1 March 2022

Sovereign and Public Sector

Ukraine
Rating Report

CCC UNDER REVIEW

Credit strengths

- Bettered macroeconomic stability pre-crisis
- Reconstruction of FX reserves and curtailed net external debtor position
- Improved banking-system governance
- Support of multilateral institutions
- Drop of public debt ratio since 2015

Credit challenges

- War on sovereign territory and associated severe credit implications
- Elevated external financing requirements
- Restricted market access
- Modern history of sovereign restructuring
- Banking-system vulnerabilities

Rating rationale:

The ratings downgrade reflects: i) Russian escalation of conflict in Ukraine – resulting in an anticipated weakening across multiple credit metrics; and ii) implications of this unjustified aggression with respect to heightening political instability.

Further ratings challenges include: i) elevated external financing requirements and significant sovereign debt redemptions; ii) restricted debt capital market access; iii) a modern record of sovereign credit default; iv) weaknesses within the institutional framework; and v) banking-system vulnerabilities.

Enhanced macroeconomic stability entering the crisis: Ukraine benefits from improvements of macroeconomic policies and strengthened economic stability since a 2014-15 geopolitical crisis.

Enhanced external-sector resilience: The credit ratings consider reconstruction of Ukraine's FX reserve stock over the past years, an improved net international asset investment position, reduced external debt and reduced banking-system dollarisation entering 2022.

Support from multilateral institutions: Ukraine holds a track record of supportive and constructive relations with the IMF as well as with other multilateral and bilateral creditors.

Ukraine's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Extraordinary adjustment* (notches)	Final rating
		Weight	Indicative rating		Notches		
Domestic Economic Risk		35%	bb-		-1/3		
Public Finance Risk		25%	a-		-1/3		
External Economic Risk		10%	bbb		-2/3		
Financial Stability Risk		10%	bbb		-2/3		
ESG Risk	Environmental Risk	5%	aa-		0		
	Social Risk	5%	a-		-1/3		
	Governance Risk	10%	c		-1/3		
Overall outcome		**bb+**		**0**	**-3**	**-3**	**CCC**

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. *For Ukraine, an extraordinary adjustment to a CCC issuer rating reflects consequences of war with Russia. For more details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The review for a developing outcome represents an outstanding likelihood the foreign- and/or local-currency sovereign ratings may be changed over the next six months.

Positive rating-change drivers

- Armistice signed or conflict eases
- Stabilisation of the debt trajectory
- External-sector dynamics re-anchored
- Banking-system risks eased

Negative rating-change drivers

- Coerced change of Ukrainian government
- External-sector risk profile weakens
- Public debt outlook weakens
- Banking-system risks escalate

Ratings and Outlook

Foreign currency

Long-term issuer rating	CCC/Under Review Developing
Senior unsecured debt	CCC/Under Review Developing
Short-term issuer rating	S-4/Stable

Local currency

Long-term issuer rating	CCC/Under Review Developing
Senior unsecured debt	CCC/Under Review Developing
Short-term issuer rating	S-4/Stable

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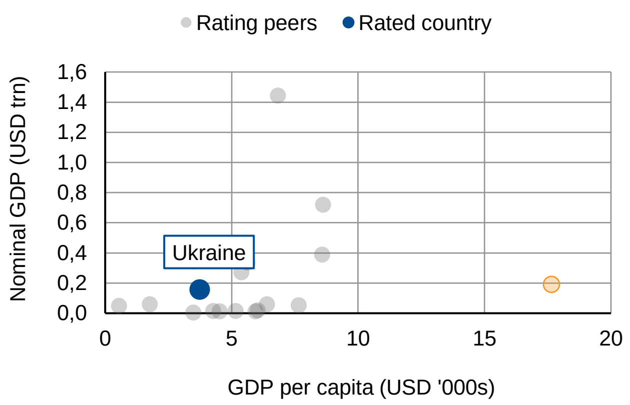
Domestic Economic Risks

