Ukraine

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS 29 September 2014

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The economic downturn has been more severe than expected. This has worsened government finances, raised the government debt trajectory and led to a plunge in foreign exchange reserves. Access to external financing is key to the country's credit standing and more financing is likely to be required.

Country Risk Analysis

Summary

The dire security situation and political uncertainty are the main factors increasing Ukraine's country risk. Other negatives include weak external balances with dwindling foreign reserves as well as a poor business environment and weak governance indicators. Ukraine's country risk is limited mainly by its relatively high level of development and its open and commodity rich economy providing good export potential. The new IMF programme and EU's free-trade benefits offered this year add to these strengths.

A much worse than expected environment has pushed the Ukrainian economy deeper into recession, worsened government finances, put upward pressure on the government debt trajectory and lead to a reduction in foreign exchange reserves. The exchange rate has depreciated more than 60 percent against the US dollar in 2014. The economy is now expected to contract by at least 7% this year. While weaker domestic demand and the depreciated currency have contributed to shrinking the current account deficit, pressures on the capital account remain.

Access to external financing remains key to the country's short and medium-term liquidity position and to the country's risk class. Ukraine has a roughly USD 12 bn in interest rate and amortizations falling due through the end of 2015. Hence, the government's continued adherence to the IMF programme after the election is imperative. Even if disbursements from the IMF and other international financial institutions are made according to schedule servicing sovereign debt can be a challenge. Debt restructuring both in the public and private sector is a non-negligible risk. Alternatively, Ukraine may have to tap bond markets for additional capital or external aid from the IMF or EU may have to be increased.

Ukraine: Key country risk factors

Strengths
Support from IMF programme
Well educated labour force
Strong commodity based export potential
High level of GDP per capita

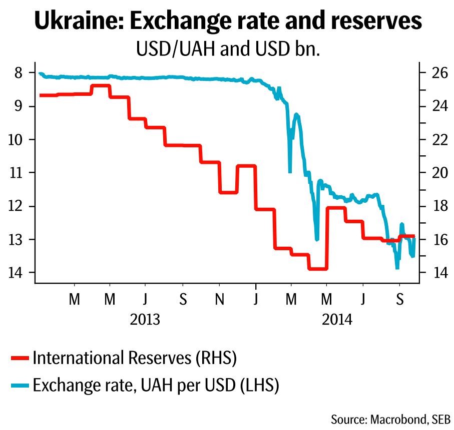
Weaknesses
External finances
Government finances
Political instability, weak governance indicators
Regional security situation

Recent economic developments

Ukraine signed a new Stand-By Arrangement with the IMF in April. The arrangement runs over 2 years and offers in total USD 17 bn of financing. USD 3.2 bn was disbursed when the agreement was signed and an additional USD 1.4 bn in late August. The next disbursement of USD 2.8 bn. is scheduled for December. The EU has granted Ukraine a unilateral free-trade agreement and the respective parliaments have agreed to implement a full bilateral agreement by end-2015.

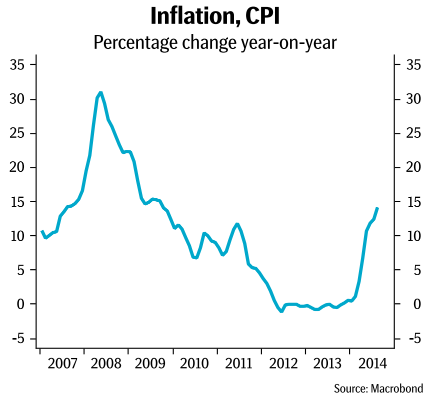
Steeper than expected recession: Real GDP fell by 4.6% yoy in the second quarter of 2014, excluding the impact of the loss of Crimea and Sevastopol (3% of GDP in 2012) on the statistics. High economic and political uncertainty weighed on investments while declining incomes added further headwinds to households' consumption. Moreover, the freeze of activity in the East has reduced Ukraine's export supply. The IMF programme assumes a contraction of 6.5% this year. SEB expects a more severe slowdown of 8% and zero growth in 2015.

Falling currency, but far from free float regime: The central bank announced in March that it would let the currency float. Since then the exchange rate has depreciated 60 percent against the US dollar. The fall comes despite that the central bank has taken several measures, both interest rate hikes and administrative measures, to contain the depreciation of the hryvnia. For example, in August, the central bank required that exporters surrender 100% of foreign-currency export proceeds. Such measures highlight transfer and convertibility risks. Over time, the central bank plans to adopt a formal inflation targeting framework.



