Ukraine

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A peaceful transition to a reform minded new government has gone hand in hand with a continued recovery in economic growth and improved macroeconomic stability. Prudent fiscal policy has contributed to falling government debt ratios. External financing needs remain high.

Country Risk Analysis

Summary

The political scene has undergone a fundamental yet peaceful change in the past year. A new, reform oriented leadership has a single majority in parliament and has swiftly started to implement a series of reforms. Following the economic collapse in 2014-2015, real GDP growth has recovered and accelerated further in 2018. Growth in 2019 has also started on a relatively strong note. Furthermore, price developments have been benign. Inflation is now down to single digit levels helped by an appreciating exchange rate and restrictive monetary policy. Adding to this, the previous administration's implemented structural reforms together with an improved budget balance gives the country's new leadership a relatively favourable starting position.

A key vulnerability is the sovereign's high external funding needs, in particular in relation to a low level of international reserves. The new government is aiming at securing a new long-term agreement with the IMF. We expect that such a programme will be in place in the near-term. This is an important assumption underlying our view on country risk. Another risk to the outlook comes from political developments and the risks of a failed political dawning. In addition, geopolitical risks remain important.

Over the past year, two of the major external rating agencies upgraded their sovereign rating. One of them maintained a positive outlook.

Recent economic developments

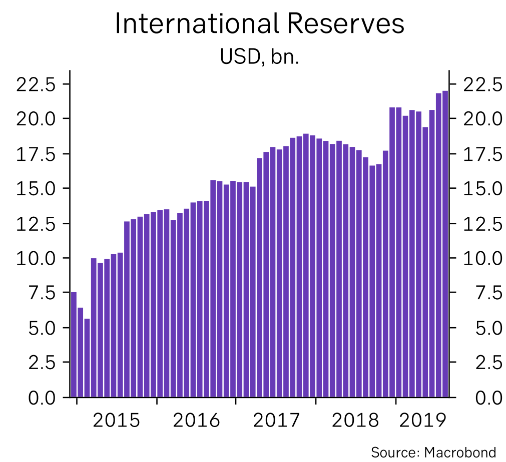
Growth recovers and inflation is declining. Following the economic collapse in 2014-2015, growth has recovered. In 2018, the pace of real GDP expansion accelerated to 3.3% driven by strong domestic demand, in particular by household spending being supported by rising incomes and high remittance flows. 2019 has started on a relatively healthy note with the first estimate of second quarter GDP growth surprising on the upside at 4.6% yoy. Furthermore, price developments have been benign. The inflation rate fell to 11% in 2018, down from 14% the previous year. An appreciating exchange rate and still restrictive monetary policy has helped reduce it to single digit levels in 2019.

Per capita incomes remain significantly below pre-crisis levels. Given that the population is shrinking, GDP per capita has been growing at a slightly higher rate. Nevertheless, given the sharp fall in the post-crisis years, the level of per capita income (just below USD 3000) is still only about two thirds of what it was in 2013.

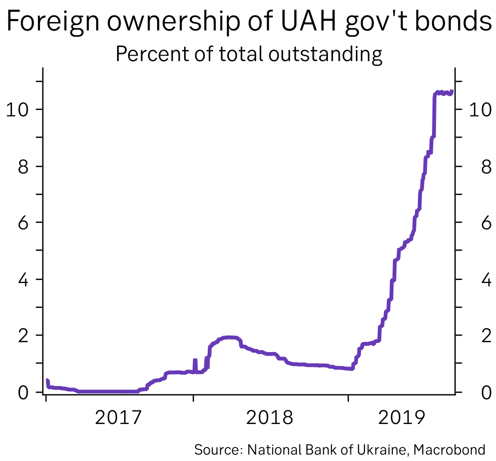
Agreement on new IMF programme is crucial and likely in the near-term. External debt obligations are significant in the near-term, in particular in relation to the level of foreign reserves. Consequently, the reliance on external financing remains high and constitutes a key credit constraint. A 14-month loan agreement with the IMF was signed in December 2018. Only the first tranche was disbursed before parliament was dissolved in mid-2019. The new government is aiming at securing a new longer-term agreement. We expect that such a programme will be in place before year-end 2019. This is an important assumption underlying our view on country risk.

External deficits edged up in 2018. The current account deficit rose in 2018, to 3.3% of GDP on the back of strong domestic demand and an appreciating exchange rate. The deficit is mainly covered by debt creating inflows as foreign direct investments (FDI) remain relatively low. Remittances, on the other hand, have risen to new highs following rising emigration to the EU. Developments in 2019 indicate a shrinking current account deficit. Export re-orientation towards the EU continues. This could help to contain the current account deficit going ahead, although strong domestic demand and reduced gas transit payments from Russia will work in the opposite direction.

