

How Ukraine Became a Market Economy and Democracy

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UKRAINE

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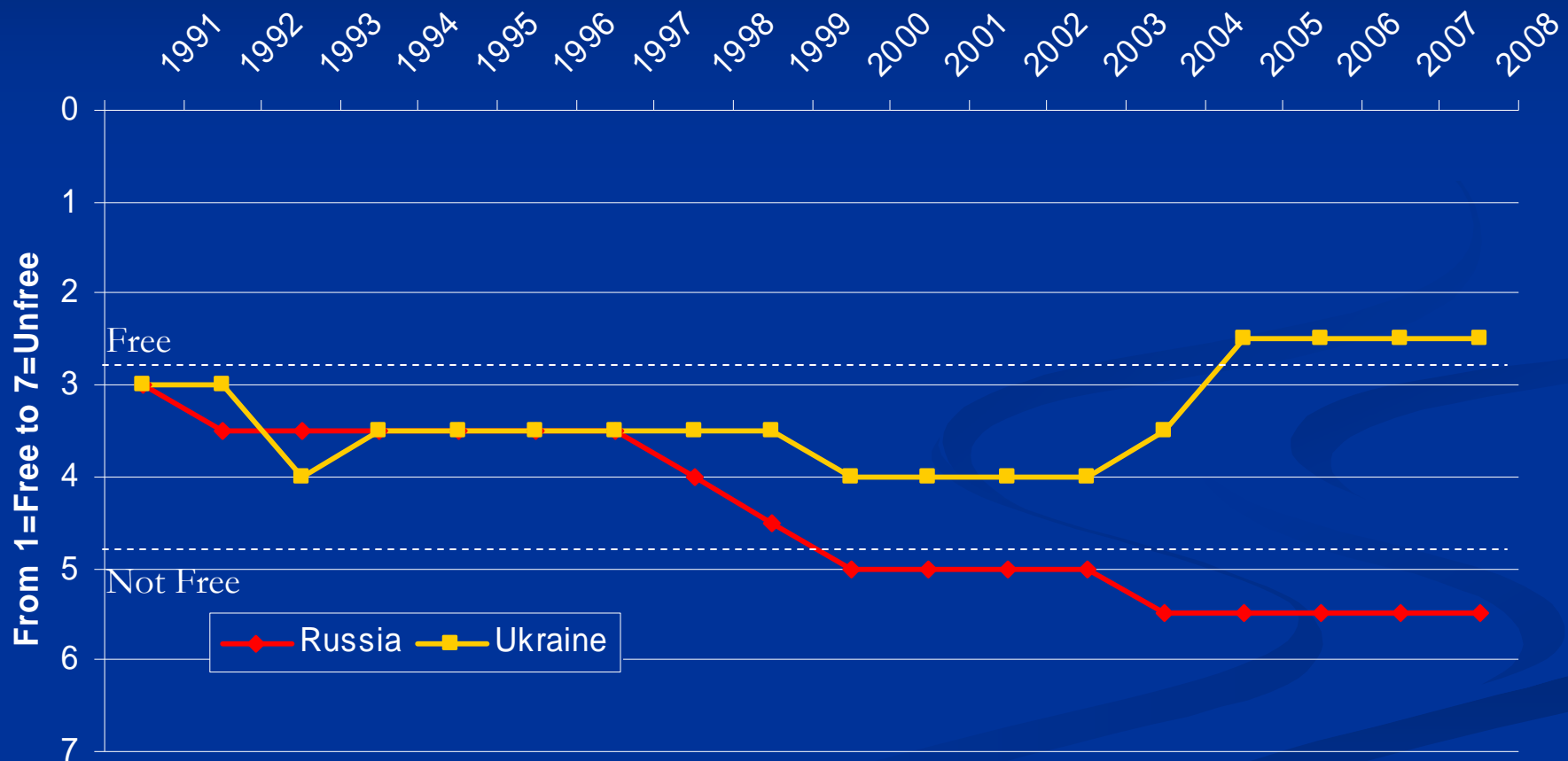
Why Ukraine?

1. Only democracy in the FSU
2. Lagging behind economically but catching up
3. Hard hit by financial crisis: needs international support
4. Geopolitically large loose piece

Orange Revolution: Brought Political Freedom

- Freedom of speech, association and media
- Free and fair elections

Democracy since 2005



Political Equilibrium: Advantages

- All three major parties are center-right parties
- Big businessmen behind all parties
- Uniquely broad consensus on domestic policy

Political Equilibrium: Problems

- Nobody can govern: President regularly vetoes decisions by Prime Minister
- Substantial corruption
- Too little legislation and reform
- Constitutional reform needed

What to Look for?

- Presidential elections

January 2010: Tym vs Yan?

- Constitutional change?

