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INSIDE UKRAINE

**UKRAINE AND NEW
GEOPOLITICAL
REALITIES**

January 26
2017/ #63

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Public policies



1. Ukraine's place in US policy under the administration of Donald Trump

The beginning of Donald Trump's presidency in the USA will become the starting point for a new world order that may significantly change the rules of international cooperation and Ukraine's place in it. The absence of Ukraine in the foreign policy program of the new White House's head raises three possible scenarios in respect to our country. The international position of Ukraine to a great extent depends on whether Kyiv will manage to find new points of convergence with Washington and present a plan for the peaceful settlement of the «Ukrainian crisis».

The policy of the 45th US President Donald Trump concerning Ukraine became the leading issue in the social and political discourse of Ukraine since the victory of the Republican in the presidential election in November 2016. However, this tough debate may be resolved only after there is a general understanding of US foreign policy in the new geopolitical cycle.

The victory of the candidate positioning himself as an anti-system politician demonstrates a

crisis of traditional American political culture. In particular, the policies of liberalism and globalization, in which the United States have played a leading role for a quarter century, no longer meet the needs of most American citizens. Brexit, as well as growing popularity of nationalist parties in Europe, are additional indicators for the public demand in the reduction of the interdependence in the world.

The victory of Trump evidences of a new geopolitical cycle in the world politics.

As a result, we may assume that **US policy in respect to Ukraine during the administration of Trump will be determined by the following factors:**

1. Interests of American citizens, business and political elite, as well as other US policy actors. In particular, the administration of Trump will be mainly focused on the issues of internal policy, i.e. the return of the production base to the USA, the creation of new job opportunities and the increase of the domestic consumption market. US foreign policy will be mostly subordinated to domestic needs. Consequently, after Trump's victory, global politics will acquire more and more features of protectionism and anti-globalism;

2. Positioning of power centers in world politics.

According to Trump's pre-election statements, US foreign policy priorities will include competition with China, the fight against terrorism and the strengthening of the nuclear nonproliferation regime. These particular issues may result in the loss of US global leadership in the long run. The strategy of retrenchment will provide for a reduction of costs allocated by the USA to its military-political alliances, forcing allies to take greater responsibility for their own security. In addition, the business approach of Trump's team would mean that the USA will maintain more pragmatic relations with allies and rivals following the formula «quid pro quo» (a favour for a favour);



3. The policy of Russia and leading EU member states.

While our country is absent in the list of priorities of Trump's foreign policy program, US relations with EU countries and Russia will still affect the interests of Ukraine to some extent. Thus, recent criticism of Trump towards EU and NATO policies show a crisis in transatlantic partnership. As a consequence, weakening of the unity of the West threatens to decrease support for Ukraine in the conflict with Russia. In turn, the ambiguous statements of the newly elected US president toward Russia raise the question of whether Washington will remain a key partner of Kyiv in counteracting Russian aggression.

Trump's policy may complicate the international position of Ukraine.

4. The current state of US-Ukrainian relations.

Apart from sanctions against Russia, Ukrainian-American relations are still being determined by the instruments that were established under the presidency of Bill Clinton and George W. Bush,

including the Budapest Memorandum signed in 1994 and the United States-Ukraine Charter on Strategic Partnership signed in 2008. As of end of 2016 the main areas of bilateral relations concerned counteracting Russian aggression, strengthening democracy in Ukraine and cooperating in the defense and security fields as well as energy security in Europe;

5. Contacts of the Ukrainian elite with the administration of Trump.

The Ukrainian political elite effectively counted on the victory of Hillary Clinton and did not develop communication with the ultimate winner of the presidential elections. In addition, the lofty rhetoric of certain Ukrainian politicians may seriously harm the development of bilateral relations after Trump's victory. The scandal involving the head of Trump's electoral headquarters Paul Manafort may also be taken into consideration when building relations between Washington and Kyiv.

Ukraine's leaders staked on the victory of Hillary Clinton.

6. **Force Majeure.** The escalation of the conflict in Donbas or another international crisis in Eastern Europe could change the US approach to relations with Russia and Ukraine, accumulated during the presidency of Trump.

Donald Trump is the second US president in a row whose doctrine does not contain Ukrainian-US relations as a separate area of foreign policy. This shows a devaluation of Ukraine's role in the global strategy of the USA due to Washington's unjustified expectations of Kyiv, the availability of more reliable partners in the region and the emergence of more dangerous challenges in other parts of the world.

Trump's rise to power opens up a wide range of possible scenarios for the development of the international situation concerning Ukraine, which will be primarily determined by the ratio of interest in the US Republican Party.

