Research Update:

Ukraine 'B/B' Ratings Affirmed; Outlook Stable

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Overview

- It is not yet clear how recent changes to the governor and board of the National Bank of Ukraine (NBU) will affect central bank independence, monetary policy, and Ukraine's relationships with key creditors.
- However, foreign exchange (FX) reserves provide a cushion against potential adverse developments in the external financing environment.
- We are therefore affirming our 'B/B' sovereign credit ratings on Ukraine.
- The outlook is stable.

Rating Action

On Sept. 11, 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 economy from the weak external environment and the potential for a reversal of past reforms, against the country's external buffers.

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 were to backtrack on key reforms, such as ensuring the independence of the NBU, which acts as both the monetary authority and financial system regulator.

On the other hand, we could consider raising the ratings over the next year if we anticipated 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 outperform our projections.

Rationale

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

Stronger macroeconomic management since 2015 and augmented 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).

Institutional and economic profile: The preservation of previously implemented reforms will be critical to maintaining access to official and commercial creditors amid external uncertainties

- Ukraine's economy will contract by 6% in 2020 before staging a domestic demand-led recovery in 2021.
- Although Ukraine does not face imminent external funding pressures, a prolonged discord with its official creditors could restrict access to commercial financing at reasonable rates.
- The NBU's ability to act in accordance with its price stability mandate, despite political pressures and as inflationary pressures build, will be an important signal of its continuing independence.

We expect Ukraine's real GDP to contract by 6% in 2020 after authorities imposed stringent containment measures in March, closing down large parts of the economy to limit the spread of infection. Domestic demand has since rebounded with the easing of restrictions and will be the main driver of the economic recovery through 2021. While industrial and agricultural production continued throughout the lockdown, smaller businesses and employees in the informal sector appear to have borne the brunt of the fallout so far.

The NBU has moved to an accommodative monetary policy stance to support the economy, cutting the key policy rate by a cumulative 750 basis points this year. Moreover, the government announced a Ukrainian hryvnia (UAH) 65 billion fund (1.5% of GDP) to limit the economic impact of the COVID-19 pandemic by increasing spending on health care and unemployment benefits. When expenditure on health proved lower than targeted, the government diverted part of the fund toward road infrastructure. Other fiscal measures include various tax exemptions, pension hikes, wage increases for medical personnel, a furlough scheme, and higher social benefits.

Half of 2020's sizable budgetary gap will be financed by concessional borrowing from IFIs. This includes assistance from the EU and the World Bank, and disbursements under an 18-month, $5 billion International Monetary Fund (IMF) program, which is Ukraine's fifth in the past 10 years.

Unlike some previous IMF programs, the conditions associated with disbursements from the current arrangement are relatively light. However, any reversal of previously implemented reforms is likely to endanger relations with the IMF, and possibly other creditors.

In this context, we note the resignation of former NBU governor, Yakiv Smoliy, citing political pressures, and subsequent personnel changes to the NBU board. These events raise questions regarding the potential impairment of the central bank's independent judgement. The independence of the NBU, and its success in taming double-digit inflation, dismantling capital controls, and restoring financial stability, have been key achievements of Ukraine's reforms over the past half-decade.

How the NBU will balance political demands for low interest rates and a weaker hryvnia as inflationary pressures--currently muted--build will send an important signal to Ukraine's creditors. Bigger concerns would be raised if we saw amendments to the law governing the NBU or a change in the NBU's stance on Privatbank (the country's largest lender, which was nationalized in 2016). However, we do not view either of these scenarios as likely.

The government does not face immediate funding pressures. It retains access to local and international markets and has received disbursements from some of the concessional loans available to it over the past few months. However, a prolonged discord with its official creditors could have a knock-on effect on its access to commercial markets at reasonable rates. A recent constitutional court ruling regarding the 2015 appointment of the head of the National Anti-Corruption Bureau could therefore be of concern. That said, Ukrainian authorities have managed to circumnavigate such challenges previously, by tightening legislative loopholes.

Flexibility and performance profile: Government external debt issuance, engagement with IFIs, and favorable current account dynamics have continued to support FX reserves through 2020

- We expect a sharp, short-term, COVID-19-related deterioration in Ukraine's fiscal balance to result in a long-term increase in the government's debt burden.
- Import compression, continued external demand for Ukraine's agricultural 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.

After several years of contained fiscal deficits and declining government debt-to-GDP, Ukraine's budgetary gap will widen to 7.5% of GDP in 2020 from 2.1% in 2019 owing to the COVID-19 policy response and revenue losses. About half of the shortfall will be met via concessional borrowing from IFIs and the remainder will be met through local and international commercial debt issuance.

