18 November 2022

Sovereign and Public Sector

Ukraine
Rating Report

CC
NEGATIVE OUTLOOK

Credit strengths

- Significant international financial support
- Adept central-bank response to crisis
- Improved economic resilience since 2014-15 geopolitical crisis
- Enhanced banking-system governance

Credit challenges

- Long-run debt sustainability risk
- Recent record of sovereign restructuring
- External-sector risks
- Banking-system risk

Rating rationale:

Significant international financing support: Loan and grant financing from a range of international multilateral and bilateral-official benefactors. Sustained international financial assistance coupled with increasing borrowings in the domestic market are crucial to reducing monetary financing and reinforcing long-run debt sustainability.

Institutional preparedness for this crisis: The National Bank of Ukraine (NBU) adopted speedy administrative and capital controls after the war escalated such as to preserve foreign-exchange reserves, stem deposit flight, inject liquidity and adopt regulatory forbearance. It has appropriately raised the policy rate to 25% to control inflationary pressure and boost attractiveness of hryvnia assets.

Enhanced macroeconomic stability entering the crisis: Ukraine benefits from enhancements of its macroeconomic policy frameworks and strengthened economic stability since its 2014-15 crisis.

Ratings challenges include: i) long-run debt sustainability risk amid protracted war; ii) a recent record of sovereign debt restructuring; iii) risks to external-sector resilience and still-elevated dollarisation; and iv) banking-system vulnerabilities.

Ukraine's sovereign rating drivers

Risk pillars		Quantitative		Reserve currency	Qualitative*	Final rating (foreign currency)
		Weight	Indicative rating	Notches	Notches	
Domestic Economic Risk		35%	ccc	UAH [+0]	0	CC
Public Finance Risk		20%	a-		-2/3	
External Economic Risk		10%	bb-		-1/3	
Financial Stability Risk		10%	bb		-1/3	
ESG Risk	Environmental Factors	5%	aa-		0	**Final rating (local currency)**
	Social Factors	7.5%	bbb+		-1/3	
	Governance Factors	12.5%	c		-1/3	CCC
Indicative outcome		**b+**			**-2**	
Additional considerations (local currency)**					**-1**	
Additional considerations (foreign currency),*****					**-2**	

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 local-currency issuer rating reflects consequences of war with Russia. ***A further one-notch adjustment to foreign-currency ratings of CC reflects higher default risk than on local-currency debt. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook reflects a view that risks to the long-term ratings are skewed to the downside.

Positive rating-change drivers

- Debt sustainability outlook improved and/or debt restructuring were less likely
- External-sector dynamics re-anchored
- Conflict reaches ceasefire
- Banking-system risks eased

Negative rating-change drivers

- Increased likelihood of a (further) debt restructuring or non-payment

Ratings and Outlook

Foreign currency

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

Local currency

Long-term issuer rating	CCC/Negative
Senior unsecured debt	CCC/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

