S&P Global Ratings

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Research Update:

Ukraine 'B/B' Ratings Affirmed; Outlook Stable

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Overview

- Ukraine's growth, balance of payments, and public finances all outperformed our expectations in 2020.
- Reserve adequacy has improved, providing a cushion against potential adverse external developments including further delays in the disbursement of concessional loans.
- However, epidemiological considerations still pose an important risk.
- We are therefore affirming our 'B/B' sovereign credit ratings on Ukraine.
- The outlook is stable.

Rating Action

On March 12, 2021, 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 on the long-term ratings is stable.

Outlook

The stable outlook balances the risks to Ukraine's economy from continued delays in accessing concessional financing, the weak external environment, and the potential for a reversal of past reforms, against the country's external buffers.

We could raise the ratings over the next year if we anticipate that public finances would consolidate faster than we currently forecast. This could result from a stronger economic recovery and discretionary policies. The rating could also benefit should Ukraine's external liquidity metrics outperform our projections.

We could lower the ratings if disruptions to funding from concessional programs or capital markets over the next year call into question the government's ability to meet debt service obligations. Such disruptions could happen if the government backtracks on key reforms, such as ensuring the independence of the National Bank of Ukraine (NBU), which acts as both the monetary authority and financial system regulator.

Rationale

The ratings on Ukraine are constrained by its low per capita income and developing institutions.

Stronger macroeconomic management since 2015 and augmented foreign exchange (FX) reserves support our sovereign ratings on Ukraine. The ongoing implementation of reforms helps the government access commercial debt markets and receive concessional funding from international financial institutions (IFIs).

The public health situation remains challenging, with the third wave of COVID-19 infections pushing hospitalization rates above those seen early last year. Meanwhile, Ukraine's vaccination rollout remains at an earlier stage than most European peers', implying potential risks to our baseline projection of an accelerating recovery this year.

Institutional and economic profile: Vested interests and endemic corruption continue to thwart reform progress and confound Ukraine's relations with international creditors

- Ukraine's economy will rebound with 4.0% growth in 2021 after contracting 4.2% in real terms in 2020.
- Epidemiological considerations--in particular, the slow pace of inoculations and vaccine hesitancy amid rising infections and virus variants--remain a significant risk.
- We anticipate that the legislature will close gaps in anti-corruption laws over the course of the year, enabling one disbursement in 2021 under the stalled $5 billion IMF program and unlocking other concessional loans.

We project real GDP growth of 4.0% for Ukraine during 2021 versus a contraction of 4.2% in 2020, reflecting a gradual stabilization of the public health situation, and a recovery in demand. Unlike many other European countries, Ukraine's GDP proved relatively resilient to the global pandemic last year, since services sectors at most risk due to social distancing (arts, entertainment, recreation, retail, accommodation, and food services) make up only about 2% of gross value added (GVA). On the other hand, industrial and agricultural production, which together account for one-third of GVA, have continued to expand with little disruption. A noteworthy exception to the weakness in services last year was Ukraine's booming information technology sector, which--unconstrained by lockdowns--saw exports increase 20%.

For 2021, we project a solid recovery beginning in the second quarter. Remittance inflows and government support measures, including pension and wage hikes, should all support a rebound in consumption that will only be partially offset by a recovery in imports.

The key risk to our forecast remains uncertainty about the distribution and take-up of vaccines. Like in many emerging economies, Ukraine's initial rollout has been slow primarily on account of lagged deliveries. Moreover, vaccine hesitancy is high, with nearly half of the population not in favor of inoculation.

Epidemiological considerations pose the most important risk to our macro projections. Authorities have secured 25 million doses so far through various sources, enough to immunize 30% of the population with two doses. However, vaccine delivery is likely to remain slow. Ukraine is set to receive 2.3 million doses--of 8 million secured--via the World Health Organization's COVID-19 Vaccines Global Access (COVAX) facility in first-half 2021, enough to administer two doses per person to 2.7% of its population.

