CIS Fixed Income Daily

08 October 2008

Today's news

Russian government and CBR to provide US$36bn capital for banks

This injection will be in the form of subordinated loans equivalent to around 4% of the banking sector's total assets and almost fully covering the short wholesale debt of Russian banks. The move should also support their capital levels.

Russia: Reserve Fund provides a good cushion in case of low oil prices

The two sovereign funds stood at about US$190bn in total as of 1 October.

Russia: Government discussing EUR 4bn loan for Iceland

Announcement comes as big surprise at the time when the market crisis intensifies in Russia.

Ukraine: Inflation in September declined to 24.6% YoY

Monthly inflation reached 1.1% in September. Hikes in gas tariffs and educational services led the growth last month. We maintain our forecast for 20.5% inflation at the end of 2008.

Ukraine: NBU Council widens currency band forecast to 4.55-5.35/USD

This is first official support for hryvnia depreciation. However we doubt that the NBU will keep the exchange rate in the new band.

Companies in this issue

Company	Currency	YTW (%)	Rec	Previously	Since
none					

Source: ING

Benchmark yields

	Last	%ch (DoD)
UST 10Y (US$)	3.459	-0.143
Russia 10Y (RUB)	7.580	-0.660
Russia 10Y (US$)	5.894	0.079
Russia '30 (US$)	7.558	0.363
Ukraine '16 (US$)	13.834	0.477

Currencies

	Last	%ch (DoD)
RUB/US$	26.14	-0.49
KZT/US$	120.06	0.02
UAH/US$	5.54	4.33

Money market rates

	Last	%ch (DoD)
3 months RUB	9.5	0.08
3 months KZT	5.70	0.00
3 months UAH	11.88	0.00

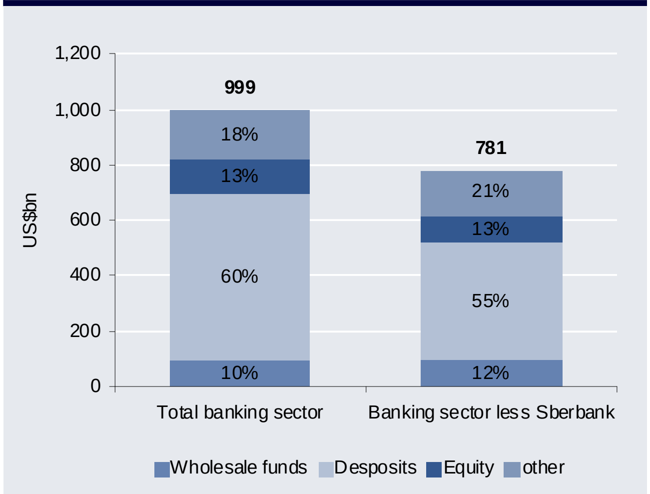
Russia

Russian government and CBR to provide US$36bn capital for banks

The capital injection will come in the form of subordinated loans with not less than five-year terms. Sberbank[f] will get US$19bn directly from its key shareholder, the Central Bank of Russia (CBR), while the Russian government will provide the remaining US$17bn, out of which VTB[def] and Rosselkhozbank[de] should receive US$7.6bn and US$0.95bn respectively. The other rated banks may count on subordinated loans from the government to the extent of 15% of their charter capital, and only if their shareholders additionally contribute double the government's injection. According to Minister of Finance, Alexei Kudrin, the support to major banks will come in several tranches within a one-year period. Additionally Mr Kudrin said that starting from mid-November, over 100 rated banks would get access to unsecured loans from the CBR, similar to those that the government distributes via its monthly deposits across only 28 banks.

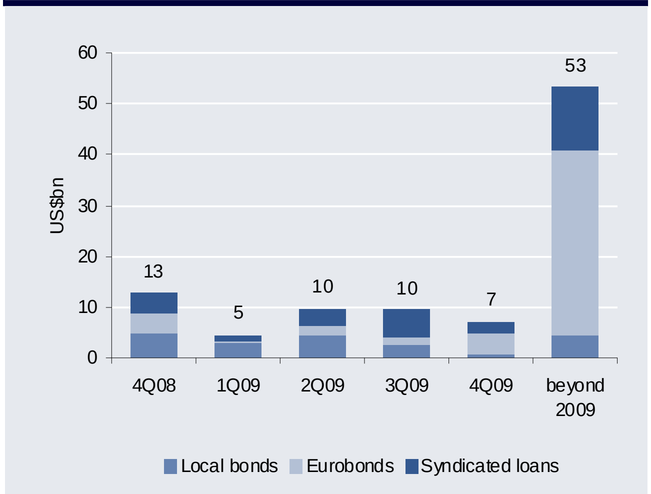
The announced volume of subordinated loans is equivalent to around 4% of the banking sector's total assets and up to 5% in case the move is supported by the shareholders of commercial banks. According to our estimates, such funding support almost fully covers the US$37bn of wholesale debt that domestic banks may have to redeem over the next twelve months. Apart from direct financing, the five-year subordinated loans should also increase the banks' overall capital levels as it can be accounted as tier 2 capital for them, consequently allowing for more leveraging going forward.

Fig 1 Banking sector funding structure, June'08



Source: CBR, Company data, Cbonds, Bloomberg, ING

Fig 2 Term structure of banks wholesale debt



Source: CBR, Company data, Cbonds, Bloomberg, ING

We view the announced measure as positive for the banking sector both from the standpoint of refinancing risks and that of development plans in the currently difficult financing environment. At the same time, just as for previous measures, the subordinated loans are quite concentrated on state-controlled banks, with three of them receiving more 75% of all the funds provided. As a result, we see increasing opportunities for state-run banks to further strengthen their market position on the back of the generally falling lending activity of their peers.