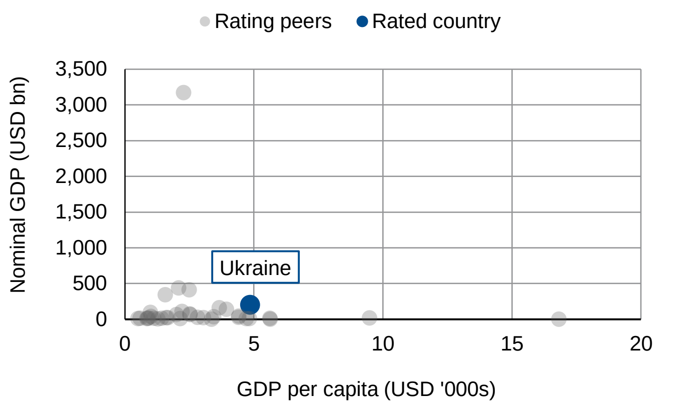
Domestic Economic Risks

- **Growth outlook:** After having contracted by 4% in 2020 during Covid-19 crisis peaks, real GDP recovered in 2021 – growing 3.4%. The full-scale invasion of Ukraine since end-February 2022 has triggered unprecedented damage for the economy, causing significant disruption to the labour market, as well as to supply and production chains. With the conflict easing in some regions – and liberation of multiple Ukrainian territories, adaptation of businesses to wartime conditions and period of opening of a "grain corridor", the economy started GDP recovery from Q3 2022. Nevertheless, persistent logistical challenges, destruction of productive capacity and decline of household real incomes constrain speed of recovery. We have expected Ukraine's economy to contract by 31% this year but revise our expectation for 2023 recovery to 7% (from 12.5%), with output remaining next year over 25% under 2021 levels.
- **Inflation and monetary policy:** CPI inflation reached 26.6% YoY in October and core inflation continued to exceed 20%, mostly driven by consequences of the Russian full-scale invasion such as supply-chain disruption, destruction of production facilities and reduction of the supply of goods and services. Inflation is now projected by NBU to accelerate to 30% by end of 2022. However, NBU expects to continue reducing monetary financing of the state budget and recalibration of restrictions of forex markets – such as to contain price pressures and anchor inflation expectations. Inflation is seen slowing to around 20% next year and further drop to below 10% in 2024. At its October monetary policy meeting, the Central Bank decided to hold its policy rate at 25%, after a sharp 15pp hike in June. The current level of the policy rate is expected to be maintained at least until Q2 2024, although the NBU remains ready to opt for additional hikes if needed to limit inflation and maintain stable international reserves stocks.
- **Labour markets:** The unemployment rate was at 10.9% as of Q4 2021. According to NBU estimates, the unemployment rate started to increase significantly after the full-scale invasion, peaking at 35% in Q2 2022, due to the war and economic depression. Unemployment is expected to decline amid output recovery, although remain well higher than pre-2022 levels.

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

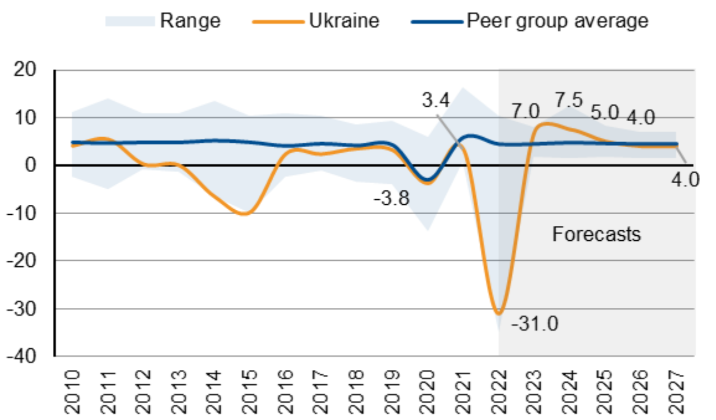
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Growth potential of the economy	Neutral	0	Robust growth potential but significant uncertainty around recovery trajectory given the war
	Monetary policy framework	Strong	+1/3	Significant pre-crisis improvement of monetary governance centring around inflation targeting; central-bank measures since the Russia-Ukraine crisis have been crucial in anchoring macroeconomic and financial stability
	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, USD



