



THE PBN COMPANY

REGIONAL INSIGHT. GLOBAL IMPACT.



Ukraine's Coalition Countdown and the Foreign Policy Backdrop

Policy Matters: September 2008

EXECUTIVE SUMMARY

Prime Minister Yulia Tymoshenko and Ukraine's Parliament have until October 3 to form a new ruling coalition or face possible dismissal by President Viktor Yushchenko, which would trigger another snap parliamentary election. Back-room deals are currently focused on two potential configurations. The first is a grand coalition between the Yulia Tymoshenko Bloc (BYuT) and the Party of Regions led by former Prime Minister Viktor Yanukovich, which would command a constitutional majority that could directly challenge the rule of President Yushchenko and slow down Ukraine's integration with Euro-Atlantic institutions, while stabilizing relations with Russia. The second is an expanded pro-Western coalition that includes the Bloc of Volodymyr Lytvyn, which would allow key legislation to be passed, but would not directly challenge Yushchenko's constitutional powers and keep Ukraine on its pro-Western track. If talks break down and snap elections are called, December 21 appears to be a likely poll date.

Ukraine's internal political strife is causing problems for President Yushchenko's Euro-Atlantic international agenda. While WTO and EU relations seem on track, the NATO membership road map seems no closer than it was earlier this year, despite strong American support. Geopolitical tensions between Russia and the West are forcing European politicians to temper their Ukrainian-integration rhetoric.

Ukraine's unstable political environment and stalled economic reforms have led to an overheated economy. Macroeconomic policies remain hostage to populist government spending programs. Ukraine's inflation rate surged to 30% in April and remains the highest in Europe. The stock market, which was one of the world's best performers in 2007, has been labeled 2008's worst performer. Despite attracting almost \$7 billion in foreign direct investment during the first half of 2008, a sudden halt in foreign capital inflows is expected, which will adversely impact the banking and key export industries. Ukraine's business community and the burgeoning middle class are feeling the global credit crisis firsthand and preparing for frugal times ahead.

USA



EUROPE



RUSSIA



UKRAINE



KAZAKHSTAN

DOMESTIC POLITICS: COALITION SCENARIOS

THE GEORGIAN STRAW

The August conflict between Georgia and Russia was the straw that broke the back of Ukraine's ruling pro-Western coalition earlier this month. The pro-presidential Our Ukraine-People's Self Defense Bloc lobbied for a parliamentary resolution condemning Russia's invasion of Georgia. The Yulia Tymoshenko Bloc (BYuT) sought a more balanced position toward Russia, using as a basis the resolution adopted by the European Union. Months of tense relations between coalition partners reached a peak over the summer when both sides accused the other of betraying national interests. When the two partners could not agree on the Georgia resolution's wording, Tymoshenko reacted angrily with an end-run against Yushchenko by siding with the Party of Regions on constitutional amendments to limit presidential powers. That move led the Our Ukraine Bloc to officially end its coalition partnership with BYuT.

Ukrainian politicians are concurrently playing out three political scenarios, each of which has its separate political benefits and costs. One is expected to emerge during the coming days to lead Ukraine out of the current political stalemate.

SCENARIO 1: A TYMOSHENKO-YANUKOVYCH COALITION

Analysts argue that a marriage of convenience between former foes and ideological opponents Tymoshenko and Yanukovich is quite possible. In this coalition Yanukovich could be named parliamentary speaker, while Tymoshenko would retain the Prime Minister's post. More important, a BYuT-Regions coalition would control a constitutional majority of 331 seats in a 450-seat parliament, which would allow it to pass amendments to Ukraine's Constitution that could destabilize the current balance of political power and change Ukraine's foreign policy course. Experts forecast this coalition would be able to take the following steps:

- Amend the Constitution and curtail its democratic principles including abolishing the current balance of powers between the President and Parliament in favor of the latter;
- Impeach President Yushchenko, a step advocated by the Communist Party;
- Dismiss the President's appointed Foreign and Defense Ministers, thereby significantly curtailing Ukraine's pro-European and pro-NATO policy in favor of more conciliatory positions vis-à-vis Russia;
- Raise the 3% threshold for parliamentary elections, which would likely lead to a two-party system and preserve the coalition's control over political levers in the near term.

A coalition between Tymoshenko and Yanukovich would also have economic repercussions: both leaders personally advocate principles of a command economy and have a mixed reputation among Ukraine's large exporters and financial industrial groups. This coalition may

accelerate privatization and the redistribution of remaining state assets among those business interests that finance their political parties.

