Moody's
INVESTORS SERVICE

Rating Action: Moody's upgrades Ukraine's ratings to B3; stable outlook

12 Jun 2020

London, 12 June 2020 -- Moody's Investors Service, ("Moody's") has today upgraded the Government of Ukraine's long-term issuer and senior unsecured ratings to B3 from Caa1. The outlook on the ratings is stable.

The main driver of the decision to upgrade the ratings to B3 is the easing of Ukraine's near-term funding challenges and the safeguards afforded to recent improvements in its external vulnerability as a result of the announced new financing programme with the International Monetary Fund (IMF)[1]. The decision to upgrade the ratings also reflects Moody's expectation that the new IMF programme will help anchor the reform progress achieved in recent years.

Concurrently, Moody's has affirmed the Ca senior unsecured rating on the $3 billion Eurobond that Ukraine sold in December 2013. The sole subscriber of the notes was the Russian government. The bond is under dispute due to the international armed conflict between the two governments. The Government of Russia (Baa3 stable) has sued Ukraine for repayment of the bond in English courts, under whose jurisdiction the bond was issued, and the case is set for trial.

The stable outlook on the B3 rating balances the country's strengthened macroeconomic stability and moderate levels of government debt against ongoing governance challenges, improved, albeit still elevated, vulnerability to external shocks and political risks. Furthermore, Moody's believes that the prospects for reforms needed to further enhance Ukraine's credit profile are impaired as the authorities focus on responding to the pressures arising from the coronavirus outbreak.

Finally, Ukraine's long-term foreign currency bond and deposit ceilings have been raised to B2 from B3 and Caa1 from Caa2 respectively, while the short-term foreign currency ceilings for bonds and deposits remain Not Prime (NP). The country ceilings for local currency bonds and deposits have also been raised to B2 from B3.

RATINGS RATIONALE

RATIONALE FOR THE UPGRADE TO B3

EASING OF FUNDING AND EXTERNAL PRESSURES AS RESULT OF NEW MULTILATERAL FINANCING

The main driver of the decision to upgrade Ukraine's ratings to B3 is the easing of Ukraine's near-term funding challenges as well as the safeguarding of recent improvements made to Ukraine's external vulnerability as a result of the new IMF programme and associated multilateral financing support. Moody's noted at the time of assigning the positive outlook in November 2019 that sustaining the progress made in reducing Ukraine's sizeable external vulnerability, including reaching agreement on a new IMF programme, would support an upgrade in the rating.

The new 18-month IMF Stand-by Arrangement (SBA) programme, which was secured after the passing of a new banking law and land reform, provides up to around $5 billion in funding support to help Ukraine cope with the pressures arising from the coronavirus outbreak, with just below half of the available financing under the programme (around $2.1 billion) disbursed immediately. The programme's emphasis, in addition to funding support, is on safeguarding the reform achievements to date and will require Ukraine to advance only limited structural reforms focused on progressing governance and anti-corruption measures. The IMF reduced the scope of the programme from a previously targeted 3-year Extended Fund Facility, which would have had a greater focus on longer-term structural reforms.

Moody's estimates the new IMF agreement will, together with crystallising disbursements from other multilateral and bilateral lenders such as the World Bank and European Union (Aaa stable), provide funding support worth up to $8.6 billion (6% of 2020 GDP) to help alleviate Ukraine's sizeable financing challenge.

Securing additional multilateral funding has become vital as Ukraine's financing needs have risen sharply given the marked deterioration in the country's macroeconomic conditions. With the economy forecasted by Moody's to contract by 4.5% this year and the fiscal response to the coronavirus outbreak, Moody's expects the government's budget deficit to increase to 7.5% of GDP in 2020, up from a deficit of 2.0% of GDP in 2019.

Together with an already large debt refinancing schedule, Moody's estimates the government's gross funding needs for this year at around 16% of GDP, with a smaller but still challenging funding need next year.

