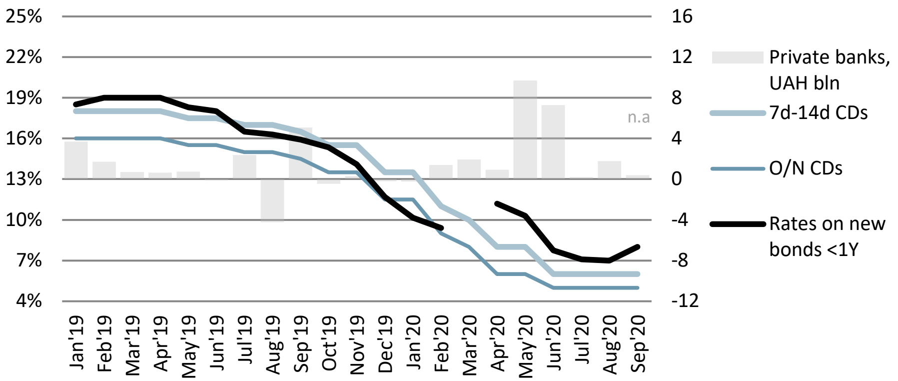
** In excess of what the banks received as capital contributions (estimated UAH 188.0 bln in 2018-Aug. 2020, UAH 194.8 bln in Sept. 2020).*
Source: NBU, Concorde Capital calculations

Domestic deficit financing: What can make private investors interested?

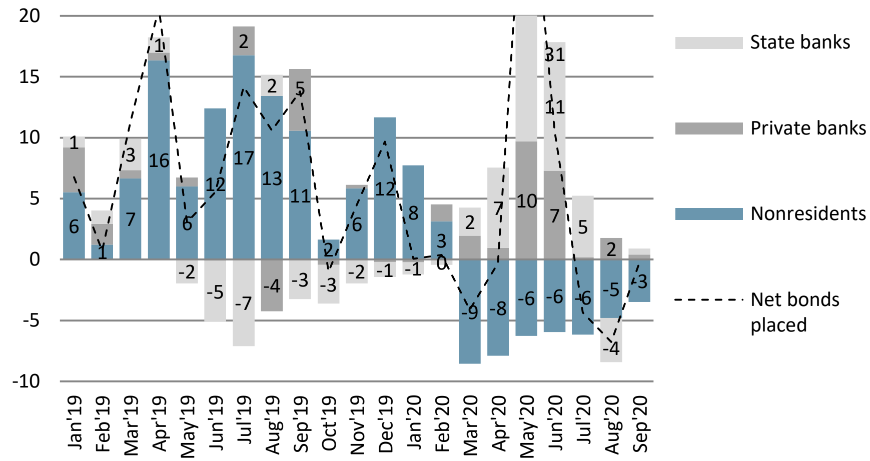
Private domestic banks, as we analyzed above, can provide additional demand for up to UAH 90 bln, if no changes on their balance sheet happen (which we don't expect). The banks are buying short-term bonds, as their liabilities are mostly short term.

The NBU did a great job in cutting the key rate – and therefore the rates on CDs (the alternative investments to bonds) – to 5-6% now, from 11.5%-13.5% in January. It has yet to be seen whether the recent rates on new 3-9-month bonds (7-8%) are enough to generate demand from private banks. We believe private banks will demand higher rates – 9 to 10% – to be interested in a significant increase of their exposure to state bonds. Alternatively, the NBU's possible decrease of the key rate will be helpful to stimulate demand for bonds.

Net UAH local bond purchases by private banks, UAH bln



Net purchases of local UAH-denominated bonds, UAH bln*



Non-residents seem to remain the main hope of MinFin in providing demand for local UAH bonds (as it was the case in 2019), even though they are currently actively selling the bonds.