However, four major obstacles stand in the way of this coalition's longevity. First, a political union of former enemies would result in heavy electoral losses for both Tymoshenko and Yanukovich, which would hinder their presidential ambitions. Second, a grand coalition would isolate liberals in both camps, which would accelerate internal political opposition, leading both parties to splinter and eventually cause the President to call for new parliamentary elections. Third, the coalition may find power sharing difficult – especially as there is only one Prime Minister's seat, and both Tymoshenko and Yanukovich see themselves as heads of government. Finally, Yanukovich and his allies distrust Tymoshenko and believe she will likely deceive them in the future in pursuit of her own presidential ambitions.

SCENARIO 2: FORTIFYING THE DEMOCRATIC COALITION

Former Rada Speaker Volodymyr Lytvyn controls 20 “centrist” MPs and positions his bloc as the peacemaker in a conflict-ridden Parliament. In the past, both Yushchenko and Tymoshenko have favored Lytvyn's entry into a coalition, but at different times were unable to close the deal. Media reports indicate Yushchenko is likely to bless a new coalition with Lytvyn, but only if Tymoshenko rescinds her party's September 2 vote for constitutional amendments that limit presidential powers. If the triumvirate coalition materializes, Volodymyr Lytvyn could regain the speaker's seat and stabilize the group by guaranteeing 248 votes to pass key legislation such as the state budget and other reforms. However, a new union between Yushchenko and Tymoshenko would require concessions that neither side has yet begun to offer.

SCENARIO 3: SNAP ELECTIONS

President Yushchenko has again regained the political initiative in Ukraine by forcing Parliament to either form a new coalition or again face voters, the third time in as many years. In their public rhetoric, both the Party of Regions and BYuT oppose snap elections and have called on politicians to preserve stability in Ukraine for the sake of socioeconomic reforms that have yet to be passed in Parliament.

However, Yushchenko's resolve to call snap parliamentary elections may result in further marginalization of his own Our Ukraine Bloc. Going into a snap election, opinion polls show the Party of Regions and BYuT tied at 23-24% in their public support. Meanwhile, Our Ukraine, the Lytvyn Bloc and the Communists are all above the 3% threshold but remain firmly in single digits. More than 20% of voters remain undecided.

Polls show Yushchenko's potential allies could increase their support among an electorate that has grown weary of the three-way conversation in Ukrainian politics that has held economic reforms hostage to the naked ambitions of Ukraine's top three political leaders. Polls show current Rada Speaker Arseniy Yatseniuk and former Defense Minister Anatoliy Grytsenko have the highest potential voter support if they were to form a new political party. National Security and Defense Council Secretary Raisa Bohatyreva, who has the support of Rinat Akhmetov,

Ukraine's wealthiest businessman, also appeals to Ukraine's middle class with liberal economic views. Moreover, the president's allies in the Our Ukraine Party, United Center Party, and various national-democratic parties continue to appeal to western Ukrainian voters who have soured on Tymoshenko due to her tempered reaction to the Russian-Georgian crisis.

Whatever the outcome of the current political crisis, Ukraine's politicians will continue to group themselves around the three leading candidates for the 2010 presidential campaign. Opinion polls show that Tymoshenko and Yanukovych stand nearly equal chances of being elected President (25% and 24.6%, respectively) if the election were held today. Incumbent President Yushchenko trails in third place with 16.2% support. Yushchenko is using the tense geopolitical environment between Russia and the West as a defining moment for Ukraine's domestic policy and international relations. Portraying Tymoshenko and Yanukovych as pro-Russian politicians who do not have Ukraine's national security interests in mind, Yushchenko could potentially boost his popularity by positioning himself as the only politician who firmly defends Ukraine's European aspirations and integration agenda.

FOREIGN POLICY: INSTITUTIONS AND EAST-WEST TENSIONS

UKRAINE AND GEORGIA

The Russian-Georgian military conflict has provoked a deep political crisis in Ukraine, revealing a divide between the President and Prime Minister and precipitating the fracturing of the country's ruling coalition.

From the first days of the Georgian conflict, Yushchenko expressed his unequivocal support for Georgia and President Mikhail Saakashvili. Yushchenko saw Russia's military intervention in Georgia as a threat to Ukraine's territorial integrity and protested against the possible involvement of Russia's Black Sea Fleet, stationed in Ukrainian territory in Crimea. He issued a decree demanding that the fleet give 72 hours notice before moving its vessels.

