VOL 2 NO 2 (30 SEPTEMBER 2009) EDITOR: DR TARAS KUZIO

Ukraine Analyst

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Publication and Subscription Information

Ukraine Analyst is published bimonthly except in July and December when monthly issues will be published. Each 8-page issue of Ukraine Analyst is devoted to current politics, international affairs, energy, business and trade. Ukraine Analyst welcomes articles for consideration for publication. Special and double issues will have 12 pages.

Institutional, business and library subscription: $500, Individual subscription: $300, Student subscription $150. Subscribers can access current and archived back issues of Ukraine Analyst at **www.taraskuzio.net.**

Political Fragmentation in Ukraine

During Leonid Kuchma's presidency (1994-2004) the two wings of Ukrainian politics that were described as 'ideologically drive', the right and left, were often contrasted with the ideologically amorphous centre of Ukrainian politics. This framework was used to explain why the left and right supported the April 2004 change in the parliamentary election law that made elections held on a fully proportional system. 'Centrist' political parties opposed the change in the law from a mixed election system as it was assumed that they elected most of their deputies in majoritarian (single mandate) districts. In the March 2002 elections this was indeed the case as the For a United Ukraine (ZYU) bloc which elected far more deputies to parliament through single mandate districts than on the proportional half of the elections where ZYU only obtained 11 percent and third place. Our Ukraine bloc and the Communist Party came first and second respectively seemingly confirming that 'ideologically driven' parties would improve their performance under a proportional election law.

Five years of political life under President Viktor Yushchenko and two parliamentary elections (March 2006, September 2007) have shown these assumptions to be wrong. The Party of Regions came first in both elections and has not suffered from the proportional election law first used in the 2006 elections. The Our Ukraine bloc, in contrast, came in third, with 14 percent of the vote, or ten percent less than in 2002 when Ukraine used a mixed election law. The Communist Party fared even worse, losing three quarters of its votes and dropping to 5 percent in the 2006 and 2007 elections, compared to 20 percent in 2002. The left and right have fragmented during Yushchenko's five year rule. The following analysis will provide a spotlight on the declining fortunes of the Socialist Party and Our Ukraine.

Centre-Left

Ukraine was the only country in the CIS with a strong centre-left party that was a member of the Socialist International. The Socialist Party (SPU) was formed in October 1991 when the Communist Party (KPU) remained banned and evolved towards a pro-Ukrainian statehood and pro-democratic position in the course of the 1990s. The SPU played a key role, together with the Yulia Tymoshenko bloc, in the four years of anti-regime protests that engulfed Ukraine between November 2000 (when the Kuchmagate crisis began) and November 2004 (when the Orange Revolution began). SPU leader, Oleksandr Moroz, stood in the first round of the 2004 elections but agreed to support Yushchenko's candidacy in the second and repeat second rounds.

The SPU was represented in the two orange governments in power between 2005-2006 and campaigned in the March 2006 elections in support of joining an orange parliamentary coalition. The coalition negotiations took three months and were completed except for the issue of who would become Parliamentary Speaker, a position SPU leader Oleksandr Moroz sought after. Our Ukraine's refusal to give this position to Moroz led him to take his faction out of the coalition negotiations. In July-August 2006 this gave the opportunity for an alternative Anti-Crisis coalition to be established between the SPU, KPU and the Party of Regions. Moroz received his coveted position of Parliamentary Speaker.

The defection has haunted the SPU ever since reducing its support in opinion polls to less than 2 percent. The SPU failed to cross the three percent threshold in September 2007, when it obtained 2.86 percent, which proved to be a bombshell for the party as this was the first time since 1991 that it remained outside parliament. Political parties outside parliament in Ukraine tend to become quickly marginalised unless they undertake a thorough reform of their policies and replace their leaders, which they rarely do. The SPU's votes were taken by the Tymoshenko bloc and the Volodymyr Lytvyn bloc enabling the former to increase its support compared to 2006 and the latter to enter parliament.

The SPU remains one of a number of small centre-left parties outside parliament, such as the All Ukrainian Union of the Left "Justice", the Social Democratic Party, the Social Democratic united Party (SDPUo) and others. To attempt to enter the next elected parliament these parties are negotiating an election bloc.

Five Problems Faced by Left

Leadership: insiders in the SPU will openly admit that the SPU cannot revive itself as a serious political force unless it replaces Moroz who is discredited. The SPU would need to elect a new, younger leader to give it the opportunity to again become an important political force in Ukrainian politics.

Generational: the leadership of the left is dominated by the older generation in their 60s, most of whom are more Socialist than Social-Democratic in their views. Their unwillingness to permit internal democratic debate on why the SPU is in crisis has led to an outflow of many young SPU activists.

