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Research Briefing | Ukraine

Market optimism masks uncomfortable political realities

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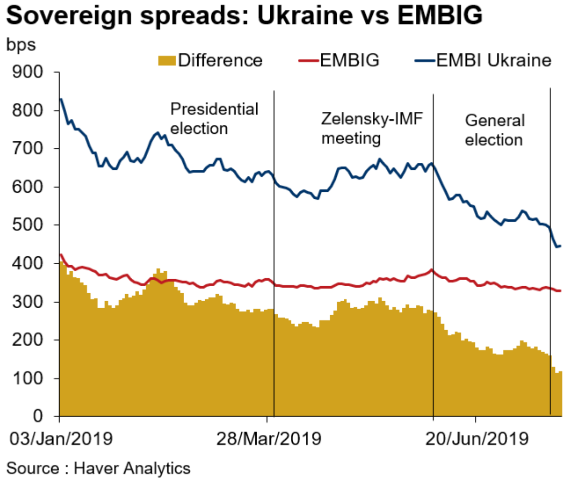
- **Despite President Zelensky's liberal appeal, we remain sceptical that the new administration will be able to overhaul the institutional environment and expect Ukraine's economic policy mix will ultimately run into similar challenges as the previous government.**
- **We think the new government will implement sufficient macroeconomic reforms to ensure continued cooperation with the IMF, but insufficient structural reforms to kick-start a more dynamic economic growth model.**
- **Even though Zelensky's success is credit-positive, we are not convinced it justifies a 70% contraction in the risk premium between Ukraine and the rest of the EM universe. We therefore see room for some unwinding of the rally.**

An unprecedented mandate

An outright majority in the parliament – the first in Ukraine's history – gives President Zelensky and his party a strong mandate to implement their proposed package of reforms. With 96% of the votes counted, the Servant of the People party received 43% of the votes, providing it with 253 out of 450 seats in Ukraine's parliamanet (26 Crimean and Donbas seats are vacant). Markets have appreciated Zelensky's run, with bond spreads plummeting by over 300bps since early-year peaks, including a drop of 50bps in the three days after the election. While the election has been credit-positive, we believe the rally may by now be overdone.

A period of relative political stability beckons. Yet it also poses risks of an erosion of systemic checks and balances. We think Zelensky will present a business-friendly cabinet that will agree a new IMF programme, justfying the rally in bonds. But the policy dilemmas remain similar to those that have existed for years. His two months in office as president have given few indications that he and his team will be able to meet the challenge of delivering on the key promise to fight corruption – Ukraine's "achilles heel" – that serves as a major drag on growth and competitiveness.

Chart 1: Ukrainian spreads have plummeted on Zelensky's success



Source : Haver Analytics

Spreads on Ukrainian debt have dropped by 330bps YTD, with the difference between Ukraine and the rest of the EM universe narrowing by 70%.

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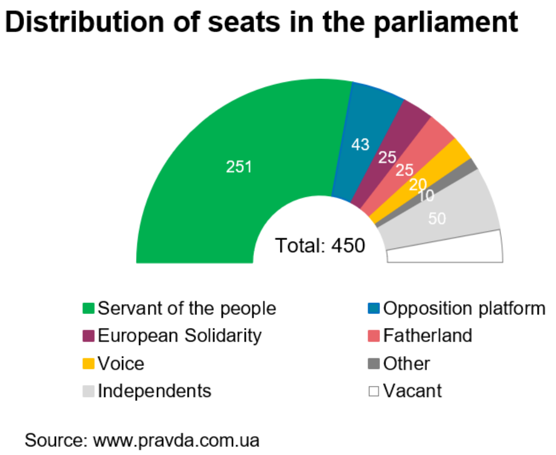
Chart 2: New composition of the parliament

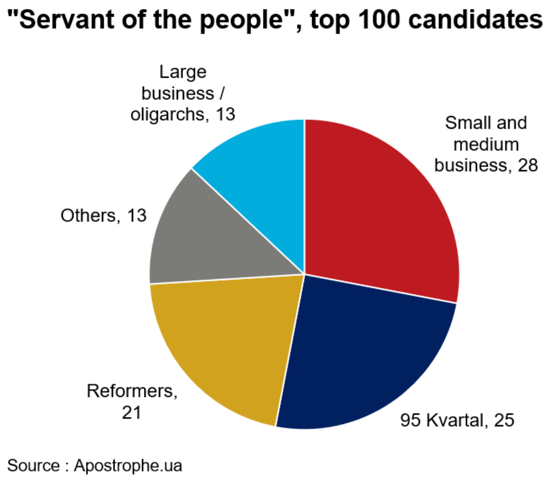


With 251 out of 450 seats in the parliament, Zelensky will be able to form the first majority government in Ukraine's history

What does Zelensky's party look like?

