Ukraine | Research
Economics / Politics
Desk Note

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Ukraine sovereign risk

Financing from IMF (preferred) and Russia are options, unlike 2008

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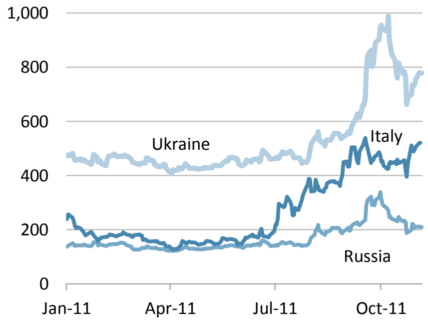
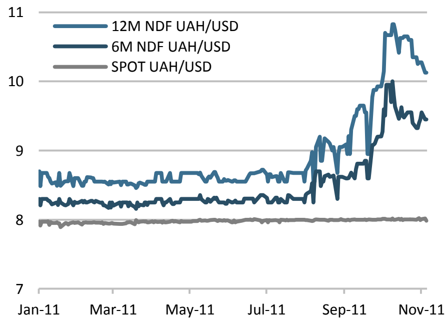
- Ukraine's key challenge in 2012, in our view, is the external financing gap, which we project at USD 4.5 bln (2.5% of GDP)
- There are several options to plug this deficit: unlocking the USD 15.6 bln loan from the IMF; tapping Russia for bridge financing; draining central bank reserves and/or devaluing the hryvnya (UAH)
- We believe unlocking the IMF loan is Ukraine's most preferred and most likely scenario. It is less favorable politically as it requires unpopular residential gas tariff hikes. Yet, it is the only option that supports the more critical issue of currency stability and keeps all other external financing opportunities open
- We think Ukraine will ultimately raise household gas rates to satisfy one of the main conditions for the release of IMF loan tranches, and is just waiting to see if can soften the magnitude of the potential hike with a sweeter gas deal from Russia
- Once negotiations with Russia are concluded, the Ukrainian government will move quickly to distance the timing of the tariff hike as much as possible from parliamentary elections next October. This implies IMF tranches could start flowing again to Ukraine in the next 2-4 months
- The NBU will strive for a steady UAH exchange rate through 2012, particularly with elections coming up. We believe that with external financing (be it from the IMF or Russia), they will succeed in maintaining hryvnya stability, barring any new shocks to the global financial system

Ukraine vs. peers 5Y CDS, bps



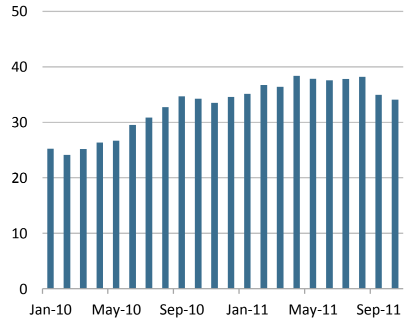
Source: Bloomberg, Concorde Capital estimates

UAH/USD NDF and SPOT



Source: Bloomberg, Concorde Capital estimates

NBU's FX reserves, USD bln



Source: NBU, Concorde Capital estimates

Several options to cover the financial gap in 2012

As weakness in external commodity markets persists and global debt markets remain closed, Ukraine is likely to see deterioration in its external accounts in 2012. In our base case, we expect the current account gap to widen to 5.5% of GDP next year (vs. 4.5-5.0% in 2011E), with net capital inflows (projected at 3.0% of GDP) offsetting only part of the shortfall. We project Ukraine to face an external financing gap of about USD 4.5 bln (2.5% of GDP) next year.

Ukraine's 2012 external financial gap, possible scenarios	USD bln
Base case	**-4.5**
Net impact of:	
Global turmoil continues – gov't fails to raise debt via Eurobonds as planned	-3.5
Steel prices drop by 15-20% from current level (vs. flat y-o-y in base case)	-3.5
Gas import volumes are cut to 33 bln m3 (vs. 42 bln m3 in our base case)	+3.5
Ukraine gets a USD 50/ths m3 discount for Russian gas	+2.1

Source: Concorde Capital estimates

Ukraine has at least three options to deal with the shortfall without resorting to local currency devaluation, with unlocking its IMF loan the most preferable. However, if cooperation with the IMF falls through, the government will most likely tap Russia. The third option of spending NBU reserves to prevent UAH devaluation in 2012 can still be avoided, in our view.