- **Growth outlook:** The Ukrainian economy is expected to have fallen into deep recession in 2022 – with large-scale disruption to economic activity amid war with the Russian Federation and an evolving refugee crisis. Over the medium run, trend growth is estimated of around 2.5% (under a National Bank of Ukraine (NBU) estimate of 4%), in reflection of working-age population decline of an estimated 0.8% per annum between 2022-2026 under UN projections as well as reflection of robust potential for productivity gain. Realised economic growth in Ukraine has averaged only 0.3% since 2010 due to experience of multiple crises.
- **Inflation and monetary policy:** Inflation of 10% YoY as of January 2022 is seen further increasing given recent depreciation of the exchange rate and further rises of natural gas and food prices. The NBU, after prudently raising the reference policy rate four percentage points since March 2021 to 10%, is expected to further hike rates in support of hryvnia and the sustenance of price stability. Amid high inflation and geopolitical uncertainty, three-year hryvnia yields stand presently circa 30%, more than doubling from 13.4% prior to escalation in this geopolitical crisis – with currently impaired domestic capital-market liquidity.
- **Labour market:** The economy presents a "medium" rate of unemployment (9.6% as of Q3 2021) under an international comparison. We estimate unemployment to have averaged 10% in 2021 prior to 12% in 2022 and 2023. Labour force participation rate of 72.8% in 2020 (as regards the 15-64 year old age group).

Overview of Scope's qualitative assessments for Ukraine's *Domestic Economic Risks*

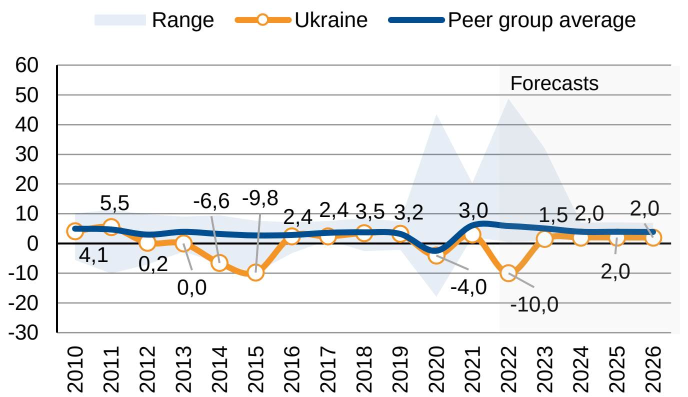
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Growth potential of the economy	Neutral	0	Robust growth potential but uneven pattern of growth due to vulnerability to crisis
	Monetary policy framework	Weak	-1/3	Significant improvements in monetary governance, although still outstanding questions surrounding central bank autonomy
	Macro-economic stability and sustainability	Weak	-1/3	Average economic diversification and labour market flexibility; conflict with Russia undermines longer-run macroeconomic stability

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH forecasts

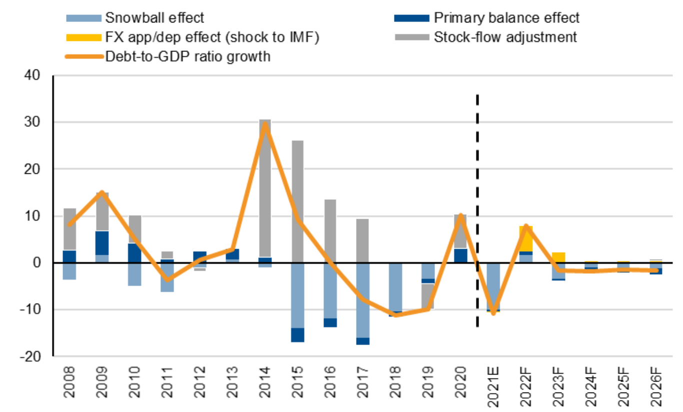
Public Finance Risks

- **Fiscal outlook:** Under a baseline economic scenario, amid this conflict, the general government deficit reverses progress from 2021, increasing to 6.1% of GDP in 2022, from 3.6% in 2021 (and compared with 6.0% during 2020 Covid-19 crisis peaks). This is followed by an average general government deficit of 4.0% over subsequent years 2023-26.
- **Debt trajectory:** Under a scenario of equivalent severity to a 2014-15 geopolitical and economic crisis during which hryvnia devalued significantly, growth contracted an aggregate of 15.7% over a two-year period while inflation spiked, Ukrainian government debt could rise to 89.8% of GDP by 2024 (from circa 50% as of end-2021), before moderation to 78.4% by 2026.
- **Debt profile & market access:** Restricted access to international debt capital markets and greater limitations in overall funding capacity via domestic capital markets after Russia's military incursion. Around 59.6% of Ukraine's public debt is externally held as of end-2020, with sovereign Eurobonds and multilateral loans representing 28.2% and 14.6% of aggregate government debt, respectively. Exposure to exchange-rate risk is substantive, with around 65% of the current debt stock being foreign-currency denominated. Average term-to-maturity of government debt stands around 7.4 years (near an emerging market average). Under a scenario of equivalent severity to a 2014-15 geopolitical crisis, aggregate government gross financing requirements could rise in this scenario to 17.5% of GDP by 2022 before 17.2% on average over 2023-26 – above an IMF 15% "high scrutiny" threshold for emerging-market borrowers.

