THE CARNEGIE PAPERS

THE UNDERACHIEVER

Ukraine's Economy Since 1991

Pekka Sutela

UKRAINE | MARCH 2012

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Summary

When Ukraine became independent in 1991, there were expectations that it would in the near future become a wealthy free market democracy and a full member of the European and Euro-Atlantic communities. The largest country geographically wholly European, and the fifth-biggest European nation by size of population, it was hoped, would become a member of the European Union (EU), the North Atlantic Treaty Organization (NATO), and the Organization for Economic Cooperation and Development (OECD).

Ukraine never fulfilled those expectations. Instead, it is seen as an underachiever, sometimes as a sick man of Europe, and perhaps even as a potentially failed state thanks to its geopolitical situation, historical burdens, and the mistakes made in institutional development and policy.

Economically, Ukraine has grown along with the region. As such, growth rates have not been low, but they come after the economically devastating 1990s and are not built on a sustainable foundation. For years Russia provided Ukraine with underpriced gas while Ukraine's export prices increased rapidly. Over the decades Ukraine, however, grew dependent on oil and gas coming from Russia, at almost no cost. Today, 70 percent of gas consumed in the country is imported. But the terms of trade improvements this provided, like other economic windfall gains, are fortunate only if well handled. Unfortunately, Ukrainian economic policy was unable to make proper use of the windfalls of the 2000s.

Going forward, Ukraine must abandon its reliance on a disappearing foreign trade windfall. Prices must be set at a more realistic level, and Ukraine should rid itself of its dependence on outside funding. Rampant corruption is standing in the way of Ukraine's transition to a true free market. If it truly wants to progress, the government must encourage competition and crack down on corrupt practices. Only then can Ukraine begin to expose its economy to more foreign competition and investment and truly live up to its potential.

Ukraine After Independence

In 1991 Ukraine was one of the poorest Soviet republics. Statistics for the time are notoriously uncertain, but the best ones available show Ukraine's GDP at just $1,307 per capita. Only Azerbaijan, Georgia, Kyrgyzstan, Tajikistan, and Uzbekistan lagged behind Ukraine; even Moldova and Turkmenistan, generally regarded as very poor Soviet republics, were ahead of Ukraine.

Traditionally, Ukraine was an agrarian country—the breadbasket of the Russian empire. In the twentieth century it endured several devastating shocks: Two world wars and a civil war were fought on its soil. Forced collectivization and Stalinist industrialization created immense damage and suffering. German occupation during World War II brought ruthless exploitation, and the Holocaust decimated the important Jewish population. Stalinist purges, the war and its aftermath displaced and killed millions of people. Later policies turned the previously cosmopolitan country into a secluded Soviet republic.

Though Soviet practices helped Ukraine modernize its mining and metallurgy sectors, for example, they came at a high cost. Its agrarian-based economy suffered hugely from forced collectivization and the drive to industrialization. And Ukraine eventually became dependent on oil, minerals, and later relatively cheap gas from Russia. It turned high-quality but almost free energy and raw materials into processed goods that were badly overpriced on Soviet markets relative to their world-market quality. Though on the post-Soviet scale, Ukraine inherited relatively good infrastructure and capital stock, in many respects what was built then was not maintained.

From these beginnings, Ukraine had to create a functioning democratic state, a vibrant civil society, and a competitive economy integrated with both post-Soviet and European markets. What has been achieved should not be underestimated. The divide between the mostly Ukrainian-speaking west and north and the Russian-speaking east and south has not proven impossible to bridge. Unlike in Russia, Ukraine has had genuinely competitive politics. There is a lively civil society, and the economy has gotten back on its feet to a degree.

Yet, not only was Ukraine's starting point modest, the country was also exceptionally badly hit by the disorganization of the early transition. As nation building came to dominate the first years following Ukraine's independence, politics were in continued turmoil and centered around jockeying for power. Economics therefore suffered.

Ukraine's economy contracted annually between 9.7 and 22.7 percent in 1991–1996. The country experienced hyperinflation and an exceptionally huge production decline for a country not ravaged by a major war. Official

GDP collapsed by almost half from 1990 to 1994, and slow decline continued throughout the decade. Economic growth would not resume again until 2000. The budget deficit was, at 14.4 percent of GDP, exceptionally large. Barter and the use of surrogate moneys and foreign currencies prevailed. Ukraine had introduced a sovereign currency, the hryvnia, but it was little used. A shadow economy swelled and compensated for an unknown share of the economic collapse.

Ukraine thus ended up in a vicious, difficult-to-break circle. Political instability hindered the building of functional administrative institutions like tax authorities, and escaping into the untaxed shadow economy was easy. Corruption also helped ease that transition. As the tax base grew narrower, attempts to increase tax revenue often meant that what could be taxed was taxed too heavily. This again forced many citizens and companies into the shadow economy. In the process, any respect for law tended to evaporate. This was not a good environment for competition, investment, and growth of new industries.

Little approaching consistent macroeconomic and structural policies emerged before the presidency of Leonid Kuchma from 1994 to 1996.[1] As discussed by economist Anders Åslund, Ukraine's coordinated transition to a market economy encompassed the Washington Consensus dimensions of liberalization, stabilization, privatization, and institutional change. Yet, as liberalization combined with the increase in corruption and the growth of the shadow economy, stabilizing the economy was difficult. On the one hand, the ability to raise revenue remained weak. On the other hand, it was always politically difficult to control subsidies and other expenditures.

Some finance to cover the fiscal gaps was available from international financial institutions. Money could also be created by the central bank, to be channeled through state and other banks to privileged industries and households alike. Both small economic units—shops, service establishments, and the like—and the large-scale Soviet industries were privatized, the latter usually to their Soviet-era managers. The prevalence of the shadow economy and the continued existence of open and hidden state subsidies, however, meant that a clear demarcation between the state and a free market economy never emerged.

