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International and Domestic Financial Crisis Responses in Latvia and Ukraine, 2008-2010

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Introduction

The global financial crisis which began in 2008 found some of its worst-hit victims in Central and Eastern Europe, among the emerging economies which had been communist 20 years earlier. In recent years these "transition economies" had been growing at rates to make the more mature economies of Western Europe envious, with some doubling in size in just several years.

Once the crisis emanating from the United States hit the region, however, the growth markets became unreliable markets. Some countries fared better than others – Poland was the only country in the European Union to grow in 2009, at a clip of 1.2%[1] – but several economies were devastated by the international crisis. The Baltic States of Latvia, Estonia and Lithuania, which had already begun to intentionally slow down their overheating economies, went from leading the EU in GDP growth to leading it in economic contraction. The IMF opened rescue programs with Latvia, Hungary and Romania in the EU and Ukraine in the region outside the EU. In Eastern Europe's darkest days in February 2009, when the government of Latvia fell, the *Economist* ran a cover story describing the crisis in the new member states as "the bill that could break up Europe."[2]

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[1] *The Economist*, "Poland's strong economy: Horse power to horsepower," January 28, 2010, http://www.economist.com/world/europe/displaystory.cfm?story_id=15394158.

[2] *The Economist*, "The bill that could break up Europe," February 26, 2009, http://www.economist.com/opinion/displaystory.cfm?story_id=E1_TPTRQGVV, see also "Argentina on the Danube?" February 19, 2009, http://www.economist.com/opinion/displaystory.cfm?story_id=E1_TPTQQJNV.

We chose to travel to Latvia and Ukraine to study the crisis in Central and Eastern Europe. Both were once republics of the Soviet Union, but they are of vastly different sizes, histories, and other characteristics. Latvia, a small country of 2.2 million people, reoriented itself towards the west and aggressively reformed its economy following independence, and joined the European Union in 2004 along with seven other post-communist countries, plus Cyprus and Malta. Despite what the two enormous blue and yellow flags – the blue sky over yellow fields of Ukraine and the ring of stars of the EU – hanging outside the Ministry of Foreign Affairs in Kyiv might suggest, Ukraine is not a member of the EU. A sprawling country of 45 million whose economy has reformed rather slowly since the fall of the Soviet Union, attaining World Trade Organization membership only two years ago, Ukraine remains far from the status of candidate for EU enlargement. But both were growing strongly before the global financial crisis and contracted sharply once it started. Latvia led the European Union in growth, with GDP rising 12.2% in 2006 and 10.0% in 2007. Ukraine grew 7.9% in 2007. In 2009 Latvia's economy shrunk by 17.5% of GDP, while Ukraine's shrunk by 15.0%.[3]

The international community and EU specifically, especially in the case of its member states, had good incentive to help out. In both countries, foreign-owned banks dominate much of the lending market, so that the losses due to bank failures would be felt in Western European countries like Sweden (home of Swedbank, a dominant lender in Latvia) and Austria (home of Raiffeisen, a dominant lender in Ukraine). If Latvia were to go off its peg to the euro, the three other EU member states which are also pegged to the euro with the intention of joining the eurozone as soon as they can – Estonia, Lithuania, and Bulgaria – might be taken down by the contagion as currency traders sensed vulnerability, such as in the Asian crisis of the late 1990s. Ukraine's fiscal problems also can affect the wider region, as January 2009 showed. Russia's state-owned natural gas company Gazprom did not hesitate to shut off natural gas to Ukraine when the government (which significantly subsides citizens for their energy usage) did not pay its bills on time, and no gas going to the important transit country of Ukraine meant no gas going to a number of EU member states for several days in the dead of winter, causing suffering and an interruption to economic activity.

In their internal and international economic situations in the crisis, Latvia and Ukraine make an interesting contrast. Latvia's membership in the European Union and the tight peg of the lat to the euro meant that the EU was far more important as an international actor in the Latvian case

Economist Intelligence Unit figures. Estimates vary of course, and the shrinkage is measured in local currency, while Ukraine's currency was devalued by about 40%, meaning its GDP in terms of U.S. dollars, for instance, has shrunk much more.

than the IMF was, and indeed EU membership, requiring the yielding of some of Latvian's sovereignty, meant that international actors were more important in Latvia than in Ukraine. Having reformed thoroughly in the process of EU accession, Latvia had relatively strong institutions. The political consensus existed and a strongly independent central bank held firm enough that Latvia has been able to implement stringent austerity measures for an internal devaluation while maintaining the peg of the lat to the euro with the aim of joining the eurozone as soon as possible. Its economy was also based strongly enough on investments and not on exports (Latvia's trade deficit reached 24% of GDP in 2007) so that retaining a strong currency made sense for the country and its influential financial sector. Latvians may be suffering but the course of action chosen appears to be the least-bad solution with eurozone membership as the paramount objective, and the government has so far been able to implement it successfully.[4]

We argue that in keeping its currency peg during the crisis, Latvia was responding to international pressure and domestic hopes because as a member of the European Union that is pegged to the euro but has not yet adapted it, Latvia was in a very unique situation (shared by only 3 other countries: Bulgaria, Estonia, and Lithuania; although Denmark and Sweden are also pegged they do not have plans to adapt the common currency soon). This involved maintaining a currency peg for a set amount of time according to the rules of an external body (the European Central Bank) in order to become an official member of an international currency area, replacing a minor national currency with one traded worldwide. Latvia's situation is thus unique in history as well as at our present moment. Latvia is therefore not "the new Argentina" and we endorse the maintenance of the peg with the caveat that events may yet prove us, the EU, Latvia, and the IMF wrong. While painful, controversial, and debatable, Latvia's response appears to have been a successful one so far. After our trip, Latvia was succeeded as the economic basket case of the EU by the much larger economy of Greece, which fought the possibility of default in the biggest crisis with which the eurozone has yet been faced in its decade of existence. This is the real "bill that could break up Europe," a major challenge that remains unresolved and which could ultimately affect Latvia directly if the EU or its eurozone accession policy is altered because of the Greek crisis.

Ukraine, on the other hand, has been party to a much more traditional IMF rescue and prescription, with the EU playing almost no role at all. Ukraine's economy hit a "sudden stop" once Lehman Brothers collapsed in the United States in mid-September 2008 and international liquidity quickly dried up. The government sought help from the IMF and dropped the peg of

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The Economist, "Baltic Thaw, Aegean Freeze," Feb. 25, 2010, http://www.economist.com/world/europe/displaystory.cfm?story_id=15581056.

the hryvnia to the U.S. dollar as advised, reaping the export benefits of a weak currency. While Latvia's monetary policy choice can be debated, Ukraine is decades from EU membership much less the euro, and losing the peg was an obvious remedy in the situation. The export sector was helped by the weaker currency, although a drop in the price of steel, Ukraine's key export, undermined this benefit. Fiscal austerity was more of a problem. A presidential election was coming up in January 2010. Ukraine is an immature democracy, poorer, less economically reformed and with far weaker institutions than its neighbors. With the political scene dominated by two populists leading sizable parliamentary factions and a president so unpopular by 2009 as to be a lame duck, reforms were stymied by a lack of political consensus and vote-winning social spending. The international response, while helpful on the whole, has been less significant compared with Latvia because of Ukrainian politics, and the IMF has been criticized for being too lenient with Ukraine. However, several tranches of IMF aid to Ukraine have been delayed and the last remains undelivered as the country does not yet have a 2010 budget. Ukraine has continued to live above its means.

However, the election is now in the past, opposition leader Viktor Yanukovych's victory over Prime Minister Yulia Tymoshenko in February 2010 was internationally acknowledged and the country saw no large protests despite Tymoshenko's claims that the election was not legitimate. Yanukovych took office as the fourth president of independent Ukraine on February 25, 2010, and was able to quickly oust Tymoshenko and form a new government in the Supreme Rada led by longtime close ally Mykola Azarov, creating the political stability the country needs to move forward and properly deal with the economy. Yanukovych and Azarov may have bad reputations in the West for crony capitalism and some see a risk that Ukraine could be turning towards authoritarianism. However, greater political unity is probably beneficial for Ukraine's short term economic policymaking because the government should be able to enforce its agreements with the IMF. The appointment of Sergei Tigipko, a successful banker who came in third place in the presidential election, as deputy prime minister with responsibility for dealing with the IMF is a hopeful sign. With the election over but the country's fiscal situation bad enough that Ukraine's 2010 could still be worse than 2009 if there is a "double dip" recession spurred by default, Yanukovych should be wise enough to act in his country's clear interest. Many of the people we spoke to in Ukraine said that a clear decision in the election was more important than who won for reasons of stability. Now they have received that clear decision and the resultant accumulation of power by one group.

Ultimately, in Latvia the crisis response was dominated by international players: the European

Union, International Monetary Fund, and World Bank (as Latvian President Valdis Zatlers calls them, "the coach," "the policeman," and "the nanny," respectively[5]) and the strong policy of the central bank to maintain the currency peg, Latvia's governments simply cooperated with the prescription. In Ukraine, the crisis response was strongly shaped by the domestic political situation, with the IMF coming to the aid of a schizophrenic and fairly uncooperative victim. None of the country's leaders fully embraced austerity, Prime Minister Tymoshenko's crisis performance receives mixed reviews, while her opponents prioritized her defeat over long-term economic health. With the elections over, Ukraine has lost its excuse not to cooperate.

The situation in both countries remains fairly precarious, for reasons of economic instability and a bad fiscal situation in Ukraine and for reasons of political instability that could spur economic instability in Latvia. While the situation remains dynamic and this paper incorporates developments that followed our research trip, we have chosen to cut off adding in the latest developments as of April 1, 2010 (except in the concluding section). At this point the new government in Ukraine had been formed, led by Azarov, and negotiations with the IMF resumed, but no 2010 budget passed. In Latvia the People's Party had just exited the government but Prime Minister Valdis Dombrovkis's government has survived as a minority government. Greece has not yet defaulted.

