Orange Reunion

Tymoshenko takes charge

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Who Gets What:
Distribution of Posts
In the New Coalition

Tymoshenko Bloc

Cabinet leadership:
Prime Minister
Minister of the Cabinet

Parliament leadership:
First Deputy Speaker

Ministries:
Finance; Economy; Energy; Agriculture; Coal; Construction; Health; Emergencies; Culture

Other state agencies:
State Property Fund

Our Ukraine

Cabinet leadership:
Deputy Prime Minister for Regional Politics

Parliament leadership:
Speaker

Ministries:
Internal Affairs; Justice; Industry; Labor and Social Affairs; Family, Youth and Sport

Other state agencies:
Antimonopoly Committee

Socialists

Cabinet leadership:
First Deputy Prime Minister

Parliament leadership:
Ombudsman for Human Rights

Ministries:
Ecology, Education, Transport

President

Ministries: Defense, Foreign Affairs

Other state agencies:
General Prosecutor, SBU, Armed Forces

The formation of an "Orange" coalition and the pending return of Yulia Tymoshenko at the head of a new government sets a course of western-oriented reforms for the year ahead. With the political landscape changed by her growing popularity, her second term should be more productive and less populist than her first. With steel prices recovered from last year's slump, the economy should be able to absorb higher gas prices and still post moderate growth.

After months of topsy-turvy negotiations, the three parties that led the 2004 Orange Revolution have finally committed to reuniting in a new ruling coalition. It was a pivotal decision which sets the course for Ukraine for the year ahead. Faced with the intensifying geopolitical rivalry between the West and Russia, Ukraine is practically forced to choose sides. The decision is to go West.

This is a very positive outcome, as Ukraine's long-term interests are clearly in reforming its economy according to western models and integrating into the common European market. If opponents of the Orange Revolution had been brought back to power, it would have given the impression that Ukraine was having second thoughts about its recent western-oriented course. Much of the pressure on the EU to open its markets and on Ukraine to carry through with reforms would have dissipated.

The coalition has agreed on a detailed reform program that goes much farther than anything the last two governments promised. With a little voting discipline, World Trade Organization membership could be achieved by the end of this year.

However, the investment community is understandably skeptical of the new coalition and of Yulia Tymoshenko, who will return as prime minister. After last year's experience, when the market's high hopes for Tymoshenko's first government were largely disappointed, the market's attitude this time around will be "we'll believe it when we see it".

Meanwhile the economy is proving its resilience. It has always been evident to those of us living here that the economy was healthier than the low GDP figures reported since early last year. Now May's monthly y-o-y GDP figure has come in at 8.5%, and we have to caution that it could be slightly overstated.

The crucial economic problem for the past year was the slump in the steel industry, which was pushed into recession by last year's drop in global demand and took further hits from last year's "re-privatization" affair and from the winter gas price increase and gas shortages. Now the industry is recovering on the back of a rebound of world prices.

The main challenge of the new government will be its relationship with Vladimir Putin's administration in Russia. Putin will of course be disappointed that the pro-Russian Regions party was not brought into government. Although he has nothing against Tymoshenko personally as he does not see her as an ardent nationalist, he will resent her and President Viktor Yushchenko's continued pro-western direction. There will be further tough negotiations ahead on gas supplies and we still expect another price increase before the end of the year.

Don’t assume Tymoshenko won’t last

At first glance, the new coalition looks almost exactly the same as the troubled coalition that was formed with such fanfare in February 2005 and collapsed so pathetically only seven months later. Tymoshenko will return as prime minister. Petro Poroshenko, who last year was national security adviser, will be speaker of parliament. Last year he and she spent most of their time sniping at each other until President Yushchenko couldn’t stand it anymore and sacked both of them. Tymoshenko’s and Poroshenko’s mutual hatred is as strong as ever. So their new coalition could like an effort to put Humpty Dumpty back together again.

And yet very much has changed since last year. Last year’s rivalry was driven largely by the competition for position in the current parliament. Now that is done and the next election on the schedule, the next presidential vote, isn’t due until late 2009.