- Social unrest?

**2. A Market
Economy
Was Created**

A Dynamic Market Economy since 2000

- Critical mass of market reforms
- ...and privatization
- Conservative fiscal policy

7.6% GDP growth a year 2000-7

Delayed Market Reforms

- Delay was harmful:
 - Hyperinflation &
 - massive output fall: officially 54%
- 2 radical reforms bouts did it:
 - Q4 1994: Kuchma stopped hyperinflation
 - Q1 2000: Yushchenko completed market reforms

3. Financial Crisis Hit Hard

Why Hit So Hard

1. Collapsing steel industry: 42% of exports
2. Fixed exchange rate with USD
3. Messy politics
4. International finance dried up

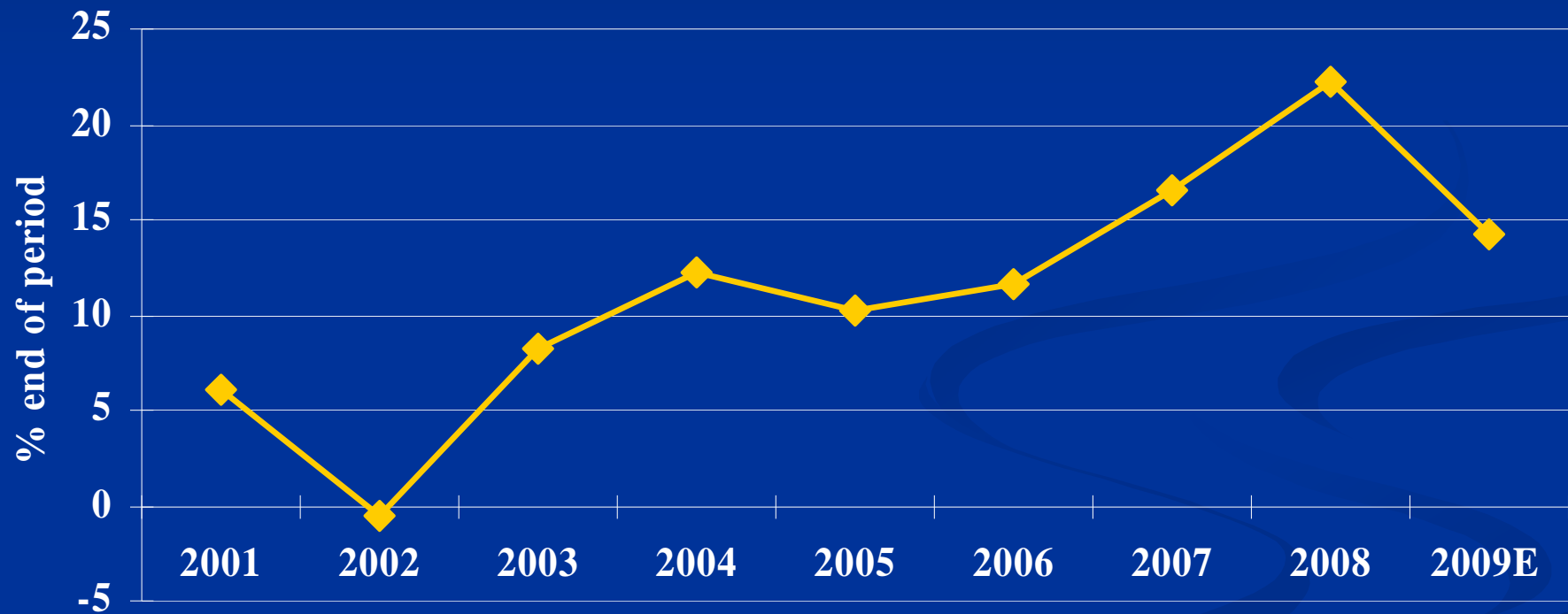
Monetary Expansion Constrained

2007: 51%; 2008: 31%; 2009 13%?



