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United States Department of State

Washington, D.C. 20520

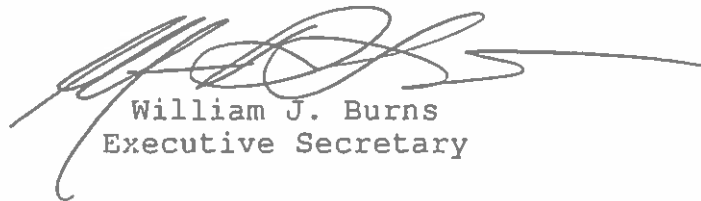
February 16, 1996

UNCLASSIFIED (with ~~CONFIDENTIAL~~ attachments)

MEMORANDUM FOR ANDREW D. SENS
EXECUTIVE SECRETARY
NATIONAL SECURITY COUNCIL

Subject: Papers for the President's and Vice President's
Meetings with Ukrainian President Leonid Kuchma,
February 21, 1996

Enclosed is a computer disk containing Background Papers
for the President's and Vice President's use during their
meetings with Ukraine President Leonid Kuchma, February 21,
1996. The memos themselves were initially sent on February 15.



William J. Burns
Executive Secretary

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Attachments:

Background Paper: Overview of US-Ukraine Relationship
Background Paper: Domestic Political Situation
Background Paper: Economic Reform and Privatization
Background Paper: Relations with Russia/CIS
Background Paper: Global Integration and European Security
Background Paper: Energy Situation

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US-UKRAINE: OVERVIEW OF BILATERAL RELATIONS

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The past year has been one of remarkable achievements in the US-Ukraine bilateral relationship. Your State Visit to Kiev in May provided important public recognition of the great progress Ukraine has made in introducing a genuinely democratic political process, resolving longstanding security issues, undertaking serious economic reform and respecting human rights. Prime Minister Marchuk's meeting with Vice President Gore in Washington in September helped to maintain a serious working dialogue. More recently, Secretary Perry's travel to Kiev in January and Secretary Christopher's meeting with President Kuchma earlier this month in Helsinki served to bolster US political visibility at a time when concerns about communist resurgence in Russia and winter energy stocks weighed heavily on Ukrainian minds.

As 1996 unfolds Kiev faces important challenges -- implementing a new constitution, meeting Trilateral Statement targets, coping with a burdensome energy debt to Russia and getting its IMF program back on track, to name a few. Problems with Russia, whether over the final division of Black Sea Fleet assets, CIS integration pressures, compensation for tactical nuclear warheads or other issues, will likely remain chronic. Ukraine and the G-7 will have to provide substance to the Chernobyl closure and energy market restructuring programs. Similarly, Kuchma will have to make hard political decisions quickly on the most critical reform elements -- including privatization -- if he is to sustain any political momentum for reform or maintain credibility among international donors. This will not make the job of reform any easier.

The challenge for the US this year is to bolster Ukraine in its efforts and demonstrate that we remain committed to an active political dialogue. At the same time, our fundamental message should stress that Ukraine must follow through on its commitments. This means tough decisions -- there is no viable alternative if Ukraine is to make the transformation to a market-based economy. If Ukraine does follow through, we must be prepared to respond quickly to ensure that its efforts bear fruit in a timely fashion. Delivering on a promise of continued assistance (\$225 million in FY96 funds) will help to demonstrate our commitment.

Kuchma should leave Washington confident that the decisive action he must take will have a positive impact on the economy and will serve to strengthen Ukrainian statehood, both in terms of its economic security and its overall survivability as a nation. He must understand that inaction will only serve to erode Ukraine's few tangible economic gains to date and isolate Ukraine from the international donor community.

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POTUS/Kuchma: Background/Overview of Bilateral Relations

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UKRAINE: DOMESTIC POLITICAL SITUATION

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President Kuchma faces several significant domestic challenges in 1996. Chief among these are the adoption of a new, post-Soviet constitution and the acceleration of comprehensive economic reforms. Kuchma's ability to meet these challenges will have a most profound impact on Ukraine's development.

