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Letters from Kyiv

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Pryvit vsim![1] I am writing this letter from Borispol airport where sadly, but understandably, the duty-free shop does not carry Roshen Chocolate. Like much in Ukraine these days, the decision not to carry Roshen is based on politics. After all, Roshen is owned by former President Poroshenko[2], and the duty-free shop is owned by his archrival, Ihor Kolomoisky, one of Ukraine's wealthiest oligarchs (if not the wealthiest). But more about Mr. Kolomoisky later.

In addition to Roshen Chocolate (don't worry, I scored some from the airline lounge!), my priorities in Kyiv were threefold:

1) **Confirm the political outlook given Ukraine's new president, the upcoming parliamentary elections, and the process of forming a new government;**
2) **Assess the status of Ukraine's program with the International Monetary Fund, the country's financing needs, and its efforts for structural reform;**
3) **Evaluate the fallout, particularly for the National Bank of Ukraine (NBU), from the ruling that invalidated the nationalisation of PrivatBank, the country's largest private bank.**

Roshen Chocolate Located!

Photo credit: Giancarlo Perasso

Ukraine's new president, Volodymyr Zelenskiy[3], took office at a promising time. My initial walkabout upon arrival revealed more construction than I had ever seen in Kyiv (my first trip was in 1992), and the optimism is evident in the economic data as well. Both household and business confidence are up, investment is growing strongly (+18% year-over-year in Q1) as are retail sales. Furthermore, a bumper agricultural output is expected this year. **The consensus is for 2019 GDP growth of 2.5%, but with material upside risk.**

I was, therefore, very eager to meet with policymakers and politicians as well as experts from international financial institutions, the EU, and the private sector to verify if my relatively positive impression was grounded in reality.

[1] *"Hello everyone!"*

[2] *Poroshenko was President of Ukraine from 2014 to 2019 and lost soundly to Volodymyr Zelenskiy as a second-term candidate.*

[3] *Prior to politics, Zelenskiy was an actor who portrayed the President of Ukraine in a popular television series.*

A Solidifying Political Backdrop With Some Remaining Uncertainties

President Zelenskiy was quick to name his core team. Most are members who worked with him in his media career, although their lack of government experience isn't too concerning. These new members are part of the presidential administration, not the government (which is responsible for economic policy), and there are a couple of experienced people in key posts: Andriy Bogdan as Chief of Staff, former Minister of Finance Oleksandr Danyluk as head of the Security Council, and Vadym Prystayko, an experienced career diplomat, as one of the Deputy Chiefs of Staff (he will likely move to Minister of Foreign Affairs in the new government).

The crucial question is whether President Zelenskiy is truly independent, or whether he is somehow "influenced" by Mr. Kolomoisky, whose assets include the 1+1 television channel (which broadcast Mr. Zelenskiy's show), PrivatBank (previously nationalised by the NBU on the brink of bankruptcy amid numerous irregularities), and other industrial and service companies (including the airport duty-free shops). In addition, a British court froze Mr. Kolomoisky's international assets following a guilty verdict that he is now appealing in Ukraine. So, although Mr. Kolomoisky has some pending legal issues, it may be fair to say his reputation is less than pristine.

In terms of potential influence, the president's appointments appear to be a mixed bag: Mr. Bogdan, the chief of staff, is widely labelled as a "Kolomoisky person." On the other hand, Mr. Danyluk's credentials are impeccable. Still, I appear to be among the few who found it slightly concerning that the person in charge of the president's personal security used to be Mr. Kolomoisky's bodyguard—at this point, I chalk my concern up to watching too many political thrillers.

When we met with economic policy officials in the administration, we remained on topic and heard the right things: the independence of the central bank is sacrosanct; cooperation with the IMF is crucial; the anti-corruption drive will regain momentum; and land reform remains a crucial pillar of economic transformation. All good soundbites, but perhaps a bit too rehearsed. Don't get me wrong though—the officials had never met with international fixed income investors, and the rough spots in their delivery were understandable. And while I believe these people have the best intentions, I am not entirely sure whether they have a full grasp of the difficulty of the tasks discussed. For example, land reform in Ukraine has been discussed for years, but with little action given that the vested interests have been well represented in Parliament. With Ukraine's Parliamentary elections set for July 21, 2019 (after a good deal of legal wrangling), it remains to be seen whether these vested interests maintain the critical mass needed to again stifle the push for land reform.

As the elections approach and the parties prepare their list of candidates, it appears that there are only two among the President's top 20 that are assumed to have loyalties to Mr. Kolomoisky. Opinion polls show the president's party hovering around 50% nationally, which should assure him of about 100 representatives of the more than 400 seats in the Rada. The difficulty of relying on opinion polls is that half the representatives are elected in a national vote, while the other half are elected in individual constituencies. The President's strong popularity should help his candidates in individual constituencies, but local politics can be fickle, and one cannot rule out some disappointment for the president's candidates.