'New' versus 'Old' SPU: the older and younger generation in the SPU have two different world views. The former cling to some vestiges of the Soviet past and political culture while the young are strong supporters of the SPU integrating within the European left mainstream (together with Ukraine) and of the party becoming more Social-Democratic in its orientation.

Communist Problem: not all SPU members, especially younger ones, will support an election alliance with the Communist Party. In Kharkiv *oblast*, a SPU stronghold, the SPU and KPU have poor relations because of conflicting business interests.

Oligarchs: not all SPU members will agree to join an alliance with the SDPUo, the only Ukrainian political party that was refused membership in the Socialist International because of its anti-democratic tendencies and links to corrupt oligarchs.

Centre-Right

The most fragmented area of the political spectrum is the centre-right. The Our Ukraine bloc faces competition from the Yulia Tymoshenko bloc, which took over in the 2006 and 2007 elections as the leading orange political force, but also from an increasingly fragmented Our Ukraine. If there was once only nine parties in the Our Ukraine-People's Self Defence bloc that fought the 2007 elections, this number has since grown to 14 parties and NGO's (budding parties) represented within its 72 deputies. Instead of merging the nine parties into a strong presidential party that would mobilise voters for Yushchenko in the presidential elections the centre-right has continued to fragment.

Rukh (Ukrainian Popular Movement for Restructuring) was the main anti-communist centre-right political party until the 2002 elections. Formed as a Popular Front in 1989, it was led by the former political prisoner Vyacheslav Chornovil who died in a 1999 car accident. Currently, Rukh is led by former Foreign Minister Borys Tarasiuk. Rukh was the first Ukrainian party to establish links to the European People's Party, the centre-right political group in the European Parliament, and Rukh's youth wing is one of two Ukrainian youth organisations (the other being Democratic Alliance) that belong to the youth wing of the EPP. Rukh was a member of the 2002, 2006 and 2007 Our Ukraine blocs but moved closer to Yulia Tymoshenko in 2008-2009. Tarasiuk's relations with President Yushchenko remain strained: Tarasiuk was not invited to the September 20th anniversary of the founding of Rukh organised by the presidential secretariat and as a consequence rejected the state medal that he was awarded.

Reform and Order Party brought together many intellectuals from Rukh and has always been led by former Finance Minister Viktor Pynzenyk. In the late 1990s Reforms and Order was close to Viktor Yushchenko and lobbied him to stand as a candidate in the 1999 presidential elections, but he refused. In 2002 Reforms and Order joined the newly created Our Ukraine bloc but in 2006 and 2007 joined the Yulia Tymoshenko blocs.

Our Ukraine was created as a bloc of centre-right parties in late 2001 after Yushchenko was removed as Prime Minister in April 2001. In the 2002 elections the bloc included 10 parties and came first with 24 percent of the vote. In the 2006 and 2007 elections the Our Ukraine bloc included 6 and 9 parties respectively and came third on both occasions with 14 percent of the vote. The Our Ukraine People's Self Defence bloc has 72 deputies in parliament of whom only one group numbering 17-20, For Ukraine!, headed by Vyacheslav Kyrylenko, remains pro-Yushchenko. The remaining deputies have either aligned with Tymoshenko or have established new political forces.

People's Union-Our Ukraine Party was established as Yushchenko's presidential party in 2005 after he was elected president. It was envisaged that the other parties in the Our Ukraine bloc would merge with the People's Union-Our Ukraine Party into a stronger presidential party that would assist him winning a second term in office. In the 2006 and 2007 elections the People's Union-Our Ukraine party was one of the parties inside the Our Ukraine blocs.

Our Ukraine's Six Deep-Seated Problems

Leadership: The Our Ukraine bloc and the People's Union-Our Ukraine party have never had charismatic leaders. The

Centrist Parties in the Yushchenko Era

Political Party	Elections	Political Situation
Party of Regions	Came first in the 2006 and 2007 elections with 31 and 34% of the vote	Merged with the Republican Party and Labour Party.
Party of Industrialists and Entrepreneurs (PPPU)	In the 2006 elections the PPPU entered parliament within the Our Ukraine bloc. In the 2007 elections the PPPU received seats in the Party of Regions.	A highly marginal party that is an outgrowth of the 'Red Directors' Union of Industrialists and Entrepreneurs associated with Anatoliy Kinakh.
Labour Party	Failed to enter parliament in 2006. Entered parliament in 2007 in the Volodymyr Lytvyn bloc.	Presidential candidate Serhiy Tyhipko will seek to revive the party.
Social Democratic united Party	Failed to enter parliament in 2006 after standing in a bloc of four parties (SDPUo, Republican Party, Centre Party, Women for the Future union).	The SDPUo did not compete in the 2007 elections and has become marginalised. Too closely associated with Viktor Medvedchuk, the SDPUo will compete in the next elections in a bloc of left-wing parties.
People's Democratic Party (NDP)	The NDP failed to enter parliament in 2006 after standing in a bloc of four parties (NDP, Democratic Party, Christian Democratic Party, Christian Liberal Party).	The NDP did not compete in the 2007 elections and has become marginalised.
Agrarian Party/ People's Party (NP)	The NP failed to enter parliament elected in 2006 when it stood with three parties (NP, Peasant Democratic Party, All-Ukrainian of the Left-Justice"). The NDP entered parliament elected in 2007 in the Volodymyr Lytvyn bloc (NP and Labour Party).	The NP took votes from the Socialist Party which became unpopular after it defected from the orange coalition in July 2006 and joined the Anti-Crisis coalition with the Party of Regions and Communist Party. If the SPU revives the NP could again become marginalised. The NP is too closely associated with Lytvyn. The Lytyn bloc joined the democratic (orange) coalition in December 2008.