Overview of Scope's qualitative assessments for Ukraine's *Public Finance Risks*

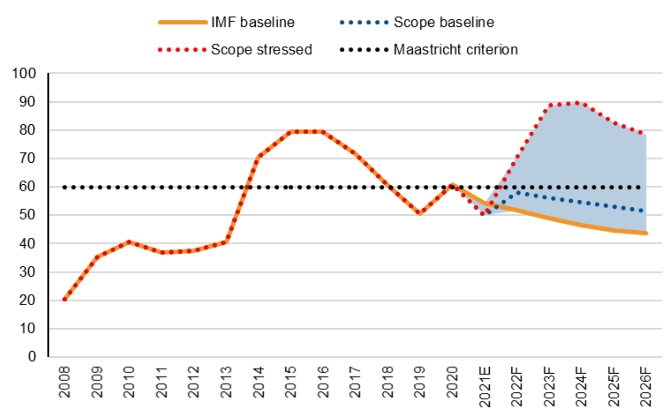
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Neutral	0	Record of moderate fiscal deficits including primary surpluses with oversight from the IMF and multilateral creditors
	Debt sustainability	Weak	-1/3	Anticipated weakening in the debt trajectory amid crisis; debt sustainability vulnerable under adverse scenarios of sharp currency depreciation and economic recession
	Debt profile and market access	Weak	-1/3	Vulnerabilities from loss of international market access, a still developing domestic capital market, high foreign-currency risk in government debt, access to multilateral & bilateral lenders of last resort

Contributions to change in debt levels, pps of GDP



Source: IMF, Scope Ratings GmbH forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF, Scope Ratings GmbH forecasts

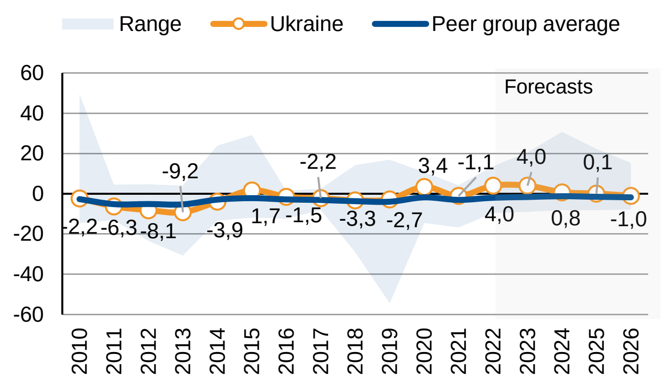
External Economic Risks

- **Current account:** After hikes in commodity prices and a decline of imports resulted in a temporary current account surplus of 3.4% of GDP in 2020, Ukraine returned to a current account deficit as internal demand recovered from this Covid-19 crisis and terms of trade reversed, with a balance of an estimated -1.1% in 2021. The current account is seen reverting to a surplus during 2022 (of 4% of GDP) as imports collapse during this conflict. Net foreign direct investment (FDI) totalled 3.1% of GDP in the year to Q3 2021, with such inflows having accelerated in 2021. However, FDI is likely to be impaired amid current military tension.
- **External position:** On basis of external debt deleveraging, Ukraine's net international investment position was bolstered from an ebb of -50.2% of GDP in Q3 2015 to -12.3% by Q3 2021. Gross external debt had been curtailed to 69.4% of GDP in Q3 2021, from 131.3% as of Q4 2015.
- **Resilience to external shocks:** Ukraine's credit ratings acknowledge the substantive efforts made by the authorities to bolster economic resilience since a 2014-15 geopolitical crisis during Russia's annexation of Crimea. Nevertheless, existing external-sector buffers remain inadequate under a more severe or prolonged crisis given ultimately modest reserve coverage of 56% of short-term external debt as of January 2022. While Ukraine has rebuilt its foreign-exchange buffers over the recent years, reserves declined USD 1.9bn from Dec-2021 post-2012 peaks to USD 27.5bn in January. The central bank's selling of foreign exchange has eased currency market volatility and held the degree of weakening of hryvnia to a manageable 10% against euro since November 2021. However, as reserves are depleted amid acceleration of capital outflows, sell-off risks for hryvnia increase.

