UNIVERSITEIT LEIDEN

Lessons from Ukraine

A Survey of IMF Conditionality and Domestic Politics between 1994 and 2002

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Introduction:

On December 1st, 1991 over 92% of Ukrainians voted for independence from the USSR. Turnout was over 84%. Every province voted by a majority for the new nation's independence. Even in Russian-majority Crimea, 54% of the electorate backed the secession from the Soviet Union. [1]

Numerous reports, most famously the ones issued by Deutsche Bank between 1990 and 1992, argued that Ukraine had the best prospects for a successful economic transformation towards a free market economy. [2] At the time, the nation had a population of more than 52 million people and a landmass greater than that of France. Ukraine produced a disproportionate amount of the former USSR's economic output despite only having 20% of the total population. In the late 1980s, Ukraine accounted for 33% of all vegetable production, 40% of the grain harvest, 25% of all meat, 50% of sunflower seeds, and 60% of sugar beets produced in the Soviet Union. It also produced 50% of the iron ore, 25% of the coal, 45% of the cast iron, and 37% of the steel in the USSR. [3]

Despite this potential, Ukraine managed to set the dubious record for the worst economic performance of a nation not devastated by war. From 1989 to 1994 GDP declined by 48%, while the underground economy expanded to 46% of GDP. [4] Inflation was rampant, topping 2000% in 1992 and 10000% in 1993. [5] This was partly the result of price liberalization, but mainly due to the rapid monetary expansion carried out by the National Bank of Ukraine (NBU). The high budget deficits of the early 1990s were almost entirely financed by lending from the Central Bank. [6]

The social consequences of the economic freefall, the tensions over the status of the Crimean Peninsula, and disputes with Russia over Ukraine's Eastern borders and the Black Sea Fleet

[1] Chrystyna Lalpychak, "Over 90% vote yes in referendum; Kravchuk elected president of Ukraine", *The Ukrainian Weekly*, December 8, 1991

[2] Jurgen Corbet, *The Soviet Union at the crossroads: Facts and figures on the Soviet republics*, Deutsche Bank, 1990

[3] Tamara Woroby and Andrew Bihun, "The Ukrainian Economy: One Year After Independence: Can a new prime minister lead the country out of its economic malaise?", *Eurasian Reports: Trade and Technology in the Commonwealth of Independent States,* 1992

[4] Anders Åslund, *Ukraine: What Went Wrong and How to Fix It*, eBook, 2015, Location 1593

[5] https://www.statbureau.org/en/ukraine/inflation

[6] Oleksandr Petryk, *History of Monetary Development in Ukraine*, 2006

put the new country's future in question. A national intelligence estimate issued by the CIA in 1994 posited that Ukraine may fail as a nation state within a decade. [7]

Leonid Kuchma, a Russian speaking Red Director from Dnepropetrovsk, sought to change course for the country. Kuchma promised to enact a radical program of price liberalization, financial stabilization, and privatization, as well as to improve relations with Russia and to find a conclusive resolution for the Crimean dispute. A key component of his agenda included a partnership with the IMF which began in October of 1994. [8]

This study aims to examine the impact of IMF programs in Ukraine during the period between 1994 and 2002. Many questions have been raised about the effectiveness of IMF-backed adjustment programs. Some Ukrainian politicians and academics have been eager to blame the fund for Ukraine's transition woes. [9] After the efficacy of the Fund's reforms is evaluated, I will attempt to scrutinize whether the economic impact observed was mainly a result of the IMF's conditionality or of domestic political factors.

A 1998 paper by Nadeem Ul Haque and Mohsin Khan examines the challenges in measuring the success of IMF programs. Studies on the effectiveness of IMF interventions lack a counterfactual, namely a plausible "what if" the fund was not involved condition, employ different methodologies, use different metrics for measurement and often utilize non-equivalent samples of study subjects. [10]

This paper is a case study divided into eight parts. The theoretical framework consists of an introduction to the challenges present in post-Communist transitions, an overview of IMF conditionality, the approval procedure for IMF programs, the Fund's lending facilities, an analysis of the challenges in international development efforts, and an inquiry into the importance of institutions. Subsequent sections include the research design, an overview of the political situation during the post-independence Kravchuk period, the IMF programs in Ukraine, key domestic events between 1994-2002, graphs of the fluctuations observed in the studied variables, an evaluation of the effectiveness of the Fund's conditionality, and a summary with concluding remarks.

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[7] Steven Pifer, "Averting Crisis In Ukraine", *Council on Foreign Relations*, 2009

[8] Åslund, *Ukraine: What Went Wrong and How to Fix It*, eBook, location 1656

[9] Lorenzo Figliuoli and Bogdan Lissovolik, *The IMF and Ukraine: What Really Happened,* 2002

[10] Nadeem Ul Haque and Mohsin S. Khan, "Do IMF-supported Programs Work? A Survey of the Cross-Country Empirical Evidence", *International Monetary Fund*, 1998

The units of measurement will be eight separate indicators. Four of them, annual GDP growth, the budget deficit as a percentage of GDP, the rate of inflation and Foreign Direct Investment (FDI) are purely economic. The other four are measurements of perceived institutional strength. They include the relevant World Bank Governance Indicators, namely government effectiveness, regulatory quality, rule of law, and control of corruption.

Their changes throughout the period of the IMF-influenced program will be used to evaluate the effectiveness of the Fund's efforts in helping Ukraine make a successful transition towards becoming a functioning market economy. An analysis of documents will be used to determine whether the changes were primarily the result of IMF conditionality or of domestic politics.

Theoretical Framework:

Challenges in Post-Communist Transitions:

While few could clearly anticipate the variety of obstacles which the newly independent, post-communist states would have to face along the way, Claus Offe was able to correctly identify the inherent contradictions posed by such transitions. He argued that no theory existing at that time, whether it was democratic or revolutionary, could express anything more than "modest descriptions of single aspects." Thus, according to Offe, the job of the theoretician in these unprecedented transitions would be to simply understand what happened in retrospect. [11]

He provides concrete examples about why the analysis relevant to previous transitions cannot apply in the case of post-Communist states, which lays the groundwork for his evaluation of the risks that the latter would have to contend with. The first three waves of countries experiencing political modernization, the post-World War 2 democracies of Italy, West Germany and Japan, the democratizations of Portugal, Spain and Greece in 1970s, and the end of Latin American dictatorships in the 1980s, had two major advantages. [12]

First, they were mostly able to preserve their territorial integrity and were not beset by large scale land disputes, migrations, and ethnic strife. Secondly, and perhaps most important, the three waves of transition had to only contend with a political and constitutional transformation. The Old Warsaw Pact States had to further transfer assets from state ownership to private hands. For that, they had to create an entirely new class of entrepreneurs, in a politically transparent way so that the newly democratic electorate would not be angered. [13]

Thus, Offe argues, the former Communist nations are faced with three simultaneous challenges. The first one is territorial and it deals with the establishment of a cohesive nation-state with secure borders which limits internal ethnic strife. The second, which Offe terms "Glasnost", is the establishment of a constitutional democracy which ensures competitive politics and the protection of human rights. Finally, "Perestroika" necessitates the establishment of institutions which can protect property rights and are conducive to competitive private enterprises and the fair redistribution of newly privatized assets. [14]

Thus, the transitioning nations have set themselves on a path where the democratic modernization, the economic liberalization, and the interethnic/territorial conflicts may work

[11] Claus Offe, "Capitalism by Democratic Design?", *Social Research*, 1991, p. 503
[12] Offe, "Capitalism by Democratic Design?", p. 503
[13] Offe, "Capitalism by Democratic Design?", p. 504
[14] Offe, "Capitalism by Democratic Design?", p. 508

to simultaneously undermine each other. Offe argues that historically, market economies preceded democratic transitions. Only after a society was able to establish robust market institutions, conducive to economic growth, then the social structures would emerge which could lead to deliberation and compromise, and eventually to democracy. [15]

However the capitalism emerging in Eastern Europe is not the type that is driven by an already existing constituency of property owning bourgeois. It is a political capitalism, designed and implemented by pro-reform elites. Therefore, its success rests on the continuous approval by the public through the democratic process. [16] The problem is that the people may become disillusioned by the economic transformation.

