



International
Centre for
Policy
Studies

INSIDE UKRAINE

#2, December 2009

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Domestic Politics and Policy

In brief

In November, policy continued to take a back seat to politics as both government and opposition spent the month fighting phantoms, as well as each other. Prime Minister Yulia Tymoshenko has continued her very public campaign to fight the flu epidemic, despite the World Health Organization saying that the situation in Ukraine was no worse than in other countries. Her government has requested UAH 1bn to fight the "second wave" of the epidemic – expected by some experts to hit in December or January – but the president and opposition blocked the funding.

The Party of Regions (PoR) was equally assiduous in its pursuit of the dismissal of the government due to its refusal to implement social spending increases passed into law in October. This appeared little more than a public relations play, and the PoR admitted on Nov. 30 it couldn't gather enough votes to get the motion through parliament. Even if it did, the Tymoshenko government would continue working in an acting capacity until the elections.

While the mudslinging between the two frontrunners continues, the other candidates are engaged in a no less contentious fight for third place. Former National Bank governor Serhiy Tihipko is making ground in opinion polls, while former parliamentary speaker Arseniy Yatseniuk is on a downward curve. Tihipko says he could be prime minister under Yanukovich or Tymoshenko; Yatseniuk says he's not interested in the role.

Shadow boxing

In speeches and television addresses to the nation, Tymoshenko slammed her opponents for politicizing the swine flu issue, and then proceeded to attack the president and the opposition for blocking her attempts to release UAH 1bn to combat the virus. Taras Berezovets, an adviser to the prime minister, was quoted in *Foreign Policy* magazine as saying that the epidemic had been overblown in order to boost her ratings as the "white knight" who saved the country. The opposition says this would be throwing good money after bad, following allegations that the UAH 50mn allocated for swine flu

preparations earlier this year were embezzled. In any case, a UAH 1bn shot in the arm for Ukraine's health system seems like *ad hoc* act of desperation that will not solve the fundamental problems of a system that for years has simply sucked up funds, and is in dire need of structural reform. Tymoshenko announced that she wants to reform the healthcare system from spring next year, basing it on medical insurance.

The PoR, meanwhile, has spent the past couple of weeks collecting signatures in an attempt to dismiss the government. Party leader and presidential frontrunner Viktor Yanukovich said the move was motivated by the government's refusal to implement the spending increases mandated by the social standards law adopted on October 30. But at the end of the month, the PoR admitted that it couldn't muster sufficient support to dismiss the government. In any case, the government would continue working in an acting capacity until the elections. The PoR likely knew all along that it can't get rid of the government, but it is intent on demonstrating to the bitter end its desire to rid the country of the "Orange forces." The tactic could backfire and benefit Tymoshenko, as the image she has carefully cultivated – that of the country's savior, who is working while other politicians are blocking – becomes more deeply entrenched.

Even without a dismissal of the government, Tymoshenko said she accepts that extraordinary parliamentary elections are almost inevitable after the presidential ballot if a parliamentary majority is to be formed. Senior PoR members say Yanukovich will also call an election, and they expect to lead the new government.

Going for bronze

Meanwhile, the battle among the other 16 candidates for third place in the ballot – and a strong bargaining position for a top government post – is heating up. Recent polls have shown a rise in support for Tihipko, a former National Bank governor and a successful private banker who gave up his business in order to run in the presidential race.

His campaign has built on his image as a successful businessman who will strengthen the economy. After reaching around 4 percent in October, two separate opinion polls in November put him in third place, ahead of Yatseniuk, who had held the spot for several months. His rise is likely linked with the precipitous fall of Yatseniuk, whose reputation as a young economist and reformer has eroded. In one poll he received more support than Yatseniuk as "a promising young politician." Tihipko benefits from his relative youth and perceived moderate views, presented in simple messages on billboards and in numerous magazine interviews.

Tihipko said on a television talk show that he has a good chance of becoming prime minister under either Tymoshenko or Yanukovych. He was Yanukovych's campaign manager in 2004, and most recently co-chaired the National Investment Council with Tymoshenko. Senior PoR figures have refuted the idea of Yanukovych choosing Tihipko, who quickly distanced himself from the 2004 Yanukovych campaign after the second round. PoR-friendly media in eastern Ukraine have been attacking Tihipko, accused by some of being a technical candidate for Tymoshenko against both Yanukovych and Yatseniuk. He is one of Yanukovych's main competitors for votes in the east and south. He also comes across as a more moderate version of Yanukovych, who has built his campaign on having a strong team of business professionals. Yanukovych said recently that he believes there will be space for both Tihipko and Yatseniuk in the government. Yatseniuk has said he doesn't want a position.

Yushchenko gave his campaign a kick-start with a television interview in which he claimed he'd been fighting for 18 months to prevent a coalition between PoR and BYuT. He accused Yanukovych and Tymoshenko of being "the same eggs from different sides."

Anatoliy Hrytsenko, a former defense minister, is running the most open campaign, refusing the backing of big business and accounting for all spending on his website. His campaign is aimed against the

political class as a whole, using the slogan, "Enemy of their state." This taps into enormous public disillusionment with politicians, but without the means to fund a large-scale campaign, and no backing from the media moguls, his ratings remain low. Hrytsenko's best bet, as one of his posters says, is of being "First among the losers."

Ghosts from the past

The fighting among the so-called "second tier" candidates is no less vicious than that among the front-runners. Socialist Party candidate Oleksandr Moroz has decided to revisit his old allegations that Parliamentary Speaker Volodymyr Lytvyn was involved in the murder of investigative journalist Georgiy Gongadze. Analysis of audio recordings in Germany has reportedly proved the authenticity of the voices, and the tapes are now in the prosecutor-general's hands. This is unlikely to be as explosive as it may at first seem. A chief suspect in the case was arrested over the summer but there has yet to be any real progress.