The subordinated loans are expected to be financed from the budget funds and CBR resources, which on the whole may potentially decrease country's FX reserves by 6-7% (US$36bn out of US$550bn reserves).

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Reserve Fund provides a good cushion in case of low oil prices

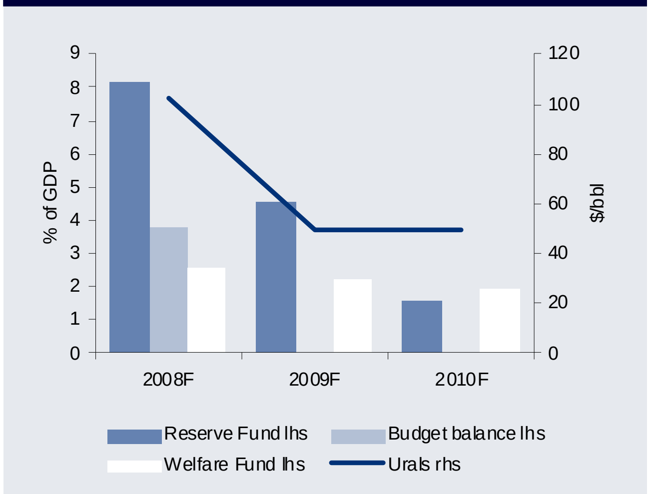
The two sovereign funds stood at about US$190bn in total as of 1 October.

According to the Finance Ministry, the Reserve Fund stood at RUB3.6tr (US$138bn) and the Welfare Fund at RUB1.2tr (US$45.8bn) as of 1 October. To understand how these funds could help the government and the economy to weather the global economic downturn, we have conducted a simple simulation. On the back of yesterday's news on the possible use of the sovereign funds to support the banking sector, we reduced our Welfare Fund estimate for end-2008 by RUB450bn (although at the moment, there is no certainty on this).

In our first scenario, the average Urals oil price is US$50/bbl in 2009 and 2010 (this roughly corresponds to US$54/bbl for Brent). As the Reserve Fund has already reached the amount stipulated in the 2008-2010 Fiscal Programme for this year, we assume that its assets will remain at RUB3.6tr in January 2009. Given the current spending targets, it seems that after a portion is used to cover the budget shortfall, the Reserve Fund would still have RUB2.3tr in its coffers by end-2009, and RUB0.97tr by end-2010. There would be no need to use the Welfare Fund at all.

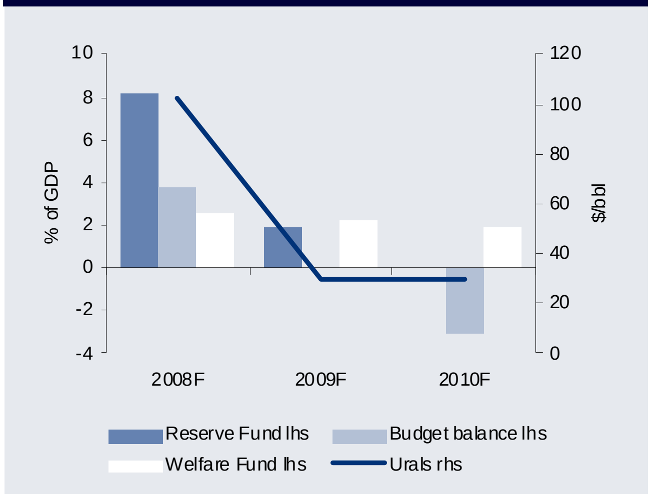
In our second scenario, the average Urals oil price is US$30/bbl (Brent US$32/bbl) in both 2009 and 2010. In this case, the Reserve Fund would be sufficient to completely cover the resulting budget deficit only in 2009. The federal budget would then end 2010 with a not-so-deep deficit of about 3% of GDP. Again, we assumed that the Welfare Fund will remain untouched; in reality, the government will be tempted to dig into it.

Fig 3 Russia: Urals oil price US$50/bbl in 2009-10



Source: ING

Fig 4 Russia: Urals oil price US$30/bbl in 2009-10



Source: ING

We have assumed (quite unrealistically) that there will be no fiscal policy response from the Russian authorities to these two rather extreme oil price scenarios. But even in these circumstances, a significant fiscal tightening would be unlikely given the authorities' determination to preserve growth momentum.

We admit that there is a risk to our analysis from a possible underestimation of the negative impact of sharp drops in oil prices on the real economy. In recent years, we have only seen the positive spillover effect of rising oil prices on the economy. Our previous modelling suggests that growth responds asymmetrically to oil price movements, with an extra US$1 of oil price adding less ppts to the growth rate than a fall by US$1 would subtract from it. Besides, we are concerned about the possible negative impact on the real estate market and its implications for consumer confidence.

Despite the sharp drop in oil prices, the two sovereign funds provide adequate protection for the public finances for a rainy day. Given the previous statements by the rating agencies, we expect a negative impact on the sovereign ratings if the government digs into them to prop up the banking system.

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Government discussing EUR 4bn loan for Iceland

Announcement comes as big surprise at the time when the market crisis intensifies in Russia

Yesterday, the media reported that the government of Iceland had requested a EUR 4bn loan, which the Russian government is currently considering. According to the Central Bank of Iceland, the funds will be provided for three to four years at LIBOR +(0.3-0.5)%.