Latvia

Latvia, along with Iceland, has been a poster child for the global financial crisis. The biggest real estate bubble in Europe had begun to pop well before the Lehman Brothers failure inaugurated the global crisis. Latvia's GDP shrank by 4.6% already in 2008 (compare with a 3.6% contraction in Estonia, 0.6% growth in Hungary, 2.4% growth in Ukraine, 2.8% growth in Lithuania, and 5.0% growth in Poland). After years of rapid economic growth, in 2009 Latvia saw its economy plunged into a double-digit recession. Faced with huge macroeconomic imbalances and feeling the pressure of the global downturn causing its exports to plunge, Latvia accepted a €7.5 billion loan from the European Union (EU) and International Monetary Fund (IMF) at the end of 2008 in order to help stabilize the financial system and maintain Latvia's tight peg to the euro adopted in 2004.[6]

The decision to maintain the peg and strong currency in the hopes of keeping investments

Deutsche Welle, "Broad support is crucial for tough reforms, Latvia's president tells Greece," March 30, 2010, http://www.dw-world.de/dw/article/0,,5411466,00.html.

Latvia joined the Exchange Rate Mechanism II on December 30, 2004 at 1 EUR = 0.702804 LVL.

from losing their value and to allow accession to the common currency as soon as possible – the plan had been 2008, but inflation kept Latvia out before the crisis, and now 2014 is the optimistic target – was the key decision and quite controversial. It required a painful and difficult internal devaluation of budget cuts and tax increases, while economic or popular pressure could still break the peg, although the central bank has been successful thus far, a year and a half into the currency crisis. The IMF would normally insist on devaluation of the currency; the fact that Latvia's maintenance of the peg has been given the go-ahead in the international response is the result of the special situation of the European Union and the effect devaluation would have on Latvia's neighbours – from Swedish banks that would be damaged by non-performing loans to neighbours like Estonia who have also pegged to the euro with the goal of adopting the common currency as soon as possible. Prominent international economists such as Nobel laureate Paul Krugman and Mark Weisbrot of the Center for Economic Policy and Research have strongly criticized Latvia's stubborn adherence to the euro peg and the concomitant pro-cyclical policies, citing Argentina's devaluation in 2001 as the positive counter-strategy.[7]

We believe the chosen strategy was the best choice for the European economy and less certainly for the Latvian economy itself. By not devaluing, Latvia prevents the meltdown of the financial system and spillover across the Baltic region. However, there is a clear trade-off for Latvia as the peg makes the immediate crisis more difficult and it could ultimately fail. The international institutions involved provide a certain smokescreen for the Latvian government for unpopular measures. Still, the current climate and impending elections might result in changes on the political scene that could jeopardize the consistency of a recovery program that has already been at odds with a reluctant parliament and a resistant constitutional court. As Latvia's President Valdis Zatlers said, "the most important thing is to keep the public's support for the plan for the next few years. Because this is not a rescue plan for one year, it's a rescue plan for four years and the end point is joining the euro in 2014."[8] Given that public support could dry up over such a long period of hard times, the success of the Latvian plan is not secure yet.

Some of the changes have already occurred. While elections are still due in October 2010, there is a chance that they could come early. Prime Minister Valdis Dombrovskis of the New Era party led a five-party conservative coalition beginning in March 2009 after the crisis caused the previous government to fall. However, the largest party in the coalition, the People's Party, began

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See Paul Krugman, "Riga Mortis," *New York Times*, February 10, 2010, http://krugman.blogs.nytimes.com/2010/02/10/riga-mortis/; Ray Weisbrot, "Latvia's recession: The Cost of Adjustment with an 'Internal Devaluation,'" February 2010, Center for Economic and Policy Research.

Deutsche Welle, "Broad support is crucial for tough reforms, Latvia's president tells Greece," March 30, 2010, http://www.dw-world.de/dw/article/0,,5411466,00.html.

distancing itself from the economic policies and left the coalition in March 2010. Without the People's Party, Dombrovskis has only 47 of the seats in the 100-seat parliament, the Saeima, instead of 64, but he has continued on with a minority government. When the elections are held, the center-left Harmony Centre is expected to gain seats, but because they are seen as pro-Russian (their leader Nils Ušakovs, an ethnic Russian, has been mayor of Riga since July 2009) their share of the vote may be limited and the center-right may be able to hold on to power. Because of the political backlash against the management of the economic crisis, the Economist Intelligence Unit writes there is still a significant risk that the currency will eventually be devalued and anticipates Latvian accession to the eurozone at 2015 at the earliest.[9]

On the international scene, the Greek debt crisis and German reluctance to come to the rescue has caused the very survival of the eurozone to be questioned in the pages of the *Financial Times* and the *Economist*. We cannot deal extensively with this larger euro crisis here, but it is worth noting because it could lead eurozone members to try to exclude additional countries that have had financial difficulties, like Latvia. Fears that the eurozone accession strategy was losing credibility could undermine the peg in Latvia and eventually cause devaluation.

Latvia's strategy of clinging to the euro peg prioritizes investors' trust and long-term goal of joining the eurozone as a means of securing access to international lending facilities and foreign investment over the potential risk of structural damage to the country's real economy. Although internal deflation is unavoidable where devaluation is not an option, the feasibility of such a tough measure is a gamble the government has had to take on. More regrettable is the fact that the window of opportunity for reform is being used for superficial reform, not the necessary overhaul of the tax system. Institutional shortcomings, political fragmentation and governance issues hinder the measures to combat some of the more socioeconomic stumbling blocks to economic recovery.

A question deserving further research is the validity of the Maastricht criteria: part of Latvia's trouble has arisen from its development strategy geared towards nominal convergence with the rest of the European Union. This looked fairly successful on the surface until 2007 but the necessary structural reforms of the real economy were not undertaken to secure a safe standing for Latvia within the EU. The implication is that merely numeral criteria given by the Maastricht Treaty are no sufficient yardstick to measure economic preparedness. The Greek sovereign debt crisis gives weight to this proposition and further throws into doubt whether current eurozone members will keep their promises to Latvia when it approaches fulfillment of

Economist Intelligence Unit, Country Report: Latvia, March 2010; *The Baltic Times*, "People's Party pulls out of ruling coalition," March 18, 2010, http://www.baltictimes.com/news/articles/25234/.

these criteria.

Latvia and its economy in the European Union

Like Ukraine, Latvia emerged as an independent country during the collapse of the Soviet Union. However, Latvia and its Baltic neighbours Estonia and Lithuania remembered a time of independence as internationally recognized nation-states. Decades after the Baltic States gained freedom from imperial Russia with World War I and the Russian Revolution, the Molotov-Ribbentrop pact between the Soviet Union and Nazi Germany resulted in their forced incorporation into the Soviet Union, never recognized by the United States. Independent Latvia thus oriented itself strongly towards the west in the 1990s and 2000s. With Estonia leading the way, the Baltic States managed to reform their economies to the extent that they had to be included in the eastward expansion of the European Union and NATO in 2004, because they were arguably better prepared than Slovakia, Romania and Bulgaria. The reorientation, NATO membership, and strict language and citizenship laws which discriminated against ethnic Russians, many of whom moved to the Baltics after they were incorporated in the Soviet Union, led to difficult relations with Russia. The European Union became Latvia's largest trading partner, although infrastructure continues to link the Baltics with their large neighbor.

The Latvian economy was reformed and privatized to the point where it was one of the easiest countries in the world to do business, ranking 27th in the World Bank's 2010 list,[10] ahead of Austria (28), the Netherlands (30), France (31) and Poland (72), to say nothing of Russia (120) and Ukraine (142). However, Latvia's attractiveness led to high inflation and large external imbalances as well as investment, development and strong growth. The current account deficit was chronically high, hitting $6.5 billion or 24% of GDP in 2007, with imports double the value of exports – which were mostly low value-added goods such as wood products and textiles.[11]

An important element of Latvia's development has been its credible peg to the euro, which made the lat a strong currency, like the euro. The peg was fixed in 2004 with a long-term view to Latvia's accession to the Economic and Monetary Union and accompanied by the Latvian Central Bank's unilateral commitment of keeping a narrow +/- 1% currency band. The peg has served Latvia's credibility and eliminated currency risk, enhancing the appeal for foreign investment and international trade. Yet the currency stability came at the price of Latvia's independent monetary policy. As Latvia had to adjust its interest rates according to the ECB's

World Bank Group, "Economy Rankings" in "Doing Business 2010" report, available at: http://www.doingbusiness.org/economyrankings/.

Economist Intelligence Unit, Country Profile: Latvia, 2009.

targets, the Central Bank stood practically toothless in the fight against inflation, which was spurred on by the expansion of credit through the foreign banks moving into the economy. Cutting wages was the only method available to curb inflation, which, however, did not happen until the last minute.

Before and especially after EU accession, Latvia saw a rapid expansion of the liberalized banking industry. The process of European integration transformed the development of Latvia's financial sector, which became dominated by a banking sector run by large foreign finance houses, mainly from the Nordic countries.[12] By 2001, the Hansabank group (Swedbank) and the Swedish Skandinavska Enskilda Banken covered more than two-thirds of the assets in the Baltic banking sector, leaving Latvia's Parex Banka as the one major Baltic bank which was still locally owned.[13] The high capital inflow in form of foreign-currency-denominated loans and a growing mortgage market fueled a construction boom. The result was a fully-fledged housing bubble ready to burst by early 2007. This development was accompanied by an equally high consumption boom, which wage increases contributing to high inflation, 10.1% in 2007 and more than 6% for several years before that.

The IMF, alarmed by these early warning signs of an overheated economy, advised the government to intervene in early 2007. The attempts to cool down the overheated economy caused the house prices to fall and the asset bubble to implode even prior to the international financial crisis. Debtors started to default and even before the global downturn in demand in 2008 devastated Latvia's exporters, the domestic scene was set for a financial disaster.

Crisis, rescue and currency peg

With large-scale capital outflows and intense exchange rate pressure, in December 2008 Latvia requested assistance from the International Monetary Fund (IMF) and the EU, agreeing on a 27-month $10.5 billion Stand-by Arrangement (SBA) loan program with the objectives of relieving the immediate liquidity crisis, ensuring long-term stability, and maintaining the exchange rate peg.[14] To meet the terms of the agreement, the government had to slash 700 million lati ($1.2 million) from the budget. On February 20, 2009, the government led by Prime

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Martin Adahl, "Banking in the Baltics – The Development of the Banking Systems of Estonia, Latvia and Lithuania since Independence – The Internationalization of Baltic Banking (1998-2002)," *Focus On Transition* 2: 2002, http://www.oenb.at/en/img/adahl_ftr_202_tcm16-10384.pdf, p. 110-111. In 1998, Skindinavksa Enskilda Banken (Sweden) took a 32% stake (raised later to 44%) in Unibanka; in 1999 Meria Nordnaken (Sweden) purchased Latvijas Investiciju Banka; in 2000 Norddeutsche Landesbank Girozentrale (Germany) bought Rigas Komerbanka; and the Skindinavksa Enskilda Banken raised its stake in Unibanka to almost 100%.

