September 2021

# Ukraine inches towards IMF disbursements

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## The fast view

- Last year's announcement of a US$5 billion IMF programme was a key driver of Ukrainian eurobond outperformance. But a reversal in reform momentum in the second half of the year threatened to derail the programme.
- The set-back raised doubts over Ukraine's ability to secure funding from other international financial institutions; increased the likelihood of international flows to the country's local debt markets drying up; and threatened to drive up the cost of funding in the eurobond market.
- Since then, stronger leadership from President Zelensky and a change at the top in the White House seems to have nudged things back in the right direction, and the recent passing of some key legislation has helped put the IMF programme back on track.
- Ukraine remains a work in progress. Structural reforms are still needed, and some serious governance weak spots remain. But we think the government will realise that delivering what is necessary for the IMF programme to continue is in its best interests.
- Ukraine's ongoing participation in an IMF programme would be a clear positive for the country's credit strength and has the potential to lead to rating upgrades. This, combined with attractive valuations, make it an interesting market for EM debt investors.

## A classic frontier market tale

Ukraine perfectly encapsulates the challenges and rewards of frontier market investing. With fragile politics, underdeveloped institutions and capital markets, and entrenched corruption networks, the country's participation in IMF programmes since the 2014 Maidan revolution has been crucial to investor confidence. Reforms tend to progress in a 'two steps forward, one step back' manner – another common trait among frontier markets.

The announcement of a US$5 billion IMF programme last year was a key driver of Ukrainian eurobond outperformance. However, in the second half of the year a reversal in reform momentum threatened to derail the programme. Since then, stronger leadership from President Zelensky and a change at the top in the White House seems to have nudged things back in the right direction. In this piece we examine the recent trends in Ukraine, where that leaves the country's participation in the IMF programme, and what it means for investors.

## How the IMF programme seemed in jeopardy

In the second half of 2020, the country's participation in the IMF programme seemed increasingly in jeopardy. Concerns arose about central bank independence following the resignation of the governor under (in his words) "systematic political pressure". Elsewhere, politically motivated judicial rulings threatened to undo much of the country's judicial reforms and undermine the country's nascent anti-corruption architecture. Furthermore, concerns continued around the reform credentials of both Zelensky's government and the parliament (Rada) – where, on paper, Zelensky's party held a majority, but in reality, many MPs' allegiances lie with oligarchs rather than the party/government.

Each of these factors was negative from a governance perspective. However, the threat they posed to the IMF programme was even more acute as without an IMF deal, the country's financing requirements were seriously challenged. The absence of an IMF disbursement raised doubts over Ukraine's ability to secure funding from other international financial institutions; increased the likelihood of international flows to the country's local debt markets drying up; and threatened to drive up the cost of funding in the eurobond market.

## Politics have turned more conducive

It's been a rollercoaster presidency for Mr Zelensky. Initially seen as a handpicked puppet of oligarch Kolomoisky, early in his reign he surprised the world with his anti-corruption stance, only to see the corrupt judiciary push back on reforms in the second half of 2020. Sinking poll ratings dented his political capital and undermined his control of the Rada, with many in his party beholden to competing oligarch interests.

However, in 2021, Zelensky's fortunes have risen. In part this was the result of an (arguably orchestrated) ratcheting up in tensions with Moscow, with Zelensky benefiting from the 'war time leader' poll boost. More interestingly, however, was his strong tilt against the oligarchs by using the National Security Council to circumvent more traditional routes to curbing oligarch power. First, he targeted the Russian-backed oligarchy and the TV channels it controlled – with clear support from the new US administration. He has maintained this tough stance through the introduction of an anti-oligarch bill and in his general rhetoric. Both of these developments have seen his poll ratings rise and this has helped to enhance his influence over his party's MPs in parliament.

The new US administration has taken a closer role in Ukrainian politics and helped to shore up support for reforms. US Secretary of State Antony Blinken visited Kyiv in May and has continued to push for anti-corruption reforms behind the scenes, and during Zelensky's recent visit to Washington, reforms and Russia were the key talking points.

## Positive momentum has brought the IMF programme back on track

In quick succession in June, a number of important pieces of legislation were passed by parliament – steps that improve the oversight of the judiciary and enhance the country's anti-corruption credentials. The Rada has returned from its summer recess, and two further pieces of legislation (one on anti-corruption, the other on central bank corporate governance) are now being debated and, provided the legislation is passed in the spirit of the IMF's requirements, should be sufficient for the IMF to reach a staff-level agreement on disbursement. Indeed, the IMF is gearing up for a country visit next week.

Over the longer-term, we also think it is important that Zelensky is signalling that he wants to sign a new IMF programme (the current one expires in December), and in the meantime the finance ministry has signalled its willingness to extend the current programme by six months.

## Challenges remain

While there has undoubtedly been strong progress on the above reforms, Ukraine remains a work in progress. Further structural reforms are needed to unlock the country's growth potential so that it can catch up to the income levels of regional peers.

The judiciary will remain a roadblock – at the time of writing it is attempting to push back on some of the recently passed reforms. Oligarch-controlled corporations and media still dominate the country's economy and control a large portion of the country's parliament. Moreover, Zelensky himself can be viewed as ambivalent to the rule of law at times. For instance, in attacking Viktor Medvedchuk (the Russian-backed oligarch) he used legally dubious security laws, and his anti-corruption stance seems selective – largely targeting those oligarchs that politically oppose him as he starts to lay the groundwork for a re-election bid in 2024.

The challenges can also be exemplified by the central bank, where there are clear tensions within the institution. Governor Shevchenko, interviewed in the Financial Times, blamed oligarchs for undermining his authority at the central bank by organising mass resignations. However, a respected insider who is close to the Monetary Policy Committee refuted such allegations and said it was Mr Shevchenko himself who was undermining the institutional capacity of the central bank. This would certainly seem to chime more with what the IMF has said in the past – part of the reason it is requiring a fresh piece of legislation to strengthen corporate governance at the institution.

The authorities' attitude to the IMF is also at times ambivalent. Recent comments from the economy minister – suggesting that the central bank needs to coordinate policy more closely with the government – will not go down well with the IMF. Ultimately, however, we think a constraints-based analysis suggests that Ukraine will continue to participate in the IMF programme for three reasons:

- Geopolitics: increased tensions with Russia this year have reinforced the need for closer integration with the West, and ongoing participation in an IMF programme is an important component of that.
- Market discipline: in the absence of an IMF programme, far from being able to pursue heterodox monetary policy/loose fiscal policy etc., without an IMF anchor, Ukraine's authorities would need to be more conservative to retain market access at current funding costs.
- Elections: continued IMF programme participation should help to secure a robust post-pandemic recovery ahead of the 2024 elections.

## What does it all mean for investors?

Ukraine's ongoing participation in an IMF programme would be a clear positive for the credit strength of the country, both directly (facilitating important ESG improvements, providing a credible fiscal anchor, etc.) and indirectly (in terms of financing – helping to reduce the amount and cost of market borrowing). The country's progress may also start to support credit rating migration – of note, Fitch recently upgraded its outlook to positive.

We continue to find Ukrainian assets compelling. A premium remains in the country's sovereign spreads, while the GDP warrants offer upside potential, particularly if the country re-engages with structural reforms designed to improve growth potential. In the local currency bond space, unhedged yields have widened on the back of the central bank's hiking cycle, presenting an attractive and diversifying source of frontier market return potential, in our view.

While there is the potential for further mis-steps, there is cause for optimism that the balance is shifting more firmly in favour of a positive structural story.

## Important information