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Assessing Ukrainian Risk in Light of Recent Developments

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It's been exactly nine years since the last mass protests in Ukraine. The Orange Revolution in 2004 succeeded in the specific short term goals of invalidating the Presidential elections and allowing for a revote, but failed in its longer term objectives of dramatically improving the Ukrainian economy and bringing Ukraine closer to its desired integration with the European Union. The new wave of protests in Ukraine that began on the night of November 21, 2013 is known as Euromaidan, and is a result of the decision by the Ukrainian government to suspend their negotiation with the EU on the signing of the Association Agreement and Free Trade Agreement. These protests continue today and the outcome of this wave of demonstrations is still unknown.

However, most analysts agree on 3 likely scenarios that could develop over the short term. The first scenario is based on the official statements of the Ukrainian government that their course on European integration is unchanged and that they will actively engage with the EU in the new round of negotiations to improve the terms of the deal (primarily seeking financial support from the IMF and EU), potentially signing the agreements as early as March 2014. The second scenario is based on persistent rumors that a secret deal is being negotiated with Russia that will result in substantial financial and trade assistance to Ukraine in exchange for closer cooperation and potentially joining the Customs Union with Russia, Belarus and Kazakhstan in the future. Finally, a third scenario would be continuing discussions with both EU and Russia over a more extended period of time in an attempt to secure the best deal for Ukraine.

The uncertainty of the moment resulting from these three possible scenarios has produced significant civil tensions in the country and additional pressure on the Ukrainian economy and its fiscal health. While the overall level of debt in Ukraine is reasonable as compared to many countries in Europe and the rest of the world, its structure creates short-term concerns. A very significant pressure from Ukraine's largest trading partner – Russia – has made the situation significantly worse. Russia of course is doing this to achieve its political objectives of bringing Ukraine back into the fold. The EU and the United States of America are now facing an important question of how badly they want to have Ukraine as an independent European country versus "losing it" to Russia. It remains to be seen if they will be able to stand up to a clear and present effort by Russia to reassert their influence (if not dominance) over the second largest country to come out of the old Soviet Union.

From an investor point of view, there are two questions that are critically important to decide whether to invest in Ukraine in 2014. It is clear that the opportunities to invest will be quite attractive due to the increased country risk that will surely depress valuations. These questions are – is there likely to be significant civil unrest in the country and how will the overall creditworthiness of Ukraine be affected by recent events. The first question is more difficult to answer, but based on the long history of Ukraine, the probability of violence or significant, prolonged civil unrest is very low. The Ukrainian people continue to surprise many observers by their peaceful and tolerant way of trying to change their country for the better. In spite of continuing provocations, the last three weeks of protests in Ukraine have been remarkably peaceful. It is very likely they will stay this way and a compromise will be found over the coming days and weeks.

In assessing the current international creditworthiness of Ukraine, it is important to determine whether Ukraine is facing a "solvency" issue or a short-term liquidity problem.

Countries with excessive amounts of foreign public debt are facing solvency issues, as these countries may not be able to serve their large foreign public debt now or even in the future. This is the case for countries such as Greece and Portugal, whose public debts exceed 100% of GDP and are denominated in a currency they do not control. Most likely future debt cancellations will be required. In the meantime, they will need to take drastic fiscal austerity measures to regain international competitiveness (through internal or external devaluations) and increase their capacity to serve their large foreign obligations.

Ukraine is not facing a "solvency" issue, but a short-term liquidity issue, as foreign public debt is not excessive. The country's foreign public debt (Treasury plus National Bank of Ukraine) amounts to $30.4 billion or only 16% of GDP, or 35% of Ukraine's exports of goods and services. These ratios are much lower than in most European or emerging countries, making Ukraine fundamentally a solvent country.

But Ukraine's liquidity problem comes from the fact that most of its foreign debt is short term, with average maturities of about three to four years. In fact, about $8 billion of Ukraine's public foreign debt is due in 2014, compared to international reserves of about $19 billion. This liquidity problem was complicated by the fact that Russia drastically reduced its imports of Ukrainian goods in the last year and planned to reduce them even further if Ukraine were to sign a free trade agreement with the European Union.

This liquidity problem is at the core of Ukraine's current political difficulties, as it led the Ukrainian government to postpone the signing of a Free Trade and Association Agreement (FTAA) with the European Union. This postponement has led to the current massive demonstrations in Ukraine. But the postponement was motivated in great part by the government's realization that the signature of this FTAA would exacerbate the liquidity problem of the country.

An FTAA with the European Union would have significant benefits for Ukraine over the medium to long term, increasing foreign investments, exports and GDP. But these benefits take years to materialize. Over the short term, the signing of the FTAA would have increased Ukraine's international financing requirements, particularly due to the extraordinary trade pressures put on by Russia's Customs Union. The Customs Union is Ukraine's largest trade partner, accounting for 33% of Ukrainian exports of goods or about $22 billion in 2012. According to the State Statistical Service of Ukraine, exports to Russia's Customs Union fell by about $5 billion over January-September 2013 compared to the same period in 2012. Although other factors (such as the economic slowdown) contributed, the decline is principally attributed to cooling trade relations between Russia and Ukraine, after the FTAA began to take on momentum. With the signing of the FTAA with the EU, the reduction in trade with Russia would have increased Ukraine's trade deficit by an additional $8 billion in 2014, leading to a current account deficit that could have been as high as $15-20 billion in 2014. By delaying the signature of the FTAA, the government expects that Ukraine's exports to the Customs Union would improve by about $13 billion, thereby considerably improving its short-term liquidity position.

