THE UKRAINE ECONOMY IN THE TIME OF POLITICAL INSTABILITY[1]

Ing. Miloš Bikár, PhD.

Organisation: Corporate Finance Department, Faculty of Business Management, University of Economics in Bratislava, Slovak Republic

Email address: milos.bikar@gmail.com

Abstract:
The paper deals with the analyses and predictions of the Ukraine economy development and the main factors influencing the current and future economy and the structure of GDP. The economic turmoil reflects recent political instability, but Ukraine's economic problems were long in the making. Dodgy economic policy, distaste for reform and endemic corruption have brought the country to its knees. Ukraine's problems are not just political. In recent months its economy has taken a hammering. The paper highlights the monetary policy including currency prediction, public debts, inflation levels, as well as commodity import and export dependency.

Keywords:
Economic turmoil, political instability, fiscal and monetary policy, external vulnerabilities, exchange rate volatility, public financial management.

JEL classification: E 58, F 34, G 15, G18, H 60

Introduction

Ukraine, comparable in size and population to France, is a large, important, European state. The fact that it occupies the sensitive position between Russia and NATO member states Poland, Slovakia, Hungary, and Romania adds to its geostrategic significance. Many Russian politicians, as well as ordinary citizens, have never been fully reconciled to Ukraine's independence from the Soviet Union in 1991, and feel that the country belongs in Russia's political and economic orbit. The U.S. and European view (particularly in Central and Eastern Europe) is that a strong, independent Ukraine is an important part of building a Europe whole, free, and at peace.

Ukraine gained independence after the collapse of the Soviet Union in 1991 and has since veered between seeking closer integration with Western Europe and reconciliation with Russia, which supplies most of the country's energy. Ukraine is a unitary republic under a semi-presidential system with separate powers, legislative, executive, and judicial branches. Europe's second largest country, Ukraine is a land of wide, fertile agricultural plains, with large pockets of heavy industry in the east. While Ukraine and Russia share common historical origins, the west of the country has close ties with its European neighbours, particularly Poland, and Ukrainian nationalist sentiment is strongest there. A significant minority of the population of Ukraine are Russians (17 %) or use Russian as their first language. Russian influence is particularly strong in the industrialised east. Since the dissolution of the Soviet Union, Ukraine continues to maintain the second-largest military in Europe, after that of Russia, when reserves and paramilitary personnel are taken into account.

---

[1] The presented working paper is the output of the scientific grant VEGA n. 1/0042/13 *The impact of the global economy development and the influence of the public finance consolidation on the financial management of companies acting in the Slovak Republic.*

In the immediate post-Soviet era Ukraine was a massively unproductive economy. Like most former Soviet republics it suffered huge output declines and soaring inflation. But Ukraine was among the hardest hit of the lot. Hyperinflation in the early 1990s resulted from lack of access to financial markets and massive monetary expansion to finance government spending, in the face of sharply declining output. The Ukrainian population was scarred by the experience of hyperinflation. In response, in 1996 the Ukrainian central bank replaced the old currency, the karbovanets, with the hryvnia and pledged to keep it stable in relation to the dollar. The currency continued to wobble through the late 1990s, however, and particularly amid the Russian rouble crisis of 1998. Fig. (1) illustrates the benchmark comparison in the change of the real GDP per capita during years 1992-2013 among post-Soviet area countries [1].

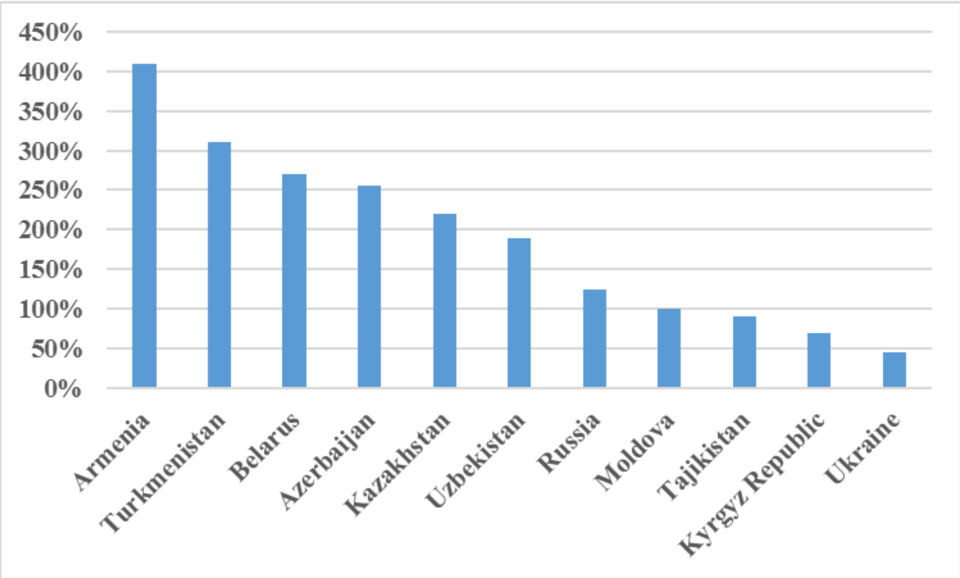

Fig. (1) The change of the real GDP per capita (PPP basis) 1992-2013

The first president after independence, former Communist Party official Leonid Kravchuk, presided over a period of economic decline and runaway inflation. His successor, Leonid Kuchma, oversaw steady economic recovery, but was accused of conceding too much to Russian economic interests. Opposition to Mr Kuchma grew, further fed by discontent at controls on media freedom, manipulation of the political system and cronyism. The authorities' attempt to rig the 2004 presidential elections led to the "Orange Revolution", with reference to the colour of the main opposition movement.

