Ukraine

Analyst: Martin Carlens. Tel: +46 8-763 96 05. E-mail: martin.carlens@seb.se

Implementation of a sufficient number of economic reforms together with the continued stabilisation of the economy has been just enough to keep the country's IMF programme on track. Economic growth is back, but an accelerated pace is needed to stabilise rising debt ratios.

Country Risk Analysis

Summary

Following years of economic contraction, Ukraine's economy finally expanded in 2016. GDP growth of 2.3% is likely to be followed by a slightly lower pace in 2017, despite continued macroeconomic stabilization. Despite positive growth, the previous years' slowdown means that the size of the economy and the level of per capita GDP are still lower than in 2006.

The external balances have improved gradually with the current account deficit being at moderate levels and foreign reserves on a steady upward trend. Meanwhile, the exchange rate has strengthened lately, partly reflecting positive investor confidence. External debt, however, remains at challenging levels as deleveraging in the private sector is overshadowed by rising public borrowing.

Broader government debt is rising despite fiscal policy being appropriately geared towards very moderate budget deficits. Furthermore, the state of the financial sector that since long has weighed on country risk is slowly improving.

That the economy has stabilized and is growing again is a testament to the progress made since the country embarked on the IMF supported reform programme in 2015. The implementation of wide ranging reforms, including in the energy sector and to the economic policy framework has marked the start of a long process of necessary adjustment. Lifting the economy to a higher growth path needed to accomplish a convergence in incomes with regional peers and to handle the country's debt burden in the medium term requires that the reform momentum is maintained. With elections looming and with the country about to finance itself on global bond markets, there is a risk that incentives for this could weaken.

One of the major credit rating agencies upgraded Ukraine's sovereign rating one notch in August 2017. The main drivers behind the upgrade were argued to be the cumulative positive impact of structural reforms and the improvement in the external position.

Recent economic developments

IMF programme remains largely on track. Continued strong international political support for Ukraine was reflected in the disbursement of another USD 1 bn IMF loan tranche in April 2017 despite a wide range of performance criteria being missed. A sufficient number of reform steps had been taken. This makes the total sum disbursed of the programme's roughly 17.5 bn just above USD 7 bn. Fulfilment of the IMF programme which ends in March 2019 remains a key assumption underlying our view on country risk. Although we assume that there will be further delays in planned disbursements, not least due to the elections looming in 2019, the government's commitment to the programme still appears strong.

Economic activity slowing temporarily on trade blockade. The steady economic recovery in 2016 with GDP rising 2.3% was slightly better than expected. A strong rebound in domestic demand was supported by expansionary economic policies. Growth in 2017 may turn out slightly lower as a trade blockade with the Donbass region has led to some temporary cooling of industrial activity.

Source: Macrobond

Inflation remains in double digit territory. Inflation fell significantly during 2016, averaging 13.9% on the back of a stabilising currency and a more consistent economic policy. So far in 2017, rising food prices and, later hikes in utility prices have pushed inflation a bit higher. In July, it reached nearly 16%. Expectations are for some moderation towards the end of the year.

External balances have improved gradually... After three years of improving current account balances, the deficit widened to 4.1% of GDP in 2016 (-0.2% in 2015). The rise stemmed from accelerating imports as investments recovered, particularly in machinery and equipment. This deficit level is still low compared to most peers. Foreign direct investments (FDI) continued to recover during 2016 but are still lower than their historical average and lower than most regional peers. Meanwhile, with external financing from the IMF and others continuing to flow, international reserves have been on the rise. They recently reached the highest level since 2013, close to USD 18 bn or the equivalent of about 4 months' of imports.

…but foreign debt levels remain challenging. IMF disbursements have contributed to lifting external debt in the past few years. Continued deleveraging among private corporations and banks, however, helped reduce the country's overall external debt slightly in 2016 when it reached around 129% of GDP. This is relatively high given the low level of reserves. Most observers expect a continued downward trend in indebtedness, but some are not as optimistic.

Continued gradual dismantling of capital controls. Although the improving external position has let the central bank (NBU) continue the liberalization of capital controls, some still remain in place. It is generally expected that the process will progress slowly throughout the year as the NBU weighs the burden these controls have on investment flows against the risks that lifting them poses to the exchange rate.

Investor sentiment broadly positive. Financial market sentiment towards Ukraine has been largely favourable. Equity markets have risen since 2016 and CDS spreads have been on a steady decline during 2017. Meanwhile the exchange rate versus the USD is roughly at the same level as one year ago thanks to a steady appreciation during 2017. If these conditions prevail, Ukraine will be able to return to global financial markets later in 2017 as planned, without it being overly costly.

Economic policies

Fiscal policy geared towards moderate deficits. Following several years of budget deficits in excess of 6%, the fiscal situation started stabilising when the IMF programme was embarked on in 2015. Last year, the general government deficit rose to about 2.2 % of GDP (1.2% in 2015), an over-performance compared to the planned 3.7% deficit thanks to higher than expected revenues. The budget for 2017 targets a deficit of 3.1% which appears realistic considering a strong performance in the first half of the year. These deficit ratios are lower than among peers.