Source: IMF World Economic Outlook (WEO), Scope Ratings

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

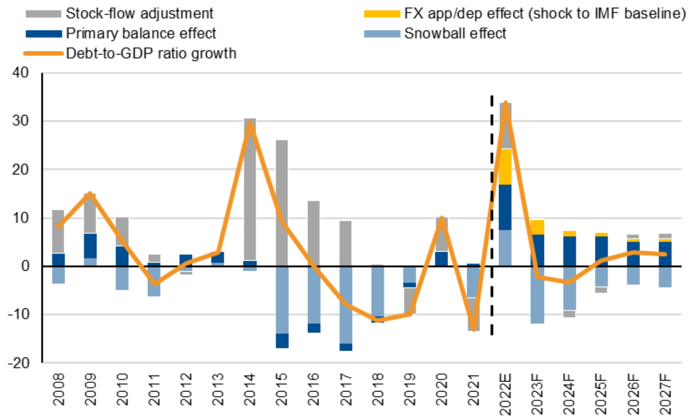
Public Finance Risks

- **Fiscal outlook:** The government has introduced a series of administrative controls and tax deferrals such as to mitigate economic damage from the war. Revenue has been cushioned via early transfer of dividends from state-owned enterprises, advanced tax payments as well as disbursement of grant monies from international donors. Expenditure has risen significantly and shifted in direction of security and social demands. This resulted in a widened budgetary gap of about USD 5-7bn a month (3.6-5.1% of annual GDP per month). The 2023 State Budget foresees gradual recovery of tax revenue, especially in VAT and individual income tax collections, although expenditure ought to remain substantively higher than pre-crisis levels and earmarked nearly 50% for army and security deployment. We see the budget deficit having reached 14.5% of GDP this year (revised down from an earlier Scope estimate for 19.7%), before 14.2% of GDP in 2023 and averaging 12.6% over 2024-27.
- **Debt trajectory:** The severe 2022 drop of economic output has placed substantive pressure on debt sustainability: we see Ukraine's debt-to-GDP ratio rising from 47.6% of GDP as of end-2021 to 81.4% of GDP in 2022, dropping to 79.2% amid 2023 economic recovery, before concluding a forecast horizon to 2027 around 83% of GDP – held up by long-run reconstruction costs. This reflects, nevertheless, an improvement from our previous debt-sustainability assessment for Ukraine, reflecting outperformance of the budget deficit. However, under an adverse scenario, Ukraine's public debt could nevertheless rise to above 100% of GDP.
- **Debt profile and market access:** In view of restricted access to international debt capital markets, government introduced war bonds during March 2022 to open up financing options via domestic markets. International financial assistance and increasing borrowings from the domestic market are crucial to curtailing monetary financing, the latter which, if prolonged, could rapidly become unsustainable, resulting in pressure on hryvnia and depletion of forex reserves. After the liability management exercise concluded during August 2022, around USD 6bn of foreign-currency debt service has been deferred two years, with the first Eurobond maturity after the suspension phase falling due on 1 September 2024.

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

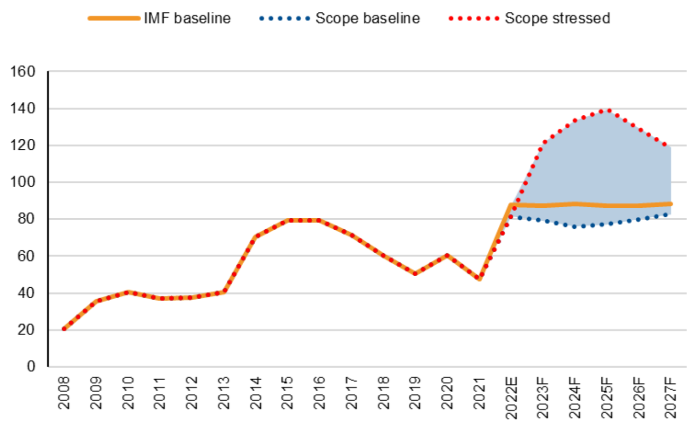
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a-	Fiscal policy framework	Neutral	0	Record of fiscal discipline with oversight of the IMF and multilateral creditors; revenue-raising flexibility reduced due to the war
	Debt sustainability	Weak	-1/3	Significant weakening of debt sustainability amid crisis; debt sustainability vulnerable under adverse economic scenarios
	Debt profile and market access	Weak	-1/3	Restricted market access, high foreign-currency risk in government debt, but access to significant multilateral and bilateral funding options

Contributions to changes in debt levels, pps of GDP



Source: IMF WEO, Scope Ratings forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF Request for Purchase under the Rapid Financing Instrument–Press Release (October 2022), Scope Ratings forecasts

