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INSIDE UKRAINE

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

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

The analytic paper will be published on a weekly basis and it will consist of three components: political competition, economic situation and state decisions.

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1. Political competition

Political competition inside the country is softened due to the Russian military intervention in Crimea and massive anti-Ukrainian informational campaign of the Kremlin. Internal mobilization caused by external threat and concentration of public attention on the Russian aggression created ideal conditions for distribution of offices by Batkivshchyna and its minority partner – Svoboda. In fact, as of today both parties took political responsibility to conduct reforms. UDAR and Party of regions deliberately distance themselves from the process in order to start presidential election campaign without any formal ties to government.

1.1. Positions of key political players

Having used achievements of revolutionary Maidan, Batkivshchyna took the initiative and replaced Party of regions as a leader in construction of power vertical. Such proactivity is rather negatively perceived by representatives of Maidan. They believe that for the last three months this party had a moderate position in negotiations with Viktor Yanukovich and did not play crucial role in his removal from presidential office. Yet, when the process of power distribution started, Batkivshchyna took a lead in it.

Svoboda takes an active part in distribution of posts, but many officials who represent this party are criticized for the absence of respective managerial experience and insufficient qualifications. Amount of the offices both parties have received does not correspond to the level of their popular support. It allows other political players to question the legitimacy of the whole process.

Obviously, on the wake of national upheaval due to overthrow of Yanukovich's dictatorship and also due to the Russian aggression in Crimea, both parties were expected to be extremely careful in the process of government creation. It had to be based on the principals of professional qualifications and wide political representation. Rejection of such approach weakens governmental positions both in the country and abroad.

Having voted for appointment of a new government, UDAR does not give its representatives for ministerial posts. Deputies of the party emphasize that they always championed for an anti-crisis technocratic government and new personalities in politics. Such statements implicitly criticize inclusion of well-known politicians in the government. Vitaliy Klichko's desire to distance himself from unpopular steps of new authorities and receive a better starting point before presidential elections is revealed in his appeal to new government to start reforms and ensure democratic and transparent presidential elections.

UDAR's passivity may become counterproductive. Avoiding responsibility for solving crisis in the country, Klichko's team may miss the point when positions of Svoboda and Batkivshchyna get stronger. UDAR tries to play the role of Maidan's representative and safeguard of its achievements. Vitaliy Klichko's chances on the presidential elections will depend on his proactivity in achieving these goals.

Petro Poroshenko received an opportunity to become one of major candidates for presidential elections and outweigh three former opposition leaders. He makes smart moves both focusing on important social issues and

Batkivshchyna plays a key role in distribution of power

Officials from Svoboda do not have managerial experience

UDAR champions for anti-crisis technocratic government and new personalities in politics

Petro Poroshenko has an opportunity to become one of

integrating in power vertical. Volodymyr Groisman, Vinnytsia mayor, associated with this politician, became Minister of regional development. He is believed to be capable of reforming this area due to his extensive successful experience in local government. In 2012 Petro Poroshenko also helped to finance Vitaliy Yarema, first vice prime minister. Governors of Vinnytsia, Kyiv and Mykolaiv regions are also associated with Petro Poroshenko.

major candidates for presidential elections.

Recovering from loss of power, Party of regions tries to find new forms of its functioning. MPs who had left its faction formed two parliamentary groups (“Economic Development” and “Sovereign European Ukraine”), while the rest try to consolidate under the leadership of Sergiy Tigipko.

Party of regions is looking for new forms of its functioning.

Transformation of the party will continue while facing a number of serious challenges. Representatives of Party of regions are responsible for disastrous economic policy of recent years, critical surge of corruption, bloodshed during protests and growing separatist movement in the South and the East. After pro-Russian actions in Crimea it will be hard for Party of regions to play Russian card and they will need to find new approaches to work with Russian-speaking electorate in this region.

One of the options is to transform it into the party of business. Though Party of regions largely consists of key Ukrainian businessmen and their representatives, their political program was always aimed at using Soviet slogans and influencing working class in the South and the East. Now it has all the chances to evolve into republican party of American type.

Party of regions may evolve into republican party of American type.

In order to get rid of all the critics Party of regions has accumulated for the last years, it may be used as a basis for a new political force oriented at electorate in the South and the East. Sergiy Tigipko is the most probable candidate to lead this new party and represent it at the presidential elections.

We will see what option Party of regions will choose after the party convention scheduled for March 15th. It is only then that ideological self-identification of Party of regions remains will become clear.

