CONCORDE CAPITAL

Ukraine
Economy |
Research Note

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Economic recovery

Ukraine’s creative destruction

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Ukraine is now a different country after the EuroMaidan protest movement and worsened relationships with Russia. Its people have matured to view the authorities as their equals and servants. Traditional institutions such as the police and tax inspection are considered useless in their current form, requiring complete overhaul. Our “brother” from the north has become our worst enemy, who in bad faith occupied part of the country. Disregarding the incredible shocks that Ukraine has endured recently, the country’s economic prospects now look much better than even half a year ago. No doubt, the economy will experience a downward correction in 2014 with substantial GDP decline (we project 3.7%) and falling real incomes on the back of hryvnia devaluation and inflation. However, after fiscal and currency adjustments, and in light of the EU market opening to Ukrainian goods, we are optimistic about economic revival and anticipate GDP recovery of 2.3% already next year. The issue remains of fundamental reforms in the long run since effective radical changes require political consistency; however, this point will remain unclear till the day a new political leadership emerges after the May 25 presidential elections, which we believe will go smoothly.

- Sovereign default looks unlikely, regardless of aggravated economic problems. The IMF has been offering promising signals and Ukrainian authorities have implemented positive reforms that include trimming the 2014 budget, approving a new procurement law, and boosting natural gas rates for business and households. We expect the IMF agreement will be signed in the coming days.
- The economy will experience a downward correction in 2014 on the back of the hryvnia decline and conflict with Russia. However, we see at least three points that will enable the economy to recover quickly already at the start of 2015: (a) unlike the 2008 crisis, world trade is on the rise, which promises strong demand for exports after the hryvnia’s decline; (b) unlike the early 90s, Ukraine has state institutions and private property rules established, which means that reforms will be more about “improving” rather than “building from scratch”; and (c) the inflow of foreign financial aid, as well as non-Russian demand for exports, will be reliable during the upcoming months
- Reforms started by the Cabinet are important for macro stabilization, but so far they have targeted only short-term goals that primarily involve fiscal consolidation. To create the grounds for long-term sustainable growth, radical reform of the judiciary, local legislatures and law enforcement bodies is critical.
- The National Bank of Ukraine (NBU) has released the hryvnia’s devaluation potential and even overshot the market equilibrium level. We estimate the new justified exchange rate at near 10.5 hryvnia per USD, which should reduce the C/A deficit to 4.7% of GDP in 2014 from 9.2% of GDP in 2013.

Post revolution: understanding the new country

Ukraine has changed dramatically in the political and economic realms since November. The new Ukraine is now in a position to rebuild its institutions and structures, which had been rotting under the administration of former President Viktor Yanukovych. In particular, we see five critical spheres that look totally different compared to what we used to know and assume about them.

Core changes in Ukraine, 2014

	Before	Now
Change in authorities	Kleptocrats aimed at preserving power at any cost. Blocked economic reforms and indulged in populist, short-term economic policies, eventually resulting in wide dissatisfaction and social strife.	Old political hacks, mixed with fresh-faced reformers, who do not have conflict of interests with personal business. Yet many of the hacks have corrupt histories. No personified leadership or exclusive group of insiders; however, the new Cabinet is united in the face of external aggression.
Relations with Russia	In December 2013, Yanukovych and Putin agreed on a lower gas price (USD 268.5/tcm) starting in 1Q14 and a USD 15 bln loan for 2013-14 (with USD 3 bln arriving in December). They also agreed on deepened trade relations between the two countries, shutting the door on the EU Association Agreement.	Gazprom has demanded Ukraine pay a natural gas price of USD 485.5/tcm since 2Q14. Russia has cancelled its loan commitment on USD 12 bln, begun to re-establish trade barriers on Ukrainian exports.
Energy security	Russia was relatively amenable for consistent gas supplies, even with Ukraine's permanent payment delays and growing debt for gas. The Black Sea shelf was among Ukraine's most promising oil and gas deposits.	Moscow threatens to start requesting prepayments for gas supplies. Amidst the probable escalation of the current military conflict, Ukraine risks losing Russian gas and oil imports. The occupation of Crimea (and the loss of its offshore gas resources) effectively blocked Ukraine's possibilities to boost gas extraction in the Black Sea shelf.
Crimea	A part of Ukraine that generated nearly 3.7% of GDP. At the same time, the peninsula was financially unsustainable and received large budget subsidies (nearly UAH 9.0 bln in 2011). Hosted Ukraine's naval forces and numerous military bases.	Territory tightly occupied by Russia. Russia has confiscated property of Ukraine's Armed Forces and the government. Multiple disputes have arisen such as citizenship, compensating occupied state property and reimbursing lost investments. Yet Crimea's occupation will even save some money for the national budget since it won't be earmarked subsidies.
Exchange rate	A de facto, fixed exchange rate regime with minor and controlled fluctuations. The approach was among the reasons for the permanently high C/A deficit.	The NBU withdrew from the market, thus launching a complete laissez-faire currency regime. As a result, the hryvnia devaluated more than 30% (having since recovered), even jumping above its equilibrium level. Such an approach will enable cutting the C/A deficit to a more sustainable level.