Discretionary measures to narrow the deficit have not been spelled out, but we believe the underlying economic recovery will aid the process. A proposed 30% hike in the minimum wage in 2021, following a 6% increase this year, would slow the pace of consolidation.

Although fiscal balances will gradually recover, we project that the pandemic will have a longer-lasting impact on the government debt burden. Net general government debt will remain elevated for the next three years, peaking at 66% of GDP in 2021. This compares with a ratio just below 50% at the end of 2019. Given that nearly 60% of government debt is FX-denominated, the forecast is sensitive to exchange rate developments.

Nonresidents' holdings of hryvnia-denominated government bonds (excluding NBU holdings) have reduced to 20% of total local-currency government debt, from a peak of nearly a third in February this year. Relative to 2019 and 2020, the government faces a lighter FX-denominated amortization schedule in 2021, totaling $5.5 billion (nearly 4% of GDP). Of this, we expect nearly $3 billion of domestically issued FX bonds, mostly held by domestic banks, to be fully rolled over.

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 has been running a record current account surplus, which we attribute 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 a fifth of the export basket); and favorable terms of trade. Demand for agricultural exports held up, although production was affected by the late start of the harvest in some areas.

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.

In our view, Ukraine has strengthened its external buffers against balance-of-payment risks. The NBU's FX reserves have been increasing since 2015, via borrowings and outright FX purchases. FX reserves stood at $29 billion at the end of August. Moreover, the proportion of the central bank's own reserves has increased to about 60% of overall FX reserves, from about 45% in 2015. We project that the NBU's FX reserves (net of the reserves commercial banks are required to maintain with it against their FX liabilities) will cover about four months of current account payments on average through 2023. The central bank intervenes to avoid excessive volatility and to augment reserves. So far in 2020, the NBU has made net FX purchases of $1.2 billion, despite some sales in March and July to stabilize the hryvnia.

Ever 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 and toward its target and has dismantled numerous capital controls. The NBU has also pushed through reforms to strengthen financial stability, in its role as a supervisor.

At 49%, banks' nonperforming loans (NPLs) remain high, but are almost fully provisioned. Nearly half of the system's NPLs are held by the four state-owned banks: Oschadbank, Ukreximbank, Ukrgasbank, and PrivatBank. In particular, PrivatBank's NPLs amount to nearly 80% of its loan portfolio because of legacy related-party lending before it was nationalized. We anticipate that there will be some deterioration in asset quality over the next year, especially in consumer loans.

The government's strategy for these state-owned banks includes the appointment of independent supervisory boards, and a gradual clean-up and eventual part-privatization of at least Oschadbank and PrivatBank. With reforms at all four state-owned banks progressing--albeit more slowly at Ukreximbank and Oschadbank--we do not expect any of them to need additional recapitalization from the central government during the next year.

Key Statistics

Table 1

Ukraine Selected Indicators

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Economic indicators (%)										
Nominal GDP (bil. UAH)	1,587	1,989	2,385	2,984	3,561	3,975	3,848	4,250	4,597	4,971
Nominal GDP (bil. $)	132	91	93	112	131	154	146	144	152	162