Mass protests, a revolt by state media against government controls and the fracturing of the governing coalition brought in European-Union mediation and a re-run of the election. A fragile alliance of anti-Kuchma forces, from pro-Western democrats, socialists, business interests and nationalists united behind opposition leader and former Prime Minister Viktor Yushchenko, who won the presidency. Mr Yushchenko secured the transparency of the democratic process, the rule of law and media freedom, but his efforts to move towards NATO and EU membership made slow progress in the face of Western reluctance to antagonise a resurgent Russia and a divided public opinion in Ukraine itself. Rivalry with his prime minister, Yuliya Tymoshenko, soured into open antagonism, and neither proved able to cope with the worldwide economic downturn after 2008. Their opponent in the 2004-2005 Orange Revolution, Viktor Yanukovych, won the 2010 presidential election. He swiftly re-oriented foreign and trade policy towards Russia and clamped down on media freedom. He also had various opponents, most prominently Ms Tymoshenko, imprisoned in trials regarded at home and abroad as politically-motivated.

1. The economy development

After Russia, the Ukrainian republic was the most important economic component of the former Soviet Union, producing about four times the output of the next-ranking republic. Its fertile black soil generated more than one-fourth of Soviet agricultural output, and its farms provided substantial quantities of meat, milk, grain, and vegetables to other republics. Likewise, its diversified heavy industry supplied the unique equipment (for example, large diameter pipes) and raw materials to industrial and mining sites (vertical drilling apparatus) in other regions of the former USSR.

Shortly after independence in August 1991, the Ukrainian Government liberalized most prices and erected a legal framework for privatization, but widespread resistance to reform within the government and the legislature soon stalled reform efforts and led to some backtracking. Output by 1999 had fallen to less than 40 % of the 1991 level. Ukraine's dependence on Russia for energy supplies and the lack of significant structural reform have made the Ukrainian economy vulnerable to external shocks.

Both Russia and Ukraine stabilised by the early 2000s. Capital flowed back, attracted in part by relatively high interest rates (the early 2000s, when the Fed pushed its main interest rate down to 1 % for an extended period, were a rehearsal of sorts for the post-crisis environment). As foreign cash flooded in the money supply grew rapidly: from 2001 to 2010 broad money increased at an annual rate of 35 %. In 2006 and 2007 credit growth averaged 73 %. Assets began to look extraordinarily bubbly and high inflation damaged Ukraine's export competitiveness.

A dispute over price rises prompted Russia briefly to cut supplies for use by Ukraine in January 2006 and raised concerns across Europe too. The gas was switched back on only after Ukraine agreed to pay almost twice the former price, which rose sharply again for 2007. In January 2009, Russia again cut gas supplies in a row over unpaid fees. Ukraine depends on imports to meet about three-fourths of its annual oil and natural gas requirements and 100 % of its nuclear fuel needs. After a two-week dispute that saw gas supplies cut-off to Europe, Ukraine agreed to 10-year gas supply and transit contracts with Russia in January 2009 that brought gas prices to "world" levels. The strict terms of the contracts have further hobbled Ukraine's cash-strapped state gas company, Naftohaz.

After the global crisis, and as the euro crisis intensified, Ukraine suffered from a drought in capital flows (along with much of central and eastern Europe) which placed strong downward pressure on the hryvnia. Protecting the currency drained the central bank’s reserves, which tumbled from a high of USD 40 billion in 2011 to about USD 12 billion today. Later on the central bank admitted defeat and let the currency go. Currency depreciation, while necessary, will be an economic headache for Ukraine in the short term. About half of its public debt is in foreign currencies: as the hrvynia loses value, Ukraine’s debt burden rises. Debt financing has also become more difficult as a result of the Federal Reserve's taper, which has wrong-footed many emerging markets by stanching the previously steady flow of capital in their direction.

Ukraine has proven reluctant to engage in reform. For a while it felt as if it didn't need to: high commodity prices during the 2000s supported growth. Many of Ukraine's exports went to Russia, a country that was also doing well on the back of high oil prices. But Ukraine was badly hit by the financial crisis and plummeting steel prices. GDP fell by 15 % in 2009. That made it a prime candidate for economic streamlining. In 2010 the IMF agreed to loan Ukraine USD 15 billion. Major targets for reform were Ukraine’s cushy energy subsidies. The state gas company, Naftogaz, only charges consumers a quarter of the cost of importing the gas. Cheap gas discourages investment: Ukraine is one of the most energy-intensive economies in the world and domestic production has slumped by two-thirds since the 1970s. The IMF ended up freezing the deal in 2011 after Kiev failed to touch the costly subsidies. In other areas reform has been half-hearted. The government did meet its public deficit target of 2.8 % of GDP in 2011. Yet this was achieved by skimping on capital expenditures while overspending on wages and pensions: hardly the recipe for sustainable economic growth. Progressively lowering the rate of corporation tax has also weakened the state's finances. Tab. (1) presents the 10-years overview of the Ukraine state budget development [2].

