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## TYMOSHENKO'S FIRST 100 DAYS: FOREIGN POLICY, ECONOMIC AND POLITICAL CHALLENGES

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### INTRODUCTION

Russian challenges over Ukraine's potential NATO membership, natural gas supplies to Ukraine and gas transit to Europe have been at the center of Prime Minister Yulia Tymoshenko's first 100 days as head of the Ukrainian government. Tymoshenko took office in late December, following snap parliamentary elections, after which she and the Our Ukraine-National Self-Defense group loyal to President Yushchenko formed a parliamentary coalition called the "Union of Democratic Forces." They number 228 pro-Western MPs and form a slim majority in the 450-seat Verkhovna Rada. The "Orange Union" gives Yushchenko the first pro-Western government and parliamentary majority in independent Ukraine's 15-year history.

The ruling coalition's main international objectives are to anchor Ukraine into global trading bodies such as the WTO and Euro-Atlantic institutions such as NATO and the EU. Reaching these strategic goals depends on the coalition's ability to remain united around geopolitical aims and to compromise on tactical challenges at home. An imperfect constitution, corrupt government practices, controversial privatizations, and rising inflation are some of the major challenges facing the coalition government. Political rivalries, special business interests and personality clashes are characteristics of the ruling democratic union that remain to be overcome. Nonetheless, a fragile quid-pro-quo is emerging among orange allies in Kyiv that could lead to a longer than expected tenure for Prime Minister Tymoshenko and real progress on President Yushchenko's drive to strengthen Ukraine's political and economic ties to Europe.

## UKRAINE AND NATO MEMBERSHIP

The NATO Membership Action Plan (MAP) is a major item on the coalition's foreign policy agenda. After assembling the coalition government and parliamentary majority, in mid-January Yushchenko, Tymoshenko and Rada Speaker Arseniy Yatsenyuk signed a joint letter to NATO officially stating Ukraine's request to embark on the NATO MAP, which, if granted, could eventually lead to Ukraine's membership in the alliance. Yushchenko is a strong supporter of NATO membership as a means of decreasing state budget expenditures on defense through entering into a collective security arrangement with the alliance. He told U.S. Secretary of State Condoleezza Rice that Ukraine was ready for the MAP in February at the World Economic Forum in Davos, and Tymoshenko lobbied for Ukraine's intensified dialogue with NATO during a meeting with the NATO Secretary General Jaan de Hoop Scheffer in Brussels.

At the same time, Ukraine's parliamentary opposition paralyzed the legislative chamber in January over the NATO initiative. In August 2006, Party of Regions leader Viktor Yanukovych promised President Yushchenko that he would support Ukraine's MAP ambitions in exchange for being nominated Prime Minister. A month later as Prime Minister, Yanukovych traveled to NATO headquarters in Brussels only to inform the alliance that Ukraine was not ready for the action plan. Yanukovych made his second trip to NATO headquarters weeks ago, this time as Ukraine's opposition leader, arguing against the MAP for Ukraine, citing polls that suggest more than half of the electorate opposes membership in the alliance.

Kyiv's pursuit of the NATO MAP has also drawn harsh criticism from Russian President Vladimir Putin, who has warned that extending NATO to Russia's border would threaten the country's national security. Putin warned that Moscow could be forced to target its missiles at Ukraine if the former Soviet republic joins the alliance, and Russia's Foreign Minister Sergei Lavrov compared NATO enlargement to a return of the Cold War.

At the early April NATO Summit in Bucharest, the alliance will consider the MAP requests of Ukraine and Georgia, as well as the membership candidacies of Albania, Croatia and Macedonia. The MAPs for Ukraine and Georgia are supported by the United States, Canada, the United Kingdom, and most of the alliance's Central and East European member nations. France, Germany, Italy, Spain, Greece, and Norway have expressed concerns that relations with Russia will suffer if NATO admits Ukraine and Georgia, and may cause friction between Brussels and Russia's newly elected President Dmitry Medvedev. Recognizing that leaders in Ukraine and Georgia are making a strong NATO push, Putin has offered NATO the use of Russian land and airspace to supply its security forces in Afghanistan in exchange for the alliance not taking Ukraine and Georgia into its ranks. A NATO spokesman has said the alliance is negotiating accords on land and air corridors to transport troops and equipment, which could be announced when President Putin attends the Bucharest summit.

