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Country update **UKRAINE**

Summary

The external financing risks for the Ukraine have markedly risen, since the IMF has discontinued disbursements under the two and a half year lending program of USD 15.2bn signed in July 2010. The IMF demands hikes of domestic gas prices, but Ukraine’s government is reluctant to do so ahead of the October 2012 elections. Instead, it wants to renegotiate a gas contract with Russia to reduce the imported gas prices, but negotiations have been unsuccessful thus far. In 2012, economic growth is expected to slow to 2.5%, as investment and private consumption are expected to fall. Overall, the economy is very unbalanced and the country needs to structurally improve its external position.

Things to watch:

- On-going IMF negotiations
- External financing risks
- Gas price dispute with Russia

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Ukraine

National facts	
Type of government	Republic
Capital	Kyiv
Surface area (thousand sq km)	603
Population (millions)	45.8
Main languages	Ukrainian (97%)
	Russian (24%)
Main ethnic groups	Ukrainian (67%)
	Russian (17%)
	Belarusian (1%)
Head of State (president)	Viktor Yanukovych
Head of Government (prime-minister)	Mykola Azarov
Monetary unit	Hryvnia (UAH)

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	156	0.23
Nominal GDP at PPP	328	0.42
Export value of goods and services	89	0.41
IMF quotum (in mln SDR)	1372	0.63
Economic structure	*2011*	*5-year av.*
Real GDP growth	5.2	1.4
Agriculture (% of GDP)	9	9
Industry (% of GDP)	34	35
Services (% of GDP)	56	57
Standards of living	*USD*	*% world av.*
Nominal GDP per head	3429	32
Nominal GDP per head at PPP	7208	58
Real GDP per head	2095	26

Social and governance indicators	rank / total
Human Development Index (rank)	76 / 187
Ease of doing business (rank)	152 / 183
Economic freedom index (rank)	163 / 179
Corruption perceptions index (rank)	152 / 183
Press freedom index (rank)	116 / 178
Gini index (income distribution)	27.51
Population below $1.25 per day (PPP)	0%

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
Russia	26	Russia	37
Turkey	6	Germany	8
China	5	China	8
Kazakhstan	4	Poland	5
Main export products (%)			
Non-precious metals			34
Food, beverages & agricultural products			19
Machinery & equipment			18
Fuel & energy, incl ores			13
Main import products (%)			
Fuel & energy, incl ores			32
Machinery & equipment			21
Chemicals			11
Food, beverages & agricultural products			10
Openness of the economy			
Export value of G&S (% of GDP)			57
Import value of G&S (% of GDP)			63
Inward FDI (% of GDP)			4.5

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

Ukraine's economy grew by 5.2% in 2011, on the back of positive investments and private consumption growth. This is slightly higher than the 4.8% GDP growth we predicted in our last country risk report of April 2011. In 2012, growth is expected to slow to 2.5%, as investment and private consumption are expected to fall given the financing risks the country faces. The country portrays twin deficits as the current account and budget deficit are in the red. The liquidity position is very weak. FX-reserves cover imports by a meagre 3 months and debt service only by 35%. Furthermore, foreign debt is very high at 132% of export revenues. Overall, the economy is very unbalanced and the country needs to structurally improve its external position.

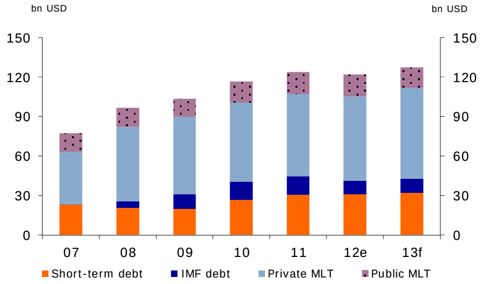
The unstable political situation does not help either. President Yanukovich is using various tactics to cement his executive power, from changing existing laws in his favour to sentencing his most threatening opponent, former PM Tymoshenko, to seven years in prison. While the latter is a blow to the opposition, opposition remains sizeable and together with the frequent shift in alliances in parliament, this is likely to cause future political instability.

In this update, we analyse the external finances of the country and we provide an update on Ukraine's on-going negotiations with the IMF. We conclude with an analysis on the gas dispute Ukraine faces with Russia.

