

“UKRAINE, MOLDOVA, THE EUROPEAN UNION AND U.S. INTERESTS”

TESTIMONY OF ANDERS ÅSLUND

SENIOR FELLOW

PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

NOVEMBER 14, 2013

U.S. SENATE COMMITTEE ON FOREIGN RELATIONS

SUBCOMMITTEE ON EUROPEAN AFFAIRS

## **Executive Summary**

On November 28-29, the European Union has planned to sign the long-concluded Association Agreement with Ukraine and initial deep and comprehensive free trade agreements with Moldova and Georgia at its Eastern Partnership summit in Vilnius. No political event in Europe this year is more important than this summit. It would indicate a substantial European integration of Ukraine, Moldova and Georgia.

Yet, it is doubtful whether the EU will agree to sign the Association Agreement with Ukraine. Its President Viktor Yanukovich is reluctant to fulfill the European demands for political freedom and rule of law. In particular, he does not want to pardon former Prime Minister Yulia Tymoshenko, whom he narrowly defeated in the presidential elections in February 2010. He had her sentenced to seven years in prison without any serious legal grounds. If the EU does not accept to sign in Vilnius, the Association Agreement could be signed after renewed Ukrainian presidential elections in March 2015.

Russia has reacted sharply against Ukraine's intention to sign the Association Agreement with the EU and demands that Ukraine instead joins its Customs Union with Belarus and Kazakhstan. Moscow has already launched some trade sanctions and is threatening with more. It is likely to block most imports from Ukraine to break both the national finances and specific pro-European businessmen. The Kremlin has publicly threatened to drive Ukraine into default. Once again, as in

January 2006 and January 2009, the notoriously unreliable Russian state-dominated gas company Gazprom may cut its supplies to Ukraine. It has already made loud complaints about Ukrainian arrears.

Because of poor economic policies, Ukraine is economically highly vulnerable. The EU has offered to give Ukraine more early market access, but that remedy will take some time. In the short term, Ukraine has sufficient gas reserves to manage through the winter. Ukraine's public finances are so shaky that the country might need a new IMF agreement.

For the EU, the Moldovan case is much simpler. Moldova is more democratic, freer and less corrupt than Ukraine. The current Moldovan government is pro-European and supports European integration whole-heartedly. The country is poor but pursues a sound economic policy leading to a high growth rate and no longer requires any IMF support.

Yet, Moldova is more vulnerable to Russian threats than Ukraine because it is much smaller, poorer and a part of Moldova's territory, Transnistria, is controlled by Russian "peacekeepers." An obvious danger is that Russia recognize Transnistria as an independent state as it did with the Georgian territories Abkhazia and South Ossetia in 2008. Moreover, Moldova is completely dependent on Gazprom for its supply of natural gas, and it could once again face a cut in the Russian gas supply. Finally, Gazprom has large claims on Moldova for unpaid gas that has been delivered

to Transnistria beyond the control of the Moldovan government. Moscow could utilize this large debt to put Moldova into default. If this would happen, the IMF could arrange new financing for Moldova, since it has been a successful client.

Mr. Chairman and Ranking Member Johnson,

I would like to thank you for this opportunity to speak on an important topic. No political event in Europe this year is more important than the European Union Eastern Partnership summit in Vilnius November 28-29. The key question is whether Ukraine and the European Union will sign the long-concluded Association Agreement. The Ukrainian government is reluctant to fulfill all conditions, leaving the signing in doubt. The Ukrainian economy is in poor shape and most vulnerable, and the Russian government is threatening Ukraine with draconian sanctions if the country does sign the EU agreement.

The United States is well liked and highly influential in Ukraine and can do a great deal to influence that country's choice simply by speaking up. The main objectives for U.S. policy on Ukraine should be to support democracy. If democracy is secured, Ukraine is likely to choose a Western geopolitical orientation. If the United States wants to be important, it is important, and in few places is the United States more appreciated than in Eastern Europe.

I first visited Ukraine in 1985 and have kept in close touch with the country ever since. I worked as an economic advisor to the Ukrainian government from 1994 to 1997. I have continued to follow its economic and political development. I have written extensively on Ukraine, including one book of my own and two edited volumes.

### The Importance of the European Association Agreement

After Ukraine had become a member of the World Trade Organization in 2008 under the government of Prime Minister Yulia Tymosehko, the European Union started negotiating a very substantial Association Agreement, which includes a deep and comprehensive free trade agreement. President Viktor Yanukovich has maintained a pro-European line and his administration completed the negotiations in November 2011, but its signature has been delayed because of European concerns about the Ukrainian government's poor observation of rule of law, human rights and political freedom.