Whereas last year’s government served at the president’s pleasure, this year’s coalition government will be supported by a revised constitution that greatly bolsters the powers of the cabinet and the parliamentary majority. The results of the March parliamentary elections and Tymoshenko’s continuing popularity have greatly strengthened her position. Yushchenko’s powers as president have shrunk and his popularity has fallen. So has the popularity of his political movement, Our Ukraine.

Given their weakness, Yushchenko and Our Ukraine are mainly interested in securing their defenses. They insisted on maximum control over law enforcement, including the interior and justice ministries. The president still controls the general prosecutor, the SBU national security police and the defense ministry. Yushchenko and Our Ukraine also insisted on the speaker position, which is a good bully pulpit for criticizing the government, and an important position to hold if they were to decide to quit the coalition. They seem to have intentionally given Tymoshenko free reign on economic policy out of hope that she will foul up and wreck her popularity.

As for Poroshenko, he has been very successful in maneuvering himself into a strong position within Our Ukraine, which lacks any other dynamic leader. He and a group of his allies effectively forced Our Ukraine’s party leadership to nominate him as speaker by threatening not to support the coalition (the decision was subject to approval by the broader Our Ukraine bloc, which includes several smaller allied parties). But he is very unpopular with voters, and many in Our Ukraine resent him. He appears to hope that by putting himself in the public eye he can gain popularity.

As long as Tymoshenko maintains her popularity, Yushchenko and Our Ukraine would gain nothing from breaking their alliance with her. If Our Ukraine forged a coalition with the Regions party, Regions would get almost all the real power, due to its much greater numbers in parliament (186 seats to at the very most 55 Our Ukraine MPs who would join such a coalition). Dissenters from Our Ukraine would create a new centre-right party that would aim for Our Ukraine’s electorate. Yushchenko would stand little chance of re-election in 2009 and Our Ukraine would have grim prospects in the next parliamentary vote, as their voters would feel betrayed. Tymoshenko would return, stronger than ever. That is why Yushchenko and Our Ukraine did not form a coalition with Regions now. There’s no reason to assume this situation will change in six months or a year or even two years.

So, most likely, this coalition will last. Be prepared for the possibility that it could collapse early, but don’t assume it. The most important thing to watch is Tymoshenko’s popularity. If its drops, then Yushchenko would be tempted to seek early parliamentary elections. A split of Our Ukraine,

which is a complex assortment of small groups with differing interests, could also spark a crisis possibly leading to early elections. A combination of the

Regions party and any Our Ukraine splinter group would not be able to sit a government against Yushchenko's will.

Tensions within the Orange camp are sure to flare when the candidates start positioning themselves for the 2009 elections. That for now is far away.

Tymoshenko vs Oligarchs, Round Two?

Tymoshenko and her bloc will have the finance, economy, energy, agriculture, coal and construction ministries, plus the state property fund, the state oil and gas company Naftogaz, and the tax administration. The main checks on her policy decisions will be the other two coalition members' factions in parliament, which could block any legislation; the regional governors, who have substantial powers and are all Yushchenko allies (governors are appointed and dismissed jointly by the president and cabinet); and the president, who could veto legislation or challenge the constitutionality of cabinet decisions. Her bloc's strength within the cabinet will be strong enough to carry almost any cabinet vote.

Tymoshenko's performance on economic policy last year was patchy. She pushed through populist social spending increases when the state budget was already overburdened by pre-election spending promises. In her zeal to close tax loopholes, she hurt some legitimate foreign investors and scared some domestic business groups into moving part of their incomes back into the shadows. She sent the oil-refining industry into a tail-spin by canceling duties on imports of oil products (which balanced Russia's export duties on crude oil). Although she insists she was misunderstood, she gave the impression that she wanted to challenge dozens if not thousands of pre-Orange Revolution privatizations.

But she also improved tax collection dramatically, which had always been one of the country's biggest problems. She scared big industrial groups into trying to be good corporate citizens, including by improving their transparency and corporate governance. Most public companies showed increased profits as they brought income *out* of the shadows.

