

February 21, 2012

Ukrainian Economy

Uninspiring start to 2012

The first macro data reported for 2012 point to a challenging year ahead. Economic growth moderated in January and should remain low (we stick to our projection of 1.9% growth in 2012) without a trigger from external markets. The NBU is keeping tight control of the currency market and remains determined to defend the hryvnya at its current level. The primary market for government debt remains quiet due to insufficient liquidity in the banking sector and, with no signs of improvement, we do not rule out that the government might accept a 9.5%+ interest rate to raise debt abroad this spring. The prospect of Ukraine resuming its IMF standby loan program seems remote as the election-minded government does not seem desperate for new IMF money at this point.

Economic growth expectedly turns anaemic in January

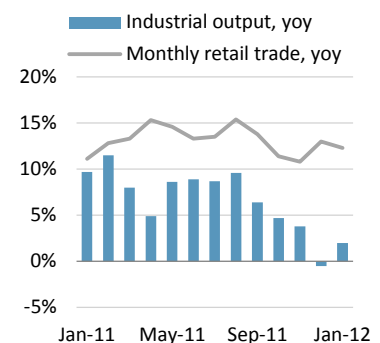
Economic indicators for January were weak, with major sectors either struggling to stay positive or having already slipped into the negative. Industrial output edged up 2.0% yoy in January (vs. -0.5% yoy in December), while transportation turned negative. Agriculture, a key growth driver in 2H11, increased a mere 0.5% yoy last month. Retail trade remains the only bright spot as it continues to hover in the double digits (+12.4% yoy in January). This clearly attests to continued strength in domestic demand, which we expect will be the main economic driver this year. With external demand slackening, we do not rule out real GDP turning negative on a year-on-year basis in 2Q12. We maintain our projection of 2012 GDP increasing 1.9% yoy (vs. 5.2% in 2011), but note that the current balance of risks is to the downside.

Hryvnya stable as NBU steps up interventions

The NBU had to sell net USD 0.9 bln in January to maintain the current hryvnya exchange rate (vs. net purchases of USD 0.2 bln in December). This was likely due to deterioration in the merchandise trade balance. On a positive note, demand for hard currencies from households subsided – net FX purchases decreased to USD 0.5 bln last month from USD 0.7 bln in December, implying depreciation expectations among the population remained muted. Overall, NBU reserves fell by USD 0.4 bln in January to USD 31.4 bln (3.6 months of 2012E imports). We expect reserves to decline by another USD 1.0-1.2 bln in February on continued NBU interventions and repayment of USD 0.6 bln to the IMF that the NBU drew back in 2008. We continue to believe the NBU will prioritize UAH/USD stability throughout 2012, even though it may cost the central bank up to 1/4 of its reserves (USD 7-8 bln), according to our estimates.

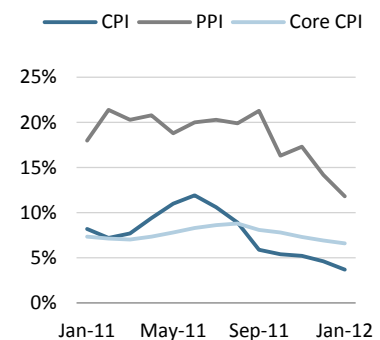
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Monthly ind. output and retail trade



