THE BLEYZER FOUNDATION

Turning Transitions Into Prosperity

February 2, 2012

External Financing Risks for Ukraine in 2012

Dr. Edilberto Segura and Olga Pogarska

Summary:

- Ukraine had a good economic year in 2011.
- However, Ukraine's external imbalances started worsening in the second half of 2011.
- 2012 will be a difficult year because of a likely large current account deficit, large external debt service due during the year, and likely purchases of foreign exchange by the population.
- Under an optimistic case (30% probability), Ukraine will be able to finish 2012 without any devaluation.
- Under a baseline scenario (60% probability), Ukraine may face some Hryvnia devaluation pressures that may being the exchange rate to UAH 8.5 – 9.0 per US Dollar by year end.
- Under a more pessimistic scenario (10% probability), Ukraine may face a devaluation in excess of UAH 9.0 per dollar, to about 9.5 Hryvnias/dollar.
- The expected value for the exchange rate at the end of 2012 is 8.6 Hryvnias/dollar.

Ukraine had a good economic year in 2011, with the economy growing by 5.2% yoy and consumer inflation contained to 4.6% yoy by year-end, the lowest level in the last 9 years. The government was also able to reduce fiscal imbalances, with the public sector deficit narrowed to 4.4% of GDP in 2011, down from 7% of GDP in 2010 and 8.9% of GDP in 2009. In addition, during the first half of 2011, Ukraine benefited from improved access to international financial markets and managed to maintain high external debt rollover ratios (for both private and public) even in the absence of the IMF program. These developments allowed the NBU to increase its international reserves to $38 billion by end-August 2011.

However, external imbalances increased during the second half of 2011. Due to weakening exports since July 2011, higher energy prices and robust domestic demand, the current account deficit of the balance-of-payments widened to 5.5% of GDP (or about $9 billion) in 2011. Furthermore, since the summer of 2011, due to the intensification of the Eurozone debt crisis, Ukraine experienced difficulties in rising sufficient external financing to fully meet its short-term external debt financing needs, which were quite high at about $50 billion at the beginning of the year. In addition, given high devaluation expectations, there was strong population demand for foreign currency throughout the whole year. According to the NBU data, net population purchases of foreign currency amounted to $13.4 billion in 2011, generating additional Hryvnia depreciation pressures

During 2011, the NBU and the government were able to contain these depreciation pressures and maintain the Hryvnia exchange rate quite stable. They achieved this stability by a combination on NBU interventions and some administrative measures. The NBU spent about $6.5 billion of its international reserves from September to December 2011, reducing international reserves to about $31 billion by the end of the year. The NBU also significantly tightened Hryvnia liquidity, which constrained demand for foreign currencies and stimulated demand for Hryvnias. It also introduced additional requirements for the purchase of foreign exchange by the population. In addition, due to the difficulties in securing external financing, the government issued US Dollar-denominated and US Dollar-indexed domestic bonds, in order to tap the significant amount of foreign currency outside the banking system of Ukraine.

In 2012, the external situation is likely to remain challenging for Ukraine, even if we assume that the Eurozone crisis may be brought under control in the near future. Already the risks of a major Eurozone collapse has been contained by (i) the large liquidity injections made to EU banks by the European Central Bank, particularly the provision of three-year funds with minimum collateral; (ii) the likelihood that the crisis in Greek would be alleviated by the cancellation of 50% of its private public debt; and (iii) the strong austerity and growth-oriented measures announced by the new governments in Italy and Spain.

Nevertheless, for Ukraine a main risk in 2012 is that the cancellation of Greek debts by EU banks may lead to de-leveraging and lower roll-over rates for their credits. In fact, debt write-downs would likely lead to significant de-leveraging by European commercial banks as they will have to bring back capital adequacy ratios to required levels. De-leveraging will be particularly painful for Central and Eastern European countries, where European banks control about 80% of the banking system. Even though the share of EU banks in the Ukrainian banking system is only 35% of the Ukrainian banking system, European bank de-leveraging is likely to hit Ukraine through lower external debt rollover ratios for all Ukrainian borrowers.

