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Ukraine After the Crisis: Recovery and Reform, not Revolution or Russification

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It could be the libretto of a grand opera. The Prince and Princess of a democratic revolution, who gained power after a long struggle against the old guard, fall out with each other. The political love affair ends and they spend all energy fighting each other rather than representing the people that brought them to power. The old villain from the dark period returns, and his reputation recovers as the Prince and the Princess quarrels. Amid destruction and economic collapse, the fire of the democracy revolution burns out. People yet again turn to the villain for leadership. He returns to power, but uses it again to benefit his own kin. He solidifies his own position by colluding with foreign powers and terrifying his enemies into silence. In the third act, the decline and fall of the country begins.

But it is not a libretto, nor is it a tragedy by Shakespeare. It is how many observers view the modern history of Ukraine. And as with many grand stories, it builds on a combination of real substance and manufactured spin. While political romantics believe in the transformational power of revolutions, realists tend to see history evolve endogenously and incrementally. Ukraine's Orange Revolution was the beginning of a new wave of soft revolutions in parts of the former Soviet Union where the old guard had resisted funda-

SUMMARY

This Policy Brief aims at examining Ukraine's economic woes and what it needs to do to improve economic performance. At the centre of the Brief are the effects on Ukraine of the economic crisis and the policy programme devised to improve economic performance. The crisis hit Ukraine hard and Gross Domestic Product fell by 15 percent in 2009. The economy is now recovering, but economic growth will not return to pre-crisis levels anytime soon. Ukraine went through a classic emerging-market crisis – it was too dependent on export of steel and metals, and it was too exposed to adverse development on international credit markets.

The reform agenda set out by the new Ukrainian government is ambitious. If the government delivers on its promises – and obligations to the International Monetary Fund – economic policy will move in a liberal direction and economic growth is likely to pick up. There are hesitations about the ability to push through all reforms, but the Ukrainian government has been forced to tie itself to the IMF mast and should make full use of this opportunity to liberalize economic policy and modernize the economy.

There are also hesitations based on President Yanukovych and his political orientation towards Russia. Sceptics may or may not be proven right – it is too soon to tell. What seems clear, however, is that Ukraine favours a much more pragmatic approach to its neighbors in the east and the west. It is not difficult to understand why. Ukraine's relations to Russia had to improve and as long as the EU does not wish to start the process for full accession, Ukraine needs to find its own way and build a reform and future agenda on other foundations.

mental political change that would bring democracy, individual liberties and market economy. It was an historic and important moment for Ukraine. Yet as with other revolutions, it could not alone bring fundamental change of the society and the economy. Predictably, new leaders were taken hostage by political realities. It is understandable that many people inside and outside Ukraine is disappointed by the inability of Viktor Yushchenko and Yulia Tymoshenko to deliver on the promises set out during the Orange Revolution. But the task now should be to pave the way for the reforms needed to change the socio-economic structure of Ukraine – the reforms that were neglected in the post-revolutionary period.

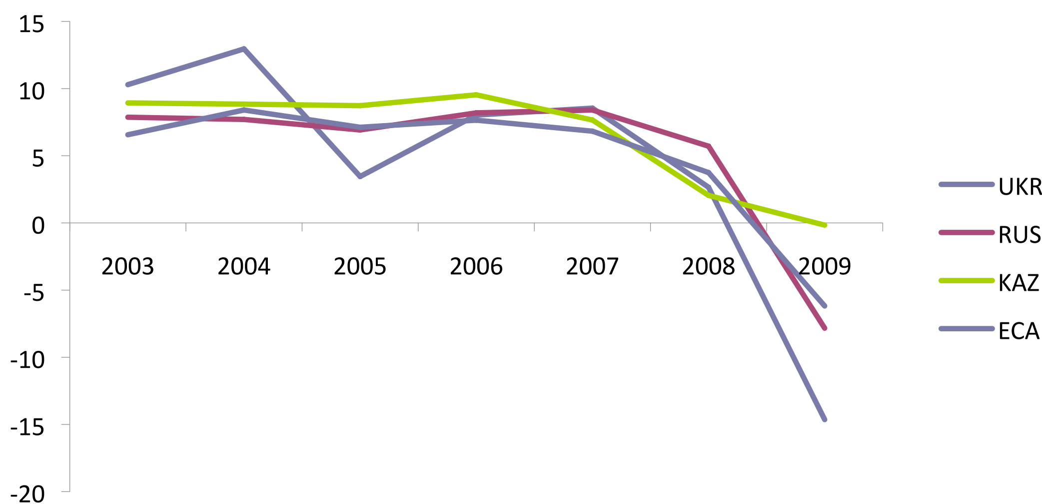
This Policy Brief aims at examining Ukraine's economic woes and what it needs to do to improve economic performance. Naturally, developments during the crisis and the various packages by the International Monetary Fund (IMF) will be at the centre of the paper. Furthermore, the reforms initiated by the Ukrainian government will be discussed in light of the overall reform needs. Finally, the paper discusses what approach policymakers in the EU should take in relations with Ukraine and its new government.