External finances in dire straits

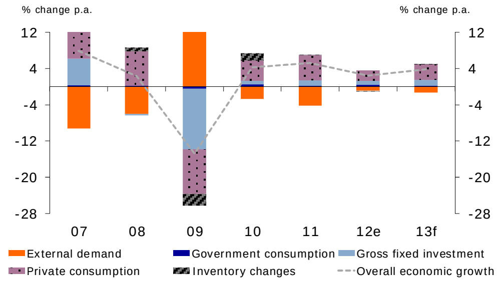
The external refinancing risks for the Ukraine have markedly risen, since the IMF has discontinued lending under the two and a half year lending program of USD 15.2bn signed in July 2010. While one tranche was disbursed at the end of 2010, the Ukraine has not received any of the available IMF funds in 2011. After the IMF undertook a monitoring mission to Ukraine's capital, Kiev, in October 2011, the deadlock has continued as Ukraine is reluctant to raise domestic gas tariffs and the IMF is sticking to this condition. Ukraine's finance minister Mr. Khoroshkovskiy flew out to Washington this January for talks to resume the lending program, as he is aware that Ukraine badly needs the IMF package, not in the least to send the right signal to the financial markets. The government badly needs the IMF package as its gross refinancing needs for the whole year of 2012 are estimated at about USD 10bn, of which USD 2bn is maturing external debt. The Ukrainian economy as a whole has around USD 50bn in external debt due to be refinanced in 2012. Ukraine still needs about USD 2bn to cover the country's external financing needs for the whole year of 2012. Total external debt is high at 72% of GDP in 2012, while the current account is no source of foreign exchange for the country as it is in continuous deficit and is expected to record a 4.1% of GDP deficit this year.

Figure 1: External debt



Source: EIU

Figure 2: Growth performance



Source: EIU

The government has turned to the domestic bond markets for financing, as it is unwilling to pay the high interest rates demanded in the international capital markets. In December 2011, the Ministry of Finance started issuing Treasury bonds denominated in USD on the domestic market. Now, the government has permitted the Ministry to issue Treasury bonds denominated in euros as well and it intends to launch foreign-currency bonds with the additional favourable features for investors. Yielding 3-5% per year, the new securities will have a maturity of one to three years, and the ministry hopes that they will be attractive to local banks as an alternative to keeping some of their foreign currency reserves abroad. It also issued a new innovation of hyrvnia-denominated debt indexed to exchange-rate movements.

The success of these securities has been mixed. The hyrvnia-denominated debt indexed to exchange-rate movements was met with little demand, but the debut of euro-denominated bonds on 27 March 2012 was very successful. The USD-denominated bonds were also placed successfully, but the rising yields on these debt securities highlights the difficult financing environment the government faces.

The recent debt issuances have ensured Ukraine's external finances at least until the elections in October 2012. Only after the elections, we expect the government to at least partially cede to IMF demands. Until then, the government will remain unwilling to raise domestic gas prices. We expect that the Ukraine government will be able to muddle through in 2012, despite the heavy debt repayments. We believe the resumption of the IMF loan-package will certainly boost investor confidence and push down yields, which would decrease external refinancing risks.

Gas wars with Russia

Instead of raising politically-damaging domestic gas prices ahead of the October elections, the Ukraine government wants to cut the price of gas imported from Russia. It has declared a deal struck with Moscow in 2009 illegal, and thrown the prime minister of the time, Yuliya Tymoshenko, in jail for brokering the agreement in a case condemned by the EU and the US as politically motivated. Talks with Russia's gas giant Gazprom over revising the terms have dragged on for more than a year. And, despite some aggressive Ukrainian bluster recently, there is little sign that Kiev can escape the terms of the ten-year contract.

Ukraine has demanded two changes. First, it has demanded a price cut of more than a third, which Gazprom rejects. And second, that it is allowed to buy less gas than the contract stipulates because it cannot afford the required quantities at these prices. It bought 40bn cubic meters last year, and is contracted to buy 42bn cubic meters this year. It wants to slash that to 27bn. Again, Gazprom rejects the idea, pointing to Ukraine's contractual obligations.
In January 2012, another meeting between Ukraine's government and Gazprom broke up with no progress over breaking the impasse. Russia says that it will only agree to lower gas prices in return for one of two things.

First, that Ukraine joins a customs union between Russia and two other CIS states. Ukraine has repeatedly rejected that idea because it would make it impossible for it to sign a deep Free Trade Agreement with the EU. However, since this agreement was postponed because of Brussels' anger over the jailing of Ms. Tymoshenko, among other things, Ukraine is now careful to say that it has not ruled out joining the Customs Union, but continues to press for a so-called '3+1' arrangement. This would mean freeing up trade with the three customs union countries, but avoiding deeper economic integration. Russia has not warmed to the idea, which could still allow Ukraine to drift towards the EU, rather than Russia.

The second alternative offered by Russia is for Gazprom to buy control over Ukraine's gas-pipeline network in return for cheaper supplies. Ukraine's government explicitly rejected the idea. Some 80% of Russia's gas exports to the EU are transported through Ukraine and Moscow wants to secure the supply chain by controlling the pipelines. Ms. Tymoshenko signed the controversial gas-supply deal in January 2009 after supplies to Europe were cut off briefly following another dispute over prices between Ukraine and Russia.

