KCS Country Risk & Threat Advisory

KCS Group Europe
Risk & Threat Advisory Paper

Political Risk Advisory Briefing: Ukraine
December 2019

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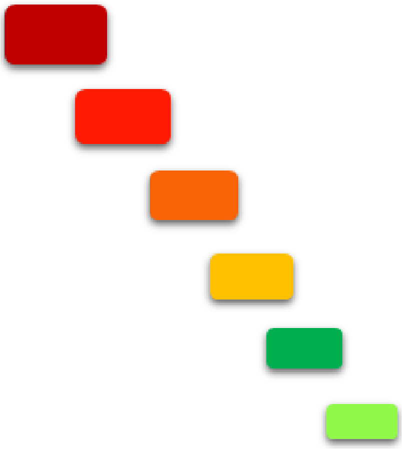
Country:	Ukraine
Population:	42.22million
Source:	Trading Economics

Ukraine has a Possible risk rating of 4.5

6	**Very High**	The assorted threats described in the report are almost certain to have a derogatory effect.
5	**High**	The threats are extremely likely to negatively affect the business.
4	**Very Possible**	There is a strong likelihood of problems arising in this country.
3	**Possible**	There is a fair chance of problems arising in this country.
2	**Low**	There is a low likelihood of any threats impacting business.
1	**Very Low**	There are virtually no impediments to successful business in this country.



Background to disaster

By every metric, Ukraine matters. It is the second largest country of the former Soviet Union by population (circa 44 million people) and the third largest by the size of its economy (after Russia and Kazakhstan). It boasts a projected GDP of $150 billion USD in 2019 and a projected real GDP growth of 3.0% for the year (according to IMF forecasts). It is an agricultural powerhouse, the *'breadbasket of Europe'*, and is the largest grain exporter globally. And its location is of geopolitical importance, sitting as it does between East and West, Russia and the EU, and occupying the northern shore of the Black Sea: simultaneously making it a major flashpoint in European, Middle Eastern and global affairs.

It is thus perhaps inevitable then that Ukraine is one of the most turbulent and chaotic countries currently in existence. A path that arguably started in the collapse and splintering of the Soviet Union in 1991, it worsened during the so-called *'Orange Revolution'* in 2004 and reached what was suspected to be a climax in the *'Euromaidan Revolution'* of winter 2013. With the former caused by electoral fraud in the Presidential election and the latter by a volte face in signing an agreement establishing a closer relationship with the EU, it seemed that Ukrainian problems were, for the most part, internal.

However, since 2014 the political, economic and social situation has undeniably been even more challenging, with Russia's annexation of the Crimean peninsula in March and the subsequent, and still ongoing, conflict in eastern Ukraine resulting in 13,000 lives lost, 1.5 million people displaced and a loss of investor confidence as the country descends into what is essentially civil war.

The past five years have been particularly challenging, with Russia's annexation of the Crimea in March 2014 and the ongoing Russian-backed conflict in eastern Ukraine, which has claimed more than 13,000 lives and led to more than 1.5 million people being displaced.

In terms of foreign policy, Ukraine has traditionally balanced its relationship with the EU and the US on the one hand, whilst maintaining strong ties to Russia on the other hand, seeking to benefit from having Russia and the West compete for its affections. This strategy changed under President Petro Poroshenko (2014-19), who followed an unambiguously pro-Western foreign policy course, which has of course raised Russia's hackles – never a move without risk.

The investment environment and challenges to doing business

The conflict plunged Ukraine into recession with GDP contracting by a combined *circa* 16% in real terms in 2014-15, the Ukrainian hryvnia being devalued by more than 70% in February 2015 and annual inflation peaking at almost 50% in 2015. From 2016, the economy started to recover with moderate GDP growth resuming, however inflation will only return to below double digits this year and the National Bank of Ukraine's key policy rate remains elevated at 15.5%. Although the currency is currently at its highest rally in five years, downturn across the economy as a whole is expected.

This is worsened by the fact that it is the metallurgical and energy industries, on which the economy and the supply chains depends, that are predicted to experience the worst. In part this is down to falling price in iron and steel commodities, and also (perhaps) because the strong currency is affecting exports, so much so that Ihor Kholomoyski, a key metallurgical oligarch, stands accused of running an intimidation campaign against the NBU to get them to weaken the currency and get exports flowing again. We shall hear more of Kholomoyski later, but this does illustrate how in Ukraine even a fundamental matter such as the economy cannot be fully separated from political interference.

Irrespective of this, Ukraine remains dedicated towards encouraging foreign business and investment. The country already operates a program of fiscal management which is helping to reduce debt and inflation, the key gas sector is being demonopolized and the government is fast-tracking reforms to accelerate development. The intention is there, it is just the system into which these intentions are fed that is so rotten.