Vested interests continue to confound Ukraine's relations with international creditors. A $5 billion program agreed with the IMF last year has stalled following rulings by Ukraine's constitutional court that rolled back previously implemented anti-corruption reforms. A push to tighten legislative loopholes is currently underway. These efforts include reinstating criminal liability for falsified electronic declarations and amending the law on the National Anti-Corruption Bureau to prevent the premature dismissal of its head, alongside reforms to the judiciary. We view the recently imposed sanctions by the Biden administration in the U.S. on oligarch Igor Kolomoisky as a strong renewal of western backing for President Zelensky's reform agenda.

Opposition from within the president's party has eroded the government's effective parliamentary majority and could yet frustrate efforts to end the stalemate and unlock concessional financing. However, in our base case we anticipate that a cross party consensus--motivated partly by the need to avoid abrupt fiscal tightening--will enable the passage of the requisite laws. Even with further delays to tranches, the government's continued market access and liquidity buffers will allow it to continue to service debt during the year.

Flexibility and performance profile: Although we don't identify elevated risks to debt service this year, relations with official creditors will remain vital to meet large budget financing needs.

- Import compression, continued external demand for Ukraine's agricultural and services exports, and favorable terms of trade have supported a record current account surplus, alongside a change in accounting methodology.
- External buffers against balance-of-payment risks have strengthened and we project that FX reserves, net of required reserves, will cover four months of current account payments on average through 2023.
- The NBU has hiked interest rates on rising inflationary pressures after several cuts over the course of 2020.

The general government deficit widened to an estimated 5.5% of GDP in 2020, lower than budgeted by 2 percentage points. Revenue intake outperformed our expectations owing to strong consumption dynamics and improvements in administration. Measures from the government to support the economy included higher unemployment benefits, pension top-ups, and minimum wage hikes. The government also ramped up infrastructure spending during the year although delays in official financing implied some curtailment of spending. In 2021, the government has penciled in a deficit of 5.3% of GDP, which factors in continued capital expenditure and another 20% minimum wage hike.

Relative to 2019 and 2020, the government faces a lighter FX-denominated amortization schedule totaling $5.5 billion (nearly 4% of GDP) in 2021. Of this, we expect nearly $3 billion of domestically issued FX bonds, mostly held by domestic banks, to be fully rolled over along with maturing hryvnia bonds.

Considering the still-elevated deficit this year, concessional financing will remain important. Our projections incorporate one further IMF tranche in 2021 of $0.7 billion, in turn unlocking further World Bank and EU concessional loans of about $1.5 billion. Even then, we project the government will issue the equivalent of $5 billion-$6 billion in fresh commercial debt this year, both domestically and abroad.

Higher inflationary pressures will aid government debt dynamics. Despite the headline deficit barely reducing in 2021 and considering projected FX depreciation on 60% of the debt stock, net general government debt will remain at about 60% of GDP. Inflation was below the NBU's 5% target for much of 2020, averaging 2.7% during the year but rising over the target in recent months thanks to increasing food and energy prices. This prompted a 50-basis-point (bps) interest rate hike in early 2021 after cumulative 750 bps cuts in the previous year. After cutting their holdings of hryvnia-denominated government bonds through last year, nonresidents have increased their holdings to about 18% of total local currency government debt (excluding NBU holdings) in recent months, though still down from a peak of nearly one-third in February 2020.

GDP warrants represent more of a risk to interest costs rather than a sizeable contingent liability in our opinion. In 2021, the debt management office will pay out $40 million (0.02% of GDP) based on 2019 growth. Based on our growth and deflator projections, we calculate payoffs on warrants of $250 million (0.2% of GDP) in 2023 and $136 million (0.1% of GDP) in 2024.

There is a residual risk for Ukraine's government balance sheet related to the 2013 $3 billion Eurobond, which was not restructured in 2015 and is held by Russia (see "Ukraine Foreign Currency Ratings Lowered To 'SD' (Selective Default) On Distressed Debt Restructuring," published Sept. 25, 2015, on RatingsDirect). In the event of a court ruling against Ukraine and its refusal to pay in full, legal or technical constraints on Ukraine's commercial debt service to other creditors could potentially apply.

In 2020, Ukraine ran a record current account surplus, due in part to a change in the accounting treatment of losses on foreign investment. Stripping this effect out, the current account remains in surplus thanks to import compression; continued external demand for Ukrainian agricultural exports (which account for more than one-fifth of the export basket); favorable terms of trade; and lower volumes of energy imports. The external services surplus widened to 3% of GDP. We expect the current account balance to return to deficit as domestic demand and import growth revive. Moreover, the volume of Russian gas transiting through Ukraine will continue to decline over the forecast period.

