Expertise

Ukraine: The Need for Economic Depth as Part of the Ability to Resist

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Abstract Die russische Invasion in der Ukraine vom Februar 2022 und die daraufhin von den meisten westlichen Mächten verhängten harten Sanktionen haben die Anfälligkeit der russischen Wirtschaft offengelegt. Lange als eine «Tankstelle, verkleidet als Staat» verspottet, ist die russische Wirtschaft seit Russlands Krim-Annexion im Jahre 2014 und der Besetzung des Donbass einerseits weniger leistungsstark, gleichzeitig aber auch strapazierfähiger geworden. Auf der anderen Seite ist Belarus, Moskaus Juniorpartner bei der Invasion, strukturell instabil und steht vor dem Zusammenbruch. Demgegenüber hat sich die Ukraine als wesentlich robuster erwiesen als erwartet, was zu einem grossen Teil auf die Reformen zurückzuführen ist, die seit dem Verlust der Krim und der russischen Besetzung des Donbass umgesetzt worden sind. Dieser Artikel skizziert die wirtschaftliche Bedeutung der einzelnen Akteure in diesem Krieg und zeigt auf, dass auch ökonomische Faktoren es der Ukraine ermöglicht haben, die erste Angriffswelle zu überstehen und sogar zurückzuschlagen.

Keywords Ukraine; Russia; economic institutions; transition, resilience; war

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Introduction

Heretofore unthinkable, the armed forces of the Russian Federation invaded the sovereign nation of Ukraine on 24 February 2022. Expecting the Ukrainian armed forces to collapse in the face of a numerically superior force, the Russian invasion of Ukraine has not quite been going to plan. Severe resistance and an inability to capture major objectives within two weeks of the war did not mean that the Russian military effort was doomed to failure, but it did show a massive miscalculation on the part of Russian planners with regard to the resilience and capabilities of the Ukrainian military. As of the writing of this paper, an estimated 10,000 Russian troops (according to the Ukrainian armed forces' General Staff, a number which is of course disputed by Russian authorities) had died on Ukrainian soil, leading to a seeming shift in tactics towards targeting civilian centers indiscriminately (as in previous Russian invasions, i.e., Aleppo [Gutman, 2018] or Groznyy [Evangelista, 2004]).

Perhaps even more daunting than the military failures and reversals, from the point of view of the Kremlin, is that the invasion has exposed the massive fragility of the Russian economy. Responding to Russia's unprovoked attack with a rare show of unanimity, the European Union (EU) has imposed far-reaching sanctions on Russia, its leaders, and its economic institutions (including the Central Bank of Russia). The immediate impact of these sanctions was a free-fall of the country's financial and public sector, threatening the entire superstructure of the state and plunging the country into chaos the likes of which it hadn't seen since its financial crisis in 1998. Despite the physical toll being visited upon Ukraine, Russia may end up as the country seeing the much longer-term damage for the same reasons its military has been so surprised: a lack of strategic economic depth, making it highly susceptible to exogenous shocks.

The View from Kyiv

Ukraine's economic progress has been far more halting than others in its neighborhood, especially in Poland (Hartwell, 2016) but also when compared with the Baltic States (chief among them Estonia, see Norkus [2007]). In the first decade and a half of transition, Ukraine was slow to stabilize its macroeconomy and eliminate price distortions, instead devolving into long protracted political battles between the executive and the parliament on who should have more power. The Parliament (the Verkhovna Rada) itself remained an obstacle to reform, comprised of many unreconstructed communists who put the brakes on any needed market liberalization, aided by unclear rules on where the Rada's obstructionism would realistically end (Wolczuk, 2001). At times during this political struggle, the Rada even appropriated for itself emergency powers regarding the economy (Åslund, 2009).

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The first 15 years of Ukrainian independence thus saw a struggle for political power but with halfhearted economic reforms. Reliant on Russian energy subsidies and with no political will to remove the state from the economy, the country first saw hyperinflation and all of its associated effects on political development (Hartwell, 2018), while corruption proliferated in the energy sector and elsewhere. The entrenchment of vested interests made it much more difficult to consider important reforms, and even the first popular uprising, the Orange Revolution of 2004/05, stalled in terms of its ability to create a functioning market economy. Every aspect of commerce was regulated, controlled, supervised, and, far too often, demanded a payment to the state.