Before the decision to postpone the signing of the FTAA, the Ukrainian government was planning to obtain a $15 billion loan from the IMF to enable it to meet its current account and capital account financing requirements. Preliminary discussions had led the government to believe that the IMF would provide these funds with "reasonable" conditionality, such as a gradual and focused increase in utility prices to the population and a gradual widening of the exchange rate band. However, a recent letter issued by the IMF established harder conditions that would have been politically unacceptable. This harshening of the IMF conditions may have been due to changes in IMF's management of Ukraine's operations. But in any case, it signaled to the government that the only reasonable source of short-term liquidity support could come from Russia (through additional exports, financial support and lower gas prices), thereby giving additional justification to the postponement of the signature of the FTAA, as demanded by Russia.

The current situation is as follows. Ukraine is re-opening discussions with the EU for the possible signing of the FTAA in March 2014, based on the provision by the EU/IMF of about $10 billion of liquidity support on reasonable terms. This was based on recent statements by the EU that it was prepared to consider financial support. The IMF also stated that it would consider a gradual adjustment of its loan conditionality. EU/IMF financial support would be enough to stabilize international reserves and the foreign exchange rate.

If this financial support were not to be provided by the EU/IMF at reasonable terms, Ukraine will again postpone the signature of the FTAA and will seek liquidity support from Russia. In this case, it is likely that Russia would require significant "enhancements" to provide this support, possibly in the area of privatization or sale to Russia of key public enterprises in the energy/gas sector, including the gas transit pipeline to Europe. On the other hand, it is unlikely that Ukraine would agree to Russia's proposal to join the Customs Union with Russia, Kazakhstan and Belarus. Such a Customs Union would require renegotiation by Ukraine of a number of international agreements. It would also not be in the best interest of the ruling class of Ukraine. Furthermore, the large size of the current public demonstrations in Ukraine has made it clear to the government that joining the Customs Union would lead to even larger demonstrations.

In any event, from an economic point-of-view, the recent events regarding the FTAA are not necessarily all negative. The signing of the FTAA would have aggravated a short-term liquidity problem and could have led to a financial crisis. Although the decision was handled poorly from a political perspective, the government took an understandable measure by postponing the signing of the FTAA as Ukraine can now address its short-term FX financing issues. As noted above, it is now trying to secure sufficient financing from either the EU/IMF or from Russia.

In either of these two cases, the end result is bound to be favorable, with stabilization of international reserves and relative stability of exchange rates. In fact, if the short-term liquidity problem is resolved, there is little economic justification for a large devaluation of the Hryvnia. The Hryvnia is not overvalued due to the fact, during the last few years, inflation in Ukraine has been significantly below the inflation of its main trading partners. With low inflation, purchasing power parity estimates are now favorable for Ukraine, indicating reduced exchange rate pressures from the side of economic fundamentals. Furthermore, a devaluation is unlikely to make major improvements in the current account. It would not help to increase Ukrainian exports, as the main constraint for exports has been Russia's political retaliation and deteriorated economic conditions in most of Europe. On the import side, Ukraine's main imports consist of energy goods from Russia, which are expensive principally due to Russia's energy pricing policies for Ukraine. Domestic consumption of imported Russian gas is driven by domestic gas prices (which are government controlled) and not by the imported energy prices or the foreign exchange rate. Given these circumstances, if the current liquidity issue is addressed, the Hryvnia foreign exchange rate is likely to remain relatively stable, with a "contained" devaluation to about 8.5 to 9.0 UAH/US$ by the end of 2014.

Over the medium term, either of the two scenarios (closer to the EU or closer to Russia), both carrying different types of risk, are likely to be positive in helping Ukraine to resolve its liquidity crisis. Closer economic integration with the EU through a FTAA would put Ukraine in the supply chain for Europe. Over the medium term, this FTAA should expand foreign direct investments, domestic investments for modernization, greater competitiveness and exports and GDP growth. On the other hand, over the medium term, closer integration with Russia may permit Ukraine to benefit from lower energy prices for its industry. It may also permit Ukraine to participate in Russia's ambitious modernization program of the army and navy, expenditures on which are expected to amount more than $650 billion for ten years. All this would substantially reduce Ukraine's current account deficits, spur exports and economic growth, allowing the government to keep natural gas tariffs to population unchanged, while simultaneously narrowing Ukraine's fiscal deficit. In both cases, there would be notable improvement in the Balance of Payments, which would allow the Hryvnia exchange rate to remain relatively stable over the medium term.

Regardless of the outcome of the current crisis, its impact on export oriented businesses is not likely to be significant. Although political risks have increased, there is no scenario where a well-run export-oriented firm would be significantly impacted. For these firms, most output and input prices are based on international prices and are therefore unaffected by local conditions or even changes in the exchange rate. Over the medium term, Ukraine's competitive advantages (large and educated population, low labor costs, rich agricultural land, good natural resources such as shale gas, good infrastructure, good geographical location, etc.) should make international investments very profitable. Furthermore, the recent political crisis has reduced valuations somewhat, making investments more attractive at least over the short term.

It is reasonable to expect that 2014 will be a difficult year for Ukraine and its economy, but it is also very likely that this year will produce a more definitive resolution in Ukrainian aspirations than 2004. With depressed short-term valuations in agricultural business but a much better medium to long-term outlook, 2014 could prove to be a very good year to invest in Ukrainian agriculture.