FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ukraine at 'B'; Outlook Stable

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Fitch Ratings - London - 26 Feb 2021: Fitch Ratings has affirmed Ukraine's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'B' with a Stable Outlook.

KEY RATING DRIVERS

Ukraine's 'B' IDRs reflect its track record of multilateral support and a credible macroeconomic policy framework that has underpinned a relatively high degree of resilience to the coronavirus shock. Ukraine's human development indicators compare favourably with the peer group, it has a net external creditor position of close to 13% of GDP, and general government debt is somewhat lower than the 'B' median. Set against these factors are weak governance indicators, a high degree of legislative and judicial risk to policy implementation, and low external liquidity relative to a large sovereign external debt service requirement.

The Stable Outlook reflects expectations for gradual fiscal consolidation and continuation of macroeconomic policies that helped preserve broad stability in external finances during last year's shock. The ability to issue Eurobonds and available domestic liquidity has provided some limited space to manage a delay over the next six months in completing the first review of the IMF stand-by arrangement (SBA). The coronavirus shock temporarily reversed improvements made in recent years in terms of a declining debt burden and normalisation of growth prospects after the 2014-15 geopolitical and economic crises. At the same time, the political position of the administration has weakened somewhat and recent Constitutional Court policy reversals further underline the risks to SBA compliance, which constrain the rating.

There has been slow progress against the first review of Ukraine's USD5 billion IMF SBA (signed in June alongside a USD2.1 billion disbursement) and Fitch considers there is sizeable risk to its completion. In particular, parliamentary approval for anti-corruption and judicial reform legislation will be challenging. IMF prior actions in these areas were partly a response to Constitution Court rulings in 4Q20 that restricted the powers of the national anti-corruption agency and withdrew criminal liability for false asset declarations. We see somewhat less implementation risk to the other significant new SBA requirement to reverse December's imposition of a temporary cap on gas prices. The review had already been delayed by IMF concerns around the replacement of the governor of the National Bank of Ukraine (NBU) in July.

There would be greater political impetus to legislate remaining prior actions in 2H21 as the need for at least staff-level SBA approval to unlock other official and external financing would become more acute (with USD2.2 billion external amortisation in September and a spike in budget funding need towards year-end). Government cash holdings of USD3 billion (USD1.8 billion in foreign-currency), a lighter repayment schedule over the next six months, and available domestic liquidity provide some financing space. The government plans to front-end issuance in 2021 with a greater focus on domestic financing. Fitch also assumes for 2021 one IMF disbursement of USD0.7 billion, USD1.5 billion of other official financing, higher Eurobond issuance than the planned USD1.4 billion, and a 0.2% of GDP drawdown on fiscal reserves.

Although the government received a USD0.6 billion EU Macro-Financial Assistance disbursement and issued a USD0.6 billion Eurobond in December, continued engagement with the IMF is key to maintaining access to external financing over a longer period. Domestic banks increased holdings of domestic government debt by USD7.2 billion since February 2020 to 51% of the total as the non-resident share fell 7pp, and there is some uncertainty around their capacity to sustain such increases over time, despite current ample liquidity and strong deposit growth.

The balance of payments has been resilient to the coronavirus shock, and foreign exchange reserves increased to USD28.8 billion in January 2021 from USD27.0 billion in February 2020. A very large improvement in the terms of trade, sharp import contraction, and a statistical change in the treatment of foreign investor losses drove a 7pp improvement in the current account balance in 2020 to a surplus of 4.4% of GDP, offsetting private sector capital outflows.

Fitch forecasts the current account returns to deficits of 0.3% of GDP in 2021 and 1.2% in 2022 due to recovering domestic demand and less favourable terms of trade, but this will be more than compensated by higher net FDI, portfolio and foreign-currency deposit inflows. We project foreign exchange reserves at 4.5 months of current external payments at end-2022, compared with 3.4 months at end-2019, and the projected 'B' median of 4.3 months. Ukraine's external liquidity ratio improved by around 12pp in 2018-2020 to 91% but is still below the peer group median of 116%. Sovereign amortisations remain relatively high, averaging USD4.8 billion in 2021-2022, albeit down from USD7.0 billion in 2020.

GDP growth is estimated to have contracted by 4.2% in 2020, compared with the 'B' median contraction of 4.5% and our expectation at the previous review of 6.5%. The impact of the Covid-19 shock and poor grain harvest (which subtracted 1pp from GDP) was cushioned by firm wage growth, employment support measures, robust remittances, a positive net trade contribution and moderate monetary and fiscal stimulus. We forecast GDP growth of 4.1% in 2021 driven by private consumption, higher agricultural output and a partial recovery in investment. The second wave of Covid-19 has been much more severe than the first but the mortality rate is declining and we assume economic restrictions remain limited. Fitch forecasts GDP growth edges down to 3.8% in 2022, in line with declining economic slack and withdrawal of policy stimulus.

Inflation rose to 6.1% in January, marginally above target, from an average 2.4% in 10M20, driven by higher commodity and energy prices, a weaker currency, and a 20% increase in the minimum wage in January, with core inflation at 5.0%. Fitch anticipates a further rise in inflation to 6.9% at end-2021 (with a 100bp policy interest rate increase to 7% in line with NBU forward guidance) falling back to within target at 5.3% at end-2022 but still above the projected 'B' median of 4.0%. In our view, the replacement last year of the NBU governor and a number of deputy governors has increased the downside risk of looser monetary policy than assumed in our forecast.