Year	Nominal (UAH million)			In % of GDP			Revenues from state property privatization (UAH million)
	Revenues	Expenditures	Deficit (–), Surplus (+)	Revenues	Expenditures	Deficit (–), Surplus (+)	
2004	70 337,8	79 471,5	-10 216,5	20,4	23,0	-3,0	9501,5
2005	105 330,2	112 975,9	-7 945,7	23,9	25,6	-1,8	20758,9
2006	133 521,7	137 108,1	-3 776,6	24,5	25,2	-0,7	558,8
2007	165 939,2	174 254,3	-9 842,9	23,0	24,2	-1,4	2458,8
2008	231 686,3	241 454,5	-12 500,7	24,4	25,5	-1,3	482,3
2009	209 700,3	242 437,2	-35 517,2	23,0	26,5	-3,9	…
2010	240 615,2	303 588,7	-64 265,5	22,2	28,0	-5,9	1093,4
2011	314 616,9	333 459,5	-23 557,6	24,2	25,6	-1,8	11480,3
2012	346 054,0	395 681,5	-53 445,2	24,5	28,0	-3,8	6763,5
2013	339 180,3	403 403,2	-64 222,9	23,3	27,7	-4,4	1 480,0

Table (1) Overview of the Ukraine State Budget (revenues and expenditures) 10-years development

Corruption and poor governance are other major problems. The Ukrainian shadow economy is one of the biggest in the world—at around 50 % of GDP, according to IMF research. Businesses operating underground tend not to pay taxes, further depriving the government of funds. The Ukraine's new prime minister estimated that USD 37 billion had gone missing during Viktor Yanukovych's rule.

Movement toward an Association Agreement with the European Union, which would commit Ukraine to economic and financial reforms in exchange for preferential access to EU markets, was curtailed by the November 2013 decision of President Yanukovych against signing this treaty. In response, on 17 December 2013 President Yanukovych and President Putin concluded a financial assistance package containing USD 15 billion in loans and lower gas prices. However, the end of the Yanukovych government in February 2014 caused Russia to halt further funding. With the formation of an interim government in late February 2014, the international community began efforts to stabilize the Ukrainian economy.

2. The monetary policy and exchange rate regime

The global monetary policies, especially Fed's announcement of tapering has had a substantial impact on Russia, Ukraine and Turkey, which have been experiencing considerable capital outflows and currency depreciation since mid-2013. These developments in Russia and Ukraine were exacerbated by rising political uncertainty, which reached its climax in the context of the geopolitical tensions caused by the crisis over Crimea in March 2014. A further escalation of the conflict, including EU sanctions vis-à-vis Russia, could severely affect the economic situation of the whole region. So far, however, the impact of the political crisis on other CESEE countries has been contained. The countries have relatively limited direct export linkages with Ukraine. Also, Russian gas exports seem to continue to run smoothly. Similarly, the crisis has so far had only limited impact on financial markets in the region [3]. The Russian economy, by contrast, already seems to be substantially affected (rising capital outflows, rating downgrades, slowdown of economic activity).

From the Ukraine view, in 2013, the monetary policy was operated under difficult macroeconomic conditions - global market conditions were unfavourable for Ukraine's main exports, industrial output declined by 4.7 %, and real GDP demonstrated zero growth. A 13.7 % increase in agricultural output in 2013 provided impetus for economic growth. In spite of there being difficulties with accessing global financial market resources, Ukraine was able, on time and in full, to meet all of its foreign currency internal and external debt obligations of USD 12.3 billion, of which USD 5.7 billion were obligations to the IMF. This had a bearing on international reserves, driving them down by USD 4.1 billion, to USD 20.4 billion. At the same time, Ukraine's balance of payments showed signs of improvement. The overall balance of payments recorded a surplus of USD 2.0 billion in 2013, compared to a deficit of USD 4.2 billion in 2012. The current account deficit was USD 16.3 billion in 2013, versus a deficit of USD 14.3 billion in 2012. The increase in the deficit was due to a 7.6 % drop in merchandise exports, driven by unfavourable global commodity market conditions for Ukrainian exporters. Over that period, merchandise imports were down by 5.8 % [4]. Tab. (2) presents the overview of current account and gross external debt development over a period of last years.

Period	**Current account**		**Export of goods and services**		**Import of goods and services**		**Gross external debt, by the end of period**	
	millions of US dollars	in % to GDP	millions of US dollars	in % to GDP	millions of US dollars	in % to GDP	millions of US dollars	in % to GDP
2005	2 531	2,9	44 378	51,4	43 707	50,6	39 619	45,9
2006	–1 617	–1,5	50 239	46,6	53 307	49,5	54 512	50,6
2007	–5 272	–3,7	64 001	44,8	72 153	50,6	79 955	56
2008	–12 763	–7,0	85 612	47,1	99 962	55,1	101 659	55,9
2009	–1 732	–1,5	54 253	46,3	56 206	48	103 396	88,3
2010	–3 018	–2,2	69 255	50,7	73 239	53,7	117 346	86
2011	–10 245	–6,3	88 844	53,8	99 001	59,9	126 236	77,3
2012	–14 315	–8,1	90 035	51,1	104 361	59,2	135 065	76,6
2013	–16 355	–9,1	85 312	47,2	100 796	55,8	142 520	78,3

Tab. (2) The Current Account and the Gross external debt of the Ukraine

The capital and financial account recorded a surplus of USD 18.2 billion in 2013, versus a surplus of USD 10.1 billion in 2012. The increase was mainly due to borrowing by the government and private sectors, and weaker demand for foreign exchange cash. The increase in foreign cash holdings outside banks declined by 2.1 times, to USD 3.8 billion (down from USD 8.0 billion in 2012).

The National Bank of Ukraine has taken a number of conventional economic measures to stabilize the situation - mainly raised the discount rate, streamlined the norms of banking supervision and foreign exchange control, ensured the banking system liquidity, and set up an independent Audit Committee. At the start of the year 2014, the National Bank of Ukraine deliberately opted for a flexible exchange rate regime, which best fits for the country, and allowed the market forces to determine the exchange rate based on the results of trading on the interbank foreign exchange. The central bank intentionally does not intervene in the foreign exchange market as it deems it inexpedient to manipulate the market benchmark, which would serve as a starting point for market players.

