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
- Weakening external-sector resilience
- Severe economic recession
- Increasing banking-system risks

Rating rationale:

The upgrade of Ukraine's foreign-currency ratings to CC reflects conclusion of foreign debt restructuring following execution of Ukraine's liability management exercise on Eurobond debt and GDP-linked securities launched 20 July 2022. The restructuring resulted prudently in deferral of nearly USD 6bn of debt service over the next two years and received consent of bondholders of around 75% of the aggregate principal amount, more than the two-third minimum required for the operation's success. In line with Scope's sovereign criteria and rating definitions, upgrade to a CC rating reflects creditworthiness of Ukraine's newly-restructured Eurobond debt.

Ukraine's sovereign rating drivers

Risk pillars		Quantitative scorecard: Weight	Quantitative scorecard: Indicative rating	Reserve currency adjustment (notches)	Qualitative scorecard: Notches	Extraordinary adjustment	Final rating
Domestic Economic Risk		35%	ccc	Reserve currency adjustment (notches)	0	Extraordinary adjustment – foreign currency (notches): **-2**	**CC**
Public Finance Risk		25%	bbb		-2/3	Extraordinary adjustment – local currency (notches)	**Final rating**
External Economic Risk		10%	bb+		-1/3		
Financial Stability Risk		10%	bb		-1/3		
ESG Risk	Environmental Risk	5%	aa-		0		
	Social Risk	5%	a-		-1/3		
	Governance Risk	10%	c		-1/3		
Overall outcome		**b+**		**0**	**-2**	**-1**	**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 local-currency issuer rating reflects consequences of war with Russia. A further one-notch adjustment to foreign-currency ratings of CC reflects higher credit risk for foreign- as compared with local-currency debt. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook for foreign- and local-currency long-term debt represents the view that risk to the sovereign ratings is skewed to the downside over the forthcoming 12-18 months. This reflects risk to still-weak long-run government debt sustainability resulting from severe economic recession, fiscal and external-sector stress, and substantive uncertainty around the future evolution of the war. Despite deferral of foreign debt service payments for two years, a broader restructuring of debt, such as involving principal write-down and/or further postponement of debt service, involving the private sector is probable over the future.

Positive rating-change drivers

- Conflict reached ceasefire
- Debt sustainability outlook meaningfully improved and/or debt ratio stabilised
- External-sector dynamics re-anchored
- Banking-system risks eased