The past is also being dragged up by the PoR. Senior members, including Yanukovych, have reignited the issue of ballot-rigging in 2004, suggesting that there was no fraud and that he actually won. Yanukovych claims he had a winning margin of 900,000 votes, and that mass fraud has not been proved in court. The failure of the authorities to investigate the fraud allegations, which is the reason Yanukovych can make these claims, is lamentable. It is also concerning that the PoR refuses to accept what happened. Not only would acceptance allow the country to move forward, but it would also send a message that vote-rigging is unacceptable.

This is particularly current as a murky election law, as well as dodgy voter lists, is causing local and foreign observers to raise concerns about the possibility of fraud in the January ballot. Critics say the law opens a number of loopholes for abuses, with restrictions on observers and limitations on challenging vote fraud.

Economy

In brief

The major economic news in November was the gas deal reached by the Ukrainian and Russian prime ministers in Yalta. Ukraine will not be fined for taking less gas in 2009 than stipulated in last January's agreement, and the volumes to be purchased in 2010 have been reduced. State-run gas companies Naftohaz and Gazprom signed the agreements into the contracts on November 24.

Payments are likely to remain problematic, however, with no IMF money forthcoming to support the budget. Ukraine's political leaders have moved no closer to the political consensus required to release the next \$3.8 bn installment, despite urging from the international community.

With or without the IMF, the economy is still struggling, although there was some mildly positive news this month in improved GDP growth, a stronger hryvnia, and moderate inflation.

Energy saviors and energy savers

Leaving aside the political dimension of the gas deal (discussed in our *Foreign Policy* section), Ukraine has come out of the negotiations well. Russian prime minister Vladimir Putin's promise to waive fines for not taking as much gas in 2009 as agreed was finally written into the contracts signed last January. A new import volume was also agreed for next year, along with a market price for the gas (Gazprom forecasts an average of \$280 per 1,000 cubic meters), and a 60 percent rise in the transit tariffs paid to Ukraine. Questions remain, however, as to the formula used to determine the "market price" for Ukraine, and this could lead to tensions down the road.

Despite this progress, the agreement does not solve Ukraine's payment problems. Although the country has managed to pay its monthly bills on time this year, its October payment was only made after special drawing rights from the IMF were converted to dollars. The November and December payments should be covered by this cash¹, but Deputy Prime

Minister Hryhoriy Nemyria has warned that making the January payment could be tough.

The opposition has condemned the move to a market price as potentially crippling to industry. It has also criticized the prime minister for failing to raise the gas price for end consumers, as demanded by the IMF. But Ukraine can't have its cake and eat it. A move to market prices should serve to force attention onto the underlying problem: Ukraine's lamentable energy efficiency due in large part to artificially low gas prices.

Friends of Ukraine

Energy inefficiency has been widely discussed, but not addressed. In tackling the issue, Ukraine enjoys significant support from its international partners. On November 26, the European Commission and the Swedish EU Presidency launched the Eastern Europe Energy Efficiency and Environment Partnership — whose first target is Ukraine. This will allow for the investment of tens of millions of Euros toward energy efficiency in the region. But as with cooperation with the IMF, the onus is on leaders in Kyiv to unlock the benefits of such goodwill. This month in Brussels, Chris Bryant, the United Kingdom's Europe Minister, hosted a meeting with the foreign or Europe ministers from other EU member states and Ukraine. The message of this "Friends of Ukraine" meeting was that the country's leaders need to find consensus on the social spending rises that are blocking the release of further IMF funds.

The same goes for other loans currently on the table, such as the \$1.7 bn offered by the World Bank, the EBRD and the EIB, to help pay for gas supplies from Russia. This month, the EBRD announced that disbursement of the first \$300 mn portion would be delayed until next year as Ukraine had failed to implement the necessary reforms.

The support is there for systemic, structural reforms, but Ukraine has to tap it.

¹ These funds are not linked to the \$16.4 bn standby arrangement that has been put on hold.

Jitters remain

There were some mildly positive signs for the economy in November, with the government announcing a 15.9 percent year-on-year contraction in the third quarter, compared with 17.8 percent in the previous quarter. (See the *Topic of the Month* section for more on Ukraine's economic recovery.)

Still, the markets were spooked by a technical default by state railway monopoly Ukrzaliznytsya on a \$550 mn loan from Barclays. The company is in restructuring negotiations, but European bankers were worried that the default would trigger a cross-default on a Deutsche Bank loan with a sovereign guarantee. Ukrzaliznytsya subsequently stated that there was no such link and that restructuring talks only concerned the Barclays loan. The Ukrainian government also confirmed its solvency with a cou-

pon payment on a sovereign Eurobond. But the jitters were a telling indicator of the nervousness about Ukraine's ability to fund its debts in the light of the IMF's reticence to transfer the \$3.8 bn. It was also an indictment of the government's poor communication, as investors were left in the dark for several days following the technical default.

The end of the month saw some confidence return as fears around Ukrzaliznytsya subsided and Moody's affirmed Ukraine's rating at B2 with a negative outlook.

The hryvnia strengthened, pulling back towards 8 to the dollar, with the National Bank even buying dollars for the first time this year. Relief about the gas agreements and dollar to hryvnia conversions of the massive funds being spent on the presidential campaigns contributed to the strengthening trend.