Fiscal policy: tough 2014 but default unlikely

Ukraine's parliament approved in March a revised spending 2014 plan and anti-crisis measures (austerity and tax hikes on the wealthy). Indeed, the spending cuts were the most dramatic in the country's recent history (see our April 1 report on amended budget for more details). Consequently, the Cabinet froze wages, pensions and social payments and promised to fire 10% of state officials and nearly 80K policemen. Simultaneously, the Cabinet raised taxes on large pensions and royalties for mineral extraction, re-introduced the progressive income tax and imposed VAT on pharmaceuticals and grain trading.

Though both revenue and spending were adjusted to more realistic levels, the deficit was approved almost unchanged at UAH 63.8 bln (4.2% of GDP, vs. UAH 66.9 bln in December 2013). To make matters worse, the Cabinet also envisaged UAH 33.3 bln (2.2% of GDP) in refinancing for Naftogaz this year (in light of the hryvnia decline and imported gas price hike), widening the effective fiscal gap to UAH 97.1 bln, or 6.4% of GDP (from 5.0% of GDP in 2013). In other words, regardless of the tightened revenue plan, spending still needs to remain substantial and the authorities anticipate state debt to reach 43.6% of GDP (based on a UAH exchange rate at 10.5 hryvnias per USD throughout the year) by the year end (vs. 40.2% of GDP reported in 2013).

State budget stats, UAH bln*

	2013	Initial 2014	Revised 2014	Revised 2014 / 2013
State budget revenue	339.2	395.3	372.9	10.0%
% of GDP	23.31%	23.91%	24.47%	1.2pp
State budget spending	403.4	462.2	436.8	8.3%
% of GDP	27.73%	27.96%	28.66%	0.9pp
State budget deficit	64.2	66.9	63.8	-0.6%
% of GDP	4.41%	4.05%	4.19%	-0.2pp
Pension Fund subsidy	83.2	87.4	83.8	0.7%
% of GDP	5.72%	5.28%	5.50%	-0.2pp
Incl. Pension Fund deficit coverage	21.8	22.1	18.1	-16.8%
% of GDP	1.50%	1.34%	1.19%	-0.3pp

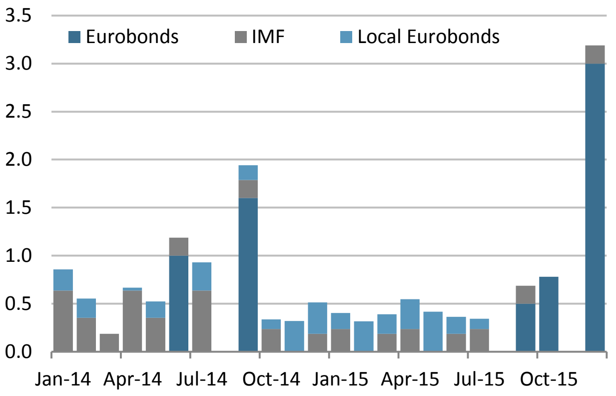
**Unless other stated*

Source: Verkhovna Rada, MinFin, State Statistics Committee of Ukraine, Concorde Capital estimates

We are quite positive about Ukraine's solvency through the year, notwithstanding the approved large fiscal gap (4.2% of GDP for the state deficit and an additional 2.2% of GDP for Naftogaz). In April-December, Ukraine will have to pay back USD 6.4 bln in foreign currency debt, and the repayment burden will rise to USD 7.4 bln in 2015. At the same time, Ukraine has USD 27 bln of committed external support for 2014-2015, according to the IMF. Already the U.S. and Ukrainian governments signed a loan guarantee agreement for USD 1 bln and the EU Foreign Affairs Council approved a mid-term loan of EUR 1 bln and an additional EUR 610 mln in macro-financial aid.

