

# UKRAINE: THE ECONOMY AS A SOURCE OF INSECURITY

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## **State of Affairs**

The continuous 10 year economic decline in Ukraine has already caused devastating effects on the quality of life and the prospects for democracy and security. The severe overall macro-economic instability, the slow pace of reforms, weak institutions, the domestic and international debt burdens, a dominant informal sector and crime were already linked into a vicious circle that is difficult to break out of. The absence of the rule of law, checks and balances (civil society), competition and a social safety net represent a severe constraint for both economic and social development in this country, where decapitalisation of assets and human resources, increasing poverty and declining life expectancy create a potential for social tension and unrest.

Official statistics reveal figures of devastation that would suggest that social unrest is almost there, though a closer look at reality shows that a number of hidden buffers still keep society in peace. Indeed, to many people's surprise, Ukraine has not collapsed although official statistics would suggest that it should have done.

Keeping society "intact" in relative terms is partly a reflection of unreported incomes and resources - the proverbial cash in the mattress - to which many people turn in dire circumstances. This implies that the free market is in reality stronger than it might seem on the surface, though not yet strong enough to make it on its own, to become an efficient and dominant reallocator of resources. Its gains have been won against tremendous odds such as unfair competition, prohibitive taxation/regulation and an unreliable financial system.

Therefore, it would be premature to assess the economy and its potential only on the basis of registered data. It would be equally wrong to ignore the important role of the large shadow sector as a second-best core of the economy and as an essential social buffer providing income to otherwise "statistically" dead segments of the population. To this end, before ensuring an environment where a formal economy could survive, it would be counterproductive to fight against the informal sector because it performs an important role of a social buffer - a role that the state is no longer able to ensure.

## Some Brakes on Stabilisation

Considering this rather desperate state of affairs uncovers some urgent issues that need to be addressed:

- Current economic disequilibria, combined with crime, highly uneven distribution and devastating living conditions result in a widespread belief that life before transition was better and that apparent “democracy” and “market” produce no good for society. Hence, the danger of (already apparent) opposition to both a market economy in principle and the reforms needed to achieve it. Contrary to widespread perception, the transformation process is neither irreversible nor desired by the public. The cost of transition is clearly not bearable at extremely low levels and Ukraine may have reached a level that cannot be sustained. As a result, vanishing hopes and energy shortages could result in social unrest and violence, which can easily invite new dictatorships and kill democracy before it was born. This does not mean that the people of Ukraine should not pay the cost of a still painful and misleading transition. They have to pay this cost, but a defaulting borrower (as Ukraine is) has to search for compromising win-win solutions where both “creditors” and “borrowers” are better-off compared to a straightforward default of a bankrupt borrower that has to go to jail. Contrary to the old Austrian saying that “the situation is hopeless, but not serious”, one should note that the situation is indeed serious, but not hopeless. Not yet.
- Having a legacy of rigid dictatorship, the people of Ukraine have become used to a higher degree of suffering as compared to other C&EE countries. This implies weak or even an absence of bottom-up civic pressures as well as a lack of will and capacity to change the current situation whereby governments, often in alliance with organised crime, rob society. In other words, unlike in Poland, there is not even an embryonic civil society (or a memory of it), that could put the elite under pressure to force them to become accountable. It is naive to assume that those who fight for power will act in the public interest if there is no pressure so to do from below.
- Hence the need to support more actively the “third pillar” and the SME sector as well as to act on their behalf when the cumbersome issue of IFIs and aid is at stake. In this context, one should also have in mind the traditionally strong sense of dignity and strength that could be found among the survivor nations of the FSU. This implies unpredictable abilities to withstand hard conditions and suffering especially when it comes from “home”. This coincides with social and religious values (orthodox Christianity in Ukraine in particular) that are difficult to reconcile with market rules. Most people in Ukraine would not understand the extent to which capitalism is grounded on Christianity, because they see community socialism as the prime expression of Christianity or do not see any application of Christianity to current economic life, violent and messy as it is.

