Moody's downgrades Ukraine's ratings to Ca with a stable outlook

Rating Action | *10 min read*

10 Feb 2023 Moody's Investors Service

London, February 10, 2023 -- Moody's Investors Service ("Moody's") has today downgraded the Government of Ukraine's foreign- and domestic-currency long-term issuer ratings and foreign-currency senior unsecured debt ratings to Ca from Caa3 and changed the outlook to stable from negative.

The downgrade of the ratings to Ca is driven by the effects of the war with Russia that are likely to pose long-lasting challenges to Ukraine's economy and public finances. These challenges increase risks to government debt sustainability, making a debt restructuring with significant losses for private-sector creditors very likely.

The stable outlook reflects balanced risks at the Ca rating level, which is consistent with a recovery in the event of default typically in the order of 35 to 65%. A cessation of the military conflict leading to a significant resumption of economic activity over the near term might result in lower losses in case of a restructuring, while in case of a further escalation of the military conflict, the losses for private sector investors could be larger than implied by a Ca rating.

Ukraine's local- and foreign-currency ceilings have been lowered to Caa3 from Caa2. The one-notch gap between the local-currency ceiling and the sovereign rating reflects considerable policy uncertainty and unpredictability amid very high geopolitical risks, and the presence of large pressures on the external position. The foreign-currency ceiling is aligned to the local-currency reflecting weak policy effectiveness and elevated indebtedness but also the easing of some restrictions on foreign exchange transactions after the moratorium introduced on most cross-border payments at the start of the invasion.

RATINGS RATIONALE

RATIONALE FOR DOWNGRADING UKRAINE'S RATINGS TO Ca

The key driver of the downgrade of Ukraine's ratings to Ca is the increase in risks to government debt sustainability against the backdrop of the protracted war with Russia and its implications for the economy and public finances.

Moody's estimates that real GDP contracted by around 30% in 2022 given the very large costs in terms of human losses and population displacement as well as the

military attacks targeting critical infrastructure. According to the Kyiv School of Economics, the estimated damage to infrastructure stood at $138 billion as of December 2022, equivalent to 70% of 2021 GDP.

Moody's expects in its baseline scenario that the war will be protracted, and the economy to register a small contraction of real GDP by 2% in 2023, followed by a mild recovery in 2024. Moody's growth projections assume that continuing military attacks will prevent a significant rebound in economic activity which would be driven by large scale reconstruction. Despite the high degree of uncertainty surrounding the evolution of the military conflict, in its baseline scenario, Moody's expects that macroeconomic and financial stability will be maintained.

FEEDBACK

Ukraine's economy is supported by the four-month IMF Program Monitoring with Board Involvement that will test the authorities' policy implementation capacity amid exceptionally difficult conditions as well as catalyze donor support. The program aims at improving revenue collection, stimulating the domestic debt market, preserving financial sector stability, and improving transparency. Its successful implementation can pave the way for a funded program already this year that can further anchor policymaking and improve governance. The latter will be key to finance post-conflict reconstruction. In Moody's view, while prospects of EU accession remain very distant, the accession process will drive institutional reforms and anticorruption efforts.

Nevertheless, despite large financial support from international partners, Moody's expects that the war will continue to keep Ukraine's public finances and external position under severe pressure. The government deficit excluding grants is estimated to have reached almost 30% of GDP in 2022 but the provision of significant external support led to an estimated smaller figure of 17% of GDP. The budget will remain under significant pressure in 2023 due to large defense and social spending, although Moody's expects the deficit to decline to around 8% of GDP (including grants), mainly reflecting expenditure cuts amid constrained funding availability.

The current account posted a surplus of 5.7% of GDP in 2022 as the surplus in the income balances due to external grants more than offset the large trade deficit. Foreign-currency reserves were in part rebuilt after the pressure experienced in the first part of the year and stood at $27 billion in January 2023 from $29 billion in December 2021. The external position is better than Moody's originally anticipated but this reflects large external support and capital controls, including a ban on most cross-border payments, that helped to reduce pressure on the balance of payments. That said, Moody's expects the current account balance to move into a small deficit in 2023, mainly driven by a widening trade deficit reflecting reduced export capacity and sustained imports, in particular of food, fuel, and materials for repairs.