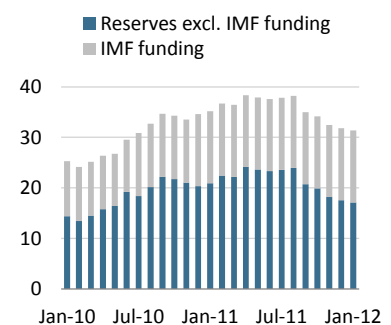
Source: UkrStat

CPI and PPI, yoy



Source: UkrStat

NBU reserves, USD bln



Source: NBU, Concorde Capital

The government has been reluctant to accept IMF conditions so far

Since the start of 2012, there has been no meaningful progress on Ukraine resuming its IMF standby loan program. Recently, the IMF reiterated that new tranches are strictly conditional on prior actions (including gas tariff hikes and full reimbursement of VAT arrears). Separately, last week, the U.S. Assistant Secretary of State said continuation of the IMF-Ukraine program is also contingent upon the Ukrainian government's respect for democratic principles. Though not an official IMF position, the comment signals more work will be necessary by the Ukrainian government to put the program back on track. At this point, the government is not desperate for IMF money, but we think its stance could change if it fails to raise a much-needed USD 1.5-2.0 bln in Eurobonds by mid-1H12 and/or the economy's external accounts continue to worsen.

Primary government bond market still quiet

The primary market for government bonds has been largely quiet this year, with the government raising just UAH 4.6 bln (USD 575 mln) so far, only 8% of its full year target (not accounting for the fact that 39% of that amount is short-term and redeemable by end-2012). Demand has been feeble for both standard UAH and USD-denominated securities as banks apparently do not believe the recent improvement in the sector liquidity is sustainable. As there was a seasonal budget surplus and no sizable debt redemptions in January, the government managed to meet its budget obligations without substantial borrowings. The remainder of 1Q12 is likely to be more challenging – the government is due to redeem UAH 2.9 bln (USD 363 mln) in local debt on Feb. 22 and another UAH 4.7 bln (USD 594 mln) in March. Should demand for local sovereign bonds remain muted in the coming months, we expect the Finance Ministry to either monetize the budget deficit (by selling bonds to state banks which would put the securities up as collateral for loans from the NBU) or accept a punitive 9.5%+ rate to borrow from international markets.

Macro data and forecasts

	2005	2006	2007	2008	2009	2010	2011E	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	14.3	8.1
Investments in fixed capital, % chg yoy	3.9	20.9	23.9	1.6	-50.5	4.9	11.2	7.0
Nominal GDP, UAH bln	441	544	721	948	915	1,095	1,314	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	3,618	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	9.1
CPI average, %	13.5	9.1	12.8	25.2	15.9	9.4	8.0	5.2
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	-2.9	-9.3	-11.9
% of GDP	2.9%	-1.5%	-3.7%	-7.1%	-1.4%	-2.1%	-5.6%	-6.3%
Merchandise trade balance, USD bln	-1.1	-5.2	-10.6	-16.1	-4.3	-8.7	-13.8	-15.8
% of GDP	-1.3%	-4.8%	-7.4%	-8.9%	-3.7%	-6.3%	-8.4%	-8.4%
Service trade balance, USD bln	1.8	2.1	2.4	1.7	2.4	4.7	4.6	3.8
% of GDP	2.1%	1.9%	1.7%	0.9%	2.0%	3.4%	2.8%	2.0%
Financial account balance, USD bln	8.2	4.0	14.7	9.7	-12.0	7.9	6.8	4.8
% of GDP	9.5%	3.7%	10.3%	5.4%	-10.2%	5.7%	4.1%	2.6%
FDI net, USD bln	7.5	5.7	9.2	9.9	4.7	5.8	6.6	5.5
% of GDP	8.7%	5.3%	6.5%	5.5%	4.0%	4.2%	4.0%	2.9%
Gross NBU reserves (eop), USD bln	19.4	22.4	32.5	31.5	26.5	34.6	31.8	22.1
Debt								
Public debt, USD bln	15.5	15.9	17.6	24.6	39.7	54.3	59.2	64.2
% of 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
% of 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	121.9	123.4
% of GDP	46%	51%	56%	56%	88%	85%	74%	66%
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	8.20
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	-2.3	-2.9
% of GDP	-1.8%	-0.7%	-1.1%	-1.5%	-4.1%	-5.8%	-1.4%	-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%	8.3%	8.1%
Average monthly salary, USD	160	206	268	235	239	281	330	366
Real disposable income, % chg yoy	23.9%	11.8%	14.8%	7.6%	-10.0%	17.1%	7.7%	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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