Negative rating-change drivers

- Increased likelihood of 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

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Bloomberg: RESP SCOP

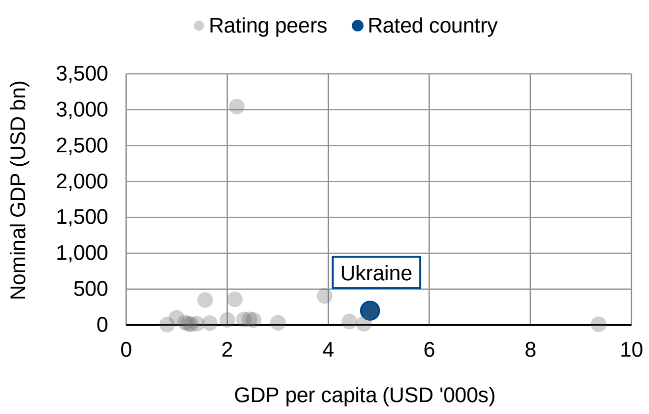
Domestic Economic Risks

- **Growth outlook:** Real GDP contracted 4% in 2020 during Covid-19 crisis peaks, but thereafter recovered during 2021 with 3.4% economic growth, due to gradual easing of pandemic restrictions anchoring private-demand recovery as well as a better-than-anticipated harvest. The full-scale invasion of Ukraine since end-February 2022 has triggered an unprecedented shock for economic activity: despite areas of the country where the conflict has eased starting to recover and businesses adapting gradually to wartime conditions, disruption of labour markets as well as of supply and production chains persist across the nation. We expect Ukraine's economy to contract 31% this year before rebounding 12.5% in 2023, with output remaining next year over 20% under 2021 levels.
- **Inflation and monetary policy:** CPI inflation reached 22.2% YoY in July, rising from 10% in January due to large-scale supply-chain disruption as well as destruction of production capacity and infrastructure. Some disinflationary forces, however, are emerging from logistical restrictions of exports, excess supplies of agricultural products and moratoria on the raising of heat tariffs and gas distribution during martial law. With the war's escalation, the NBU decided to postpone decisions as regards the key policy rate and concentrate on maintaining price and financial stability via capital controls, a fixed exchange rate, FX-market interventions and monetary financing of the state budget. Given acceleration of inflationary pressure and inadequate yields on hryvnia assets, the central bank sharply hiked the policy rate in June 15pps to 25% to protect household incomes and savings in hryvnia, boost attractiveness of hryvnia assets to counter dollarisation while easing pressures in the forex market. We see this key rate being raised to 30% by year-end, before being cut to 20% by end-2023.
- **Labour markets:** The economy displayed an average rate of unemployment (10.9% as of Q4 2021) under international comparison before the further invasion. After a sharp decline in March, labour market activity is gradually recovering, despite the number of vacancies remaining subdued as compared with numbers of jobseekers.

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

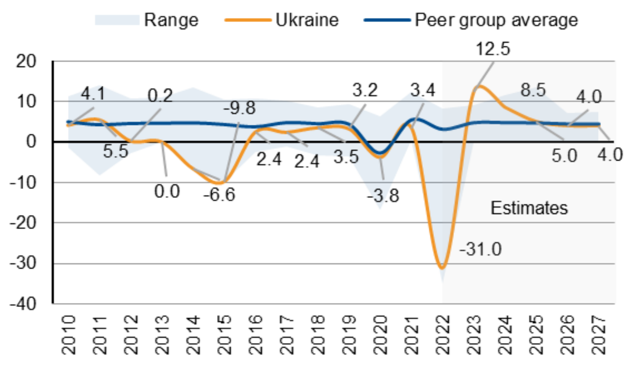
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Growth potential of the economy	Neutral	0	Robust growth potential but uneven pattern of growth due to vulnerability to crisis
	Monetary policy framework	Strong	+1/3	Significant pre-crisis improvement of monetary governance 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 '000s



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

Real GDP growth, %



Source: IMF WEO, Scope Ratings forecasts

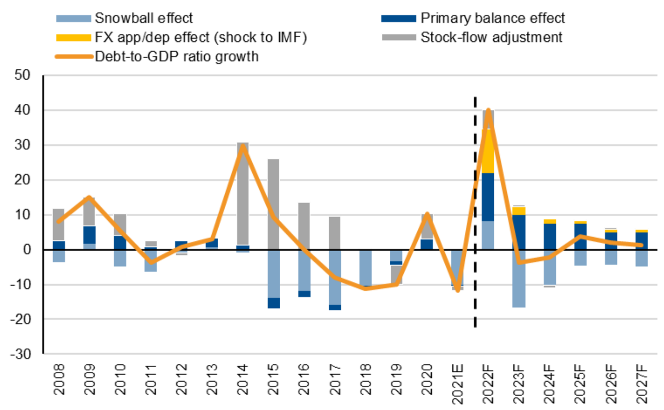
Public Finance Risks

- **Fiscal outlook:** To mitigate the economic shock from the war, the government has introduced a series of administrative controls and tax deferrals, contributing to a substantive reduction of tax revenue since March 2022. Revenue, however, was cushioned by early transfers of dividends from state-owned enterprises, advanced tax payments and disbursements of grant funds from international institutions. Expenditure also rose significantly and shifted towards security and social needs. This resulted in a wider budgetary gap of circa USD 5-7bn a month (3.6-5.1% of annual GDP per month), mostly financed via international, central-bank and local-government-bond financing. We expect the budget deficit to reach 19.7% of GDP this year, after 4% in 2021, before averaging an elevated 14.9% over 2023-27. The costs of Ukraine's reconstruction are estimated as USD 750bn (312% of average 2023-27 GDP).
- **Debt trajectory:** The severe 2022 decline of economic output will place significant pressure on debt sustainability: we see the debt-to-GDP ratio increasing to roughly 89.1% of GDP in 2022, from 48.9% at the end of 2021 and to conclude a forecast horizon to 2027 around 90%. Under an adverse scenario of more severe economic loss or more timid economic recovery, wider deficits, more extensive exchange-rate losses and/or further crystallisation of contingent liabilities, Ukraine's public debt can rise to above 100% of GDP.
- **Debt profile and market access:** Access to international debt capital markets remains restricted, but the government introduced a new debt instrument — war bonds — to open up funding via domestic capital markets. The government has borrowed USD 4.7bn via local government bonds since 24 February from domestic and foreign banks, but with a further USD 8.5bn of war bonds covered by purchases of the NBU under momentary extraordinary monetary financing operations. Circumscribed market access, higher local borrowing rates after the NBU's recent rate hike and monetary financing reflect an unsustainable funding backdrop – highlighting growing fiscal and balance-of-payment risks absent acceleration of international assistance and/or an earlier end of the conflict. Average term-to-maturity of government debt is around 7.4 years (near an emerging-market average).