Foreign and Security Policy

In brief

November was marked by three foreign and security policy developments. First, it saw the continuation of the Russia-Ukraine energy soap opera, with prime ministers Tymoshenko and Putin putting on paper some of what they had been saying for months. On November 20, the two heads of government finally formalized some of the verbal agreements concluded in September, giving Ukraine more flexibility in its gas consumption and reducing the risk of another cutoff in the near future.

It was also a busy month for EU-Ukraine relations in the run-up to the December 4 Summit. The meeting was seen by some as a disappointment, due to the unrealistic expectations raised by President Yushchenko. As for the entry into force of the Lisbon Treaty and the nomination of the EU's top two officials, they are not game-changers when it comes to the Union's relations with Ukraine.

The end of the month brought regional security to the forefront, with Russian president Dmitry Medvedev tabling a draft European Security Treaty encompassing North America, Europe, and parts of Asia. The proposal is designed to place Russia at the centre of the European security system. While Ukraine is not the initiative's main target, it is an important piece of the regional puzzle.

Tying the knot?

November was yet another important month in the Russia-Ukraine gas saga. Prime ministers Tymoshenko and Putin, attending a CIS heads of government summit in Yalta, met on November 20 to hash out an agreement to ensure the stability of their energy partnership — and their political relationship.

The agreement has been portrayed by some as a breakthrough in the Russia-Ukraine energy relationship, with Tymoshenko obtaining significant concessions from Putin. Most importantly, the deal stipulates that Ukraine is not to be fined for buying less gas in 2009 than required in the January contract, a promise verbally made by Putin in September. (See our *Economy* section for detailed information on the terms of the agreement.)

It is unclear what promises were made in exchange for Putin's flexibility, but there is noise that Russian interests could be strategically placed to acquire and/or control key infrastructure in Ukraine. On November 16 — before her meeting with Putin — Tymoshenko acted to dispel such speculation, calling Ukraine's gas transit system a "national treasure that must permanently remain in Ukrainian state ownership."

As always in the Russia-Ukraine energy relationship, and *a fortiori* with the election less than two months away, this business deal has clear political undertones. It seems designed to support Tymoshenko's presidential bid by demonstrating her ability to negotiate with, and extract concessions from, Russia. Indeed, on November 19 President Yushchenko issued an open letter to President Medvedev, calling for a number of revisions to the January 2009 contracts. The letter was ignored by Moscow, but on the 20th Tymoshenko and Putin inked an agreement containing many of Yushchenko's demands. Putin lauded Tymoshenko as a "tough negotiator," while Tymoshenko applauded her Russian counterpart's willingness to "meet us halfway."

In political and geopolitical terms, the deal is designed to show that Tymoshenko can work constructively with Russia, that a good relationship with Moscow can yield concrete benefits for Ukraine, and that Russia is not the ruthless hegemon depicted by some. It is also intended to demonstrate Putin's flexibility and Tymoshenko's assertiveness toward Russia — qualities not often ascribed to these two leaders since the last gas crisis in January.

The portrayal of the agreement as a major positive step is also meant to send a clear signal that Yanukovich, Moscow's longtime favorite, has lost that status to Tymoshenko. That message was further driven home when Yanukovich, attending the United Russia party congress in Saint-Petersburg, was unable to meet with senior Russian officials. Intended to test and bolster his support among Russia's leaders, the trip confirmed his fall from grace.

The agreement is not the panacea that some have described, nor is it actually a breakthrough in Russian energy diplomacy. Moscow has already agreed to reduce or ignore "take-or-pay" provisions in some of its contracts with EU countries. In addition, the goodwill that drove Putin to waive the fines was facilitated by the simple fact that Ukraine would not have been able to pay them in any case. This would have led to another gas crisis and deprived Gazprom of much-needed cash, in addition to damaging its credibility as a reliable energy supplier to Europe. It was clearly in Russia's interest to ensure that Gazprom would be paid, even if that meant charging less.

Even then, it is far from certain that the agreement will be enough to avoid another disruption. Naftohaz

has consistently struggled to meet payment deadlines, and the company may not have the \$700 bn to pay for its December gas in early January. In addition, the price-fixing mechanism has yet to be finalized, with Gazprom declining to respond to a request by Naftohaz to review the formula. Significantly, Gazprom also did not respond to a *note verbale* from the Russian Presidential Secretariat to the same effect. This reflects Russia's own internal divisions, which, when combined with those of Ukraine, could increase risks exponentially.

Therefore, while the November 20 deal is a positive step, another cutoff cannot be excluded.

Time to talk

The gas agreement came as Ukraine prepared for the December 4 EU-Ukraine Summit, which President Yushchenko had portrayed as a potential watershed in relations with the European Union. The president had namely raised the unrealistic expectation that Ukraine's Association Agreement (AA) with the EU could be signed at the meeting.

That was not to be. The Summit, and annual event despite Yushchenko's depiction of it as exceptional, was never expected by the EU side to feature the conclusion of the AA. In fact, such gatherings are generally not an opportunity for important agreements to be signed. As the meeting drew closer and the impossibility of concluding negotiations in time became more evident, expectations on the Ukrainian part therefore declined drastically. What the president had portrayed as a high point in EU-Ukraine relations was in fact to be a rather routine meeting, and a further illustration of the failure of Ukraine's European strategy since 2004.

The joint statement issued after the Summit welcomed Ukraine's progress on a number of fronts, namely membership in the Energy Community Treaty, which it could join on December 18. But it also emphasized the need for the country to reform its energy sector, ensure political and economic stability, and combat corruption. Though a visa facilitation agreement is in place and a readmission agreement is to take effect this January, Yushchenko's objective of a visa-free regime for Ukrainians remains unmet. Indeed, only three countries supported a roadmap in that direction at a recent meeting in Brussels. Last but not least, membership clearly remains off the table.

