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Bringing Ukraine Back on Track

Abstract

Ukraine's history has been a turbulent one, and currently the country is in a crisis. The purpose of the article is to discuss how Ukraine can move away from the current East-West competition that poses a risk of dividing the country into two. What does it take to move a united Ukraine forward? How can Ukraine progress economically, politically and improve its security profile? The methodology used in the article is the case study method and it often compares Ukraine's performance with Poland, a country of a similar size in terms of population, land mass, and located in geographic proximity. The article argues that more inclusive and sustainable growth in Ukraine will require increased productivity of the economy, more benefits from international trade and investment supported by closer integration into the global economy, as well as a well-governed domestic economy with stronger institutions to withstand pressures from vested interests. The US, EU and NATO must make more efforts to help Ukraine resolve the current conflict with Russia, which in turn needs to stop the military engagement in Ukraine to let it recover and benefit from integration and cooperation with the West. NATO membership and full EU membership should not be considered for now, but Ukraine should be an independent and neutral buffer state between the East and the West, with full access to the EU common market. Ukraine needs increased financial support, especially from the EU, US, IMF and the World Bank for its reconstruction.

Key words: Ukraine, Poland, economic crisis, international relations, international organizations and security.

JEL Classification: F10, E60, N14.

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Introduction

The recent bizarre phone conversation between the US president Donald Trump and his Ukrainian counterpart Volodymyr Zelenskij reminded us of this neglected country that has long been facing an economic and security crisis. Ukraine is classified as a lower middle income country by the World Bank (World Bank 2019c). It has considerable potential for economic growth for several reasons, including fertile land, substantial natural resources and a geographic location linking Europe and Asia, the east and the west. Ukraine has a long industrial tradition and a skilled labor force (World Bank 2019b).

The fall of the Soviet Union in 1991 resulted in the collapse of GDP in Ukraine (see figure 1 and 2 below). This was to a large extent due to the disruption of commercial and production networks associated with the disintegration of the Soviet Union and its central planning system.

In 2000–2008 Ukraine's GDP grew more than seven percent a year. However, the pattern of that growth was based on international capital inflows and credit expansion that proved unsustainable. Ukraine is still suffering the consequences, most noticeably in the high nonperforming loans in the banking sector and difficulties in accessing new credit.

Between 2014 and 2016 Ukraine experienced serious economic, political, and security challenges. The nation was increasingly concerned over serious governance failures, capture of the state by groups with vested interests and corruption. This resulted in the *Maidan* uprising that eventually triggered new elections and changes in the government. These changes also resulted in a rift between Ukraine and Russia, and a realignment of commercial relationships with the rest of the world. In addition to the Russian occupation of the Crimean Peninsula, the government of Ukraine lost control of a part of the country and a military conflict began in the eastern part of Ukraine (World Bank 2019b).

The recent coronavirus (COVID-19) crisis, which has turned into a global health and economic crisis, is now severely affecting Ukraine's economic growth performance (see projection for 2020 form the IMF, figure 2).

The article is organized as follows: (i) discussion about the purpose of the research and research questions, (ii) discussion about research methods, (iii) Ukraine's current challenges that include discussion about: economic performance and productivity after the fall of the Soviet Union; integration with the West and the conflict with Russia; the effect of weak governance and corruption; outward migration, and finally (iv) conclusions.

The aim of this article is to discuss how Ukraine can break away from the current East-West competition that poses a risk of dividing the country even further, and possibly splitting it into two separate countries, East-Ukraine and West-Ukraine. What would it take to move a united Ukraine forward economically, politically and to improve its security profile? What are the issues holding back progress in Ukraine? Under what conditions can Ukraine exit the current deadlock, raise its economic growth and stop, or at least reduce, the massive outward migration of its youngest and most talented people to richer countries, and perhaps see more of them returning to help rebuild a country that has been suffering from this crisis for too long? What does it take for Ukraine to achieve a higher, more sustainable and shared economic growth? What can the international community do to help in this process?

