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ANALYSES

The problems with Ukraine's 'election' budget

The official statistical data on the Ukrainian economy in January show that the crisis is dramatically worsening. However, the possibilities of improving the situation, at least by the end of the year, are limited. These depend mainly on an improvement in the global markets for the products of Ukraine's metallurgic and chemical industries. In this situation, the government's actions have been focused on measures intended to minimise Yulia Tymoshenko's political losses in the run-up to the presidential election planned for January 2010.

Prime Minister Tymoshenko's main concern is the budget, which even her political partners see as unrealistic. Nevertheless, Tymoshenko intends to implement this budget, ignoring the real deficit and keeping all the welfare programmes at the current level. Tymoshenko appears to be considering her actions exclusively in the context of the elections, without any regard for their long-term economic and political consequences.

The budget should not frighten the voters

The government tabled its draft 2009 budget, envisaging a 5.5% GDP growth and a stable exchange rate of the Ukrainian currency, in September 2008, when the symptoms of the crisis had already been increasingly apparent in Ukraine over the previous two months. Due to the parliamentary crisis, however, the Verkhovna Rada could not consider it. Meanwhile, the next two months brought about a sudden decline in industrial production and GDP. The very high foreign trade deficit, the outflow of portfolio investments and the interrupted influx of foreign direct investments, combined with indolent policy of the National Bank of Ukraine (NBU), caused a sudden slump in the hryvnia's exchange rate, from 4.85 to the US dollar in August to over 8 in mid-December and, in some periods, even over 9 to the dollar. The budget, which was eventually considered by the parliament in late December, had to be adjusted. However, Tymoshenko categorically rejected the macroeconomic assumptions prepared by the Finance Ministry, which assumed the 5% drop of the GDP in 2009, the average yearly exchange rate around 8.5 hryvnia to the dollar, and the inflation ceiling of 16%. The finance minister Viktor Pynzenyk was dismissed from the team working on the draft budget. The budget arrangements were finally co-ordinated by the first deputy PM Oleksandr Turchynov, and presented to the parliament by PM Tymoshenko. Since it had been assumed that GDP would grow by 0.4%, it was possible to provide for higher budget revenue, and thus not only keep all the fixed welfare expenses and programmes at last year's level, but also allocate some funds to anti-crisis programmes. The government created some safeguards, such as envisaging a budget deficit of 2.9% of GDP (31 billion hryvnia) and an inflation rate of 9.5%. Since the real inflation is expected to reach 16.5% this should bolster the budget's nominal revenue and facilitate the financing of the deficit. The adoption of a single-digit inflation index is also a good PR move, especially given the annual inflation rate of 22.8% in 2008.

The budget's realistic capacity

No-one except the prime minister has so far had the courage to publicly claim that the adopted budget is realistic. Even members of the Tymoshenko's own party maintain that the budget deficit will be higher. The budget revenue will not grow because the GDP will decline (by anything from 5% to as much as 10%, according to different predictions) and the individual budget revenue items will be lower than planned. This is a consequence of the current condition of Ukraine's economic operators who will generate losses (and therefore pay less income tax), the declining individual incomes (I income tax), and a substantial decrease in imports (less revenue from VAT and excise tax on imported goods). These decreases cannot be offset by the increase in excise tax on a number of goods. The revenues from privatisation will be lower, especially since it is expected that President Yushchenko will continue to obstruct plans to sell large enterprises. Tax revenue will also be affected by the 'grey economy', which has been expanding in the crisis conditions. The tax breaks the government has granted to selected sectors and companies, including the tax exemption for Naftohaz (until October 2009) and the tax reliefs for the metallurgic and chemical sectors, will also have an effect. At the same time, spending at the beginning of the year will be higher because the government will have to support Naftohaz in its settlements with Gazprom (gas is to be purchased at US\$360 per 1000 m³, whereas the internal price has been set at US\$228.9).

The budget in January – PM Tymoshenko wins the battle

According to the official information presented by Yulia Tymoshenko and representatives of government, the January budget has been implemented to 101%. This is an unusual achievement, given the fact that official figures as of 26 January indicated that revenues in the state budget's general account had been received up to 44.5%, and 46.8% in the special fund. Even if taxes were paid during the last ten days of each month, the mobilisation observed during the last four days of January can barely be regarded as natural. The budget revenue was probably supplemented artificially, for example by the customs clearance of gas purchased by Naftohaz in 2008 (between September and December) and thus repayment of taxes, after having previously transferred budget subsidies to Naftohaz. The taxpayers were also mobilised to the greatest possible extent. The NBU chief has admitted that the Bank had repaid the quarterly amount of the surplus of the central bank's revenue over its expenses approved in the budget (1 billion hryvnia), even though the normal practice was to repay it at the end of the quarter. According to unofficial information, taxes were collected from economic operators in advance for the entire quarter (in keeping with Ukrainian law). Finally, funds from last year's budget account with the NBU were also used to finance the shortages.