They may very rightfully suspect that the elites will use their power to enrich themselves by plundering the state. Furthermore, the market liberalization process will inevitably create inequalities that would clash with what Offe terms a culture of "authoritarian egalitarianism". This could have the effect of blocking the passage of necessary economic reforms, which would promote future economic development, because the economic situation is already dire. [17]

Thus, the public may end up rejecting both political and economic liberalization. The lack of a strong civil society, calling for the protection of individual rights and solidarity, was another major handicap. Rather than having organization along ideological lines, political mobilization would likely be based on ethnicity and/or religion and often in opposition to internal minorities or external enemies. [18]

Offe foresaw seven scenarios which could arise due to the mutually obstructing forces. All of them have come to fruition in the various post-Warsaw Pact republics. They include: (1) Democratic politics blocking or distorting the road to privatization and hence marketization, (2) Privatization succeeding, but failing to lead to marketization and hence to growth and prosperity; this could be due to the conservation of cartels and monopolistic structures that make the transition one that occurs not from "plan to market" but "from plan to clan" (D. Stark), (3) Privatization succeeding, but leading to the obstruction of democratic politics through powerful interferences originating from domestic or international owners of capital, (4) Democratic politics evolving, but failing to lead to the peaceful resolution of social

[15] Offe, "Capitalism by Democratic Design?", p. 512
[16] Ibid. p. 513
[17] Ibid. p. 515
[18] Ibid. p. 511

conflict as it is dominated by ethnic, territorial, and minority conflicts that do not lend themselves to democratic forms of compromise, (5) Marketization succeeding, but failing to generate the reality of (or even the widely perceived prospect for) an equitable distribution of its benefits, (6) Accumulated disappointments and frustrations with these failures may give rise to demands for a type of "democracy" that is based on an institutional structure other than civil liberties and representative government—for example, a populist presidential dictatorship, (7) Conversely, frustrations with economic performance and distribution may also lead to demands for marketization without private property; for example, a return to state ownership of the productive assets. [19]

Offe argued that the transition, which would simultaneously lead to the establishment of a nation state, democracy, and a market economy, requires a lot of patience on behalf of the public.[20] One way to facilitate the process and to overcome the triple obstruction would be to use the international system in order to provide desperately needed resources and the incentives for institutional reforms. [21]

The challenges that international organizations face is that the incentives they provide must align in such a way that they reinforce the efforts to seriously redefine the domestic political equilibrium. Changing a government is often insufficient. History is littered with cases where reformers fell victims to the Iron Law of Oligarchy. If the institutions of the state are designed to facilitate extraction and rent-seeking, then the new elites, which mobilize to replace the old ones, are faced with an incentive structure that impels them to replicate the behavior of their predecessors. [22]

The world is still primarily organized along the lines of nation states which jealously guard their sovereignty. Therefore the idea of an international institution directly interfering with the domestic political structure is likely to clash with the traditional Westphalian paradigm. Can an international body provide the sizable incentives which would truly redefine a nation's political equilibrium and make it rewarding for domestic elites to push for lasting structural reforms and inclusive economic institutions? The International Monetary Fund (IMF) is one such institution and according to the Fund, it's explicit mission is "to foster global monetary

[19] Ibid. p. 520-521
[20] Ibid. p. 521
[21] Ibid. p. 523
[22] Daron Acemoglu and James Robinson, "The Role of Institutions in Growth and Development", *World Bank*, 2008, p.20

cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world." [23]

IMF Conditionality:

The IMF gives its members access to various credit facilities subject to its conditionality. In the simplest language, conditionality refers to the strings attached to any aid package. According to the Fund, conditionality deals with both strategic and tactical matters. The overall program is designed by the IMF in close cooperation with the country, while the specific tools to implement it and to monitor its progress are also jointly agreed upon. [24]

Conditionality is as much a set of concrete procedures as it is a theoretical concept. It begins with the Letter of Intent. The letter is the product of the preliminary negotiations between the Fund and the recipient country. In the document, the member nation outlines the policies that have been implemented so far and the ones it intends to implement throughout the duration of the program. The policies need to be precisely stated in a framework that allows the Fund to adequately measure their performance.[25]

According to the Fund, the main justification for its conditionality measures are to restore an adequate balance of payments and macroeconomic stability, while maintaining economic growth and especially in the case of low income countries, reducing poverty. [26] The focus on the balance of external payments, at the expense of emphasizing changes within the domestic economy, allows the Fund to maintain a certain level of political impartiality. [27] On the other hand, the IMF's original Articles of Agreement do not include economic growth as an explicit goal, but simply as a by-product of trade expansion and a stable international monetary system. [28]

One common criticism of the IMF is that it has demanded too much reduction on the demand side, i.e. cutting spending, while ignoring other possible remedies, such as currency devaluation. [29] Critics argue that the impact of such policies was most acutely felt by the poor

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[23] "ABOUT THE IMF", IMF, http://www.imf.org/external/about.htm
[24] "IMF Conditionality", IMF, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/28/IMF-Conditionality, 2016
[25] Jacques J. Polak, "THE CHANGING NATURE OF IMF CONDITIONALITY", *OECD DEVELOPMENT CENTRE*, 1991, p.24
[26] "IMF Conditionality", IMF, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/28/IMF-Conditionality, 2016
[27] Polak, "THE CHANGING NATURE OF IMF CONDITIONALITY", p.48
[28] Articles of Agreement of the International Monetary Fund, https://www.imf.org/external/pubs/ft/aa/, 1944
[29] Polak, "THE CHANGING NATURE OF IMF CONDITIONALITY", p.30

due to reductions in welfare services and food subsidies. [30] The Fund's programs only began to explicitly address matters of economic growth in the late 1980s. [31] By then, the IMF's role had changed from that of a short term lender, to a development institution whose goals are more similar to those of the World Bank. [32]

The Fund's newly embraced mission was best articulated by its Managing Director Robert Camdessus in 1990. He said that: "Our prime objective is growth. In my view, there is no longer any ambiguity about this. It is toward growth that our programs and their conditionality are aimed. It is with a view toward growth that we carry out our special responsibility of helping to correct balance-of-payments disequilibria." He further clarified his statement by adding that he sought : "high quality growth, which does not include flash-in-the-pan growth fueled by inflation and excessive borrowing, growth at the expense of the poor or the environment, or growth run by the state." [33]

Approval Procedure for IMF Programs:

Most IMF funding facilities are directly tied to various concrete and clearly demonstrable policies. The most common indicators of such plans are prior actions, quantitative performance criteria (QPCs), indicative targets, and structural benchmarks. [34]

Prior actions are measures that the recipient country needs to take before receiving the first disbursement of financial aid. From the point of view of the Fund, such actions ensure that the program has the right foundation to succeed and/or that the country returns to the economic/financial equilibrium from which it had deviated in the first place. [35] As late as 1979, the Fund was hesitant to require too many prior actions from its borrowers. This was mostly because it did not want to be seen as pushing forth policies onto countries desperate for emergency financing. [36] The IMF has defended its renewed insistence on prior actions by arguing that more pre-emptive reforms on behalf of the borrowers reduces the amount of policy commitments in the official letter of intent, thus minimizing intrusive reviews and

[30] Polak, "THE CHANGING NATURE OF IMF CONDITIONALITY", p. 32
[31] Polak, "THE CHANGING NATURE OF IMF CONDITIONALITY", p. 30
[32] Door Balakrishnan Rajagopal, "International Law from Below: Development, Social Movements and Third World Resistance", 2003, p. 130
[33] Ibid.
[34] "IMF Conditionality", *IMF*, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/28/IMF-Conditionality, 2016
[35] Ibid.
[36] Polak, "THE CHANGING NATURE OF IMF CONDITIONALITY", p. 25

allowing the members to take ownership of their own policies. [37] Examples of prior actions required by the Fund include price liberalization and budgetary adjustments. [38]

QPCs are specific, easily measurable criteria that have to be satisfied in order for a country to pass a periodic review. QPCs deal with macroeconomic tools that can be modified by the borrower. They include modifications to the budget deficit, the amount of reserves held by the central bank, and/or adjustments to the money supply. Indicative targets are similar to QPCs and are usually requested by the IMF when there is not sufficient information to establish a concrete QPC. Once the information is provided, such targets can be turned into QPCs. [39]

Structural benchmarks are non-quantifiable measures that are deemed critical by the IMF for the successful completion of the reform program. They are usually seen as the most intrusive and controversial elements of the Fund's conditionality because they often affect the economic and political standing of various key interest groups and constituencies. They often involve changes to the country's financial sector, its public management system, or the privatization of key industries. [40]

Since IMF funds are usually disbursed in instalments, they are subject to periodical reviews. The reviews gauge whether the initial conditions agreed upon are being met and if new developments necessitate certain modifications to the program. If the QPC targets are not met, the Fund's Executive Board can issue a waiver for small deviations or if the variation will not be detrimental to the completion of the overall program. [41]

Lending Facilities:

The majority of IMF lending happens on a non-concessional basis. [42] The interest rate charged is based on the short-term interest of the five major currencies, namely the US Dollar, the Euro, the British Pound, the Chinese Yuan and the Japanese Yen. [43] The amount a country can borrow is derived from a numerical multiple of its quota. The quotas are based on the

[37] Ibid.
[38] "IMF Conditionality", IMF, https://www.imf.org/en/About/Factsheets/Sheets/2016/08/02/21/28/IMF-Conditionality, 2016
[39] Ibid.
[40] Ibid.
[41] Ibid.
[42] "IMF Lending", IMF, http://www.imf.org/en/About/Factsheets/IMF-Lending, 2016
[43] "SDR Interest Rate Calculation", IMF, http://www.imf.org/external/np/fin/data/sdr_ir.aspx, 2016

weighted average of GDP (50%), market openness (30%), economic variability (15%), and international currency reserves (5%).[44]

