Euler Hermes Economic Research

Country Report

Ukraine

Growing again, but crises remain unresolved

General Information

GDP	USD90.6bn (World ranking 63, World Bank 2015)
Population	45.2mn (World ranking 31, World Bank 2015)
Form of state	Republic
Head of state	Petro POROCHENKO (President)
Next elections	2019, presidential and legislative

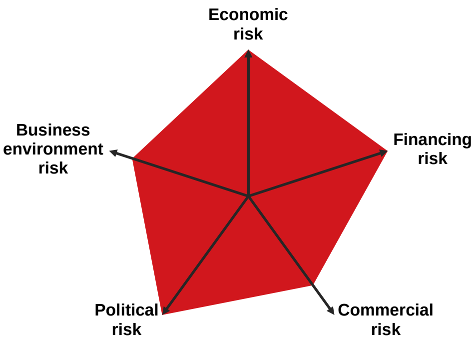
Strengths

- Fertile black soil
- Willingness to support from International Financial Institutions and bilateral donors

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
- Continued high exchange rate risk
- Low FX reserves, implying significant transfer and convertibility risk
- High public debt, of which two thirds in foreign exchange
- Very 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	13%	1	20%	Russia
Turkey	7%	2	10%	Germany
China	7%	3	10%	China
Egypt	5%	4	6%	Belarus
Poland	5%	5	6%	Poland

By product (% of total)

Exports		Rank		Imports
Agricultural products; foodstuff	38%	1	32%	Mineral products (incl. oil, gas)
Metals & metal producs	25%	2	16%	Machinery
Machinery	10%	3	13%	Chemicals & pharmaceuticals
Mineral products (incl. oil, gas)	8%	4	9%	Agricultural products; foodstuff
Chemicals & pharmaceuticals	6%	5	7%	Plastics & rubber

Source: State Statistics Service of Ukraine (2015)

While the severe political crisis goes on...

Ukraine has been in economic crisis since 2011 and in recession from mid-2012 to 2015. In 2014-2015, the violent conflict between government forces and separatists in east Ukraine and the related serious dispute with Russia (which annexed Crimea in March 2014 and supports the separatists) drastically aggravated the economic crisis. After the second ceasefire agreement from February 2015, the fighting in the east eventually slowed down somewhat in 2016, however, in the past few months it has re-escalated. After two years of deep recession (-6.6% in 2014 and -9.8%) the economy returned to modest growth in 2016, estimated at +1.5%.

...the recession has ended, at least,...

Details of Q4 and full-year 2016 GDP are not available as yet, but the breakdown of Q1-Q3 shows that domestic demand drove the recovery. Consumer spending grew by an average +2.4% y/y (after dropping by -20.4% in full-year 2015), public spending by +0.2% y/y (+1.7% in 2015) and fixed investment rebounded by +15.5% y/y (-9.2% in 2015). Exports continued to contract by -5.3% y/y (-13.2% in 2015) while imports edged up by +2.2% y/y (-17.9% in 2015) so that net exports still made a large negative contribution to growth in Q1-Q3.

Euler Hermes expects the gradual recovery to continue and GDP to increase by +2% in 2017. Still, the annual level of GDP in 2017 will be around -13% below the level in 2012 and even -22% below the level in 2008 (i.e. before the global financial crisis which also hit Ukraine hard). Moreover, downside risks to our forecast prevail, including renewed intensification of political instability and disruptions to international funding programs.

...but exchange rate risk remains high...

Since the National Bank of Ukraine (NBU; the central bank) abandoned the peg of the UAH to the USD (at 1:8) in February 2014, the currency has substantially lost in value. One year later, it hit a record low of 1:30 against the USD in February 2015 as the NBU ceased FX interventions because its FX reserves had fallen dramatically. After recovering from that overshooting, the UAH has continued to fall since mid-2015, in part because of a lasting disruption in the IMF lending program. Summarizing, after losing half of its value against the USD in 2014, another third in 2015 and -12% in 2016, the UAH is standing at around USD1:UAH27 at the time of writing, i.e. it has lost -71% since end-2013. Although the gap between the official exchange rate and the middle rate on the FX cash market has narrowed during 2016, Euler Hermes expects downward pressures on the currency and the depreciation to continue in 2017, albeit at a more moderate pace (around -10%), with bouts of volatility being highly likely.

