

Ukraine cabinet reshuffle:

IMF deal under threat

Executive summary

Ukrainian President Zelensky initiated a reshuffle of the Cabinet of Ministers five months after it received what was supposed to be its one-year immunity. The move, which lacked an adequate explanation by the president, was treated negatively by fixed income investors. Unfortunately, we have no positive message to them: the sovereign risk indeed has risen, primarily because these changes significantly reduce the chances for Ukraine's smooth cooperation with the IMF.

We don't see any potential for the new cabinet to do anything better than the previous one, which also raises the risk of Ukraine being plunged into a serious political crisis as early as this year. Among the key implications of this are risks of populist politics instead of structural reforms and that corrupt oligarchs regaining control of decision-making.

Taking all this into account, we no longer see an IMF deal in 2020 as a base-case scenario.

Therefore, we recommend investors to avoid Ukraine public debt (both local and international), at least until there is a clear and unequivocally positive message from the IMF about Ukraine. We also recommend taking this opportunity to invest in Ukraine GDP warrants, for which we see a fair price to be above 100% of par. We also see potential upside for the fundamentals of DTEK Energy (DTEKUA). To be sure though, we should wait for the approval of a new energy minister.

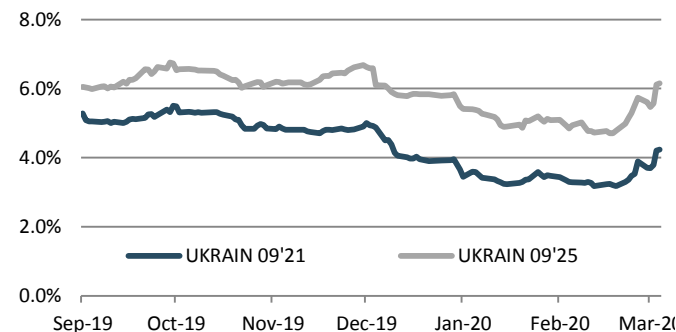
IMF deal under threat from populist path

Our main conclusion from these events is the new cabinet of PM Denys Shmyhal must choose one of these political strategies, **none of which offer much chance for an IMF deal this year**:

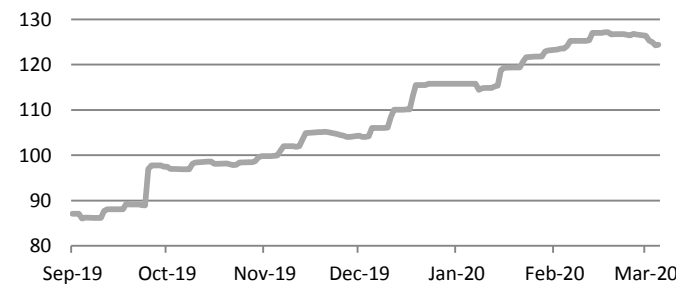
- **Indulge in populism and concede to oligarchs to survive.** This approach will help produce strong results in the October local elections. But it entails risks of a wider budget deficit, scrapped plans to break up monopolies and restrict oligarchic power, and the abandonment of long-term structural reforms. All this does not look acceptable to the IMF.
- **Continue the reform path and risk being replaced.** The option of pursuing reforms, as Honcharuk's cabinet did, means being under constant threat of immediate dismissal. This also means IMF cooperation is not likely, as the fund prefers not to deal with lame ducks who won't be able to deliver on their taken commitments.
- And there is some small chance for what Zelensky called "a cabinet that will do the impossible." By its definition, such a scenario cannot be treated as a base case.

The cabinet reshuffle, however, does not completely rule out the possibility of a soon deal with the IMF. If the fund's key demand will remain the adoption of a law that prevents the denationalization of Privatbank (as the only demand from the fund in 2016 was its nationalization), the chance for a deal remains solid. So we recommend closely following the IMF's messages.

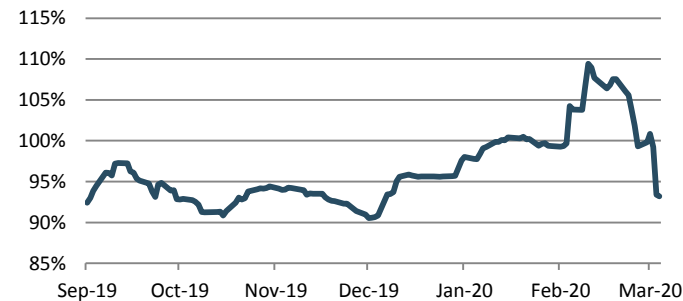
Ukraine dollar Eurobonds YTM



Non-residents exposure to Ukraine local gov't bonds, UAH bln



Ukraine GDP warrants price, % of par



Key concern: Poor reasoning of Honcharuk cabinet dismissal

Considering that the cabinet, led by former PM Oleksiy Honcharuk, got its one-year program approved by the parliament on Oct. 4, which gave it one-year immunity to boot to fulfill it, its sudden dismissal draws much concern in light of no reasonable arguments regarding its ability to implement its program.