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During this decade, power structures, networks, and behavioral patterns—many of them inherited from Soviet administrative markets—took root; many of those institutions and tendencies have proved resilient to change up until this day. Political scientist Francis Fukuyama uses Ukraine as one example of how regime change from an authoritarian to a democratic government will not lead to success without "a long, costly, laborious, and difficult process of institution building."[2] Even after the initial privatization process, a state cannot necessarily protect newly private property—as long as assets can continue to be redivided and wealth is secured by corruption and powerful private interests.

And that is what tragically happened in Ukraine. Behind the facade of an electoral democracy, both inherited and newly arisen economic structures held on to actual power. These usually regionally based structures are more often than not personified as oligarchs controlling key industries of the country. Sometimes the dividing line between legitimate capitalists and plain criminals is blurred, and elected politicians may be little more than covers for their interests.

Growth and Exports

Between 2001 and 2008, the Ukrainian economy picked up significantly. Many of Ukraine's large-scale capitalists—the oligarchs—are former Soviet-era industrial managers who succeeded on a grand scale when industries were privatized. Their wealth was originally based on a traditional, simple formula: convert cheap energy and raw materials into metals and manufactured goods. The six richest Ukrainians are all metallurgy magnates.[3] Oligarchs, in fact, were probably the best available domestic owners in terms of productivity enhancement.[4] The state would have been a dysfunctional owner, no large institutional investors emerged, and there was not a wide base of small-scale investors.

Oligarchs were probably the best available domestic owners in terms of productivity enhancement.

In Ukraine—like in Russia—incumbent managers were present at the birth of private property and could harness privatization. The political atmosphere of nation building helped keep foreigners—Russians and Westerners alike—mostly out of the game. The major exception was the financial system; several banks both from the West and the East have entered Ukrainian markets. Research shows, however, that privatization to foreign owners in Central Europe and Ukraine alike generally brought about the best results in terms of efficiency, technological upgrades, market access, and jobs.[5] The preference generally given in Ukraine to incumbent domestic owners meant that the industries did not live up to their full efficiency potential while the financial system proved perhaps even too apt at channeling foreign funds to Ukraine.

The fundamental fact is that the positive 2001–2008 growth performance was not so much based on reforms as on transient factors. And that type of change is unstable. Ukraine faced extreme currency inflation at the beginning of the 1990s. Though the hryvnia started to be more widely used than barter, foreign currencies, and surrogate monies, inflation remained quite high and the hryvnia a weak currency. This was bad for investment, long-term competitiveness, and economic growth but provided some price competitiveness.

High export revenue from the traditional industries of metals, metallurgy, engineering, chemicals, and food was also a factor. Crucially for Ukraine's survival, between 2001 and 2008, as metals and chemicals prices boomed on the back of fast international economic growth while the price of gas imported from Russia remained low, terms of trade improved by 50 percent. Monetization also helped to drive this boom, as the ratio of credit to GDP grew extremely fast—from 7 to almost 80 percent over just several years.

In less than a decade, Ukraine leaped from an economy not based on money to having a banking sector comparable in relative size to that of many well-established market economies. Credit was at last available, and not only from state-controlled and other politically connected banks, but from reputable foreign banks channeling easy international liquidity to Ukraine as they did to other emerging economies.

In less than a decade, Ukraine leaped from an economy not based on money to having a banking sector comparable in relative size to that of many well-established market economies.

From 2000 to 2007, Ukraine's real growth averaged 7.4 percent and was thus very similar to Russia's. In both countries, this growth was driven by domestic demand: orientation toward consumption, other structural change, and financial development. In Ukraine, domestic demand grew in constant prices by almost 15 percent annually. It was supported by expansionary—procyclical—fiscal policy generally driven by populism for perceived short-term political gain.

Further, industrial capacity left idle in the 1990s was brought into use, capital inflows surged after 2005, and credit growth was fueled by external borrowing. In terms of markets, in 2000, the EU was already the largest, purchasing almost a third of Ukraine's exports. It was followed by Russia and Asia, with a share of just under a quarter for both. In 2009, Asia passed the EU, but together they still accounted for 55 percent of exports. Fast-growing Asian economies are now the basic consumers of Ukrainian metallurgy products, and Russia's exports of oil and gas suffer from low growth in Europe more than Ukraine's exports do.

Meanwhile, the price of gas remained low. In 2008, the price paid by Ukraine for gas was still less than half of that paid by Western European countries. Over a longer period, this growth pattern was bound to be unsustainable. This is the most important single fact of Ukraine's economic prospects. The improving terms of trade of the 2000s were a positive windfall, but Ukraine did not know how to use that windfall wisely. Ukraine's economy and its growth prospects ultimately suffered from its nationalism and inefficiency.

The Curse of Improving Terms of Trade

Economists have written widely about what is called the resource curse. Countries rich in natural resources are supposed to grow slowly and invest little, and suffer from corruption and lack of democracy, in addition to other failings. The Ukrainian curse was not so much a matter of having resources—though Ukraine has many of them. Ukraine's traditional revenue-earning pattern has been to turn underpriced often Russian materials into world-market-priced commodities. The curse involves the difficulties of having to continue running traditional industries relying on cheap inputs and increasingly dear outputs.

The windfall Ukraine enjoyed meant that industry did not have to diversify or become more sophisticated—two characteristics that are necessary for competition in today's markets. In 2000, metals and mineral products accounted for half of Ukraine's exports. Adding agrofood and chemicals took the proportion to just over 70 percent. In 2008, the shares remained quite similar, with agrofood increasing from 11 to 16 percent. Steel export unit value grew more than four times between 2000 and 2008, while steel export volume grew only little between 2000 and 2004, and then stagnated.

The success stories of Ukrainian exports, as measured by the Balassa index, consist of railway equipment (much in demand in Russia), iron and steel, fertilizers, animal oils, and oil seeds.[6] Agribusiness is based on Ukraine's black earth, some of the world's most fertile agricultural soil. It is through developing this black earth that a quarter of Ukraine's hundred-richest persons[7] made their fortunes. The lands will be the object of the next property grab when the current moratorium on agrarian land sales is one day cancelled. Still, Ukrainian agribusiness targets mass production of basic grains (and chickens), not boutique production of very high-value ecological produce and other specialties, increasingly demanded by neighboring European consumers.