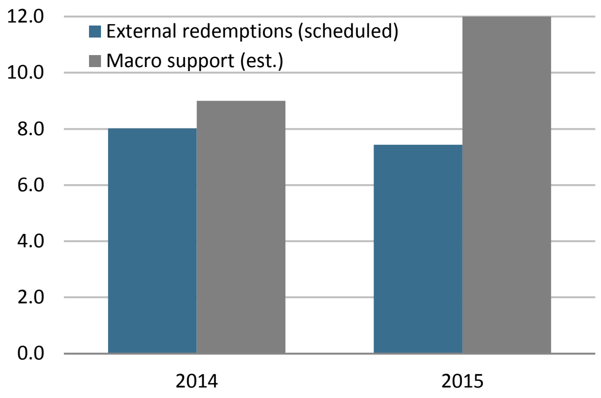
No doubt, the money is conditional on IMF cooperation, but so far we have observed a real readiness of the authorities to comply with IMF requirements: household and commercial gas prices are set to rise, the revised 2014 budget was approved, and a new procurement law was adopted. Given that we do not see any other way for the government out of its crisis without Western support, we are quite confident the Cabinet will implement everything required by the IMF. Thus, we are very optimistic about unlocking the committed USD 27 bln, which should also secure solvency on Ukraine's external debt servicing.

Government's ForEx repayments, USD bln



Source: MinFIn, NBU

ForEx repayments vs. promised macro support, USD bln



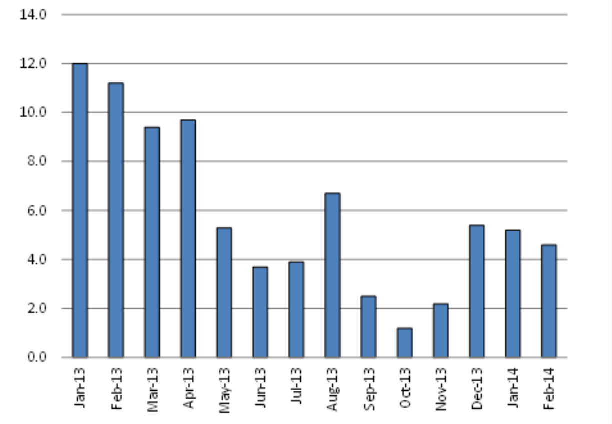
Source: MinFIn, NBU, IMF, Concorde Capital estimates

Economy promises to recover quickly after currency and fiscal correction in 2014

Recent events have considerably changed Ukraine's economic reality. Society is demanding market reforms, and the authorities are ready to respond, as demonstrated by its commitment to IMF reforms. We see quite a tough 2014 with the cooled economy and corrected real incomes on the back of budget cuts and currency devaluation. However, after this period of adjustment and assuming fulfilled reforms and avoidance of war, we see a high chance for fast recovery (GDP +2.3% yoy) and sustainable growth to start as early as 2015.

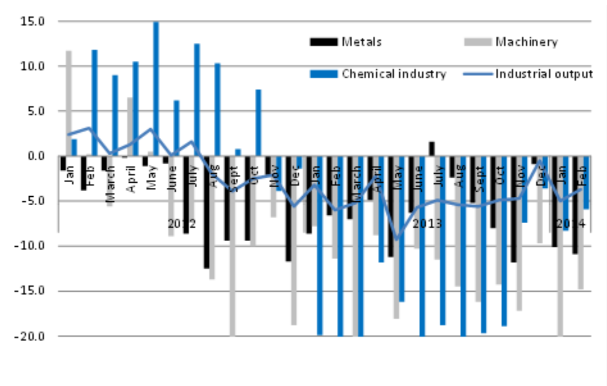
Examining specific economic markers closer, external demand will be damaged by the sliding Russian economy and on-going conflict. Private consumption is set to fall on the back of hryvnia devaluation (which is 39% YTD, as of today), budget sequestration and promised gas rate hikes. We expect investment will fall 8.1% yoy this year and government consumption to drop 5.7% yoy this year in relation to military aggression risks. To make matters worse, after last season's record high grain harvest (+36.4% yoy in 2013), we are very likely to see falling agri-production merely owing to a high comparative base (-1.9% yoy through the year). In light of these trends, we project GDP to fall 3.7% in 2014.

