Hilmar Þór Hilmarsson

Article

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HOW CAN UKRAINE ACHIEVE INTERNAL AND EXTERNAL STABILITY AND SUSTAINABLE GROWTH?

Hilmar Þór Hilmarsson, PhD, Professor
School of Business and Science
University of Akureyri, Iceland

Abstract

The objective of the article is to discuss how Ukraine can achieve internal and external stability and sustainable economic growth. The article argues that more inclusive and sustainable economic growth in Ukraine will require increased productivity of the economy with skilled workforce and adequate physical capital, more benefits from international trade and investment supported by closer integration into the global economy, and well-governed economy with stronger domestic institutions to withstand pressures from vested interests. At the center of these goals, the strength and durability of the transformation will depend upon successful structural reforms, commitment by political leaders in the coming years and stronger support from the international community. The US, EU and NATO should make more efforts to help Ukraine resolve the current conflict with Russia, and Russia needs to stop the military engagement in Ukraine to allow the country recover and benefit for more integration and cooperation with the West. At the same time, NATO membership and full EU membership should not be considered for now, but Ukraine should be an independent and neutral buffer state between the East and the West, with full access to the EU common market and free from the devastating effects of the current East-West competition for its people and territory. Internal and external stability is critical for fast and sustained economic growth and for Ukraine's ability to keep more of its young and most talented human capital within its borders. Ukraine needs increased financial support from the EU, US, IMF, and the World Bank for the reconstruction of its economy.

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Introduction

The recent Russian military build-up at the Ukraine's border (See, for example, Reuters, 2021) returned to our minds a neglected country that has suffered for too long. According to the World Bank Ukraine is a lower middle-income country. The country has significant potential for economic growth, endowed with important assets, such as, fertile land, considerable natural resources, a geographic location at the crossroads of Europe and Asia, and an industrialized base with a skilled labor force.

The fall of the Soviet Union in 1991 resulted in the collapse of GDP in Ukraine, see Figure 1 and 2 below. This was to a large extent due to the disruption of commercial and production networks associated with the disintegration of the Soviet economy and its central planning system.

In 2000-08 Ukraine's GDP grew more than seven percent a year. However, the pattern of that growth was based on international capital inflows and credit expansion that proved unsustainable. Ukraine is still paying the consequences, most noticeably in the high nonperforming loans in the banking sector and difficulties in accessing new credit. The 2008/09 crisis affected Ukraine GDP severely, see Figure 2. In 2014-16 Ukraine experienced serious political, security, and economic challenges. Public discontent over fundamental governance failures, capture of the state by vested interests, and corruption brought the *Maidan* uprising triggering new elections and changes in government. These changes also led to the rupture of economic and political relationships and the realignment of commercial relationships with the rest of the world. In addition to Russian occupation of Crimean Peninsula, the government effectively lost control of parts of Ukraine and military conflict began in the east of the country. The recent coronavirus (COVID-19) crisis, which has turned into a global health and economic crisis, is now severely affecting Ukraine's economic growth performance, see, Figure 2.

Ukraine has thus experienced four major economic crises since 1991. First after the fall of the Soviet Union, second the global crisis in 2008/09, third the crisis in 2014-16 and forth the COVID-19 crisis. Each time the country was ill prepared for such events.

Research Questions and Methodology

The aim of the article is to address the question, what would it take to move Ukraine forward economically? What is holding back progress in Ukraine? Under what conditions can Ukraine exit the current deadlock, raise its economic growth, and stop, or at least reduce the massive outward migration of its youngest and most talented people, and perhaps see more of them returning to help rebuilt a country suffering for too long? What does it take for Ukraine to achieve higher more sustainable and shared economic growth? What can the international community do to help in this process?