It remains unclear whether Ukraine and Georgia will be granted the full membership “road map,” or a lesser version that would appease Moscow’s concerns. On April 1, international attention to the NATO debate will be heightened, as U.S. President George W. Bush plans a visit to Kyiv on the eve of the Bucharest Summit. Bringing Ukraine and Georgia into the alliance is one of his key foreign policy objectives before leaving office.

## WTO AND PROSPECTS FOR AN EU FREE TRADE AGREEMENT

Ukraine became the 152nd member of the World Trade Organization on February 5, after almost 14 years of negotiations. The last step remaining in the membership process is formal Verkhovna Rada approval of the accession protocols, which is expected no later than July 4, 2008. WTO membership is a major step in further integrating Ukraine into the global economy, and one of the few public policy measures that has the backing of the country’s three major political parties – the Party of Regions, Our Ukraine, and the Yulia Tymoshenko Bloc.

WTO membership provides Ukraine with enhanced access to the economies of all WTO members, including the large European Union market. The EU is already the destination for about 35% of Ukraine’s export goods and services, and negotiations are beginning on a Free Trade Agreement that Kyiv wants concluded by the end of 2008. Ukraine’s economy is expected to see gross exports expand by an additional 1.7%, as membership in the trading body eliminates many barriers. In particular, growth is expected in the metals sector (Ukraine is the world’s 8th largest steel maker), where production is expected to rise by 22% when WTO rules come into force. Foreign direct investment, averaging about \$7 billion annually since President Yushchenko took office in 2005, is expected to grow during the next five years as a result of both WTO membership and preparations ahead of the 2012 European Football League Championships in Ukraine. The Euro 2012 Games are expected to attract more than \$20 billion in infrastructure development and construction projects in six major Ukrainian cities – Kyiv, Lviv, Kharkiv, Donetsk, Dnipropetrovsk, and Odessa.

The primary issue in talks over a Free Trade Agreement (FTA) between Ukraine and the European Union is how far the agreement will go: whether it will simply eliminate tariffs on trade in goods and services, or represent a deeper agreement that could lead to rapid economic growth and greater benefit to both the EU and Ukraine.

During the past five years, Ukraine’s dynamic economic growth has owed much to high demand for metallurgical products in world markets. This global demand, however, is currently declining. Expected price increases for externally sourced energy and Ukraine’s own modest natural resources dictate that a successful EU-Ukraine FTA strategy must decrease dependence on the energy-hungry metals sector and open the door for Ukraine to become an internationally competitive economy in a diversified range of industries and service sectors. High on the list of priority sectors are energy, telecommunications and transport. A joint study conducted by three EU and Ukrainian think tanks argues that a more comprehensive FTA, which would be more

difficult to negotiate in the short-term, would bring greater long-term benefits that would facilitate more rapid economic integration and cooperation between Kyiv and Brussels.

Meeting the EU challenge seems to be a key priority for President Yushchenko and the Tymoshenko government. Both have made efforts to improve the business climate. Yushchenko eliminated Ukraine's visa regime and opened Kyiv's doors to businessmen and investors. Tymoshenko made inroads into cleaning up Ukraine's customs checkpoints, which are gateways for contraband goods destined for Europe.

## ECONOMIC CHALLENGES

Ukraine is experiencing its eighth consecutive year of economic growth with an average annual growth rate of 7%, one of the highest in Europe. In early February, President Yushchenko outlined for investors five key economic priorities for 2008. They include:

1. Improving the investment climate through transparent and competitive privatization tenders;
2. Amending laws on corporate governance, and liberalizing stock market trading activities to make the exchange accessible to more local and international investors;
3. Liberalizing land regulations, particularly in the agricultural sector;
4. Adopting a new tax code that reduces tax burdens on manufacturers and individual taxpayers;
5. Introducing laws that criminalize responsibility for corruption, in conjunction with efforts to clean up the court system and police force.

One of the key obstacles to reaching these objectives is disagreement within the coalition over the appointment of key officials for managing reforms. Several holdovers from the Yanukovych government remain at the helm of the Anti-Monopoly Committee and the privatization authority known as the State Property Fund. The coalition may reach a common position on appointing ministers committed to reforms in the coming weeks.

## PRIVATIZATION

In early January, the Tymoshenko government approved an extensive list of state enterprises for privatization in 2008 that could add \$6-9 billion in revenues to the state budget. They include the telecommunications monopoly UkrTelecom, the Odessa Port Chemical Plant, and controlling stakes in several regional power companies. Both Yushchenko and Tymoshenko are committed to open competitive tenders with the highest bidder taking the prized assets. The model for these transactions is the 2005 sale of the Kryvorizhstal metals plant to Mittal Steel for \$5 billion, more than five times the price paid for the asset by industrialists Viktor Pinchuk and Renat

Akhmetov in a closed tender organized by the outgoing Kuchma administration. Several tenders have already been announced, with the first bids scheduled for May and June.