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

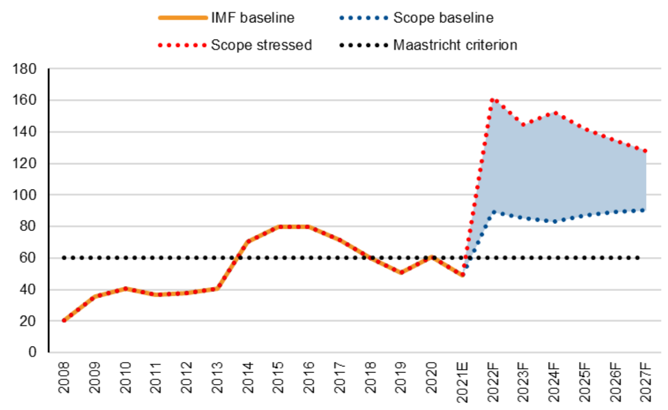
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb	Fiscal policy framework	Neutral	0	Record of fiscal discipline with oversight from the IMF and multilateral creditors; revenue-raising flexibility reduced due to conflict
	Debt sustainability	Weak	-1/3	Significant weakening of debt sustainability amid this crisis; debt sustainability vulnerable under adverse economic scenarios
	Debt profile and market access	Weak	-1/3	Restricted international and domestic market access, high foreign-currency risk in government debt, but access to significant multilateral & 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 WEO, Scope Ratings forecasts

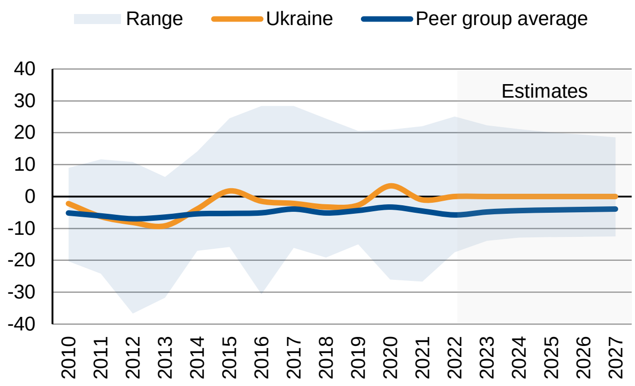
External Economic Risks

- **Current account:** After hikes of commodity prices and a decline of imports resulted in a current-account surplus of 3.4% of GDP in 2020, Ukraine returned to a current-account deficit in 2021 as domestic demand recovered and terms of trade reversed, with a deficit of -1.3% of GDP last year. The full-scale invasion has meaningfully compromised Ukraine's export capacity and brought imposition of goods-import restrictions, as well as restricted travel-services imports and IT-services exports. However, narrower goods-trade deficits due to import contraction, remittances inflows, alongside curtailed reinvested earnings and barred dividend payment align with a modest current-account surplus expected in this year. Net foreign direct investment (FDI) aggregated to 3.7% of GDP in 2021. However, FDI has been impaired in 2022.
- **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 60% by Q1 2022. Consequently, Ukraine's net international investment position (NIIP) was strengthened, standing at roughly -5% in Q1 2022, correcting from a peak of -50.2% of GDP in Q3 2015.
- **Resilience to short-term external shocks:** While Ukraine has rebuilt foreign-exchange reserves over recent years, existing external-sector cushions are, at this stage, inadequate under presently extended crisis conditions. This is in consideration of modest forex reserve coverage of under 40% of short-term external debt (on remaining maturity basis) as of June 2022, declining from 62% at end-2021. Foreign-currency reserves have declined USD 10bn since December 2021 to USD 19.1bn by July 2022. Central-bank sales of foreign exchange and monetary financing of a state funding gap drive acceleration of reserve losses. FX sales have defended a fixed exchange rate against the US dollar to reduce uncertainty in the economy. The official hryvnia exchange was devalued 25% against US dollar on 21 July, resulting in significant convergence with the unofficial hryvnia rate.