At first glance, it is quite surprising that the Russian authorities are considering granting a several billion euro loan at a time when the market crisis in Russia has again deepened (just yesterday, the government announced an additional $37bn liquidity injection from the budget). The two countries do not have very strong economic ties and there is no obvious gain for Russia from this arrangement (according to a law which will be considered by the Duma in its second reading today, the government will help Russian external borrowers to refinance their short-term debt at the much higher rate of LIBOR+5%). The loan would not put too much strain on the Russian government's finances: for comparison, the federal budget posted a monthly surplus of EUR 5.9bn in July. The size of the proposed loan to Iceland is probably comparable to the amount that the CBR spent on Monday and Tuesday this week on the FX market supporting the rouble at its current level against the bi-currency basket.

The provision of a EUR 4bn loan to Iceland would have no material effect on the Russian government's fiscal situation. It is probably being aimed at creating a positive impression in the markets at a time when there is an evident lack of confidence.

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Ukraine

Inflation in September declined to 24.6% YoY

Monthly inflation reached 1.1% in September. Hikes in gas tariffs and educational services led the growth last month. We maintain our forecast for 20.5% inflation at the end of 2008.

The State Statistics Committee reported 1.1% MoM CPI growth over September, thus turning again into an inflation phase after two months of deflation. The figure is almost in line with our forecast and consensus of 1.0% MoM. Inflation last month was not as dramatic as it was a year ago because food prices remained almost flat (0.3% MoM) due to further seasonal price declines. Thus annual inflation still continued to slow, to 24.6% YoY in September versus 26.0% in August. The monetary impact on inflation is quite low now as the NBU is still keeping monetary policy tight.

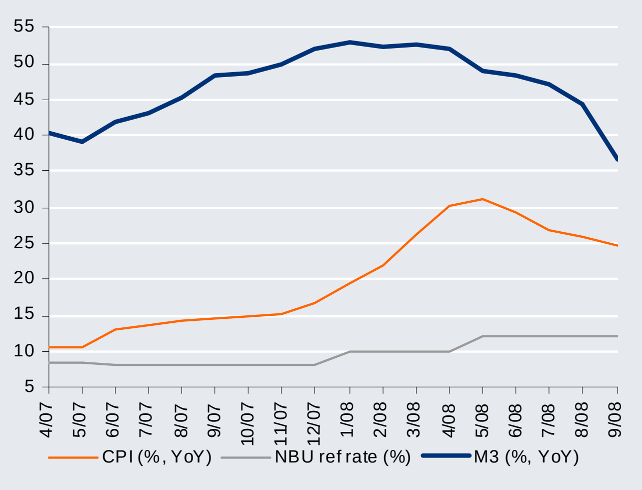
The return of rising CPI in September was not a surprise for the market while the most significant price impact came from the expected hike in gas supply tariffs (14.1% MoM), the seasonal adjustment in tariffs for educational services (21.2% MoM) and the two-fold increase in the excise duty for tobacco products (2.0% MoM). These are one-offs and should not affect CPI levels at least until the year-end. However the most significant danger for inflation comes from prices of other public utilities (house maintenance, water supply, sewage and heating) which are showing constant monthly growth of 1.8% over 2008.

Besides a further seasonal drop in food prices, world commodity prices also affected Ukrainian inflation in September. In particular, the decline in world oil prices pressured prices of fuel products in Ukraine downwards in September (-6.0% MoM).

We believe that a good grains harvest and possible limitations on Ukrainian food exports into Russia will further affect the slowdown in inflation until the end of the year. Another sharp drop in world oil prices would reduce the price of oil products and restrain growth in transport tariffs. A further rise in public utilities tariffs remains the major risk for inflation’s reduction. Thus we expect price growth of 1.4% in October while 20% rise in local calls since 1 October will accelerate the trend. From the other side, a continuation of tight monetary policy and reduction in money aggregate growth will further restrain inflation for the rest of the year. Thus we reiterate our forecast for CPI over 2008 at 20.5%.

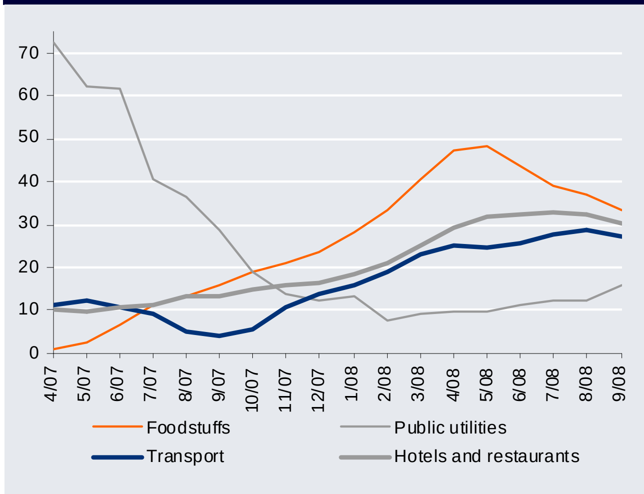
The major risks for higher inflation still come from the possibility of another round of early parliamentary elections and a rise in the price of gas supplied by Russia in 2009. According to Head of Naftogaz Oleg Dubina, the new price will be within US$250-300/bcm, or 43-70% higher than in 2008. We also estimate further planned hikes in public utilities as electricity tariffs have remained flat for several years in a row, while the National Electricity Commission expects gradual increases in residential electricity tariffs starting from 2009.

Fig 5 Gap between CPI and M3 growth is smaller



Source: State Statistics Committee, NBU

Fig 6 Public utilities showed the highest inflation



Source: NBU, ING

As inflation was a biggest risk for the economy over 1H08, its slowdown will have a positive effect on real economic growth. However the risk of early elections, upcoming hikes in prices for Russian gas and further price hikes of public utility tariffs will keep inflation in the double digits next year.