The "constitutional accord" between Kuchma and the Rada helped to avert a major constitutional confrontation between the executive and the legislature by granting Kuchma extraordinary executive powers for one year, pending the adoption of a new constitution. As the June deadline for the accord approaches, debate over the constitution will begin to dominate the political agenda. Major differences have already surfaced. The Rada will fight Kuchma's desire to preserve most of his enhanced powers in the new constitution. Kuchma also is backing the creation of a bicameral parliament -- a change which could further dilute the power of the unicameral Rada. Another obstacle to timely adoption will be the ratification mechanism itself, which requires constitutional issues to be decided by a two-thirds majority in the Rada -- a tough hurdle even under the best of circumstances. Kuchma may try to circumvent this process by taking the constitution directly to the people for approval via referendum.

No less important on the Rada's agenda is the budget. Despite recent progress in finalizing draft appropriations, the budget has become highly politicized by leftists currying favor with public demands for increased deficit spending. Powerful state industries and politically strong trade unions also clamor for continued subsidies. Complicating the debate is the government's obligation to adopt a budget consistent with IMF priorities, without which a fourth tranche of IMF funds cannot be made available.

The Kuchma administration has vowed to hold the line on expenditures, as evidenced by the government's refusal to cave in to striking coal miners earlier this month. This newly found austerity is being driven not only by the IMF's requirements, but also by the realization, both within government circles and a growing portion of the public at large, that delaying reform further is no longer an option. Indeed, one of the pluses that emerged from the strike is the understanding that faster, not slower reforms, could have alleviated the sharp payments crisis in the coal industry.

Fortunately, Ukraine's overall human rights picture is not an issue complicating the domestic political scene. Despite recent, apparently isolated, incidents involving government interference with the news media, widespread human rights abuses continue to be virtually absent in Ukraine.

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POTUS/Kuchma:Background/Domestic Political Situation

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UKRAINE: ECONOMIC REFORM AND PRIVATIZATION

Ukraine has made some progress on economic reform, despite the lack of major structural reform to date. Yet the situation remains precarious, as evidenced by the IMF's decision to hold up additional loans to Ukraine because of concerns over the 1996 budget and Kiev's difficulty in paying foreign obligations.

In not much more than a year, the Kuchma government has created a rough economic order out of chaos. By controlling the budget deficit at 4% of gross domestic product (GDP), down from 8.6% in 1994, it reduced inflation from 400% in 1994 to 180%. The government also liberalized the foreign exchange regime, freed most prices, and went a long way toward freeing trade. The result was not only macroeconomic stabilization but some measure of progress for the population and the economy. Also in 1995, the GDP declined 13% (from 23% in 1994), but the social impact is limited by Ukraine's policy of continuing to pay workers even when enterprises stop producing. Exports increased 4.5% in 1995, and by 40% to non-NIS countries. Agricultural output declined just 3%.

Yet Ukraine's position is still precarious. The IMF has not decided yet whether to release the \$700 million remaining in the \$1.5 billion Stand-by Arrangement, and several large World Bank loans also are contingent on Fund action. International reserves equal only four weeks of imports, far below the 12 weeks considered minimal. A financial panic could quickly exhaust foreign currency reserves and force the central bank to impose exchange controls. Kiev would find it even more difficult to pay for Russian energy.

Ukraine needs economic growth to stop living on the edge financially, and growth requires investment. Structural reforms, such as privatization, tax reform and a stable foreign investment regime, are critical to investor confidence. Ukraine's comprehensive reform program -- including privatization -- began late in 1994. Since then small-scale privatization has made considerable progress, but technical and political snags have slowed implementation of the medium and large-enterprise program. Strong parliamentary opposition, has hampered efforts to speed up privatization.

During his September 1995 meeting with Prime Minister Marchuk, the Vice President emphasized the importance of moving privatization forward. Since then, Ukraine has made some progress but is still well behind the initial target of privatizing 8,000 medium and large-scale enterprises by the end of 1995. Some 1,400 have sold more than half their shares; negotiations continue on a realistic target for end of 1996.

While our discussions with Ukraine are continuing on steps Ukraine must take to accelerate medium and large-scale privatization, it will be important for you to underscore what needs to be done, and that we will continue to work with Ukraine to ensure successful implementation.

