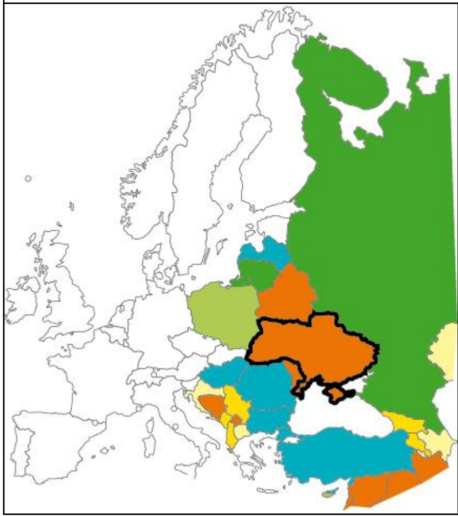
COUNTRY RISK ANALYSIS

# Ukraine

CREATING CONFIDENCE IN YOUR EXPORTS



COUNTRY RISK CATEGORY

**7/7**

The country risk categories range from 0 to 7. The lower the number the better the credit rating the country has.

0 1 2 3 4 5 6 7

EKN'S OUTSTANDING GUARANTEES IN THE COUNTRY

**Short-term transactions:** SEK 13 million

**Medium and long-term transactions:** SEK 246 million

EKN'S POLICY

**Sovereign risks:** Restrictive risk assessment

**Other public risks:** Restrictive risk assessment

**Bank risks:** Restrictive risk assessment

**Corporate risks:** Restrictive risk assessment

See “EKN'S POLICY” section

DATE

**20/03/2013**

## Need for reforms and financial support

The political and economic situation in Ukraine has been difficult over recent years. The demand for the country's export goods fell sharply due to the financial crisis. The imprisonment of former Prime Minister Julia Tymosjenko contributed to a deteriorating relationship with the EU. Relations with Russia have periodically been strained as well. However, more recently Ukraine held constructive discussions with the EU and the International Monetary Fund – IMF. An agreement with the IMF is likely to be signed in the spring. This could also result in support from the EU. An agreement with the IMF would help finance the current account deficit and reduce the risk of a liquidity crisis. The agreement will be linked to demands for economic reforms. Protests may arise when these reforms are implemented, but they are not expected to be of a scope that will be unmanageable for the political leadership.

**STRENGTHS**

- Strategic geographic location
- Substantial export commodities such as steel and raw materials
- IMF negotiations are in progress

**WEAKNESSES**

- Critical debt situation and dependence on external financing
- Periodically strained relations with the EU, Russia and international lenders
- Rising current account deficit

POLITICS

## Foreign policy tightrope

At the parliamentary elections last year Janukovich's party cemented its hold on power without gaining majority. Meanwhile, the opposition, with the now jailed Tymosjenko at the helm, has been remarkably weak. However, popular protests like those in the autumn of 2010 may well flare up again, although there is a conflict fatigue among the general public which will reduce the risk of widespread protests. Janukovich also enjoys support from major business interests in the country who are not served by protests or changes to current policies.

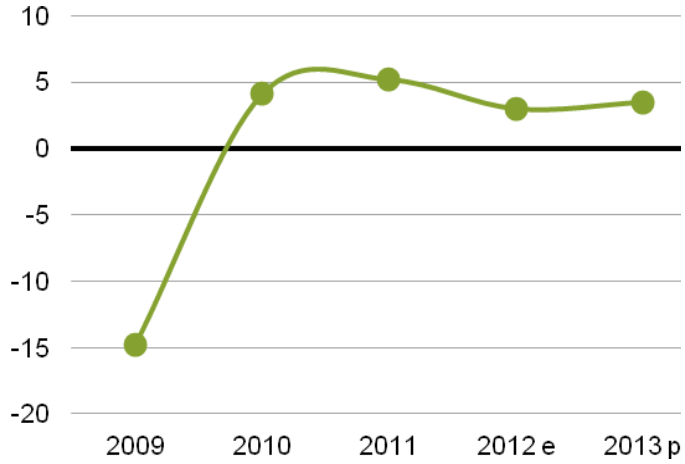
The relationship with Russia once again deteriorated when the Russian state-owned gas company Gazprom charged USD 7 billion for gas in early 2013, which it claims that Ukraine agreed to buy. Russia also wants Ukraine to join the common trade union with Belarus and Kazakhstan. Ukraine's politicians would rather move closer to the EU, while a large part of the electorate prefer Russia. Janukovich has endeavoured to maintain Ukraine's ties with the EU countries in order to conclude a free trade agreement. In February, negotiations resumed with the EU and the outcome resulted in financial support, under the proviso that an IMF agreement is concluded. Later this year, Ukraine is also expected to conclude an association agreement with the EU. In order for this to be possible, Ukraine has made some concessions in the handling of the jailed Tymosjenko. In the short term, problems with the relationship to the EU, international lenders such as the IMF and Russia may arise, primarily due to the unwillingness of the political leadership to meet their demands. However, the country is expected to continue to balance its relationships over the next three to four years.

