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Ukraine's economy hostage to political one-upmanship

After the economic storm battered Ukraine last fall, some foreign politicians, investors and newspapers whispered ever more loudly through the dark winter that Ukraine was heading for economic meltdown.

By the beginning of 2009, yields on the country's government bonds were the highest in the world, with the exception Ecuador—which was already in default. But Ukraine did not default. So why the panic-mongering?

Ask analysts in Ukraine and abroad and you'll hear one reason over and over: political risk, writes ICPS associate analyst James Marson.

He discusses why it is that Ukraine's economy is so often hostage to political squabbles

Dueling trios

As the crisis raged, President Viktor Yushchenko and Premier Yulia Tymoshenko were "at each other like dogs," as Viktor Chernomyrdin, Russia's former ambassador to Kyiv, put it. Unable to agree on a workable anti-crisis plan, they have wasted their efforts pointing fingers, slinging mud and working at cross-purposes.

In Fall 2008, as the crisis hit, Mr. Yushchenko called a snap VR election in an attempt to get rid of Ms. Tymoshenko, only to postpone the ballot when the situation deteriorated. He accused her Government of running up huge debts to finance the Budget deficit. She accused the National Bank, which is subordinated to the President, of being a "den of corruption." She claimed the new gas contracts signed with Russia in January eliminated a corrupt intermediary connected with the President; he claimed the contracts the Premier had agreed would be a millstone around the country's neck. And so on.

But the Orange duo is by no means the only ones to blame. The main contribution of the opposition Party of Regions, led by Viktor Yanukovich, has been to constantly block Verkhovna

Rada this past year, paralyzing legislative work. Then there was Mr. Yanukovich's half-hearted attempt to bring "the people" onto the streets in spring, marching under banners reading "No to the crisis." Constructive opposition this was not.

Biting the hand that feeds

The International Monetary Fund has been a guiding hand for Ukraine, providing almost US \$11 billion in loans since last autumn in exchange for key reforms to help combat the crisis. But further cooperation is in doubt as Ukraine's economy remains in thrall to the political ambitions of the country's leaders, now that the next Presidential race is scheduled for January 2010.

Ms. Tymoshenko has been unable—or unwilling—to push through gas rate increases promised to the IMF. Mr. Yanukovich made a Budget-busting increase in social spending his sole aim. Mr. Yushchenko signed a law raising wages and pensions at the end of October, despite IMF demands not to. Both the President and the leader of the opposition have caught the Premier in a populist pincer movement, placing an even greater burden on

Budget resources that are already threadbare and jeopardizing further IMF loans.

Promises, promises

However, there could be light at the end of the tunnel. Ukraine's democratic system means that President Yushchenko is unlikely to be re-elected in the face of widespread disappointment at his failure to implement reforms.

That leaves Ms. Tymoshenko and Mr. Yanukovich as the leading contenders. By steering the country away from the edge and pushing through sufficient reforms to keep an exasperated but lenient IMF on board despite political paralysis, the current Premier has shown herself an able crisis manager. Her team is promising a year of deep and comprehensive reforms if she wins the elections, although the proof, of course, will be in the pudding.

Mr. Yanukovich has as yet to offer much of a program, beyond promising "power and the people" and an end to what he called the "chaos, lawlessness and economic ruin" brought about by the quarrelling leaders (himself, of course, excluded!).

Whatever the outcome of the election, though, it won't be a magic pill. Ukraine's Constitutional mess, which leaves an unclear division of power between president and premier, together with deep-rooted political rivalries, will continue to block the door to reforms. But a new President could provide the impetus to force it open.

Buried by the Budget

The higher social standards recently approved by the legislature look more like a raid on the country's assets than a deliberate step to improve the standard of living of the average Ukrainian. And, like corporate raids, it was accompanied by scandalous remarks, aggressive taunts and fisticuffs among the participants. Just like a raiders' attack, the real motives of the ringleaders were camouflaged behind ill-fitting masks of legitimacy, justice and the common good

What has happened to the country that, judging by the comments of politicians, experts and journalists, has caused the President and Premier, the coalition and opposition, National Bank of Ukraine and the International Monetary Fund to suddenly lose their sleep and their appetites? As of 1 November 2009, the subsistence minimum and minimum wage went up, the two basic indicators that are used to calculate the salaries of all those employed in the public sector, most social benefits provided by the state, and the contributions all the country's employers have to pay on their payrolls.

As a result, if the calculations of the Ministry of Finance are to be believed, an additional UAH 8 billion will be needed to cover these new social standards this year and UAH 71bn next year. Meanwhile, the consolidated expenditures in the 2009 State Budget are UAH 274bn. This means that every month of this year has nearly UAH 23bn allocated in Budget spending, while the last two, after the new rates kick in, will have an additional UAH 4bn each in new spending. This means the expenditure side of the State Budget of Ukraine is going to grow a pro-rated 17%.

We can argue loud and long about how unpredictable and reliable MinFin's calculations are, but the reality is that, even the amounts in the current Budget are not being released in full. Of course, we are not talking about its socially protected and most politically sensitive component: salaries, pensions and social assistance are at least being paid without any noticeable delays. Any cutback in these payments would be political suicide for all concerned, both the current and any other Government. Moreover, the state is effectively holding to its social commitments for

some time already at the expense of other public spending that is not so visible to the general public.

The worse it gets, the better it is

And this is not even the worst. Presuming that someone could just wave off Ukraine's science or education sector, its Armed Forces or the residential services sector, the main thing is for pensioners and mothers with large families to feel sated. As Professor Preobrazhenski in the well-known story by Mikhail Bulgakov put it: "Go for it: if there's a social revolution, you won't have to heat."

It all boils down to the fact a nominal rise in disposable incomes is economically unjustified, as it does nothing to raise GDP or to increase productivity. And this will have a major impact on the economy as a whole. In short, the economy will not forgive such a move. By its nature, the economy is a system that works towards equilibrium. If the balance is upset, the economy will on its own respond with higher prices and a further devaluation of the hryvnia.

Although this may sound unexpected, it's highly likely that this is the scenario that most of the guilty parties in the political game of one-upmanship are expecting the most. Yet further inflation and devaluation could be a lifesaver both for the current Government and the one that will be formed under the new President. After all, they will then need, not around US \$1 billion but, possibly, a much smaller amount, to maintain the new social standards introduced in 2009.

What's more, such a turn of events is completely acceptable to the two most powerful political forces in Ukraine. If

the hryvnia declines, Ukraine's export industries will become more competitive again, especially the steel industry, which is not in the best of times just now and which is largely controlled by members of Party of the Regions and BYT. At the same time, the collapse of the hryvnia can always be blamed on political circumstances or ruthless speculators.

Bad chess

There's no question at all that raising social standards was a purely political move that is likely to worsen an already-bad situation with the Budget deficit and, in this way, to discredit the current Government and Premier as one of the frontrunners in the upcoming Presidential race. This situation suits politicians in other parties quite well, which is obvious from a look at who voted to raise these standards. The decision was approved on the principle, "the worse, the better," as all its negative consequences will hurt the Premier and help her political competitors.

The irony is that the Tymoshenko Government has become hostage to its own populism and spendthrift social policies. It was unjustifiably generous social benefits that brought BYT so many votes in the previous election. Think back to the UAH 1,000 compensation given to depositors of the soviet savings bank...which gave a healthy shove to higher inflation at the time. For Ms. Tymoshenko to go against her own position will threaten her place in the eyes of voters and bring considerable losses. Thus, the BYT Government finds itself in a stalemate position: any step it takes will put its main piece under threat. White may have the first move, but it doesn't always win. ■

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