

ENGAGING UKRAINE IN 2009¹



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Ukraine and Ukrainians will be tested over the course of 2009. The global financial and economic crisis already has provoked a deep recession and falling living standards. Kyiv will need to make a real effort to strike a balance between integration into Europe and the Euro-Atlantic community and maintaining stable relations with Russia. Doing so will not be easy, as Russia regards Ukraine's pro-Western policy as inimical to Russian interests, and Ukraine's politics are subject to influence from Moscow. In particular, Ukraine must address its energy security situation, where it remains vulnerable to Russian pressure.

Ukraine is the most democratic state in the post-Soviet space, and its domestic debate is vibrant and open, but its politics are highly dysfunctional. The bitter political feud between President Victor Yushchenko and Prime Minister Yuliya Tymoshenko, former allies in the Orange Revolution, has paralysed most policymaking. With a presidential election likely to be held in January 2010, the infighting will only get worse. Regions Party head Victor Yanukovich, the main opposition leader, has little incentive to work for good policies, as he stands to gain politically as disapproval of the president and prime minister grows.

All of this makes dealing with Ukraine difficult for the US government, but it also makes working with Ukraine more urgent. It remains in America's interest that Ukraine continue its development as a stable, independent, democratic market economy, with growing links to Europe and the Euro-Atlantic community. In the circumstances of the coming year, however, engaging with Kyiv to advance that goal will prove no easy task.

As it organises its policy toward Ukraine, Washington should focus on four areas:

- structure a bilateral dialogue to have maximum influence with Ukraine's leaders.
- assist Ukraine in dealing with the financial/economic crisis.
- promote serious actions to strengthen Ukraine's energy security.
- help Ukraine deepen its relations with the European Union and NATO while avoiding a crisis with Russia.

US interests in Ukraine

With everything else on the Obama administration's policy agenda, finding time to address Ukraine will be difficult. Over the past seventeen years, however, Washington has made a significant investment of time, energy, and assistance resources in Ukraine. It should remain engaged to promote that country's successful transformation into a modern European democracy.

Ukraine had the world's third largest strategic nuclear arsenal on its territory at the time of the Soviet Union's collapse in 1991. Kyiv's decision to give up those arms

¹ This is the short version of the article published in the Policy Paper No.13, March 2009, The Brookings Institution, Washington, D.C., – www.brookings.edu



dramatically reduced the number of nuclear systems that could target America and provided a breathtaking success in the nuclear non-proliferation effort. However, by late 1993, US officials had come to recognise that, while the nuclear weapons issue was extremely important, the United States had broader interests in Ukraine.

Clinton administration policy statements thereafter identified Ukraine's development as a stable, independent, democratic market economy, with growing links to Europe and the Euro-Atlantic community, as being in the US interest. *First*, such a Ukraine was seen as likely to be a net contributor to shaping a wider, more stable and secure Europe – a high priority for the United States. *Second*, given Ukraine's decisions to give up nuclear arms and adopt responsible controls on its missile technology, Washington saw Ukraine as a partner in tackling key proliferation challenges. *Third*, with a population in the early 1990s numbering some fifty million, a reforming, economically growing Ukraine offered an attractive market for US trade and investment. It was not surprising, therefore, that then-Secretary of State Madeleine Albright designated Ukraine as one of four pivotal countries in the world whose development as a stable democratic partner for the United States deserved greater attention of time and resources from US policymakers.

While Ukraine remains an important non-proliferation partner, and American business has become increasingly involved there (with cumulative direct investment of some \$1.5 billion in 2008), the primary reasons for engaging Ukraine remain geopolitical. A successful Ukraine promotes stability. Moreover, a democratic and prosperous Ukraine firmly anchored in Europe will offer a model that might encourage Moscow to pursue a more cooperative, integrative foreign policy and give up any thought of seeking to restore the Russian empire. A weak and unstable Ukraine, on the other hand, would not be an attractive partner for the European Union or NATO, would worry its Central European neighbours, could prove an unreliable energy transit country, and might tempt Moscow even further to interfere in its politics. Were Ukraine to plunge into severe crisis, become a "grey security zone", or turn away from Europe back toward Russia, it would be a major setback for US policy, particularly the objective of promoting a more stable and secure Europe.

Between the mid-1990s and 2008, US-Ukrainian relations made significant progress. Washington and Kyiv created a binational commission chaired by Vice President Al Gore and President Leonid Kuchma in 1996. US officials led the drafting of an Alliance policy that in 1997 produced a NATO-Ukraine charter on a distinctive partnership and established a standing NATO-Ukraine Commission. The Orange Revolution and Yushchenko's assumption of the presidency in January 2005 gave US-Ukrainian relations a new impulse. The April 2005 Bush-Yushchenko meeting produced warm atmospherics and a road-map for further developing US-Ukrainian relations.

