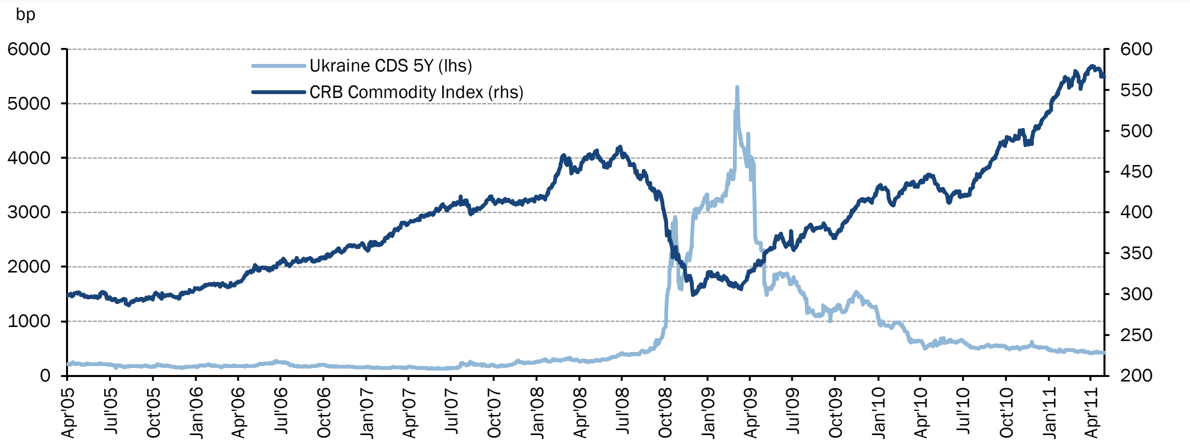
S I D E – N O T E

Current account and trade openness

Geopolitical risk in the EM region provides significant upside risks, both for energy markets and other commodities group. Given the negative correlation between commodity prices and CDS on Ukrainian sovereign debt, we expect this may, *ceteris paribus*, restrain the spread at least in the short-term period. We expect that the capital account will more than mirror the C/A, covering the insufficient amount of foreign currency in 2011. At the same time, we see additional tasks for the government to make such net borrowing more "civilized", ease excessive hot money inflows and stimulate investment demand. Generally, the mode of deficit finance relies on a fragile path and places the economy on an shaky foundation.

There is good evidence that terms of trade are an important determinant of Ukraine's sovereign yield spread. We plot commodity prices as measured by the Commodity Research Bureau (CRB) commodity index in the figure below and find that commodity prices and Ukraine's spread, in fact, exhibit a strong negative correlation (see graph). Since many emerging markets are important commodity exporters, we expect an improvement in the terms of trade and a resulting decline in spreads when commodity prices rise.

Ukraine's sovereign 5Yr CDS vs commodity prices



Source: Bloomberg

The natural interpretation is that when commodity prices are high, commodity exporters are more likely to repay their external debt, which reduces the yield spread they face in international capital markets. For example, the large increase in commodity prices from 2002 to 2007 narrowed the spread significantly. The intuitive sense as to why this measure is relevant for the pricing of debt becomes apparent when one considers a steel-exporting country. The country generates dollar revenue by exporting steel and spends dollars on imports. If the price of steel rises, the country is in a better position to generate export revenue and repay its dollar-denominated liabilities. Bondholders, however, care not only about recent changes in the terms of trade, but also about the risk of a large adverse shock in the future – perhaps, a large decline in the price of steel, as in our example. As a result, the volatility of terms of trade must be positively correlated with spreads.