How to finance budget expenses in the months to come?

The fact that last year's reserves and future budget revenues have been used up creates a serious risk for the handling of the fixed budget expenses in February and the months to follow. Official figures on the economic situation in January (deep decline in nearly all sectors) indicate that the budget revenue

may be lower than was predicted in even the most pessimistic scenarios. The scale of the risk is indirectly evidenced by the government's decision not to publish the monthly GDP figures. Tymoshenko is urgently seeking funds to finance the real deficit. At the same time, for political reasons, she is unwilling to publicly admit how serious the problems that the government is facing are; her address to the parliament on 5 February is one example of this attitude, as is her refusal to take into account the IMF's recommendations concerning adjustments to the budget, even if the price of this turns out to be an IMF decision not to remit the second instalment of its stand-by loan on time.

Tymoshenko has attempted to force the NBU to finance the deficit by including an obligation in the budget law for the NBU to purchase state treasury bonds from banks, and to consult the government about the terms on which the banks' operations should be refinanced. When the head of the NBU refused, Tymoshenko forced the parliament to adopt an extraordinary decision cancelling the December 2004 appointment of Volodymyr Stelmakh as the central bank chief. However, she did not succeed in restoring her loyal aide Serhiy Tyhipko to the post of NBU chief. The head of the central bank cannot be replaced without the president's endorsement, and Viktor Yushchenko is not interested in having Stelmakh dismissed.

In this situation Tymoshenko has started to seek foreign loans. According to the government's information, several countries have been asked for a loan of US\$5 billion (not all have confirmed this), but consultations have only been held with Russia, which is willing to grant Ukraine a two-year loan on fairly favourable financial terms and subject to unspecified additional conditions. Moscow's practice of granting loans to CIS states suggests that these conditions might be of both an economic and a political nature. Tymoshenko is prepared to take the risk in order to solve the current budget problems, and US\$5 billion would cover a major portion of the deficit. Ukraine also has good chances of obtaining a US\$1.8 billion loan from the World Bank.

Prospects for the PM's tactics

Tymoshenko's tactics are limited to surviving, with minimum disruption, until the presidential election, which will probably take place in January 2010.

Her main challenge is the implementation of the budget, because the prime minister will blame other problems on her opponents, especially the president and the National Bank of Ukraine. However, the budget expenditure will be very difficult to finance. It is next to impossible to place state treasury bonds on both domestic and European markets, especially since Ukraine's currency obligations rating was lowered again. Neither does it seem realistic to force the central bank to make additional issues.

In this situation, the success of Tymoshenko's budget plan depends entirely on her ability to obtain a foreign loan. US\$5 billion would enable the government to cover the real deficit, and Tymoshenko would be able to start the election campaign smoothly in the autumn of 2009.

If the government fails to obtain the loan, it may face difficulties financing the fixed budget expenses, including paying public sector salaries and pensions in February. Naftohaz may also experience serious problems with paying for the Russian gas. This scenario could completely undo Tymoshenko's chances in the presidential election.

Anna Górska

Russia and Turkey intensify co-operation

The state visit of the Turkish president Abdullah Gül to Russia on 12–15 February, which was concluded with the signature of a joint political declaration with the Russian president Dmitry Medvedev, became an opportunity for Moscow and Ankara to demonstrate the rapprochement between the two countries. Their main area of co-operation is the Southern Caucasus, in particular resolving the Nagorno-Karabakh conflict, which was the main subject of talks between the two presidents.

Intending to expand its influence in the region at the West's expense, Russia is seeking to resolve the Karabakh conflict on its own terms and establish itself as the guarantor of any agreement to be reached. Turkey, Azerbaijan's strategic partner, may assist Moscow in this endeavour by putting pressure on the Azeri authorities. Turkey's objective is to strengthen its own position in the region at the same time.

Over the last year, Russia's has become Turkey's main trade partner, although the trade balance is very unfavourable for Ankara. It should be expected that, contrary to Russia's declarations about closer co-operation in this sphere, Turkey will in fact seek to counterbalance Russian influence in its economy, especially the energy sector, by co-operating with other partners.