Over the course of the next year, US and Ukrainian officials resolved most of the key questions on the bilateral agenda. At the start of 2009, few bilateral

problems burden the US-Ukrainian agenda, and the two countries enjoy positive relations. This means that the Obama administration can focus on broader issues that affect Ukraine's ability to proceed down its reform path. Those questions include: grappling with the consequences of the global financial and economic crisis, strengthening its energy security position, improving its investment climate, tackling corruption, and managing its foreign relations. The potential vulnerability of Central European states to an economic collapse in Ukraine gives the US government an additional incentive to engage Kyiv.

Four major challenges facing Ukraine in 2009

Ukraine in early 2009 faces four major challenges. The *first* is the lack of political coherence in Kyiv, brought about primarily by the feuding between the president and the prime minister and their almost complete inability to work together. This is a problem in and of itself. It also complicates Ukraine's ability to deal with the other three challenges.

Second, as the impact of the global financial and economic crisis has deepened, Ukraine has plunged into a major recession. The country's financial stability will be severely tested.

Third, Ukraine's energy sector is dysfunctional and non-transparent, providing ample opportunity for economic rent-seeking through market manipulation and for Russian interference in Ukrainian politics. As demonstrated in January 2009, the Kremlin remains prepared to use energy as a political tool.

Fourth, Ukraine needs to develop its links with the European Union and NATO at a time when its relations with Moscow are tense and European states are striving not to provoke Russia.

Political disarray in Kyiv

Ukraine has gone through a gradual constitutional reform from a predominantly presidential system to a mixed presidential and parliamentary system, as agreed in the constitutional compromise of December 2004 at the end of the Orange Revolution. The result is that Ukraine today has neither a presidential nor a parliamentary system, but a hybrid. In this system, neither the president nor prime minister has been able to rule.

The infighting between Yushchenko and Tymoshenko, and between the presidential secretariat and the cabinet, has meant that the governmental authorities – the president, prime minister, and their staffs together – have performed abysmally in addressing Ukraine's needs. Many had hoped at the start of 2008 that Yushchenko and Tymoshenko could work together to consolidate needed reforms. However, very little was accomplished over the course of the year.² A particular failing has been the lack of movement in consolidating economic reforms. The government carried out no major privatisations. Despite a large pro-business majority in the Rada, it passed few major pieces of economic reform legislation.

As noted, ambiguities in Ukraine's constitutional order add to the confusion. As one example, the constitution appears to grant to the prime minister and her cabinet

2 See Janusz Bugajski, Steven Pifer, Keith Smith and Celeste A. Wallander, "Ukraine: A Net Assessment of 16 Years of Independence," Center for Strategic & International Studies, February 2008 for the kinds of recommendations that Western analysts advocated and thought possible in 2008. Few of the recommendations were implemented, as the same authors noted in a report entitled "Implementation of Key Tasks and Recommendations," Center for Strategic & International Studies, February 2009.

primacy for management of the economy. Nonetheless, the president and his secretariat have persistently inserted themselves into operational considerations of economic policy, including on energy, privatisations and macro-economic matters. No progress on constitutional reform or clearing up such ambiguities was made during 2008. The lack of a credible, functioning constitutional court compounds the problem.

Ukraine Plunges into Financial and Economic Crisis

As the global financial crisis has deepened, Ukraine has become one of the countries most severely hit. In September 2008, the Ukrainian economy seemed to be in good health. Unfortunately, the economy turned out to be highly vulnerable. *First*, the steel sector was a prime driver of GDP growth during 2000-2007. In the first half of 2008, steel accounted for no less than 42% of Ukraine's exports.³ In the second half of the year, however, international steel prices and demand collapsed – and with them, Ukrainian exports.

Second, the National Bank of Ukraine insisted until spring 2008 on maintaining a fixed peg of the hryvnia to the US dollar, something no other country in the region did. As a result, the hryvnia depreciated sharply in relation to the Euro, and the hryvnia's depreciation attracted short-term bank speculation. The short-term capital inflows, in turn, boosted Ukraine's money supply by 51% in 2007.⁴ That aggravated inflation, which accelerated rapidly at the end of 2007 and peaked at 31% in May 2008, compared with a year earlier.⁵ The speculative currency inflow caused Ukraine's current account deficit to widen to 6.6% of GDP in 2008, which increased Ukraine's private foreign debt.⁶ Still, the Ukrainian economy did not appear that bad off, apart from high inflation. In August 2008, Ukraine's international reserves peaked at a respectable \$38 billion.⁷

The *third* cause was Ukraine's messy politics, in particular the constant clashing between the president and prime minister. International investors perceived Ukrainian politics as irresponsible and dysfunctional, blocking major investments and privatisations, and began to stay away.⁸

A run on the hryvnia started in late summer 2008, and international financial markets closed completely to Ukraine in September. Suddenly, it became virtually impossible for Ukrainian companies to refinance foreign loans, which meant that any requirement for major refinancing caused an enterprise failure.