Research Methods

This article simultaneously employs the case study method and comparative analysis. The case study method enables a researcher to examine the issues at hand in greater depth (Yin 2009). Among the sources of evidence used for the analysis are the authors interviews conducted in Ukraine and Poland in September 2019, including conversations at the World Bank offices in Kiev and Warsaw. The author also interviewed experts from the Kiev School of Economics and Warsaw School of Economics. Comparative analysis is used as it enables a researcher to assess and explain the political phenomenon among cases (Lancaster & Montinola 1997). It helps capture the effects of complex and interrelated causal influences and facilitates our understanding of political issues at national and international levels (Ragin 2014). Additionally, the literature on the comparative analysis is rich with suggestions on how such an inquiry should proceed (Lijhart 1975). The article often compares Ukraine's performance with that of Poland, a country of a similar size in terms of population, land mass, and located in geographic proximity with Ukraine. The two also share a common history, are large countries in European context, and are important for Europe's economy and security.

Economically Poland has been among the most successful transition countries after the fall of the Soviet Union and is now firmly integrated with the West, e.g. via EU and NATO membership which also strengthens its security profile. In contrast Ukraine remains politically divided, its economic performance has been mixed at best, and it currently suffers from a conflict with Russia, its security uncertain.

The article also uses several sources of secondary data, including reports and scholarly literature such as peer-reviewed articles and books. The database used for the graphs in the article comes from the IMF World Economic Outlook (WEO) database (IMF 2019 & 2020) and from World Bank reports (World Bank 2019a & 2019b).

Ukraine's Current Challenges

The key challenges that Ukraine is currently facing discussed in this article are as follows: (i) the erratic economic performance of Ukraine after the fall of the Soviet Union, (ii) uncertain integration with the West[1] with associated conflict with Russia, (iii) weak governance and corruption, and finally (iv) a massive outward migration of its human capital, primarily young and skilled Ukrainians, to richer European countries.

Other articles and reports tend to analyse Ukraine's challenge from an economic, political or security point of view. In contrast this article seeks to consider all those challenges simultaneously and in a more comprehensive way.

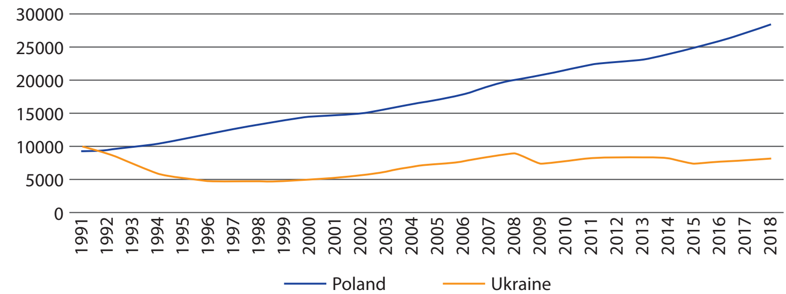
Economic Performance and Productivity after the Fall of the Soviet Union

When Ukraine initiated its transition in 1991, its GDP per capita was similar to that of its neighbour Poland. By 2018 Ukraine's GDP per capita (PPP terms) was less than one third of that in Poland (see figure 1). This happened in spite of the fact that Ukraine has a more favourable climate, better soil and more mineral deposits. Furthermore, in 1991 Ukraine had a stronger industrial base than Poland, as well as lower public debt (Hilmarsson 2019b).

The only period of high growth in post-Soviet Ukraine did not last long and was supported by favourable external conditions. Prior to the global economic and financial crisis (between 1999 and 2008) Ukraine's average rate of growth of GDP was about seven percent per year (see figure 2). With this growth rate Ukraine almost doubled its GDP per capita in a single decade (see figure 1; IMF 2019 & 2020).

