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INSIDE UKRAINE

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The International Center for Policy Studies (ICPS) restores issuing analytic paper «Inside Ukraine», the last issue of which was prepared in September 2010.

The aim of the publication is to provide objective information on current political events in Ukraine and thorough analysis of major tendencies in domestic politics. Such analysis will assist in setting priorities in the process of implementing reforms in Ukraine and in evaluating quality of state decisions from the viewpoint of their impact and sustainability. Special attention is paid to evaluation of political competition in Ukraine and ability of key political players to address challenges.

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1. The Government policy

The Government is not able to organize the anti-terrorist operation in Donbas. Some attempts come up against the leadership incompetence and sabotage of the local security forces. Failures in the fight against separatism are exacerbated by the lack of the Government's information policy. Stabilization of the situation in the East is possible only through the involvement of regional elites who are opinion leaders for the local population and have the resources to establish control over the region.

1.1. Managerial failures of the anti-terrorist operation

The active phase of the anti-terrorist operation in Donbas does not bring the expected results. The first achievements of the Ukrainian security forces were immediately smoothed over the losses and serious administrative errors.

On the first day of the reactivation of the anti-terrorist operation, there were reports on unblocking of the Sviatohirsk and destructing of three roadblocks nearby Sloviansk. However, the security forces failed to neutralize significant forces of gunmen. Moreover, they did not arrest any terrorist, they just forced them out from the positions occupied.

The National Security and Defense Council stated that the anti-terrorist operation would be conducted in several stages and the first stage had already reached its results. Now, the second phase has begun. Its aim is to block the gunmen in Sloviansk.

This city is the main center of the militants who seized the premises of police, Ukraine's Security Service and City Council buildings. It was chosen due to good geographical location: on the borders of Kharkiv, Donetsk and Luhansk regions and on the international highway Kharkiv - Rostov-on-Don. Flexible logistics also enables the coordination of administrative buildings seizure in other localities: Kramatorsk, Donetsk, Horlivka. On April 28, the police department in Konstantynivka was seized. This city is also located nearby Sloviansk and Kramatorsk.

Another reason for implementing separatist scenario in northern Donbas is large arms arsenals of the Soviet era, as well as the strong influence of Viktor Yanukovich's entourage in the region. For instance, former Prosecutor General Viktor Pshonka worked in Kramatorsk for 17 years, and the son of former Prime Minister Oleksiy Azarov became MP representing Sloviansk in 2012.

Starting point for separatist scenarios in Sloviansk can be an energy factor too. The city is located in the center of one of the largest fields of shale gas in Ukraine – the so-called “Yuzivka Project”. During Viktor Yanukovich's presidency, an agreement to develop this field was signed with the Dutch company “Shell”. This project enables to ensure energy independence of Ukraine in a few years. Therefore, it constitutes a direct menace to Russia's "Gazprom".

The spread of separatism from Sloviansk to other areas is similar to the spread of cancer metastases. The problem can be solved only if it is localized. The Ukrainian authorities failed to do so, although it was the main goal of the second phase of the antiterrorist operation.

On April 26, three SBU officers were captured in Horlivka and

Anti-terrorist operation in Donbas does not bring the expected results

Choosing Sloviansk as a center of separatism was a deliberate decision based on a number of specific reasons

The energy factor of separatism

transported to Sloviansk without any obstacles though the security forces claimed that the city was completely blocked. The detention of security officers and the absence of support groups during the operation demonstrate the incompetence of leadership and a strong pro-Russian intelligence network incorporated in the structures of Ukrainian security forces.

On April 25, separatists detained OSCE military mission, which consisted of eight foreign military officers and five Ukrainian militaries. The Ukrainian authorities have not taken any steps to release them, even though it is the Government that is responsible for stabilizing the situation on the territory. The main purpose of the separatists is to show that the Ukrainian Government in Kyiv is completely ineffective and has no influence on events in Donbas. Head of the so-called militia in Sloviansk Ihor Strelkov said that negotiations for the release of hostages would be conducted only with the Russian Federation. Thus, the separatists are trying to raise the issue of legitimacy and subjectness of the Ukrainian government in the eyes of the international community.

Separatists try to show that the authorities in Kyiv do not control the regions

1.2. The Government has not defined its information policy

The Government's failures in conducting anti-terrorist operation are further aggravated by the lack of basic information policy. Excessive activity of the Minister of Internal Affairs Arsen Avakov in social networks cannot be called information policy in any way.

