Euler Hermes Economic Research

Country Report

Ukraine

Stuck in unresolved crises

General Information

GDP	USD131.805bn (World ranking 59, World Bank 2014)
Population	45.36mn (World ranking 31, World Bank 2014)
Form of state	Republic
Head of state	Petro POROCHENKO (President)
Next elections	2019, presidential and legislative

Strengths

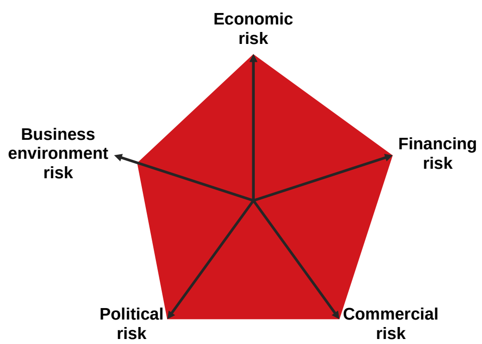
- Fertile black soil
- Willingness to support from International Financial Institutions and bilateral donors

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 high transfer and convertibility risk
- High public debt, of which two thirds in FX
- 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)

Economic Overview

Ongoing severe political crisis has aggravated long-lasting economic crisis ...

Ukraine has been in economic crisis since 2011 and in recession since mid-2012. In 2014-2015, 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 only slowed down somewhat in recent months (but could flare up again at any time) – and the related serious dispute with Russia (which annexed Crimea in March 2014 and supports the separatists) have drastically aggravated the economic crisis. A balance-of-payments crisis evolved in 2014 and foreign exchange (FX) reserves dwindled despite large-scale international financial support. The recession deepened, with real GDP contracting by -6.6% in 2014 and -9.9% in 2015.

... but deep recession has bottomed out

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 -22% y/y, public consumption by -1%, fixed investment by -15%, exports by -20% and imports by -24%. However, quarterly data indicate that the recession has bottomed out, with real GDP contracting by -1.2% y/y in Q4, after -7.2% in Q3, -14.6% in Q2 and -17.2% in Q1. Euler Hermes expects the gradual recovery to continue and forecasts GDP to increase slightly by +1% in 2016, mainly thanks to base effects. However, even then the annual level of GDP in 2016 will be around -16% below the level in 2012 and even -25% 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 programmes.

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 February 2014, the currency has depreciated rapidly. 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. The UAH then recovered to an average 1:22 in Q2-Q3 2015 before falling again since Q4, presumably because of a disruption in the IMF lending programme. Summarising, after losing half of its value against the USD in 2014, the UAH lost again one third in 2015. Standing at around USD1:UAH26 at the time of writing, it has lost -70% since end-2013. Although the gap between the official exchange rate and the middle rate on the FX cash market has narrowed during February 2016, Euler Hermes expects downward pressures on the currency and the depreciation to continue in 2016, albeit at a more moderate pace (-10% to -15%), with bouts of volatility being highly likely.

Inflation falls but remains high

The sharp UAH depreciation has fed through to consumer price inflation which has surged further from 24.9% at end-2014 to a peak of 60.9% y/y in April 2015. It ended 2015 with 43.3% y/y in December, bringing the annual average to 48.5%. The NBU hiked its key monetary policy interest rate accordingly in several steps to 30% in March 2015, but it started an easing cycle in August 2015, cutting the policy rate to 22% since September. Euler

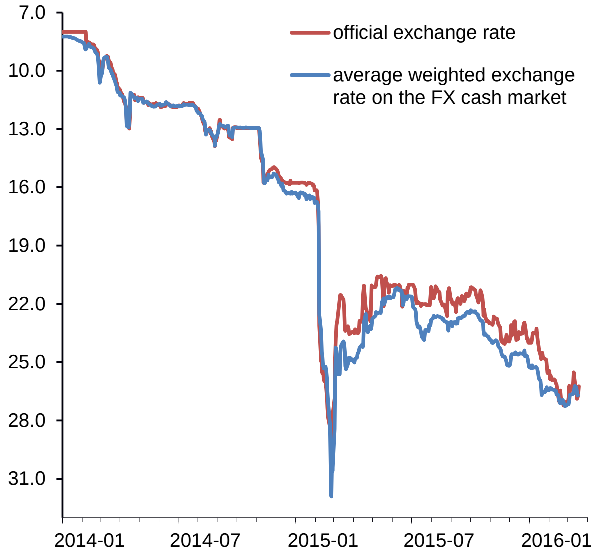
Key economic forecasts

	2014	2015	2016f	2017f
GDP growth (% change)	-6.6	-9.9	1.0	1.0
Inflation (%, end-year)	24.9	43.3	12.0	8.0
Fiscal balance (% of GDP) *	-10.1	-8.0	-4.5	-3.6
Public debt (% of GDP)	71.2	95.0	92.0	90.0
Current account (% of GDP)	-3.5	-0.3	-1.5	-2.0
External debt (% of GDP)	100.4	141.5	140.0	130.0

* Includes Naftogaz operational deficit.

