

Ukraine's Financial and Political Crisis

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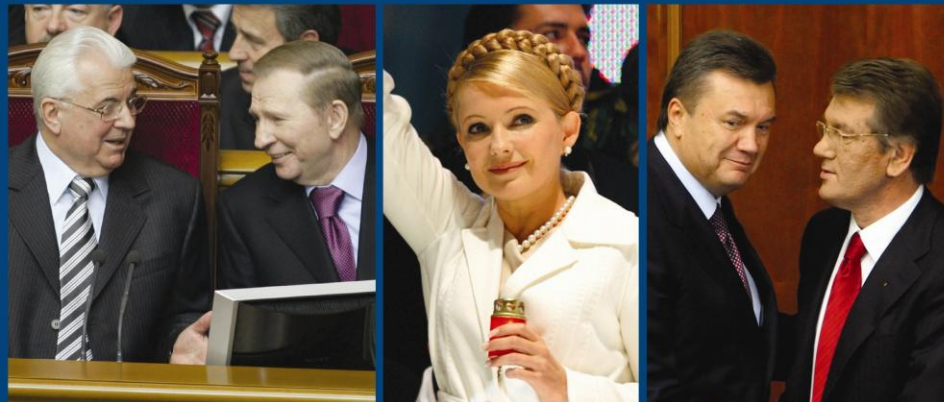
Peterson Institute for International Economics, Washington, DC

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UKRAINE

HOW UKRAINE BECAME A MARKET ECONOMY AND DEMOCRACY



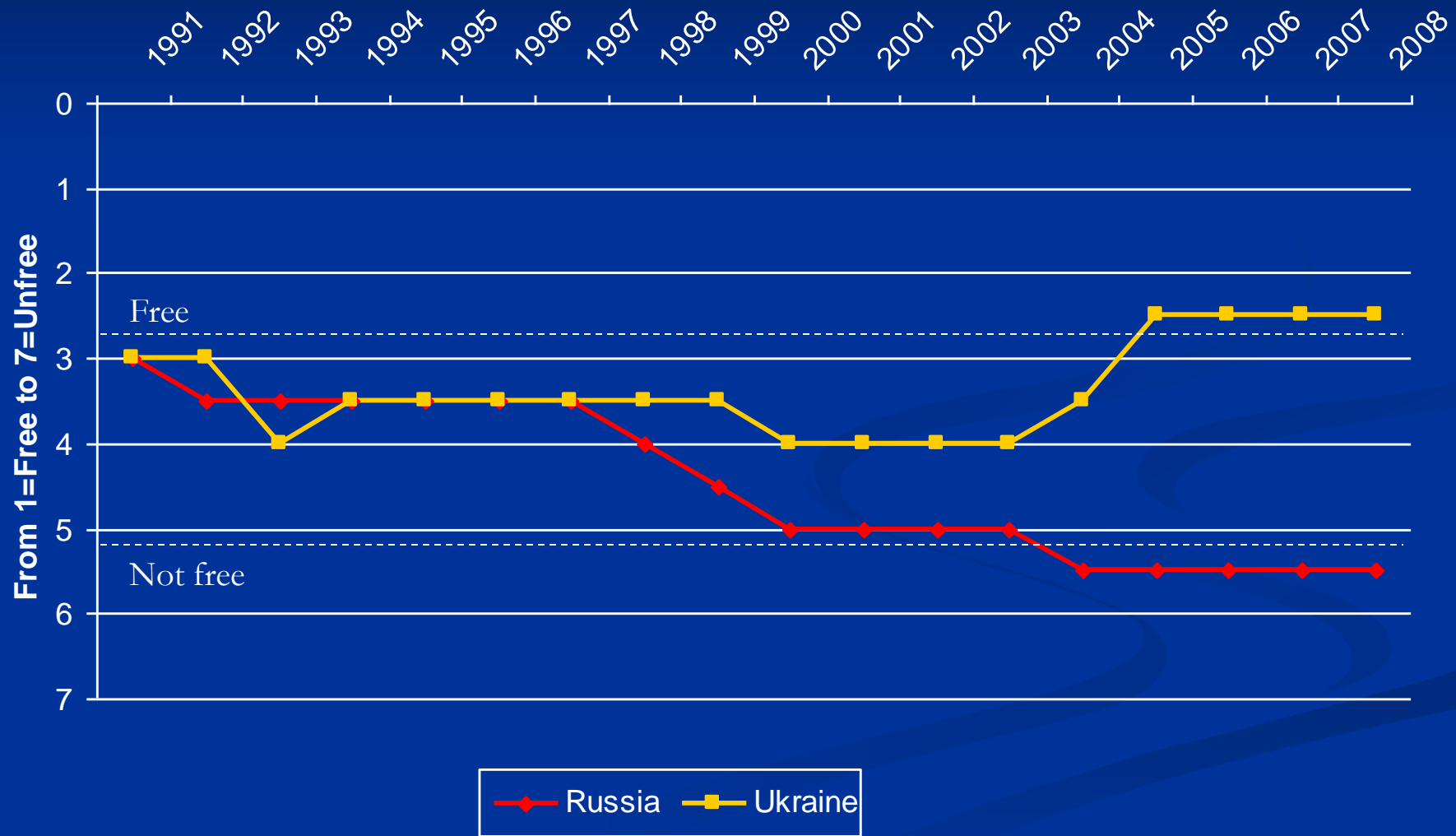
Theses

1. Democracy, but constitutional reform needed
2. Hard hit by financial crisis: needs international support
3. Ukraine can only turn to the West

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 is needed

What to Look for?