Overview of Scope's qualitative assessments for Ukraine's *External Economic Risks*

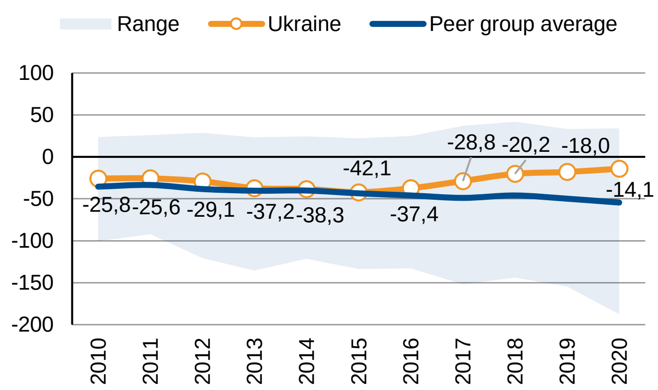
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Current account resilience	Neutral	0	Risk from capital outflows, reliance upon remittances flows, temporary rebound expected in the current account, impairment of FDI
	External debt structure	Weak	-1/3	Decline of external debt, high share of external debt that is short-term, composition embeds significant share of Eurobonds
	Resilience to short-term shocks	Weak	-1/3	Significantly enhanced levels of reserves; however, reserves nevertheless moderate as far as coverage of short-term external debt

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

Net international investment position, % of GDP



Source: IMF, Scope Ratings GmbH

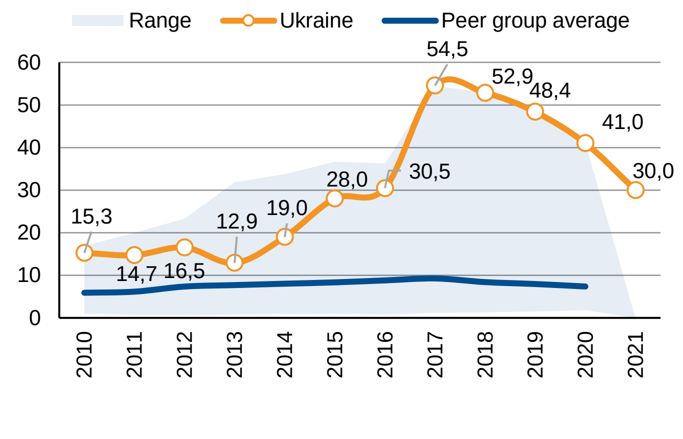
Financial Stability Risks

- **Banking sector:** The tier 1 capital ratio had dropped to 11.7% of risk-weighted assets in January 2022 with an average return-on-equity ratio of 33% as of the same month. The level of non-performing loans (NPLs) is elevated, of 29.5% of gross loans as of January, albeit down from a previous peak of 50% in May 2020. The risk associated with high NPLs is partially mitigated by a high provisioning rate (92%). Concentration risk is elevated. System-wide dollarisation, after moderation prior to this conflict, reversed in January 2022, with deposits in foreign currency rising to 35% (from 32% in December 2021), with loans in foreign currency of 30% (29% in December 2021). Further increases in dollarisation are expected amid demand for hard currency during economic uncertainty.
- **Banking sector oversight:** Banking-system governance was bolstered over the past years, supported by an enhanced central bank macroprudential policy framework. Profitability of domestic banks alongside outstanding capital cushions enabled banks to meet fresh capital requirements introduced since 2022 – such as a requirement to cover 50% of operational risk with capital and an increase of risk weights as regards unsecured consumer loans as well as foreign-currency government securities. 2021 stress testing of 30 large banks revealed capital risks declined as compared with 2019 stress testing, although interest rate risk remained a core concern for many bank balance sheets, including risk under a scenario of decline in value of securities holdings.
- **Financial-system reform:** Financial-system reform has been guided by the financial sector development programme for the period to 2025, aiming to develop the nation's domestic capital markets and further a process of curtailment of foreign-currency exposure in the economy and dependence upon external markets. Such objectives are furthermore anchored by the EU-Ukraine Association Agreement as well as other international commitments.

