Ukraine
Rating Report

SCOPE B NEGATIVE OUTLOOK

Credit strengths

- Improved macroeconomic stability
- Reconstruction of FX reserves and curtailed net external debtor position
- Improved banking-system governance
- Support of multilateral institutions
- Declining public debt trajectory since 2020

Credit challenges

- Elevated geopolitical tensions alongside relatively weak institutional framework
- Elevated external financing needs
- Vulnerability to restricted market access
- Recent sovereign restructuring of 2015
- Banking-system vulnerabilities

Rating rationale:

Enhanced macroeconomic stability outlook: Ukraine benefits from improvements of macroeconomic policies and macroeconomic stability since a severe 2014-15 geopolitical and economic crisis. General government debt had been placed on a sustained downward trajectory in the run-up to this Covid-19 crisis. A flexible exchange rate, a strengthened inflation targeting framework and increased foreign-exchange reserves represent material improvements since 2015.

Enhanced external-sector resilience: The credit ratings consider reconstruction of Ukraine's FX reserve stock, an improved net international asset investment position and reduced external debt.

Support from multilateral institutions: Ukraine has a track record of supportive and constructive relationships with the International Monetary Fund and other concessional multilateral institutions.

Ratings challenges include: i) elevated geopolitical tensions alongside a weaker institutional framework; ii) elevated external financing requirements and significant sovereign debt redemptions; iii) exposure to phases of restricted international debt capital market access; iv) a modern record of sovereign default; and v) remaining uncertainties surrounding autonomy of the central bank.

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-	0	-1/3	-1	B
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	-1	

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 B issuer rating reflects unique geopolitical risk. For more details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook represents our view that risks to the sovereign ratings are skewed to the downside over the forthcoming 12-18 months.

Positive rating-change drivers

- Geopolitical risks ease
- Debt sustainability improves
- Reduction of external vulnerabilities
- Banking-system reform supports debt capital market development
- Steps taken in institutional reform

Negative rating-change drivers

- External-sector risks escalate – such as were geopolitical risks to heighten
- Public debt ratio increases substantively
- Reform commitment weakens
- Banking-system risks escalate
- Institutional risk increases

Ratings and Outlook

Foreign currency

Long-term issuer rating	B/Negative
Senior unsecured debt	B/Negative
Short-term issuer rating	S-4/Stable

Local currency

Long-term issuer rating	B/Negative
Senior unsecured debt	B/Negative
Short-term issuer rating	S-4/Stable

Lead Analyst

Dennis Shen
+49 69 6677389-68
d.shen@scoperatings.com

Team Leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone +49 69 6677389-0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