In addition, preparations for stress-testing exercises to assess the resilience of Ukrainian banking institutions were realised. In order to placate emotional swings in depositor behaviour, the National Bank of Ukraine has taken steps to provide immediate liquidity support to the banking system by introducing an conventional refinancing operations carried out through both regular and extraordinary liquidity-providing tenders and offering overnight loans. To make banks feel comfortable, the regulator has lifted restrictions on the number of bids submitted by banks to the National Bank of Ukraine to obtain overnight loans. The National Bank of Ukraine has also introduced two new instruments designed to provide liquidity support to those banks that suffer a bank run. Since early April 2014, deposit withdrawals have slowed. This trend points to the efficiency of this policy. In addition, the amount of cash foreign exchange that individuals sold to banks outstripped the demand for foreign exchange by USD 250 million as of April 22, 2014 [5]. Moreover, there was a drastic fall in the total turnover of foreign exchange transactions due to a number of factors, including the imposition of pension insurance fund duty on purchases of foreign currency.

The foreign exposures of internationally active banks to Ukraine were much smaller than those to Russia. At end-December 2013, foreign claims equalled USD 27 billion on an immediate borrower basis and USD 24 billion on an ultimate risk basis. European banks accounted for more than 90 % of all foreign claims on the country. The majority (USD 15 billion) of the foreign claims (on an ultimate risk basis) on Ukraine comprised the local claims of foreign banks' Ukrainian affiliates [6]. Fig. (2) illustrates the consolidated foreign claims on Ukraine, by nationality of reporting banks (values in USD billions).

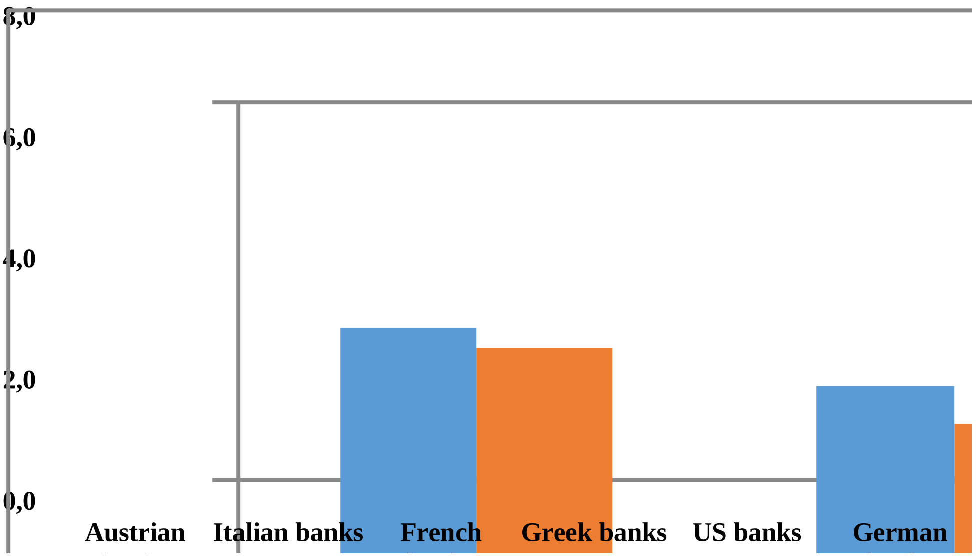

Fig. (2) Consolidated foreign claims on Ukraine, by nationality of reporting banks

For comparison, at end-December 2013, on the eve of the recent tensions in Ukraine, BIS reporting banks' foreign claims (which comprise cross-border claims and claims booked by local affiliates) on Russia stood at USD 241 billion on an immediate borrower basis and USD 218 billion on an ultimate risk basis. French (USD 49 billion on an ultimate risk basis), US (USD 32 billion) and Italian (USD 29 billion) banks reported the largest outstanding stocks of foreign claims on Russia. Cross-border claims accounted for the majority of US banks' foreign claims on the country. By contrast, most of the foreign claims of French and Italian banks on Russian residents consisted of local claims booked by these banks' Russian affiliates. Such claims are to a large extent funded locally.

In the mid-term view, the Bank of Ukraine implement the exchange rate policy within the framework of the managed floating exchange rate regime, not hindering rouble exchange rate developments determined by economic fundamentals. Fig. (3) illustrates the Hryvnia exchange rate fluctuations against USD and EUR parity.