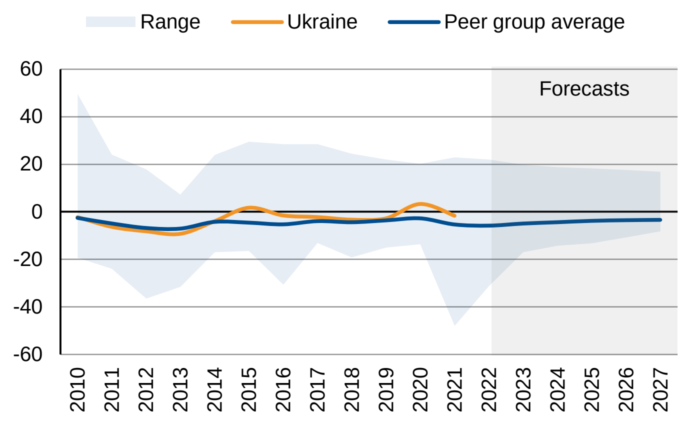
External Economic Risks

- **Current account:** After a current-account surplus of 3.4% of GDP in 2020 due to hikes of commodity prices and a decline of imports, Ukraine returned to a 1.3% of GDP current-account deficit in 2021 as domestic demand recovered and terms of trade reversed. In the first months after the full-scale invasion this year, Ukraine's export capacity was meaningfully compromised and restrictions for goods, travel-services imports and IT-services exports were required. Exports recovered in Q3 2022 due to opening of the grain corridor and record-high supplies of electricity to the EU, while cancellation of preferential tax regimes manifested slowdown of importing. Therefore, a current-account surplus is expected for this year, which is likely to revert back to a current-account deficit next year. However, international financial support will remain significant – furthermore fostering foreign-direct-investment inflows – and any improvements in security conditions could support export-sector growth. Remittances from diaspora continue to help forex inflow.
- **External position:** Due to external-debt deleveraging, gross external debt has been curtailed over the years, from 131.5% as of Q4 2015 to roughly 59% by Q2 2022. Consequently, Ukraine's net international investment position (NIIP) was strengthened, standing around -5% of GDP in Q2 2022, correcting from an ebb of -50.2% of GDP as of Q3 2015.
- **Resilience to short-term external shocks:** Foreign-currency reserves increased to USD 22.0bn in October 2022, from USD 19.1bn in July, thanks to steady inflow of funding from international partners and NBU reductions of its FX sales. Official reserve (incl. gold) coverage of short-term external debt (by remaining maturity) has likewise improved, reaching 44.8% in October, from 38.9% as of July 2022 lows, although still well beneath a 62% level at end-2021. The expected reduction of NBU financing of the national government and continued receipt of international financial assistance ought to support stemming further reserve losses. The official hryvnia exchange rate was devalued 25% against the US dollar in July 2022, resulting in convergence with the unofficial hryvnia rate although the unofficial rate has since returned to 9% weaker compared with current official dollar-hryvnia rates.

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

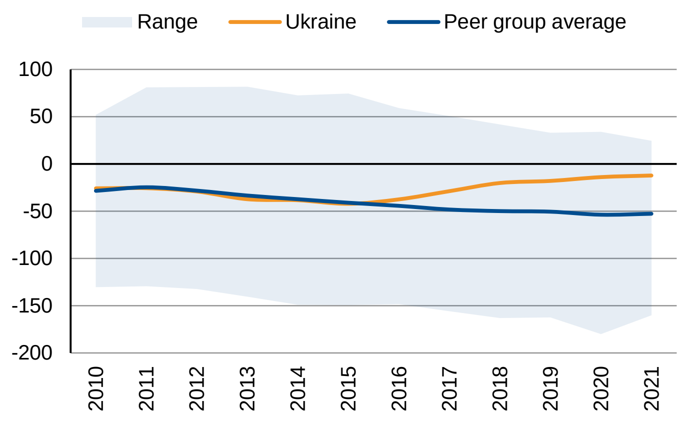
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb-	Current account resilience	Neutral	0	Risk from capital outflows, reliance upon remittances inflows, temporary rebound in the current account
	External debt structure	Neutral	0	Decline of external debt ratio, high share of external debt that is short-term, composition embeds significant shares of Eurobonds, maturity of some external debt extended during debt restructuring
	Resilience to short-term external shocks	Weak	-1/3	Moderate levels of reserves, representing modest coverage of short-term external debt