Fitch anticipates gradual fiscal consolidation in 2021-2022. The general government deficit widened 3.5pp in 2020 to an estimated 5.5% of GDP, below the target of 7.5% and the 'B' median of 7.7%. Revenues were supported by a shallower-than-expected recession, tax efficiency gains, and some underspending on the support package. We forecast the deficit narrows to 5.1% of GDP in 2021 as further recovery in tax revenues more than offsets higher social spending and lower dividend payments from state-owned companies (which totalled 2.1% of GDP in 2020). Our 2022 deficit forecast of 3.7% of GDP assumes some moderate new tightening measures, and will also be dependent on the availability of financing and extent of IMF engagement.

General government debt rose 11.2pp in 2020 to 55.6% of GDP (62.8% with guarantees), below the 'B' median of 63.8%. The 17% depreciation of the hryvnia against the US dollar last year was a contributory factor, with 62% of total debt foreign-currency denominated, broadly in line with the peer group median of 61%. Fitch projects general government debt stabilises at 54% of GDP in 2021-2022 and under our medium-term debt projections (which assume average GDP growth of 3.4% and primary surplus of 0.3% of GDP in 2023-2024) declines slightly to 53% at end-2024.

The political position of the administration has weakened somewhat, as resistance to reform from vested interests and oligarchs has held back reform legislation, and President Zelensky's polling ratings have fallen to 23% from 29% in September last year. Alongside the risk of further Constitutional Court policy reversals, this also threatens to undermine approved reforms such as the bank resolution framework and other aspects of the anti-corruption agenda. In terms of the Russian-Ukrainian conflict, substantial near-term progress towards a resolution is unlikely, in our view.

Banking sector risks have steadily reduced in recent years but the sector remains burdened by state-bank legacy problem loans. The non-performing loan (NPL) ratio fell to 41.0% at end-2020 from 48.4% at end-2019, but we expect a moderate worsening in asset quality as regulatory forbearance expires this year. However, the sector's very high NPL provisions ratio (98%), adequate core capital ratio (15.7%), robust profitability (return on equity 20%), and a more supportive legislative framework are expected to then drive good progress towards targets to lower the NPL ratio by around 20pp over the next three years. The deposit dollarisation ratio fell 2pp in 2020 to 38% driven by strong local currency deposit growth, but still compares unfavourably with the 'B' median of 30%. The large share of state banks in the sector (53% of assets) gives rise to contingent liability risk for the sovereign.

ESG - Governance: Ukraine has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. These scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Ukraine has a low WBGI ranking at the 32nd percentile, reflecting the Russian-Ukrainian conflict, weak institutional capacity, uneven application of the rule of law and a high level of corruption.

RATING SENSITIVITIES

The main factors that could, individually or collectively, lead to positive rating action/upgrade are:

- External Finances: Further reduction in external financial vulnerabilities, for example due to a sustained increase in international reserves, strengthened external balance sheet and greater financing flexibility.

- Public Finances: General government debt/GDP returning to a firm downward path over the medium term, for example due to post-coronavirus fiscal consolidation.

- Macro and Structural: Increased confidence that progress in reforms will lead to improvement in governance standards and higher growth prospects while preserving improvements in macroeconomic stability.

The main factors that could, individually or collectively, lead to negative rating action/downgrade:

- Macro and External Finances: Increased external financing pressures, sharp decline in international reserves or increased macroeconomic instability, for example stemming from extended delays in the disbursements from the IMF programme due to deterioration in the consistency of the policy mix and/or reform reversals.

- Public Finances: Persistent increase in general government debt, for example due to a more pronounced and longer period of fiscal loosening, economic contraction or currency depreciation.

- Structural: Political/geopolitical shocks that weaken macroeconomic stability, growth prospects and Ukraine's fiscal and external position.

SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Ukraine a score equivalent to a rating of 'B' on the LTFC IDR scale.

Fitch's sovereign rating committee did not adjust the output from the SRM to arrive at the final LTFC IDR.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LTFC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

KEY ASSUMPTIONS

Fitch does not expect resolution of the Russian-Ukrainian conflict or escalation of the conflict to the point of compromising overall macroeconomic performance.

Fitch assumes that the debt dispute with Russia will not impair Ukraine's ability to access external financing and to meet external debt service commitments.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Ukraine has an ESG Relevance Score of 5 for Political Stability and Rights as WBGI have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight. A major escalation of the conflict in the east of Ukraine represents a risk.

Ukraine has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI have the highest weight in Fitch's SRM and in the case of Ukraine weaken the business environment, investment and reform prospects; this is highly relevant to the rating and a key rating driver with high weight.

Ukraine has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver.

Ukraine has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Ukraine, as for all sovereigns.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Ukraine	LT IDR	B Rating Outlook Stable	Affirmed	B Rating Outlook Stable
•	ST IDR	B	Affirmed	B
•	LC LT IDR	B Rating Outlook Stable	Affirmed	B Rating Outlook Stable
•	LC ST IDR	B	Affirmed	B
•	Country Ceiling	B	Affirmed	B
• senior	LT	B	Affirmed	B

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 26 Oct 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.12.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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Sovereigns Europe Ukraine