ECONOMY

## Need for economic reforms

Ukraine went through the sharpest economic downturn in the region in 2009. The following year saw the growth rate rebound and since then it has been between three and five percent. In the coming years, growth is expected to remain at roughly the same level. Export dependence to EU countries is currently an inhibiting factor given the economic development of the EU. Ukraine has been reluctant to fully implement the economic reforms that the IMF previously called for. This applies particularly to pricing for gas and to changes in the pension system. Measures to allow heat and gas prices to adjust to the market instead of being heavily subsidised for private individuals are necessary for the economy to recover. Ukraine's pension system is also facing severe financial difficulties and requires substantial state transfers of funds from the state budget. Further reforms are necessary but are politically very unpopular. However, as presidential elections will not be held until 2015, there is time to implement the reforms. The unclear willingness to reform means that pinning down more precise dates for when the changes can be implemented has not been given in the current situation.

GDP GROWTH (%)




*The growth rate has recovered following the financial crisis. Source: IMF*

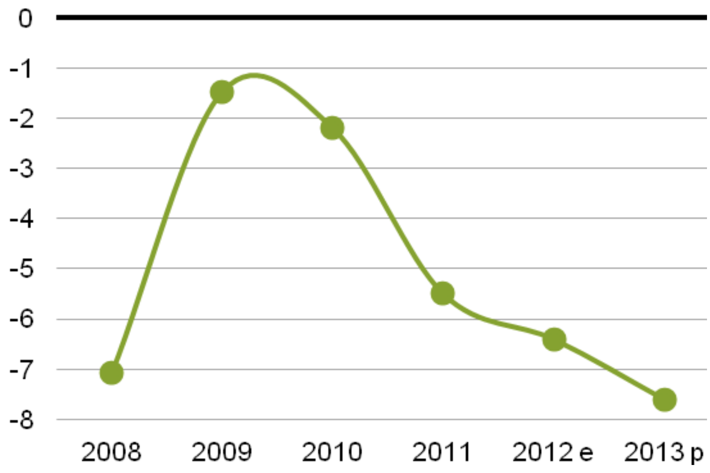
Public finances remain vulnerable. The budget deficit is expected to continue at around four percent of GDP. Despite this, the state increased social spending in 2012. The government was reluctant to implement unpopular reforms before the parliamentary election in 2012, which resulted in the IMF putting the loan programme on hold in early 2011. However, talks with the IMF to conclude a new agreement resumed in early 2013. The tone has so far been much more constructive than previously, making it likely that an agreement between Ukraine and the IMF will be made. Historically, Ukraine has shown that it has the ability to pull itself back from the brink, and the assessment is that the country is expected to do so again this time, with support from the IMF. Until the agreement is concluded and the reforms have begun, the country's financing costs will remain high.

BALANCE OF PAYMENTS AND DEBT ISSUES

## Difficult financial situation

Ukraine is grappling with a significant current account deficit and the country remains dependent on exports. Exports account for over half of the country's GDP and consist mainly of raw materials and steel. Ukraine is also dependent on importing oil and gas. About three quarters is imported, mainly from Russia and Kazakhstan. With shrinking international reserves and IMF lending suspended, it has become increasingly difficult to finance the current account deficit. A weakening of the currency will be difficult to avoid, given the macroeconomic imbalances and lack of foreign confidence in the current economic policy. A weaker currency would certainly benefit export-oriented companies, but private consumption and the fragile banking system would be negatively affected.