This free trade agreement would abolish nearly all customs tariffs between the European Union and Ukraine as well as lead to regulatory convergence in technical standards, food standards, competition policy, state aid and energy policy. It would have a considerable positive impact on the Ukrainian economy. The economists Veronika Movchan and Ricardo Giucci have concluded that it would add 12 percent to Ukraine's GDP in the long term, and Oleksandr Shepotylo has assisted that it would expand Ukraine's exports by 46 percent in the long term.

It is not only a trade agreement but also a far-reaching reform plan for the Ukrainian state. The EU has committed itself to considerable technical assistance. Sixty state agencies in various EU countries have committed themselves to reform their Ukrainian counterparts. This could amount a cleansing of Ukraine's pervasive

corruption and the state-building that Ukraine itself so far has failed to accomplish. The EU state agencies have already a successful record from the previous enlargements of the Union.

The European Union and Ukraine are supposed to sign the Association Agreement at the EU summit in Lithuania's capital Vilnius on November 28-29. The problem, however, is that the first declared aim of this agreement is "to promote gradual rapprochement between the Parties based on common values..." and European values is not Yanukovich's comparative strength. He exercises full control over courts and law enforcement, utilizing them at will, not least for jailing opposition leaders. In August 2011, Yulia Tymoshenko was arrested and later sentenced to seven years in prison for abuse of power in a blatantly flawed court proceeding.

Yanukovich has all reasons to sign the Association Agreement. A pro-European policy enjoys solid majority support in Ukraine, so he cannot be re-elected in March 2015, if he fails to sign this month. All the leading businessmen are eyeing the European market for their future expansion. Russia's President Vladimir Putin seems to keep Yanukovich in such low regard that Yanukovich has concluded that they cannot work together.

For long the EU representatives had in unison demanded that Yanukovich carry out several major legal and political reforms, but the president just stonewalled them. But evidently Putin really scared Yanukovich's, and at the end of August

Yanukovych did not only reconfirm his long-lasting pro-European stance but he completely changed his tune on EU conditions. Suddenly, he promised to adopt all the legislation that the EU demanded. This involved constitutional amendments on the judicial system and the constitutional court, laws on all arms of law enforcement, a new electoral law, and renewed elections where parliamentarians had wrongly been deprived of their seats. A slew of laws have been going through the parliament.

The main stumbling block has been the treatment of Tymoshenko. The EU and Yanukovych agreed that she needed medical treatment abroad. The EU has demanded that Yanukovych pardons her, which he does not want to do. Yanukovych desires to keep her out of the country or in prison without political rights. The Ukrainian parliament, where Yanukovych has complete control over the majority, is currently adopting a law that will not be acceptable to the EU. Will Yanukovych pardon Tymoshenko or gamble? The EU is not likely to give in. Ukraine is a pervasively corrupt country, and the EU experience is that its main failures have been caused by excessive softness.

#### Poor Economic Policy and Great Vulnerability

For years, the Ukrainian government has pursued a miserable economic policy, rendering a serious financial crisis possible or even likely. As most former Soviet states, Ukraine is subject to predatory rule. Its masters have one clear objective: To enrich themselves.

In February 2010, Viktor Yanukovich won free and reasonably fair presidential elections with a narrow margin over then-Prime Minister Yulia Tymoshenko. He represented the Russian-speaking electorate in eastern and southern Ukraine, while Tymoshenko found most of her support in the Ukrainian-speaking west and center of the country. This balance between west and east has kept Ukraine more open and pluralist than Russia.

Most of all Yanukovich represented the interests of a limited number of big businessmen in Donetsk, his eastern home region and its metallurgical industry. President Yanukovich started off with full control of parliament, government and courts. His first government represented nine big business groups, but he quickly reduced their number to three. Instead, friends of his son Oleksandr have come to dominate the government since December 2012. These young businessmen from Donetsk hold all key economic posts in the government.

Yanukovich started his presidency by adopting an ambitious structural reform program and on that basis he concluded a stand-by agreement with the IMF of \$15 billion for two and a half years. Yet, by November 2010 reform came to an end, and Ukraine received only the first two tranches of this loan of a total of \$3 billion.

Yanukovich's economic policies have stayed off track. An IMF mission visited Ukraine in February 2011, and it set three key conditions that the government has

not fulfilled. The IMF continues to insist upon them. An additional demand is that some sense into the tax system.