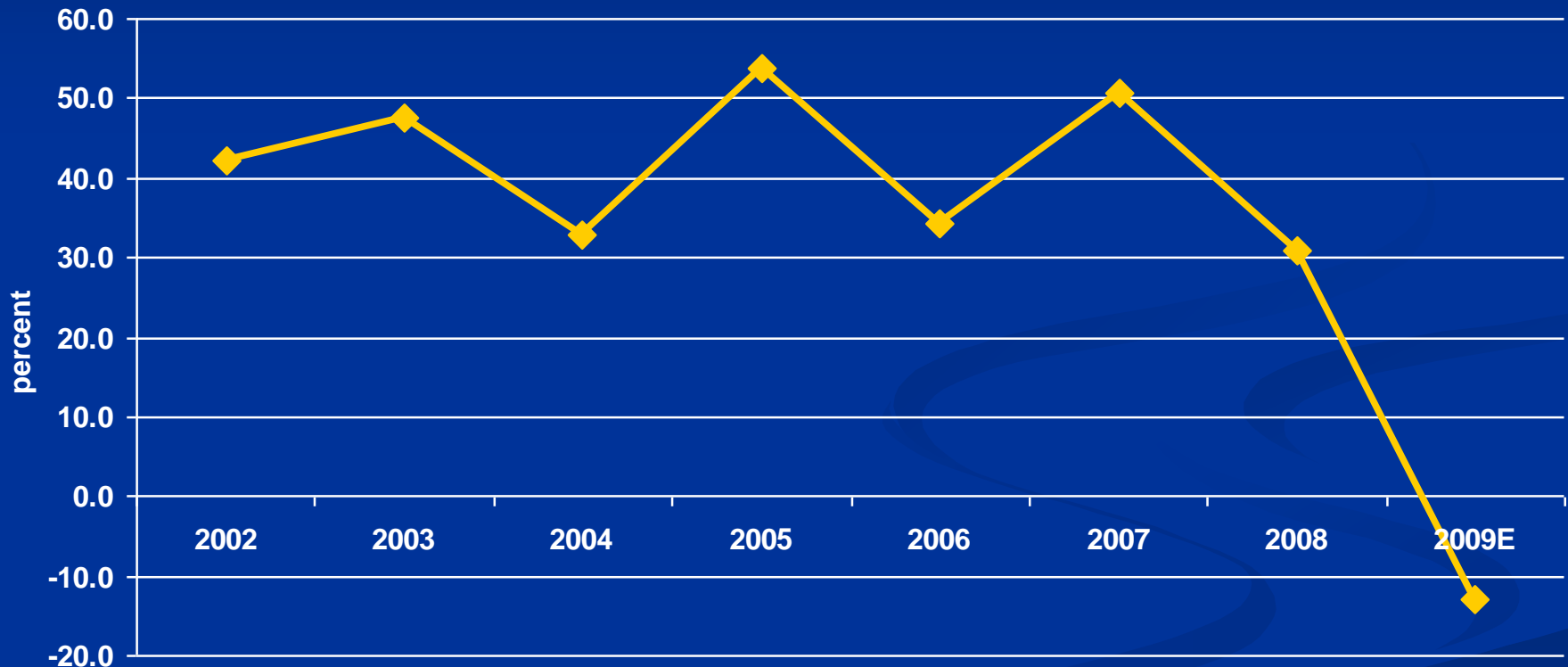
- Constitutional change:
Parliamentary system?
- Presidential elections: The
earlier the better