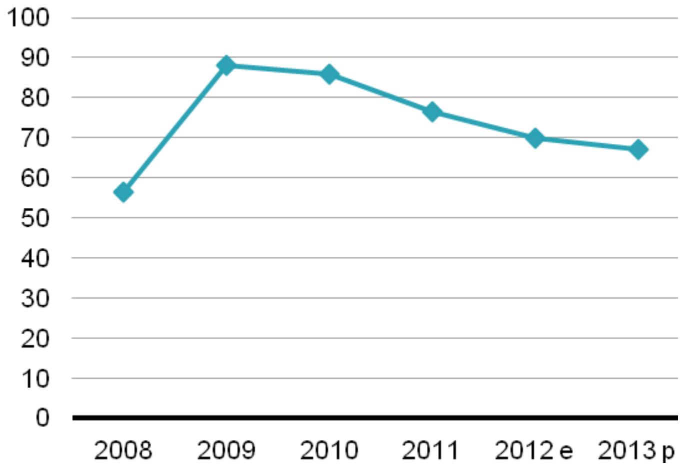
CURRENT ACCOUNT BALANCE (% OF GDP)




*The current account deficit has risen substantially in recent years. Source: IMF.*

The current account deficit is partly covered by foreign direct investment. Investments have been stable in recent years at just over four percent of GDP and come principally from Europe. Much of it derives from Cyprus where many Ukrainian companies are based for tax reasons. Ukrainian capital invested in Cyprus is reinvested in Ukraine, but the scope depends on the confidence in the country's economy. Another part of the deficit is covered by loans. Although the state as recent as last year issued bonds, borrowing costs are expected to remain high. The average maturity of external debt is relatively short. This makes Ukraine vulnerable to developments in the loan market.

EXTERNAL DEBT (% OF GDP)




*External debt remains high, but the trend is positive. Source: IMF.*

External debt has declined in recent years relative to GDP. However, the banking sector's liabilities are increasingly made up of loans with short maturities which is an increasing risk factor. This has consequently resulted in the increased susceptibility of the banks to rising borrowing costs and a lack of liquidity, although companies have recently had a healthy mix of short and long maturities. In summary, it is mainly the financial sector that is exposed to the willingness of international lenders to renew Ukrainian loans, with the risk of rising borrowing costs as a result.

CURRENCY POLICY

## Stable exchange rate at the cost of declining international reserves

The country was forced to abandon its fixed exchange rate policy as a result of the financial crisis. Since then a managed peg to the dollar has been applied, which means that the currency is adjusted in relation to the US dollar. The currency initially fell heavily in value, but has subsequently stabilised. This stabilisation is mainly due to the central bank pursuing a tight monetary policy, and in reality has tried to maintain a fixed exchange rate in relation to the dollar. When the central bank defended the exchange rate in 2012 with support purchases of currency, international reserves dropped by almost a quarter. At current rates, this corresponds to only three to four months of imports. The scope for further support using international reserves is limited. The central bank has introduced exchange restrictions, which means that permission must be sought for major transactions by export companies. Different regulations and interventions have reduced the credibility of the foreign exchange policy.

As the current account deficit has widened, international reserves are expected to shrink further. A weakening of the hryvnia is expected unless the IMF agreement is concluded. The Ukrainian currency is not fully convertible, and EKN has not yet tested the possibilities for guarantees for local currency financed transactions.

FINANCIAL SECTOR

## Banking sector under continued pressure

Ukraine has nearly 200 banks. The sector is relatively fragmented. The assets of the three largest banks are equivalent to about a third of the assets of the entire sector, and the ten largest represent about half. The degree of concentration is lower than for other countries in the region. A quarter of the assets are held by foreign-owned banks. The foreign-owned banks, most of which are from Western Europe, have downsized operations in recent times. As a result of the crisis over 20, mostly smaller banks, were liquidated. Ukraine has generally been unwilling to rescue private banks during the years of crisis, although there were selective instances.

A high level of dollarization, a large proportion of bad loans and low reserves mean that uncertainty and weak profitability in the banking sector is likely to persist in future years. The proportion of bad loans is, on paper, around fifteen percent, but is much higher if renegotiated loans are included. This means that credit risks are significant.

The profitability of the banking sector is poor, not least because of high credit losses. The banking system has limited access to liquidity. Domestic private banks are generally in a more difficult position than foreign-owned banks, while banks closely associated with the state can rely on state aid. Many of the smaller private banks were weak even before the crisis, and are therefore finding it difficult to survive. In all assessments of private banks, foreign exchange exposure, ownership structure, asset quality and exposure to weak industries must all be considered.