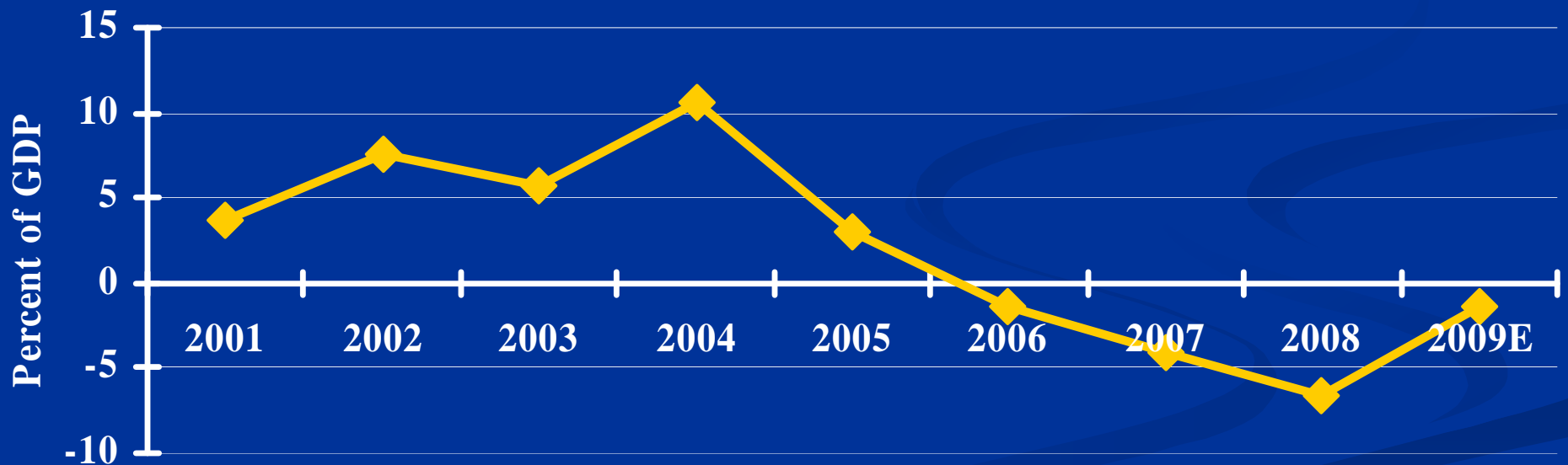
Source: Dragon Capital, January 2009

Inflation Peaked at 31% in May 2008; now 22%



Source: Dragon Capital, February 2009

Current Account: -6.7% of GDP in 2008 rendered Ukraine vulnerable



Source: Dragon Capital, February 2009

Solution: IMF Program

- Concluded in less than 4 weeks
- Substantial financing: \$16.4 billion
- Standard conditions
 - Balanced budget
 - Abandoning peg for floating exchange rate
 - Bank restructuring