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

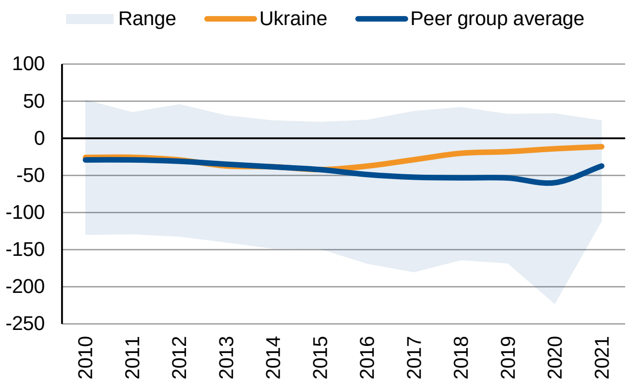
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Current account resilience	Neutral	0	Risk from capital outflows, reliance upon remittances inflows, temporary rebound expected in the current account, impairment of FDI
	External debt structure	Neutral	0	Decline of external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

Current-account balance, % of GDP



Source: IMF WEO, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

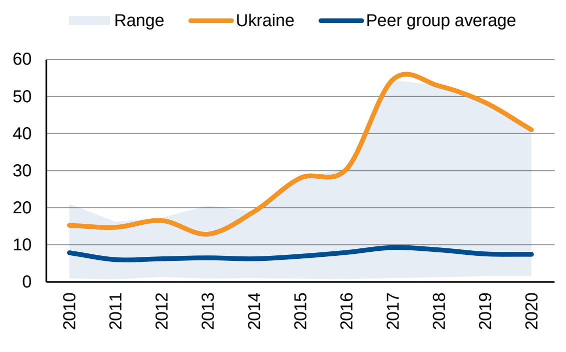
Financial Stability Risks

- **Banking sector:** The system-wide tier 1 capital ratio dropped to 11.7% of risk-weighted assets by January 2022, before the full-scale invasion, with an average return-on-equity ratio of 33% the same month. The banking sector recorded a UAH 0.16bn loss in Q1 as higher provisions of UAH 21.6bn were needed for expected losses due to the war. Around 75% of such provisions had been assigned in March, resulting in return on equity dropping to -0.2% in the month. The non-performing loan (NPL) ratio remains elevated, easing to a still elevated 26.6% of gross loans in February from 29.5% in January, due to liquidation of two Russian state-owned banks, but rising again slightly by May to 27.6% as financial institutions started gradual recognition of deterioration of loan quality. Concentration risk is high. System-wide dollarisation has recently increased, with savings migrating to foreign- from domestic-currency. Before recent re-dollarisation, the share of bank deposits in foreign currency had earlier dropped 3.1pps since January to 31.7% as of May 2022, with loans in foreign currency likewise having declined 4.5pps over a same period to 25.2%. Foreign currency-denominated deposits have slightly increased in June, to 33%.
- **Private debt:** Private debt of Ukraine remains limited as households and non-financial corporations (NFCs) demonstrate only trifle amounts of loans outstanding as a share of GDP borrowed in national currency, amounting to roughly 4% and 8% as of May 2022. Shares are even smaller for loans in foreign currency (under 0.5% of GDP for households, around 4% for NFCs). Deposit funding in domestic currency has remained strong: between the full-scale invasion and end-May, retail deposits rose around 19%, with corporate deposits in hryvnia rising 4%. The outflow of deposits in foreign currencies halted. Term deposit outflows slowed in May and are smaller than those observed during the crisis of 2014.
- **Financial imbalances:** Ukraine's banking system faces significant credit-risk and profitability challenges, given the effect of the current severe economic downturn on loan quality and bank incomes. Supportive policy measures such as repayment holidays, reduced commissions and loan restructurings could ease the impact of the crisis on asset quality, and their eventual phase-out is expected to be gradual even after martial law is lifted. A delayed recognition of financial losses, however, could result in sharp deterioration of financial positions when losses are recognised in the future.