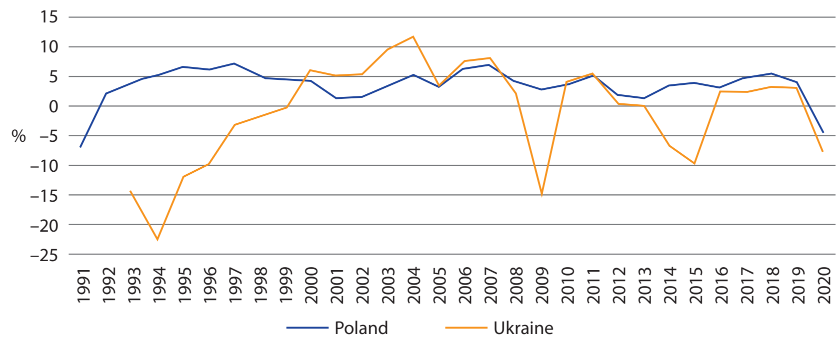
[1] Most notably the EU, NATO and the US.

Figure 1: Gross domestic product (GDP) per capita, USD, Constant prices – PPP



Source: IMF 2019.

Figure 2: Gross domestic product (GDP) – Constant prices – Percent change



Source: IMF 2020.

According to the World Bank about half of the accumulated income gap between Ukraine and Poland after the fall of the Soviet Union can be explained by divergent growth trajectories during the first decade of the transition (World Bank 2019b). However, the 2000s and 2010s were also challenging, most notably the global crisis of 2008–2009 and the Crimea crisis of 2014–2015 (see figures 1 and 2).

The recent coronavirus (COVID-19) crisis, which has now turned into a global health and economic crisis, is now severely affecting Ukraine's economic growth performance. This also true for other countries such as Poland, as can be seen in the GDP projection for Poland and Ukraine for 2020 (figure 2; IMF 2020).

The collapse of GDP in Ukraine in the 1990s was to a large extent due to the disruption of commercial and production networks associated with the disintegration of the Soviet Union. The term between 2000 and 2008 was a period of recovery. During the 2008–2009 global crisis Ukraine experienced a deep recession in 2009, with GDP declining by about 15 percent. A fragile and short-lived recovery ended in an even deeper recession of 2014 and 2015. This was triggered by the Euromaidan uprising and a conflict with Russia in the Eastern part of Ukraine. As a result, during the period of 2014–2015 Ukraine's GDP fell by cumulative 16 percent (World Bank 2019b; IMF 2019 and 2020) (see figure 2).

According to the World Bank at the GDP growth rate before the COVID-19 crisis hit, about three percent per year, it would have taken Ukraine almost 100 years to reach the income levels of Germany and about 50 years to reach those of Poland (World Bank 2019b). This gloomy outlook increases pressure on outward migration from Ukraine, as the young and most talented Ukrainians don't want to wait, but rather choose to vote with their feet, and leave the country for richer, western countries and, in some cases, Russia.

Aggregate productivity in Ukraine remains low. According to the World Bank it takes 17 days for an average worker in Germany to produce as much as an average worker in Ukraine in a year (World Bank, 2019b). The differences in output per worker between Ukraine and Germany are due to both capital and efficiency gaps. Improved productivity of the aggregate economy will e.g., require improved public investment and infrastructure to lower costs and equip companies to produce more competitively (World Bank 2019b).

To increase investment in Ukraine, both public and private, an increased assistance from institutions such as the World Bank, the EU and the US is vital. Regional Banks such as the European Bank for Reconstruction (EBRD) and the EU's European Investment Bank (EIB) can also play an important role. Export credit agencies (ECAs) can also help facilitate much needed trade and investment flows to Ukraine with their guarantee instruments (see, e.g. Dinh and Hilmarsson 2012)

Integration with the West and the Conflict with Russia

The absence of a clear path to the European Union accession limited the resources available to transform Ukraine's economy anywhere close to the transformation that took place in the neighbouring Poland, that had a shared vision for EU membership and successfully accessed EU investment grants.

Ukraine remains a politically divided country with the western part tending to support EU and NATO accession, while the eastern part tends to favour stronger relations with Russia. Seeking a full and immediate EU membership may thus not be realistic while keeping the country united. Russia also sees Ukraine's EU aspirations, and particularly NATO membership, as a security threat. As EU and NATO have moved closer to Russia proper, the blowback from Moscow has increased (Howorth 2017). Nevertheless, Ukraine's access to the EU common market remains critical.