Small but rising external buffers. International reserves have risen on the back of IMF support and a string of Eurobond issuances. In August, foreign reserves reached USD 22 bn, equivalent to just above 3 months' of imports. This is the highest level since 2013. However, it is low relative to country risk peers. Furthermore, given the country's large external refinancing needs and its vulnerability to confidence shocks, external buffers overall should be considered relatively low.



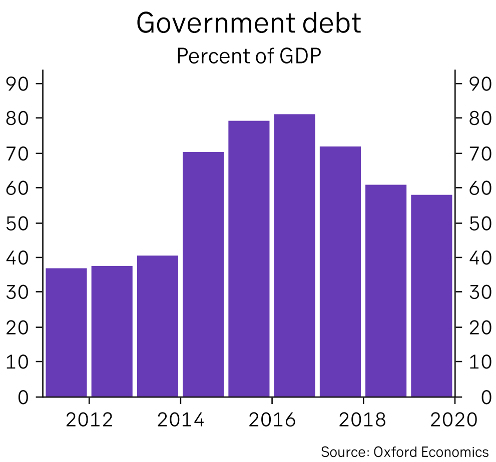
Financial market sentiment has been favourable. Financial market sentiment towards Ukraine has been favourable since early 2018. CDS spreads have decreased steadily, longer-term Eurobonds have recently been issued at below 7% interest rates, and foreign holdings of domestic government bonds have risen significantly since early 2019. This has contributed to a steady appreciation of the exchange rate versus the USD to the strongest level in more than 3 years. As a result of the strong demand for Ukrainian debt, borrowing by the government is ahead of schedule.



Economic policies

Fiscal policy has remained prudent. Risk of overly expansionary fiscal policies due to the election year did not materialize. Following a broadly unchanged budget deficit of 2.1% in 2018, expectations are for a general government deficit of 2.3% of GDP in 2019. A first draft of the new government's first budget (for 2020) indicates continued prudent policies. Plans are to reduce the headline budget deficit next year, despite an increase in defence spending. This should contribute to a continued decline in government debt ratios.

Government debt has declined. Four years of primary budget surpluses coupled with a recovery in nominal growth has led to a decline in government debt as a share of GDP. Debt has fallen from more than 80% in 2016 to roughly 60% by the end of 2018. This is lower than most country risk peers. At the same time, contingent liabilities remain significant. Most observers expect the debt ratio to decline further in the near-term helped by steady growth, prudent fiscal policy and declining interest rates.



Debt sustainability vulnerable to exchange rate depreciation. A significant share of the debt (more than two thirds) is denominated in foreign currency making it highly vulnerable to swings in the exchange rate. Much of this is owed to multilateral creditors. Expectations for a moderate depreciation of the currency will thus lead to upward pressure on the debt burden. To reduce this vulnerability the government opened up the local government bond markets to foreign investors, and in early 2019 opened for trade through Clearstream (an international central securities depository). As noted, since then, foreign holdings of domestic government bonds have risen significantly.

Resolution of Russian owned Eurobond is likely to be years away. The sovereign's USD 3 bn Eurobond owned by Russia and left out of the 2015 debt restructuring remains a potential risk to the government balance sheet. A final ruling from the UK courts is likely to be years down the road, however.

Interest rate cuts signal NBU expectations of falling inflation. Following a series of interest rate hikes in 2018, the National Bank of Ukraine (NBU) started reversing course in 2019. Recently, the policy rate was reduced to 16.5%, signalling central bank expectations that inflation is heading back towards the target range of 5+-1% in 2020. This appears likely.

Banking sector remains important fiscal contingent liability. Risks to government finances from the banking sector have decreased following several rounds of recapitalisation and a stabilisation of the macroeconomic environment. Indeed, banking sector reform is generally considered one of the most successful Ukrainian reforms in recent years. Capital adequacy has risen and asset quality at private banks has improved. This is positive for country risk. However, the large share of state-owned banks in the sector (more than half of total bank assets) and their poor asset quality (NPL share still rising) represents an important contingent liability for the government.

Improved sovereign credit ratings. Over the past year, two of the major external credit rating agencies improved their sovereign ratings of Ukraine. One based the upgrade largely on the improved external financing conditions following the new IMF agreement in late 2018. The other, more recent upgrade, was motivated mainly by the sovereign's timely access to external financing in general, reduced political uncertainty following the shortened election period this summer and the stable parliamentary majority (see further below), and improved macroeconomic stability. This agency also maintained a positive outlook.