However, since 2014 and the protests of the Euromaidan, Ukraine began a long-delayed and painful process of transformation to shake off its post-Soviet malaise (Figure 1). The move towards a market economy has not been perfect by any means, as the Ukrainian state is still too involved in the economy, corruption is still problematic, and President Zelensky has not been

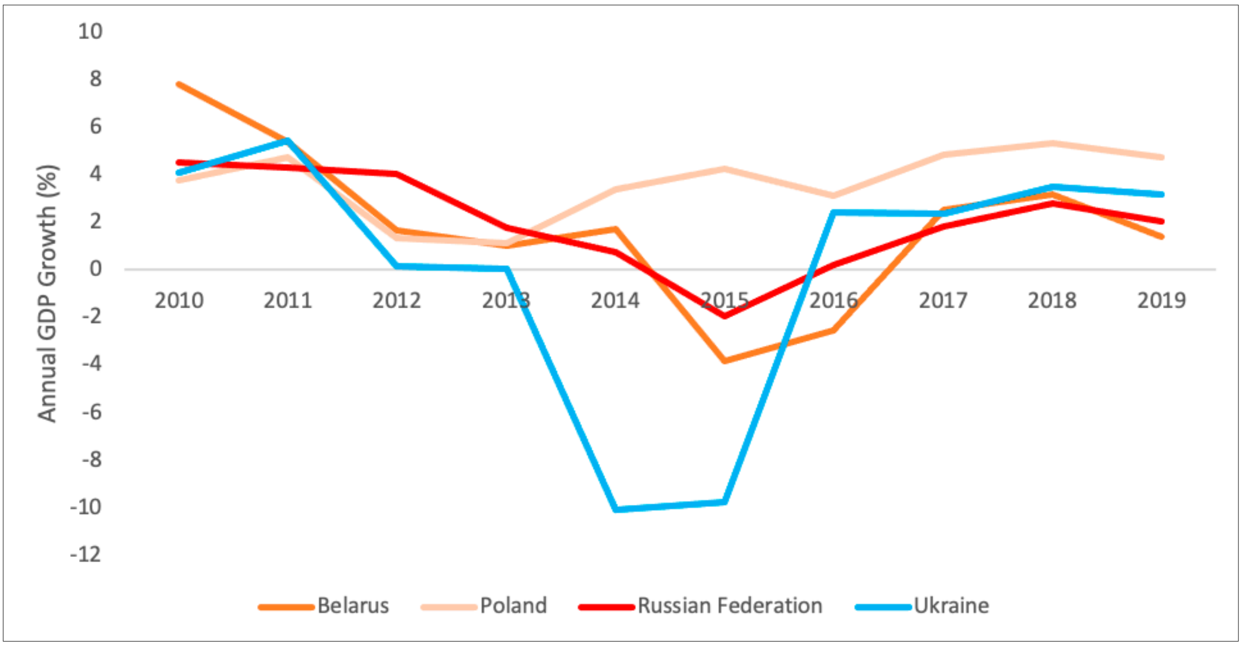

Figure 1: GDP growth (annual %) - Ukraine, Poland, Belarus, Russian Federation (Source: World Bank, 2022)

as focused on judicial reform as he should have been. But in the interim, and already under a state of war, Ukraine has made great strides towards liberalization and becoming a fully functioning market economy. The anachronistic land sale moratorium, prohibiting the sale of agricultural land, was finally lifted in 2021 after 20 years of «temporary authorization», macroeconomic stability was painfully achieved, the creaking banking sector was shored up and consolidated, and Ukraine reformed its natural gas sector to stop it being a spigot for massive corruption. These oft-delayed reforms have created an economy which was much more resilient and was learning how to grow; just as Ukraine's military was learning to fight in Donbass against Russia, the country's move West was teaching Ukrainian businesses how to operate in a free market environment. This success was capped by the conclusion of a Free Trade Agreement with the European Union (DCFTA), an agreement fully in force since 2016, which has allowed certain sectors of the Ukrainian economy (including poultry farming) to thrive.

The State of the Invaders

Contrast this economic performance with Ukraine's invaders, Belarus and Russia. Belarus, the junior partner in the invasion, has been allowing the staging of the Russian invasion on its territory and, on March 1st, appeared to actively take part in the invasion as a belligerent (although the extent of their involvement is disputed). However, the country itself had very little economic depth to begin with: Belarus is a tiny, landlocked country whose economy has barely moved away from its Soviet past. Indeed, central planning and large and inefficient state-owned firms dominate the economic landscape, and the private sector is a mere 45.5% of employment throughout the country (Chubrik, 2021), a number comparable to Poland in 1991 and Ukraine in 1995. After the fraudulent elections of 2020 which placed Aleksander Lukashenko back at the helm of the creaking economy, Belarus has shown no inclination to change its economic path. The only bright spots in the economy, as its success in information technology, occurred in places where the state was absent or neglectful and where private initiative was allowed to blossom.

