March 29, 2012

Ukrainian Economy

Growth remains weak, external accounts improve

Ukrainian economic growth remained weak in February (industrial production rose a mere 1.6% yoy) amid deterioration in external markets and disrupted transportation due to tough weather conditions. Two bright spots in February were strong private consumption (retail turnover rose 14.0% yoy) and moderation in external funding pressure. NBU reserves declined just 1% mom to USD 31.0 bln in February, a tiny amount considering the large volume of external debt redemptions. While the government recently postponed a Eurobond placement, saying it wanted to hold out for an 8.5% rate, it has been successful in raising money on the local primary debt market (volumes were up 2.9x mom in February and 2.1x mom in March).

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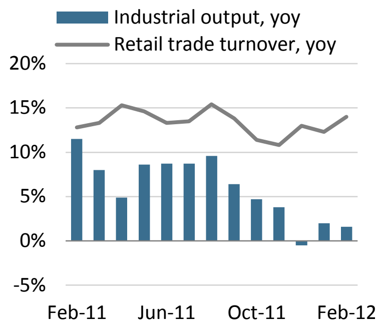
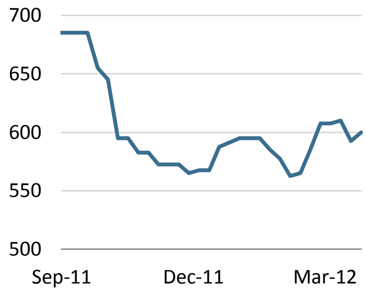
Monthly ind. output and retail trade



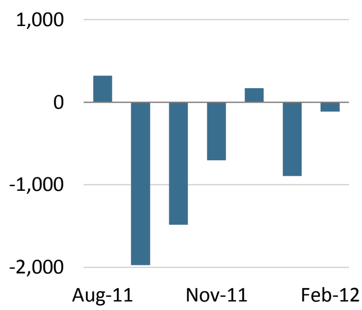
Source: UkrStat

Steel CIS Export Billet (Black Sea), USD/ton



Source: Bloomberg

Net NBU interventions, USD mln*



** Negative figures indicate NBU sales*
Source: NBU

Growth remains weak, private consumption the only bright spot

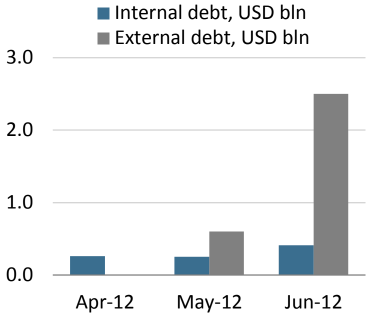
Ukrainian economic growth remained weak in February amid deterioration in external markets and disrupted transportation due to tough weather conditions. Industrial production continued to slow, adding a mere 1.6% yoy in February (vs. +2.0% yoy in January) despite one more work day than last year. Metallurgy, Ukraine's core processing industry, remained in the red for the fourth consecutive month (-4.3% yoy in February) and machinery added just 0.2% yoy (vs. +11.7% yoy in January). Yet, we believe a deeper drop is metallurgy production is unlikely – prices for metals have remained little changed for the last few weeks, indicating demand has stabilized. We expect industrial production growth to remain weak in 2Q12, with export-oriented industries the main drag.

Construction, one of the fastest growing sectors last year, slid negative (-0.5% yoy in 2M12) for the first time since 2010. However, retail turnover (a proxy for the private consumption) remained a bright spot amid the overall weakness, rising a solid 14.0% yoy (vs. +12.3% yoy in January), backed by robust growth in nominal salaries (+19.7% yoy in February) and the lowest inflation in the last nine years (+3.0% yoy in February). Solid growth in household income should keep private consumption strong and is supportive of our 2012 GDP growth projection of 1.9%.

External funding pressure eased considerably

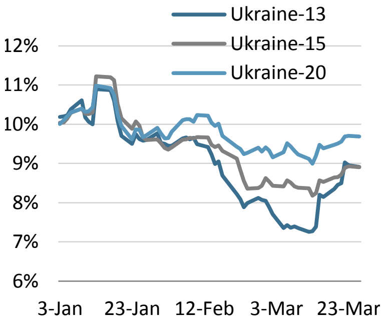
The NBU spent a paltry USD 0.1 bln in February to support the national currency, in sharp contrast to USD 0.9 bln sold in January. The population's net FX purchases also declined considerably, contracting by 1/3 mom and 3.5x compared to last year's peak in November. NBU reserves fell 1% mom (USD 0.3 bln) to USD 31.0 bln as of end-February, despite sizable external debt redemptions (including the NBU's repayment of USD 0.6 bln to the IMF and Privatbank's redemption of its USD 0.5 bln Eurobond).