The significant depreciation has fed through to consumer prices. Increases in regulated prices have amplified inflation impulses from the currency weakness and pushed CPI inflation to more than 14% in yoy terms in August.

External finances a major weakness in the country risk profile. Weak domestic demand and currency depreciation has led to imports contracting significantly more than exports. This has contributed to a fall in the current account deficit from 9% at end-2013 to an expected 2-3% in 2014. Capital outflows were significant in the first quarter of 2014 but turned to an inflow of USD 0.65 bn. in the second quarter. Gross international reserves have fallen dramatically to USD 16.1 billion, equal to 2.4 months of import cover, in August 2014.



Ukraine has about USD 12 bn of principal and interest payments coming due through the end of 2015, according to Bloomberg. A significant portion of the payments relate to debt owed to the IMF. The USD 3 bn bond repayment to Russia is due in December 2015, although Russia has the right, according to the bond documentation, to demand early repayment. Even if disbursements from the IMF and other international financial institutions come on stream as projected, which is not certain given the uncertain geopolitical environment, servicing sovereign debt may be a challenge.

It is likely that Ukraine will either have to tap bond markets for additional capital or that assistance from international financial institutions will have to be expanded. Global support for additional financial assistance is probably more easily gathered than has been the case relating to agreeing on sanctions on Russia. Further on liquidity, another uncertainty in the near-term relates to Ukraine's energy bill. The country owes Russia's Gazprom over USD 5 bn and the gas company has cut off supply to Ukraine in response to unpaid bills. It is expected that a repayment plan for the debt is negotiated in the near-term, but unclear how much of a burden this will be for the economy.

Solvency may indeed be strained in the medium-term as government debt as a share of GDP will rise at least through 2015 (see below). Hence, debt restructuring is yet another possibility. If the government would want to restructure their debt, they would have a good excuse for it. Some also believe that Ukraine would be a good testing case for the IMF's new re-profiling policy being discussed in light of the poor experience in Greece.

Weak government finances are adding to external pressure and concern over sustainability. The ongoing conflict has put increased pressure on government finances. Tax revenues from the east have been lower than expected while support to the banking sector has been higher. Authorities expect the general government budget deficit to rise from 4.8% to 5.8% this year, or to 10.1% if shortfalls from the oil company Naftogaz is included. For 2015 and 2016, the government has had to agree with the IMF on lower than previously planned deficits. These targets appear to be on the optimistic side. Like most forecasts they build on the assumption that the conflict with Russia will subside in the coming months, and it builds on a relatively limited contraction in GDP. Larger fiscal imbalances will lead to a continued rise in government debt. According to the IMF's August analysis, total debt will peak just above 70% of GDP in 2015, up from about 40% in 2013, but still meet the Fund's sustainability requirements.

The situation for the domestic banks has deteriorated sharply: The state of the banking sector has deteriorated along with the domestic macroeconomic situation in general and the weaker currency in particular. Deposit outflows were dramatic in early 2014 but have since then stabilised somewhat. However, FX-denominated deposits continue to shrink. Around fifteen banks have failed since the beginning of the year and are in the process of being resolved. The remaining banks report average capital adequacy ratios of nearly 16% as of end June but there are reports that regulatory ratios are upheld partly due to significant regulatory forbearance in terms of recognising asset quality problems. The share of non-performing loans rose to nearly 15% in June. In the IMF's base scenario, the ratio will rise to 21.5% by end-2016.

A stress testing by external auditors of the 15 largest banks was concluded in August and revealed that nine of the banks needed to increase their capital. Stress testing of an additional 20 banks will be finalised by the end of October. The IMF projected in July that public sector resources of nearly 3% of GDP will have to be allocated to bank restructuring during 2014-2015. As the currency has depreciated more than assumed in the IMF programme, there is a high probability that the government will have to provide even larger capital injections into the system.

Elections to produce more EU-oriented parliament: President Poroshenko has dissolved parliament and elections are called to take place on October 26. Despite its dissolution the parliament will remain operational until then. Recent polls indicate that the president's Solidarity party will win at least a fifth of the votes but not a majority and thus will need to form a ruling coalition. This being said, it is still not clear exactly who will run for the respective parties. Most analysts agree, however, that the change in government will not be significant, but that parliament will be markedly more EU-oriented and. All leading parties have signalled their support for the authorities' IMF-supported economic programme.