exception was in 2002 when the Our Ukraine bloc won the elections as an opposition force led by the deposed Prime Minister Yushchenko who became in 2002-2004 leader of the opposition. The People's Union-Our Ukraine/Our Ukraine bloc are often led by people associated with the presidential secretariat. Since June 2009 the head of People's Union-Our Ukraine party is the head of the presidential secretariat, Vera Ulianchenko, who commands little respect as a political leader. Ulianchenko lived in exile outside Ukraine in the second half of the 1990s because she was associated with a major corruption scandal, the asset stripping of the Blasco shipping fleet that took place during President Leonid Kravchuk's term in office. Ulianchenko is close to First Lady Kataryna Yushchenko.

Public Support: public support has declined for the Our Ukraine bloc from 24 percent in 2002 to 14 percent in the 2006 and 14 percent in the 2007 elections. Opinion polls currently give the People's Union-Our Ukraine party (or as it is sometimes described in surveys as the Viktor Yushchenko bloc) only 2-3 percent (see the tables by the Razumkov Centre for Political and Economic Studies showing its declining support over 2008-2009, http://www.uceps.org/eng/socpolls.php?cat_id=36). Many political commentators believe the party may not cross the 3 percent threshold and thereby would not enter the 2012 parliament.

Yushchenko: the Our Ukraine bloc/People's Union-Our Ukraine party is completely identified with President Yushchenko. As the president's ratings have collapsed, especially in 2008-2009, so too did the ratings of these two political forces (see Yushchenko's ratings over 2005-2009 in table form at http://www.uceps.org/eng/poll.php?poll_id=67).

Geography: the Our Ukraine bloc won 3 Galician and Trans-Carpathian *oblasts* in the 2006 elections and only the Trans-Carpathian *oblast* in the 2007 elections. Support for both the Our Ukraine bloc and Yushchenko is confined to only western Ukraine. In Kyiv, cradle of the 2004 orange revolution, Our Ukraine's support has collapsed, as seen in the 2008 Kyiv city elections where it failed to cross the 3 percent threshold.

Desertion: The majority of the nine parties in the 2007 Our Ukraine-People's Self Defence bloc and the new parties and NGOs created since the 2007 elections no longer support Yushchenko. A majority of the faction voted to support joining the democratic coalition with the Tymoshenko bloc and Volodymyr Lytvyn bloc. Defectors from a pro-Yushchenko to a pro-Tymoshenko position include three of the nine parties in the Our Ukraine bloc: People's Defence headed by Yuriy Lutsenko, Rukh headed by Borys Tarasiuk, and Anatoliy Grytsenko head of the new Civic

Initiative. Other parties and NGO's in the Our Ukraine - People's Self Defence bloc did not support the vote to join the coalition but also no longer back Yushchenko. These include two new political forces: Arseniy Yatseniuk, leader of the Front for Change and the third most popular presidential candidate, and Viktor Baloga, head of the United Centre party. Of the 72 Our Ukraine-People's Self Defence faction MP's, only approximately 20 continue to support Yushchenko in the For Ukraine! group headed by Vyacheslav Kyrylenko. The head of the faction, Mykola Martynenko, is a supporter of the coalition. Martynenko is head of the Kyiv branch of the People's Union-Our Ukraine party and his support for joining the coalition shows the degree to which dissent exists within Yushchenko's party (as well as more broadly within the Our Ukraine-Peoples Self Defence faction).

Competition: the People's Union-Our Ukraine party faces competition on the centre-right from a fragmented and very crowded number of centre-right parties. Some of these parties are likely to do far better than People's Union-Our Ukraine in future elections. Current polls give the Yatseniuk bloc 8-10 percent support compared to only 2-3 percent for People's Union-Our Ukraine.