Tymoshenko should perform better this time around. She is a year older and a year wiser. She has assembled a bigger and more professional political team and she is getting better advice from a wider range of consultants. She is likely to make the best progress in again prodding big industrial groups to further improve their transparency and corporate governance. She has made clear that she will not launch any new efforts to reverse old privatizations. Her old project to re-privatize Nikopol Ferroalloy, which has been dangling in a state of near-completion since she was sacked last year, might finally be finished off.

Despite the continuing rivalries within the Orange camp, this parliament will be far more supportive of reforms than any previous legislature. All three parties in the coalition have clearly committed themselves to the project of aligning Ukraine's legislation with EU norms. Even the opposition is largely supportive. That in itself is an historic breakthrough, although of course the implementation won't happen quickly or easily. There is also strong support from both the coalition and opposition in favor of developing Ukraine's capital markets.

Tymoshenko has reiterated her commitment to revising the gas supply agreement made in January 2006 and excluding the intermediary RosUkrEnergo, whose main shareholders are Gazprom and a shadowy Moscow-based Ukrainian business group with strong ties to the Kremlin. She said she would do so in a "friendly manner". The response from

Moscow has been mixed: Gazprom reacted harshly, warning that Europe's supplies could be threatened, but Alexander Zhukov, a deputy prime minister, said the response would depend on what Tymoshenko suggests. Poroshenko has supported Tymoshenko's position. The US government has very strongly supported her position and offered its help, although it's not clear what the US could do. Tymoshenko is appealing to European governments to get involved in an advisory committee that she wants to set up.

Since the gas price in the January agreement was not fixed, any Ukrainian government would have faced tough negotiations. Tymoshenko is doing the right thing by taking on the issue now rather than waiting till winter. However, the price of renegotiation is likely to be a commitment by Ukraine to a schedule of price increases leading to full market prices. In our view the most important thing is security, which the January agreement did not deliver.

Growth Accelerating

May GDP and industrial output figures were well above everybody's forecasts. GDP rose by 8.5%, industrial output by 10% – the best monthly numbers since 2004 and up sharply from April (GDP +3.5%/industry +0.5%) and the first quarter (+2.4%/+0.2%). GDP growth for Jan-May came to 4%.

There are several factors contributing to this sudden improvement. One is simply that Easter fell this year in April and last year in May. That somewhat depressed April's numbers and somewhat flattered May's.

April was also the first month after the anniversary of the March 2005 bud get revision adopted in the wake of the Orange Revolution. The revision slashed state construction spending and eliminated "free trade zones," which resulted in an artificial decline in wholesale trade numbers. Trade and construction dropped last year by 6.9% and 8.5%, respectively. Since April, year-on-year figures compare "oranges to oranges", and the real strength of the trade and construction sectors shows through. They grew in May by 11.8% and 12.7%, respectively, up from 6.7% and 4.2% increases in Jan-April.

Growth was held back early in the year by the gas shortages and by the prolonged uncertainty as the government delayed deciding how to pass on the price increase to industry. Ukraine is not the only country paying more for energy, and higher commodities prices are helping industry cope.

Growth was also inhibited in the first quarter by a negative trade balance (4.2% of GDP) as gas prices rose and industrial exports dropped, and by huge purchases of dollars by the population ($1.6 bn), who were apparently made nervous by the gas ordeal and elections. To preserve the dollar peg, the national bank bought most of the excess hryvnya ($2.1 bn worth in Jan-April) and in doing so created a shortage of cash. But the tide turned in May when the national bank was able to sell $244m worth of hryvnya. Inflation returned to 0.5% in May after two months of deflation, but is much improved over last year. The central bank has since spurred liquidity further by reducing its discount rate by one point to 8.5%.

Most importantly, metallurgy output was up 8.2% in May after being down by 1.6% in Jan-April. Steel prices have been climbing since the start of the year, but Ukrainian metallurgy was slow to react for the reasons cited above. The steel sector's recovery should result in a substantially improved trade balance.

But there are also reasons to be conservative, including the further gas price increase that we are expecting sometime during the second half of the year. Agriculture analysts are predicting a mediocre harvest. For now we stand by our forecast of 3% GDP growth this year.

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