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Sovereign spin

CEEMEA | Strategy

Ukraine - One the brink

Summary view

- We review the probability of default in Ukraine, and conclude that the risks are being under-estimated.
- The near term pressure point is not sovereign debt service, but the balance of payments, but an exchange rate/banking crisis would inevitably feed back into public finances, stressing the sovereign's "ability to pay".
- The external financing position is unsustainable without external financing support. We estimate the external financing gap at close to USD13-14bn, even with relatively generous assumptions, and not making any assumptions over possible capital flight.
- Given current political flux/tensions we think it will be difficult for the Yanukovych administration to quickly conclude financing agreements either with Russia or the EU/IMF. However, we think the current "muddle through" scenario is no longer sustainable.
- The UAH is likely to depreciate precipitously without external support, and we think this will also push Ukrainian debt prices markedly lower.
- With the market likely trading Ukrainian sovereign/corporate debt prices at distressed levels we think it will be too tempting for the authorities not to undertake an "opportunistic" debt restructuring so as to wipe the sovereign balance sheet clean and prioritise payments of pensions/wages in the run up to a likely closely fought presidential election campaign in 2015.
- Also, if the government is then forced into an IMF programme, post a BOP crisis, we think that moral hazard arguments will encourage the IMF to seek to bail-in private creditors to any Ukraine bail-out programme. This will be important to improve the IMF's own credibility going forward, and to ensure that stressed sovereigns are encouraged to move more quickly onto IMF programmes – i.e. to prevent countries "doing a Turkey" in the future, and playing investors off against the IMF, and vice a versa.
- We think that current debt prices – Ukraine 10Y yielding just 10.2%, despite the enormity of the challenges facing Ukraine on both the political and economic front do not adequately capture the risk.

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Default risk is under-estimated

There currently seems to be a lot of debate in the market over the probability of Ukraine defaulting, with different views being offered. We attempt to add our own perspective, but suffice to say we think that default risk is being seriously under-estimated.

Review of Ukraine budget/debt financing equation suggests a difficult but, at first glance, not untenable position.

At first glance dent financing needs are not that onerous

Sovereign debt liabilities (FX and UAH) falling due over the next year amount to around USD10bn (5.5% of GDP) – with around USD300m due to year end 2013. The budget deficit is likely to come in around 5% of GDP in a best case scenario, but might end up being 7-8% of GDP given the risks that the current political crisis deepens the recession and undermines fiscal revenues. Note that presidential elections are due in March 2015, and the assumption has to be – especially given the current low popularity of incumbent President Viktor Yanukovych that he will want to spend in the run up to that election. This would make me tend to think that the deficit will be at the top end of these expectations. So taking a more cautious assumption of a budget deficit of 7% of GDP adds another USD12bn or so to budget/debt financing needs for the sovereign and hence indicative of total government debt/deficit financing needs of around USD22bn.

But the cash balance is at rock bottom

Set against this the MOF has around USD150m currently on its single Treasury account – a remarkably low balance. It is difficult to imagine much inflow in terms of revenues from state asset sales – this year has already seen minimal receipts from this source, i.e. UAH979m as of October, less than one-tenth the annual target.

The NBU can print money, and it is doing

Given zero inflation (-0.1% as of October 2013) the NBU can still print money – it already has around 60% of domestic government debt on its balance sheet. That certainly helps buy time, albeit it also complicates the other pressure point, i.e. the regime's current hard FX policy.

Nevertheless, assuming that the bulk of domestic liabilities can be met through local issuance/NBU printing, this still leaves around USD6bn or so in FX sovereign financing needs. This does not appear that onerous, given the NBU still has USD18bn or thereabouts in FX reserves.

But herein in my mind is the key pressure point/risk, i.e. external financing and limited FX liquidity more generally.

The external financing position is though key

Ukraine's gross external financing needs over the next year – assuming no FX adjustment – are likely to include a current account deficit of around USD13bn (the 12mma deficit as of October 2013 was USD15.3bn, hence we assume some weakening in economic activity reduces the CAD moderately), and short term debt by remaining maturity of around USD62bn. This suggests a total external financing requirement of USD75bn over the next 12 months. Now of the external debt liabilities falling due, around half are likely trade finance and expected to be rolled. This leaves around USD32bn in M< debt liabilities which need to be financed over the next 12 months. Assuming 75% of these are rolled again – assuming a high weight of intercompany loans – this indicates a gap on debt financing of around USD8bn. Add this to the current account deficit and this gives a figure of around USD20bn which needs to be financed. I would expect net FDI to total around USD4bn (12mma to October). Currently, and without some form of official (bilateral or external) financing anchors it is difficult to see much in terms of portfolio inflows. However, let's assume some friendly fund managers, for some reason beyond my own understanding given the risks, care to take a "punt" and throw in a USD2-3bn in financing through private placements, et al. This hence leaves a gap to be financed still of around USD13-14bn.

Clearly one means to close the above gap would be by allowing the UAH to depreciate and/or by deflating the economy, to shrink the current account deficit to fit. The problem therein is that the economy is already in recession (minus 1% print expected this year), the Yanukovych regime is already unpopular so unlikely to want to deflate the economy further, or indeed let the UAH peg go if it can help it – the latter is the regime's one policy anchor, and measure of its economic policy "credibility" in the eyes of the man on the street. So we assume no major contraction in the CAD this year.

