
Introduction

I visited Ukraine for the first time in October 1985 to attend an economics conference at the State Planning Committee in Kyiv organized by the United Nations. Coming from Moscow, Kyiv made a very nice impression on me. It was greener, cleaner, and more orderly. In the evenings, people strolled around Khreshchatyk, the main street, and they were surprisingly friendly compared with the rude and rough Muscovites. Although people predominantly spoke Russian in the street, one instantly felt that this was another country. I enjoyed the pleasant atmosphere and intriguing society and have returned numerous times.

The drawback, however, was that Kyiv was isolated from the outside world and provincial. People turned around in the street at the sight of a foreigner. The Ukrainian economists were renowned as the most orthodox Marxist-Leninists in the Soviet Union. The intellectual night was deep. A peculiarity was that Ukraine had the liveliest religious life, with more active churches than any other part of the Soviet Union.

Today, everything has changed. One of Europe's old nations steeped in history, Ukraine is now an unquestioned independent nation and an open society. All Westerners can travel to Ukraine without a visa. It is the largest purely European country by size and the fifth largest by population.

This book offers a political and economic history of Ukraine from 1991 until 2008 meant to be accessible to a wide range of readers. It focuses on how and why key policies were made. At the time of its writing, it is the only book covering the whole period of Ukrainian independence that discusses both politics and economics. I hope it contributes to the understanding of what happened in Ukraine after 1991.

Main Arguments of the Book

Ukraine's postcommunist transition has been one of the most protracted and socially costly, but it appears to have taken Ukraine to a desirable destination. I offer below a brief summary of the main arguments in this book.

No Revolution, but National Independence

"Ukraine is not Russia," as President Leonid Kuchma (2003) named his book, is an insight that is as simple as it is profound. Unlike Russia, Ukraine did not experience a revolution when the Soviet Union collapsed. For Ukraine, the all-dominant goal was national liberation and nation-building, which was spearheaded by Ukrainian nationalists, the Ukrainian communist establishment, and the Soviet collapse. Russia, by contrast, needed to abandon its empire, while going through a liberal revolution against communism. Though similar in many ways, these two countries encountered completely different challenges, so their transformations had to be different.

On the one hand, it meant that Russia did more market economic reform at an early stage, which limited its social costs of transition. On the other hand, Ukrainians were prepared to accept higher social costs because their project was to build a nation, while the Russians had to reconcile themselves with the loss of empire.

Ukraine's Main Goal Was Nation-Building

Ukraine's aim was the building of a Ukrainian state and nation. Since it is a large state with a thousand-year history, this was a natural choice for the vast majority of the population. The Ukrainian nation builders were acutely aware of prior failures. The Ukrainian Cossack autonomy of the 17th century never resulted in an independent state. From 1917 to 1920, the burgeoning Ukrainian nation had several governments, which were all rash and radical, but the state succumbed to the Red Army. This time, national unity was crucial, which meant that the dominant groups had to be accommodated to accept the new independent state.

Therefore, the new Ukrainian state was formed by an alliance of Ukrainian nationalists organized in Rukh mainly in the west and Kyiv, national communists led by Leonid Kravchuk, and pragmatic state enterprise managers headed by Leonid Kuchma. The formation of this broad alliance had many consequences. Nearly the whole population was mobilized for the new nation: Over 90 percent of Ukrainians voted for independence on December 1, 1991, and separatism was surprisingly subdued.

The broad unitary approach of nationalism allowed a certain emphasis on the revival and extension of the Ukrainian language, but Russian

and various minority languages were respected. Democracy-building, though, was put on the back burner. Initially, economic reform was sacrificed altogether. The nationalists thought Ukraine's main economic problem was exploitation by Russia, which would cease with Ukraine's independence. They did not realize that the main stumbling block was the inefficient Soviet economic system, because discussion of economic reform before independence was rudimentary. The national communists preferred to rule in the old way, while the state enterprise managers used new opportunities to enrich themselves.