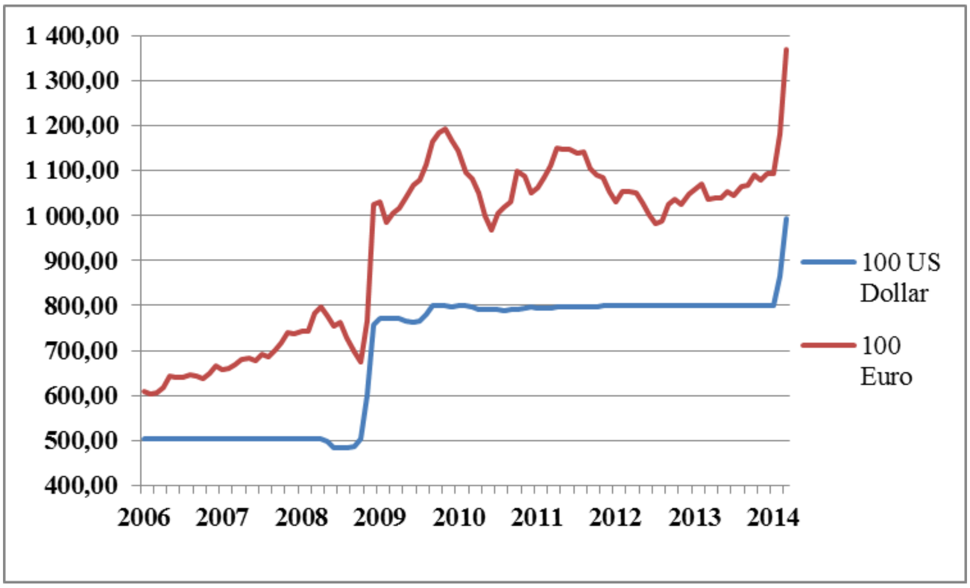

Fig. (3) Ukraine Hryvnia - historical development against EUR and USD

Until mid-January 2014 Ukraine currency, the hryvnia, was fixed at 8:1 with the dollar; it now trades at about 11:1. The government has issued short-term debt at interest rates as high as 15 %; this year its bonds have done about as badly as Venezuela's. In early May 2014, Ukraine received the first tranche of SDR 2.058 billion of IMF loans (about USD 3.19 billion) under a two-year Stand-By Arrangement (SBA), which caused the gold and foreign exchange reserves to increase. As of May 1, 2014, preliminary data show that the stock of gold and foreign exchange reserves stood at USD 14.2 billion in equivalent.

3. The regional development

Ukraine's regions continue to struggle economically, having failed to regain the growth momentum they enjoyed in the years before the crisis hit in 2008-09. Export demand remains muted, and domestic demand growth is constrained by slow credit growth, lack of fiscal space and an institutional environment that is not conducive to investment.

Inter-regional disparities are large by OECD standards and they continue to increase. However, they are not out of line with those of Ukraine's peers. The increase in disparities has been driven almost entirely by the city of Kyiv, with most other regions' contributions to growth being roughly in line with their size. There is evidence of significant disparities in access to basic services, especially education. Moreover, the human development index deteriorated in most Ukrainian regions during 2000-10, and only 12 % of the population lived in regions where it improved. Productivity performance in much of Ukraine has been relatively poor. The industrial capital stock is limited and deteriorating. The large informal labour market makes it difficult to assess labour-market trends with precision but the link between education and productivity appears to be weak.

Ukraine is a highly centralised polity. There is wide agreement on the need for greater decentralisation, but sub-national governments often face capacity challenges and they are extremely fragmented at lower levels, making it impossible to realise economies of scale or even to perform some basic service-provision functions effectively. Sub-national governments tend to depend heavily on central transfers, the allocation of which they find at times to be both unpredictable and less than transparent.

Reforms to sub-national public finances have been in preparation for some time and need to be taken forward. Lack of resources combined with weak arrangements for the assessment of service quality mean that access to good-quality public services remains a challenge for many. Fig. (4) illustrates the dependency on central government transfers from the state budget [7].

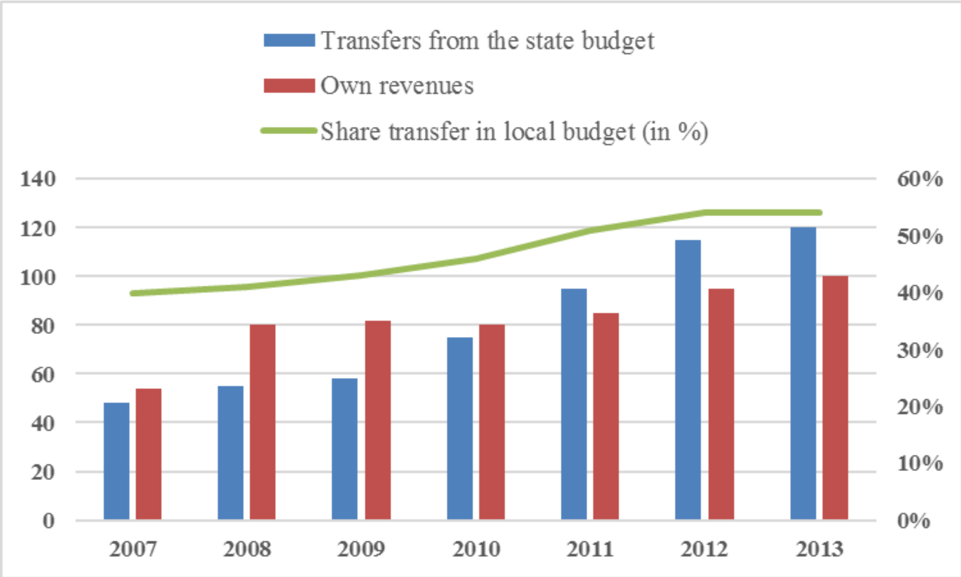

Fig. (4) Dependence on central government transfers (values in UAH billions)

Regional development policy is undergoing a major legislative and institutional overhaul, after a decade of incomplete reforms. This presents both a challenge and an opportunity: the governance of regional development policy needs to be strengthened, the range of instruments used needs to be broadened and clarified, and the mechanisms for performance monitoring and evaluation need to be enhanced.

Ukraine has taken a number of steps to bring its regional policy framework into line, focusing on investment, competitiveness and a multi-sector horizontal approach, as opposed to using subsidies and transfers to pursue compensatory objectives via a top-down sectoral policy. However, the current regional policy framework still lays great stress on traditional compensatory measures, and the degree to which the shift towards the new paradigm is reflected in day-to-day practice will depend on how the authorities tackle the implementation challenges associated with recent and currently pending reforms, as well as their success addressing the governance and policy gaps described above. The current tight fiscal environment will make it even harder to meet these challenges but it also makes implementation success more important than ever.