...and inflation in double digits

The sharp UAH depreciation fed through to inflation which surged to a peak of 60.9% y/y in April 2015 and an annual average of 48.5% in full year 2015. Thereafter, inflation eased rapidly to a temporary low of 6.9% y/y in June 2016 but, as base effects faded, it rose again to 12.6% y/y in January 2017.

The NBU hiked its key monetary policy interest rate accordingly in several steps to 30% in March 2015, before starting an easing cycle in August 2015, cutting the policy rate to 14% by October 2016.

Euler Hermes expects inflation to remain in double digits in 2017 and monetary policy to stay on hold for some time.

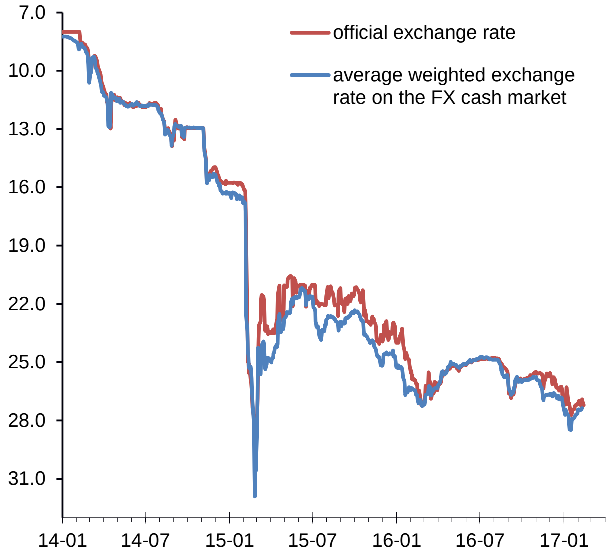
Key economic forecasts

	2015	2016	2017f	2018f
GDP growth (% change)	-9.8	1.5	2.0	2.2
Inflation (%, end-year)	43.3	12.4	11.0	9.0
Fiscal balance (% of GDP) *	-2.1	-3.8	-4.2	-3.6
Public debt (% of GDP)	80.1	93.0	92.0	86.0
Current account (% of GDP)	-0.2	-3.9	-4.2	-3.8
External debt (% of GDP)	134.6	135.3	125.9	119.2

* Includes Naftogaz operational deficit.

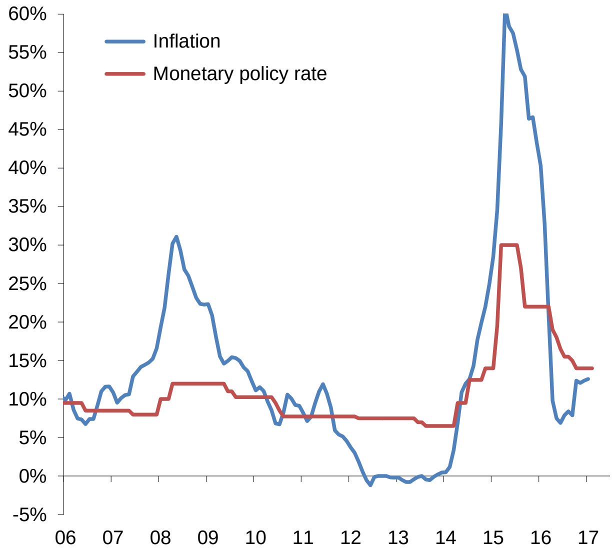
Sources: National sources, IMF, IHS, Euler Hermes

UAH per USD exchange rates



Sources: National Bank of Ukraine, Euler Hermes

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



Sources: National sources, IHS, Euler Hermes

Bumpy IMF program performance leaves public finances in critical stage...

Public finances have rapidly deteriorated since 2012, with the fiscal deficit surging to -10.1% of GDP in 2014, 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.