However, the aforementioned factors allow us to determine the three most probable scenarios in the USA-Ukraine-Russia triangle: the "big deal", confrontation and freeze.

First scenario: the «big deal»

If Trump's administration manages to come to an agreement with the Kremlin, the normalization of American-Russian relations will be reached at the expense of Ukraine's interests. The requirements of the Russian side for such a normalization may include: recognition by the US of annexation of Crimea; refusal of military and political support to Ukraine; the abolition or limitation of anti-Russian sanctions. Requirements from the US side may include: reduction of Russian military presence along the eastern flank of NATO; closer coordination in the fight against terrorism in the Middle East; the withdrawal of troops from Donbas or the reduction of its nuclear potential.

Big deal contradicts Ukrainian national security

This means that Ukraine is actually returning to the sphere of influence of Russia and the US has finally lost interest in the «Ukrainian crisis». Notwithstanding the mutual benefits from such a deal, it will be difficult for Washington and Moscow to implement it in practice. Firstly, the sides can hardly reach an agreement regarding the equivalence of exchange requirements. Secondly, this scenario creates a risk for the destabilization of Ukraine due to the unfavourable conditions of the crisis settlement imposed by external actors.



Second scenario: confrontation

The aggravation of the US-Russian confrontation may occur for many reasons. In this scenario, Russia could be ready to apply tough measures varying from the renovation of full-scale hostilities in Donbas to new cyber-attacks

against the US and the EU. In turn, the USA could impose new sanctions towards Russia, provide Ukraine with lethal weapons and strengthen conventional military forces and its nuclear arsenal. At the same time, the US would remain outside the conflict and would not take part in its settlement, shifting the responsibility for European security to its allies in Europe. The USA has a good chance to win in "the endurance race" with Russia, although the US may face a certain international isolation due to the unwillingness of the majority of European states to maintain confrontation.

Ukraine will incur great losses for the US-Russia confrontation.

In this case, the biggest losses would be felt by Ukraine, whose chances of survival would depend on how Kyiv could succeed in mobilizing national resources in the short term, accelerating reforms and finding external support.

Third scenario: freeze of the «Ukrainian crisis»

There might be an alternative scenario if the USA and Russia do not reach an agreement concerning Ukraine, although they both will realize that the temporary freezing of the current conflict might be more acceptable than further confrontation. In this case, the Crimea and Donbas problems will remain unsolved, anti-Russian sanctions will remain in force and the US will refrain from providing Ukraine with lethal weapons. The «Ukrainian crisis» will be put aside from international policy and will not be an obstacle for cooperation between the US and Russia in respect to solving other international security issues

For the moment freeze of the "Ukrainian crisis" is convenient for all players.

In the short term prospective, this option may be suitable for all players: the USA would save significant recourses from confrontation against Russia, the EU would be satisfied with limited Ukrainian instability and Russia would have limited intervention in the conflict and would use Ukrainian economic and politic failures for propaganda purposes. Such a scenario may open certain opportunities for Ukraine,

although Kyiv will have to count only on Ukrainian resources in strengthening national security and creating a competitive economy. This scenario may play the role of the «test of maturity» for the Ukrainian state.

Trump is expected to encourage Ukraine to review its foreign policy.

In summary, the presidency of Trump will force Ukraine to radically reconsider its foreign policy, taking into account that the world is now entering a new geopolitical cycle. The vulnerability of Ukraine will increase if Kyiv's foreign policy continues to be guided by out-of-date policies. In order to strengthen the international position of Ukraine, it is necessary to take a proactive stance in relations with the

USA and other centers of influence. In particular, Kyiv should offer new fields of cooperation with Washington that would meet mutual interests in the current circumstances and would be based on the principle of «quid pro quo» (a favour for a favour). In addition, Kyiv should offer a comprehensive settlement plan for the «Ukrainian crisis» as soon as possible before the US, Russia and other players reach agreements behind Ukraine's back.

Economic analysis



1.1. The risks of the nationalization of PrivatBank

At the end of December 2016, the biggest private bank in Ukraine was nationalized. The PrivatBank transition to state ownership has raised a number of critical issues. The key questions are whether the change of ownership will disrupt the financial system and rate jumps in particular, how effective the state as an owner will be and what will happen to deposits of the bank's 20 million customers.

Not only PrivatBank, but also virtually all banks have recognized a need for recapitalization and the quality of loan portfolio over the past three years. The problems are due both to objective factors – the economic crisis and the recent sharp devaluation of the hryvnia – but also subjective ones – failures and the deliberate abuse of banks' top management and owners. The size of the bank and its significance for the whole country are unique for Ukraine, which explains the scale of the problem. There are

more than 20 million customers who have over 150 billion UAH in the bank.