The most important IMF condition is to hike the domestically gas prices. Incredibly, Ukraine imports natural gas from Russia for over \$400 per 1,000 cubic meters, but the Ukrainian government insists on purchasing natural gas produced in Ukraine at the ridiculously low price of \$53 per 1,000 cubic meters and it sells gas to consumers and utilities at such low prices. The purchased and sold quantities at these low prices do not add up. Apparently, somebody is buying gas at the low regulated price and sells it at the higher, making fortunes on this arbitrage. We do not know who benefits, but Yanukovych has adamantly opposed raising these prices. To sell gas at lower than the purchasing prices causes the state oil and gas company Naftogaz losses amounting to 2 percent of GDP each year, which eventually are financed by the state budget, that is, the taxpayers.

The second IMF condition is to reduce the budget deficit. Instead, Yanukovych has let it expand because of a variety of populist social expenditures. Competitive public procurement has basically ended. Large public contracts are distributed among cronies, and the kickbacks or overpricing reported by the independent media that still exist is often 50 percent of the contract. Yet, no legal measures are undertaken against the senior officials, who have been singled out for large-scale embezzlement.

This year, the budget deficit is likely to reach almost 6 percent of GDP, and the public debt is set to exceed 40 percent of GDP, which might be more than Ukraine can bear. The Ukrainian government could ignore IMF demands for the last two years because it could borrow on the international Eurobond market at ten-year yields of 7.5-9.5 percent, but now these yields have risen to 12-13 percent, depriving the Ukrainian government of access to the international capital market.

The third IMF condition is that Ukraine introduces a more flexible exchange rate, which is a code word for depreciation. The exchange rate of the Ukrainian hryvnia is pegged at too high a level. As a consequence, last year Ukraine's current account deficit was 8.2 percent of GDP, though this year it might decline toward 6 percent of GDP because of a contraction of imports. As a consequence of the overvalued exchange rate, Ukraine's international reserves have shrunk steadily since September 2011, when they peaked at \$38 billion. In October, they fell to \$20.6 billion, corresponding to only 2.6 months of imports, and they are set to contract further. The general market expectation is a depreciation of the hryvnia, which is reflected in the low and falling ratings of outstanding Ukrainian credits.

Rather than following the IMF suggestions, the Ukrainian government has imposed strict currency regulations, to make it exceedingly difficult to take money out of the country. It has also pursued very high interest rates. Last year, posters with the picture of Gerard Depardieu promised 19.5 percent interest on one-year time deposits in a Ukrainian savings bank. The high interest rates have kept inflation at

zero, but they have also killed investment and thus liquidated economic growth. Output has fallen for the last five quarters. The expected contraction for 2013 is now 1 percent, but it might become 1.5 percent.

This is a truly poor economic policy. The IMF mission just inspected the situation October 17-29 and issued a press release that is more scathing than the IMF ever is. The only positive observation was some improvements in the still awful business environment. Yet, all relevant top officials from the prime minister down met with the IMF mission, showing that the Ukrainian government is anxious to keep the doors to the IMF open, so that they call for IMF support on short notice.

Ukraine is quite likely to end up with a financial crisis at the end of this year. The most likely process would be a run on Ukrainian bank deposits and on currency exchanges, leading to such a decline in reserves that the country becomes forced to a disorderly devaluation, which would be accompanied with plenty of bank and company defaults.

### Russian Threats of Sanctions

Since 2009, President Vladimir Putin's policy toward Ukraine has had one aim: to compel Ukraine to join his Customs Union with Belarus and Kazakhstan, which is supposed to evolve into a more political Eurasian Union from 2015. Ukraine,

however, has persistently opposed such Russian proposals because it would preclude its European ambitions.

For long, the Kremlin did not pay much attention to Ukraine's dealings with Europe, possibly thinking that the EU could not accept Yanukovich's behavior. But in the middle of the summer Moscow started with a trade war with Ukraine. To begin with, it blocked exports to the Russian market from a couple of big pro-European Ukrainian businessmen producing steel pipes and chocolate. In August, Russia blocked most Ukrainian exports for two weeks through red tape at the border. Russia has hardly eased up but imposed new trade barriers on for example rail cars, to drive Ukraine into default, and to cut gas deliveries once again. Yanukovich and his government have pleaded by all means, but President Putin has offered no concessions, only persistent threats.