Adahl p.111.

Latvian Institute (2009) 'International Monetary Fund. Republic of Latvia. Request for Stand-by arrangement. Fact sheet number 1', January 28.

Minister Ivars Godmanis, in power since December 2007, fell, the second government worldwide to do so since the global crisis began, after Iceland's.[15] On February 24, Standard & Poor's downgraded Latvia's credit rating to a non-investment "junk" grade BB+, and the cost of borrowing spiked, practically halting lending to Latvia.[16]

The currency peg, at the center of a macroeconomic turmoil, began to be called into question on the domestic and international scene. But actually, the maintenance of the currency peg, as stated in Latvia's technical memorandum of understanding, was in fact never called into question by Latvia's policymakers. Devaluation was discredited in Latvia's official circles as a strategy from several perspectives: firstly, there is a consensus in the political sphere over the euro as the only viable long-term strategy for securing access to international lending facilities and investment; crucially, the Nordic banks as considerable stake-holders see their euro-denominated loans rendered useless in the case of devaluation. These reasons were accepted by the IMF, which initially favoured a devaluation of the lat and submitted to the pressure from Latvia and the EU.

An outspoken critic of the peg, Professor Vyacheslav Dombrovsky of the Stockholm School of Economics,[17] has linked the currency board policy to conditions at the Latvian Central Bank. Binding itself too early and too readily on the narrow 1% band to the euro, the bank has become a prisoner of its own words. Furthermore, it has been also suggested that the devaluation was not an option that could have been efficiently administered at the bank, which since 2004, has followed the single monetary policy of peg-maintenance. While path-dependency certainly plays a role, it has to be underlined that given overall macroeconomic imbalances in the Latvian economy, especially the risky capital flows fuelling inflation, as well as central bank's inability to regulate foreign-owned banking sector, the bank is in a weak position to handle any policy other than the peg-preservation. The controversy surrounding the currency peg thus bears no more than a retrospective lesson: the unilaterally adopted 1% currency band has proven to be of doubtful value. However, to manage devaluation within the customary 15% band now would call the attention of currency speculators and make a management of the currency less feasible than a strong commitment to a narrow peg.

The implications of keeping the peg spelt a harsh adjustment policy for the Latvian economy. Not being able to devaluate, it had to undergo a process of internal devaluation – i.e.

David L. Stern, "Latvia's Government Falls on Economic Toll," *New York Times*, February 20, 2009, http://www.nytimes.com/2009/02/21/world/europe/21latvia.html.

Laura Cochrane, "Latvia's Credit Risk Rises to Record on Bankruptcy Concern," *Bloomberg*, February 27, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax2zgkO07EV4.

Dombrovsky keeps a blog at: http://www.politika.lv/blogi/index.php?id=60725.

deflation. Since the catch-up in competitiveness on a technological scale had not been achieved prior to the crisis, the Latvian economy will have to adjust in the opposite direction. After the current account deficit has been radically healed by a rigorous cut of imports, the two points on the agenda remain inflation and the budget deficit.

While other countries have implemented stimulus programs to restore their economies, the Latvian recovery centers on the restoration of macroeconomic balance and consolidation of the banking sector. A post-crisis Latvian stimulus could further jeopardize the necessary deflation process. Secondly, in Latvia's small, open economy a stimulation of domestic demand would provide little impulse for the domestic industry but largely benefit importers, again, jeopardizing the improvement of Latvia's trade balance. The special attention to the banking sector needs to be further explained: Latvia's private sector is strongly dependent on foreign direct investment. Accordingly, a restoration of international investors' confidence in domestic stability remains the key priority. A firm commitment to the restoration of the macroeconomic balance could eventually reverse the downgrading of the country's credit rating and restore the country's attractiveness as investment destination.

There has been much discussion of the boon a devaluation would bring for Latvia's export sector and Latvia's economy overall. Weisbrot and Krugman cite Argentina as the recovery model Latvia should orient its policy on – a fairly ill-informed suggestion, considering Latvia is a tiny EU economy with few resources, land mass and population and Argentina a Latin American giant. Devaluation would not only make Latvia's exports more competitive, but make the imports of intermediate goods and energy more expensive, and because the economic crisis is global and especially bad in Latvia's region, it would be difficult to get out of the crisis through export growth. And since most of Latvia's trade happens within the Baltic region, a "beggar-thy-neighbor" policy would be hardly be well-received and could spread problems.

IMF regional mission chief Christoph Rosenberg stressed that Latvia's highly flexible labor market bears higher potential to buffer the adjustment: "Roughly one third of the adjustment comes from revenue measures (increases in indirect rather than direct taxes to support wage deflation) and two thirds from cutting expenditures (wages and spending on goods and services). It was important to us at the IMF and the authorities that the 2009 budget fully protects two essential expenditure categories: co-financing of EU-supported capital projects and social spending, which is set to increase as a share of GDP compared to 2008. The program also contains institutional reforms to put the expenditure reduction on a permanent footing."[18] Wage deflation is painful and means Latvia's workers will bear the brunt of the adjustment with only some increase in social spending to make up for it, but the IMF judged that wage growth in excess of productivity growth was one large underlying problem, and Rosenberg notes that Latvian wages had doubled in real terms since 2001 before being cut by 25% now. Still, this could significantly undermine the sustainability of austerity measures given the fact that Latvia is a democracy.

The strategy therefore was to stabilize the financial sector and revitalize lending in the private sector to stimulate the economy via business incentives. The stabilization of the banking sector included measures reforming the legal system, such as improving the framework for debt restructuring and the insolvency process. A new law on bank take-overs has been passed, supervision and monitoring has been enhanced. With the help of foreign staff (including US Treasury officials), Parex Bank was temporarily nationalised in collaboration with the European Bank for Reconstruction and Development (EBRD) and recapitalized in May 2009. The goal was to provide sufficient liquidity to the financial sector and reverse the credit downgrading to make the country once more a feasible destination for foreign direct investment. Yet as Latvia remains expectant of foreign funds, it will continue to be unable to regulate their practices domestically, as EU regulation confers this task to a firm's home country rather than host country. Therefore, the Latvian authorities have little power to supervise the lending practices that have led to the accumulation of bad assets on banks' balance sheets and are now becoming a political issue as in Parex Bank's case. The stability of the future economic development thus relies not only on the government's capacity to attract necessary funds but also on the EU ensuring more efficient cross-border regulation to prevent predatory lending in small economies such as Latvia. In spite of the turmoil, the Nordic banks decided to signal commitment instead of pulling out of Latvia and the recovery program has been designed in cooperation with them. Yet with a view to the last five years, it is clear that Latvia's economic turmoil is also a consequence of a lack of domestic regulatory oversight. The challenge for the future is to find a working consensus facilitating investment but preventing predatory lending with the help of a regulatory regime that might limit the foreign banks' revenue prospects.

Cooperation between IMF and EU

Christoph Rosenberg, head of the regional IMF mission, concisely outlines the Fund's strategy in Latvia and responds to Krugman and other critics in his article "Why the IMF Supports the Latvian Currency Peg," *Roubini Global Economics*, January 6, 2009, http://www.roubini.com/euro-monitor/254975/why_the_imf_supports_the_latvian_currency_peg.

Prior to the financial crisis, the IMF was present in Latvia as an advisor for financial and macroeconomic balance. In that function, early warnings had been issued with regard to Latvia's overheating economy, advising reform from an early stage onwards. In that function, the IMF has found itself in the curious role of observing early on the effects of the EU accession and structural assistance that was not deemed unequivocally beneficial. An IMF statement of June 2006 elaborates the general concern about the overheated economy. An obvious point of concern is the bank of Latvia's limited capability to fetter domestic liquidity, due to foreign dominance of the domestic banking sector. Yet another point of concern was the over-enthusiastic use of EU structural funds in the Latvian economy and the additional inflationary pressure it caused. The consequent recommendation referred therefore to the strict rationalization of self-financed projects, but also demanded that "EU-funded projects should be sequenced to ensure that only the highest-priority projects are implemented first, while those likely to exacerbate bottlenecks (e.g. in construction) should be deferred to the extent possible under EU rules."[19]

Cooperation between the two international institutions seems to have at best limited. Prior to Latvia's official request for a loan, the IMF announced publicly that "in cooperation with the European Commission, some individual European governments, and regional and other multilateral institutions, we are working with the authorities on the design of a program that maintains Latvia's current exchange rate parity and band."[20] Latvia's official letter of intent when requesting a loan, again, cites the "support of the EU under the balance of payments facility, together with bilateral and multilateral commitments demonstrates the international community's backing for our reform strategy," pledging reform under supervision and consultation of the IMF.[21]

Contrary to the cooperation process in the Ukraine, the EU retains the senior position when it comes to the implementation of reforms in Latvia. Although the IMF is addressed as the first instance of authority with regards to the loan jointly issued by IMF, EBRD, EU and World Bank, the EU is still preeminent in the authorisation. Under pure IMF consultation, the advice might be more custom-tailored to the specifically Latvian experience, but the EU has an explicit interest in maintaining the stability of the whole region, including indirectly connected EU members with similar economic structure and strategy. The role of the EU in the international response to Latvia's crisis has thus been more political and pushy, even though the IMF receives

International Monetary Fund, "Republic of Latvia – 2006 Article IV Consultation Mission Preliminary Conclusions," June 6, 2006, https://www.imf.org/external/np/ms/2006/060606a.htm.

International Monetary Fund, "IMF Statement on Latvia," December 7, 2008, https://www.imf.org/external/np/sec/pr/2008/pr08310.htm.

Republic of Latvia's Letter of Intent to IMF, December 18, 2008, http://www.fm.gov.lv/preses_relizes/dok/Letter_of_Intent_2008-12-18.pdf.

most of the attention of the international and Latvian media.

