2

Leonid Kravchuk: Nation-Building and Hyperinflation, 1991–94

At the request of philanthropist George Soros, Professor Oleh Havrylyshyn and I went to Kyiv in the second week of August 1991 to evaluate Ukrainian thinking on economic reform. He opened all doors for us.

In the fall of 1991, Ukraine was quite an absurd place. It was still a part of the Soviet Union, but the Soviet government had effectively lost control of most things that mattered: wages, tax revenues, and money supply. As a result of these dismal fiscal and monetary policies, shortages prevailed, and prices on the free private market were skyrocketing. The dominant state shops were literally empty because of artificially low regulated prices. Output was plummeting because nobody had any real incentive to work. The strange thing was that Kyiv was exceedingly normal. People were courteous and nice. It was not dangerous to walk in the streets late at night. Flowers were still planted in public parks. Yet, by the end of 1991, the average salary at the free exchange rate of the Soviet ruble was $6 a month. The old Soviet system replete with state control was still in place, but it had stopped producing. The economy was collapsing before our eyes, but Ukrainians were preoccupied with their nation's forthcoming independence.

Everybody was upset over the infamous "Chicken Kiev" speech[1] that US President George H. W. Bush had made when he visited Kyiv on August 1, 1991. He had told the Ukrainians to stay in the Soviet Union: "We will maintain the strongest possible relationship with the Soviet Government of President Gorbachev . . . as a federation ourselves, we

1. *New York Times* columnist William Safire nicknamed it so.

want good relations . . . with the Republics. . . . Americans will not support those who seek independence in order to replace a far-off tyranny with a local despotism. They will not aid those who promote a suicidal nationalism based upon ethnic hatred" (Bush 1991). But the Soviet Union could no longer be saved.

Finding qualified economists in Kyiv was not easy in August 1991. Throughout their rule, the Soviet leaders had feared Ukrainian nationalism, imposing far more severe repression on this republic than on Russia. Talented Ukrainians regularly moved to Moscow, which offered the best careers as well as more intellectual freedom. Ukraine, with 52 million people, had only one economics journal, which was dogmatic and mediocre. The curious consequence of this repression was that opposition in Ukraine focused on one issue: national revival. Secondary topics such as democracy attracted little attention and the building of a market economy even less.

We met three memorable economists. Volodymyr Pylypchuk, chairman of the influential parliamentary Economic Reform Committee, was a leading reform economist of nationalist inclination. He was convinced that Ukraine was rich and its economy would flourish only if Russian exploitation ceased. We tried to inform him that Ukraine enjoyed highly beneficial terms of trade with Russia and that a transition to market prices would cost Ukraine several percent of its GDP (Orlowski 1993, Tarr 1994, IMF 1994). Pylypchuk listened incredulously. He did favor a market economy, but his conception of it was vague.

During my first visit to Ukraine in 1985, I met Academician Oleksandr Yemelianov, director of the Institute of Economic Research of the State Planning Committee of Ukraine. He was the most dogmatic communist economist I have ever met. Now Yemelianov was President Leonid Kravchuk's chief economic adviser. When I met him again in 1991 he reassured us of his support for market economy and private enterprise, but his new vision did not match his (lack of) economic knowledge. As long as the formidable Yemelianov was chief economic adviser to the president, no market reform was possible. Curiously, he was soon ousted because of a sordid corruption scandal.

Our third meeting was positive. Oleksandr Savchenko was a leading Rukh economist. He was young and bright, spoke English, and had some training from Harvard University. Yet he was hardly strong enough to storm the fortifications of the collapsing command economy.[2] The building of a market economy would evidently be postponed until Kravchuk and Yemelianov were gone.[3]

2. Savchenko is currently deputy chairman of the National Bank of Ukraine.

3. Oleh Havrylyshyn drew a more optimistic conclusion and became deputy minister of finance in 1992.

As was necessary in Soviet days, I flew out through Moscow, where I met Pilar Bonet, a long-time Spanish correspondent in Moscow, on August 17. The stalemate in Moscow was untenable, and we speculated whether a hard-line coup would take place, as Gorbachev's former top associates Eduard Shevardnadze and Aleksandr Yakovlev had warned in December 1990. We agreed that a coup was possible, but it was impossible to say whether or when it would take place. The next day all hell broke loose.

National Independence

In April 1991, at his residence in Novoe Ogarevo outside Moscow, Gorbachev had instigated negotiations for a new looser "union of sovereign states" to replace the Soviet Union. From the outset, the Balts, Georgians, Armenians, and Moldovans had refused to join these talks, since they insisted on full independence. Soon the Azerbaijanis also withdrew. Thus, only 8 out of the 15 union republics participated, rendering Ukraine pivotal. Without Ukraine, the Soviet Union no longer appeared viable. As Zbigniew Brzezinski (1994, 80) later put it: ". . . without Ukraine, Russia ceases to be an empire, but with Ukraine suborned and then subordinated, Russia automatically becomes an empire."

The new union treaty was ready to be signed in Moscow on August 20, upon Gorbachev's return from a long summer holiday in Crimea. But, the party hard-liners felt betrayed by him. All Gorbachev's closest collaborators ganged up on him, organizing a coup and setting up the State Committee for the State of Emergency (GKChP) on August 19, 1991. The GKChP issued a manifesto, "An Appeal to the Soviet People," the first goal of which was to stop "the liquidation of the Soviet Union" (Dunlop 1993, 194–99).

In Ukraine little happened. The Ukrainian communist leadership quietly subordinated themselves to the putschists. Kravchuk equivocated, neither supporting nor opposing the GKChP. By August 21 the coup in Moscow had failed. Then Kravchuk took the lead. On August 24 the Ukrainian parliament declared Ukraine independent by an overwhelming majority of 346 to 1. As the eminent historian of Ukraine Roman Szporluk (1994, 1) has observed: "it is essential to remember that the independent Ukraine proclaimed in August 1991 did not define itself as an ethnic state. It was a jurisdiction, a territorial and legal entity, in fact, a successor of the Ukrainian SSR. Its citizens were of different ethnic backgrounds and spoke Ukrainian and Russian to varying degrees, but also other languages." Importantly, the Ukrainian identity was defined as civic and political and not as ethnic or linguistic.

The Ukrainian Soviet Socialist Republic was renamed Ukraine. August 24 became Ukraine's National Day. Formally, Ukraine remained a part of the Soviet Union. Only the three Baltic republics became universally recognized independent states at this stage. On August 30 the presidium of the Ukrainian parliament banned the Communist Party of Ukraine (CPU) and later confiscated its property, as in Russia, but nobody was held responsible for CPU deeds and the communists were not purged or prosecuted (Kuzio 2000, 185). The old state apparatus replete with communists remained in place.

With amazing skill, Kravchuk had transformed himself within less than two years from communist ideological policeman to national communist leader and now to Ukraine's first president and national leader. He had become the symbol of national independence, so nationalists could not attack him effectively, but the communists still trusted him, and so did Russian-speaking Ukrainians (Prizel 1997, 343).

A large number of state-building measures followed the Declaration of Independence. The parliamentary majority voted to form a Ukrainian Ministry of Defense and take control over all armed forces on Ukrainian territory. It decided to introduce a Ukrainian currency and passed a Law on State Frontiers. All references to Ukraine as "socialist" were deleted from the constitution (Kuzio 2000, 183–89).

The parliament decided to reconfirm its decision on national independence with a referendum on December 1, 1991. No less than 90.3 percent of the population voted for independence, and participation was high, at 84 percent. A majority voted for Ukrainian independence in each region, with the minimum being 54 percent in Crimea.

On the same day, Ukraine's first presidential elections were held. Kravchuk won with 61.6 percent of the votes, followed by Vyacheslav Chornovil, who received 23.3 percent (table 2.1). Characteristically, the left gathered behind one candidate, Kravchuk, while the right was divided between five candidates. Yet Kravchuk's support was quite evenly distributed across the country, and he won in all regions but western Ukraine (Kuzio 2000, 194–201).

Ukraine's greatest challenge was to break out of the Soviet Union. The overwhelming verdict in the referendum on independence facilitated that effort. Ukraine was lucky because Russian President Boris Yeltsin also desired to end the union as fast as possible, and he acted instantly and decisively (Åslund 2007b). In complete secrecy, Yeltsin organized a summit one week later with Kravchuk and the reformist chairman of the Belarusian parliament, Stanislav Shushkevich. The relationship between Yeltsin and Kravchuk was good. As Kravchuk (2001) commented: "Both Yeltsin and I needed one another. He was interested in me as an ally in his run for power. I was trying to use him to ensure the full independence of Ukraine without a painful split of economic ties and without more undesirable conflicts with Moscow."

