Research Update:

Ukraine Ratings Affirmed At 'B/B'; Outlook Stable

March 13, 2020

PRIMARY CREDIT ANALYST

Aarti Sakhuja
London
(44) 20-7176-3715
aarti.sakhuja
@spglobal.com

SECONDARY CONTACT

Karen Vartapetov, PhD
Frankfurt
(49) 69-33-999-225
karen.vartapetov
@spglobal.com

RESEARCH CONTRIBUTOR

Ashay Gokhale
Mumbai
+ (91)2240405817
ashay.gokhale
@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF
SovereignIPF
@spglobal.com

Overview

- Despite solidifying fundamentals, including higher foreign exchange (FX) reserves, modest budget deficits, and declining government debt to GDP, Ukraine faces risks arising from the deteriorating external growth and financing environment.
- Moreover, the implications of a recent government reshuffle for Ukraine's reform momentum and relationships with key creditors is uncertain.
- We are therefore affirming our 'B/B' sovereign credit ratings on Ukraine.
- The outlook is stable.

Rating Action

On March 13, 2020, S&P Global Ratings affirmed its global scale long-term foreign and local currency sovereign ratings on Ukraine at 'B' and its Ukraine national scale ratings at 'uaA'. We also affirmed the short-term ratings at 'B'. The outlook is stable.

Outlook

The stable outlook balances the risks to Ukraine's commodity-driven economy from the deteriorating external environment and uncertainties around potential policy shifts following the appointment of a new cabinet, against the country's stronger external buffers and improving government debt dynamics.

We could consider a positive rating action over the next year if the government makes progress on its reform agenda while preserving earlier achievements, including the independence of the National Bank of Ukraine (NBU)--both the monetary authority and financial system regulator. We consider this critical to the government maintaining access to official and commercial financing at reasonable rates. The rating could also benefit should Ukraine's external liquidity outperform our projections.

On the other hand, we could lower the rating if disruptions to funding from concessional programs or capital markets over the next year call into question Ukraine's ability to meet large FX-denominated repayments. Such disruptions could happen if the government were to backtrack on key reforms.

Rationale

The ratings on Ukraine are constrained by its low per capita income and challenging institutional and political environment.

Stronger macroeconomic management--evidenced by lower inflation and public deficits, the improving profile of government debt, and higher FX reserves--support our sovereign ratings on Ukraine. The ratings are also supported by Ukraine's ongoing implementation of reforms, which helps the government access commercial debt markets and receive concessional funding from international financial institutions (IFIs). In our view, the quality and predictability of monetary policy and financial sector supervision at the NBU, even in the face of occasional political pressures, is a noteworthy and highly positive development.

Institutional and Economic Profile: While government reforms over the past half-decade have improved macroeconomic outcomes, relations with concessional creditors remain critical amid external uncertainties

- The coronavirus outbreak represents an important downside risk--both directly and via its effects on the demand for and prices of Ukraine's key export commodities.
- Nonresident inflows into the domestic bond market are sensitive to shifts in external financing conditions and any potential backtracking by authorities on matters such as the NBU's independence.
- The implications of a recent government reshuffle for Ukraine's reform momentum and relationship with key creditors is uncertain.

Amid a slowdown in reform momentum, a fall in popularity, and rising factionalism within his "Servant of the People" parliamentary party, President Zelensky has reshuffled his cabinet. The previous prime minister, finance minister, and the minister for economy and agriculture have been dismissed. It is too early to reach any conclusion as to what the reshuffle implies for economic policy and Ukraine's relations with its creditors. The new prime minister, Mr. Denys Shmygal, has called for a revision to the 2020 budget to increase social spending.

Meanwhile, IMF board approval for a new $5.5 billion three-year program is unlikely until parliament passes legislation related to land reform and--more importantly--to strengthen the bank resolution framework. The implementation of the latter would make it harder for PrivatBank--which was nationalized in 2016 at a cost of 6% of GDP--to be returned to its previous owners in the event of a court ruling to that effect.

Ukraine's parliament (the Rada) has introduced more than 4,000 amendments to the land reform bill. The proposed law has proven controversial and may ultimately be passed in a diluted form. The issue of foreign ownership of agricultural land is likely to be put to a referendum in the future. Even then, the potential lifting of the long-standing moratorium on the sale of agricultural land would be a momentous step in raising the sector's productivity.