Support for Presidential Candidates by Parties and NGO's in the Our Ukraine-Peoples Self Defence bloc

Political Party and NGO	Presidential Candidate
Peoples Union-Our Ukraine (V.Ulianchenko)	Viktor Yushchenko
Ukrainian Republican Party "Sobor" (A.Matvienko)	Yushchenko
For Ukraine! Group* (V.Kyrylenko)	Yushchenko
Rukh (B.Tarasiuk)	Yulia Tymoshenko
Self Defence (Y.Lutsenko)*	Tymoshenko
Christian Democratic Union (V.Stretovych)	Tymoshenko
European Party of Ukraine (M.Katerynchuk)	Tymoshenko
Pora (V.Kaskiv)	Tymoshenko
Civic Initiative* (A.Grytsenko)	Anatoliy Grytsenko
Front for Change* (A.Yatseniuk)	Arseniy Yatseniuk
Ukrainian Peoples Party (Y.Kostenko)	Yuriy Kostenko
United Centre (V.Baloga)*	Unclear
Forward Ukraine (O.Novikov)	Unclear
Party Defenders of the Fatherland (Y.Karmazin)	Unclear

Established since the September 2007 Pre-Term Elections

Who Will Our Ukraine Support in the Presidential Elections?

Although it is clear that the People's Union-Our Ukraine party will support Yushchenko's candidacy this is far less clear for the Our Ukraine-People's Self Defence bloc. The People's Union-Our Ukraine party reminded other parties in the bloc that they had signed an agreement on 2 August 2007 giving their support to Yushchenko's candidacy. The bloc declared it was being established with the aim of 'supporting the political course of President Viktor Yushchenko' and the 'realisation of the presidents programme' (*Ukrayinska Pravda*, 24 September).

A majority of the political parties and groups in the Our Ukraine-People's Self Defence bloc will either support Tymoshenko's candidacy or their own, not Yushchenko.

Two years on, the political situation has dramatically changed. A majority of the political parties and groups in the Our Ukraine-People's Self Defence bloc will either support Tymoshenko's candidacy or their own, not Yushchenko (see box). Oleksandr Tretiakov told *Zerkalo Nedeli/Tyzhnia* (11 September) that the Our Ukraine-People's Self Defence bloc faction would only support Tymoshenko's candidacy if she agreed to back their policy positions as President. These included a European orientation for Ukraine, NATO membership and a parliamentary-presidential system. Tymoshenko had agreed to these demands, Tretiakov explained, and the faction would therefore support her candidacy.

Tretiakov may be presumptuous to believe he could speak with Tymoshenko as though the faction was united in its stance. The bloc has been noticeable for its disunity and fragmentation. But, he is certainly correct to believe that the majority of the faction no longer support Yushchenko for a second term. The reasons are a mixture of personal, political and realism (i.e. who of the two, Tymoshenko and Yushchenko, have the best chance of winning the election). Tretiakov was personally insulted when he saw his name was not in the first 100 of the Our Ukraine election list prepared for pre-term elections in autumn 2008 that did not take place. Borys Tarasiuk, head of Rukh, was personally affronted by not being invited to the 20th anniversary of Rukh celebrations in Kyiv. In protest Tarasiuk rejected a state medal awarded to him. Tretiakov, who was Yushchenko's senior adviser in 2005, and the faction leader, Mykola Martynenko, have both publicly called on Yushchenko to not stand for a second term, a call which Yushchenko has ignored.

Ukraine's Economy Hits Bottom

by Tim Ash

Ukraine's State Statistical Committee (SSCU) released estimates for Q2 real GDP and also industrial output data for July. Both show a slowing in the rate of year on year decline but, that said, the actual rate of decline was still brutal and indeed quite remarkable for a non-conflict economy. Real GDP is thus reported to have fallen by 18 percent in Q2, moderating the rate of decline from 20.3 percent YOY in Q1. In Emerging Europe, Ukraine's rate of GDP decline was second only to Lithuania (minus 13.3 percent YOY in Q1, and minus 22.4 percent YOY in Q2) in its severity, and around double the rate of decline experienced by Russia.

In Ukraine's case, a brutal terms of trade shock, which has seen the prices of Ukraine's main export, metallurgical goods, which accounts for 40 percent of exports, decline by more than half year on year. This combined with the impact of the global credit crunch which saw external and bank financing dry up, an FX/balance of payments crisis and a banking sector crisis, alongside recurrent political weakness/logjams have all added to the mix.

In terms of industrial production, output declined by 'just' 26.7 percent YOY in July, a 'moderation', when compared to the 30.4 percent fall in aggregate over the first 7 months of the year. As of July 2009 industrial production was running at around 67 percent of the level of December 2006, albeit marking something of a recovery compared to lows reached in January 2009, when industrial production was running only at 56 percent of the December 2006 level; for five of the past 6 months since MOM output has expanded. This would also suggest that the economy is close to its lows and has now perhaps bottomed, albeit it is perhaps too early to speak about sustained recovery.