There is no single government agency that would regularly provide information on developments in Donbas, and the steps taken by the Government to combat external aggressors and separatists. There is no balanced information on the facilities seized by separatists, the number of gunmen and weapons. It is impossible to win without knowing your enemy.

Information policy should have a specific purpose and identify the problems it solves. Just like any other policy, it must have a state body responsible for its implementation and regulatory framework. If there are any obstacles to its implementation, they must be clearly identified and eliminated.

The resources of regional broadcasters funded from the budget are not used for countering separatism. They are staffed by local journalists and are popular among the local public. The authorities in Kyiv have not established communication with these state companies. There is no mechanism for selecting key messages to be broadcast to the local population. The separatists clearly understand the importance of television in the current situation, so TV towers and Regional State Television and Radio Broadcasting Companies are seized among the first, along with administrative buildings and security forces offices.

Separatists understand the importance of local television better, than the Government

1.3. The importance of oligarchs' position on fighting separatism

The appointment of Ukrainian billionaire, Ihor Kolomoisky, as the Governor of Dnipropetrovsk region prevented spread of separatism to this Ukrainian region. A strong stance of the Governor and his ability to mobilize significant financial resources of the local business has played an important role in keeping the separatist movement out of Dnipropetrovsk region.

In order to stabilize the situation in the entire macroregion, Kolomoisky has called on his colleagues to establish the Council of

Governors of the southeastern Ukraine with the headquarters in Dnipropetrovsk. The main tasks of a new body may be ensuring the conduct of democratic elections, the coordination of the fight against separatism and the elaboration of a new Constitution with more powers delegated to the regions.

One of the reasons behind this is Kolomoisky's desire to get the leverage on the situation in all eight regions of Ukraine: Luhansk, Donetsk, Dnipropetrovsk, Kharkiv, Zaporizhya, Kherson, Mykolaiv and Odesa. However, the Ukrainian Government may be willing to pay such a price for countering the separatism in the East. On the other hand, the potential growth of Kolomoisky's influence may meet much opposition from other regional elites, and in the end it may destabilize the situation even more.

Meanwhile, Rinat Akhmetov does close to nothing to fight the separatism in Donetsk region. The businessman says that Donbas should remain part of Ukraine, but he does not use his resources to influence the situation. The separatists are running a destabilization spree in the most brazen way in several places in the region, kidnapping people, terrorizing the supporters of united Ukraine and seizing local broadcasting stations right under the nose of the main sponsor of the Party of Regions.

The strike of miners at the companies owned by Rinat Akhmetov in Krasnodon has clearly shown that the local population cares more about economic demands rather than political ones. It points to the fact that the external factors are playing a leading role in fueling the separatism.

The Government needs to conduct negotiations with politicians and businessmen that have influence in the East. Both Kyiv and Moscow realize how important they are for the stabilization of the situation in the East. The assassination attempt on Gennadyi Kernes, who previously was an active supporter of pro-Russia rallies and then changed his mind for collaboration with the Ukrainian government, should be seen as an attempt to withdraw Kernes from the political game. It will also become a signal for the rest of regional elites, which have not made up their mind yet as to which side to take.

1.4. The parade of referendums

The Government disregards the active preparation of the separatists for a referendum in Donbas planned for 11 May. At the referendum, the people will be asked if they support the idea of the independence of the People's Republics of Luhansk and Donetsk. In the meantime, the representatives of a self-proclaimed People's Republic of Donetsk are demanding that the local authorities provide them with the means to exert their right to vote and are threatening to use force to get hold of the lists of voters on May 6.

We should expect the escalation of the confrontation in the East on May holidays. The mass takeover of administrative buildings in Luhansk region before May 1 should be viewed as a preparation for this scenario. Apparently, there will be attempts to spread destabilization further to the neighbouring Kharkiv region.

The Ukrainian authorities should not only define its clear position on the referendum, but also take preemptive steps to counter the separatism. By resuming an anti-terrorism operation in the East, the Government should not forget about Kyiv, as public events in the Ukrainian capital during the holidays may be used for provocations.

Kolomoisky wants to establish the Council of Governors of the southeastern Ukraine

Rinat Akhmetov is making no effort to fight the separatism

It is important to establish a dialogue with opinion leaders in the East

It is expected that the confrontation will be escalated on May holidays

The Donetsk Governor, Serhiy Taruta, thinks that holding the national referendum on the decentralization along with the presidential elections on May 25 will help unite Ukrainian people in their support for reforms and European values. The increased turnout of the voters in the East is an apparent advantage, as for the moment the local population is not ready to participate actively in the presidential elections. However, in order to conduct a referendum, it is necessary to eliminate the centers of the separatist movement in Donbas. Otherwise, the lack of control over this region may threaten the democratic nature of this process.