Nonperforming loans (NPLs) in the Ukrainian banking system reduced to 41% as of December 2020 from 49% the year before. This was due to the write off of legacy NPLs, mainly by the four state-owned banks, with the largest declines at PrivatBank. We forecast NPLs in the system will reduce to about 20% by year-end 2022 as write offs of legacy NPLs, fully provisioned, will outweigh asset-quality deterioration due to COVID-19 and seasoning of loans in 2021.

We expect the rehabilitation of state-owned banks will continue in line with the government's aim of reducing its ownership in the sector to 25%. It intends to do this via the sale of PrivatBank and minority stakes in Oschadbank, Ukreximbank, and Ukrgazbank. We view the International Finance Corporation's recent loan to Ukrgazbank, convertible into a stake in the bank's capital, as a step in this direction.

Key Statistics

Table 1

Ukraine Selected Indicators

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Economic indicators (%)										
Nominal GDP (bil. LC)	1,989	2,385	2,984	3,561	3,975	4,013	4,508	4,922	5,323	5,757
Nominal GDP (bil. $)	91	93	112	131	154	149	156	165	176	187

Table 1

Ukraine Selected Indicators (cont.)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
GDP per capita (000s $)	2.1	2.2	2.6	3.1	3.7	3.5	3.7	4.0	4.3	4.6
Real GDP growth	(9.8)	2.4	2.5	3.4	3.2	(4.2)	4.0	3.5	3.0	3.0
Real GDP per capita growth	(4.5)	2.8	2.9	3.9	3.8	(3.6)	4.6	4.1	3.6	3.6
Real investment growth	(9.2)	20.4	16.1	16.6	14.2	-40	40.0	15.0	10.0	10.0
Investment/GDP	15.9	21.7	19.9	18.6	12.6	5.3	9.4	11.7	13.3	14.7
Savings/GDP	21.5	19.7	16.9	13.7	9.9	9.8	8.0	9.6	10.7	11.3
Exports/GDP	52.6	49.3	48.0	45.2	41.2	38.2	37.3	36.5	35.8	34.9
Real exports growth	(13.2)	(1.8)	3.8	(1.3)	6.7	-5	4.5	3.3	3.5	3.5
Unemployment rate	9.5	9.7	9.9	9.1	8.6	10.0	10.0	9.0	8.5	8.5
External indicators (%)										
Current account balance/GDP	5.6	(2.0)	(3.1)	(4.9)	(2.7)	4.4	(1.5)	(2.1)	(2.6)	(3.3)
Current account balance/CARs	8.6	(3.2)	(5.1)	(8.5)	(4.9)	8.4	(2.9)	(4.1)	(5.1)	(6.8)
CARs/GDP	64.2	61.6	60.7	58.1	55.0	52.7	51.8	51.5	50.6	49.5
Trade balance/GDP	(3.8)	(7.4)	(8.6)	(9.7)	(9.3)	(4.2)	(7.3)	(8.2)	(8.6)	(9.1)
Net FDI/GDP	(0.4)	4.1	3.3	3.4	3.4	(0.3)	2.5	2.5	2.5	2.5
Net portfolio equity inflow/GDP	0.2	0.2	0.1	(0.0)	0.0	0.1	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	149.9	118.9	115.6	115.0	106.8	93.4	99.9	100.6	100.8	102.3
Narrow net external debt/CARs	152.2	143.1	119.2	103.5	90.8	89.7	85.6	81.1	77.4	75.8
Narrow net external debt/CAPs	166.7	138.6	113.4	95.5	86.6	97.9	83.3	77.9	73.6	71.0
Net external liabilities/CARs	65.4	60.7	47.4	34.8	32.7	23.7	26.8	30.4	34.1	39.5
Net external liabilities/CAPs	71.5	58.8	45.1	32.1	31.2	25.9	26.0	29.2	32.5	37.0
Short-term external debt by remaining maturity/CARs	75.7	42.2	36.0	34.2	27.5	31.3	32.1	31.9	30.9	31.1
Usable reserves/CAPs (months)	1.5	2.6	2.5	2.7	2.7	4.1	4.1	4.1	4.0	3.9
Usable reserves (mil. $)	12,858	15,062	18,252	20,331	24,677	28,368	29,988	31,034	32,176	32,327
Fiscal indicators (general government; %)										
Balance/GDP	(3.2)	(2.2)	(1.4)	(2.1)	(2.1)	(5.5)	(5.3)	(3.5)	(3.0)	(2.5)
Change in net debt/GDP	21.8	15.3	6.1	1.0	(4.0)	11.9	7.0	4.2	3.7	3.2
Primary balance/GDP	1.3	1.9	2.4	1.2	0.9	(2.5)	(2.2)	(0.4)	0.3	0.7