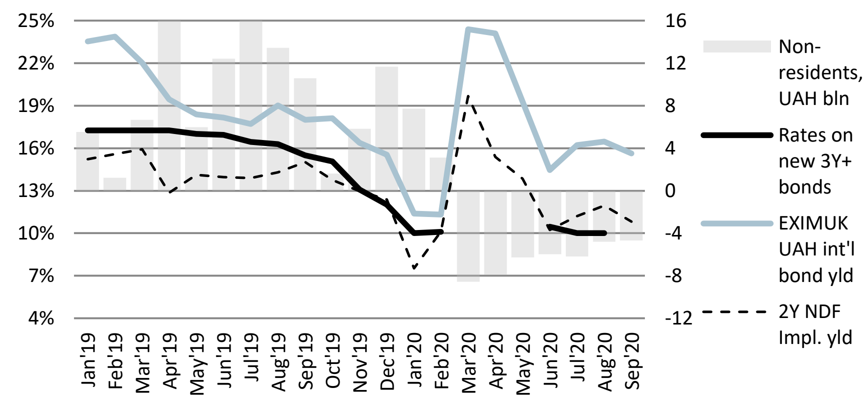
To get them back to purchase of local bonds, MinFin will have to raise their rates on primary market. The current market conditions (rates of Eurobonds and NDFs) resemble the situation of November-December 2019. Then, non-residents were actively buying mid-term bonds at the rates of 12%-13% (currently MinFin is not ready to offer more than 10%, but this might change).

There are, however, two things that differ the current situation from late 2019:

- Now we have more uncertainty about Ukrainian currency, plus risks of new COVID-related troubles in the economy.
- Non-residents have learned that Ukrainian local bonds are illiquid.

All this may require higher offer rates for non-residents to come back (about 13% - 15%).

Net UAH local bond purchases by non-residents, UAH bln



** Excluding net purchases by the NBU, as well as bonds issued to bail out state banks (UAH 6.84 bln in Sept. 2020)*
Source: NBU, MinFin, Concorde Capital estimates

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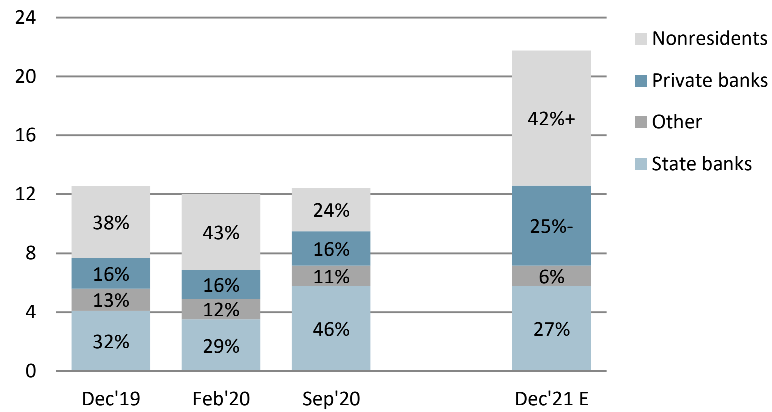
Risks of non-residents massively purchasing local bonds

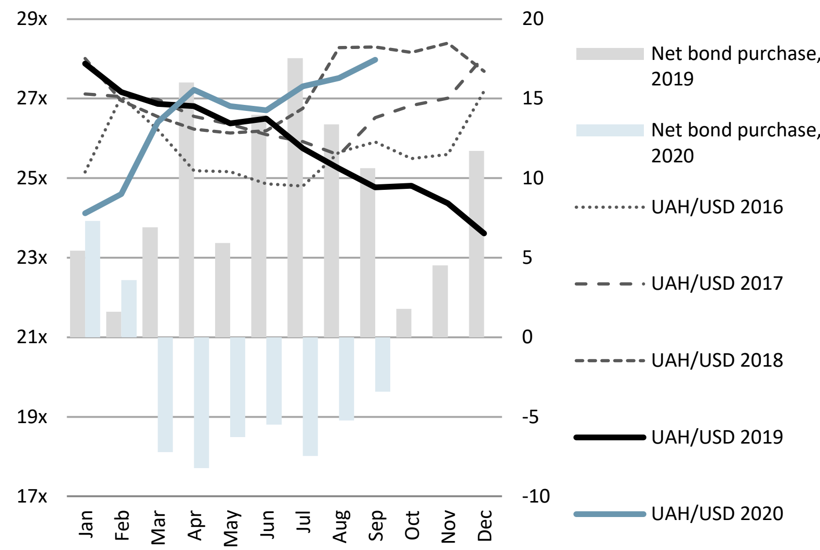
Based on the analysis above, we conclude that around UAH 180 bln of the planned new local bond supply should be purchased by non-residents. However if the government goes forward with its plan to reattract foreign investors to local bonds, it will face numerous troubles:

- To make non-residents interested, MinFin will have to raise the rates on mid-term bonds. In this way, it will send a wrong signal to the market, which will be contrary to the president's desire to lower rates on the market as much as possible.
- The 2019 increase of non-residents' exposure to local bonds was widely criticized by top officials, including the head of the NBU Council Bohdan Danylyshyn, who labeled this phenomenon a "financial pyramid." Therefore, it will be politically unpopular for MinFin to come back to "building a pyramid."
- The share of non-residents in local bonds on the market (excluding bonds held by the NBU and bonds that state banks received as capital injection) will exceed 40%, which many foreign investors might consider as an exceedingly high level. Such a share was already observed in early 2020, and led to the inability of non-residents to exit the market during the COVID-related turmoil. In case of any other turmoil, the situation will repeat itself. In addition, a significant increase of non-residents' exposure to local bonds will further tempt the government to implement a restructuring of local debt, which is another risk.
- Massive money inflow of foreign currency from non-residents to the local market will result in visible revaluation pressure on the hryvnia.
  - In 2019, the supply of money from non-residents (in the equivalent of UAH 109 bln) was among the key contributors to the hryvnia strengthening by 17% over a year. Namely, the inflow of cash from non-residents in fall 2019 prevented the Ukrainian currency from its seasonal devaluation observed in 2016-2018.
  - If non-residents buy even more local bonds this time, the revaluation pressure will be greater.
  - In turn, this will put Ukraine's budget plan under risk, as the UAH/USD exchange rate is planned at 29.1x in 2021. A stronger hryvnia will have a poor effect on budget proceeds from import duties and import VAT, thus widening the budget gap and financing needs. Also, it will worsen the competitiveness of Ukrainian exporters, and thus will have a negative effect on Ukraine's real sector indicators.
  - To prevent such an outcome, the National Bank will have to proactively buy dollars on the market and change the revaluation trend. This might throw into question the NBU's independence and could spoil the government's relations with IFIs.
- Most likely, MinFin will prefer placing more international bonds instead of local bonds to prevent possible negative outcomes.

Holders of "market" * local bonds, USD bln equivalent



Non-residents' net purchase of local bonds (UAH bln) and exchange rate



** Excluding bonds held by the NBU and bonds issued to bail out state banks*
Source: NBU, MinFin, Concorde Capital estimates

Alternatives to market financing: More IFI loans, budget consolidation, “QE”

Our primary conclusion is that Ukraine’s government will have to rely heavily on external financing of its budget deficit, as Ukrainian lenders will only be able to lend about UAH 70-80 bln (about USD 2.7 bln) in the next 15 months, or about 20% of the budget’s expected financing needs of UAH 387 bln (USD 13.3 bln).

- Some portion of financing will come from “conventional” creditors like IFIs and Western governments (gross USD 3.2 – 4.7 bln, or net USD 1.5 – 3.0 bln).
- If no policy changes happen in Ukraine, the rest can be raised from international private lenders (about USD 7-10 bln net).
- This will require raising interest rates on local bonds, or a massive placement of international bonds, which will increase MinFin’s exposure to foreign currency risk and also will result in higher borrowing costs.

For Ukraine’s government, raising the rates could become unacceptable. To avoid this, the government can:

- **Try raising more conventional borrowings**. This does not look like an affordable task, taking into account that Ukraine is not in a crisis situation, which could explain massive multilateral financing. Meanwhile, Ukraine is not hurrying to behave predictably enough for IFIs to be willing to provide more financing (recall, about USD 2.5 bln of the nearly agreed upon financing is being delayed currently).
- **Reducing the budget deficit** (in addition to the amount that we have already “cut”). That would be an ideal scenario for creditors, but its viability looks doubtful.
- **Make the central bank purchase local bonds**, directly or indirectly. This could be a disastrous scenario that will result in spoiling relationships with all the international creditors, as the IMF can consider such a change in “monetary policy” as irresponsible and a liquidation of the NBU’s independence. While such a scenario looks undesirable, it cannot be completely ruled out. So far, the NBU’s management is opposing the idea, but a possible replacement of the top NBU official responsible for monetary policy could change its position very fast.