The methodology used in the article is the case study method. Compared to other research methods, a case study enables the researcher to examine the issues at hand in greater depth (Yin, 2009). Among the sources of evidence used for the analysis are secondary data, including reports and scholarly literature such as peer-reviewed articles and books. The database used for the graphs in the article came from the IMF World Economic Outlook (WEO) database (IMF, 2019 and 2020) and from World Bank reports (World Bank, 2019a & 2019b). The author also conducted interviews in Ukraine and Poland including at the World Bank offices in Kiev and Warsaw and met with experts at the Kiev School of Economics, the International Humanitarian University in Odessa, and Warsaw School of Economics.

Ukraine's key challenges

The key problems highlighted in this article are: (i) the poor economic performance of Ukraine post-Soviet Union, (ii) uncertain integration with the West, most notably the EU, NATO, and the US, with associated conflict with Russia, (iii) weak governance and corruption, and finally, (iv) massive outward migration of its human capital to richer European countries.

Post-Soviet Union economic performance

At the beginning of its transition in 1991, Ukraine's gross domestic product

(GDP) per capita was similar to that of neighboring Poland. By 2018 Ukraine's GDP per capita (in purchasing power parity, PPP terms) was less than one third of that in Poland, see Figure 1. This happened though Ukraine has better climate and soil and more mineral deposits, and in 1991 it had a stronger industrial base and lower public debt than did Poland.

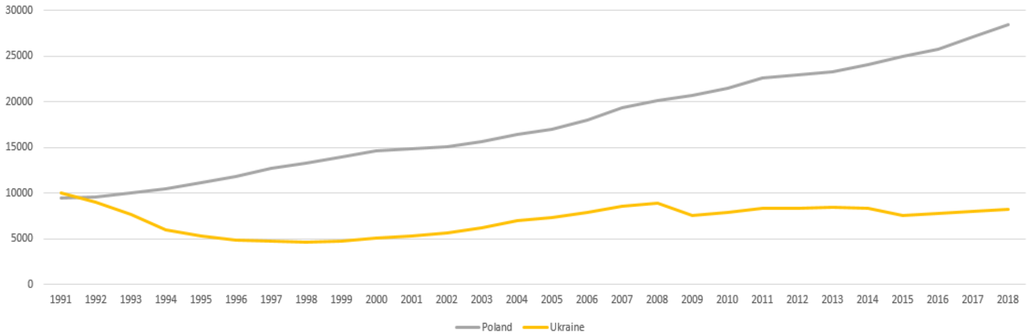

Figure 1. Gross domestic product per capita, USD constant prices – PPP
Source: IMF (2020)

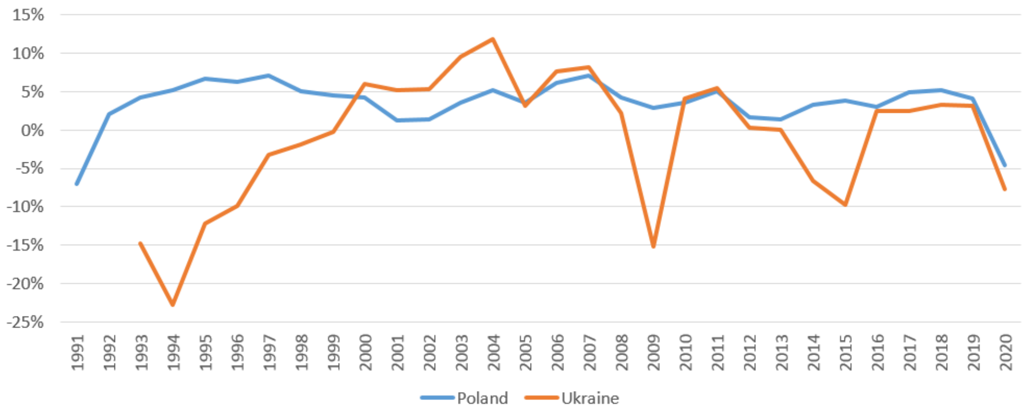

Figure 2. Gross domestic product constant prices - Percent change
Source: IMF (2020)

The only period of high growth in Ukraine post-Soviet Union was short lived and supported by favorable external conditions. Before the global crisis (between 1999 and 2008) Ukraine's average rate of growth of GDP was about seven percent per year, see Figure 2. With this growth rate, Ukraine managed to almost double its GDP per capita in one decade on, see Figure 1.