"Ukraine fatigue" in the EU has been growing since the beginning of the year, with political squabbling keeping the country on the brink of another gas war with Russia. With the January election looming, political maneuvering has crowded out rational thinking in Kyiv. In early November, European Commission President Jose Manuel Durao Barroso even had to call President Yushchenko to ensure that there would be no "blockages" preventing Ukraine from paying its gas bill to Gazprom on time — a reference to reports that President Yushchenko was obstructing the necessary financial transfers. Ukraine's unreliability has frustrated European leaders, who have linked their offer of a €610 mn loan to disbursement of the fourth tranche of the IMF loan, not expected before the election.

The December 4 summit, therefore, far from breaking ground in bilateral relations, was merely an opportunity for the EU to emphasize the need for stability, reform, and fair elections in Ukraine.

Lisbon, Brussels, and musical chairs

However ordinary in content, the summit did have the distinction of being the first to take place under the Lisbon Treaty, which came into force on December 1. It was nevertheless held under the previous institutional arrangement, with Barroso and Swedish prime minister Fredrik Reinfeldt representing the Union. Catherine Ashton, the new High Representative of the European Union for Foreign Affairs and Security Policy, was initially expected to make the trip but announced on December 2 that she would remain in Brussels to attend a meeting of the North Atlantic Council scheduled for the same day. Her absence from the summit can also be attributed to a number of other factors, namely her newness in the post and her pending confirmation by the European Parliament.

Given Ashton's limited foreign policy experience, her views on Ukraine remain unclear, as do those of the new President of the European Council, Herman van Rompuy. But she hails from the United Kingdom, which is by and large favorably predisposed to Ukraine's accession to the EU, while van Rompuy's Belgium has generally opposed clear movement in this direction. Still, the significance of these stances is not to be overstated. It is up to Ukraine to prove itself worthy of a membership perspective, and up to the EU 27 to approve any membership application.

Despite all this, November did bring one potentially pleasant surprise for Ukraine. The month saw the unveiling of the proposed new European Commission, one in which the Enlargement and Neighbourhood Policy portfolios are merged. While this may simply be a technical change, it could have consequences for Neighbourhood countries looking for a membership perspective. Nevertheless, it is too early to tell what policy shifts, if any, the change could bring. Finally, the fact that the new post is to be held by the current Czech Minister for European Affairs, Stefan Fuele, may also be a piece of good news: his country has tended to support Ukraine's European aspirations.

Russian hospitality

November also proved an important month for regional security. On the 29th, President Medvedev tabled his proposal for a European Security Treaty (EST) encompassing North America, Europe, and parts of Asia. First advanced in June 2008, Medvedev's idea is to replace the current NATO- and US- dominated European security system with one in which Moscow will have greater pull. Predictably, the proposal has met an unenthusiastic reception from NATO members weary of undermining the OSCE. Nevertheless, NATO Secretary-General Anders Fogh Rasmussen has promised to study the draft.

Though not the most important actor in this game, Ukraine has a crucial role to play. It is one of the most important former Soviet states for Russian national security. As the geographical bridge between Russia and Western Europe and the host of the Black Sea Fleet, it is a key "geopolitical pivot" that Moscow cannot afford to lose. The EST can be seen as an effort by Russia not only to insert itself into the European security system, but also, at least in part, to give Ukraine a "third way" between NATO membership and official Russian satellite status.

With Yushchenko's pro-NATO strategy discredited, Yanukovych leading in the polls, and Tymoshenko warming up to Putin, the proposed Treaty seems tailor made to suit Ukraine's political climate. Neither of the frontrunners in the presidential race has as yet officially reacted to the proposal, but on November 24 — less than a week before it was put forward — Yanukovych called for a "new European security system." Tymoshenko has also argued for such a

system, though she has not removed her signature from a January 2008 petition for Ukraine to be offered a NATO Membership Action Plan (as Arseniy Yatseniuk has). In any case, she has vowed to submit Ukraine's accession to any collective security arrangement to a referendum, as have the rest of the country's main political forces.

It should however be emphasized that Ukraine is working to align its foreign and security policies with those of the EU. Indeed, the AA currently being negotiated will in part be designed to create momentum in this direction. The possibility of Ukraine

choosing to follow the European lead on this issue can therefore not be excluded.

Finally, as noted in the previous issue of *Inside Ukraine*, November brought news that the Ukraine-Belarus border would finally be demarcated. After meeting on November 5, President Yushchenko and President Aleksandr Lukashenko of Belarus announced that more than 12 years after its signature, the border agreement between the two countries would be submitted to the Parliament of Belarus for ratification.

Topic of the Month: Is Ukraine Coming out of the Recession?

In brief

As far as recessions go, the current economic crisis is one for the history books. The worst downturn since the Great Depression, the slump has shaken the world economic order, (almost) literally wiping some countries off the map. A 2008 cover for The Economist magazine featured a map of the world – absent Iceland, whose economy had gone bust practically overnight.

Ukraine may, for once, be better off than Iceland. But the country's economy has been among the worst-hit by the recession, and with the presidential election just around the corner, political power plays have only made things worse. Will things get worse before they get better? Or is Ukraine working its way toward growth?

Is Ukraine coming out of the recession?

The short answer is yes.

True, 2009 will have seen Ukraine's GDP lose about one-seventh of its value. Industrial production for January-October 2009 was only 73.6 percent of that for the same period in 2008, while unemployment jumped from 6.9 to 9.9 percent between the last quarter of 2008 and the second quarter of 2009.