Organized retail trade, yoy change



Source: State Statistics Committee of Ukraine

Industrial output, yoy change



Source: State Statistics Committee of Ukraine

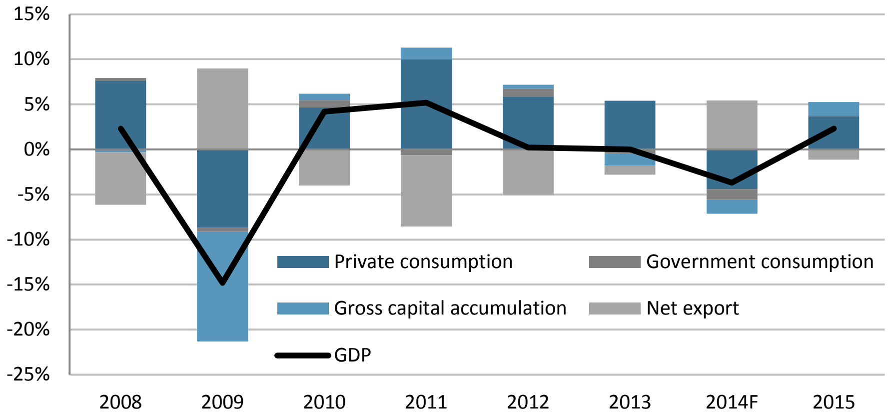
Though the situation in the real sector looks depressing at the moment, we are very positive about the national economy's mid-term recovery. In contrast to the 2008 crisis, we see at least three hopeful factors that should help the domestic economy recover quickly:

- unlike in 2008, world trade is on rise, which means the hryvnia devaluation will put domestic exports in a good position;
- unlike the early 90s, Ukraine already has basic institutions established (private property rights and distribution, financial systems and markets, state institutions, etc.). They are weak and demand significant reforming, but they do not need to be built from scratch;
- despite the narrowing demand from Russia, Ukraine will have at least two sources to compensate that loss: investment demand fuelled by IFI money (infrastructure projects and other support), and non-Russian external demand fuelled by the EU Free Trade Area and hryvnia decline.

What's more, if the authorities do manage to implement large-scale market reforms (deregulation, closing tax evasion and cross-subsidies schemes, strengthening property rights, etc.), the growth will translate into long-term sustainable dynamics. But an adjustment occurring in 2014 is crucial before the positive effects of reforms will be observed in the real sector.

For the year 2015, we anticipate exports to recover (+3.5% yoy in real terms) on the back of the hryvnia's decline and opened EU market. What's more, investment inflow (at least from IFIs and Western governments) will help investment demand revive (+7.9% yoy). Private consumption also will be catching up (+5.2%) as soon as exports start growing and investment restarts. Thus we project economic recovery to start in early 2015, with GDP growing 2.3% yoy in 2015.

Components of GDP growth



Source: State Statistics Committee of Ukraine, Concorde Capital estimates

Reforms to start with courts, law enforcement

Short-term reforms look more or less clear so far: budget spending cuts, a relaxed hryvnia, increased domestic rates for natural gas, improved procurement legislation, etc. However, those steps are more targeted towards stabilizing the current situation rather than building fundamentals for long-term development. In this respect, loud political declarations of large-scale reform prospects are quite uncertain.

We see radical overhauls of the judiciary and law enforcement bodies as among the most crucial steps needed for long-term sustainable growth. Overregulation, bribery, monopolization of markets, poor protection of property rights and other diseases of the system have infected corrupt judges, prosecutors and police officers, who are quite skilful in abusing “law enforcement” tools. In this respect, the interim government’s lustration initiative and plan to dismiss 80K officers (nearly half the police force, excluding the internal army) are on the right track. Still, reforming law enforcement is not a one-off pursuit, requiring years of tedious reform and political commitment.