On December 8–9 they met with only a handful of aides at a desolate Belarusian hunting lodge in Belovezhskaya Pushcha. Kravchuk (2001)

Table 2.1 Results of presidential election, December 1, 1991

Candidate	Percent of votes
Leonid Kravchuk	61.6
Vyacheslav Chornovil	23.3
Levko Lukyanenko	4.5
Volodymyr Grynyov	4.2
Ihor Yukhnovskiy	1.7
Others, against all, or not valid	4.7
Total	100
Voter turnout (percent)	84.2

Source: Uryadovyi Kur'er, 1991, no. 38–39.

appreciated Yeltsin's choice of time: "The principal difference of this meeting compared to previous meetings was that I came there armed with the popular vote of the Ukrainian referendum. In addition, at this time I was already President." Together these three heads of state agreed to dissolve the Soviet Union. As Yeltsin (1994, 113) saw it: "In signing this agreement, Russia was choosing a different path, a path of internal development rather than an imperial one." He insisted that this was "a lawful alteration of the existing order" because it "was a revision of the Union Treaty among the three major republics of that Union." The Treaty of the Soviet Union of 1922 had been invalidated. Kravchuk (2001) concurred: "The Belovezhskaya Pushcha accord gave us two chances: to bury the dead empire in a civilized and Christian fashion and to preserve the half-destroyed economic ties. Unfortunately, we used only one of them."

On December 21, 1991, the other remaining union republics (apart from fiercely nationalist Georgia) reconfirmed this decision in Kazakhstan's capital, Alma-Ata. In place of the Soviet Union, 11 former Soviet republics created the Commonwealth of Independent States (CIS).[4] The CIS was reminiscent of the British Commonwealth, even though various Russians tried to make something more of it, but with little success. On December 25 the Soviet Union ceased to exist. Russian President Yeltsin replaced Soviet President Gorbachev in the Kremlin, and the Soviet flag was lowered for the last time and replaced with the Russian flag. All the remaining Soviet republics, including Ukraine, became fully independent and replaced the Soviet flag with their new republican flags. Soon the whole world recognized their independence.

Suddenly Ukraine had achieved the full independence that some had dreamed of for centuries, while most had not dared to hope for it, and no

4. They were Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

state questioned its sovereignty. National liberation had been fast and perfectly peaceful. The new nation's borders were secure, and it had a democratically elected and undisputed president in Kravchuk. This was Ukraine's moment of euphoria.

Kravchuk as President

Kravchuk was an amazing politician. Andrew Wilson (2002, 182) has caught his character:

> Always a consummate opportunist, Kravchuk became Ukraine's preeminent figure in the build-up to independence by skillfully constructing a public persona that was most things to most people. As president, he sought to delay any final act of self-definition for as long as possible by maintaining the broadest possible consensus amongst elites.

As chairman of the parliament, Kravchuk was already perceived as president. He realized that Soviet power was collapsing. As he later wrote: "We understood that the USSR was doomed and had to be replaced with a looser super-national structure. Such a union would allow the former Soviet republics to survive during their process of building their own institutions and national economies" (Kravchuk 2001). He was a jovial, clubbable, and understated man. It was easy to like him but difficult to think of him as a leader. He said little worth quoting, but his political intuition was superb, and he seemed to find a compromise with everybody. A popular anecdote had Kravchuk turning down an offer of an umbrella when he went out into the rain, because "I just walk between the drops."

Kravchuk cleverly switched from communism to Ukrainian nationalism without a hitch, gaining popular credibility with surprising talent. He realized where history was taking him: "Collapse was in progress for a long time and the end of it could be disastrous. The head of each republic just wanted to exit this geopolitical construct with minimal loss" (Kravchuk 2001).

He established Ukraine's independence swiftly and successfully. His nationalism was so moderate that he convinced the east and south to vote for independence. He happily adopted the three important national symbols: the blue-and-yellow flag, the trident, and the old national anthem. Ukrainian became the official state language, but Russian was generally accepted. Kravchuk also led the national communists, who opted for independence because they wanted the old communist establishment to stay in power.

The president's second success lay in foreign policy. Ukraine had few institutions of a sovereign state, but it had a rudimentary Ministry for Foreign Affairs with a small corps of able diplomats and an original membership of the United Nations. The small Ukrainian diplomatic corps comprised some of the brightest and most able people at that time.

Kravchuk masterfully managed the breakaway from the Soviet Union as well as Ukraine's control over the Soviet armed forces in the country. Crucially, Kravchuk insisted on all servicemen swearing an oath of obedience to the Ukrainian state, which made quite a few soldiers depart. He persistently pursued Ukraine's denuclearization.

His shortcoming, however, was that he had a minimal political agenda, essentially consisting of the establishment of the Ukrainian state and amicable foreign relations as well as his maintenance of power. Besides, he was very indecisive. Kravchuk had no clue about economic policy. Like Yeltsin in Russia, he started his term with substantial powers to legislate with decree, but unlike Yeltsin, he barely used his powers. He defended himself: "The president should be responsible for building the state, while the prime minister should manage the economy."[5] Ukraine's economy was descending into chaos with galloping inflation and plummeting output.

Nor was Kravchuk interested in political institution-building. His view of politics was to compromise with everybody within the existing political system. After the vote of independence and the election of Kravchuk as president on December 1, 1991, Rukh leader Vyacheslav Chornovil advocated the dissolution of the predemocratic parliament and early elections, but Kravchuk opposed early elections. Thus, he missed his chance to build a ruling party, and his national communism was never constituted as a party. Ukraine's parliament remained fractured and dysfunctional for over a decade. Its old Soviet constitution from 1978 persisted with amendments. Still, his ultimate virtues were that he stuck to the democratic rules and peacefulness in both domestic and foreign affairs.

I had the privilege of assisting Kravchuk for two days at the World Economic Forum in Davos in January 1991. I was surprised by his friendliness and humility, but it was difficult to believe that he would become the leader of a big country. When I met him a few years later and complained about his failed economic policies, he did not defend himself but looked down unhappily.

Liberation from Russia

Ukraine's first challenge was to form new relations with Russia.[6] Although Ukrainian historiography paints a bleak picture of Moscow, Yeltsin's desire to rid Russia of the burden of empire greatly helped Ukraine (Yeltsin 1994).

---

5. Quoted in Prizel (1997, 345).

6. Overall sources of this section are Olcott, Åslund, and Garnett (1999) and Garnett (1997).

The Ukrainian authorities took over government and enterprises from Russia with ease. Since the real state was the Communist Party, the simultaneous prohibition of the Communist Party of the Soviet Union (CPSU) and the CPU resolved much of this task. With independence, Ukraine faced five major issues in its relations with Russia, namely, the integrity of its borders, military (denuclearization and the division of the Soviet Black Sea Fleet), economic (mainly the breaking up of the ruble zone and credits), energy (gas prices and the payment of gas purchases), and CIS integration.

Of these assignments, the most important was the recognition and security of Ukraine's state borders, which Yeltsin appreciated. Dankwart Rustow (1970) emphasized the importance of securing the borders of a state, because otherwise the state could not be stable and no democracy could be built. On November 19, 1990, on behalf of the Russian Federation, Yeltsin and Kravchuk signed a Treaty on the Basic Principles of Relations between Russia and Ukraine (Sherr 1997). This treaty "acknowledged and respected the territorial integrity of the Ukrainian Soviet Socialist Republic," although it remained a part of the Soviet Union. Through his consistent policy of no border revisions, Yeltsin kept such issues off the agenda, but only in 1997 was a final treaty concluded.

An old saying runs that, while the United States had a military-industrial complex, the Soviet Union was a military-industrial complex. However complex the dissolution of the military was, it passed amazingly easily because of goodwill on both the Russian and Ukrainian sides, with keen engagement of the United States, especially Secretary of State James Baker (Goldgeier and McFaul 2003). With amazing ease, Ukraine took command over the conventional forces on its territory.

The big and lasting military dispute was the status of the Soviet Black Sea Fleet and its base, Sevastopol, on Crimea. One concern was the division of the Black Sea Fleet; another was Ukraine's sovereignty of Crimea and Sevastopol. It was subject to numerous partial agreements and remained the dominant topic of negotiations between Ukraine and Russia from 1992 until 1997; a series of bilateral agreements gradually generated a solution. The demarcation of the border in the Black Sea was never undertaken but was left in limbo.

An initial agreement was concluded in January 1992, awarding Ukraine 30 percent of the ships (excluding nuclear vessels). Yeltsin and Kravchuk reached a more specific agreement in June 1992 about dividing the Soviet Black Sea Fleet into equal halves, while Ukraine would sell a substantial number of ships from its share to Russia. At a summit in Moscow in June 1993, the two presidents provisionally agreed that Russia could lease Sevastopol. The Russians insisted that Sevastopol be the headquarters of the Russian Black Sea Fleet, but the Ukrainian constitution prohibited foreign bases. In 1992–93, the Russian parliament vehemently opposed Yeltsin, claiming that the 1954 transfer of Crimea to Ukraine was illegal and that Sevastopol belonged to Russia (Sherr 1997). As a result, Yeltsin could not conclude any agreement with Ukraine because the Russian parliament would have refused to ratify it. The Russian communists and populist nationalists loved antagonizing Ukrainians, many of whom perceived such provocations as Russia's "real" foreign policy. Since Ukraine's economic crisis was worse than Russia's in 1992–94, its negotiating position gradually weakened.