Market access on better terms has allowed the government to issue longer-dated bonds at lower yields in both local and foreign currencies. Even so, we believe that maintaining cordial relations with official lenders such as the IMF remains valuable: it underlines the authorities' reform intent and shapes investor perception, ultimately influencing the government's ability to issue commercially at a reasonable cost. This is particularly the case amid volatile global markets and waning external demand. Moreover, we believe that nonresident inflows into the domestic bond market are sensitive to shifts in external financing conditions and any potential backtracking by authorities on matters such as the NBU's independence.

Ukraine's relations with Russia are tenuous. Despite recent prisoner swaps and the presidents of both countries engaging in Normandy-format talks, each side's position on Donbass in Eastern Ukraine makes a near-term resolution appear remote. While there have been efforts to de-escalate tensions, ceasefire violations and fatalities in the region continue. We note that Ukraine's defense outlay constitutes about one-fifth of the government's budget.

Real GDP expanded by an estimated 3.3% last year, spurred by domestic demand. High real wages growth continued to stoke consumption. Being still heavily reliant on commodities, Ukraine's economy is vulnerable to a slowdown in global growth. Coronavirus represents an important downside risk both directly and via its effects on the demand for and prices of Ukraine's key export commodities.

Over 2020-2023, we project real GDP growth of 3% on average. In our view, Ukraine would have to attract more investment flows from abroad for a more meaningful and sustained pick-up in growth. In this context, the current government's legislative efforts to effect land reform could lift growth over our current projections as could improvements in the business environment. We note investment is just 19% of GDP, down from the peak of 30% in 2007 prior to the global financial crisis. Another factor inhibiting economic growth is weak banking sector lending, particularly to the corporate sector. From 2014 to 2019, real credit growth to the private sector contracted cumulatively by 80%.

Flexibility and Performance Profile: While Ukraine's FX reserves are at a record high, the external financing environment has deteriorated

- Ukraine's current account receipts are highly susceptible to fluctuations in commodity prices.
- The larger presence of nonresidents invested in Ukrainian hryvnia-denominated domestic bonds can, in an adverse scenario, magnify pressures on the exchange rate.
- The NBU has lifted numerous capital controls, improved financial stability, and brought inflation much closer to its target.

The Clearstream link to Ukraine's domestic bond market in 2019, coupled with high real interest rates, caused a surge in foreign participation in hryvnia-denominated government securities. Government FX-denominated debt has reduced to about 60% from about two-thirds previously. The government has also been able to issue internationally in FX at lower rates and longer maturities. We view positively the creation of a debt management office and legislation enabling the government to pre-finance upcoming redemptions.

2020 is another heavy year for government repayments with FX-denominated debt service of $6.7 billion (nearly 4% of estimated 2020 GDP). Of this, we expect the $3 billion of domestic bonds to be fully rolled over. We anticipate the government will finance the rest via a mix of commercial and official borrowing, including proceeds from the €1.25 billion Eurobond issued in January.

Nonresidents now hold about one-quarter of domestically issued hryvnia-denominated domestic bonds, excluding NBU holdings. An exodus of these investors from their holdings could magnify pressures on the exchange rate in an adverse scenario. Moreover, Ukraine's current account receipts, while growing by double-digits annually over the past three years, are highly susceptible to fluctuations in commodity prices. In 2019, the current account deficit benefited from favorable terms of trade, continued remittance inflows, and a 1.8% of GDP settlement from Gazprom to Naftogaz.

Strong domestic demand will push the current account deficit up toward 4% of GDP through 2023, requiring substantial financing from abroad. We expect the majority of these financing flows will be debt-creating. The proportion of net direct investment in financing Ukraine's recurrent external deficits has been declining since 2016. The NBU estimates that round-tripping (where capital leaves the country and then is reinvested in the form of foreign direct investment [FDI]) accounted for 20.6% of FDI inflows in 2018. An important medium-term risk related to the transit of Russian gas via Ukraine has abated with a deal reached in December. Volumes transiting via Ukraine on to Europe will decline, however, from about 2% of GDP in 2019 to 1% in 2020 and to below 1% in 2021-2024.

We view Ukraine's external buffers against balance of payments risks as having strengthened. The NBU's FX reserves have been increasing since 2015 via borrowings and outright FX purchases. In 2019, the NBU took advantage of the appreciating hryvnia and purchased nearly $8 billion. FX reserves stood at nearly $27 billion at the end of February. Moreover, the proportion of NBU own reserves has increased to nearly 65% of overall FX reserves from about 45% in 2015. We project that the NBU's FX reserves (net of required reserves commercial banks are required to maintain with the NBU on their FX liabilities) will cover about three months of current account payments on average through 2023. The NBU intervenes to avoid excessive volatility and to augment reserves.

