Euler Hermes Economic Research

Country Report

Ukraine

Peace, not just money, needed for economy to recover

General Information

GDP	USD177.4 bn (World ranking 55, World Bank 2013)
Population	45.5 mn (World ranking 30, World Bank 2013)
Form of state	Republic
Head of government	Petro POROCHENKO (President)
Next elections	2019, presidential and legislative

Strengths

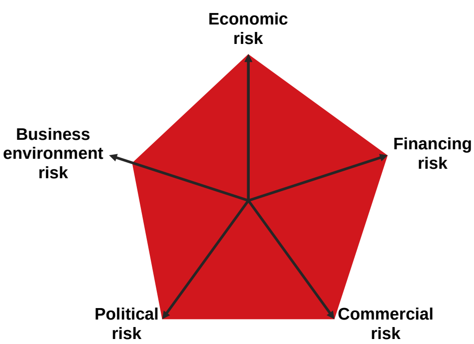
- Fertile black soil
- Transit country for Russian gas exports

Weaknesses

- Severe conflicts with separatists in east Ukraine ...
- ... and with Russia (which supports the separatists)
- History of political instability and government inefficiency; weak constitutional framework
- High economic dependence on Russia (major trading partner, in particular natural gas supplier)
- Poor economic policy track record
- Balance of payments crisis; very high exchange rate risk
- Very low FX reserves, implying high transfer and convertibility risk
- Looming sovereign default or debt restructuring
- High external debt
- A generally weak business environment

Country Rating

D4



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Russia	24%	1	32%	Russia
Turkey	5%	2	10%	China
Egypt	5%	3	8%	Germany
China	4%	4	6%	Belarus
Italy	4%	5	6%	Poland

By product (% of total)

Exports		Rank		Imports
Iron Steel	23%	1	17%	Natural Gas
Cereals	9%	2	11%	Refined Petroleum Products
Fats	6%	3	4%	Pharmaceuticals
Commercial Vehicles	6%	4	3%	Cars And Cycles
Iron Ores	6%	5	3%	Plastic Articles

Source: Chelem (2012)

Ongoing severe political crisis has aggravated long-lasting economic crisis

Ukraine has been high country risk long before the political crisis and conflicts erupted in late 2013/early 2014. The economic crisis developed following the suspension of an IMF funding programme in April 2011. Macroeconomic imbalances widened again, especially the current account deficit and the fiscal deficit, and downward pressure on the UAH increased. Foreign exchange (FX) reserves declined with accelerating pace as a result of recurrent central bank intervention to defend the then quasi-fixed exchange rate, capital flight and the financing of fiscal deficits. Since mid-2012, the Ukrainian economy has been in recession.

Since 2014, the violent conflict between government forces and separatists in east Ukraine – which has been ongoing despite two ceasefire agreements in September 2014 and February 2015 – and the related serious dispute with Russia (which annexed Crimea in March 2014 and supports the separatists) have drastically aggravated the economic crisis in Ukraine. A balance-of-payments crisis has evolved, FX reserves have dwindled despite large-scale international financial support, the recession has deepened, and a sovereign debt restructuring/ default is looming in 2015-2016.

Deep recession to continue in 2015

Real GDP dropped by -15.2% y/y in Q4 2014, following -5.3% in Q3, -4.6% in Q2 and -1.2% in Q1. This indicates that GDP contracted by about -6.5% in 2014 as a whole, weighed down by the conflict in east Ukraine, which has taken a significant toll on the industrial base and exports, undermined confidence and caused pressures on the financial system. Details of Q4 and full-year GDP are not available as yet, but the breakdown of Q1-Q3 shows that private consumption contracted by an average -3% y/y, fixed investment by a hefty -22%, exports by -10% and imports by -17%. Public consumption was roughly flat in Q1-Q3. Against the backdrop of the ongoing political crisis, the plunging exchange rate and rapidly rising inflation, Euler Hermes expects the downtrend to continue well into 2015 and forecasts a contraction of GDP by around -8%.