The greatest economic problem after the dissolution of the Soviet Union was the persistence of the ruble zone. The Soviet ruble and the CIS nuclear command were the only surviving common institutions after December 1991. Fifteen central banks were issuing ruble credit, that is, money, in competition with one another. The more money a country issued, the larger the share of the common GDP it extracted. Russian imperialists, conservatives, and rent seekers wanted to maintain the ruble zone because they were benefiting from its seemingly free money. The International Monetary Fund (IMF 1992) sought to find a working arrangement, so that the ruble zone countries would agree on how much money to issue, and it refused to condemn the ruble zone as a moral hazard (Odling-Smee and Pastor 2002), while the Russian reformers who realized its detriment were too weak to defeat it (Gaidar 1993). The three fiercely independent Baltic states swiftly abandoned the ruble zone, saving themselves from hyperinflation. The countries most closely allied with Russia (Belarus, Kazakhstan, and Tajikistan) hoped it would survive.

Ukraine, however, wanted to have its cake and eat it too. Ukrainian officials hoped to exploit the ruble zone for continued access to cheap Russian raw materials and credits, therefore postponing their long-declared introduction of a national currency. Ukraine's departure from the ruble zone occurred in fits and starts, with its exit being declared repeatedly but not really happening. Ukraine introduced its own coupon, which was called *karbovanets*. At one time, it was only legal tender in state shops. Then it functioned as cash, while bank transfers remained in the ruble zone. It was a mess, and the National Bank of Ukraine (NBU) continued to issue ruble credits. Because of this uncontrolled monetary regime Ukraine experienced hyperinflation in 1993. Finally, by September 1993, the Central Bank of Russia ended the ruble zone. At that time, Ukraine had accumulated a large debt to Russia for goods delivered through state trade but never desired by any consumer. The persistence of the hyperinflationary ruble zone until the fall of 1993 was the single biggest blow to Ukraine (Åslund 1995; Dabrowski 1995; Granville 1995, 2002).

Another economic problem was the distorted foreign trade system. Ukraine established a Soviet-type Ministry of External Economic Relations, which started regulating foreign trade with licenses, quotas, and permits in the old Soviet fashion. For years Ukraine remained completely dependent on trade with the other former Soviet republics, which was dominated by state trade with fixed quotas and prices that were far below the market level until 1994 (Michalopoulos and Tarr 1996). Trade within the former Soviet Union became the privilege of old State Planning Committee officials, who conducted it in their old fashion. Ukrainian ministers were so lost in the new situation that they continued traveling to Moscow, as they had in Soviet days, asking for all kinds of goods. They increasingly realized that nobody in Moscow wanted to see them as state trade faded away. From 1995 Ukraine's trade with former Soviet republics started becoming reasonably market-oriented, with the important exception of gas trade.

For Ukraine the old Soviet external debt was not a real problem but a confusing irritant. As the Soviet Union was breaking up, the US Treasury had one concern. It wanted the future Soviet republics to guarantee their "joint and several" responsibility to service the Soviet debt, which they willingly did in November 1991. In practice, this would not have worked, which the Russian reformers understood. They magnanimously offered to take over all the debt but on the condition that they also received the assets, which were worth much less (Åslund 1995). All former Soviet republics but Ukraine accepted these conditions. The Ukrainians, however, suspected that the Russians were cheating them and that the Soviet assets were much more valuable. They demanded an account of the Soviet assets, which the still-disorganized Moscow was unable to provide. Ukraine then demanded certain Soviet properties abroad, mainly embassies. This discussion lingered but was in effect resolved as Russia had suggested. For Ukraine, this agreement was highly advantageous, allowing the country to start afresh without external debt.

The CIS was supposed to manage multilateral relations among the former Soviet republics. It concluded many agreements, of which only a few were of significance. Ukraine's relationship with the CIS was ambivalent. It signed the CIS treaty but never ratified it. Even though Ukraine was one of the founders of the CIS and regularly attends CIS meetings, as if it were a full member, formally it is not because Ukraine objects to CIS claims to supernational authority. Ukraine's long-standing policy has been to go along with purely technical and economically beneficial decisions but stay away from foreign and security policy.

The CIS Agreement on the Creation of a Free Trade Zone in 1994 was supposed to form the basis of trade between the CIS countries, but it never came into force because Russia did not ratify it. Instead a bilateral free trade agreement on June 24, 1993 regulated trade between Ukraine and Russia. Trade among the CIS countries has never been particularly free. Whenever a company or industry in one CIS country successfully exports to another CIS country, the importing country clamps down with a sudden quota or prohibitive import tariff. For example, Russia restricted imports of vodka from Ukraine in 1996. The CIS lacks a conflict-solving mechanism, so the countries concerned can settle trade disputes only through bilateral negotiations. Without the guidance of principles, many conflicts remain unsolved. This trading system is highly inefficient, and the number of trade disputes only accumulates. As a consequence, the share of Ukraine's trade with the former Soviet Union has dwindled (Åslund 2003a).

Little is known about cooperation between the security police. Unlike the situation in the communist parties and the military, these links were neither disrupted nor revealed. They presumably remain strong and substantial. A case in point is the attempt to poison Ukrainian presidential candidate Viktor Yushchenko in September 2004.

On the whole, the Soviet Union was dissolved with surprising ease. The greatest problem was the monetary disorder that resulted in hyperinflation, in much the same way as most of the successor states of the Hapsburg Empire were hit by hyperinflation because they did not withdraw fast enough (Pasvolsky 1928). This was all the more disturbing because some of the great economists of the day had recently revived those insights (Sargent 1986, Dornbusch 1992). The Black Sea Fleet remained a persistent irritant. Yet Dominic Lieven's (2000) verdict holds true that no empire passed away as peacefully as the Soviet empire did.

Ukraine's Denuclearization

The all-dominant American concern about Ukraine was its nuclear arms. Ukraine was the third largest nuclear power in the world, after the United States and Russia but before China. The Americans wanted the Ukrainian nuclear arms transferred to Russia and destroyed, but Russia played only a secondary role in these negotiations. Incredibly, US Secretary of Defense William J. Perry regarded Ukraine's reluctance to give up its nuclear missiles as "the single biggest threat to international peace and security that we faced anywhere in the world" (quoted in Goldgeier and McFaul 2003, 166).

From the outset, Kravchuk committed himself and his country to a complete destruction of Ukraine's strategic and nuclear weapons (Goldgeier and McFaul 2003, 49). In December 1991 Kravchuk accepted the destruction of all its 176 intercontinental ballistic missiles (ICBMs) with 1,180 warheads (Wolczuk 2002, 35). After the Chornobyl catastrophe, a broad Ukrainian popular opinion wanted to get rid of them. Another early ambition was a policy of neutrality, which was even enshrined in its Declaration of State Sovereignty of July 16, 1990, but it was soon ignored (Larrabee 1996, 143). Still Ukrainians held a strong urge to stay out of US-Russian rivalry.

The United States demanded that Ukraine sign and ratify the Treaty on the Reduction and Limitation of Strategic Offensive Arms (START I) and the Nuclear Non-Proliferation Treaty (NPT) as a nonnuclear power. On May 23–24, 1991, the ministers for foreign affairs of the United States, Belarus, Kazakhstan, Russia, and Ukraine met in Lisbon and signed the START protocols. Kravchuk committed Ukraine to becoming nonnuclear "in the shortest possible time," which he specified to seven years after START had come into force (Goldgeier and McFaul 2003, 56).

Ukraine wanted economic assistance, help with its denuclearization, and security guarantees, but the United States was not very forthcoming. This was a time when the United States seemed to get everything for free, and it was reluctant to pay real money or make serious commitments. A diplomatic breakthrough came at the Group of Seven (G-7) meeting in Tokyo in July 1993, when President Boris Yeltsin proposed that he, President Bill Clinton, and Kravchuk sign a trilateral accord on Ukraine's denuclearization.

In 1994 Ukraine's denuclearization was resolved with three important international treaties. First, on January 14, 1994, Yeltsin, Clinton, and Kravchuk signed the Trilateral Accord in Moscow, in which Ukraine committed itself to "the elimination of all nuclear weapons, including strategic offensive arms, located in its territory." The accord contained several paragraphs of American-Russian security guarantees. The United States and Russia stated that they would

> reaffirm their commitment to Ukraine, in accordance with the principles of the CSCE [Conference on Security and Cooperation in Europe] Final Act, to respect the independence and sovereignty and the existing borders of the CSCE members states and recognize that border changes can be made only by peaceful and consensual means; and reaffirm their obligation to refrain from the threat or use of force against the territorial integrity or political independence of any state, and that none of their weapons will ever be used in self-defense or otherwise in accordance with the Charter of the United Nations.[7]

In a private letter to Clinton, Kravchuk promised that Ukraine would be nuclear free by June 1996. When Kravchuk visited Washington in March, Clinton promised Ukraine an aid package of $750 million, which was quite a small amount.

The second important step was that the Rada ratified START I without conditions in February 1994. In return, the United States offered special security guarantees to the three countries that agreed to give up their nuclear arms, Belarus, Kazakhstan, and Ukraine.

In November 1994 the Rada took the final step toward formal denuclearization by ratifying the NPT as a nonnuclear country. Ukraine fulfilled Kravchuk's promise and completed its transfer of nuclear arms by June 1996, and much of its denuclearization was carried out with the help of American military experts and financing (Goldgeier and McFaul 2003, 170).

