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Ukrainian Foreign Currency Financing Needs in 2013

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The main factor that will affect the economic and financial situation of Ukraine in 2013 will be its ability to meet its large external financing needs during the year. In fact, Ukraine, foreign exchange debt service obligations during 2013 will be substantial amounting to about $69 billion as noted below:

1. Public Sector Foreign Debt Service Obligations for 2013 are as follows:

(i) Interest payment for public and publicly guaranteed debts in 2013 is estimated at about $3 billion (i.e. total public debt amount $32 billion @ 10% interest rate = $3.2 billion)

(ii) Principal re-payments to the IMF of about $5.5 billion;

(iii) Principal re-payments of Eurobonds on a level of $3.5 billion;

Therefore public sector foreign debt service obligations in 2013 are estimated at $12 billion

2. Private sector Foreign Debt Service Obligations for 2013:

Foreign Debt Service Obligations by the private sector for 2012 include two components: **(1) repayments of the short-term debt** and **(2) repayments of the portion of the long-term loans maturing during the year.** According to the National Bank of Ukraine, at the end of the third quarter of 2012, commercial banks owed $22.6 billion to foreign creditors, of which short-term loans accounted for $4.8 billion. In addition, the corporate sector had $68.5 billion in foreign obligations including $27.3 billion of short-term loans (of which $20.2 billion were trade credits). This means that in 2013, the private sector must repay about $32 billion of its short-term external debt. In addition, the data from the central bank indicates that about 44% of the long-term debt matures within a typical year, which roughly corresponds to 50% repayment of the total long-term debts held by banks and 40% of the total long-term debts held by the corporate sector. Thus, we estimate that the portion of the long-term debt to be repaid in 2013 by the private sector will be equal to $25.4 billion. This means that **the total external debt repayment of the private sector is about $57 billion** (this number is broadly consistent with NBU data). Assuming that the foreign debt repayments tend to be higher at the begging and the end of the year, we assume the following debt-repayment schedule for the private sector:

Projected private sector foreign debt repayments in 2013

$ billion	Q1	Q2	Q3	Q4	Annual
Banks	3.4	2.1	3.4	4.8	13.7
Corporations	8.8	8.8	13.1	13.1	43.8
Total private	**12.2**	**10.8**	**16.6**	**17.9**	**57.5**

Between the public and private sectors, Ukraine will be required to serve about $69 billion of foreign debt in 2013.

Ukraine's ability to serve this debt will depend of various external and internal developments, including the capacity and wiliness of European banks to roll-over Ukraine's debt and support their local subsidiaries in Ukraine. This in turn will depend on the evolution of global economic conditions. Three scenarios are considered for debt rollover rates:

Base-Line Scenario:

Relative stability of the global financial markets would keep rollover rates of the private sector external debts on a high level, comparable to 2012.

Banking Sector Debt Service - rollover rate 50%

			2013		
$ billion	Q1	Q2	Q3	Q4	Year
Debt repayments	-3.4	-2.1	-3.4	-4.8	-13.7
Debt rollover/new borrowing	1.7	1.0	1.7	2.4	6.9
Net inflow	**-1.7**	**-1.0**	**-1.7**	**-2.4**	**-6.9**

Corporate Sector Debt Service – rollover rate 100%:

			2013		
$ billion	Q1	Q2	Q3	Q4	Year
Debt repayments	-8.8	-8.8	-13.1	-13.1	-43.8
Debt rollover/new borrowing	8.8	8.8	13.1	13.1	43.8
Net inflow	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**

Optimistic Scenario:

Better world economic conditions and flows of funds to emerging markets may lead to higher rollover rates, as follows:

Bank Debt Service - rollover rate 70%

			2013		
$ billion	Q1	Q2	Q3	Q4	Year
Debt repayments	-3.4	-2.1	-3.4	-4.8	-13.7
Debt rollover/new borrowing	2.4	1.4	2.4	3.4	9.6
Net inflow	**-1.0**	**-0.6**	**-1.0**	**-1.4**	**-4.1**

Corporate Sector Debt Service – rollover 120%

			2013		
$ billion	Q1	Q2	Q3	Q4	Year
Debt repayments	-8.8	-8.8	-13.1	-13.1	-43.8
Debt rollover/new borrowing	10.5	10.5	15.8	15.8	52.6
Net inflow	**1.8**	**1.8**	**2.6**	**2.6**	**8.8**

Pessimistic Scenario:

A deterioration in the health of foreign banks may lead to lower rollover rates, as follows:

Banking Sector Debt Service - rollover rate 40%

		2013			
$ billion	Q1	Q2	Q3	Q4	Year
Debt repayments	-3.4	-2.1	-3.4	-4.8	-13.7
Debt rollover/new borrowing	1.4	0.8	1.4	1.9	5.5
Net inflow	**-2.1**	**-1.2**	**-2.1**	**-2.9**	**-8.2**

Corporate Sector Debt Service – rollover 80%

		2013			
$ billion	Q1	Q2	Q3	Q4	Year
Debt repayments	-8.8	-8.8	-13.1	-13.1	-43.8
Debt rollover/new borrowing	7.0	7.0	10.5	10.5	35.0
Net inflow	**-1.8**	**-1.8**	**-2.6**	**-2.6**	**-8.8**

Additional Foreign Financing Needs.