Exchange rate risk remains very high

Since the National Bank of Ukraine (NBU; the central bank) abandoned the peg of the UAH to the USD (at 1:8) in early February 2014, the currency has depreciated rapidly. Even though the NBU continued to intervene in FX markets to stabilise the exchange rate, the UAH had lost about half of its value by end-January 2015. Then, the UAH plunged by -22% against the USD on 6 February 2015 as the NBU ceased FX auctions because its FX reserves had fallen dramatically. The UAH fell further to a record low of 1:30 against the USD on 26 February before recovering somewhat in early March (1:23 on 6 March). Noteworthy, a gap of 5-6% between the official exchange rate and the middle rate on the FX cash market has remained, indicting continued downward pressures on the currency. All in all, since the NBU's FX reserves remain relatively depleted, the UAH remains highly vulnerable to further volatility and depreciation in the foreseeable future.

Rising inflation and interest rates

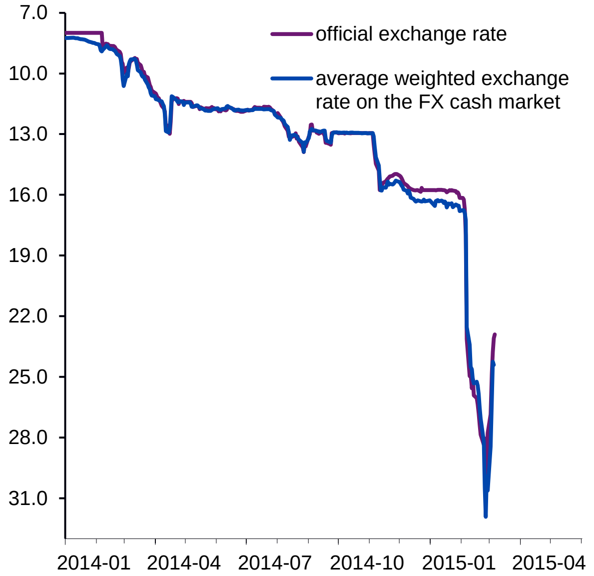
The sharp UAH depreciation has fed through to consumer price inflation which has surged from just

Key economic forecasts

	2013	2014	2015f	2016f
GDP growth (% change)	0.0	-6.5	-8.0	1.0
Inflation (%, end-year)	0.5	24.9	25.0	10.0
Fiscal balance (% of GDP)	-4.8	-10.0	-10.0	-5.0
Public debt (% of GDP)	40.9	70.0	75.0	70.0
Current account (% of GDP)	-9.2	-4.2	-2.0	-3.0
External debt (% of GDP)	75.4	90.0	115.0	110.0

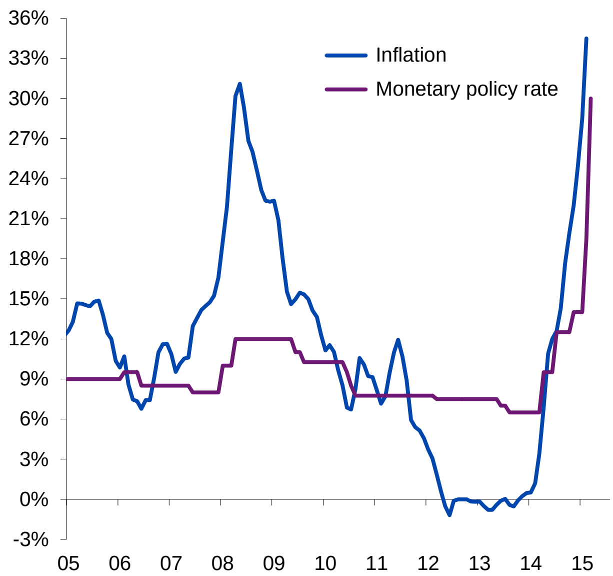
Sources: National sources, IHS, Euler Hermes

USD:UAH exchange rates



Sources: National Bank of Ukraine, Euler Hermes

Monetary policy interest rate (%) and inflation rate (y/y, %)



Sources: National sources, IHS, Euler Hermes

0.5% at end-2013 to 24.9% at end-2014 and 34.5% y/y in February 2015. The NBU hiked its key monetary policy interest rate accordingly in five large steps from 6.5% at end-2013 to 30% in early March 2015. Nonetheless, Euler Hermes expects inflation to remain above 30% in H1, before gradually easing in H2, reaching perhaps 25% at end-2015.

