Euler Hermes Economic Research

Country Risk Analysis

Ukraine

High external liquidity risk

General Information

Form of state	USD165.2bn (World ranking 54, World Bank 2011)
Population	45.71 millions (World ranking 30, World Bank 2011)
Form of state	Republic
Head of government	Viktor YANUKOVYCH
Next elections	2015, presidential

Strengths

- Fertile black soil.
- Transit country for Russian gas exports.

Weaknesses

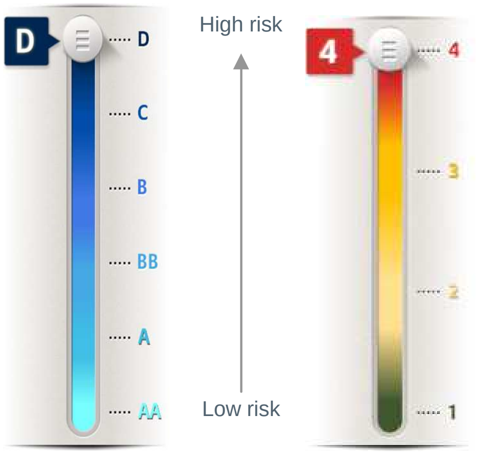
- History of political instability and government inefficiency; weak constitutional framework.
- High economic dependence on Russia (major trading partner, in particular gas supplier).
- Considerable vulnerability of market confidence to external shocks and political events (exchange rate risk and banking sector risk).
- Poor economic policy track record.
- Vulnerable external liquidity position (large current account deficits, low FX reserves).
- High external debt.
- A generally weak business environment.

Country Rating

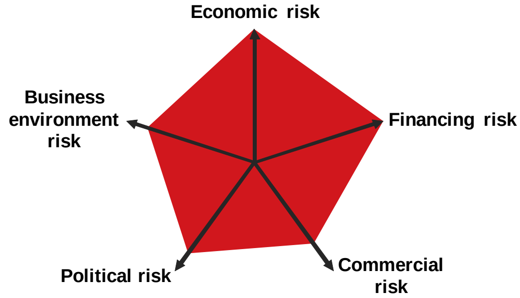
D4

Country Grade

Country Risk Level



Risk Dimensions



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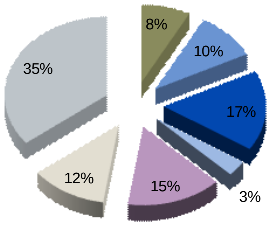
Economic Structure

GDP breakdown (% of total, 2010)



Sources: Chelem, IHS Global Insight, Euler Hermes

Trade structure (% of total, 2010)

By destination/origin

Exports		Rank		Imports
Russia	25%	1	36%	Russia
Turkey	6%	2	9%	Germany
Italy	5%	3	8%	China
Non-OPEC Middle East	4%	4	5%	Poland
Germany	4%	5	4%	Belarus

By product

Exports		Rank		Imports
Iron Steel	27%	1	16%	Natural Gas
Refined Petroleum Product	6%	2	7%	Refined Petroleum Products
Iron Ores	6%	3	7%	Crude Oil
Fats	5%	4	4%	Plastic Articles
Cereals	5%	5	3%	Pharmaceuticals

Economic Forecasts

	Average 2000-08	2009	2010	2011	2012f	2013f	2014f
GDP growth (% change)	6.9	-14.8	4.1	5.2	0.2	1.5	3.2
Inflation (%, end-year)	12.5	12.3	9.1	4.6	-0.2	5.9	5.0
Fiscal balance (% of GDP)	-2.5	-6.3	-5.8	-2.7	-5.3	-5.5	-5.5
Public debt (% of GDP)	26.1	35.4	40.5	36.0	38.3	39.3	40.6
Current account (% of GDP)	2.4	-1.5	-2.2	-6.3	-8.0	-7.0	-6.8
External debt (% of GDP)	50.7	88.2	86.0	77.2	78.5	91.5	96.4

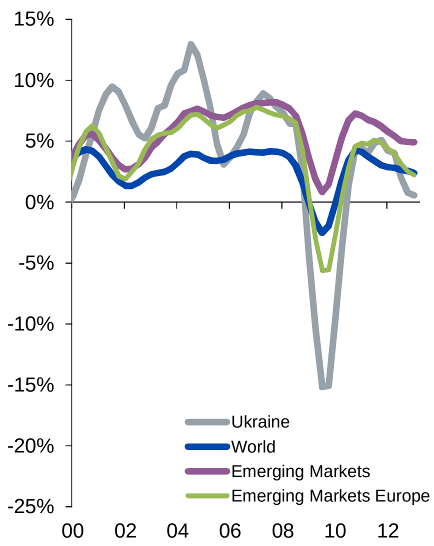
Sources: IHS Global Insight, National sources, Euler Hermes

Economic Growth

Return to recession.

