AYA Capital

DESK – NOTE

BoP and FX: Is this time different?

We see a number of lights flashing across the board in Ukraine's external balance, which have the potential to turn red in 2012. The current account deficit continued to widen in 2011, reaching the highest level in the post-crisis period (5.9% of GDP) on deteriorating core-commodity trade balance and widening non-commodity trade deficit. At the same time, scarcity of foreign capital against the backdrop of volatile capital markets and absence of structural reforms have reduced inflows on the capital account, while making them more unstable. Ukraine's current external position remains highly vulnerable to a sudden change of risk sentiment and exogenous shocks, which in our view have the potential to disrupt macroeconomic stability and once again undermine the local currency's peg to the USD in 2012. We expect the NBU to continue its 'UAH defense' policy course in 2012. Yet, we argue below that shock-absorption capacity of reserves may be inadequate to maintain the stability of the exchange rate under both scenarios, making external assistance a necessity or mild devaluation an inevitability.

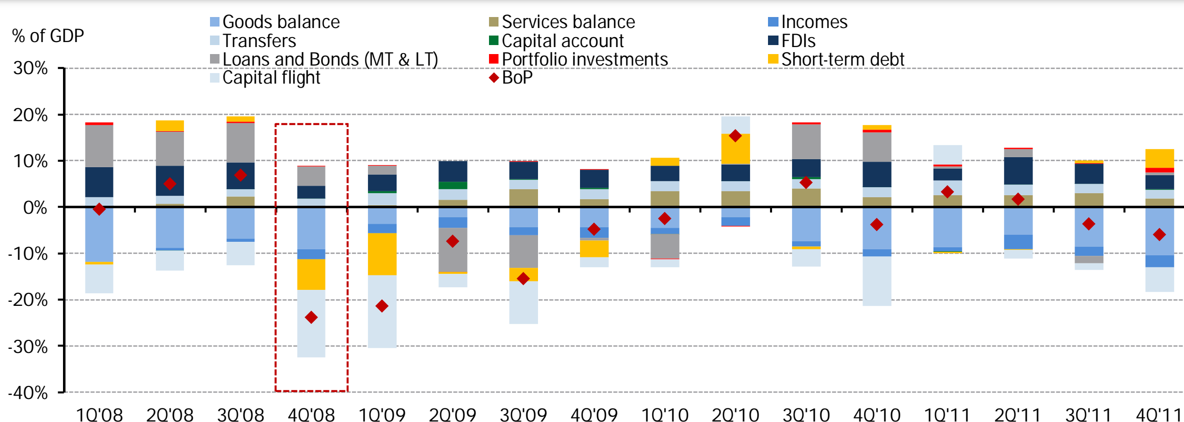
Excerpts from scenarios	2012 'No shocks' scenario	2012 'Depressed growth' scenario
USD/UAH rate, e-o-p	8.1-8.3	8.6-8.9
Current account balance, USD bn (deficit)/surplus	(9.3)	(2.9)
Current account balance, % of GDP (deficit)/surplus	(5.1)	(1.7)
Overall BoP, USD bn (deficit)/surplus	(5.1)	(8.9)

Source: NBU, AYA estimates and calculations

As we argued in our desk-note on Ukraine's economy ("Bracing for a bumpy ride"), the **'twin deficit problem' poses one of the key threats to Ukraine's economic performance in 2012 in light of the highly uncertain global economic prospects.** In this desk-note we focus on the external imbalance as in our view it has the greatest potential to undermine macroeconomic stability this year.

Thus far, developments on Ukraine's balance of payments have offered little comfort and external position remains unenviable. Unfavorable trends in Ukraine's balance of payments that resumed in the post-crisis period only became more pronounced in 2011 and persist to date, suggesting that the exchange rate correction in 2008 brought little adjustment to the country's external balance. In the 4Q'11 the current account deficit widened, while capital inflows were mostly of short-term nature, which induces us to perceive an increase in Ukraine's overall vulnerability in 2012.