The loan conditions bind the Latvian government to spending cuts. The government has pledged to cut its budget in several ways as well as implement tax reforms to increase the government revenue accordingly. Counting up the adjustment from the first letter of intent issued by the government to the second one appreciates the difficulty to implement reforms in Latvia, especially at the moment. The initial plan encompassed budget cuts as high as 500 million lat in 2009. Public demonstrations dubbed the "penguin revolutions"[22] in January 2009 may have attracted exaggerated interest in the foreign press. Yet a second memorandum by the government addressed to the IMF in late July 2009 clearly highlights the fact that in spite of tackling the balance of payments crisis fairly well on paper, the underlying adjustments impose rather harsh conditions on the population. Seeing that the political stability of the Latvian government has been called into question, with Prime Minister Ivars Godmanis' resignation in February 2009 and with politicking ahead of the impending October 2010 elections, it is questionable whether the executive will summon the strength to push rather vicious budget cuts through the fairly strong parliament.

Eventually, under EU pressure the 2010 budget was reviewed and passed by the Latvian government in 2009 and approved by the IMF. The Latvian government has committed itself to consolidate the fiscal deficit by 500 million lat. About half of this amount is accorded to budget cuts, the other half to additional government revenue. Current Prime Minister Valdis Dombrovskis, who assumed office on March 12, 2009, has shown particular ardour to keep to IMF prescriptions and bring the recommended austerity measures to fruition, with the eventual goal of adjusting the currently soaring budget deficit to the Maastricht criteria by 2012, in spite of the unpopularity of these measures in the run-up to the elections. Overall, the program has made considerable progress in spite of domestic setbacks. It is instructive to compare Latvia's situation to that of Ukraine, another IMF loan recipient. Here, too, the EU is involved, but the primacy of the IMF as authority over EU involvement is clear. Reform in Ukraine has been marginal and stumbled over populist politics in the run-up to the presidential election. The pressure the IMF could exert met its limits. In Latvia, in comparison, the presence of legally binding EU regulations and the political leverage the trade bloc can exert on Latvian politics is creating

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Godmanis had told citizens in his New Year's Eve address that, as penguins get through the cold winter by huddling together for warmth, Latvians should do the same to get through the economic turmoil. Several hundred did huddle together in January, protesting outside the parliament and throwing some snowballs and cobblestones through windows. *All About Latvia*, "Nasing Spesal – Penguin Revolution," January 13, 2009, http://allaboutlatvia.com/article/743/penguin-revolution/.

additional pressure for a reform push in spite of lagging domestic consensus.[23]

Domestic reception of austerity measures and internal devaluation

The necessity of austerity however might cause a change of government that could undermine the consistency of the program and jeopardize its efficacy. With a view on political volatility, it is not only the reality of austerity measures but their form that should be subject to more scrutiny. The present constitution and the composition of parties in the government makes it difficult to push through the right reforms. The partisan structure in Latvia's young democratic system has not found a clear ideological alignment yet; the parties' respective orientation usually follows a single issue, or, more commonly, a stance on ethnicity. Latvia, with a Russian minority of 35%, is still struggling to integrate this part of the population in the post-independence climate of EU-philia with lingering resentment against the old occupation is mirrored more on the political than the private scene. Dombrovskis had to keep consensus of a five-party coalition; having now lost the People's Party, he leads a minority government. Sweeping reforms are therefore hard to push through a parliament that cannot revise but only veto the annual budget.

In addition to this, the relatively weak executive finds it increasingly more difficult to secure backing in the relatively strong parliament which has the final say over budget reforms.[24] Vested interests have hindered tax reforms that could have proven valuable. Latvia's political stalemate does not necessarily hinder the austerity measures, as Dombrovskis has made progress; however, budget cuts and tax increases are not accompanied by the kind of reforms that could solve some basic issues in Latvia's current administration. The only strategy the government can be reliably committed to is its objective of joining the eurozone - even if the means to do so meet contention.

The cuts in social spending have been accepted by the population used to facing tough economic crises, however people have also shown their resentment and disillusionment with the government policies. The cuts in education spending in particular have sparked resistance from students, while the slashing of public sector wages, again especially in the education sector, has met similar reactions from trade unions. The envisaged reduction of pensions by 70% has been ruled out by the constitutional court as unlawful and required the government to rethink their plan on the budget cuts.

The Latvian tax system is also highly relevant to the economic problems and recovery. Latvia

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Andrew Willis, "Almunia keeps up pressure on Latvia," *EUObserver*, October 14, 2009, http://euobserver.com/9/28825.

The problem of political fragmentation has been voiced in all interview conducted in Riga, especially during the interviews with Prof. Dobrovsky and Swedbank's Maris Mancinski.

has a flat-tax rate system, which both made it a desired destination for foreign investors and domestically created difficulties to target specific groups in a reform move needed to balance to budget. In the past two years, Latvia followed Ireland's strategy, only to experience the same capitalist pitfall. Thus in July 2004, the corporate income tax was reduced to 12.5%, to be implemented by July 2006. In response to the financial crisis, changes were made to the rates: the flat income tax for individuals in 2008 was 25%, 15%, if self-employed. Corporate tax rate was raised moderately to 15%. The standard VAT tax was 18%, a reduced rate of 5% relating to certain goods and services such as medicine or public transport. Further reforms in 2009 raised the VAT rate to 21% and the reduced rate to 10%, in response to the EU pressure. Certain goods and services, such as hotel services, books and water supply services have been taken off the reduced rate list. Meanwhile, personal income tax rate was reduced to 23%, while tax credits are applied to disabled people. New amendments as of February 2009 are to levy taxes on petroleum products, alcoholic and non alcoholic drinks.[25]

However, the tax incident remains focused on four basic groups only: income tax, personal tax, consumption and addenda. In spite - or because - of the boom in recent years, no dividend, interest rate, capital or real estate tax has been established, that could have moderated the growth of financial and real estate sector and increased government revenue (the current real estate transfer tax imposes a mere 2% on the buyer, property tax levies 1% on the owner).[26] In consequence, effectiveness of the tax raise in the current situation is not only corroded by the soaring unemployment in Latvia.[27] As an expert on Latvia's shadow economy, Juris Pajders, had noted, the crisis led to a situation where “about one third of country’s enterprises are in danger of being closed, another third will most probably stop paying taxes (in order to sustain existence) and the rest will definitely turn to shadow practice.”[28] The government revenue is therefore doubly burdened by rising expenses and dwindling income as many decide to return to the informal sector. The growth of the grey economy is one of the most worrying signs for Latvia’s government. Reports show, for example, that smuggling of cigarettes has increased by about seven times from January to November 2009, if compared with last year's findings.[29] Grey economic activity does not only diminish government revenue, but make it hard to report on the

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“Latvia Tax News 2009,” http://www.worldwide-tax.com/latvia/lat_econonews.asp.

“Latvia V.A.T. and Other Taxes,” http://www.worldwide-tax.com/latvia/lat_other.asp.

Anna Molin, “Latvian Annual CPI Falls Further Amid Deep Recession,” *Wall Street Journal*, February 8, 2010, http://online.wsj.com/article/BT-CO-20100208-706764.html?mod=WSJ_World_MIDDLEHeadlinesEurope.

Eugene Eteris and Olga Pavuk, “Shadow economy in the Baltics and around the world,” *The Baltic Course*, February 27, 2009, http://www.baltic-course.com/eng/round_table/?doc=16515.

Alla Petrova, “Cigarette smuggling cases increased seven times in Latvia in January-November,” *The Baltic Course*, December 26, 2009, http://www.baltic-course.com/eng/markets_and_companies/?doc=21889.

country's economic growth. This made itself felt in 2009 already: a second letter of intent by the Latvian government requested a waiver for the declaration of the budget, seeing that government revenue after initial cuts and reforms turned out to be much lower than expected.[30]

The second part of the recommended strategy for Latvia's recovery prescribes internal devaluation to close the gap between productivity and wage costs, to ensure the competitiveness of Latvia's export sectors in the future. But the fear is justified that the relatively painful process of getting to this stage could do irreversible structural damage to the Latvian economy. The country is therefore facing a considerable dilemma: on one side, the restoration of stability of fiscal and financial respects is crucial to the Latvian economy, for the future attraction of FDI flows. The considerable structural incongruence between lagging productivity and soaring wages would be solved at the root as opposed to be covered up by devaluation measures. On the other hand, as noted by Vyacheslav Dombrovsky, the danger of a "lost decade" of development might take too great a toll on the national economy to recover its previous levels of output. In this sense, "internal deflation" could prove a risky experiment: with a view to the stickiness of prices, firms might choose to fire personnel instead of cutting wages. The consequence could be higher unemployment before the desired decrease in price level. Another, even less desirable scenario would be the bankruptcy of the majority of Latvia's industry before its export volume has been revived by global demand.[31]

The reason why this adjustment process could pre-empt a Schumpeterian revival is a natural problem of Latvia as a small, relatively poor country in economic trouble adjoined to a European bloc with free travel and work arrangements. Already in times of economic boom, many young Latvians chose to seek work abroad (especially in England and Ireland). In times of necessity, such as now, emigration and consequent brain drain can have a devastating effect on Latvia's envisaged future as a knowledge-based, diversified, export-led economy with a strong SME basis. In spite of a highly developed historic and cultural environment and general entrepreneurial spirit, the lack of human capital is noticeable. Thus, for example, the governmental institutions in charge of the crisis response were forced to draw on assistance from outside for the simple lack of expertise. Also, with much of the workforce unemployed, skills can be lost which could exacerbate the human capital problem.

The problem rests not only with the current lack of economic opportunity but an intrusion of the ethnic controversy into the education sector. The general knowledge of Russian is replaced with a

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Republic of Latvia's Letter of Intent to IMF, July 27, 2009, http://www.fm.gov.lv/preses_relizes/dok/Letter_of_Intent_2009-07-27.pdf.