There are five key non-concessional IMF lending facilities. They are the Stand-By Arrangement (SBA), the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL), the Extended Fund Facility (EFF), and the Rapid Financing Instrument (RFI). [45]

The SBA has been the most widely used mechanism for financial assistance. The main goal of the SBA is to help countries deal with temporary balance of payments problems. Specific reform programs are designed by the borrower in consultation with the Fund with measurable targets which are meant to address the problems faced by the country. The periodic monetary disbursements are dependent on the member state meeting the targets. This loan mechanism is most closely associated with the concept of IMF conditionality. The program usually lasts for 12-24 months and repayments take place 3-5 years from the time the funds are first loaned. Borrowers can negotiate a SBA with the IMF on a precautionary basis. In such a case, the money is available, but the country can choose not to borrow it. This is often done to insure against a deteriorating economic situation and/or to assure other creditors that the member state has a credible program to deal with any future challenges. [46]

The FCL is an instrument aimed at countries which have a strong economic position and a proven track record. According the latest IMF lending guidelines, the primary requirements are a sustainable capital flow position, sound public finances, a low inflation rate, and a well supervised financial sector. Such a facility is made available over a one or two year period and the money can be accessed upfront, rather than in installments. Unlike the SBA, there is no conditionality, therefore the countries are not required to implement any specific policies beforehand or during the program. Similar to the SBA, a country can apply for an FCL line of credit on a precautionary basis without actually accessing it. The repayment schedule is the same as the SBA, 3-5 years. [47]

The PLL is similar to the FCL. It is aimed at countries with stable macroeconomic positions and a track record of implementing sound policy reform programs. PLL countries may face certain risks which prevent them from qualifying for an FCL loan, but they do not require the significant adjustments that an SBA program would demand. Therefore, the conditionality

[44] "IMF Lending", IMF, http://www.imf.org/en/About/Factsheets/IMF-Lending, 2016
[45] Ibid.
[46] Ibid.
[47] Ibid.

attached to such loans is much lighter and it is only demanded to specifically address the potential vulnerabilities a member is confronted with. The durations range from 6 months to 2 years. Unlike the FCL, PLL programs lasting more than six months are subject to semi-annual reviews. There are strict limitations on the amount that can be disbursed and like in the case of the SBA and the FCL, the loans can be made available as a precautionary measure. [48]

The EFF differs from the above three lending facilities. It is aimed at helping countries that are dealing with medium and long term structural problems which require significant economic reforms. This facility has been used extensively in light of the current financial crisis. EFF programs last longer than the three previous ones, up to four years. Repayment of the loan usually finishes 4-10 years after the first disbursement. [49]

Finally, the RFI was created to consolidate all previous emergency lending facilities. It is used to provide rapid assistance to members which are faced with urgent macroeconomic challenges. Conditionality is limited, but so is the amount that can be borrowed, which is set at a fraction of the member's annual quota. [50]

Nevertheless, the IMF has had to be flexible when confronted with novel situations. The fall of the Soviet Union put the Fund into uncharted territory. It had to assist the transitioning nations in creating functioning market economies, despite decades of distortions from collectivization and central planning.

In the beginning of the 1990s, the IMF lent to countries on an ad-hoc basis, starting with Poland in 1990 to support the now famous Balcerowicz Plan. The Fund continued lending in the same fashion until the dissolution of the Soviet Union in 1992. By then, it became clear that most post-communist countries could not meet the normal lending standards to qualify for normal IMF assistance. [51]

The Systemic Transformation Facility (STF) was introduced in 1993 as a bridge mechanism which would provide quick financing to countries while allowing them to build up the capacity and credibility to qualify for loans under the standardized Fund facilities. The amount of money that could be borrowed under an STF was small relative to other IMF programs, however, so were the strings attached to it. For example, the country could

[48] Ibid.
[49] Ibid.
[50] Ibid.
[51] James Roaf, Ruben Atoyan, Bikas Joshi, Krzysztof Krogulski and an IMF Staff Team, "25 Years of Transition Post-Communist Europe and the IMF", IMF, 2014

maintain budget deficits as high as 10% of GDP. More than half of the nations in transit accessed the STF when it was introduced in 1993. [52]

Challenges in International Development Efforts:

Daron Acemoglu adopts a critical view on the role of international institutions in fostering effective economic development. According to his analysis, the prescriptions administered by the IMF are based on a faulty premise that prosperity can be engineered by the implementation of the right policies. [53] He does not take an issue with the content of the policies themselves. Macroeconomic goals such as price liberalization, inflation targeting, and stable currency management, as well as microeconomic policies like privatization and better public sector management are desirable. [54]

Nevertheless, insistence on the so-called Washington Consensus, while being necessary according to Acemoglu, does not address why the bad policies and institutions came into existence in the first place. [55] When the political economy constraints that led to the macroeconomic imbalances are not resolved, he argues, the bad politics will continue to lead to bad economics. [56]

His criticism of the IMF in particular is that the damaging domestic policies are not the result of economic ignorance on behalf of the political elites. [57] The leaders of a country know fully well that large budget deficits and hyperinflation will be harmful for their economy. [58] However, deficit spending and the printing of large sums of money enables political elites to enrich themselves personally, as well as to adopt the necessary clientelistic policies which allow them to stay in power. [59] The stability of some states may very well be dependent on the maintenance of economically inefficient and disruptive redistributive actions.

Throughout his work, Acemoglu gives numerous examples where economically sound, IMF-negotiated reforms had little impact because of the unchanged political equilibrium. He terms this the "seesaw effect". [60]

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[52] Ibid.
[53] Daron Acemoglu, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*, 2012, p. 439
[54] Ibid. p. 440
[55] Daron Acemoglu, "Governance, Growth, and Development Decision-making", World Bank, 2008, p. 6
[56] Ibid. p. 4
[57] Acemoglu, *Why Nations Fail*, 2012, p. 440
[58] Acemoglu, "Governance, Growth, and Development Decision-making", World Bank, 2008, p. 4
[59] Ibid. p 4
[60] Daron Acemoglu and James Robinson, "The Role of Institutions in Growth and Development", 2008, p. 11

In such cases, the reforms introduced by the IMF and other international donors do fix certain economic imbalances which caused the distortions that necessitated the international assistance in the first place. Nevertheless, because the political structure of that particular state remained unchanged, the ruling elites found other detrimental ways to redistribute rents and to enrich themselves.

In Argentina, the Fund-backed reforms, which included a currency board and central bank independence, were successful in reducing inflation. Nevertheless, while the elites could no longer print money and redistribute foreign currency reserves to preferred factions, they instead bought support by giving away the proceeds of privatized assets to supporters. In addition to that, while inflation was brought under control, the budget deficits ballooned. Finally, barriers to entry were introduced to protect established players in the market from competition. Thus neoliberal policy prescriptions could be exploited to serve the interest of rent-seeking constituencies. [61]

Scholars of the IMF and the Fund's own staff have become acutely aware of the challenges posed by the political economy structure of a particular state. Such considerations are very sensitive due to the Fund's image of being an apolitical, technocratic entity. Allan Drazen has argued that the main instances of conflict in the implementation of IMF conditionality are not between the IMF and the recipient country, but rather between different constituencies within the country itself. For him, an understanding of the borrower's ability to successfully implement the negotiated reforms is inseparable from the country's own political constraints. [62]

Drazen's central claim is that the role of special interests needs to be examined in a discussion about conditionality and national ownership of IMF-negotiated policies. This is because the reforms demanded by the Fund may damage the welfare of such groups by taking away a rent-generating activity. [63] In his analysis, conditionality only becomes relevant when there is a wide divergence between the demands of a pro-reform government and various entrenched interests.[64] Drazen suggests two ways for the IMF and other international donor organizations to use conditionality as a way to overcome domestic political resistance to reforms.

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[61] Ibid., p 12-13

[62] Allan Drazen, "Conditionality and Ownership in IMF Lending: A Political Economy Approach", 2002, p. 38

[63] Ibid. p. 43

[64] Ibid. p. 41

First, lending could target the material interests of opposing veto players. According to his mathematical model, if lending were to have a positive effect for the particular group, then it would be more willing to accept certain reforms, or at least refrain from blocking their passage. Since the stabilizing effects of the loan package would benefit the group far more than the loss it could experience from the demanded reforms, the interest group is far less likely to reject them. [65]

In the first scenario, the government is the sole agenda setter, while the interest groups only have the power to block the IMF-negotiated macroeconomic reforms. Drazen explores another possibility in his model, one which the Fund often encounters in its lending operations. In many cases, the central government is not the sole agenda setter in a country. [66] Examples include states where the military or various moneyed interests compete with the government of the day for political influence.