In the 4Q'11 Ukraine's external position grew more vulnerable



Source: NBU, AYA estimates and calculations

Note: USD-denominated GDP figures were obtained by dividing the nominal GDP in UAH by the average exchange rate of the corresponding period. Balances presented above are given as net figures (inflows minus outflows).

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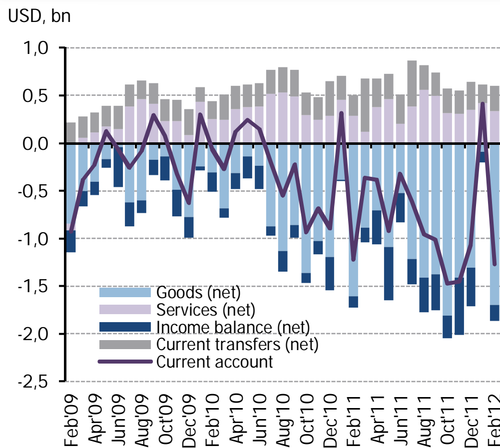
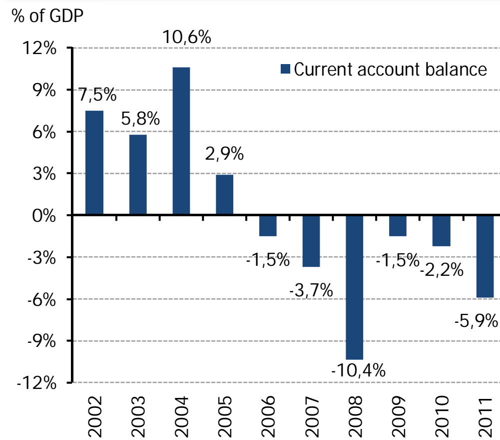
Despite a certain moderation in the final months of the year, **Ukraine's current account deficit widened to 5.9% of GDP in 2012 – the highest level in the post-crisis period**, and the second highest figure in a decade (10.4% of GDP was recorded in 2008).

Current account deficit continued to widen in the final months of 2011 with little change as of Feb'12...



Source: NBU, AYA estimates and calculations

... Reaching the highest level in the post-crisis period

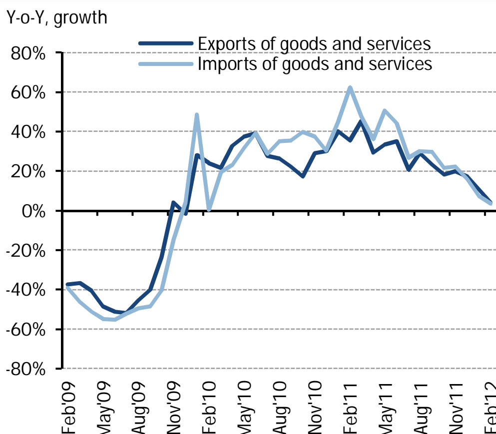


Source: NBU, SSC, AYA calculations

Deteriorating commodity-trade balance places additional pressure on the BoP

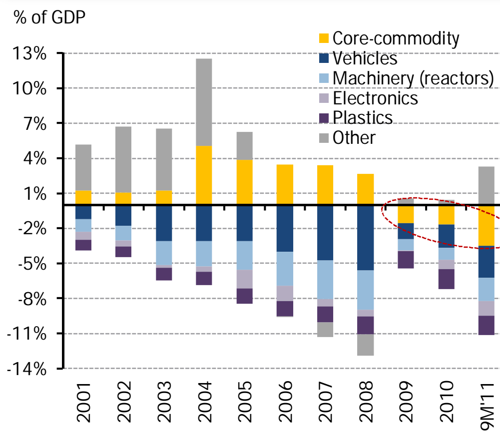
In the absence of domestically produced high-quality non-food items, the private sector continued to purchase vehicles and other consumer items, pushing the overall non-commodity trade balance further into the red. At the same time **we draw attention to the growing negative impact of the core-commodity trade balance[1] in the post-crisis period**. In 2011, Ukraine experienced a double hit to its net commodity balance - higher import prices of natural gas, faltering demand and declining prices for base metals. Both of these factors contributed to the widening of the current account deficit. The state of the core-commodity trade balance is vital for the economy as it affects the other aspect of the twin-deficit problem – budget deficit.