The Ukrainian economy has experienced a major shock since October 2008. The three industries hit the worst

have been steel, mining and construction. By January 2009, industrial production had fallen by 34% compared to January 2008. The decline is broad-based, but the key industries are recording declines of approximately 50%.⁹ Exports measured in US dollars are projected to fall by almost 50% in 2009, and imports are expected to fall even more (the silver lining is that this should minimise the current account deficit).¹⁰ Nobody can offer a precise forecast for GDP in 2009, but in January, GDP fell by 20% compared to January 2008.¹¹ Many analysts see a double-digit slump for the year as likely.

Fortunately, Ukraine approached the IMF as an early applicant for assistance in October 2008. The IMF Board adopted a two-year standby program, worth a potential total of \$16.4 billion, on November 5. It contained three main conditions. *First*, Ukraine had to let its exchange rate float to render the value of the hryvnia realistic. The hryvnia has depreciated by about 50% since last summer. With this new, more realistic value, the exchange rate appears to be bottoming out and stabilising.

Second, the IMF insisted on a responsible fiscal policy. The negotiations within the Ukrainian government and with the IMF have focused on the scale of the budget cuts that will be necessary as the economy contracts and state revenues plummet. Budget cuts in an election year are difficult, and the president and his staff appear to relish the fact that Tymoshenko must make hard choices about curtailing some popular expenditures. Although the IMF standby agreement called for the 2009 budget to be in balance, the budget approved by the government and Rada included a 3% deficit of GDP, which the IMF reckons will realistically be a 5% deficit.¹² The IMF can accept a small budget deficit, but then the Ukrainian government needs to find other international financing. In February, disagreement over Ukraine's budget deficit stalled the second disbursement of IMF financing.

Third, the IMF demanded bank restructuring. Unlike most other countries, the National Bank of Ukraine has scrutinised most of the country's commercial banks and identified their bad loans, so bank restructuring is proceeding apace.

The negative impact on the real economy will be dramatic. A double-digit GDP decline could amount to a contraction in US dollar terms by over 40% due to the hryvnia's fall. Perhaps two million Ukrainians will lose their jobs. An additional two million who work across the Europe may have to return due to Europe's economic downturn. The economic situation is bound to fuel social and political tensions.

³ State Statistics Committee of Ukraine online database, www.ukrstat.gov.ua (accessed March 4, 2009).

⁴ National Bank of Ukraine (NBU), www.bank.gov.ua (accessed February 27, 2009).

⁵ State Statistics Committee of Ukraine online database, www.ukrstat.gov.ua

⁶ Dragon Capital, "Ukrainian Economy: Making Progress to Unlock IFI Lending."

⁷ National Bank of Ukraine (NBU), www.bank.gov.ua

⁸ Anders Aslund, *How Ukraine Became a Market Economy and Democracy*, Peterson Institute for International Economics, Washington, D.C., 2009.

⁹ State Statistics Committee of Ukraine online database, www.ukrstat.gov.ua

¹⁰ Dragon Capital, Monthly Macro Research, "Ukrainian Economy: Bracing for Tough Year," January 30, 2009.

¹¹ Dragon Capital, "Ukrainian Economy: Bracing for Tough Year."

¹² Unian, "Verkhovna Rada Passed State Budget – 2009," December 26, 2008, <http://www.unian.net/eng/news/news-292400.html>.



Ukraine, however, may well be able to escape default. Even if it receives only IMF funding this year, its own reserves likely will stay above the \$20 billion mark. That is not good, but it is far from default. The greatest structural weakness is the state oil and gas company *Naftohaz*, which loses a couple of billion dollars a year due to adversely regulated prices (which means that *Naftohaz* cannot recover its costs in many sales), mismanagement and corruption.

Looking to the longer term, there are reasons to believe the Ukrainian economy could recover rapidly, provided the global recession does not deepen too far. At present, Ukraine has a highly competitive exchange rate, which should help it expand exports faster than other states. With the decline of the steel sector, the Ukrainian economy is likely to become much more diversified; this could include expansion of its agricultural and machine-building sectors. As a member of the World Trade Organisation, Ukraine has secured reasonable market access, although it is important to broaden its access further. The more quickly the government acts now to deal with the crisis, the more likely a faster recovery.

Threats from the new gas deal and weak energy policy

Ukraine uses energy prodigiously. Its economy is said to be the single most energy-intensive in the world. For example, it uses more than twice as much energy per unit of GDP as does Poland. Moreover, Ukraine imports most of its fuel, almost all of it from Russia. Although most analysts believe that Ukraine could significantly expand domestic extraction of natural gas and oil from on-shore and offshore deposits, price caps and government policies that interfere with market mechanisms have kept domestic production of energy well below what it should be. The price caps and government policies have also sustained excessive demand and contributed significantly to recurring energy-related tensions with Russia.