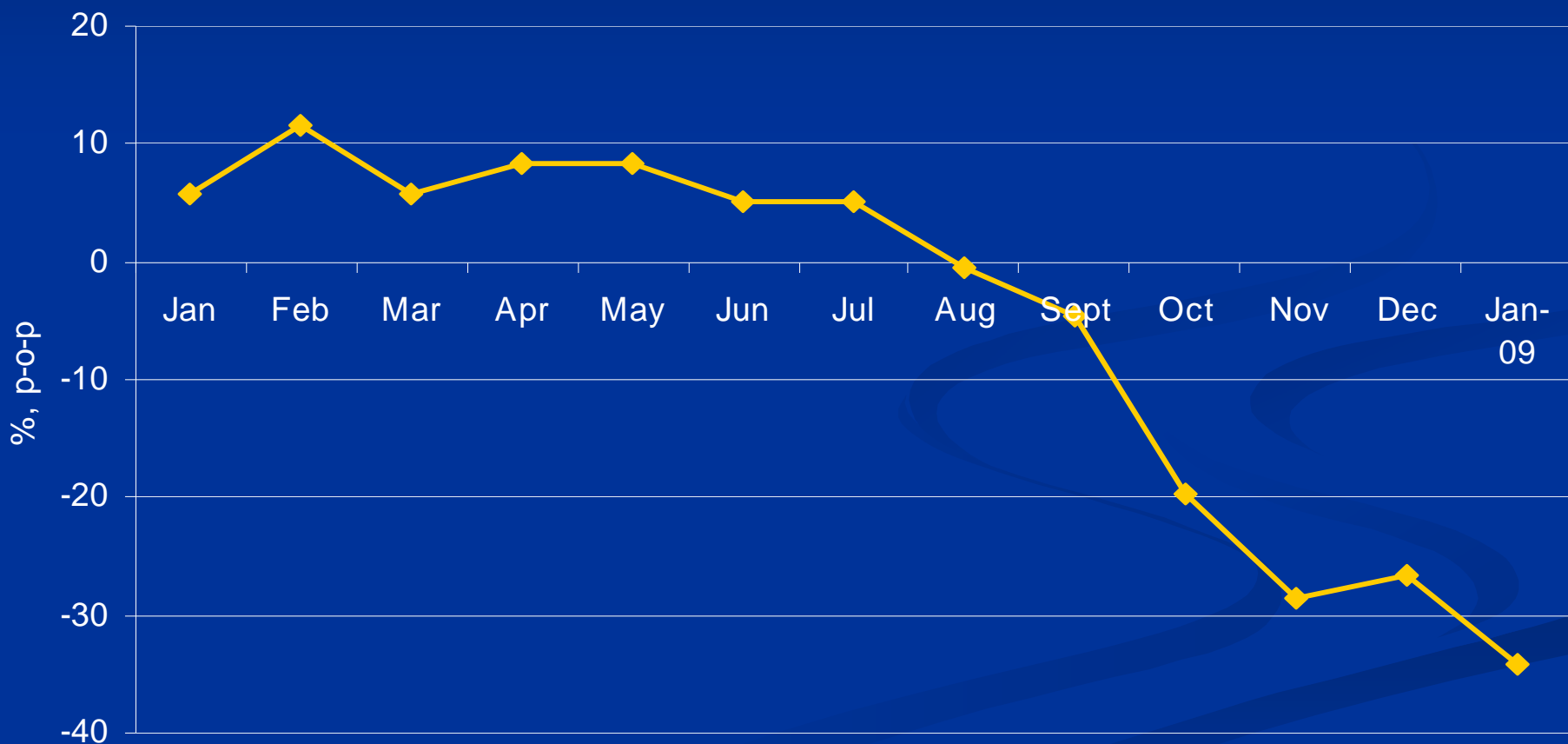
Economic Outcome

- GDP fell by 20% in January
- Industrial production plummeted by 34% in January (steel & mining)
- Depreciation of hryvnia by 50%
- Inflation abated to 22%