According to available NBU data, Ukraine will have to repay about $54 billion in 2012 as noted in the side table. Out of this amount, $8 billion is due by government authorities (the Ministry of Finance and NBU) and about $12 billion and $34 billion are due by banks and corporations respectively. Ukraine's external debt financing needs account for 30.5% of forecast GDP in 2012 and exceed the level of gross international reserves. In addition, due to projected strong domestic consumption and high energy prices, Ukraine's current account deficit is likely to stay high at about 5% of GDP in 2012. Furthermore, population demand for foreign currency will remain an important factor, affecting the foreign exchange situation in Ukraine. The impact of this factor will be partially compensated for by greater inflow of foreign currency related to Ukraine's co-hosting of Euro-2012 football championship and parliamentary elections. Nevertheless, altogether these three factors (current account deficit, high external debt repayment needs and cash foreign currency balance) will exert depreciation pressures on the Hryvnia.

External Debt by Residual Maturity, Estimate at end-2011

Public debt	8.0
Banking sector	12
Corporate sector (incl. inter-company lending)	34
Total	**54.0**

Source: NBU, The Bleyzer Foundation

The actual degree of Hryvnia devaluation, however, will depend on Ukraine's ability to rise external financing to cover its foreign exchange needs. Below we present three scenarios (optimistic, base case and pessimistic), depending on a number of alternative assumptions, as described below.

General assumptions, common for all three scenarios:

1. The world economy will slowdown but will develop without major shocks.

2. The Greek debt cancelation will proceed, with the ECB providing support to the affected European banks. Nevertheless, the debt write-downs will lead to de-leveraging, particularly in Central and Eastern Europe.
3. European banks that have their subsidiaries in Ukraine will maintain their businesses.
4. Ukrainian banks and corporations will not default on their external obligations.
5. Ukrainian negotiations with Russia will not result in major price reduction of imported natural gas to Ukraine.
6. Ukraine will reduce its current account deficit to about 5% of GDP in 2012, compared to 5.5% in 2011. This will happen principally through lower volumes of natural gas imports[1] and non-energy imports. Exports would be maintained.
7. Ukraine will not be able to get external financing under bilateral agreements (e.g., with Russia, China, India, etc.).

The main assumptions for the three alternative scenarios are as follows:

	Optimistic	Baseline	Pessimistic
IMF co-operation	The IMF program is restored during 2012. This will allow Ukraine not only to roll over principal payments to IMF but also to receive some extra financing.	Co-operation with the IMF remains stalled for most of the year. After parliamentary elections, the IMF disburses in the amount equal to Ukraine's principal due to it.	Co-operation with the IMF is not resumed, due to weaknesses in domestic policies.
Loan to Russian state-run VTB bank	Fully rolled over (by either prolonging the loan or converting the loan into Ukraine's external bonds).	The loan is fully rolled over.	Ukraine is required to repay the loan.
Access to foreign financial markets	The resumption of the IMF program will unlock external financing from other international organizations and will reassure foreign investors in the sustainability of Ukraine's macro outlook. Hence, Ukraine will be able to access foreign debt markets. Rollover rates for private debt average 93%	Access to foreign debt markets is more limited but Ukraine receives some financing from international organizations (e.g., the World Bank). Rollover rates for private debt averages 83%	The Eurozone crisis and EU bank de-leveraging are more serious and compounds weaknesses in domestic policies. Rollover rates for the private debt are lower at 76%. IFIs provide only limited financing to Ukraine.

Ukraine's External Public Debt

Due to a turbulent situation on international financing markets since summer 2011, Ukraine's external borrowing plans were not met in 2011. Furthermore, as the government was reluctant to raise natural gas

[1] According to the Ukrainian authorities, Ukraine plans to import 27 billion m3 of natural gas. However, this amount does not include natural gas volumes imported by chemical enterprises in accordance to direct contracts between these companies and Russian Gazprom. According to mass media, about 8 billion m3 of natural gas will be imported according to these contracts. Hence, total amount will be 35 billion m3, which is 12.5% lower than in 2011.