Drazen's model shows how IMF conditionality can strengthen the hand of the government vis-à-vis other power-wielding groups. The scale of the financial assistance offered by the Fund forces such interest groups to accept reforms that go beyond the status quo, even if the reforms do not directly affect their material position. The IMF literature refers to this as the "backbone strengthening" effect of conditionality. Thus in theory, the Fund can work to empower a reform-minded government at the expense of potentially obstructionist interests and non-state actors. [67]

While it is possible for the Fund to retune its conditionality to take political economy factors into account, this creates another set of potential problems. The IMF would be taking sides in what may be a politically fractured society. The fact that there may be special interests with veto powers, or even worse, agenda formulating capabilities, is evidence that the borrower faces problems that are far bigger than a comparatively simpler macroeconomic imbalance. This would jeopardize the Fund's mission as an apolitical force dedicated to solving seemingly technocratic economic problems.

In a 2002 commentary, the IMF was forced to defend its record over its advice and programs in Ukraine. In the paper, the Fund's economists argued that "often the IMF's ability to facilitate implementation of the appropriate economic policies is constrained by domestic

[65] Ibid. p. 56
[66] Ibid. p. 59
[67] Ibid. p. 65

political considerations”. They concede that Ukraine’s problems of poor tax collection, inadequate law enforcement, and the lopsided power of various unproductive actors at the expense of profitable sectors of the economy, was something that could not be solely addressed through insistence on macroeconomic stability. [68]

Unfortunately, it was and still is beyond the remit of the Fund to push for deep and politicized structural reforms. While the stabilization measures were necessary to rescue the economy from its continuous freefall, they could not resolve the country’s deep rooted problems, which prevented the development of the necessary market-supporting institutions.

In another IMF report, analyzing the role of the Fund 25 years after the post-communist transition first begun, the writers acknowledge that “the impact of external assistance pales in significance to domestically-driven reform and development.” [69] The report acknowledges the importance of institutions as well as the difficulty of their permanent establishment due to opposition from vested interests. [70]

The report cites a variety of academic studies. One of them, by De Melo et al (2001, p. 1), concluded that “economic liberalization is the most important factor determining differences in growth.” [71] Nevertheless, this finding was challenged by subsequent surveys. Campos and Coricelli (2002, p. 825), summarizing various previous academic studies and reports, found out that price liberalization and macroeconomic stability alone were not sufficient for stable growth. Instead, their findings suggest that “institutions enabling the functioning of a market economy are a fundamental precondition, particularly relating to financial markets and social safety nets.” [72] A further study by Djankov and Murrell (2002), showed that privatized enterprises restructured faster and performed better than publicly owned ones. Nevertheless, that only happened when the proper legal and regulatory institutions were in place. [73]

Thus, over time, the Fund and its economists have recognized that macroeconomic adjustments are insufficient to fix deeply rooted structural problems. Sustainable economic growth is predicated on the presence of supporting institutions. The report, chronicling the IMF’s involvement in the post-Communist nations, states that “the transition to a market

[68] Lorenzo Figliuoli and Bogdan Lissovoli, “The IMF and Ukraine: What Really Happened”, IMF, 2002
[69] James Roaf, Ruben Atoyan, Bikas Joshi, Krzysztof Krogulski and an IMF Staff Team, “25 Years of Transition Post-Communist Europe and the IMF”, IMF, 2014, p. vii
[70] Roaf et al, “25 Years of Transition Post-Communist Europe and the IMF”, IMF, 2014, p. 5
[71] Ibid. p. 24
[72] Ibid.
[73] Ibid. p. 22

economy is at heart a transformation of legal and economic institutions, and of individual firms and households' incentives and behaviors." [74] The Fund's economists emphasize the necessity of a business-friendly environment where companies can be started, expanded, and if necessary liquidated in an ordinary fashion. [75] In the former Warsaw Pact States, this required "far-reaching legal, administrative, and institutional reforms across a broad front." [76]

The Importance of Institutions:

Economists from Douglas North to Daron Acemoglu have posited that differences in institutional arrangements account for economic disparities between countries and are the primary determinants of long-run economic growth. [77] North defines institutions as "the rules of the game in a society; more formally, they are the humanly devised constraints that shape human interaction. In consequence they structure incentives in exchange, whether political, social, or economic." [78] The incentives provided by institutions determine whether economies grow, stagnate, or decline. This is primarily due to the costs of transaction. [79]

North's argument is based in part on the ideas of Ronald Coase's famous analysis on transaction costs as explained in his Nobel Prize winning papers, "The Nature of the Firm" and "The Problem of Social Cost". While Coase's analysis focused on firms trading in the open market and the role of courts in producing Pareto-efficient outcomes, his ideas can be applied to the institutions that determine the incentive structure of a national economy. North claims that markets can only be truly efficient if they exclude transaction costs, which does not happen in real life due to problems of human cooperation. [80]

Coase showed how the price of obtaining goods is not limited to the price of the goods themselves. Entrepreneurs have to factor in the costs of information, bargaining, and the enforcement of contracts. [81] Similarly, economic institutions which reduce barriers to entry, secure property rights, and uphold the rule of law can reduce transaction costs. [82] Therefore, such institutions become key drivers for economic growth since high transaction costs can reduce incentives for economic transactions. Acemoglu shows a strong correlation between

[74] Ibid. p. vii
[75] Ibid. p. 6
[76] Ibid.
[77] DARON ACEMOGLU, SIMON JOHNSON, and JAMES A. ROBINSON, "INSTITUTIONS AS A FUNDAMENTAL CAUSE OF LONG-RUN GROWTH", 2005, p. 388
[78] Douglas North, *Institutions, Institutional Change, and Economic Performance*, 1990, p.3
[79] Douglas North, *TRANSACTION COSTS, INSTITUTIONS, AND ECONOMIC PERFORMANCE*, 1996, p. 6
[80] Ibid. p. 9
[81] Ronald Coase, *The Nature of the Firm*, 1937, p. 395
[82] Douglas North, *Institutions*, 1991, p. 98

legal protections against property expropriation and GDP per capita. [83] In Djankov's study, countries with high costs of entry for startups were more likely to have higher levels of corruption and larger informal economies. Conversely, democratic nations had lower barriers to entry and less regulations. [84]

If institutions are necessary for a market to function, then why are all nations not developing the right institutions which would minimize transaction costs? Acemoglu picks up North's analysis on transaction costs and aims to examine why an institutional divergence occurs between nations. According to him, the key factor is that institutions do not just determine the aggregate growth potential of an economy, but also the distribution of resources. [85]

Acemoglu posits what he calls the "social conflict theory" of institutional development. According to him, economic institutions are determined by the distribution of political power in a society, which is in turn a product of its political institutions. Since not all groups will benefit from the same economic arrangements, he argues that those with political power will generally put in place the institutions that maximize their own economic rents. [86] Nevertheless, such extractive institutions will likely fail to maximize overall wellbeing because they will not lead to the necessary innovation and creative destruction which are vital for economic growth. [87]

Acemoglu concedes that growth may occur under extractive institutions. He shows how the Soviet Union experienced tremendous development by pushing workers away from inefficient, small-scale agricultural plots into large industrial complexes. Similarly, slave-owning sugar planters in Barbados were able to generate growth because they were selling a cash crop with a strong global demand. [88]

However, extractive institutions, particularly in the case of the Soviet Union, eventually stopped producing the kind of growth which would allow the Soviet Union to overtake the US as Nobel Prize winning economist Paul Samuelson predicted on numerous occasions. [89] The incentive structure of the Soviet Economy failed to create the necessary impetus for economic innovation. The only sectors where the Soviet Union kept up with its Cold War rivals were in

[83] Acemoglu et. al, "INSTITUTIONS AS A FUNDAMENTAL CAUSE OF LONG-RUN GROWTH", p. 403
[84] Djankov et. al, *THE REGULATION OF ENTRY*, 2002, p. 1
[85] Acemoglu et. al, "INSTITUTIONS AS A FUNDAMENTAL CAUSE OF LONG-RUN GROWTH", p. 436
[86] Acemoglu et. al, "INSTITUTIONS AS A FUNDAMENTAL CAUSE OF LONG-RUN GROWTH", p. 427
[87] Acemoglu, Why Nations Fail, 2012, p. 144
[88] Ibid. p. 120
[89] Ibid. p. 121

defense and aerospace, mainly because it was faced with a Space and Arms Race. [90] However, there is something far more insidious about an economy based on extraction. Extractive institutions lead to the amassing of wealth in the hands of a small elite. Since the path to enrichment is through direct control of those institutions, an economy based on extraction plants the seeds for its own destruction. Such economies usually end up in unrest, civil war, and the total breakdown of order which made the extraction possible in the first place. [91]

If growth and stability are desired, then why do elites introduce extractive institutions, rather than inclusive ones? There are two closely related explanations.

