FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Ukraine at 'B'; Outlook Stable

Fri 04 Sep, 2020 - 16:01 ET

Fitch Ratings - London - 04 Sep 2020: Fitch Ratings has affirmed Ukraine's Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'B' with a Stable Outlook.

A full list of rating actions is below.

KEY RATING DRIVERS

The ratings of Ukraine reflect its credible macroeconomic policy framework that had lowered inflation and narrowed fiscal deficits prior to the coronavirus shock, and a record of multilateral support. These strengths are set against low external liquidity relative to high financing needs associated with large sovereign debt repayments, a vulnerable, albeit improving, banking sector, and weak governance indicators. The coronavirus shock has at least temporarily reversed Ukraine's improvements made in recent years in terms of a declining debt burden, normalisation of growth prospects after the 2014-2015 geopolitical and economic crises, and reduced growth volatility.

Ukraine's new IMF programme has been designed to reduce financing constraints and support a recovery in international reserves. Ukraine received the first tranche (USD2.1 billion) under a USD5 billion 18-month stand-by arrangement (SBA) for budget support in June. The sovereign also issued a USD2 billion Eurobond in July. Easing of external-financing constraints allowed the sovereign to buy back external bonds maturing in 2021-2022 and to repurchase close to 10% of its outstanding GDP warrants.

Fitch estimates that Ukraine has met close to 68% of its 2020 fiscal financing needs of USD23.5 billion (USD14.2 billion in amortisations including debt prepayments). Fitch expects one additional disbursement from the IMF SBA (USD0.7 billion) and the first tranche of a new EUR1.2 billion loan in 2020. Available domestic liquidity and government cash holdings provide room to accommodate remaining financing requirements, which in turn are dependent on the pace of expenditure implementation. Domestic banks, most notably state-owned, have increased exposure to government debt, as foreign investors have reduced their share of domestic government bonds by about USD1.5 billion since February to 16% (not including National Bank of Ukraine, NBU, holdings).

International reserves rose to USD29 billion at the beginning of September, due to central bank FX purchases (net USD1.2 billion YTD in 2020) and external financing. We expect international reserves to finish 2020 at USD27.4 billion or 4.5 months of current external payments (CXP), slightly above the projected 4.1 months for the 'B' median. In our forecast for a gradual return of the current account deficit and continued access to external financing, reserve coverage will average 3.8 months of CXP in 2021-2022. External liquidity, measured by the country's liquid external assets-to-liquid external liabilities, will rise to 112% for 2021, close to the 118% forecast for the 'B' median.

External financing needs have declined compared with previous years (35% of international reserves) in spite of large debt repayments, reflecting higher international reserves and a projected current account surplus (2.5% of GDP) in 2020, due to fairly resilient exports and remittances, sharp decline in imports and improved data availability on reinvested earnings by foreign investors. External financing needs will rise in 2021-2022 with the return to a current account deficit (reaching 3.5% of GDP by 2022). External sovereign amortisations (government plus NBU) will decline from USD6 billion in 2020 but will remain large averaging USD4.3 billion in 2021-2022 (bond repayments of USD2 billion and USD1 billion, respectively).

Fitch considers that continued engagement with the IMF is key for Ukraine to maintain access to external financing. However, the IMF SBA implementation risks are significant given Ukraine's poor record from previous programmes and potential judicial rulings and legislative initiatives that lead to reform reversals. In Fitch's view, unexpected and frequent cabinet changes early in the year, especially those related to key economic positions such as the Minister of Finance, and political pressure on NBU, leading to the governor's resignation in July, create policy uncertainty. In addition to eroding hard-earned policy credibility, reduced central bank independence could lead to reversal in the improvements in macroeconomic and financial-sector stability, constrain access to external financing and increase Ukraine's vulnerability to shocks.

Inflationary pressures remain subdued (2.4% yoy in July; core 3%), but inflation is expected to approach the 5% NBU target by end-2020 due to higher energy and food prices as well as recovering domestic demand. Fitch expects inflation to average 5.3% in 2021 and 5.7% in 2022, above the forecast 4.4% and 4.8% 'B' medians. The NBU cut policy rates to a record low 6% in June (750bp in 1H20) in response to the pandemic, but further easing could be constrained, in Fitch's view, by rising inflationary pressures and the proposal of a significant minimum wage increase in 2021.

Fitch maintains its April forecast that the economy will contract 6.5% in 2020. The economy reportedly contracted 11.4% in 2Q20. Improving retail sales, industrial production and construction reflect reviving consumption and investment, while faster expenditure implementation in 2H20 and lower interest rates will support recovery. We expect growth to reach 3.8% and 3.5%, respectively, in 2021 and 2022, in line with our medium-term forecasts for Ukraine. However, downside risks to our forecasts remain, given uncertainty around the extent and duration of the coronavirus outbreak, and the duration or re-introduction of restrictions, especially given the reported uptick in coronavirus cases in Ukraine.

Fitch forecasts the general government deficit to reach 6.5% of GDP in 2020, below the projected 7.7% under the IMF SBA and 7.3% 'B' median. Large dividend payments from state-owned companies (1.8% of GDP), and recovering tax collection (except for import-related taxes) have supported government revenues, while expenditure growth remains moderate YTD and concentrated in social transfers and health spending. We forecast fiscal consolidation to proceed at a gradual pace, with the general government deficit shrinking to 5.4% of GDP in 2021 and 4.2% in 2022. Although the government has indicated they intend to pursue expenditure initiatives to support growth such as the proposed minimum wage increase (up to 30% in 2021), the actual pace of fiscal consolidation will depend on continued engagement with the IMF and available financing.

General government debt will increase to 57.4% of GDP (65.1% including guarantees) and 60% by 2022, from 44.4% (50.4% with guarantees) in 2019 and close to the forecast 65.3% 'B' median. Fitch forecasts that Ukraine general government debt will stabilise at around 60% in 2022-2023 and decline gradually thereafter with the return of primary surpluses. Risks to the debt dynamics stem from a weaker exchange rate (64% foreign currency-denominated debt), lower-than-expected growth or failure to narrow the fiscal deficit.

Improved supervision and capitalisation levels and NBU's liquidity support have reduced risks to financial stability. Although NPLs have declined slightly to a still high 48% (96.8% covered by provisions) in July, the weaker macroeconomic outlook will likely lead to asset-quality deterioration, thus increasing the risk of additional fiscal costs in capitalisation requirements for state-owned banks (59% of total system assets). The government has approved the strategy to reduce NPLs through write-offs, which could support progress in reducing the NPL overhang. Deposit- (41%) and loan- (41%) dollarisation remains high and some of the recent progress could be reversed in the short term.

The government under President Zelensky remains popular but its political position has weakened somewhat, especially in the Rada, as resistance to reform from vested interests and oligarchs has not only delayed and weakened reform legislation, but also now threatens to undermine approved reforms such as the strengthened bank resolution framework and the anti-corruption agenda.

In Fitch's view, President Zelensky remains committed to achieving a resolution to the conflict with Russia. Although both countries have engaged in prisoner exchanges and ceasefire agreements, we do not anticipate a near-term resolution to the Russian-Ukrainian conflict.

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 29%, reflecting the conflict with Russia in the east of Ukraine, weak institutional capacity, uneven application of the rule of law and a high level of corruption.

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.

RATING SENSITIVITIES

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

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

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

- 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.

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 conflict in eastern Ukraine 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 and investment 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

Sovereign Rating Criteria (pub. 27 Apr 2020) (including rating assumption sensitivity)

Country Ceilings Criteria (pub. 01 Jul 2020)

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, v1.2.0 (1)

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

Sovereign Rating Model, v3.12.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Ukraine	EU Issued

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Sovereigns Europe Ukraine