2. Financial Crisis Hit Hard

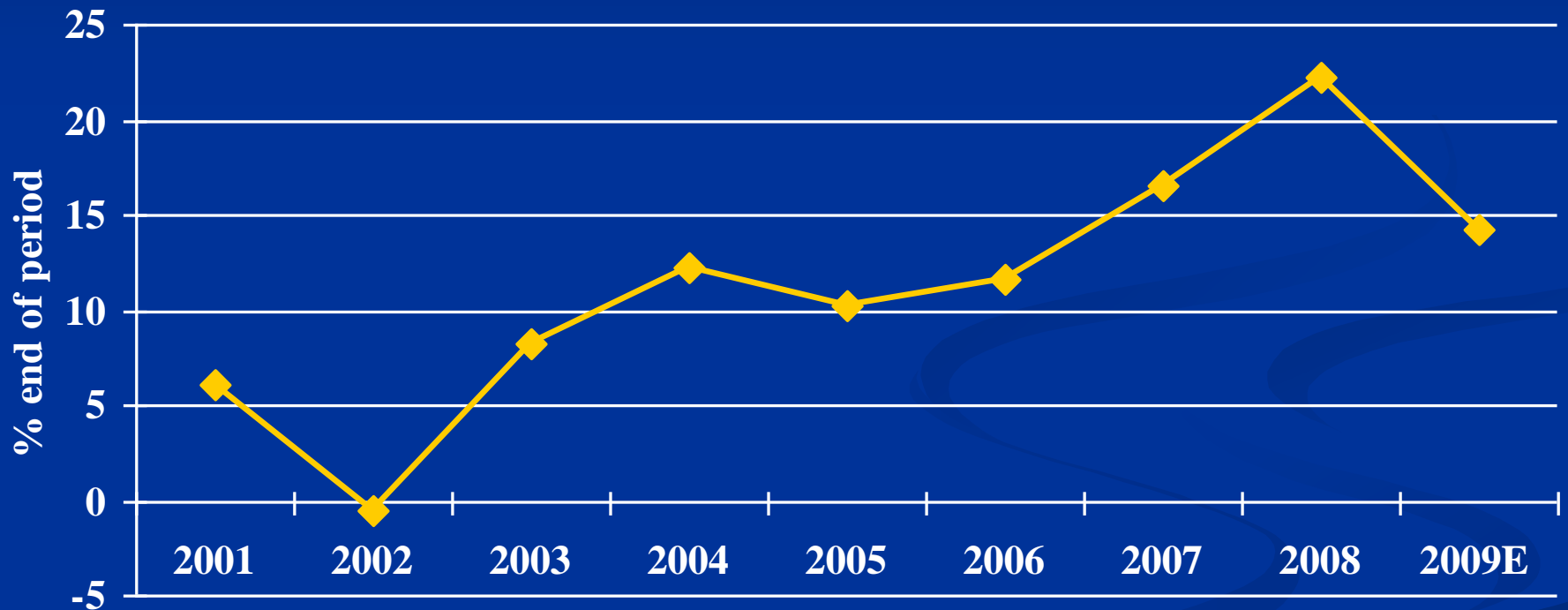
Why Hit So Hard

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

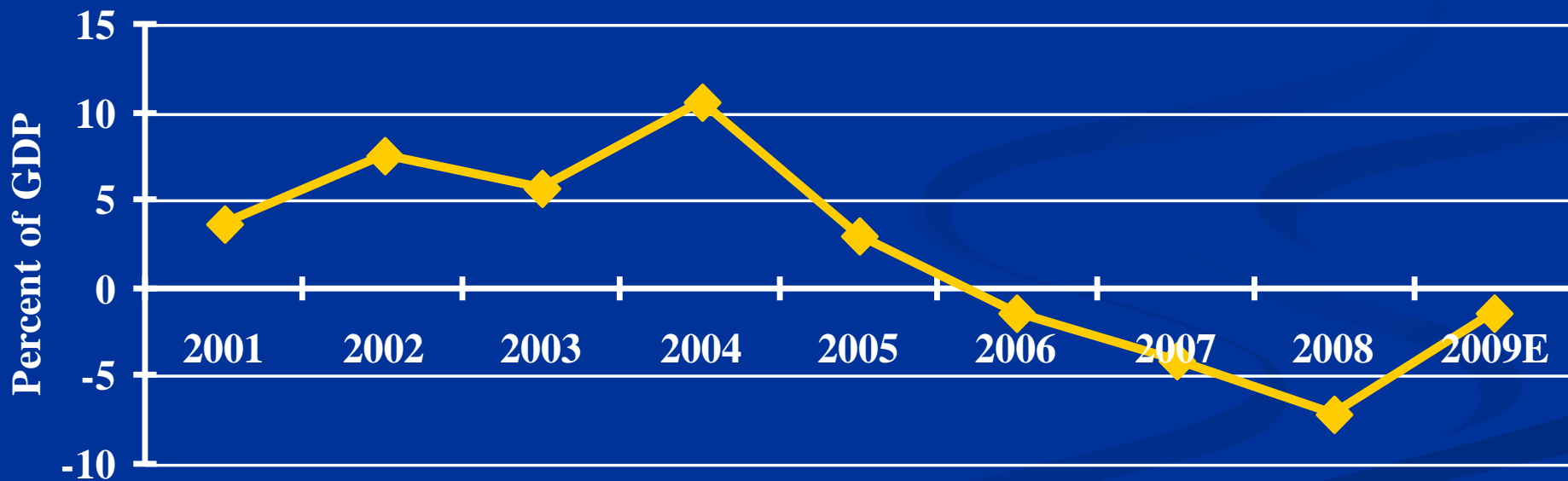
Excessive Monetary Expansion 40-50% a year