The January gas war between Russia and Ukraine drew broad attention to the weakness of Ukrainian

energy policy, as well as to Ukraine as a vulnerable link in Europe's gas supply chain (through which Europe receives some 20% of its total gas needs). Russia stopped all gas flowing to Ukraine. The effect was to cut off consumers in Central and Western Europe as well, thereby provoking a major European energy crisis. The matter was resolved only after several false starts and bitter recriminations. Two new agreements were signed on January 19, and by January 22, pipeline volumes were starting to return to normal in all the European countries whose supply had been affected by the standoff.¹³ The new agreements are a significant departure from past Russian-Ukrainian practice,¹⁴ but they include significant risks for Ukraine, and they only begin to address the longstanding shortcomings of Ukrainian energy policy.

Ukraine is obliged to pay by the seventh day of each month the amount owed for gas delivered in the preceding month. If Ukraine fails to pay by the prescribed date, then from that moment on, Ukraine is obliged to pay in advance for the month ahead. This provision poses a very serious challenge to *Naftohaz*: a single, one-day delay in payment can trigger the change to month-ahead payments for the duration of the agreement.

More broadly, Ukraine's energy policies thrive on non-transparency, waste, and politicisation. In the political year that is 2009, with the upcoming presidential election, the combination of the new deals and bad overall policy could prove highly destabilising. Urgently needed reforms are again at risk, which could magnify the macroeconomic and political difficulties.

Ukraine's energy sector is far more complex and troubled than it needs to be.¹⁵ The country has a long history of producing, processing, and transporting oil and gas. It has significant hydrocarbon deposits both on-shore and under the waters of the Black Sea. Its strategic location and extensive existing infrastructure give it great significance in the gas markets of Eurasia. Unfortunately, in the period since Ukraine gained its independence in 1991, the energy sector has served successive rounds of leaders as a political trophy and tool. Decisions regarding energy policy have traditionally been made to favour certain industrial and personal interests. Deals reached by one political leader are reversed when successors come to power.

Perhaps most significant of all, Ukraine is a country in which the price of energy – the most fundamental instrument that guides the allocation of resources – is thoroughly and deliberately subverted. The gas prices charged to retail consumers consistently fail to cover the cost of gas plus the services of distribution and marketing, because political leaders have been unwilling to take the unpopular step of raising prices.

In the first quarter of 2009, when Ukraine imported gas for \$360 per TCM, the prices paid by industrial users and consumers within Ukraine were substantially lower. The import price at the Ukrainian-Russian border (before

¹³ For a useful chronology of the crisis, see Simon Pirani, Jonathan Stern and Katja Yafimava, "The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment," Oxford Institute for Energy Studies, 2009, <http://www.oxfordenergy.org/pdfs/NG27.pdf>.

¹⁴ *Ukrainska Pravda* published what it said were the agreed texts of the new agreements. This assertion was not officially confirmed, but neither was it contradicted. For the sales-purchase agreement, see *Ukrainska Pravda*, "Gazovoye Soglasheniye Tymoshenko-Putina – Polniy Tekst," January 22, 2009, <http://www2.pravda.com.ua/ru/news/2009/1/22/87168.htm>, and for the transit agreement, see *Ukrainska Pravda*, "Kontrakt o Transite Rossiyskogo Gaza + Dopsoglasheniye ob Avansye 'Gazproma'," January 22, 2009, <http://www2.pravda.com.ua/ru/news/2009/1/22/87178.htm>.

¹⁵ This discussion draws heavily on analysis by Edward Chow and Jonathan Elkind, "Where East Meets West: European Gas and Ukrainian Reality," *The Washington Quarterly*, Center for Strategic & International Studies, vol. 32, number 1, January 2009.

value-added tax was applied) translated to a price of 2,772 hryvnia per TCM at the end of January (when the exchange rate was 7.7 hryvnia to the dollar). In January, the price of gas (including value-added tax) for industrial consumers was 2,570 hryvnia per TCM; for utility companies 873 hryvnia per TCM; and for households 650 hryvnia per TCM.¹⁶ Consequently, each cubic meter of gas consumed contributes to a cascade of indebtedness, a situation that only worsens when gas bills are not paid.

Domestically-produced gas is treated worse than imported gas. Gas from Ukrainian wells is meant to be sold for use in the residential and institutional (government budget-supported) sectors, and the prices are capped far below the already-subsidised gas price for industrial consumers. This artifice only further misdirects market forces. It deters investment in domestic gas production and creates lucrative opportunities for corruption – such as when domestically-produced gas is resold to favoured traders and re-labelled as “imported” so that it can be sold for higher prices.

As a result of weak energy policies and the new gas deal with Russia, energy will remain a major challenge throughout 2009 and beyond. In fact, throughout the entire period of negotiating the new gas deal, the presidential secretariat constantly attacked the actions of the government and accused them of acting counter to Ukraine’s interest. Fighting over the gas arrangements by domestic political forces that seek financial advantages contributes to the instability of the contracts. Some analysts in Europe and the United States believe a new gas dispute could break out as early as the spring 2009.