There are more than 20 million customers who have over 150 billion UAH in PrivatBank

The social aspect of the problem should not be overlooked – 3.2 million pensioners, more than 500,000 students and 1.6 million socially vulnerable households use PrivatBank. In addition, PrivatBank is most likely the main bank for small and medium-sized enterprises. 500,000 individual entrepreneurs and 600,000 enterprises of different ownership forms and sizes have their accounts in the bank.

The bank broke the norms of reserve requirements for almost a year, and debt arrears on stabilization loans amounted to 14 billion UAH. The regulator demanded that PrivatBank provide additional collateral for corporate loans but the bank's management would not. The early promulgation of a new version of the Memorandum of Cooperation of the

Government with the IMF, which discussed the possible nationalization of the bank system, became an additional reason for a probable change of ownership. Although the bank was not mentioned, there were no doubts about its name.

The NBU regularly prolonged the terms of recapitalization, but the shareholders and management failed to complete the task and therefore talks about the possibility of nationalization started. Key participants played their cards close to their chest until the last moment – the bank's management denied the possibility of nationalization and justified all the announcements about the nationalization by the information war against the bank. NBU representatives insisted on the fact that any information about a bank was banking secrecy. Despite assurances from the bank representatives and the regulator, citizens began to withdraw money from their accounts. More than 2 billion UAH was withdrawn through ATMs a few days before the nationalization.

More than 2 billion UAH was withdrawn through ATMs a few days before the nationalization

During this period, there were frequent problems with PrivatBank payment cards. As a result, late in the evening on December 18, the decision to nationalize PrivatBank was made.



The decision to nationalize PrivatBank rather than liquidate it (which happened to most

commercial banks that fail to meet the conditions of the regulator) is a forced but logical solution. However, such a decision may pose a number of systemic risks to the financial system. Among positive aspects is the fact that credit risks of PrivatBank declined sharply due to the nationalization – the state gives 100% guarantee to depositors now. To demonstrate the reliability of the new state-owned bank, the Ministry of Finance even declared its intention to transfer its employees' salary projects to PrivatBank. .

The decision to nationalize PrivatBank is a forced but a logical solution.

It is unlikely that the liquidation was seriously considered given the importance of the bank for the financial system of Ukraine and a keen interest from the international community. It is no wonder that immediately after the announcement of the nationalization there were a lot of congratulations from government officials and international organizations on successful solution to a complex problem.

The risks and issues of nationalization

- *The stability of the financial system*

There is considerable public concern about the likelihood of another collapse of the financial system or the sharp devaluation of the hryvnia in the next six months because of PrivatBank issues. The government has assured that the bank will continue to operate normally, and the NBU has enough tools to monitor the situation in the financial market.

Currency fluctuations had psychological grounds and were caused by a mounting panic among the population.

However, these claims have not secured the Ukrainian currency market against currency fluctuations in the short term.

Fluctuations had psychological grounds and were caused by a mounting panic among the population.

- *Accountability of perpetrators*

It is of critical importance that a thorough investigation is conducted to hold people accountable for withdrawing nearly 5 billion USD from the most systemically important bank. According to experts' estimates, loans to related parties amount to 90% of the loan portfolio of legal entities. Obviously, transferring the bank to state ownership, the shareholders reached certain agreements with the government, and therefore the settlement of the issue will largely depend on the political will of the leadership of the country and specific arrangements.



Another problem lies in finding resources to tackle capital shortages caused by the imprudent policy of management and owners of the largest private bank in Ukraine, as well as by failures of the regulator. It has been decided that the Ministry of Finance will issue bonds that the NBU will buy to replenish the bank's capital.

The government plans to allocate 148 billion UAH for the recapitalization of the bank.

In total, the government plans to allocate 148 billion UAH for the recapitalization of the bank. In fact, the burden will fall on all taxpayers in Ukraine who will be forced to pay a few thousand hryvnia for the previous PrivatBank management and owner's activities as well as the inefficiency of the

state.

- *The prerequisites for devaluation*

The NBU believes that issuing bonds will not have a dramatic impact either on the hryvnia or the level of inflation. The probability that the issued funds will go to the secondary market is insignificant because most of them will stay in the capital of PrivatBank for paying off debts. In addition, the process of capital injections in the bank will take place in phases and over a period of a few years.

The NBU believes that recapitalization will not have a dramatic impact either on the hryvnia or the level of inflation.