The first one is on the surface simply contained to the economic sphere. Extractive institutions allow elites to generate rents. Today, the Ukrainian economy still has around 2,000 state owned enterprises which employ over 900,000 people. It is alleged that as many as 1,500 are worthless and are simply used to redistribute money from the state budget to various unknown interests. To privatize such companies, or to institute the secure property rights and low barriers to entry that would allow open competition against them, would reduce the economic rents of the predatory elites. [92]

The issue is best articulated by Nobel laureate Joseph Stigler in his *Theory of Economic Regulation*. He argues that "regulation is acquired by the industry and is designed and operated primarily for its benefit." [93] Djankov further elaborates that "industry incumbents are able to acquire regulations that create rents for themselves, since they typically face lower information and organization costs than do the dispersed consumers. [94] In this theory (Stiegler's), the regulation of entry keeps out the competitors and raises incumbents' profits."

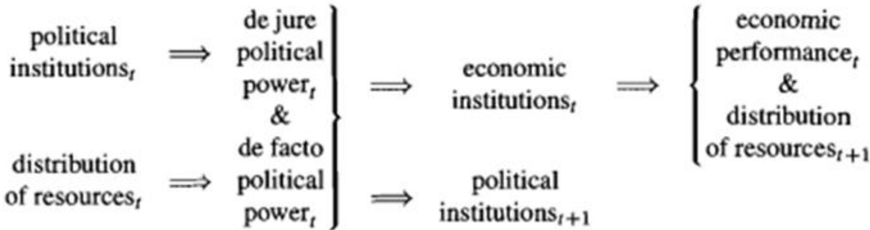
An example from China shows how the economic explanation of predatory institutions is closely tied to the distribution of political power, which forms the basis for the second explanation. Dai Guofang, originally a small processor of scrap metal, attempted to compete with the inefficient state owned Chinese steel producers. For reasons ranging from concerns

[90] Ibid.
[91] Ibid. p. 144
[92] Eric Hontz, "Ukraine Needs to Privatize its State-Owned Companies — But Rushing It Would Repeat the Mistakes of the Past", April 20, 2016
[93] George Stigler, *The Theory of Economic Regulation*, 1971, p. 3
[94] Djankov et. al, *THE REGULATION OF ENTRY*, 2002, p. 2

about the overheating steel market, to the failure of local authorities to follow national rules while granting him permission, Dai was sentenced to five years in prison. [95]

It is widely agreed that private development is essential for economic growth and development. Why would a government then jail entrepreneurs for making cheaper goods?

This question is answered by Acemoglu's discussion on the distribution of political power. According to him, there are two types of political power, de-jure and de-facto political power. De-jure political power is derived from the political institutions of a society, namely its constitutional arrangements. Those who wield de-jure political power can then shape the country's economic institutions, thus determining both its economic performance and distribution. De-facto political is the power possessed by groups outside of the political system. Examples of this can be military apparatus in Chile during the Cold War or in modern day Turkey. Those with de-facto political power can challenge the holders of de-jure political power through protests and military coups in order to take control of the political institutions and to remodel the economic institutions in their favor. [96]



Therefore, despotic regimes that aim to ensure their own survival will be weary of inclusive economic institutions because such institutions will generate wealth for people who do not hold de-jure political power and thus increase the latter's de-facto power. On the other hand, extractive economic institutions allow the predatory elites to distribute rents to their supporters in order to safeguard their own tenure.

Powerful players from outside the political center can therefore challenge the holders of de-jure political power. Such was the case in England during the Glorious Revolution and in the Netherlands during the revolt against the Habsburgs. The Atlantic trade allowed for the creation of a new class of merchants. Their interests in safeguarding their wealth were diametrically opposite to those of the predatory monarchies. Through armed conflict, they

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[95] Zhang Boling, *China steel industry forges ahead with reform*, http://www.marketwatch.com/story/china-steel-industry-forges-ahead-with-reform-2013-05-09, 2013
[96] Acemoglu et. al, "INSTITUTIONS AS A FUNDAMENTAL CAUSE OF LONG-RUN GROWTH", p. 448

were able to take control of the political institutions, thus remaking the economic institutions into ones that safeguarded the property rights of the land and capital owners. This resulted in rapid economic growth and, particularly in the case of England, eventual industrialization, since a wider segment of society could now effectively participate in the development of the economy. [97]

Predatory regimes are well aware of the dangers posed by de facto power. This is why the commanding heights of the economy in such entities are often given to cronies who are not the best qualified people, but who can be counted on for political support. Therefore, Acemoglu argues, the key variable for whether a regime opts for either inclusive or extractive institutions is the concern it has for its own security. [98]

In his previous works, he demonstrates why some colonies, like those in Australia and North America, ended up with inclusive institutions, while those in Africa, Central America, the Caribbean, and the Indian Subcontinent had ones that encouraged extraction. Where the Europeans were faced with deadly diseases and/or a large native population, their survival was precarious. Therefore, property rights were not extended across large segments of the population which effectively limited their abilities to fully participate in the economy. The emphasis in such colonies was on the rapid extraction of rents. On the other hand, where Europeans settled in large numbers and/or they did not face the danger of deadly diseases, property rights for entrepreneurs and small holders were guaranteed. [99] This analysis of insecurity is applicable to political regimes as well. When the security of the rulers is threatened, they prefer extractive economic institutions that reward their supporters and help stabilize their rule at the expense of growth for the entire system.

[97] Ibid. 393
[98] Daron Acemoglu and James Robinson, "The Role of Institutions in Growth and Development", 2008, p. 4
[99] Ibid.

Research Design:

This section explains the empirical approach taken throughout the case study. Its method is primarily deductive as opposed to inductive.

In cases where the inductive approach is prominent, the research begins with the collection of data, its subsequent analysis, and ends with the development of a generalized theory that attempts to explain the patterns that were uncovered. In deductive, theory-guided studies, the analysis begins with a hypothesis and/or a theory. After the data is evaluated, a conclusion is drawn on whether the hypothesis/theory is borne out by the data. [100]

This survey is anchored on certain theoretical presumptions. It utilizes Claus Offe's description of the triple challenges uniquely faced by post-Communist states, Daron Acemoglu's theory of institutions as the primary determinants of long-run growth, as well as his analysis and that of others on the limitations of international development efforts. The case study also addresses the nature and procedure of IMF lending and conditionality.

Two hypotheses are proposed:

H1: The IMF-backed programs between 1994-2002, despite popular belief in Ukraine, were effective in aiding the country's transition towards becoming a functioning market economy.

H2: Domestic political events during the same period played a far more significant role than the IMF's conditionality in explaining the observed variations in economic development.

Independent variable:

The independent variable in the study will be IMF conditionality as measured by the implementation of Fund-negotiated reforms and evaluated during periodic reviews in the Institution's documents.

Dependent variables:

The dependent variables include eight metrics. Four of them, FDI, Inflation, GDP Growth, and the Budget Deficit as Percent of GDP, measure conventional economic phenomena. The other four are measures of perceived institutional capacity. As established in the theoretical framework, durable and inclusive institutions are crucial for the establishment of a fully functioning market economy. The institutional variables are the World Bank Governance

[100] JACK S. LEVY, "Case Studies: Types, Designs, and Logics of Inference", January 18th, 2008

Indicators which are best suited for this particular study. They include Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. It is important to note the limitations of the institutional indicators. They measure perceptions of governance capacity as expressed by citizens, civil society leaders, and experts. Therefore, they provide a general direction of the quality of governance within a particular state, rather than a final destination.

Summary of Variables:

Variable:	Source:	Description:
IMF Conditionality	IMF Reports	The jointly agreed economic reforms which the Ukrainian Government would implement in exchange for financial assistance
FDI	World Bank	Investment by an individial or a company in another country which results in the acquisition of a controling stake or direct ownership in a foreign enterprise
Inflation	World Bank	Sustained increase in the prices of goods and services, thereby eroding purchasing power
GDP Growth	World Bank	Annual % growth in Gross Domestic Product
Budget Deficit	World Bank, National Bank of Ukraine	Budget deficit as % of total economic output
Government Effectiveness	World Bank	Captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures
Regulatory Quality	World Bank	Captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote development
Rule of Law	World Bank	Captures perceptions of the extent to which agents have confidence in and abide by the rules of society
Control of Corruption	World Bank	Captures perceptions of the extent to which public power is exercised for private gain

Political Situation Post-Independence and the Birth of the Oligarchs:

On December 1st 1991, as the overwhelming majority of the Ukrainian people voted for secession from the USSR, Leonid Kravchuk was elected to be the newly independent Republic's first President. A former head of the Supreme Soviet of the Ukrainian Socialist Republic (the Party Assembly) and Secretary responsible for ideology (propaganda), Kravchuk threw his lot with the nationalist cause after the disintegration of the Soviet Union became imminent in the failed August, 1991 Coup d'état. [101]

Kravchuk handily defeated his chief opponent, Vyacheslav Chornovil, who led the nationalist Rukh movement, by 61% to 23%. Chornovil's party had little appeal beyond his strongholds in Western Ukraine and therefore Russian speakers and the Left rallied behind Kravchuk. [102]