National Security and Defense Council of Ukraine expressed their support for the national referendum, but it was noted that the referendum should be held on June 15. In both cases, there are many difficulties along the way. First, the referendum should be called by the President instead of acting President. In order to circumvent that rule, a new law should be introduced. Secondly, there is no mechanism for the implementation of the referendum's results in Ukraine. That puts the referendum in the category of consultative public opinion polls. Apart from this, it takes money and time to hold a referendum on such important issues. The Deputy Head of the Central Election Commission of Ukraine, Andriy Mahera, thinks that the Central Election Commission of Ukraine is able to organize a referendum before June 15, but only provided that the relevant decree of the Verkhovna Rada of Ukraine is issued.

The effectiveness of the referendum will depend on how the questions are formulated, and whether the consensus between different political parties in Ukrainian parliament as to their formulation is reached.

***The referendum
on decentralization
may be held on
June 15***

2. Economic situation

Macroeconomic indicators, published by State Committee of Statistics, demonstrate negative dynamics. The drop was caused by structural problems in Ukrainian economy and its weak institutional structure, aggravated by current political crisis and conflict with Russia.

2.1. Deterioration of economic indicators

Comparing to the respective period of the last year, in 1Q 2014 Ukrainian GDP dropped by 1.1%, index of industrial production decreased by 5%. The drop of mining volumes was less significant – 1.3%, while manufacturing decreased by 7.7%. The fastest decline was observed in machine engineering – 17.9%, metal industry – 10.7% and chemical industry – 5.3%.

GDP drop made up 1.1%

In comparison with 2013, export decreased by 10%, while import – by 17.9%. In January-March 2014 inflation made up 103.0%.

Turnover of wholesale trade decreased by 2%. Cargo turnover dropped by 3.1%, while passenger turnover – by 3.8%. Construction industry fell by 6.4%.

According to our estimates, in 2014 Ukrainian GDP will drop by 6.5%. If to take into account Crimea annexation and disregard input of the peninsula into GDP (average of 3.7%), GDP drop will surpass 10%. Inflation is forecast at the level of 15.4%.

Major reasons for inflation are increase of money supply hryvnia depreciation

Major reasons for inflation are increase of money supply due to massive withdrawal of deposits from the banking system and increase in the price of imported goods due to hryvnia depreciation.

Negative impact on GDP dynamics will be exerted by decrease in private consumption by 10%. Drop of state consumption will be lower and it will make up 3%. Gross capital formation is expected to decrease by 12%. Export will decrease by 14%, while import – by 18%.

Major factors which will negatively influence economic dynamics include: drop in domestic consumption due to decrease in real income, acceleration of inflation, deterioration of economic relations with Russia, gas price hike which will increase prime costs of production in a number of industries, further deterioration of the situation in the East and possibility of military invasion, which will negatively impact the investment climate.

Regardless of the crisis, default is unlikely. The National Bank has enough resources to make regular repayments of the state debt. The situation will be also improved after expected financial aid from international organizations arrives.

Default is unlikely

Deterioration of economic indicators was caused by a number of factors and the Euromaidan is not one of them. On the contrary, it is unsatisfactory economic situation that led to popular unrest. The crisis was caused by structural economic problems, low efficiency of institutional environment and delay with systemic reforms.

The important task for 2014 is to create basis for economic development. It should be viewed in the light of two defining factors: investments and institutions. Without efficient institutional mechanisms investments will be impossible.

A significant deal of attention should be paid to two aspects of institutional policy elaboration.

First of all, ownership rights should be protected. Investors are especially susceptible to this factor. A wave of corporate raids in 2006 negatively influenced investment climate in Ukraine. In this regard special attention should be paid to prompt and efficient implementation of court decisions.

Secondly, the Government should restore trust to the state as a driver of economic policy. It may be achieved through fight against corruption and establishment of dialogue between the state and the business, which should be represented not only by large financial groups, but also by smaller companies. Lack of trust significantly influences overall investment climate.

2.2. Problems of banking sector

Banking sector faces a number of problems, one of which is to invigorate the repo market. At the moment there is a situation when the repo market has a low liquidity, which decreases banks' demand for state securities and makes liquidity management difficult.