A new balance of power forming in the Southern Caucasus

Moscow first started undertaking more intensive measures to resolve the Karabakh conflict in autumn 2008. On 2 November 2008, the presidents of Russia, Armenia and Azerbaijan, Dmitry Medvedev, Serzh Sargsyan and Ilham Aliyev, signed a declaration on the peaceful resolution of the conflict. This became possible after the Russian intervention in Georgia, during which Moscow demonstrated that it would not hesitate to use military power to defend its interests, and Baku lost any hope that it could restore Azerbaijan's territorial integrity by force, giving up its militant rhetoric in consequence.

Moscow's plan most probably involves deploying a Russian peacekeeping force in the conflict zone. In this way, Russia could step up its military presence in the region while at the same time building its image as a responsible state committed to promoting stability (and obliterating the impression left by the Georgian intervention). This approach is a novelty in Russia's policy: before 2008, Moscow preserved its influence in the Caucasus by 'managing' conflicts and keeping them 'frozen', whereas now it seeks to achieve the same objective by resolving conflicts on its own terms. Its recognition of the independence of Abkhazia and South Ossetia was the first 'conflict resolution' of this kind, and is now being followed by efforts to impose peace in Nagorno-Karabakh on Armenia and Azerbaijan.

Turkey proposed the creation of a Platform for Co-operation and Stability in the Caucasus while the war in Georgia was still going on (PM Recep Tayyip Erdogan visited Moscow and Tbilisi during the conflict). While recognising Russia's leading role in the Southern Caucasus, Ankara wishes to strengthen its own position in the region and normalise its relations with Armenia (by re-establishing diplomatic relations and opening the border). Normalising relations with its neighbour would offer Turkey an important asset in its accession talks with the EU.

APPENDIX

Probable content of the Russian-Turkish peace initiative on Nagorno-Karabakh

The initiative will probably build on the general assumptions of the plan developed several years ago by the OSCE Minsk Group, the body responsible for the Karabakh peace process under an international mandate (the Group is co-chaired by Russia, the USA and France). The plan exists in several variants with slightly different details. It provides for the Armenian withdrawal from the occupied territories around Karabakh (except for the Lachin corridor connecting Karabakh with Armenia), and the return of Azeri refugees to the area. Karabakh itself would remain under Armenian control, while the final determination of its status would be postponed for 15–20 years. The Armenian and Azeri communities would be separated by the peacekeeping troops. The plan also provides for the simultaneous lifting of the blockade of the transport routes (roads and railways) from Azerbaijan to Nakhichevan, from southern Armenia to Yerevan via Nakhichevan, and from Armenia via Azerbaijan to Russia.

The most important modification would probably concern the composition of the peacekeeping force, which would be made up not of international troops but solely Russian soldiers (on the Armenian side) and Turkish military observers (on the Azeri side). In addition, the package might include opening the Turkish-Armenian border, which has been closed since the early 1990s.

It should be expected that Russia would seek to obtain formal approval of its actions from the entire OSCE Minsk Group, which holds the international mandate for conducting the peace process, in order to create the impression of Moscow as a responsible participant in multilateral arrangements, operating within the remit of its mandate (as one of the Group's co-leaders).

If the Karabakh conflict were resolved under the aegis of Moscow and with Russia as the guarantor of peace, this would create a new balance of power in the region. The presence of Turkey, a state friendly towards Russia and at the same time a NATO member, as a major regional player, would be an important element in this new arrangement and would mitigate the impression of Russian dominance.

The games over Nagorno-Karabakh

Intensive political consultations have taken place in recent weeks between Moscow, Ankara, Baku and Yerevan, which indicates that large-scale preparations for the announcement of a Russian-Turkish peace initiative on Nagorno-Karabakh are in progress (for example, the Turkish head of diplomacy Ali Babacan has met his Armenian counterpart Eduard Nalbandian around ten times, an unprecedented number for two states which officially maintain no diplomatic relations). In this context, it was expected that the initiative would be announced during Turkish president Gül's visit to Russia. This did not take place, perhaps because of the leaks in the Turkish press claiming that Baku and Yerevan had already reached an initial peace agreement (the Azeri and Armenian ministries for foreign affairs immediately denied the claims), or because of the rising tension in the conflict area (it is possible that Azeri and Armenian opponents of the agreement have been behind the increased number of armed incidents along the ceasefire line).