7. US Department of State Dispatch: Trilateral Statement by the Presidents of the U.S. Russia and Ukraine in Moscow on January 14, 1994.

Ukraine had behaved perfectly responsibly and fulfilled its substantial commitments. Although some Ukrainian nationalists regretted that their country had given up its nuclear missiles, the policy of denuclearization enjoyed strong popular support, and no Ukrainian government has revisited it. A lasting stricture, however, was that Kravchuk had given up the country's nuclear arms too cheaply.

The Grand Bargain of Ukraine's New Political Forces

Just before independence, Ukraine's politics had assumed a structure that was to last throughout the 1990s. Three broad forces formed Ukraine's politics: national democrats, the hard left, and an amorphous center. The national democrats were the driving force. Their main organization was Rukh, with 20 to 25 percent of the electorate. Their opponents were the hard left, dominated by the communists, who together with allies could gather up to 40 percent of the votes. As a consequence of this stalemate between the right and the left, the fluid center came to dominate the government.

Rukh set the political agenda with its goal of Ukraine's independence. However, from the elections in March 1990 Rukh's leaders understood that they were not strong enough to gain power on their own. Therefore, they sought what Wilson (2002, 174) calls "a grand bargain" or "historical compromise" with the national communists, whom Rukh accepted in power as long as they supported Ukraine's independence. Rukh was a movement of western and central Ukraine, which was both nationalist and democratic, but its emphasis on nationalism grew more dominant over time, hindering it from reaching out to other democrats.

Throughout the 1990s, Ukraine's hard left remained remarkably strong, with some 40 percent of the votes in the parliamentary elections of 1994 and 1998. The dominant left-wing group was the unreformed CPU, which did not even change its name. The CPU was prohibited on August 30, 1991, but it was allowed to reconstitute itself under the same name in June 1993, though without any legal claim to its predecessor's property. During its formal absence, it neither changed nor lost much support. It was the main advocacy group of the Russian-speaking population in Ukraine, demanding that Russia become a second state language. It favored "the voluntary creation of an equal Union of fraternal peoples . . . on the territory of the former USSR" (Wilson 2002, 191). Retirees dominated the CPU, which functioned as a trade union for pensioners. Petro Symonenko became the first party secretary of the CPU when it reemerged, and he has remained so.

In October 1991 communist leader Oleksandr Moroz founded the Socialist Party slightly to the right of the CPU. He stayed close to the communists but appeared more democratic, and although he cherished the cause of Ukraine's Russian speakers, he spoke Ukrainian. Moroz styled himself as a social democrat, but his economics remained communist. He favored state ownership, price controls and rigorous protectionism. Politically he was a realist: "Anybody who does not regret the collapse of the USSR has no heart; anybody who wants to restore the Union has no head" (Wilson 2002, 191–92).

To the left of the CPU, Natalia Vitrenko set up the vitriolic Progressive Socialist Party, which specialized in attacking the IMF and international capitalism. A characteristic statement of hers in 1995 was: "The deindustrialization, the de-intellectualization, and the degradation of Ukraine, all can be attributed to the recommendations of the IMF, since it is they who proposed to us, as the means of reform, to decontrol prices, to liberalize currency exchange, to deregulate foreign economic activity, and to have forced-march privatization. The IMF, together with the Soros Foundation, trained the personnel who came to carry out these policies."[8]

These three parties were to dominate the left. They remained communist on economics, favoring predominant state ownership, including of agricultural land, central planning, and far-reaching autarky. All three were too extreme to participate in a rational economic discussion.

The standoff between the national democratic right and the hard left served power to the center on a silver platter throughout the 1990s. Unlike the two ideological forces, the center was pragmatic and formative, driven by self-interest. To quote Oscar Wilde, they knew "the price of everything and the value of nothing." The center reacted swiftly to economic changes and altered nature ever so often. The transformation of this nebulous political center explains Ukraine's political development, which was usually fractured in about 10 party factions and many independent deputies.

The political center emerged in July 1990, when Leonid Kravchuk as newly elected chairman of the Ukrainian parliament adopted a national communist platform. He embraced independence, with the implicit condition that the old communist Nomenklatura would stay in power. The national communist program was completed with the independence of Ukraine, and from 1992 the movement started dwindling because of its lack of purpose.

Instead, another pragmatic part of the old communist elite came to the fore: the state enterprise managers, or "red directors." Unlike Kravchuk, they focused on the economy, but their aims were ambiguous. Two factions rose to prominence. One group of red directors came from coal mines and steelworks in Donetsk, led by Yukhym Zviahilskiy. They were pure rent seekers.

---

8. Rachel Douglas, "Flattened by IMF, Ukraine in Geopolitical Crosshairs," *Executive Intelligence Review*, December 10, 2004.

Another faction was formed by managers of military machine-building in Dnipropetrovsk, headed by Leonid Kuchma. They were driven by self-interest as well, but they also wanted a functioning market economy, although they did not quite know what that meant. These two forces were confusingly similar, but they opposed one another. Kuchma promoted gradual market reforms, while Zviahilskiy rejected them.

The missing force in Ukrainian politics was liberalism. Liberals were few and split into Ukrainian and Russian speakers. The most prominent early representative was probably Volodymyr Lanovyi. The government usually contained a couple of liberal economic reformers, whose ungrateful task was to stave off the complete collapse of the economy, while being scorned by the united left.

Thus, the political center mastered power and action, but it had no strategic goal. The national democrats set the political agenda, although they formed a minority. The hard left was little but a reactionary force. It never gained executive power, but it held a blocking majority in parliament, since the right and the center were split into multiple feuding factions. The unfortunate consequence was that minimum legislation was promulgated in the 1990s. The dysfunctional constitutional arrangement hindered both the president and prime minister from promulgating legislation, but the parliament could oust neither. The result was stalemate and frequent political crises. A positive effect, however, was pluralism with strong checks and balances.

A caricature of this time showed a number of apparatchiki with the caption "Ukraine's old communist rulers." The next picture was identical, but its caption read "Ukraine's new democratic rulers." Ukraine's old elite had their cake and ate it too. They were no longer supervised by anybody, neither the KGB nor Moscow nor the Communist Party, and they could quietly appropriate Soviet state property.

Nationalist Economic Policy with Little Thought

Kravchuk's chief economic adviser Oleksandr Yemelianov dominated economic policymaking in newly independent Ukraine. He presented an economic program called Fundamentals of National Economic Policy, which the parliament adopted on March 24, 1992. This program reflected nationalist sentiments, calling for Ukraine's immediate exit from the ruble zone and the introduction of a Ukrainian currency, the hryvnia. Alas, it contained few details and did not suggest a transition to a market economy (Kravchuk 2002, 48–50).

A young liberal economist, Volodymyr Lanovyi, entered new prime minister Vitold Fokin's government as deputy prime minister for the economy. He looked like Ukraine's answer to Poland's Leszek Balcerowicz, Vaclav Klaus of the Czech Republic, or Russia's Yegor Gaidar. In opposition to Yemelianov, Lanovyi presented his own Plan for Economic Policy and Market Reform in March 1992. This was Ukraine's first program calling for a transition to a market economy. It contained standard reform prescriptions, such as monetary stabilization, sharp budget cuts, tax reform, price liberalization, deregulation of foreign trade, and rapid privatization. Lanovyi's program was used to facilitate Ukraine's entry into the IMF and the World Bank in the spring of 1992, but it went nowhere. Lanovyi was isolated and lacked the necessary political support. In July 1992, when price increases caused discontent, Kravchuk sacked him. On September 30, 1992, Fokin fell, which prompted a complete change of government (Kravchuk 2002, Prizel 1997).

By the summer of 1992, half a year after its independence, Ukraine had no economic program or even a budget. The ignorance of economics was astounding, and international interaction was minimal, as foreigners found few Ukrainian economic policymakers to whom they could talk. The Soviet economic system remained the only known game in town. Suspicious of both Poles and Russians, Ukrainian nationalists objected to their "shock therapy." A national consensus favored gradual reforms promoting a socially oriented market economy, but that became a pretext for doing nothing. In the constitutional chaos, the president, prime minister, and parliament liberally blamed the rampant economic crisis on one another.

National institution-building dominated the economic agenda as well. Ukraine already had many ministries, but some were added, and the NBU had been established in July 1991. The old Soviet bureaucrats stayed at their posts. Economic policy was painfully absent, but nature abhors a vacuum. As the Russian reformers liberalized most prices in Russia in January 1992, Ukraine was forced to go along, which led to a price rise of 285 percent that month.[9] For the rest, old-style state orders, which were remnants of central planning, persisted.

Ukraine's early economic policy amounted to the issue of massive ruble credits and budgetary subsidies to industry and agriculture, while the government tried to restrict sales through rationing and prices and exports through administrative controls. As Pynzenyk (2000, 79–80) lamented: "The main argument for a soft monetary policy was the idea that an increase in the money supply would stimulate an increase in nominal GDP. Additional arguments were the purported need for government purchases of agricultural goods and the social protection of the population from growing consumer prices. The Ukrainian way of 'saving' the national economy and 'protecting' the population through inflation resulted in serious economic decline and falling real living standards."

