

3rd Ukraine Reality Check (Policy Review)

Ukraine After Riga: Small Steps Instead of Big Promises

Non - Paper, April – May 2015

The third Ukraine Reality Check took place on 16th of April 2015 in Riga, Latvia and was organised by the Eastern Europe Studies Centre (Lithuania) in cooperation with the Centre for Eastern Studies (Poland), the Centre for Euro-Atlantic Integration and Democracy (Hungary), and the Central European Policy Institute (Slovakia), in close cooperation with the Latvian Presidency of the EU and with the support of the International Visegrad Fund and the European Endowment for Democracy. The meeting gathered top Ukrainian and Western analysts, observers, and practitioners to discuss the latest political, security, and socio-economic developments in Ukraine and provide evidence-based analysis and policy advice. Previous Reality Check meetings were held under the auspices of the Lithuanian Presidency of the EU in Kyiv in June 2013 and October 2014. Non-papers are available at [EESC](#) and at [CEPI](#) websites.

Summary of Conclusions

More than a year after Maidan, and six months since the formation of a new so-called unity government in Kyiv, some positive news are coming from Ukraine: political legitimacy and central authority have been strengthened, civil society is highly engaged in governing, and some steps towards “de-oligarchization” are being taken.

Inclusion of external actors, such as the direct military involvement of Russia, but also political, economic, and (to a lesser extent) security support from the West, remain crucial factors influencing developments on the ground. Kyiv believes the second Minsk agreement has put Ukraine into a worse situation than it had been after the first round of talks. The contact line between government forces and the separatists is being formed amid ongoing skirmishes and shootouts. Most importantly, neither Ukraine nor Russia have shown willingness to provide economic and financial aid to Donbas, even after Minsk II it remains a crucial element if the conflict is to be frozen and life in the region is to return to a modicum of normality. It appears that the main fight between Russia and Ukraine is over who *should not* have the „separatists“ parts of Donbas. It is mostly on external actors to push both sides to limit violence, allowing more intrusive OSCE inspections, and further encourage the political process.

Ukraine’s main challenge remains corruption and the urgent need to implement reforms. Under the current circumstances, Ukraine can be seen as performing better than expected. Yet concrete reform efforts correlate with the desire to secure re-election votes, as well as continued rent-seeking mechanisms. This leads towards an ambivalent situation where the government wastes precious time touting populist measures, while the society is becoming increasingly radicalized (among other factors) due to lack of reforms.

It seems that the Ukrainian political elites will carry out reforms as long as these don’t disrupt their own core political and economic interests. For many Ukraine watchers this is reminiscent of the situation after the Orange Revolution, this time with more far-reaching consequences both locally and globally.

Policy Recommendations

The unwillingness to implement the Minsk agreements’ political dimension is rather clear on both (local) sides and this should be the main focus of external actors. Beefing up the OSCE capacity may be key in order to ensure proper monitoring and conflict prevention – yet this does not mean only an increase in numbers and equipment, but to allow unimpeded access for the monitors. In order to move forward with the political

dimension, representatives that can speak with a degree of legitimacy on behalf of Donbas should be found and included in on-going talks. This is unlikely to be possible without an inclusive election.

Noting that it will take years to bring Ukraine closer to the European norms and standards, the European Union needs to help maintain a pro-European spirit of the Ukrainian society – an uphill challenge given the economic and security challenges the country faces. But Ukraine should take more concrete small steps toward European integration instead of pushing for big promises and believing that membership is a panacea. Focusing on the technical process instead of constantly pushing for unity would gain more supporters across the EU. Example: the EU can't lift the visa regime until technical requirements are met by the Ukrainian side.

Instead of demanding a Marshall Plan from the West, the Ukrainian government needs to concentrate more on domestic reforms and proceed with implementation of the Association Agreement and DCFTA with the EU. Ukrainian businesses' reluctance or even resistance to switch to new standard is also an important and often overlooked factor. Reform communication should be taken much more seriously given that it is still largely missing.

Although the EU's efforts in Ukraine are challenged by Russian rhetoric (and propaganda) which is questioning Europe's ability to help Ukraine - the real challenge is Ukraine's weak capacity and lack of political will. This can be addressed by more visible European involvement and assistance in areas where citizens feel a direct impact on their lives, such as improving the business environment for investors and SMEs, reforming the education and healthcare system, etc.

However, any further direct economic aid to Ukraine's government in addition to the IMF rescue package should continue to be conditioned by the delivery of key reforms, particularly focusing on widespread corruption in the judiciary sector.

Undoubtedly the greatest motivation to reform lies within Ukraine's civil society, not its vast bureaucracy. Yet, the main issue of state is not the number of bureaucrats, but their attention (individual interest) and efficiency (serving citizens' interests). On the other hand, Ukraine cannot make reforms without bureaucrats; therefore the key is for the state management and administration to be reformed, streamlined, and have its expertise/capacity built so the bureaucrats can work more efficiently and engage outside stakeholders such as civil society or interest-based groups.

The EU should consider improving coordination among its mechanisms, institutions, and member states. Communication is also hampered by the (cacophony of) "statements diplomacy", while it is increasingly unclear who is speaking on behalf of the EU when it comes to Ukraine.