In explaining his decision, among Zelensky's more meaningful complaints were poor budget collections and the negative industrial statistics of recent months. However, these shortcomings were not related to the government's work, nor did they affect fiscal sustainability and the public welfare (wages continue to grow at high single-digit real rates).

As there is no clear and well-grounded reasoning behind the premature dismissal, we see two possible true reasons, each offering no optimism about the new cabinet:

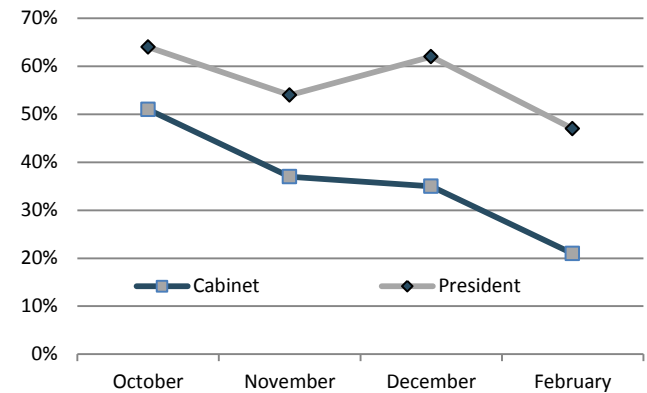
1. Zelensky is spooked by plummeting poll ratings. Public support for the cabinet has been rapidly plummeting since its appointment in late August, starting at 51% in September before slipping to 35% in November and 21% in February, according to a poll conducted by the Kyiv International Institute of Sociology. Zelensky is well-known for being very sensitive to public opinion (having built his career as a performer), and he was likely spooked that the dissatisfaction with former MP Honcharuk could spill over (Zelensky's support path has been 64%-62%-47%, respectively). For that reason, he was likely harboring the notion of a cabinet reset for a couple of months in order to collect and then dump the public's discontent on a convenient scapegoat.

This sets a precedent that the new cabinet's main KPI will be its poll ratings.

2. Centrengo of discord. Several local media reported that the president had an argument with Honcharuk last week about the government's policy regarding Centrengo, which is effectively controlled by tycoon Ihor Kolomoisky. The tycoon is widely recognized as the main sponsor of Zelensky's presidential campaign. Zelensky's alleged discontent about Honcharuk's attempt to replace a Centrengo top manager, endorsed by Kolomoisky, reportedly led to Honcharuk's threat to leave the government. Such allegations do not look unreasonable, taking into account that this attempt to change Centrengo's management did not succeed.

This means, in choosing between spoiling relationships with a powerful tycoon or the prime minister, Zelensky will opt for the latter. And the cabinet ministers, to remain in place, should respect this position.

Percent of public that supports actions of:



Key concern: Implications

The main conclusion from these events is that **the success of Shmyhal's cabinet will be based on its popularity among the public and its ability to compromise with powerful oligarchs.**

The recipe for survival for Shmyhal and his cabinet in the current Ukrainian political landscape is:

1. Pursue short-term populist measures instead of long-term structural reforms,
2. Maintain positive relations with oligarchs to gain favorable news coverage on their television networks.

This has largely been Zelensky's strategy in his first nine months in office. In the same spirit, we can conclude that President Zelensky's political strategy will remain:

- Pursuing short-term populist measures to maintain poll ratings,
- Satisfying the oligarchs, especially Kolomoisky, who could decide to target him for removal instead of the prime minister,
- And, as of this week, a possible new element of rotating the cabinet, perhaps as often as once or twice a year, in order to deflect public dissatisfaction.

All this has the following implications, which should be of utmost concern for the investment community:

- Increased **risks for public finance and public debt**,
- **Freezing** or even rolling back of long-term, structural **reforms**,
- **More concessions** in protecting state interests against powerful **oligarchs**,
- And most disturbingly, the high likelihood that the cabinet **won't be able to seal** the deal on the planned loan **program with the IMF**, which is always the advocate of painful reforms and concerned about the budget deficit.