9. National Bank of Ukraine, State Statistics Committee of Ukraine online database, www.ukrstat.gov.ua (accessed on August 31, 2007).

Prime Minister Kuchma: Aborted Reform

On October 13, 1992, the Ukrainian parliament confirmed Leonid D. Kuchma as prime minister.[10] Unlike his predecessors, Kuchma was no apparatchik but the country's foremost red director, the director general of the world's biggest missile factory, Pivdenmash (Russian: Yuzhmash), in Dnipropetrovsk, which produced SS-18, the world's largest intercontinental ballistic missiles. Kuchma was Ukrainian but a Russian speaker. He was a no-nonsense man, stating that "Ukraine was on the verge of collapse," but his economic insights were limited. He began with a parliamentary coup against President Kravchuk, persuading the parliament to transfer to him for half a year the president's rights to rule over the economy by decree.

Kuchma established an economic reform team that was to last. He made Viktor Pynzenyk, a liberal Rukh deputy and sophisticated economist from Lviv, his deputy prime minister for economic reform, who mobilized a group of young liberal reformers. In January 1993 the agrarians in parliament lobbied for the appointment of the young deputy chairman of the Agro-Industrial Bank, Viktor Yushchenko, as chairman of the NBU. He was an economist and former *kolkhoz* accountant from a village in Sumy oblast in eastern Ukraine. In 1993 Kuchma appointed another reform economist, Roman Shpek from Ivano-Frankivsk in western Ukraine, minister of economy. Strangely, nobody noticed that Kuchma, the classical red director, assembled a team of three nationalist liberal economists.

In December 1992 and January 1993 Pynzenyk's reform team composed Ukraine's first serious program of market reform, Basic Principles for a National Economic Policy. Although it amounted to a big step forward, it was a mixed bag. The primary task was to curb inflation to 2 to 3 percent a month by improving budgetary discipline but also through wage and price controls and more progressive taxation. The program advocated faster privatization and the introduction of private ownership of land. It favored breaking up monopolies and promoting competition, ending the state's monopoly on retail trade; simplifying registration of new small enterprises; and making restrictions on foreign investment less onerous. Yet the program was protectionist, favoring stringent quantitative controls on imports and export controls for scarce goods. Kuchma supported better trade relations with Russia, which was not reflected in the program.

Many of these reforms were implemented, as the government issued dozens of significant decrees and the parliament promulgated reform laws. The Law on Privatization was improved, social welfare payments were pruned, and retail trade was opened to private competition. These

10. The main sources of this section are Kravchuk (2002, 52–56) and Prizel (1997, 346–48).

measures were market-oriented but neither radical nor comprehensive. Most of the program was not implemented for lack of commitment or the inflationary crisis. However decisive Kuchma sounded, he shared Kravchuk's disdain for radical market reform and preferred to talk about a special Ukrainian model introduced through evolutionary change. When Kuchma tried to advance privatization, the parliament blocked it.

In May 1993 Kuchma's half-year of special powers expired. Neither Kravchuk nor the parliament had any desire to prolong them. In the summer of 1993, the tenuous balance of power between the three branches of government broke down, and the specter of economic collapse was frightening. Once again, the coal miners in Donbas went on a crippling ten-day strike, threatening politics and the economy with chaos. The strike made Kravchuk call for early presidential elections in July 1994, although his five-year mandate expired in December 1996. At the same time, early parliamentary elections were scheduled for March 1994.

Kuchma, who was a fighter, reacted by issuing a more hard-hitting and detailed economic reform program with five major components: tax reform, energy price agreement with Russia, fast privatization of all enterprises, promotion of exports, and restriction of NBU credits to industry. Since it ran counter to the left-wing majority in parliament and his own constituency of state enterprise managers, it could not fly, but Kuchma had shown his mettle to the Ukrainian public. When he received no parliamentary support, he submitted his resignation, which the parliament repeatedly refused to accept, but on September 21 he quit. He made a dramatic exit to prepare himself for presidential elections.

Pynzenyk (1999, 30–31) later commented: "A few sensible politicians spoke of monetary emission as unacceptable and the need to undertake absolutely necessary but not always pleasant decisions, but their voices were lost in the choir of those who spoke of the uniqueness of the Ukrainian situation and the opportunities to get out of it with special, purely, Ukrainian methods."

Kuchma did not achieve much during his brief premiership, but he was the first Ukrainian executive who seemed to care about the national economy. He initiated some elements of market reform and advocated standard financial stabilization and privatization, even if deregulation was barely conceived. Three fixtures had emerged in Ukraine's political scene: Kuchma, Pynzenyk, and Yushchenko.

Prime Minister Zviahilskiy: Unabashed Rent Seeking

Kravchuk drew three lessons from the Kuchma intermezzo: He wanted a weaker prime minister, he should be in charge of the economy himself, and it was better to return to a command economy. All these three conclusions helped to finish off Kravchuk.

On September 22, 1993, Kravchuk appointed Yukhym Zviahilskiy acting prime minister.[11] One week later, he abolished the post of prime minister, demoting Zviahilskiy to acting first deputy prime minister never to be confirmed by parliament. Kravchuk also attempted to merge the presidential administration with the cabinet of ministers, but the forceful Zviahilskiy functioned as prime minister.

Overtly, Kuchma and Zviahilskiy appeared to be similar, as leading state enterprise managers and Russian speakers from eastern Ukraine, but Kuchma came from Dnipropetrovsk and Zviahilskiy from Donetsk. Kuchma's industry was sophisticated machine-building, while Zviahilskiy managed Ukraine's largest coal mine (which he privatized to his own advantage) and was a prominent commodity trader. The key difference was that Kuchma cared about the national interest, whereas Zviahilskiy was preoccupied with his personal affairs.

Together Kravchuk and Zviahilskiy tried to rebuild a command economy, although their aims were very different. Kravchuk, who knew nothing of economics, opposed a market economy, while the clever Zviahilskiy realized that more regulations bred more rents to the privileged few. They tried to reestablish the former Soviet central planning system with state orders for important goods. As in the old days, they commanded guaranteed state supplies to state enterprises producing on state orders. Prices were controlled, and state subsidies covered differentials between controlled prices. They, however, stopped short of setting plan targets for the production of individual enterprises.

This attempt at revived central planning failed miserably. Output continued to fall, and hyperinflation peaked at 10,155 percent in 1993.[12] The old communist control system was gone, and the red directors pursued their own interests. Regardless of the government's aggravated regulations, businessmen started to adjust to the market.

The only winners of this policy reversal were Zviahilskiy and his business partners. They made money on foreign trade arbitrage between low domestic prices of energy, metals, and chemicals and much higher world market prices. Since they controlled foreign trade licensing, they ensured that profits stayed in their circle. Zviahilskiy went too far. After Kuchma was elected president in the summer of 1994, Zviahilskiy was prosecuted for embezzling state-owned aviation fuel that he had sold for exports for $25 million. The sum was paid into his personal offshore bank account. Zviahilskiy fled to Israel for three years until he negotiated his return to Ukraine with the new authorities in 1997 (Wilson 2005, 9). Since

11. The main source of this section is Kravchuk (2002, 56–58).

12. The standard definition of hyperinflation is 50 percent a month or more (Cagan 1956).

his return, he has thrived as one of the leading businessmen in "old Donetsk" and been a steady member of Ukraine's parliament, being one of the powerbrokers in the Regions of Ukraine.

Hyperinflation and Economic Disaster

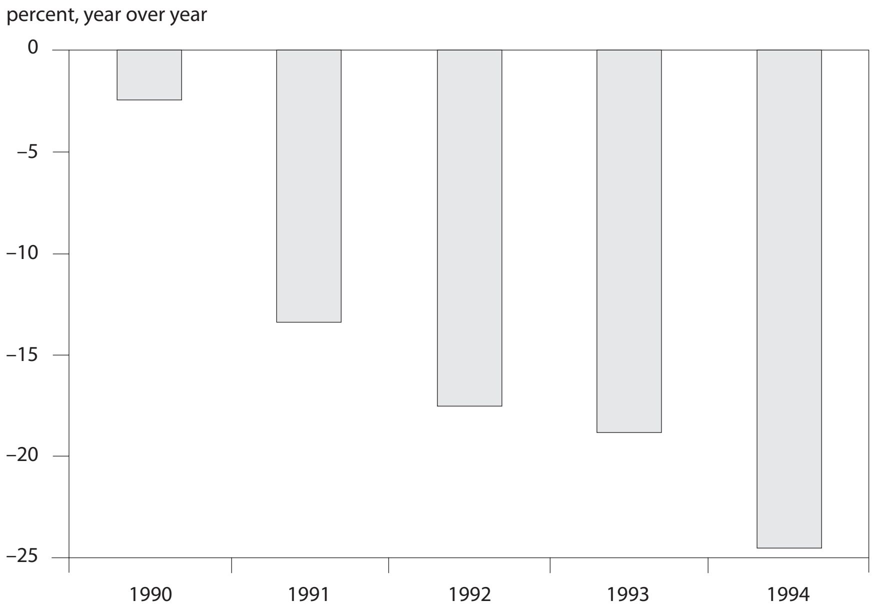
By 1994 neither plan nor market governed the Ukrainian economic system. The old centrally planned economy had stopped functioning, but no market economy had arisen. Enterprises remained predominantly state-owned. By the end of 1993, the European Bank for Reconstruction and Development (EBRD 1994) assessed that only 15 percent of Ukraine's GDP originated in the private sector. The government tried to control deliveries between state enterprises, but largely failed to do so. However, the state strictly controlled foreign trade. Prices of most essential goods were controlled, although most prices were free.