4. The Crimea and the Ukraine Crisis

The Crimea was originally an autonomous republic on the Black Sea, which was part of Russia until 1954. Except of the industrialised east, the Russian influence was particularly strong in Crimea as well, mainly because the Russian Black Sea Fleet is based there. Crimea is also the homeland of the Crimean Tatars whom Stalin accused of collaborating with the Nazis and deported to Central Asia in 1944. More than 250,000 have returned since the late 1980s.

In the wake of the collapse of the Yanukovych government and the resultant 2014 Ukrainian revolution in February 2014, a secession crisis began on Ukraine’s Crimean Peninsula, which had a significant number of Russophobe people. On 1 March 2014 Viktor Yanukovych requested that Russia use military forces to establish legitimacy, peace, law and order, stability and defending the people of Ukraine. On the same day, Putin requested and received authorization from the Russian Parliament to deploy Russian troops to Ukraine and took control of the Crimean Peninsula by the next day. In addition, NATO was provided by most Russians as encroaching upon Russia's borders. The weighted heavily upon Moscow's decision to take measures to secure her Black Sea port in Crimea.

On 6 March 2014, the Crimean Parliament voted to enter into the Russian Federation with rights of a subject of the Russian Federation and later held a referendum asking the people of these regions whether they wanted to join Russia as a federal subject, or if they wanted to restore the 1992 Crimean constitution and Crimea status as a part of Ukraine. Though passed with overwhelming majority, the vote was not monitored by outside parties and the results are internationally contested. Crimea and Sevastopol formally declared independence as the Republic of Crimea and requested that they be admitted as constituents of the Russian Federation. On 18 March 2014, Russia and Crimea signed a treaty of accession of the Republic of Crimea and Sevastopol in the Russian Federation, though the United Nations General Assembly voted in favour of a non-binding statement to oppose Russian annexation of the peninsula. Crimea and Sevastopol became de facto administrated by the Russian Federation, which claims them as Republic of Crimea and federal city of Sevastopol. Internationally they are still recognised as parts of Ukraine.

Meanwhile, unrest began in the Eastern and Southern regions of Ukraine. In several cities in the Donetsk and Lugansk regions armed men, declaring themselves as local militia, seized government buildings, police and special police stations in several cities of the regions. Talks in Geneva between EU, Russia, Ukraine and USA yielded a Joint Diplomatic Statement referred to as the 2014 Geneva Pact, in which the parties requested that all unlawful militias, including Right Sector, a far-right militia group, lay down the arms and vacate seized government building, and also establish a political dialogue that could lead to more autonomy for Ukraine's regions. The fighting does not admit to the name and it is low-intensity, but people are dying. It has elements of an insurgency, a civil war, foreign intervention and an information war.

Russia has not moved its troops across the border as many feared, but it is fighting through proxies: Soviet army veterans, saboteurs, irregulars from Crimea, mercenaries and outright criminals. They grabbed government buildings in Eastern Ukraine and provoked the Kiev government into an "anti-terrorist" operation. Indoctrinated by Russia's information war, many civilians took up arms to resist what they believed to be a fascist regime that had seized power in Kiev. Most of the fighting is between armed men. The local police and security services silently support the rebels: local authorities are careful not to oppose them. Journalists, particularly Ukrainian ones, have been kidnapped. Hatred of the Ukrainian language and symbols has been whipped to alarming levels.

On May 11th 2014, the rebels held bogus referendums, proclaimed themselves independent and asked to join Russia. Yet Russia's goals appear different from those in Crimea. It is not interested in annexation, which would carry high financial and human costs. Despite the rebels' claims that 90 % of the population supports the Donetsk People's Republic, polls find that only 5 % want Donetsk to become a state and another 27 % want to join Russia. Russia's aim is to destabilize Ukraine and turn the south-east into a buffer zone that can be used to block further Ukrainian moves towards the West, whether through a trade deal with the European Union or some link to NATO.

In many ways the Donbas was an easy target not just because it was mainly Russian-speaking, but also because it retains much of its old Soviet identity. Partly because it was dominated by Soviet industrial behemoths, paternalism and collectivism are still strong there. The share of small and medium-sized businesses in Donetsk is less than 5 %. Individualism, a defining feature of the rest of Ukraine, is weak, whereas the western and some central parts of Ukraine saw independence in 1991 as a gain and a gift, the south-east of the country saw it as a historic accident. Many people in Donetsk feel nostalgic for the Soviet Union. A celebration of Victory Day in Donetsk featured portraits of Stalin.

Ukraine may nevertheless be able to keep its current borders (albeit minus Crimea). But the question is what sort of country will lie within those borders. Mr Putin wants to turn it into a federation and refers to separatists as “supporters of federalisation”. What Mr Groisman and the Ukrainian government offer instead is devolution of power (both financial and political) from the centre to local councils, cities and regions, which would make the government more accountable and transparent. The reform has been in the works for some time and could have gone faster had it not been stuck in the Ukrainian parliament. There has been little progress on reform since the new government came to power.

In May 2014, Ukrainian oligarch Petro Poroshenko won presidential election, the man who has long supported the country's pro-European movement despite being unaffiliated to any political party. The "chocolate king", as the owner of Ukraine's largest confectionery manufacturer Roshen is known, was a key backer of the 2004 Orange Revolution and once served as foreign minister under Yulia Tymoshenko, the Orange Revolution star whom he roundly defeated at the last election. Mr Poroshenko comes to power in a country wracked by civil war in the east and uncertainty over relations with Russia, which saw its political influence in Kiev crumble with the overthrow of Mr Yanukovych. But he appears to have solid backing from Washington and Brussels, eager to see stability return to Ukraine. He has a unique opportunity, to start a direct dialogue with the citizens of the south and the east of his own country.