According to the World Bank about half of the accumulated income gap between Ukraine and Poland is explained by divergent growth trajectories during the first decade of the transition, see Figure 3 (World Bank, 2019b). But the 2000s and 2010s have also been challenging, most notably the global crisis in 2008/09 and the 2014/15 Crimea crisis (see Figures 1 and 2). Now the COVID-19 crisis is severely affecting Ukraine's economy.

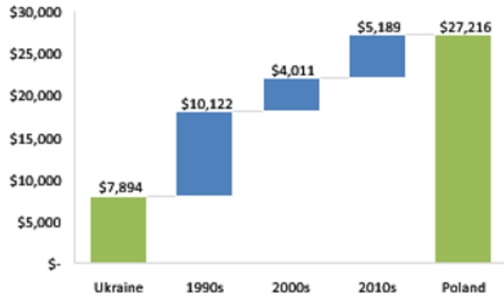

Figure 3. Decomposition of widening income gap between Ukraine and Poland: Income per capita in Ukraine and Poland, in USD PPP, 2017
Source: World Bank (2019b)

The collapse of GDP in Ukraine in the 1990s was to a large extent due to the disruption of commercial and production networks associated with the disintegration of the Soviet Union. Then there was recovery from 2000 to 2008. During the 2008/09 global crisis Ukraine went on to experience a sharp recession in 2009, with GDP falling by about 15 percent. A weak and short-lived recovery gave way to an even sharper recession in 2014-15, triggered by the Euromaidan events and a conflict in the East of Ukraine. As a result, during 2014-15 Ukraine's GDP fell by a cumulative 16 percent, see Figure 2.

At the GDP growth rate, before the COVID-19 crisis hit, about three percent per year, it would, according to the World Bank, have taken Ukraine almost a hundred years to reach the current levels of income of Germany and about fifty years to reach income levels of Poland, see Figure 4 (World Bank, 2019b). This will increase pressure on outward migration as the young and most talented Ukrainians are unlikely to want to wait, but choose to vote with their feet, and exit the country to richer Western countries and some to Russia.

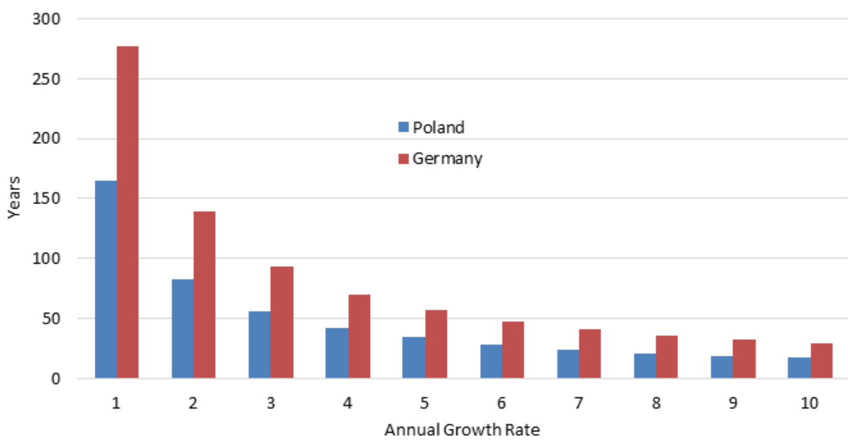

Figure 4. A Relationship between annual GDP per capita Growth and years needed to close the income gap between Poland/Germany and Ukraine
Source: World Bank (2019b)

Aggregate productivity in Ukraine remains low. According to the World Bank an average worker in Germany can in 17 days produces as much as an average worker in Ukraine in one year (World Bank, 2019b). Differences in output per worker between Ukraine and Germany are due to both efficiency gaps and capital gaps. Increasing productivity of the aggregate economy will among other things require improved public investment and infrastructure to reduce costs and equip firms to be able to produce more competitively (World Bank, 2019b).