Corruption remains the major obstacle to reforms. New laws on party funding and media ownership can improve electoral processes but the key steps that need to be taken are decentralization as well as constitutional and judicial reform. The role of oligarchs in Ukraine is unlikely to be eliminated in the near future – but there should be a clear ambition to make the business environment and their role in it more transparent, while their monopolies targeted by improving investment climate and rule of law.

The EU's sanctions against Russia need to be commensurate to the aggression demonstrated. Lifting the sanctions seems pre-mature if Russia continues to support separatists in Donbas, refuses to withdraw its military forces from Ukrainian territory.

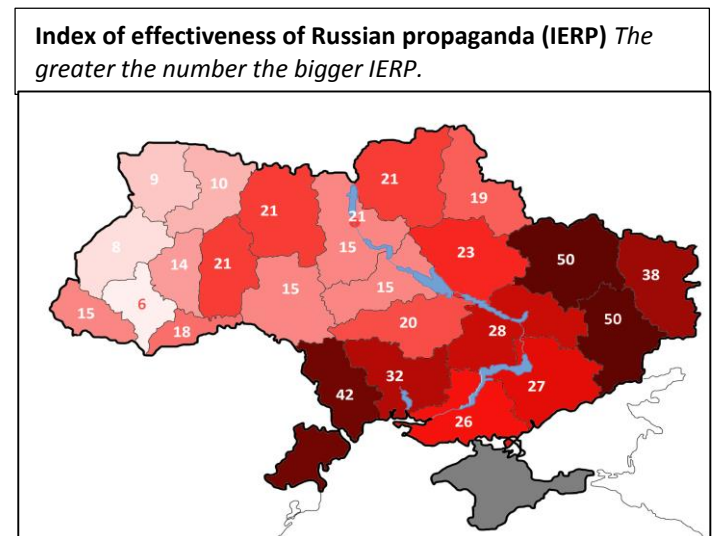
Public Perceptions: Propaganda Sensitive

The Ukrainian crisis has created many misconceptions including the one about the inter-ethnic nature of the conflict in Donbas. This was exploited by Russian media to justify Russia's military support for separatist forces. Instead of being centred on the language or ethnicity elements, the events in eastern Ukraine were an identity crisis at the best. They were, more realistically, a conflict of educated elites vs. masses or urban

vs. rural population; or simply a discontent of local elites with the policies of the post-Maidan government in Kyiv.

The results of public opinion surveys by Kyiv International Institute of Sociology (KIIS) reveal a shift of public attitude towards independence of Ukraine. After annexation of Crimea only 3 percent of respondents expressed preference for the unitary state between Ukraine and Russia. This is a significant change, given that between Ukraine’s independence in 1991 and 2013, public support for a common Ukrainian-Russian state had been growing, with the exception of the wars in Chechnya and Georgia. In 2012-2013, 33 percent of Crimean respondents wanted to unite Ukraine and Russia into one state. In Luhansk and Donetsk the numbers were 37 and 28 percent respectively. According to February 2015 data, support for unification decreased to 10 percent in Ukraine’s East, 4 percent in the South, 1 percent in the West, and no support in the Central Ukraine.

While the public opinion shift benefits Ukraine, it also exposes the fact that the society can be easily influenced propaganda. Another survey by KISS confirms that this is especially the case in the regions of eastern and southern Ukraine, which are predominantly Russian speaking and traditionally vote for pro-Russian politicians and parties.



Minsk Agreements: Damned if you comply, damned if you don't

The Minsk agreements are the only ones to carry formal signatures of all conflicting parties, including representatives of the self-proclaimed “Donetsk People’s Republic” (DNR) and “Luhansk People’s Republic” (LNR). According to February-March 2015 data by KIIS, 74 percent of Ukrainians approve of these agreements. In Donbas, both rebel-held areas and Ukrainian-controlled territories support the Minsk solution of the conflict, with 83 percent in favour and 8 percent against. However, the implementation is lost “in translation” mostly because both parties – Ukraine and separatist forces backed by Russia – follow a different interpretation of the sequence of provisions.

Moscow is annoyed by Kyiv’s hesitation to implement the political provisions of the agreement and restore economic ties with “DNR” and “LNR”. Kyiv’s assessment that it has been asked to make more concessions under Minsk II is one of the key issues contributing to violations of ceasefire and Ukraine’s hesitant implementation. Instead of focusing on the political dimension, Kyiv (correctly) emphasizes and prioritizes the removal of Russian fighters and weaponry from Ukrainian territory, which Moscow is unwilling to do so till Kyiv complies with political process. Based on the Minsk agreements Moscow is likely to be seen as the

winner in the short term: the promise of war (escalation) may make the West lean on Kyiv, while limited escalation can put pressure on Ukraine to move forward with political process.

In the summer there is expected to be an intensification of military actions from the separatists' side and further Russian attempts to destabilise Kyiv. It might not be in Russia's interest for Ukraine to collapse, but enabling a more pro-Russian government in Kyiv is part of Moscow's designs. An early parliamentary elections, rumoured lately in Kyiv, may be seen as a step for most actors out of the deadlock around the Minsk agreements as well as the result of the limited space for reforms and the subsequent economic recovery.