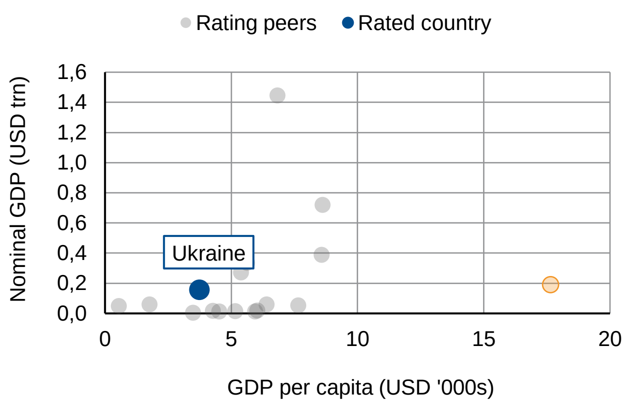
Domestic Economic Risks

- **Growth outlook:** After estimated output growth of 2.5% during 2021, a below-consensus 1.5% economic growth during 2022 and 2023 could be observed absent escalation of military conflict; nevertheless, there are both upside as well as downside risks to 2022 and 2023 growth estimates. A slow pace of vaccination poses continued risk to recovery, with Covid-19 restrictions extended to 31 March 2022. At the same time, recovery has been supported by a recent solid pattern of growth of private consumption and investment, rise in main export product prices, such as of agricultural products and commodities, and gains of real wages (8% YoY in November 2021). 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 a 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 has risen, standing at 10% YoY as of December 2021 – double an inflation objective although slightly easing off September highs of 11%. Disinflation has seen challenges amid more persistent global inflation and the second-round effects of higher food and energy prices. Further inflationary pressures are expected due to risk of escalation of conflict with Russia – via forex channels as well as via global natural gas and food prices. The NBU has prudently hiked the reference policy rate six times since March 2021, tying to a cumulative rate increase of 4pps since last March, reaching 10% presently, with further hike(s) anticipated. Amid inflation and geopolitical tension, three-year hryvnia yields stand presently around 16.75%, an increase from 13.4% a month before.
- **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 9.8% in 2022 and 10% in 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*

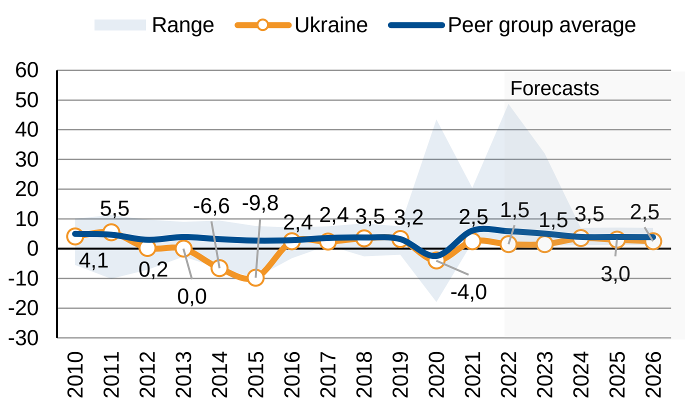
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Growth potential of the economy	Neutral	0	Robust growth potential but uneven pattern of growth due to vulnerability to crisis
	Monetary policy framework	Weak	-1/3	Significant improvements in monetary governance, although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

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH forecasts

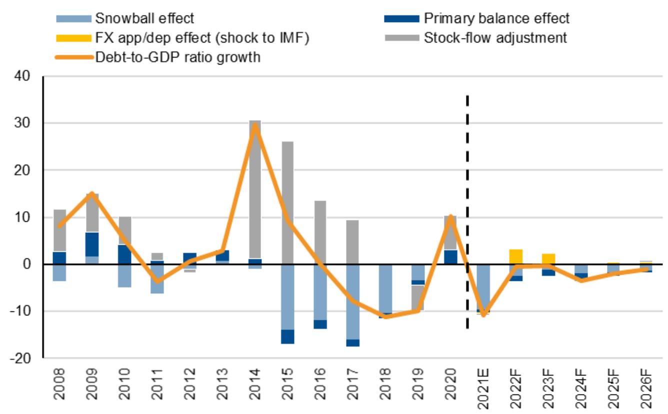
Public Finance Risks

- **Fiscal outlook:** Under a baseline scenario of moderate interruption to recovery due to geopolitical tension, the general government deficit edges sideways to 3.5% in 2022, from 3.6% in 2021 (but down from 6.0% in 2020). This is followed by an average general government deficit of 2.7% over subsequent years 2023-26 (returning in direction of the more moderate deficit levels of pre-Covid-19 of an average of 2% over 2015-19).
- **Debt trajectory:** Ukraine's debt stock has moderated to date from crisis peaks of 60.8% of GDP as of end-2020 to around 50% by end-2021 – briskly returning to pre-crisis (2019) levels of 50.2%. Under a scenario of moderate interruption to recovery due to geopolitical tension, hryvnia depreciation alongside higher inflation for longer, this declining debt trajectory nearly halts over 2022-23 prior to resumption of decline from 2024, reaching 42.8% by 2026 – which, under such a scenario, would represent the lowest such debt ratio since prior to the 2014-15 crisis. However, under an adverse scenario of a repeat of a severe 2014-15 geopolitical crisis with Russia under which hryvnia experienced much sharper devaluation, growth severely contracted over a two-year period while inflation spiked, Ukraine's government debt would increase to 92.2% of GDP by 2024, prior to moderation to 80.6% by 2026.
- **Debt profile & market access:** Restricted access to international debt capital markets and still outstanding limitation in overall funding capacity via domestic capital markets. 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. Aggregate government gross financing needs are material, amounting to around 13.5% of GDP in 2022 before averaging an estimated 10.3% per year over 2023-26.

