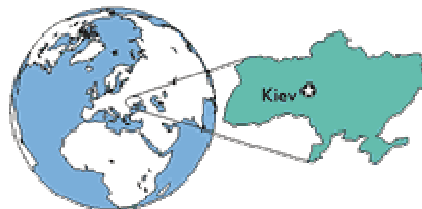


# COUNTRY REVIEW

## Ukraine



13 September 2010

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**EULER HERMES COUNTRY RISK GRADE: D**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## Strengths

- Fertile black soil
- Large-scale FDI inflows

## Weaknesses

- Weak constitutional framework
- History of political instability and government inefficiency
- High economic dependence on Russia (major trading partner, in particular gas supplier)
- Considerable vulnerability of market confidence to external shocks and political events
- Weak fiscal position
- Vulnerable external liquidity position
- High external debt
- A generally weak business environment
- Banking sector remains under strain

## Country Risk Assessment

Ratings	Ukraine		Median Grade D	Peers		
	Latest	Previous		Bosnia-H.	Kazakhstan	Niger
<b>Systemic Political Risk:</b>	<b>P3-</b>	<b>P3-</b>	<b>P3-</b>	<b>P3-</b>	<b>P3-</b>	<b>P4</b>
<b>Systemic Economic Risk:</b>	<b>E6</b>	<b>E6</b>	<b>E6</b>	<b>E6</b>	<b>E6</b>	<b>E6</b>
ME rating:	ME6	ME6	ME6	ME6	ME6	ME6
<i>Structure</i>	5.0	5.0	6.0	6.0	4.0	6.0
<i>Policy</i>	6.0	6.0	5.6	5.6	5.6	6.0
<i>Solvency</i>	6.0	6.0	4.3	3.9	5.5	4.2
<i>External Liquidity</i>	6.0	6.0	4.3	6.0	6.0	4.8
SBE rating:	SBE5	SBE5	SBE5	SBE6	SBE5	SBE6
<b>COUNTRY GRADE:</b>	<b>D</b>	<b>D</b>		<b>D</b>	<b>D</b>	<b>D</b>

**Nomenclature:**

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

## ECONOMIC STRUCTURE

<b>Country Profile</b>	
Capital city:	Kiev
Population:	45.706 mn (2009)
GDP:	USD 117422 mn (2009)
Currency:	Hryvnia (UAH)
Form of state:	Mix of presidential and parliamentary republic
Head of government:	Prime Minister Viktor YANUKOVYCH (since February 2010)
Next elections:	Legislative: 2012 / Presidential: 2015

<b>Major Industries (% of GDP at market prices, 2009)</b>	<b>Global Assumptions</b>	2010	2011	
Services	58.0%	Real GDP grth (% yr/yr)	3.3	2.9
Industry	31.5%	Inflation (% av) *	1.2	1.4
Agriculture	10.5%	Dated Brent (USD/b)	75	70
		* Major economies		

<b>Main Exports (% of total, 2009)</b>		<b>Main Imports (% of total, 2009)</b>	
Non-precious metals & articles	32.5%	Fuel & energy, incl. ores	34.5%
Agricultural & food products	24.0%	Engineering products	20.0%
Engineering products	17.5%	Chemical products	11.5%
Fuel & energy, incl. ores	10.0%	Agricultural & food products	11.0%
<b>Lead Export Markets (% of total exports, 2009)</b>		<b>Lead Import Markets (% of total imports, 2009)</b>	
Russia	21.5%	Russia	29.5%
Turkey	5.5%	Germany	8.5%
China	3.5%	China	6.0%
Kazakhstan	3.5%	Poland	5.0%