Faster growth of imports has been only part of the problem...



Source: NBU, SSC, AYA calculations

... as Ukraine experienced a steadily deteriorating core-commodity trade balance

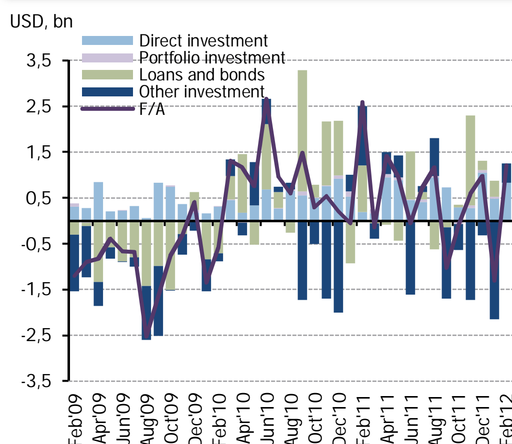


Source: NBU, SSC, AYA calculations

[1] Core-commodity trade balance refers to the difference between Ukraine's largest export and imports items, namely steel exports minus mineral fuels (oil&gas) imports.

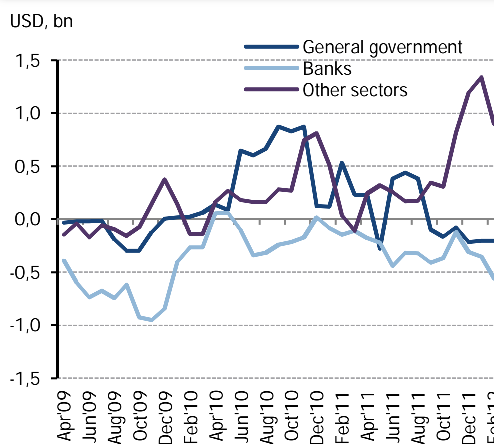
The dynamics on the other side of the external balance – the financial account – and its outlook are not comforting either. **Ukraine continues to rely on choppy capital inflows on the financial account with a minor share of FDIs largely representing Ukraine's own funds recycled back from the offshore zones**. The banking sector continues to deleverage, while the sovereign is crowded out of international capital markets by the refinancing needs of the European nations and still elevated borrowing costs.

Choppy capital flows are expected to remain a dominant feature of the financial account



Source: NBU, AYA calculations
Note: F/A – financial account, including capital account

Net new external borrowing has been volatile (3-month moving average)



Source: NBU, AYA calculations

As we argued in our desk-note on Ukraine's economy, the crisis of confidence and persistent uncertainty over the outcome of the European sovereign finances have increased risk aversion which is having an impact on Ukraine's ability to borrow abroad. In fact, heightened concerns over liquidity have already translated into higher CDS spreads for Ukraine which were only lower than Greece's and Portugal's in Jan'12.

We do not see any substantial improvements in 2012 for political and economic reasons

We do not expect any significant improvements in Ukraine's external position this year as current dynamics reflect entrenched structural idiosyncrasies the resolution of which requires substantial adjustments. In this sense, political will and real commitment to reforms is a crucial prerequisite for change. However, Ukraine's upcoming parliamentary elections are unlikely to sway the politicians in favour of correcting these imbalances, delaying crucial reforms and perpetuating structural problems. In fact there are already signs that the authorities have sought to apply cosmetic changes such as discounts to the import gas prices, rather than addressing the fundamental issues.