Spreading panic may threaten the exchange rate, which in turn will lead to the fall of hryvnia. Comprehensive communication should confront negative expectations in society. Unfortunately, as previous experience shows, communication is not within the competence of the banking regulator. However, panic will subside when the technical disruption during the transition period minimizes and NBU experts and former management start working smoothly and efficiently.

Comprehensive communication of the NBU should confront negative expectations in society.

A "peaceful" solution to the situation between the main shareholder and the government benefits the situation, as the management declares an apparent readiness to cooperate with the NBU in transition. The IMF's avid interest in the situation is essential since it strongly supports the nationalization.

- *The state's effectiveness as an owner*

Experts believe that the state is an ineffective owner. The customers of the state OshchadBank will agree because they often complain about the quality of service. As regards PrivatBank, there

is a chance that the state will not remain its owner for a long time – nationalization conditions include the further privatization of the financial institution after the improvement of its financial condition. The EBRD expressed interest in a potential asset. However, the chances for the privatization of the nationalized PrivatBank are not high given how privatization programs are carried out in Ukraine.

The growth of the state's share in the banking market threatens competition.

Another risk that the nationalization of PrivatBank faces is the growth of the state's share in the banking market, which threatens competition and creates the preconditions for a super-state bank that will finance questionable projects for interest groups, which will be able to control decision-making in the bank.

2.1. The probability of IMF tranche for Ukraine

There is a strong probability that Ukraine will receive the next tranche of the IMF loan at the beginning of February. Both the head of the NBU and the Minister of Ukraine have made statements about that. The final agreement on the terms of tranche will be reached in the coming weeks, and the IMF is holding consultations with the authorities. If a sensible decision on the loan is made, the mission will recommend that the IMF Boards allocate another tranche. However, despite this optimistic forecast, Ukraine hardly completed the structural benchmarks laid down by the program.

The most notable achievements in the period of the last tranche were the adoption of the budget for 2017 and the nationalization of PrivatBank, which was one of the IMF conditions. According to recently released information, the IMF memorandum and possible conditions for its revision determine

the feasible fundamental requirements:

The IMF requirements can be updated

1. **Subsidy adjustment and its monetization**, which implies that customers should receive money for saving resources.

2. **Pension reform** – the Parliament will approve legislation relevant to: the gradual adjustment of the statutory retirement age; further reduction of the scope requirements for early retirement; review of the eligibility criteria for the minimum pension; consolidation of pension legislation and application of a single principle without pension privileges for any profession (exception for the military); expansion of the base for the social security contributions; equitable tax treatment of pensions; better link between the income and the contributions, and encouragement to declare actual incomes.

3. **Land reform**, which will be difficult to carry out due to a moratorium until 2018.

4. **Audit of PrivatBank and implementation of the restructuring plan.**

5. **A single register of social benefits**, which will contribute to their revision

6. **Anti-corruption courts**

7. **Privatization** – the 2017 budget again foresees the sum of 17 million UAH from privatization but the task is challenging considering the situation with the Odessa Port Plant.

There are 2 scenarios for further cooperation between Ukraine and the IMF:

There are 2 scenarios for further cooperation with the IMF

1. **Optimistic** – the IMF will offer concessions and Ukraine will receive the next tranche of 1 billion USD in February 2017. Ukraine will

continue to meet structural benchmarks, and there will be a chance to get 3 more tranches in 2017 – 1.9 billion USD in May, 1.3 billion USD in August, and 1.3 billion USD in November. It is an unlikely scenario because meeting most of the structural benchmarks entails political risks due to populist decisions in the government.

2. Pessimistic – most of the structural benchmarks will not be met and others will be delayed. Hence the situation of 2016 may

recur (Ukraine received only one tranche of 1 billion USD). IMF loans do not only provide support for international reserves and external payments but also serve as an important indicator of the country's stability for other potential investors. If Ukraine does not fulfil all the commitments under the IMF arrangement, the next loans will not be granted, which may discourage cooperation with other donors.



Political competition



1. Political attitudes among Ukrainian oligarchs

The domestic political agenda in Ukraine The domestic political agenda in Ukraine continues to depend on the international geopolitical situation. The main political players are waiting for the first steps towards Ukraine from the new US administration in order to adjust their activities in accordance with the new geopolitical realities.

At the same time, the Ukrainian government and opposition realize that within at least two months, it will be clear whether a «big geopolitical deal» between Washington and Moscow will be concluded and whether the “Ukrainian issue” will be a part of the negotiation menu between Russia and the United States. That is why the political players in Ukraine will make maximum efforts to strengthen their political positions and demonstrate themselves as a negotiable partner to Russia and the West.