In reviewing the breakdown of production by industrial branch for the period January through June, while generally it is assumed that the metallurgical sector has been disproportionately influenced, the data suggests a pretty broad based decline. Thus, while manufacturing suffered a 36.6 percent YOY contraction over this period, within this total metallurgy was down 43 percent YOY, chemicals down by 44 percent, with mechanical engineering suffering most, with a 52.5 percent YOY decline (within the latter category transport equipment and goods lost 65 percent of output YOY, not surprising given this sector has been disproportionately impacted globally). Manufacturing sectors which performed best included foodstuffs (down 5.8 percent YOY), and some light industries, including leather and paper goods where the decline was limited to around one-fifth. Declines in mining (minus 18.2 percent YOY) and production and distribution of electricity natural gas and water (minus 17.4 percent YOY) were somewhat more limited.

The above data are, however, aggregates and mask the fact that the recession has been most acutely felt in regions, even cities, with particular concentrations in export oriented industries. For the period January through June, for example, industrial production declined by 46.7 percent in Trans-Carpathia *oblast* and 45.2 percent YOY in Volyn *oblast*, while the aggregate decline over this period for Ukraine was 31.1 percent YOY. At the other extreme, *oblasts* which performed better included Kherson (-8.9 percent YOY) and Chernivtsi (-16.7 percent YOY), the former is better known for their rural orientation and hence production was perhaps buoyed by its foodstuffs industries.

Notwithstanding the regional and sector specific nuances to the recession, the aggregate data does still suggest that the economy hit bottom some time in Q1. That said, with an approximate 19 percent YOY decline in GDP over the first half of 2009, official (e.g. IMF) projections for a real GDP decline of 8 percent over the full year in 2009 appear optimistic, with a minus 15 percent out-turn appearing more likely on the basis of the figures. This should provide a very low base for 2010, and indeed the government is already speaking of 3 percent real GDP growth being pencilled in for its budget planning process for next year. This could still prove optimistic, and herein much still depends both on the global economy and the outcome of presidential elections in January.

Relations with the IMF

An IMF mission visited Ukraine in July for the second review under the Stand-By Agreement (SBA), and left with a recommendation for the release of the next tranche of US $3.3bn in IMF funding (two tranches were in fact combined). The Fund noted the need for certain prior policies, but indicated progress on key issues such as the recapitalisation of the banking sector. The IMF agreed to increase the budget deficit target to 6 percent of GDP, reflective of a recognition that the impact of the global financial crisis has been much more severe than initially expected and hence the impact on budget finances has been drastic. The IMF is also placing a high emphasis on the need to consolidate the deficit of Naftohaz Ukrainy (targeted at 2.6 percent of GDP) with that of the general government. The consolidated budget deficit target, including Naftohaz, is thus 8.6 percent of GDP.

There is a big discussion, amongst investors in particular, that the IMF has been much more understanding to Ukraine than perhaps some of its regional peers (e.g. perhaps Latvia and Serbia) reflective of Ukraine's geopolitical importance to some of the IMF's larger shareholders. Obviously this might well be disputed by the IMF. We would argue that the IMF has to adopt a case by case approach, recognising different political settings and understanding best how to deliver on its goals of improving the policy environment over perhaps a longer time-frame. The speed and ease by which Ukraine secured disbursement of the latest tranche would certainly be used as evidence by those arguing that the IMF had a generous approach to Ukraine. Notwithstanding the discussion over the IMF's broader strategy towards Ukraine, it is difficult to see the IMF being in a position to disburse the next tranche in November. By that time Ukraine will be in election mode, and we doubt that the government will be able to deliver sufficiently on the IMF agenda by then to enable the IMF to provide a trance in the elections. The IMF will also probably want to defend itself from accusations of potentially bank rolling the government in the run-up to elections.

Budget and Debt Financing

The significant widening in the budget deficit, and the fact that international capital markets are effectively closed to Ukraine (5Y CDS is still north of 1,500bps) has left the country dependent on official financing. The general budget deficit to June is estimated at around UAH17bn. Annual debt redemption's due in 2009 are estimated at UAH29bn, which creates a huge budget financing gap, assuming little scope for budget tightening in H2 2009 in the midst of an election campaign.

The Treasury has managed to re-launch domestic debt auctions, issuing UAH11bn in the year to date; albeit at the price of yields on government bonds in the 15-25 percent range. Privatisation receipts were targeted at UAH8bn for the year, but are unlikely to reach even UAH1bn partly due to legislative blocks to sales and the global crisis. The gap in budget financing is thus expected to be covered by World Bank Funding (US$1.9bn) and also IMF funding; around half of IMF disbursements are in fact earmarked for budgetary support. With the disbursement of the next IMF tranche in late July the government will have secured approximately US$5bn in budget financing from multilateral sources this year. Essentially this should enable the government to close the budget gap to October-November.

