

Ukraine

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Higher foreign reserves and lower financing needs following the debt restructuring in 2015 have reduced external vulnerability. In addition, there has been a very gradual improvement in several key macro indicators. Significant risks loom over the economy, including a faltering commitment to the economic reform programme and an escalation of the conflict in the East.

Country Risk Analysis

Summary

The long delayed decision from the IMF to release a USD 1 bn loan tranche in late September was not as much of a boost of liquidity as it was a boost of comfort to those having doubts about the direction of the Ukrainian economy. Following drawn-out political bickering during the spring, one of the reasons for the delay, some stabilisation of the political situation has followed. Fulfilment of the IMF programme remains a key assumption underlying our view on country risk. Ukraine's track record in this respect is weak. While there is an explicit, strong commitment to the economic programme from the government much uncertainty remains. With a very fragile majority in parliament, the pace of reform going ahead is expected to be very piecemeal and political set-backs should be expected. Nevertheless, the country has come a long way since the revolution. Helped by a relatively strong civil society and press, it is not likely to fall back to square one.

The economy has continued to stabilise. Following a GDP contraction of nearly 10% last year, growth should pick up to about 1% this year. Inflation has come down and despite an expected rise in the second half of 2016 there is even a risk that the central bank might undershoot the 8% inflation target for 2017. Government finances ended last year on a more positive note than expected although government debt has been rising rapidly.

The current account was roughly in balance by the end of 2015 but is likely to show small deficits in the near term as exports fail to pick up. Financing of the deficit will come through external credits and FDI which have started to recover from low levels. The improved external position has allowed the authorities to start easing FX market restrictions.

All major credit rating agencies upgraded Ukraine's sovereign rating in late 2015 following the agreement with holders of the country's Eurobonds.

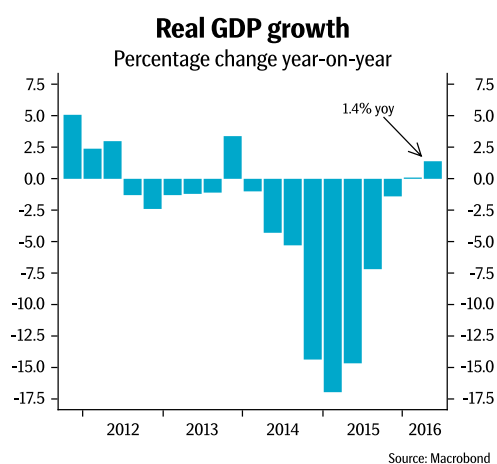
Recent economic developments

Delayed IMF disbursement finally is made. With economic reforms progressing slower than planned, disbursements under Ukraine's USD 17.5 bn IMF programme had been put on hold. However, following a positive assessment by the IMF's Board in mid-September USD 1 bn was finally made accessible to Ukraine, making the total amount disbursed so far just above USD 7 bn. The disbursement should unlock loan guarantees from the US as well as EU and other complementary funds which are necessary to fill the government's financing gap.

The country's financing needs eased significantly following the Eurobond restructuring in 2015 which postponed about USD 11.5 bn in principal payments falling due in 2015-2019. This makes it unlikely that any new restructuring would happen before 2020. Still, as the hair-cut taken by bond holders was relatively small (about 20%), Ukraine's debt woes cannot be regarded as completely cured. Fulfilment of the IMF programme remains a key assumption underlying our view on country risk. The government's commitment to the programme appears strong although we do envisage political setbacks on the way.

Economic activity has recovered.

Following a contraction in real GDP of 9.9% in 2015, the economy is on a recovery trend. Actually, growth rates started improving in the second quarter of 2015. Growth is not export led as would normally be expected following a sharp depreciation of the exchange rate. A permanent loss of demand from Russia and a contraction of production in the East are important restraining factors. Instead growth is domestically driven. Real wage growth has picked up recently although low household incomes and poor sentiment are producing only a gradual recovery in household spending.