Transitory government has large influence groups of Yulia Tymoshenko and Arseniy Yatsenyuk. Though Maidan promoted a more responsible approach to selection of officials and their accountability, a new government was largely formed on the principle of personal loyalty to political leaders. Maidan also criticized the fact that some ministers (Yuriy Prodan, Lyudmyla Denysova) already held offices, but they did not do any important steps to eliminate corruption in respective areas.

Inclusion of civic activists into government is a form of flirting with Maidan

Inclusion of civic activists in the government upon the insistence of Yuliya Tymoshenko is often interpreted as her attempt to flirt with Maidan and weaken positions of Arseniy Yatsenyuk. Some journalists believe that granting offices to representatives of Maidan creates only resemblance that protesters’ interests are considered.

In general, efficiency of all the newly appointed ministers will be evaluated based on their ability to translate political decisions in administrative procedures and reform their ministries. Political parties which brought these politicians to power may either increase or lose their potential, depending how efficiently they will control the whole process. With the help of international support, government has an opportunity to break vicious circle of closed political and economic institutions and switch to corruption-free upward development of the country. Governmental steps in the following month will either confirm or cast away these hopes.

Government has a chance to initiate corruption-free upward development of the country

1.2. Russian military threat as consolidation factor

Though presidential campaign 2014 has already started, political competition between potential candidates is switched to stand-by mode due to events in Crimea. Russia's military intervention, stirring of separatist tendencies in the Southern East and intensive informational campaign against Ukraine consolidated political camps in the Parliament. A vivid example is constitutional majority voting on March, 2nd.

On the other hand, response of Ukrainian government to Crimean events was not systemic and now it is losing to the Kremlin's propaganda machine. Major protection means is appealing to international players and avoiding any provocations Russians try to cause.

In addition to Crimea, pro-Russian demonstrations took place in Kharkiv, Lugansk, Donetsk and other cities of the Southern East. It should be noted that participation of Party of regions in these events is minor: activists for demonstrations are brought from Russian border regions or organized from local pro-Russian chauvinists. To neutralize appeals to separatism, Vitaliy Klichko asked Ukrainians all over the country to actively demonstrate their civic position through participation in rallies to support Ukraine's territorial integrity and sovereignty.

Appointment of major businessmen as governors in respective regions became another response to the external threat. On March 1st, Sergey Taruta, CEO of ISD Corporation, addressed Ukrainian businessmen with appeal to unite their efforts and protect Ukraine. In several hours it was announced that he had agreed to become governor of Donetsk region. Dnipropetrovsk region will be governed by Igor Kolomoisky, co-owner of Privat Group and Chairman of European Jewish Congress. This appointment totally refutes Russia's official propaganda, which displays Ukrainian protesters as radicals supporting neo-fascist ideology. Rinat Akhmetov, the richest man in Ukraine, also declared that he would do everything possible to keep territorial integrity of Ukraine.

As a conclusion, Russia's military threat did not only move competition between political parties in the parliament to the back-stage, but also became a consolidation factor for population and economic elites. Government should use this consolidation not for the purpose of comfortable office distribution, but to start systemic reforms, should it be reforms in taxation, health care or civil service. It is hard to imagine a better moment for such reforms.

Russia's military intervention consolidated politicians in the Parliament

Participation of Party of regions in pro-Russian rallies is minor

Appointment of businessmen as governors is a response to external threat

Military threat moved political competition to the back-stage

2. Economic situation

One of the key tasks of new government in economic sphere is to ensure stability of national currency, find solutions for economic crisis and ways to finance state budget. Fulfillment of these tasks will depend on the government capacity to promptly and effectively implement reforms in economic sphere and receive financial assistance from external sources.

2.1. Exchange rate

In 2010 – 2013 the National Bank pursued the policy of fixed exchange rate in Ukraine. Maintenance of stable exchange rate, increase of trade deficit and large repayments of external loans led to drastic decrease of gold and forex reserves – from USD 38 bln. in August 2011 to USD 15 bln. in late February 2014.

In the beginning of 2014 inability to maintain exchange rate led to quick depreciation of hryvnia. Negative impact of the latter might have been avoided if the NBU had started planned devaluation of hryvnia due to recession, which started in the second half of the year.

Considerable depreciation of hryvnia, more difficult conditions for currency purchase at interbank exchange and logistical problems on Russian-Ukrainian border will lead to drastic decrease of import in February-March. It will improve foreign trade balance, yet it will also negatively affect processing industries and export due to high dependence of domestic production on imported components. Confrontation with Russia as the largest trading partner of Ukraine may reduce trade volumes even more.