Measures to deal with external financing challenges in 2012 (ranked by priority)

	Positives	***Negatives***	***Steps to soften negatives***
IMF loan tranches totaling up to USD 8 bln	* Best for UAH stability * Best for global perception of Ukraine * Unlocks additional financing tools * Solves financing gap problem * Possibly increases NBU reserves	* Fair short-term political risk: need to raise gas/heating tariffs	* Price discount for Russian gas - but need to share gas pipeline with Gazprom
Russian loans of up to USD 4 bln	* Least short-term political risk: no need to raise gas/heat tariffs * Manageable UAH depreciation of 3-5% * Limited decrease in NBU reserves	* Worsened global perception of Ukraine * Unlikely to cover the financing gap fully - need for other tools * Makes negotiating position for gas price discounts more difficult	* Raise more debt from other parties (possibly Asian countries)
NBU reserve decrease of up to USD 7 bln	* Manageable UAH depreciation of 3-5% but higher risk of a sharp one-off devaluation * No need to raise gas/heat tariffs seemingly limits short-term political risk	* Political risks on expectations of UAH depreciation * Liquidity problems in banking system * Worsened global perception of Ukraine	* Reduce import volume or price of Russian gas * Combination with other tools of financing gap coverage
UAH depreciation by up to 20%	* Best preserves NBU reserves * No need to raise gas/heating tariffs seemingly limits short-term political risk	* Risks for stability of domestic banking system * Worst for domestic political risk: raises specter of protests * Worsened global perception of Ukraine	* Reduce import volume or price of Russian gas * Raise more debt from other parties (possibly Asian countries)

Source: Concorde Capital estimates

Either external financing option is good for UAH stability

The National Bank of Ukraine will strive to maintain the UAH exchange rate through 2012, particularly with parliamentary elections coming next October. We believe that with new external financing (be it from the IMF or Russia), they will succeed in maintaining hryvnya stability, barring any new shocks to the global financial system. We maintain our base case forecast of UAH/USD 8.0 in 2011 and 8.1 in 2012.

IMF should be back in a flash after new Russian gas deal

The IMF mission left town last week without seemingly any progress on unlocking Ukraine's USD 15.6 bln standby loan. The fund said it needed more time to settle technical issues, but we see the true reason as Ukraine's desire to take more time to conclude negotiations with Gazprom on reduced gas import volumes and/or lower prices. We think Ukraine will ultimately raise household gas rates (which is the main stumbling block in IMF talks) to release the IMF loan, and is just waiting to see if can soften the magnitude of the potential hike with a sweeter gas deal from Russia.

If talks with Russia on a sweeter gas deal fail, then we expect Ukraine to bite the bullet and adopt the 25-40% tariff hike the IMF demands in order to keep the door open to external financing; if Ukraine does secure a new gas agreement with Gazprom, then it would present the case to the IMF for compromise on a less steep hike of 10-20%.

Note that the timing also depends the government's electoral concerns – with parliamentary elections coming in October 2012, the government should move quickly to distance the timing of the tariff hike as much as possible from parliamentary elections next October. This implies IMF tranches could start flowing again to Ukraine in the next 2-4 months.

Russia is at the table to support its "little brother"

We believe the government is pushing for Russia to cut its "take-or-pay" volumes to about 33 bln m3 and/or discount its price for gas imports by USD 50 per ths m3. A victory on either front implies improved Naftogaz financials and increases the likelihood Ukraine unlocks its IMF loan with minimum political damage from a significant increase in household gas tariffs.

Ukraine's most probable concession in return for Russian generosity, in our opinion, is to offer a stake in its gas transportation system. The Cabinet of Ministers took a potential first step in this direction yesterday – by registering a bill in parliament that would allow for splitting up Naftogaz of Ukraine. Spinning off the E&P, transportation and distribution segments facilitates a potential JV in the transportation business with Gazprom.

It is also possible, independent of any gas deal, that Russia facilitates another sizable loan to Ukraine from a Russian state-owned bank, such as it did with a USD 2 bln facility from VTB in June 2010. Just yesterday local media reported Naftogaz took out a USD 550 mln loan from Russia's Gazprombank. In addition, Ukrainian officials announced last week plans to start paying for gas imports in Russian rubles, which we think only makes sense if Ukraine takes out ruble-denominated loans.

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