POTUS/Kuchma:Background:Economic Reform/Privatization

Drafter: EUR/WST:MBocchetti:S/NIS/C:SDwyer
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Clearance (s) :S/NIS:DSpeckhard
EUR/WST:EJSalazar
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UKRAINE: RELATIONS WITH RUSSIA/CIS

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Ukraine's relationship with Russia remains difficult. Kiev is worried by what it sees as growing uncertainties in Russia's political development -- Yeltsin's recent personnel changes, the strong showing of the communists in the December Duma elections, recent CIS "integration" pressures, etc. You will want to use any discussion of Russia and the CIS to underscore our desire for a productive bilateral relationship.

On bilateral issues the two sides are on schedule in dividing Black Sea Fleet support facilities, but progress on the status of the main Fleet base in Sevastopol -- the main stumbling block -- remains elusive. Similarly, despite Russia's having acknowledged its obligation in 1994, Ukraine has yet to be compensated for tactical nuclear weapons removed to Russia in 1991-92. In the meantime, several new problems have emerged, such as differences over oil transportation tariffs and an increase in excise taxes on Ukrainian goods imported to Russia. More importantly, the Russians continue to link signature of the long-delayed "Friendship Treaty" to a final BSF agreement.

Despite upbeat press play, Ukrainian officials are publicly skeptical that the April 4-5 Yeltsin visit to Kiev to sign the long-delayed Friendship Treaty will take place. They argue that the visit itself will serve as the best indicator of Russia's sincerity in seeking, as it maintains, a genuine partnership with Kiev based on respect for Ukraine's independence and sovereignty. Kiev's attitude is intended to put Moscow on notice that it is looking for actions, not words, but few in Kiev expect Moscow's policy to change for the better. Indeed, there is a growing feeling that the coming months will see a "full court press" by Russia to reverse Ukraine's perceived "drift" toward the West.

During his visit to Kiev earlier this month Russian Foreign Minister Primakov reportedly pressed Ukraine to integrate more closely with the CIS "in all spheres" and warned of the consequences of NATO's expansion eastward. Primakov has made clear that one of his top priorities will be Russia's relations with the other NIS.

Ukraine opposes any moves aimed at giving the CIS a supra-national character. Kiev's posture at the mid-January CIS summit underscored its policy of using CIS structures as a brake on Russian ambitions without compromising Ukraine's sovereignty. President Kuchma reiterated that Ukraine's national interests will continue to dictate the scope of its participation in the organization. Indeed, the Ukrainian delegation did not participate in discussion of military issues, including membership in the CIS Collective Security arrangement, and again declined to sign on to agreements forming customs or payments unions.

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POTUS/Kuchma:Background/Relations with Russia/CIS

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UKRAINE: GLOBAL INTEGRATION AND EUROPEAN SECURITY

Since its commitment to adhere to the terms of the 1994 Trilateral Statement, Ukraine has become increasingly prominent in international -- and especially European -- fora that have a bearing on regional security. Ratification of START and accession to the NPT further enhanced Ukraine's stature. Ukraine also was the first NIS country to sign up for NATO's PFP and maintained a battalion of Ukrainian troops in UNPROFOR.

Despite initial concern about meeting strict NATO certification requirements, Ukraine now maintains a battalion in IFOR (under French command). It also has contributed a helicopter unit to UNTAES (UN Transitional Administration in Eastern Slavonia, headed by an American). We have consistently and actively promoted Ukraine's participation in these organizations to underscore our view that such contributions help to enhance Ukraine's security and reliability as an international partner. Ukraine's admission to the Council of Europe in 1995 was, in part, a testament to the success of that approach. Meanwhile, Ukraine has developed a close and reliable working relationship with the OSCE, largely overcoming initial doubts about OSCE "intrusions" in sensitive areas -- like Crimea.

Despite some progress in other areas, obstacles remain to Ukraine's entry into the post-COCOM "Wassenaar Arrangement" and the Missile Technology Control Regime (MTCR) -- both of which Ukraine considers important to security, trade and export goals. We have told Ukraine we would welcome its participation in the new Wassenaar regime once we receive its commitment to end arms-related trade for military end-uses to countries whose behavior is a cause of concern (Iran, Iraq, Libya, North Korea) -- a commitment we obtained from Russia and other countries we have supported for membership. Ukrainian diplomats have signalled that the assurances will be conveyed soon.