The Association Agreement between the EU and Ukraine entered into force in September 2017 and the Deep and Comprehensive Free Trade Area started its application in January 2016 (EEAS 2019; see also EU 2014). Furthermore, the EFTA States signed a Free Trade Agreement with Ukraine in Iceland in 2010. That agreement entered into force in 2012 (EFTA 2019).

The Free Trade Agreement with the EU may, according to the World Bank, provide an institutional umbrella that expedites the modernization of the Ukrainian economy. Introducing laws and regulatory procedures and reforming non-transparent practices in Ukraine will become easier with the support of the Agreement than previously had been possible (World Bank 2019b).

In addition to this, Ukraine is affected by the United States, as the recent phone conversation between the Ukrainian president Volodymyr Zelensky and the president of the United States, Donald Trump, demonstrates (Hilmarsson 20019b). During the conversation president Trump requested an investigation of the former US vice-president Joseph Biden, now the presidential candidate for the Democratic party, and his son. During their conversation the presidents agreed that the European Union was not doing enough to help Ukraine. Trump said: 'Angela Merkel she talks Ukraine, but she doesn't do anything.' (CNN September 26 2019).

Ukraine is in a difficult position, because it needs the United States to provide it with both continued bilateral support, as well as its support in international organizations, including the Bretton Woods institutions, the International Monetary Fund and the World Bank. Both institutions are headquartered in the US capital city of Washington, DC (Hilmarsson 2019b). The US government is very influential in both institutions, not only because of its large contributions, reflecting the relative size of the US economy compared to the global economy, but also because of the geographic proximity of those institutions with the US government, most notably the White House and the US Treasury. The US government is literally next door to the IMF and the World Bank while other major powers are far away and in a different time zone.

The World Bank estimates those needs to be about US$33 billion dollars just to repay the Ukraine's public debt and finance its fiscal deficit until 2021 (World Bank 2019a). Ukraine needs continued support from the International Monetary fund after its stand-by arrangement runs ends in 2020.

This is not the first time Ukraine has been affected by external forces. With the Budapest Memorandum from 1994, Ukraine agreed to get rid of its nuclear weapons in exchange for respect of its independence and sovereignty and its existing borders. Russia, the US and the UK were signatories of this agreement (Budapest Memorandum 1994). The trouble began with the declaration issued by the heads of state and government after the North Atlantic Council in Bucharest in 2008: 'NATO welcomes Ukraine's and Georgia's Euro-Atlantic aspirations for membership in NATO. We agreed today that these countries will become members of NATO. Both nations have made valuable contributions to Alliance operations.' (NATO 2008). It was clear from the beginning that this move would not be acceptable to Russia. Eventually it resulted in the invasions of Georgia in 2008, followed by an invasion into Ukraine in 2014. The argument has been made that the US and European leaders blundered the attempts at turning Ukraine into a Western stronghold on Russia's border (Mearsheimer 2014). Russia does not want to see Ukraine integrate with the west too closely and it knows full well that NATO and the European Union are unlikely to admit countries as member states if their borders are disputed. Russia acted accordingly and invaded both Georgia and Ukraine (Hilmarsson, 2019b).

Ukraine is not of strategic importance to the US, and the EU has few obvious interests in Ukraine except cheap labour flowing to Western Europe. If Ukraine was of strategic importance to the EU or the US, there would also be a willingness to sacrifice lives, if necessary, to defend their interests. It is clear that neither the US or the EU are willing to send troops to fight with the Ukrainian military against Russia.

Interestingly, it has been argued that Russia knows what it wants from Ukraine, while Ukraine clearly knows what it wants from the EU, but the EU has no clear policy goal towards Ukraine (Getmanchuk 2014). One might add that the US does not care much about the fate of Ukraine. Ukraine doesn't seem to have much that would be vital for the US interests. Meanwhile Angela Merkel, as Trump states, 'talks Ukraine, but she doesn't do anything.' (CNN September 26, 2019).