The tug between the west and Russia

Although Kuchma first announced NATO membership as a goal in 2002, the prospect only began to appear serious following Yushchenko’s election as president. While Kuchma sought a balance between the West and Russia, Yushchenko made integration into Europe and the Euro-Atlantic community, including ultimate membership in the European Union and NATO, his primary foreign policy goal. In April 2005, NATO and Ukraine launched an “intensified dialogue.” Many expected that Ukraine would receive a NATO MAP by the end of 2006. The country by then had implemented political, economic, and defence reforms comparable to those made by countries such as Albania and Romania when they received their MAPs in 1999. However, the selection of Yanukovich as prime minister in August 2006 derailed Ukraine’s MAP prospects. He made clear that, while wanting good NATO-Ukraine relations, he did not favour a MAP.

Yushchenko reopened the debate in January 2008, when he, Tymoshenko, and then-Rada Speaker Arseniy Yatseniuk co-signed a letter to NATO Secretary General Jaap de Hoop Scheffer requesting a MAP at the April NATO summit. This time, Moscow became far more alarmed than it had over NATO-Ukraine relations in the past. Then-president Vladimir Putin suggested that Russia would target nuclear missiles at Ukraine, while

other senior Russian officials pledged to do everything that they could to block Ukraine’s integration into NATO. Meeting with allied leaders at the April NATO-Russia summit, Putin even called into question Ukraine’s territorial integrity.¹⁷

Speaking in August in the aftermath of the conflict with Georgia, President Dmitriy Medvedev described five principles underpinning Russia’s foreign policy. One was a sphere of “privileged interests” in the post-Soviet space, a formulation that appeared intended to assert for Russia a voice in the foreign policy choices of its neighbours.¹⁸ Russian officials spoke of NATO enlargement as posing an existential threat to Russia.

While NATO leaders decided not to extend Ukraine a MAP in April, they did declare that Ukraine would be a member of the Alliance. NATO foreign ministers in December decided to develop NATO-Ukraine relations further on the basis of an annual national program and work in the NATO-Ukraine Commission, setting aside the MAP issue.¹⁹

Ukrainian-EU relations in 2008 focused on negotiation of an association agreement, which will include a free trade arrangement. However, unlike previous EU association agreements with other European countries, this one will not include language recognising a membership perspective for Ukraine. This reflects longstanding EU reluctance to envisage the possibility that Ukraine might one day join the Union. The European Union also offered to develop relations with Ukraine through the EU’s Eastern Partnership outreach to post-Soviet states, though some in Kyiv worry that this is an effort to sideline any prospect of Ukrainian EU membership.

Ukraine’s relations with Russia, which have been tense since the Orange Revolution, became increasingly difficult over the course of 2008. In January 2009, the relationship between Kyiv and Moscow was at one of its lowest points since the collapse of the Soviet Union in 1991, reflecting the growing accumulation of difficult issues between the two.

Ukraine’s integration into NATO tops, but by no means exhausts, the list of Moscow’s problem issues with the Ukrainian government. Over the past year, Russian officials have also expressed concerns about: Yushchenko’s support for Georgia and Ukrainian arms deliveries to that country; Ukrainian proposals that the two countries begin negotiating now on a plan for withdrawal of the Russian Black Sea Fleet from Sevastopol and Crimea in 2017; the status of the Russian language in Ukraine; and Kyiv’s push for international recognition of the Holodomor (the 1930s’ famine that killed millions of Ukrainians) as an act of genocide. Ukraine and Russia differ over demarcation of the sea boundary in the Kerch Strait and Sea of Azov. A new mini-crisis erupted in February 2009, when “unfriendly and openly undiplomatic” comments about Yushchenko by Russian Ambassador Victor Chernomyrdin led the Ukrainian foreign ministry to threaten to expel him.²⁰ And the January gas war demonstrated how destructive the Ukrainian-Russian energy relationship could be.

¹⁶ Information provided to authors by IMF official, March 2009.

¹⁷ Unian, “Text of Putin’s Speech at NATO Summit,” April 18, 2008, <http://www.unian.net/eng/news/news-247251.html>.

¹⁸ President of Russia website, “Interview given by Dmitry Medvedev to Television Channel One, Russia, NTV,” August 31, 2008, http://www.kremlin.ru/eng/text/speeches/2008/08/31/1850_type82912_type82916_206003.shtml.

¹⁹ NATO, Final Communiqué, “Meeting of the North Atlantic Council at the Level of Foreign Ministers Held at NATO Headquarters, Brussels,” December 3, 2008, <http://www.nato.int/docu/pr/2008/po8-153e.html>.

²⁰ Kyiv Post, “Ohryzhko: Foreign Ministry’s Response to Chernomyrdin’s Comments is Timely and Adequate,” February 18, 2009, <http://www.kyivpost.com/nation/35710>.