But the worst may be over. In fact, Ukraine may already be recession-free. While year-on-year mea-

asures showed a 17.8 percent GDP decline in the second quarter of 2009, that period actually saw a 4.8 percent GDP increase over the previous quarter, according to Alexander Valchyshen of Investment Capital Ukraine. By this measure, Ukraine's recession ended in early 2009. And indeed, other data supports this view: year-on-year GDP contractions have been shrinking every quarter this year (20.3 percent for Q1, 17.8 for Q2, and 15.9 for Q3). With higher household consumption and improving conditions for exports thanks to strengthening EU economies, the IMF is predicting 2.7 percent growth for 2010.

The sentiment among the population also seems to mirror these statistics: the ICPS/GfK Consumer Confidence Index bottomed out in February and has been on an upward, albeit unsteady, trend since. In October, confidence in the economy rose for the third consecutive month, buoyed by GDP growth and a stabilized hryvnia.

The Ukrainian economy therefore seems to be on the upswing. But the champagne will have to wait: it will be years before pre-recession levels are reached, and many hurdles remain on the path toward sustainable growth.

Policybreaking

The Ukrainian recovery does not rest on solid ground, nor will it until the country's political leadership moves from politicking to policymaking.

The recession could have been worse, but it could have been much better dealt with. Politics has pervaded the government's, and the opposition's, response to the downturn, handicapping the state's ability to protect the economy. The strength of the recovery will depend in large part on political leaders' willingness to work together, a rare commodity in pre-electoral Ukraine.

The inability of President Yushchenko, Prime Minister Tymoshenko, and opposition leader Yanukovich to cooperate has cost the country dearly: \$3.8 bn, to be exact. The IMF has postponed the disbursement of the much-needed fourth tranche of its emergency loan because Ukraine has not respected the Fund's conditions. In October, Yushchenko signed a bill proposed by Yanukovich's party, greatly hiking social spending, despite Tymoshenko's objections and the IMF's insistence that he veto it. Given the unlikelihood that the political climate will improve, it is doubtful that the IMF will deem it opportune to transfer the funds before the January election.

The impact of political instability on Ukraine's recovery extends well beyond its effect on loan disbursement. Tensions have adversely affected expectations. Indeed, the increase in consumer confidence over the last couple months obscures the fact that expectations were better in May, before political chaos swept away the last remnants of sober policymaking. This situation affects the risk-benefit calculations of consumers and investors, who will sit on their wallets if they see hard times ahead.

To fix, or not to fix

No recovery will be sustainable unless sound policies are in place and reforms are pushed through.

Most immediate among these challenges will be fiscal policy. According to the National Bank of Ukraine (NBU), in the first half of 2009 budget revenues fell 4 percent, while expenditures increased 10.3 percent. With the new social spending law expected to cost up to 70 billion UAH, government spending far outpaces income. The World Bank estimates that the current draft of the 2010 budget,

which does not count this new spending, would already lead to an 8 percent deficit. This would cause fiscal problems and inflation, and would further compromise the credibility of the Ukrainian government. While it is unrealistic to expect major spending cuts before the election, the new president's first priority will therefore be to push the government to reduce its expenses.

But fiscal rationalization will not be enough to ensure growth. The health of Ukraine's economy hinges on much-needed reforms. The pension fund is hemorrhaging cash. Ukraine has one of the world's least energy-efficient economies, using three times more energy per capita than neighboring Poland. The pension deficit and the costs of heavily subsidizing energy consumption drain billions of hryvnias from the state budget year in, year out. The IMF has even made a gas price increase a condition for the disbursement of its loan to Ukraine, though it seems to have understood that such a move is impracticable before the election. Indeed, many analysts believe that Ukraine could have received the fourth tranche if Yushchenko had not signed Yanukovich's social spending bill into law. Once the new president is in place, however, the Fund is unlikely to show the same flexibility on this issue.

Improving the investment climate is also essential. This means not only easing political instability, but also fostering fair competition and combating endemic corruption. Only then will Ukraine's substantial natural and human potential be able to make a full contribution to the country's economic development. Other essential measures include bolstering the banking system, public procurement reform, and export diversification. In other words, the new president and his/her prime minister, whoever they may be, will have to hit the ground running. But with the worldwide recovery still shaky and the January ballot possibly followed by parliamentary elections, it could be a while before any reforms reach the starting gate.

Looking ahead

The worst of the recession may be over, but Ukraine's recovery rests on quicksand. Until the country's leaders cooperate on fiscal policy and push through much-needed reforms throughout the economy, sustainable growth will remain a mirage.

Featured Interview: Ceyla Pazarbasioglu, Head of the IMF Mission to Ukraine

On December 2, Ceyla Pazarbasioglu, head of the International Monetary Fund's mission to Ukraine, responded in writing to questions posed by Sacha Tessier-Stall and James Marson.

Ukraine's economy was among the hardest-hit by the recession in Europe. Why?

Ukraine was one of the hardest hit countries in Europe because its economy was less diversified and less prepared than other countries in the region and elsewhere in the world to the large external shocks that resulted from the global crisis. That's why Ukraine suffered one of the steepest drops in output and sharpest declines in the exchange rate.

Until the financial crisis hit the world economy in mid-2008, Ukraine was riding on the coattails of a global economy that had an insatiable demand for steel—a commodity that amounted to about 40 percent of the country's exports. The country was enjoying growth rates of 7-8 percent and the population benefited from generous incomes policies. Together with rising capital inflows, this fuelled an unprecedented credit and consumption boom—and a rising current account deficit. By 2008, the economy was overheating with inflation running at 25-30 percent, credit growth at 70 percent, wages rising by 30-40 percent, and the import bill growing by 50-60 percent.

