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Classified By: AMBASSADOR WILLIAM B. TAYLOR, REASONS 1.4(B) AND (D)

1. (C) Summary. Prime Minister Yulia Tymoshenko has confirmed that the GOU has held negotiations with Russia for a \$5 billion loan to cover Ukraine's expected budget deficit in 2009. After details of the negotiations were leaked, Tymoshenko quickly asserted that discussions were only in very preliminary stages, pointing out that Russia was one of several countries that the GOU had approached for direct budget support. Russia's Ministry of Finance has reportedly made the loan conditional upon Ukraine's willingness to settle a long-outstanding dispute surrounding Soviet-era debt, yet commentators in Kyiv find it difficult to believe that Russia will not expect political concessions as well. Raisa Bohatyriova, head of Ukraine's National Security and Defense Council (NSDC), told the Ambassador that Ukraine would certainly have to "sacrifice" something dear in return for Russian backing, while Valentyn Nalyvaichenko, head of the State Security Service (SBU) told the Ambassador that he too did not know Russian stipulations, but he would "bet that halting NATO" expansion is an element of Moscow's demands. End summary.

The Zero Option

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2. (SBU) Tymoshenko originally denied claims, made by Presidential energy advisor Bohdan Sokolovskiy on February 6, that Ukraine was negotiating a \$5 billion loan with Russia. She later conceded that negotiations had taken place, adding that the GOU had also approached the U.S., China, Japan, Saudi Arabia, and the EU with a request for financial assistance to help Ukraine cover the looming hole in Ukraine's 2009 budget (reftel). Tymoshenko insisted that the discussions with Russia were at a very preliminary stage.

3. (SBU) According to Zerkalo Nedeli, an influential Kyiv weekly, a "well-wisher" of Tymoshenko shared details of the visit with the newspaper. Deputy Finance Minister Anatoly



Myarkovsky, accompanied by low-level officials from the National Bank of Ukraine and the MFA, held negotiations in Moscow on February 4-6. (Note: On February 9, while not denying that discussions had taken place, the MFA nonetheless said that it was not involved. End note.) The internet newspaper Ukrainska Pravda on February 9 published what it said were GOU instructions to the negotiating party. (Note: In yet another signal of his marginalization, Ukraine's Finance Minister Viktor Pynzenyk admitted he learned of the negotiations from a journalist. End note.)

4. (SBU) According to Zerkalo Nedeli, a source in the Ukrainian delegation quoted Russian Finance Minister Aleksey Kudrin as placing specific conditionalities on Russia's willingness to provide a debt. The conditionalities enumerated by Zerkalo Nedeli all revolve around the unsolved bilateral issue of Soviet-era assets and debts.

5. (SBU) Specifically, Russia expects Ukraine's ratification of the so-called "zero option" agreement in return for the \$5 billion. The "zero option" relates to a deal among former Soviet republics that would revert control of Soviet-era property held abroad to Russia after Moscow pledged responsibility for all vestigial Soviet-era debts. Russia and Ukraine have long sparred over the deposition of Soviet-era assets. In an initial, unwieldy agreement dating from the early 1990s, the majority of former Soviet republics divided up responsibility for the Soviet Union's external debt and assets, with Russia getting 61 percent and Ukraine about 17 percent. Subsequently, the parties agreed to the so-called "zero option," whereby Russia assumed all Soviet-era external debt in return for other republics ceding to Russia any claims to Soviet-era external assets obtained under the previous agreement. Ukraine signed the agreement, but it was never ratified by the Rada. Ukraine's Ministry of Foreign Affairs has previously stated that Ukraine's claim to Soviet-era external property "far outweighs" Ukraine's proportion of Soviet debt. The fact that Ukraine technically still holds a claim on Soviet-era embassies, Russia's diamond fund, and some foreign currency assets remains a source of bilateral tension, especially since Russia has since settled Soviet-era debt through the Paris Club.