Kravchuk led Ukraine during the most intense phase of nation-building. He was a jovial man who moved with amazing ease from the top of the Communist Party of Ukraine to become the new nation's first democratically elected president. His strength was his ability to find a consensus among people with little in common, while his weaknesses were an inability to act and a lack of intellectual clarity.

Ukraine Has Maintained a Strong Emphasis on Peace

Ukraine's independence has been remarkably peaceful for many reasons. The attempts at independence from 1917 until 1920 were foiled by blood. The many Ukrainian nationalists who had fought independently in World War II achieved nothing. The Soviet Empire imploded on its own, arousing no need for military action. Russian President Boris Yeltsin peacefully dissolved the Soviet Empire from within and guaranteed the existing borders between the Soviet republics.

The new Ukrainian nation had no reason to resort to violence and every reason to avoid it. In addition, the meltdown of the Chernobyl nuclear power station just north of Kyiv on April 26, 1986 convinced a broad Ukrainian opinion to oppose nuclear arms and opt for the new nation's denuclearization. Peacefulness became a source of national pride.

The Long Delay in Economic Reforms Led to Hyperinflation, Extreme Rent Seeking, and Output Collapse

In the early 1990s the government ignored economic policy. As a consequence, Ukraine was hit by hyperinflation of 10,155 percent in 1993, suffering the greatest official decline in output of any country not ravaged by war. Total confusion prevailed in economic policy.

The little thought devoted to economic policy derived from nation-building and took exception to Russia's attempt at radical economic reform. In order to strengthen the Ukrainian state, the National Bank of Ukraine was established, but it started issuing virtually unlimited amounts of ruble credits at low interest rates, which guaranteed hyperinflation. In another attempt to strengthen the Ukrainian state, a state-controlled Soviet-

type foreign trade system was established, replete with quotas and licenses. For a few years, the prices of Ukraine's main export goods—steel, chemicals, and agricultural goods—were kept at a fraction of the world market price. Traders with good official connections made fortunes on privileged arbitrage between low domestic prices and high world market prices.

The greatest boondoggle was the importation of natural gas from Russia, whose natural gas monopoly, Gazprom, exported gas at low prices to an intermediary trading company, which shared its ample profits with top Russian officials and Ukrainian gas traders. The names of the intermediaries and beneficiaries varied, but gas trade was the dominant revenue source of the truly rich in Ukraine throughout the 1990s.

The long delay in market reforms generated no benefits. This made it more difficult to carry out market reforms because the vested interests that thrived on rent seeking had grown so strong that they were almost invincible. Since the most successful businessmen made their money by rent seeking, they ignored production. Officially, output continued to fall until 2000. Only after a full decade were the main sources of rent seeking blocked, and economic growth reemerged. The economic crisis caused social disruption through the miners' strikes in the summer of 1993 and also prompted the only serious secessionist threat in Crimea in 1994. The sustainability of the Ukrainian state was widely questioned because of its miserable economic performance. Ukraine's delayed economic reforms could have destroyed the budding state.

President Leonid Kuchma Brought about Financial Stabilization and Privatization, but Not Growth, in the Mid-1990s

The election of Leonid Kuchma to president in July 1994 offered Ukraine a badly needed break. Initially, Kuchma focused on salvaging the country from the rampant economic crisis. He advocated a normal market economy with private property and stable prices.

His first goal was to defeat inflation, which turned out to be the easiest task. The foundation stone was Ukraine's first International Monetary Fund (IMF) agreement, which was concluded in October 1994. Inflation never rose to triple digits again.

A second major achievement in the early Kuchma period was a successful program of mass privatization. As a consequence, since 1996, most of Ukraine's GDP has come from the private sector.

While these two reforms were successful, deregulation of prices and trade remained insufficient and was substantially reversed after a couple of years by the strong vested interests that lived on arbitrage between regulated and free prices, especially in the energy and commodity sectors. A market economy of sorts emerged, but it was hampered by red tape. Thus, rent seeking persisted and precluded economic growth. Ukraine

was stuck in an underreform trap until 2000. Palpable corruption and the absence of growth provided fertile ground for communist agitation against a normal market economy. Ironically, both oligarchs and communists favored excessive regulation and state subsidies to enterprises, jointly blocking market reforms and economic growth.