Public debt redemptions in 2Q12



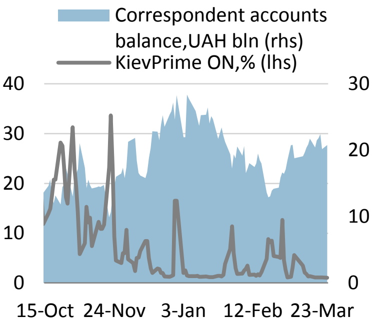
Sources: FinMin, IMF, Concorde Capital

Ukraine's Eurobond yield curves



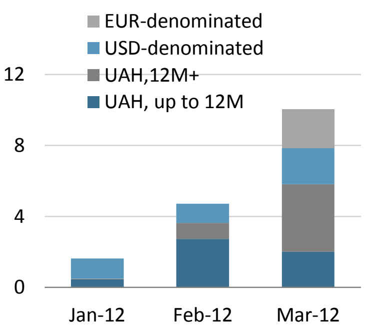
Source: Bloomberg

Banking system liquidity



Sources: NBU, Bloomberg, Concorde Capital

Primary gov't bond sales, UAH bln



Sources: Finance Ministry, Concorde Capital

According to NBU data, net capital inflows fully offset the C/A deficit in February thanks to strong FDI and trade credits, which kept the FX market broadly balanced through the month. In March, the NBU has stayed out of the market for most of the month, indicating the external financing shortfall remains insignificant. We think that muted depreciation expectations and the recent improvement in external accounts should enable the NBU to keep the UAH/USD rate broadly stable through 2012.

New IMF funds still look unlikely in 2012, Eurobond placement delayed

Ukraine redeemed USD 0.6 bln in maturing IMF debt in February while the next payment to the IMF, USD 0.6 bln, is scheduled for May. In early March, government officials claimed Ukraine might want to restructure a portion of its debt to IMF due this year, but Prime Minister Mykola Azarov later denied the rumors and the IMF Representative in Ukraine Max Alier said it was technically impossible. Thus, the only possible way for Ukraine to keep its debt to the IMF flat this year is to unfreeze its current standby loan program. Meanwhile, Ukrainian politicians up to the president continue to pointedly refuse to implement IMF-required actions.

The Ukrainian government postponed placement of USD 1.5 bln in Eurobonds, saying Ukraine is targeting a rate of 8.5% or less (while Ukrainian debt currently trades at YTM 9%+). Recent news flow, including rumors Ukraine wanted to restructure its IMF debt and S&P's downgrade of Ukraine's outlook from 'stable' to 'negative', was not supportive of Ukraine's credit profile. Therefore, we believe, the Ukrainian government is likely to wait until late April or May to go ahead with a new Eurobond, providing external capital markets conditions are supportive.

So far, we maintain our base case forecast: no IMF money and no gas deal this year, with external financing needs totaling USD 7.1 bln or 3.7% of GDP in 2012. Our projection assumes the government will fulfill its full year external borrowing plan (USD 4.7 bln, including USD 2.0 due to be repaid to VTB).

NBU signals readiness to ease monetary policy

The NBU moved closer to easing monetary policy; last week it reduced the discount rate by 25 bps to 7.5% (for the first time since 2010) and softened reserve requirements (reducing the share of mandatory reserves to be held on NBU special accounts by 10 pp to 60%) to support banking system liquidity. We think the NBU will stay committed to easing monetary policy further as long as it does not threaten the hryvnya stability.

Primary debt market revives

The primary market for government bonds has been unexpectedly active in February and March. In February, the government managed to attract UAH 4.7 bln via local bonds, 2.9x more than in January. March has been even more impressive, with UAH 10.0 bln worth of bonds placed at primary auctions, with most of the demand concentrated in UAH-denominated papers. Improvement in banking system liquidity was the key factor behind stronger interest in government bonds.

Altogether, the Finance Ministry has fulfilled nearly 27% of planned internal borrowings for 2012 as of March 29 (20%, excluding money to be redeemed in 2012). Solid local borrowings have allowed the government to fully refinance UAH 7.6 bln of local bonds maturing in 1Q12 while reducing yields on 3-6 months papers by 35-100 bps in late March. We think private banks bought the bulk of bonds with maturities up to 12 months, while state-owned banks likely were buyers of longer papers.

The government will face another challenge in 2Q12 to redeem roughly UAH 7.5 bln in local bonds and cover a budget deficit that we project at UAH 4-5 bln. Yet, hefty cash leftovers from 1Q12 (including UAH 4.1 bln of privatization receipts raised YTD) leave us confident the government will able to service its debt smoothly next quarter.

We expect the government to remain active with new local debt placements in 2Q12; we believe volumes will stay high, given improving banking system liquidity and the availability a wider range of debt instruments, including recently introduced local bonds denominated in Euros and papers with embedded put options.

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	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	-9.0	-11.9
% GDP	*2.9%*	*-1.5%*	*-3.7%*	*-7.1%*	*-1.4%*	*-2.1%*	*-5.5%*	*-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	4.9	3.8
% of GDP	*2.1%*	*1.9%*	*1.7%*	*0.9%*	*2.0%*	*3.4%*	*3.0%*	*2.0%*
Financial account balance, USD bln	8.2	4.0	14.7	9.7	-12.0	7.9	6.6	4.8
% GDP	*9.5%*	*3.7%*	*10.3%*	*5.4%*	*-10.2%*	*5.7%*	*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	22.1
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	121.9	123.4
% 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	-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%	8.3%	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%

**Estimated numbers*
*** 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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