Current account balance, % of GDP



Source: IMF WEO, Scope Ratings

Net international investment position (NIIP), % of GDP



Source: IMF, Scope Ratings

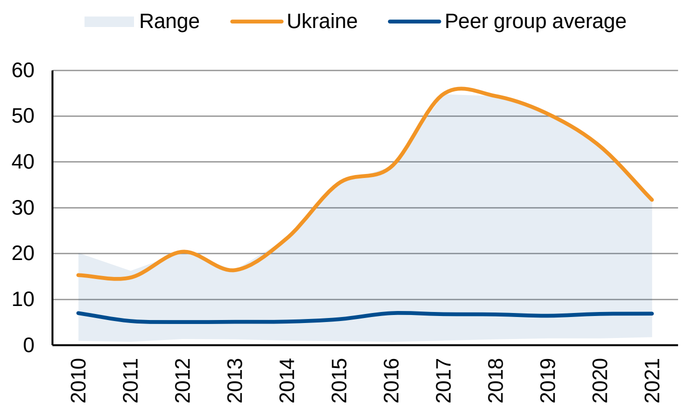
Financial Stability Risks

- **Banking sector:** Since the full-scale invasion of Ukraine, domestic banks have continued operating stably and efficiently, although losses from operational risk are likely to rise short run, with adverse consequences for capital adequacy. System-wide tier 1 capital started to drop in June 2021 (from 16.8%) and reached 11.5% of risk-weighted assets by October 2022. After non-performing loans (NPLs) had reached a low of 26.6% in February pre-escalation of the war, NPLs have resumed a rise more recently, reaching 30.8% by August, as banks gradually started recognising incurred and expected losses. Consequently, they also raised provisioning, resulting in a lowered, although currently recovering, return on equity, of 5.1% in August. System-wide dollarisation has slightly decreased since July 2022, when the share of bank deposits in foreign currency reached a peak of 39%, although remaining at high levels of 36.9% as of September. In the same month, the share of loans in foreign currency also dropped slightly (to 28.6%).
- **Private debt:** Private debt of Ukraine remains limited as households and non-financial corporations (NFCs) display loans outstanding in domestic currency of roughly 4.7% and 11.3% of GDP respectively as of September 2022. Shares are even smaller for loans in foreign currency (0.5% of GDP for households; around 5.7% for NFCs sector). Retail deposits remained stable and even increased in the early months after the war's escalation, while corporate and FX deposits declined. Starting from Q2 2022, however, outflow trends reversed and further inflows are expected given gradual economic recovery.
- **Financial imbalances:** Ukraine's banking system faces significant credit-risk and profitability challenges, in view of the effect of the war and economic depression on loan quality and banking-sector income. Supportive policy measures such as repayment holidays, reduced commissions and loan restructurings could ease effects of the crisis on asset quality, and their eventual phase-out is expected to be gradual even after martial law is lifted. However, a delayed recognition of financial losses could bring about sharp deterioration of financial positions when losses are recognised during the future.

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

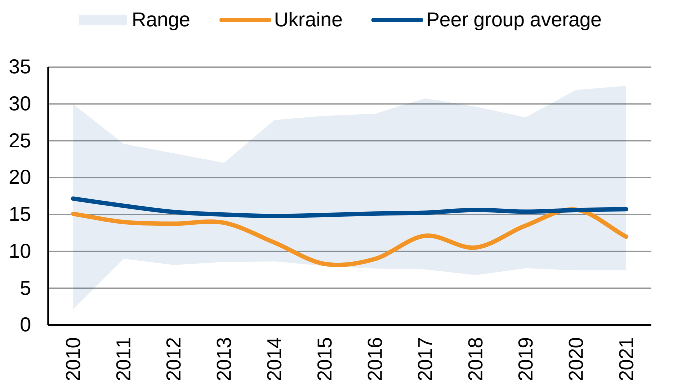
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Banking sector performance	Weak	-1/3	Declining banking-system capitalisation and profitability challenges. Elevated and rising NPL ratio, high foreign-currency risk on bank balance sheets although re-dollarisation has reversed.
	Banking sector oversight	Neutral	0	Multiple initiatives over the years to enhance banking-sector governance; regulatory processes still challenged by vested interests
	Financial imbalances	Neutral	0	Low-level of private-sector debt given developing domestic capital market