Viktor Yushchenko's Reforms in 2000 Moved Ukraine from Rent Seeking to High Growth and Completed the Market Economy

At the end of 1999 the dominant oligarchs became truly worried. Ukraine faced an evident danger of external default, and Russia's financial crash of August 1998 had devastated many Russian oligarchs. They saw only one way out: Ukraine needed a reform government that could salvage the country. Therefore, a broad coalition of center-right party factions came together in parliament and appointed as prime minister the well-respected chairman of the National Bank of Ukraine, Viktor Yushchenko. In a few months, his government cleaned up Ukraine's state finances and energy trade. It also undertook several large privatizations and significant measures against corruption. As a consequence, Ukraine swiftly turned to high and steady economic growth. Yet the old establishment paid the price of the new economic growth. Upset over the elimination of so many rent-seeking schemes, it ousted the Yushchenko government in April 2000.

The European Union recognized Ukraine as a market economy in December 2005 and the United States did so in February 2006. In their antidumping legislation, the United States and the European Union define market economies in a similar fashion as the opposite of state-trading countries. The US Customs Code defines a nonmarket economy as "any foreign country that the administering authority determines does not operate on market principle of cost or pricing structures so that sales of merchandise in such a country do not reflect the fair value of the merchandise."¹ In making that assessment, the US Department of Commerce considers six criteria: (1) currency convertibility; (2) free bargaining for wages; (3) the "extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country"; (4) the "extent of government ownership"; (5) the "extent of government control over the allocation of resources and over the price and output decisions of enterprises"; and (6) other appropriate factors.

For the purposes of this book, however, the definition above is too slanted toward trade to be adequate. A market economy is best understood as the opposite of a socialist economy, as János Kornai (1992, 360–79) outlined it. First, the economic actors must be independent from the state

1. United States Code [19 U.S.C.1677(18)], available at the US Government Printing Office website, www.access.gpo.gov (accessed on August 9, 2007).

and act freely without state commands. Second, private ownership of enterprises should dominate, and property rights need to be reasonably safe. Third, prices and trade should be predominantly free, and fourth, state subsidies must be limited. A fifth criterion could be that transactions are largely monetized. Price stability, however, is not a condition. None of these criteria is absolute because all states distort their economies somewhat (Åslund 2007b). Ukraine attained these standards and became a market economy in 2000.

Competitive Oligarchy Bred High Growth and Pluralism

The Yushchenko reforms created a market economy and went far enough to become irreversible. After his departure, similar policies persisted. A new market economic consensus had been formed.

As a consequence, the oligarchs—as the few very wealthy were popularly called—changed qualitatively. Until 1999, all the richest people in Ukraine made their money on gas trade, but from 2000 on, they became steel producers. The country had traversed the crucial hurdle from arbitrage to export production. The oligarchs were no longer courtiers who made their money on intrigues in the corridors of power, but owners of large factories with well-defined and lasting interests. Their specialization allowed new big businessmen to evolve in other industries, such as machine-building, banking, retail trade, real estate, and agriculture.

Ukraine remained an oligarchic state, where a club of big businessmen dominated the government, parliament, and media, but intense competition prevailed among them. Their focus was no longer state subsidies but the privatization of lucrative companies and their production. The more private property rights were accumulated, the stronger was the political support for property rights.

Major oligarchs had their own factions in parliament to further their causes. Their competition was not fair but vibrant, and it bred pluralism and high economic growth. While this system was corrupt and unjust, it represented a considerable advance from the parasitical rent seeking and continuous decline of the 1990s. Power was not consolidated but divided.

The Orange Revolution Represented Ukraine's Democratic Breakthrough

The Orange Revolution of December 2004 was Ukraine's moment of euphoria. After many years of semidemocratic rule, the nation achieved its democratic breakthrough. All desirable underlying conditions had accumulated. Thanks to impressive economic dynamism, breeding greater pluralism, Ukraine had outgrown its semidemocratic system. The business elite was divided through increased competition and rebellious big

businessmen could persevere. As a consequence, the millionaires rose against the billionaires. The divisions among the business elite were also reflected in law enforcement.