## INFLATION AND MONETARY POLICY

Ukrainian consumers and investors are looking for signs from the government and the National Bank of Ukraine (NBU) that inflation and monetary policy will be brought under control. However, rises in world prices for oil, gas, food, and other commodities will make it impossible for the government to get inflation down into single digits in 2008. Independent experts forecast the best-case scenario for 2008 to be in the range of 12-15%. Experts have also called on the NBU to de-link the Ukrainian hryvnia's peg to the US dollar, to lessen the impact the devaluation of the American currency in world markets will have on Ukraine's economy.

**Consumer inflation.** In 2007, consumer price inflation surged to 16.8%, the highest rate since 2000, which was the result of both supply and demand side factors. On the demand side, inflation was driven by wage growth in excess of productivity and the continuing credit boom. On the supply side, soaring prices of imported energy resources and other commodities and poor agricultural performance were the primary factors.

**Producer price inflation.** Producer price increases continue to spill over into the retail markets. In 2007, producer prices grew by 23.2%, outpacing consumer price growth. This gap is the result of manufacturers passing their higher energy prices on to consumers, limited adjustment of utility tariffs for households, and the existence of price regulations on socially important products such as bread.

**Rising consumption and shortages.** Even without higher energy prices being passed on to consumers, inflation may reach 12-15% due to continuing robust consumption growth (though slower than last year), shortages on the food market in the first half of the year, and rallying commodity prices on international markets.

**Food price inflation.** Rapidly increasing prices for foodstuffs contributed the most to CPI growth in 2007, and much of the same is expected in 2008. Foods represent the largest weight in the consumer basket (about 60%), and prices increased nearly 23% in 2007. Food inflation was the result of poor harvests, buoyant consumption and a sharp price swing in agricultural and food commodities globally on the back of growing demand from emerging markets (particularly China, India, Brazil, and other fast growing economies). It was worsened by drought in the summer of 2007 and higher fuel prices, as well as a shift toward biofuel-oriented crops, which along with adverse weather conditions caused a decrease in agricultural output, particularly in grains.

**Exchange rate.** Despite the official hryvnia-dollar exchange rate remaining stable, depreciation of the US dollar with respect to other world currencies – particularly the euro and the ruble, has further contributed to making imported goods and services denominated in these currencies more expensive for Ukrainian consumers.

**NBU's tight monetary policy.** Though expansion of monetary aggregates was not the leading factor causing inflation to skyrocket in 2007, the NBU implemented a tight monetary policy introducing reserve requirements on funds attracted by commercial banks from abroad in November 2007 and raising its discount rate by 200 basis points to 10% since the beginning of 2008. However, considering the rather weak transmission mechanism and mostly non-monetary nature of inflation, the situation may require further tightening as well as more coordinated government measures.

### PRICE CONTROLS ON PETROL

Retail prices for petrol in Ukraine have risen along with world crude oil prices. As a result, some price points for petrol have risen by as much as 20% during the past three months. Tymoshenko's government has discussed internally the possibility of signing a memorandum with major oil companies to cap prices on certain oil products. Tymoshenko pursued a similar policy with oil companies while Prime Minister in 2005, as did Prime Minister Yanukovich in 2007. However, free market proponents within the President's inner circle, as well as major oil companies who have not had the best working relationship with Tymoshenko, remain reluctant to come to the table.

## GAS SUPPLIES AND GAZPROM RELATIONS

Tymoshenko's first 100 days in office were further tested by the Russian natural gas monopoly Gazprom, which claimed in early January that Kyiv had amassed a \$1.5 billion debt for natural gas supplies in the autumn of 2007. An early February meeting in Moscow between President Yushchenko and Putin resulted in an agreement for natural gas delivery set at \$179.50 per thousand cubic meters and Ukraine's payment of all arrears.

After agreeing to pay the gas debt for 2007, Kyiv was informed that its debts had grown by another \$600 million in 2008, based on a price of \$320 per thousand cubic meters, which drew a sharp reaction from the Tymoshenko government. Industry insiders claim the autumn 2007 gas arrears were created by RosUkrEnerg (RUE), the intermediary partially owned by Gazprom, which is selling discounted Central Asian gas to Ukraine. Allegedly, this led Russian authorities to arrest Semyon Mogilevych, one of RUE's main beneficiaries, in Moscow. Speculation exists that Dmitry Firtash, RUE's Ukrainian partner, was also to have been arrested, but did not make the trip to Moscow as planned.