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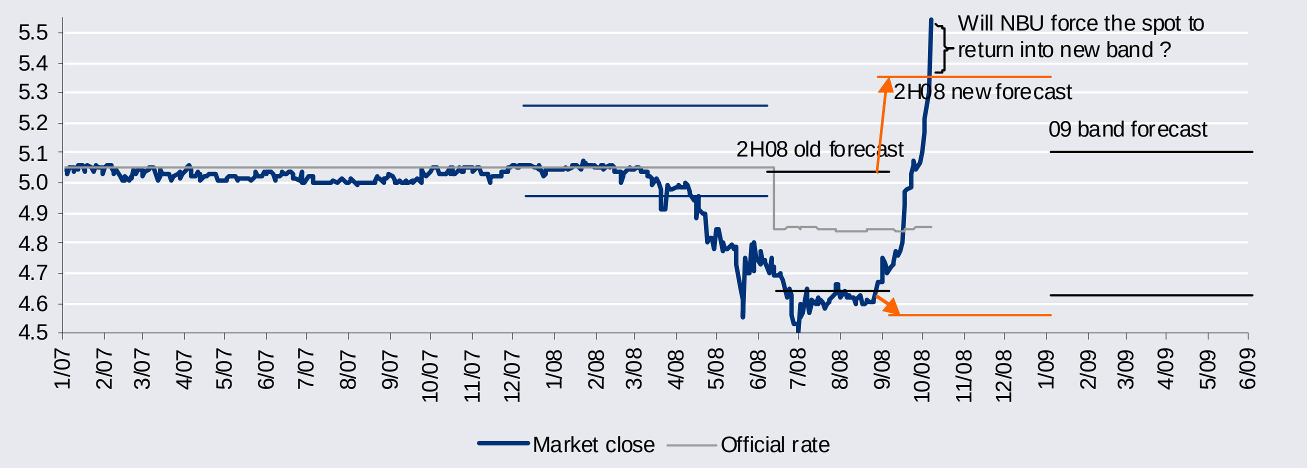
NBU Council widens currency band forecast to 4.55-5.35/USD

This is first official support for hryvnia depreciation. However we doubt that the NBU will keep the exchange rate in the new band.

Sharp hryvnia weakening over recent days and the inability of the National Bank to move the spot rate within the currency band, forced the NBU Council to walk behind the market and widen the currency band ‘forecast’ for end-2008 to 4.95/USD +/-8% instead of the previous guidance of 4.85% +/-4%. This was the first official confirmation of a change in NBU policy towards hryvnia depreciation. This is entirely in line with our expectations that the current situation on the FX market may not be resolved by only interventions because the market lacks foreign currency supply. And the deficit of foreign currency is a consequence of the balance of inflows and outflows on the current account and financial account. We regard the current decision of the NBU Council as an attempt to indicate to the market a new support level for the exchange rate. We believe, however, that it will hardly be effective unless the National Bank constantly supports this level with interventions while not adjusting the official UAH/USD rate closer to the market spot. However recent precedents demonstrate that setting the official exchange rate and deciding on the interventions is rather the power of the NBU Board than the NBU Council. The recent confrontation between these governing bodies in May showed that the Board has more power in setting current exchange rate policy while the Council has rather an advisory or declarative power.

We believe that the National Bank’s exchange rate policy depends more on the decision of the NBU Board, which may not follow the new guidance for the exchange rate band, as in May. If we do not get clear comments from NBU officials on this decision, we believe that the National Bank may not immediately follow this band and will further allow the UAH/USD exchange rate to depend entirely on FX market forces. Note the FX market closed the day yesterday at 5.54/USD which is 3.6% above the upper limit of new band ‘forecast’. The most recent statements of NBU officials about a gradual move to a more flexible exchange rate regime support our view that NBU may not adhere to the new currency band in the nearest future.

Fig 7 Spot rate is still outside the new band forecast



Source: NBU, ING

Raising the upper limit of the currency band towards 5.35/USD means that the NBU has basically agreed to allow depreciation in the near term. However this decision will not stop the rise of the spot rate on the FX market unless the NBU adjusts its official exchange rate upwards and enters the FX market with interventions supporting the new band.