In addition to foreign debt service obligations, Ukraine will require foreign exchange to cover its likely Current Account deficits and the purchase of foreign exchange by its population. On the other hand, Ukraine should be able to attract some foreign direct investments.

a. **The base-line scenario is that current account deficit requiring financial coverage would be around $10 billion in 2013 (excluding interest rate payments on public foreign debt which are counted separately), a figure similar to the one in 2012.** Typically, current account deficits are smaller in 2nd and 3rd quarters, which are reflected in our quarterly projections. Under an optimistic scenario, the current account deficit may be even higher, given that higher economic growth would induce additional imports. The current account gap under these scenarios would be as follows:

		2013			
Current account gap, *$ billion*	Q1	Q2	Q3	Q4	Year
Base-line scenario	-2	-2	-3	-3	-10
Optimistic scenario	-3.5	-2	-2.5	-3	-11
Pessimistic scenario	-3	-2	-1.5	-1.5	-8

b. **Population demand for foreign currency** is typically skewed towards the end of the year, thus we assume that most currency purchases by households will be executed in the second half of 2013.

Considering implementation of the NBU restrictions on purchasing forex by the population we expect that the lowest bound in demand will be at a level of $8 billion for the base-line scenario.

	2013				
***Forex purchases by population,** $ billion*	Q1	Q2	Q3	Q4	Year
Base-line scenario	-1.6	-1.6	-2.4	-2.4	-8
Optimistic scenario	-1	-1	-1.5	-1.5	-5
Pessimistic scenario	-2	-2	-3	-3	-10

c. **Foreign Direct investments**: Thanks to some positive signals of the stabilization on the global financial markets, more upbeat data on the global economic growth beyond the Eurozone, under the base-line scenario, we believe that in 2013 Ukraine will be able to receive around ***$4 billion in FDIs.***

	2013				
***FDI,** $ billion*	Q1	Q2	Q3	Q4	Year
Base-line scenario	1	1	1	1	4
Optimistic scenario	1	1	1.5	1.5	5
Pessimistic scenario	1	0.75	0.75	0.5	3

Combining the estimates for foreign debt service, current account gaps, purchase of foreign exchange by the population and FDI's, we get the following results for Ukraine's total external gap:

Estimated external financing gap for Ukraine on a quarterly basis, $ billion

Base-line scenario	2013				
	Q1	Q2	Q3	Q4	Year
OUTFLOWS					
Current account deficit	-2	-2	-3	-3	-10
Debt repayments					
Government/NBU	-2.7	-3.7	-2.7	-3	-12.1
Banks	-3.4	-2.1	-3.4	-4.8	-13.7
Corporations	-8.8	-8.8	-13.1	-13.1	-43.8
Population purchases of the foreign currencies	-1.6	-1.6	-2.4	-2.4	-8
Total outflows	**-18.5**	**-18.1**	**-24.7**	**-26.3**	**-87.6**
INFLOWS					
FDI	1	1	1	1	4
Debt rollover/new borrowing					
Government/NBU	0	2	1.2	2	5.2
Banks (50% rollover)	1.7	1.0	1.7	2.4	6.9
Corporations (100% rollover, no new borrowing)	8.8	8.8	13.1	13.1	43.8
Total inflows	**11.5**	**12.8**	**17.1**	**18.5**	**59.8**
External financing needs	**7.0**	**5.3**	**7.6**	**7.8**	**27.8**

Optimistic scenario	2013				
	Q1	Q2	Q3	Q4	Year
OUTFLOWS					
Current account deficit	-3.5	-2	-2.5	-3	-11
Debt repayments					
Government/NBU	-2.7	-3.7	-2.7	-3	-12.1
Banks	-3.4	-2.1	-3.4	-4.8	-13.7
Corporations	-8.8	-8.8	-13.1	-13.1	-43.8
Population purchases of the foreign currencies	-1	-1	-1.5	-1.5	-5
Total outflows	**-19.4**	**-17.5**	**-23.3**	**-25.4**	**-85.6**
INFLOWS					
FDI	1	1	1.5	1.5	5
Debt rollover/new borrowing					
Government/NBU	0	2	1.2	2	5.2
Banks (**70% rollover**)	2.4	1.4	2.4	3.4	9.6
Corporations (**120% rollover**)	10.5	10.5	15.8	15.8	52.6
Total inflows	**13.9**	**14.9**	**20.9**	**22.6**	**72.3**
External financing needs	**5.5**	**2.6**	**2.4**	**2.8**	**13.3**

