Ukraine central bank governor's resignation poses temporary shock

Ukraine's central bank Governor Yakiv Smolii resignation due to "systemic political pressure" comes as a heavy blow for the current administration. The central bank independence and credibility is a key pillar in the IMF programme which is being questioned once again, but in our view things are not irreparable just yet

Yakiv Smolii, Ukraine's central bank governor announced his resignation

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A heavy blow

Ukraine's central bank Governor Yakiv Smolii's resignation due to "systemic political pressure" comes as a heavy blow for the current administration.

He took office in May 2017 and has been favourably perceived by markets as a fierce defender of central bank's independence. During his predecessor's mandate - Valeria Gontareva who also resigned in 2017 - Smolii was part of the crisis team dealing with the bankruptcy of smaller banks, stabilising the currency and getting IMF support.

It might be premature to speculate on Yakiv Smolii's successor, we believe that policy continuity is more likely than not

Since 2017, under his mandate, the central bank's inflation-targeting regime gained traction and credibility, allowing the Bank to gradually bring inflation and borrowing costs down. He was also one of the main negotiators of the latest IMF agreement approved in early June 2020.

The resignation needs to be approved by Ukraine's parliament, the Rada, which looks like a formality after the president accepted it. The vote could take place tomorrow but the proposal for a new governor will be made by the president and will need Rada approval.

While it is premature to speculate on his successor, we believe that policy continuity is more likely than not.

Not a decisive game-changer yet

The Governor's resignation serves as a "wake-up call" for policymakers.

For now, things don't look irreparable in our view and we don't think the IMF agreement will be at risk in the near future. Close monitoring from both the IMF and the European Union should ensure that the arrangements go ahead as planned.

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Central bank independence is integral in the arrangement with the IMF and we don't think policymakers will risk jeopardising it. The cancellation of yesterday's Eurobond issue – (US$1.75 billion of 2033 notes) and tender offer on the 2021 and 2022 notes which otherwise could have been called a success – is not helping strained public finances but is not a decisive game-changer either. We think Ukraine is likely to return to markets at a later stage once the situation has calmed down.

The central bank will probably need to spend away some reserves to provide FX liquidity to both the government and markets, but the starting point of USD 25bn last month is strong enough in our view to ensure safe navigation through these turbulent times.

Political landscape becoming fluid

In recent months, we have seen increasing tensions within the ranks of Zelensky's Servants of the People party which has clouded the political situation. The failure to get some legislation passed has become more than just one-offs lately, meaning that the situation can turn quite tight in case a no-confidence vote is proposed.

The legislation needed for the IMF agreement was passed with the help of other parties, namely

Voice and European Solidarity which together have 47 votes in the parliament. Despite having 248 MPs (the minimum needed to pass ordinary legislation is 226 votes), the Servants of the People party could muster only 175 votes in the latest attempt to approve the government's action plan.

All this does not necessarily mean that the majority in the parliament now belongs to someone else, but rather that the President will need to negotiate alliances for each legislation.

The hryvnia depreciated by 1.3% this morning, but we expect the central bank to manage this contextual depreciation in a judicious way and provide liquidity to the market.

Until the situation becomes clearer, we expect the exchange rate to test higher towards 28, but don't see fundamental reasons for a more sustained depreciation. On the interest rate side, we were expecting a sharp reduction in the pace of rate cuts anyhow - 5.50% our year-end key rate forecast.

A longer pause at 6.00% looks more likely now.

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