At the same time, the new IMF programme will help to safeguard the improvements made in reducing Ukraine's external vulnerability in recent years. Moody's expects Ukraine's strengthened foreign exchange reserves, which increased markedly in 2019 on the back of strong foreign investor demand, to be preserved as the new IMF programme buffers against the country's large refinancing needs and helps to limit private capital outflows by supporting investor sentiment. Moody's forecasts foreign exchange reserves (excluding gold) to remain around $22 billion by the end of the year, sufficient to cover around four months of imports and substantially larger than the nadir of $4.7 billion in February 2015, as credible monetary policy and generally limited external pressures support a continued broad stabilization in the exchange rate.

PROGRESS ACHIEVED ON ITS REFORM AGENDA WELL ANCHORED UNDER THE NEW IMF PROGRAMME

The decision to upgrade Ukraine's ratings to B3 also reflects Moody's expectation that the new IMF programme -- apart from alleviating the government's near-term funding challenges and safeguarding the improvements made in reducing Ukraine's external vulnerability in recent years -- will help to anchor the reform progress achieved in recent years and support a continuation of Ukraine's improved monetary and fiscal policy settings.

In particular, Moody's expects the IMF programme will help to preserve the recent strengthening in the monetary policy framework, including the adoption of a more flexible exchange rate as part of an inflation targeting framework as well as enhancements to central bank independence, which has helped to reduce inflation and improve macroeconomic stability. Furthermore, the passing of a new banking law in May 2020 will help to preserve the comprehensive banking sector reforms undertaken in recent years by preventing former owners of banks declared insolvent from regaining their assets.

Continued engagement with the IMF will also help to ensure that Ukraine's fiscal prudence, with a track record of primary budget surpluses helping to reduce the government debt burden in recent years, will be sustained over the medium term.

Furthermore, the recent passing of a bill to lift the longstanding ban on agricultural land sales, albeit still restricting the ability for foreigners to purchase land, is an important step towards establishing a more competitive and open land market.

Finally, while measures of corruption and the rule of law still point to challenges in this area, Moody's expects the country to sustain recent progress on anti-corruption reforms, including the establishment of new bodies to handle corruption cases and the reintroduction of a law criminalising the illicit enrichment of government officials.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook on the B3 rating balances Ukraine's strengthened macroeconomic stability and moderate levels of government debt against ongoing governance challenges, improved, albeit still elevated, vulnerability to external shocks and political risks.

Moody's expects Ukraine's stronger external position and improved macroeconomic stability will provide a degree of medium-term resilience to the impact of the global coronavirus outbreak as it sharply weighs on Ukraine's near term economic and fiscal performance.

In particular, the comprehensive clean-up of the banking system undertaken under previous IMF programmes has helped to preserve financial stability during the current crisis, while inflation has been much lower than in past crises, providing scope for the central bank to continue supporting the economy.

As a result, while Moody's expects the economy -- through restrictions on domestic activity, weaker external demand and lower remittances -- to contract sharply this year, economic growth is expected to recover gradually from the second half of 2020, with real GDP forecast to rise by around 3.6% in 2021.

Ukraine's economic recovery will be supported by its sizeable agriculture exports which are relatively resilient to price movements, low exposure to tourism and status as a net energy importer. That said, a larger than expected impact on global demand and commodity markets could result in a more protracted drag on growth.

At the same time, Moody's forecasts the economic and fiscal deterioration will lead to a more than 12 percentage point increase in Ukraine's government debt to GDP ratio to around 63% in 2020, although government debt will still remain in line with rating peers. That said, Ukraine's fiscal strength will continue to face notable exchange rate risks from a substantial share of government debt which is denominated in foreign currency.

The stable outlook on the B3 rating also reflects that, while improved, Ukraine's vulnerability to external shocks constrains the potential for further upward rating momentum given its dependence on international lenders to help finance large external repayments due over the coming years.

Despite growing strongly, foreign exchange reserves at the end of 2019 only covered around half of external debt maturing within 12 months, while Ukraine's external vulnerability indicator, Moody's measure of reserve adequacy, is forecast to reach around 218% at the end of 2021, much weaker than the B-rated median of 92%.

