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Meeting Summary

The Management of Ukraine's Economy under Yanukovych

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Summary of opening remarks

Ukraine's economy is facing serious challenges. The reform programme initiated by Yanukovych is less comprehensive and profound than it appears on paper. On the one hand, Ukraine has adopted a new customs code and budget code; tax reforms as well as a massive deregulation programme and substantial cuts in public administration were undertaken. The growth rate of 5.2% also looks promising at first glance. But the privatisation programme gave preference to five groups close to the president who now have access to the most important industries and services in Ukraine including mining, the chemical and pharmaceutical industry, electronics and telecommunication. These fields are essentially closed to foreign investors. The exception is agriculture. Ukraine produces 67 million tonnes of grain per year and several companies are active in the agricultural sector. However, major land reform is planned for 2013 to allow the sale of agricultural land which has been forbidden to date. At worst, this could lead to a massive landgrab and nationalisation.

Who or what could intervene in these alarming developments? The European Union's room for manoeuvre is limited for political reasons: the negotiations over the much-anticipated Deep and Comprehensive Free Trade Area agreement are frozen due to the imprisonment of Tymoshenko and other opposition politicians. As the trade agreement would give decisive impetus to Ukraine's economy and the modernisation of its administration, the prioritisation of Tymoshenko's case seems rather odd.

The International Monetary Fund demands that Ukraine raise the gas price for the population in order to release IMF loans – a requirement Ukraine has not fulfilled yet. Instead, Ukraine continues to import and subsidise expensive Russian gas while low-priced Ukrainian gas is sold abroad with immense profit. All in all, 4.5% of Ukraine's GDP is spent on gas subsidies. Because the Ukrainian government will not raise the gas price before the parliamentary elections, relations with the IMF will remain tense. Fortunately for Ukraine, its funding needs of circa 12 billion US-dollars will be covered by Russia (to 50%) as well as by Euro- and domestic bonds.

Due to the fact that relations with the EU and the IMF have reached a deadlock, Russia is the most important economic player in Ukraine at the moment. Yanukovych's government is in on-going negotiations with Russia over the revision of their long-term gas contract, offering Russia a 50% stake in its gas transportation system, which currently accounts for about 80% of Russian natural gas exports to Europe. However, Russia has the upper hand

in these negotiations: the planned the South Stream project will change Ukraine's central position as a transit country in the long-term. From an economic point of view, South Stream is not profitable for Russia, but personal rivalries and mistrust between both countries are probably the decisive factor. The best advice for Ukraine might therefore be to shut down their pipeline system which has already poisoned Ukrainian politics to a large extent. In conclusion, without serious reform efforts, Ukraine's economy – profitable for only a few groups – has no prospect of stable growth. Ukraine's foreign economic relations in particular have to be revised in order to escape the current deadlock.

Questions and Discussion

The biggest stumbling block for Ukraine's economy is the state itself. Personal enrichment is widespread whereas a sense of national duty hardly exists among politicians. In terms of corruption, Ukraine has made the least progress of all former Soviet countries. Important reforms of the health and education system have been delayed. The Ukrainian GDP per capita amounts to only 25% of Russian GDP per capita, although it was 10% higher than Russia's in 1989. There is little chance that the parliamentary elections on 28 October 2012 will bring major changes. Oligarchic groups will continue to function within the system even if the opposition wins due to Yanukovich's loss of support in south Ukraine.

Against this background, the speaker was asked what the first reform step of the opposition should be. He emphasized that Ukraine is a European country and hence the European Union is key to Ukraine's modernisation: Ukraine should use EU instruments to reform its administration, especially the tax authorities, and follow the tremendously successful example of Central and Eastern European countries. It seems unlikely that Ukraine will join the Eurasian Customs Union in the near future as Yanukovich seems to be committed to the DCFTA with the EU. However, his position might change depending on how much financial assistance Russia is prepared to give to Ukraine.

The banking sector in Ukraine has changed dramatically over the last couple of years. Foreign banks (excluding Russia), previously accounting for 40% of the banking sector, have shrunk to 27%, while Russian banks have moved in (11%). Ukrainian state banks have massively expanded. The main reason for this structural change is the devaluation of the currency, which was a massive shock for foreign banks holding Ukrainian grivny. In particular, the fixing of the

exchange rate is a worrying development because investors are discouraged from using Ukrainian currency within the financial system. Even if the financial sector were still working smoothly, the exchange rate could easily come under pressure; it should be immediately changed to a floating currency rate to avoid speculation against the grivna.

Asked how much influence China exerts in Ukraine, the speaker explained that China does indeed have major influence in the region but less so in Ukraine. Moldova, Serbia and Belarus receive substantial support in form of loans from China, but an agreement between Ukraine and China on several economic projects, including a high-speed rail for Euro 2012, fell through due to insufficient impetus from the Ukrainian side and lack of coordination within the Ukrainian government.