CRISIS AND RECOVERY

The global crisis hit Ukraine hard. Gross Domestic Product (GDP), which had grown at steadily high levels in the pre-crisis period, plunged in 2009. GDP per capita fell by close to 15 percent (see Figure 1). Ukraine's economy contracted more than most other economies in the region – and in the world. Only Latvia plays in the same league, when compared to other European countries. Ukraine suffered a contraction twice the size of the contraction in Russia and the average contraction in the Europe-Central Asia (ECA) region.

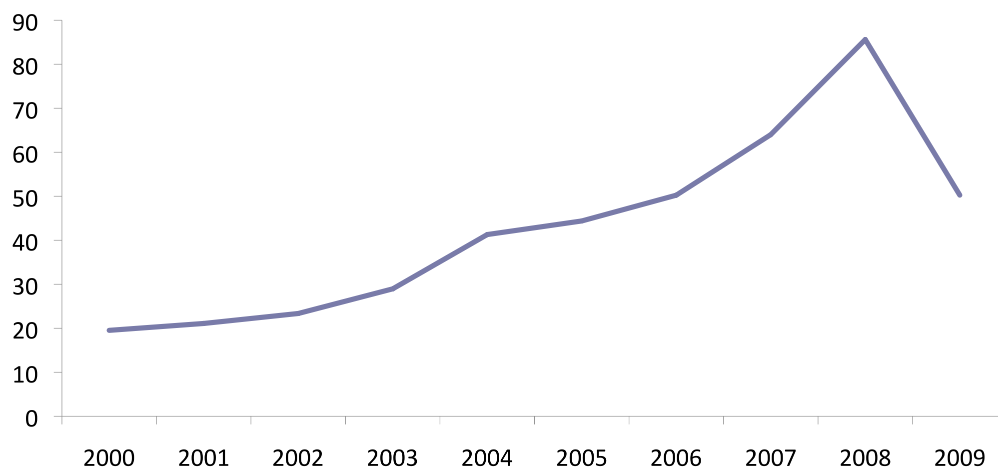
What explains the sharp fall in Ukraine's economy? Two explanations are central in order to understand the severity of the economic collapse. Firstly, Ukraine's economy was highly dependent on the export of commodities, steel and agricultural produce in particular, and as world prices and demand fell, Ukraine's export revenues collapsed (see Figure 2). Export revenues fell by a greater degree than GDP, and the current account deficit expanded in the first quarters of the crisis. Revenues from steel exports were particularly hit and some of the miners and steel producers had to stop production. For a sector that represents a big share of GDP, the contraction in the world metal market had a devastating effect. Steel pro-

FIGURE 1: GDP PER CAPITA GROWTH (ANNUAL %)



Source: World Bank, World Development Indicators

FIGURE 2: EXPORTS OF GOODS AND SERVICES (BOP, CURRENT USD, MIO)



Source: World Bank, World Development Indicators

duction in Ukraine fell by approximately 30 percent in 2009; overall production of metals shrunk by 55 percent between November 2007 and November 2008. Naturally, the eastern parts of Ukraine, the heartland of industrial steel production, were hit the hardest. Other key export goods of Ukraine, like cereals, were less affected by the crisis. But no product category in the portfolio of Ukrainian export managed to expand during the crisis.