BUSINESS ENVIRONMENT

## Extensive corruption and weak business climate

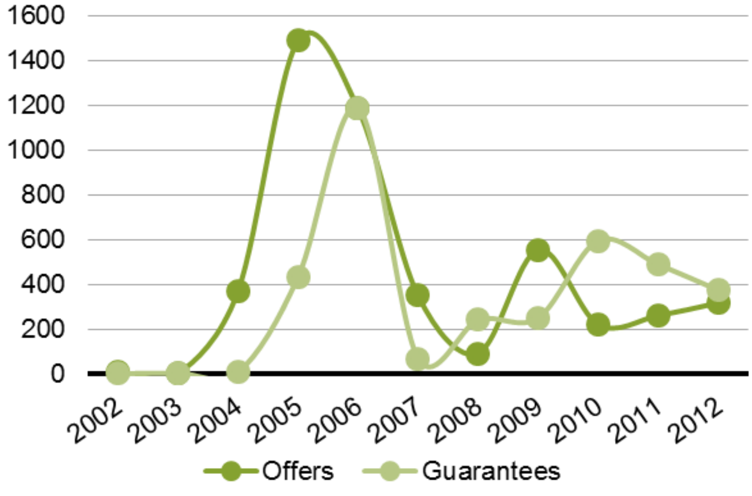
The business climate is cumbersome from a creditor perspective. Doing Business classifies the country as one of the worst in the region at 137 of 185. Financial transparency is lacking and few companies report according to international standards and have audited accounts. There are major differences between Ukrainian and international accounting standards and adaptation is sluggish. This complicates the assessment of the creditworthiness of Ukrainian companies, as most companies comply with local standards. When assessing corporate risks, transparency in the company is therefore of the utmost importance. The legal system and regulatory environment are unpredictable. Laws and regulations frequently change and are not always consistent. The regulatory environment is weak and corruption is widespread even in the judiciary. By way of example, Ukraine ranks as number 144 (out of 174) in Transparency International's corruption index.

EKN'S EXPOSURE

## Varying provision of guarantees to Ukraine

Less than half of one percent of total Swedish exports goes to Ukraine. In addition, this figure dropped last year. The main export commodities are machinery and telecom equipment. Vehicles are also an important export product, but sales have been volatile due to the economic situation in recent years. Generally speaking, demand comes mainly in the form of the expansion and updating of infrastructure, largely originating from the Soviet era. In addition, over three-quarters of all steel mills were built more than 20 years ago, which means that many of them are in need of modernisation. There is also demand from the agriculture and food production sectors.

EKN'S OFFERS AND GUARANTEES, SEK MILLION (AT DECEMBER 31)




*The provision of guarantees has been very volatile. Source: EKN*

Over the period 2008-2012, EKN issued guarantees for 86 transactions with a total value of almost SEK 2 billion for companies exporting to Ukraine. EKN's exposure currently totals SEK 221 million in offers and SEK 264 million in guarantees. The exposure consists primarily of transactions with paper mills and food producers.

| COUNTRY RISK ANALYSIS | DATE | |
|---|---|---|
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PAYMENT EXPERIENCE

## Poor payment experience during the financial crisis

EKN's experiences since the financial crisis have been poor. The number of late payments increased and loss prevention measures have been initiated. Over the period 2010-2012, EKN had indemnification payments amounting to almost SEK 120 million. In total, claims in the current situation are SEK 79 million. Payment plans have been renegotiated and indemnifications made in several transactions, particularly in the transport sector. The past two years have seen payment delays greatly reduced. EKN's experiences of bankruptcy proceedings and withdrawals of securities have shown that both market presence, knowledge of local circumstances, and a lot of time are required to achieve success. The overall institutional structure is weak which is creating unpredictability. Final losses could be high in cases of bankruptcy. The risk of bankruptcies has risen as a result of the crisis. However, the problems have subsided.

EKN'S POLICY

EKN classifies Ukraine in country risk category seven, an assessment undertaken in collaboration with the OECD. Furthermore, some form of restrictions applies to all buyer categories. For other public risks, such as municipalities, EKN requires that there is a state guarantee from the Ministry of Finance.

For transactions with buyers in the private sector (banks and companies), EKN has a restrictive policy and EKN normally requires letters of credit, bank or government guarantees for transactions of this type. Transactions are otherwise assessed strictly on their own merits. The factors especially taken into account are the buyer's currency earnings, and the financial information and ownership structure.