RosUkrEnerg has been a sore spot in Ukrainian politics since 2003, when it entered the scene as a third party to a bilateral agreement administered by Russia's Gazprom and Ukraine's Naftogaz. President Yushchenko accepted RUE as Moscow's condition for inexpensive gas supplies to Ukraine and business end-users. RUE has amassed billions, while Ukraine's gas monopoly teeters on the brink of bankruptcy. Tymoshenko made the replacement of RUE a primary pledge in her 2006 parliamentary campaign. She toned down her anti-RUE rhetoric in the 2007 snap-election campaign, and it appears she may have made progress on removing the

intermediary in the recently-concluded natural gas delivery scheme. Her Cabinet insists that Gazprom remove RUE from the deal by the end of March, and Tymoshenko would like to limit Gazprom sales to Ukrainian industries to a maximum of 7.5/bcm, in contrast to that level serving as a minimum as stipulated in the current agreement. Gazprom and Naftogaz are battling for access to the most profitable segment of the local market – Ukraine's industrial consumers. Payment from this sector is much more predictable than from residential customers. An acceptable resolution over RUE may coincide with Gazprom's own efforts to improve transparency and corporate governance as it accesses international capital markets to help finance further gas exploration.

Tymoshenko will be pushing for a long-term bilateral agreement between Gazprom and Naftogaz on setting gas prices. However, experts concur that 2008 could be the last year of discounted natural gas for Ukraine, especially if Kyiv is offered the NATO MAP. Turkmenistan and Kazakhstan, two of Ukraine's main gas suppliers, have already indicated – in suspected collusion with Moscow – that their gas deliveries in 2009 will be at global market prices.

## POLITICAL CHALLENGES

### ELECTION PROMISES

Ukraine's democracy continues to mature, as for the first time political parties are beginning to deliver on promises made to voters during election campaigns. During the most recent snap parliamentary election campaign, Yulia Tymoshenko promised voters she would compensate them for savings lost to hyperinflation in the 1990s. Various governments have paid close to \$1 billion in compensation to State Savings Bank deposit holders for savings lost during the past decade. Tymoshenko promised, and looks poised to deliver, approximately \$1.2 billion in 2008 state budget revenues to pay each claimant the equivalent of \$200 in compensation. Finance Ministry officials have committed themselves to using non-inflationary methods within a sustainable fiscal framework to pay out the additional compensation to depositors. A registry of individual deposit holders has been created, and the Tymoshenko government plans to fully settle the compensation payments within a two-year period. Economists have criticized Tymoshenko for the populist measure that they claim will further fuel inflation, but the public seems to be satisfied with the plan and is giving Tymoshenko high marks in opinion polls.

The Our Ukraine/National Self-Defense group loyal to President Yushchenko made canceling MP immunity a key election promise during the last campaign. Last week, with the support of the Tymoshenko Bloc, a bill on canceling deputy immunity was passed by the Rada in the first reading and sent to the Constitutional Court for an expert opinion. The measure is expected to pass if the revocation of immunity extends to court justices as well as the President.

## CONSTITUTIONAL AMENDMENTS

President Yushchenko has argued that Ukraine needs to continue evolving as a parliamentary republic with a strong president. At the same time, a new draft of the Constitution, Yushchenko argues, should strengthen direct democracy. Among some of his proposed amendments are:

- Allowing ordinary citizens to appeal to the Constitutional Court when their constitutional rights have been violated;
- Instituting a “public veto,” a referendum initiated by voters to cancel laws or specific provisions in a law that has been passed by the Rada;
- Establishing the status of the parliamentary opposition and spelling out its rights;
- Dropping unlimited immunity for MPs;
- Granting the President “legal instruments of influence to prevent violations of the Constitution, eliminate threats to the existence of the state, and prevent risks to national security;”
- Preserving the principle of forming a government based on a coalition of deputy factions, but “balancing the mechanisms for political accountability in Government” to reflect “that the competence of the Cabinet of Ministers is closely tied to the powers of the President of Ukraine, who has Constitutionally enshrined powers in the designation of executive appointments.”