While a new parliamentary situation is likely to lead to a favourable change in balance in politics, Ukraine's oligarchs appear stronger than ever. This is happening despite the condemnation of the corrupt oligarchy during the Maidan protests and despite the fact that the business empires of the oligarchs are doing poorly. One reason is that the security situation has led to calls for stability first and reforms second. Here the oligarchs are playing a significant role in their respective geographies. Going forward, this may leave them in a good negotiating position for continued influence after the security situation calms.

Structural features

Unsustainable economic model: Judging solely by GDP per capita, Ukraine at USD 3882 would be rated in the lower investment grade category. In addition, while agriculture still accounts for a large share of GDP, the economy is relatively diversified. Manufacturing exports account for nearly half of all exports. With such an economic structure and significant natural resources Ukraine should be able to benefit from growth in both emerging markets and more developed economies.

However, weak governance and poor economic policy making have caused the country to jump from one crisis to the next. Ukraine's economic model has built on the maintenance of a fixed exchange rate accompanied by loose fiscal policy and large quasi-fiscal losses ultimately covered by the budget. This has resulted in an overvalued exchange rate, large twin deficits, a constant rise in indebtedness and recurrent difficulties with external financing. Furthermore, it has created rapid real wage growth which resulted in a rising share of household consumption at the expense of net exports.

Corruption remains deeply rooted: On governance, legal procedures are still much the same as under the former president Yanukovych. In the parliament, for example, laws are being passed without discussion or opportunity for commentary, coming into force the same day they are decided on. This is reflected in very poor scores in the World Bank's governance indicators. It has a particularly bad track record in fighting corruption, scoring only marginally better than, for example, Russia and Pakistan while "government effectiveness" is barely stronger than Bangladesh. It scores 25 on Transparency International's corruption perception index compared to the average score of emerging market economies of 37.3. This places Ukraine on 144th place out of 175 countries.

Ease of doing business ranking of 189 countries

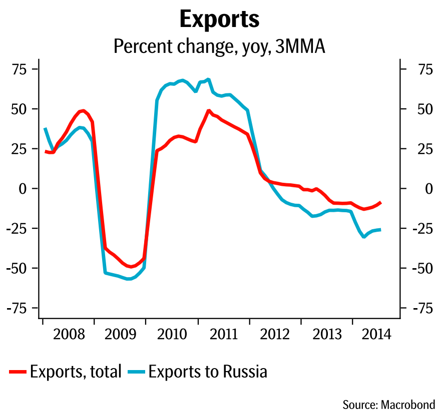
	2014
Ukraine	112
Uganda	132
Albania	90
Russia	92
Libya	187

Source: World Bank, 2014

The business climate as measured by the World Bank's Doing business index has improved over the past year but remains a drag on the country's risk class. Ukraine advanced to 112th place out of 189 countries, with peers Uganda at 132 and Albania in 90. Similarly, Ukraine advanced slightly in ranking in the World Economic Forum's competitiveness index.

Outlook

The central bank recently cautioned that the GDP contraction could be as large as 10% this year. Domestic demand will be depressed by government spending cuts and a war-related tax increase. Nevertheless, economic activity is expected to bottom-out in early 2015 when the depreciated exchange rate and the EU trade deal should contribute to an export-led recovery as supply constraints start to ease. A weakening Russian economy and a more tepid than expected recovery in the euro area, both regions being recipients of one quarter of Ukraine's exports, would naturally delay such a recovery. Inflation is expected to continue rising through 2014 to perhaps as much as 20% by year-end but decline in 2015. The current account deficit should decline to 2%–4% of GDP in 2014 and 2015 as domestic demand remains muted.