Overview of Scope's qualitative assessments for Ukraine's *Financial Stability Risks*

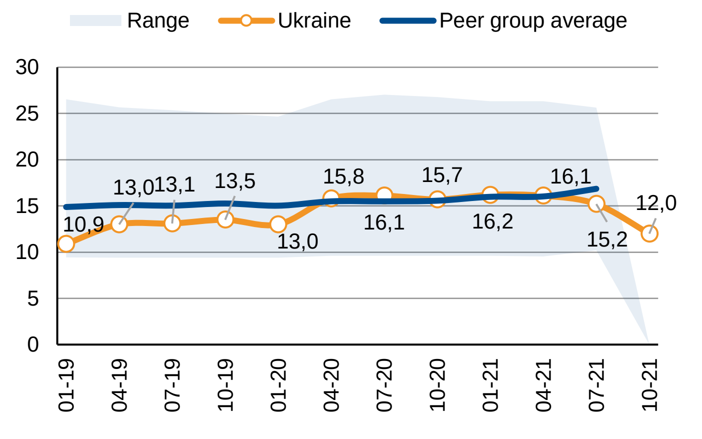
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Banking sector performance	Weak	-1/3	Adequate bank capitalisation & liquidity, profitable banking system, NPL ratio is rapidly declining but still elevated, concentration risk, high albeit declining foreign-currency risk on bank balance sheets
	Banking sector oversight	Weak	-1/3	Multiple initiatives ongoing to enhance banking sector governance; however, regulatory processes still challenged by vested interests
	Financial imbalances	Neutral	0	Low level of private-sector debt amid developing domestic capital market

Non-performing loans, % of total loans



Source: IMF, Scope Ratings GmbH

Regulatory tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

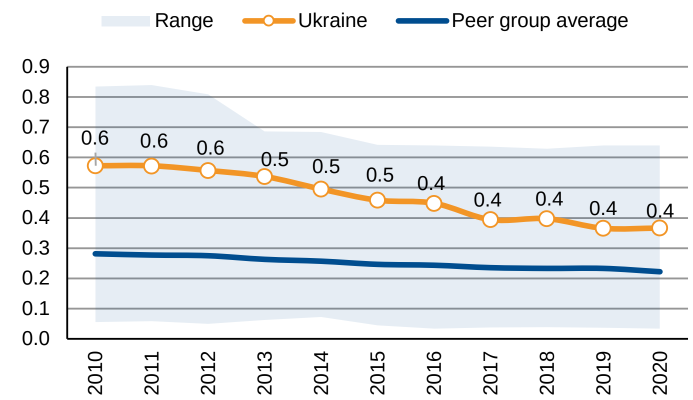
ESG Risks

- **Environment:** Ukraine's economy faces high transition costs in attaining a more sustainable economic model, as reflected in elevated carbon emissions per unit of GDP. The current government aims to bring emissions to 65% under 1990 levels by 2030 and achieve full climate neutrality by year 2060. Ukraine has committed to ending coal-fired power generation by 2035 while investing significantly into renewables. There is exposure to natural as well as man-made disasters such as frequent flooding, harsh winters, storms, mine disasters as well as the legacy of the 1986 Chernobyl disaster.
- **Social:** Ukraine's labour market performance is mixed, as reflected in average levels of unemployment and labour market participation. Average international rankings with respect to education and lower marks as regards healthy life expectancy. Demographic trends represent a significant challenge to longer-run economic growth. Ukraine's old-age dependency ratio is expected to rise in parallel with a decline of the working-age population of -0.8% per annum over 2022-26 according to United Nations estimates.
- **Governance:** The downgrade of Ukraine's credit ratings to B- significantly reflects governance-associated risk in implications of this military invasion for potential heightened political instability and possible reversal of Ukraine's past institutional and macroeconomic reform under scenario of a forthcoming coerced change in the Ukrainian government. The 2019 presidential and parliamentary elections in Ukraine delivered prospect for the government under President Volodymyr Zelenskyy to address longer-standing structural weaknesses. Reforms aiming to quell political and endemic corruption have been undertaken. Major challenges have hindered this reform process, however, such as Constitutional Court challenges and adverse court rulings.