Pension reform is crucial for medium-term fiscal sustainability. The government's medium-term budget outlook targets a gradual narrowing of the deficit to 2% of GDP by 2020. In order to reach this, a revamping of the pension system which is in significant deficit is a necessary condition. Pushing through a legislation package in this area has proven challenging and has been delayed several times in the context of the IMF programme. However, the necessary legislation has now passed a first reading in parliament and chances are high that it may be passed in the autumn. Other policy measures aimed at strengthening tax revenues are progressing under the IMF programme. Risks to public finances include the conflict in the East, which led to defense spending doubling in 2016 compared with 2014. There is also a risk of fiscal slippage in the run-up to the presidential elections in 2019.

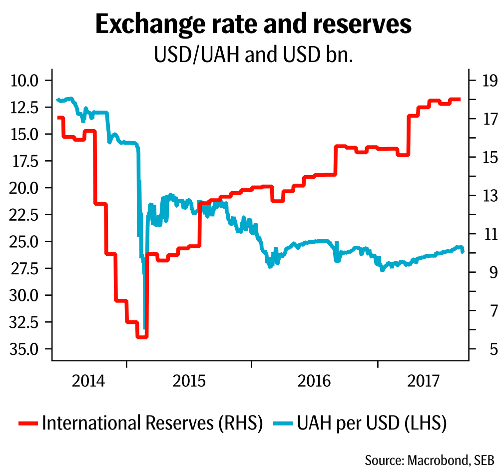
Russia's payments claims. On a positive note, a litigation case filed by Russian Gazprom against Naftogaz for nonpayment that have been threatening the fiscal outlook and debt sustainability was resolved in June 2017 when an international arbitration court denied the claim. The long-running story of Ukraine's USD 3 bn bond owed to Russia, however, is far from over as the bond is being litigated in British courts.

Government debt has been rising rapidly. The recession combined with the exchange rate depreciation (roughly 70% of the debt is denominated in foreign currency) and large financing needs in the state owned companies have produced a rapid rise in government debt. It continued up in 2016 to about 85% of GDP, partly due to bank recapitalisations (see below), implying more than a doubling since end-2013. This is a high level for a low-income country. The IMF forecasts that the debt ratio should level-out in the near-term and decline below 70% by 2021.

More challenging financing requirements down the road. 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. However, debt repayments on USD-denominated domestic debt are set to rise in

2018. Furthermore, in 2019, the restructured Eurobonds begin to mature, implying debt repayments of roughly USD 6 bn. The IMF programme assumes that most of the maturing debt will be re-financed. This will require the government to turn to the bond markets, both locally and foreign, for new borrowing. Preparations for a bond issuance before end-2017 (an assumption in the IMF programme) are well advanced.

Interest rates cut again. The central bank has largely been successful in tempering the high inflation levels of 2015. This has allowed the bank to cut policy rates twice in 2017 to 12.5%. However, some acceleration in price increases since late 2016, makes it unlikely that the NBU's inflation target of 8% (+-2%) for year-end will be met. Since the start of 2017 appreciation pressure on the hryvnia has given the NBU room to build reserves.



Conditions in the banking sector continue to improve. The closure and recapitalisation of banks have continued at a steady pace, leaving the remaining banks in a stronger position. Most recently, the government nationalized and recapitalized the country's largest bank Privatbank after a failure by the owners to recapitalize the institution. This should have reduced overall risk in the financial sector. Increased confidence in the sector is reflected in rising bank deposits. Still, lending growth remains weak and the ratio of non-performing loans is still very high at around 50% by some definitions.

Sovereign credit rating was upgraded. One of the major credit rating agencies upgraded Ukraine's sovereign rating one notch in August and introduced a positive outlook. The main drivers behind the upgrade were argued to be the cumulative positive impact of structural reforms (including in the gas and in the banking sectors) since 2015 and the improvement in the external position.

Political situation

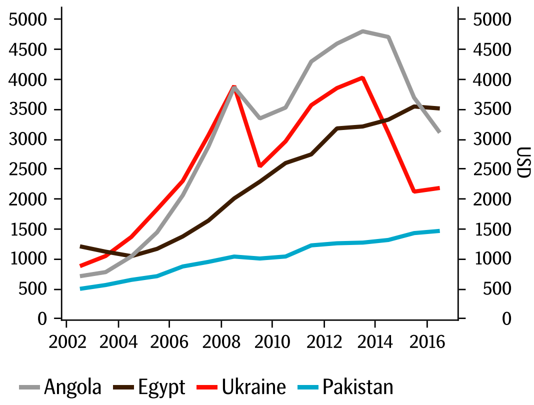
Ruling coalition persists. Since early 2016, the ruling coalition has been fragile and marred by sporadic tensions. Moreover, the coalition's two main parties have only been able to garner majority support in parliament by relying on support from other loosely related factions. Consequently, it has been forced to perform a delicate balancing act when being pressured from both the side of EU integration (anti-Russian and pro Maidan square) supporters and from pro-Russian (anti-Maidan) forces. So far, it has been successful in this balancing act and has consistently been able to garner the votes needed to push through new legislation. Presidential and parliamentary elections are looming in 2019.