Secondly, Ukraine was highly exposed to international capital markets. Banks and firms had taken up considerable loans on the international debt markets and needed to roll over debt as loans matured. Fortunately, Ukraine was not exposed to toxic debt in the same as many European banks, but as the credit markets generally dried up, and as the share of Non-Performing Loans (NPL) in Ukrainian banks increased as the property market collapsed, Ukrainian banks run into difficulties. Seven Ukrainian-owned banks have been put under the authority of the Ukrainian government. Recapitalization needs have decreased considerably in the past 18 months, but there are still remaining fragilities in the banking system.

Furthermore, the property boom in pre-crisis Ukraine was driven by an expansion of debt. In the three years before the crisis, property prices in Ukraine went up by around 600 percent. Kiev and other development hubs in Ukraine were for many years vast and vibrant construction sites. With rising property prices, people could also expand consumption on the back of increasing asset values, and in that way push domestic demand with the help of external credit. But this driver of growth ended abruptly with the crisis. The property market collapsed in the second half of 2008 and continued to fall in early 2009. House prices in Kiev fell by 40 percent. Fixed investments, to a large degree denominated by investments in real estate, dropped by 46 percent in 2009. A few months into the crisis, Kiev looked in many ways as a ghost town – a city that had ceased to exist. It was still a construction site with building cranes everywhere. But not actual work was going on. Construction workers and firms had left the sites. About half of the real estate developments in the country were put on hold.

These two factors, falling export revenues and adverse effects from the credit squeeze, were the main drivers of the contraction in the Ukrainian economy. Domestic demand fell by almost 25 percent in 2009. The construction and retail sectors, which had lifted domestic demand in the pre-crisis years, were now the main factors behind the fall. Construction output, for example, fell by 35 percent in 2009. As employment shot up and as wages were cut for many workers in the industrial sector, the adverse effect on demand became very strong.

In other words, Ukraine went through a classic emerging economy crisis. In Ukraine, the force of the crisis was stronger than usual as it was fostered by a global

credit squeeze and a recession in key export markets for Ukraine. Hence, the severity of the crisis reflected the fragile economic structure of Ukraine, with considerable dependence on steel production and exports. As the world economy boomed in the pre-crisis years, and as China's demand for raw materials to its industry and real estate developments grew tremendously fast, it was not difficult for Ukraine to push growth. It only had to ride the curves and avoid irrational economic policies that would halt its capacity to supply world markets with metals.

Yet it was clear to most discerning economic observers that this growth trend could not be sustained unless Ukraine diversified its economic base and cooled down property-driven growth. Past Ukrainian governments, however, did not achieve much on economic reforms. There were plenty of ideas and proposals, but they all got stuck in political battles between warring fractions of the Orange Revolution movement. One of the few real economic reform achievements in the pre-crisis years was Ukraine's accession to the World Trade Organisation (WTO) in early 2008.

Nevertheless, crisis management is Ukraine has been better than expected.[1] This judgment applies to the former as well as the current government. With the assistance of the International Monetary Fund and other creditors, the immediate financial and fiscal problems were addressed swiftly. Thanks to good policy responses, the GDP contraction has stopped and Ukraine is forecasted to have positive growth in 2010. Estimates from the IMF and the World Bank suggest that growth will be in the region of 3.5 to 4 percent in 2010.[2] In 2012, the World Bank estimate real growth to be 5 percent.[3] Such growth levels are a good distance away from pre-crisis growth levels. Yet they are comparatively high, and growth can increase further if the Ukrainian government is successful in its new drive to improve economic performance.