Table 1

Ukraine Selected Indicators (cont.)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
GDP per capita (000s $)	2.9	2.1	2.2	2.6	3.1	3.7	3.5	3.5	3.7	3.9
Real GDP growth	(6.6)	(9.8)	2.4	2.5	3.4	3.2	-6	4.0	3.0	3.0
Real GDP per capita growth	(6.3)	(4.5)	2.8	2.9	3.9	3.8	(5.4)	4.5	3.5	3.5
Real investment growth	(24.0)	(9.2)	20.4	16.1	16.6	14.2	-15	10.0	6.0	6.0
Investment/GDP	13.4	15.9	21.7	19.9	18.6	12.6	8.9	10.0	10.7	11.4
Savings/GDP	9.9	21.5	19.7	16.8	13.6	9.9	13.0	7.9	7.6	7.7
Exports/GDP	48.6	52.6	49.3	48.0	45.2	41.2	39.4	39.5	38.9	38.3
Real exports growth	(14.2)	(13.2)	(1.8)	3.8	(1.3)	6.7	(4.5)	4.5	3.3	3.5
Unemployment rate	9.7	9.5	9.7	9.9	9.1	8.6	10.5	10.0	9.0	8.5
External indicators (%)										
Current account balance/GDP	(3.5)	5.6	(2.0)	(3.1)	(4.9)	(2.7)	4.2	(2.2)	(3.2)	(3.7)
Current account balance/CARs	(6.2)	8.6	(3.2)	(5.2)	(8.5)	(5.0)	7.5	(4.0)	(5.9)	(7.0)
CARs/GDP	56.3	64.2	61.6	60.6	58.1	54.9	55.1	53.6	53.6	52.7
Trade balance/GDP	(5.4)	(3.8)	(7.4)	(8.6)	(9.7)	(9.3)	(5.2)	(8.0)	(9.6)	(9.8)
Net FDI/GDP	0.2	(0.4)	4.1	3.3	3.4	3.4	-2	2.5	2.5	2.5
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	161.3	146.9	137.2	133.0	123.5	112.0	115.8	115.6	114.8
Narrow net external debt/CARs	135.7	152.2	143.1	119.3	103.6	90.9	95.5	98.3	94.1	91.9
Narrow net external debt/CAPs	127.8	166.7	138.6	113.4	95.5	86.6	103.3	94.5	88.8	85.9
Net external liabilities/CARs	67.2	65.4	60.7	47.4	34.8	32.8	30.6	35.8	39.7	45.0
Net external liabilities/CAPs	63.3	71.5	58.8	45.1	32.1	31.2	33.1	34.4	37.5	42.0
Short-term external debt by remaining maturity/CARs	85.0	88.5	76.5	62.3	56.4	48.2	54.0	56.6	54.0	52.4
Usable reserves/CAPs (months)	2.7	1.5	2.6	2.5	2.7	2.7	4.0	4.5	4.3	4.3
Usable reserves (mil. $)	6,698	12,858	15,062	18,252	20,331	24,677	29,912	31,189	33,023	33,901
Fiscal indicators (general government; %)										
Balance/GDP	(10.3)	(3.2)	(2.2)	(1.4)	(2.1)	(2.1)	(7.5)	(5.3)	(3.0)	(2.5)
Change in net debt/GDP	31.8	21.8	15.3	6.1	1.0	(4.0)	14.8	6.8	3.7	3.2
Primary balance/GDP	(7.0)	1.3	1.9	2.4	1.2	0.9	(4.8)	(2.3)	0.1	0.6

Table 1

Ukraine Selected Indicators (cont.)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue/GDP	40.5	42.4	38.5	40.3	39.8	39.5	37.0	38.5	39.5	40.0
Expenditures/GDP	50.7	45.5	40.7	41.7	41.9	41.6	44.5	43.8	42.5	42.5
Interest/revenues	8.2	10.5	10.6	9.3	8.2	7.7	7.3	7.8	7.9	7.7
Debt/GDP	69.4	79.1	81.1	71.8	60.9	50.3	66.7	67.3	65.9	64.2
Debt/revenues	171.5	186.6	210.3	178.1	153.0	127.4	180.4	174.7	166.9	160.5
Net debt/GDP	68.1	76.1	78.7	69.0	58.8	48.7	65.1	65.8	64.6	62.9
Liquid assets/GDP	1.3	3.0	2.3	2.7	2.1	1.6	1.6	1.5	1.4	1.3
Monetary indicators (%)										
CPI growth	12.1	48.7	13.9	14.4	11.0	7.9	3.0	6.0	5.0	5.0
GDP deflator growth	15.9	38.9	17.1	22.1	15.4	8.1	3.0	6.2	5.0	5.0
Exchange rate, year-end (UAH/$)	15.82	24.03	27.30	28.10	27.72	23.81	29.00	30.00	30.50	31.00
Banks' claims on resident non-gov't sector growth	11.8	(2.4)	(1.6)	1.2	5.4	(9.7)	0.0	5.0	7.5	7.5
Banks' claims on resident non-gov't sector/GDP	66.9	52.1	42.8	34.6	30.5	24.7	25.5	24.3	24.1	24.0
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
Real effective exchange rate growth	(21.7)	(6.9)	(0.5)	5.2	6.4	15.1	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 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. UAH--Ukrainian hryvnia. 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 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 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. NBU--National Bank of Ukraine.

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 List, Sept. 3, 2020
- Sovereign Ratings History, Sept. 3, 2020
- Global Sovereign Rating Trends Midyear 2020: Outlook Bias Turns Negative As Governments Pile On Debt To Face COVID-19, July 30, 2020
- Sovereign Risk Indicators, July 14, 2020. An interactive version is also available at http://www.spratings.com/sri
- 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

Rating Withdrawn

	To	From
Ukraine		
Senior Unsecured	NR	D

Ratings Affirmed

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