## Basic indicators

<b>Selected economic indicators</b>	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	142,719	180,239	117,422	130,760	145,520
Population (mn)	46.2	45.9	45.7	45.5	45.3
GDP per capita (USD)	3,090	3,924	2,569	2,875	3,216
Real GDP growth (% yr/yr)	7.9	2.3	-15.1	4.0	3.0
Inflation (% eop)	16.6	22.3	12.3	10.0	10.0
Fiscal balance (% of GDP)	-2.0	-3.2	-11.3	-9.9	-6.0
Public debt/GDP (%)	12.8	19.9	36.9	46.0	48.0
Current account balance (% of GDP)	-3.7	-7.1	-1.5	-0.5	-1.0
External debt/GDP (%)	56.0	56.4	88.0	80.3	79.0
External debt/Exports of goods & services (%)	124.9	118.7	190.4	172.1	187.6
Debt-service ratio (%)	17.9	16.5	35.0	32.4	32.2
Foreign exchange reserves (USD mn)	31,783	30,792	25,493	30,000	30,000
Import cover (months)	5.3	3.7	5.4	5.8	5.7
Official exchange rate, UAH:USD (av)	5.05	5.27	7.79	7.93	8.00
Official exchange rate, UAH:EUR (av)	6.92	7.71	10.87	10.23	9.60
f: CRU central forecast					

Sources: National Bank of Ukraine, State Statistics Committee, IMF, World Bank, Euler Hermes Economic Studies

## Political Stability

The "Orange Revolution" in late 2004 brought a political regime change, increased political openness and democratic transition, but did not lead to political stability. Major "Orange" allies soon fell out with each other and domestic politics were chronically paralysed by constitutional weaknesses that produced continuous power struggles between the presidency and parliament, as well as fragile coalition governments which were often short-lived. The result was high political uncertainty and policy discontinuity. Government ineffectiveness became a particular problem during the global financial crisis as the government was unable to implement sound economic policies, thus exacerbating the impact on the domestic economy. Moreover, relations with neighbouring Russia, Ukraine's most important trading partner and essential energy supplier, deteriorated significantly under the presidency of Viktor Yushchenko.

In early 2010 Viktor Yanukovich, whose contested victory in late 2004 presidential elections was overturned by the Orange Revolution, made a remarkable comeback, winning the presidency over Yulia Tymoshenko and Viktor Yushchenko, the one-time Orange leaders who had turned into bitter foes. In March 2010, parliament formed a new three-party coalition government, the Stability and Reform alliance, and approved Mykola Azarov—regarded as loyal to new President—of the Party of Regions as Prime Minister, displacing Yulia Tymoshenko. As a result, the new government is more cohesive than its predecessors and much better placed to implement policies. But it remains to be seen whether it is really able and willing to pursue effective policymaking. Vested interests will continue to exert influence on policymakers. Another challenge is to abolish the existing constitutional weaknesses in order to reduce the high level of systemic political risk.

Relations with Russia are likely to improve. An economically important deal was struck in May 2010, which prolongs Russia's lease on the Black Sea Fleet base in Sebastopol for 25 years until 2042, in exchange for a 30% discount for Ukrainian gas imports from Russia until 2019. The discount should save Ukraine at least USD2bn this year, easing fiscal pressures.

President Yanukovich is also likely to seek good relations with the EU. However, NATO membership, an important target of his predecessor Yushchenko, has been dropped for the time being.

The IMF is generally supportive of Ukraine. The Fund provided a USD16.5bn loan under a two-year Stand-By Arrangement (SBA) in late 2008 when Ukraine was hard hit by the global economic crisis. The funding was suspended a year later because of failure to implement crucial reforms, but a new 29-month USD15bn SBA was approved in July 2010, aimed at supporting fiscal, energy, monetary policy and financial sector reforms.

## Economic Stability

As a result of its fertile black soil, Ukraine has remained a large agricultural producer, with the sector still accounting for 10.5% of GDP. Industry contributes 31.5% to overall GDP and services 58%. The economy is highly dependent on its main trading partner Russia, on energy imports and on exports of metal and agricultural products, which together with a lack of significant economic reform make it highly vulnerable to external shocks, such as major price changes and disruptions of supply and demand.

After contracting by 15.1% in 2009, real GDP grew by 4.9% yr/yr in Q1 and 6% in Q2 2010. Growth in H1 was mainly driven by a recovery in external demand, which caused industrial production to increase by 10.4% in Q1 and 13% in Q2. However, on a monthly basis the pace of industrial production growth has already decelerated from a peak of 17.4% yr/yr in April to just 6.4% in July. The recovery in domestic demand has been more subdued. After 14 months of yr/yr decline, retail sales posted marginal growth of 0.6% in March 2010 and have since accelerated to 9.2% in both June and July. We expect H2 growth overall to weaken as base effects fade, external demand eases and the recent drought may affect domestic demand. We currently forecast about 4% growth in calendar 2010 and 3% in 2011.