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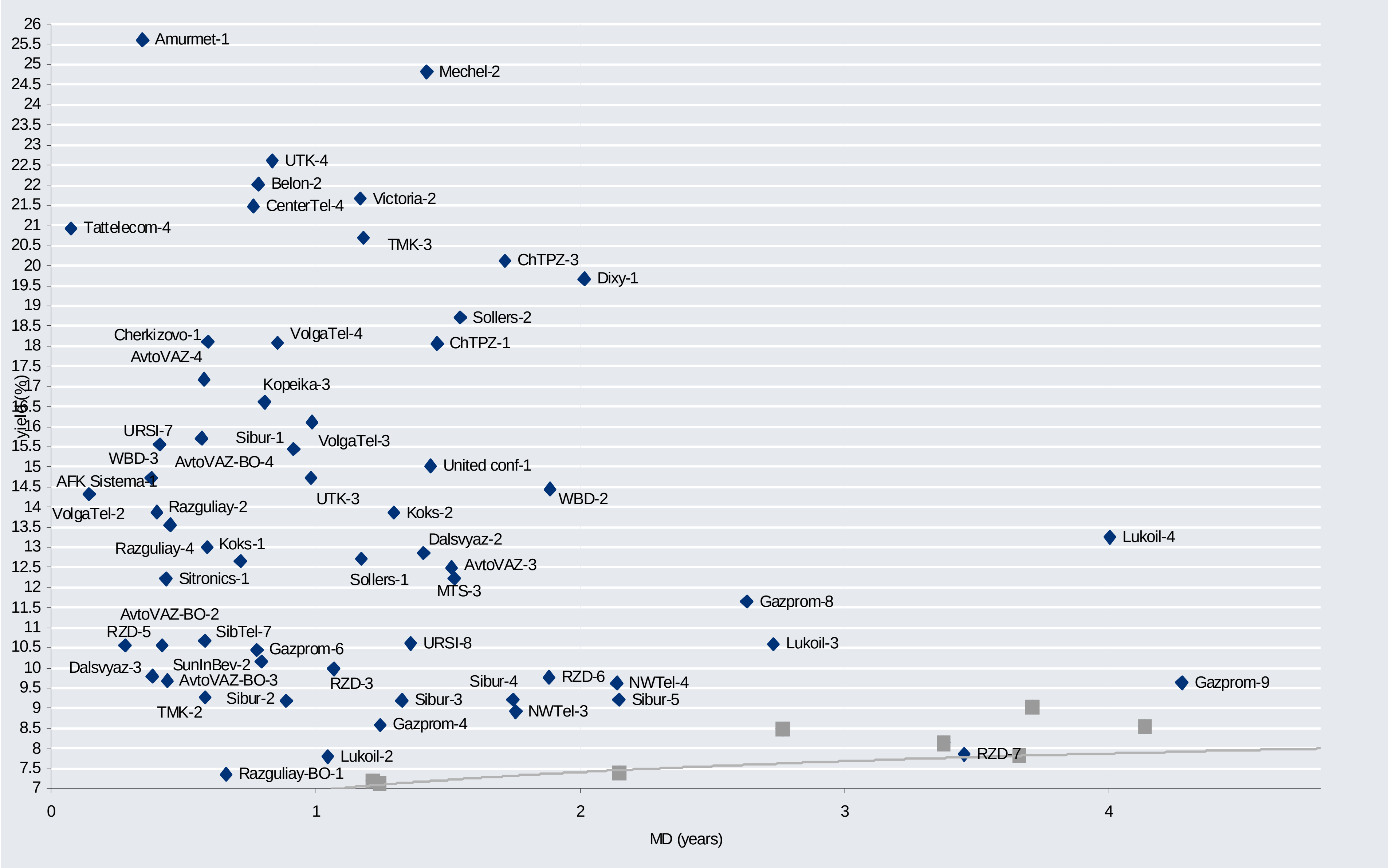
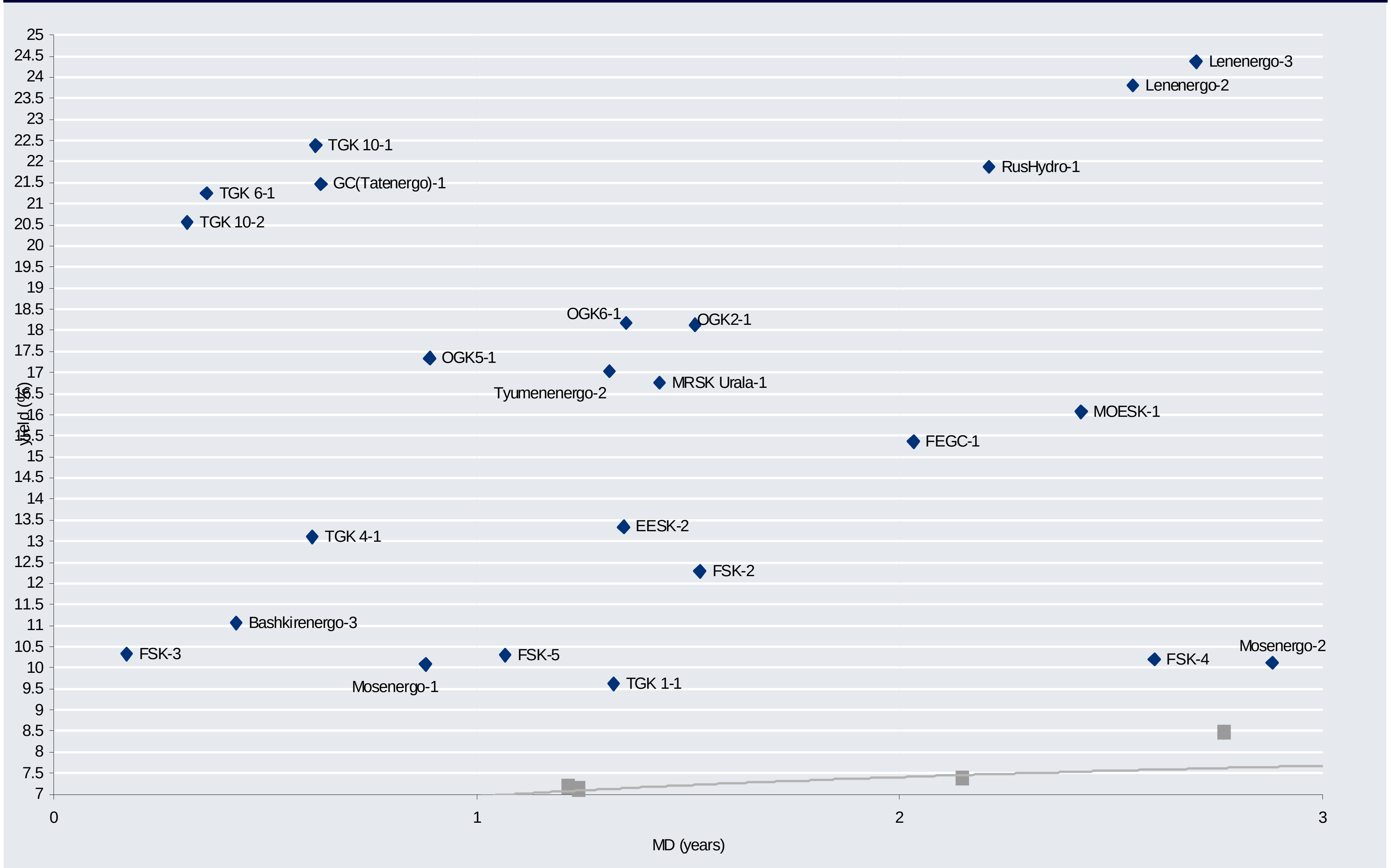
Russia's rouble corporate debt universe