Pessimistic scenario	2013				
	Q1	Q2	Q3	Q4	Year
OUTFLOWS					
Current account deficit	-3	-2	-1.5	-1.5	-8
Debt repayments					
Government/NBU	-2.7	-3.7	-2.7	-3	-12.1
Banks	-3.4	-2.1	-3.4	-4.8	-13.7
Corporations	-8.8	-8.8	-13.1	-13.1	-43.8
Population purchases of the foreign currencies	-2	-2	-3	-3	-10
Total outflows	**-19.9**	**-18.5**	**-23.8**	**-25.4**	**-87.6**
INFLOWS					
FDI	1	0.75	0.75	0.5	3
Debt rollover/new borrowing					
Government/NBU	0	2	1.2	2	5.2
Banks (**40% rollover**)	1.4	0.8	1.4	1.9	5.5
Corporations (**80% rollover, no new borrowing**)	7.0	7.0	10.5	10.5	35.0
Total inflows	**9.4**	**10.6**	**13.8**	**14.9**	**48.7**
External financing needs	**10.5**	**7.9**	**9.9**	**10.5**	**38.9**

Conclusions

Our base-line scenario estimates that the **external financing gap of Ukraine may reach $28 billion in 2013.** This amount is larger than the current amount of foreign exchange reserves in the NBU. Under an optimistic scenario, the external financing gap would reach $13 billion, which is about half of the reserves of the NBU. All this means that if no additional financing is secured, Ukraine will face a crisis during the year.

To secure external financing, Ukraine has three options:

1. **IMF financing**. The government has said to the recent IMF mission that it does not intend to comply with one of the IMF's most critical conditions; that is, to increase the price of natural gas delivered to the population and industrial sector. This government position will preclude IMF financing. But there is still the possibility that the IMF or the government may want to be more flexible in the coming months.
2. **Borrow in the international capital markets.** This option may be feasible given the recent increases in the flows of funds to emerging economies. The government may have to pay higher interest rates due to the absence of IMF financing; but may be willing to accept this burden.
3. **Reach an agreement with Russia** to drastically reduce gas prices and provide additional financing. Russia may require two conditions to agree to this request: a deal to own or rent Ukraine's gas pipeline to Europe; and agreement by Ukraine to join the Custom Union with Russia, Belarus and Kazakhstan.

For recent government statements, Ukraine is likely to pursue options 2 and 3 during the coming months. With either of these financing options, we assume that enough foreign financing will be available to allow Ukraine to avoid a major depreciation of the Ukrainian currency. However, greater Hryvnia volatility may be experienced during 2013, putting the Hryvnia under depreciation pressures. Monetary authorities are likely to continue using administrative restrictions as well as tight banking sector liquidity management to contain the size of a possible Hryvnia depreciation. Hence, we expect that the Hryvnia will depreciate only moderately by about 12% to UAH 9 per USD by the end of 2013.

ATTACHMENT: MACROECONOMIC ASSUMPTIONS

External economic assumptions:

- The base-line forecast rests on the assumption of no or marginal acceleration of the world economy in 2013, principally due to ongoing turbulences in the Eurozone. However, 2013 is forecast to be a little bit better than the previous year. The global growth is expected to strengthen in 2014 but the recovery will be gradual.

- At the same time, data on global steel prices show that international prices on these commodities bottomed out in November 2012 and are gradually rebounding since then. According to MEPS, global carbon steel price index grew by 2.7% from November 2012 to January 2013. Improving world commodity prices should support Ukraine's exports.

- Due to tough conditionality, Ukraine will not be able to secure a new IMF program during 1H 2013. But it may be willing to do so later in the year, as financial conditions deteriorate. Even so, its implementation beyond 2013 may not be smooth, particularly in 2H 2014, when Ukraine will enter presidential elections campaign. This scenario, hence, suggests periodic turbulences on the foreign exchange market of Ukraine.

- Access to foreign financing will remain restricted by administrative measures of the NBU. In general, we assume that foreign financing should allow Ukraine to avoid a major depreciation of the Ukrainian currency. However, greater Hryvnia volatility may be experienced.

- Ukraine will continue negotiations with Russia to reduce natural gas prices. In our baseline scenario, however, the talks will not produce a major price discount. The dispute over the $7 billion gas bill from Russian Gazprom to Ukraine for consuming less Russian natural gas in 2012 than contracted will be settled without paying off the bill.

- FTA with the EU either will not be signed during 2013 or its implementation will be quite limited.