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

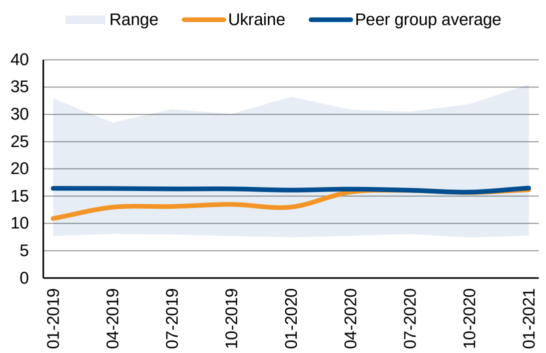
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Banking sector performance	Weak	-1/3	Declining banking-system capitalisation and profitability. NPL ratio elevated, concentration risk, high foreign-currency risk on bank balance sheets amid re-dollarisation.
	Banking 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: World Bank, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

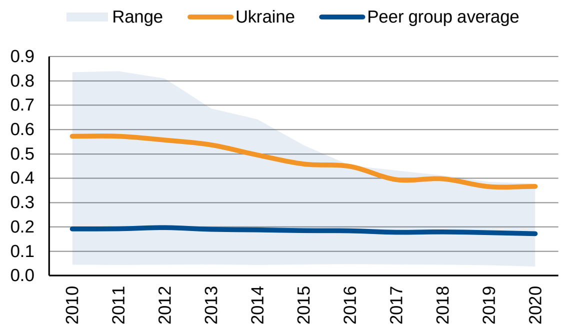
ESG Risks

- **Environment:** Ukraine's economy faces high transition costs 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% 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 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. The raging war is causing huge, long-lasting environmental and climate damage as far as waterways, air and soil pollution, forest destruction and increase of carbon footprint due to the use of weapons, which contributes to greenhouse gas emissions.
- **Social:** Ukraine's labour-market performance is mixed, as 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 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 United Nations 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 the end of February, the European Union formally agreed in June to candidate status for Ukraine – starting a longer-term 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*

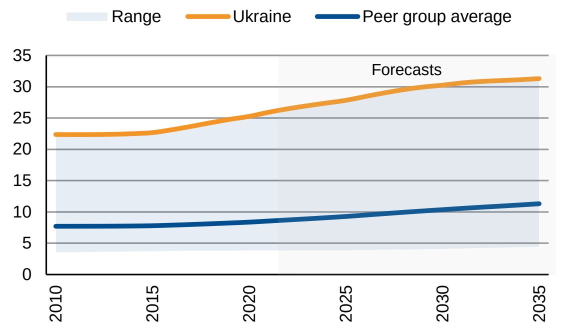
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
b	Environmental risks	Neutral	0	Transition risks outstanding for a higher carbon-intensity developing economy; ambitious climate objectives
	Social risks	Weak	-1/3	Poverty, emigration and internal displacement of persons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