Vyacheslav Dombrovsky interview.

preference for English, as a clear sign of an ideological and economic orientation away from the East and towards the West. This development is visible in Latvia's foreign policy stance, which is marked by security concerns vis-à-vis Russia. Yet this stance also bears implications for Latvia's economic future. As a small, open economy dependent on external demand, Latvia has a clear geographic advantage as a nexus between the EU and its large eastern neighbor. The development of Latvia's banking sector - given reforms in regulation and supervision - could carve out a position for the country as a financial center for the region. Also, three ice-free ports with trading traditions to both East and West make the Latvian coast towns destinations for the transit of resources and manufactures throughout the year.

Yet current trends show that Latvia's identity redefinition towards Europe, in particular its Nordic neighbours, might pre-empt its younger generation from using their geography to their comparative advantage. The stringent Latvian language laws, initially designed to preserve the primacy of the Latvian language and so Latvian identity over Russian presence, make it virtually impossible for Latvian universities to teach in any other language than the national one - not even English (with the sole exception of the Stockholm School of Economics in Riga). Therefore, in spite of relatively good and widespread knowledge of English amongst the population, interchange with other universities (through the Erasmus program for example) is proving difficult, as is the exchange of academic personnel. Secondly, the knowledge of the Russian language, although violently opposed by the legislature, could prove an invaluable advantage for the younger entrepreneurial society.

The ideological turn to the West is also reflected in the changing trade pattern with a reorientation towards EU members like Germany and the UK. However, regional trade with the other Baltic Statees remains preeminent as does the dependence on energy and raw material imports from Eastern European countries outside of the EU. This clashes with Latvia's security concerns in a post-Cold War era. Like their Polish, Czech, Lithuanian and Estonian counterparts, Latvian politicians prominently decry the EU's lack of a strong contrarian stance towards Russia and hence turn to the US to draw attention to their politico-economic dilemma as small states embedded in the Western security structures but geographically close to the "Russian sphere of interest." In the future Latvia will predictably build on its comparative advantage in wood products and the food industry, even though a reconsideration of its geographically convenient position could open new opportunities in both East and West. For the near future, however, security concerns and ethnic politics are likely to suppress this economic opportunity. It remains to be seen whether Latvia's economy will survive a possibly prolonged adjustment period without losing its most important resource: its population.

Conclusion

During our visit to Latvia, one of our sources suggested that if there was a united political will and a coherent long-term political plan, the problems of this small country could be solved easily. The truth is that being an open economy, closely tied to the EU single economic market, and with no other feasible economic growth model but an export-led growth model, Latvian officials cannot be in control of all the aspects of macroeconomic policy-making. In this sense, the maintenance of the peg versus devaluation is not the most important question. Given the need for investment and the importance of the euro for Latvia's future, keeping the peg to the euro and thus contributing to the stabilisation of the financial sector was the right choice. With the global financial breakdown, naturally, states across the world have increased stringency in terms of public finances and in the regulatory sphere, but given the interconnectivity and foreign-owned character of Latvia's banking sector, Latvia has no other choice but to rely on improved policies across the EU.

The vital issue for Latvia remains whether politicians will indeed continue to focus on issues that tackle the basic deficiencies of the economy, such as tax reform or improving educational legislation to tackle human capital outflow. The efforts of international organizations can reach only as far as monetary policy or financial bailout. We have seen that the IMF/EU attempt to push through more austere tax policies does not in fact fit into the domestic political situation, where tax distribution and administration rather than levels of taxation form the underlying problem.

Latvia also needs to settle its identity. An over-concentration on the foreign policy, and especially security issues vis-à-vis its Eastern borders, serves unfortunately as a distraction from dealing with domestic problems. Despite current political fragmentation, the politicians must find ways to solve the lacking integration of the Russian minority in the political life, and should find a working consensus with the Russian minority. The July 2009 election of Nils Ušakovs, who is of Russian descent and leader of a political alliance that advocates increased use of Russian in education and administration and less stringent citizenship laws, as mayor of Riga is a hopeful sign. Geography is arguably Latvia's Achilles heel but also its comparative main advantage. With its ports, historical trade patterns, energy needs but also language skills, it can serve as a bridge between East and West. Strictly Western orientation brings opportunities for young people but also created risks for Latvia's future economic growth, which requires entrepreneurs and the ability for people to take advantage of the economic potential of foreign languages, above all

English and Russian. It is to be hoped that the upcoming elections in October 2010 will focus on the real issues and find constructive solutions to lead Latvia out of recession.

Ukraine

Ukraine has also been a prominent victim of the global economic downturn. The roots of the crisis in Ukraine were external, but the country's economic situation contained numerous vulnerabilities which caused a deep contraction and are slowing recovery. Despite help from the International Monetary Fund, the country's divided politics in the run up to the key presidential election, conducted in two rounds in January and February 2010, impeded sound economic policy responses and caused uncertainty. Ukraine's austerity program could not compete with Latvia's given the lack of support by domestic leaders for tough reforms. However, the government's response with the aid of the IMF has been sufficient to ward off disaster thus far. While Viktor Yanukovych's election was not accepted by his rival Yulia Tymoshenko, the international community congratulated the president-elect after the OSCE ruled the elections "free and fair" and he was sworn in as the fourth president of independent Ukraine without social unrest. A new government led by Yanukovych ally Mykola Azarov should provide greater stability and impetus for further economic measures to deal with the crisis, but we are yet to see a strong commitment to austerity, while manifold economic problems and uncertainty remains.

Ukraine has been marked by complex political discord in recent years but its economy had been booming throughout the 2000s after suffering through a full decade of negative growth in the 1990s. Ukraine was dubbed a market economy by the United States and the European Union midway through the decade and became a member of the World Trade Organization in May 2008. However, the country remains a notoriously difficult place to do business with corruption problems and a stifling bureaucracy. On the latest Doing Business index compiled by the World Bank, Ukraine ranks 142nd among 183 economies, while Russia ranks 120th and Latvia ranks 27th.[32] The ambassador of the European Union to Kyiv gave an unusually blunt assessment of Ukraine's problems in November 2009 when he told reporters: "Corruption, red tape, administrative obstacles of every kind – these are the only things that serve the interests of those who today control the economy because they do not want competition. They are allergic to competition. The vast majority of Ukrainians cannot have employment, cannot have decent

World Bank Group, "Economy Rankings" in "Doing Business 2010" report, http://www.doingbusiness.org/economyrankings/.

salaries, do not have a decent social system, because the country today is in many aspects like 20 years ago."[33]

Before the crisis, Ukraine also had a significant inflation problem, with double-digit inflation since 2004, peaking at 31% in May 2008, the third highest rate in the world at that point.[34] This was largely due to the peg to US dollar.

The crisis in Ukraine was the imported by the global crisis in September 2008, however. A collapse in world construction demand was a major hit to Ukraine's key export sector, steel. A banking crisis developed quickly. The International Monetary Fund stepped in with a $16.4 billion Stand-By Agreement in October and the National Bank of Ukraine was forced to drop the peg of the hryvnia to the dollar and let it decline sharply in value. However, after the devaluation, Ukraine's political economy and the proximity of an important presidential election meant that enforcing the conditions of the IMF deal would be a difficult proposition. Ukraine's government has only received $10.6 billion so far, with the rest held up by the lack of a 2010 budget, passage of which was delayed until after the election but which the new government hopes to pass in April 2010.

Before the crisis

Different Eastern European victims of the crisis came into 2008 in fairly different positions. Latvia was a booming economy with its currency tightly pegged to the euro as it sought to join the single currency as soon as possible. Hungary, like other larger Central and Eastern European EU members Poland, the Czech Republic and Romania, had more moderate growth and inflation but kept its currency in free float. Slovakia and Slovenia already had the euro. All of these economies had been reformed enough to enter the European Union. Ukraine's situation is unique, in many ways more analogous to that of Russia although its path has also differed from that of its larger neighbor. It did reform economically and democratize, but it did so late, in its second decade of independence, after spending the 1990s forging the Ukrainian nation, combating Crimean separatism, and reforming the economy only slowly. The new currency, the hryvnia, was introduced in 1996 and pegged to the US dollar. The result of a hesitating transition from communism had been a decade-long economic contraction, a rising underground economy, and a new politically powerful class of oligarchs comparable with Russia's. While Ukraine beat hyperinflation early in Leonid Kuchma's presidency (1994-2005),

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Rachkevych, Mark, "Stranglehold," *Kyiv Post*, Dec. 3, 2009, http://www.kyivpost.com/news/nation/detail/54353/

Anders Aslund, "Ukraine's Financial Crisis, 2009," *Eurasian Geography and Economics*, 2009, 50, No. 4, pp. 371–386.

the country verged on default at the turn of the century. The chairman of the central bank (the National Bank of Ukraine, NBU), Viktor Yushchenko, became prime minister in 2001 and embarked on numerous economic reforms, with gas oligarch Yulia Tymoshenko fighting her former competitors to clean up the energy trade as deputy prime minister for energy. Yushchenko lasted a year in office before the oligarchs ousted him (Tymoshenko's first stint in public office was even shorter), but his reforms led to a turnaround in the economy, which grew an average of 7.5% a year from 2000 to 2007.[35]

The political earthquake of the Orange Revolution in November and December 2004 brought Yushchenko and Tymoshenko back into power as president and prime minister, and led Kyiv to turn away from Moscow towards Brussels and Washington. However the political alliance of Yushchenko and Tymoshenko lasted only until May 2005 before a nasty breakup occurred and she was fired. Both backed reprivatization for companies that had been originally been sold in breach of the law, most notably in the case of Kryvorizhstal, the country's largest steelworks bought by the country's two richest men, Rinat Akhmetov and Victor Pinchuk, but Tymoshenko was more of a state capitalist and Yushchenko more of a liberal.[36] The real cause of their split has not been well-explained, however, despite its huge significance for Ukrainian politics. The political power of Viktor Yanukovych, the presidential candidate backed by Kuchma and Moscow in 2004, and his Party of Regions grew. The country went through two governments led by different prime ministers, including Yanukovych, before Tymoshenko returned to the office in December 2007. Yanukovych's opposition Party of Regions was the largest party in the 450-member Supreme Rada with 175 seats, followed by the Yulia Tymoshenko Bloc with 156 seats and Yushchenko's party Our Ukraine with 72. The Communist Party of Ukraine and another bloc led by former Kuchma aide and Rada Speaker Volodymyr Lytvyn have small delegations. (While new parliamentary elections have not been held, the Party of Regions' Azarov was brought to power with support from additional legislators from Our Ukraine in March 2010).

