

#### Inside Ukraine

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#### The Government Policy

The militants' disregard of the Minsk agreements, the concentration of their armed forces along the front line and the need for a symbolic victory on the eve of May 9 indicate an increased likelihood of the deterioration of the situation in Donbas in the coming weeks.

Taking this into consideration, the criticism from military officers who demand changes in the General Staff - namely the optimization of staff, the career advancement of commanders who have distinguished themselves in combat and an improvement in motivation and military discipline in the army -requires an immediate response from the authorities.

At the same time, the competition for the head of the National Anti-Corruption Bureau is about to be completed. Although the selection process was transparent and public, the authorities are now trying to influence the results because they do not consider any of the candidates to be loyal enough. Such approaches undermine the credibility of the Ukrainian authorities among domestic society and foreign partners.

#### The potential for conflict escalation in Donbas



Ukraine continues to adhere to the Minsk agreements unilaterally, while the militants' actions are aimed at simulation rather than the actual withdrawal of heavy weapons. Not only does the capture

of Debaltseve after the ceasefire reflect the militants' deliberate ignoring of the Minsk-2 agree-

Militants simulate the withdrawal of heavy weapons.

ments but also the disregard of provisions including the withdrawal of heavy weapons within 14 days after the ceasefire, the OSCE's inability to use drones to verify the process, the exchange of hostages based on the principle "all for all" within five days after the withdrawal of weapons. According to Petro Poroshenko, as of March 15, 2015, militants have violated the "ceasefire" regime more than 1,100 times.

These factors indicate the probability of an aggravation of the situation in Donbas in the coming weeks. The additional arguments for this scenario are:

• The increase of militant groups along the front line (according to experts' estimates, there are 35-40 thousand militants in Donbas now, of which 10 thousand are Russian militaries);

- The vigorous actions in Mariupol, Donetsk and Luhansk areas (frequent shelling of Shyrokino, Avdiivka and Stanytsia Luhanska);
- The Kremlin's pursuit to raise stakes in the confrontation with the West (a propaganda film "Crimea. Back home", The Kremlin Vladimir Putin's order continues to raise

to put on full combat alert the Northern Fleet and certain units of the Western Military

stakes in the confrontation with the West.

District from March 16, 2015);

• The Kremlin's understanding of the propaganda importance of the 70th anniversary of Victory Day symbolism;

• The improvement of conditions for sabotage operations with the arrival of spring (green forests greatly increased the efficiency of Russian commandos at the beginning of the conflict last year).

The recent attack of pro-Russian militants in Stanytsia Luhanska, Foreign Minister Sergii Lavrov's disapproval of the changes to the law "On special order of local government in certain districts of Donetsk and Luhansk regions" and the statements of the Russian Federation President's Press Secretary Dmytro Peskov that DPR/LPR signal on the failure of the Minsk agreements are other proofs that this scenario is possible.

# Officers demand changes in the General Staff

The possibility of the conflict's escalation and full-scale hostilities again shows the need for the improvement of Ukraine's defense capacity and an analysis of previous mistakes made by the military command of the country. The fact that, during antiterrorist operation (ATO), 65 % of Ukrainian losses

in armored vehicles and 70% of Ukrainian losses in artillery were a result of pockets near Izvarino, Illovaisk and Debaltseve proves that the military command - not the mili-

Most of Ukrainian losses in vehicles and artillery were caused by "pockets".

tary units - is to be blamed. These encirclements led to considerable human losses. Recently, military prosecutors published their conclusions, according to which 360 Ukrainian soldiers died, 180 people were missing and more than 500 were wounded as a result of the Illovaisk pocket. Most of these losses took place on August 29, 2014, when there was an order to retreat through the corridor provided by the Russian troops.

The actions of the General Staff are criticized not only by public experts, but also by combatants. On March 11, 2015, the media published an interview of Colonel Viktor Pokusa, who analyzes mistakes of the command and gives recommendations how to avoid them in future. On March 12, 2015, an address to the

President written by commanders of the units who retreated from Debaltseve was published in the media, in which they wrote about the inaction of headquarters in preparation for this operation.

Major elements of their criticism included the low competence of the General Staff and operational headquarters, insufficient work with human resources, which means

Officers draw attention to the incompetence of the General Staff.

no promotion possibilities for the most talented commanders, a lack of motivation for military men to stay in the army and the sporadic work of military prosecutors that does not ensure discipline in the troops.

Military headquarters continue functioning as if there is no war. They have an excessively large staff, a complicated structure and extremely bureaucratic procedures. Military command does not use intelligence enough, is unaware of the real situation on the front line and often cedes initiative to the separatists.

A complex management system can be explained with high numbers of senior officers who are to be employed at respective positions. AcA complicated management system is explained with excessive numbers of generals in Ukraine.

cording to the army reform supported by the President, there is an initiative to create several more headquarters and increase the number of general-level positions from 121 to 151. Combatants emphasize that the staff of headquarters should be decreased by 3-4 times and all the officers employed there should go through the ATO zone first in order to understand the specific nature of current hostilities. Further, this would revive the soldiers' trust in the General Staff.

Another way to return trust to headquarters and increase their efficiency is through the promotion of commanders who have proved their efficiency in military operations. It is also important to work more with conscripts whose appointment to higher positions is blocked due to the resistance of career officers.

An increase in army size and an improvement in its morale are directly related to increased motivation, including of a financial nature. After a year in the ATO zone many units return home for demobilization. It is necessary to use these officers at least to transfer their experience to new conscripts who have just started their training at the firing ground. Currently the government uses only administrative methods – the presidential administration offered to oblige demobilized people to serve in the military reserve.

The officers have specific recommendations how to improve management in the army. Military

command will show their maturity if they consider such remarks without trying to deny any criticism.

Criticism should be considered, not denied.

## Delay with the appointment of the Head of Anticorruption Bureau

On February 7, 2015, Petro Poroshenko stated that the Head of the National Anticorruption Bureau (NAB) would be appointed within the following week. Since then, six weeks have passed, but no one knows who will head the new agency dealing with the fight against corruption. The problem is that both the President and the Prime Minister lack confidence in the loyalty of the candidates selected by the respective commission.

The competition is the first case in modern Ukrainian history in which candidates for the position of the head of a key state agency were selected by a jury of opinion leaders and the process was public and transparent.

The selection commission consists of nine members, appointed by the President, the government and the Parliament. 200 candidates submitted their application for the call, and 21 people were shortlisted for a public interview with the same set of questions. Out of this number, on March 6, 2015, the selection commission chose 4 candidates for the President to make a final choice. Currently,

these candidates are undertaking a special verification of documents conducted by the Ministry of the Interior, the Ministry

The selection of the NAB Head has reached its final stage. of Justice, the Ministry of Education, the Ministry of Healthcare and the State Fiscal Service.

The commission granted the strongest support to Viktor Chumak, MP from "Bloc of Petro Poroshenko" and deputy head of the anticorruption committee at the Verkhovna Rada (7 votes), Artem Sytnyk, lawyer and former prosecutor from Kirovohrad (6 votes), Mykola Siryi, former deputy head of the State Committee in Entrepreneurship and member of the Ukrainian Association of Lawyers (5 votes), and Yakiv Varichev, lawyer and former investigator at the the Prosecutor-General Office in the times of the USSR (5 votes).

However, over the last two weeks, there were at least two attempts by the Ukrainian officials to influence the competition and broaden the list of candidates presented to the President.

On March 5, 2015, several MPs of "Bloc of Petro Poroshenko" and "People's Front" registered the draft bill No. 2339, under which it was proposed to cancel the age limit for the dismissal of the NAB Head (65 years). It will be considered this week. If it is supported by a parliamentary majority, the competition will be prolonged and new candidates will be able to submit their documents within 14 days. Giovanni Kessler, member of the selection commission, already stated that "attempts of the

Verkhovna Rada to change the rules at the end of the competition threaten the independence of the commission decision".

According to another scenario, out of 4 candidates only one person will be able to pass the special inspection, which is a mere verification of document authenticity. According to anticorruption legislation, the President has to get at least two candidates for a final decision to be made. Thus, the selection commission will have to revise the selection results.

Both for the Ukrainian society and international partners, the selection of the NAB Head is an indicator of whether the Ukrainian government is serious in its intentions to fight corruption. The selection process has

been public and transparent thus far. Any attempts of the officials to manipulate the selection results will breed mistrust in the capacity of the government to implement reforms.

Interference in the selection of the NAB Head undermines trust to Ukrainian officials as regards reforms.

#### **Economic situation**

The IMF decision to provide Ukraine with a loan has had no impact on the FX rate as of yet. However, it may have positive repercussions in a mid-term perspective. For the time being, the hryvnia value is kept at the same level due to the NBU's management of the FX market. However, in the mid-term perspective, the NBU may use the IMF loan for currency interventions, which will satisfy the pent-up demand for FX. The IMF's recommendations on the reforming of Ukraine's financial market in general

and its banking sector in particular are an important aspect of the IMF's financial assistance.

The lack of progress on a comprehensive reforming of "Naftogaz of Ukraine" PJSC adds to instability in the energy market and will eventually result in significant losses suffered by businesses and households. The government has tried to solve gas problems by increasing the fiscal pressure on energy enterprises, reducing the heating season and hiking up tariffs for households.

# The impact of a new IMF bailout program on financial system



Over the last week, FX rates in the interbank FX market have been fluctuating between 22 and 23 UAH/USD. The main reason for the hryvnia's stabilization has been the introduction of rather tough NBU administrative restrictions. The balance between currency demand and supply has been changed

due to banks' inability to purchase currency, exporters' obligations to sell 75% of currency receipts and new changes in the monetary policy.

The main reason for the hryvnia stabilization is NBU administrative restrictions.

In the current situation, importers cannot purchase FX worth more than EUR 25,000 without the regulator's permission. The NBU approved of only a small number of importers' applications, thus increasing excess supply of FX. In fact, FX demand is being artificially held back. It should be noted that owing to the hryvnia's instability and a lack of available alternative objects for storing and saving, foreign currency has become one of the main investment instruments in Ukraine, which accounts for an increased demand for FX. As a result of recent administrative measures, FX surplus was purchased

by the NBU, which replenished its FX reserves by USD 1 bln.

Administrative restrictions may last for three months, starting from the moment of their introduction. However, the NBU's management does not exclude the possibility of the premature lifting of administrative measures provided the FX rate is stabilized, especially in view of the fact that the IMF insists on the temporary nature of the restrictions. In such a situation, it is extremely important to ensure that it is qualitative changes in the structure of supply and demand and the diminution in public anxiety that account for the hryvnia's stabilization instead of exclusively artificial NBU-imposed restrictions on currency demand.

In case administrative restrictions are lifted, the pent-up demand for currency on the part of importers

may lead to a new wave of hryvnia devaluation and capital outflows from Ukraine . In such a

The pent-up demand may cause a new wave of devaluation.

situation, the IMF funds may help keep the situation under the NBU's control; the regulator may intervene in the FX market and prevent a sharp devaluation of the hryvnia. It is noteworthy that out of the USD 5 bln. provided as the first IMF tranche, USD 2.5 bln was used to replenish FX reserves. The provision of new tranches will be contingent upon the results of regular inspections by IMF representatives of the implementation of necessary reforms (the execution of the so-called structural indicators by Ukraine).

Developments in Ukraine's embattled east are an important factor of the hryvnia's value dynamics. The current stabilization in the currency market is also conditioned by a cessation of hostilities in Donbas. In case of their resumption and a large offensive by pro-Russian forces, public anxiety and FX demand may grow and the hryvnia may keep depreciating.

The implementation of IMF requirements may have a positive long-term impact on the development of the banking sector, the restoration of public trust and eventually the hryvnia's stability. In the first place, the IMF expects that the NBU will be more independent from the government, especially as regards the financing of its expenditures. Also, the NBU will have to undergo a significant structural transformation.

One of the key NBU tasks is to step up control of the banking sector . In compliance with IMF requirements, at the beginning of March, a law to

increase the responsibility of the final beneficiaries and banks' top management was adopted. Among other

The NBU should step up control of the banking sector.

provisions, the law stipulated that a sentence of 5 years will be imposed for inflicting insolvency on a financial institution for mercenary reasons (e.g., insider lending). There are doubts as to whether this law can be fully implemented in light of the existing corruption and abuse of office in the financial sector. Changes in banking regulation also provide for a NBU loan register, international financial reporting standards to be adopted by banks by the second half of 2015 and the elaboration of the strategy for state banks supervision by September 2015.

It is expected that major banks will be screened to figure out the necessary amount of extra provisioning and capitalization. The NBU has somewhat relaxed control on banks due to a sharp decline in the hryvnia's value. Taking into account the current level of hryvnia devaluation, the necessary amount for extra capitalization of the Ukrainian banking system may reach around UAH 150-250 bln.

Also, the banking system will see further sanitation of beleaguered financial institutions . The fi-

nancial sanitation procedure will need to be improved at the legal

Further financial sanitation is expected.

level, in particular as regards the restructuring of bad loans, the development of extrajudicial mechanisms and the implementation of a memorandum on the restructuring of FX mortgage loans.

### The salvation of «Naftogaz» as an example of anti-reforms

Despite government's statements on the need to increase the economic efficiency of "Naftogaz" and

the government's international commitments to energy sector reform,

"Naftogaz" reform is again delayed.

the state continues to solve the gas issue by increasing fiscal pressure on energy enterprises, reducing the heating season and imposing higher tariffs for households.

While reporting on the government activities in the energy sector, Energy Minister Volodymyr Demchyshyn focused on the need to lessen gas consumption to reduce expenditure. He expressed his hope that the terms of the so-called "summer" package between the European Commission, Ukraine and Russia would be agreed upon to resolve the issue of gas prices and gas transit. This indicates a situational approach to the settlement of strategic issues as regards the development of the gas sector and energy security.

Instead of restructuring "Naftogaz" under the terms and conditions of the EU Third Energy Package, which includes the removal of the "Naftogaz" monopoly on gas production, transportation and supply as well as the introduction of new approaches to increasing profitability and streamlining corporate management, the government continues to increase financial injections into "Naftogaz" and its international debts.

Revenues from higher tax rates for gas producers and tariffs for households will be the main financial source to compensate for government expenditures. In a time of economic instability and limited capacity to attract loans in the domestic market, this approach is perceived as the best option available,

as both gas producers and households are the most diligent tax payers. Another argument in favor of this decision is an attempt to reduce the income of profitable companies to the

The government solves the problems through raising taxes for gas companies and tariffs – for households.

benefit of the state and fix tariffs at a reasonable price level.

However, small companies are thereby deprived of opportunities to streamline manufacturing and increase gas production, while their foreign investors have no other choice but to consider leaving the Ukrainian market. Due to an increase in rental payments for gas extraction from 20 to 70%, companies such as "Poltava oil and gas company", "Karpatygaz", "Geo-Alliance", "Kub-Gas" and "Burisma" are close to shutting down their businesses. Consequently, the investment environment becomes more unstable and Ukraine loses its business reputation.

The situation with the tariffs is even more complicated. Recently, private incomes have shrunk not only due to lower real wages, the freezing of wages and pensions and high unemployment rates, but also as a result of the hryvnia's devaluation, inflation, the introduction of additional taxes and, finally, a significant increase in tariffs. In 2014 alone, an increase in gas and heating prices for end users amounted to 56% and 40% respectively.

In compliance with IMF requirements, Ukraine must increase the retail gas price for households by an average of 285 % (UAH 3,600 per 1,000 cm and UAH 7,187 per 1,000 cm for the 1st and 2nd categories of consumers, respectively.

tively) and the retail heating price for households by an average of 67% (UAH 625 per Gcal) from April 1, 2015. There are serious doubts about the ability of households to pay such great tariffs in view of the fact that an average salary is equal to UAH 2,000-4,000. This means that there is a high likelihood of amassing debts to public utilities and the underfinancing of "Naftogaz". In this case, subsidies to households may be considered as an indirect financing of "Naftogaz". However, there is a question whether they will suffice to cover the deficit of the company and what source the subsidies may come from.

Despite the critical state of "Naftogaz" reform, Ukraine has promised the IMF to suspend state subsidies to the company only by 2017 and reduce the combined deficit of the public management sector and "Naftogaz" from 10.3% of GDP in 2014 to 7.4% of GDP in 2015 and to 2.6% of GDP by 2018.

In view of these terms, a rapid reforming of "Naftogaz" seems unlikely.

In the updated EU-Ukraine Association Agenda, which was approved on March 16, 2015 by the EU-Ukraine Cooperation Council, Ukraine reaffirmed its commitment to comply with its obligations to the EU in terms of the restructuring of "Naftogaz". In particular, it discusses the adoption of laws on a new regulator in the gas and electricity market as well as the restructuring of state companies based on the provisions of the Third Energy Package.

Today, the lack of progress on a comprehensive reforming of "Naftogaz" increases instability in the energy market and leads to great losses suffered by businesses and the general population. A further delay in the resolution of the key problems of the company threatens the functioning of the gas sector and may lead to a subsequent loss of positions in the sphere of energy security, empty state coffers and reduce social welfare benefits.

Delay with "Naftogaz" reform threatens energy security.

#### **Political Competition**

After the IMF's financial assistance has been received, changes in the Ukrainian government are possible. Arsenii Yatseniuk has an annual immunity from resignation, but in case one of the coalition members leaves the coalition, the Cabinet may incur significant personnel rotations. Petro Poroshenko seeks to strengthen control over the government while some coalition members are interested in increasing their quota in state authorities. The failure to keep to the coalition agreement and the lack of reforms may be seen as formal reasons for the coalition's dissolution. Therefore, the scenarios of internal developments will depend

primarily on the conflict in Donbas and the Prime Minister's actions. In this regard, the option of synchronizing early parliamentary elections with local ones, which are scheduled for October 2015, is discussed in political circles.

The newly formed parliamentary group of Vitalii Khomutynnyk, "Renaissance", intends to compete with "Opposition bloc" for the electoral heritage of the Party of Regions in the south-eastern regions of Ukraine. This parliamentary group is oriented towards Ihor Kolomoiskyi, who strives to diversify his political influence in various regions of Ukraine.

# The preconditions for the government restructuring



Petro Poroshenko has managed to ensure political stability for at least the next three months. Arsenii Yatseniuk's manipulations and threats regarding "People's Front" leaving the ruling coalition will

not be as menacing for the President and "Bloc of Petro Poroshenko". The issue of macroeconomic support from the IMF

Poroshenko has ensured political stability in the near future. has been settled, the hryvnia has stabilized and the truce in Donbas, though fragile, is maintained.

The President is facing a difficult dilemma now: how to increase his political influence in the government without knocking down the fragile "government building"?

The drop of Arsenii Yatseniuk's ratings, the lack of real reforms and the willingness of other coalition partners to increase the number of their rep-

resentatives in the authorities provide objective factors for changes in the government. The explicit military rhetoric of the Prime Minister annoys not only most of the political establishment, but also the public. The President also does not like the fact that the Prime Minister controls the police and access to financial channels as well as tries to influence foreign policy. The information campaign

against Arsenii Yatseniuk regarding the inability of the current government to implement reforms has been launched on one of the central channels.

Domestic political preconditions for restructuring the government.

On March 15, 2015, a congress of the Radical party of Oleh Liashko was held, which questioned the need to stay in the coalition. As a result, it was decided that the party would leave the coalition if the coalition agreement were violated. Such statements are similar to the rhetoric of Yulia Tymoshenko, the leader of "Batkivshchyna", who publicly criticizes the government for the lack of decentralization reforms.

Interestingly, "Bloomberg" presented Natalia Yaresko to the Western world as a promising Ukrainian politician in one of the articles. The candidacy of

Natalia Yaresko is optimal both for the President and the West, which requires guarantees of transparency of the IMF's finances. It is worth mentioning that the Finance Minister has become quite active in HR policy – all deputy ministers have been substituted by people from the business. Obviously, the assignment of a first deputy of "Bloc of Petro Poroshenko", Ihor Kononenko, to the position of Deputy Prime Minister may become the first step to wield the political influence of the President in the government.

It is not clear how Arsenii Yatseniuk will react after the possible coalition collapse – that is, whether he will resign or work until a new coalition is formed. However, the President will have the option of forming a "technocratic government" with-

out politicians. This format of the apolitical government will be the most appropriate under crisis and war.

A technocratic government is the most appropriate option in times of war.

Nevertheless, the most significant factor that will affect the stability of the government is the problem of conflict settlement in Donbas. The further escalation of the conflict and the threat posed by an external enemy could somewhat slow down the competition for power and resources.

## The potential competitors of "Opposition bloc"

The group "Renaissance", which consists of 22 majoritarian members mainly people from Odessa and Kharkiv regions plans to develop the party structure and branches in all regions of Ukraine. In the nearest future, in all the local councils where there are "Renaissance" representatives, there are plans to create separate parliamentary groups that will work on project promotion in the regions.

The party "Renaissance" will play with "Opposition Bloc" on one electoral field in local and parliamentary elections.

The deputy group "Renaissance" is a rival to "Opposition bloc" for the electorate in South and East.

Viktor Ostapchuk, MP, member of the same group and a long-time associate of Vitalii Khomutynnyk, heads this political force. Interestingly, the political party "Renaissance" was registered in 2004. At that time it was headed by former CEO of "Ukrzaliznytsia" Georgii Kyrpa, who died un-

The party "Renaissance" is represented in local councils

der strange circumstances after the second round of the 2004 presidential election. It should be noted that the party had its own parliamentary faction and representation in regional and local councils in 2005. As a result of the 2010 local elections, small deputy groups and factions were created in Kharkiv, Transcarpathian, Zaporizhia, Chernivtsi and Odessa regions. In other regions, small deputy corps are represented in the village and town councils.

Thus, this project still retains agitators and a party network, which is mainly comprised of representatives of railway, automobile trade unions

and other associations of transportation workers. The party plans to hold party congresses and conferences in the near future.

It is forecasted that the group "Renaissance" will get the largest support in Kharkiv and Odessa regions, where the party gained 0.8%-2% of the vote in 2006, 2007 and 2012.

In the 2014 early elections, the co-chairs of the "Renaissance" group Vitalii Khomutynnyk, Valerii Pysarenko and the nominal party leader Viktor Ostapchuk were elected in majoritarian districts in Kharkiv region. Another co-chair of the group, Viktor Bondar, was a chairman of the Dnipropetrovsk Regional State Administration in 2007-2010. During this period, the politician culti-

vated close business and political relations with Ihor Kolomoiskyi.

The future project will focus on Odessa and Kharkiv regions.

Odessa region remains one of the key regions for Ihor Kolomoisky, as his partner Ihor Palytsia is a Head of the regional administration there. Odessa region is represented by the biggest number of influential MPs, among which there are Vitaliy Barvinenko, Vasyl Hulyayev, Anton Kisse and Leonid Klimov. It was Leonid Klimov that actively developed branches of Party of the Regions in Odessa region in 2004-2007. Besides, Yevhen Heller (he used to be head of the budget committee of the parliament and the head of financial control department at Party of the Regions), Anton Yatsenko and Hennadiy Bobov will also take an active part in the new project development. In case of its further institutionalization, the project may be joined by former members of Communist party, Party of the Regions and other supporters of socialist ideas.

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

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