

Ukraine: the election and after

30 April 2014

Summary

The election to choose a new Ukrainian president is scheduled for 25 May. Instability in the country's east means it is not yet certain that the vote will take place at all. The election is a crucial test for post-revolution Kiev, which needs to produce an administration capable of representing all parts of the country, delivering a painful reform agenda and presenting a united front to Moscow. But there are powerful internal and external forces agitating against this.

Ukraine is scheduled to go to the polls on 25 May to choose a new president. The outcome of that election remains hard to call, not least because instability in the east of Ukraine may yet derail it altogether. The election is a crucial test for post-revolution Kiev, which needs to produce an administration capable of representing all parts of the country, delivering a painful reform agenda and presenting a united front to Moscow. But there are powerful internal and external forces agitating against this.

What is certain is that the two leading presidential candidates both have chequered pasts. The front-runner Petro Poroshenko, a successful businessman, has become both a vocal advocate of integration with the European Union and a funder and defender of the Maidan demonstrators. As a former foreign minister and leading public figure under both Viktor Yushchenko and Viktor Yanukovich he is, however, not untainted by the previous regimes. Nevertheless, with backing from the popular boxer turned politician Vitaly Klitchko and polls currently indicating that he may secure up to 40% of votes across the country - and even 18% in the south east where the current Kiev elite are

out of favour - securing the 50% plus one vote he needs to win the election in the first round is not unachievable.

His main challenger may have been in jail, but she was never out of politics. Yulia Tymoshenko knows both that she has ground to make up and that she is damaged goods. The lukewarm reception she received from the Maidan on the day she was released from prison in February had a profound effect on her. Nevertheless, she appears to have lost none of her influence and is said to be the guiding hand of many of the decisions made by the acting President Alexander Turchinov. She maintains that she has always performed better at the voting booth than in opinion polls in part because her support is strong among rural voters who are hard to poll. If she does pull off a surprise victory, her next challenge will be to convince her international counterparts to take her seriously.

After the elections

Whoever wins in May - assuming the election takes place - it is hard to overstate the challenge of reform and stabilisation that

faces Kiev even without the destabilising effect of Russian agitation. Ukraine is a fiscal disaster and the immediate focus of both key creditors like the IMF and the technocratic government led by Prime Minister Arseniy Yatseniuk has been on measures to reform both spending and revenues. Immediate IMF funding of \$18bn, with a further \$9bn to follow from other sources in May will be required to meet debt repayments. Unsurprisingly, the IMF has tied these funds to commitments to sharply cut energy subsidies and float the hryvnia.

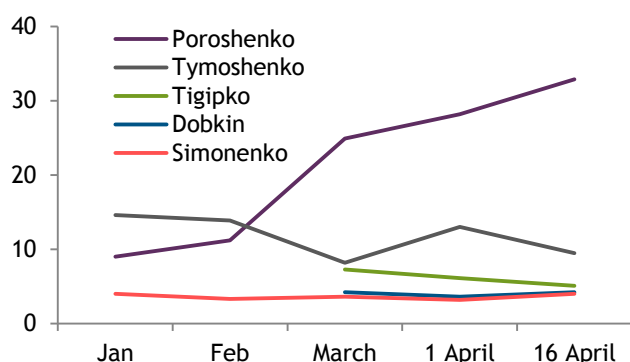


Fig 1: Polls for five leading presidential candidates (%)
Source: SOCIS, RATING, KIIS, Razumkov Centre

Then there is the corruption problem. The technocrats now running the country estimate that Yanukovich oversaw the extraction of up to \$70bn from the country's coffers for private benefit. When presenting his new public procurement law to parliament Yatseniuk claimed that 40% of the state's annual \$25bn budget had been skimmed by public officials. To put this in context, Ukraine's current budget deficit is \$6bn, yet Yatseniuk's law passed by just a single vote.

It is assumed that Yatseniuk will be retained in office by both the current presidential front-runners and he will have little choice but to move on to even more painful measures. The big questions are how 'deep'

will be the reforms the IMF insists on and how Ukraine's population receives them.

In the immediate term there are two sets of measures likely to happen quickly after the election. The first is tax reform. Despite having a flat rate for income tax like neighbouring Russia, Belarus, Poland and Romania, the Ukrainian corporate tax code is fiendishly complicated with at least 28 different taxes, a global record according to the World Bank. Yatseniuk will seek to harmonise tax rates and take measures to improve collection, which is currently predictably poor.

The second is land reform. Ukraine has a third of the globe's highly fertile black soil and has immense potential as a grain and cereal exporter. Fulfilling this potential is however hampered as although investment in agriculture is open to foreigners, land ownership is not and agriculture's share in total FDI in Ukraine is marginal - less than 2%.

Energy poses an equally knotty problem. Ukraine's Soviet-era housing is some of the least energy efficient in Europe. Energy price subsidies have been costing 7% of GDP with households paying only a fifth of the actual import price of gas. The country is heavily dependent on gas imports for power and heating, with up to two-thirds of this coming directly from Russia.

