

July 10, 2012

Ukrainian Economy

Smooth 2Q, expect calm 3Q

Ukraine coped fairly well with its challenges in 1H12, though cooperation with the IMF remains on hold and lingering gas negotiations with Russia have brought no results so far. GDP growth was close to 2% in 1H12, thanks to solid domestic consumption. The government passed its peak for external public debt redemptions and should manage to service its debt smoothly for the remainder of 2012 as domestic FX borrowings remain sizable. The NBU is still committed to preventing major hryvnya depreciation vs. the US dollar and balance of payments trends have been supportive of this goal so far. We lower our end-2012 exchange rate projection marginally to UAH 8.4/USD from UAH 8.2/USD previously as the central bank's determination to allow for greater UAH/USD volatility seems to be deepening.

Economic growth steady at around 2%, but downside risks are there

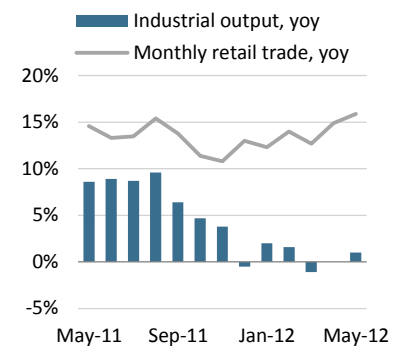
Data for individual sectors in 5M12 remains consistent with GDP growth of 1.8-2.2% yoy. While export-oriented sectors continue to suffer from weakness in external demand (metallurgy was down 1.6% yoy in 5M12 and machinery up a mere 2.2% yoy), domestic-oriented sectors are faring relatively well: retail trade surged 14.1% in 5M12 (in real terms) and the combined output of non-financial services sectors was up 13.2% yoy. A pre-election boost in social payments and double-digit growth in salaries against the backdrop of deflation will support growth in household consumption (traditionally the largest GDP component) at 7-9% yoy this year. Exports will remain a drag on economic growth as there is no evidence global commodity markets will improve any time soon. We maintain our projection of GDP growth at 1.9% yoy in 2012 but note that risks currently are to the downside. Our key concern now (besides persisting jitters in global commodity markets) is unfavorable weather conditions, which might harm this year's harvest. According to recent projections from the Agriculture Ministry, the crop harvest is expected to reach 45 million tons at best this year, which implies a 20% yoy decline.

External public debt redemptions smooth in June, peak passed

This year's peak for external public debt redemptions passed smoothly in June: the government repaid a total of USD 1.5 bln in principal and we think it remains well positioned to service maturing debt on time and in full even if plans to sell Eurobonds this year fall through. Thanks to the active primary T-bill market in June, the government raised an equivalent of USD 1.0 bln in foreign currencies (though we admit this was to a large extent thanks to the participation of state banks) and we estimate its end-June FX holdings at USD 1.1 bln. The government is due to repay USD 1.8-2.2 bln (incl. interest) in external debt in 2H12; we think it will be able to fill its gap of USD 0.7-1.1 bln by raising money domestically. Overall, the government attracted an equivalent of USD 5.1 bln (hryvnya and FX, net of T-bills to be redeemed within a year) in 1H12, or 67% of its full year target, while external borrowing stood at zero. The government looks determined to absorb all the liquidity the banking sector might accumulate through end-2012.

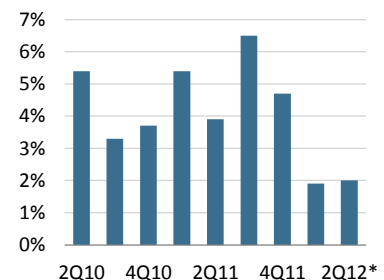
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Monthly ind. output and retail trade



Source: UkrStat

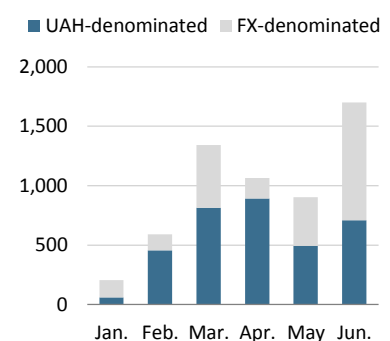
GDP growth, yoy



* Concorde Capital estimate

Source: UkrStat

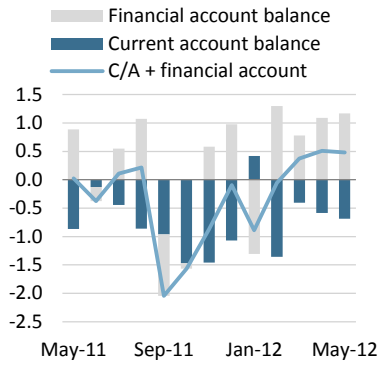
Primary gov't bond sales, USD bln*



* Local bonds

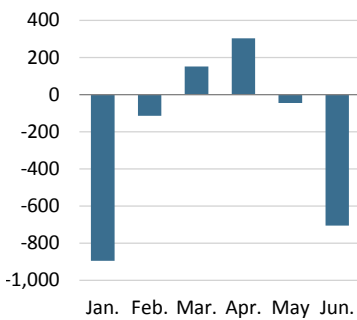
Source: Finance Ministry, Concorde Capital