Ukraine's economy and its growth prospects ultimately suffered from its nationalism and inefficiency.

The Soviet economy was overly industrialized and neglected consumption and services. Ukraine exchanged manufactured goods produced by heavy industries for energy and raw materials. Inevitably from 2000 to 2009, the share of manufactured goods in Ukraine's exports declined from 45.1 to 36.1 percent. This is not deindustrialization; it is normalization. At the same time the share of food and live animals increased from 5.6 to 15.2 percent. The share of exports of services, largely transit fees, increased from 15.1 to 19.9 percent. More worrisomely, the concentration of export structure, as measured by the Hirschman index, increased from 1996 to 2009, though not strongly. Even worse, the share of high-tech goods in Ukrainian exports is lower than in Lithuania, Bulgaria, Kazakhstan, and Poland, and hugely behind the Philippines, Mexico, and Malaysia.

The country does have some high value-added export commodities in aircraft components, helicopters, electrical machinery, and a small volume of pharmaceuticals. These are strengths inherited from the Soviet Union. However, export volumes of such goods have not increased,[8] and Ukraine has made little improvement toward diversification and sophistication. Though exports were relatively sophisticated in 2000, little progress took place by 2008. Few new export products have emerged. Few capital goods were imported, little royalty and license fees were paid, and almost no firms had international quality certification—the first step in emerging as a credible candidate for most exports. Ukraine has stepped down the value-added ladder rather than climbed up.

There was thus little investment in more diversified future export structure. The only way for such exports to continue would be if Ukraine joined competitive international supply chains. It can no longer rely on inherited post-Soviet markets.

Adding to these difficulties, Ukraine is also the quintessential transit country thanks to its Black Sea harbors, east-to-west roads and railways, and oil and gas pipelines. Transit channels are needed for Russia to trade internationally, and Ukraine happens to be sitting on many of them. This makes Ukraine more an object of economic and infrastructure development than an architect or a driver of it.

Its Black Sea harbors, east-to-west roads and railways, and oil and gas pipelines make Ukraine more an object of economic and infrastructure development than an architect or a driver of it.

Nowhere has the general picture been as clear and the details as murky as in gas transit. In Russia's view Ukraine's near monopoly position in gas transit to Europe gave it excessive bargaining power in negotiations over transit fees. Other pipelines that avoid Ukraine as the transit route are being built as a result, including the Nord Stream gas pipeline. In spite of the construction cost, a Cambridge University study[9] estimates that the two Nord Stream underwater gas pipelines from Russia to Germany and further will be commercially viable. What's more, the distance from the Yamal Peninsula, which will supply some of the gas, to markets will be shorter than using existing routes. In addition, newly constructed pipelines will need less costly maintenance than old ones. The motivation behind the prospective South Stream pipeline across the Black Sea is similar.

There is little possibility that Ukraine could proactively compete with these pipelines. Ukraine stands to lose transit fees and, partially, its key role in the Eurasian gas network. To remain competitive with alternate routes, Ukraine will have to lower transportation fees for gas still traveling through the country. Of course, an extensive pipeline system is a major irreversible cost, and that is a weighty argument in favor of continuing to use existing pipelines. How much that in the end weighs against the undoubted benefits of these new projects remains to be seen. In either case, Ukraine must create transparency in its gas transport business. One reason why eventual third and fourth Nord Stream pipelines are discussed is that the already active one is managed according to international standards. Unless Ukraine can very soon boast the same, it will lose most of its previously lucrative revenues from service exports.

Missteps at Home

With a windfall to rely on, Ukraine not only failed to diversify its exports but also mismanaged its domestic economy. Since 1992 Ukraine has had just one year, 2002, with a balanced budget. Income growth has been huge, and the ratio of domestic savings declined as consumption boomed. Since 2001 annual growth in average monthly earnings has always surpassed consumer price inflation, until 2008 quite frequently by more than 20 percentage points and never much below that. Such income growth was supported by the country's high export, especially steel, prices.

Boosted by rapidly improving terms of trade, import volumes grew much faster than export volumes and the net growth impact of foreign trade was negative by some 5 percent annually.[10] As imports were liberalized in the 1990s, consumers and investors alike preferred the superior quality, choice, and brands available from world markets. By the 2000s an increasing share of them could afford foreign goods. Cheap imports from Asian and other countries also became available. The trade balance has been consistently negative since 2005, and the current account has followed since 2006. This development marks increasing economic rationality, away from communist attempts at self-sufficiency toward higher welfare due to division of labor based on comparative advantage.

Imports contribute to welfare, but for that to be sustainable, any country also has to be able to cover the import bill with exports, running down reserves, inward investment (direct or other), or raising foreign credit. But exports, of course, were not providing the necessary boost. And Ukraine had to begin with in practice no official reserves or foreign assets and liabilities, as Russia had taken responsibility for the Soviet bequest. Ukraine inherited no assets to run down. And no reserve funds were built to sustain the fiscal situation over a longer term. Thus, Ukraine's dependence on foreign, usually short-term, funding increased (which would prove dangerous in the 2008 crisis and will threaten Ukraine in the future as well).

Net inward foreign direct investment (FDI) has been positive since 1992, varying in 2005–2010 between $5 and $10 billion annually. But most foreign direct investment has gone to closed-sector services such as retail trade and finance, while the industries inherited from the Soviet Union were privatized to domestic owners and are controlled by oligarchs. These industries have typically failed to become more competitive in more than a decade. Major needs for infrastructure investment have accumulated.

In contrast to traditional industries, foreign entry into financial services was encouraged. Up to 40 percent of bank assets have been controlled by foreign entities, but the share is now declining with only Russian banks penetrating the market. Some Western banks are downsizing their activities, and a few at least wish to exit, if they only could without losing their past investments.

In spite of inevitably worsening demographics, a huge pension burden was created. In a nation of 46 million inhabitants, the pensions of 14 million pensioners grew from 9.2 percent of GDP in 2003 to almost 18 percent in 2009.