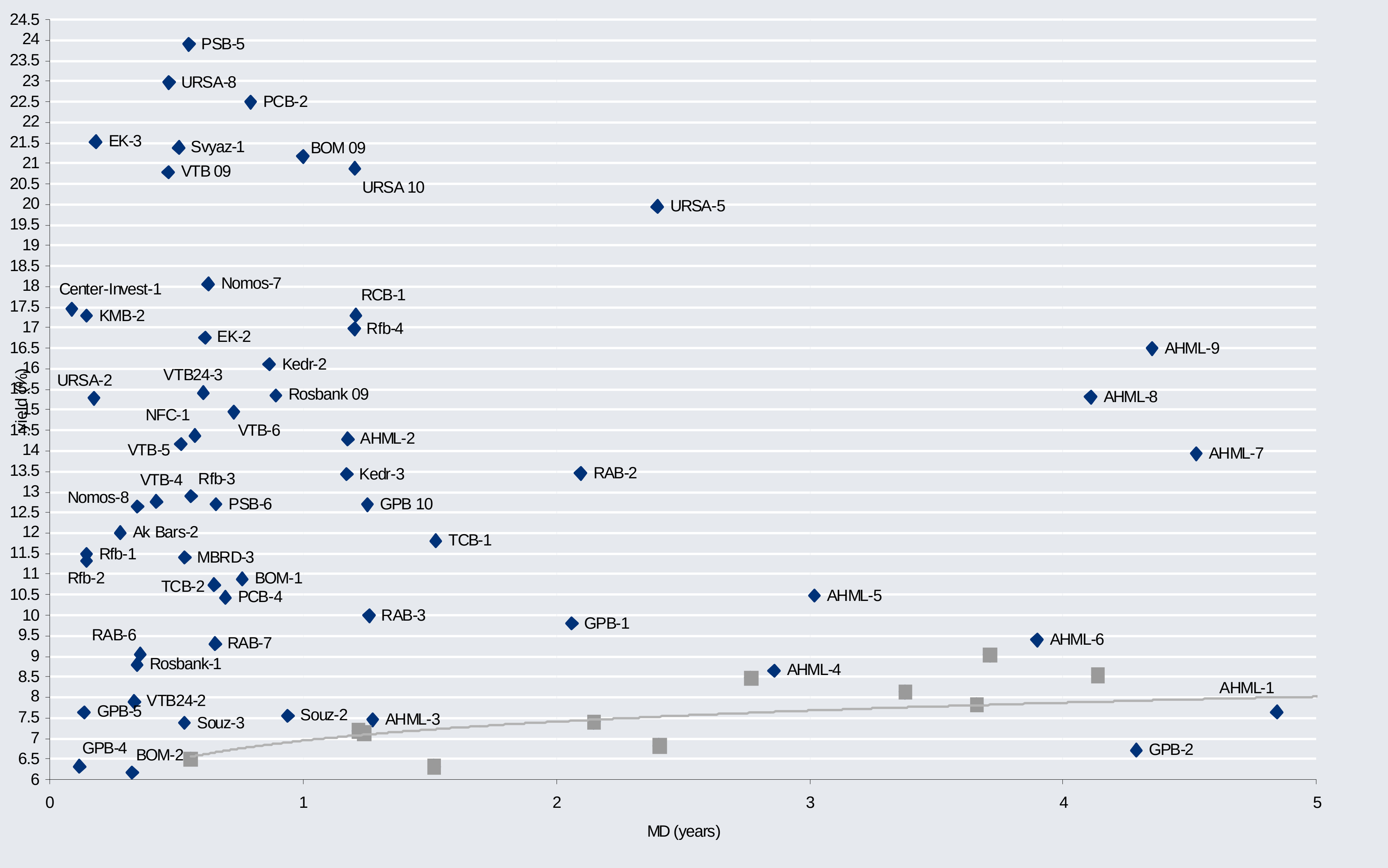
Source: Bloomberg, Micex, ING

Russia's rouble utilities debt universe



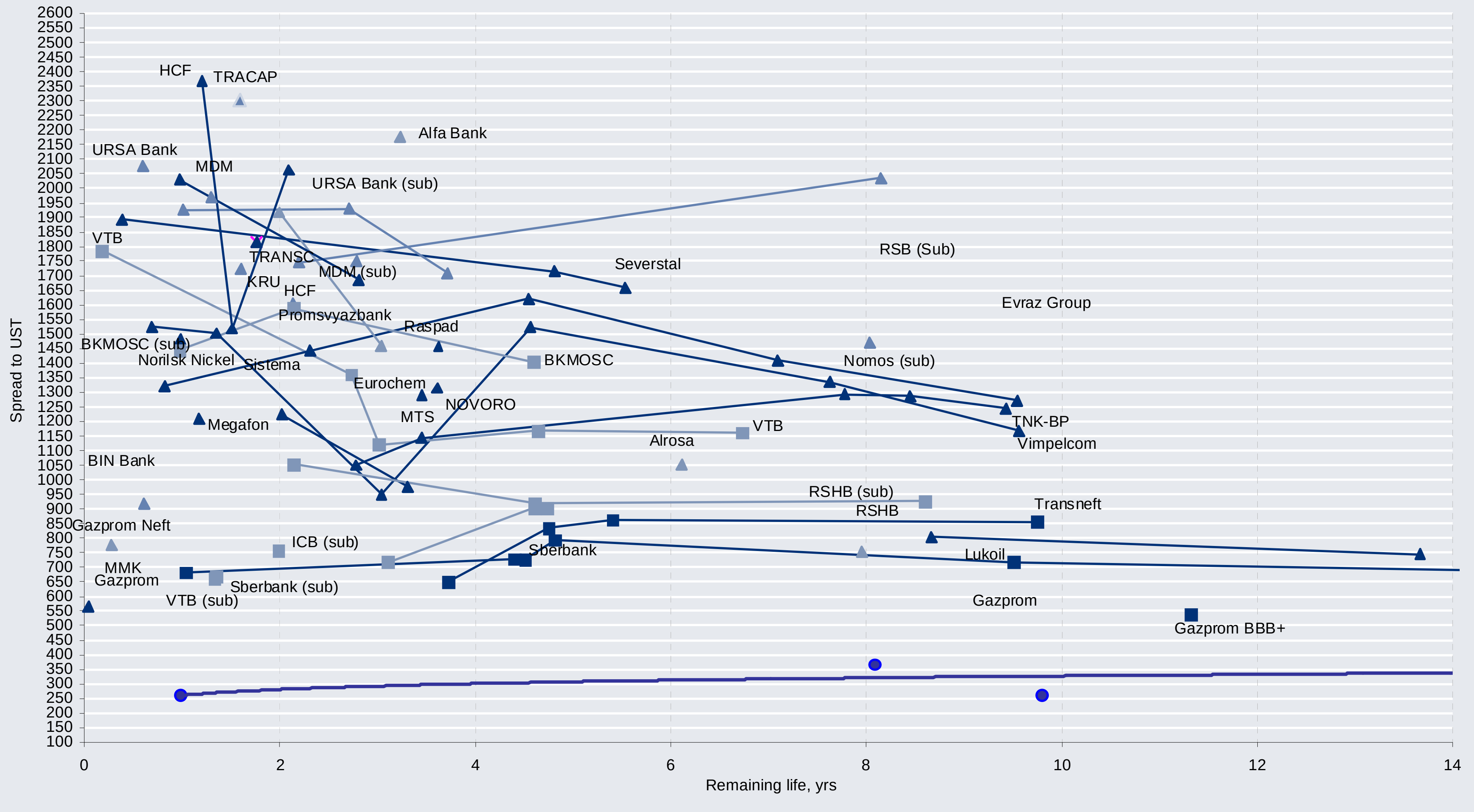
Source: Bloomberg, Micex, ING

Russia's rouble financial debt universe