6. (SBU) In addition to Ukraine accepting the so-called "zero option," Russia is also expecting Ukraine to agree to a) solve all outstanding issues related to Soviet-era assets abroad; b) solve all outstanding disputes related to Russian property in Ukraine; and c) recognize debts owed by Ukrainian banks to Russia's Vnesheconombank as sovereign debt. The second condition, in particular, caught the attention of commentators in Kyiv, as the unspecific reference to "Russian property in Ukraine" could also be interpreted as including the most sensitive and hotly disputed issue of Russia's Black Sea Fleet in Sevastopol, Crimea.

7. (SBU) Commentators in Kyiv acknowledge that Russia's Finance Ministry is understandably using the loan to leverage a solution to its long, outstanding dispute with Ukraine over Soviet-era debt. At the same time, observers find it hard to believe that Russia would limit its "conditionalities" to such matters, and would likely expect political concessions from Ukraine as well. Some have speculated that Russia could use its additional leverage to seek a renewed lease arrangement for its Black Sea Fleet base (due to expire in 2017), to gain greater access to Ukraine's energy transport network, or to expand Russian supplies of fuel to Ukraine's nuclear reactors (thereby excluding a recently signed

agreement with Westinghouse).

#### Security Chiefs Wary

8. (C) In a February 6 meeting that took place before Sokolovskiy went public with the issue, Raisa Bohatyriova, Secretary of the National Security and Defense Council (NSDC), told the Ambassador that the contours of the loan were still vague, but on the table is a ten-year deal with a two-year grace period, to be provided at five percent annual interest. Bohatyriova said the Russian offer was "so good, it will be difficult to turn down." (Note: Indicative prices for sovereign Ukrainian debt are still above 20 percent on Europe's capital markets. End note.) The NSDC chief insinuated that she and President Viktor Yushchenko had been cut out of negotiations with the Russian side.

9. (C) The NSDC head was vague about Russian conditionalities, except to say she was certain Ukraine would have to "sacrifice" something of value in return. On February 9, head of the SBU and Yushchenko ally Nalyvaichenko told the Ambassador that he also could only speculate on Russian motives, but he would "bet that halting NATO" expansion would be part of any Russian deal. Nalyvaichenko promised the Ambassador that the SBU would be "looking deeply into the matter."

#### Comment

10. (C) The idea of Russia helping Ukraine plug its budget hole has already become a hot political topic in Kyiv, with the President's allies launching attacks at Tymoshenko on a nearly uninterrupted basis, accusing her of selling out the country to Russia. The irony of Russia coming to Ukraine's fiscal rescue is also not lost on Ukraine's political commentators, coming only several weeks after the bitter and drawn-out "gas war" with Moscow.

11. (C) In any case, a sizable Russian credit at this time is worrisome for several reasons. First, no one doubts Russia's desire to expand its influence in Ukraine, and by creating new levers of control, Russia would wield greater authority in Ukrainian foreign policy circles. Secondly, while one can only speculate on the full extent of Russia's "conditionalities," it is hard to believe that they will match what the IMF and other potential western donors would expect from Ukraine: namely, fiscal discipline, backed up by a joint message from Tymoshenko and Yushchenko to the Ukrainian people on the need to take tough steps to confront the economic crisis. A big loan from Russia -- without IMF-conforming fiscal conditionalities -- could, in fact, be seen in Ukraine as proof that tough decisions are unnecessary, and that the IMF (and by extension, the West) is demanding steps that are not meant to help Ukraine, but rather to harm it.

12. (C) The loan is not a done deal, however, and it may turn out to be politically unpalatable on the heels of the recent gas dispute with Russia. The loan also shows how far Tymoshenko may be willing to go to avoid difficult political decisions that could endanger her Presidential bid. Out of

all options to fund its bloated 2009 budget, Tymoshenko is trying to salvage a bad fiscal policy with a short-term solution. To do so, she may conclude that negotiating with Russia on the heels of the "gas war" is more politically acceptable than making the difficult cuts an austerity

program demands. End comment.  
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