Since its independence, the NBU has successfully pursued its inflation-targeting mandate and improved financial stability. Since 2016, it has gradually brought inflation under control. In 2019, the hryvnia's appreciation and lower oil and food prices hastened convergence to its 5% inflation target.

The NBU has also dismantled numerous capital controls in place since 2016 and pushed through reforms to strengthen financial stability in its role as a supervisor. The banking sector has returned to profitability and nonperforming loans (NPLs) are well-provisioned and declining. Credit growth in real terms, however, is still rather weak. From July 2020, the NBU will also have greater regulatory powers over the nonbank financial sector.

In line with our expectation of Ukraine's continued engagement with IFIs, we project that the general government deficit will stay within 2.3% of GDP through our forecast horizon. The 2020 budget could be revised higher to increase spending following the appointment of the new cabinet. Defense expenditure makes up about one-fifth of the total budget and pensions 15%. Dividends from state-owned enterprises, in particular Naftogaz, and the NBU in recent years, have been important contributors to budgetary revenue. A convergence of prices charged to end-consumers with market prices has eliminated quasi-fiscal deficits at Naftogaz, aiding fiscal consolidation since 2014 when the general government deficit was 10.3%.

General government debt to GDP is on a solid downward path as a result of Ukraine's lower fiscal deficits and strong nominal GDP growth. The appreciation of the hryvnia in 2018 and 2019 further helped government debt metrics. In line with our macroeconomic and fiscal projections, we forecast that government debt will decline through 2023. The forecast remains highly sensitive to future exchange rate developments given the still-large proportion of FX-denominated debt in the overall government debt stock.

GDP warrants issued by the government in 2015 represent a contingent fiscal risk; that said, we project potential payouts through 2023 will be relatively contained. The warrants pay out two years after a year in which real GDP growth exceeds 3%; the payout increases if growth exceeds 4%.

There is a residual risk for Ukraine's government balance sheet from the 2013 $3 billion Eurobond, which was not restructured and is held by Russia. In the event of an adverse court ruling and Ukraine's refusal to pay in full, legal or technical constraints on Ukraine's commercial debt service to other creditors could potentially apply.

The Ukrainian banking sector returned to profitability in 2018. Although net consumer loans grew by 30% in 2019--albeit off a low base--corporate loan portfolios continue to decline through write offs of NPLs and limited new lending. At 48%, banks' NPLs are high but falling and are almost fully provisioned. State-owned banks comprise nearly half of the system's NPLs. In particular PrivatBank has NPLs amounting to 78% of its loan portfolio because of legacy related-party lending prior to being nationalized. The government's strategy for these banks includes the appointment of independent supervisory boards, and a gradual clean-up and eventual part-privatization of at least two of the four, Oschadbank and PrivatBank. With reforms at all four state-owned banks progressing--albeit at a slower pace at Ukreximbank and Oschadbank--we do not expect any additional recapitalization needs from the central government over the next year.

Key Statistics

Table 1

Ukraine Selected Indicators

UAH mil.	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. LC)	1,587	1,989	2,385	2,984	3,559	3,970	4,192	4,572	4,945	5,348
Nominal GDP (bil. $)	132	91	93	112	131	154	171	180	190	200
GDP per capita (000s $)	2.9	2.1	2.2	2.6	3.1	3.7	4.1	4.3	4.6	4.8
Real GDP growth	(6.6)	(9.8)	2.4	2.5	3.3	3.3	2.5	3.2	3.0	3.0
Real GDP per capita growth	(6.3)	(4.5)	2.8	2.9	3.8	3.9	3.0	3.7	3.5	3.5
Real investment growth	(24.0)	(9.2)	20.4	16.1	14.3	5.0	0.0	4.5	4.2	4.0
Investment/GDP	13.4	15.9	21.7	19.9	18.8	18.6	17.8	17.7	17.4	17.5
Savings/GDP	9.9	17.7	20.3	17.8	15.4	18.0	15.2	14.8	13.7	13.6
Exports/GDP	48.6	52.6	49.3	48.0	45.2	47.4	44.4	43.4	43.1	42.8
Real exports growth	(14.2)	(13.2)	(1.8)	3.8	(1.6)	3.0	0.0	2.5	3.3	3.5
Unemployment rate	9.7	9.5	9.7	9.9	9.1	8.5	8.0	7.5	7.5	7.5
External indicators (%)										
Current account balance/GDP	(3.5)	1.8	(1.4)	(2.2)	(3.3)	(0.7)	(2.7)	(2.9)	(3.6)	(3.9)
Current account balance/CARs	(6.2)	2.8	(2.3)	(3.6)	(5.8)	(1.3)	(5.1)	(5.8)	(7.2)	(7.7)
CARs/GDP	56.3	64.2	61.6	60.6	58.1	54.9	51.9	50.9	50.2	49.8
Trade balance/GDP	(5.4)	(3.8)	(7.4)	(8.6)	(9.7)	(9.1)	(9.2)	(9.4)	(9.2)	(9.3)
Net FDI/GDP	0.2	3.3	3.5	2.3	1.8	1.6	1.5	1.5	1.5	1.5
Net portfolio equity inflow/GDP	(0.3)	0.2	0.2	0.1	(0.0)	0.0	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	154.6	166.5	146.1	135.8	130.8	120.5	118.2	116.4	116.9	118.0

Table 1

Ukraine Selected Indicators (cont.)

UAH mil.	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Narrow net external debt/CARs	135.7	152.2	143.1	119.3	103.6	86.6	82.5	82.9	83.9	85.4
Narrow net external debt/CAPs	127.8	156.6	139.8	115.2	98.0	85.5	78.5	78.4	78.3	79.3
Net external liabilities/CARs	67.2	56.3	47.1	37.7	29.1	19.4	20.7	25.2	31.3	37.8
Net external liabilities/CAPs	63.3	57.9	46.0	36.4	27.5	19.1	19.7	23.8	29.2	35.1
Short-term external debt by remaining maturity/CARs	85.0	88.5	76.5	62.3	56.4	48.3	46.1	45.9	46.6	47.5
Usable reserves/CAPs (months)	2.7	1.4	2.6	2.6	2.7	2.9	3.2	3.4	3.5	3.5
Usable reserves (mil. $)	6,698	12,858	15,062	18,252	20,331	24,771	27,728	30,191	31,387	32,758
Fiscal indicators (general government; %)										
Balance/GDP	(10.3)	(3.2)	(2.2)	(1.4)	(2.1)	(2.1)	(2.3)	(2.2)	(2.1)	(2.1)
Change in net debt/GDP	31.8	21.8	15.3	6.1	1.0	(4.0)	4.4	2.5	3.4	2.7
Primary balance/GDP	(7.0)	1.3	1.9	2.4	1.2	0.8	0.2	0.2	0.2	0.2
Revenue/GDP	40.5	42.4	38.5	40.3	39.8	40.0	41.0	41.2	41.5	41.5
Expenditures/GDP	50.7	45.5	40.7	41.7	41.9	42.1	43.3	43.4	43.6	43.6
Interest/revenues	8.2	10.5	10.6	9.3	8.2	7.2	6.0	5.8	5.6	5.6
Debt/GDP	69.4	79.1	81.1	71.8	60.9	50.3	52.1	50.2	49.8	48.8
Debt/revenues	171.5	186.6	210.3	178.1	153.0	125.8	127.0	121.9	120.1	117.6
Net debt/GDP	68.1	76.1	78.7	69.0	58.9	48.7	50.6	48.8	48.6	47.6
Liquid assets/GDP	1.3	3.0	2.3	2.7	2.1	1.6	1.5	1.4	1.3	1.2
Monetary indicators (%)										
CPI growth	12.1	48.7	13.9	14.4	11.0	7.9	4.0	5.5	5.0	5.0
GDP deflator growth	15.9	38.9	17.1	22.1	15.4	8.0	3.0	5.7	5.0	5.0
Exchange rate, year-end (LC/$)	15.82	24.03	27.30	28.10	27.72	23.81	25.30	25.50	26.50	27.00
Banks' claims on resident non-gov't sector growth	11.8	(2.4)	(1.6)	1.2	5.4	(9.7)	6.5	7.5	7.5	7.5
Banks' claims on resident non-gov't sector/GDP	66.9	52.1	42.8	34.6	30.6	24.7	25.0	24.6	24.5	24.3
Foreign currency share of claims by banks on residents	40.0	48.4	38.9	32.2	30.5	26.3	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	45.9	45.3	46.3	46.0	42.0	40.0	N/A	N/A	N/A	N/A

Table 1

Ukraine Selected Indicators (cont.)