The recovery follows a classical cycle. It is export revenues that have driven the recovery in Ukraine. World demand and prices have picked up significantly in the past year. Real export increased by 7 percent in the first two quarters of 2010, and industrial production picked up 12 percent between January and May this year. Domestic demand is still a drag on the recovery, with weak growth in the construction and retail sectors. The construction sector is expected to recover as Ukraine soon must make final investments for the UEFA Euro 2012, the soccer tournament hosted by Ukraine and Poland. Fixed investment is expected to pick up by nearly 4 percent this year, and will grow continuously in 2011 and 2012. Still, the output gap will remain large in 2010 and 2011 due to the sustained negative impact of the crisis.

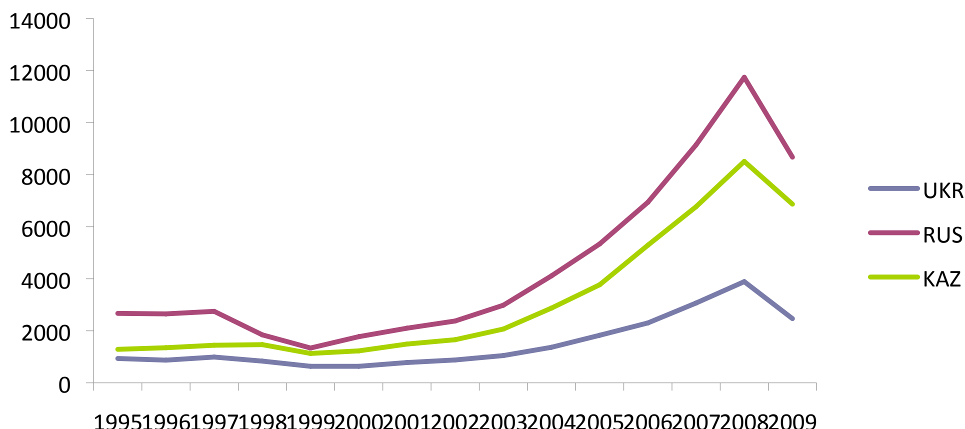
ECONOMIC REFORM – PAST, PRESENT AND FUTURE

Ukraine is a poor country. Its GDP per capita is significantly lower than in comparable countries. In 2007, GDP per capita in Ukraine was rough half of the GDP per capital in Kazakhstan and one third of GDP per capita in Russia. The distance to Russia has increased during the crisis years, despite the sharp contraction in the Russian economy in 2008 and 2009 (Figure 3).

Ukraine was poorer than most other transition countries at the time of independence and the collapse of the Soviet Union. But the distance to levels of welfare in Russia and Kazakhstan, among others, increased as a consequence of slow and half-hearted economic reforms in Ukraine. Ukraine, as other countries in ruble zone, went through a very difficult period at the time of independence and the political leadership was not fit for purpose. The first years of Leonid Kuchma's Presidency in the middle of the 1990s became an active reform period, with financial liberalization and privatizations on the agenda. But reforms were later halted and did not return as central items on the policy agenda till Viktor Yushchenko assumed office as Prime Minister and launched an economic reform agenda.

Viewed by Anders Åslund, a noted expert on Ukraine, as a period of "competitive oligarchy", economic growth took off.[4] Expectations were high that the economic reform agenda would be at the centre of Ukraine's government again when Yushchenko and Tymoshenko were brought to power after the Orange Revolution. Yet the Prince and the Princess of the Orange Revolution never managed to live up to expectations.

FIGURE 3: GDP PER CAPITA (CURRENT USD)



Source: World Bank, World Development Indicators

Ukraine performs badly in international rankings of reform and competitiveness. In the competitiveness ranking by the World Economic Forum, Ukraine is ranked 72nd of 131 reviewed countries.[5] In the World Bank Doing Business Index, Ukraine is ranked 142nd of 183 examined countries. The business climate in Palestine (Gaza and the West Bank) and Iran is better than in Ukraine.[6] Nor does Ukraine rank well in economic freedoms, as shown in Table 1. While Ukraine has increased its ratings in the noughties, it has not kept up with reforms in other countries, why its rankings have fallen.