Overview of Scope's qualitative assessments for Ukraine's *ESG Risks*

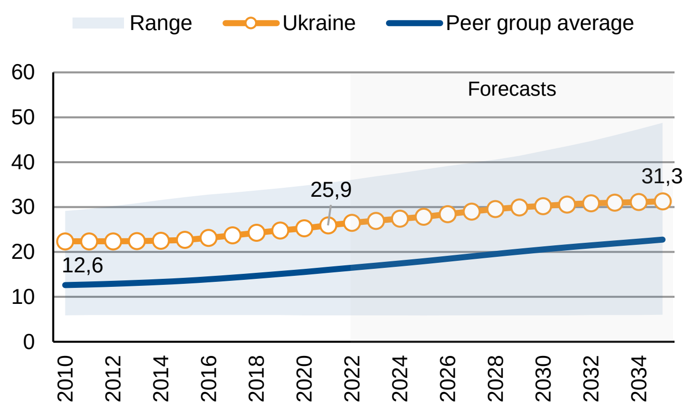
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Environmental risks	Neutral	0	Transition risk for a higher carbon intensity developing economy
	Social risks	Weak	-1/3	Demographic decline, moderate income inequality, moderate performance on education, weaker health metrics
	Institutional and political risks	Weak	-1/3	War on the sovereign's territory and associated exceptional credit rating implications; political instability risk; institutional weaknesses in areas of corruption, rule of law, judicial independence

CO_2 emissions per GDP, $mtCO_2e$



Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard after the reserve-currency adjustment.

Peer group
Georgia
Greece
Turkey

Publicly rated sovereigns only; the full sample may be larger.

Appendix II. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD '000s	2.2	2.7	3.1	3.7	3.7	4.4	5.0	5.4
Nominal GDP, USD bn	93.3	112.1	130.9	154.0	155.3	181.0	203.9	222.8
Real growth, %[1]	2.4	2.4	3.5	3.2	-4.0	3.0	-10.0	1.5
CPI inflation, %[1]	13.9	14.4	10.9	7.9	2.7	9.4	15.0	10.0
Unemployment rate, %[1]	9.5	9.7	9.0	8.5	9.2	10.0	12.0	12.0
Public Finance Risk								
Public debt, % of GDP[1]	79.5	71.6	60.4	50.5	60.8	50.0	57.9	56.3
Interest payment, % of government revenue	10.7	9.5	8.3	7.7	7.3	8.8	10.8	9.8
Primary balance, % of GDP[1]	1.9	1.5	1.1	1.1	-3.1	0.5	-0.8	0.5
External Economic Risk								
Current account balance, % of GDP[1]	-1.5	-2.2	-3.3	-2.7	3.4	-1.1	4.0	4.0
Total reserves, months of imports	3.2	3.2	3.1	3.5	4.9	-	-	-
NIIP, % of GDP	-37.4	-28.8	-20.2	-18.0	-14.1	-	-	-
Financial Stability Risk								
NPL ratio, % of total loans	30.5	54.5	52.9	48.4	41.0	30.0	-	-
Regulatory tier 1 ratio, % of risk-weighted assets				13.5	15.7	12.0	-	-
Credit to private sector, % of GDP	47.3	38.3	34.5	30.0	28.4	-	-	-
ESG Risk								
CO_2 per EUR 1,000 of GDP, $mtCO_2e$	448.4	394.2	397.4	365.6	366.4	-	-	-
Income quintile share ratio (S80/S20), x	3.5	3.7	3.6	-	-	-	-	-
Labour force participation rate, %	66.3	66.5	66.6	66.6	-	-	-	-
Old age dependency ratio, %	23.1	23.7	24.3	24.8	25.3	25.9	26.5	27.0
Composite governance indicator[2]	-0.7	-0.7	-0.7	-0.6	-0.5	-	-	-

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix III. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economies
5y USD CDS spread (bps) as of 3 February 2022	741

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