Inflation has come down. The surge in inflation following the plunging exchange rate and removal of energy subsidies pushed average inflation to nearly 50% in 2015. This surge is now over and inflation has come down to around 8% helped also by lower food prices. The continued deregulation of utility prices is expected to boost inflation in the coming months which should lift the average inflation rate this year well into double digit territory again.

Improved external position. The balance of payments situation continued to improve in 2015 with the current account ending the year roughly in balance. In early 2016, the deficit has grown slightly again on the back of a poor export performance. International reserves have been boosted, initially largely by IMF borrowing, but subsequently by a reasonably healthy balance of payments. Gross international reserves have surpassed USD 14 bn, up from 13.3 bn at the end of last year. The accumulation of reserves has been slower than projected under the programme but faster than we expected a year ago. The increase and the lower

financing needs following the debt restructuring have reduced external vulnerability.

Financing of the deficit in the near-term should not pose any serious challenge. IMF funds are being complemented by inter-governmental loans while foreign direct investment (FDI) also recovered during 2015. We note however that FDI flows are still lower than their historical average. Finally on this point, the improved external accounts have allowed the rolling-back of some of the capital controls and administrative measures that were imposed during the exchange rate turbulence. Most observers expect that these restrictions will be fully eliminated in the next few months.

Economic policies

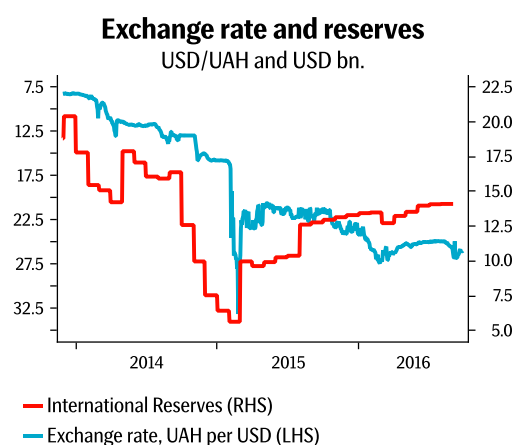
Fiscal policy roughly in line with IMF programme. Despite some improvements last year, the fiscal situation remains relatively dire. The economic contraction, the loss of tax revenues from the Eastern parts of the country and the depreciation of the currency has put pressures on government finances. Nevertheless, the budget posted a smaller than expected deficit of 1.7% of GDP in 2015. This was an improvement compared to the average deficit of more than 4% of GDP in the previous five years. The budget for 2016 targets a deficit of 3.7% of GDP which most observers feel has become a challenge to reach. Furthermore, the government recently presented its 2017 budget which aims at a 3% headline deficit assuming (slightly optimistically) a 3% GDP expansion.

Government debt has been rising rapidly. The recession combined with the exchange rate depreciation and large financing needs in the state owned companies have produced a rapid rise in government debt. At about 80% of GDP it has roughly doubled since end- 2013. Although this is less than projected by the IMF, it is a high level for a low-income country. The authorities target a ratio of 71% in 2020. However, in the near-term, debt is expected to continue rising.

Public sector external debt has risen in the past couple of years following IMF payments. Consequently, despite significant deleveraging among private corporations and banks, the country's overall external debt has risen as a share of GDP to around 140%.

Monetary easing continues. Taming inflation is the National Bank of Ukraine's (NBU) top priority. The target is 12% (+-3%) for 2016 and 8% for 2017. The gradual drop in inflation in the past year has allowed the bank to cut interest rates in several steps to 15%, down from 22% in April this year. Further cuts are expected as real interest rates are still relatively high.