Industrial Output Slumps

Industrial Output, 2008-January 2009

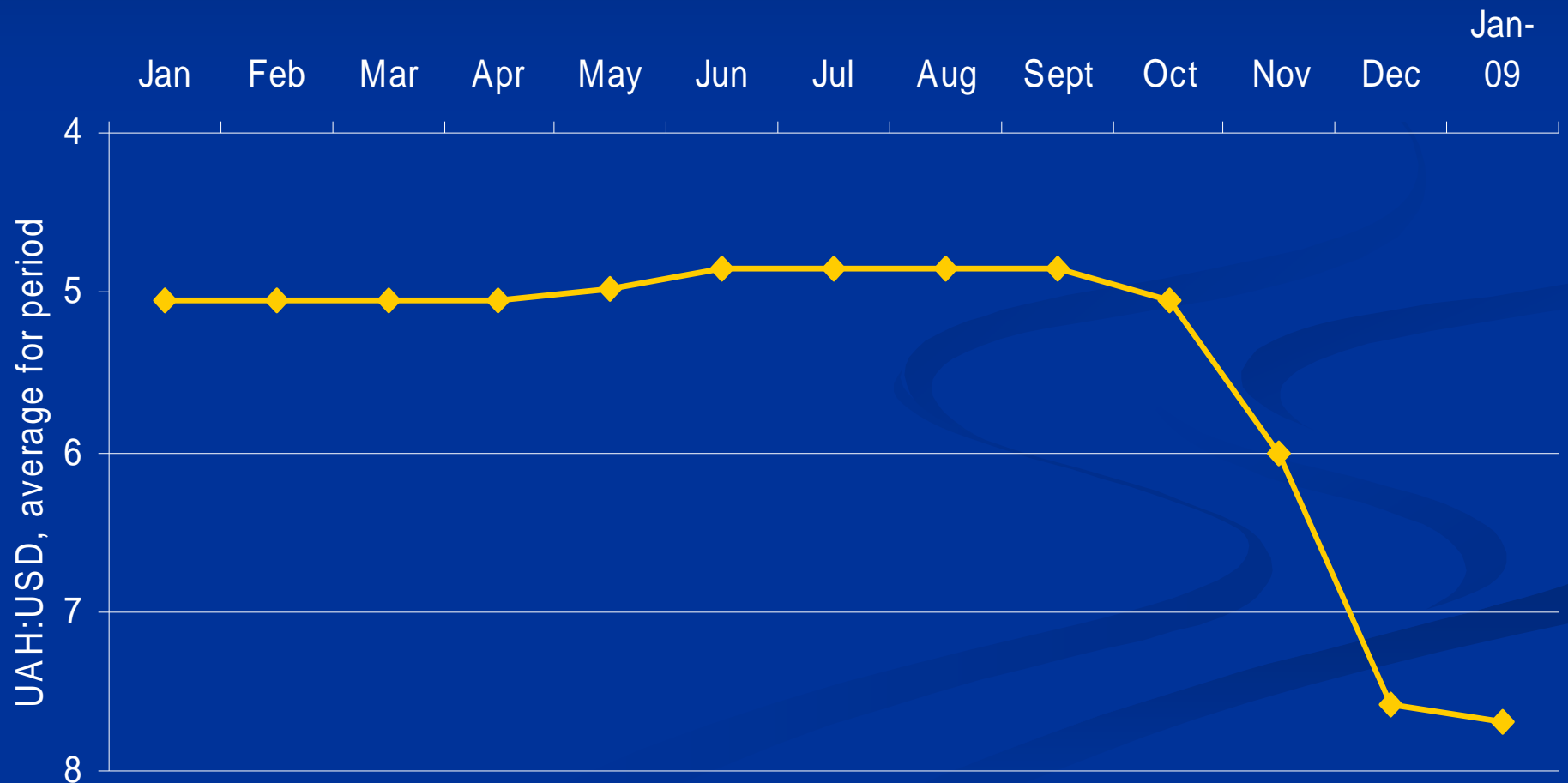
%, p-o-p



Source: Ukrainian State Committee on Statistics, February 2009

Exchange Rate Adjusted

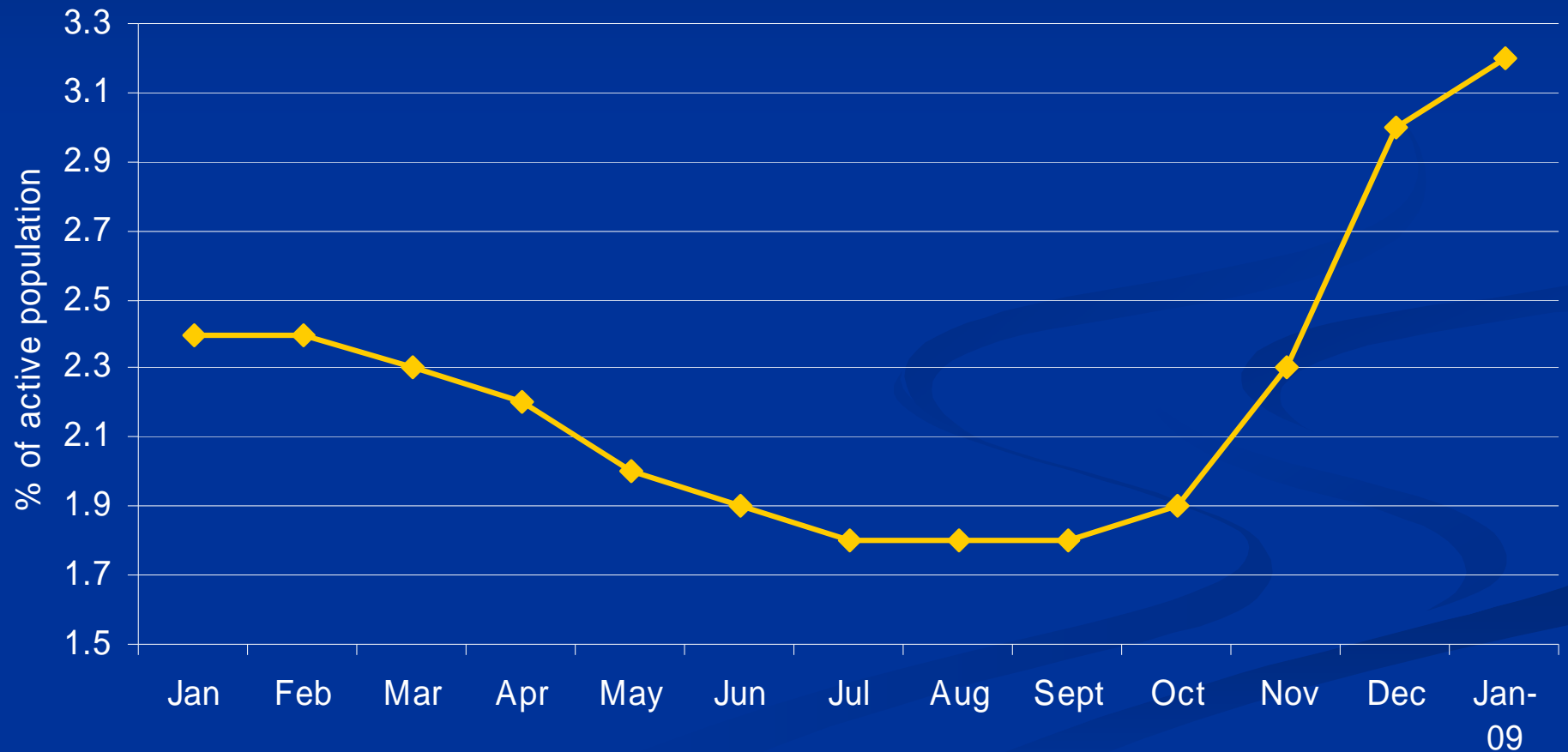
Official Monthly Exchange Rate, 2008
(UAH:USD, monthly average for period)



Source: Ukrainian State Committee on Statistics, February 2009

Rising Unemployment

Registered Unemployment, 2008-January 2009
(% of active population)



