Ukraine | Economics Research
Economics / Politics
Flash Note

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UAH/USD exchange rate

Political line-in-the-sand until October 2012 election

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- **With key parliamentary elections in October 2012, the ruling Party of Regions will vigorously pursue a steady exchange rate, despite market turbulence, and for as long as it is feasible, as part of their electoral promise of stability**
- **Devaluation pressure is intensifying, chiefly from falling steel prices (Black Sea billet FOB -10.5% to USD 615 per mt over the last three weeks) and domestic demand for US dollars (net FX purchases came to USD 2.0 bln in September)**
- **We think that if devaluation pressure persists or intensifies moving into November-December, the NBU might allow a sudden drop in the hryvnya vs. the U.S. dollar to 8.5-9.0**

Why is Ukraine keeping the UAH/USD rate fixed at 8.0?

For the current administration to stand a chance at re-election in October 2012, their #1 priority is to prove it can do better than the opposition did in 2008-2009, when the hryvnya fell over 40% against the US dollar. Ukraine's central bank has ample ammo (USD 35.0 bln in reserves as of September, equal to four months of imports) and has demonstrated that it will defend the current level. We believe the NBU will try to maintain this policy at least until the election.

How much can it fall and when?

We think that if devaluation pressure persists or intensifies moving into November-December, the NBU might allow a sudden drop in the hryvnya vs. the U.S. dollar, perhaps even overnight, to 8.5-9.0 – a level we believe would satisfy the population's expectations for bloodletting and the export lobby.

In terms of managing expectations, we do not expect clear articulation on timing. Watch policy comments directly from NBU officials: Head Serhiy Arbuzov, Deputy Head Yuriy Kolobov and Representative Valeriy Litvitskiy. Tune out what is certain to be a flood of conflicting messages and noise from all manner of other government officials. In our view, the three key devaluation drivers are the balance of payments, consumer confidence and the export lobby.

Devaluation pressure is clearly mounting

As an NBU-managed rate, a direct relationship between the UAH/USD exchange rate and external or internal factors is extremely difficult if not futile to discern. Review of key factors we believe are monitored by decision-makers makes it clear that devaluation pressure is mounting.

In our view, the three key devaluation drivers are the balance of payments, consumer sentiment and the export lobby.

1. **Balance of payments.** If external capital markets are locked and the current account balance remains in deficit, Ukraine's balance of payment could turn negative, especially given high FX needs in 2012. Ukraine's current account deficit widened to USD 4.5 bln or 3% of GDP (4Q-rolling) in 8M11, but the overall balance of payment has remained in surplus, thanks to financial account inflows. Next year external sovereign debt redemptions are relatively low at USD 3.8 bln (including USD 2.0 bln VTB loan repayment, if it is prolonged), but banks and other corporate short-term redemptions come to ~USD 50.0 bln (~35% of GDP, 4Q-rolling). Furthermore, next year the NBU is due to start repaying IMF tranches (~USD 2.7 bln) directly from FX reserves.

2. **Consumer sentiment.** According to our estimates, for the next 2-3 months, each month of hryvnya stability could cost the NBU ~3-5% of its FX reserves (~USD 1-2 bln) in the form of market interventions to maintain the interbank rate at its current level. We take September as a rough guide, last week the NBU said reserves dropped by USD 3.3 bln or 8.5% m-o-m (USD 1.9 bln of which was due to interbank interventions) to USD 35.0 bln last month. Reserves outflow stemmed primarily from high demand from the population for FX: net FX purchases rose to ~USD 2.1 bln. 'Crude' policy tools such as requiring residency documents to exchange currency (as of late September) only fueled fears. We expect domestic demand for FX to remain high in October-November due to seasonal factors and devaluation expectations.

3. **Export lobby.** The competitiveness of Ukrainian steel makers, in particular, is eroding under a stable hryvnya compared to rivals in Russia and Turkey, whose currencies have already been devalued by 10% and 12%, respectively. The steel lobby in Ukraine is strong, especially in the ruling Party of Regions.

Other factors including steel and gas prices, and the IMF could also influence the exchange rate.

- **Steel prices.** Ukraine remains highly sensitive to metals prices. Metallurgy is still the backbone of the Ukrainian economy (34% of all exports in 1H11). In May-June 2010, steel prices dropped 25.6% in nine weeks, but the hryvnya remained stable. Over the last three weeks, Black Sea FOB steel prices have fallen by 10.5% to USD 615 per mt, but are still up 12.4% YTD. If this trend continues and combines with other factors, it could prompt devaluation.

- **Gas prices.** Ukraine's monthly tab for gas is set to climb in 4Q11 (by 2.3x q-o-q to USD 4.2 bln), with rises in both Russian gas prices (from USD 350 per bcm in 3Q11 to USD 400) and volumes as Ukraine enters the heating season (from 5.2 bcm in 3Q11 to 10.0 bcm in 4Q11 according to our estimates). As Ukraine's monopoly gas importer Naftogaz purchases the gas in USD that it buys from the interbank market or central bank reserves, this represents another factor at work. However, we do not consider gas prices a critical UAH driver as Naftogaz will contractually have to foot its gas bill regardless of the exact rate.