Balance of payments, USD bln



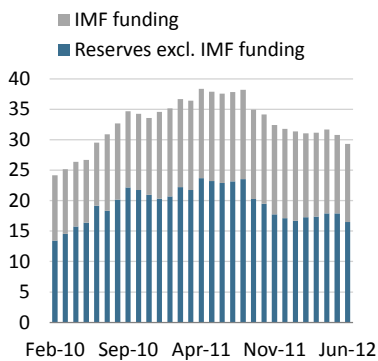
Sources: NBU

NBU net interventions, USD mln*



* Negative figures indicate NBU sales
Source: NBU

NBU gross reserves, USD bln



Sources: NBU, Concorde Capital

Only moderate hryvnia depreciation seen through end-2012

Successful government/NBU efforts to secure additional FX inflow by concluding agreements with China and Naftogaz' drawing a USD 2.0 bln from Gazprombank reinforce our view the NBU will succeed in keeping the hryvnia relatively stable vs. USD for the remainder of the year. We still lower our end-2012 hryvnia rate projection to UAH 8.4/USD from UAH 8.2/USD earlier to reflect authorities' seemingly growing determination to allow for greater hryvnia flexibility.

We stick with our projection that Ukraine's current account (C/A) gap will widen insignificantly to USD 10.9 bln this year from USD 9.3 bln in 2011 as cuts in gas imports (-20% yoy in monetary terms in 5M12) will be more substantial than the drop in steel exports (Ukraine's key export commodity). The government recently reiterated plans to slash imports of gas from Russia to 35 bcm this year from 45 bcm purchased in 2011, which should prevent any major deterioration in the merchandise trade and C/A deficits vs. 2011 figures.

The financial account surplus stood at a hefty USD 3.0 bln in 5M12 as net debt inflows to the corporate sector were strong enough to offset repayments by the government and banks. June's statistics will expectedly show a substantial gap in the financial account due to the government redeeming its USD 0.5 bln Eurobond and repaying a USD 1.0 bln portion of the USD 2.0 bln VTB loan.

The NBU sold net USD 1.3 bln (4.1% of end-2011 reserves) in 1H12 to alleviate imbalances in the local FX market (incl. USD 0.7 bln in June). Overall, NBU reserves were down 7.8% (USD 2.5 bln) in 1H12 to USD 29.3 bln, partly due to the USD 1.2 bln repayment of the IMF standby loan drawn back in 2008 and USD 1.5 bln in government redemptions in June.

As external conditions remain unfavorable, the government has apparently backed away from the idea of selling Eurobonds in the coming months to refinance maturing obligations. Instead, it stepped up efforts to attract funding from alternative sources and that has proved to be a success. In late June, the government secured a USD 3.0 bln loan from China's Export-Import Bank. The 15-year facility will carry an interest rate of 3M LIBOR +4.5% and Ukraine will start repaying the principal after a five-year grace period. While the loan is designed for projects in the agricultural sector, it will (if drawn in full already this year) boost NBU reserves by about 10% and improve the government's FX liquidity position. Additionally, the NBU signed a hryvnia/yuan swap agreement for an equivalent of USD 2.4 bln with the People's Bank of China. This gives an opportunity to fund imports from China with the yuan, which will ease demand for dollars in the local FX market. The NBU also announced it plans to sign a similar deal with Russia.

We continue to see Ukraine's 2012 external financing gap at close to USD 6.0 bln or 3.2% of GDP – the USD 4.8 bln financial account surplus is expected to partly offset the USD 10.9 bln C/A gap. As we only marginally downgraded our end-2012 UAH/USD projection (UAH 8.4/USD vs. 8.2 previously) and think the hryvnia will weaken against the US dollar in late 4Q only, we do not see reasons to revise our estimate for the external financing gap. We also stick with our end-2012 NBU reserves projection of USD 23.1 bln, but the figure does not account for potential additions due to attraction of the Chinese loan and effect of the yuan/hryvnia swap agreement.