External Public Debt due in 2012 and Potential Debt Rollover Ratios

Public External Debt		Optimistic scenario		Baseline scenario		Pessimistic scenario	
		Rollover		Rollover		Rollover	
Outstanding liabilities in 2012	$ billion	Rate, %	$ billion	Rate, %	$ billion	Rate, %	$ billion
Total	**8.0**	**110**	**8.7**	**84**	**6.7**	**13**	**1.1**
Eurobonds (Jun 2012)	0.5	80	0.4	0	0.0	0	0.0
Kyiv city (Nov 2012)	0.3	100	0.3	0	0.0	0	0.0
VTB capital loan (Jun 2012)	2.0	100	2.0	100	2.0	0	0.0
IMF principal (see schedule below)	3.4	130	4.5	100	3.4	0	0.0
Other international organizations	0.7	90	0.7	80	0.6	70	0.5
Bilateral agreements	0.2	0	0.0	0	0.0	0	0.0
Guaranteed debt	0.2	60	0.1	40	0.1	40	0.1
Other debt liabilities	1.1	80	0.8	60	0.6	50	0.5
Potential debt inflow/outflow			0.8		-1.2		-6.9

Source: IMF, Attachments to the Draft 2012 Budget Law, The Bleyzer Foundation

tariffs to population, the IMF program stalled in March 2011. As a result, total public debt to GDP fell to 36.2% of GDP in 2011, down from almost 40% of GDP in 2010.

Although the overall level of Ukrainian public debt is not excessive by international standards, a significant share of public liabilities is short-term, due within one year. Indeed, the Ukrainian authorities need to repay about $8 billion of external debt liabilities in 2012, out of which about $3.5 billion represents principal re-payments to the IMF. Potential net financing balance on external public debt varies from a surplus of about $0.8 billion under the optimistic scenario to a shortfall of $6.9 billion in the pessimistic case.

Ukraine's External Private Debt

Ukraine’s total private external debt financing requirements for 2012 are estimated at $46 billion. On a positive note, short-term trade credits and inter-company loans, which are more stable, account for more than 40% of total debt financing requirements. In the previous three years, debt rollover ratios for these liabilities exceeded 100%. Rollover rates should remain high for these obligations. At the same time, given weaker external trade outlook for Ukraine in 2012 and international financial market strains, rollovers for banks and corporations may be unfavorably impacted, but not by a large margin.

As to other private debt liabilities, a significant portion of debt is due either by subsidiaries to parent banks or by large companies owned by influential Ukrainians to their related/affiliated companies/banks abroad. According to JP Morgan, related-party debt is estimated at about 50%, though we believe this ratio could be much higher, particularly in the banking sector. This situation may simultaneously have a positive and negative impact on the sustainability of the Ukrainian private sector debt. Another positive factor is that most foreign banks present in Ukraine have stated their intentions to remain in the country. This presumes that parent banks will continue supporting their Ukrainian subsidiaries, though may not be able to provide significant additional funds. As noted earlier, Greek debt cancellations will lead to substantial de-leveraging by European banks, hence adversely affecting their abilities to support their subsidiaries financially and rollover debts to Ukrainian companies. Depending on how deep this de-leveraging process in the EU will be, and whether or not Ukraine will restore cooperation with IMF (see assumptions to public external debt rollover scenarios), potential Ukraine’s private sector external debt outflow is estimated to range from about $3.5 billion (based on an average rollover rate of 93%) to $11 billion (based on an average rollover rate of 76%), as noted in the table above.