It was close to impossible to produce in a system ridden with overregulation and understimulation. Output fell like a stone from 1990 to 1994 (figure 2.1). Officially, the total decline in GDP in these five years was no less than 48 percent (UNECE 2004, 80). To a considerable extent, though, the growth of the underground economy compensated for this drop. Daniel Kaufmann and Aleksander Kaliberda (1996) pioneered assessments of the underground economy in Ukraine and found it to have expanded from 12 percent of total GDP in 1989 to as much as 46 percent of actual GDP, or almost as large as the official economy, in 1995 (figure 2.2). Compared with other postcommunist countries, Ukraine's underground economy was very large because it expanded the most in countries without either plan or market. The situation was similar in Russia but not quite as bad, while the Polish underground economy declined sharply after 1991 because more of the economy was legalized.

Officially, investment remained high at 24 to 27 percent of GDP during the first three years of independence. The explanation is that the investment was publicly financed, and the denominator is official GDP, which means that the real investment ratio might have been half as high. Vito Tanzi and Hamid Davoodi (1997) have established in a cross-country comparison that corruption and public investment often go hand in hand, while being negatively correlated to growth.

All Ukrainian statistics from this time are of very poor quality. With the old command economy, its recording system also collapsed, and no new system was built, leaving many activities unregistered. The Ukrainian Ministry of Statistics has been inert and reluctant to adopt modern statistical methods, and it loathes transparency. As alternative statistics rarely are available, one has no choice but to use the official statistics, while occasionally lamenting their poor quality and pointing out evident biases.

Figure 2.1 Decline in Ukraine's GNP, 1990–94



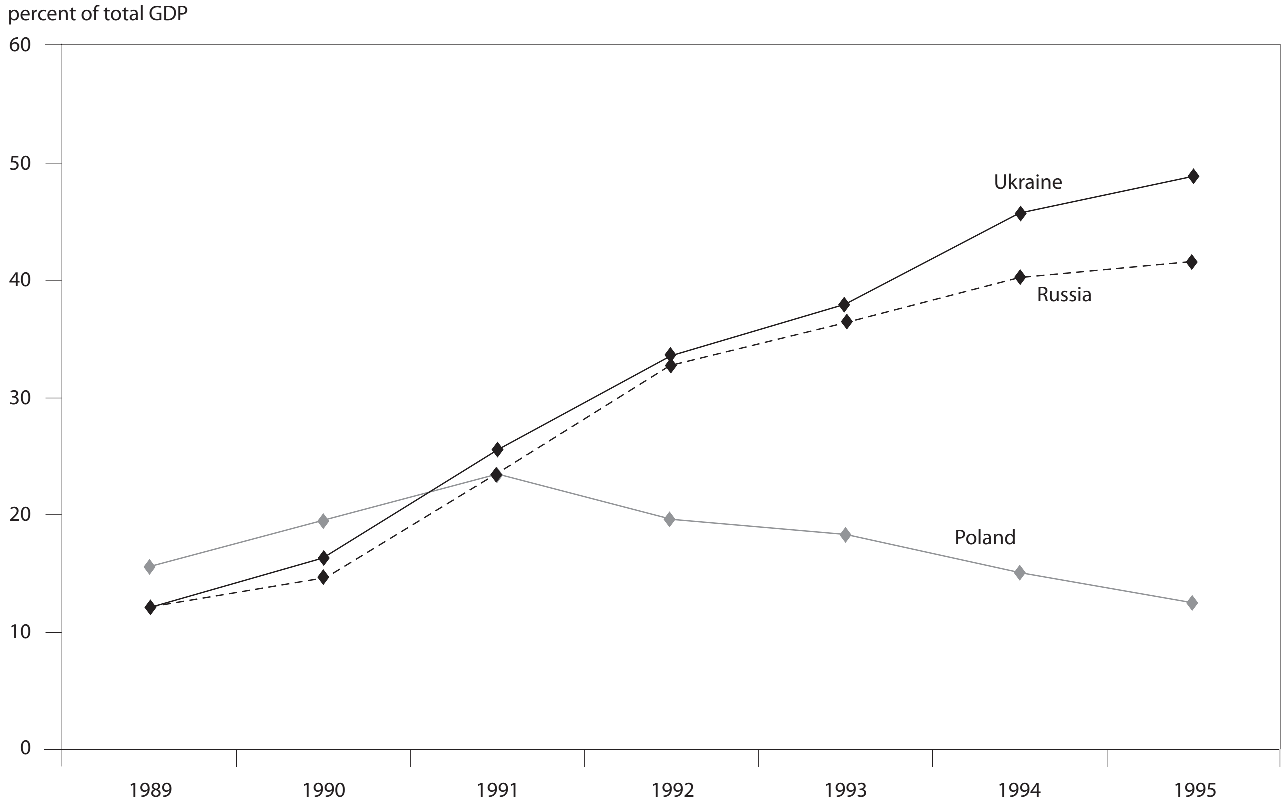
Source: Ministry of Statistics of Ukraine (1994, 10).

The main explanation for this output collapse was high inflation, which reached 2,730 percent in 1992 and 10,155 percent in 1993. After price liberalization, monthly inflation peaked at 91 percent in December 1993. Ten post-Soviet countries recorded hyperinflation, as did Poland, Yugoslavia, and Bulgaria, so Ukraine was not alone, but only war-ridden Armenia had higher hyperinflation than Ukraine (EBRD 1994). Hyperinflation disrupts all economic life and demoralizes society, as only a few insiders know how to make money on the many distortions, while the general public suffers.

Hyperinflation had three main causes: maintenance of the ruble zone, excessive monetary expansion, and too large public expenditures.[13] Monetary expansion was relentless. As early as February and March 1992 Ukraine's monetary base increased by about 50 percent a month, virtually guaranteeing hyperinflation (figure 2.3). The NBU was new and weak, and it was subordinate to the parliament, which every so often decided to issue huge credits. The NBU pursued no interest rate policy, issuing most credits at a subsidized rate of 20 percent per annum, a huge negative real interest, rendering any loan from the NBU a state subsidy.

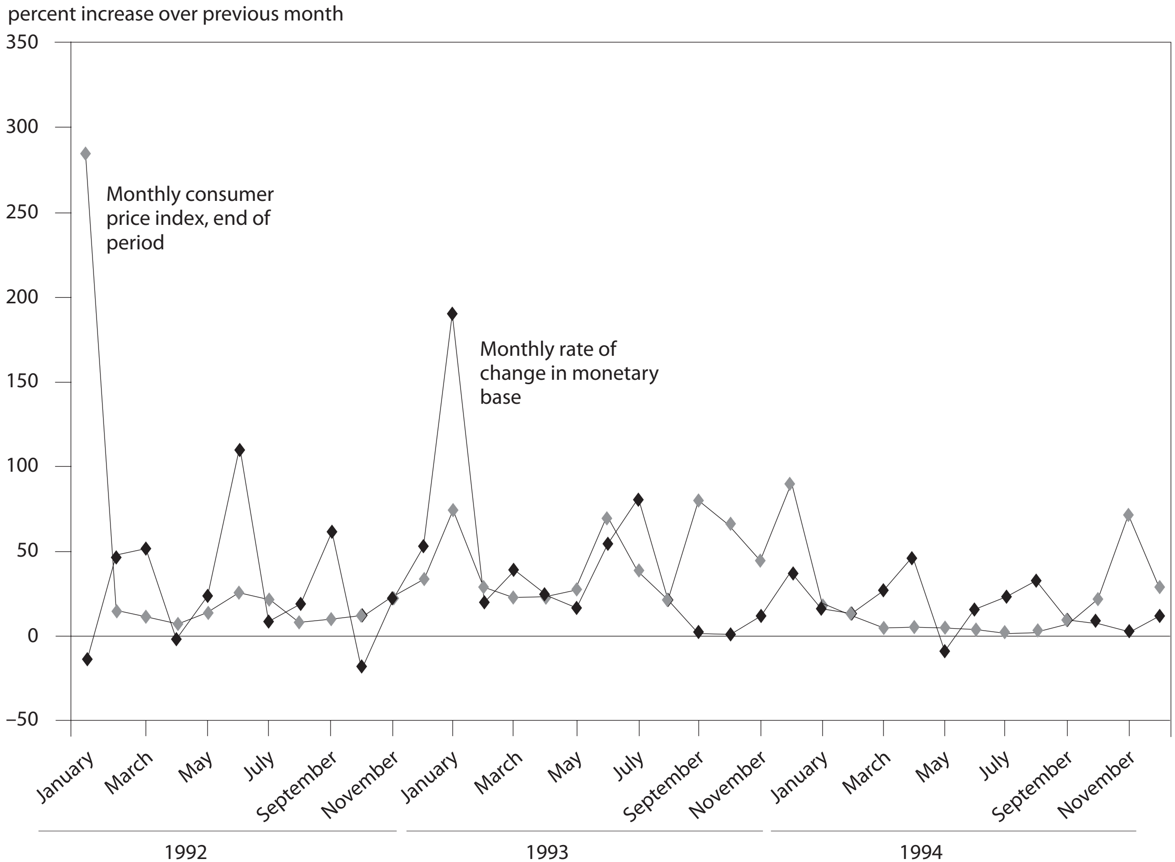
13. Major sources to this section are Dabrowski (1994) and De Ménil (1997, 2000).