The March 2002 elections had given the opposition about half the seats in parliament, providing it with a strong, legal platform. As head of the largest opposition party, Our Ukraine, Yushchenko was its leader. Although the regime controlled most media, the opposition possessed a minor TV channel, several serious weekly newspapers, and excellent internet news. Civil society developed a strong nongovernmental organization to monitor the presidential elections, and when the election rules were tampered with, over a million people took to the streets. European politicians intervened at roundtable negotiations to maintain peace and reach a compromise.

The Orange Revolution brought about a neat democratic breakthrough and peace was maintained. The existing rules were accepted by all parties and were judged by Ukraine's highest courts. In the end, orderly presidential elections were held and their outcome was respected. The winner did not take all but left the vanquished side intact. An agreement was reached on a new constitutional arrangement. Thereby Ukraine complied with Juan Linz's (1978, 5) definition of democracy:

Legal freedom to formulate and advocate political alternatives with the concomitant rights to free association, free speech, and other basic freedoms of person; free and nonviolent competition among leaders with periodic validation of their claim to rule; inclusion of all effective political offices in the democratic process; and provision for the participation of all members of the political community, whatever their political preferences.

Yet there were two serious institutional shortcomings. First, the democratic breakthrough should have been immediately followed by a parliamentary election that reflected the profound political transformation. Instead, politics became one long election campaign lasting until the parliamentary elections already scheduled for March 2006, and the revolutionary momentum was never used for reforms.

Second, the constitutional changes reduced the powers of the president but did not go far enough to create a viable parliamentary system. The new constitutional order was so inconsistent that the country became nearly ungovernable. Severe conflicts between the president and prime minister led to frequent government changes, early parliamentary elections, and minimal legislative activity.

Is Ukraine Moving toward a Parliamentary System?

Ukraine's political system has evolved very gradually. It started out as a dysfunctional post-Soviet system comprising a sovereign parliament and

an equally sovereign president, with an indeterminate prime minister hanging in between.

The electoral system to the parliament has been transformed in steps from one-man constituencies with majority election to purely proportional elections with a threshold for representation of 3 percent of the votes cast. Considering the notorious sale of seats on party lists, personal choice within a proportional system would be a positive evolution.

The distribution of power between president and prime minister has always been problematic. At present, the president has minimal power to be constructive but plenty of power to block decisions, as he mainly exercises power through his veto. In Ukraine, as in other post-Soviet countries, the presidential administration resembles the Central Committee of the Communist Party, in whose buildings it is housed. The presidential administration has reproduced the “telephone rule,” with officials giving oral commands beyond any legal order, which was characteristic of communist parties.

A persistent gridlock might be bearable if the existing legislation were appropriate, but Ukraine needs to adopt scores of new laws to establish normal rule of law. Therefore, a functioning legislature is vital. Given that the presidential system has never worked well, a transition to a full parliamentary system appears desirable. Parliamentary control facilitates transparency and accountability, which Ukraine needs to combat pervasive corruption. Not surprisingly, democracy and parliamentary rule are closely correlated in postcommunist countries. Yet the president may stay popularly elected, as in the parliamentary systems of Finland and Lithuania.

Also, at the regional and local levels, no clear division of power exists between councils and executives. Ukraine still suffers from extreme overcentralization characteristic of communism. Regional and local councils, as well as mayors, are elected, while regional governors are appointed. Logically, they should all be popularly elected. As a matter of both democracy and efficiency, regional and local governments should also be allowed to raise their own taxes and be responsible for their own expenditures rather than being subject to detailed tutelage by the central state administration.