This is one of the heaviest pension burdens globally, and negative demographics will continue to worsen the situation if needed measures, like increasing the general pension age, are not taken.

Poverty rates have dropped significantly, but many productive individuals have decided to emigrate, usually to EU countries. How many of them might return, and bring improved skills and experience along with them, is totally unclear. Ukraine's population seems poised to continue declining.

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And Ukraine's performance in estimates of competitiveness and the business environment remains abysmal. The public sector is large, badly functioning, often arbitrary, and corrupt. Not only is there a huge pension burden, public sector wages have also risen steeply. As it happens, the majority of voters are either pensioners or public sector employees. Ukraine's current fiscal situation is clearly unsustainable in the long term.

Meanwhile, public investment has been extremely low, especially given the need to bring the worn-down Soviet-era infrastructure in line with modern market-economy requirements. Behind the growth figures of the 2000s more often than not infrastructure has deteriorated, capital stock worn out, and export structure grown more one-sided. Ukraine has also remained one of the most energy-inefficient economies in the world. And this is not easy to remedy, as it is a matter of inherited industrial structure, antiquated technologies, worn-out infrastructures, and populist policies.

New, often more productive firms find it difficult to enter Ukrainian markets. While lending was overheated, small companies have continued to employ few, at least in the official sector from which tax revenue can be raised. While the pattern may have changed in a more positive direction by the mid-2000s,[11] in the beginning at least few new companies entered and few old ones exited. This has changed drastically under Viktor Yanukovych, as the statistical numbers of small companies have dropped dramatically. To some extent this may a statistical illusion, but it likely reflects a worsening business environment.

This is the background against which the peculiarities of Ukraine's political economy since 1991 become understandable. Defending the jobs and vested interests of traditional industries in the 1990s was bound to become a matter of huge rent-division games when terms of trade turned in Ukraine's favor. But instead of the positive terms of trade windfall being used to stabilize, diversify, and modernize the economy, additional rent incomes were divided up by the elites in murky ways, very large properties were accumulated by a few, and society more widely embarked on a consumption spree. The rent-division game was running against the clock; most understood that the windfall of the 2000s could not last forever.

The End of Cheap Gas

By the mid-2000s, Russia had reached several conclusions on energy and money that started to rock Ukraine's position. In the beginning of his public career, Vladimir Putin believed that Russia's income, wealth, and position in the world could be based on hydrocarbons and other resources. The problem was how the state could best control such commanding heights and keep revenue flowing in. In a few years' time, however, reality proved less rosy. Experts were convinced and the leadership came to agree that hydrocarbon production would at best grow only slowly.

As the economy was correctly expected to grow faster, maintaining export volumes would demand an evident increase in energy efficiency. Finding new export commodities would be good—that is, diversification, in the Russian political vocabulary—but obviously the scale of matters was such that Russia would remain dependent on resource exports for decades to come. The much-needed energy efficiency demanded a huge change in the whole of economy and society—as in Ukraine—a process known in Russia as modernization. For social and political stability to remain, modernization had to be state-led and top-down. Whether Russia's future would be based on resources or on the better use of them, the state had to lead the society, according to the Putin regime.[12]

The first necessary condition for modernization was to raise domestic gas and consequently power prices. A roadmap for doing that was accepted in late 2006, and an evident conclusion emerged. If Russians had to pay more, there was no reason why Belarusians, Ukrainians, and others should continue to be subsidized. Speed of change would vary for perceived political and strategic reasons, but the general trend was inevitable. This then would be the post-Soviet price revolution: higher prices for basic commodities and lower ones for manufactures—unless breakthroughs in competitiveness emerged.

The processed-goods exports of post-Soviet producers would compete against Chinese and other emerging-market goods. The prospects were not good for the Ukrainians. China's share of Russia's imports has surged, and that of Ukraine has declined. Ukraine could readily turn to the European market to sell its metals and grain, but not its manufactured products.

All of this meant that preconditions for the Ukrainian curse would cease to exist. Ukraine's terms of trade would change from a windfall to a downpour of cold rain. And Ukraine had not made the necessary domestic reforms to prepare for such a turn of events.

The simple Russian proposition has had dramatic consequences for Ukraine. There have been aspiring political leaders who have thought that the Russian decision may be turned or at least postponed by playing on the Slavic or Eurasian Union cards: Ukrainians will continue to entertain prospects of Eastern integration if Russia continues postponing inevitable price hikes.

Trying to avoid the price revolution is surely seen by some inside Ukraine as a potent argument for joining post-Soviet reintegration schemes, like Belarus has done. And clearly, most if not all in the Kremlin would have nothing against gathering together all the lands of ancient Rus. But many of them do not wish to do it on terms that run against Russia's basic economic interests, diversification, and modernization.

Others in Kiev found—like the Russians did—virtue in necessity. In the end the price revolution would benefit Ukraine by making long-postponed reforms inevitable. Perhaps as well, excessive dependence on Russia could be minimized by developing domestic sources of energy, like unconventional gas. Others took solace in the possibility that Ukraine's export prices might in the end increase faster than those of Russia's exports.

Possibilities for the future have been explored, but meanwhile populist policies have continued unabated. The Yanukovych government has refused to increase gas prices for households, as demanded by the International Monetary Fund (IMF) as a key condition for continued financial support. Waste of energy by households thus continues unabated. There has also been no progress in reducing the burden posed by excessive pension expenditures on the budget—now and especially in the future. Initializing reforms by gradually increasing the general pension age would help improve conditions in the tight labor market. In the European experience, increasing the pension age to better reflect longer life expectancy can be politically totally acceptable.

Debt Builds

Compounding this was the financial crisis that rocked the international economic system in 2007–2008. Ukraine's lack of sound domestic economic structures and debt accumulation made it especially difficult for the country to weather the financial storm.