At that time, the global crisis was beginning to take its toll on Ukraine's economy and the plunge in demand and prices for steel and the sharp reversal of capital flows brought these trends to an abrupt end. With the economy already overheated, a hard landing was difficult to avoid.

Despite the dire straits in which the Ukrainian economy finds itself, the worst-case scenarios have not come to pass. Why?

The authorities' economic program, which has been supported by the IMF, has been critical to help the country overcome the worst of the cri-

sis while protecting social stability. Remember, the situation in Ukraine was grave. The economy was in freefall. Real GDP fell by 20 percent in the first quarter of this year. The program was designed to address key problems immediately, and in many ways it succeeded.

The banking sector has been stabilized, monetary policy has been broadly accommodative, automatic fiscal stabilizers have been at play, important bank resolution legislation has been enacted, and other key reform efforts are in the pipeline. These initiatives have certainly helped avert the worst; following through with these measures and implementing prudent fiscal policies will further stabilize the economy and return the country to sustainable growth.

Ukraine still has a long way to go, which is why it is crucial that sound policies are supported and implemented by all branches of the executive. The authorities' strong consensus during the first months of the economic program helped instill confidence and optimism that Ukraine is on the path of recovery. A renewed political consensus on the way forward would certainly help restore this confidence.

The IMF has been assisting Ukraine for many years, but the country still has not pushed through key reforms. How can this be achieved?

As I mentioned earlier, some key reforms are in the pipeline, but building the necessary consensus for structural reforms can take time. In particular, reforms in key areas such as education, health, and pensions are like an investment — they require upfront financing and thus can be more successfully implemented at the stage of sustained recovery and better prospects, than during an economic freefall.

In some respects, the crisis has acted a catalyst for reform. The authorities understood the urgency and need for reforms and included in their economic program a number of structural measures aimed at restoring financial and economic stability. The program's immediate priority was to restore confidence in the financial system, and good progress has been made on that front.

But it is true that further reforms are necessary to underpin macroeconomic stability over the medium-term, increase efficiency, and improve investment prospects. For instance, increased exchange rate flexibility would help to mitigate external shocks. Regarding fiscal policy, the deep recession has created large pressures on public finances, highlighting the need for short-term savings and reforms to shore up fiscal sustainability over the medium term. Progress has been made in preparing tax and pension reform plans and a national tax compliance plan has recently been enacted. However, implementation of these reforms and energy sector reforms needs to be accelerated going forward. Measures to improve the business environment and a number of sectoral reforms will also be needed to promote sustainable growth over the medium-term.

For any economic program in any given country—whether supported by the IMF with financial assistance or not—it is paramount that the authorities own the program. In other words, they must plan, design, and implement the economic measures. We—the IMF—are ready to discuss and advise on the measures, drawing on our expertise from past crises, from other countries, and from across regions. Our experience has shown that strong ownership of an economic program instills confidence in the authorities' competence and ability to achieve economic stability and growth.

How would you assess Ukraine's cooperation with the IMF during the crisis? What have been the major successes and failures?

We have had a very good working relationship with the government, the National Bank, and the

Presidential Secretariat. Oftentimes we are dealing with difficult issues, but we are in a constant and constructive dialogue with the authorities and thus far we have been able to reach a consensus on the key policies under the program. This consensus has helped the country overcome the worst of the crisis while protecting social stability, a major success in this context.

But as I have mentioned, when the political consensus among the authorities is waning—which seems to have been the case in Ukraine recently—discussions stall and progress slows down. This can delay the implementation of the policies that are required to get Ukraine out of the crisis. That's why strong commitment by all policymakers is absolutely crucial, especially in times of crisis.

What has been the main obstacle to effective cooperation between Ukraine and the IMF? What has been the effect of the presidential election campaign on Ukraine-IMF cooperation?

Again, one word—ownership. For any economic program to be successful, there must be a minimum level of consensus. When the economic program was designed a year ago, there was a broad consensus in Ukraine on the underlying policies. All branches of executive authority, civil society, and even the opposition expressed strong support for this program. The severity of the situation had the effect of really focusing minds on what needed to be done.

But the pressure of events and political developments in the run up to the Presidential election means that consensus is now much harder to achieve. Without this, it will be much more difficult to improve the economy.

Is Ukraine emerging from the recession? If so, how would you assess the IMF's role in helping this happen? If not, why not?

Ukraine is indeed gradually emerging from the recession. Just look at the latest trends. The contraction in retail sales has slowed down and industrial production has already started to pick

up, albeit from a very depressed level. In fact, real GDP statistics indicate that the deep recession bottomed out in the first quarter.

As noted, the authorities' program has been instrumental in stabilizing an extremely difficult economic situation. In support of this, the IMF provided financial assistance to serve as a temporary buffer to avoid severe hardship for the population and further strain on the economy. At the same time, we have offered policy advice and expertise drawing on our long institutional experience with other countries and regions.

In the end, however, prudent and credible policy implementation will be key to returning the country to sustainable growth and prosperity.

What are the principal risks to Ukraine's economic recovery over the coming year? Over the next 5 years?

Of course, a lot depends on the global economy. But domestic factors are just as important. Ukraine is still in a highly fragile position. The policies under the program have stopped the bleeding, but recovery will take a long time. Lingering uncertainty is damaging for confidence and could derail recovery.