Capital flight will be the body blow

Set against the above financing gap, official FX reserves stand at around USD18.8bn (November 1, 2013, excluding gold). This represents 2.3 months of import cover (less than the 3 month level seen as the critical minimum), or 25% coverage of external financing needs. Importantly, this provides only around 46% coverage of base money. And therein is the other big risk, as the calculations above assume no capital flight. This seems to be a fairly dangerous assumption – given heightened domestic political risks, and the tendency of Ukrainians to buy FX in times of political crisis. It does not appear unreasonable to assume perhaps USD4-5bn in capital flight, which pushes up the external financing gap to nearer to USD18bn, which would wipe out official FX reserves. We doubt that the NBU would want to deplete official FX reserves to zero.

The UAH peg is unsustainable without external support

Reviewing the above, what is clear is that the external financing position is unsustainable without a major adjustment in the UAH, or the provision of a significant external financing programme, or likely both. We would best guess that any such programme would need to be in the USD10-15bn range to provide adequate assurance to the market.

Political log-jam makes doing a deal with the IMF or Russia difficult

At present we attach a low probability to such a financing programme coming either from the IMF/EU or Russia, due to the current political impasse over Ukraine's European orientation – either options seems like political suicide for the administration. The Yanukovych administration appears to have positioned itself in no-mans land, and without external support, the most likely scenario is for the UAH to face extreme downside pressure. Experience with EM currency corrections is that when they happen they are brutal and extreme – hence we see the UAH more likely ending up in the UAH11-12 range. We also assume that this would create systemic problems across the country's banks, and corporates, and with reverse flows back into public finances. Net-net Ukraine's public sector debt/GDP ratio will likely increase from sub-40% to nearer to 60%, and we expect external debt prices to drop precipitously in such a scenario. In effect Ukraine will undergo a classic EM BOP/banking/debt crisis – in the new world order of DM QE, many investors seem to have forgotten what these look like.

Momentum will take bond prices to distressed levels

Now Ukraine bulls might argue that a devaluation will help shrink the current account deficit, and if undertaken in the near term this will conserve scarce FX reserves to enable it still to meet that moderate external public sector debt burden, i.e. USD6bn or so. This might be true, but with a full blown BOP crisis in the works, and the UAH likely depreciating precipitously, Ukrainian sovereign debt prices will probably move aggressively weaker, for example, past EM crises suggest that investors will tend to dump all Ukrainian assets – and the push lower will likely not be helped by the limited risk appetite of the street (sell side), so there is unlikely to be any backstop bid. It is easily to then imagine Ukrainian debt prices trading at distressed levels – 40-50 cent handles are not unimaginable in such a scenario.

An opportunistic restructuring might just be too compelling

With Ukrainian debt prices trading at such low levels the question then becomes not one of ability to pay – which may still be there – but willingness. Would the Ukrainian authorities then look to opportunistically restructure? Our expectation is that they would.

Key in determining their decision will be their assessment of the reputational loss from undertaking such a course of action. We would perhaps make a few points therein:

First, with ratings already trading at lows of Caa1/B-, and likely to go lower in such a BOP crisis scenario the authorities might conclude that the market was already pricing/rating the sovereign as having low standing – so what further loss would be driven by then restructuring? They may also conclude that an aggressive debt restructuring would wipe the balance sheet clean, and allow the sovereign to rally back from a low base – previous experience of such debt restructurings is that investors' memories are typically short. E.g. after restructuring its debt liabilities only in 1998-2000, Russia returned to investment grade as early as 2003, having returned to capital markets even earlier.

What reputation?

Second, critics might question what "reputation" the administration has at the moment, given its failure to secure the AA/DCFTA with the EU, having promised its willingness to sign, after six years of negotiations and having agreed the text, and in long drawn out difficulties in securing an agreement with Russia over a gas/cash financing programme.

Third, with thousands of people on the streets, and facing the risk of a civil insurrection the administration might just argue "needs must", and it had to put the interests of the population – paying pensions/wages above foreign debt service, given the regime's survival would be at risk.

Fourth, a typical argument in favour of the sovereign paying is that by defaulting this would close market access for blue chip corporates. However, I would argue that they would take a similar view to the sovereign, and would, on a case by case basis seek to restructure on an opportunistic basis. Some would restructure, some decide to pay but use the opportunity to buy back debt at low prices as occurred in 2008-10. However, many of these corporates are owned by wealthy oligarchs, with deep cash reserves, offshore, and arguably they could meet any limited cash/investment needs through drawing down offshore cash reserves – at least riding through a period of limited market access, which they unlikely have now anyway.

IMF might favour "bailing-in" private creditors

Fifth, in such a BOP crisis situation, the assumption is that the sovereign would then resort to the IMF for financial support. Herein we would put a high probability on the IMF asking for private creditors to be "bailed-in" with hair-cuts extracted. From an IMF shareholder perspective the question will surely be asked as to why official money is being used to bail-out private creditors, who lent to a sovereign with already doubtful fundamentals. Also they might argue that investors willingness to lend to Ukraine, despite these doubtful fundamentals, has been part of the problem – i.e. it encouraged the government not to agree an earlier programme with the IMF, and as a result poor/inappropriate economic policy was maintained for longer than would otherwise have been the case. In effect this latter point is a classic moral hazard play – the IMF would want to bail-in private creditors, to ensure that future sovereigns do not "do a Turkey or Hungary", i.e. play the IMF off against creditors, and vice a versa. Arguably Ukraine's current difficulties would not have been so bad, if the government had had more reason to conclude an IMF agreement earlier – the availability of cheap market financing proved counter-productive, as it stalled meaningful reform.

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