Ukraine is trying to find a compromise that would avoid ceding too much control to Russia: it rejects privatizing and selling its pipelines in favor of a three-way management split between Ukraine, Russia and the EU to make supplies more secure. This has resulted in tensions at a level where fears of another gas war are rising, threatening more disruption to EU gas supplies, despite assurances from both sides that they will not allow it to happen. In fact, Ukraine's energy minister quietly accepted that there might be no other option than sticking to the terms of the agreement if no compromise could be reached: consensus estimates reckon Ukraine faces penalties of around USD 2.5bn for breaching the contract. We believe that Russia is unlikely to budge and Ukraine will have little choice but to eventually hike domestic prices as demanded by the IMF or selling to

Russia. Both options are likely to spark protests with the opposition and population and increase political and social instability.

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Ukraine

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	7.9	2.4	-14.8	4.2	5.2	2.5	3.8
Consumer prices (average % change pa)	12.8	25.2	15.9	9.4	8.0	6.5	8.0
Current account balance (% of GDP)	-3.7	-7.1	-1.5	-2.2	-5.9	-4.1	-4.1
Total foreign exchange reserves (mln USD)	31790	30800	25560	33330	30410	24100	31600
Economic growth							
GDP (% real change pa)	7.9	2.4	-14.8	4.2	5.2	2.5	3.8
Gross fixed investment (% real change pa)	24.4	-1.2	-50.5	4.9	7.7	5.5	8.0
Private consumption (real % change pa)	17.0	12.8	-14.9	7.0	8.3	3.3	5.0
Government consumption (% real change pa)	1.8	1.1	-2.4	2.7	1.0	2.2	1.0
Exports of G&S (% real change pa)	2.8	5.7	-22.0	4.5	8.3	1.2	4.2
Imports of G&S (% real change pa)	23.9	17.0	-38.9	11.1	17.4	2.9	6.2
Economic policy							
Budget balance (% of GDP)	-1.1	-1.5	-4.8	-5.9	-4.1	-4.0	-2.7
Public debt (% of GDP)	12	20	35	39	38	40	39
Money market interest rate (%)	2.3	13.7	12.6	3.4	7.0	5.0	4.0
M2 growth (% change pa)	51	31	-5	23	18	12	17
Consumer prices (average % change pa)	12.8	25.2	15.9	9.4	8.0	6.5	8.0
Exchange rate LCU to USD (average)	5.1	5.3	7.8	7.9	8.0	8.0	7.9
Recorded unemployment (%)	6.4	6.4	8.8	8.1	7.0	7.7	7.3
Balance of payments (mln USD)							
Current account balance	-5272	-12763	-1732	-3018	-9280	-7070	-7950
Trade balance	-10572	-16091	-4307	-8388	-13834	-11850	-14450
Export value of goods	49840	67717	40394	52191	69485	64130	68190
Import value of goods	60412	83808	44701	60579	83319	75980	82640
Services balance	2420	1741	2354	4404	4624	4850	5250
Income balance	-659	-1540	-2440	-2009	-3733	-3820	-2830
Transfer balance	3539	3127	2661	2975	3671	3760	4080
Net direct investment flows	9218	9903	4654	5759	6600	4550	6000
Net portfolio investment flows	-101	-2060	-444	1228	816	500	900
Net debt flows	27258	19914	3650	19865	6216	20	6250
Other capital flows (negative is flight)	-20983	-15934	-11158	-15764	-7142	-4390	2200
Change in international reserves	10120	-940	-5030	8070	-2790	-6390	7400
External position (mln USD)							
Total foreign debt	77482	96696	103435	116808	123917	121960	127600
Short-term debt	22914	20636	19873	26459	30407	30760	32120
Total debt service due, incl. short-term debt	27788	41876	46873	55153	62552	68400	72330
Total foreign exchange reserves	31790	30800	25560	33330	30410	24100	31600
International investment position	-26699	-40199	-40260	-38778	n.a.	n.a.	n.a.
Total assets	90318	106512	112500	133434	n.a.	n.a.	n.a.
Total liabilities	117017	146711	152760	172212	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-7.4	-8.9	-3.7	-6.1	-8.9	-7.0	-7.4
Current account balance (% of GDP)	-3.7	-7.1	-1.5	-2.2	-5.9	-4.1	-4.1
Inward FDI (% of GDP)	6.9	6.1	4.1	4.7	4.5	2.9	3.3
Foreign debt (% of GDP)	54	54	88	85	79	72	65
Foreign debt (% of XGSIT)	108	102	166	150	126	132	129
International investment position (% of GDP)	-18.7	-22.3	-34.3	-28.1	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	39	44	75	71	64	74	73
Interest service ratio incl. arrears (% of XGSIT)	5	4	9	7	4	4	4
FX-reserves import cover (months)	5.3	3.7	5.5	5.5	3.7	3.2	3.9
FX-reserves debt service cover (%)	114	74	55	60	49	35	44
Liquidity ratio	108	92	93	96	87	81	84

Source: EIU