The second Tymoshenko government was marked by a continued lack of cooperation between the president and prime minister. There is a structural problem here in that the constitution, reformed during the Orange Revolution, does not make one office sufficiently dominant over the other, leading to gridlock. The parliament, the Supreme Rada, was largely ineffective during the Yushchenko presidency although elections were judged free and fair.

Aslund, "Ukraine's Financial Crisis, 2009," p. 372.

Anders Aslund, *Ukraine: How Ukraine Became a Market Economy and A Democracy*, (Washington: Peterson Institute, 2009) p. 204-209.

The politicians did manage to collaborate enough to gain WTO membership for Ukraine in May 2008 and in securing IMF help for the country soon after the financial crisis began.

The failure of the Orange leadership to make significant gains towards taming bureaucracy and corruption, as well as the infighting, led to widespread disenchantment with the government in the country. Kickbacks are a big problem: the construction of the stadium in Donetsk for the Euro 2012 soccer championships, for example, funded by the country's richest man Rinat Akhmetov, has been much cheaper than the publicly-funded renovation of Kyiv's stadium. While tax rates are not particularly high, the corruption of the state pushes many in the direction of the informal economy. The Orange Revolution had been dubbed "the revolt of the millionaires against the billionaires" for its support from entrepreneurs from small and medium enterprises against the oligarchs and entrenched interests represented by Yanukovych as the chosen heir of Kuchma. However, the "revolution" had been discredited by its lack of progress by the time the economic crisis hit, which naturally made the government even less popular. For that reason many in Ukraine have been turned off of politics or did not think it was important whether Tymoshenko and Yanukovych won the presidential election as they had low opinions of both. While a third candidate could ultimately not reach the level of support of the two frontrunners and reach the run-off, Sergei Tigipko, a successful banker who managed Yanukovych's campaign in 2004, then withdrew from politics for a while, managed to gain a suprising 13% of the vote in the first round, ahead of Supreme Rada Chairman Anseniy Yatsenyuk and President Yushchenko with much less regionally concentrated support. Economic reform was at the heart of his campaign, and he pointed out that Ukraine had more than 60 agencies which can inspect, fine and close companies compared with eight in the European Union.37

Despite political battles, 2008 had been a good year for Ukraine with the WTO accession and the follow-up of an Association Agreement with the European Union, at the heart of which is a deep and comprehensive free trade area (unfortunately, negotiations to conclude that agreement are still ongoing two years later). Public finances were quite good for Eastern Europe, with budget deficits around 1% of GDP and public debt down to as low as 12% of GDP. The current account deficit had become vulnerably high, at 7.2% of GDP, by 2008, but that was not nearly as high as Latvia's or Bulgaria's. However, inflation was a major problem. With the hryvnia pegged to a weak US dollar, inflation had been in double digits since 2004 and it peaked at 31% in May, the month of WTO accession, being the third-highest in the world. Ukraine

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Mikhailo Wynnyckyj interview, see also Katya Gorchinskaya, "Tigipko gains momentum in presidential campaign," *Kyiv Post*, December 3, 2009, http://www.kyivpost.com/news/politics/detail/54352/.

was only able to start bringing down inflation by loosening the exchange rate peg. Economist Anders Aslund, a Ukraine expert, writes that the currency situation, yielding massive profits for commercial bankers off speculation, "amounted to a Ponzi scheme that could not continue for much longer. Ukraine would become a non-competitive trading country with an excessive current account deficit, as an untenable financial disequilibrium was mounting, ripe to erupt in a financial crisis."[38] The remedy was a floating exchange rate, although the devaluation would cut into citizens' savings and thus be highly unpopular. That is what the financial crisis effectively forced upon policymakers.

Aslund writes that "three factors rendered Ukraine's economy vulnerable. First, unlike many East European countries, Ukraine was not a member of the European Union and thus not eligible to receive neighborly protection. Second, Ukraine was exceedingly dependent on highly cyclical steel exports, and third, foreign investors had little confidence in Ukraine's policymaking."[39] While Latvia was in a special situation as a small (and not rich) country in the European Union, and Iceland's position as a developed country in Europe played a role as its new leadership applied for European Union membership as a future safety net in the wake of the crisis, Ukraine was in a more typical developing country situation, comparable to those faced by Latin American and Asian countries and Russia in the 1990s, places where hot markets suddenly went cold – only with worse rule of law and red tape to begin with, limiting foreign investment.

In addition to a pegged exchange rate, which imported additional American inflation to a growing economy that already had an inflation problem, Ukraine had the classic double mismatch problem of developing countries with lending taking place in foreign denominated currency. Financially, the country was vulnerable. Losing the peg would create a non-performing loans problem, contaminating the banking sector.

One of the main strengths of the Ukrainian economy turned out to be a weakness in the context of a global crisis. Ukraine grew through exports, with metals led by steel making up more than 40% of the export sector. As global investment and construction ground to a halt, the price of steel dropped about 45% in 2009. Production slowed sharply. The price of steel and production are anticipated to rise only slowly. Russia was similarly hurt by a fall in the price of its export resources, oil and gas, but customer's energy needs drop much less than their construction needs in a recession. The damage wrought by the fall in steel prices shows the risk of an undiversified economy.

Geopolitics provided another problem for the Ukrainian economy. Ukraine's long history

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Aslund, "Ukraine's Financial Crisis, 2009," p. 374.
Aslund, "Ukraine's Financial Crisis, 2009," p. 374.

of domination by Russia has not ended, as Russian involvement in the 2004 presidential election and subsequent pressuring and squabbles have shown. While former communist countries further west, like Poland, were able to reform economically with a serious prospect of EU membership, Ukraine lagged behind with little prospect of substantial integration with Europe in the near future. It had a special role as a transport country for Russian gas to European customers, and thus paid less than market prices for its own gas while Russia paid less in transport fees to Ukraine. After Yushchenko won the presidency, Ukrainian-Russian relations worsened. Ukraine's energy prices rose above those of Belarus, for example, and since Ukraine subsidized citizens' energy usage, this put a stress on government finances. When Ukraine did not pay Gazprom on time for its gas, Russia did not hesitate to shut off the flow. This worked as a political weapon. The January 2009 shut off of gas, which left many customers in Central and Eastern Europe without heat during a cold winter, especially damaged Ukraine's reputation as a reliable business partner.

Ukraine's geopolitical position means that it essentially has three general choices of orientation, which do have a clear impact on its economic position in the world. Ukraine can align itself with its historically dominant and culturally similar neighbor Russia, giving up some independence in exchange for protection and aid. Ukraine can turn away from Russia, towards the West and the world of international institutions, free markets and rule of law. Or Ukraine can attempt to balance both. Balancing is arguably the default option since independence, but the international isolation of the Kuchma regime after the 2000 murder of journalist Heorhiy Gongadze resulted in a closer alignment with Russia and President Yushchenko had unquestionably tried to align Ukraine with the West, leading to bitter relations with Russia. President Yanukovych embraced pro-Russia rhetoric as a candidate and upon his election but is expected by some to govern Ukraine in a more independent, pragmatic fashion, representing the Ukrainian oligarch's business interests, with the goal of more economic integration with Europe as well as better relations with Russia. Notably, Yanukovych did choose Brussels for his first trip abroad as president. However, his overall foreign policy record in the first two months shows more of a tilt towards Russian than many Ukraine-watchers anticipated. Still, it is early in his term, and Russian relations were a pressing problem.

In late 2008, Ukraine was a growing economy, but it was among the poorest countries in Europe with a per capita GDP measured in purchasing power parity of about $7000 – far behind the new EU member states as well as Russia, ahead of only Moldova and several Balkans countries torn by war in the 1990s, and below the global average. With 46 million people, Ukraine is slightly larger than Poland, but it has only attracted $35 billion in foreign investment since independence, compared to $200 billion for Poland since the fall of communism.[40] Although it is poor, Ukraine's size makes it the fifth largest economy in the region, after Russia, Poland, the Czech Republic and Romania. GDP was about $180 billion in 2008 before the crisis hit.

The crisis hits and the IMF lends a hand

The Lehman Brothers bankruptcy on September 15, 2008 officially inaugurated the world financial crisis by destroying international liquidity. International credit for Ukraine evaporated. This in turn led to numerous bankruptcies in Ukraine. It froze the domestic banking system, as banks had taken out loans in foreign currencies which they could no longer refinance. One-third of household deposits were withdrawn from the Ukrainian banking system. The Ukrainian government approached the IMF on October 10. The Executive Board of the IMF approved a $16.4 billion two-year stand-by agreement to Ukraine on November 5, 2008.

With help from the IMF, the Ukrainian government had three key goals according to the IMF press release: help the economy adjust to the new economic reality by floating the exchange rate and other measures, restore confidence and financial stability by recapitalizing viable banks, and protect vulnerable groups in society through targeted social spending.[41] The floated hyrvnia lost 40 percent of its value quickly.

Agreement on a second tranche of the loan to be delivered in February 2009 proved problematic due to differing growth forecasts for the year, key to running a balanced budget. Finance Minister Viktor Pynzenyk resigned in protest at Tymoshenko's budget in January 2009 and the prime minister took over IMF negotiations herself. In an interview with us, Pynzenyk said despite a surplus of ministers, Ukraine did not actually have a government, it had a "theater with one actor" – Tymoshenko. He argued that the IMF had been too lenient with Ukraine and that society did not understand the depth of the crisis while they still received their wages and pension. Pensions in Ukraine hit a world record 19% of GDP in 2009. When the parties agreed, the IMF let Ukraine run a 4% budget deficit for the year, but the government still had to levy taxes and increase the controlled prices of goods such as coal.[42]

The government stepped in to help the economy in several ways, such helping pay to

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Roman Olearchyk, Ukraine Report: "Global crisis leaves export economy badly exposed", *Financial Times*, May 19, 2009, http://www.ft.com/reports/ukraine-2009.

Camilla Anderson, "Helping Ukraine Avoid A Hard Landing," *IMF Survey*, November 10, 2008, http://www.imf.org/external/pubs/ft/survey/so/2008/car111008a.htm.