Importantly for foreign investors, this will also take Ukraine through the August-September period when gas imports and external debt redemption’s peak (around US $1.5bn in sovereign/quasi sovereign debt potentially matures in August-September, including the US$500m Naftohaz Ukrainy 09's). Ukraine's sovereign external debt schedule is then light until 2011.

The threat of a sovereign default will thus have been pushed back until after the presidential elections (at least). From the IMF's perspective they will have bought Ukraine time, until the new administration is in place after the election. The government in the run up to the 2010 presidential elections will also face a budget financing constraint, lacking the funds to go on a pre-election spending spree (we doubt the National Bank, which is in President Viktor Yushchenko's sphere of influence, will bank-roll pork barrelling by the government controlled by his arch rival Yulia Tymoshenko). It will be interesting to see what spending promises are made in the run up to the elections, and how these will be reigned in, with the help of the IMF anchor after the elections.

Resolution of the problem obviously rests on increasing domestic gas prices, which is universally acknowledged by the political establishment; but, given the political cost, has been slow to deliver on.

Over the slightly longer term, reform of Naftohaz Ukrainy is central to broader fiscal reform and this has been clearly stated by the IMF in recent communiqués. The IMF recognises the critical importance of Naftohaz to the economy, and we do not expect the IMF to object to the government supporting it in meeting its external liabilities in the year ahead, especially when the company has broader regional significance in terms of European energy security.

Reform of Naftohaz essentially means reform of domestic gas pricing, an acutely difficult political issue. Gas prices to industrial users have been raised to market levels and the government is committed to raising household gas prices; this latter issue is not as politically sensitive as this mostly relates to the supply of gas for cooking and to rural users and hence typically comprises a smaller share of household budgets. The key battleground issue, though, is gas pricing at the municipal level. The problem is that the government does not have the power to enforce gas price increases on municipal heating companies as these are controlled by municipalities. They currently charge UAH878 per 1,000 per tcm, versus cost prices of over UAH2,025. Municipal heating companies not only fail to charge consumers adequate prices to cover costs, but their collection rates are only around 50 percent, creating huge arrears to Naftohaz. This subsequently undermines Naftohaz's cash flow position and its own ability to pay for imported gas. The government is hence forced to step in by providing subsidies to Naftohaz, a situation which is clearly destabilising for Naftohaz, and creates uncertainty over the companies' ability to hold to its gas supply agreement with Gazprom which requires payment for gas supplied over the previous month by the 7th day of the following month.

The government says it is committed to increasing gas prices by 20 percent this year, and gradually raising them to cost prices, and then targeting subsidies at the poor. As to the problem of municipal gas pricing, the plan is to move the right to price gas from them to the national agency for energy price regulation, a step that is proving to be a judicial nightmare. Legally, at present, it takes at least three months to enforce gas price increases.

Banking Sector Reform

In general, as has been the case in Russia and Kazakhstan, NPLs have risen rapidly, and are likely in the range of 25-35 percent of loan books. The shear extent of NPLs reflects the depth of the recession. Official forecasts suggests a real GDP decline of 10-12 percent in 2009, and even this may appear optimistic given data for the first few months of the year; the National Bank has suggested that real GDP may have declined by 25-30 percent. As has proven the case in developed market economies (e.g. the Madoff case), recession has revealed numerous fraudulent borrowing practices. Difficulties in attaching collateral through the courts also appears to have made banks relatively pro-active in pushing debtors to re-negotiate terms; quickly seeking to capitalise overdue debt service payments, often and predictably at a very high premium. A culture of restructuring has ensued.

The high level of NPLs and doubts over the quality of existing bank capital, alongside a deletion of 35-40 percent of banks' deposit bases through the crisis thus far, left many banks in need of recapitalisation. Banking sector restructuring was a key plank of the IMF programme and herein progress does seem to have been made. The diagnostic test on banks, as per the programme, has been completed.

The banks need for recapitalisation have been assessed, and the banking recapitalisation process is under way. Foreign banks, which assume a 40-50 percent market share by assets, have in general already been recapitalised by their parents and thus the burden of recapitalisation has been shared. Seven domestically owned banks have been identified as in need of government support because existing owners proved unable to provide the required level of additional capital. Three of these banks have already received UAH10bn in capital injections with government bonds being placed on their balance sheets in exchange for the state taking equity stakes and leading roles in their corporate governance structures. A further four banks are being prepared for recapitalisation, with the cost of this latter operation put at UAH16bn.