The leaks may also have been originated by the Turkish authorities, who may wish to mitigate the impression that it is Russia who should be exclusively credited for the agreement, or from the Turkish opposition, which objects to a new architecture of the region based on close co-operation between Moscow and Ankara, as well as to the normalisation of Turkish-Armenian relations and reduced Western influence in the Southern Caucasus. Nevertheless, it should be expected that work on the peace initiative will continue, as envisaged in the declaration by Presidents Medvedev and Gül, which provides for effective measures to be taken to resolve the frozen conflicts (see Appendix 1 for more information on the probable shape of the Karabakh peace initiative).

Russia willing to invest in Turkey's energy sector

During President Gül's visit, Russia announced that its Atomstroieksport company had won the tender to construct four units of a nuclear power plant in Turkey, worth a total of US\$18–20 billion, and that Russian staff would also operate the plant once completed. According to the Russian energy minister Sergei Shmatko, Turkey would buy US\$60 billion worth of energy from the plant within 15 years.

The Turkish version is quite different. Firstly, Atomstroieksport is not participating in the tender on its own, but rather as a member of a consortium which also includes Turkish companies; secondly, the tender has not been resolved yet; and thirdly, its outcome will be subject to approval by the Turkish government (in recent years, Turkey has on several occasions cancelled finalised tenders, as in the case of the privatisation of the oil company Tüpras).

Closer energy co-operation between Russia and Turkey dates back to 2005, when the Blue Stream gas pipeline was launched, although Turkey has recent-

ly preferred to diversify its sources of energy and increase the transit of energy resources via its territory. Apart from the policy of limiting the country's dependence on a single source of supplies, the unfavourable trade balance with Russia, which Ankara has been seeking to improve, is also a factor here.

Conclusions

1. Russia is currently seeking to build its position in the post-Soviet area by new means. In the Southern Caucasus, Moscow's primary objective is to resolve the Nagorno-Karabakh conflict with a view to expanding its military presence and influence in the region, and to presenting Moscow as a peace-maker spreading stability.
2. By accepting Russia's leading role in the region, Turkey is becoming an important and valuable partner for Moscow, and may assist it in resolving the Karabakh conflict (thanks to its ability to pressure Azerbaijan, *inter alia*). The current phase of Russian-Turkish rapprochement seems to be a lasting one because it is in both sides' interest.
3. For Ankara, influence in the Southern Caucasus region may be an additional asset in its talks with the EU and the USA (relations with which have been less cordial in recent years). By normalising its relations with Armenia, Ankara would remove an important obstacle to integration with the European Union. At the same time, co-operation between Moscow and Ankara would limit the field for manoeuvre for other players, in particular the West (as the term is broadly understood).
4. This closer political co-operation has not eliminated a certain degree of distrust existing between the partners. In the case of Turkey, this manifests itself in the desire to diversify the sources of energy and strengthen Turkey's role as a transit state.

Wojciech Górecki

Russia: A loan from China in return for a pipeline section branching off from the VSTO oil pipeline

On 17 February in Beijing, the Russian prime minister Igor Sechin and the Chinese deputy prime minister Wang Qishan signed an agreement to construct a pipeline section branching off from the East Siberia-Pacific (VSTO) oil pipeline and leading to Daqing in China, while representatives of Rosneft and the oil transport monopoly Transneft signed a contract with China's oil company CNPC and the China Development Bank, under which the Russian companies will receive huge loans. The documents signed clearly demonstrate that although the negotiations were lengthy and difficult, both sides were determined to bring them to a successful end. As a result, China will become an important buyer of Russian oil.

The political decision to build a section of the VSTO branching off to China was taken during the Chinese PM Wen Jiabao's visit to Moscow in October 2008. However, the Russians said on that occasion that the signature of the final agreement was conditional on the parties setting the oil price and the terms of supply, and on China granting loans to Rosneft and Transneft (US\$15 billion and US\$10 billion, respectively). In return for these loans, Russia committed itself to supplying 15 million tons of oil a year between 2011 and 2030. According to preliminary information, the loan interest rate will be around 5.5–6% a year, and the price of oil will be linked to the price at the Kozmino port, the terminus of the VSTO. Transneft and CNPC have also signed an agreement concerning the construction and operation of the 1027 km-long pipeline section branching off from the VSTO and connecting Skovorodino with Daqing.

Thanks to the agreement, concluded on favourable terms, Russia has gained funds that will enable it to complete the first branch of the VSTO and start implementing other projects (probably including the BTS-2 oil pipeline), while Rosneft, whose debt amounts to around US\$20 billion, will be able to partly repay its dues to Western banks. <Wojk>

CES

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