Inflation Peaked at 31% in May 2008



Current Account: -7.2% of GDP in 2008 rendered Ukraine vulnerable



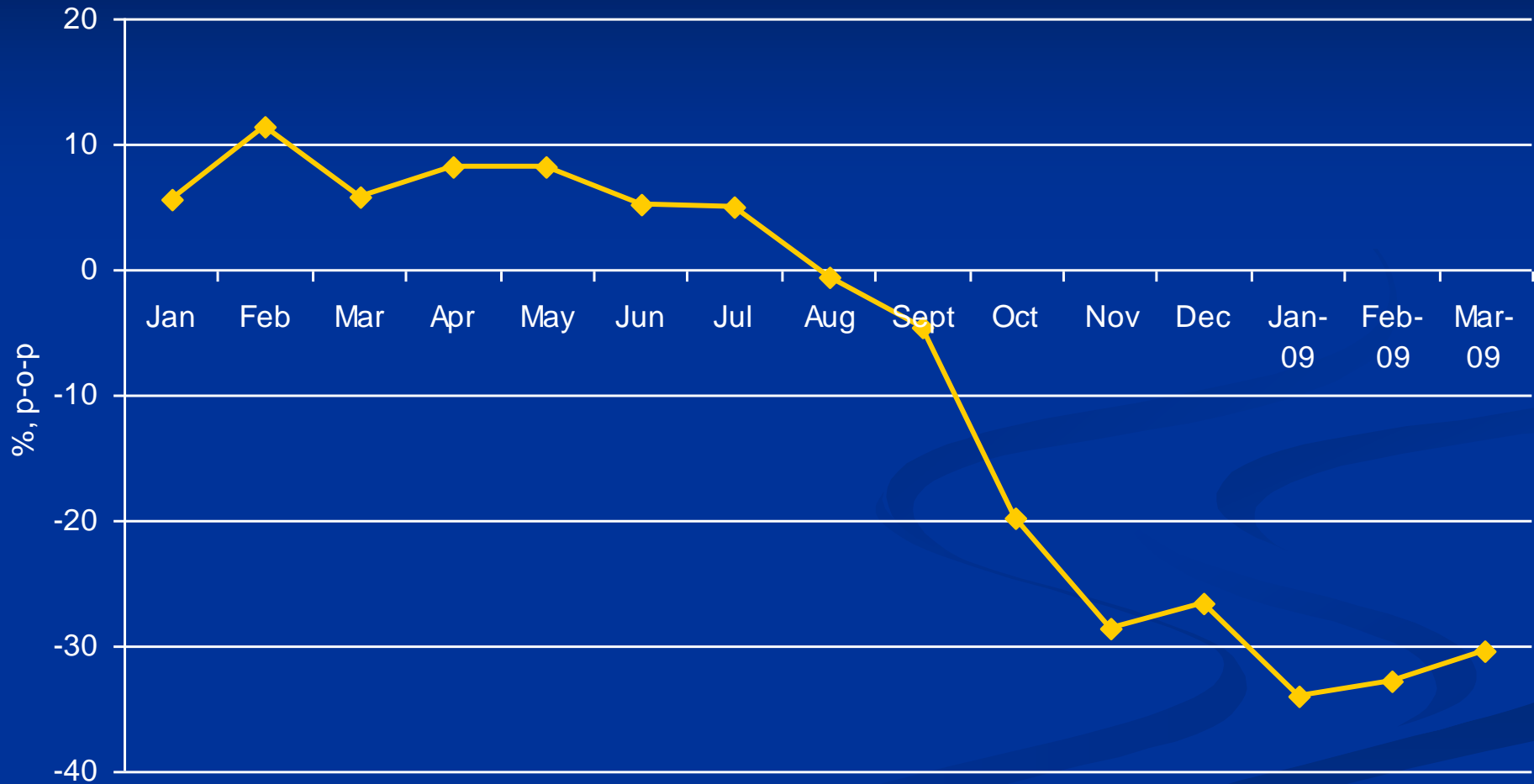
Solution: IMF Program

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

Economic Outcome

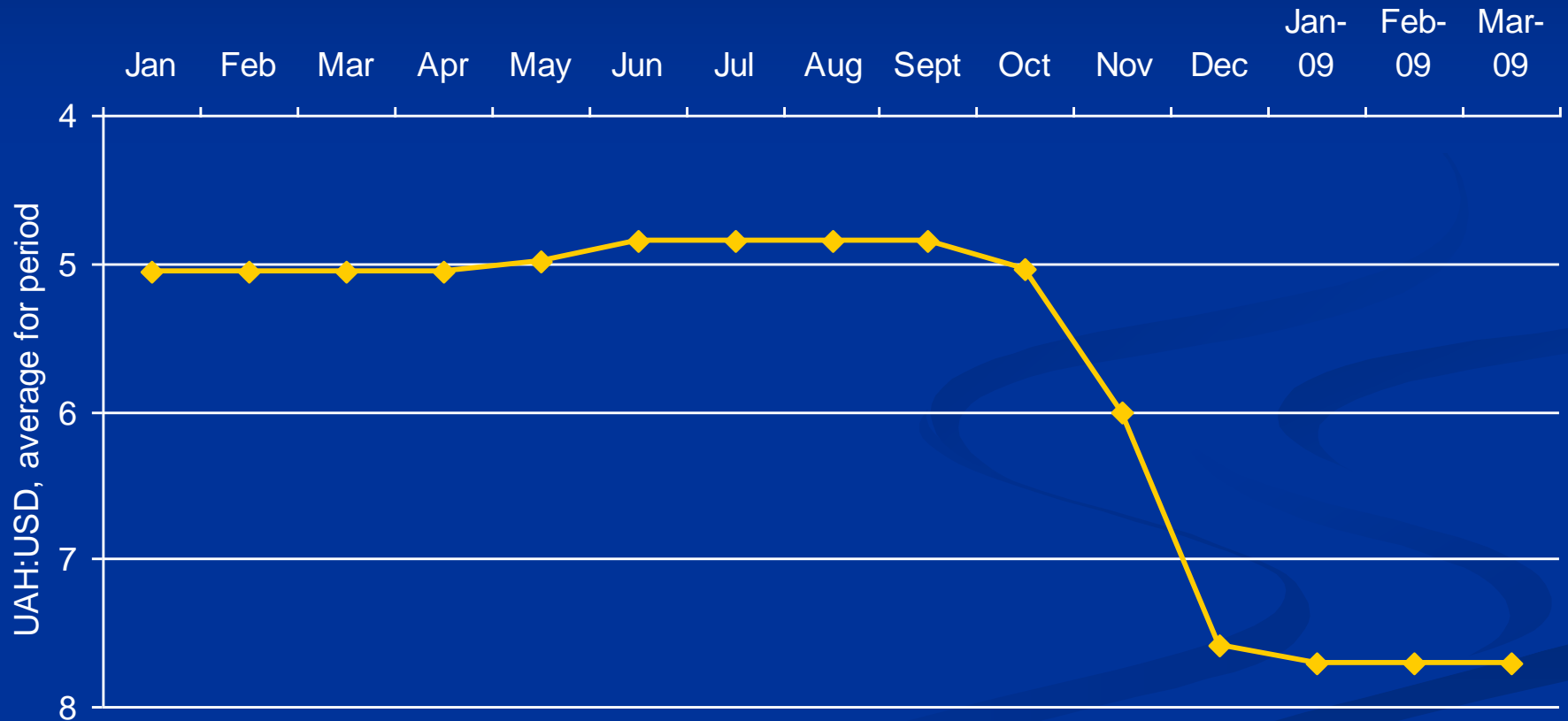
- GDP fell by ca 20% in Q1
- Industrial production plummeted by 32% in Q1 (steel & mining)
- Depreciation of hryvnia by 50%