We do believe that the policy measures pledged by the authorities under the program are the right ones to secure Ukraine's economic recovery, and improve the living standards of the Ukrainian people.

Once the immediate goal of restoring financial and economic stability is achieved, the authorities will need to pay more attention to boost-

ing medium and long-term growth prospects. So, risks to the medium-term outlook relate to the authorities' ability to sustain the reform effort and continue to implement sound economic policies.

What are the key concrete reforms the president and government must push through after the election?

Reforms that underpin fiscal sustainability over the medium-term, such as tax and pensions reforms, will be important. Energy sector reforms will also need to be moved forward to improve the transparency of the sector, reduce subsidies, and establish financially viable entities. That, of course, includes Naftohaz which needs to be put on a sound financial footing to reduce the weight of gas subsidies on the budget—and thus, on the taxpayer.

How do you see Ukraine-IMF cooperation evolving over the next 5 years?

The immediate priority will remain securing Ukraine's economic and financial stabilization and planting the seeds for a sustainable economic recovery. As one of the IMF's 186 member countries, Ukraine will continue to have a close relationship with the IMF. As all our member countries, Ukraine is part of the Fund's regular analysis of economic developments in the country, the region, and worldwide. Furthermore, Ukraine receives substantial technical assistance in banking sector, monetary policy and tax administration and policies. The Fund will continue to support the country in its strive to boost medium and long-term growth prospects in whichever way the Ukraine authorities chose this support.

Featured Interview: Martin Raiser, World Bank Country Director for Ukraine, Belarus and Moldova

On November 30, Sacha Tessier-Stall and James Marson sat down with Martin Raiser, the World Bank's top official in Ukraine, to discuss the economic crisis, the Bank's cooperation with Ukraine, and the way forward.

Ukraine's economy was among the hardest-hit by the recession in Europe. Why?

Ukraine was particularly vulnerable for both external and internal reasons.

The Ukrainian economy is highly export- and commodity-dependent: in this respect, it can be compared to those of oil-exporting countries. Ukraine has suffered greatly from a significant decline in the terms of trade, as well as from lower demand for steel, its most important export.

Ukraine's model of financial integration as a latecomer in the region also made it vulnerable. The perceived huge catch-up potential led to excessive growth in private-sector credit, often with shaky risk-assessment, and largely financed from abroad. This model was not sustainable.

On the internal side, Ukraine was rendered vulnerable by the weakness of its regulatory and institutional structure. In the years before the recession, the economy enjoyed a healthy growth rate: this convinced many that reform was unnecessary. The country therefore encountered major problems in trying to cope with the major shocks the crisis brought with it. The laws and regulations were incomplete, and the institutions not strong enough to withstand political pressures and the stress test of an unprecedented downturn. Corruption is also a major problem. These weaknesses affect not only the quality of the policies, but also their impact. The weak credibility of Ukraine's institutions has made it all the more difficult to regain confidence of investors and the population.

Finally, Ukraine lacked the fiscal space to carry out an active fiscal stimulus to stimulate the economy. While financial assistance from the IFIs to some extent smoothed the adjustment in overall spending, there was little attempt made to target spending toward the sectors where it would be most effective. Social assistance has not been particularly well targeted, and public spending on infrastructure, which could have created some fiscal stimulus, has taken the brunt of the spending reduction.

Despite the dire straits in which the Ukrainian economy finds itself, the worst-case scenarios have not materialized. Why?

When their back was against the wall, Ukraine's political and economic elites have been able to work together and reach a consensus. The anti-crisis law passed around one year ago by the Verkhovna Rada is a good example of this. The banking legislation passed with the support of MPs from across all parties in July this year is another example. Generally, in the financial sector, the worst was avoided and although collaboration between the NBU and the Government has not been smooth, some good results were achieved.

Nevertheless, with the presidential election approaching, politics has infected recovery efforts. As early as March or April, it became more and more difficult for the main actors to cooperate, especially when it came to some of the harsher measures that needed to be taken—for instance, in fiscal policy.

Some have argued that the electoral campaign has been depressing Ukraine's economy, and that once the election is over things will begin to improve rapidly. Is this what you expect?

We expect the Ukrainian economy to grow in 2010, due to the size of the contraction it experienced in 2009 and the beginnings of a recovery in the region. Nevertheless, progress will be slow. Convergence to European income levels has been set back significantly, and Ukraine will struggle to keep pace with its regional neighbours.

The big question is what the worldwide recovery model will look like. For the moment, fiscal stimulus in OECD countries and the strong investment-led recovery in China are pulling the world out of recession. But what if these factors are withdrawn? There are still risks ahead and the world could experience several years of flatter growth as the global economy is rebalanced. As for Ukraine specifically, any growth will at first come from exports and then investments, with consumption remaining a significant drag on the economy for some time. This is important, as much of Ukraine's post-2004 growth was consumer-driven.

If it is to achieve sustainable growth, the country will have to undergo significant restructuring. The Ukrainian economy is more diversified than those of Russia or Kazakhstan, but it needs to upgrade the quality of its products and introduce new and more efficient technologies. One good thing about the crisis is that it has led to movements in this direction and a better understanding among companies of the importance of cost competitiveness.

But to get the necessary investment it is crucial that Ukraine provide potential investors with at least a medium-term perspective: people will not invest in a company or factory if they cannot be sure that it will still exist, or that they will still own it, five years from now.

Long-term growth will also depend on increased competition. In Ukraine, production is still excessively centralized, monopolized even. This prevents innovation.

The World Bank has been assisting Ukraine for many years, but the country still has not pushed through several key reforms. How can the World Bank and other IFIs enforce the conditionality of their aid?