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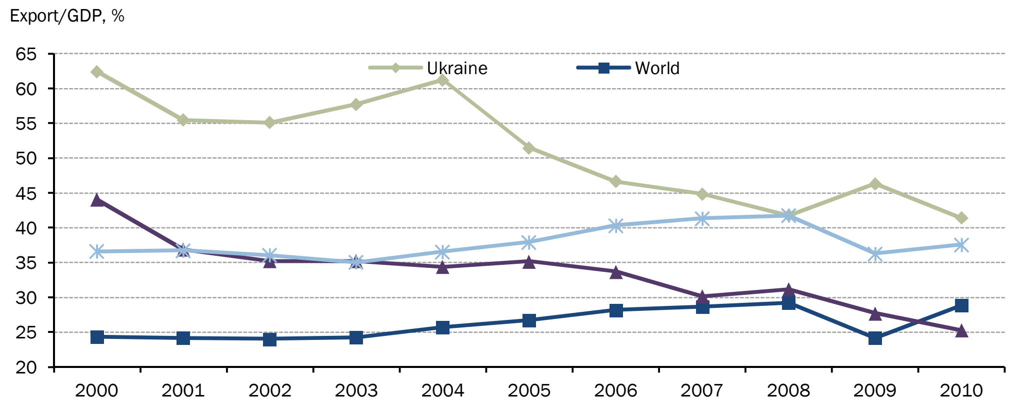
Openness of the Ukrainian economy



Source: the World Bank data and estimations

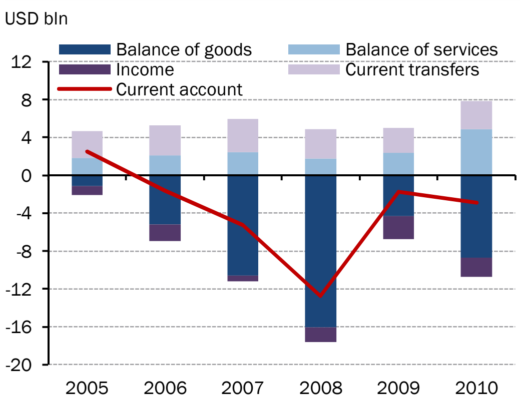
The case with Ukraine is about both openness and volatility. Historically, Ukraine has been one of the most open economies. Comparative analysis of the export shares of GDP in different regions clearly demonstrates Ukraine's significant openness to trade. In 2010, the share of exports in GDP was more than 40%.

Ukraine is one of the most open economies

Current account balance is of particular interest for us as a key determinant of terms of trade. **Recent developments show that the current account deficit in Ukraine is on the increase, due to the surge in volumes and the cost of imported energy sources (natural gas in particular),** along with the recovery in domestic consumer and investment demand for imports, exceeding the growth in prices and volumes of exported products. Moreover, there is a risk that the gap could grow further, as a contracted Russian gas price is linked to steadily rising world fuel prices.

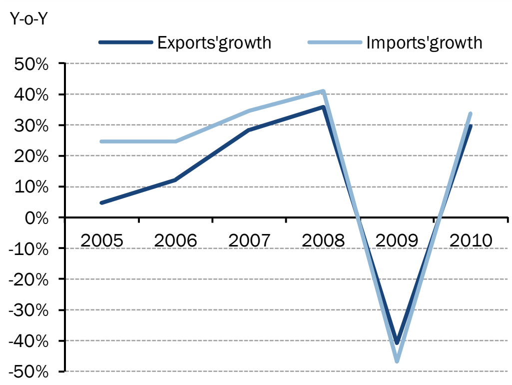
C/A deficit in Ukraine is increasing again, due to growth in energy prices and rebounding consumer demand for imports

Current account balance (2005-2010)



Source: NBU, AYA calculations

Merchandise Exports' vs. Imports‘ growth rates (2005–2010)

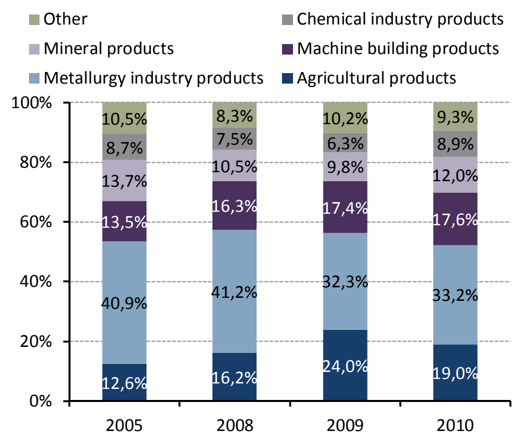


Source: NBU, AYA calculations

As one may see, **since 2006, Ukraine’s current account balance has been negative, primarily caused by increasing domestic consumer and investment demand, enhancing import growth**. Nevertheless, whatever the tendencies and events, both the balance of services and current transfers demonstrated positive dynamics. The exports of transport services has historically played a major role in a transit country, such as Ukraine. Worker remittances contributed to positive cash flows of current transfers.