Like a number of its Black Sea neighbours, Kiev has ambitions to translate its shale gas discoveries into greater energy security. Ukraine's 2030 energy strategy - published in 2012 - estimated the country's shale reserves at as much as 5-8 trillion cubic metres (tcm), although US Energy Information Administration in 2013 gave a more conservative estimate of 3.6 tcm. However, this is a medium term solution at best as the

industrial extraction cannot start until after early 2020s.

More immediately the problem is that the Russians have cancelled previous rebates and demanded a rise in the price of imported gas of over \$200 per thousand cubic metres - almost doubling the \$268 per thousand cubic metres paid before the Crimean annexation. Decision-makers in Kiev appear resigned to this although they have negotiated hard with Moscow on price. They will be looking to the EU and others to help settle the unpaid bills from Gazprom which have brought threats from Russia to cut off supply.

However, the Ukrainians know that it is now inevitable that they will have to wean themselves off total dependence on Russian gas. Progress on establishing interconnectivity with Ukraine's European neighbours will significantly improve the country's bargaining hand with Russia. This week has seen a start made with the Slovaks agreeing to 'reverse flow' on a pipeline between the two countries. Although the Slovaks were initially reluctant they agreed following significant engagement by the European Commission as well as the US. Commission President José Manuel Barroso blessed the deal with a visit to Bratislava. Work will need to progress rapidly to help Ukraine replenish the gas in its considerable storage ahead of next winter.

Holding onto the East and the oligarchs

Hanging over these policy problems is the bigger question of whether Ukraine will achieve anything approaching political normalisation after 25 May. Most of the demonstrators may have left the Maidan, but the tented village is still a fixture and the memorials to those who lost their lives are becoming as permanent as the barricades of rubble and tyres. Those remaining on the

Maidan say they will leave once they are satisfied with the result of the presidential elections.

Yet the pro-Russian nationalists who have taken over government buildings in Donetsk are doing their best to ensure that the poll does not even take place. It is also said that Tymoshenko might welcome a delay in the poll, giving her more time to re-establish herself and rebuild her political base. For Kiev, ensuring that parts of the east do not reject the new political settlement is clearly the big political problem.

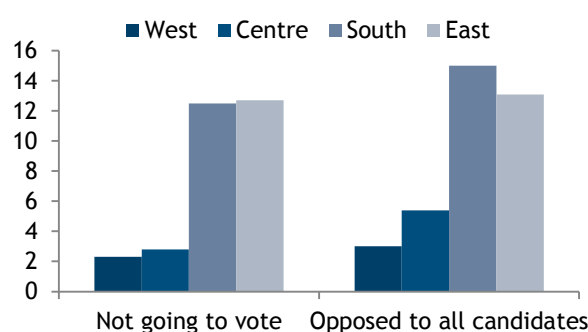


Fig 2: Presidential elections voting intentions (%)
Source: SOCIS, RATING, KIIS, Razumkov Centre

The new government recognises explicitly that it failed to engage with the population in the east of Ukraine when they took office - a combination of exhaustion and miscalculation rather than intent they say. This error has been partly corrected, with recent visits by Yatseniuk and Economic Development and Trade Minister Pavlo Sheremeta - a smart American-educated academic turned technocrat - who held town meetings in a number of eastern Ukrainian cities in March and April. The challenge for the new president will be to convince the eastern regions and their large industrial employers that the pain of the economic reforms will be worth it. The new government will need to include some high profile eastern Ukrainian

faces if its writ is going to run effectively in places like Donetsk.

Establishing stability will also be critical in projecting a united front to Moscow. If the presidential elections are held with a strong turnout from across the country - and especially if a candidate secures the required 50% of the vote to win in the first round - then the new president will be able to establish their legitimacy. In addition, if the new government can simultaneously dial down its anti-Russian rhetoric and put greater distance between the new government and the less progressive activists who made an impact at the Maidan, then Moscow will have less opportunity to take offence. However, should Right Sector and Svoboda - the two far-right parties who have been the principal targets of Russian propaganda - perform well in the elections, it will make it difficult to remove all of the ministerial portfolios they secured when the Maidan was still smouldering.

The large oligarch groups will also be important in stabilising the new administration. They know that reform of their sectors is now inevitable and in the broad national interest. But they also know that reduced subsidies and increased taxes are going to eat into their margins. The collapsing currency provides a silver lining for exporters but problems for Ukrainian corporates and banks that holding more than \$100bn in debt, about half of which is dollar-denominated. With the oligarchy a major employer, winning over this group of powerful individuals to change will be a crucial challenge.

Overall it is far too early to speak of political and policy normalisation in Ukraine. While the odds are that the election on 25 May will take place, there are powerful internal and external forces in Ukraine with an interest in ensuring that it signals anything other than a new phase of stability. Even if a strong government is elected and even if its reformist credentials are clear, the sheer scale of the fiscal and structural reform challenge in Ukraine is daunting.

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