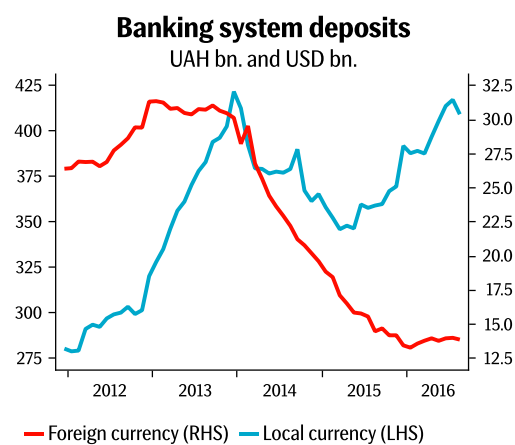
While inflation targeting is the top policy priority, the NBU is also committed under the IMF



programme to accumulate foreign reserves. As noted, reserves have increased in the past year bolstering somewhat the Bank's credibility and reducing the economy's external vulnerability.

Banking sector is still very vulnerable. Following the deepest banking crisis since independence in 2014-2015, the resilience of the sector is now gradually improving. Deleveraging is progressing and liquidity is rising. Improved confidence in the sector is reflected in rising deposits. This being said, the improvement comes from an extremely poor level. Hence, the banking system remains very vulnerable.

The quality of banks' loan portfolios were at a historical low in 2015 and non-performing loans in the sector was still close to 50% of total loans in March 2016 by some standards. Provisioning may be inadequate and, although many banks have been recapitalised following stress tests, the sector's average regulatory capital is low. Furthermore, bank lending is still very weak as high corporate indebtedness and questionable solvency of many business sectors weigh on both supply and demand for credit.



Political situation

Some stabilisation following a turbulent spring. Following a long period of more turbulence than usual in the political arena, a new coalition government was formed in April. The coalition is headed by President Poroshenko's close ally and new Prime Minister Groysman who succeeded Mr Yatsenyuk. While the reshuffling helped to avoid new elections and did stabilise the political situation, political risk remains high. The new coalition is fragile and holding just one seat more than required for a ruling majority in parliament.

Outlook

Growth to gradually gain pace. The very gradual economic recovery should lift GDP by about 1% this year. This is in line with government expectations. Consensus expectations for GDP growth in 2017 have recently been hiked. However, medium-term growth is expected to be subdued given productivity constraints from public sector inefficiencies, poor infrastructure and low investment.

External accounts to turn slightly negative. The exchange rate depreciation is not likely to lead to any near-term export-led recovery. Headwinds in the form of trade curbs from Russia and indirect Brexit effects are likely to be complemented by domestic supply constraints. Consequently, we expect the current account to swing into a deficit in 2016 and remain there in the medium-term barring any surprises in the form of weaker imports.

Failure to keep IMF programme on track is a key risk. The very incremental pace of reforms has barely kept the IMF programme on track and many challenging

conditions still remains to be fulfilled. For example, corruption remains rampant and long neglected problems such as the inefficient pension system needs to be tackled. There is a clear risk that reform implementation will slow after 2017 as coalition divisions become increasingly apparent and the opposition regroup. Hence, there is a risk that there will be more delays in the flow of external support. Still, external political support for Ukraine remains strong. This implies that funding from the IMF and EU is quite likely to be forthcoming in the medium-term despite possible small deviations from the agreed Fund programme.

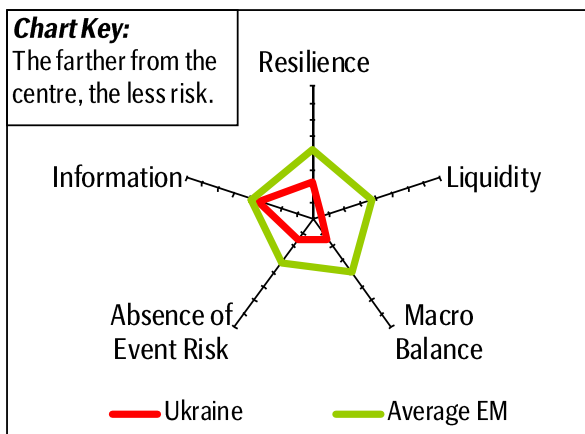
In an alternative scenario, it may turn out that challenges could prove too demanding for Ukraine, forcing it to abandon the IMF programme as it did with Fund programmes in 2002, 2009 and 2013. An interrupted IMF programme would mean losing an important economic policy anchor, deter foreign investment and produce a rise in country risk.