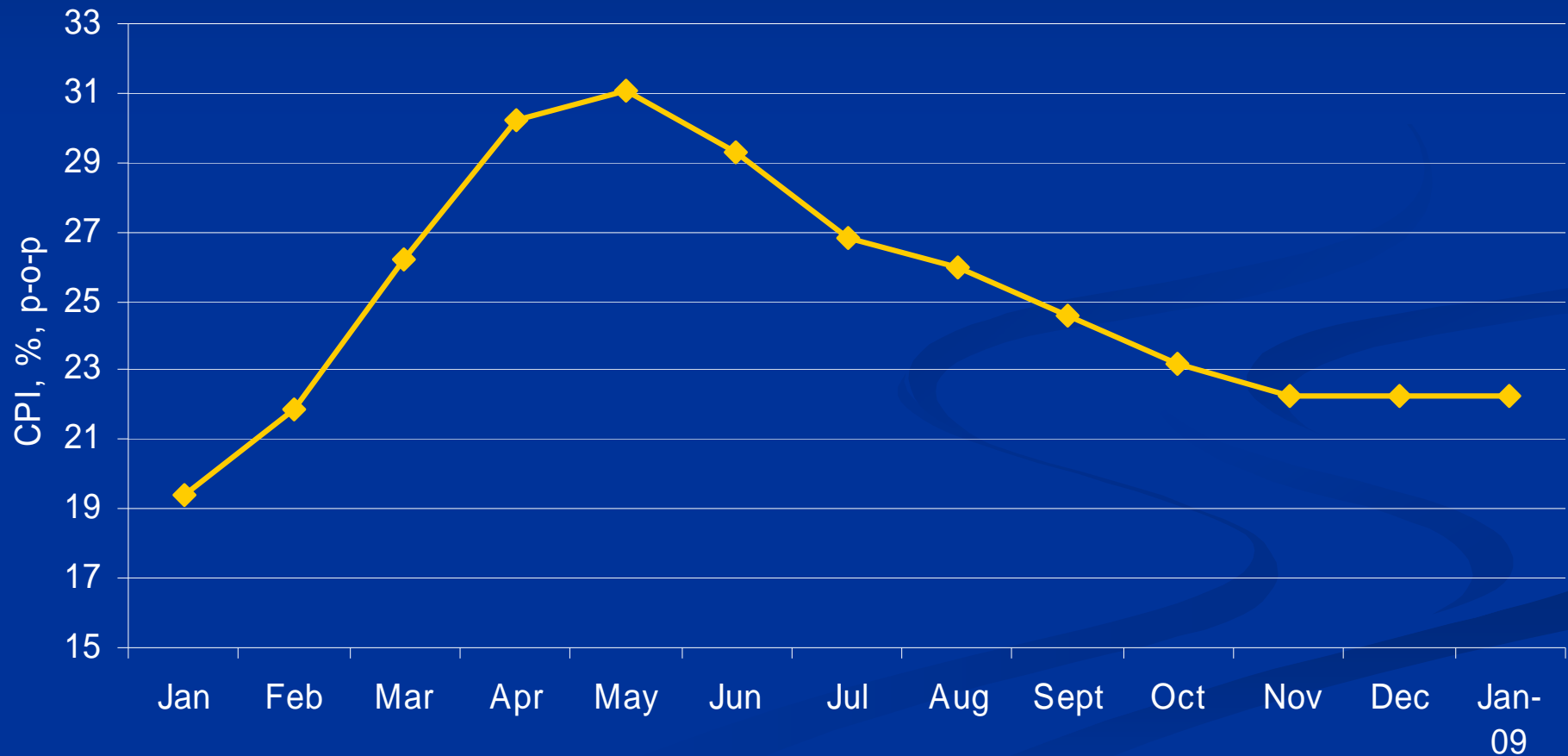
Source: Ukrainian State Committee on Statistics, February 2009

Has Ukraine Hit an Early Bottom?

- Highly competitive exchange rate
- Reserves hold: \$25bn end 2009?
- Default unlikely
- Industrial production must be close to bottom

Inflation Moderates

Inflation, 2008-January 2009
(CPI, %, p-o-p)