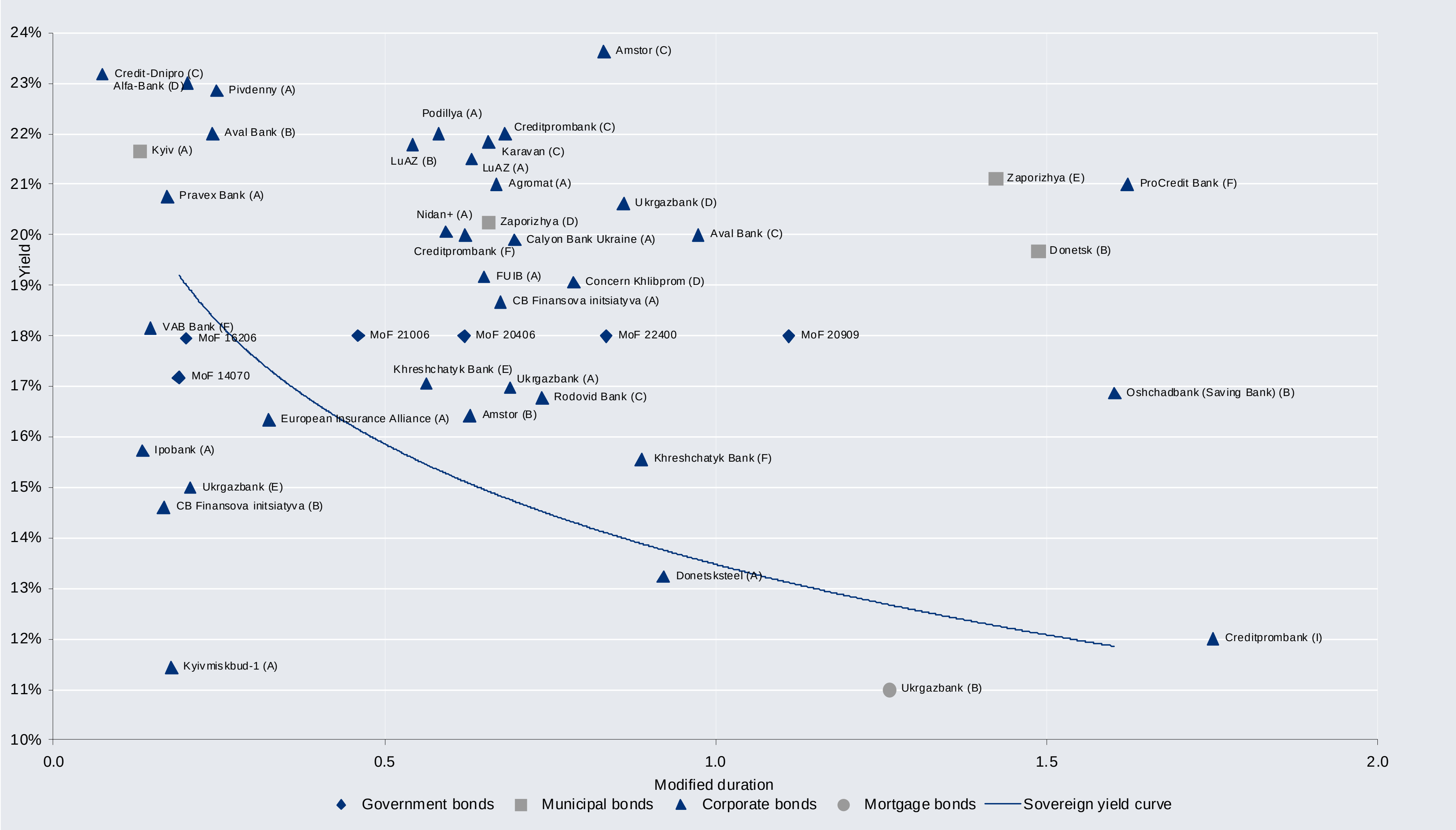
Source: Bloomberg, Micex, ING

Russian corporates - USD Credit Curve



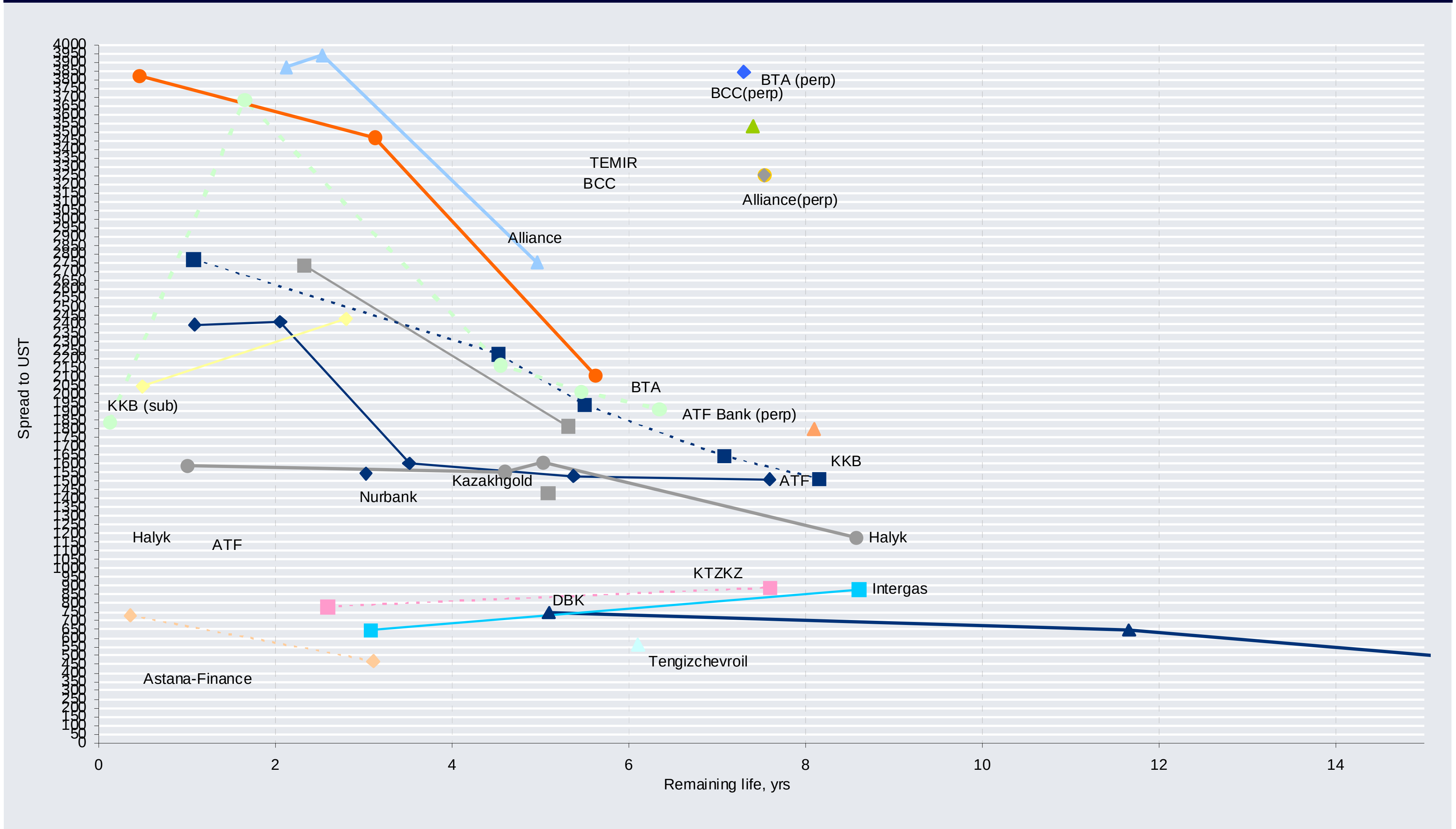
Source: Bloomberg, ING

Ukraine's domestic tradable bond universe



Notes: corporate bond issues are with outstanding UAH50m and more. Source: PFTS, I

Kazakhstani corporates - USD Credit Curve



Source: Bloomberg, ING

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