TABLE 1: ECONOMIC FREEDOM IN THE WORLD INDEX

		2000		2008	
		rating	rank	rating	rank
1.	Size of Government	4.78	94	5.50	109
2.	Legal Structure & Security of Property Rights	4.81	79	5.00	91
3.	Access to Sound Money	2.24	122	4.61	138
4.	Freedom of Trade Internationally	7.05	61	6.51	91
5.	Regulations of Credit, Labor, Business	4.79	107	6.02	112

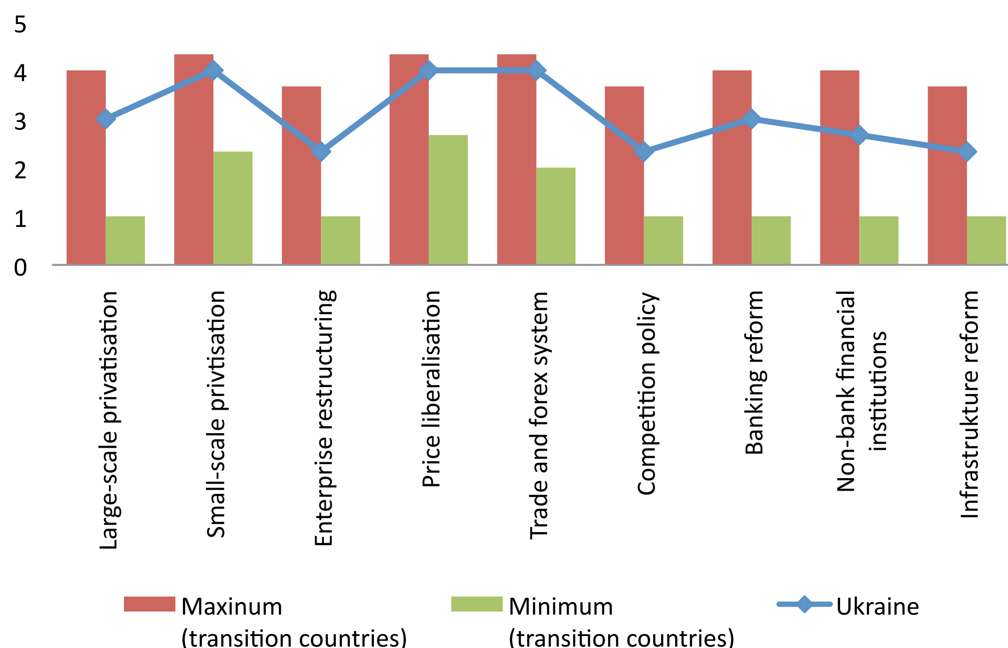
Source: www.freetheworld.com

Ukraine is also a laggard in the group of transition economies (Figure 4). It is not the worst reformer of all the transition countries, but it is far away from the top league and clearly belongs to the group of laggards. In this respect, Ukraine is similar to Former Soviet Union countries in Central Asia rather than transition countries on the eastern rim of the European Union.

Economic reforms are also underway in Ukraine, and the demands of the International Monetary Fund for approving the two Stand-by Agreements are an important but not the only source of reforms in Ukraine. It has also dawned on Ukrainian policymakers that the economy needs to improve considerably for Ukraine to increase welfare. The current government has been pro-active in its economic and regulatory policy. There was widespread skepticism, especially in the West, towards Viktor Yanukovych when he won the election early in 2010. His crafted a populist economic agenda while in opposition, and is responsible for the significant hike in social security expenditures in recent years. But the reform agenda set out by the new government is impressive. If it can deliver what it has set out to do, Ukraine will be a far more competitive and well-functioning economy in a few years time.

The question is: will Yanukovych be able to deliver? There are reasons for skepticism. Ukraine has seen many good proposals before but little has been achieved. Yanukovych hardly qualifies as a true believer in free-market economics, and has also been a bit too eager to favour his allies in the eastern part of Ukraine. Such concerns may prove to be right. So far, however, the government appears able to deliver and there is no doubt Yanukovych is pushing through reforms that annoys vested interests in the country. What also tilts the balance in favour of optimism is

FIGURE 4: TRANSITION INDICATORS, 2009



Source: European Bank for Reconstruction and Development (EBRD), Transition Indicators ACX

that the IMF packages clearly limit any potential interest on the part of the government to halt the reform agenda. The new IMF package from August this year was an important indication that the government is willing to accept the conditions that are attached to IMF support.

