Moody's
INVESTORS SERVICE

Rating Action: Moody's downgrades Ukraine's ratings to Caa2 from B3, ratings remain on review for downgrade

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London, 04 March 2022 -- 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 Caa2 from B3. The ratings remain on review for further downgrade.

The two-notch downgrade of Ukraine's ratings and the decision to maintain the ratings on review for further downgrade were triggered by the intensification of Russia's (B3 review for downgrade) military invasion of Ukraine. The ongoing review was initially triggered on 25 February by the start of Russia's military invasion of Ukraine.

The key drivers behind the decision to downgrade Ukraine's ratings are:

1. The Russian invasion of Ukraine, which will impair Ukraine's ability and possibly willingness to service its debt;

2. The severe impact that Russia's invasion will have on Ukraine´s economic and fiscal strength due to extensive damage to its productive capacity.

The intensification of the military invasion of Ukraine could have implications for sovereign debt repayments. Moody's believes Ukraine's buffers and forthcoming substantial international financial support will not be sufficient to fully offset liquidity risks stemming from Ukraine's debt repayment needs, given the large economic and fiscal costs the invasion will inflict on the country.

Moreover, the heavy human toll and the damage to Ukraine's productive capacity that the military invasion will inflict will have a severe impact on Ukraine's economic and fiscal strength, and the military conflict could also disrupt Ukraine´s existing institutions and governance set up.

The review period will allow Moody's to better assess the extent to which the invasion leads to long-lasting economic damage. It will also allow Moody's to better assess the extent to which the invasion could disrupt Ukraine's existing institutions and governance setup. Furthermore, the review period will allow Moody's to assess the extent of the financial support that Ukraine will receive from the international community and the country´s ability to continue meeting its debt obligations under a period of military conflict.

Concurrently, Ukraine's local and foreign currency ceilings have been lowered to Caa1 from B2. The one-notch gap between the local currency ceiling and the sovereign rating reflects the low predictability of government and institutions and elevated domestic political and geopolitical risks which create considerable policy uncertainty, while external vulnerabilities remain elevated. The foreign currency ceiling is aligned to the local currency ceiling, reflecting weak policy effectiveness, already limited capital account openness and elevated external indebtedness with limited foreign exchange reserves.

RATINGS RATIONALE

RATIONALE FOR THE DOWNGRADE TO Caa2 FROM B3

FIRST DRIVER: THE RUSSIAN INVASION OF UKRAINE WHICH WILL IMPAIR UKRAINE'S ABILITY AND POSSIBLY WILLINGNESS TO SERVICE DEBT

The intensification of Russia's military invasion of Ukraine that started on 24 February 2022 could have implications for sovereign debt repayments. The scale and scope of the military conflict goes beyond Moody's initial expectations and will inflict large economic and fiscal costs on Ukraine. While Ukraine benefits from improved fiscal and external buffers relative to the 2014-15 military conflict, in Moody's view, these will not be sufficient to fully offset liquidity risks given reduced funding options, foreign investor outflows and mounting pressure on the external position.

The government faces external repayments of around $6 billion in 2022 and between $2-6 billion (1-4% of GDP) each year over the next decade. Although foreign currency reserves of $27.5 billion available at the end of January 2022 covered those needs, they will come under increasing pressure at a time of reduced foreign currency inflows, particularly as the country's financing options are reduced amid heightened borrowing costs and a sustained depreciation of the hryvnia.

Ukraine is benefiting from substantial international financial support, which will help to shore up liquidity but is unlikely to be sufficient to cushion the full impact of the Russian invasion on Ukraine's credit profile. Moody's estimates that international institutions and governments have so far committed around $15 billion, including loans from the International Monetary Fund, the World Bank, the European Investment Bank (EIB, Aaa stable) and the European Union (EU, Aaa stable).

While domestic banks have been the main source of refinancing in recent years, they are unlikely to have the capacity to significantly further absorb government debt amid financial sector disruption from the invasion and the risk of significant deposit withdrawals. Moreover, the introduction of capital controls has complicated the participation of foreign investors although the government is seeking to raise further funding through its war bond initiative after issuing a one-year war bond equivalent to $270 million on 1 March, and has since eased capital control restrictions.

While the current government has continued to honour its financial obligations since the start of the military invasion, including the payment of coupons of around $300 million on eurobonds on 1 March, a prolonged military conflict would add to Ukraine's financing needs in the form of higher military spending, weighing on the government's finances and its ability to continue to repay its debt.

Moreover, the Russian invasion poses risks to Ukraine's current institutions and governance setup, with potential negative implications for the willingness to honour existing debt obligations.