Considerable pressure on hryvnia depreciation in January – February made the NBU look for new ways to control exchange rate. Official depreciation of hryvnia and switch to flexible exchange rate were announced on February, 7th. Besides, new rules for FX purchase at the interbank exchange (*the NBU Resolution No. 49*) came into effect and were aimed to facilitate control over exchange rate. These innovations include:

- Possibility to purchase FX by legal entities not earlier than on the sixth day after the amount in UAH enters special account (it is the most important restriction, which helps the NBU to evaluate demand in advance and check reliability of certain requests). In order to grant purchase of necessary FX volume, banks sign forward contracts with their customers. It partially shifts FX risks to the banks, which have to fulfill forward contract even if the exchange rate as of transaction date exceeds the exchange rate in forward contract.
- Ban to purchase FX for early loan repayments, investments abroad and insurers covering part of insurance funds.
- Restriction on FX purchase by population (equivalent of UAH 50 thsd. per month) for a number of transfers abroad. At the same time individuals may purchase FX for the amount of UAH 150 thsd. per day.

Resolution of the NBU Management Board No. 154 was approved on February, 27th. It introduced restrictions in FX transactions by banks and made amendments in Resolution No. 49.

- In order to avoid speculations, FX transactions are forbidden without FX delivery. Besides, the NBU has more levers to influence banks which are suspected in deliberate destabilization of FX market.

Gold and forex reserves reduced to USD 15 bln

Confrontation with Russia may reduce trade volumes even more

- Limitations are introduced as regards withdrawal of cash in FX. Maximum volume of cash withdrawal in FX makes up UAH 15 thsd. per day and per one client as per official NBU rate.
- In case of early withdrawal of FX deposit banks obtained the right (but not obligation) to pay it in UAH as per the exchange rate set in the bank as of the transaction date.

At the same time Resolution No. 104 softened some restrictions introduced by Resolution No. 49. In particular, in order to purchase pre-defined FX amount, a customer is now entitled to additionally channel UAH amount which is needed to fulfill the request as of the exchange date (yet a principal amount should be channeled at least in six days as it was before).

Limitations, introduced in Resolutions No. 49 and 104 are aimed to increase control over exchange rate. As any other administrative measures, they make sense only in times of crisis and should be cancelled after FX market is stabilized (for instance, termination of negotiations with IMF as regards new loans).

The NBU measures are aimed to increase control over exchange rate

2.2. State budget

Budget income in 2013 decreased due to recession and deflation. Meanwhile, budget of 2014 plans large increase of income, which is difficult to achieve in current macroeconomic situation.

According to the rough estimates of the government, planned budget income should be cut by UAH 65-80 bln., meaning down to UAH 315-330 bln. from UAH 395 bln. In this case planned increase of income comparing to actual level of 2013 will be negative and make up from -8% to -2,6% (while earlier increase of 16,6% was planned).

In order to cut expenses, government introduced austerity measures. Resolution “On austerity measures and avoiding budget losses”, approved on March 1st, 2014, introduced a set of restrictions on budget expenses. These restrictions concern employment process, payment of salaries, business trips, expenses on equipment etc. Besides, it is planned to decrease expenses on state social funds and inventorying of recreation and health institutions which are on balance of state companies.

Government has introduced austerity measures

At the same time, significant decrease of state budget deficit, which made up UAH 64.7 bln. or 4,5% of GDP in 2013, will not be achieved. In 2014 deficit will remain considerable regardless of austerity measures.

Possibilities for internal financing of budget deficit are extremely low due to bad financial standing of enterprises and deposit outflow from banking system. Under such circumstances improper policy of indirect budget financing through the National Bank, when banks purchase bonds on primary market and almost simultaneously sell them to the NBU, will continue. For the last three years the NBU portfolio of bonds increased by UAH 100 bln. – from UAH 63 bln. in the end of 2010 to UAH 163 bln. in late February 2014. Besides, state budget will be indirectly financed from internal sources through VAT certificates, possible introduction of which was announced by government.

2.3. International aid

Large external debt repayments and small volumes of FX reserves mean acute need to receive external financing in the following weeks. On

March 4, 2014, Verkhovna Rada ratified receiving the EU macrofinancial loan in the amount of EUR 610 mln. It will facilitate loan repayment and increase possibilities for financing budget expenses. On March 6th, the EU decided to provide Ukraine with EUR 11 bln.

Major financing source in 2014 will be the IMF. Ukraine started negotiations with the Fund on March 4th, 2014. In order to restore cooperation with the IMF, Ukraine needs to reduce imbalances in state finances, namely, to reduce primary budget deficit, to cut “Naftogaz” NJSC deficit (through increasing prices for gas), to reduce deficit of Pension Fund (through restrictions in the level of retirement benefits and increase of retirement age). Volume of the IMF financing is expected to be USD 15 bln. If the negotiations are finalized in a short run, the first loan tranche of USD 3 bln. may be channeled in mid-April.