Integration with the West and the Conflict with Russia

The absence of a clear path to EU accession limited the resources available to transform Ukraine's economy anywhere close to the transformation that took place in neighboring Poland that had a shared vision for EU membership and successfully accessed EU investment grants.

Ukraine remains a politically divided country with the western part tending to support EU and NATO accession, while the eastern part tends to favor stronger relations with Russia. Seeking full EU membership may thus not be realistic in order to keep the country together. Russia also sees Ukraine's EU aspirations, and particularly NATO membership, as a security threat. As EU and NATO have moved closer to Russia proper, the blowback from Moscow has increased (Howorth, 2017). Nevertheless, Ukraine's access to the EU common market is critical.

The Association Agreement between the EU and Ukraine entered into force in September 2017 and the Deep and Comprehensive Free Trade Area started its application in January 2016 (EEAS, 2019; see also EU, 2014). Furthermore the EFTA States signed a Free Trade Agreement with Ukraine in Iceland in 2010. That agreement entered into force in 2012 (EFTA, 2019).

According to the World Bank, the Free Trade Agreement with the European Union may provide an institutional umbrella that facilitates the modernization of the economy. Introducing laws and regulatory procedures and reforming nontransparent practices will certainly become easier with the support of this Agreement than had previously been the case (World Bank, 2019b).

In addition to this, Ukraine is affected by the US, as highlighted by the recent phone conversation between the Ukrainian president, Volodymyr Zelensky, and the president of the United States, Donald Trump. During it Trump requested an investigation of the former US vice-president, Joe Biden— then a nominee for the Democratic presidential candidacy—and his son. The presidents agreed during their conversation that the EU was not doing much to help Ukraine. Trump said: 'Angela Merkel she talks Ukraine, but she doesn't do anything' (CNN, 2019). With Biden now in office it remains to be seen how the relations between the two countries develop.

Obviously, Ukraine is in a vulnerable position, because it needs from the US, not only continued bilateral financial support, but also support at international organizations such as the International Monetary Fund and the World Bank, headquartered in Washington DC.

Ukraine has been affected by external forces before. With the Budapest Memorandum in 1994, it agreed to eliminate all its nuclear weapons in exchange for respect of its independence and sovereignty and its existing borders. Russia, the US and the UK were all signatories of the agreement (Budapest Memorandum, 1994). The trouble with Russia began with the declaration issued by the heads of state and government after the North Atlantic Council in Bucharest in 2008: 'NATO welcomes

Ukraine's and Georgia's Euro-Atlantic aspirations for membership in NATO. We agreed today that these countries will become members of NATO. Both nations have made valuable contributions to Alliance operations' (NATO, 2008). It was clear that this would not be acceptable to Russia and it eventually resulted in the invasions of Georgia in 2008 and Ukraine in 2014. It has been argued that US and European leaders blundered in attempting to turn Ukraine into a Western stronghold on Russia's border (Mearsheimer, 2014). Russia knows well that NATO and the EU are not likely to admit countries if their borders are disputed—and Russia acted accordingly. Russia invaded both Georgia and Ukraine.

Ukraine is not of strategic importance for the US and the EU has few obvious interests in Ukraine except cheap labor flowing from Ukraine to the Western Europe. If Ukraine was of strategic importance to the EU or the US, there would also be willingness to sacrifice lives if necessary, to defend their interests. It is clear that neither the US nor the EU is willing to send troops to fight with the Ukrainian military against Russia.