Macro data and forecasts

	2005	2006	2007	2008	2009	2010	2011	2012E
Business cycle indicators								
Real GDP, % chg yoy	3.0	7.4	7.6	2.3	-14.8	4.2	5.2	1.9
Household consumption, % chg yoy	20.1	15.9	17.1	11.8	-14.1	7.0	15.0	8.1
Investments in fixed capital, % chg yoy	3.9	20.9	23.9	1.6	-50.5	4.9	10.1	7.0
Nominal GDP, UAH bln	441	544	721	948	915	1,095	1,317	1,516
Nominal GDP, USD bln	86	108	143	180	117	138	165	188
GDP per capita, USD	1,836	2,312	3,078	3,891	2,554	3,016	3,625	4,129
Industrial output, % chg yoy	3.1	6.2	7.6	-5.2	-21.9	11.2	7.6	2.9
CPI (eop), %	10.3	11.6	16.6	22.3	12.3	9.1	4.6	5.9
CPI average, %	13.5	9.1	12.8	25.2	15.9	9.4	8.0	2.6
PPI (eop), %	9.5	14.1	23.3	23.0	14.3	18.7	14.2	11.9
External accounts								
Current account balance, USD bln	2.5	-1.6	-5.3	-12.8	-1.7	-3.0	-9.3	-10.9
% of GDP	2.9%	-1.5%	-3.7%	-7.1%	-1.4%	-2.2%	-5.6%	-5.8%
Merchandise trade balance, USD bln	-1.1	-5.2	-10.6	-16.1	-4.3	-8.4	-13.8	-14.8
% of GDP	-1.3%	-4.8%	-7.4%	-8.9%	-3.7%	-6.1%	-8.4%	-7.9%
Service trade balance, USD bln	1.8	2.1	2.4	1.7	2.4	4.4	4.9	3.8
% of GDP	2.1%	1.9%	1.7%	0.9%	2.0%	3.2%	3.0%	2.0%
Financial account balance, USD bln	8.2	4.0	14.7	9.7	-12.0	8.0	6.6	4.8
% of GDP	9.5%	3.7%	10.3%	5.4%	-10.2%	5.8%	4.0%	2.6%
FDI net, USD bln	7.5	5.7	9.2	9.9	4.7	5.8	7.0	5.5
% of GDP	8.7%	5.3%	6.5%	5.5%	4.0%	4.2%	4.2%	2.9%
Gross NBU reserves (eop), USD bln	19.4	22.4	32.5	31.5	26.5	34.6	31.8	23.1
Debt								
Public debt, USD bln	15.5	15.9	17.6	24.6	39.7	54.3	59.2	64.2
% GDP	18%	15%	12%	14%	34%	39%	36%	34%
Public external debt, USD bln	11.6	12.7	13.8	18.5	26.6	34.1	37.5	37.4
% GDP	13%	12%	10%	10%	23%	25%	23%	20%
Gross external debt, USD bln	39.6	54.5	80.0	101.7	103.4	117.3	126.2	127.4
% GDP	46%	51%	56%	56%	88%	85%	76%	68%
Monetary and banking sector indicators								
Monetary base, UAH bln	83	97	142	187	195	226	240	244
Monetary base, % chg yoy	54%	17%	46%	32%	4%	16%	6%	2%
Money supply (M3), UAH bln	194	261	396	515	487	598	683	685
Money supply, % chg yoy	54%	35%	52%	30%	-5%	23%	14%	0%
Monetary multiplier (eop M3/MB)	2.3	2.7	2.8	2.8	2.5	2.6	2.8	2.8
Monetization (avg M3/GDP), %	37%	42%	46%	48%	55%	50%	49%	45%
Bank loans, % chg yoy	62%	71%	74%	72%	-2%	1%	10%	5%
Bank deposits, % chg % yoy	60%	39%	52%	28%	-8%	26%	18%	11%
Loan-to-deposit ratio	1.08	1.33	1.52	2.05	2.19	1.75	1.62	1.53
Exchange rate								
Official UAH/USD (eop)	5.05	5.05	5.05	7.70	7.99	7.96	7.99	8.40
Official UAH/USD (avg)	5.12	5.05	5.05	5.27	7.79	7.94	7.97	8.07
Fiscal indicators								
Consolidated budget revenues, USD bln	26.2	34.0	43.6	56.4	35.0	39.6	50.0	54.3
% of GDP	30%	32%	31%	31%	30%	29%	30%	29%
Consolidated budget expenditures, USD bln	27.7	34.7	45.1	59.1	39.8	47.6	52.3	57.2
% of GDP	32%	32%	32%	33%	34%	35%	32%	30%
Consolidated budget balance, USD bln	-1.6	-0.7	-1.5	-2.7	-4.8	-8.0	-3.0	-2.9
% of GDP	-1.8%	-0.7%	-1.1%	-1.5%	-4.1%	-5.8%	-1.8%	-1.5%
General budget balance, USD bln*	n/a	n/a	n/a	n/a	-9.5	-10.1	-7.0	-5.2
% of GDP	n/a	n/a	n/a	n/a	-8.1%	-7.3%	-4.3%	-2.8%
Social indicators								
Population, mln (eop)	46.9	46.6	46.4	46.3	46.0	45.8	45.6	45.5
Unemployment (ILO methodology, avg.), %	7.8%	7.4%	6.9%	6.9%	9.6%	8.8%	8.6%	8.1%
Average monthly salary, USD	160	206	268	235	239	281	330	358
Real disposable income, % chg yoy	23.9%	11.8%	14.8%	7.6%	-8.5%	16.2%	6.1%	6.8%

* Combined balance of the central budget (excluding costs of capitalizing state banks), local budgets, social funds and Naftogaz
 Source: UkrStat, NBU, Finance Ministry, Concorde Capital

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