Kravchuk's single term in office, from 1991 to 1994, has been subjected to heavy criticism. Often portrayed as a political opportunist, Kravchuk ensured that the former Communist apparatchiks retained their central role in the governance of the new nation simply by shedding their red colors in favor of blue and yellow ones. While focusing on nation-building and the institutionalization of national symbols such as the trident of the Kievan Rus Rurikud Dynasty and the blue and yellow sky over grain fields flag, very little was done in the realm of economic reforms. [103]

Budget deficits were rampant and almost entirely financed by credits from the NBU. The 1992 deficit peaked at nearly 14% of GDP. [104] The monetization of the deficit led to skyrocketing annual inflation, surpassing 2000% in 1992 and 10000% in 1993. [105] The overall economy in that period contracted by nearly 50%. [106]

Nevertheless, certain notable individuals attempted to impress the need for drastic reforms upon Kravchuk. Volodymyr Lanovyi, the Deputy Prime Minister for the Economy, put together an ambitious program that included fiscal and monetary stabilization, privatization, price liberalization, and tax reform. Lanovyi's proposal played a key role in convincing the World Bank and the IMF to admit Ukraine as a full member. Despite his efforts, he lacked

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[101] Taras Kuzio et al., *Independent Ukraine: Nation-state Building and Post-communist Transition*, 1998, p. 6-9

[102] Kuzio et al., p. 61-62

[103] Taras Kuzio, *Ukraine: State and Nation Building*, 2016, p. 220

[104] Markiewicz et al, *Monetary Policy in Ukraine in 1996-1999*, 1999

[105] https://www.statbureau.org/en/ukraine/inflation

[106] http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2002&locations=UA&start=1994&view=chart

serious political support. After a few months in office, he was removed at the request of Kravchuk, who would later also sack Vitold Fokin, Ukraine's first Prime Minister. [107] [108]

Two factions rose to dominate the balance of power in Parliament as the Communist Party, which won the vast majority of seats in the 1990 Parliamentary election, fractured into various groupings. While nominally Communist, the two clans of Leftists-turned-pragmatists represented the so-called Red Directors who would eventually morph into Ukraine's dominant oligarchic class. One was led by Yukhim Zviahilsky and its power base was the coal and steel enterprises in Donetsk. [109] The other was headed by Leonid Kuchma, the director of Yuzhmash, an enterprise which manufactured the Soviet Union's largest intercontinental ballistic missiles and the rocket boosters for its space program. With the support of the military-industrial managers of Dnepropetrovsk, Kuchma was one of the preeminent political figures during the Kravchuk presidency. [110] The nationalist democratic movement Rukh never had more than a quarter of the seats in Parliament since their appeal was only limited to their bases of support in Western and Central Ukraine. [111]

Kuchma became prime minister despite Kravchuk's objections from 1992 to 1993. He attempted to pursue a reformist economic program and put Victor Pynzenyk in charge as Deputy Prime Minister for Economic Reform. Pynzenyk aimed to facilitate the privatization of industrial enterprises and agricultural land, to foster competition, and to ease the flow of foreign investment. [112] After receiving little help from either Kravchuk or the Communist-dominated Parliament, Kuchma resigned in September of 1993. [113]

Kravchuk subsequently appointed the Donetsk strongman Zviahilsky as Kuchma's replacement in the Prime Minister's office. The chaotic policies pushed by the pair laid the foundations for the subsequent oligarchic enrichment and the blatant plundering of the Ukrainian state. While Kravchuk seemed interested in restoring the former Soviet command

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[107] Åslund, Djankov, Havrylyshyn, *The Great Rebirth: Lessons from the Victory of Capitalism over Communism*, 2014, eBook, Location 3863
[108] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 778
[109] Roman Kupchinsky, "The Clan from Donetsk", The Ukrainian Weekly, January 12, 2003
[110] Ibid.
[111] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 461
[112] "FACTBOX: Five facts about new Ukraine finmin Pynzenyk", Reuters, Dec 18, 2007
[113] Profile: Leonid Kuchma, BBC, 1999

economy, Zviahilsky used the opportunity to freeze market reforms in order to enrich himself and his core constituents in the Donbas. [114]

Anders Åslund details four ways by which wealth was accumulated and later used to underpin the ascent of Ukraine's future post-independence elite. First, various factory managers and traders took advantage of the remaining price controls, particularly in metals and chemicals. They bought commodities at artificially low domestic prices, which were a fraction of the global price, and through their political ties they acquired licenses to export them overseas. Second, natural gas was imported from Russia and Turkmenistan at a heavily subsidized price and purchased by private companies which resold them to Western Europe at the market rate. Many of the gas deliveries were guaranteed by the Ukrainian State and the companies often did not pay Gazprom, thus saddling Ukraine with large debts, while pocketing the huge profit for themselves. Third, private firms with contractual relations to the state could borrow money at rates ranging from 20%-40%, while annual inflation ranged between 2000%-10000%. In such conditions, the loans were essentially gifts. The companies which received these loans provided often fictitious services to state-owned entities at vastly inflated prices. Essentially this was a scheme through which Red Directors were subsidized by the state in order to plunder it. Åslund's own calculations estimate that such credits accounted for over 60% of GDP in 1992 and more than 40% of the economy in 1993. Finally, subsidies were directly handed out to favored enterprises. The biggest beneficiaries were the coal and steel enterprises in the Donbas region. Åslund estimates that over 8% of GDP in 1992 and more than 10% in 1993 went to such subsidies. [115]

Zviahilsky, at the helm of the Zasyadko mine, widely known as one the most dangerous mines in the world where hundreds have perished, became Ukraine's first oligarch. [116] [117] He has been a member of every single Ukrainian Parliament since the country's independence and has been an influential politician in the pro-Russian Party of the Regions. Despite being prosecuted for stealing $20 million and fleeing to Israel, he eventually mended fences with Kuchma's subsequent government. [118] Other notable oligarchs in the early period include metals trader and media mogul Vadim Rabinovich as well as Igor Bakai, Ukraine's most famous gas trader who made his fortune by serving as an intermediary for Russian and

[114] Åslund, *Ukraine: What Went Wrong and How to Fix It*, eBook, Location 1613
[115] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 901-914
[116] Kupchinsky, "The Clan from Donetsk", The Ukrainian Weekly, January 12, 2003
[117] Шахта им. А.Ф.Засядько в Донецке. Справка, 19.11.2007
[118] Kupchinsky, "The Clan from Donetsk", The Ukrainian Weekly, January 12, 2003

Turkmen gas deliveries. All of them would become important figures during Leonid Kuchma’s presidency. [119]

[119] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1589-1604

IMF Programs in Ukraine:

The leadership of the IMF took a keen interest in Ukraine's development. Managing Director Michel Camdessus and his First Deputy Director Stanley Fischer became some of the West's biggest advocates for the country, urging other international institutions to follow the Fund's lead in providing financial support. [120] [121] When Leonid Kuchma was elected President in 1994, Camdessus went to Kiev to negotiate Ukraine's first macroeconomic stabilization program, namely a Systemic Transformation Facility (STF) from which Ukraine would borrow $763.1 million. [122] [123] In total, the Ukrainian Government would go on to receive nearly $4.3 billion in loans between 1994 and 2002, assistance that was crucial in helping the country through its transition and while it was forced to navigate around the currency crises of the late 1990s. [124]

In this section, I will document the lending facilities and programs negotiated between the IMF and Ukraine. It is important to note that not all mutually agreed policies were implemented by the administration in Kiev, that in some cases there was a substantial gap between when the reforms were agreed to and when they were actually put into force, and that not all domestic reforms were the result of IMF conditionality.