The Effect of Weak Governance and Corruption

Numerous domestic problems have contributed to Ukraine's decline, including ill-advised economic policies, failed privatization and widespread corruption. In 2017 the total net worth of Ukraine's 3 wealthiest individuals amounted to more than six per cent of Ukraine's GDP, more than three times the proportion in the neighbouring Poland (World Bank 2019b, Hilmarsson 2019b). The strong influence of vested interests on the Ukrainian economy have undermined the effectiveness of Ukraine's domestic economic institutions and delayed necessary industrial restructuring needed to develop high-value added export-oriented industries in the country.

Achieving a better balance between vested interests/oligarch and the government is one of the key arguments in favor of Ukraine's EU membership, as it could result in shared power and responsibility between Kiev and Brussels. EU membership could also help to increase professionalism in Ukraine's institutions.

Policies that would distribute economic growth dividends more fairly across society in Ukraine by creating access to opportunities for all, would make growth more inclusive. Economic growth is only sustainable if it does not leave vulnerable groups behind. But can the EU help with that? Given EU's strict fiscal and monetary policies during and post 2008/09 crisis in the Baltic States, one could question the benefits of EU membership for a country that needs more flexible fiscal and monetary policy that the EU demands. Current EU fiscal and monetary policies seem more suitable for the rich EU member states than emerging countries such as Ukraine. Also, the Baltic states, which joined the EU in 2004, do not have a very impressive record when it comes to income and wealth equality, inclusiveness and social justice (Hilmarsson 2020; Eurostat 2019). The Baltics went from Soviet central planning to neoliberalism, including flat taxes and minimal governments, too weak to support anything approaching the Nordic welfare states with progressive tax systems and systems for redistribution to the most vulnerable members of their societies (Hilmarsson 2019a). It is also notable that Poland, which performed well during the crisis of 2008–2009, has kept its own currency, thus benefiting from a more flexible monetary policy than those countries that either kept fixed exchange rates to be able to adopt the euro post crisis, like the Baltics, or already had the euro during the crisis, like Greece. Fixed exchange rate limited the ability of those governments to assist the most vulnerable members of society during the crisis as there was more pressure on the fiscal side to cut government expenditures.

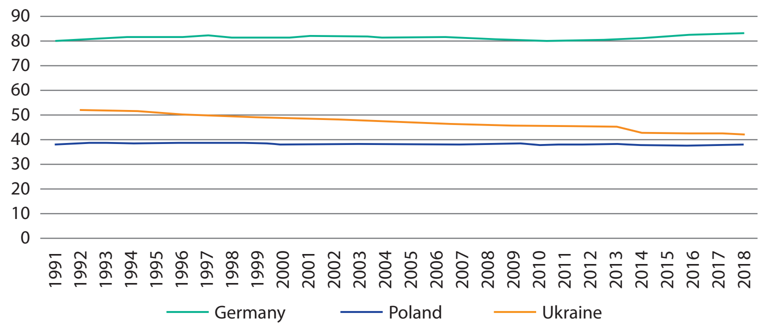
Outward Migration

There seem to be very limited economic opportunities for a large share of Ukraine's population. In 1992 Ukraine had a population of about 52 million people (IMF 2019). Now there are 42 million left. In contrast Poland's population for the same period has remained stable at about 38 million (see figure 3).

Many young Ukrainians have opted to emigrate, attracted by higher expected earnings in neighbouring countries including Poland and Germany. The majority of those leaving Ukraine are high skilled/tertiary educated (Atoyan et al. 2016).

Given the demographic trends and outward migration, a significant decline in the labour force in Ukraine is foreseeable in the next decade (World Bank 2019b). With insufficient human capital Ukraine can hardly sustain economic growth. Given the loss of skilled and highly skilled workers emigrating to higher income countries, Ukraine will not have a workforce prepared for jobs requiring high skills, and will not compete efficiently.