It was a positive surprise that Zelensky's party list was rich in business-friendly candidates and relatively light on oligarchy (see **Chart 3**). The three largest groups among the top 100 candidates on the electoral list are: (1) Close associates of Zelensky from his media business "95 Kvartal" (25 candidates); (2) Representatives of small and media business (many of whom are political novices, with as yet unclear political or economic views, 23 candidates) and (3) "Reformers", people with track records of promoting reforms (21 candidates).

Chart 3: Composition of Zelensky's party Servant of the People



The majority of Zelensky's party are new faces in Ukrainian politics, most of whom could be considered either market-positive or market-neutral. There were only 13 candidates associated with oligarchs in the top 100 on the party list.

Oligarch Ihor Kolomoisky, widely seen as Zelensky's backer, has about 6 associates on the party list. But two other oligarchs – Viktor Pinchuk (who used to promote Ukraine's European integration) and Serhiy Lyovochkin (formerly the chief of staff of the ousted president Viktor Yanukovych) – are also represented with several candidates. Overall, the "new faces", many of whom have no political experience (and 23 were even unemployed at the time of the elections), dominate the list.

Oligarchic influence a key concern

Early reports suggest that Zelensky is indeed trying to distance himself from Kolomoisky, with an inner circle emerging, consisting of people who are either not associated with Kolomoisky or are reasserting themselves as independent from him (such as Zelensky's Chief of Staff, Andriy Bogdan, Kolomoisky's former lawyer).

This doesn't mean that the influence of Ihor Kolomoisky (or, indeed, other oligarchic groups) will necessarily be limited. He can still exercise influence through Zelensky

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himself and MPs (who, reportedly, are represented in other parties as well) and through important institutions, such as the courts. The key litmus test for the new government will be Privatbank and Kolomoisky's intention to extract $2bn compensation for its nationalization in 2016 (the central bank had found it to be defrauded by Kolomoisky, as a key shareholder, for $5.5bn, which led to its bailout and nationalization).

Economic programme: liberal with a fair dose of populism

Zelensky presented a generally liberal economic programme, prioritising the fight with corruption, lowering the tax burden, replacing the tax on corporate profits with a tax on capital exit, and, first and foremost, stopping the war in Donbass. Compared to other parties that entered parliament, only the Voice party has a similar liberal economic agenda. Nevertheless, despite their progressiveness, a lot of these measures reduce the tax base beyond the levels that the IMF would find acceptable. But Zelensky has signalled that cooperation with the IMF will be prioritised if some of the proposed measures become critical for agreeing the next programme.

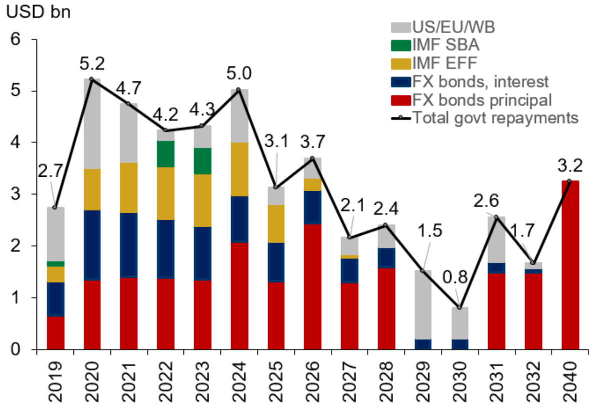
Of significant concern, however, is Zelensky's populist moves. These include proposals to ban from office the previous government of Petro Poroshenko and freeze his assets, plus impromptu raids by the security services and the NABU (the anti-corruption body) on bus maker Bogdan Motors (co-owned by former president Poroshenko), an asset management firm formerly associated with the ex-central bank governor Natalia Gontareva, who played an important role in the privatization of Kolomoysky's Privatbank (ICU), and ArcelorMittal's steel plant, the only non-oligarchic steel producer in the country. What has been presented as a fight with corruption may turn out to be a witch hunt to redistribute spheres of influence.