Optimizing the role of authorities is also important in reducing excessive state regulation and creating a breathable business environment. Overlapping functions, excessive inspections and bureaucratic requirements, and the inefficient use of available state assets are endemic among state organs. A comprehensive system-based auditing of the state machine, as well as automatizing and simplifying bureaucratic procedures, should be established.

Eliminating economic imbalances such as cross-subsidization, state support of bankrupt industrial sectors, and unjustified social protection without income-testing is one more package of reforms for the authorities’ “must list.” This direction will definitely create social tension, e.g. due to boosted gas and heating rates.

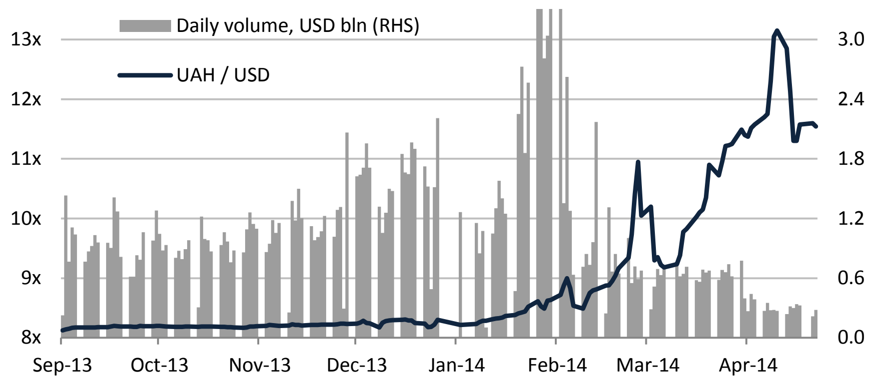
So far we have seen short-term stabilization steps from the interim government, which are certainly important at the moment. But long-term sustainable growth requires the commitment and determination to follow through with more fundamental reforms. In this context, the results of the May 25 presidential election are crucial since a sustainable political framework is needed for the successful implementation of reforms.

Hryvnia prospects: devaluation potential released, significant volatility ahead

The hryvnia experienced unprecedented volatility, undergoing sharp oscillations in recent weeks, after the NBU withdrew from the ForEx market. Drastically reduced volumes of ForEx turnover (down to USD 0.3 bln in April vs. USD 1.4 bln in February) point to the fact that hryvnia's devaluation potential has been released.

Exchange rate jumps should be attributed to the uncertainty market players experienced after unexpected changes in the rules on the market. So far, we have seen the NBU make attempts, albeit very limited, to tame the fluctuations. However, volatility will continue on the ForEx until a futures market is launched (hopefully by the end of the year, if the NBU wants to continue pursuing its laissez-faire policy).

Interbank UAH/USD market



Source: Ukrainian Interbank Currency Exchange

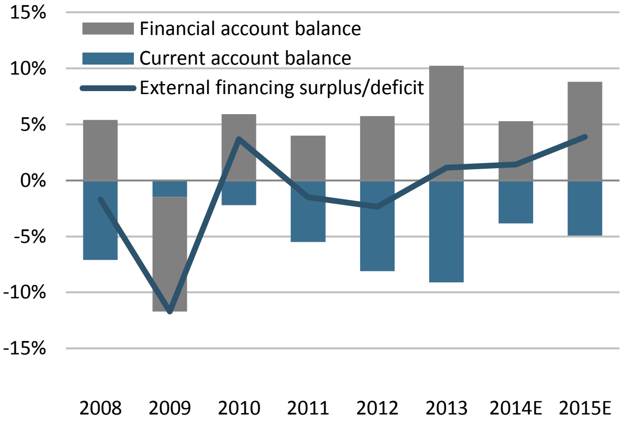
The balanced exchange rate level is close to 10.5 hryvnia per USD, according to our estimates. We see mid-term external accounts prospects substantially improving with the hryvnia's decline, combined with the EU's unilateral lifting of import tariffs and multibillion-dollar financial commitments from different countries and IFIs. We estimate Ukraine's C/A deficit shrinking to $7.1 billion (4.9% of GDP) in 2014 from $16.4 billion (9.2% of GDP) in 2013