The first lending arrangement, the 1994 STF, required a reduction of the budget deficit, the limitation of cheap credit to state owned enterprises, and the beginning of price and trade liberalization. The IMF was satisfied with Ukraine's performance in implementing the agreed reforms and the fiscal tightening "surpassed expectations." The government was allowed to withdraw all the available money from the lending facility, paving the way for a standard program in 1995. [125]

Despite the success of the STF, inflation remained high, while economic output continued to decline. More radical actions were foreseen in the 1995 Stand-By Arrangement (SBA). The IMF and the Kuchma's government would work to reduce monthly inflation to single digits, while limiting the GDP decline to 10% per year. The annual budget deficit would be expected to decline from 8.6% in 1994 to an estimated 3.3% in 1995. This reduction was to be achieved through a variety of cost-saving, but politically sensitive measures. The central government

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[120] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 3342
[121] "Camdessus Expresses Support for US$1.8 Billion of IMF Credits for Ukraine", IMF, 1995
[122] "I.M.F. to Help Ukraine to Rejuvenate Economy", New York Times Special, 1994
[123] "IMF", Ministry of Finance of Ukraine, http://www.minfin.gov.ua/en/news/mizhnarodne-spivrobitnictvo/mvf
[124] Ibid.
[125] "IMF Approves Stand-by Credit and Second STF Drawing for Ukraine", IMF, April 7, 1995

was to gradually withdraw from financing agriculture, subsidizing coal enterprises, and limiting wage increases in the public sector, while increasing utility prices and housing rents. [126]

Besides the changes on the fiscal side, the 1995 SBA envisaged the beginning of comprehensive structural reforms. First, administrative constraints and price controls would be gradually reduced to allow state owned enterprises to innovate, expand, as well as to cut costs. Second, The Ukrainian government and the Fund agreed to launch a voucher-based privatization program which would take 8,000 large and medium enterprises into the market. Finally, the authorities would continue to remove all bureaucratic obstacles that are detrimental to exporters. Despite the emphasis on deficit reduction, the program allowed social spending to increase to 2.5% of GDP in order to protect the most vulnerable groups during the transition. [127]

The 1995 reforms saw a drastic initial reduction in the rate of inflation, an increase in FDI, and a growing private sector. Nevertheless, the pace of reform slowed in the second half of 1995. Budget targets were sidestepped, the central government continued to subsidize loss-making industries, while the currency at the time, the Karbovanets, began to slide and thus inflationary pressures retuned. [128] The freefall in the GDP continued unabated.

The 1996 program, another SBA, sought to incentivize the State to resume the liberalization of the economy, to reduce monthly inflation to below 2%, and to try to further arrest the substantial reduction in GDP. To achieve those goals, the Ukrainian government agreed to pursue a wide array of fiscal and structural reforms. [129]

The authorities would reduce the budget deficit from 5% of GDP in 1995 to 3.5% in 1996. Tax reform would continue, with the removal of many arbitrary tax exemptions, while on the expenditure side, wage and program spending increases would slow down. Monetary policy from the central bank would focus on inflation reduction and the increase of the country's foreign exchange reserves. [130]

On the structural side, the government would create a treasury management system to ensure liquidity by centralizing cash flows. New measures would be implemented to facilitate the

[126] Ibid.
[127] Ibid.
[128] "IMF Approves a Stand-By Credit for Ukraine", IMF, May 10, 1996
[129] Ibid.
[130] Ibid.

privatization process, with the aim of auctioning off 70% of the shares in 5,000 large and medium enterprises. The price liberalization process was to be continued by reducing the amount of goods that require governmental approval for a price increase. Finally, the process of land reform would begin, first by creating a system for title registration. [131]

In order to deal with the falling standard of living, the authorities were to provide a housing subsidy for households where housing and utility bills exceeded 15% of total income. The pension system would also be overhauled, with emphasis being put on ensuring its solvency and ability to help those with the greatest need. [132]

In addition to the IMF financing, international creditors pledged an additional $2.4 billion to support Ukraine's transition in 1996. $1 billion would come from the World Bank, while the rest would be loaned by 14 partner countries on a bilateral basis. [133]

According to the Fund, the 1996 program was successful at reigning in inflation. This has been widely attributed to the introduction of a new currency, the Hryvnia. [134] In addition to that, structural reforms to support a liberalizing economy and a modernized tax system were introduced. Negotiations were started to agree to a more comprehensive reform program under an Extended Fund Facility. However, the negotiations broke down over several key points. [135]

Instead, the IMF and Ukraine concluded a third SBA in 1997. The main emphasis of the program was to finally return the country to growth in 1998. To do this, the Ukrainian government would work to reduce inflation from 40% in 1996, to 15% in 1997 and 12% in 1998. The Central Bank would also work to significantly bolster its foreign currency reserves to support the new currency. The consolidated budget deficit was expected to decrease to 4.6% of GDP in 1997 and to 4.5% in 1998. [136]

In the 1997 program statement, the Fund's economists acknowledged for the first time that macroeconomic stabilization alone will not allow the Ukrainian economy to return to growth. What the country needed was further deregulation, the privatization of inefficient state enterprises, and a competitive market. A key plank of the agreement would see the

[131] Ibid.
[132] Ibid.
[133] "Donors Pledge Support for Ukraine's Reforms", IMF, December 17, 1996
[134] "Statement by IMF Managing Director on Ukraine", IMF, September 13, 1996
[135] "IMF Approves Stand-By for Ukraine", IMF, August 25, 1997
[136] Ibid.

government laying the foundation for a stock market and a new bankruptcy law to ensure an orderly restructuring and/or liquidation of assets. Crucial areas that were identified as needing further reform were the energy and agricultural sectors. [137]

Despite some initial success, most of the agreed measures of the 1997 program were not put into force. The promised fiscal discipline never materialized and the reforms were not implemented. The situation was further exacerbated by domestic political disputes and the aftershocks from the Russian currency crisis. While the economy grew by 0.2% in the first half of 1998, the first growth spurt since independence, contagion spread from Russia's policies to combat a run on its Central Bank. [138] The Russian government swiftly devalued the Ruble, defaulted on domestic and foreign debt, and hiked up interest rates. [139]

At first, the National Bank of Ukraine (NBU) attempted to defend the Hryvnia's value within a band of ₴1.8-₴2.25 per $1. [140] This quickly depleted the Bank's foreign exchange reserves, from $2.3 billion in January, 1998 to less than $900 million in September, 1998 and finally bottoming out at less than $500 million in February, 1999. [141] By the beginning of 2000, the Hryvnia traded at a rate of ₴5.5 to $1. [142]

To help the Ukrainian Government maintain a stable balance of payments, the IMF and the national authorities negotiated a three year Extended Fund Facility (EFF) totaling $2.226 billion in September, 1998. [143] The facility was supplemented in 1999 with another $366 million due to falling commodity prices and the further deterioration of the Russian economy, Ukraine's biggest trading partner. [144]

While this package contained key macroeconomic goals, it was most noteworthy for its robust prioritization of structural reforms. The strengthening of the Finance Ministry, the Tax Authority, and the Customs Bureau were identified as crucial for the successful implementation of the program. Significant reductions in the size and scope of the government were to be enacted as well. Finally, the energy and agricultural sectors were to be

[137] Ibid.
[138] "IMF Approves Three-Year Extended Fund Facility for Ukraine", IMF, September 4, 1998
[139] "The Russian Crisis 1998", RaboBank, September 16, 2013
[140] Åslund*, How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1856
[141] Ibid. Location 1863-1878
[142] Ibid. Location 1864
[143] "IMF Approves Three-Year Extended Fund Facility for Ukraine", IMF, September 4, 1998
[144] "IMF Approves Augmentation of Extended Fund Facility for Ukraine", IMF, May 27, 1999

drastically overhauled, with an emphasis being put on the budget draining coal mining industry. [145]

IMF funding was delayed on numerous occasions due to domestic squabbles. In the first half of 1998, the Fund stopped disbursing aid because the Communist/Socialist majority in Parliament refused to adopt the legislation to carry out the reforms agreed between the Kuchma administration and the IMF. [146] In November, 1998 Kuchma himself decided to disregard the agreement with the Bretton Woods institution and subsequently the World Bank and the EU also discontinued all financial aid. [147]

The IMF money returned in the summer of 1999, under the increasingly vigilant oversight of First Deputy Managing Director Stanley Fischer. [148] In 2000, it was revealed that in the period between late 1996 and 1998, the NBU engaged in various non-permissible transactions which artificially inflated its foreign exchange reserves by $400 million-$700 million between September, 1997 and December, 1997. [149] Due to the reserves scandal, the IMF again stopped loaning money during the first half of 2000. [150]

The first positive assessment of the Ukrainian Government's efforts came in December, 2000 when the Fund completed Ukraine's fourth review under the EFF. First Deputy Managing Director Stanley Fischer stated that "The Ukrainian authorities should be commended for the recent improvements in economic policy implementation and progress on their reform agenda." [151]

The government at the time was led by former Governor of the NBU, Viktor Yushchenko, who is widely credited with ending the country's hyperinflationary death spiral, and Deputy Prime Minister of Fuel and Energy Yulia Tymoshenko, a former oligarch-turned-reformer.

The economy even outperformed the IMF's own forecasts (5%) for 2000, growing 5.9%, the first registered rate of growth since independence from the USSR. The fiscal position of the

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[145] Ibid. IMF, September 4, 1998
[146] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1863
[147] Ibid. 1878
[148] "IMF Executive Board Completes Ukraine Review and Approves Next Credit Tranche", IMF, June 30, 1999
[149] "Release of PricewaterhouseCoopers Report on the National Bank of Ukraine", IMF/PWC, May 4, 2000
[150] Olena Horodetska, "IMF: Ukraine must do more to win loans", KyivPost, July 1, 2000
[151] "IMF Completes Fourth Review for Ukraine", IMF, December 19, 2000

government improved significantly, with the budget deficit declining to less than 1% of GDP. [152] [153]

The IMF's economists urged the government and the NBU to relax the currency peg of the Hryvnia and to allow to it float more freely against other reserve currencies. The Fund welcomed the key reforms in the energy sector, namely the removal of barters and tax offsets as a means to pay for gas deliveries. Finally, while the IMF commended the authorities for passing their most transparent privatization law, it identified the banking system as a sector which required significant reforms. [154]

The positive feedback from the Fund resumed in 2001, with the new First Deputy Managing Director Anne Kreuger stating that "Economic performance in 2001 has been impressive, with strong growth and declining inflation. Monetary and fiscal policy in the first half of 2001 have been on track and the external position has improved markedly." GDP for 2001 grew by 9.2%, surpassing all expectations. The budget deficit remained below 1% of GDP, while annual inflation decreased from 25% in 2000 to 6% in 2001. Emphasis remained on restructuring the larger banks, while continuing the reforms in the opaque energy sector. [155]

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[152] Ibid.