Following the financial crisis and deep recession in 2009 (-14.8%), the Ukrainian economy recovered moderately in 2010 (+4.2%) and 2011 (+5.2%), driven by strong domestic demand while external demand remained weak. However, the economic performance significantly deteriorated in the course of 2012, with y/y real GDP growth slowing to +2.2% in Q1 and +3% in Q2 and shifting to contractions of -1.3% in Q3 and -2.5% in Q4, i.e. the economy is back in recession. Full year 2012 growth was a mere +0.2%, driven by an increase of private consumption by +11.7%. Government consumption grew by +2.2%. Fixed investment expanded by just +0.9% and the sharp decline of gross capital formation, by -12.9%, indicates a large drop in inventories. Exports fell sharply by -7.7% in 2012 while imports maintained modest growth of +1.9%. Early indicators for 2013 show a continued decline of industrial production by -4.8% y/y in January-February. We project real GDP to continue to contract in H1 2013, before recovering gradually in H2 and reaching about +1.5% for the year as a whole. The balance of risks to this forecast is more to the downside, especially if the global economic recovery from H2 2013 is weaker than currently forecast.

GDP growth (y/y, 4 qtrs cumulated %)

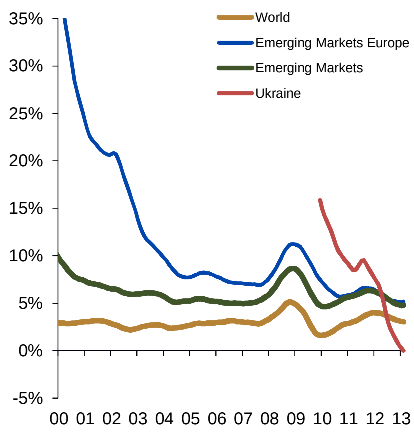


Sources: IHS Global Insight, Euler Hermes

Inflation is forecast to return later in 2013.

Headline inflation eased from double-digits until mid-2011 to 4.6% at end-2011 and has shifted to deflation at end-2012 and in early 2013 (-0.5% y/y in February). This development can in part be explained by the rapid economic slowdown and return to recession in H2 2012, but especially by the ongoing heavy subsidisation of gas retail prices and the continued quasi-peg of the UAH to the USD. The latter two issues appear unsustainable in the medium term and should Ukraine be forced to give up one or both, a sharp increase of inflation is likely to follow.

Inflation rate (%, year-end)



Sources: IHS Global Insight, Euler Hermes

Exchange rate risk remains high.

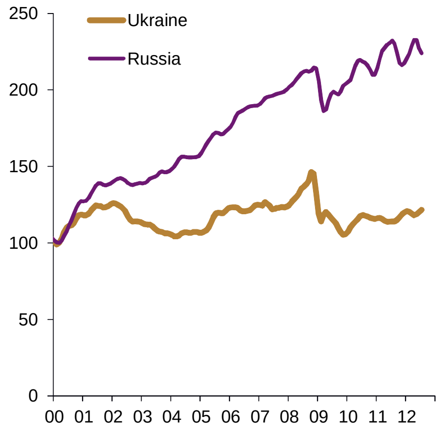
The official UAH/USD exchange rate, managed by the central bank, depreciated sharply in the wake of the 2008-2009 global financial crisis, from 4.85 at end-August 2008 to 7.70 at end-2008 and around 8.00 in August 2009 (-65%). The interbank market rate fell much steeper initially, from 4.85 at end-August 2008 to a low of 9.37 in mid-December 2008 (-93%). Thereafter it has converged towards the official rate.

The official exchange rate has been fairly stable around 8.00 since then, however, over the past two years only thanks to heavy central bank intervention. This has included heavy selling of foreign exchange (FX) reserves and, in November 2012, the introduction of capital controls. The latter were intended to protect the UAH/USD peg while preventing a further decline of FX reserves.

A view at the real effective exchange rate suggests a moderate but rising overvaluation of the UAH.

Altogether there is a high risk that the central bank may be forced at some point to give up the quasi-fixed exchange rate regime, which may result in another sharp devaluation.

Real effective exchange rate (2000=100)



Sources: IHS Global Insight, Euler Hermes

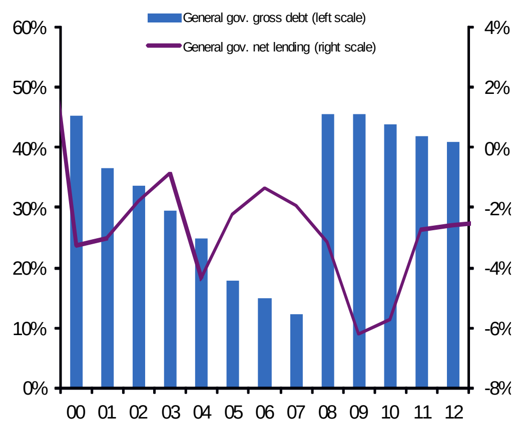
Rising sovereign risk.