This tug between the West and Russia has a domestic angle within Ukraine. Internal frictions over geopolitical orientation, the future of the Black Sea Fleet, Crimea, and official status for the Russian language could worsen. Accelerating tensions could cause the east-west divide in Ukraine to reopen. Moscow has levers to influence these tensions and has an incentive to keep them going: the Kremlin sees a divided, politically incoherent Ukraine as making the country a poor candidate for NATO or the European Union and as offering a political model that will be unattractive to the populace in Russia.²¹

An agenda for us engagement with Ukraine

As the Obama administration defines its approach toward Europe and Russia, it should pay serious attention to Ukraine. Given the relative absence of bilateral problems on the US-Ukrainian agenda, Washington can and should focus on broader issues that could accelerate, or hinder, Ukraine's development. A crowded foreign policy agenda and political incoherence in Kyiv may tempt Washington to wait to engage until Ukraine's political leadership can get its act together. But the US government do not have that luxury; absent US engagement, the situation in Ukraine will likely worsen – and later require significantly greater time and attention from Washington and European capitals.

Structuring a regular, high-level dialogue

The Bush administration's high-level engagement with Kyiv was episodic. In 2001, it downgraded the binational commission that Gore and Kuchma had chaired, leaving in place the working groups without any overarching structure. Given concerns about Kuchma, there was little engagement with him. Following Yushchenko's assumption of the presidency, high-level contacts resumed haltingly over 2005-2008. The Obama administration should regularise a high-level dialogue with Kyiv.

Washington should revive the binational commission that operated between 1996 and 2000 as a structure for managing US-Ukrainian relations. The commission should oversee the existing bilateral working groups, which deal with foreign policy issues, economic and commercial relations, energy, and defence questions. Restoring the commission would ensure that senior political levels on both sides monitor the overall state of US-Ukrainian relations and that they are positioned to intervene to break deadlocks at the working level. Vice President Joe Biden should chair the US side.

As for the Ukrainian side, it made sense in the 1990s for Kuchma to be the Ukrainian chair, as the presidency then controlled the executive branch. In contrast, executive power in Ukraine today is shared by the president and prime minister. The foreign and defence ministers report directly to the president, while most other ministers report to the prime minister. This complicates determining the chair on the Ukrainian side: in the current political circumstances in Kyiv, if Washington proposes the Ukrainian chair be Tymoshenko, Yushchenko is unlikely to cooperate, and vice versa. The alternative is to suggest that the Ukrainian side be co-chaired by the president and prime minister. Such a structure could – and should be intended to – have the effect of forcing Yushchenko

and Tymoshenko to forge common positions. When the commission meets in Kyiv, it will also be important that the vice president see the leading opposition leader, at present, Yanukovych.

This structure would create a channel between the US vice president and the Ukrainian president and prime minister that could be used to pass candid messages on reform and on sensitive issues, such as how Ukraine might deal with NATO and Russia. The vice president and other senior US officials must be blunt: they need to make clear to Yushchenko and Tymoshenko that, if the two of them cannot work together, US efforts to help Ukraine cope with the economic crisis, strengthen its energy security, or develop closer relations with Europe will yield minimal results. This message should be targeted foremost at Yushchenko, as he and the presidential secretariat bear the greater responsibility for the incoherence of Ukrainian policy over the past year.

Assisting Ukraine to deal with its financial/ economic difficulties

despite assistance from international financial institutions (IFIs), Ukraine likely will face a financing gap of about \$5 billion in 2009. A deepening crisis in Ukraine will be bad not just for the country's economy, but could have a deleterious impact on Central Europe. The US government should lead in organising an international donors' conference involving the United States, European Union, IMF, World Bank, European Bank for Reconstruction and Development (EBRD), and other IFIs and countries with the goal of raising \$5 billion in financial support for Ukraine in 2009 that would be linked to the IMF's current program. (Consideration should be given to including Russia in this effort). This should be support for one year, as the Ukrainian economy appears positioned to recover rapidly once it bottoms out, unless the global recession dramatically deepens.

While the IFIs should contribute the bulk of the additional financing, the US government should consider contributing as well. This financing should be conditioned on Ukraine sticking with conditions agreed between the donors and the Ukrainian government, including those in the November IMF standby arrangement and specific new requirements concerning energy sector reform.

The US government should also press the Ukrainian government to take other steps that would facilitate economic recovery and provide appropriate technical assistance. These actions include: abolishing the commercial code, whose outdated provisions on business contradict those in the more modern civil code and create a confused legal environment; allowing the free sale and transfer of agricultural land, which is key to establishing a land market and opening new private capital financing for Ukraine's agricultural sector; and modernising the tax code. Washington also needs to continue technical assistance to facilitate crisis management, privatisation, and other necessary structural reforms, particularly in the energy sector. For such assistance to be effective, the Ukrainian government must adopt and implement reforms. Here, too, senior US officials, including on the binational commission, must be blunt.