In fact, an almost 30% hryvnia devaluation and poor investment demand (caused by the conflict with Russia) promises at least a 15% contraction of non-energy imports through the year. No doubt, Russia will charge the maximum possible price for gas (USD 485 per tcm was announced for 2Q14). However, we anticipate the Cabinet will succeed in replacing Russian gas with reverse supplies from the EU, namely Slovakia and Poland. What's more, lower gas prices in 1Q14 already saved a lot (USD 1.7 bln) for the country. All in all, we anticipate the energy bill to remain flat yoy while general imports will decline 10.9% yoy (nearly USD 11 bln).

Though the prospects of imports are quite straightforward, the situation with exports is more disputable. The annulment of import tariffs by the EU is a very promising step but for the mid-term . At the same time, we anticipate the escalating trade war with Russia will damage a large part of Ukrainian exports (Russian destination accounted for 23.7% of Ukraine's total exports in 2013). Still for our estimates, we are relying on the hryvnia decline to offset losses from Russia, which will make the prices of Ukrainian commodities much more competitive on non-Russian markets, thus preventing a drastic exports decline in the short term.

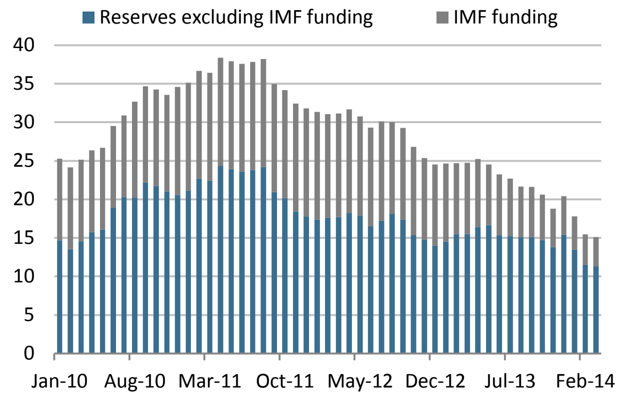
On the side of financial flows, the picture is quite clear: as soon as the IMF agreement is signed, we should see considerable technical support inflow to cover the internal foreign currency deficit (we estimate USD 8-10 bln through the year, in tranches). Against this backdrop, we project gross foreign reserves to recover to USD 22.3 bln (3.0 months of imports) by the year end.

External financing gap, % of GDP



Source: NBU, State Statistics Committee of Ukraine, Concorde Capital estimates

Gross NBU international reserves, USD bln

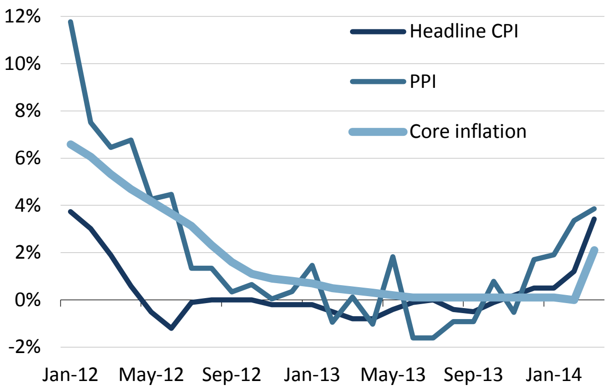


Source: NBU

CPI to speed up on UAH decline and costlier gas

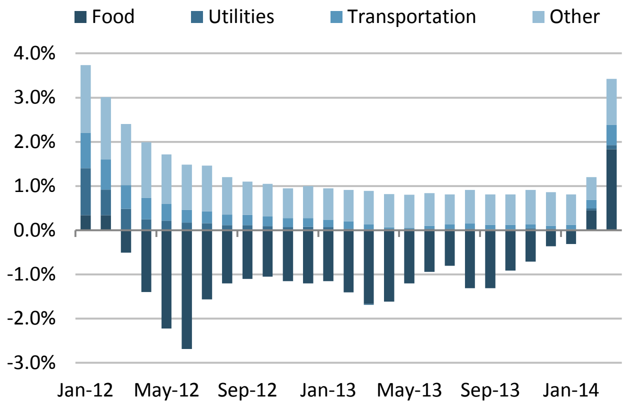
Hryvnia devaluation and gas rate hikes for business and households will be the key determinants of consumer price dynamics through the year. Food prices also will be important, but in light of the record grain harvest last year, we do not expect food prices growing fast. So by the end of 2014, we anticipate CPI growing 12.7% YTD and average CPI at 7.1% yoy).