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

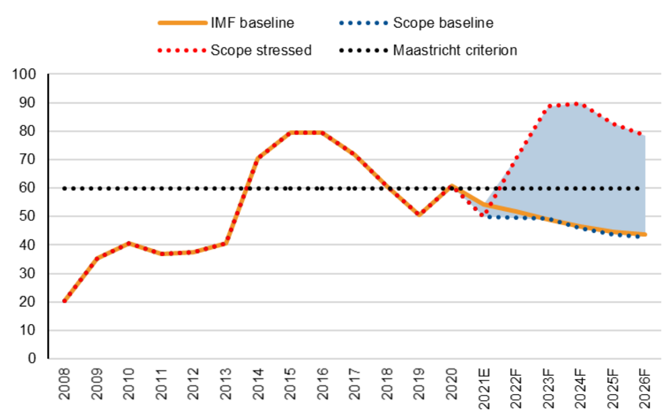
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Strong	+1/3	Record of moderate fiscal deficits including primary surpluses with oversight from the IMF and multilateral creditors
	Debt sustainability	Weak	-1/3	Compared with baseline projections, debt sustainability vulnerable under adverse scenarios of currency depreciation and sharp 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

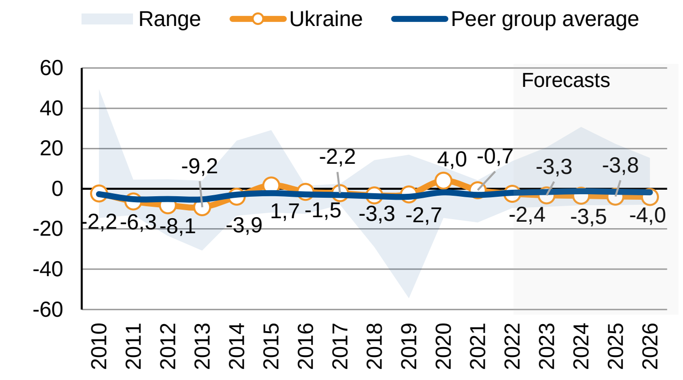
External Economic Risks

- **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 the crisis and terms of trade reversed, with a balance of -0.9% in the year to November 2021. Net foreign direct investment totalled 3.1% of GDP in the year to Q3 2021, however, with such inflows having accelerated since Q4 2020.
- **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. An improved foreign-currency reserve stock and curtailed net external debtor position bettered Ukraine's scoring under a global external vulnerability and resilience evaluation and country comparison Scope conducts annually[1].
- **Resilience to external shocks:** Heightened geopolitical tension has unwound currency appreciation of the recent past, with hryvnia having weakened 6% against the euro since November 2021 despite the central bank selling foreign exchange to smoothen currency market volatility. However, the stock of foreign-exchange reserves has improved substantially over recent years to USD 29.4 bn as of end-2021 – their highest level since 2012 (integrating in this respect a USD 2.7bn grant in August 2021 under an IMF historic special drawing rights allocation) – and compared with a reserves nadir of USD 4.7bn as of February 2015. The current reserves figure, nevertheless, only allows for moderate coverage of around 64% of short-term external debt liabilities. The NBU aims to sustain forex reserves of around USD 30bn over the medium-to-long run.