Consolidation of political power

President Volodymyr Zelensky, who won a landslide by securing 73% of the vote in April 2019, is (on paper at least) the most powerful president of Ukraine since the country's independence in 1991. Not only does he have a strong popular mandate, but he is the first post-Soviet Ukrainian president to enjoy an absolute majority in parliament. This gives him an inordinate amount of power which, regrettably, has just as much chance to be turned to bad purposes as to good.

Unlike Russia, where since the early 2000s power has largely been concentrated in the Kremlin and potential alternative centres of power such as parliament, the national media, regional governors and the oligarchs have been brought under control or reined in, Ukraine's oligarchs have up until now wielded significant influence through bankrolling political parties (and their consequent ability to influence parliamentary votes), ownership of national media and their ability to use endemic corruption in the political system and judiciary to their advantage. Buoyed by the semi-regular changing of the guard in terms of political terms, the oligarchs have become a constant and have slowly amassed more indirect power for themselves, working behind the scenes in several key industries and political arenas.

The 41-year-old president – a former actor and TV comedian – is a political neophyte and perhaps lacks the savvy and networks of some of his predecessors. He has filled a number of key positions in his administration either with individuals closely linked to certain oligarchs or with former associates from his TV production company, Kvartal 95, most of whom have very limited prior experience of working in government.

For example, his chief of staff Andriy Bohdan formerly worked as a lawyer for the aforementioned Ihor Kholomoyski, a highly controversial Ukrainian billionaire, whose TV channel (1+1) helped to make Zelensky's career as a comedian and played a key role in supporting Zelensky's election campaign. Additionally, Zelensky's appointee as head of the Security Service of Ukraine (SBU), Ivan Bakanov, is a childhood friend who headed Zelensky's presidential election campaign; his main prior work experience was as head of Zelensky's TV production company.

These are poor appointments that exacerbate the inherent problems within the Ukrainian political system: that oligarchs have entwined themselves with the mechanisms and cannot be shaken free, and the political players that are chosen every five years are not up to the tasks of stopping them.

An environment undermined by rampant corruption

In the recently published World Bank Doing Business survey for 2020, which compares business regulations in 190 economies, Ukraine ranks 64th out of 190 countries with a score of 70.2, lagging materially behind Russia (28th / 78.2 points) and Kazakhstan (25th / 79.6 points) – not to mention regional leader Georgia, which ranks 7th with 83.7 points. Nevertheless, Ukraine has climbed 7 places compared to the previous year, implementing reforms in six key areas, and has climbed 32 places compared to its 2015 ranking.

Ukraine has a poor reputation for corruption, ranking 120 out of 180 countries in the most recent Transparency International Corruption Perceptions Index (with a score of 32). However, to put this into perspective, its ranking and score is average for the countries of the former Soviet Union (excluding the Baltic countries), and both Russia and Kazakhstan perform worse than Ukraine (ranking 138th with 28 points and 124th with 31 points respectively).

Foreign investors frequently cite corruption in the judiciary, powerful vested interests and weak protection of property rights amongst the major challenges to doing business in Ukraine.

Under Zelensky's predecessor Poroshenko, a number of anti-corruption bodies were set up such as the National Anti-Corruption Bureau (NABU), the National Agency for the Prevention of Corruption (NAZK) and the Specialised Anti-Corruption Prosecutor's Office (SAPO). However, inter-agency conflict, in particular between NABU and SAPO, as well as corruption within these bodies, seriously hampered their effectiveness. At the behest of the IMF, legislation was passed to create a Higher Anti-Corruption Court in mid-2018 and it started operations in April 2019. Whether or not there is any substantial effect, is yet to be seen,

The Security Service of Ukraine (SBU), whose Directorate K is responsible for combating economic crimes and corruption, has gained a reputation for high levels of corruption itself and for shaking down businesses. Reform of the SBU and, in particular Directorate K, has been flagged as a top priority.

Ambitious reform agenda targeting 5%-7% annual GDP growth

Zelensky came to power, promising to fight rampant / entrenched corruption and to bring peace to eastern Ukraine. Aside from corruption, key domestic challenges include tackling poverty, reducing the large national debt burden, upgrading the country's poor infrastructure and public services.

The government's key priorities include boosting economic growth and investment by lifting a moratorium on the sale of agricultural land, accelerating privatisation, conducting further deregulation and strengthening rule of law through reform of the courts. The government is targeting ambitious annual real GDP growth of 5%-7% over the next five years.