Industrial Output Slumps

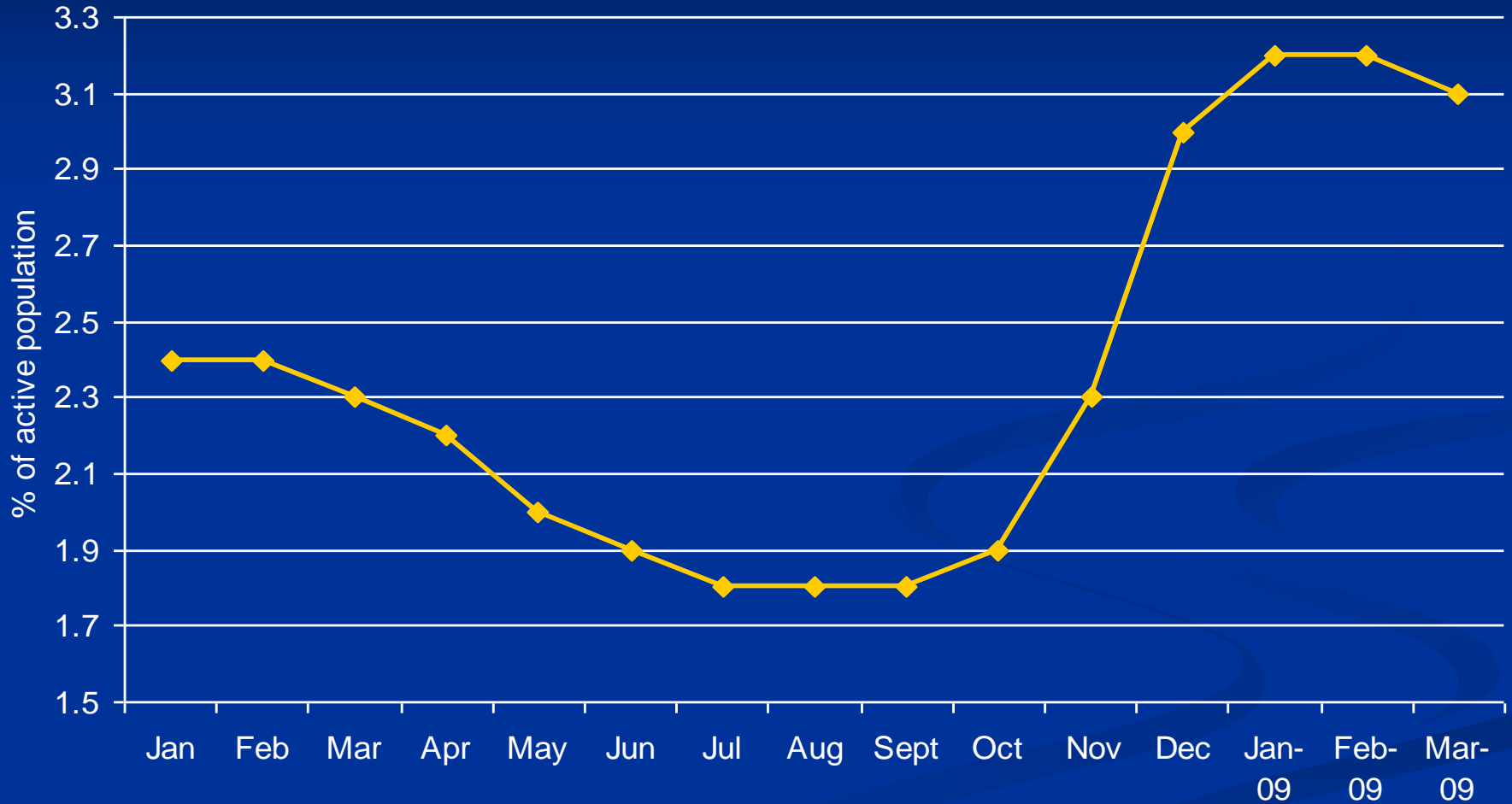


Source: Ukrainian State Committee on Statistics, May 2009

Exchange Rate Adjusted & Stabilized