Figure 2.2 Underground economy, 1989–95



Source: Johnson, Kaufmann, and Shleifer (1997, 183).

Figure 2.3 Monthly inflation and monetary expansion in Ukraine, 1992–94



Source: National Bank of Ukraine, State Statistics Committee of Ukraine online database, www.ukrstat.gov.ua (accessed on August 31, 2007).

When Ukraine was forced to liberalize prices in January 1992, prices skyrocketed, which led to demonetization, as the volume of money in relation to GDP fell sharply. The velocity or speed of circulation of coupons (*karbovantsy*) increased because nobody wanted to hold money and thus pay the inflation tax. By 1996, broad money had shrunk to a miserly 8 percent of GDP, about one-tenth of what it had been in late Soviet days.

The predominant post-Soviet view was that real money supply had to be restored, which justified massive new emissions. Large interenterprise arrears piled up, because the payment system was rudimentary and enterprises had no incentive to pay in the absence of bankruptcy or other penalties. The NBU periodically cleared the arrears through additional issuance of money. The biggest peaks in the issue of base money occurred in June 1992 (110 percent) and January 1993 (191 percent). Every summer, the agriculture lobby demanded and received large subsidized credits to finance the harvest. The rational response would have been to minimize the issue of money to achieve financial stabilization.[14]

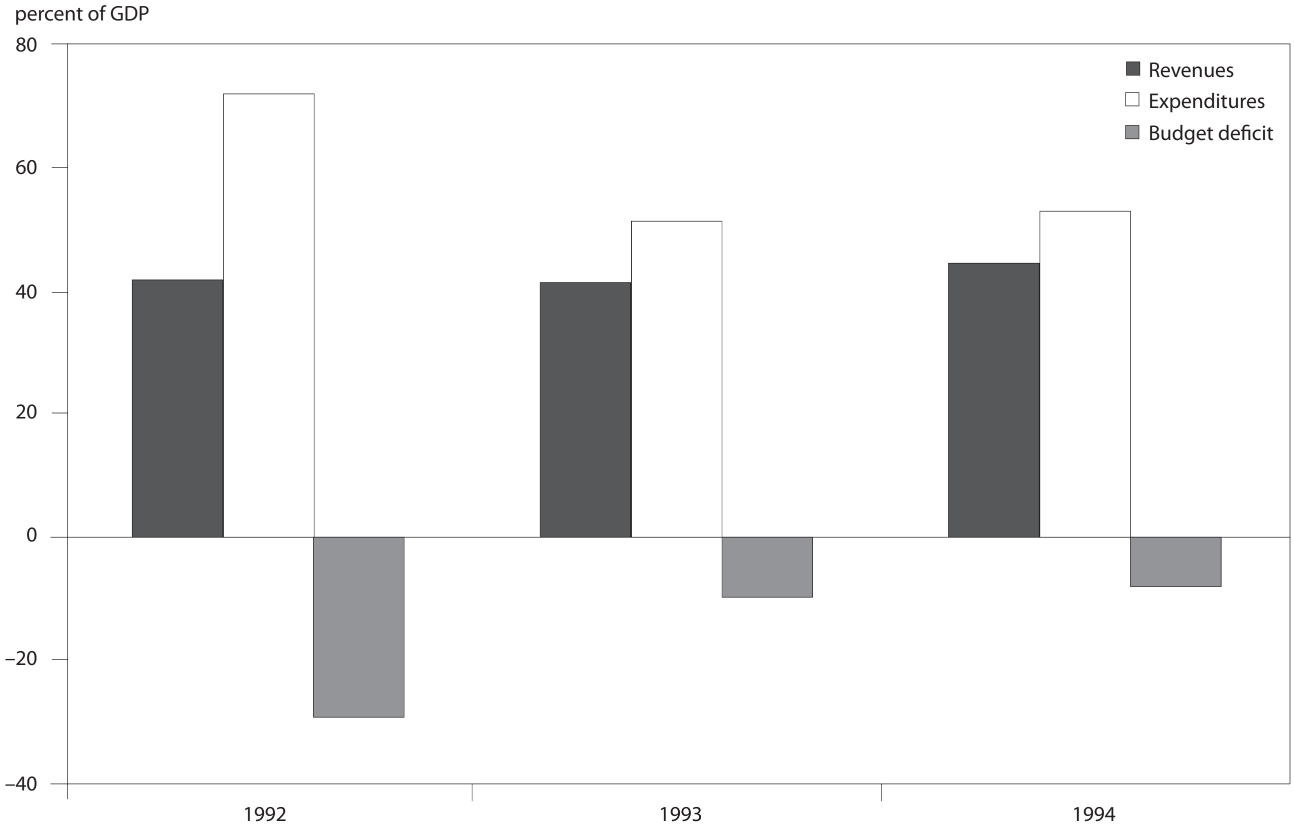
Ukraine started off with a colossal budget deficit without any constraint on public expenditures. The Ministry of Finance was very weak in the Soviet system, being the state accountant rather than a policymaking unit. It did not have full financial oversight and it was not supposed to deny expenditures. A large number of extrabudgetary funds, such as the Chornobyl Fund, the Pension Fund, the Social Insurance Fund, and the Road Fund, had revenues and expenditures beyond the purview of the ministry. The ministry remained inordinately weak for many years, as the main reformers tended to be a deputy prime minister for the economy and the minister of economy rather than the minister of finance, which was the case in most other transition countries.

State finances were nothing but chaotic. Ukraine had adopted a law on its budget system in December 1990, but budgeting was irregular and the parliament disregarded the state budget. It spontaneously ordered huge additional expenditures, mostly subsidies to industry and agriculture. Under the unclear constitutional arrangement, the government could hardly refuse expenditures. Initially, the lone voice of budget restraint was Deputy Prime Minister Lanovyi, for which he was quickly sacked. The parliament adopted the budget for 1992 as late as June that year and the budget for 1993 in April 1993 (Dabrowski, Luczyński, and Markiewicz 2000).

The 1992 budget prescribed a deficit of 2 percent of GDP, but the parliament added a variety of expenditures, expanding the deficit to an untenable 29 percent of GDP (figure 2.4). It was financed through the issuance of money, breeding hyperinflation. Officially, the budgets for 1993

14. See Banaian (1999, 43–44), Dunn and Lenain (1997, 41–42), Rostowski (1993, 1994), and Sachs and Lipton (1993).

Figure 2.4 Ukraine's total state revenues, expenditures, and budget deficit, 1992–94



Source: Dabrowski et al. (2000, 126–27).

and 1994 were close to balance but only because of absurd assumptions of increased revenues. The budget for 1994 was officially balanced with revenues and expenditures reaching 86 percent of GDP. This would have been by far the highest in the world. When the illusory revenues did not materialize, Deputy Prime Minister Pynzenyk started sequestering expenditures, withholding payments for all but the most urgent aims. As a consequence, wage and pension arrears became a bane of the 1990s but often the real reason was that enterprise managers took the opportunity to blame the state and refused to pay their workers the wages they had earned (Banaian 1999; Dabrowski, Luczyński, and Markiewicz 2000).

A wide expectation was that Ukraine's state revenues would collapse with the Soviet system and hyperinflation. Oddly, total state revenues stayed nearly constant at 41 percent of official GDP in 1992 and 1993 and rose somewhat in 1994. The main explanation was that state enterprises paid most of the taxes, from which state banks collected taxes in advance. Another reason was statistical: Official GDP was only half of the real GDP, since the tax system had driven half the economy underground.

The most important taxes in the Soviet system had been a payroll tax of 38 percent, a sales tax that varied by good, a high corporate profit tax, and foreign trade taxes, while personal income taxes were tiny at a flat rate of 13 percent. The old turnover tax had to be changed with partial price liberalization, and a very high value-added tax of 28 percent was introduced as in Russia, but it was perforated with loopholes, exempting agriculture, energy, and services. The flat personal income tax was replaced with ever higher progressive income taxes, which peaked at 90 percent in early 1994 for as modest an income as $100 a month. The payroll tax was increased for various social purposes to a total of 60 percent. The profit tax was replaced by a corporate gross income tax, which in effect became confiscatory because no deductions were allowed (Dabrowski, Luczyński, and Markiewicz 2000, 121–23).

Ukraine had established a tax system that was formally confiscatory, but two escape routes existed. One was huge loopholes and the other was massive tax evasion. Needless to say, nobody paid these confiscatory taxes. As a countermeasure, Ukraine built a formidable State Tax Administration, which soon employed 70,000 people. It was to become the independent fiefdom of the Donetsk politician Mykola Azarov and a state within the state. It was considered massively corrupt and became a major impediment to business.