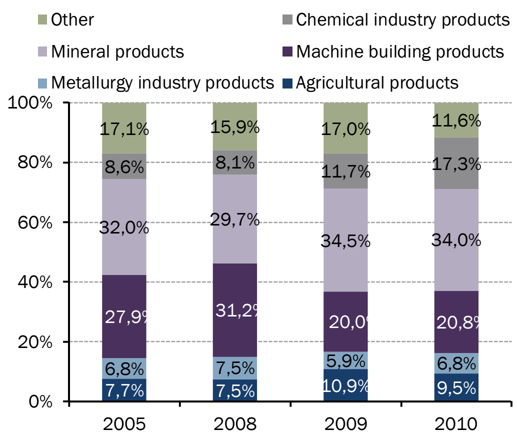
In 2010, the current account deficit increased to USD 2.9 billion, accounting for 2.1% of GDP (in 2009 – USD 1.7 billion, or 1.5% of GDP). The increasing deficit resulted from: 1) recovery in domestic demand and 2) increases in energy prices, as reflected in higher growth rates of the imports over the exports (35.4% and 29.0% respectively). Generally speaking, an increasing current account deficit takes place due to a rapid growth of all categories of imports, especially energy resources. Export growth is not as significant and is mainly due to the growth of prices worldwide.

Exports' structure, %



Source: State Statistics Committee of Ukraine, AYA calculations and estimations

Imports' structure, %



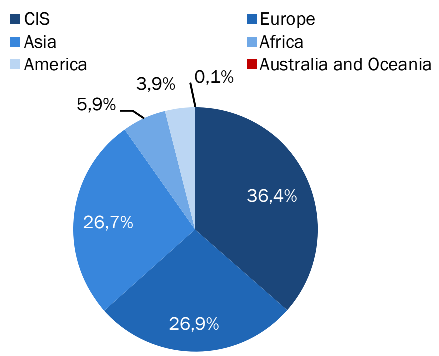
Source: State Statistics Committee of Ukraine, AYA calculations and estimations

In both pre- and post-crisis years, the structure of Ukrainian exports has not changed significantly. There is a decrease in exports in the metallurgy industry products, as global economic indicators deteriorated after the crisis. With regard to imports, the crisis resulted in a partial replacement of machine-building products with mineral products (primarily, energy sources).

In both pre- and post-crisis years, the structure of Ukrainian exports has not changed significantly

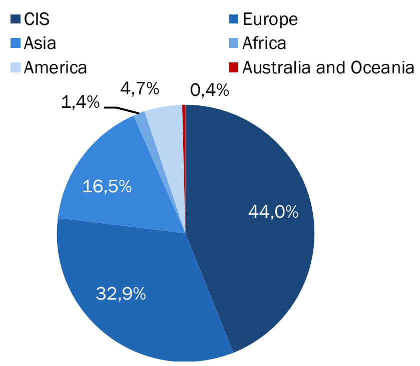
With raw materials (mainly iron ore, steel and chemical products) constituting 55-60% of total exports, Ukrainian export-oriented industries are poorly diversified. Commodities (including agricultural and food processing industry products) form 75% of total exports. The Ukrainian economy remains energy-intensive; despite the fact that companies receive no direct subsidies for energy (the country subsidizes only consumer consumption). Ukraine has failed to increase energy efficiency in the private sector. However, reforms designed to raise energy efficiency may save costs initially. Imports (mainly from Russia and Kazakhstan) cover ¾ of Ukraine's total oil and gas consumption. Thus, forecasting of current account balance actually comes down to defining the components of prices and volumes of the major exports. Such components are steel and natural gas.