Ukraine Is Turning to the West

Ukraine is increasingly turning to the West rather than to Russia. Russian President Boris Yeltsin tried to accommodate Ukraine and maintain friendly relations. He always expressed his respect for Ukraine’s borders and independence. In response, President Kuchma developed his “multi vector” foreign policy, oriented to both the West and Russia. Ukraine participated in the post-Soviet Commonwealth of Independent States (CIS)

as well as the Council of Europe. The high point of Russia-Ukraine cooperation was reached in 1997, with the Treaty on Friendship, Cooperation and Partnership and the agreement to lease the naval base in Sevastopol on Crimea to Russia for 20 years.

President Vladimir Putin broke with Yeltsin's policy of respect for Ukraine's sovereignty, making his infamous statement in April 2008 that "Ukraine is not even a state." The peak of Russian interference in Ukraine occurred during the presidential elections in the fall of 2004 that prompted the Orange Revolution, compelling Ukraine to turn to the West. Putin's ensuing aggressive policy has driven Ukraine further in that direction. Russia is Ukraine's only security threat, leaving it with little choice but to seek closer relations with the West.

On May 16, 2008, Ukraine became a member of the World Trade Organization (WTO), which is set to mold its trade policy. It is already negotiating a European Association Agreement with the European Union, which will include a wide free trade agreement. The United States should follow suit.

Russia, by contrast, has erected so many trade barriers that the share of trade between the two neighbors has declined. The basis for trade between Russia and Ukraine is a bilateral free trade agreement concluded in 1993, but it is impotent because it lacks arbitration and enforcement mechanisms, and Russia has failed to join the WTO. Ukraine did accept the Russian Common Economic Space initiative of 2003, but it was stillborn because Russia demanded more ambitious cooperation than Ukraine could accept. Repeated squabbles over gas trade and multiple Russian import embargoes on Ukrainian agricultural goods and steel pipes have harmed bilateral trade.

Commercial interests are increasingly attracting Ukraine to the European market. If Ukraine complies with the strict criteria of the EU legal rule book, the *acquis communautaire*, the European Union can hardly refuse Ukraine membership in the long term because the EU founding document, the Treaty of Rome, guarantees all European countries the right to apply for EU membership, and the recent EU eastern enlargement has clarified the rules and procedures for accession.

Structure of the Book

The structure of the book is chronological-thematic. It consists of seven chronological chapters, one chapter of background, and one concluding chapter with overall analysis. Within each chronological chapter, the main themes are analyzed in sections.

Chapter 1 provides Ukraine's background, discussing implications of its history, the awakening of society because of Mikhail Gorbachev's reforms, the early democratization, and the impact of the ill-fated Soviet

economic reforms. Chapter 2 discusses the reign of President Leonid Kravchuk from 1991 to 1994. The only salient achievement of this time was nation-building, while the economy collapsed in the midst of hyperinflation. Chapter 3 deals with the first two years of Leonid Kuchma's presidency, from 1994 to 1996, which were characterized by substantial achievements, notably financial stabilization and mass privatization. Chapter 4, which covers the period 1996–99, is devoted to a miserable period of policy stagnation, rent seeking, and continued economic decline. In 2000 hope returned to Ukraine, as discussed in chapter 5. Viktor Yushchenko became prime minister and launched energetic reforms to cleanse the economy of corruption. Finally, economic growth returned. Chapter 6 considers the ensuing period, 2001–04, which amounted to a competitive oligarchy. It was quite pluralist, although repression increased. Economic growth was high. Chapter 7 is devoted to the Orange Revolution of 2004, which was the most joyful period, representing Ukraine's democratic breakthrough. Chapter 8 discusses the confusing period after the Orange Revolution, which has been characterized by great political instability but also democracy and a broadening social consensus. Chapter 9 offers major conclusions.

Transcription is a major problem when writing about Ukraine. Most people use both Ukrainian and Russian versions of their names, and they use both languages to various extents. Similarly, all places have both Ukrainian and Russian names. I have attempted to use Ukrainian names and transcription unless it becomes odd or outright confusing. There are no agreed transcription rules from Ukrainian to English, so I try to use the most common standards. The variations are considerable, and I have taken the liberty of standardizing the transcription of names of authors in the bibliography, even when they have been transcribed differently, so that all works by one author are found in one place.