²¹ See Steven Pifer, "Averting Crisis in Ukraine," Council on Foreign Relations Special Report No. 41, January 2009 for a fuller discussion of the internal frictions within Ukraine and tensions between Ukraine and Russia, as well as for recommendations on US policy steps to alleviate those frictions.

Among other things, the binational commission should look at ways to promote greater political and academic exchanges between the United States and Ukraine, including funding to bring young Ukrainian political leaders, young professionals, and high school and college students to visit and study in the United States, including a target of college scholarships for 1,000 Ukrainian students per year. This can help Ukraine develop a larger cadre of key professionals with the skills to manage a modern economy and financial system.

The European Union and Ukraine are now negotiating an association agreement, which will contain a deep free-trade arrangement. The US government should align its approach with the EU's by adopting measures to remove barriers to Ukrainian products. While politically difficult at present, Washington might also consider the possibility of negotiating a bilateral free trade agreement with Ukraine. For Ukraine, this would imply a substantial market opening; it would strengthen Ukraine's economic links to the West and the US standing in Ukraine.

Pressing Ukraine to bite the bullet on energy sector reform

the year 2008 ended, and 2009 began, with what could be described as the cross-border equivalent of a barroom brawl – a ferocious confrontation over Russian-Ukrainian gas trade and transit that exploded into a full fledged energy crisis for Europe. The crisis had a particular impact in Slovakia, Romania, Bulgaria and the Balkans, where the gas cut-off meant no heat in freezing apartments.

At this stage, the most important questions are where Ukraine stands in relation to its long-delayed energy reform agenda, and what it should do next. The January crisis starkly demonstrated that Ukraine's actions directly affect European energy security. The crisis also makes clear the dangers – to Ukraine and to the interests of the United States and its European partners – of not addressing that agenda. Ukraine has to embrace reforms that will make it a viable member of the Euro-Atlantic community, which Kyiv says it hopes to be.

The US government must work hand-in-hand with the European Union and key member states to press Ukraine to engage in energy reform. First and foremost, Washington and its partners should secure a clear commitment from Ukraine to transition to rational energy pricing in an agreed, finite period – for example, within the next two years. This will be difficult to do, especially in the current circumstances, but the reluctance of numerous Ukrainian governments over the years to act on this is a primary reason for the weakness of Ukraine's energy sector. US and European advisors should also work with Ukraine to develop realistic projections of, and financing plans for, the subsidies that will be needed in the two-year period until pricing achieves cost-recovery levels.

The masking of real energy prices has the inevitable effect on the Ukrainian energy economy of promoting over-consumption. Many politicians in Ukraine have clung to the illusion that the country's industrial competitiveness is enhanced by artificially low energy prices. In fact, the opposite is true. Until and unless energy is rationally priced in Ukraine, and until political leaders engage in the painful task of educating the public about the dangers of artificially low energy prices, the



country will continue with hugely inefficient production that is effectively subsidised by every taxpayer in the country. Reducing energy consumption also could have the effect of providing Ukraine with further greenhouse gas emissions credits that could be sold on international markets under the Kyoto Protocol and Framework Convention on Climate Change. To date, potential buyers have shown interest in Ukraine, though that interest has been tempered by the broader challenges of the Ukrainian investment climate.

The US government should also work with its European partners to provide technical assistance that facilitates Ukraine's transition to market pricing. Support for greater energy efficiency is the logical place to start, and existing programs being undertaken by US Agency for International Development in the area of residential district heating systems (which contribute more to the debt-build-up in *Naftohaz* than any other sector) can be scaled up relatively easily. Another component of enhanced technical assistance should focus on helping the Ukrainian government to develop a program of targeted assistance whereby it can help those households that legitimately cannot afford to pay true market prices for heat and electricity. This would be more sensible than the current system, under which Ukraine provides implicit energy subsidies to most if not all energy consumers. In a future scenario of more serious-minded energy reform, prices will provide an incentive to economise on consumption and to increase domestic production, and subsidies should be directed only to those who are genuinely unable to pay.

Given the inherent instability of the January 2009 gas agreements with Russia, the US government and its European partners should undertake a systematic assessment of measures to help stabilise, strengthen, and increase the transparency of the gas operations of *Naftohaz*.

Getting Ukrainian leaders to adopt the necessary energy reform steps will be a tough challenge. Energy reform should be a key part of the agenda for a restored binational commission, and it should be at the top of the vice president's list of issues. Making firm actions on energy sector reform the conditions for additional international financing for Ukraine should provide leverage to press Kyiv to adopt those reforms.