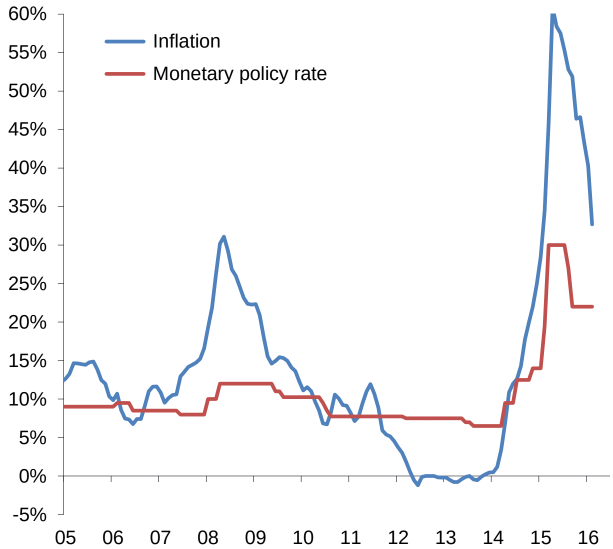
Sources: National sources, IMF, IHS, Euler Hermes

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

Hermes expects inflation to moderate to a still relatively high average 15% in 2016 and further corresponding monetary easing.

Sovereign default averted, for now, but public finances remain critical

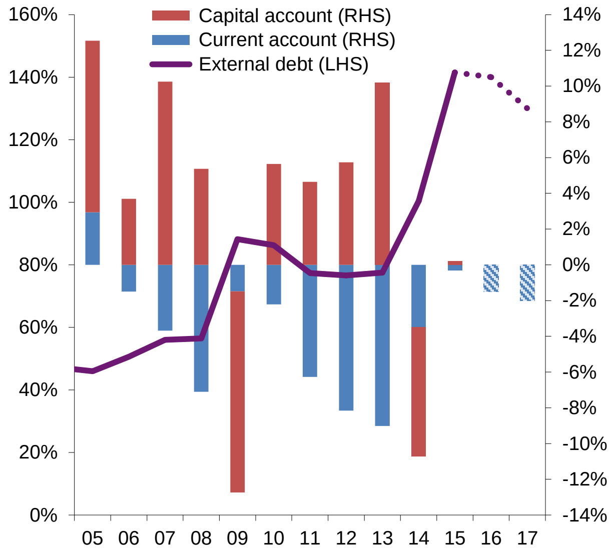
Public finances have rapidly deteriorated since 2012, with the fiscal deficit surging to -10.1% of GDP in 2014 and an estimated -8% in 2015, using a broader definition including losses of the state-owned gas company Naftogaz, unpaid gas imports, VAT refund arrears and operations by off-budget entities. And public debt rose to around 95% of GDP in 2015 (up from 38% in 2012). 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 March 2015, the government reached an agreement on a new, four-year USD17.5bn IMF Extended Fund Facility (EFF) programme, bringing the total commitment of the Fund and other resources from the international community to about USD32 bn. Moreover, in November 2015 Ukraine achieved a debt restructuring of around USD15bn with 13 private creditors. Nonetheless, the EEF programme went off track. Completion of the second review (scheduled for September 2015) and the third review (December) and the disbursement two USD1.7bn tranches have been delayed pending agreement on the 2016 budget which is subject to ongoing government-internal dispute. Even if the budget is agreed eventually in the next weeks, there is a high likelihood of further IMF programme disruption in the course of 2016. All in all, public finances remain of serious concern and a risk to the recovery.

External liquidity risk remains very high

A balance-of-payments crisis evolved in 2014 as the current account deficit (-3.5% of GDP) was accompanied by a large capital account deficit (-6.4% 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. Meanwhile, the current account deficit has narrowed and the capital account shifted back to a small surplus in 2015 and FX reserves recovered to USD12.5bn in early 2016.

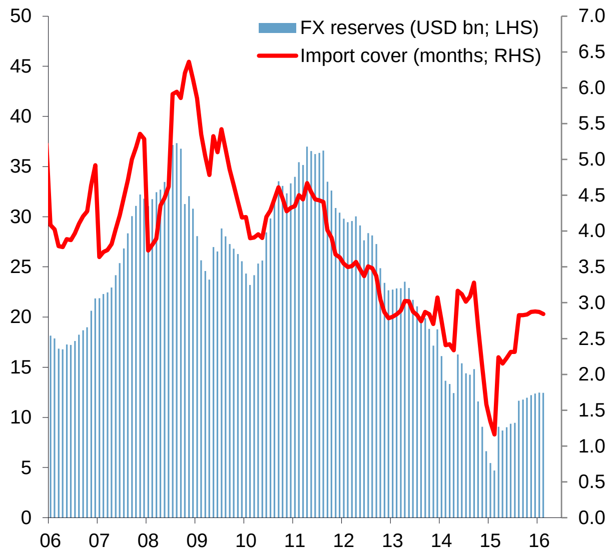
However, FX reserves are still insufficient in terms of import cover (below an adequate level of at least 3 months). In other terms, reserves cover just 22% of all (public and private) external debt payments falling due in the next 12 months, much below a satisfactory level of 100%. As a consequence, 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 and again in Q4 2015. Total external debt has risen to a hefty 140% of GDP.

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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