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Though Ukraine is not particularly deeply indebted, its debt stock has grown rapidly. Ukraine has since independence received important official development assistance. Gross reserves have grown from less than a month's imports to around five months' worth from 2005 to 2010, still a modest level. Public and private foreign debt has recently risen fast from more than \$10 billion in 1997–2002 to over \$100 billion in 2008–2009. The 2008 level was 56.4 percent of GDP and 118.7 percent of exports.

In 2009, as GDP declined and the hryvnia weakened, external debt stock was 91.5 percent of GDP and 191.6 percent of annual exports—clearly an unsustainable level for Ukraine. In late 2011, Ukraine's official reserves were some \$30 billion. Paying back its debt—barring a further accelerated depletion of foreign exchange reserves—will be close to impossible without fresh foreign finance, preferably in the form of disbursements from the IMF.

A two-year IMF stand-by arrangement, put in place in 2008, provided exceptional access to financing that was crucial in helping Ukraine through the Great Recession. In particular, it helped to prevent a banking crisis. In many respects, however, Ukraine reneged on its commitments, and the program went off-track very soon, as a 2011 IMF evaluation concludes. This holds for fiscal, exchange rate, and monetary policies, but in particular for the energy sector.

In 2008, Ukraine committed itself to phasing out all gas subsidies in three years, but little was done on that front. For some specific industries, gas prices were actually decreased in 2009. Ukrainian households still pay traditionally extremely little for the gas their everyday life depends on. At end of the year, gas prices for households accounted for about one-fifth and those for utilities for one-third of import prices. Following this, there was little left of Ukraine's credibility as a policy program partner.

Yet, another stand-by arrangement amounting to $15.3 billion was somewhat surprisingly approved by the IMF on July 28, 2010. The IMF disbursed $3.4 billion by December 2010, and in August 2011 a second arrangement review was postponed to November of that year. But the IMF mission arrived and departed without reaching common understanding with the Kiev authorities. Though Ukraine must also show how it intends to remedy the built-in fiscal dilemmas of a large shadow economy and huge pension commitments, the main issue of contention was, once again, the domestic gas price for households and utilities.

Officially the low gas prices are justified as poverty alleviation, but it is difficult to imagine a less effective and less equitable pro-poor policy. The gas price subsidy is widely viewed as a way to line the pockets of oligarchs, not help the poor. The practice is also a key hindrance to improved energy efficiency, which is badly needed in Ukraine. Oligarch-owned industries are the biggest sources of inefficiency, having survived and even succeeded for decades due to hugely underpriced energy. Inefficient industries have not lived in a real market environment: as gas prices to industries have been raised, subsidies have been channeled through the budget and the financial system. On top of that, raising prices before the 2012 and 2013 parliamentary and presidential elections is not a particularly good strategy for winning votes in a country accustomed to populist policies.

Unfortunately for Ukraine, its current domestic industry is not poised to help solve its debt problem. Ukraine, like Russia and Central Europe, has been a limited export success, as its share of world direct exports rose close to (a still very modest) 0.2 percent of GDP[13] in 2000–2008, at a time of thriving international trade overall. Ukraine benefited from originally very low labor costs, slightly lower tariffs, and high prices of its main export goods, but at the same time faced notably higher non-tariff barriers. Unlike some Central European countries that have received major FDI into export-oriented industries like car assembly, Ukraine did not generally benefit from becoming a production platform for exports. Research and development efforts among manufacturers remain very modest—on the level of Belarus, according to statistics—and there is in this respect no difference between exporter and non-exporter firms.

Ukraine is now seeking Russian financial aid, but if that comes at all, it will be at a price.

On the supply side of FDI, as the OECD puts it, "most knowledge-intensive and high value-added industrial sectors remain outside the line of vision of foreign investors. As yet, Ukraine remains a source of raw materials, an assembler of industrial components and as a large and promising market for foreign-based goods and services."[14] FDI rarely goes into manufactured exports of final goods, which have to be competitive in international markets, and therefore bring one of the main benefits of FDI—increased research and development.

The IMF cannot keep stretching its general access criteria for Ukraine. The country is now seeking Russian financial aid, but if that comes at all, it will be at a price. With a financing gap of some $6–7 billion forecast for 2012, the drop in reserves in the absence of additional foreign finance—from the IMF or Russia—would be steep, but perhaps manageable, at least for a government engaged in short-term action.

Assessing Economic Transition

A look at various economic assessment metrics helps to quantify these general trends. Ukraine's reforms in its transition from a state-led system toward a market economy did result in some early success. However, the system is still struggling in many ways, especially when it comes to corruption and the business environment.

European Bank for Reconstruction and Development Indicators

The standard early measurements of progress during a country's transition are the indicators of the European Bank for Reconstruction and Development (EBRD). The EBRD rates countries' progress on a scale from 1 to 4+, with 1 being the lowest and 4+ the highest scores assigned. At 1, no progress has been made since socialist times. At 4+, the country has reached developed-market-economy standards. Countries are rated in various areas, such as privatization, competition, and infrastructure reform. Thus countries with little private ownership are given a score of 1, while those countries with overwhelmingly large private sectors receive a score of 4+. While the relative sizes of public and private sectors are usually relatively easy to measure, some other dimensions of transition from central planning to markets are not. This, for instance, is the case with infrastructure reform. Here different sets of data must be combined with expert evaluation by EBRD economists. In spite of such uncertainties, the EBRD transition indicators are widely used. They are available for all Eurasian transition countries, and for many years.

The indicators show little change in Ukraine in the early 1990s. In 1993, just four of the thirteen indicators had advanced from level 1 ("no change"), and the highest scores were only at 2. In contrast, just three years later only four indicators, all in infrastructure reform, stayed at 1. The best performing area, price liberalization, had progressed to 4-, just two grades down from the highest possible score of 4+. There was improvement, then, on these measures at least.

Overall, by 2005 Ukraine had not gotten the highest score on any of the EBRD indicators, but it was just one grade away in small-scale privatization and price liberalization. Liberalization in a wide sense was always much easier than restructuring existing enterprises, where Ukraine lagged badly at grade 2. Freeing up prices can in principle be done overnight by issuing just one short edict. But turning mediocre Soviet plants into world-class competitors is more difficult, if not impossible.