Since May 2014, Ukraine has received financial support from the IMF, the EU and other bilateral and multilateral partners, which initially helped to finance public expenses. In March 2015, the government reached an agreement on a new, 4-year USD17.5bn IMF Extended Fund Facility (EFF) program, bringing the total commitment of the Fund and other resources from the international community to about USD32bn. Moreover, in November 2015 Ukraine achieved a debt restructuring of USD15bn or so with 13 private creditors. Nonetheless, the EEF program went quickly off track. Completion of the second review (due in September 2015) and the disbursement of the USD1bn tranche was delayed by a full year, mainly owing to government-internal disputes over fiscal measures and accumulation of external payment arrears. The third review was still pending at the time of writing, but may be completed by end-March 2017. Even then, there is a high likelihood of further IMF program disruption in 2017-2018.

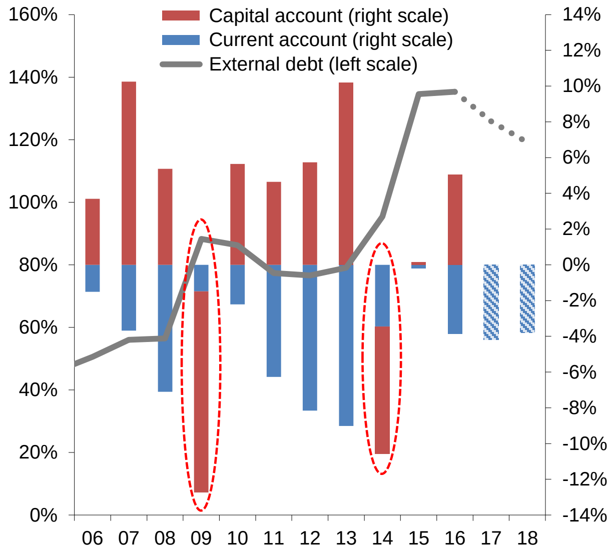
Against this background, the fiscal deficit narrowed to -2.1% of GDP in 2015 but rose again to almost -4% in 2016 and is forecast to rise further in 2017. Meanwhile, public debt rose to 93% of GDP in 2016 (up from 37% in 2011). All in all, public finances remain of serious concern and a risk to the recovery.

...and external liquidity risk remains high

A balance-of-payments crisis evolved in 2014 as the current account deficit (-3.4% of GDP) was accompanied by a large capital account deficit (-7.1% of GDP) due to capital flight. As a result, FX reserves dwindled to a low of USD4.7bn in February 2015, despite the international financial support. In 2016, the current account deficit rose again to -4% of GDP, however, it was fully covered by net FDI inflows, and the capital account shifted back to a surplus of +5% of GDP, mitigating the balance-of-payments problems to some extent.

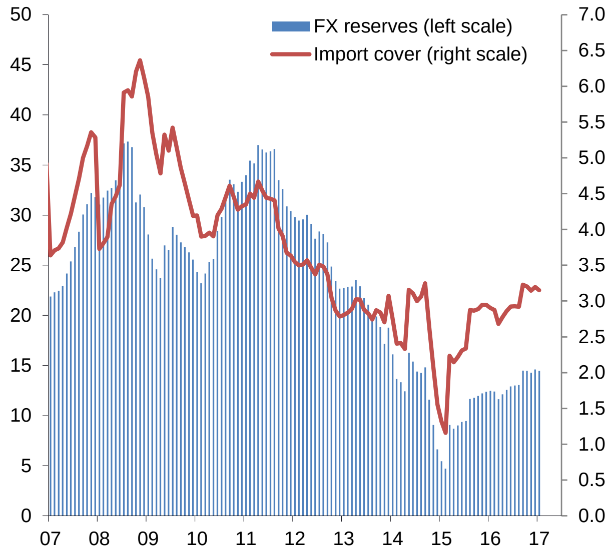
Meanwhile, FX reserves have recovered to USD14.5bn in early 2017, thus now just adequate in terms of import cover (3 months). In other terms, however, reserves cover only 20% of all (public and private) external debt payments falling due in the next 12 months, much below a satisfactory level of 100%. 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 continues to be frequently interrupted. Total external debt has risen to a hefty 135% of GDP in 2016.

Balance of payments and external debt (% of GDP)



Sources: National sources, IHS, Euler Hermes

Foreign exchange reserves (USD bn) and import cover (months)



Sources: National sources, IHS, Euler Hermes

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