Exports' geographic structure 2010



Source: State Statistics Committee of Ukraine, AYA calculations and estimates

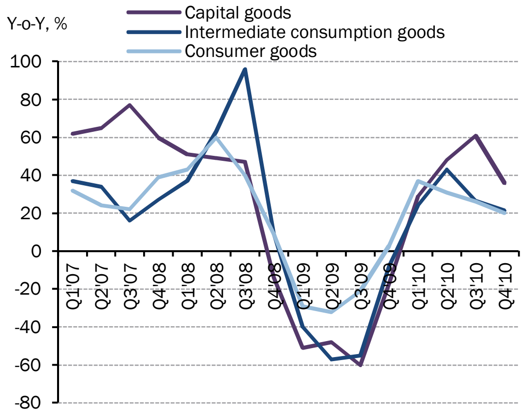
Imports' geographic structure 2010



Source: State Statistics Committee of Ukraine, AYA calculations and estimates

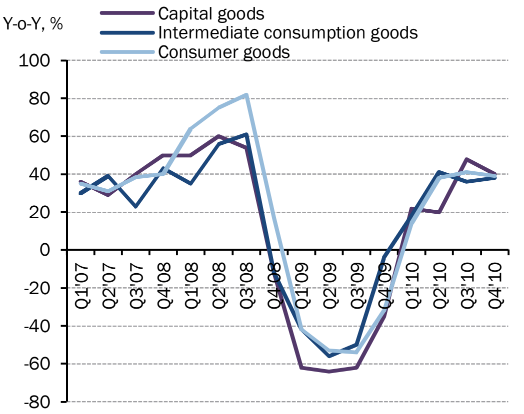
The charts above illustrate that Ukrainian goods are exported primarily to CIS countries, followed by almost equal shares to Europe and Africa. Taking into account the huge volumes of energy resources imported from the CIS, these countries constitute 44% of Ukrainian imports, with Europe and Asia following. It is worth mentioning that European goods are in bigger demand than those originating in Asia.

Merchandise exports' categories dynamics



Source: Estimations of Balance of Payments Department of NBU

Merchandise imports' categories dynamics



Source: Estimations of Balance of Payments Department of NBU

Exports and import growth in 2010 crossed all broad economic categories of goods. Exports of capital goods showed the highest growth (42.7%), while intermediate consumption and consumer goods grew at somewhat lower rates (28.6% and 27.1%, respectively). As for imports, growth rates were almost identical, with import of capital goods growing by 33.9% and intermediate consumption goods by 33.5%, and imports of consumer goods – by 32.1%.

We believe C/A will remain in the red zone over 2011-2012, due to increasing internal demand for both consumer and investment products. Nonetheless, we expect that the capital account will more than mirror the C/A, covering the insufficient amount of foreign currency. At the same time, we see additional tasks for the government in making such net borrowing more "civilized", easing excessive hot money inflows and stimulating investment demand. Generally, the mode of deficit finance lies on a fragile path and places the economy on an unsustainable razor's edge.

We believe C/A will remain in the red zone over 2011-2012, due to increasing internal demand

Case Study

"…Should somebody be concerned that the country is a net borrower and a debtor? The answer to this question depends mainly on what the borrower is doing with the borrowed money. If borrowing is financing investment that in turn is generating economic growth and higher income, borrowing is not a problem. It earns a return that more than pays the interest. But if borrowed money is used to finance consumption, to pay interest and repay the loan, consumption will eventually have to be reduced. In this case, the more the borrowing and the longer it goes on, the greater is the reduction in consumption that will eventually be necessary…"

Economics, Eighth edition, by Michael Parkin. 2008 by Pearson Education

Current account balance / GDP forecasts, %

	Date	2011	2012	2013	2016
NBU	06.12.2010	-2,5			
IMF	11.04.2011	-3,6	-3,8		-2,9
World Bank	16.12.2010	-3,1	-3,4		
S&P	31.03.2011	-3,5	-4,3	-5,0	

The recent deteriorated forecast by the IMF of Ukraine's current account deficit for 2011 is connected primarily with a growth of oil prices and, respectively, with a rise of reference prices for energy goods. Moreover, the current account deficit in 2011 is expected to rise, also due to increased domestic demand and increasing public investment expenditures related to the European Football Championship to be held in Ukraine in 2012.

Despite certain variations in projections, we consider the IMF forecasts the most relevant, since this organization is a think tank in macroeconomics, with a highly experienced staff in Ukraine; their knowledge and information comes from recent economic and political discussions with Ukrainian officials.

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