CPI and PPI, yoy



Source: State Statistics Committee of Ukraine

Headline CPI breakdown, yoy



Source: State Statistics Committee of Ukraine

For 2015, we see CPI maintaining high growth rates on the back of economic recovery and further adjustments in gas prices and heating rates (the Cabinet has promised a 40% gas price hike for the population next year after 50% this year). Against this backdrop, we estimate CPI at 6.8% YTD in 2015 (at an average inflation rate of 10.5% yoy).

Producer prices also will speed up. Energy inputs and other imported inputs will also be reflected by the hryvnia decline. What's more, we see a chance that the strengthening of Western economies might offer a boost to resource prices. Against this backdrop, we project PPI to increase 11.8% yoy (18.9% YTD) in 2014 and speed up in 2015 to 16.9% yoy (13.0% YTD).

We might see some changes in monetary policy principles in light of the recent NBU declaration to shift to inflation targeting. The authorities did not provide any details on that plan. However, in our opinion, that won't happen soon since for the time being, funding the budget deficit and restricting hryvnia volatility still remain the key priorities for the NBU. In particular, after a period of significant volatility at the ForEx, the NBU increased the discount rate by 3pp to 9.5% and the refinancing rate to 14.5% from 7.5% on April 15. Anyway, we hope that in the mid-term (probably starting in 2015), Ukraine's monetary authorities will abandon their long-held obsession with controlling exchange rates and create a full-fledged floating regime with a well-functioning ForEx futures market. Since there will be no benchmarks like foreign currency corridors or NBU commitments to keep the exchange rate at a particular level, a forward market is critical to prevent dramatic volatility and enable importers to schedule their activities well in advance.

Against this backdrop, we project the monetary base growing 19.8% YTD in 2014, primarily on the back of state deficit funding through state bonds purchases by the NBU. Interest rates in this situation promise to be volatile and are unlikely to decrease much. At the same time, for 2015 we anticipate the NBU directing more funds into crediting the economy, which should reduce the price of money. We expect the monetary base to speed up at least 23% next year.