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

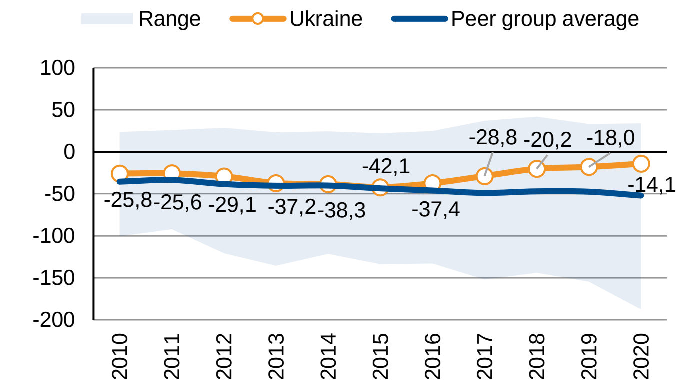
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Current account resilience	Neutral	0	Recovery in foreign direct investment, risk from capital outflows, reliance upon remittances flows
	External debt structure	Weak	-1/3	Declining levels of external debt, high share 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

[1] Scope Ratings GmbH. (2021) '2021 External Vulnerability and Resilience rankings of 95 countries: Risks for emerging economies amid rising inflation, rates'.

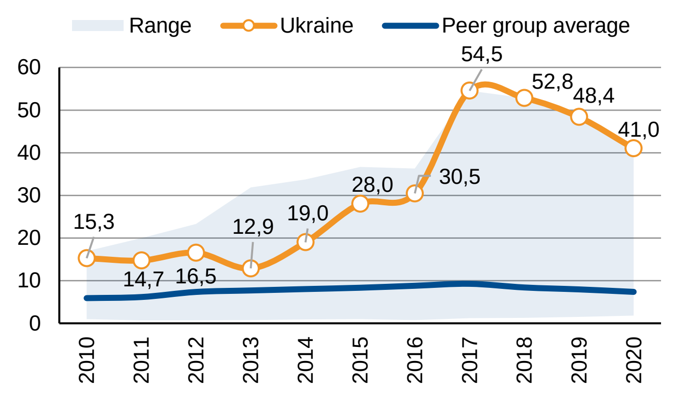
Financial Stability Risks

- **Banking sector:** System capitalisation and profitability have increased, as reflected in a tier 1 capital ratio of 14.5% of risk-weighted assets (although easing off a 2021 peak of 16.8%) and an average return-on-equity ratio of 33% as of November 2021. The level of non-performing loans (NPLs) is elevated, at 31% of gross loans as of November 2021, 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 (90%). Concentration risk is elevated. Foreign-currency risk on bank balance sheets has somewhat declined, with a share of loans and deposits in foreign currency declining to 29% (-8pps) and 34% (-6pps), respectively, between dates end-2019 and November 2021.
- **Banking sector oversight:** Banking-system governance has been bolstered, supported by an enhanced central bank macroprudential policy framework. Profitability of domestic banks alongside outstanding capital cushions enable 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 as relates to many bank balance sheets, including risk under a scenario of decline in the 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*

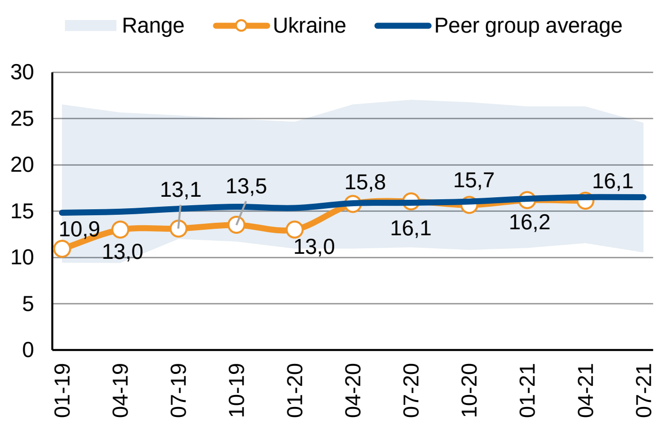
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Banking sector performance	Weak	-1/3	Adequate bank capitalisation & liquidity, profitable banking system, NPL ratio is rapidly declining but still elevated, concentration risk, high albeit declining foreign-currency 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