Rising Registered Unemployment



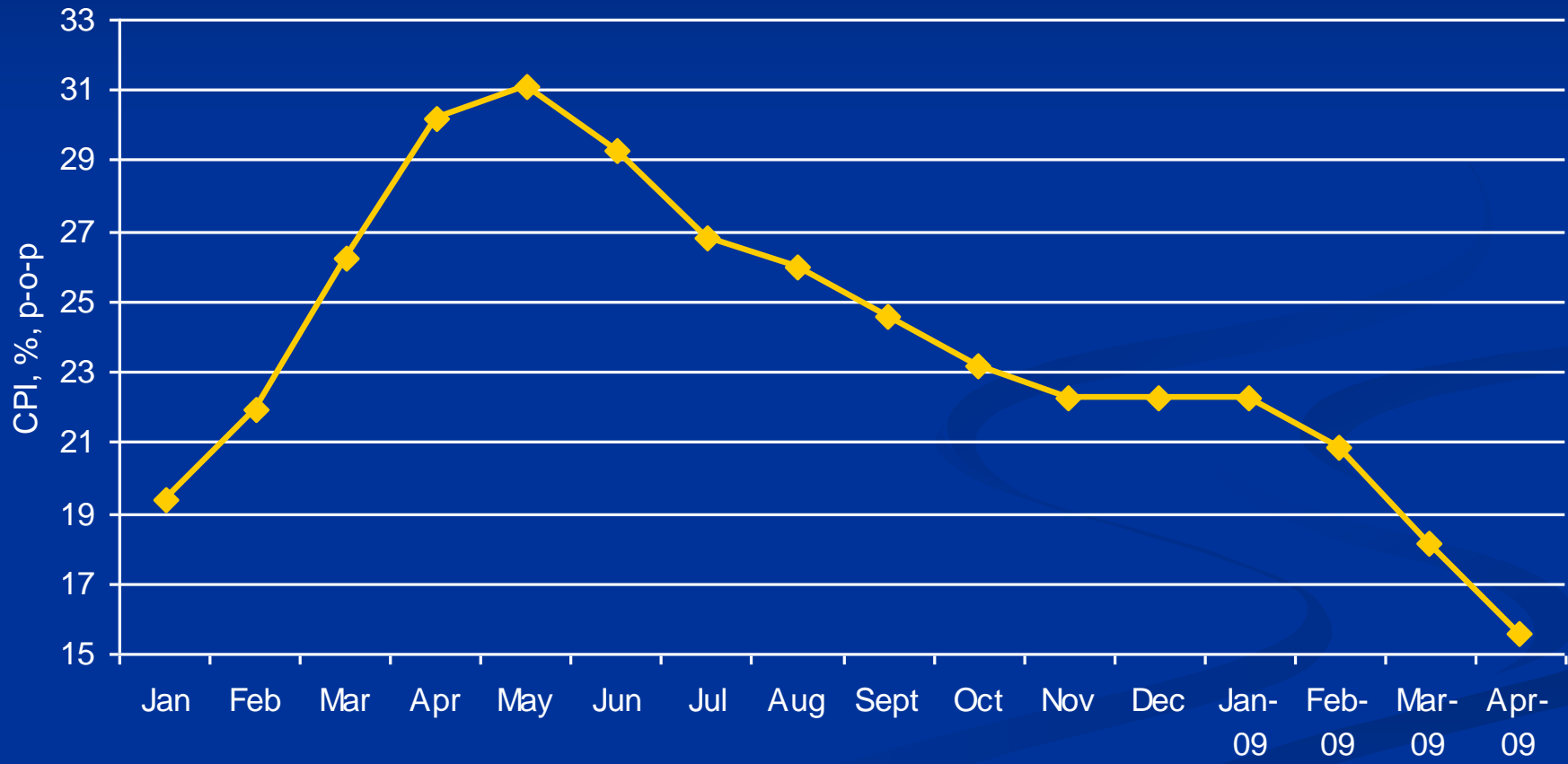
Source: Ukrainian State Committee on Statistics, May 2009