Moody's expects investor sentiment towards Ukraine, while likely to improve with the new IMF programme, will remain fragile given heightened risk aversion globally and volatile domestic politics. With constrained access to external markets, the government will rely on financing in the domestic debt market, which, while continuing to develop, still provides only a limited capacity to replace external funding, particularly if multilateral funding disbursements were to be delayed in light of Ukraine's mixed track record in complying with previous IMF programmes.

Finally, Moody's believes that the prospects for reforms needed to further enhance the country's credit profile are impaired this year and next, as the authorities focus on responding to the social and economic pressures arising from the coronavirus outbreak.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Moody's takes account of the impact of environmental (E), social (S), and governance (G) factors when assessing sovereign issuers' economic, institutional and fiscal strength and their susceptibility to event risk. In the case of Ukraine, the materiality of ESG to the credit profile is as follows.

Environmental considerations are material to Ukraine's credit profile given its marked reliance on the agriculture sector, despite ongoing efforts at diversification, such that adverse weather events can add volatility to the country's exports.

Social factors are material to Ukraine's credit profile given its adverse demographic trends. A persistent demographic drag will likely constrain the country's labour supply and limit Ukraine's long-term growth potential. Moody's also regards the coronavirus outbreak as a social risk under its ESG framework, given the substantial implications for public health and safety, and that the outbreak will have an adverse economic and fiscal impact for Ukraine.

Governance considerations are material to Ukraine's credit profile. Ukraine receives relatively unfavorable scores on the Worldwide Governance Indicators in the categories of government effectiveness, rule of law and control of corruption, which serves to impede more robust entrepreneurial activity and investment. The country's weak governance standards will likely continue to hamper institutional capacity and act as a headwind to material credit improvements.

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

Ukraine's ratings could move higher up within the B-rating category if Moody's concluded that progress on structural reforms were expected to materially enhance Ukraine's credit profile through addressing some of the sovereign's structural credit constraints, including those emanating from its weak institutions and external position.

Such progress would likely include improvements to the business environment which helps to foster stronger investment, including from abroad, and raise productivity growth. In particular, faster progress on anti-corruption reforms, including tangible results from the establishment of new anti-corruption bodies, and measures to enhance the integrity of the judiciary, with evidence of a material improvement in the rule of law and control of corruption, would be positive. Furthermore, faster progress on reforming state-owned enterprises which helps to enhance competition and reduce risks to public finances, would also provide upward rating pressure.

Progress in addressing these credit constraints would likely rely on safeguarding previous reforms which have helped strengthen economic stability, including enhancements made to central bank independence and the comprehensive clean-up of the banking system.

Conversely, Ukraine's ratings would be downgraded if a recurrence of external pressures were to result in a marked deterioration in Moody's assessment of Ukraine's external vulnerability and give rise to renewed concerns around government financing.

For example, a sharp reduction in the country's foreign exchange reserve buffer in relation to its external repayments obligations would lead to downward pressure on the rating. Furthermore, a breakdown in co-operation with the IMF resulting in material delays to multilateral financing and impairing access to external markets, which in turn hampers Ukraine's ability to repay its debt obligations, would be negative. In addition, indications of backsliding on critical prior reforms would be negative for the rating. Finally, downward ratings pressure would also derive from an escalation of geopolitical tensions that have a negative spillover on Ukraine's economic and fiscal strength.

The publication of this rating action deviates from the previously scheduled release dates in the sovereign calendar published on www.moodys.com. This action was prompted by the approval by the IMF Board of a new 18-month Stand-By Arrangement facility for Ukraine including an initial funding disbursement.

GDP per capita (PPP basis, US$): 9,775 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.2% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 4.1% (2019 Actual)

Gen. Gov. Financial Balance/GDP: -2.0% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.9% (2019 Actual) (also known as External Balance)

External debt/GDP: 79.2% of GDP (2019 Actual)

Economic resiliency: b3

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

On 10 June 2020, a rating committee was called to discuss the rating of the Government of Ukraine. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. 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 issuer has become less susceptible to event risks.

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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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1133569 .

Items color coded in purple in this Press Release relate to unsolicited ratings for a rated entity which is non-participating.

REFERENCES/CITATIONS

[1] IMF Press Release 09-Jun-2020

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