Aslund, "Ukraine's Financial Crisis, 2009," p. 382.

complete construction projects that were more than 80% complete.[43] Saving the banks was another challenge. More than half of banking assets in Ukraine are owned by foreign companies, which was a saving grace in the crisis because richer countries like Austria could inject their banks with funds, while an IBC/EBRD program helped exposed foreign banks as well. But with foreign debt obligations maturing in 2009, Ukraine's government orchestrated a bailout plan that included the nationalization of three of the largest of Ukraine's 180+ banks (Kiev Bank, Ukrgazbank, and Rodovid Bank).[44] With two of the country's largest banks (Oschadbank and Ukreximbank) already state-owned, this increased the state's stake in the domestic bank market to 13 to 15%. The recapitalization effort has gone primarily into the hands of the state banks and foreign-owned banks, resulting in only 10%-15% of the recapitalized effort in the "hands of private Ukrainian capital."[45] Two banks with bad problems (Nadra and Ukrprombank) were slated for recapitalization, but eventually obligations on clients' deposits were passed on to Rodovid Bank instead.[46] Bad loans tripled to about 60 billion hyrvnia (roughly $5 billion), from about 2.2% to about 7% of total loans, between January and October 2009, according to the NBU. Credit has tightened, with few banks doing any mortgage lending in a housing market where prices have fallen. The banking sector remains unhealthy.

Meanwhile, Ukraine faces tough fiscal issues with revenues low, a suffering citizenry in need of assistance, and the needs to maintain energy subsidies so that state energy company Naftogaz can meet its payments to Russian natural gas company Gazprom, and to recapitalize banks. The final $6 billion from the IMF has not been delivered because of Ukrainian political competition, essentially. Both new taxes and spending efforts from the Tymoshenko government were blocked by President Yushchenko and the opposition Party of Regions. Ceyla Pazarbasioglu, the IMF mission chief to Ukraine, says the main hurdle to the implementation of the program is "ownership: For any economic program to be successful, there must be a minimum level of consensus."[47] The international organizations have been frustrated working with Ukraine and seeing little progress.

In recent months the IMF has paid special attention to Ukraine's 2010 state budget, still yet to be passed, which has prevented delivery of the final tranche. The parliament, with its leaders running for president, failed to adopt any key laws in late 2009 and early 2010, and

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Mikhailo Wynnyckyj interview.

Economist Intelligence Unit, Country Report: Ukraine, August 2009.

Economist Intelligence Unit, Country Report: Ukraine, January 2010.

Kyiv Post, "Tymoshenko: Obligations on deposits of Bank Nadra's clients to be transferred to Rodovid Bank", December 14, 2009, http://www.kyivpost.com/news/business/bus_general/detail/55064/.

IMF Survey, "IMF Urges Ukraine to Stick With Recovery Policies," November 4, 2009, http://www.imf.org/external/pubs/ft/survey/so/2009/INT110409A.htm.

declined to pass the 2010 draft budget prepared by the Tymoshenko government. A crucial part of the 2010 budget planning is the "social standards law," including generous wage and pension increases. The Party of Regions demanded a hike in the minimum wage and official subsistence level in summer 2009, going as far as to physically block the parliament, and it was eventually passed and signed into law by Yushchenko despite opposition from Tymoshenko's bloc. The new law could cost an unsustainable 7 percent of GDP in 2010, according to the IMF. The IMF supports an increase in wages and pensions in line with expected inflation (around 10 percent), however is worried that anything more generous would put inflationary pressure on the economy and would have to be paired with cuts elsewhere. Pazarbasioglu argues that having the Ukrainian government live within financing constraints while keeping the economy sustainable with welfare indexed to inflation is the best way to help the poor.

Mykolo Azarov's government has recommenced negotiations with the IMF in hopes of getting the final $6 million. In the most recent developments, the IMF sees Ukraine's 2010 budget deficit at 6 percent of GDP including payments to state-run energy company Naftogaz and bank recapitalization costs according to the government. The IMF is demanding a 4 percent deficit including 1 percent for Naftogaz. The government is planning is budget on an assumption of 3.7% GDP growth this year and has announced plans to raise taxes on alcohol and luxury goods to raise revenue.48

Policy options

The global financial crisis exposed vulnerabilities in the Ukrainian economy from the lack of diversity in its exports to its currency peg to international business's lack of trust in the government and wariness of the bureaucracy, to fiscal challenges. But it also has given indications of what policies Ukraine should follow to strengthen its economy.

In monetary policy, the hyrvnia is best off in a free float which prevents future currency crises. The benefits of a floating currency have been shown by Poland, which was the only EU country to continue positive growth in the crisis, and the crisis showed the dangers of a peg for the financial sector. If policymakers determine to fix the exchange rate once again, however, a peg against the euro or a mixed basket of currencies might make more sense than a peg against the US dollar, as Ukraine's leading trading partners are the European Union and Russia, not the US. Monetary policy should focus on growth while combating inflation.

Daryna Krasnolutska and Kateryna Choursina, "Ukraine Says Still No Accord With IMF on Budget Gap," *Bloomberg*, March 30, 2010, http://www.bloomberg.com/apps/news?pid=20601095&sid=amzA.tHlmb70; "Ukraine Sees 2010 Budget Deficit Narrowing 1.6 Points," *Bloomberg*, March 24, 2010, http://www.businessweek.com/news/2010-03-24/ukraine-sees-2010-budget-deficit-narrowing-1-6-points-update1-.html.

Boosting international competitiveness is also important and this must be done by increasing transparency and competition against corruption and vested interests – an uphill battle, but one that needs to be fought. Ukraine's spectacular corruption has provided an enormous drag on the legal economy and foreign investment. The shadow economy has appeared to increase during the crisis, meaning that Ukraine's economic contraction is not actually as deep as it looks. As Professor Mikhailo Wynnyckyj of Kyiv-Mohyla Academy described to us, many businesspeople have officially closed their businesses, but they then just use cash in transactions, 50 people are actually employed and products are available in stores – this is an attractive alternative to dealing with inspectors, kickbacks, and taxes based on projected earnings. At this point, many estimate that the shadow economy is worth 50% or more of the legitimate economy. Movements towards guaranteeing property rights would secure faith in a law based system that is trustworthy, hopefully reducing the incentives to engage in corruption, the major impediment to development in Ukraine. The ingredients for recovering from the crisis and continuing growth are there.

The government should promote greater diversity in Ukraine's exports from dependence on steel. Ukraine has a comparative advantage in agriculture with some of the world's richest soil and greater access to the European market through an Association Agreement could help increase food exports. Land privatization remains a difficult political issue but there is huge potential here.

Fiscal policy will remain a challenge because of low revenues. Ukrainian banks need help that the state is hard-pressed to afford and recapitalizations are hard to put into a budget plan. The social standards law passed in autumn may be an attempt to help out citizens hit hard by the crisis as well as a ploy for votes, but the country cannot afford it. Yanukovych's Party of Regions was the sponsor of the legislation, passed while they were in opposition and signed by Yushchenko. Now that Yanukovych is president, he will need to make an adjustment so that the law does not bankrupt his country. Ukraine's chances of default are hard to judge, some of our sources dismissed it, others, such as Pynzenyk, thought it was a distinct possibility. Yields on the country's debt have been above 10% for more than two years, with Standard and Poor's rating Ukrainian long-term debt at B, well below investment grade.[49] According to CMA's Global Sovereign Credit Risk Report, Ukraine has fallen from having the riskiest sovereign debt worldwide (at the start of 2010) to fourth place, behind Venezuela, Argentina and Pakistan

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Kateryna Choursina and Daryna Krasnolutska, "Ukraine Debt Costs Poised to Drop, Rival Greece, On Russia Deal," *Bloomberg*, April 22, 2010, http://www.businessweek.com/news/2010-04-22/ukraine-debt-costs-poised-to-drop-rival-greece-on-russia-deal.html.

(Latvia comes in at number 8 in the quarterly report released in April 2010).[50] This largely because of the election halved the risk in the credit default swaps market, rather than because those countries got worse. Although this is an improvement and the markets have focused on Greece and other eurozone economies like Portugal in recent weeks, it is self-evident that Ukraine is still not in a great situation here.

Maintaining a responsible fiscal policy is thus a must for Ukraine to attract foreign investment. It will require reform of the bureaucracy and corruption. Shrinking the size of government is helpful, making it more functional is even more important. These are steps that will clearly be profitable for Ukraine in the long term.

Energy is a related issue. Ukraine used to pay much less than market price for gas from Russia, but its discount has been falling in recent years, so that now it pays about 80% more than the more Russia-friendly Belarus. The state still heavily subsidizes the energy consumption of its citizens, so that Ukrainians pay about 30% of the true cost, but this is unsustainable under current conditions and the IMF is pushing the government to reduce the subsidies. This is necessary to make the economy more modern and market-based, and will reduce a strain on state finances. The energy security of Ukraine has been constantly challenged by the state-run company Naftogaz having trouble making its payments to Gazprom. This resulted in the infamous cut-offs of Russian gas to Ukraine and thus Europe, as roughly 80% of Russian gas to Europe passes through Ukraine's pipelines, most notably in January 2009. The IMF allowed Ukraine to use its international reserves for gas payments at the last minute in December 2009.[51] Time will tell whether Yanukovych's election eliminates the problem of cut-offs and their direct and economic costs, as the cuts are widely seen to have been made on political grounds more than economic ones during the Yushchenko presidency. Yanukovych has already opened negotiations with Moscow to sell control of the pipelines to a consortium including Gazprom, which could allegedly save Ukraine $3.7 billion per year by securing a lower price.[52] However, there is a clear downside in this dependence upon a Russia that has leverage to pressure Ukraine for political concessions on issues such as NATO membership. Market energy prices are ultimately the best way to go.

Another key element of Ukraine's fate is the role of Europe. The European Union has not offered even the prospect of membership to the countries of the former Soviet Union other than

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CMA, "Global Sovereign Credit Risk Report, 1st Quarter, 2010," April 2010, http://www.cmavision.com/images/uploads/docs/CMA_Global_Sovereign_Credit_Risk_Report_Q1_2010.pdf.

Chris Kirkham, "IMF Lets Ukraine Use Reserves to Cover Gas Payments," *Bloomberg*, December 31, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=acEcuiMY6kQM.