In terms of its external orientation, Belarus is integrated fully with Russia and the Russian-led Eurasian Economic Union (EaEU), meaning barriers towards the European Union and the rest of the world but (in theory) free movement of goods and capital between Belarus and other members of the EaEU. In reality, the

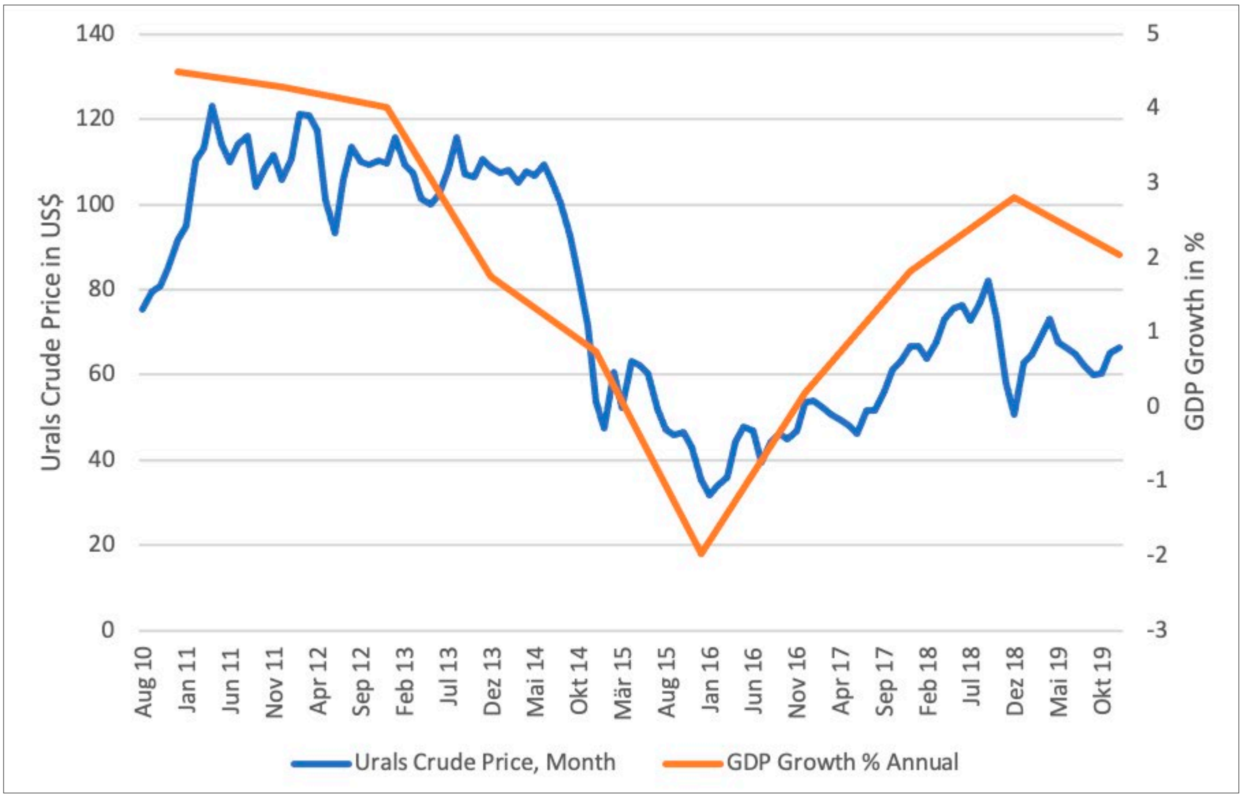

Figure 2: Price of Urals Crude in current US$ v. GDP Growth in Russia, 2010-2019 (Source: World Bank and Investing.com, 2022)

membership of EaEU has been anything but dedicated to liberalization (Dragneva and Hartwell, 2021), and the EaEU has acted as an amplifier for rather than a buffer from exogenous shocks (Dragneva and Hartwell, 2022). Moreover, the only benefit that Belarus appears to garner from the EaEU – apart from unhindered access to Kazakh markets to sell its tractors – are the massive energy subsidies that Minsk receives from Russia (and even these are subject to the whims of the Kremlin, see Martynau [2013]).