4. The Current Economic and Political Situation

Ukraine is much poorer than other European countries, despite advantages such as rich soil, a strategic location, and a substantial heavy industrial sector. In 2011, Ukraine’s Gross Domestic Product (GDP) per capita in purchasing power parity terms was only 21 % of that of the EU average and only 43 % of Russia’s. In 2010 its foreign direct investment (FDI) per capita was USD 979, less than half of that in Russia and about a quarter of Poland’s FDI per capita [8]. Foreign companies often cite such issues as rampant corruption and serious shortcomings in the rule of law (including a weak judiciary) as key stumbling blocks to foreign investment. The fall in Ukraine’s currency increases Ukraine’s real debt burden (which is denominated in foreign currencies) and hurts ordinary Ukrainians, in part because it makes imported consumer items more expensive.

On April 30, 2014, the IMF approved a USD 17 billion loan for Ukraine. Including the IMF loan, the accord is expected to unlock USD 27 billion in international aid to Ukraine over two years. Ukraine has received the first USD 3.2 billion tranche of the loan. Subsequent tranches will be released if Ukraine meets loan conditions. One of the main goals features of the IMF-supported reform plan is to reduce Ukraine’s deficits. The budget deficit and the deficit of the state-owned gas firm Naftogaz would have reached a combined 12 % of GDP this year, which would have been impossible to finance. The reform plan will involve significant expenditure cuts, including cancelling wage and pension increases, cutting government employment and social spending, and cutting corruption through a new government procurement law. Inflation in Ukraine is expected to continue to rise, and the IMF has predicted it will reach 12 % in 2014. Revenue increases are also envisioned, including ending tax evasion schemes and other frauds. Naftogaz’s deficit (7.5 % of GDP in 2012) is targeted for elimination by 2018, partly by reforming the company, and partly by substantial increases in currently heavily subsidized domestic natural gas prices. Ukraine is obliged to keep a “flexible” exchange rate, which will likely mean a weak currency for the near future.

Energy is a key factor in Russian-Ukrainian relations. Ukraine is heavily dependent on Russia for its energy supplies. In 2012, 63 % of Ukraine’s natural gas consumption came from Russia as well as nearly three-quarters of its oil and other liquid fuels [9]. However, Ukraine’s vulnerability to Russian pressure has been mitigated by the fact that the main oil and natural gas pipelines to Central and Western Europe transit its territory. In 2012, about 60 % of Russian natural gas destined for Europe transited Ukraine. Past Russian efforts to greatly increase gas prices for Ukraine provoked a crisis that resulted in cut-off of Russian gas to

Western Europe for several days in January 2006. A second gas crisis occurred in January 2009, resulting in a gas cut-off of nearly three weeks.

Russia has sought control of Ukraine's natural gas pipelines and storage facilities. Its efforts have been unsuccessful, due to Kyiv's refusal to cede control of one of its key economic assets. This fact, as well as the 2006 and 2009 gas cut-offs, has led Russia and some European countries to plan and build pipelines to bypass Ukraine. Gazprom has developed gas pipelines under the Baltic Sea (called Nord Stream) and through the Balkans (called South Stream) to Western Europe. Nord Stream made its first gas deliveries in 2011. South Stream has started construction, with first deliveries projected for 2015.Ukraine has few short-term alternatives to Russian natural gas. The best hope is to import cheaper gas from Central Europe, using the former Soviet gas transit pipelines in "reverse flow" mode. In the long term, Ukraine could develop its own shale gas reserves, improve exploitation of its own domestic gas reserves, import liquefied natural gas, or import gas from Azerbaijan, Central Asia, and elsewhere via pipelines through the EU's planned Southern Energy Corridor. Ukraine will also to have to make much greater strides in energy conservation; it currently consumes about as much Russian gas as Germany, but with a much smaller economy.

The Ukrainian government's main foreign policy priorities are to secure international support for Ukraine's sovereignty and territorial integrity, as well as international assistance to ameliorate the country's dire economic situation. Ukraine has requested assistance from NATO for its military. NATO has agreed to support the country's defense reforms, including advice on the protection of critical infrastructure.

The United States have made support for Ukraine to establish security and stability, pursue democratic elections and constitutional reform, revive its economy, and ensure government institutions are transparent and accountable to the Ukrainian people. Ukraine embarks on this reform path in the face of severe challenges to its sovereignty and territorial integrity. To ensure, that Ukrainians alone are able to determine their country's future without intimidation or coercion from outside forces, the United States offered a package of assistance totaling USD 50 million to help Ukraine pursue political and economic reform and strengthen the partnership between the United States and Ukraine [10].

Ukraine seeks eventual EU membership, but most EU countries have opposed raising this issue, in part due to the huge burden a large, poor country like Ukraine could place on already-strained EU coffers. The Association Agreement is the EU's main instrument to promote European values and deepen economic ties with Ukraine and other former Soviet countries. The agreement includes a free trade agreement with the EU, formally known in EU jargon as a Deep and Comprehensive Free Trade Agreement (DCFTA). Although the DCFTA further opens potentially lucrative EU markets to Ukraine, it also requires it to adopt EU legislation and standards and to expose its own firms to tough competition from EU imports. Approximation to EU norms could also lead to increased foreign investment in Ukraine.