What are the core elements of the reform agenda?

One of Yanukovych's first reforms when he assumed office in early 2010 was to establish the Committee on Economic Reforms. The Committee is tasked to coordinate the reform process and to ensure implementation. And attached to it is a new Coordinative Centre for Economic Reforms, headed by a respected economist, Oleksandr Danylyuk. Such bureaucratic moves seldom qualify as an important reform, but in Ukraine it does. It was one of the key conclusions of the Independent International Experts Commission, chaired by Anders Åslund and Oleksandr Paskhaver, a former adviser to Yushchenko that heads the Centre for Economic Development institute in Ukraine, which suggested the establishment of a Reform Commission with key government ministers.[7] In a country that has failed to achieve reforms because of internal bickering and turf wars, a clear institutional structure for reforms is central.

In early June, the Committee on Economic Reforms, helped by the international consultancy McKinsey, set out a very ambitious and liberal agenda for the period up to 2014. The entire programme comprises several hundred of initiatives, but the main elements of the strategies can be summarized as follows.

- The state budget should be stabilized and made more effective. The Ukrainian tax system should be simplified in a new Tax Code that will help lower tax rates but increase tax collection. New rules for fiscal discipline should be established and public debt management will be reformed. Transparency in public finances should increase and the role of the Finance Ministry should be strengthened. A new anti-corruption drive will be established. Furthermore, the National Bank of Ukraine should be given more independence and the agenda suggests new policies to curb inflation and to improve the stability of the financial system.

- The social security system will be reformed to increase access and the management of social services. Pension system reform is one element

in this reform package. The educational system should also be reformed, bringing the Ukrainian system closer to European standards.

- The business climate will be reformed to attract greater amounts of investments. A central plank in this strategy is to improve the system for licenses and permits, which is notoriously dysfunctional in Ukraine. The amount of permits needed to start and expand business will be cut and the time needed to obtain a permit should be shortened. Other regulatory systems are set to be reformed to bring Ukraine closer to European and WTO standards. More state-owned enterprises should be privatized and the role of the government in the economy should decrease.

- Improved relations to other markets are envisioned in the strategy. Access to the EU market should improve through a new Free Trade Agreement that goes beyond WTO rules. Improved access to other CIS markets is also a target in the agenda.

- Perhaps the strongest commitment to reform is expressed in the new policy towards modernization of infrastructure and the primary sectors. The energy sector will be shaked up considerably, with liberalization of prices and an end to subsidies. Other primary sectors will be liberalized, partly through privatization.

The reform agenda is ambitious – far more ambitious than, for example, the Russian programme for modernization. Certainly, the government could have gone further and taken up the full set of recommendations from the Independent International Expert Commission. Notably, the ambitions on integration with the European Union are not as strong as they should be, and the new government is clearly more pragmatic in its approach to integration with the EU than previous governments. Yet if the government delivers on its promises and obligations, it will certainly usher the contrary in a liberal direction and a new period of sustained growth.

The reform agenda also has clear imprints of the IMF and the conditions it has attached to the loans it has given to Ukraine (see Box 1 on IMF conditionality). If Ukraine fails to deliver on the agreements with the IMF, it certainly would not be the first time in history that a recipient of IMF money would flaunt the conditions. In fact, the record of the IMF tom bring about needed reforms in countries is not as impressive as the IMF sometime suggests. At the end of the day, the prospect for reforms depends entirely on the determination of the government to push comprehensive reforms – which always is a difficult task as many vested interests prefer status quo.