Key macro indicators

	2008	2009	2010	2011	2012	2013	2014F	2015F
Economic activity indicators								
Real GDP, % chg yoy	2.3	-14.8	4.1	5.2	0.2	0.0	-3.7	2.3
Household consumption, chg yoy	13.1	-14.2	7.2	15.0	11.7	7.8	-5.6	5.2
Investments in fixed capital, % chg yoy	-1.2	-50.5	4.0	10.1	0.6	-6.6	-8.1	7.9
Nominal GDP, UAH bln	948	913	1,083	1,302	1,411	1,454	1,524	1,725
Nominal GDP, USD bln	180	117	137	163	176	177	145	157
GDP per capita, USD	3,881	2,541	2,981	3,557	3,859	3,893	3,195	3,452
Industrial output, % chg yoy	-5.2	-21.9	11.2	8.0	-0.5	-4.7	-5.1	3.1
CPI (eop), %	22.3	12.3	9.1	4.6	-0.2	0.5	12.7	6.8
CPI average, %	25.2	15.9	9.4	8.0	0.6	-0.3	7.1	11.8
PPI (eop), %	23.0	14.3	18.7	14.2	0.3	1.7	18.9	13.0
External accounts								
Current account balance, USD bln	-12.8	-1.7	-3.0	-10.2	-14.3	-16.4	-7.1	-8.1
% GDP	-7.1%	-1.5%	-2.2%	-6.3%	-8.1%	-9.2%	-4.9%	-5.2%
Merchandise trade balance, USD bln	-16.1	-4.3	-8.4	-16.3	-19.5	-19.6	-10.7	-12
% GDP	-8.9%	-3.7%	-6.1%	-10.0%	-11.1%	-11.1%	-7.4%	-7.6%
Service trade balance, USD bln	1.7	2.4	4.4	6.1	5.2	4.1	4.5	4.8
% GDP	0.9%	2.1%	3.2%	3.7%	3.0%	2.3%	3.1%	3.1%
Financial account balance, USD bln	9.7	-12.0	8.0	7.8	10.1	18.4	9.8	14.5
% GDP	5.4%	-10.3%	5.8%	4.8%	5.7%	10.4%	6.8%	9.2%
FDI net, USD bln	9.9	4.7	5.8	7.0	6.6	3.4	2.9	5.2
% GDP	5.5%	4.0%	4.2%	4.3%	3.8%	1.9%	2.0%	3.3%
Gross NBU reserves (eop), USD bln	31.5	26.5	34.6	31.8	24.6	20.4	22.3	27.2
Public debt								
Public debt, USD bln	24.6	39.8	54.3	59.2	64.5	73.1	73.5	80.6
% GDP	13.7%	34.0%	39.6%	36.3%	36.6%	41.3%	50.7%	51.3%
Public external debt, USD bln	18.5	26.6	34.8	37.5	38.7	37.5	41.5	46.5
% GDP	10.3%	22.7%	25.4%	23.0%	22.0%	21.2%	28.6%	29.6%
Gross external debt, USD bln	101.7	103.4	117.3	126.2	135.1	142.5	150.2	161.6
% GDP	56.5%	88.4%	85.6%	77.4%	76.8%	78.3%	103.6%	102.9%
Monetary and banking sector indicators								
Monetary base, UAH bln	187	195	226	240	255	307	368	452
Monetary base, % chg yoy	31.6%	4.4%	15.8%	6.3%	6.4%	20.30%	19.80%	23.00%
Money supply (M3), UAH bln	516	487	598	686	773	910	1073	1367
Money supply, % chg yoy	30.2%	-5.5%	22.7%	14.7%	12.8%	17.60%	17.90%	27.40%
Monetary multiplier (eop M3/MB)	2.8	2.5	2.6	2.9	3.0	3.0	2.9	3.0
Monetization (eop M3/GDP), %	54.4%	53.3%	55.2%	52.7%	54.9%	62.6%	70.4%	79.2%
Bank loans, % chg yoy	72.0%	-1.5%	1.3%	9.4%	1.7%	11.7%	18.1%	25.8%
Bank deposits, % chg yoy	26.7%	-6.9%	24.4%	18.0%	16.4%	17.1%	12.6%	28.1%
Loan-to-deposit ratio	2.04	2.16	1.76	1.63	1.42	1.36	1.43	1.40
Exchange rate								
Official UAH/USD (eop)	7.58	7.97	7.96	7.99	7.99	7.99	10.5	11.0
Official UAH/USD (avg)	5.27	7.79	7.94	7.97	7.99	7.99	10.5	11.0
Fiscal indicators								
Consolidated budget revenues, USD bln	56.5	37.0	39.8	49.8	55.7	54.0	45.3	52.3
% GDP	31.4%	31.6%	29.1%	30.6%	31.6%	30.5%	31.2%	33.4%
Consolidated budget expenditures, USD bln	58.7	39.4	47.8	52.1	61.5	61.7	51.6	58.1
% GDP	32.6%	33.7%	34.9%	32.0%	34.9%	34.8%	35.5%	37.0%
Consolidated budget balance, USD bln	-2.2	-2.4	-8.0	-2.3	-5.8	7.7	6.2	5.7
% GDP	-1.2%	-2.1%	-5.8%	-1.4%	-3.3%	4.3%	4.3%	3.7%
General budget balance (incl. Naftogaz), USD bln	n/a	-5.3	-10.7	-3.2	-7.0	8.7	9.4	7.6
% GDP	n/a	-4.5%	-7.8%	-2.0%	-4.0%	4.9%	6.5%	4.8%
Social indicators								
Population, mln (eop)	46.1	46.0	45.8	45.6	45.6	45.5	45.4	45.4
Unemployment (ILO methodology, avg.), %	6.9%	9.6%	8.8%	8.6%	8.3	8.0	8.2	8.1
Average monthly salary, USD	343	245	282	330	378	398	336	369
Real disposable income, % chg yoy	7.6%	-10.0%	17.1%	8.0%	13.5	5.3	-5.6	3.4

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