The IMF approved a new 29-month USD15bn SBA in July 2010. The core of the accompanying economic reform programme is comprehensive fiscal consolidation. Prior to the Fund's formal approval, the authorities had been required to implement sweeping budget and financial sector reforms as a first step. However, it will be challenging to abide by the successive targets of the programme. The fiscal deficit is to be contained to 5.5% of GDP in 2010, 3.5% in 2011 and 2.5% in 2012. The cash deficit of Naftogaz, the state oil and gas utility, is to be limited to 1% of GDP in 2010 and eliminated in 2011. Bank recapitalisation costs and the settlement of VAT refund arrears should be limited to about 3.3% of GDP in 2010 and eliminated thereafter. Thanks to the new IMF SBA, funding of the 2010 budget should be manageable, but the 2011 budget will be a crucial task and

meeting the fiscal deficit target appears difficult. Particularly unpopular are reforms that will raise energy tariffs substantially and overhaul the pension system. Failure to implement such reforms led to the suspension of the previous IMF funding programme in late 2009.

The IMF-supported economic reform programme also aims at shifting monetary policy from exchange rate targeting to inflation targeting under a more flexible exchange rate regime, with near-term core inflation to be maintained in single digits. Headline inflation had fallen from an average 25% in 2008 and 16% in 2009 to 6.8% yr/yr in July 2010, but picked up again to 8.3% in August. We expect inflation to increase further to about 10% yr/yr at end-2010 and to remain around that level in 2011, owing to rises in taxes and energy tariffs as well as higher food prices in view of the drought-related poor harvest in 2010. The official UAH/USD exchange rate, managed by the central bank, depreciated sharply in the wake of the intensified global financial crisis, from 4.85 at end-August 2008 to 7.70 at end-2008 and around 8.00 in August 2009 (-65%). Since then it has been fairly stable around that level. 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%). Since then it has converged towards the official exchange rate. Real effective exchange rate data from the IMF suggest that the UAH is currently no longer overvalued.

Foreign exchange (FX) reserves fell from a high of USD37.3bn in August 2008 to a recent low of USD23.2bn in February 2010 (-38%), but had recovered to USD31.6bn in August. While this is sufficient to cover almost six months of imports, it covers only about 80% of external debt payments due in 2010 and 65% of the debt due in 2011, leaving Ukraine vulnerable to market confidence reversals.

The current account deficit narrowed from 7.1% of GDP in 2008 to 1.5% in 2009 and shifted to an estimated surplus of 0.8% in H1 2010. However, as external demand is expected to ease and the recent drought may also affect exports, we forecast the current account to record small deficits in 2010 and 2011 overall. Net foreign direct investment inflows have been fairly strong at around 4% of GDP in both 2009 and H1 2010.

Gross external debt has risen sharply in relation to GDP (88% at end-2009) and of export earnings (190%) as a result of the depreciation and the recession. The external debt-service ratio is forecast at a hefty 32% in both 2010 and 2011. About one third of external debt is public. Total public debt is forecast to rise to about 45% of GDP in 2010.

## Structural Business Environment

The Structural Business Environment is well below average, with serious impediments to strong, sustainable growth. Ukraine is ranked 142nd out of the 210 economies in our assessment overall. Areas of particular weakness in our assessment include administrative inefficiency, poor rule of law, corruption perceptions, protection of vested interests, weak corporate governance, poor investor protection, underdeveloped infrastructure, and a weak banking sector. Asset quality in the banking system is still deteriorating and the share of non-performing loans to total loans has continued to rise to 15% in March 2010. Higher risk aversion by banks has resulted in shrinking bank lending. Nonetheless, the private sector debt rollover rate has increased to about 85% in H1. Still, at the now much weaker exchange rate, some Ukrainian companies and households will continue to struggle to service their FX-denominated loans (which account for about half of all private sector loans).

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Charts