In some ways, recent Russian actions in Ukraine are the culmination of long-standing Russian resentment of the outcome of the Cold War. In 2005, Russian President Vladimir Putin called the collapse of the Soviet Union "a major geopolitical disaster." Russian leaders have also asserted that the post-Soviet region is an area of privileged interests of Russia. Part of the justification for that assertion is an alleged right to protect Russian citizens and "compatriots" (persons deemed to be linked to Russia by language, culture, or ethnicity). Moreover, Ukraine has a particularly important place in Russian psychology, according to many experts. Putin has referred to Ukrainians as "brothers" of the Russian people. Eastern Orthodox civilization, in which Russians see themselves as the leading force, got its start in Kievan Rus (a state centered on what is now part of Ukraine) when Prince Vladimir converted to Christianity in 988. Russians often point out that their ancestors spilled a great deal of their blood to incorporate most of what is now Ukraine into the Russian empire, and a great deal more to keep it within the empire (and its successor, the Soviet Union) through many wars.

5. Results and Discussions:

Ukraine's economy could (realistically) be standing to grow at over 4 % annually for the next quarter century, if will have a government ready to reform and west Europe would support it. Better policy can bring that growth forwards (higher growth rates, faster catchup growth). Here's why:

- Poland's GDP has grown at a 4.3 % geometric average since 1995. If Ukraine can follow Poland's path (EU integration, cleaning up corruption, simplifying bureaucracy, improving institutions) then Ukraine has potential for even faster catchup growth (from a lower base).
- Exports and imports (integration in the EU and world economies) are an important (and easy to attain) aspect of that growth. Both Polish exports and Polish imports have grown at 8.7 % rate annually (geometric average) since 1995. That means Polish businesses now have easy access to the world's best capital equipment, supporting higher productivity and living standards. That means the most productive Polish businesses (and multinationals basing ops in Poland) can access global markets (high wages), and Polish consumers can increasingly afford the world's best and most modern consumer goods. Trade means growth - and Ukraine can achieve similar performance to Poland (and the rest of Central Europe) through integration in EU markets.
- Success in bringing black market activity into the open would, in itself, double measured GDP. Ensuring that business competition (and resource allocation) is led by productivity performance rather than political connections, would support rapid productivity catch-up thereafter. Yes, energy subsidies must go; in the same vein, business taxes must be rationalized, simplified and enforced without exemptions or favours.
- Ukraine sits on the second longest stretch (after Kazakhstan) of the shortest-path land corridor between China and the EU. There is a massive untapped market for freight rail, Autobahns and every kind of pipeline and cable. Letting that infrastructure be built would immensely improve Ukraine's competitiveness as a production location.
- Ukraine has very high standards of education, an exceptional density of people with PhDs, and an overwhelming focus on mathematics, hard sciences and engineering. Ukraine has some of the world's best talent (and science and capacity) in specialist steels, nuclear engineering, aerospace and algorithm development. And Ukraine has a large workforce with practical and technical/ tradesman skills also. If Ukraine were integrated in EU markets under a normal legal and tax environment, there would certainly be massive investment (from car manufacturers, Airbus, white goods manufacturers, software development businesses, etc). New Ukrainian businesses would far more easily achieve lucrative deals with developed world clients - and grow.
- Ukraine is an obvious case where there is an inefficient capital-labour imbalance. Ukraine has a massive highly skilled workforce in close proximity to massive markets. The only problems are a lack of modern capital equipment and legal barriers. Remove the barriers, build institutions that allow capital inflow, and in this environment direct investment is able to achieve high single digit GDP growth rates.
- In particular, Ukraine has 12 new nuclear reactors currently on-plan or under construction. Ukraine's electricity is less than a quarter the price of neighbouring Poland's or Slovakia's. If integrated in EU markets, Ukraine might as well build extra reactors and export the electricity. Further, perhaps Ukraine's businesses could achieve access and scale to export civilian nuclear technology (and reactor installations) across Europe and globally (at far lower cost than prevailing French models).

Right now Ukraine is worried about payment ability against foreign creditors, especially to Russia for a gas supply and improving economic management. First two big bills are imminent: Ukraine needs to find about USD 25 billion this year to finance its large current-account deficit and to meet foreign creditors. Foreign-exchange reserves are only USD 12 billion. Default is certainly on the cards. When the crisis does end, addressing its economic backwardness must be a major objective. Yes, Ukraine has been devastated by incompetent government, by pillaging oligarchs and by Russia holding it captive. Yet Ukraine has the potential to boom and bloom.

References:

[1]The Economist, 2014. Ukraine and Russia. Why is Ukraine's economy in such a mess? London, May 2014. Reachable at: http:/www.economist.com/news/finance-and-economics/21589459-after-decade-long-boom-emerging-markets-have-flopped-and-then-bounced>.

[2]The National Bank of Ukraine, 2014. Monetary policy report. Kyiv, April 2014.

[3]E. Nowotny, 2014. Emerging markets – boom and bust. Governor of the Central Bank of the republic of Austria, before the United Nations Economic and Social Council. New York, April 2014.

[4]The Ministry of Finance of Ukraine, 2014. State treasury service reports. Kyiv, February 2014.

[5]The National Bank of Ukraine, 2014. Statistical bulletin. Kyiv, March 2014.

[6]S. Avdijev, P. Wooldridge, 2014. International banking and financial market developments. BIS consolidated banking statistics. June2014.

[7]The Ministry of Finance of Ukraine, 2014. Central government transfers report. Kyiv, April 2014.

[8]S. Woehrel, 2014. Ukraine: Current Issues and U.S. Policy. Congressional Research Service, Washington, May 2014.

[9]U.S. Energy Information Administration and International Energy Agency, 2014. 16 % of natural gas consumed in Europe flows through Ukraine. Washington, March 2014. Reachable at: http://www.eia.gov/todayinenergy/detail.cfm?id=15411>.

[10] The White House, 2014. Fact Sheet: U.S Crisis Support Package for Ukraine. Washington, April 2014. Reachable at: http://www.whitehouse.gov/the-press-office/2014/04/21/fact-sheet-us-crisis-support-package-ukraine>.