Internal economic assumptions:

- Higher agricultural harvest. Thanks to favorable weather conditions (snowy winter with no severe frosts), about 92% of winter crops are in good conditions. The Ministry of Agricultural Policy and Food of Ukraine projects a 20% increase in crop harvest to 55 million tons in 2013. These expectations form also good prospects for agricultural exports.

- Regardless of whether or not an IMF program is approved, due to fiscal funding limitations Ukraine will have to carry out tougher fiscal austerity measures, which will result in lower public investments and wage growth in 2013. Due to forthcoming presidential elections, government spending on wages and pensions will increase in 2H 2014, underpinning stronger private consumption growth.

- Shaky position of European banks will prompt continuing deleveraging of their subsidiaries in Ukraine and/or their exits from the country. These processes will weigh on paces of credit growth in Ukraine. At the same time, some acceleration in bank credit activity may be expected in 2014 amid stronger economic growth, exports and consumer demand.

GDP growth. The Ukrainian economy is forecast to increase by about 2% yoy in 2013 and 4% yoy in 2014. In 2013, real GDP growth will be underpinned by domestic consumption and exports. At the same time, the growth in private consumption will be slower than in 2012 due to tighter fiscal policy and subdued bank lending. Exports will rebound to growth thanks to modest improvement in world steel prices, good agricultural harvest and favorable base effect. In addition, imports will decelerate due to the government policy to cut off energy imports and slower demand growth. In 2014, some acceleration in imports will be more than compensated by more robust growth in private consumption and further strengthening of exports. Gradual resumption of bank credit will also support investment activity.

Inflation. Despite the fact that raising natural gas tariffs to population is one of the main conditions to restore cooperation with IMF, the government is still not ready to fulfill this requirement. While Ukraine is unlikely to avoid tariff increases, the government may raise tariffs for wealthy households. In addition, food price inflation may be rather moderate thanks to a likely good agricultural harvest in 2013. However, due to low statistical base, consumer inflation will accelerate to about 8% yoy. Given that presidential elections are scheduled for March 2015 (with election campaign starting in 2014), utility tariff adjustment is projected to be gradual also in 2014. Monetary policy, which is projected to remain tight during 2013 to sustain Hryvnia depreciation pressures, may be softened in 2014 to stimulate bank credit activity. Therefore, inflation is forecast to marginally improve to about 6% in 2014.

Fiscal deficit. Ukraine ended 2012 with public sector deficit of about 5% of GDP. For 2013, the government targets state budget deficit at 3.2% of GDP. Since virtually no actions were announced to reduce Naftogaz and Pension Fund deficits, fiscal deficit in 2013 may remain at around 5% of GDP. The size of the planned fiscal gap for 2013 is unlikely to satisfy IMF, which insists on tough fiscal austerity to adjust for existing macroeconomic imbalances. Assuming Ukraine eventually reaches a new agreement with the IMF (most likely in late 2013), we forecast fiscal deficit will be reduced to about 3.5% of GDP in 2013 and 2.5% of GDP in 2014.

Hryvnia exchange rate and international reserves. Given Ukraine's high external financing needs, Hryvnia will be under pressure during 2013. Monetary authorities are likely to continue using all kinds of administrative restrictions as well as tight banking sector liquidity management to suppress Hryvnia depreciation pressures. Hence, Hryvnia depreciation would be contained to about 12% to UAH 9 per USD by the end of 2013. Financing under a new IMF loan in late 2013 and improved confidence of foreign investors after the loan is approved will help keeping Ukraine's gross international reserves from further depletion in 2014. However, they will remain at a rather low level. Hryvnia depreciation should improve Ukraine's competitiveness. Coupled with strengthening exports and lower external debt financing needs in 2014, this will lead to moderate improvement in gross international reserves, while Hryvnia will remain relatively stable in 2014.

Current account balance. In 2012, the Current Account gap widened to $14.4 billion, or 8% of estimated GDP, a new high level for Ukraine. Such a significant widening (from 5.5% of GDP in 2011) clearly indicates the severity of external imbalances of Ukraine and contributes to Hryvnia depreciation pressures. At the same time, in the base-line scenario slower domestic consumption growth and government policy to reduce energy imports will contain large increases in the current account deficit in 2013 and in 2014.

Forecast summary	**2012 (e)**	**2013**	**2014**
Economic Growth (GDP, annual var. in %)	0.2	2.0	4.0
Fiscal Balance (% of GDP)	-5.0	-3.5	-2.5
Inflation (CPI, annual variation in %, eop)	-0.2	8.0	6.0
Exchange Rate (UAH per USD, eop)	8.0	9.0	9.0
Current Account (% of GDP)	-8.1	-8.3	-7.9
International Reserves (USD bn)	24.5	25.0	27.0
External Debt (USD bn)	132.0	138.0	145.0