Russia is already sanctioning Ukraine and it is threatening with more sanctions. They are essentially of three kinds. First, Russia is likely to block all kinds of imports from Ukraine with the clear intent on breaking both the national finances and specific pro-European businessmen. In 2012, Russia accounted for 26 percent of Ukraine's exports, about as much as the EU. Some of these sanctions are already in place.

Second, President Putin's Advisor Sergey Glaziev has threatened that Russia will drive Ukraine into default. Russia accounts for only 6.5 percent of Ukraine's external

debt, but Russian banks in Ukraine account for 12 percent of Ukrainian banking assets.

Third, once again as in January 2006 and January 2009, the notoriously unreliable Russian state-dominated gas company Gazprom may cut its supplies to Ukraine. It has already made loud complaints about Ukrainian arrears.

Both Russia and Ukraine are members of the World Trade Organization, Ukraine since 2008 and Russia since August 2012, but neither country complies with its WTO commitments. For Ukraine, WTO complaints against Russia would take too long time to be useful, since the country is in a rampant crisis. The EU can offer immediate additional market access as compensation for Russian trade sanctions, but Russia and the EU are equally large importers of Ukrainian goods and services, each taking one quarter of Ukraine's exports.

Rather than complying with the clear and transparent EU conditions, Yanukovych went to see Putin at his summer residence in Sochi on October 27. The two men reportedly met for 4-5 hours, but came out without agreement.

### No Happy End is Likely

Yanukovych is walking on eggshells as a bull in a china shop. The economic situation is precarious. The risk for a run by ordinary Ukrainians both on banks and the

Ukrainian currency is apparent. The rating agencies mercilessly downgrade Ukraine ever lower, and corporate defaults are all too common.

In order to survive this winter without major economic disruption, Yanukovich needs to pardon Tymoshenko, sign the Association Agreement, and then quickly conclude an IMF stand-by agreement. Russia is all too likely to block Ukrainian exports to Russia, cut various forms of bank financing, and probably also gas supplies. Yet, there is no sign of him doing what it takes with regard to the EU, the IMF or Russia.

On November 8, Yanukovich signed a law amending the tax code that would make it possible to deny Vitaly Klichko, the opposition leader, the right to run as a presidential candidate. Meanwhile, the parliament is about to adopt a law on Tymoshenko that will not be satisfactory to the EU. Just in case, Yanukovich also stated that he would not allow any increase in the gas price for consumers.

As long as Ukraine does not join the Russian-sponsored Customs Union, Russia is likely to deliver a triple-whammy to Ukraine, blocking its exports to Russia through trade sanctions, cutting gas exports, and imposing various financial sanctions. The United States can and should protest against such actions. Trade sanctions, as those already deployed, appear to violate Russia's commitment to the WTO. The EU can offer expedited market access. Cuts in exports would mainly harm Russia's gas company Gazprom. Ukraine has sufficient volumes of gas stored for the winter, and

Europe can manage by other means. Financial sanctions are best countered through a renewed IMF agreement with Ukraine, which presupposes that Ukraine carries out necessary financial reforms.

### Moldova Deserves All Support

In Vilnius, the Republic of Moldova is supposed to initial the deep and comprehensive free trade agreement it has concluded with the European Union. This agreement is of great economic importance for Moldova. It also opens novel perspectives of European integration and government reform. The current Moldovan government is pro-European and supports the agreement wholeheartedly, so that the complications that prevail in Ukraine are not at hand in Moldova. The country has currently quite a good economic policy with an expected growth rate this year of 5.5 percent and it no longer requires any IMF support.

Yet, Moldova is subject to a greater threat from Russia than Ukraine because it is much smaller, poorer and a part of Moldova's territory, Transnistria, is effectively controlled by Russian "peacekeepers." President Putin has appointed Deputy Prime Minister Dmitri Rogozin his envoy for Moldova.

First, Rogozin has demanded that Russia is allowed to open a consulate in Transnistria, which the government of Moldova has refuted. There is a clear danger that Russia will recognize Transnistria as an independent state as it did with the

Georgian territories Abkhazia and South Ossetia in 2008. The United States can and should tell the Russian authorities that such a step would be impermissible.

Second, Moldova is completely dependent on Gazprom for its supply of natural gas, and it could once again face a cut in the Russian gas supply. Moldova has agreed with Romania to build an alternative gas pipeline, but it will be completed only next year.

Third, Gazprom has large claims on Moldova for unpaid gas that has been delivered to Transnistria beyond the control of the Moldovan government. Moscow could utilize this large debt to put Moldova into default. If this would happen, the IMF could arrange new financing for Moldova, since it has been a successful client.