Cooperation with the IMF to be renewed

Ukraine will need continued IMF support to avoid default. The sovereign debt repayment schedule looks onerous over the next two years (**Chart 4**), FX reserves are low, while the current account remains in deficit (3.3% of GDP in 2019, and expected to narrow to 3% in 2020/2021). Furthermore, we expect growth to remain subdued.

The fact that Zelensky can form a majority government means that negotiations with the IMF may begin as soon as September and the new programme may be agreed by October – sooner than markets have been anticipating (end of 2019). This will allow Ukraine to comfortably roll over its debt due this year and in 2020-2021 by unlocking funding from other international financial institutions and issuing bonds.

Chart 4: Ukraine's FX-denominated debt repayment schedule



Source : Bloomberg, IMF, Oxford Economics estimations

Ukraine faces a heavy debt repayment schedule over the coming 5.5 years, with the majority of debt restructured in 2015 coming due.

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However, quite a few of the proposals in Zelensky's economic programme are yet to be aligned with the IMF conditions (**Figure 1**). These include measures that narrow the tax base without appropriate compensatory mechanisms, such as lower social insurance contributions or replacing corporate income tax with the capital exit tax.

$6-8bn Extended Fund Facility likely to be agreed

Still, we believe Zelensky will appoint a relatively market-friendly cabinet that will ultimately be able to align the government's position with that of the IMF. We believe the shorter-term contentious issues of gas tariff liberalisation and of the nationalisation of Privatbank (contested by the previous owner Ihor Kolomoisky) are likely to be resolved in a way that will enable the implementation of the IMF programme. The other most important aspect of the IMF's conditions – ensuring a fully operational anti-corruption court – will be more difficult to achieve. Land and pension reforms may also be delayed – the former is crucial for boosting growth, and could add about 1pp to annual GDP growth.

We expect Ukraine to receive the first $0.5bn tranche from the new programme in Q4 this year, followed by another $1.5bn in 2020, if Ukraine meets the key fiscal conditions. Further disbursements, however, may again hit the roadblock of Ukraine's typical difficulty with passing institutional and anti-corruption reforms. Our base case (70%) is that the future programme will commence successfully, but will ultimately face similar challenges of delayed implementation of reforms and incomplete disbursal of funds, putting recurring pressure on reserves and Ukraine's borrowing costs. So, we see a 25% chance that the programme will be fully implemented and disbursed, and a 5% chance that it will go off track in the early stages.

But the rally is likely overdone

The spreads on Ukrainian debt have rallied by nearly 400bps YTD, with the difference relative to the EMBIG average shrinking from 406 in January to 118 at the time of writing (see **Chart 1**). Given the above scenarios, we are not convinced that Zelensky's success justifies a 70% contraction in the risk premium between Ukraine and the rest of the EM universe, even though it is certainly market-positive. We therefore see room for some unwinding of the rally going forward.

Figure 1: Zelensky's economic programme vs IMF conditions

Servant of the People, programme	IMF
Liberalising the land market	In favour, one of the conditions of EFF
Restoring criminal liability for illicit enrichment	In favour, one of the conditions
Preserving the simplified tax for individual enterprises	Proposes annulling simplified taxation for legal entities
Lower social insurance tax	IMF against sharp tax reduction without compensatory measures
Two tier pension system	Sceptical; prefers broader reform that includes higher pension age
Capital exit tax instead of corporate income tax	Against, as would lower tax revenues
Gas tariffs: initially proposed renegotiating	Liberalising retail gas tariffs from 2020
Privatbank: risk of roll-back	Ensuring Privatbank resolution is maintained
Tax amnesty (0% tax for declared incomes)	Initially opposed
Replace tax police with financial investigations service	Not specified
Promote direct democracy	Not specified
Cheaper mortgages for young people	Not specified
Not specified	Launching Anti-Corruption Court
Not specified	Adopting Anti-Money Laundering legislation
Not specified	Privatisation of SOEs
Not specified	2020 budget to be in line with the parameters of the programme
Not specified	Central bank independence, inflation targeting, higher reserves

Source: IMF, OE research

In line with IMF conditionality
Not in line with IMF conditionality

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