- **The IMF factor.** We see at least three ways relations with the IMF could precipitate or negatively affect devaluation – (1) with the USD 16 bln loan program frozen, no new tranches will be coming to bolster NBU reserves, (2) in order to restart cooperation, the IMF might call on Ukraine to increase exchange rate flexibility (either via establishing a wider corridor or floating mechanism), and (3) the general confidence factor if cooperation is not restarted.

UAH/USD rate stability is key political issue ahead of October 2012 election

With key parliamentary elections coming in October 2012, we believe the ruling Party of Regions will vigorously support a steady exchange rate, despite market turbulence, and for as long as it is feasibly possible, as part of their electoral promise of stability. For the current administration to stand a chance at re-election, the #1 priority is to prove it can handle economic pressure better than the opposition did in 2008-2009, when the hryvnya fell over 40% against the US dollar.

Hryvnya stability is the key economic indicator for the population – it will have an extremely low tolerance for devaluation

- **Line-in-the-sand issue with the electorate.** When campaigning for presidential office in late 2009, Viktor Yanukovych often touted stability as his main goal – this idea was further ingrained when political parties friendly to Yanukovych joined together and dubbed their grand alliance the "Stability and Reform" coalition in April 2010. In our view, the population is already conditioned to accept other headline economic measures such as inflation (6% in 1H11) and high unemployment, but has a much lower tolerance for devaluation.

- **The National Bank of Ukraine is controlled by a Yanukovych man.** Before he went to the NBU, Arbuzov was the head of Ukrainian Biznes Bank, which is based in Yanukovych's hometown of Donetsk.

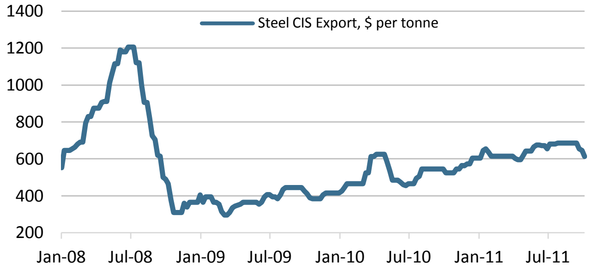
- **Other reforms have been unpopular.** The issue of exchange rate stability is even more acute since reforms pursued by the government since they came to power in February 2010 have been divisive and unpopular, starting with the April 2010 Russian Black Sea Fleet for gas discount deal, the annulment of 2004's Constitutional amendments in May 2010, then the tax reform in fall 2010, followed by pension reform and the prosecution of former Prime Minister Yulia Tymoshenko in summer 2011. Numerous protests have sprung up along the way from a surprisingly varied demographic groups and wide geographic spread. The political toll is perhaps most evident in President Viktor Yanukovych's "disapproval" rating, which rose from 28.5% in April 2010 to 47.6% in April 2011, according to Razumkov Center opinion polls.

Devaluation could prompt unpopular consumer gas price hikes, which in spite of IMF demands, the government has already been resisting

- **Household gas tariff hikes.** Devaluation of the hryvnya effectively increases the price of imported gas for state-owned Naftogaz of Ukraine, which would further aggravate its already cavernous budget deficit (~1.5% of GDP in 2011E by our estimates). As Naftogaz is subsidized by the state to cover the difference in its rates for households and the actual gas price from Russia, devaluation could prompt another unpopular hike in consumer gas tariffs, which in spite of IMF demands the last year, the government is still resisting tooth and nail.

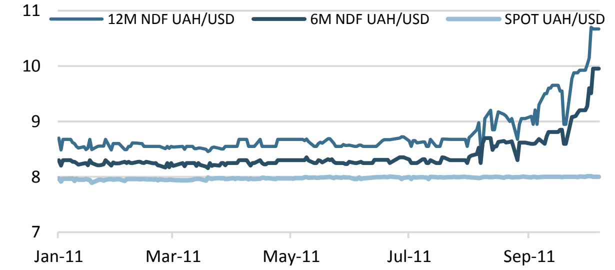
Ukraine macroeconomic charts

Steel prices, Black Sea, FOB, USD per mt



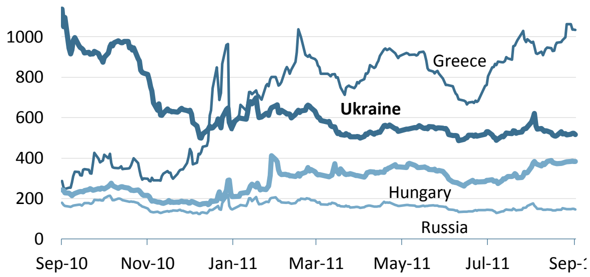
Source: Bloomberg, Concorde Capital estimates