The situation as measured by the indicators was also bad in other relatively complicated reform dimensions, like infrastructure, non-banking financial institutions, and banking reform. The score for competition policy was low as well at 2+, but there the best score among all assessed countries remained at just 3.

In 2010, Ukraine's trade and foreign exchange system had joined the top performers, but still the country did not reach the highest score in any aggregate dimension. The laggards remained those already mentioned—notably the financial sector and competition policy—along with enterprise restructuring, competition policy, and infrastructure reform all at just 2+. These are the kind of technically demanding reforms that also require a high degree of political will and consensus in the face of vested rent-seeking interests, both characteristics that Ukraine has lacked.

The EBRD transition indicators have not only been available across the transition countries since 1989, they are also simple and have therefore been indispensable for researchers and public discussion alike. But they are based on subjective assessments and tend to reflect the traditional transition thinking as fundamentally a matter of state withdrawal from the economy. The more control a state gives up, the more progress is being made, according to these assessments. The EBRD has therefore since 2010 complemented them with forward-looking, sector-based indicators, as shown in table 1. They should be more transparent and disciplined than the old iteration.

Table 1 compares Ukraine on these indicators with Kazakhstan and Russia, the other two large, partly resource-based, partly industrial countries in the post-Soviet space. Though the scoring looks simple, it is in fact quite complex. For instance, the agribusiness score is a composite of seven criteria, with a total of 30 indicators. A similarly low score may thus tell of very different problems in each country. Altogether there are several hundred sector/country ratings behind the overall EBRD picture of 29 countries.[15] A star denotes those indicators that have improved since 2010, all by just one grade.

Table 1. Sector Transition Indicators 2011: Overall Scores

		Kazakhstan	Russia	Ukraine
Corporate sectors	Agribusiness	3-	3-	3-
	General industry	2	3-	2+
	Real estate	3	3-	3-
Energy	Natural resources	2-	2	2-
	Sustainable energy	2	2	2+
	Electric power	3+	3+	3
Infrastructure	Telecoms	3	3+	3-
	Water and waste-water	2*	3-	2*
	Urban transport	2*	3	3-
	Roads	2+	3-*	3-
	Railways	3	3+*	2
Financial sectors	Banking	3-	3-	3-
	Insurance and other	2+	3-	3-
	MSME finance	2	2	2
	Private equity	2-	2+	2-
	Capital markets	3	4-	3-

Source: EBRD, *Transition Report* (2011). Scores run from 1 (no progress) to 4+ (developed market economy standard)

Altogether, in sector-level indicators Ukraine is on par with Kazakhstan (as well as Georgia, FYR Macedonia, Armenia, and Moldova, not shown here) and somewhat behind Russia, which it leads slightly in transition indicators. Most of the sector-level indicators are the same or very similar in all three countries. Ukraine lags in railways and slightly in telecoms, and only leads by one grade in sustainable energy. In view of its ambitions to become a regional financial center, Russia has a notable lead in private equity and capital markets. Overall, the differences between Kazakhstan, Russia, and Ukraine are very small, but then these economic indicators do not attempt to measure democracy, freedom, and civil society. There, Ukraine would surely fare much better than its authoritarian neighbors to the east. Ukraine has become less free under the Yanukovych government and the prospects are not bright. The sentencing to prison of Yanukovych's main political competitor, former prime minister Yulia Tymoshenko, harmed Ukraine's international position. Still, Ukraine is not an authoritarian country.

The Business Environment and Enterprise Performance Survey

The preferred alternative to using EBRD transition indicators has become Business Environment and Enterprise Performance Survey (BEEPS). EBRD and the World Bank have undertaken BEEPS in the transition region periodically since 1999.[16] In the last survey in 2008–2009, 12,000 firms were surveyed in 29 countries. They were asked to assess the severity of sixteen potential obstacles to doing business on a scale from 0 (no problem) to 4 (very severe). Again and again, skills availability, corruption, and tax administration emerge as the key endemic problems of the business environments in transition countries.

In Ukraine almost all companies complain about tax rates and corruption. Fewer firms than before report unofficial payments but the bribe tax, the share of bribes in annual sales for all firms, is almost unchanged at 1.6 in 2005 and 1.5 percent three years later. This means that those firms reporting unofficial payments paid larger amounts: 3.2 percent of annual sales in 2005 and 6.3 percent in 2008. A quarter of companies stated that bribery is frequent in dealing with taxes. Courts and customs followed. In the 2010 Transparency International Corruption Perceptions Index, Ukraine is number 134 out of 178, after Kazakhstan at 105 but before Russia at 154.

These estimates are supported by a detailed microlevel analysis by Gorodnichenko and Peter.[17] They found that though Ukrainian public sector employees received 24–32 percent less in wages than their private sector colleagues, there was no difference in consumption and asset-holding levels. Their lower-bound estimate for the extent of bribery in Ukraine was about 1 percent of GDP. That is in line with the bribery tax estimates just cited.

After tax rates and corruption, in 2008 the greatest obstacles were perceived to be access to land, tax administration, and courts. The skills and education of workers, which had been the second biggest obstacle in 2005, followed in sixth place. This was the largest change recorded over these years, but it can be explained in a number of conflicting ways. Weaker demand for skills in a time of crisis is the most likely explanation.

Doing Business in Ukraine

Finally, the World Bank Group also publishes Doing Business reports. In contrast to those already discussed, these reports are not about perceptions or expert views but use two kinds of data: the reading of laws and regulations as well as time and motion indicators (for example, how long it takes to register a company). The 2011 report covers 183 economies. Table 2 gives the relative positions (out of 183) of Kazakhstan, Russia, and Ukraine. The lower the number, the better the situation in the country.