Risks of debt surge for quasi-fiscal reasons

Besides a heavy planned financing gap, there are other initiatives in the government that might swell state and guaranteed debt in the next 15M.

Even without these initiatives, we estimate the ratio of Ukraine's state and guaranteed debt to GDP will exceed 60% by the end of this year. This is likely to prevent any increase of Ukraine's credit ratings next year, or might even worsen ratings' outlooks to negative.

If another debt-raising initiative is used by the government, this will push debt ratios further and put under question Ukraine's debt sustainability and credit ratings stability.

Yet this is another reason to expect increasing rates on Ukraine debt instruments in the near future.

Ukraine state debt, eop

	2019	9M20E	2020E	2021E
State debt, USD bln	74.4	72.7	78.0	85.8
- UAH bln	1,761	2,057	2,263	2,488
- % of GDP	44%	52%	57%	55%
Guaranteed debt, USD bln*	10.0	10.0+	10.0+	10.0+
- UAH bln	237	285+	292+	292+
- % of GDP	6%	7%+	7%+	6%+
State + Guaranteed, USD bln	84.4	82.7	88.0	95.8
- % of GDP	50%	59%+	64%+	62%+

Limits on state-guaranteed debt removed

The 2021 draft budget (as well the valid budget law for 2020) suspends a couple of provisions of the budget code that limit state-guaranteed debt:

- That limits on state-guaranteed debt and the size of state guarantees should be explicitly stipulated by the state budget law.
- That the amount of state guarantees provided cannot exceed 3% of planned proceeds of the general fund of the central budget (or UAH 25.7 bln in 2020 and UAH 28.4 bln for 2021).
- That the cabinet has to receive consent from the parliament to exceed the ratio of state and guaranteed debt to GDP of 60%.

It is likely that the final budget law for 2021 will also keep such suspension provisions (they were able to do it in 2020, so they can in 2021), unless the IMF will be opposed.

Such provisions imply the government can increase state-guaranteed debt with no limits in the next 15M. Thus far, the government did not take advantage of such provisions in the 2020 budget law (net guaranteed debt raised in 8M20 was about UAH 4 bln, including guarantees for the road construction operator for UAH 11 bln). However, the worst (in terms of the budget deficit and the need for financing various government projects) is yet to come.

Although state debt is unlikely to exceed the 60% threshold in 2020-2021, the size of state & guaranteed debt can exceed 64% already as of the end of 2020 (even if no new state guarantees will be provided by the end of this year).

If the government exceeds the limits on state guarantees in 2020 and 2021, as allowed by budget laws, the amount of state guarantees could surge by the end of 2021, as compared to end-2019. This could bring the ratio of state & guaranteed debt to GDP well over 63% in 2021.

The good news here is that it won't be very easy to finance such guaranteed debt, taking into account the government's budget financing appetites.

Financing of state companies and market inefficiencies

After two years of absence of quasi-fiscal debt initiatives, this year Ukraine reinstated the issuing of state debt for resolving state companies' problems:

- In September, the government issued UAH 6.84 bln of bonds to inject equity to state Ukreximbank.
- The parliament adopted a law to resolve debt issues on the wholesale electricity market that emerged before July 2019. Based on this law, state companies Energoatom and Ukrhydroenergo may receive equity contributions (in the form of state bonds) in exchange for written off debts from the liquidated wholesale electricity market operator. The size of the new bond issue has yet to be revealed, while it is known that a possible bailout of Energoatom can be as high as UAH 11.7 bln. For forecasting purposes, we assume this legal initiative will increase state debt by UAH 15 bln by the end of 2020.
- Another "sizeable" legal initiative (not yet voted on in parliament) is to place UAH 19.6 bln in state bonds to help the operator of the new electricity market to repay its debt to green energy producers. While it does not look possible that MPs will be able to approve such an initiative this year, the problem of raising arrears due to power market inefficiency won't disappear. State support, so far, looks like one of the straightforward ways to resolve the issue, sooner of later.

** Assuming no new state guarantees will be provided after Sept. 1, 2020*
Source: MInFin, NBU, Concorde Capital estimates

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