The problem is caused by low trust to the issuer, especially with regard to T-bills nominated in USD; actual absence of the secondary market for T-bills, which increases discount under repurchase agreements; and a small volume of T-bills nominated in UAH with two-year maturity.

Banks which finance reverse repurchase agreements are forced to decrease volumes of transactions with T-bills nominated in USD. Otherwise, in case contractor does not meet obligations under reverse repo, FX position of the bank increases and the bank has to attract and sell USD in order to stabilize it. Taking into account limited opportunity for most banks to attract FX resources, such risk decreases banks' activities on reverse repurchase of T-bills nominated in USD.

The National Bank may take steps to invigorate the repo market in short term. For these purposes it has to make quotations for purchase of FX T-bills with considerable discount on a regular basis. It will facilitate reverse repo as in case contractor is unable to make reverse repurchase, T-bills will be sold to the National Bank.

Activation of the repo market will increase demand for state securities. As a result, banks will be able to manage liquidity more effectively. In general, it will give a push to the secondary market of T-bills.

2.3. Situation in the energy market

Ukraine and Slovakia signed memorandum on reverse gas supplies. This agreement meets requirements of the European energy community. The parties agreed that the memorandum foresees the use of small and big reverse routes.

In early May representatives of Russia, Ukraine and the EU will meet to discuss the issue of Russian gas supplies. As a reminder, in April Putin sent a letter to the leaders of the EU countries raising the issue of Ukrainian debt for the gas. In the reply, Jose Manuel Barroso, President of the European Commission, stated that Gazprom is fully responsible for gas supplies to Europe. Putin responded that the Russian company indeed is responsible for the gas supplies to Europe, but it is Ukraine that is responsible for transit.

Ukraine calls the EU to take decisive steps to ensure stable supplies of gas. The European Commission believes that contractual reliability of

***Banking sector
needs
invigoration of
the repo market***

***The National
Bank may
influence the
repo market***

***Reverse gas
supplies from
Slovakia to
Ukraine are set***

Russia as a supplier is at stake. 18 EU countries will be able to settle the gas issue not only between the EU and Russia, but also between “Gazprom” and “Naftogaz” if they dare to purchase gas on the Russian-Ukrainian border. At present “Gazprom Export” sells Russian gas on the EU-Ukraine border. The question is whether European gas companies are ready to re-negotiate contracts with “Gazprom”. All in all, it would meet the requirements of the Third energy package.

At the same time Ukrainian gas market needs reforms. Investors face the problems of gas balance and access to extracted gas. As an example, in May 2013 capitalization of “Misen ENERGY AB” made up USD 650 mln. After “Naftogaz” denied access to Ukrainian gas transport system to the Ukrainian subsidiary of the company, its stock price in Stockholm decreased more than twofold.

The Government has to reform the gas market and create legal system which would be effective and under which investors would understand requirements, prospects and guarantees for their business.

Only transparent and clear legislation, implementation of laws under the obligations Ukraine has taken as a member of the Energy Community, will enable reforms of the gas market and attract the investors.

***Investors face
the problems of
gas balance and
access to
extracted gas***

3. Political competition

The lack of bright antipodes and the marginalization of the Party of Regions, which previously was the main representative for the East, makes the presidential election campaign inert and sluggish. No candidate offers a solution for separatism in the East. The polls show a significant difference between Petro Poroshenko and other candidates in terms of electoral support. It makes Yulia Tymoshenko look for alternative scenarios.

3.1. Poroshenko's desire to hold elections in one round

Poroshenko hopes to hold the elections in one round. According to Vitaliy Kovalchuk, the head of Poroshenko's campaign office, the victory of the candidate in the first round will demonstrate the unity of Ukrainian nation and increase the legitimacy of the new government.

Beside the significant popular support, as indicated in opinion polls, the candidate is also supported by the representatives of big business. Yuriy Lutsenko, the leader of the Third Ukrainian Republic, also appealed to vote for Poroshenko. The politician believes that the competition between the pro-Western candidates Tymoshenko and Poroshenko in the second round can irritate the voters in the East, so the turnout in the second round could be much lower. Although the turnout decline will not have legal consequences, the presidential elections in one round will show the public consolidation around the idea of reforms implementation.

During the last week Petro Poroshenko changed the tactics of the presidential campaign. Previously, he served as a peacemaker and preferred to resolve the crisis by diplomatic means with the assistance of the international community, while last week the politician visited Luhansk region and inspected the situation at the border with Russia. The politician urged to resume the direct negotiations with Moscow aiming to resolve the crisis between the two countries.