Has Ukraine Hit an Early Bottom?

- Competitive exchange rate
- Reserves hold: \$25bn end 2009?
- Default unlikely
- Did industrial production bottom out in January?

Inflation Moderates

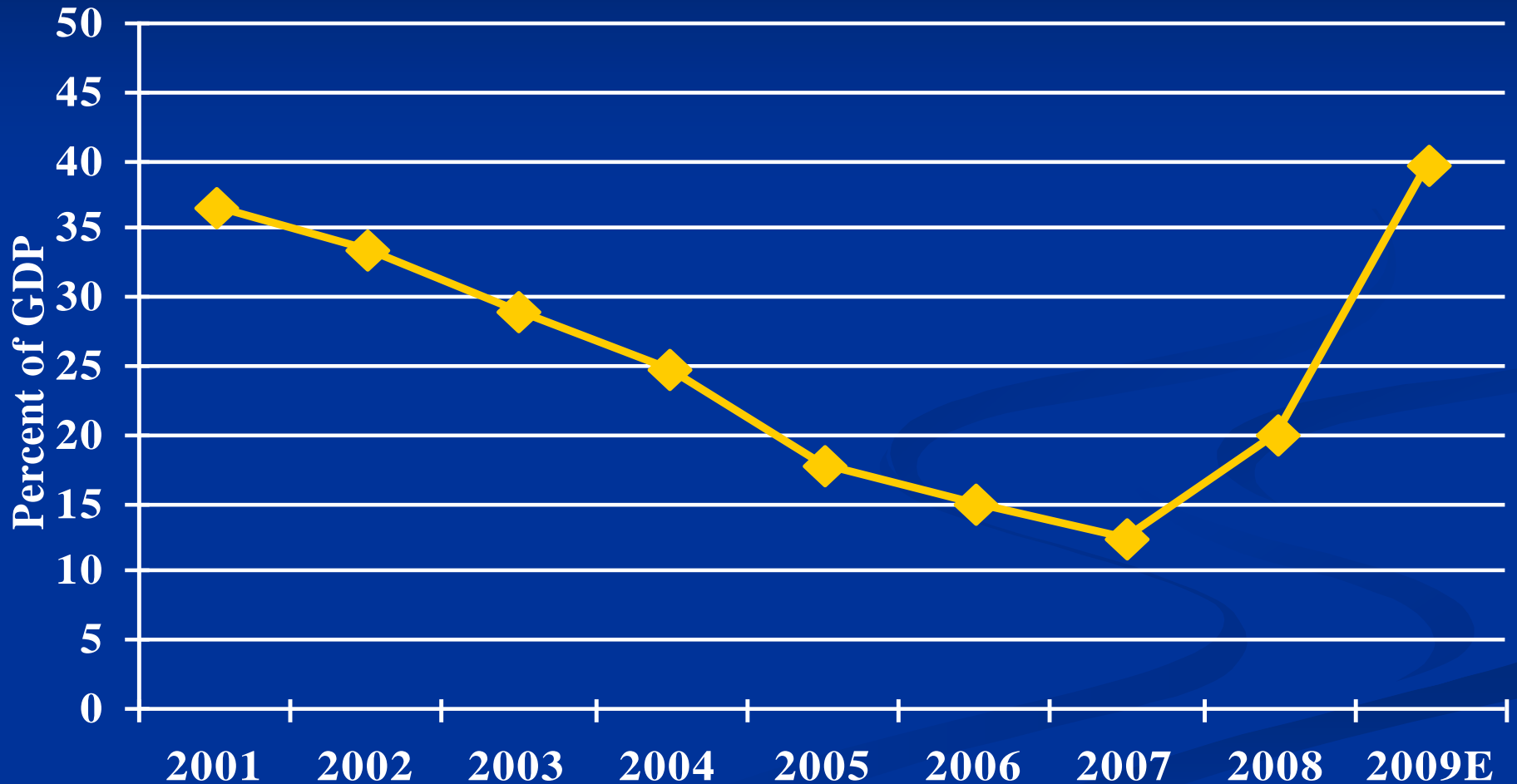
15.6% in April



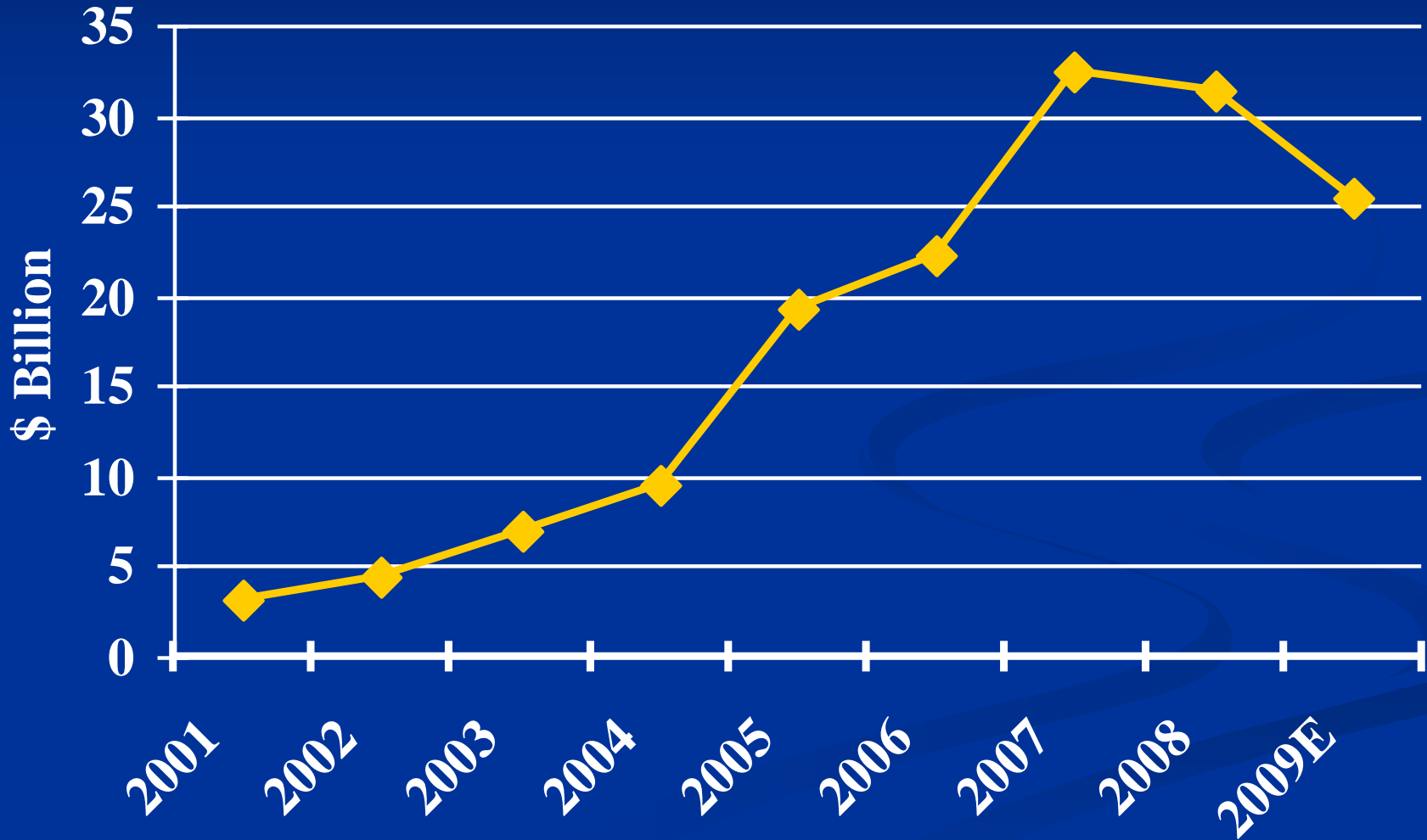
The Budget Deficit Remains under Control: 4% of GDP in 2009?



Public Debt Was Minimal & Rise Tenable



International Reserves: Falling But Sufficient



Source: Dragon Capital, April 2009

What to Look for?

- Budget discipline?
- More international financing?

3. 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, therefore ineffective

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 is likely

Putin's Objectives toward Ukraine in Gas War

1. Destabilize Ukraine
2. Arouse a frozen eastern Ukraine
3. Let the Ukrainian gas pipeline system implode
4. Discredit Ukraine in Europe

Ukraine's Response

1. Gas for 3 months in storage
2. New pipeline to eastern Ukraine
3. Sufficient technical gas in pipe
4. Gazprom lost its reputation and market

Tough Gas Negotiations





After Midnight...







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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

Victory 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 Europe Can Do

1. European Association Agreement
2. Gas cooperation March 23 EU-Ukraine declaration
3. Twinning of government agencies
4. Budget financing
5. 1,000 scholarships

Political Prospects

- Democracy 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

- IMF agreement and international support are vital
- Ukraine is likely to weather the financial crisis
- Corruption must be controlled & hit by crisis
- In the long run: European convergence

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