The consensus in Kyiv is that the president's party will do very well overall, but will probably need a coalition partner to be able to form a government. This partner could actually be Batkivshchyna, the party led by Yulia Tymoshenko[4], that is currently polling around 8%, or the new party led by Ihor Vakarchuk, a former representative and well-known singer, who has always professed very sensible economic ideas. **Hence, it appears a Zelenskiy and Vakarchuk duo could be more positive for the country when compared to a Zelenskiy and Tymoshenko ticket.**

IMF On Hold, But Financing Needs Appear In Check

Ukraine's current IMF Stand-by-Arrangement had an expiration date in March 2019 and remains frozen—thus any further tranche disbursements are unlikely—as the IMF awaits a new government that can discuss the prospects for a structurally strong program. The IMF and the domestic authorities generally seem to be on the same page, even though there is a mild and respectful disagreement between the IMF and the NBU. The IMF would like foreign exchange reserves to be around $30 billion, while the NBU thinks that the current level, around $20 billion, is adequate given that the exchange rate is fully flexible. If the exchange rate depreciated, the NBU would rather hike the policy rate rather than intervene in the FX market. A pretty sensible stance, in my view. Still, prevailing circumstances allowed the NBU to add more than $1 billion to its FX reserves so far this year.

[4] Tymoshenko is the former Prime Minister of Ukraine and a proponent of EU and NATO integration. She was a leader of the "Orange Revolution." After a prison term, she came in second in the 2014 presidential election and third in the 2019 presidential election.

This leads us to the country's much-discussed financing needs. **The consensus is that the country needs to raise $3 billion in the remainder of 2019.** While we were in Kyiv, a euro-denominated Eurobond issue was announced, which could total an estimated €500 million to possibly €1 billion. In addition, there is another €500 million that the EU is ready to disburse after the IMF agrees on a new program (a staff level agreement should suffice to disburse the money), and there is a World Bank guarantee that could unlock the equivalent of $1 billion in borrowing. **Even if the Eurobond issuance falls slightly flat, the funding shortfall would be slightly less than an equivalent of $1 billion, which can be easily covered in the local market.**

So far this year, international investors have bought an equivalent of about $1.5 billion in local bonds, and the recent activation of Clearstream for local Ukrainian bonds should facilitate additional international interest in the local bond market. And let's not forget the local financial institutions that keep rolling their bonds into new issues. Investors probably recall that the Ukrainian real policy rate is one of the highest in the world and that the NBU is steadily building its reputation and credibility. Inflation is on a declining path (ok, some hiccups have occurred now and then, but overall the trend is downward). Even if the new IMF agreement is postponed to early 2020, it's hard to see Ukraine having major problems covering its financing needs. **However, reaching an agreement in the near term remains crucial because the country is facing heavy debt redemptions in 2021 and 2022.**

A Challenge for the NBU

Elsewhere, the future of PrivatBank is in unchartered territory. There is no procedure for returning an insolvent bank to its original shareholder, and the consensus in Kyiv is that Mr. Kolomoisky is not really interested in reacquiring the bank. Instead, it appears he would rather have the charges against him lifted and his international assets unfrozen. If a higher court gives Mr. Kolomoisky a favourable verdict, the NBU would very likely look to re-nationalise the bank given its insolvency.

A Sparse, Yet Noisy Demonstration in Front of the Presidential Palace

Photo credit: Giancarlo Perasso

It could take a week for the NBU to re-nationalise the bank. Yet, the concern is that lines will likely form outside the branches, professional agitators may stoke unrest, Mr. Kolomoisky's TV station (one of the most popular in the country) could rail against the NBU, and the NBU's reputation as the bank supervisor could come under scrutiny. If this scenario plays out, it would pose a crucial test for the new administration to show its commitment to the central bank and to turn page for the better.

While the PrivatBank situation is among the challenges facing Ukraine, **the country's overall outlook appears promising. I would dare say that the country's new reform effort could be "three steps forward, one step backwards," rather than yesterday's tango of "two steps forward, one step backward." Therefore, our large hard currency overweight position currently appears sensible with the caveat that there may be periodic bouts of volatility, but we are more than compensated for this at current pricing levels.**

Finally, a few parting thoughts. I have to report that Kyiv's food-delivery bikers are riding on the sidewalk as crazily as those in New York, London or Milan. Is this familiar cosmopolitan characteristic reassuring or worrying? I don't know, but keep your head up on the sidewalks of Kyiv!

In perhaps another progressive sign, President Zelenskiy decided to open a previously closed area around the presidential palace as a symbolic gesture that allows the public to get closer to the seat of government. During a meeting with administration officials, a small but boisterous band of protesters subsequently emerged in front of the palace, which added a wrinkle to our conversation (the protest was about some construction in Kyiv; has NIMBY-sim arrived in Kyiv as well?)

Cheers,

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