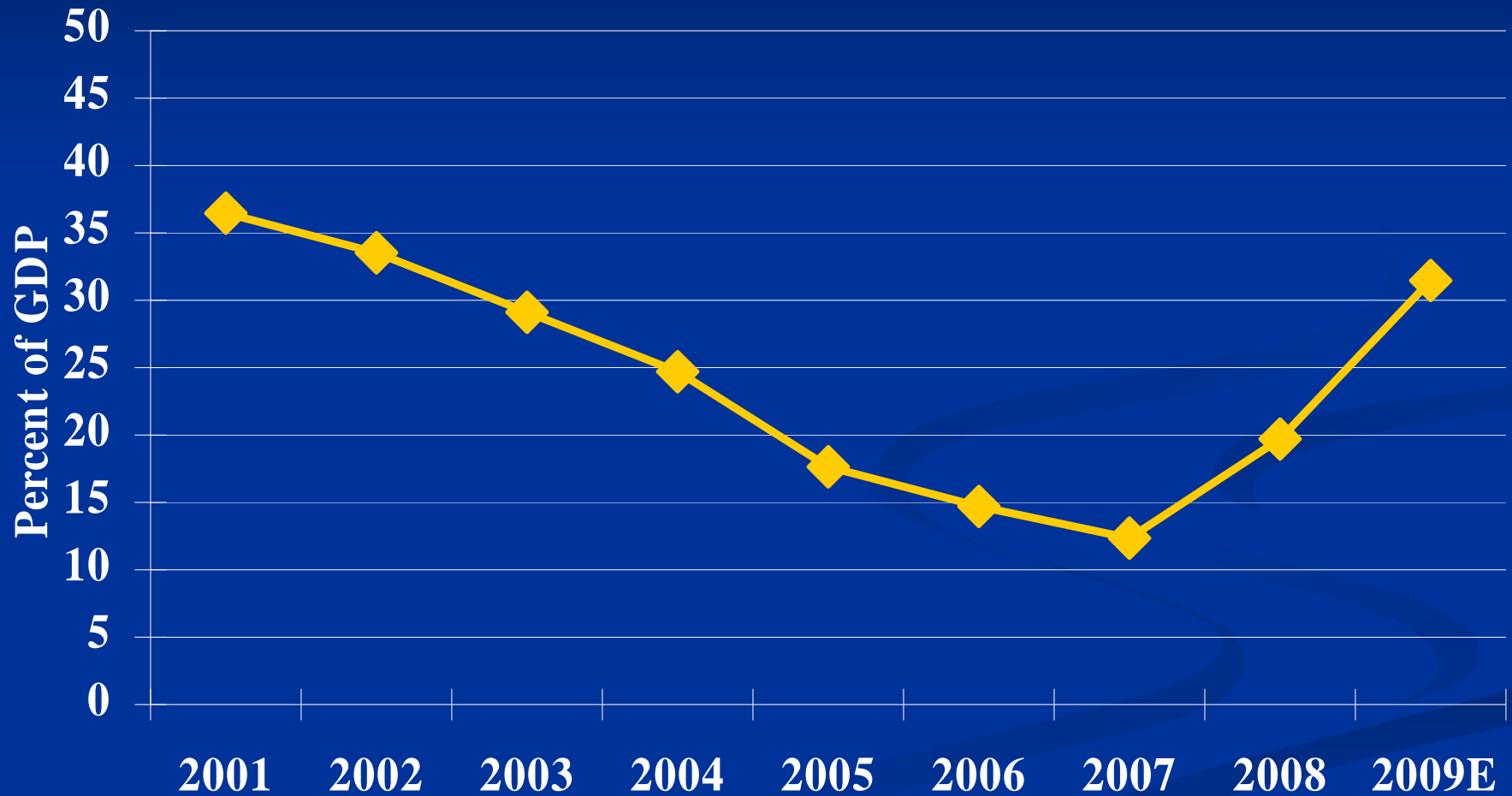
Source: Ukrainian State Committee on Statistics, February 2009