Non-performing loans, % of total loans



Source: IMF, Scope Ratings

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings

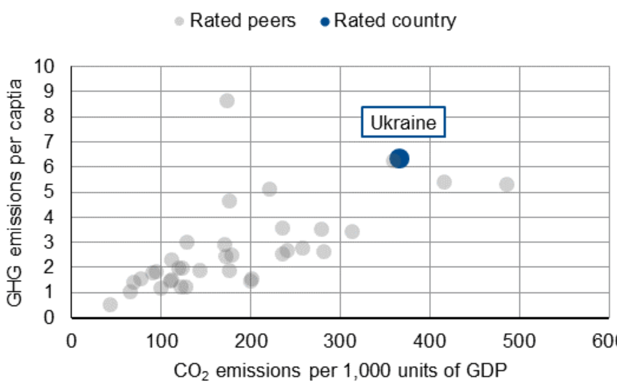
ESG Risks

- **Environment:** Ukraine's economy faces high transition costs to a more sustainable economic model, as reflected in elevated carbon emissions per unit of GDP. The current government aims to bring emissions to 65% below 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. The war is causing significant, long-lasting environmental and climate damage.
- **Social:** Ukraine's labour-market performance is reflected in average rates of unemployment and labour-market participation (under international comparison) *before* the war escalated. Ukraine sees average international rankings with respect to educational performance and lower marks as regards its healthy life expectancy. According to World Bank simulations, due to the war, the share of the population with income under the national poverty line might reach 70% this year, compared with 18% in 2021. Demographic trends represent a significant challenge to longer-run economic growth. Ukraine's old-age dependency ratio is expected to rise, despite gradual recovery of the working-age population from 2024 on, according to 2022 UN estimates.
- **Governance:** 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 were undertaken. Major challenges have hindered the reform process, however, such as Constitutional Court challenges and adverse court rulings. Governance and institutional risks relate to the military conflict, as Russia seeks annexation of further regions of Ukraine. After Ukraine applied for EU membership at end-February, the European Union formally agreed in June 2022 to candidate status for Ukraine – starting a longer-run process for the nation's EU accession, but subject to conditions for enhancement of rule of law and anti-corruption legislation.

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

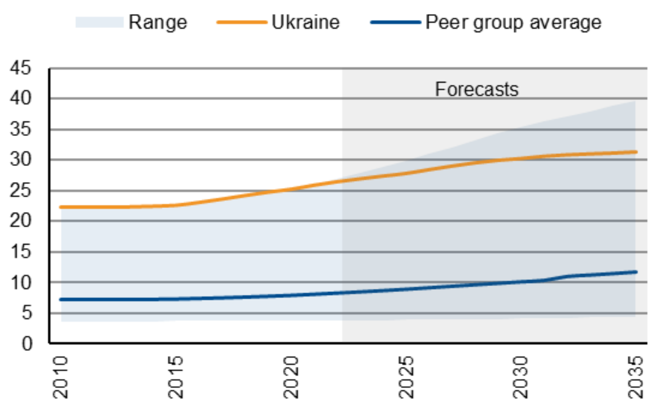
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b-	Environmental factors	Neutral	0	Transition risks outstanding for a higher carbon-intensity developing economy; ambitious climate objectives
	Social factors	Weak	-1/3	Poverty, emigration and internal displacement of persons due to the war, demographic decline and rising old-age costs, moderate income inequality, moderate performance on education, weaker health metrics
	Governance factors	Weak	-1/3	War on the sovereign's territory and associated exceptional adverse credit-rating implications