From an economic perspective, Ukraine's external balance is unlikely to see substantial improvements as we see weaknesses in its main components. The goods and services balance is projected to end the year with a sizable deficit - according to our calculations, of around 5.4% of GDP under the "no shocks" scenario and 2.5% of GDP under the depressed growth scenario. The persistence of this imbalance, as argued above, reflects Ukraine's structural features of the economy which cannot be corrected in the short-term. We also see **lower private remittances given a recessionary economic outlook and high levels of unemployment in Europe** (second source of remittances) and slowing growth in Russia (primary source of remittances). Finally, the **negative net income balance is also likely to widen given the dominance of short-term borrowing at higher interest rates under uncertain financial conditions on the financial markets**.

At the same time, as we outlined in our desk-note on Ukraine's economy, volatility on the capital markets is likely to persist further given the highly probable underperformance of the fiscal adjustments by a number of countries, i.e. Greece and possibly Portugal. Such conditions create a highly unfavourable environment for domestic borrowers both via elevated borrowing costs and reduced access to funding[2]. In an environment of high risk aversion and scarcer credit availability foreign investors are likely to be more selective in allocating their funds and demand a higher return. Therefore unstable capital flows of largely short-term nature are likely to be a dominant feature of Ukraine's financial account in 2012, particularly in case the resumption in cooperation with the IMF fails to take place.

In addition, unconducive business environment and lack of economic reforms are likely to further deter inflows of long-term equity capital, hence FDIs are unlikely to provide sufficient funding. Moreover, there could be traditional deceleration of new FDI inflows on the eve of parliamentary elections.

With no adjustments Ukraine is expected to face difficulties in covering its external financing needs

With this in mind, and considering the risks outlined in the previous section, we maintain that the key themes for Ukraine's external position remain largely unchanged. We still expect Ukraine to experience significant difficulties in meeting its external financing needs this year as IMF loan repayments come due, negative current account dynamics are likely to persist, and availability of foreign credit is limited. For a country with a de-facto fixed exchange rate regime and a high level of dollarization downside risks are obvious. In our view, in the absence of structural reforms that would foster import substitution and greater FDI inflows, **such balance threatens the de-facto fixed exchange rate regime and Ukraine's overall macroeconomic stability going forward and particularly in 2012**.

According to our calculations Ukraine is expected to have the following BoP in 2012:

Balance of payments scenarios

	2011		No shocks		Depressed growth	
	USD, bn	*% of GDP*	*USD, bn*	*% of GDP*	*USD, bn*	*% of GDP*
Merchandise balance	(13.8)	(8.4)	(14.5)	(7.9)	(7.7)	(4.5)
Services balance	4.2	2.6	4.6	2.5	3.4	2.0
Income balance	(3.7)	(2.3)	(3.5)	(1.9)	(2.2)	(1.3)
Transfers	3.6	2.2	4.0	2.2	3.6	2.1
Current account balance	**(9.7)**	**(5.9)**	**(9.3)**	**(5.1)**	**(2.9)**	**(1.7)**
Capital account	0.09	0.1	0.2	0.1	0.1	0.05
FDIs	6.6	4.0	4.6	2.5	3.0	1.8
Portfolio investment	0.7	0.5	0.2	0.1	(0.2)	(0.1)
Loans and bonds	2.2	1.3	2.4	1.3	0.7	0.4
Other capital	(2.3)	(1.5)	(3.2)	(1.8)	(9.6)	(5.6)
Financial & capital account balance	**7.3**	**4.4**	**4.2**	**(2.2)**	**(6.0)**	**(3.5)**
Overall balance	**(2.5)**	**(1.5)**	**(5.1)**	**(7.3)**	**(8.9)**	**(5.3)**

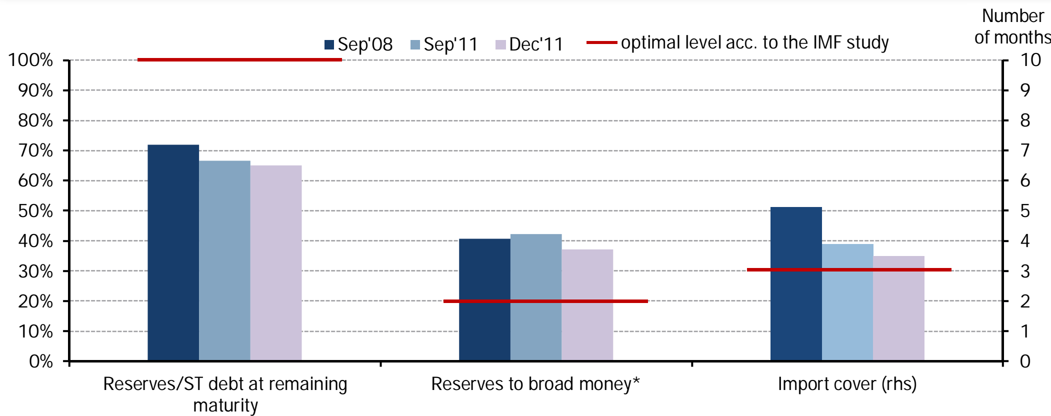
Note: certain figures may not match due to rounding

We have reservations about the central bank's ability to provide sufficient support without external assistance

In 2012, the stability of the exchange rate will be a function of willingness and ability of the monetary authorities to provide backstop measures. We are doubtless as to the former element of stability, since devaluation would be highly disruptive to the financial system and the broader economy, and hence effectively exclude such reason for the abovementioned political motives until parliamentary elections in Oct'12. At the same time, **we have reservations about the central bank's ability to provide sufficient support without external assistance.** Based on the standard metrics, **Ukraine's reserve adequacy appears to be lower than in the pre-crisis period of 2008.**

[2] Ukraine's deputy minister of finance announced that the ministry views the current yield levels as overly high for borrowing and suggested a 9% threshold for considering foreign loans

Shock-absorbing capacity of NBU reserves is weaker than on the eve of the 2008 crisis



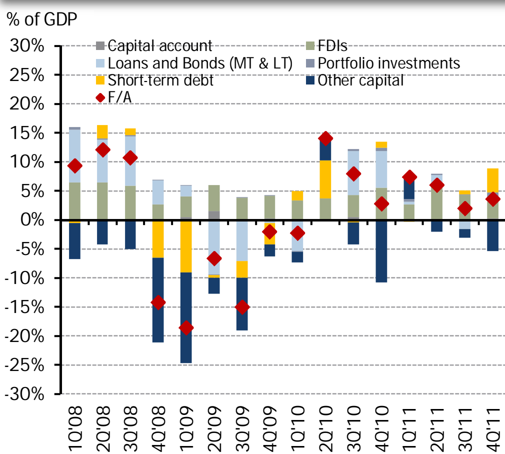
Source: NBU, IMF, AYA estimates and calculations
Note: * Broad money refers to M2 (M1 + transferable deposits in foreign currency and other deposits)

These indicators and the state of the balance of payments are highly suggestive that Ukraine's external position is more vulnerable than it was in Sep'08 prior to the onset of the crisis. We particularly point out the first of the 3 reserve adequacy indicators – reserves-to-ST debt at remaining maturity. Consistent with empirical studies carried out by the IMF, this indicator is most important for open small economies with substantial yet unstable access to capital markets[3]. In fact, as presented on the graph below, short-term debt was among the principal drains on reserves during the crisis period.