Tymoshenko avoided open confrontation and criticism of Russia's actions against Georgia while acknowledging that "Georgia's territorial integrity and sovereignty should be respected." Tymoshenko explained her neutrality as an attempt to avoid dragging Ukraine into a conflict with Russia. She delayed implementing Yushchenko's decree on 72-hour notice for Russian vessel movements from Ukraine's Black Sea ports. Many analysts concluded she was hoping to cultivate Moscow's support for a presidential bid in 2010.

Casting Tymoshenko's impartiality as disregard for Ukraine's national interests, Yushchenko demanded that Tymoshenko's Rada faction support a parliamentary resolution sharply condemning Moscow for its actions in Georgia. The pro-Yushchenko Our Ukraine-People's Self Defense faction issued an ultimatum to Tymoshenko, demanding her party support the Georgia resolution or quit the coalition.

During its September 2 opening session, the Verkhovna Rada examined seven resolutions related to the Georgia-Russia conflict, ranging from condemnation of Russia's aggression against Georgia (submitted by Our Ukraine), to disapproval of aggression from both sides (submitted by Tymoshenko's faction), and recognition of North Ossetia's and Abkhazia's independence (submitted by Yanukovich's Party of Regions). Although the votes on all seven resolutions failed, they revealed the democratic coalition's inability to reach a unified position on the conflict.

Surprisingly, however, the war in Georgia also exposed divisions within the Party of Regions, specifically between the Yanukovich-led group and Akhmetov-led wing of pragmatic businessmen. A prominent party member and Akhmetov ally, National Security and Defense Council Secretary Raisa Bohatryova, issued a statement in support of Georgia's sovereignty, after which Yanukovich expelled her from the party.

UKRAINE-EU SUMMIT

On September 9, President Yushchenko, French President Nicholas Sarkozy and EU President Jose-Manuel Barroso met in Paris to ink an historic "Association Agreement" between Ukraine and the European Union. While the accord stops short of promising EU membership to Ukraine, it does signal a new era in relations between Brussels and Kyiv, and is similar to the association agreements signed with East European countries and the Baltic States before they became member-states of the European Union.

A major achievement for Ukraine, the EU-Ukraine Association Agreement will create a Free Trade Area between the parties. The EU is by far the largest foreign investor in Ukraine, while Ukraine is the EU's 16th largest trading partner and the 13th largest export market for European goods. The dialogue on a long-term visa-free regime for short-stay travel between the EU and Ukraine is likely to be signed in 2009.

Energy cooperation remains a joint strategic interest between the EU and Ukraine, with the latter making commitments to Brussels on enhancing gas-sector reforms including modernization of its gas transit system. And the Euro 2012 Football Championship Finals has been viewed as additional impetus for investment flows into the Ukrainian economy, and in particular, the development of infrastructure projects throughout the country.

UKRAINE AND NATO

April's NATO Summit in Bucharest declared support for eventual membership of Ukraine and Georgia in the alliance, though the Membership Action Plan (MAP) was offered to neither. Kyiv and Tbilisi are looking to December's NATO Ministerial in Brussels as another opportunity, particularly in view of the Russian incursions into Georgian territory in August. However, Germany and France have both continued to weigh their positions against the effects such a move would have on relations with Russia.

The fall of Ukraine's pro-Western ruling coalition prompted foreign experts to argue that internal divisions among the country's leadership will decrease the likelihood of a MAP offer to Ukraine in December. During his September 5 visit to Ukraine, U.S. Vice President Dick Cheney stated that the Bucharest decision remains unchanged for Ukraine and Georgia, but added that Ukraine's best hope to overcome external threats is "to be united domestically first and foremost." U.S. Senator Richard Lugar, the Ranking Republican on the Senate Foreign Relations Committee, visited Kyiv on the eve of Cheney's visit and also called on the President and Prime Minister to smooth out their differences and work together, as the current turmoil is used by some as justification that Ukraine is not ready for a MAP.

President Yushchenko is attempting to convince Ukraine's foreign partners that a decision on Ukraine's MAP should be made based on the security threat in the region posed by Russia and not based on Ukraine's political instability, which he stresses is indicative of the country's democratic development. During his September 4 meeting with G7 ambassadors, Yushchenko described the process of NATO membership as a "two-way street," meaning it is not only in Ukraine's interest but also in Europe's interest to broaden the zone of Euro-Atlantic peace and security.