Emissions per GDP and per capita, $mtCO_2e$



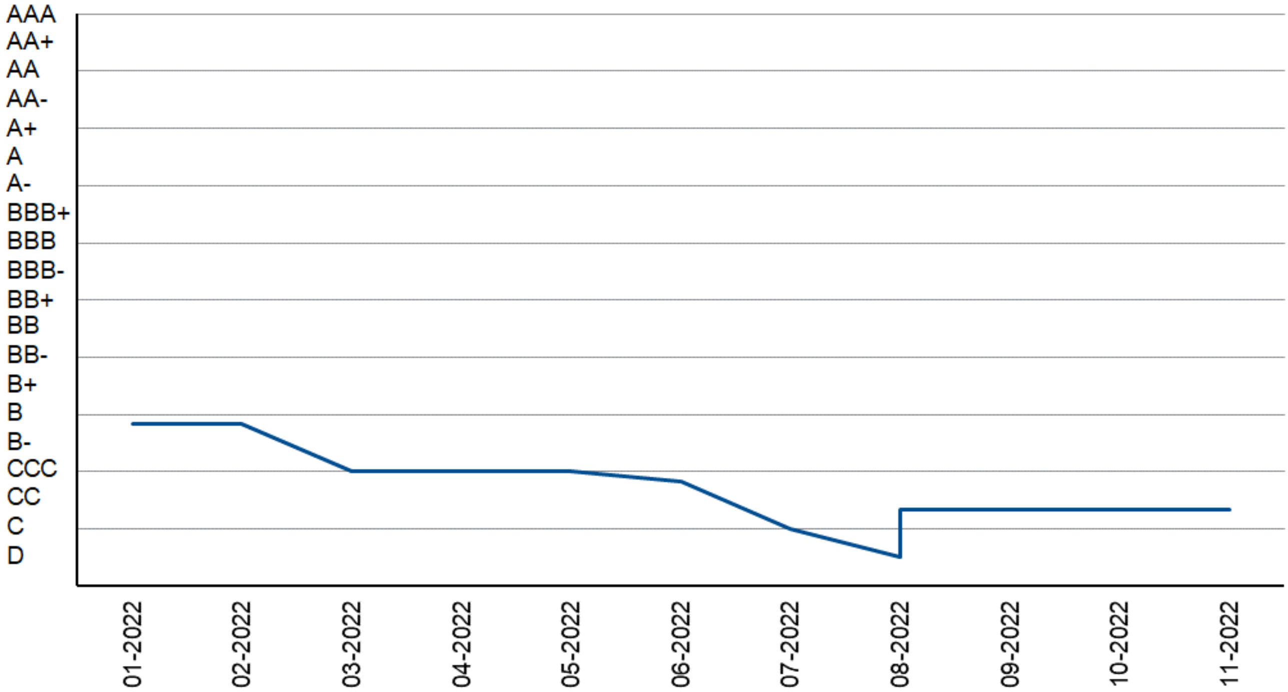
Source: European Commission, Scope Ratings

Old age dependency ratio, %



Source: United Nations, Scope Ratings

Appendix I. Rating history (foreign-currency long-term issuer rating)



NB. Positive/Negative Outlooks are treated with a +/-0.33-notch adjustment. Credit Watch positive/negative with a +/-0.67-notch adjustment.

Appendix II. Rating peers

Peer group*
n/a

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, including a methodological reserve-currency adjustment.

*Publicly rated sovereigns only; the full sample is larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 30 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard, in line with Scope's Sovereign Rating Methodology. The metrics and sources for the data presented here ensure comparability across global peers and may therefore differ from national and other selective international statistics.

Pillar	Core variable	Source	2017	2018	2019	2020	2021
Domestic Economic	**GDP per capita, USD '000s**	IMF	2,656	3,118	3,690	3,778	4,862
	Nominal GDP, USD bn	IMF	112.1	130.9	154.0	156.4	199.7
	Real growth, %	IMF	2.4	3.5	3.2	-3.8	3.4
	CPI inflation, %	IMF	14.4	10.9	7.9	2.7	9.4
	Unemployment rate, %	WB	9.5	8.8	8.2	9.1	8.9
Public Finance	**Public debt, % of GDP**	IMF	71.6	60.4	50.5	60.6	47.6
	Interest payment, % of revenue	IMF	9.5	8.3	7.7	7.3	7.7
	Primary balance, % of GDP	IMF	1.5	1.4	1.1	-3.0	-0.5
External Economic	**Current account balance, % of GDP**	IMF	-2.2	-3.3	-2.7	3.3	-1.6
	Total reserves, months of imports	IMF	3.2	3.1	3.5	4.9	3.6
	NIIP, % of GDP	IMF	-28.8	-20.2	-18.0	-14.0	-12.3
Financial Stability	**NPL ratio, % of total loans**	IMF	54.8	54.4	50.5	43.5	31.7
	Tier 1 ratio, % of risk-weighted assets	IMF	9.8	12.0	10.9	13.0	16.2
	Credit to private sector, % of GDP	WB	38.3	34.5	30.0	28.2	-
ESG	**CO_2 per EUR 1,000 of GDP, $mtCO_2e$**	EC	394.2	407.2	370.9	366.3	346.3
	Income share of bottom 50%, %	WID	22.2	22.7	22.6	22.6	22.6
	Labour-force participation rate, %	WB	66.5	66.6	66.6	-	-
	Old-age dependency ratio, %	UN	23.7	24.3	24.8	25.3	25.9
	Composite governance indicators*	WB	-0.7	-0.7	-0.6	-0.5	-

* Average of the six World Bank Worldwide Governance Indicators.

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economies
5y USD CDS spread (bps)	N/A

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

10 avenue de Messine
F-75008 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 94 91 66 2

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

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