

Ukraine is becoming dependent on Russian loans

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On 29 March, the state-owned Naftogaz announced that it is seeking to open a credit line for \$2 billion with Russia's Gazprombank for a period of 7 years. By way of explanation, Naftogaz said that it did not have the resources to pay for Russian gas, due to high prices and customers' rising debts. The suspension of Ukraine's cooperation with the IMF in late 2010 resulted in a significant increase in credit costs for Ukrainian companies in Western banks. In this situation, Russian loans are often their only source of funding. The result is that both Ukraine and Ukrainian companies are falling ever deeper in debt with Russian banks.

The high prices for Russian gas are leading to widening trade deficits and declining foreign exchange reserves. Moreover, Ukraine is facing increasing debt problems; in total, Ukraine has to repay more than US\$10 billion before the end of 2012, US\$3.7 billion of which it owes to the International Monetary Fund. It seems likely that Kyiv's credit dependence on Moscow will deepen, which will give Russia additional instruments to put pressure on Ukraine; if the economic situation deteriorates significantly, this may lead to Ukrainian enterprises being acquired by Russian capital.

Naftogaz's problems

Naftogaz's application for Russian credit is an open admission that the company is unable to pay for Russian gas on its own. In January, President Viktor Yanukovich said that in order to pay its bills to Gazprom, Ukraine needs to borrow half a billion dollars every month. To this end, the state has *de facto* subsidised Naftogaz by getting state-owned banks to buy bonds in the company. In 2012 over US\$1.5 billion was realised in this way. The company's financial problems have been caused by higher prices for Russian gas, resulting from the contracts signed in 2009 (US\$426 per 1000 m³ in the second quarter of this year). However, Naftogaz would not be in such a difficult situation were it not for the fact that some customers are not paying for the gas they receive. The information available suggests that the state's gas customers owe US\$3.1 billion, most of which is accounted for by heating and industrial customers. Gazprombank's reply to Ukraine's request is not yet known, but last year Naftogaz received a loan from the same bank of US\$500 million (for one year).

Problems with public debt...

Naftogaz's problems are linked to Ukraine's growing problems with supporting public debt. Although it is relatively small (US\$59.2 billion, or 36% of GDP) in comparison to most European countries, the majority (63%) of it is foreign debt. Kyiv's main problem is the unfavourable structure of the debt – namely, the predominance of short-term debt (see Appendix).

In 2010, Ukraine signed an agreement with the IMF to open a credit line for US\$15 billion, but after two tranches were transferred (a total of \$3 billion), the IMF halted its lending in late 2010 because of Ukraine's failure to meet the conditions, including the absence of any reform of the gas sector. As a result, the cooperation was suspended as of the end of 2010. The IMF's main condition for resuming its cooperation is a 50% increase in gas prices for consumers, which the government does not want to do just six months before parliamentary elections. Ukraine's situation is even more difficult because 2012 saw the start of the loan repayment from the previous programme of cooperation with the IMF. In February the Ukrainian government had already paid US\$575 million, but must still pay US\$3.1 billion by the end of this year, and a total of nearly US\$13 billion by the end of 2015 (see Appendix). In addition, 1 June is the deadline for the repayment of a US\$2 billion loan which the Ukrainian government obtained in 2010 from Russia's Vneshtorgbank. The deadline has already been postponed three times, and Ukraine will most likely try the same tactic again. So far, Russia has repeatedly declared its readiness to continue lending to Ukraine. In February, the head of Russia's Sberbank, German Gref, said that it would be possible to help Kyiv repay its IMF loan.

... and the debts of business

The government's unwillingness to make reforms led to the suspension of cooperation with the IMF, making it difficult for Ukrainian companies to obtain loans on European markets. In this situation, the only option in many cases is to take loans from Russian banks. The state banks Sberbank and Vneshtorgbank are particularly active in this field. The external debt of the corporate (non-banking) sector reached US\$67.7 billion at the end of 2011 (an increase of 19.3% from last year). Although there is no information on the levels of the Ukrainian companies' debts to Russian banks, we can estimate that they must amount to several billion dollars for the year 2011 alone. The largest loans in the last year include several made by Sberbank: \$500 million to the company DTEK, \$250 million to Ukrtelekom, and \$260 million to the Yuzhne Design Office. In addition, a number of companies are in talks with other Russian banks.

An increasingly difficult economic situation

These problems have been aggravated by unfavourable trends in foreign trade and the expected economic slowdown. After the economic collapse in 2009, Ukraine recorded a growth in GDP over the next two years (by 4.2% and 5.2% respectively), but it still has not returned to pre-crisis levels. The government predicts that economic growth will reach 3.9% in 2012, although international institutions (including the EBRD) estimate that figure at about 2.5%. In addition, Ukraine's foreign trade deficit has increased; last year it reached US\$6.75 billion (an increase of 125%). The main reason for this is the increased spending on

gas imports from Russia. The purchase costs for gas increased by \$4.7 billion over the last year (see Appendix), resulting in a negative balance of payments (US\$-2.4 billion in 2011) and a decrease in Ukraine's foreign exchange reserves (by 20% since August 2011, to \$31 billion; see Appendix).

Conclusions

- The main cause for Ukraine's deteriorating financial situation is the high price of Russian gas. Considering that the contracts with Gazprom are valid until the end of 2019, and that the price of the raw material is likely to remain high, Ukraine will have to reach an agreement with Russia to reduce gas prices to avoid bankruptcy. Another option would be to carry out a profound reform of the gas sector and implement real diversification.
- It is very likely that Gazprombank will make another loan to Naftogaz. Russia is exploiting Ukraine's problems servicing its debt to increase that country's dependence on Russian loans. The fact that state banks are leading the way in this suggests that these activities are supported by the Russian government. This process will go deeper in connection with the *de facto* disconnection of Ukraine from Western loans. If the slowdown observed in the Ukrainian economy turns into a full-blown crisis, that could lead to Russian traders acquiring a number of Ukrainian companies.
- It is unlikely that cooperation with the IMF will be suspended before the parliamentary elections. Later, Ukraine may choose to raise its gas prices. However, even the resumption of lending will not solve Ukraine's problems; it will only allow the refinancing of previous loans from the IMF. At the moment, it seems unlikely that the Fund will provide Ukraine with more aid unless the latter meets the conditions.