It has been argued that Russia knows what it wants from Ukraine, while Ukraine clearly knows what it wants from the EU, but the EU has no clear policy goal towards Ukraine (Getmanchuk, 2014). And one can add that the US does not care much about the fate of Ukraine. There seems little in Ukraine vital for US interest.

Weak Governance and Corruption

Many internal problems have contributed to Ukraine's decline, including misguided economic policies, corruption and failed privatization. In 2017 the total net worth of Ukraine's three richest individuals comprised more than six per cent of Ukraine's GDP, more than three times the proportion in Poland (World Bank, 2019b). The influence of vested interests on the economy have undermined the effectiveness of Ukraine's economic institutions and delayed much needed industrial restructuring toward developing high-value added export-oriented industries. Activing a better balance between vested interests/oligarch and the government is one of the key arguments in favor of Ukraine's EU membership as it could result in a more shared power and responsibility between Kiev and Brussels.

Policies that would distribute economic growth dividends more fairly across society in Ukraine by creating access to opportunities for all would make growth more inclusive. Economic growth is only sustainable if it does not leave vulnerable groups behind. But can the EU help with that? Given EU's strict fiscal and monetary policies during and post 2008/09 crisis in former Soviet Republics, such as the Baltic States, one could question the benefits of EU membership for a country that needs more flexible fiscal and monetary policy that the EU demands. Policies those are more suitable for the rich EU member states than emerging countries like Ukraine. Also, these former Soviet Republics that have joined the EU do not have a very impressive record when it comes to income and wealth equality, inclusiveness and social justice (Hilmarsson, 2019a, 2019b; Eurostat, 2020). The Baltics went from Soviet central planning to neoliberalism, including flat taxes and minimal governments, too week to support anything approaching the Scandinavian welfare states with progressive tax systems and systems for redistribution to the most vulnerable members of their societies.

Outward Migration to Richer Countries

There are limited economics opportunities for a large share of Ukraine's human capital. In 1992 Ukraine had a population of about 52 million people (IMF, 2019). Now here are 42 million left. In contrast Poland's population has remained stable at about 38 million for the same period, see Figure 5.

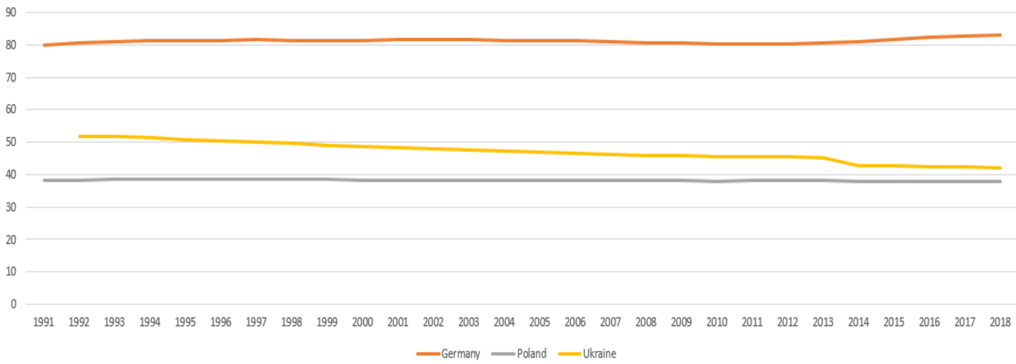

Figure 5. Population – Millions

Source: IMF (2019)

Many young Ukrainians have opted to emigrate, attracted by higher expected earnings in neighboring countries including Poland and Germany. The majority of those leaving Ukraine are high skilled/tertiary educated (Atoyan et al., 2016). Given demographic characteristics and outward migration, there will be a significant decline in the labor force in Ukraine in the next decade. Without sufficient human capital Ukraine cannot sustain economic growth, will not have a workforce prepared for highly skilled jobs and will not compete efficiently.