SECOND DRIVER: THE SEVERE IMPACT OF RUSSIA'S BROADENED INVASION ON UKRAINE'S ECONOMIC AND FISCAL STRENGTH DUE TO EXTENSIVE DAMAGE TO ITS PRODUCTIVE CAPACITY

Moody's expects that the broadened invasion of Ukraine by Russia will cause material and lasting damage to Ukraine's economic and fiscal strength. The intensification of the military conflict and the targeting of large cities has already and will likely continue to cause significant damage to Ukraine's infrastructure, although it is not currently possible to assess the exact magnitude of that damage. Even if the military conflict is brought to an end relatively soon and significant external support is provided to help reconstruction, it will likely take a significant amount of time to repair the extensive damage to the country's productive capacity caused by the military conflict. Moreover, the heavy human toll that the military conflict will inflict, together with a significant displacement of the population, will exacerbate already challenging demographic trends and durably constrain Ukraine's economic potential.

The magnitude and scope of the damage on the economy caused by the invasion will also weaken Ukraine's fiscal strength and its ability to service its debt. While it is not possible to estimate the exact magnitude of the fiscal impact of the military conflict at this stage, Moody's expects it will result in a significant increase in Ukraine's general government debt burden from an estimated 54% of GDP at the end of 2021 given higher fiscal deficits and as the large share of foreign currency debt exposes government finances to currency depreciation.

At the same time, the invasion and its aftermath will act as a drag on the government's financial resources. Repairs to key public infrastructure will materially weigh on government spending. Moreover, the severity of the economic damage from the military conflict will have long-lasting negative implications for the government's revenue generation capacity.

RATIONALE FOR MAINTAINING THE REVIEW FOR FURTHER DOWNGRADE

The review period will allow Moody's to better assess the extent to which the invasion leads to long-lasting economic damage. It will also allow Moody's to better assess the extent to which the invasion could disrupt Ukraine's existing institutions and governance setup. Furthermore, the review period will also allow Moody´s to better understand the extent to which international financial support allows Ukraine to cover its debt obligations and any liquidity pressures stemming from the government's external refinancing needs.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Ukraine's ESG Credit Impact Score is highly negative (CIS-4), reflecting moderately negative exposures to environmental and 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, carbon transition and the weak preservation of natural capital, reflected in its low agriculture yields despite its abundance of very fertile black soil, which explains its E-3 issuer profile score. Its exposure to physical climate risk is exacerbated by the importance of the agricultural sector (both in terms of economic contribution and employment), which makes the country's exports vulnerable to climate change and adverse weather events. Ukraine's exposure to carbon transition comes from the fact that transit of gas from Russia to Europe via Ukraine provides a valuable source of foreign-exchange revenue.

Exposure to social risks is highly negative (S-4 issuer profile score) and reflects unfavourable demographics and risks related to labour and income, with relatively high youth unemployment, as well as weak health outcomes, and this is despite favourable educational attainment. A persistent demographic drag will likely constrain Ukraine's scope for strengthening its economic competitiveness. In addition, the on-going military conflict and the dislocation of large parts of the population this entails increases risks around the health and safety and access to basic services of the population as well as the access to housing.

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

GDP per capita (PPP basis, US$): 13,129 (2020 Actual) (also known as Per Capita Income)

Real GDP growth (% change): -3.8% (2020 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 5% (2020 Actual)

Gen. Gov. Financial Balance/GDP: -5.7% (2020 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 3.4% (2020 Actual) (also known as External Balance)

External debt/GDP: 80.8% (2020 Actual)

Economic resiliency: b3

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

On 3 March 2022, a rating committee was called to discuss the rating of 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 materially decreased. The issuer's susceptibility to event risks has very materially increased.

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

FACTORS THAT COULD LEAD TO AN UPGRADE OF UKRAINE'S RATINGS

Given the review for downgrade, an upgrade of Ukraine's ratings is remote.

Ukraine's Caa2 ratings would likely be confirmed at their current level if the armed invasion is brought to an end relatively swiftly, containing the overall damage from the military conflict on Ukraine's economic and fiscal strength and leaving Moody's confident that the government will remain able and willing to continue to honour its debt repayment obligations. The provision and disbursement of additional international financial support which helps to shore up the country's financing position and limit acute government liquidity and external risks would be a key factor supporting the confirmation of the ratings at the Caa2 level.

FACTORS THAT COULD LEAD TO A DOWNGRADE OF UKRAINE'S RATINGS

A prolongation, further intensification and further geographic expansion of the military invasion, resulting in very significant additional damage to Ukraine's economic strength beyond Moody's current expectations, would put downward pressure on the ratings. A disruption of Ukraine´s existing institutions and governance setup would also exert negative credit pressure. Ukraine's ratings could also be downgraded if international financial support proved insufficient to effectively mitigate mounting liquidity risks.

The publication of this rating action deviates from the previously scheduled release dates in the UK sovereign calendar published on www.moodys.com. This action was prompted by the intensification of Russia's military assault in Ukraine.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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

REGULATORY DISCLOSURES

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 at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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The person who approved these credit ratings is Alejandro Olivo.

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