OFFICIAL COUNTRY DATA AND CREDIT RATINGS

OFFICIAL COUNTRY DATA

**Area:** 603,700 km² (1.3 times Sweden)
**Population:** 45.7 million (2011)
**Population growth:** -0.4 % (2011)
**GDP:** USD 138 billion in 2010 (Sweden USD 458 billion in 2010)
**GDP/capita:** USD 3,483 in 2011 (Sweden USD 58,288 in 2011)

CREDIT RATING

| | COUNTRY CEILING | SOVEREIGN RATING |
|---|---|---|
| **Moody's:** | B3 | B3/Negative |
| **S&P:** | B | B/Negative |
| **Fitch:** | B | B/Stable |

Country analyst

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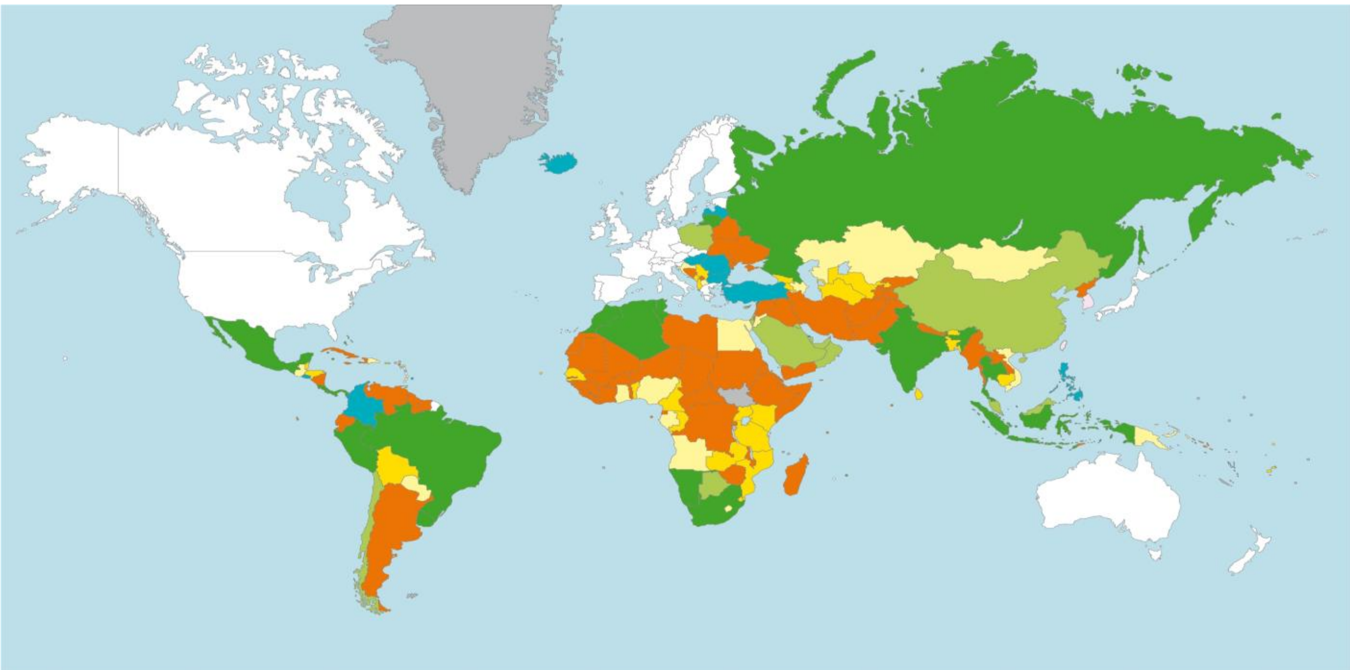
EKN's view of the world



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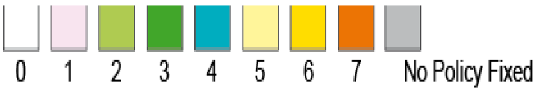


## EKN – CREATING CONFIDENCE IN YOUR EXPORTS

EKN is a government agency that supports Swedish exports and the internationalisation of Swedish industry. This we do by offering exporting companies and banks guarantees for payment and financing, together with advice on business structure and risk management. Our services provide an extra level of confidence, increased competitiveness and more opportunities for successful export transactions.

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