UAH mil.	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Real effective exchange rate growth	(21.7)	(6.9)	(0.5)	5.2	6.4	20.1	N/A	N/A	N/A	N/A

Sources: State Statistics service of Ukraine (Economic Indicators), National Bank of Ukraine, State Statistics service of Ukraine (External Indicators), Ministry of Finance of Ukraine, State Statistics service of Ukraine (Fiscal Indicators), and National Bank of Ukraine, International Monetary Fund (Monetary Indicators).
Adjustments: Usable reserves calculated by subtracting required reserves for resident foreign-currency deposits from reported international reserves. General government expenditures calculated as reported expenditure plus expenditure related to Naftogaz. Government debt calculated as reported state debt plus state guarantees.
Definitions: Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. N/A--Not applicable. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. e--Estimate. f--Forecast. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Ukraine Ratings Score Snapshot

Key rating factors	Score	Explanation
Institutional assessment	5	Reduced predictability of future policy responses because of moderate risk of challenges to political institutions. Relatively weak transparency and uncertain checks and balances between institutions.
		Ukraine continues to face external security risks. Despite efforts to de-escalate tensions and the resumption of talks between Ukraine and Russia, ceasefire violations and fatalities in the Donbass continue.
Economic assessment	5	Based on GDP per capita ($) as per Selected Indicators in Table 1.
External assessment	5	Based on narrow net external debt and gross external financing needs as per Selected Indicators in Table 1.
		There is a risk of marked deterioration in the cost of or access to external financing.
Fiscal assessment: flexibility and performance	3	Based on the change in net general government debt (% of GDP) as per Selected Indicators in Table 1.
Fiscal assessment: debt burden	4	Based on net general government debt (% of GDP) and general government interest expenditures (% of general government revenues) as per Selected Indicators in Table 1.
		Despite a recent increase in the local currency portion of its overall debt stock, about 60% of government debt is denominated in foreign currency.
		The banking sector’s exposure to the government is about 20% of its assets.
Monetary assessment	4	The hryvnia generally floats freely with intermittent interventions from the NBU.
		The NBU has enjoyed success since its independence in pursuing its inflation-targeting mandate and improving financial stability. Inflation has been converging towards the NBU's target and the trend has broadly been in line with that of its major trading partners.

Table 2

Ukraine Ratings Score Snapshot (cont.)

Key rating factors	Score	Explanation
		The transmission mechanism is weak, as demonstrated by still weak real credit growth.
Indicative rating	b+	As per Table 1 of "Sovereign Rating Methodology."
Notches of supplemental adjustments and flexibility	-1	Factors that are not fully captured in the indicative rating that could have a negative impact include the implications of a recent government reshuffle on reforms and Ukraine's relations with key creditors, and risks arising from volatility in the external growth and financing environment.
Final rating		
Foreign currency	B	
Notches of uplift	0	Default risks do not apply differently to foreign- and local-currency debt.
Local currency	B	

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 18, 2017, details how we derive and combine the scores and then derive the sovereign foreign currency rating. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in score does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the scores. In determining the final rating the committee can make use of the flexibility afforded by §15 and §§126-128 of the rating methodology.

Related Criteria

- General Criteria: Methodology For National And Regional Scale Credit Ratings, June 25, 2018
- Criteria | Governments | Sovereigns: Sovereign Rating Methodology, Dec. 18, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- General Criteria: Rating Implications Of Exchange Offers And Similar Restructurings, Update, May 12, 2009

Related Research

- Unrestrained Supply Swamps Oil Outlook: S&P Global Ratings Revises Oil & Gas Assumptions, March 9, 2020
- The Coronavirus Will Shave 50 Basis Points Off Eurozone Growth, March 4, 2020
- Coronavirus And Its Possible Impact On Global Sovereign Ratings, Feb. 13, 2020
- Banking Industry Country Risk Assessment: Ukraine, Nov. 28, 2019
- Emerging Markets Are Grappling With Faltering Growth And Rising Policy Uncertainty, Report Says, Oct. 16, 2019
- Ukraine Ratings Raised To 'B' On Improved Macroeconomic Management; Outlook Stable, Sept.

27, 2019

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed	
Ukraine	
Sovereign Credit Rating	B/Stable/B
Ukraine National Scale	uaA/--/--
Transfer & Convertibility Assessment	B
Senior Unsecured	B
Senior Unsecured	D