Structural policies and institutions

Governance standards is a weakness but business climate improves. Governance standards have not changed materially during the past few years. Ukraine generally scores poorly in the World Bank's governance indicators compared to country risk peers. Corruption related indicators, in particular, are weak although there has been a steady improvement over the past years. In Transparency International's corruption perception rankings Ukraine has advanced over the past years to 120th place of 180 countries, leading Russia. The completion in 2018 of an anti-corruption structure comprising of the National Anti-Corruption Bureau, the Anti-Corruption Prosecutor's Office and the Anti-Corruption Court was seen as an important step in the fight against corruption. The new government has pledged to step up efforts. Meanwhile, broad business climate indicators such as the World Bank's Doing Business index have improved steadily in the past years.

Political situation

Elections have given the new leadership full mandate for their agenda. The political scene has undergone a fundamental change in the past year. Following a win in the presidential elections, President Zelensky's Servant of the People party (SP) secured a historically strong position in the July parliamentary elections. With 254 seats out of 450, the party now holds a comfortable majority. Although its representation falls short of the 300 seats needed to change the constitution they have already been successful in securing support for such changes.

Impact on country risk will depend on actual implementation. The strong position of the new government was secured based on relatively sketchy reform plans such as taking stronger action against corruption, dealing more effectively with Moscow and cleaning up the judicial system. The new leadership also aims to secure a new IMF programme. Many of these objectives have been political mainstream for some time in Ukraine, but implementation has faltered or been delayed.

Rapid start on legislative front signals a bright outlook. The rapid pace of new legislation being adopted in the past months, including ending parliamentarians' immunity to criminal charges and dealing with illicit enrichment, indicates that this time around could be different. The government has also announced a detailed time schedule for adopting a broad range of reforms such as the privatisation of state-owned companies, lifting the moratorium on land sales, and reforms of labour and product markets.

Outlook

Economic growth to remain around 3 percent. Domestic demand should remain the prime growth engine in the near-term. However, private investment activity is unlikely to accelerate which is likely to limit the pace of growth. NBU forecasts growth at 3% for 2019 while the government expects 3.3%. A steady decline in inflation is expected to give the NBU room to lower rates substantially. Developments on the current account balances are uncertain as the future level of transit fees from Russian gas are difficult to predict. Meanwhile, we expect conditions to be in place that will let the NBU continue to gradually lift capital account restrictions.

Medium-term outlook largely unchanged. Lifting growth beyond current levels in the near-term would be challenging given, not only relatively low investments but also constraints to productivity and poor infrastructure. Although we assume that economic reforms will be introduced at a steady pace over the next few years, history shows that the impact on GDP growth rate will be 3-5 years' away. This means that it is likely to take years for Ukraine to reach the levels of GDP per capita seen in 2013.

Is politics this time around really different? One of the most important risks to the outlook comes from political developments and the risks of a failed political dawning. For example, when details of reforms need to be hammered out, difficulties in aligning the potentially diverse interests among SP representatives could lead to a fractioning or collapse of the SP. Furthermore, inexperience may weaken the President's capacity to resist strong business interests. For example, any backtracking on last year's nationalisation of PrivatBank would risk halting IMF support and would most likely lead to a collapse in foreign investor sentiment. Yet another risk is the new concentration of powers to the President and his party if it, for example, is high-jacked by special interest groups such as oligarchs.

Interference with the central bank independence is another risk. The NBU has gained strong independence enshrined in a revised central bank law and has developed an inflation targeting policy framework at par with central banks in more advanced economies. Any political attempts to tamper with this independence would threaten the cooperation with the IMF (and thereby most other external funding sources) and would be clearly credit negative.

Relations with Russia could improve but military conflict still poses risks. There are some indications that relations with Russia may improve under the new Ukrainian leadership. However, our view on country risk does not incorporate any major improvements in the security situation in the near-term. For example, the fulfilment of the Minsk agreement will likely remain remote. A downside risk to our main macroeconomic scenario is an intensification of the military conflict in the East. Should the conflict spread or intensify it would risk dampening sentiment and reducing economic activity. It would also pose risks to public finances.