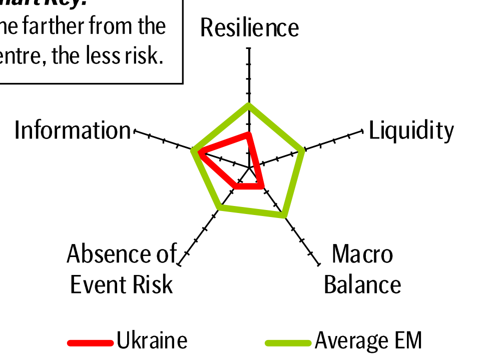


Developments in the conflict in the East are key for Ukraine's credit fundamentals. Ukraine's passing of a bill for "special status" for Donbas and recent agreements on a buffer zone are likely to support the current ceasefire through the parliamentary elections in late October. What is likely going forward is that Ukraine will not be able to secure a military victory in the East. It is also likely that the longer-term aims of Poroshenko and Putin are fundamentally at odds with each other. In addition, Poroshenko will have to contend with radical domestic forces that are less willing to negotiate with Putin while Putting could feel hamstrung by a nationalistic sentiment in the Russian population. Several observers argue that this indicates that the situation in the East will develop into another "frozen conflict". Any future settlement in the ongoing conflict would need to include that Russia accepts Ukraine's European choice, and specifically its association with the EU. NATO membership for Ukraine, by contrast, is more out of reach. Ukraine will probably not become a formal federation, but would need to allow a significant degree of decentralization, including in economic, financial and linguistic issues.

Ukraine: Risk Profile

Key ratios	**2014**
Population (Mn)	45.5
GDP/capita (US$)	2 942
Real GDP (% chg)	-8.0
Inflation (%)	11.0
Current Account (% of GDP)	-4
Reserves/imports (months)	3
Budget balance (% of GDP)	-5.8
Government debt (% of GDP)	68

Chart Key: The farther from the centre, the less risk.



External Ratings:
Fitch: CCC
Moody's: Caa3 / Neg.
S&P: CCC

Peers:
Albania
Angola
Libya
Uganda

Graph: Ukraine shows no particular strengths but is generally weaker than the average emerging market country as illustrated by the red solid line falling uniformly inside the green one.

Source: OEF (Oxford Economic Forecasting), IMF and SEB estimates

Ukraine: Key Economic Indicators

	2010	2011	2012	2013	2014	2015	2016	2017
Macroeconomic								
GDP (% chg)	4.1%	5.2%	0.2%	0.1%	-8.0%	0.0%	2.0%	5.3%
GDP (US$ bn)	136	163	177	182	132	130	142	156
GDP/capita (US$)	2 962	3 571	3 882	4 026	2 942	2 913	3 191	3 542
Investments/GDP	15%	16%	16%	15%	13%	14%	15%	15%
Trade/GDP (%)	104%	97%	87%	79%	101%	109%	109%	107%
Money & Prices								
CPI inflation (%)	9.4%	8.0%	0.6%	-0.3%	11.0%	10.0%	6.0%	5.0%
Money supply, M2 (% chg)	24%	15%	13%	18%	4%	11%	10%	11%
Interest rates	8%	8%	8%	7%	8%	8%	8%	8%
Government Finances								
Budget balance/GDP	-5.8%	-2.8%	-4.6%	-5.9%	-5.8%	-3.9%	-2.7%	-2.4%
Govt debt/GDP	41%	37%	37%	42%	68%	74%	71%	67%
Balance of Payments (USD bn)								
Current account	-3.0	-10.2	-14.3	-16.4	-5.3	-2.8	-3.4	-4.8
as % of GDP	-2.2%	-6.3%	-8.1%	-9.0%	-4.0%	-2.1%	-2.4%	-3.1%
Export of goods	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Imports of goods	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other CA flows, net	-3	-10	-14	-16	-5	-3	-3	-5
FDI, net	5.8	7.0	6.6	6.8	5.0	4.9	5.3	5.9
Loan repayments	23.5	24.1	24.6	26.3	25.0	23.8	23.2	23.3
Other capital flows, net	-18	-24	-25	-21	-25	-24	-22	-21
Chg in intl reserves	7.8	-2.9	-7.7	-3.9	-0.7	1.7	3.0	3.3
External Debt & Liquidity (USD bn)								
Total debt	125	135	135	142	146	149	151	155
o/w short term debt	27.3	32.7	34.8	38.5	41.8	42.4	43.2	44.3
Reserves	33	30	23	19	18	20	23	26
Exchange rate vs USD	7.9	8.0	8.0	8.0	11.5	12.9	13.1	13.1
Oil price (Brent)	$112	$109	$107	$103	$106	$109	$113	$117

Source: OEF (Oxford Economic Forecasting), IMF and SEB estimates

Rating history				
Fitch (eoy)	B	B	B	B-
Moody's (eoy)	B2	B2	B3	Caa1
S&P (eoy)	B+	B+	B3	B-

Type of government: **Democracy**

Next elections: Legislative elections 2014

Other:

Latest PC deal: Rescheduled debt 1994 and 1995. 2006 agreement to prepay this debt 06-11.

Latest IMF arrangements: 24 month Stand-By Arrangement agreed in May 2014

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