This provoked sharp criticism from Yulia Tymoshenko who believes that the parties should not deviate from the format of Geneva negotiations. At the same time, it is seen that the Geneva agreement were unsuccessful, as Russia did not take any steps to de-escalate the conflict in eastern Ukraine.

3.2. Lost hopes of Yulia Tymoshenko

Yulia Tymoshenko tried to negotiate with separatists in Donbas, but the negotiations were unsuccessful. Now Tymoshenko and Poroshenko changed roles of "warrior" and "peacemaker". After attempts to reach a compromise with separatists, the image of the "Batkivshchyna" leader is perceived softer, while the Poroshenko's appeal to use force against the separatists and start direct negotiations with Russia added aggressiveness and rigidity to his image.

Tymoshenko is trying to impose her game on the billionaire, but she fails. High hopes were pinned on the joint debates, but the draw has placed candidates in different triples. Tymoshenko even offered Poroshenko to hold an open debate on Poroshenko's TV-channel "5 kanal", but the current favorite has not responded to the proposal so far.

The weakening of internal political position of the "Batkivshchyna" leader is confirmed by the release on bail of Yevhen Bakulin, the former head of "Naftogaz" company. Bakulin is a member of the so-called "gas

Elections in one round will demonstrate unity of Ukrainians

Poroshenko does not agree with Tymoshenko on negotiations with Russia

Tymoshenko is trying to impose her game on the billionaire

group” of Dmytro Firtash, Yuriy Boyko and Serhiy Lyovochkin, that is a personal enemy of Tymoshenko ever since the “RosUkrEnergo” times. The Bakulin’s release on bail triggered a fierce criticism by both Tymoshenko and Arsen Avakov, the Interior Minister and a close ally of Tymoshenko.

Tymoshenko realizes that her chances to win the presidential election are extremely small, so she can implement other scenarios. One of them is to cut the presidential power that according to the 2004 Constitution is already tightly limited.

On April 29, the Prime Minister of Ukraine Arseniy Yatsenyuk proposed to agree on a new draft of the Constitution before May 25, and deprive the future President of a number of functions, including the appointment of ministers of defense and foreign affairs. This option will play into the hands of both Yatsenyuk and his ally Yulia Tymoshenko.

***Tymoshenko’s
back-up plan is
under way***

3.3. Vitali Klitschko starts in Kyiv

The attention to the mayor elections in Kyiv is much smaller than to the presidential one. The main candidates for the capital’s mayor are Vitali Klitschko, Lesya Orobets, Mykola Katerynychuk, Volodymyr Bondarenko and Andriy Illyenko.

Even opponents of the “UDAR” leader recognize that Vitali Klitschko has undeniable chances for victory. His position could have been diminished only if the mayoral elections were held in two rounds. This idea was pressed through by “Batkivshchyna” and “Svoboda”, but representatives of “UDAR” managed to postpone this decision.

***Vitali Klitschko
has all the
chances to
become mayor in***

In case of his victory, Vitali Klitschko will face many challenges. Firstly, it is not clear what authority will have the new mayor and how he will be affected by the decentralization announced by the Government. Secondly, he will be elected only for one and a half years, as the following nationwide local elections will be held in October 2015. Thirdly, his efficiency will depend on the new complement of the Kyiv City Council.

This is why the elections to the Kyiv City Council raise more interest than the Kyiv mayor elections. Klitschko’s “UDAR” and Poroshenko’s “Solidarnist” have a common list. “Batkivshchyna” and “Svoboda” started partially to align their candidates in Kyiv districts. Although the Party of Regions will ignore the mayor elections in Kyiv, its list to the Kyiv City Council will be headed by Nestor Shufrych. Also representatives of the Leonid Chernovetsky’s “young team” and leaders of major construction companies will try to get into the Kyiv City Council. The party “Samopomich” (“Self-help”) of the Lviv Mayor Andriy Sadovy will also try to get votes.

If Vitali Klitschko is elected as mayor of Kyiv, he will need to prove himself in the role he is not used to. His efficiency will depend on who will be in his team as well as his ability to formulate a clear development program for the capital. The main aspects of the program should be the reforms of the housing and communal services in the capital and the fight against corruption.

***Klitschko’s
efficiency will
depend on his
team and his
program of
reforms for the
capital***