After narrowing from around 6% of GDP in 2009-2010 to 2.7% in 2011, the fiscal deficit is estimated to have risen again to 5.3% of GDP in 2012 and is forecast to increase further in 2013-2014. Total public debt has widened from 35% of GDP in 2009 to around 38% in 2012, a figure that appears moderate at first sight.

Worrisome, however, sovereign funding risk has risen again in recent years as a result of the ongoing stalemate of government negotiations with both the IMF and Russia's Gazprom. For the last three years, President Yanukovich has been seeking—unsuccessfully to date—a deal with Gazprom on lower prices for imported gas which would help Ukraine somewhat with its fiscal problems.

A 29-month USD15bn IMF Stand-By Arrangement (SBA) from July 2010 to end-2012 went off track in April 2011 as a result of the start of expansionary fiscal policy and the government's unwillingness to reduce the heavy subsidisation of gas retail prices, a key request of the IMF. Currently, the Ukrainian government has requested for a new USD15bn SBA to assist it with its USD9bn external-debt servicing this year (nearly 75% of which is to be repaid to the IMF). However, the outlook for support remains slim as long as the government does not move on its position regarding the domestic gas price subsidies, which remain the key obstacle. Sovereign refinancing risk is likely to increase further.

Fiscal balance and General government debt (% GDP)



Sources: IHS Global Insight, Euler Hermes

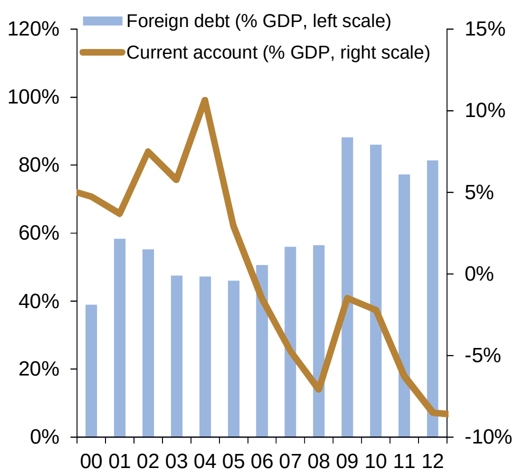
The widening current account deficit ...

The current account deficit widened sharply to USD10.2bn (6.2% of GDP) in 2011 and rose further to USD14.4bn (8% of GDP) in 2012. We forecast the annual external deficit to remain large at around 7% of GDP in 2013-2014. Net foreign direct investment (FDI) inflows amounted to USD7bn in 2012, covering just 48.6% of the current account deficit. The remainder had to be financed through new external debt.

... pushes up the already high external debt burden.

Gross external debt has continued to rise and stood at USD132bn in Q3 2012 (about 78% of GDP), up from USD126bn at end-2011 (76% of GDP). A shortening maturity structure for the private sector highlights an increasing risk aversion among international lenders.

External debt and current account (% of GDP)

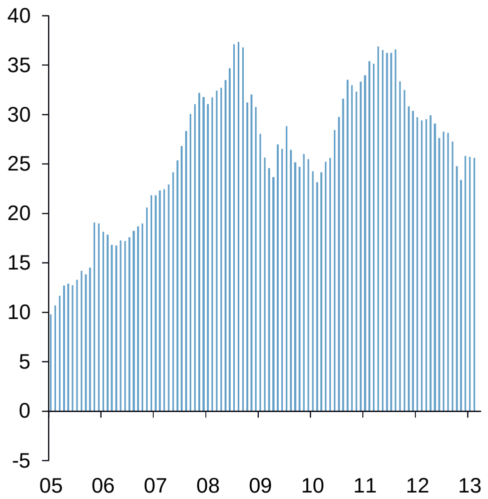


Sources: IHS Global Insight, Euler Hermes

FX reserves continue to decline rapidly.

FX reserves stood at USD22.8bn in February 2013, down 22% from a year earlier and down 38% from an all-time high in April 2011 (the month when the previous IMF programme went off track). The decline of FX reserves is a result of continued central bank intervention to defend the quasi-fixed exchange rate, which has faced considerable downward pressure over the past two years. Critically, current FX reserves meanwhile cover just 2.5 months of imports and only 40% of all external debt payments falling due in 2013.

FX reserves (USDbn)



Sources: IHS Global Insight, Euler Hermes

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