On MTCR, the principle obstacle has been Ukraine's resistance to forgoing short range missiles. We are working closely with Ukrainian diplomats to craft a mutually acceptable position. Without resolution, Ukraine could carry through with its threat not to adhere to INF limitations on medium range missiles. Ukraine's record on implementing the CFE Treaty has been good, although final action has been postponed on Treaty-limited equipment whose ownership remains in question until the Black Sea Fleet assets are divided. While START implementation is proceeding with only minor technical problems, Ukraine's first try at ratifying the Open Skies agreement failed, probably thanks to considerable confusion and poorly briefed parliamentarians. The government intends to resubmit the agreement once the members are properly briefed. Finally, Secretary Christopher underscored to President Kuchma in Helsinki earlier this month our hope to conclude agreement on a CTBT in June, and sign in September.

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POTUS/Kuchma:Background/Global Integration and European Security

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PM/CBM:DGlassman
EUR/SCE:CHoh (info)
PM/A TEC:JNovak
PM/SPN:DAppleton

Ukraine has been hard pressed to meet its energy needs and is seeking to reduce its reliance on Russia -- it imports half of its energy and relies on Russia for 90% of its imports. Through 1994 Ukraine incurred over \$2.5 billion in energy debts to Russia and Turkmenistan. Under its IMF agreement, since 1995 Ukraine has had to remain current on fuel imports. Its ability to finance imports is hampered because many Ukrainian consumers do not pay their energy bills. Ukraine views stabilization of its energy sector as key to proceeding with Chornobyl closure.

Energy sector reform: The GOU has deferred implementation of an electricity sector restructuring program that would introduce market prices, citing low fuel supplies and social concerns. We are urging the GOU to implement the program because of its importance for energy efficiency, additional IFI financing, and attracting private investment. On February 7 President Kuchma issued a decree to reform the antiquated coal sector, which may close up to 100 mines. He will have World Bank support. We are preparing a program to support demand-side efficiency measures.

Current supplies: Entering the winter Ukraine had low but adequate energy stocks, comparable to last year's. Following a miners' strike in February, Ukraine's coal reserves have been depleted, although most miners have returned to work following government pledges to pay back-wages. The coal shortage has put additional pressure on fuel oil reserves.

Petroleum and Gas: At a USG-sponsored conference, U.S. companies expressed interest in rehabilitating Ukraine's old oil and gas fields and exploring for new deposits. However, companies are reluctant to invest without clearer foreign investment regulations. Symptomatic of its erratic investment climate, Ukraine has postponed its Black Sea oil exploration program three times. Ukraine's plan to build an oil terminal in Odesa to diversify oil imports has been delayed by ownership controversies and lack of financing.

Nuclear: Nuclear power accounts for almost 40% of Ukraine's electricity production. Ukraine wants to reduce its reliance on Russian fuel by building a nuclear fuel fabrication plant (currently it receives fuel rods at no cost from Russia in exchange for its nuclear warheads). While U.S. firms were interested, Ukraine conditionally awarded the contract to Russia's MINATOM. However, we question the economic viability of the plant given alternative fuel supplies and other pressing investment needs. We are considering initiating negotiations with Ukraine on a peaceful nuclear cooperation agreement. The Atomic Energy Act requires an agreement for the export of nuclear fuel and reactors.

U.S. Assistance: Ukraine is considering using up to \$100 million of an AID agricultural credit facility to buy U.S. fuel for the agricultural sector. The GOU considered using the EXIM credit program for fuel imports but determined the 180-day repayment term is too short (the AID program has 540-day terms).

POTUS/Kuchma:Background/Energy Situation

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cleared:S/NIS:DSpeckhard

EUR/WST:JPurnell

S/NIS/C:SDwyer

EB/EPC:JSteele

PM/SC:CKessler

PM/NE:JDooley

E:MColeman

AID:RICHORD

Energy:JElkind

S/P:AWeiss