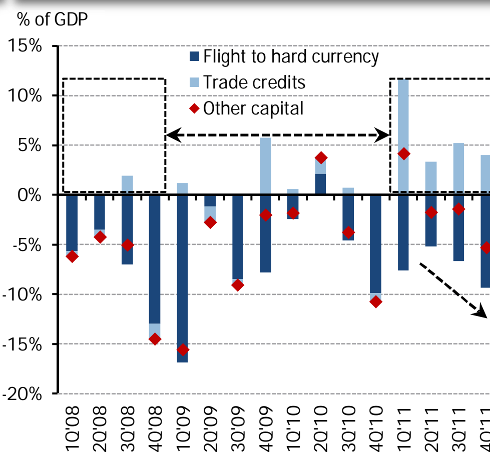
However, capital flight remains the most important factor that persistently undermined the exchange rate stability in 2008 and henceforth. A large part of capital flight on Ukraine's balance of payments occurs due to a local currency run by the population, as hryvnias are converted into a hard currency, primarily the US dollar. Given our outlook on the current account dynamics and the highly uncertain nature of capital flows, a repeat of a run on the local currency remains a major source of threat to the exchange rate in 2012.

Capital flight remains the largest potential disruptive force

The "Other capital' figure on the F/A appears small on the surface



As short-term and reversible trade credits mask increasing flight to hard currency



Source: NBU, AYA estimates and calculations

[3] IMF (2000). Debt and Reserve-related indicators of external vulnerability

The recent dynamics, revealed on the graph above, may not serve as a cause for alarm on the surface, yet a closer look at the '*Other capital*' component on Ukraine's BoP indicates the opposite. The overall '*Other capital*' figure on the financial account side of the BoP in itself is not a large one compared to the crisis period. Yet, according to our analysis, the figure was lowered by a presence of large positive figure of trade credits in 2011 that has offset an increased flight to hard currency, as can be seen on the graph below.

However, in times of crises of confidence and collapsed trade, reduced trade credits are unlikely to provide an offsetting buffer, which should result in a major source of pressure on the BoP and the exchange rate.

At this juncture, we do not share the much propagated view that NBU maintains adequate foreign currency reserves. Firstly, the abovementioned indicators point to a weaker reserve position at the end of 2011 than in the run-up to the 2008-2009 crisis. Secondly, Russia, which held among the largest foreign currency reserves in the world, yet allowed its ruble to depreciate by approximately 40% in 2008, demonstrated that the cost-benefit analysis has a threshold for continued intervention.

Based on the above, we maintain that external financing is a matter of necessity rather than optionality. As we argue in the *Public finances* section of our recent Quarterly Economic Overview (Macro Outlook 2012: 1Q Update), Russia is the most attractive funding source under the "no shocks" scenario, while we do not exclude that the government could still continue to fund itself through local debt markets until the parliamentary elections. At the same time, funding from the IMF comes to the fore under the "depressed growth" scenario.

The cost-benefit analysis warrants UAH-defense policy guidance in 1H'12

For now, based on the macroeconomic outlook and likely opening of wholesale debt markets for the Ukrainian sovereign, we believe that the central bank is within its ability to maintain the exchange rate stable under the "no shocks scenario", while **the cost-benefit analysis also warrants UAH-defense policy guidance in 1H'12.** However, the capacity is limited under the "depressed growth" scenario and cooperation with the "lender of last resort" will be crucial in case of an adverse shock.

In this context, we believe the NBU is likely to succeed in holding up the exchange rate in 2012 under the "no shocks" scenario, with a possible allowance for flexibility and managed devaluation within 8.1-8-3 range in the 2H'12 to accelerate export growth. However, in the event of an abrupt external shock, such as under the depressed growth scenario, the cost-benefit analysis for interventions could result in NBU allowing greater exchange rate flexibility to the peg, with the exchange rate reaching 8.6-8.9 UAH/USD, with the presence of significant volatility both on the interbank and cash markets. Notably, we do not expect a devaluation in magnitude of the 2008 level, as the NBU has an effective administrative anti-crisis toolkit used previously. Given that run on local currency by the population remains the main drain on reserves, we expect the NBU to follow up with additional administrative measures in case of severe deterioration (limits on deposits withdrawal, a limit on one-time local currency conversion into hard currency, interbank trading etc.)

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