Liquidity pressures will remain significant despite the recent agreement to defer bond payments that offers temporary relief. Moody's projects very large financing needs of around 20% of GDP in 2023, which are expected to be mainly covered through external donor support and the remaining by issuances on the domestic market. According to

The authorities are introducing measures to increase financial institutions' participation in the domestic bond market, including through the increase of banks' reserve requirements to be met in part with government bonds. Potential banking system's challenges in absorbing new government securities issuances or delays to official disbursements could force the authorities to rely on monetary financing also in 2023.

Ukraine's government debt burden is rapidly rising with risks to the debt trajectory tilted to the upside. Moody's estimates that debt-to-GDP increased by almost 35 percentage points to 82% of GDP at end-2022 and projects it will exceed 90% of GDP at the end of 2023. While the debt trajectory is subject to a significant degree of uncertainty depending on the evolution of the military conflict, it also faces risks from further exchange rate depreciation given the large share of foreign currency-denominated debt (estimated at close to 70% at end-2022). The materialization of contingent liabilities from SOEs, particularly from the energy and financial sectors, although difficult to quantify, poses an additional fiscal risk.

As a result, Moody's expects that the public debt dynamics will prove unsustainable, increasing the likelihood of a broader debt restructuring resulting in significant losses being imposed on commercial creditors as official creditors demand private sector participation.

The structure of the GDP-linked warrants issued as part of the 2015 debt restructuring also poses a fiscal risk over the medium term. In particular, under a scenario of strong reconstruction-led growth this could trigger large payouts on the instruments.

RATIONALE FOR THE STABLE OUTLOOK

While there is significant uncertainty around its timing and form, a debt restructuring has become highly likely in light of the sustained economic disruption and the large fiscal costs of the war. The stable outlook reflects balanced risks at the Ca rating level in terms of losses to private creditors. A cessation of the military hostilities leading to a significant resumption of economic activity over the near term might result in lower losses in case of a default, while in case of a further escalation of the military attacks, the losses for private sector investors could be larger than implied by a Ca rating.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Ukraine's ESG Credit Impact Score is very highly negative (CIS-5), reflecting moderately negative exposure to environmental risk, very high exposure to social risks, and a very weak governance profile. The latter, together with moderate wealth levels, helps to explain Ukraine's relatively low resilience to E and S risks.

Ukraine is moderately exposed to environmental risks. These include physical climate risks, waste and pollution, and natural capital which explains its E-3 issuer profile score. Its exposure to physical climate risk and natural capital risk is exacerbated by the importance of the agricultural sector (both in terms of economic contribution and employment).

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on Ukraine's credit profile for many years to come given the large fiscal needs the reconstruction of critical infrastructure will generate. Furthermore, large emigration will exacerbate already challenging demographic trends and weigh on longer-term growth potential. According to the UN estimates, the working-age population will shrink twice faster than before the invasion by 2030.

Ukraine has a very highly negative governance profile score (G-5 issuer profile), reflecting weaknesses in the rule of law and corruption, which hinders the business environment, as well as a track record of sovereign defaults.

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GDP per capita (PPP basis, US$): 14,326 (2021) (also known as Per Capita Income)

Real GDP growth (% change): 3.4% (2021) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 10% (2021)

Gen. Gov. Financial Balance/GDP: -3.3% (2021) (also known as Fiscal Balance)

Current Account Balance/GDP: -1.9% (2021) (also known as External Balance)

External debt/GDP: 64.8% (2021)

Economic resiliency: caa1

Default history: At least one default event (on bonds and/or loans) has been recorded since 1983.

On 07 February 2023, a rating committee was called to discuss the rating of the Ukraine, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have materially decreased. The issuer's institutions and governance strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The systemic risk in which the issuer operates has not materially changed.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

Indications that the recovery for bondholders in the event of default is expected to be higher than what implied by a Ca rating could lead to upward pressure on the rating. This could be in the context of a shorter military conflict leading to an earlier normalization of economic conditions, helping to contain Ukraine's financing needs and reducing risks to the sustainability of Ukraine's government debt.

Ukraine's ratings could be downgraded if a more severe military conflict were to give rise to a further increase in debt sustainability risks, liquidity and external pressures, increasing the likelihood of a debt restructuring that would result in losses in excess of 65%.

PRINCIPAL METHODOLOGY

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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