High risk of sovereign default

The rapid deterioration of public finances since 2012 has intensified in 2014. The fiscal deficit is estimated to have increased to 10% or so of GDP, using a broader definition including losses of the state-owned gas company Naftogaz, unpaid gas imports, VAT refund arrears and operations by off-budget entities. And public debt rose to around 70% of GDP in 2014 (up from 41% in 2013). Since May 2014, Ukraine has received financial support from the IMF, the EU and other bilateral and multilateral partners, which has helped to finance public expenses. In February 2015, the government reached a preliminary agreement on a new, four-year USD17.5 bn IMF bailout program, bringing the total commitment of the Fund and other resources from the international community to about USD32 bn. However, the new program will also require a restructuring of sovereign debt held by the private sector, details of which are still unclear, thus leaving a degree of uncertainty.

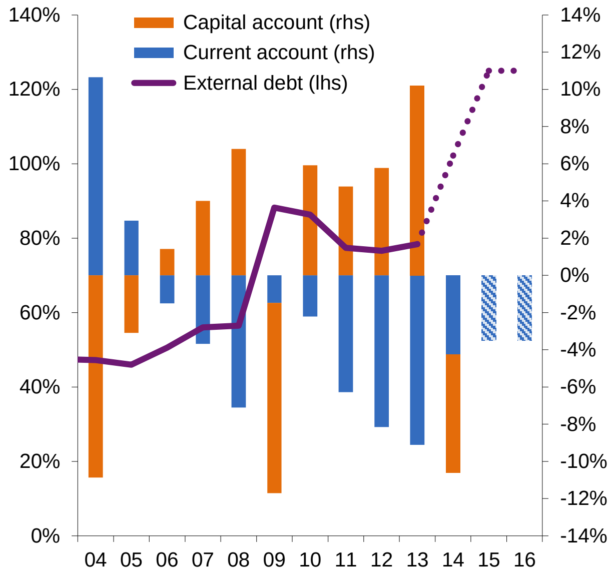
Balance of payments crisis

A balance-of-payments crisis has evolved in 2014, even though the current account deficit narrowed to -4.2% of GDP in 2014 (from -9.2% of GDP in 2013) because the capital account shifted into deficit as well (-6.4% of GDP). As a result, FX reserves have dwindled from USD18.8 bn at end-2013 to USD4.7 bn in February 2015, despite the international financial support. Current reserves cover less than one month of imports, well below an adequate level of at least three months. In other terms, reserves cover less than 10 of all (public and private) external debt payments falling due in the next 12 months, much below a satisfactory level of 100%. As a consequence, non-payment risk will remain very high, not only in the private sector but also in the public sector, especially if external financial support would be interrupted as it did in late 2014.

Very high external debt to GDP ratio

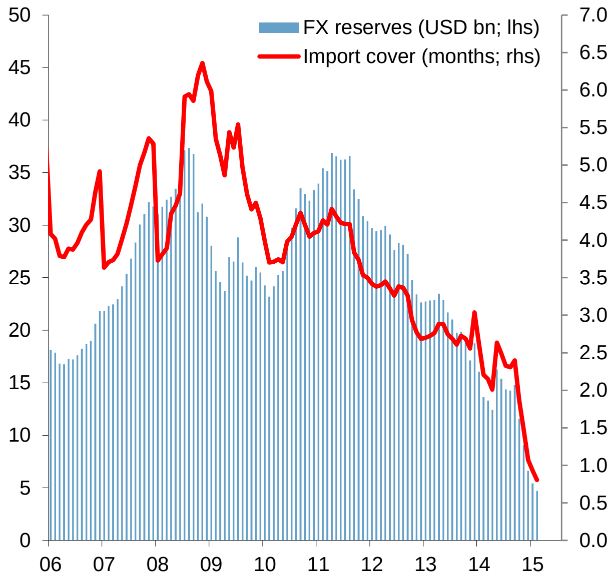
Gross external debt declined from USD 142 bn at end-2013 to USD136 bn in Q3 2014, but rose to about 90% as a share of GDP. Euler Hermes expects this already high ratio to increase to at least 115% in 2015, as a result of the UAH depreciation (95% of external debt is denominated in hard currencies) and forthcoming financial aid from international institutions.

Balance of payments and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves and import cover



Sources: National sources, IHS, Euler Hermes

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