Table 2. Doing Business 2011: Kazakhstan, Russia, and Ukraine

	Kazakhstan	Russia	Ukraine
Altogether	59	123	145
Starting a business	47	108	118
Dealing with construction permits	147	182	179
Registering property	28	51	164
Getting credit	72	89	32
Protecting investors	44	93	109
Paying taxes	39	105	181
Trading across borders	181	162	139
Enforcing contracts	36	18	43
Closing a business	48	103	150

Source: doingbusiness.org

This study does nothing to flatter Ukraine. It tracks with Russia in ease of doing business, but Kazakhstan is in a totally different—much better—group of countries. However, this study is—as said—based on existing laws and regulations as well as time and motion measures. Russia's exceptionally good position in enforcing contracts is based on information provided by the Moscow Court of Arbitration that it takes 37 different procedures, 281 days, and 13.4 percent of the claim as cost to enforce a contract through court. In Kazakhstan (rank 36), the same measures are 38 procedures, 390 days, and 22 percent cost. The corresponding numbers in Ukraine are 30, 345, and 41.5 percent. The Moscow Court of Arbitration has an exceptionally good reputation compared to other Russian courts, but still what happens in practice may be worse than the official record. On the other hand, there is no reason why the same might not hold for Ukraine as well.

There are some seeming inconsistencies between survey-based and measured assessments of the business environment. Thus, in Doing Business, trading across borders is in Ukraine less of an obstacle than in Russia and Kazakhstan, but still Ukraine scores badly on it in international comparison. However, in the BEEPS survey, Ukrainian respondents ranked customs and trade regulations at 13 out of 14 among their perceived obstacles to business, tracked only by labor regulations. In 2005, customs and trade regulations had been at rank

9, also out of 14. A possible explanation is that while 83 percent of firms saw this as no or at most a moderate obstacle in 2005, this share was down to 75 percent three years later. Perhaps the regulations had indeed become stricter at least relative to those in other countries, and the companies that were hit by them were hit hard.

Given the difficulty of doing business in Ukraine, the prevalence—already briefly discussed above—of the informal economy comes as no surprise. Its officially estimated share of GDP in 1998 was 31.1 percent, but other estimates, including growth since the 1990s,[18] can go up to 60 percent. This would make the Ukrainian informal sector one of the biggest among all transition economies, relatively speaking. An authoritative World Bank study[19] estimates that the global average share of the shadow economy came down from 34.0 percent of official GDP in 1999 to 31.0 percent in 2007. In Ukraine, the share declined from 52.7 to 46.8 percent. That 2007 share is distinctly greater than in Kazakhstan (38.4), Tajikistan (41.0), and Russia (40.6). Among transition economies, just Azerbaijan and, at the time, Georgia had higher shares of the shadow economy.

If such studies are to be believed, the Ukrainian shadow economy is simply huge. It goes hand in hand with corruption. The weak government is unable or unwilling to maintain elementary order in the country, and much corruption naturally involves state institutions and civil servants. In addition, corruption often connects with other crime as well. To collect sufficient revenue, the official part of the economy is taxed unnecessarily hard. Actual incomes are higher than shown statistically but also more unevenly distributed, as the ability to offer corrupt services varies from person to person.

When corruption, rather than efficiency, investment, and competition, becomes the main source of economic success, it clearly becomes a drag on growth and welfare.

Some researchers conclude that a modest amount of corruption acts as grease in the economic wheels in societies with badly functioning institutions and when states hinder rather than promote economic activity. But when corruption, rather than efficiency, investment, and competition, becomes the main source of economic success, it clearly becomes a drag on growth and welfare. Not surprisingly the richest nations are also those generally assessed to be the least corrupt.

Caution is needed, however, as many figures presented as true are difficult to combine in a consistent way. Thus the OECD[20] cites an official estimate that two-thirds of the informal economy is in agriculture and 95 percent of agricultural production is informal. This cannot be regarded as credible.

Not All Bad News

The picture of Ukraine's economy is certainly not totally bleak. The World Bank[21] notes in a generally very critical report that many highly positive actions and reforms were in fact taken by Ukraine between 2000 and 2008.

They include World Trade Organization accession with the reforms embedded in the process; the monetization of the economy away from non-payments and barter; and legislation in different fields, including for instance joint stock company law and budget code. A flat income tax was introduced, and agricultural land was titled. There is a moratorium on sales of agricultural land, but it can be leased for long terms.

Ukraine could be a rich country. No other European country can boast its resources of coal, iron, gas, and rich agrarian land. Almost three-quarters of its area is agricultural land, more than half arable. Though the quality of legendary black earth deteriorated during the Soviet decades, it remains among the best globally. Barring an unexpected lack of precipitation, climate change, if it entails gradual warming of the average winter temperatures in the region, should further improve Ukraine's competitive position in European food markets. Ukraine was able to reach acceptable food market access conditions in negotiations with the EU on a Deep and Comprehensive Free Trade Agreement, and since climate change implies less rain in the Mediterranean area, Ukraine will be the natural source of potentially increasing European imports.

The country has some oil and conventional gas, and perhaps more importantly, possesses as much as 4 percent of global coal reserves. Though more than half of energy consumed is imported, reserves of unconventional gas are estimated to be several trillions of cubic meters in size, promising gas independence from Russia in about two decades. Indeed, Ukraine's growth rate in 2001–2008, boosted by exceptional improvement in terms of trade, was fully comparable with Eurasian hydrocarbon producers at some 7 percent annually.

Though the population has declined from about 52 million in 1991 to less than 46 million today—and the decline continues—it is generally better educated than populations in other lower-middle-income-level countries. That, along with its proximity to EU markets, is one of Ukraine's competitive advantages.

Infrastructure is in spite of deterioration in relatively good shape. The Soviet Union left industries, for instance in crucially important metallurgy, that are generally taken to be in better condition than in Russia. Though in Soviet years Kiev was even more thoroughly isolated from foreign influences than Moscow—the latter being a very modest positive exception in this respect among Soviet cities—Ukraine has inherited major research and development capacity that is in line with Soviet standards and scale.

But this potential has been tragically neglected. In 1990, according to an IMF estimate,[22] Ukraine used just under half of the efficiency available from Soviet technologies. By 2005 Western technologies were available, and relative to this standard, Ukraine used just 22 percent of the efficiency potential.