Table 1

Ukraine Selected Indicators (cont.)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue/GDP	42.4	38.5	40.3	39.8	39.5	38.0	38.5	39.5	40.0	40.0
Expenditures/GDP	45.5	40.7	41.7	41.9	41.6	43.5	43.8	43.0	43.0	42.5
Interest/revenues	10.5	10.6	9.3	8.2	7.7	7.8	8.0	8.0	8.2	7.9
Debt/GDP	79.1	81.1	71.8	60.9	50.3	62.3	62.5	61.4	60.5	59.1
Debt/revenues	186.6	210.3	178.1	153.0	127.4	164.0	162.3	155.5	151.2	147.7
Net debt/GDP	76.1	78.7	69.0	58.8	48.7	60.1	60.5	59.6	58.8	57.5
Liquid assets/GDP	3.0	2.3	2.7	2.1	1.6	2.2	2.0	1.8	1.7	1.6
Monetary indicators (%)										
CPI growth	48.7	13.9	14.4	11.0	7.9	2.7	7.7	5.5	5.0	5.0
GDP deflator growth	38.9	17.1	22.1	15.4	8.1	5.4	8.0	5.5	5.0	5.0
Exchange rate, year-end (LC/$)	24.03	27.30	28.10	27.72	23.81	28.34	29.50	30.00	30.50	31.00
Banks' claims on resident non-gov't sector growth	(2.4)	(1.6)	1.2	5.4	(9.7)	(3.0)	5.0	7.5	7.5	7.5
Banks' claims on resident non-gov't sector/GDP	52.1	42.8	34.6	30.5	24.7	23.7	22.2	21.8	21.7	21.6
Foreign currency share of claims by banks on residents	48.4	38.9	32.2	30.5	26.3	22.0	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	45.3	46.3	46.0	42.0	40.0	37.7	N/A	N/A	N/A	N/A
Real effective exchange rate growth	(6.9)	(0.5)	5.2	6.4	15.1	(1.5)	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, IMF (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 claims on 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. 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	5	Based on net general government debt (% of GDP) and general government interest expenditure (% of general government revenue) as per Selected Indicators in Table 1.
		About 60% of government debt is denominated in foreign currency.
		The banking sector's exposure to the government is about 28% of its assets.
Monetary assessment	4	The hryvnia generally floats freely with intermittent interventions from the National Bank of Ukraine (NBU).
		The NBU has enjoyed success since its independence in pursuing its inflation-targeting mandate and improving financial stability. Inflation has been converging toward the NBU's target and the trend has broadly been in line with that of its major trading partners.
		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	0	
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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Ratings History, March 10, 2021
- Sovereign Ratings List, March 10, 2021
- Sovereign Ratings Score Snapshot, March 2, 2021
- Sovereign Risk Indicators, Dec. 14, 2020. An interactive version is available at www.spratings.com/sri.
- Global Sovereign Rating Trends Midyear 2020: Outlook Bias Turns Negative As Governments Pile On Debt To Face COVID-19, July 30, 2020
- Default, Transition, and Recovery: 2019 Annual Sovereign Default And Rating Transition Study, May 18, 2020
- Sovereign Debt 2020: Emerging Market EMEA Borrowing Will Likely Inch Up 0.6% To $473.3 Billion, Feb. 20, 2020

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

Ratings Affirmed

Ukraine National Scale	uaA/--/--
Transfer & Convertibility Assessment	B
Senior Unsecured	B
Senior Unsecured	D