Tracking Reforms

Ukraine and its political elite continue balancing between two contradicting programs: the program of Maidan, which calls for a more direct democracy, rule of law, and reducing the role of state, and the program of war, which requires security, and military reform. In addition to its inability to prioritize, the leadership is also being criticised for its lack of long-term strategies. For example, stopping social payments to Donbass is likely to be a result of financial shortage, not of strategic consideration. As a result, while a deliberate longer-term strategy is missing, it is de facto being formed by tactical and piecemeal steps the government takes if and when required.

While there is a consensus between the three power centres – the President, the Parliament, and the Cabinet – a shortage of unifying political leadership is evident. President Poroshenko and Prime Minister Yastenyuk have learned a lesson from their predecessors and do not publicly expose disagreements. However, they are already caught up in a cycle of upcoming elections and future political ambitions. By underestimating society's willingness to tighten its belts – 10 percent of population is ready to suffer for as long as needed and 33 percent for another year – the government is losing the momentum for reforms, thereby actually lowering their re-election chances. Currently three parliamentary parties – Petro Poroshenko Bloc, Samopomich and Batkivschyna – continue to enjoy public support, while Yatsenyuk's People's Front is suffering from a drop in support.

Instead of avoiding reform-related stress, the government needs to adjust its communication, especially with the most sensitive part of Ukraine – rural areas, where people are struggling to provide for basic needs and are living in a survival mode. If the need for and implications of reforms were communicated properly, for example, people could see what exactly the increased tax rates are being used for and their patience could be sustained longer – otherwise the risk of further radicalization and a popular backlash against the government measures continues to grow.

Economic Trends

Ukraine's economy has been put on a life support by the latest IMF programme. In 2014, Ukraine's financing gap was estimated for \$21.5 billion; currently it is estimated that this gap will nearly double to \$40 billion in 2017. This increase comes primarily from revised assumptions about Ukraine's own sources of funding and reduced expectations of the FDI or the ability to regain market access until 2018.

The IMF is now endorsing the idea of debt restructuring to narrow this financing gap. Therefore, the latest program is a combination of a bailout and a bail-in, or, essentially, a default. The \$40 billion financing gap will

partly be covered by the \$17.5 billion and \$7.2 billion provided by international donors as a bailout, while the remaining \$15.3 billion is a “soft default”.

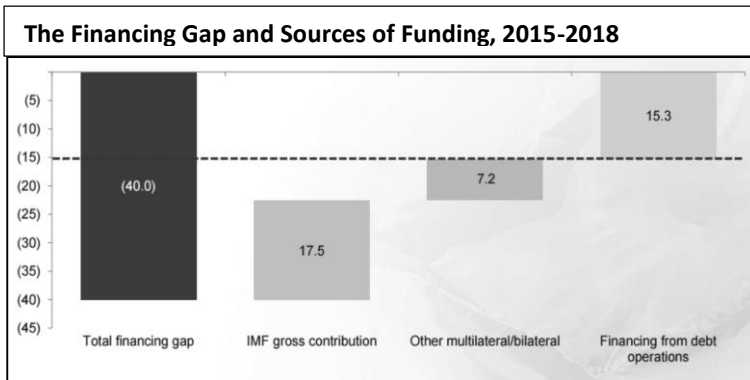
The success of the IMF program will depend on multiple factors: Ukraine’s ability to raise \$15,3 billion from debt restructuring, military stability in Donbas, growth of GDP, and the ability to meet fiscal targets. The latter appear somewhat

optimistic: in the first quarter of 2015 Ukraine GDP shrank 17.6 per cent year on year. The estimated budget deficit is also based on conservative estimates of bank recapitalization and defence and security spending.

Some, rare, optimistic voices such as Yuri Gorodnichenko at an Atlantic Council` paper pointed out that Ukraine`s economy has a potential of recovery based on a stable currency and fiscal position (central and local governments had a fiscal surplus in the first quarter of 2015), realistic domestic gas price, stabilizing inflation and pace of reforms. However, real signs of economic recovery will include regaining of market access, FDI inflow, and improvement of the country’s credit rating, which is among the bottom three in the world, together with Venezuela and Argentina.

Currently around 85 percent of businesses are not satisfied with the current investment climate in Ukraine. Among their main concerns are regressive currency regulation, devaluation of currency, unclear policies of the National Bank of Ukraine, tax authorities’ pressure, introduction of the additional import duty, unclear government strategy, and lack of professionals at the middle level. Deregulation, fighting corruption, executing tax and judicial reforms, and stabilizing the financial market could improve the environment for investment.

The public mood regarding economic revival of Ukraine is rather pessimistic. Based on a March 2015 survey by KISS, 64 percent of Ukrainians think that situation will only worsen within next year and only a bit over 10 percent hope for improvement. However, from a long-term perspective, 42.2 percent believe that the situation will get better in the next five years and 23.4 percent think that it will worsen. The most pessimistic voices are in Southern and Eastern Ukraine, particularly in Donbas.



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