Total External Financing Needs

External Private Debt due in 2012 and Potential Debt Rollover Ratios

				Optimistic scenario		Baseline scenario		Pessimistic scenario	
Private External Debt	**Outstanding debt, $ billion**			**Rollover**		**Rollover**		**Rollover**	
				Rate, %	**$ billion**	**Rate, %**	**$ billion**	**Rate, %**	**$ billion**
Banking sector	**12.0**	o/w		**87**	**10.5**	**77**	**9.3**	**65**	**7.8**
Banks with foreign capital	10.2	Owned to parent ban	7.5	90	6.8	80	6.0	70	5.3
		Owned by other foreign banks (principally European ones)	2.7	85	2.3	75	2.0	60	1.6
Other Ukrainian banks	1.8			80	1.4	70	1.3	50	0.9
Corporate sector	**34.0**			**95**	**32.3**	**86**	**29.1**	**80**	**27.2**
Trade credit and inter-company lending	19.0			100	19.0	90	17.1	85	16.2
Loans	10.0			90	9.0	85	8.5	80	8.0
Other debt liabilities*	5.0			85	4.3	70	3.5	60	3.0
Total private external debt	**46.0**			**93**	**42.7**	**83**	**38.4**	**76**	**34.9**
			Potential debt outflow		-3.3		-7.6		-11.1

Source: NBU, The Bleyzer Foundation

Given estimated external debt outflows, high current account deficit and likely foreign currency demand by the population, Ukraine’s net external funding shortage will be large under the baseline and pessimistic scenarios. This shortage will need to be covered by reductions in the NBU’s international reserves.

Ukraine's External Funding Needs in 2012						
Total External Financing Needs	Optimistic scenario		Baseline scenario		Pessimistic scenario	
$ billion	**Outflow**	**Inflow**	**Outflow**	**Inflow**	**Outflow**	**Inflow**
CA balance*	8.5		8.5		8.5	
External Public Debt	8.0	8.7	8.0	6.7	8.0	1.1
External Private Debt	46.0	42.7	46.0	38.4	46.0	34.9
Banks	*12.0*	*10.5*	*12.0*	*9.3*	*12.0*	*7.8*
Corporates	*34.0*	*32.3*	*34.0*	*29.1*	*34.0*	*27.2*
FDI		5.0		4.0		3.0
Foreign Currency Cash balance**	3.0		4.0		6.0	
Total	**65.5**	**56.5**	**66.5**	**49.1**	**68.5**	**39.0**
Potential Change in Int'l Reserves	***-9.0***		***-17.4***		***-29.4***	
International Reserves as of End-2011	**31.8**					
International Reserves as of End-2012	***22.8***		***14.4***		***2.4***	

Under an optimistic scenario, the country may face an external financing shortfall of $9 billion, which would reduce reserves to $22 billion. This level of reserves, at 2.5 months of imports, is manageable. The exchange rate for the Hryvnia with respect to US Dollar could be maintained unchanged. We give a 30% probability to this scenario.

Under the baseline scenario Ukraine's external funding shortage is estimated at $17.5 billion, which would cause a reduction in gross international reserves to $14.4 billion, or less than 2 months of imports. At this level of reserves, the NBU may not be able to maintain the current exchange rate. Most likely, the NBU will also introduce new administrative measures and liquidity restrictions to contain a larger devaluation. Nevertheless, the Hryvnia may devalue to about UAH 8.5- 9.0 per US Dollar by the end of the year. We give a 60% probability to this scenario.

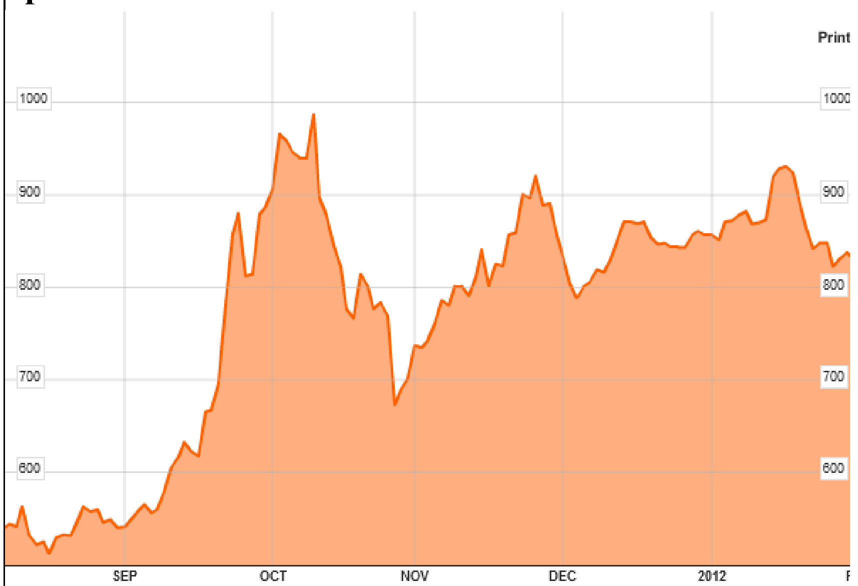
In the pessimistic case Ukraine's reserves will be exhausted and would face a financial crisis during the year, with devaluation in excess of UAH 9.0 per US Dollar, probably at UAH 9.5 per dollar. We give only a 10% probability to this scenario, as the government will take whatever measures may be needed to avoid it, including satisfying IMF requirements.