Figure 3: Population – Millions



Source: IMF 2019.

On one hand the burden on investment and productivity growth are very high in Ukraine, given that its labour force is projected to decline due to the demographic factors and migration out of Ukraine. On the other hand, the contribution of capital to support growth is also constrained by a low savings rate in Ukraine, as well as low foreign direct investment. Also, to be productive a workforce requires physical capital and a well governed economy (World Bank 2019b).

For the richer EU member states, the outward migration from Ukraine to EU is not necessarily a bad thing. Countries like Germany are facing severe competition from Asian countries, most notably China. Getting skilled workers from Ukraine, an industrial country, willing to work for low pay helps in this competition.

Conclusions

What are the options for Ukraine now? How can the country move forward?

One can hardly say that there is much pressure from the international community to help Ukraine. The European Union benefits from young and skilled people emigrating from Ukraine, and Ukraine has lost about 10 million since 1991. Many Western-European countries are aging and in need of young people. Many Ukrainians leave for neighbouring Poland, perhaps with the goal to reach Germany, an industrial power that needs skilled workers for its industry and where the pay is good compared to what is being offered in Ukraine. Others leave for Russia where the per capita income is higher than in Ukraine (Hilmarsson 2019b).

Ukraine is not of any significant strategic importance to the United States. The US is increasingly occupied with East Asia, because of the rise of China, and the Persian Gulf countries due to an abundance of oil. The EU sanctions hurt Russia, but Russia is unlikely to accept any further integration of Ukraine into the West, especially NATO membership. Russia also opposes the EU membership. Geographically Ukraine is perhaps as important for Russia as Canada or Mexico for the United States. What would the US do if Russia or China formed a military alliance with those countries? The Cuban Missile Crisis had also demonstrated that the US do not tolerate other superpowers building close alliances with countries in America.

Ukraine is stuck in an economic and security crisis, and its territorial integrity is in question. In a low economic growth scenario, more people in eastern Ukraine may want emigrate to Russia, with its higher per capita income. A growing number in western Ukraine could meanwhile see continuing benefits in migrating to the EU and other western European countries. The risk is that an already divided country will formally split into two (Hilmarsson 2019b).

Should Ukraine be a neutral buffer state, between the West and Russia, not seeking immediate EU and NATO memberships? Ukraine could possibly receive more financial assistance from the EU, the US, the IMF and the World Bank under the condition that Russia would respect its territorial integrity.

The EU's European Investment Bank, the European Bank for Reconstruction and Development, and export credit agencies could also help with foreign investment and trade (Dinh and Hilmarsson 2012).

With strong international support Ukraine could possibly have sufficient peace and stability to grow economically. Whatever direction is chosen it needs to have the acceptance of the Ukrainian people, as most of them prefer to keep their country together. Nevertheless, EU, NATO and US leaders need to start tabling options that would also be acceptable for Russia. Ukraine politicians need advice and even initiative from the West here.

What can be said about conditions for favourable, inclusive growth dynamics for Ukraine? The first condition is political commitment. Fast and sustained economic growth sufficient for Ukraine to catch up requires long-term commitment by its political leaders. There is a need to adjust the role of the state, providing people with an equal opportunity and strengthening rule of law to make domestic institutions more resilient (World Bank 2019b). Second, economic growth and development depend on human and physical capital, and on the factors affecting their productivity.

The speed of growth has, to a large extent, driven Ukraine's ability to keep its highly skilled labour force within its borders by offering attractive job opportunities, but also by the pace of public and private investment. This investment requires increased domestic savings and an external capital flow into Ukraine. Facilitating foreign direct investment and integration into international value chains, improving logistics and connectivity to fully leverage external opportunities is also important. Thirdly, more integration into the world economy, especially the common EU market, is critical. Markets for exports and opportunities to import ideas, technology, and know-how is vital for Ukraine.

To achieve this much needed economic growth Ukraine needs to maintain stable macroeconomic policies and above all it needs peace and stability, not the deadlock that is, to a large extent, caused by the East-West competition for this country in a crisis.

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