Ukraine's foreign trade remained quite limited in absolute terms and concentrated on the former Soviet republics, but in 1992 exports alone were actually larger than the deflated GDP, which was as small as $10 billion in current US dollars in 1992.[15] Trade was patently imbalanced, but

15. EBRD online database, www.ebrd.com (accessed on July 1, 2008).

the deficit was limited by the absence of financing since Ukraine was not creditworthy.

Rent Seeking: Rationale of Ukraine's Early Economic Policy

There was reason for this madness.[16] The small communist elite remained in power and designed the postcommunist transition to make money on economic distortions (Åslund 1996, 1999; Hellman 1998; Shleifer and Vishny 1998). To maximize their rents, they needed a slow transition. Much public attention was devoted to the country's excessive dependence on Russia, while the harmfulness of the inherited communist economic system, though universally recognized, attracted little public interest.

Radical reforms were initially discarded as characteristic Russian rashness, incompatible with Ukrainian peacefulness and moderation. As a manifestation of the Ukrainian state, a cumbersome bureaucracy and regulatory system were being built. These conditions bred severe corruption and rent seeking. In particular, the Zviahilskiy government maximized its personal revenues by intentionally introducing cumbersome foreign trade regulations. A mixture of state enterprise managers, new entrepreneurs, government officials, commodity traders, bankers, and outright criminals thrived on the resulting extraordinary rent seeking. From 1991 to 1993 four forms of rent-seeking dominated.

The first method was to buy metals and chemicals at home, where their prices were kept low through price regulation, and sell them abroad at the world market price. This required access to metals and export permits. In 1992 about 40 percent of Ukraine's exports were commodities (IMF 1993, 113), and their average domestic price was about 10 percent of the world market price. Hence, the total export rents amounted to some $4.1 billion, or 20 percent of the country's GDP in 1992. The beneficiaries were managers of state metallurgical companies, commodity traders, foreign trade officials, and some politicians.

The second trick was to import certain commodities, notably natural gas from Russia at a low subsidized exchange rate, and resell them at a higher domestic price. If the government paid for the deliveries because of state guarantees for gas imports, it was even more profitable. The beneficiaries were a small number of gas importers and their government partners, who shared the profits with their Russian partners in Gazprom.[17]

The third way was subsidized credits. In 1993, when Ukraine experienced 10,155 percent inflation, huge state credits were issued at an

16. This draws on Åslund (2000).

17. We lack the numbers for an estimation for these early years.

interest of 20 percent a year. State credits were therefore sheer gifts, given to a privileged few. Net credit expansion to enterprises was no less than 65 percent of GDP in 1992 and 47 percent of GDP in 1993 (calculated from IMF 1993, 109; IMF 1995, 73, 105).

The fourth form of rent seeking was straightforward budget subsidies, which amounted to 8.1 percent of GDP in 1992 and 10.8 percent of GDP in 1993. They were concentrated on agriculture and energy, that is, gas and coal, which became totally criminalized by a struggle over these subsidies (IMF 1995, 94).

In comparison with Russia, export rents were lower, import rents much higher, subsidized credit significantly larger, and direct enterprise subsidies about the same. In total, these Ukrainian rents approximately equaled Ukraine's GDP compared with Russian rents, which equaled 81 percent of GDP in Russia in 1992; rents were higher in Ukraine than in Russia in 1993 as well (Åslund 1999). These rents were largely accumulated abroad in tax havens through capital flight.

In this way, a small group of privileged insiders usurped a huge share of GDP in the early years of transition and grew even stronger. Their wealth was not based on property but on arcane financial flows. For society, the result was untold social suffering and sharply rising income differentials. Ukraine reached a Gini coefficient of 47, about as much as Russia or the Latin American average (Milanovic 1998, 41).

By 1994 the social consequences were becoming untenable, and the very cohesion of Ukraine was in danger, as it was approaching state bankruptcy. In 1994 the US Central Intelligence Agency (CIA) even issued a shocking National Intelligence Estimate entitled "Ukraine: A Nation at Risk," postulating that Ukraine might fail as a state and that there might be no Ukraine in 5 to 10 years (Pifer 2004). Moreover, the inflation tax no longer benefited rent seekers, as it had declined with demonetization (Åslund, Boone, and Johnson 1996). The rent-seeking elite started accepting the idea of low inflation and could contemplate financial stabilization.

Crimea: Threat of Secession

Ukraine had a few border territories on the west and the east that could claim special national treatment, but the only region that aroused serious concern was Crimea, which was the newest Ukrainian territory and completely Russified.

Crimea was the ethnic homeland of the Crimean Tatars, whom Stalin deported collectively to Central Asia in 1944 for alleged collaboration with the Germans. In 1954 Nikita Khrushchev transferred Crimea from the Russian Soviet Federated Socialist Republic to the Ukrainian Soviet Socialist Republic to celebrate the 300th anniversary of Ukraine's union with Russia. Russians saw this as capricious extravaganza, especially as Crimea was the favorite Soviet vacation spot and entirely Russian speaking. Before the collapse of the Soviet Union, the Soviet authorities allowed Crimean Tatars to return, and soon a quarter of a million arrived. For tactical reasons, the Crimean Tatars joined hands with Ukrainian nationalists, since their common enemy was Russian nationalism.

Russian nationalists who controlled the regional Crimean council exploited the approaching collapse of the Soviet Union. In November 1990 this council condemned Crimea's 1954 transfer to Ukraine. In January 1991 they organized a referendum that raised Crimea's status from autonomous oblast to an Autonomous Soviet Socialist Republic, which the Ukrainian parliament confirmed.

The referendum on Ukraine's independence on December 1, 1991, however, was a big blow to the Russian nationalists, since 54 percent of the residents on the peninsula voted for Ukrainian independence and even 57 percent in Sevastopol, the base of the Soviet Black Sea Fleet (Kuzio 2000, 202–24).

Yet, the Russian nationalists continued to strengthen Crimea's autonomy in several small steps. Its regional council declared Crimea a republic, announced self-government, and adopted a constitution. These events were spread out, and the Ukrainian government and parliament fought each step. The Russian nationalists in Crimea were also held back by the lack of official Russian support, as Yeltsin insisted on the inviolability of the borders of the former union republics.

As the Ukrainian economic crisis deepened, the Russian nationalists were reinvigorated and instituted the post of president of Crimea, and on January 30, 1994, pro-Russian Yuriy Meshkov was elected the first president. He invited a group of relatively liberal Russian economists from Moscow to operate his government and intensified Crimea's ambitions at ever greater autonomy. Curiously, Meshkov entered into endless quarrels with the Crimean parliament like Kravchuk with the Ukrainian parliament, but Meshkov went too far by disbanding the Crimean parliament.

Deftly, the Ukrainian government waited for the locals to fail to govern Crimea. The Crimean economy fell into complete chaos and criminalization, while in late 1994 Ukraine launched financial stabilization, making Crimea look more dysfunctional. In March 1995, on President Kuchma's initiative, the Ukrainian parliament scrapped the Crimean constitution as well as the post of president of Crimea. The peak of Crimean separatism was over, and it was brought under control. After Crimean separatism had been contained, all other separatist aspirations looked all the more futile. Ukraine had secured its integrity, even though Russian nationalists have remained active with steady support from some Russian politicians, notably Moscow Mayor Yuriy Luzhkov.

Kravchuk: Father of the Nation

After his election defeat in July 1994, Kravchuk and his staff departed without protest from the presidential administration, which was located in the old Central Committee building on Bankova. This was Ukraine's first democratic transition of power. Kravchuk remains a public personality in Kyiv, sometimes a centrist member of parliament. His achievements and failures can be summed up in five points.

First, as Robert Kravchuk (2002, 58; no relation) notes, President Kravchuk deserves to be called the Father of the Ukrainian Nation. He convinced 90 percent of the population to vote for independence, and he was elected new Ukraine's first president. He managed to take Ukraine out of the Soviet Union peacefully and swiftly.

Second, Kravchuk instigated Ukraine's denuclearization in agreement with Russia and the United States, and he prepared the ground for international guarantees of Ukraine's national sovereignty.

Third, Kravchuk failed to improve Ukraine's dysfunctional Soviet constitution. The rising tensions between president, prime minister, and the capricious, disorganized parliament rendered Ukraine close to ungovernable. However, Kravchuk did not undermine democracy and freedom and set a high democratic precedence by leaving power without protest.

Fourth, economic policy could hardly have been more disastrous. No postcommunist country was hit by such hyperinflation and such a huge decline in output without war as Ukraine. This enormous cost was brought upon the Ukrainian population for no good purpose. No market economy was built, and a sheer minimum of privatization was undertaken. An entrenched machine of rent seeking was established.

Fifth, the economic collapse was so severe that it threatened the nation's integrity. The worst specter of secession was Crimea's attempt in 1994. It failed because Boris Yeltsin opposed separatism and Crimea's economic failure was even greater than Ukraine's.

Ukraine had become independent peacefully, but for it to be a viable state, the constitutional order and the economic system had to be fixed. Kravchuk lacked the ability to fix these problems, but to his great credit he bowed out after losing the presidential elections in July 1994.