The Russian economy dwarfs that of Belarus, and the fact that Russia is the prime mover behind the invasion of Ukraine makes it the more interesting of the two. Long derided as a «gas station masquerading as an economy» – in the memorable words of then-US Presidential candidate John McCain in 2008 – Russia has been championed as having learned from the experience of the beginning of its invasion of Ukraine in 2014 (Guter-Sandu and Kuznetsova, 2020). While relatively milquetoast sanctions from the West caused some difficulties in Russia's supply chains, the shift towards import substitution created by the countersanctions imposed on the EU mainly harmed the Russian in the street and actually meant a boost to Russian business (Korhonen, 2019).

Moreover, the regrettable truth is that Russia, especially when compared to Belarus or even Ukraine of the 1990s, had much more of a market mentality since it began its (now incomplete) transition. It went much farther on privatization and had a serious economic team designing the radical reforms needed to break the back of communism. After the financial crisis in 1998, policymakers used this experience as their «Weimar moment» to keep the country on the straight and narrow when it came to macroeconomic stability. However, the flaws in the Russian economy after the crisis (and to a large extent, before) are structural, with a careless disregard of property rights and an overweening state concerned with political goals rather than economic efficiency (European Commission, 2020).

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The first invasion of Ukraine 2014 accelerated pre-existing trends under Putin, with Russia's international isolation and focus on global political goals shelving any attempts at diversification; as a consequence, the Russian economy (and the Russian state) became far more concentrated in natural resource extraction and processing. One must remember that Russia was already heading into a recession before the Western sanctions in 2014, and the combination of sanctions and becoming a mono-economy has made the entire institutional framework more fragile and dependent upon oil (Figure 2). Dominated by large quasi state-owned concerns, with the commanding heights (finance, energy, communications) wholly under state control, the Russian economy has taken huge steps backwards in its resilience over the past decade. And in terms of economic institutions, the only effective player has been the Central Bank of Russia – the same Central Bank which is now the direct target of US and EU sanctions, and which continued Russia's macroeconomic stability as the rest of the economic façade started to crumble.

Conclusion

In order to fight and win a war, military equipment and resolve are a must, but economic depth is also a necessity, especially if it the war becomes protracted for both parties. Russia has the upper hand in terms of proximity to its supply lines and of course its industrial heartland, but the Western sanctions, of a scale and speed never seen before, has widened the already-exposed cracks in Russia's economy. Indeed, with unprecedented sanctions targeting the Central Bank of Russia, and a Russian stock market that was closed for several days as a result of the unprecedented sanctions, the aggressor has demonstrated that it may not have the economic resilience necessary to survive the war that Putin has unleashed on Ukraine. Even if military facts on the ground support a Russian victory, it will be Pyrrhic at best; beyond the probably lingering resistance from Ukrainian partisans, the utter isolation of the Russian economy from the West – but also Japan in the east – will drive further stagnation, brain drain, and economic misery. A country built on oil and gas and state-directed «national greatness» objectives cannot survive when that very same national greatness is undercut by a sobering economic reality.

Ironically, the country which was supposed to collapse easily, Ukraine, has shown itself to have the resilience that Russia is woefully lacking. As noted above, Ukraine's economy is not a powerhouse with depth and resilience like even Poland or other transition economies, to say nothing of advanced Western markets: moreover, Ukraine's resilience has been fortified by international aid, without which it too would collapse under the Russian onslaught. But the reality of the last eight years of reform that Ukraine has undertaken – if even tentative and halting – have shown the overwhelming benefits of moving away from a Russian-style, top-heavy crony state. If Ukraine survives as a sovereign state out from under the thumb of Russia, it can continue to reap those benefits; in fact, it may be able to accelerate its reforms to make the country more like the numerous post-communist states in the EU that have grown their economy much faster than Russia. There is also a possibility that an independent Ukraine may become part of the European Union, although that reality is both a long way away and cur-

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rently unthinkable given the Russian invasion. At the very least, the country has demonstrated a depth of resilience that was unthinkable at the time of the Crimea annexation and invasion of the Donbass in 2014.

Where does this leave the clash of economic systems, from relatively freer market Ukraine to crony Russia and Soviet Belarus? I have argued before that macroeconomics has a massive effect on political institutions (Hartwell, 2018), and the economic shock that all three are experiencing in 2022 are likely to exacerbate pre-existing trends. However, if the war and its associated sanctions continues to bite into the economies of the two invading nations – which remain highly susceptible to exogenous shocks, reliant on political connections, and unable to deliver consistent growth – the deteriorating situation may open opportunities for real change. Indeed, the world may then see an epoch-making regime change in the making, as ordinary Russians and oligarchs wonder just how this military intervention benefits them economically. If such an event comes to pass, perhaps we can say there were benefits globally to economic weakness as well. ◆

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