Given the probabilities assigned to the three scenarios, our expected value for the foreign exchange rate at the end of 2012 is 8.6 Hryvnia/dollar. For comparison, the table below provides the current foreign exchange projections for the end of 2012 (in Hryvnias per dollar) by major international financial firms and think-tanks (whose average is 8.5 Hryvnias/dollar):

The Bleyzer Foundation	8.6
Alfa Bank	8.1
Bank of America/Merrill Lynch	10.0
Credit Suisse	8.1
CASE Ukraine	8.3
Deutsche Bank	7.9
EFG Eurobank	8.1

HSBC 9.5
ING
J.P. Morgan
Morgan Stanley
OTP Bank
Raiffeisen Research
Raiffeisen Capital
SEB Bank
UniCredit
Simple Average
8.5

Spreads on Ukraine's CDS over the last 6 months



Source: Bloomberg

Reflecting current risks, the premiums for Ukrainian Credit Default Swaps grew from about 500 basis points in mid-August 2011 to the current level of 850 basis points, the third highest level after Greece and Portugal, and on par with Venezuela. For comparison, the 2008 financial crisis in Ukraine started when spreads on Ukrainian CDS were close to 600 basis points.

As the external situation looks challenging for Ukraine, through different channels, we have been urging the Ukrainian authorities to implement measures that will help reduce Ukraine's vulnerabilities.

International experience indicates that the country must do two things: (i) secure significant foreign financing to give confidence to creditors that the short-term debt will be served; and (ii) implement a program of economic reforms to give confidence that debt will not continue to growth – which requires fiscal austerity – and that the economic will maintain its pace of growth – which requires improvements in the business environment. Our **recommendations** included:

- Restore co-operation with IMF as soon as possible. This will provide not only necessary foreign financing but will also help to reassure foreign investors that the macroeconomic situation in Ukraine will be under control;
- Applied for bilateral and multilateral financing from other international sources, including EBRD, the World Bank, the EIB, etc.;
- Ensure the signing of the proposed FTA with the EU as soon as possible. Though the economy of the European Union is forecast to contract in 2012, it is still the world's large trade market, much larger than the BRIC markets (in recent times, the Ukrainian authorities often talk about closer trade relations with BRIC countries at the expense of the EU, referencing to much higher growth rates in these countries compared to the EU). The FTA with the EU will not only bring Ukraine into the EU supply chain, facilitating exports, but will stimulate FDIs in Ukraine and will increase the readiness of the European banks to roll over Ukraine's external debt obligations;
- Develop a credible economic reform program to improve business climate in Ukraine and stimulate domestic production of consumer goods;
- Avoid fiscal loosening ahead of autumn parliamentary elections and take measures to reduce fiscal deficits or even have a surplus on public finances;
- Keep monetary policy tight and increase interest rates to increase demand for Hryvnia, but simultaneously provide sufficient and timely refinancing to liquidity-thirsty banks to avoid a bank crisis;
- Improve co-ordination between NBU, the Ministry of Finance and other related government agencies, clarify responsibilities and develop contingency plan of actions in case the crisis occurs. Avoid conflicting statements by top officials, which would undermine confidence. Ensure higher transparency of government and monetary authorities' measures;
- Carry out stress test of the Ukrainian banking system under realistic assumptions and develop a comprehensive program for banks subject to potential risks.