Aid conditionality, in the strict sense in which it is often understood in Ukraine, has actually not worked in the countries where it has been tried, and there is no reason for Ukraine to be any different. Real reform cannot be forced: it can only come about when a country sincerely wants it – which Ukraine does. On that basis, we have a dialogue about what is needed, and of course we want to make sure that our support helps advance the right policies.

It is important to understand that the World Bank and the IMF have different functions. The role of the IMF is to ensure macroeconomic stability and prevent a financial meltdown. So far, this has worked. As for the World Bank, it complements this by pushing a medium- and long-term agenda. Because structural reforms often do have temporary fiscal costs associated with them, the World Bank provides support for such reform through the budget in the form of Development Policy Loans. Of course, in the crisis, the IMF and ourselves are working very closely together.

How would you assess Ukraine's cooperation with the World Bank?

I would say that cooperation has reasonably good. We have had good access and a good dialogue with policy makers, both from the current government and with previous governments. Not all of our recommendations have been taken, and in some areas where we think Ukraine really urgently needs reform, very little has happened. But this is the case in other countries, too, and I believe we do have a role and add value in Ukraine.

During the current crisis, the World Bank has been trying to help in four key areas.

The first area was ensuring fiscal reallocations for the poor. This has not happened to the extent we want, namely due to political impossibility of adopting a revised state budget. Ukraine has two programs that could have made a difference if they had received additional funding: one is for single mothers, and the other is for the poor. Unfortunately, the absence of a state budget prevented these programs from receiving the funding they needed.

The second was assistance to the financial and banking sectors. This was a broadly a success. The sector has been stabilized, and deposit outflows have been stopped. Funds blocked in individuals' bank accounts were made available again, in contrast with previous financial crisis experiences.

The third area was fiscal stimulus. Here, results have been mixed. While we have been able to help fund some critical infrastructure projects, such as in roads or municipal infrastructure, the budget as a whole has not been prioritized towards growth-enhancing expenditures during the crisis, as already mentioned.

Finally, there was the need to improve the investment climate. This has remains an unfinished agenda despite repeated political commitment, as corruption and lack of transparency remain major problems.

Is Ukraine emerging from the recession?

Yes. 2010 should bring economic growth.

What are the main risks to recovery?

Fiscal policy is the main risk. The government's revenue shortfall has been much greater than anticipated, so spending will definitely have to be cut. Delaying this will increase risk and bring macroeconomic pressure. But there is no reason to believe that the appropriate measures cannot be taken, although they will likely have to wait until after the election.

What are the priority reforms the new president should push for?

The top priority should be fiscal reform, especially as relates to pensions, energy, and public procurement. This is urgent. Second comes financial-sector reform: dealing with non-performing loans and completing the recapitalization of the banking sector, improving governance, regulation and transparency in the sector, resolving problem banks effectively and managing the state-owned banks. Tax reform and measures to improve the business climate should also top the agenda. In a more medium-term perspective, decentralization of economic decisionmaking and reform of financing and service delivery models in health, education and municipal utilities should also be tackled.

How do you see World Bank-Ukraine cooperation over the next five years?

We are here in a long-term perspective, and we understand that there will be both good years and bad years. But in general, I am optimistic that our cooperation with Ukraine will continue, and should reforms accelerate, may even grow.

Important Events in December

Ukrainian Events

December 1–2

Visit of President of Brazil Luis Ignacio Lula da Silva to Ukraine.

Result: signing of visa facilitation agreement; discussion of the Brazil-Ukraine space project Tsyklon-4.

December 2

Arrival of US Ambassador to Ukraine John Tefft.

December 2–3

Visit of Polish Minister of Sport Adam Giersz.

Result: announcement of the host city of the EURO-2012 final (Kyiv).

December 4

EU-Ukraine summit.

Expected outcome: talks on EU-Ukraine cooperation on climate change, energy and the recession.

December 5

Visit of Israeli Minister of Foreign Affairs Avigdor Lieberman to Ukraine.

December 7

Meeting of Ukrainian and Russian Deputy Foreign Ministers, Volodymyr Khandohiy and Grigoriy Karasin.

Expected outcome: finalized negotiations on the composition of the Russian component of the commission on border demarcation; discussions on the Russian fleet in the Black sea and blacklisting practices for *personae non grata*.

December 9–10

Visit of Prime Minister Yulia Tymoshenko to the European People's Party congress in Bonn.

December 20–21

Visit of the President of the European Parliament, Jerzy Buzek, to Ukraine.

Date unspecified

Visit of the Defense Minister of the UAE to Ukraine.

International Events

December 1

Lisbon Treaty enters into force.

Expected outcome: invigoration of the new institutional set-up of the European Union.

December 3–4

NATO-Ukraine Commission meeting in Brussels, attended by Minister of Foreign Affairs Petro Poroshenko.

Expected outcome: ministerial-level negotiations on Ukraine's National Annual Programme.

December 4

EU-Ukraine summit.

Expected outcome: talks on EU-Ukraine cooperation on climate change, energy and the recession.

December 7

Election of the President of Moldova.

December 7–18

UN climate conference in Copenhagen (COP 15).

Expected outcome: political agreement on common measures to fight climate change.

December 8

Foreign Ministers Summit of EU-27 and Eastern Partnership countries in Brussels.

Expected outcome: launching talks on the Association Agreements with Eastern Partnership countries (except Ukraine).

December 10–11

European Council

December 18

Energy Community Treaty Ministerial Council meeting in Zagreb.

Expected Outcome: Ukraine's accession to the European Energy Community.