Thus, the cost of bank recapitalisation to be borne by the state coming in around UAH26bn, which is below the UAH44bn planned in the original IMF programme, and does not appear to jeopardise the sovereign's debt sustainability position. We estimate that the public sector debt-to-GDP ratio will rise from less than 20 percent in 2008 to around 40-45 percent of GDP as of the end of 2009, still low by regional standards. There appears to be lingering concern over state control and oversight of banks which have been forced to recapitalise; herein existing owners still appear not to have received the message that the state is now the majority owner and they need to take a back seat.

Balance of Payments and Exchange Rate

The reduction of gas consumption reduces the draw on the balance of payments from energy imports; assuming that Russia does not enforce its right to keep Ukraine to the agreement to import 42 bcm of gas annually. Industrial consumption of gas has fallen by around one half to 20 bcm. Household consumption is down more modestly at 18 bcm, with municipal heating companies consuming 10 bcm, and transmission costs of 4-5 bcm, this suggests useage of only 55 bcm, down from around 72 bcm in recent years. Even given the increase in gas import prices in 2009 to an expected average of US$228 per 1,000 cu metres, from US$179.5 one year earlier, this still suggests a saving in gas import costs of US$1-1.5bn annually. As the economy continues to recover next year, gas consumption by industry is expected to revive somewhat, but is never expected to return to pre-crisis levels largely due to extensive energy conservation efforts at diversification away from gas (e.g. to coal).

As elsewhere in the region the combination of deflation in domestic demand, and a currency adjustment, has brought a marked narrowing in the current account deficit from around 7 percent of GDP in 2008, to an expected out-turn of close to balance in 2009. Concerns over high debt roll-overs have eased through a combination of high roll-overs by foreign-owned banks (90 percent), plus some debt restructuring by domestic borrowers. The provision of IMF and World Bank financing has also helped to stabilise the exchange rate. The IMF appears generally happy with the NBU's management of exchange rate policy, reducing interventions more generally. IMF government efforts to resolve problems in the banking sector through a recapitalisation process have also helped stem capital flight.

Whether the exchange rate will remain stable in the run up to the presidential elections is debatable though. Typically, the UAH weakens in the run up to elections as dollarisation increases on the back of concern over mounting political risks. Add to this the likely stalling in IMF disbursements, and the continued need to fund gas imports, and the UAH will likely have an easing bias to year-end that is likely to be contained in the UAH8-9 per US$1 range. From a balance of payments perspective the UAH does not appear over-valued at present, but political risk could still fuel yet more capital flight over banking sector stability (those that wanted to remove deposits from banks and convert to FX have already done this). There are also suggestions that Ukrainian FX holdings (under the mattress) may already be around US$90bn; this does not seem unreasonable given the size of the country and its recent track record of crisis.

Balance of Payments Improves

The National Bank of Ukraine has released balance of payments data for Q2 2009, which shows some encouraging prospects for a period of greater stability for the UAH.

1. The current account actually recorded a surplus of US $162m in Q2 2009, a remarkable turnaround from the US $3.4bn deficit posted for the comparable quarter in 2008. This also represented the first quarterly surplus recorded since Q3 2006. On a 12m. moving average basis, the current account deficit is running at US$6.5bn, half the record US$12.9bn deficit posted for the full year in 2008. Given current trends for the full year in 2009, the current account is expected to come in flat.

2. Much of the improvement on the current account was driven by the improving merchandise trade account where the deficit narrowed to US$655m in Q2 2009, from US $4.4bn one year earlier. While exports were down by 51.4 percent YOY largely driven by lower prices and volumes of metallurgical exports (accounting for 40 percent of exports), imports were lower by a staggering 57.4 percent YOY. The 40 percent+ nominal depreciation of the UAH, and the huge deflation in domestic demand, which might have produced a 15-20 percent YOY contraction in real GDP in H1 2009, has driven this latter contraction.

3. The surplus on services narrowed slightly to US$422m in Q2, from US$492m one year earlier, perhaps reflective of much lower gas transit through Ukraine from Russia.

4. The deficit on the income account rose to US$657m in Q2 2009, from just US$283m one year earlier, a reflection of the increase in the stock of external debt to around US $100bn as of April 1 2009, from US$87.8bn one year earlier. Plus, higher risk premiums attached to Ukrainian debt/EM risk in general.

5. Net transfers rose to reach US$1.1bn in Q2 2009, from US$833m one year earlier.

Capital and Financial Account

1. Net FDI inflows slowed to US$1.1bn for the quarter, one third of that received a year earlier level (US$3.1bn). This suggests full coverage of the current account in 2009 from non-debt creating inflows which is a positive.

2. Net portfolio flows were flat (minus US$2m), from net inflows of US$68m in Q2 2008. The stock level is very low as most foreign portfolio investors long departed Ukraine.