CO_2 emissions per GDP, $mtCO_2e$



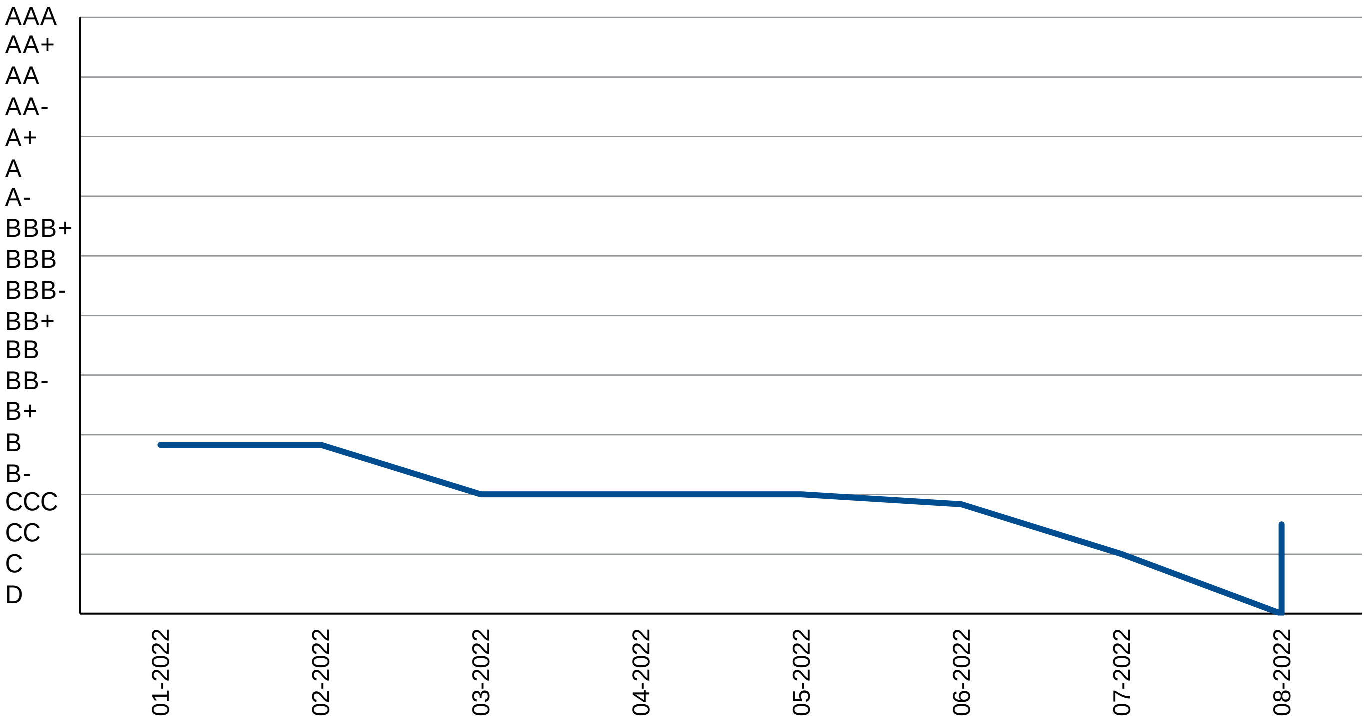
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



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

Appendix II. 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 embedding a methodological reserve-currency adjustment.

Peer group
Egypt
Nigeria
Uganda

Appendix III. 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	3.8	4.8	-	-
Nominal GDP, USD bn	93.3	112.1	130.9	154.0	155.3	198.3	-	-
Real growth, %[1]	2.4	2.4	3.5	3.2	-3.8	3.4	-31	12.5
CPI inflation, %	13.9	14.4	10.9	7.9	2.7	9.4	-	-
Unemployment rate, %[1]	9.5	9.7	9.0	8.5	9.2	10.3	-	-
Public Finance Risk								
Public debt, % of GDP[1]	79.5	71.6	60.4	50.5	61.0	48.9	89.1	85.3
Interest payment, % of government revenue	10.7	9.5	8.3	7.7	7.3	7.8	-	-
Primary balance, % of GDP[1]	1.9	1.5	1.1	1.1	-3.0	-1.1	-13.7	-10.0
External Economic Risk								
Current account balance, % of GDP	-1.5	-2.2	-3.3	-2.7	3.3	-1.6	-	-
Total reserves, months of imports	3.2	3.2	3.1	3.5	4.9	3.6	-	-
NIIP, % of GDP	-37.4	-28.8	-20.2	-18.0	-14.1	-12.4	-	-
Financial Stability Risk								
NPL ratio, % of total loans	39.0	54.8	54.4	50.5	43.5	31.7	-	-
Tier 1 ratio, % of risk-weighted assets	9.0	12.1	10.5	13.5	15.7	12.0	-	-
Credit to private sector, % of GDP	47.3	38.3	34.5	30.0	28.2	-	-	-
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	3.8	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 WEO, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economies
5y USD CDS spread (bps) as of 19 August 2022	10,972

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