Ukraine must either gain in efficiency on its own or continue to underperform. The former is a tall order though by no means impossible; the latter will push Ukraine to the European periphery for decades to come. It would be poor and unequal, politically unstable, suffering from the hemorrhage of the bright and educated, and forced to try to play a very difficult political and economic game using the few advantages it has.

International Integration

Some have hoped that international organizations would provide Ukraine with economic stability and encourage reform-making. Bulgaria and Romania, for example, have benefited greatly from the prospect of European integration and the policy anchors that provides. One IMF study estimates that were Ukraine to reach the Romanian level of institutional standards by 2015, the economy would grow by 8.5 percent annually. If it continues to lag in institutional development, Ukraine would have growth of just 2.5 percent annually. However, the United States, the European Union, international organizations, and others have had significant problems deciding how to relate to Ukraine.

All European nations have the right to apply for membership in the European Union, but a Ukrainian application is neither encouraged nor expected in any foreseeable future. A Deep and Comprehensive Free Trade Agreement is seen as the interim solution. Negotiations for such an agreement were begun in 2008, but its implications are unclear and longevity undetermined. Such an agreement requires the lesser partner to align itself with EU rights, rules, and standards (including many but not all of the EU *acquis communautaire*), thus forging a path between classical free trade and the regulatory approximation that is necessary for membership. Curiously, in fall 2011 the protection of Ukraine's irrelevant car industry was the last issue to be resolved with the EU. An agreement on agriculture—the traditional stumbling block in free trade—was resolved faster.

It has been hinted that freeing Yulia Tymoshenko might help unlock the gates of Deep and Comprehensive Free Trade Agreement. The problem is that a commitment by Viktor Yanukovych—or the next president—to implement EU regulatory convergence has little if any credibility. Were the agreement signed in coming years, it would face a long and difficult process of ratification. Ukraine could presumably count on support by such neighbors as Poland and Lithuania but would certainly face others who would be more skeptical, especially in northwestern Europe. No eventual agreement with the EU will open the way to membership anytime soon.

Theoretically, that differs from NATO. Ukraine was indeed declared a future NATO member in Bucharest, but there was never an accession plan. Neither will there be in the foreseeable future: Yanukovych's Ukraine does not even pretend to aim for membership. OECD accession will be a matter of the distant future at best. After twenty years, Ukraine continues to lack the policy anchors imposed by key accession conditionality.

Though Ukraine continues to see its future in Europe, not in Eurasia, it very much wishes to have the best of both worlds: access to the all-important European markets as well as access to equally important Russian commodities, preferably heavily underpriced. This has been the balancing act since 1991. Leaders change, but the essence of policy remains.

The Way Forward

Ukraine was a potentially rich country made poor by a tragic history. During the years following independence, Ukraine has grown with the region, but relative to many expectations, this has been a bitter disappointment. Ukraine is seen as an underachiever.

Shortly after Ukraine gained independence, much time and energy was spent on building statehood and its symbols. Rational economic policies were slow to emerge, and in political turbulence they were rarely followed through consistently. Corruption became endemic, and many now see the country as governed by groupings bridging the private and the public spheres, the lawful and the illegal.

Not so long ago it seemed that Ukraine was on the brink of change. The Orange Revolution of 2004 raised many hopes. It attracted huge sympathy and support inside and outside the country. And blueprints for economic reform were available. In 2005, the Blue Ribbon Commission for Ukraine, a body sponsored by the United Nations Development Program that reviewed Ukraine's economic and social policies in light of the Orange Revolution, delivered more than a hundred proposals for social and economic change to the newly elected President Viktor Yushchenko.

But five years later, the World Bank noted that after the Orange Revolution "laws and institutions did not change materially." The Bank listed Ukraine's fiscal crisis, investment climate, financial system, and public sector governance as the priority sectors for reform and drafted large and thorough sets of short- and medium-term measures to improve the system. Sector-oriented reform proposals are also available. A 2011 study, *Turning Ukrainian Agriculture into an Engine of Growth*, came up with a large set of proposals for the country's agricultural sector.

Though political conditions in Ukraine have changed for the better, the zeal of eight years ago has evaporated without truly deep economic reform. So much is currently amiss in the Ukrainian economy and society that any new wave of reforms should ideally reach across the whole society and should be long lasting—stretching across political and elections cycles. Desirable as such consistency would be, reaching for the ideal is illusory in any society. But setting the right priorities is also difficult. That, however, is precisely what Ukraine must do.

To make change, Ukraine needs political leadership more than anything else. Political instability leaves little room for long-term purposeful policies. The country's political future cannot really be predicted, but assuming even a mild improvement over the increasingly autocratic and erratic Yanukovych regime, a possibility of concentrating on needed economic change might open in coming years. Three overarching tasks are evident. They are all wide-ranging, but detailed roadmaps on what to do already exist.

First, Ukraine can no longer rely on a terms of foreign trade windfall. Domestic prices must be set at a realistic level; much needed greater efficiency cannot come from explicit and implicit subsidies. To continue evolving Ukraine needs access to domestic long-term funding. The current combination of dependence on foreign funding and lost international credibility is nothing short of lethal.

Second, the weak and corrupt Ukrainian state must be reformed. Corruption and state favors are the greatest barriers to more free markets with healthier competition and a growing small and medium enterprise sector. Current pension and subsidy burdens put the state in an impossible position fiscally and indirectly force the growth of the shadow economy.

Third, the oligarchic structure of the economy can only be counterbalanced by an economy more exposed to foreign competition and investment. That can only be realized when the previous two tasks have been tackled in a credible and consistent way. As matters stand, Ukraine cannot really expect much foreign investment, nor can Ukraine really be recommended to most investors.

Europe, the United States, and the Euro-Atlantic community will continue to engage with Ukraine. But wisdom starts with acknowledging the facts, and that Ukraine is a relative failure is a fact. Illusions have to be shed where they still exist. The future is in Ukrainian hands, not in those of outsiders, either Western or Eastern.

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