Amending Ukraine's Constitution requires 300 votes in the 450-member Rada. Given the nearly even split between the ruling coalition and the opposition, it appears unlikely that any of the President's initiatives stand a chance of being passed. However, as modern Ukraine's history demonstrates, constitutional amendments are bargaining chips used to settle major political crises. We can expect the same in the future.

## THE BATTLE FOR KYIV

Prime Minister Yulia Tymoshenko has been a stern critic of Kyiv Mayor Leonid Chernovetsky, who has been accused of supporting sketchy land deals worth billions to political and business cronies, and buying off city council members from Tymoshenko's bloc with spoils from lucrative city contracts and land projects. The Cabinet of Ministers has repeatedly called for Chernovetsky's dismissal in appeals to the President and the Verkhovna Rada. Tymoshenko even announced that her MPs would boycott parliament until it adopts a resolution dismissing the Mayor and calling for new city council elections in the nation's capital.

President Yushchenko suspended Chernovetsky for 15-day period earlier this month and ordered an investigation to be conducted. A week later, fearing the investigation would whitewash the Mayor's record, parliament voted for early city council elections and then dismissed Chernovetsky. The move caught Viktor Baloha, the head of Ukraine's Presidential Secretariat, by surprise. As it is alleged, Baloha has been conspiring with several of Chernovetsky's top aides to finance a new political group that would support Yushchenko's 2009

re-election campaign. Almost all of Yushchenko's MPs in the Rada voted to dismiss Chernovetsky, with the exception of those loyal to Baloha.

Yushchenko met with Tymoshenko last week to discuss putting forward a single candidate from the ruling coalition to run for the Kyiv Mayor's seat in the May 25 election. Together the two political heavyweights could muster the support of three-quarters of the city's voters, who predominantly favor the democratic coalition. However, Tymoshenko, who took more than 50% of the vote in the city during the past election, is keen to support a candidate loyal to her. Control over Kyiv appears to be a key factor for a leader running in the next presidential election in late 2009. Yushchenko and Tymoshenko are both likely to run in that election, making the upcoming race of key importance.

### COALITION LONGEVITY

Calls for Yulia's Tymoshenko's resignation as Prime Minister began days after she took office on December 26, 2007. Ukraine's Constitution is clear that a Prime Minister appointed after snap elections has at least one guaranteed year in office without threat of a no-confidence vote or other removal from office. Tymoshenko's main opponents are the business interests with political ties to the Party of Regions, who stand to lose tax and other government privileges as she attempts to close budget loopholes and raise revenues for ambitious social-spending plans. Her opponents have ratcheted up a voluble anti-NATO campaign, which first brought the parliament to a halt, but now seems to have backfired as poll numbers show support for Tymoshenko rising, while support for the Party of Regions is falling.

Of particular concern to coalition MPs is the criticism of Tymoshenko from Viktor Baloha, head of Yushchenko's Presidential Secretariat. While Baloha has been mandated with keeping the peace with the opposition Party of Regions and the Lytvyn Bloc, he has been overly critical of the Tymoshenko government, coalition MPs claim, for moving slowly on liberal reforms. This contrasts heavily with the most recent parliamentary race, in which rhetoric from the Tymoshenko and Yushchenko camps was closely coordinated and led to electoral gains for both.

As the 2009 presidential campaign approaches, Yushchenko's secretariat has begun to distance itself from Tymoshenko's economic policies, hedging their bets that liberal economic policies will be pushed aside, which they fear will lead to a slowdown in domestic growth and personal consumption in the currently difficult global economic environment. While both Yushchenko and Tymoshenko recognize the long-term political benefits of an orange union are far greater than the tactical differences between them, Ukrainian politics and public policy will remain hostage to their personal rivalries leading up to the 2009 presidential race. While 2008 poses many challenges for the orange political forces, their potential accomplishments could serve as the foundation for the next election cycle, which could include both parliament and the presidency.

## CONCLUSION

Prime Minister Tymoshenko's first 100 days have presented her and the ruling coalition with a number of political, economic and foreign policy challenges. With a decision on Ukraine's MAP request due next week, the success-failure tally of her administration to date can be depicted as follows:

### Successes

- Increased budget revenues from customs duties jumping five-fold by cracking down on contraband
- Reduced VAT machinations
- Began talks on a Free Trade Agreement with the EU

### Half-Steps

- Partially removed RUE from Russian-Ukrainian gas trade
- Limited progress on repaying VAT arrears to exporters
- Slow movement on introducing electronic tax filings for businesses

### Failures

- Escalating inflation
- Threats of price controls on petrol and food
- Company re-privatizations

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