Kholomoyski and

Kholomoyski epitomises state capture by big business interests in Ukraine. In 2014, when the central government was very weak, Kholomoyski was appointed governor of Dnipropetrovsk, forming and financing volunteer battalions to protect the region against Russian aggression. However, when he used these battalions as a private army to further his own business interests in 2015, he was sacked by President Poroshenko.

Kholomoyski, together with Gennadiy Bogolyubov, owned PrivatBank (Ukraine's largest bank, holding a third of the country's retail deposits) until its nationalisation by the Ministry of Finance in December 2016. The regulator found a US$5.5 billion hole in the balance sheet caused by fraudulent related party lending to the shareholders' other businesses, which ultimately triggered the decision to nationalise the bank. In December 2017, PrivatBank under its Ministry of Finance appointed management team secured a London High Court ruling freezing more than US$2.5 billion of assets worldwide belonging to Kholomoyski and Bogolyubov.

In April 2019, however, a Kiev court annulled the 2016 decision of the National Bank of Ukraine (NBU) to declare PrivatBank insolvent, threatening to reverse the 2016 nationalisation (corruption in the court system continues to be widespread). Kholomoyski has said he has no interest in regaining the bank, but wants US$2 billion in compensation for losses he claims were incurred during the nationalisation. An aggressive campaign of intimidation has been launched against the NBU and the management of PrivatBank, which the NBU has publicly blamed on Kholomoyski.

To date Zelensky has remained above the fray, but the fate of Kholomoyski and PrivatBank is correctly viewed as a litmus test for Zelensky's presidency and for whether his administration is capable of taking on corrupt vested interests or not. Failure to put an end to the PrivatBank farce and to pursue the confiscation of Kholomoyski's assets in all jurisdictions in order to compensate the state for the funds it has had to deploy to recapitalise PrivatBank would send a clear signal to corrupt businessmen and state officials that they have little to fear from the new president and that they can continue to act with impunity. This would seriously undermine investor confidence and likely limit foreign investment, as well as jeopardising the entire banking sector clean-up. Furthermore, the IMF has made it clear that further loans will not be forthcoming if Kholomoyski is let off the hook.

However, the President faces a difficult choice: if he does move against Kholomoyski, the billionaire will likely declare all-out war, mobilising his considerable resources – including media resources – against the president. This could be highly destabilising, and the resultant mudslinging could seriously damage Zelensky's public image, to say nothing of the risks of a change in government should Kholomoyski (who personally controls four separatist battalions in Ukraine) decide that the government is no longer fit for his purpose.

Russian influence on the rise?

In a recent interview to the *New York Times*, Kholomoyski, who as governor of Dnipropetrovsk in 2014 was instrumental in repelling Russian aggression, declared that it was time for Ukraine to give up on the West and to turn back towards Russia. Whilst Kholomoyski clearly has his own agenda, there is a risk that in the absence of sufficient Western support for Ukraine, it may end up drifting closer to Russia.

The pro-Russian Opposition Platform – For Life party took second place in the July 2019 parliamentary election with 13% of the vote, winning 44 seats. One of the leaders of the party is Viktor Medvedchuk, who served as chief of staff to former President Leonid Kuchma. He is a close confidant of President Vladimir Putin, who is godfather to Medvedchuk's daughter.

Traditionally, the SBU has been heavily infiltrated by the Russian intelligence services. Prior to the 2013-14 "Euromaidan Revolution", Russia's Federal Intelligence Service (FSB) had total access to the SBU and thousands of highly classified documents were stolen and taken to Russia in the aftermath of Euromaidan. Under President Poroshenko, efforts were made to purge the SBU of FSB plants and pro-Russian elements. However, such is the extent of corruption in the Ukrainian intelligence services that Russian intelligence services have had no problem in continuing to infiltrate Ukraine's intelligence services. Only a serious and systematic crackdown on corruption by the new president and his team can hope to curtail Russia's infiltration of the SBU.

Conclusions

It is clear that Ukraine warrants its high-risk rating. There is danger at every level: whether it be the weak politicians incapable of mounting effective change, the oligarchs that have become a ruling class almost by default, the system that encourages corruption or the battle-of-wills between Ukraine versus Russia, Ukraine versus the West and Ukraine versus Ukraine. What these amount to is an environment that can never be considered 'safe' and which requires constant attention and vigilance across the board. All because an individual at ground-level is clean, does not mean that those behind him are. All because there are no fingerprints of an oligarch on a business, does not mean that these have not been deliberately wiped clean. And all because the west of Ukraine is slowly stabilising into some form of peace, does not mean that Russia is not attempting to regain control over its historical sphere of influence. Ukraine remains a navigable and attractive business market, one misstep is all it will take for an unprepared company to fatally slip up.