UAH/USD NDF, SPOT



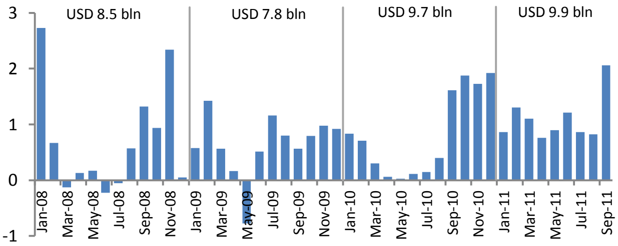
Source: Bloomberg, Concorde Capital estimates

CDS (Sovereign debt, 5Y, USD), bps



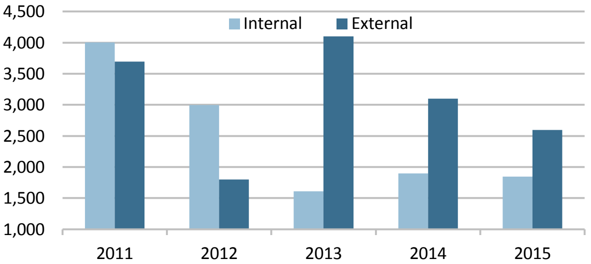
Source: Bloomberg, Concorde Capital estimates

Net FX purchases by population, USD bln



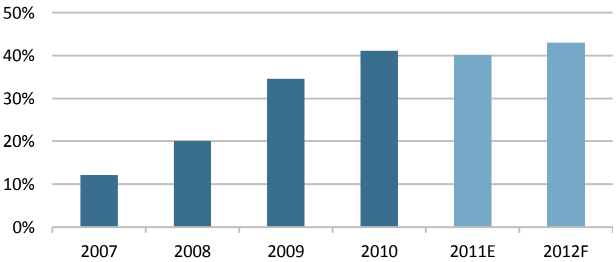
Source: Bloomberg, Concorde Capital estimates

Public debt scheduled redemptions, USD mln



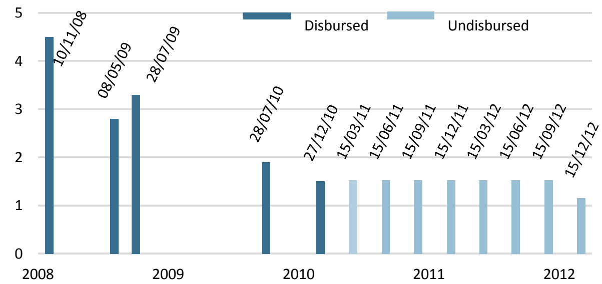
Source: Finance Ministry, Concorde Capital estimates

Public debt, % of GDP



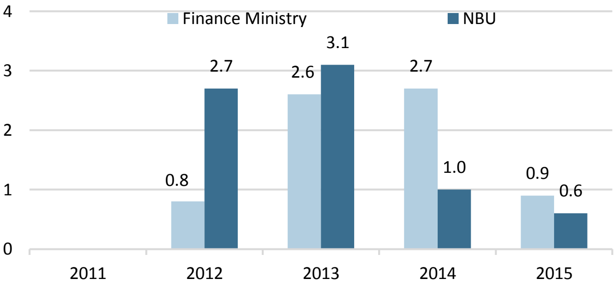
Source: Finance Ministry, Concorde Capital estimates

IMF tranche disbursement plan, USD bln



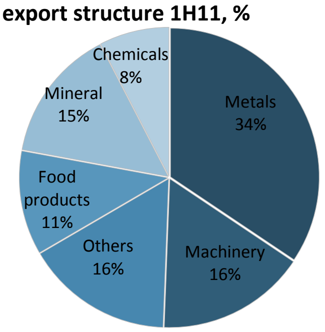
Note: According to initial IMF memorandum from 2008
Source: IMF, Concorde Capital estimates

IMF debt maturity profile, USD bln



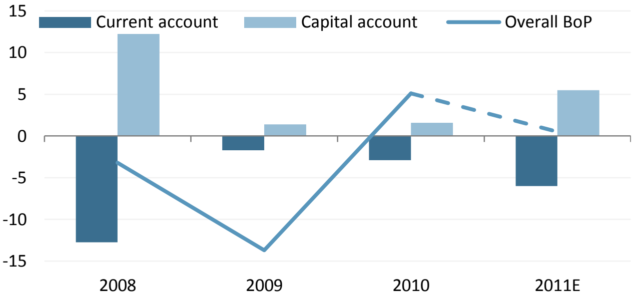
Source: IMF, NBU, Finance Ministry, Concorde Capital estimates

Merchandise export structure 1H11, %



Source: State Statistics Committee, Concorde Capital estimates

Balance of payment performance, USD bln



Source: NBU, Concorde capital estimates

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