Ukraine: Key Economic Indicators

	2015	2016	2017	2018	2019	2020	2021	2022
Macroeconomic								
GDP (% chg)	-9.8%	2.4%	2.5%	3.3%	3.2%	3.1%	3.0%	3.1%
GDP (USD bn)	91	93	112	125	136	146	158	173
GDP/capita (USD)	2 122	2 181	2 633	2 938	3 221	3 488	3 801	4 169
Investments/GDP	14%	16%	19%	21%	22%	22%	22%	22%
Trade/GDP (%)	108%	109%	99%	90%	86%	82%	78%	74%
Money & Prices								
CPI inflation (%)	48.7%	13.9%	14.4%	11.0%	8.1%	7.3%	6.9%	6.8%
Money supply, M2 (% chg)	44%	42%	32%	32%	46%	46%	47%	54%
Interest rates	22%	14%	15%	18%	15%	12%	10%	8%
Government Finances								
Budget balance/GDP	-1.2%	-2.2%	-2.2%	-2.1%	-2.3%	-2.4%	-2.4%	-2.4%
Govt debt/GDP	80%	81%	72%	61%	58%	53%	50%	49%
Balance of Payments (USD bn)								
Current account	1.6	-1.3	-2.4	-4.6	-4.5	-4.4	-3.8	-3.5
as % of GDP	1.8%	-1.4%	-2.2%	-3.7%	-3.3%	-3.0%	-2.4%	-2.0%
Export of goods	47.9	47.0	48.6	49.4	50.7	52.2	54.1	56.0
Imports of goods	50.3	54.9	62.0	62.4	65.8	68.0	70.1	72.5
FDI, net	0.4	0.8	1.7	2.5	2.7	2.9	3.1	3.4
Loan repayments	25.2	8.6	9.4	19.5	20.2	20.7	21.2	21.7
Other capital flows, net	-45	-19	-12	-4	-9	-8	-8	-10
External Debt & Liquidity (USD bn)								
Total debt	117	115	113	130	135	138	141	145
o/w short term debt	20.0	20.2	22.3	25.6	26.5	27.1	23.5	24.9
Reserves	12.4	11.9	15.6	19.8	21.6	23.6	27.9	31.8
months of imports	4	3	3	3	4	4	5	--
Exchange rate vs USD	21.8	25.6	26.6	27.2	28.5	29.2	29.9	30.3
Oil price (Brent)	$44	$54	$71	$61	$66	$67	$69	$71

Source: Oxford Economics, IMF and SEB estimates

Rating history (end of year)				
Fitch	CCC	B-	B-	B-
Moody's	Caa3	Caa3	Caa2	Caa1
S&P	CC	B-	B-	B-

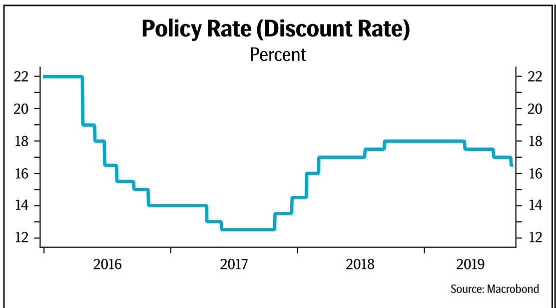
Type of government: **Democracy**

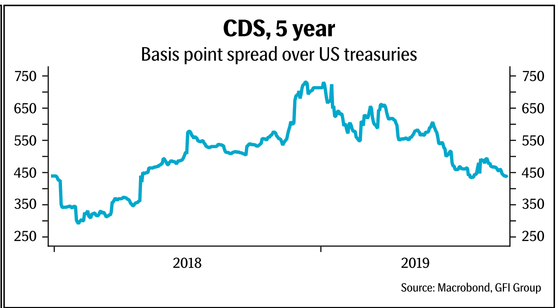
Next elections: Legislative elections 2024, presidential elections 2024

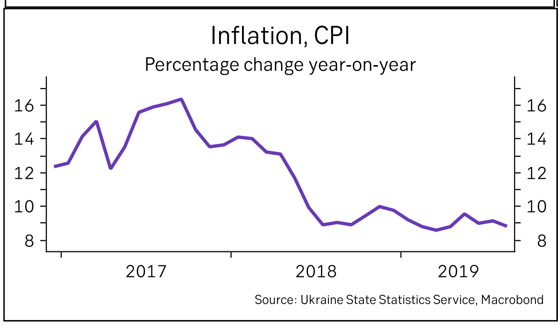
Other:

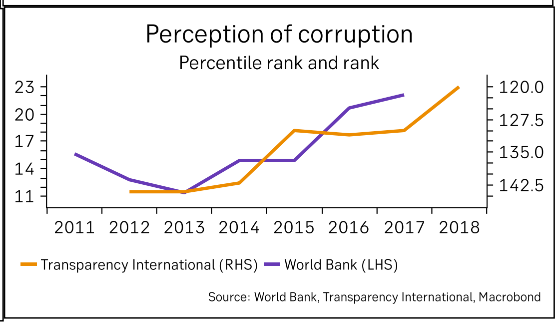
Latest PC deal: Rescheduled debt 1994 , 1995 and 2015.

Latest IMF arrangements: USD 3.9 bn. 14 month Standby Arrangement agreed in December 2018









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