Andrew E. Kramer, "Seeking Lower Fuel Costs, Ukraine May Sell Pipelines," *New York Times*, March 24, 2010, http://www.nytimes.com/2010/03/25/world/europe/25ukraine.html.

the Baltic States, as it focuses on consolidating its recent enlargement, improving its governing structures, keeping the eurozone healthy, and the eventual possible enlargement to the countries of the western Balkans and Turkey. Ukraine is likely too big a project for a fragile EU to engage in even the beginnings of the accession process (some Ukrainian officials have spoken of 2020 as a target date for accession, but there is still a good chance that countries like NATO member Albania, Serbia and Bosnia-Herzegovina would be joining only then). Nevertheless the EU does play a role in Ukraine, including budget support, and should be a model for Ukraine as it develops its institutions. The EU is indeed that model, although progress is slow. But completion of the Association Agreement which the EU offered Ukraine in 2008 should be a priority for Yanukovych and Azarov. A deep free trade area with the EU could be the impetus for greater European investment in the country, taking advantage of lower costs. Access to European markets would also be beneficial the development of sectors like agriculture. It is a long road to the European Union and reaching the destination is hardly a cure-all, at Latvia can attest to, but it is a road worth traveling.

Conclusion

Ukraine was a particularly messy country going into this financial crisis, and it will remain a particularly messy country coming out of it. But with the help of the IMF, Ukraine appears to have weathered the crisis relatively well in the opinion of Anders Aslund, an economist who knows the country well. He argues that international fears of default were much greater than they should have been because of lack of confidence in Ukrainian policymakers, but that outsiders' conclusions that "politics was irresponsible and in complete gridlock…did not at all correspond with the government's actual rather skilful management of the crisis."[53] Others, from the voters to experts, disagree. However, Ukraine has not seen complete economic catastrophe on the level of Iceland, Latvia or Greece yet, and a deal between the new government and the IMF for further aid can be expected in May 2010. Azarov anticipates a 6% budget deficit for 2010.

There are reasons to be optimistic about the Ukrainian economy going forward. The reliance on steel exports was one of the major problems Ukraine had in the crisis, as production dropped precipitously. But the devalued currency will help exports grow this year, while some of our contacts were optimistic that the crisis would push the country to diversify its exports. This could in turn weaken the power of the oligarchs and lead to a broader entrepreneurial class which would demand market reforms. The President of the American Chamber of Commerce was

Aslund, "Ukraine's Financial Crisis, 2009," p. 383.

very optimistic about the economy's long-term prospects, comparing Ukraine with the BRICs (Brazil, Russia, India and China) as a growth market with strong margins for multinational corporations while still painting a picture of a tough environment in which to do business.[54] EU membership seems far away but an Association Agreement with a deep free trade area should come into effect during the Yanukovych presidency. And the Euro 2012 soccer championship, which Ukraine is co-hosting with Poland, is welcomed because it will leave behind a legacy of improved infrastructure.

Bringing more of the underground economy above ground, reducing the power of the oligarchs and increasing transparency in the economy are necessary for the long-term economic health of Ukraine as a market economy that can compete in Europe and the world. The challenges remain grave, but Ukraine's future does look bright if one chooses to be optimistic.

Conclusion

The early chapters of crisis response have been closed in both Latvia and Ukraine. The international response managed to limit contagion from bank failures in these countries to the rest of Europe. Latvia has managed to keep its currency peg, and neither country has faced default. But full recovery to fiscal and macroeconomic health remains far away and the situations remain dynamic.

Latvia's peg to the euro could yet be undermined by internal political and economic factors, given that the euro-adoption strategy requires sticking with the peg for several more tough years and that citizens will have their say, with a major party already leaving the government since our visit to the country and elections to be held in October. Meanwhile, the sovereign debt crisis in Greece that emerged in 2010 is threatening the future of the eurozone itself. The core European countries will likely be reluctant to allow new members to join the currency zone in the future. If there is no safe haven in the euro at the end of the tunnel, Latvians will be angry with both their government and Europe. But Latvians have little say over the ultimate form of the European Union, of which they are a small fraction of the population, and of the eurozone, of which they are still just a prospective member. For Latvia, the failure or success of their economic recovery strategy will be measured over the next four or five years by the continued maintenance of the currency peg, the return of foreign investment, a return to growth and a return to rising incomes all around.

After more than a year of the economic rescue project being impeded by electoral

Jorge Zukowski interview.

politics, Ukraine's political situation appears to have stabilized with the triumph of Viktor Yanukovych and his allies. However, Ukraine's new leaders need to make compromises and reforms to get the rest of the IMF money, return the economy to strong growth, improve the sovereign debt situation, and make the country a more attractive target for foreign investment in the short and long run. The IMF money has helped Ukraine but the international and domestic crisis response was subordinated to Ukrainian political battles. Arguably the IMF was too lenient with Ukraine's leaders rather than forcing reforms that would be to the long-term benefit of Ukrainian citizens rather than to the short term benefit of preventing Ukrainian economic collapse from sending shockwaves across Europe. Nearly absent from Ukraine in the crisis as the IMF led the international response, the EU should reinvigorate their involvement in the development and international economic integration of the country.

In the most recent developments as work on this paper was concluding, President Yanukovych came to an agreement with Russia to extend the lease on the Russian naval base at Sevastapol in the Crimea a full quarter century beyond 2017, when it is due to leave, a deadline written into the Ukrainian constitution.55 Crimea has an ethnic Russian majority and Vladimir Putin has questioned Ukraine's sovereignty over the peninsula although his Boris Yeltsin had affirmed this in the 1990s. Sevastapol is the historic home of the Black Sea Fleet going back more than a century but this was considered an infringement of Ukraine's sovereignty by nationalists. The decision has caused the first significant public protests of Yanukovych's regime as he moves Ukraine towards Russia. Tymoshenko, Yushchenko and other leaders spoke against the deal, and it was narrowly passed through the Supreme Rada in a rowdy session that included fisticuffs and the throwing of eggs.56 The extension of the naval base lease is rightly controversial, but it will help Ukraine recover from its economic crisis in the short term, as it will result in a significant discount on the price of gas for Ukraine, about 30 percent, enough to give some relief to Ukraine's fiscal problems by reducing expenditures. On the revenue side, Russia also pays Ukraine about $100 million annually for hosting a military base on its territory. Perhaps Greece should take note: Russia has long dreamed of possessing a warm water port and Greece has a wealth of suitable harbors.

Deputy Prime Minister Tigipko and the IMF continue negotiations on Ukraine's 2010 budget and future IMF loans, with the country seeking $20 million over the next two and a half years and needing to cut to keep its 2010 deficit below 6 percent of GDP for the IMF to continue

Clifford J. Levy, "Ukraine Woos Russia With Lease Deal," *New York Times*, April 21, 2010, http://www.nytimes.com/2010/04/22/world/europe/22ukraine.html?scp=2&sq=ukraine&st=cse.
Clifford J. Levy, "Ukraine Extends Lease on Russian Naval Base," *New York Times*, April 27, 2010, http://www.nytimes.com/2010/04/28/world/europe/28ukraine.html?hp.

its aid.[57]

Beyond the economic level, Yanukovych has made a stir in foreign policy, although he has also dealt with the West, for example agreeing with US President Barack Obama to give up Ukraine's nuclear materials. His performance in office and moves that contradict the Ukrainian constitution (although he has gotten away with them) give new credence to critics who argue he is no democrat. Yanukovych could conceivably consolidate power enough to curb Ukraine's recently won democratic freedoms, especially since Ukrainians are currently quite disenchanted with politics, but his moves since taking power may also give new impetus to the Orange forces in opposition and bring a return to political instability. Ukraine remains a fascinating country to watch.

Interviews

Conducted by Professor Mitchell Orenstein, Amanda Lullo, Zuzana Svetlosakova, Philip Bednarczyk, Antonia Karaisl, Catherine Sear, Gregory Fuller, Heather Kauffman, Laura Beke, Sean Parramore, Theodore Reinert, Alexandra Jenkins, Michael Manetta, Vanya Vulperhorst, January 10-17, 2010 unless otherwise indicated.

Liepaja, Latvia

Silva Golde, Deputy Mayor of Liepaja

Liepajas Metallurgs – Ilana Ivanova, Andrew Kolesin, Alex Zaharin

Students of Liepaja University

Riga, Latvia

Vyacheslav Dombrovsky, Stockholm School of Economics and Baltic International Centre for Economic Policy Studies

Maris Elerts, Deputy director, Investment and Development Agency of Latvia

Ojārs Kalnins, Director, The Latvian Institute

Maris Mancinskis, CEO, Swedbank AS

Nils Melngailis, Chairman, Parex Bank

Daryna Krasnolutska and Katerina Choursina, "Ukraine Plans to Borrow $4.3 Billion Abroad in 2010," *Bloomberg*, April 26, 2010, http://www.bloomberg.com/apps/news?pid=20601095&sid=a2ppiQPfHRHc.

Matt Stokes, Political and Economic Officer, Embassy of the United States of America

Agnese Timofejeva, Deputy Director, International Financial Policy Department Ministry of Finance of the Republic of Latvia

Kyiv, Ukraine
Andriy Bespyatov, Dragon Capital
Centre for Policy, Oleksandra Betliy, Veronika Movchan, Oksana Kuziakiv
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Vitaliya Mudruk, Sector Manager, Technical Barriers to Trade, Financial Services, European Union Delegation to Ukraine
Yuri Nartov, real estate developer
Viktor Pynzenyk, former Finance Minister of Ukraine
Dmytro Romaneuko, KOMPEKS-V Limited Liability Company
Pablo Saavedra, World Bank
Dimitry Sologoub, Head of Research Department, Raiffeisen Bank
David Stern, New York Times
Elena Voloshina, International Finance Corporation
Mychailo Wynnyckyj, Associate Professor, National University of Kyiv-Mohyla Academy
Sabina Zawadski, Reuters
Jorge Zukowski, President, American Chamber of Commerce in Ukraine
Washington, DC, United States

Vaira Vike-Freiberga, former President of the Republic of Latvia ("Transatlantic Cooperation and Security" discussion at Paul H. Nitze School of Advanced International Studies, September 29, 2009)

Suzy Yoon and Aurora Ferrara, World Bank (November 20, 2009)