## **The Role of State and International Co-operation**

### **The State**

It must be acknowledged that while economic efficiency requires both private ownership and competitive markets, Ukraine lacks both. The adverse combination of market forces and monopolistic domination of rulers and power groups results in a grotesque quasi-liberal system, described as “oligarchic socialism” by David Snelbecker. This system, where crony capitalism and rent-seeking monopolies have produced a caricature out of what an open and democratic society was meant to be, is at the core of most problems. It has already discredited the transformation towards a market economy and democracy. It is no wonder that more and more people oppose reform and the market and become sentimental about the way communism was, even at the expense of losing hard-gained and enthusiasm-led independence.<sup>1</sup>

Hence the danger of Catch 22: high social costs - no reforms - high social costs - social unrest and human/capital displacement, all these fuelled by the state (non) performance. The state is both weak - when it comes to the rule of law, transparency, accountability and public goods - yet strong when it comes to monopoly, red tape, political lending and the misallocation of resources.

A better understanding of this issue requires a reflection of both the country background and the impact of the ongoing painful transformation. Unlike countries in Latin America, or even China, the state institutions in Ukraine (FSU) used to ensure full employment and provision of public goods/utilities and social safety, however poor these were. There was no private sector, no market mechanism. Therefore, a rapid disengagement of the state appeared both impossible and destructive in many respects, e.g. provoking sound anti-market feelings of those who were most vulnerable - the poor, indeed the majority of population.

One of the often-cited advantages of Ukraine is its well-educated human capital. However, the current disengagement of the state from education is already depleting this resource and the worst of such an impact has yet to come. The issue is that while the state is not able to maintain the provision of adequate services, functions and utilities, the private sector is not ready to take over such responsibility. At the same time, the demand side is also presently rather weak and therefore, without the reallocating/redistributing role of the state, demand cannot meet supply for a variety of public goods (such as education) that are essential for the success of the economy in Ukraine.

There is no doubt that the state has to disengage as an owner of assets and administrator of industries. However, its role as policy-maker, regulator, social peace-keeper (safety net), institutions and law builder, investor in human capital and as the provider of financial system safeguards is badly needed, if market and democracy are expected to function.

## **International Co-operation - Current Affairs and Policy Implications**

The capacity to design and implement sound economic policies depends on a number of developments that need urgent and active international support:

- A critical mass of reforms is needed. This, however, requires two conditions that barely exist in Ukraine. Firstly, bearable social consequences/costs, and secondly, knowledge and commitment geared towards a widely supported goal such as EU membership, rather than to short-term crisis management.
- Easier mobility of people and goods in Poland and Hungary, compared to Ukraine, was also a factor that facilitated earlier adoption of new standards, ideas, and business practices. It would indeed be very unfortunate for a shaky Ukraine to suffer, rather than benefit, from EU enlargement, as it will be further cut off from the flux of the aforementioned mobility and values.
- Once they become actors in the global economy, emerging markets also become very vulnerable towards shifts in international financial flows over which they have no control. The Russian financial turmoil of 1998 has severely affected Ukraine, adding external problems to domestic ones. Therefore, economic stability should also be seen a function of risk management in an international context, requiring concerted efforts of international players at the economic centre in particular. Even a relatively stable economy could destabilise overnight as a result of contagion effects and systemic risks. Security can be washed away and replaced by social unrest as a result of rapid shifts in wealth, as such shifts might reflect a collapsing financial system. A rapid loss of savings and basic social protection as a result of a financial crisis also means a loss of momentum and painful investment that took years or decades to develop. Examples include Indonesia, Brazil, Albania and Bulgaria.

To deal with the above and other issues, there is a clear need for new forms of international co-operation that are geared to results, vision and integration rather than being a piece-meal approach. While EU assistance to Ukraine is essential, it could take the lead in such reorientation if European stability is seen as a more comprehensive objective. It is also important to gear international co-operation and reforms more clearly to improved standards of life in order to restore enthusiasm and support for reforms. Otherwise, lengthy reforms (whether real or virtual) and declining standards do not match often unrealistic expectations and result in evaporating support for reforms, as well as the rise of protectionism, nationalism and authoritarianism. Therefore, the role of aid is often negative if clearly defined objectives do not exist or were not reached, because what remains is mixed feelings, a sense of dependency, incapacity and even humiliation.

While it is clear that aid could not succeed without the proactive role of recipient governments, it has to facilitate and ensure this role. This will require a reconsideration of responsibilities for and ownership of reform, especially if

supranational institutions are expected to play an increasing role, as is the case with the EU.

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### *Note*

- 1 A survey of the Kiev National Institute of Sociology at the Kiev Mhilia Academy, published by Virpati Igaz (01.99) indicated that the respondents approval of private property dropped from 66% in 1994 to 34% in 1997.