3. M&LT debt flows posted a net outflow of US$2.5bn in Q2 2009, versus a net inflow of US$3.5bn in Q2 2008 (US $13.5bn in net inflows from this source for the full year in 2008). One year earlier, Ukraine had been still benefiting from flush global markets. Net disbursements of M&LT debt amounted to US$8.3bn in Q2 2008, falling to just US $2.7bn one year earlier. Net repayments, meanwhile, totalled US$5.2bn in Q2 2009.

4. Short term loans posted a net outflow of US$354m, compared to a net inflow of US$1.1bn one year earlier. The good news is that the level of outflows slowed from US $2.2bn in Q1 2009, and US$1.1bn in Q4 2008.

5. Other investment (which probably is the closest proxy for capital flight) slowed to a net outflow of just US$527m in Q2 2009, down from US$2bn one year earlier. This compares with a huge net outflow from this source of US $12.2bn between June 2008 and the end of March 2009 (i.e. at the height of the global crisis).

6. Q2 2009 saw a US$2.1bn draw down in FX reserves, an improvement from the US$5.2bn loss in reserves in Q1 2009, and US$3.1bn draw down in Q4 2009.

In conclusion, the National Bank data suggests a much more supportive backdrop for the UAH, particularly on the current account. The provision of official IMF financing has helped to stabilise the balance of payments, and in the short term the release of the next tranche of US$3.3bn in IMF financing should help Ukraine come through the peak in debt service payments looming in August-September.

Thereafter, the risk is that the commencement of the election campaign for presidential elections in January begins to increase capital flight, pressurising the UAH somewhat and probably to around UAH9:US$1 at year end 2009 (most flight capital has already probably left Ukraine, suggesting much less scope for a repeat of the meltdown from H2 2008). Assuming a 'constructive' outcome to those elections, the BOP position suggests some scope for the UAH to bounce back, probably to close to current levels by mid-2010.

What is President Yushchenko Doing?

by Tammy Lynch

I stood on the Maidan in Kyiv for the 17 days that became known as the Orange Revolution. I am an American, but I listened to the speeches, talked to the "campers," joined the chanting and waved my orange flags and my creased, worn streamers. I watched as a million people soared on the wings of a collective euphoria.

During these 17 days, presidential candidate Viktor Yushchenko railed against corruption, promised to solve politically-motivated murders and vowed to involve "the people" in the process of state building.

And then …. he took office. Five years later, those million-strong euphoric expectations have crashed to the ground. Corruption has not decreased. Political crimes have not been solved. And few in Ukraine believe that "the people" matter.

The blame for this must not solely be laid at President Yushchenko's door. One thing is clear, however – in five years, Yushchenko has proven unable to work efficiently with any government, any prime minister, or any political bloc to pass his stated reform agenda. This week, in an apparent attempt to undermine Prime Minister Yulia Tymoshenko, President Yushchenko attacked her government – again. In the process, he also perhaps unwittingly launched an attack on Ukraine itself. On 17 September, Yushchenko announced that the IMF is being too lenient with Tymoshenko's government, implying that the Fund should suspend disbursement of the remaining tranches of a $16.4 billion loan. 'I am very disappointed," Yushchenko said, "that the policies in 2009 departed so far from the memorandum [of understanding with the IMF]', as his aide further warned that the IMF had said it would not disburse more money this year. So far, the country has received over $10 billion from the Fund. The government quickly disputed these statements.

Yushchenko is correct about one thing – the IMF has been very lenient. A majority of agreed reforms have not occurred. However, President Yushchenko should look in the mirror to see one of the reasons. A number of reforms have been enacted by the Prime Minister's direct decree. Prime Minister Tymoshenko was forced to rely on decree power after Yushchenko's parliamentary allies refused to vote for IMF-supported changes to the pension fund and Naftohaz gas company funding. Yushchenko made no attempt to rally his troops on behalf of these policy alterations. Yushchenko also has avoided campaigning personally for the implementation of the IMF's toughest reform requirement – higher gas prices for consumers. With an election four months away, it is unlikely any politician will board that reform train.

The biggest problem with Yushchenko's critique of the IMF's leniency is not whether it is true. Rather, his comments undercut his own government's work with an international lending organization, while signalling to other investors that they should stay away. He has spotlighted a potential problem, but done nothing to fix it – a common event during his presidency. In the process, a president who is supposed to represent his country has actually undermined it. So, what if the IMF listened? Would the situation in Ukraine improve? Hardly. In fact, a suspended IMF loan could have a fatal effect on Ukraine's bond yields, further destabilize the currency, squash Naftohaz's attempts to restructure its Eurobonds and freeze Foreign Direct Investment indefinitely. Is President Yushchenko too concerned with undermining his prime minister – and presidential campaign opponent – to understand this?

Jamestown's Eurasia Blog, 24 September 2009.