Helping Ukraine deepen its links with the west while avoiding crisis with Russia

Yushchenko remains committed to integrating Ukraine into the European Union and NATO, and deepening those links is in the interest of the United States and Europe. Advancing that integration is difficult at present. The Ukrainian elite and a growing number of Ukrainians (who may now exceed a majority) favour Ukraine's integration into the European Union. NATO membership, however, remains controversial both among the elite and the public. Moreover, the Russians regard Ukraine in zero-sum terms and see any deepening in its relations with the West as representing a loss for Russia. And concerns in Europe about provoking Russia undercut support for a MAP for Ukraine. Equally damaging to Yushchenko's policy has been the feuding in Kyiv; the lack of coherence in the Ukrainian government severely weakened Ukraine's case for a MAP in the second half of 2008 as well as its ability to cope with the January gas dispute.

NATO ministers in December 2008 agreed that the annual national program and NATO-Ukraine Commission would be the mechanisms for now to develop NATO-Ukraine relations. European concerns about Russia and political turmoil in Kyiv mean that a MAP is not possible anytime soon. The Ukrainian government appears to understand this. Most, if not all, of the substance of a MAP – in terms of planned reforms, exercises, exchanges and other contacts with the Alliance – could be put into an annual national program. (Here, too, however, the financial crisis may have an impact. Defence Minister Yuriy Yekhanurov told his NATO counterparts in February that limited budget resources might cause Ukraine to scale back some planned exercises).

The US government should counsel the Ukrainians to proceed on the basis of an annual national program and set aside their desire to receive a MAP. There is no reason now for Kyiv to get bogged down in an unrealistic attempt to secure a MAP, especially when it can develop its practical relations with NATO in an annual national program. Washington should also offer to consult privately with the Ukrainians as they develop their proposed program, so that the plan – which Kyiv hopes to share with NATO in the spring – is as robust as possible and crafted in terms likely to secure Allied support. The administration might suggest that the Ukrainians consult with the Polish government, which wants to help Ukraine thicken its relations with NATO. US officials should work at NATO to win approval of a substantive annual national program.

In the run-up to the April NATO summit, US officials should seek language for the summit statement that reaffirms the Bucharest statement that Ukraine will be a member of the Alliance. US officials should also press for language that makes clear that the Alliance does not accept the notion of a sphere of influence in the post-Soviet space or that Moscow's claimed "privileged interests" allow it to determine the foreign policy courses of other post-Soviet states, in order to reassure countries such as Ukraine.

Washington should also urge that the European Union maintain robust engagement with Ukraine. Given that MAP has been put on hold in large part due to the concerns of European allies about provoking Russia, US officials should ask that EU engagement with Ukraine take up some of the slack to signal Kyiv that Western

interest remains strong. Accelerated negotiation of the association agreement, and its free trade arrangements, would send such a positive signal. The European Union should also use its Eastern Partnership to strengthen links with Ukraine.

More broadly, Washington should coordinate with the European Union on the key points to stress to Kyiv. Tough messages – for example, on the need for Ukrainian leaders to press reforms – will carry greater weight when delivered by US and EU officials in unison.

To the extent that the Obama administration can improve US-Russian relations and if there is parallel improvement in NATO-Russian relations, these will be positive developments for Kyiv. The Ukrainian government have historically had greater freedom of manoeuvre in the context of warmer relations between the West and Russia.

The US government will want to monitor the tense relations between Kyiv and Moscow. On the one hand, it should advise the Ukrainian government not to provoke needless crises or fights with Russia. For example, it might make sense for the president not to press Moscow to begin negotiations now – in a fractious political year in Ukraine – on withdrawal of the Black Sea Fleet when its lease expires in 2017. Washington should also be clear with Kyiv as to the extent of – and limits on – American support the Ukrainian government can expect if a confrontation between Ukraine and Russia breaks out.

At the same time, Washington should be equally clear with Moscow on the risks for Russian relations with the United States and the West should Moscow fan internal tensions within Ukraine or provoke a crisis with Kyiv. Washington's desire to "reset" the relationship with Moscow likely would not survive a Russian-Ukrainian crisis caused by the Russians. As appropriate, US officials may wish to remind Moscow of the security assurances extended to Kyiv by the United States, Russia and the United Kingdom in the 1994 Budapest memorandum regarding Ukraine's sovereignty, territorial integrity and freedom from economic coercion.

Conclusion

Dealing with Ukraine in its current state will not be easy for Washington, but it is important. A lack of attention to Ukraine now could well require far greater attention in the future, should the country go off track or become immersed in crisis. Ukrainian leaders of course must do their part. Robust US engagement, however, could prove decisive in prompting them to act. Robust engagement includes tough messages delivered in full candour.

For all the frustrations of watching developments in Kyiv, it is not the time for "Ukraine fatigue". It remains in the US interest that Ukraine continue its democratic and market economy transformation, and that it avoid internal crisis – either political or economic – or confrontation with Russia. Establishing a high-level, political channel; assisting Kyiv in avoiding a financial calamity; pressing the Ukrainian government to take the long-needed steps on energy sector reform; and advising the Ukrainians on how to deepen relations with the West while avoiding crisis with Moscow should be central parts of the US strategy to achieve these goals in the difficult circumstances of 2009. ■