Stepped up military conflict is another downside risk. An underlying assumption to our overall risk assessment is that the military conflict in the eastern regions does not escalate and that it subsides in the medium term to what most observers view as a “frozen” conflict. Here lies a significant downside risk. Should the military conflict spread or intensify it would risk dampening sentiment and delaying any recovery in industrial production and exports.

Ukraine: Risk Profile

Key ratios

	2016
Population (Mn)	44.6
GDP/capita (USD)	2 013
Real GDP (% chg)	1.1
Inflation (%)	16.0
Current Account (% of GDP)	-1.6
Reserves/imports (months)	4
Budget balance (% of GDP)	-3.9
Government debt (% of GDP)	93



External Ratings:

Fitch: CCC
Moody's: Caa3
S&P: B-

Peers:

Albania
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.

Ukraine: Key Economic Indicators

	2012	2013	2014	2015	2016	2017	2018	2019
Macroeconomic								
GDP (% chg)	0.2%	0.0%	-6.6%	-9.9%	1.1%	2.5%	3.0%	3.0%
GDP (USD bn)	176	183	134	91	90	95	101	109
GDP/capita (USD)	3 879	4 060	2 967	2 022	2 013	2 133	2 290	2 480
Investments/GDP	18%	17%	14%	14%	14%	15%	15%	15%
Trade/GDP (%)	83%	75%	83%	99%	101%	100%	98%	96%
Money & Prices								
CPI inflation (%)	0.6%	-0.3%	12.2%	48.7%	16.0%	9.0%	8.0%	7.5%
Money supply, M2 (% chg)	30%	34%	24%	10%	20%	29%	24%	21%
Interest rates	8%	7%	14%	22%	12%	9%	8%	8%
Government Finances								
Budget balance/GDP	-4.3%	-4.8%	-4.5%	-1.2%	-3.9%	-3.0%	-3.0%	-2.6%
Govt debt/GDP	38%	41%	71%	80%	93%	92%	86%	79%
Balance of Payments (USD bn)								
Current account	-14.3	-16.5	-5.3	-0.2	-1.5	-1.7	-2.0	-2.3
as % of GDP	-8.1%	-9.0%	-3.9%	-0.2%	-1.6%	-1.8%	-1.9%	-2.1%
Export of goods	62.0	57.0	48.9	40.6	41.2	43.5	45.7	48.0
Imports of goods	83.2	80.3	62.6	48.8	49.4	50.9	53.4	56.4
Other CA flows, net	7	7	8	8	7	6	6	6
FDI, net	7.2	4.1	0.3	0.4	0.8	1.5	2.2	2.4
Loan repayments	25.0	32.0	12.4	20.4	19.5	19.3	19.5	19.8
Other capital flows, net	-29	-31	-23	-27	-16	-20	-16	-14
External Debt & Liquidity (USD bn)								
Total debt	131	147	131	126	127	128	130	132
o/w short term debt	34.8	34.8	22.4	21.6	21.8	22.0	22.3	22.6
Reserves	23	19	7	12	16	18	19	22
Exchange rate vs USD	8.0	8.0	11.9	21.8	25.5	27.0	28.0	28.5
Oil price (Brent)	\$109	\$99	\$52	\$44	\$50	\$52	\$59	\$68

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

Rating history

Fitch (eoy)	B	B	B-	CCC
Moody's (eoy)	B2	B3	Caa1	Caa3
S&P (eoy)	B+	B3	B-	CC

Type of government:

Democracy

Next elections

Legislative elections 2019, presidential elections 2019

Other:

Latest PC deal

Rescheduled debt 1994 and 1995. 2006 agreement to prepay this debt 06-11.

Latest IMF arrangements

USD 17.5 bn. four-year Extended Arrangement agreed in March 2015