Outlook

Growth to gain pace in 2018. The trade blockade with the occupied East prompted most analysts to cut their 2017 GDP forecasts before the summer. We still see growth this year at 1.7% or perhaps somewhat higher, and expect it to accelerate to nearly 3 percent in 2018. This is roughly in line with NBU forecasts. Household spending growth is expected to accelerate helped by the minimum wage hike and rising disposable incomes on the back of stabilising inflation. The firming recovery in 2018 should add to the economy's resilience and contribute to reducing country risk.

GDP per capita

USD



Source: World Bank

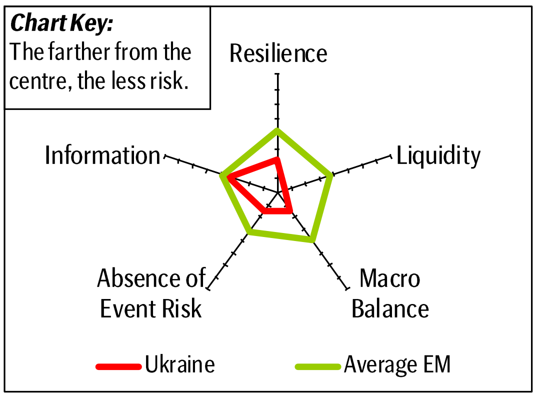
This being said, medium-term growth is expected to be subdued given productivity constraints from public sector inefficiencies, poor infrastructure and low investment. Consequently, it will take years for Ukraine to work itself back to levels of GDP per capita seen in 2008.

Failure to keep IMF programme on track is a key risk. A key risk is if the reform challenges 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 lead to 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	2017
Population (Mn)	44.6
GDP/capita (USD)	2 242
Real GDP (% chg)	1.7
Inflation (%)	11.5
Current Account (% of GDP)	-3.7
Reserves/imports (months)	6
Budget balance (% of GDP)	-2.6
Government debt (% of GDP)	91



External Ratings:
Fitch: B- (sta)
Moody's: Caa2 (pos.)
S&P: B- (sta)

Peers:
Argentina
Iran
Egypt

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

	2013	2014	2015	2016	2017	2018	2019	2020
Macroeconomic								
GDP (% chg)	0.0%	-6.6%	-9.8%	2.3%	1.7%	2.8%	3.0%	2.5%
GDP (USD bn)	183	134	91	93	96	102	110	118
GDP/capita (USD)	4 020	2 941	2 122	2 179	2 242	2 400	2 605	2 808
Investments/GDP	17%	14%	14%	16%	17%	17%	17%	18%
Trade/GDP (%)	75%	83%	103%	104%	106%	104%	100%	98%
Money & Prices								
CPI inflation (%)	-0.3%	12.2%	48.7%	13.9%	11.5%	8.9%	7.5%	6.5%
Money supply, M2 (% chg)	34%	24%	10%	15%	20%	20%	21%	20%
Interest rates	7%	14%	22%	14%	11%	10%	8%	8%
Government Finances								
Budget balance/GDP	-4.8%	-4.5%	-1.2%	-2.2%	-2.6%	-2.9%	-3.0%	-3.2%
Govt debt/GDP	41%	71%	80%	85%	91%	86%	79%	72%
Balance of Payments (USD bn)								
Current account	-16.5	-4.6	-0.2	-3.8	-3.6	-3.7	-3.9	-4.1
as % of GDP	-9.0%	-3.4%	-0.2%	-4.1%	-3.7%	-3.7%	-3.6%	-3.5%
Export of goods	57.0	48.9	42.4	41.8	42.4	44.4	46.3	48.4
Imports of goods	80.3	62.6	51.4	55.7	59.0	61.4	63.8	66.4
Other CA flows, net	7	9	9	10	13	13	14	14
FDI, net	4.1	0.3	0.4	0.8	1.5	2.2	2.4	2.6
Loan repayments	32.0	14.2	25.9	19.4	19.3	19.8	20.2	20.7
Other capital flows, net	-31	-26	-33	-11	-4	1	-6	-4
External Debt & Liquidity (USD bn)								
Total debt	148	131	123	126	129	132	135	138
o/w short term debt	34.8	22.7	19.9	20.4	20.9	21.4	21.9	22.4
Reserves	19	7	12	12	25	31	38	46
Exchange rate vs USD	8.0	11.9	21.8	25.6	27.0	28.0	28.5	29.0
Oil price (Brent)	$52	$44	$48	$46	$52	$62	$68	$0

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

Rating history (end of year)				
Fitch	B	B-	CCC	B-
Moody's	B3	Caa1	Caa3	Caa3
S&P	B3	B-	CC	B-

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