The main trends of the Ukrainian oligarchy in 2017 will be as follows:

1. Actual formation of an oligarchic consensus on restoration and normalization of economic and business relations with Russia.

2. Interest in conducting early parliamentary elections without changes to the electoral legislation.

3. Search for an alternative candidate, who will be able to perform the functions of a political arbiter after the end of Petro Poroshenko's term.

4. Review of the access and consolidation of resources around Poroshenko and his entourage.

5. Significant reduction of the resource base and rental incomes of monopolies among «old oligarchs».

6. Fragmentation of oligarchic alliances and disintegration of traditional interest groups (gas, coal, agricultural, energy, etc.) in Ukrainian politics.

The proposal of Ukrainian oligarch Victor Pinchuk to review the foreign policy of Ukraine and relations with Russia caused a stormy discussion in expert and political circles in Ukraine. After the publication of his article in the WSJ, Viktor Pinchuk tried to position himself in the West, but primarily before Poroshenko, as a possible negotiation channel between Kyiv

and Washington.

Viktor Pinchuk positions himself as a potential negotiator with the West and Russia

Therefore, the authorities continue to closely monitor the expert discussion and reaction of the Ukrainian society regarding the statements, which are contrary to the official position of the President.

Rinat Akhmetov and Dmytro Firtash also advocate the restoration of economic relations with Russia, but due to objective reasons, they cannot carry out informal or political pressure on the power.

Oligarchic groups of Akhmetov and Firtash are fragmented

The war in Donbas, drop in world commodity prices and removal of these oligarchs' companies from state monopolies significantly reduced their political influence. Moreover, Petro Poroshenko directly negotiates with businessmen and politicians from the "gas" or "coal" groups of interests. The President's policy thus contributes to the further collapse and fragmentation of the groups "Firtash-Lyovochkin" and "Akhmetov-Novinskyi". It should be noted that the existence of economic contradictions between the groups of Akhmetov and Firtash made the political project "Opposition bloc" plunge into a political crisis and to the verge of collapse.

There is a situational political neutrality observed in the relations between Poroshenko and Kolomoiskyi.

Kolomoiskyi and Poroshenko concluded a situational political neutrality

Despite the fact that the channel «1+1» received a continued broadcasting license from the government, the political implications from «Privatbank» nationalization may occur in the spring.

Kolomoiskyi monitors the political situation and at any convenient moment can mobilize his political assets, which are primarily right-wing and radical parties.

The group of political hawks "Turchynov-Avakov", which is also oriented towards Kolomoiskyi, systematically advocates radical decisions on the districts of Donetsk and Luhansk regions and continuation of the war with Russia. Recently, the leader of the «NC» Andriy Biletskyi even accused the National Guard leadership of separatism and corruption. Despite the fact that the



National Guard is a structure of the Interior Ministry, its political leadership is appointed by the President. That is why the Biletskyi's statements are nothing but a direct accusation against the President of military troubles and failures.

Andriy Biletskyi accused the National Guard leadership, appointed by president, of separatism and corruption

In turn, Poroshenko has no political allies and in his activities counts on his closest business entourage, security forces and bureaucracy apparatus. The vast majority of other oligarchs do not like the political strengthening and concentration of power in the hands of Poroshenko, who also serves as the political arbiter and president and who, at the same time, wants to be the only oligarch.

Big agricultural businessmen, grain traders and regional latifundists, who are shareholders of the political project

«Agrarian Party”, are the most organized politically. Despite the fact that the Agrarian Party is a project affiliated with Bankova street, it demonstrates an active party building.

Thus, under the present circumstances, all oligarchs seek early parliamentary elections that would change the balance of powers.

The authorities should approve new electoral legislation

In this context, the course of Trump's administration towards Ukraine will be a determining factor. If the West and Russia agree on Syria and Ukraine, the incumbent Ukrainian parliament will probably be unable to perform the necessary political decisions. In this case, Poroshenko will face a dangerous dilemma: to dissolve the parliament as a result of the Russian-American pressure, including financial one, or to fulfil the requirement of political hawks and to start regaining control over certain areas of Donetsk and Luhansk regions by military means.

Given the fact that there is no legal coalition in the parliament, there are possible risks that in 2017, early parliamentary elections can be launched that is not in favour only to the People's front. However, if the current rules of the game and electoral legislation are preserved, the parliament will not be rebooted qualitatively. The authorities should elaborate and approve the new electoral code which will make a political competition more transparent and fair.

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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The project is implemented with
the support of the Embassy of
Switzerland in Ukraine

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