On one hand the burden on investment and productivity growth are particularly high in Ukraine given that its labor force is projected to decline due to the demographic factors and migration. On the other hand, the contribution of capital to support growth is also constrained by a low domestic savings rate and low foreign direct investment. Also, to be productive a workforce requires physical capital (i.e. infrastructure) and well governed economy.

For the richer EU member states, the outward migration from Ukraine to EU is not necessarily a bad thing. Countries like Germany are facing competition from Asian countries, most notably from China. Getting skilled workers from Ukraine, an industrial country, willing to work for low pay helps in this competition.

Conclusions

The recent Russian military build-up at the Ukraine's border returned to our minds a neglected country frozen in conflict. There does not seem to be much pressure from outside forces to help. The EU benefits from the flow of mostly young and skilled people from Ukraine, amounting to about 10 million since 1991. The populations of Western-European countries are aging. Many Ukrainians leave for Poland, some on the way to a Germany which needs skilled workers for its industry and where the pay is better. Others leave for Russia where per capita income is higher than in Ukraine.

Ukraine is not of strategic importance to the US, which is increasingly preoccupied with Asia, because of the rise of China, and the Persian Gulf countries, and because of oil. EU sanctions hurt Russia, but the latter seems unlikely to accept further integration of Ukraine into the West especially NATO membership. Russia also opposes full EU membership. Geographically Ukraine is perhaps as important for Russia as Canada or Mexico for the US. What would the US do if Russia or China formed a military alliance with those countries? The recent military build-up at Ukraine's border is a signal from Russia that it will not tolerate Ukraine's accession to the EU and NATO.

In the meantime, Ukraine is stuck in a crisis. In a low-growth scenario more and more people in eastern Ukraine may want to join Russia, with higher per capita income. An increasing number in western Ukraine could meanwhile see continuing benefits in migrating to the EU. The risk is that an already divided country will formally split into two.

Should Ukraine be an independent and neutral buffer state, between the EU and Russia, not seeking formal EU and NATO membership? It could co-operate with and receive increased financial assistance from the EU, the US, the IMF and the World Bank, also under the condition that Russia would respect its territorial integrity. Export Credit Agencies can also facilitate trade and investment in Ukraine (Hilmarsson and Dinh, 2013). In that scenario, Ukraine could possibly have some peace to grow and reach its economic potential. Whatever scenario is chosen it needs to have the ownership of the Ukrainian people, not only outside forces. Despite divisions, most Ukrainians want to keep the country together. Nevertheless, EU, NATO and US leaders need to start tabling options that would also be acceptable for Russia. Ukraine politicians need advice and even initiative from the West here.

What can be said about conditions for favorable inclusive growth dynamics for Ukraine? The first condition is political commitment. Fast and sustained economic growth sufficient for Ukraine to catch up requires long-term commitment by its political leaders. There is a need to adjust the role of the state, giving everyone an equal opportunity and strengthening rule of law to make economic institutions more resilient. Second, economic growth and development depend on human and physical capital, and on the factors affecting their productivity. The speed of growth is to a large extent driven Ukraine's ability to keep its highly skilled labor force within its borders by offering attractive job opportunities, but also by the pace of investment, public and private. This investment requires increased domestic savings and external capital flow into Ukraine. Facilitating FDI and integration into global value chains, improving logistics and connectivity to fully leverage external opportunities is also important. Third, more integration into the world economy, especially the common EU market, is critical. Markets for exports and opportunities to import ideas, technology, and know-how are vital for Ukraine.

To achieve this much needed economic growth Ukraine needs to maintain stable macroeconomic policies and above all it needs peace and stability, not the deadlock that is to a large extend caused from and the East-West competition for this country in crisis. It is time for the West and the East to stop torturing Ukraine and instead help Ukraine build a healthy, sustainable and enabling environment for growth and prosperity. This is not only important for Ukraine, but it will also benefit the whole European continent and ease tensions between the US and Russia.

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