The Budget Deficit Remains under Control



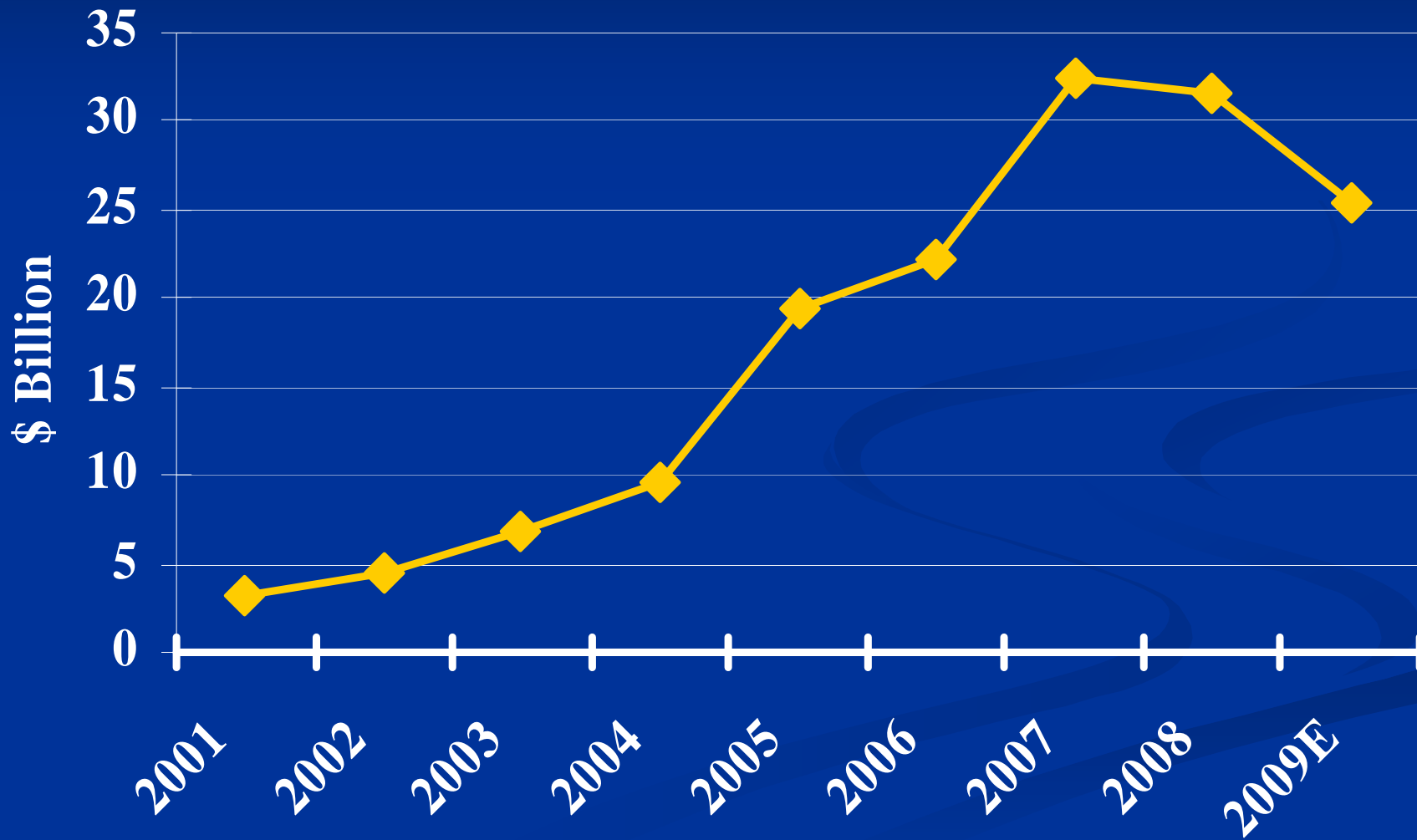
Source: Dragon Capital, February 2009

Public Debt Rises But Was Minimal



Source: Dragon Capital, February 2009

International Reserves: Falling But Sufficient



Source: Dragon Capital, February 2009

What to Look for?

- Budget discipline?
- More international financing/size of reserves?
- Social unrest?

**4. Ukraine Has
Little Choice But
Turn to the West**

The Threat: Putin on Ukraine

- Crimea was simply given to Ukraine by a CPSU Politburo's decision, which was not even supported with appropriate government procedures that are normally applicable to territory transfers.
- Ukraine, in its current form, came to be in Soviet-era days... From Russia the country obtained vast territories in what is now eastern and southern Ukraine...
- If the NATO issue is added there, along with other problems, this may bring into question Ukraine's existence as a sovereign state.

NATO Summit, Bucharest, April 2008

Russia's Policy on Ukraine

- Minimal official contacts
- Gas wars
- Trade sanctions
- Threats over NATO association
- Anti-Ukrainian propaganda

Entirely hostile, but now financing?

What Can Russia Do?

- War is out of question
- Gas and trade wars do little good
- Passports are allegedly distributed – unlikely to work
- Huge Russian funding for presidential elections in January 2010 is likely

Domestic destabilization: attractive

Outcome of Gas War

1. No intermediary: Less corruption & less dependence on Russia
2. Long-term agreement
3. Normal prices and tariffs set by formula: more predictable

Good for Ukraine

West-orientation of Foreign Policy

1. WTO accession on May 16, 2008, could boost Ukraine's growth by 1-2 % points a year
2. European Association Agreement with EU, including free trade, is likely by 2010
3. National Action Plan with NATO

What to Look for?

- International financing from East or West?
- European Association Agreement?

US Could Have Great Impact

1. Guarantee security
2. Provide bilateral financing
3. Free Trade Agreement
4. 1,000 scholarships a year
5. Biden-Tymoshenko Commission
6. Re-engage in Ukrainian reforms

Political Prospects

- Democracy will be tested during the financial crisis: likely to hold
- The constitutional crisis needs to be solved: European parliamentary system obvious solution
- Political financing drying up with financial crisis: Major positive change

Economic Prospects

- Ukraine is likely to weather the financial crisis
- Many economic and social reforms are needed
- Corruption must be controlled
- In the long run: European convergence