Other concerns: New-old people in MinFin and other ministries

Consistent MinFin policy of 2015-2019 under risk of review

Since the painful restructuring of international debt in 2015, and up until February 2020, Ukraine's MinFin was implementing policy that was welcomed by international creditors:

- Fiscal consolidation and tough control over government expenditures, with no room for populism,
- Consistent management of state debt and increased product line of debt instruments,
- Reliable cooperation with the IMF as the backbone for Ukraine's positive credit story.

Despite a few rotations of MinFin heads, few mid- and high-level officials in the ministry changed in the last five years, which allowed for maintaining and fulfilling consistent policies. Ultimately, all the finance ministers were sharing the same approaches and same values up until now.

And all this consistency is now under risk, as the new finance minister, Ihor Umanskiy, seems to share different values that are populist-oriented, in line with the president's approach.

Another possible cause for concern is Umanskiy's previous tenure as finance minister having been under former PM Yulia Tymoshenko, among the IMF's biggest critics in Ukraine. However, Umanskiy tried to eliminate such concerns with a March 6 statement that IMF cooperation should remain a top priority for Ukraine

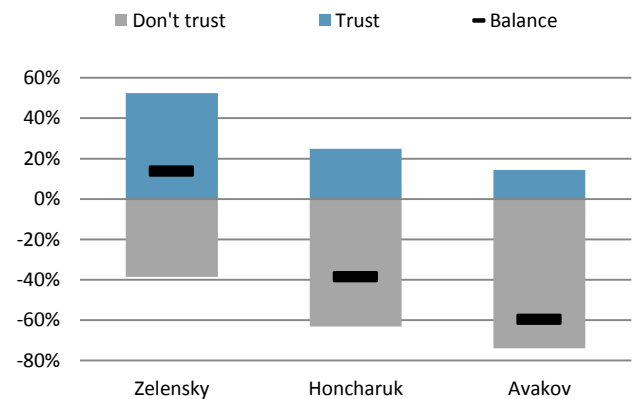
New cabinet returns relics of the past

Zelensky and his loyal party, The People's Servant, promised to bring no "old guard" politicians to government positions during the presidential and parliamentary election campaigns. With the election of Honcharuk's cabinet in August, they proved their adherence to that promise. The only exception was the reappointment of the highly criticized Arsen Avakov as internal affairs minister, which Zelensky described as a temporary measure that might be reconsidered by end-2019.

However, Zelensky not only failed to remove Avakov in late 2019, but also left him in the cabinet during this latest rotation. That's despite Avakov being among the least popular politicians, with about 74% of Ukrainians distrusting him as of mid-February, according to a Razumkov Center poll.

Meanwhile, two ministers in the Shmyhal cabinet served in the Russian-oriented Yanukovich administration, as well as Umanskiy from the 2009-2010 Tymoshenko cabinet. This eliminates most expectations for desperately needed structural reforms.

Public trust/distrust of select politicians, Feb. 2020



Other concerns: Cabinet consists of random people, starts with populism

New cabinet doesn't share reform vision, lacks key ministers

Unlike Honcharuk's cabinet, whose members underwent a uniform selection process that required shared values of reform, Shmyhal's cabinet was cobbled together within a week, with some candidacies being reportedly reviewed for a mere few hours. In this rush, several ministers refused to remain in the government, including former economy minister Tymofiy Mylovanov. Having been asked to lead a rejuvenated agriculture ministry, likely in order to lead the farmland market launch this year, Mylovanov indicated the new cabinet isn't committed to free markets and government noninterference, hinting at his view that the launch may be disrupted in some way.

Besides the economy and agriculture ministries being left without a leader, the energy, education and culture ministries remain leaderless. We view this as a sign that many otherwise talented bureaucrats don't want to be involved in a presidential administration that is struggling for survival. Nor do they want to be sacrificed in six months at the altar of Zelensky's popularity.

Populism detected, which may be concern for the IMF

Before this abrupt change in personnel, we were expecting that a possible IMF could emerge some time in 3Q20.

The key impediment to the IMF deal remains the adoption of a so-called anti-Kolomoisky bill, which is legislation that will prevent the return of Privatbank to its former shareholders, who are accused of enormous crimes. We still hope that this bill will be approved in April, avoiding a delay that would hurt the IMF deal.

With the new populist government, however, a revision of the 2020 state budget is underway to accommodate Shmyhal's call for higher social spending, among the key goals he declared in his address to parliament before being elected as prime minister. Two days later on March 6, he confirmed the 2020 budget is already under review.

Needless to say, this initiative will inevitably lead to a widening of the budget deficit, which is always among the IMF's key concerns.

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