Besides, a number of countries and international organizations declared that they are ready to provide additional financial assistance to Ukraine to mitigate negative social effects of crisis and to conduct reforms. For instance, the US Government is ready to provide USD 1 bln to support Ukrainian economy. EBRD also stated it is ready to finance Ukraine for the amount of EUR 5 bln. till 2020.

Loans and financial aid from other countries and international organizations will be a major source for external funds coming to Ukraine. There are no possibilities to borrow from private investors at the international capital markets due to high default risks in Ukraine.

International aid may allow the government to start introducing a package of systemic internal reforms. Absence of reforms will not only lead to termination of financial assistance, but also to the loss of a unique opportunity to make reforms in the country.

Major financing source in 2014 will be the IMF

Borrowing options are limited due to high default risks in Ukraine

3. State decisions

Governmental appointments became some of the key issues in state politics of the last week. The major task of a new government is to make a transition from Stalin-style HR policy, which foresees strict fulfillment of tasks in vertical command-and-control system, to HR development policy. The latter should be aimed at training officials to obtain specific skills and knowledge needed to fulfill functions on a particular working place.

3.1. HR policy

On February 27th, 2014, Verkhovna Rada approved candidates for the government of national trust. The day before, candidates were presented at People's Viche at Maidan Nezalezhnosti in Kyiv.

There are doubts that new members of the government will know how to organize and conduct reforms in democratic society with high level of competition and transparency.

People who earlier worked in the government (Yuriy Prodan, Lyudmyla Denysova, Arsen Avakov) have experience in command-and-control administration, but not in democratic governing.

New personalities in the government who have come from non-governmental sector do not have experience in state governance. However, under pressure of experienced members of the government, they will subconsciously and automatically use command-and-control style of governing.

Nowadays there are two major requirements to the government: to develop adequate steps in crisis situations and algorithms for reforms. All the other requirements and evaluation criteria are secondary.

Prior to any reform a governmental official, responsible for it, needs to arrange consultations with all the interested parties. It will allow them to analyze positions of the interested parties and to understand what potential support groups the innovation will have. It will also help to define how to mitigate threats for vulnerable social groups.

New government will be analyzed based on their capacity to organize reforms and translate political decisions in administrative procedures.

It is extremely important whether officials will be able to efficiently cooperate with the public, and correctly define what support groups these reforms will have so that these groups may be used in reform-making process.

It is of no less importance to understand what social groups will be negatively affected by reforms and what scale the potential losses will have. Such an approach will help to develop measures to mitigate negative impact of reforms on vulnerable social groups.

Even if there is a political will to implement reforms, it is highly likely that the process will face serious problems.

The most important task for the government is to organize immediate training of civil servants and representatives of local authorities (from Prime Minister to head of village council) under the programs "after the first appointment" and "a new state policy".

Every new political leader in the government should be trained till the level when s/he is able to transform political decisions in administrative procedures. Nowadays political decisions in Ukraine are not linked to

NGO activists who have become part of the government do not have experience and skills in state administration

New government will be analyzed based on their capacity to organize reforms

Organization of civil servants training is a key task for the government today

administrative procedure of their implementation since old command-and-control vertical does not function, while democratic one is not created yet.

New government does not have right to fail as it was after the Orange revolution. As well, it does not have right not to understand that, except for political will, reforms also require administrative mechanisms of implementation.

Any reforms in Ukraine will fail not because the government consists of old corrupted officials or inexperienced youth, but because they came to state apparatus which represents remains of Stalin-era command-and-control system. In this situation ministers will either reform command-and-control vertical and transform it in democratic bureaucracy or completely lose.

In the light of these recommendations we should mention a central executive body which has all the levers to achieve new quality of HR policy in the country, but is often overlooked by politicians. It is the National Agency of Ukraine on Civil Service, which is a huge HR department working with all civil servants in Ukraine. It is this institution that has to define the form of training, what categories of governmental employees it should be targeted at, what exams the employees need to pass in order to obtain the next rank etc. Acting Head of this institution is Yulia Kovalevska, appointed in July 2013. There is not a single politician talking about change in management, or, which is even more important, in methods and aims of this Agency. Thus, it casts serious doubts on the capacity of civil service to reform itself.

*National Agency
on Civil Service
should play a
crucial role in
reforming the
system of state
governance*