BOX 1: IMF CONDITIONALITY

The Executive Board of the IMF recently approved a new Stand-By Arrangement for Ukraine to support economic reform. The IMF has underlined three main sectors of the reform: fiscal, financial and energy. The main *fiscal* goal of the programme is to reduce deficit to 3.5% of GDP in 2011, 2.5% in 2012 and put the public debt below 35% by 2015. The Ukraine government has also committed itself to improve the pension system, public administration and tax system. The targets in the IMF agreement are similar to those set out in the reform agenda, but they are more detailed. The *financial* reforms mostly focus on the banking system. Banks should be recapitalized, supervision of banks should be strengthened and there should be a new institutional framework that gives the National Bank of Ukraine greater independence. The IMF also wants to reform exchange rate policy towards greater flexibility and transparency. In the *energy* sector, the IMF wants to strengthen the financial position of gas sector and reduce the deficit of Naftogaz. The IMF also demands liberalisation of prices in public utilities.

Prior Actions

- Enact a supplementary budget with fiscal measures of UAH 16 billion and consistent with a 5.5 percent of GDP deficit for the general government in 2010 and the commitments in the MEFP (Memorandum of Economic and Financial Policies).
- Increase gas tariffs for all households and utility companies by 50 percent (effective August 1, with the coming billing cycle).
- Enact amendments to the NBU (National Bank of Ukraine) law in line with IMF recommendations.
- Amend NBU Resolution 47 (to strengthen the emergency liquidity assistance framework and eliminate the possibility of NBU lending to the private sector) in line with IMF recommendations.
- Adopt legislation transferring the authority for setting heating tariffs for communal utilities to a new independent regulator.

Quantitative and Continuous Performance Criteria

- Floor on net international reserves
- Ceiling on net domestic assets
- Ceiling on the cash deficit of the general government
- Ceiling on cash deficit of the general government and Naftogaz
- Ceiling on publicly guaranteed debt
- Non-accumulation of external debt payments arrears by the general government

Quantitative Indicative Targets

- Ceiling on monetary base
- Ceiling on VAT refund arrears

Structural Benchmarks

- Enact legislation to revoke the law “On temporary ban to levy penalties for overdue payments of utility bills” so that any arrears on utility payments accumulated after October 1, 2010 are subject to penalties. *By September 30, 2010.*
- Agree with Fund staff on a schedule for phasing out existing restrictions on the foreign exchange market. *By October 31, 2010.*
- Complete audit for Nadra Bank before any decision on its resolution. *By October 31, 2010.*
- Enact legislation on pension reforms consistent with commitments in the MEFP. *By December31, 2010.*
- All banks should meet capital requirements and capital deficient banks should increase their capital in line with the approved plans. *By December 31, 2010.*
- Complete due diligence of state-owned banks in line with 21 of the MEFP. *By December 31, 2010.*
- Initiate the implementation of the reform and restructuring strategy for Naftogaz in accordance with the principles of the Brussels declaration. *By December 31, 2010.*
- Amend the law “On surcharges for the purposes of mandatory state pension insurance” 400/97-BP to permanently eliminate the surcharge on non-cash purchase and sales of foreign currency. *By December 31, 2010.*
- Formulate a comprehensive public administration reform plan aiming to improve the cost efficiency of public service delivery. *By March 31, 2011.*
- Adopt amendments to the Law of Ukraine “On restoring the solvency of the debtor or announcing him/her bankrupt” and related regulations to expedite insolvency proceedings and to facilitate out-of-court restructuring. *By June 30, 2011.*

Source: International Monetary Fund (2010) Ukraine—Request for Stand-By Arrangement and Cancellation of Current Arrangement Staff Report; Staff Supplement; Press Release on the Executive Board Discussion, IMF Country Report No. 10/262, August 2010

CONCLUDING REMARKS

The new government in Ukraine has clearly put emphasis on economic reforms. Yet many observers, including the author of this paper, have been hesitant about the willingness of the government to deliver the reforms. Two factors have provoked the hesitation. Firstly, the new government operates in a difficult political environment and has, as previous governments, alliances with interests that wish to stall the reform agenda. In this regard, Ukraine is no different than other countries. It is only in textbooks and political rhetoric that comprehensive reforms are an easy task. In real life, however, there will always be obstacles and resistance that attempts to derail a reform agenda. The key to success has often been speed; swift action by governments limits the capabilities of reform-resisting forces to organize forceful opposition. Clearly, this has been recognized by the Ukrainian government; many of the new reforms will be delivered between late 2010 and 2012.