UKRAINE-RUSSIA RELATIONS

Relations between Kyiv and Moscow appear to be at a new low point. Ukraine's uncompromising position on Euro-Atlantic integration, strong criticism of Russia's military conflict with Georgia and disputes over the Russian Black Sea Fleet's involvement in the conflict have strained official relations. In moving closer to Euro-Atlantic security structures, Ukraine also wants to begin immediate negotiations with the Kremlin on removing Russia's Black Sea Fleet from Ukrainian territory by 2017. Russian Foreign Minister Sergei Lavrov has called Ukraine's actions "unfriendly toward Russia" and accused the country's leadership of supplying arms to Georgia and forcing NATO membership on a population that opposes the alliance. To further complicate matters, a Ukraine-Russia Friendship Treaty expires on October 1, 2008, and neither side has moved to extend the accord.

Tense bilateral relations have also affected Ukraine's internal political dynamics. Yushchenko accused Tymoshenko of betraying national security interests by soft-pedaling the Rada resolution condemning Russian aggression in Georgia. He referred to Tymoshenko's actions on filling the Odesa-Brody pipeline with Caspian crude en route to Europe and the cancellation of numerous Black Sea hydrocarbon exploration projects as policies pursued on Moscow's behalf that run counter to Ukraine's attempts to diversify its energy resources. In turn, Tymoshenko called Yushchenko's anti-Russian rhetoric "hysteria."

Against this backdrop, Ukraine and Russia are in the midst of negotiating Russian natural gas prices for 2009. While Foreign Minister Lavrov has promised the cost of Russian gas for Ukraine will double from \$170/bcm to \$340/bcm, Tymoshenko hopes her political ties to the Kremlin will help lower the price. Oleh Dubyna, her appointed head of Ukraine's state-run oil and gas monopoly Naftogaz Ukrainy, has offered not to raise gas transport costs through

Ukraine to Europe in exchange for a more favorable price. He has also offered Gazprom access to oil and gas fields in the Black Sea, the licenses for which are currently held by American and European investors.

Russian leaders have also announced the possibility of trade sanctions against Ukrainian imports such as sugar, milk and other dairy products. While these measures would hurt Ukrainian farmers who rely on exports to Russia, they would also force Ukrainian exporters to seek new trading partners and decrease longer-term dependence on the Russian market. In the short run, such a move would not be received favorably by Ukraine's WTO negotiators, who could block Russia's accession to the global trading body.

CONCLUSION

This final week of September is an eventful one for Ukraine's domestic politics and foreign relations. President Yushchenko begins the week with talks in Washington with U.S. President George Bush as well as congressional and business leaders, and then travels to London and Rome for bilateral meetings. Prime Minister Yulia Tymoshenko travels to Moscow to meet with Russian Prime Minister Vladimir Putin to discuss gas prices for 2009. In Kyiv, parliamentarians scramble to piece together a ruling coalition by October 3 or face potential dismissal from the President and a call for new elections. Yushchenko has hinted he will give parliamentarians the time they need if the makings of a coalition coincide with his international security and domestic policy priorities. He could also let the Rada discredit itself further in the eyes of voters by not immediately calling for snap elections. This would unnerve an already frantic Tymoshenko and also give smaller political parties the time needed to prepare for a future election challenge, which could possibly alter the current stalemate among Ukraine's ruling political elite.

FOR QUESTIONS OR MORE INFORMATION, PLEASE CONTACT:

Myron Wasyluk (Kyiv)

Senior Vice President
Tel: +38.044.270.7240
myron.wasyluk@pbnco.com

Blake Marshall (Washington)

Senior Vice President
Tel: +1.202.466.6210
blake.marshall@pbnco.com

ABOUT THE PBN COMPANY

The PBN Company is the leading strategic communications consultancy specializing in Russia, Ukraine and other CIS markets. The firm's Government Relations practice performs a variety of services for Western and CIS corporate clients, including: strategy development and implementation; advocacy and lobbying; political monitoring and analysis; issue campaigns; conflict resolution and crisis communications; public affairs positioning; and internal GR capacity building.

PBN's clients include international corporations such as Arcelor-Mittal, Bank of New York Mellon, BP, Bristol-Myers Squibb, Citigroup, Dell, Deutsche Bank, Enel, Merrill Lynch, Motorola, Pepsi, Telenor, and Xerox. CIS clients include Basic Element, Dixy, Ferrexpo AG, Lukoil, MMK, MTS-UMC, Renaissance Capital, Rolf Group of Companies, Rosneft, Sberbank, and Ukraine's Export-Import Bank.