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

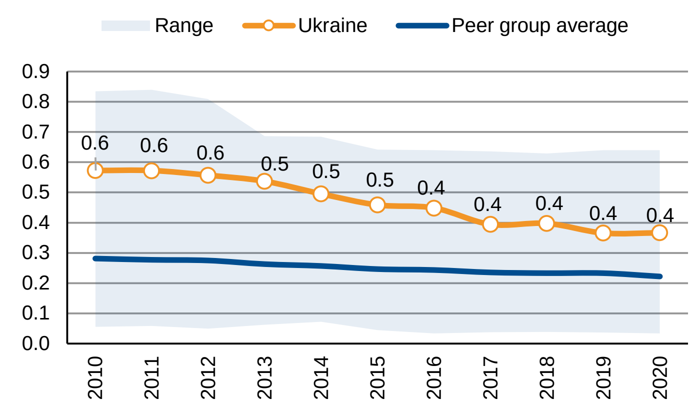
ESG Risks

- **Environment:** Ukraine's economy faces high transition costs in the attaining of a more sustainable economic model, as reflected in elevated carbon emissions per unit of GDP. It aims to bring emissions to 65% under 1990 levels by 2030 and achieve full climate neutrality by 2060. Ukraine has committed to ending coal-fired power generation by 2035 while investing significantly in 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 2019 presidential and parliamentary elections in Ukraine delivered prospect for the government to address longer-standing structural weaknesses. However, unexpected and frequent changes in leadership, including in key postings such as the Minister of Finance and Central Bank Governor, have resulted in institutional and economic uncertainty. Reforms aiming to quell political and endemic corruption have been undertaken. Major challenges have hindered this reform process, however, including Constitutional Court challenges and adverse court rulings. Risk of escalation of military conflict with Russia significantly weighs on Ukraine's credit risk perceptions.

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

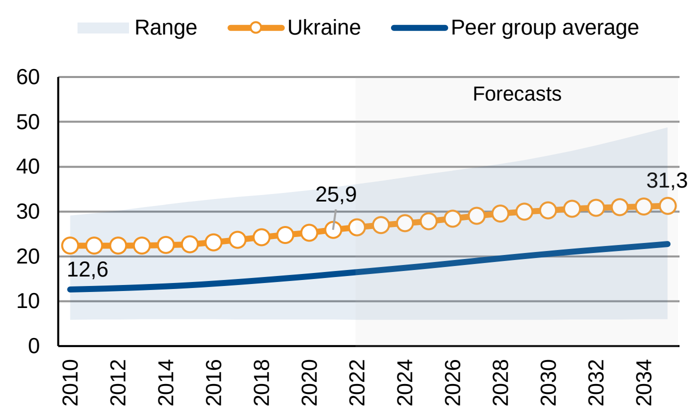
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Environmental risks	Neutral	0	Transition risk for a higher carbon intensity developing economy
	Social risks	Weak	-1/3	Demographic decline, moderate income inequality, moderate performance on education, weaker health metrics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

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	2.5	1.5	1.5
CPI inflation, %[1]	13.9	14.4	10.9	7.9	2.7	9.4	9.4	7.5
Unemployment rate, %[1]	9.5	9.7	9.0	8.5	9.2	10.0	9.8	10.0
Public Finance Risk								
Public debt, % of GDP[1]	79.5	71.6	60.4	50.5	60.8	50.0	49.6	49.2
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	1.1	1.4
External Economic Risk								
Current account balance, % of GDP[1]	-1.5	-2.2	-3.3	-2.7	4.0	-0.9	-2.0	-2.0
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	52.8	48.4	41.0	-	-	-
Tier 1 ratio, % of risk weighted assets	9.0	12.1	10.5	13.5	15.7	15.2	-	-
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 28 January 2022	823

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

23 Boulevard des Capucines
F-75002 Paris

Phone +33 6 62 89 35 12

Oslo

Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid

Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan

Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 8295 8254

Scope Ratings UK Limited

London

52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer