

Ukraine: debt, democracy and division

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Summary

The interim government formed in Kiev this week will need political skill, external support and good fortune if it is to restore stability, hold the country together and satisfy the high hopes for economic and political change. Kiev's choices will be fundamentally shaped by the choices of its neighbours, above all Russia and Vladimir Putin. The current situation is a blow to Putin's standing and a threat to his vision of Russian strategic policy. Kiev, Brussels and Moscow are now likely to be locked in a struggle for Ukraine's future in which bigger tensions between the sweeping ambitions of its neighbours will be as decisive as the decisions of Ukrainians themselves.

As acting Ukrainian President Alexander Turchynov forms his new government in Kiev this week, Russia's President Vladimir Putin must decide his next move. Recent events in Ukraine will concern him in a number of ways. He will worry about instability on Russia's doorstep. He will be deeply concerned at a major reversal for his policy of binding his neighbours into a Russian sphere of economic and political influence. He will be smarting at the apparently easy defeat of his proxy in Viktor Yanukovich and his misreading of the scale of popular Ukrainian anger at the decision to abandon closer ties with the EU. More subtly, he will be conscious of the echo from Russia's own protests in advance of his return as President. But while Putin has clearly suffered a major reversal in Ukraine, he still has cards to play. How he plays them will matter for Ukraine. It will also tell us much about Russia and Moscow's relationship with Europe.

Debt and democracy

Ukraine's future is far from settled. The country faces two voids: one political and one

financial. Presidential elections are planned for 25 May and there is no shortage of political figures eager to fill the gap left by Yanukovich, but most are tarnished, including former Prime Minister Yulia Tymoshenko. It is far from clear that a genuinely unifying figure will emerge from within the protest movement, and if they do whether the country will split east-west politically. [As we noted last September](#), Ukraine is a lot less settled in its European vocation than western media coverage sometimes suggests.

The interim government announced on 26 February and endorsed by the Parliament on Thursday is an attempt to balance competing interests. Maidan activists have been given the culture, healthcare and sports portfolios, as well as a new anti-corruption body. A group close to Tymoshenko have been given the home affairs, energy, welfare, and national security and defence portfolios. The right-wing Svoboda party will be responsible for foreign affairs and the environment. Finance is the only portfolio which has gone to Yanukovich's Party of Regions, with

education and economy filled by apolitical figures. Members of Yanukovych's post-2010 government and oligarchs have been excluded. One notable absence is former boxer Vitaly Klitschko and his UDAR party, who will most likely concentrate on his presidential campaign.

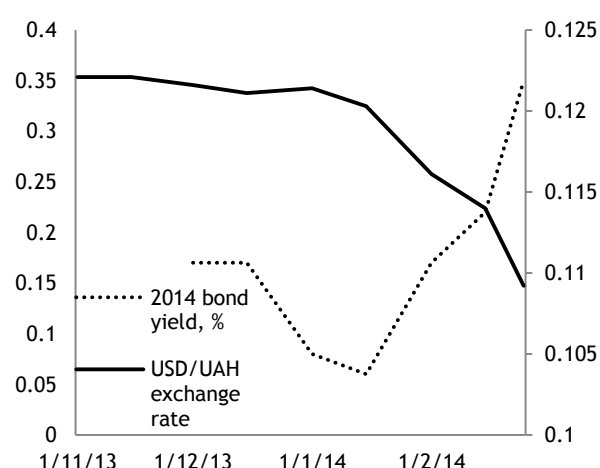


Fig 1: Ukraine 2-year bond yield (LH) and USD/UAH exchange rate (RH)
Source: Bank of Ukraine

The interim government may be short lived, but is important because it will set the terms for the May elections. It must also secure at least some of the external support that is urgently needed if Ukraine is to avoid an economic crisis. The \$15bn loan from Russia agreed at the end of last year has been put on hold, with only \$3bn disbursed. The Ukrainian Finance Ministry this week appealed for \$35bn to cover 'immediate needs'. Ukraine's sovereign bond yield has tripled in the past three months making it difficult for the government to service its \$73bn debt, which has doubled in the last five years. Foreign reserves have been shrinking rapidly and are now thought to be sufficient to cover just two months of imports. The hryvnia has lost 11% of its value since November (Fig 1). With a current account deficit at 8.9% of GDP and reports of depositors taking funds out of Ukrainian banks, the pressure on the hryvnia

has prompted the central bank to impose limits on foreign currency withdrawals.

Ukraine's potential creditors face a dilemma: how much should be promised or handed over now - and with what conditions - before the outcome of the May election is known? The outcome of that election is profoundly uncertain, as are the consequences, especially if Crimean separatists get their way and hold a plebiscite on the future of their peninsula on the same day. The EU will be wary, but will recognise - in a way that it has chosen not to recognise up to now - that taking a risk with its money is probably unavoidable if it is to stabilise Ukraine. There is recognition in Europe that the hardline approach the EU (and Germany in particular) took in November only pushed Yanukovych closer to Moscow.

This means stepping in with short-term support, which Brussels has signalled it intends to do. A Ukraine that wants to sustain a westward facing posture will ultimately also have to strike a new deal with the IMF, which will build on the three loans made since 2008 and which will mean unpopular reforms. These will include cutting gas subsidies, fiscal consolidation, exchange rate flexibility, cleaning up the financial system and structural reforms to improve the business climate. This will inevitably mean squeezing some of the oligarchs. The heady atmosphere of political renewal is going to have an undercurrent of tough choices and fiscal medicine for both rich and poor.

The EU is also likely to re-table the idea of liberalising trade. A Free Trade Agreement with the EU, which would eliminate most tariffs, presents opportunities, but also involves adjustment costs. These would fall disproportionately in the Russian-leaning east and south of the country, as the most

vulnerable and inefficient industries are located there. This requires careful sequencing and investment if the costs and the social consequences are to be manageable. What the oligarchs - largely discredited and with most of them sitting on the fence throughout the crisis - choose to do with their money is important in this context. If they pull out then Ukraine's balance sheet will be considerably weaker.

Putin's move

Moscow will not simply be a bystander as these events unfold. A more westward orientation for Kiev now looks inevitable. But Putin does have cards to play and he will have influence over the outcome. Putin could of course be a force for relative stability and a partner for Washington and Brussels. But if he follows form he is much more likely to see events in zero sum terms. The rapid deterioration of EU-Russia relations over the last five years is part of the reason why so little attempt was made by Brussels to manage Moscow's reaction, should Kiev have chosen in 2013 to sign an Association Agreement with the EU. Unless Russia takes an unprecedentedly constructive approach, already strained EU-Russian relations are only likely to worsen.

Moscow could undermine the new government by disrupting gas exports or Ukrainian imports. Last summer, Russia blocked perishable Ukrainian food imports to Russia just long enough for them to spoil. Other recent import bans included chocolates produced by Petr Poroshenko's Roshen confectionery company - Poroshenko is a known pro-EU advocate - and railway carriages which account for 13% of all Ukrainian exports to Russia. Much of this plays against Putin's professed objective of drawing Ukraine into Russia's long-term economic

orbit, but Putin may simply see it as buying time in the hope that the new government in Kiev will be fractious and fragile and that fresh opportunities for Russian influence will emerge.

A third strategic alternative for Russia is to seek to solidify Russian influence in the east and south of the country, including the Crimea where Russia's Black Sea fleet is stationed. This could take a variety of forms up to and including *de facto* separation. Moscow has not associated itself directly with the groups taking over government buildings in the Crimea this week. But Moscow could signal its solidarity, and at the same time chip away at Kiev's authority, by issuing ethnic Russians with passports, as it did in Georgia in 2008. The renewed call from the Moscow Patriarch this week for three Ukrainian Orthodox churches to unite under the aegis of Russian Orthodox Church is another, more subtle, sign of Russian influence.

The mobilisation of Russian forces along the Crimean border and the seizure of Crimea's airports suggest that full-scale military intervention is a distinct possibility. Belligerence will come with a price for Moscow, which is not to say that it will be ruled out. When Russia invaded Georgia in 2008, the price was ultimately paid not in Russian military *materiel* but in impact on Russia's financial standing. The yield on domestic rouble bonds jumped by 150 basis points and foreign reserves fell over \$16bn in a week alongside a 6% fall in the MICEX. The market reaction *in Russia* to events in Ukraine has so far been modest, but that could change if problems escalate, with Russia likely to feel the brunt of the impact.

What is certain is that Kiev, Brussels and Moscow are now likely to be locked in a struggle for Ukraine's future, in which bigger

tensions between the sweeping ambitions of its neighbours will be as decisive as the decisions of Ukrainians themselves. Europe is solicitous and flattering of Ukraine's desire for reform and democratic renewal, but, at least up to now, has offered limited concrete incentives to Kiev. It is unable, for its own internal reasons, to offer a concrete prospect of EU membership. Russia is binary and anxious of the implications of 'losing' Ukraine to the west along with so much of its former sphere of influence. It is shaped by Putin's own profound anxiety about the destabilising and transformative power of civil unrest. Moscow has some very powerful short-term economic and energy leverage that it is not afraid to use. Putin has played these cards before. History suggests investors and observers should expect him to be prepared to play them again.

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