The second hesitation is political and concerns the political orientation of President Yanukovych, especially his relations to the Kremlin. Those who view Yanukovych as a Russian poodle looked to be proven right soon after he assumed office. The policy towards NATO membership was reversed – Ukraine is no longer an applicant for membership. In April, a deal was struck with Russia over the Black Sea Fleet in Sevastopol. Some members of the new government have strong links to the Kremlin and its favoured oligarchs. Deteriorating conditions for media freedoms have also been laid at the door of the President, suggesting he favours Putin-style authoritarianism. The rhetoric on accession to the EU and an Association Agreement has gone somewhat cold. More recently, Yanukovych has been eyeing the Russian government for industrial partnerships.

What should one make of this? It is too soon to tell, of course, what the verdict on Yanukovych will be in future. Critics may be proven right, or they may not. What seems to be clear, however, is that the central plank of Yanukovych’s approach is pragmatism. Such an approach is understandable for three reasons.

Firstly, Ukraine’s relation to Russia had to improve. Regardless the profile of the government, it is too difficult for Ukraine to be in constant quarrels with Russia. After all, Russia is one of the main investors and export destinations for Ukraine. Ukraine is also dependent on energy supply from Russia. Ideally, commercial relations would not be subject to political quarrels, but that has not been a realistic option for Ukraine. The extreme positions in the debate over Ukrainian relations to Russia have been, one the one hand, the assertion that Ukraine should cut as fast as possible its relations to Russia and, on the other hand, the supposition that Ukraine should accept all demands from Russia in order to keep the im-

perial neighbor happy. None of these strategies would work. Nor are they desirable.

Sooner or later, Ukraine would have to find another relation to Russia. That is now underway. And there are good and bad signs. The withdrawal of its NATO application is arguably uncontroversial – this has not really been on the cards for several. More problematic, however, is the maintained Black Sea Fleet in Sevastopol and the attempts to politically engineer commercial deals with the Russian government and its favoured oligarchs.

What speaks against Russification of Ukrainian policy is that key allies of Yanukovych are in opposition to such a strategy. Some of the oligarchs that support Yanukovych have their main competitors in Russia and are dependent on the European market for its sales. Heightened Russification of the economy is also unlikely as Europe is a far more important export destination and source of foreign direct investments than Russia. Any strategy for increased exports and FDI will have to be oriented towards Europe. Furthermore, Ukraine is a member of the WTO and cannot sign up to whatever trade-policy ploy that comes out of the Kremlin, like the Customs Union with Belarus and Kazakhstan. Ukraine will hardly risk faulting on its WTO obligations just to please the Kremlin.

Secondly, it is understandable that Ukraine's ideological interest in the European Union has cooled a bit. Europe has effectively turned down the proposal of the past Ukrainian government to establish a process for full accession. One can debate the merits of the EU's decision, but it is a hard fact that Ukraine has to deal with. This is not to say that Ukraine, or the new government, has lost interest in an Association Agreement. Clearly, it has not, and steps have recently been taken to conclude this negotiation process (e.g. Ukrainian membership in the EU's Energy Community). Yet any government in Ukraine would have to change the tone and substance of the country's position towards the EU. As long as full accession is not possible, Ukraine will also have to find a more pragmatic approach towards the EU.

Lastly, Ukraine needs to put much more political energy into domestic economic and political reforms. Inevitably, this implies a changing context for the role of outside partners and governments in the reform process. The prospect of full accession to the European Union will in future take more of a backseat role. It is no longer such a galvanizing force for reforms it was five years ago. Ukraine's new partner for reforms is the IMF. That maybe just what Ukraine needs to have a successful period of reforms.

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