[153] World Data Bank, World Bank

[154] "IMF Completes Fourth Review for Ukraine", IMF, December 19, 2000

[155] "IMF Completes Fifth and Sixth Reviews for Ukraine under Extended Arrangement", IMF, September 20, 2001

Key Domestic Events:

The IMF-negotiated reforms did not happen in a vacuum. Numerous significant economic and political events happened in the period between 1994 and 2002 which directly impacted the pace of reforms. In this section I aim to outline some of the key ones.

The most significant event in that period was the election of Leonid Kuchma, a Russian speaking Red Director from the East, to the Ukrainian Presidency. He managed to defeat his former boss, the Ukrainian speaking incumbent President Leonid Kravchuk. Kuchma campaigned on a platform of economic reform and closer ties with the Russian Federation. [156] Kuchma had previously served as Kravchuk's Prime Minister and while he attempted to pass market reforms, he received scant support from the Parliament, the Cabinet, or Kravchuk. [157]

The election result came as a surprise. In the first round, Kravchuk won 38% of the vote versus Kuchma's 32%. Nevertheless, in the second round Kuchma secured 52% of the electorate with most of his support coming from the Russian speaking East and South. [158] Many of the Communist voters from the first round also paradoxically backed Kuchma's message of market reforms. [159] It is likely that pragmatism prevailed over ideology as monthly salaries in Ukraine at the time were $15, versus $100 in Russia and over $1,900 in the US. [160] [161]

Kuchma, working closely with the central bank chief Viktor Yushchenko, sought to stabilize the economy. The monthly inflation peaked at over 90% in December, 1993. [162] To combat it, the NBU stopped issuing money at the request of parliament. [163] Kuchma drastically reduced the budget deficit, thus further hindering the inflationary monetization of the debt, from 8.9% of GDP in 1994, to 6.6% in 1995, and 4.9% in 1996. [164] The President also liberalized most consumer prices, barring essential goods and services such as housing rents and energy where the pace of liberalization was slower due their politically sensitive nature. Rates on both income taxes and the VAT were significantly reduced. Finally tariffs and non-quantitative

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[156] Åslund*, How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1062
[157] Åslund*, How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 805
[158] STEVEN ERLANGER, "UKRAINIANS ELECT A NEW PRESIDENT", New York Times, July 12, 1994
[159] Dmytro BAZIV, 1999 Elections: Kuchma and Communists together again!, 15 June, 1999
[160] ERLANGER, "UKRAINIANS ELECT A NEW PRESIDENT", July 12, 1994
[161] Social Security Administration, United States of America
[162] https://www.statbureau.org/en/ukraine/inflation
[163] Marek Dabrowski (ed.), Marta Dekhtiarchuk, Urban Górski, Pavel Kovalev, Yurii Kuz'min, and Khwaja Sultan, *Ukraine: From Fragile Stabilization to Financial Crisis*, January, 1999
[164] Malgorzata Markiewicz, Marta Dekhtiarchuk, Urban Górski, *Monetary Policy in Ukraine in 1996-1999*, 1999

restrictions on trade, especially imports, were either drastically reduced or abolished. [165] While Kuchma's early reforms did not immediately return the economy to growth, the GDP contraction slowed down significantly.

Kuchma's biggest economic achievement was the introduction of the Hryvnia in September, 1996, which has survived as Ukraine's currency until the present day. The Hryvnia was symbolic since this was the name of the currency of the first Ukrainian State, the medieval Kievan Rus. The new currency was important for both economic and political reasons. It showed that Ukraine was an independent nation with a currency that could hold its own in the global marketplace. Before Kuchma's election, the Karbovanets, Ukraine's first post-independence currency, had gone from being at parity with the Russian Ruble to being worth less than 5% of its Eastern counterpart. [166] Despite subsequent devaluations due to external financial shocks, the Hryvnia put an end to Ukraine's hyperinflationary days.

By 1996, Kuchma had reversed his reformist drive. He was confronted by a hostile blocking minority of Communists and Socialists and thus many of his reforms were passed through presidential decree rather than parliamentary approval. He needed the backing of the Left for a new constitution and he was concerned for his own political survival in the upcoming parliamentary and presidential elections. [167]

In the spring of 1996, Kuchma appointed his Energy Minister, Pavlo Lazarenko, as Prime Minister. Even though Lazarenko's term lasted just one year, he is estimated to have enriched himself to the tune of $200 million. [168] He pushed for policies which favored United Energy Systems of Ukraine, (UESU), a gas trading company from Dnepropetrovsk which he co-owned with Yulia Tymoshenko. [169] He monopolized grain exports under an agency that he controlled, buying cereals at artificially low domestic prices and exported them for the market price on the world market. [170] Privatized assets were given to favored groups and the economy was heavily encumbered with red tape and inspections which were avoidable for the right fee. [171]

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[165] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1154-1179
[166] ERLANGER, "UKRAINIANS ELECT A NEW PRESIDENT", July 12, 1994
[167] Åslund, *How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1352
[168] "It's a Gas—Funny Business in the Turkmen-Ukraine Gas Trade" Global Witness, April 2006, p. 23
[169] Ibid. p. 22
[170] RAYMOND BONNER, "Ukraine Staggers on Path to the Free Market", APRIL 9, 1997
[171] Robert Lyle, "Ukraine: No One Actually Fighting Corruption", RFE/RL, February 09, 1999

Lazarenko, who attempted to assert himself as the dominant political figure over Kuchma, was eventually fired from his post. Nevertheless, he did not go down without a fight. He, along with his business partner and protégé Yulia Tymoshenko, created a new party called Hromada (Community) to challenge Kuchma in the 1998 parliamentary elections. Lazarenko failed to get a significant number of seats, due to mainly only winning votes from his stronghold of Dnepropetrovsk. [172] Parliament eventually voted to strip him of his immunity. [173] After first trying to flee to Switzerland, he was arrested for money laundering, corruption, and fraud in the United States. There he was convicted and served 6 years out of a 9 year sentence. [174]

Five main oligarchic factions would emerge from the 1998 elections and they would hold the balance of power in Parliament against the non-reformed Communist/Socialist Left. Kuchma became highly dependent upon them for carrying out his legislative priorities. They were the Social Democratic United Party, the Democratic Council, Labor Ukraine, the Greens, and a group of independents who would eventually form the Party of the Regions. [175]

The Social Democratic United Party had very little interest in social democracy and was led by pro-Russian oligarch Victor Medvedchuk. Medvedchuk, along with his partners, the Surkis brothers, had commercial holdings in real estate, football, and electricity distribution. He would become one of Kuchma's foremost allies in Parliament. [176]

The Democratic Council was headed by oil trader Oleksander Volkov and gas trader Igor Bakai and served as a vehicle to protect their monopolistic interests in importing energy commodities from Russia and Central Asia. Labor Ukraine, another centrist force, was financed by steel and oil magnate Victor Pinchuk and led by Serhiy Tyhypko. [177] The Green Party was a front for the owners of the heavily polluting Zaporizhstal steel maker. [178] Finally, rival independent members of parliament from the Donbas region would unite to lay the foundations for the future political powerhouse, the Party of the Regions. Its agenda was

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[172] Stefan Korshak, "Ukraine: Candidates Look To Dnipropetrovsk Region For Support", RFE/RL, March 09, 1998
[173] "Lawmakers strip jailed Ukrainian ex-premier of parliament seat and immunity", KyivPost, February 7, 2002
[174] "Former Ukrainian Prime Minister Sentenced to 97 Months in Prison Fined $9 Million for Role in Laundering $30 Million of Extortion Proceeds ", FBI, November 19, 2009
[175] Door Kravchuk, *Ukrainian Political Economy: The First Ten Years*, 2002, p. 88
[176] Taras Kuzio, "Ukrainian Politics, Energy and Corruption under Kuchma and Yushchenko", 2008
[177] Kravchuk, *Ukrainian Political Economy: The First Ten Years*, 2002, p. 88
[178] Taras Kuzio, "Ukraine: Campaign Controversies", Oxford Analytica, March 26, 2002

supportive of Kuchma, closer ties to Russia, and the material wellbeing of the steel and mining industry in Donetsk and Luhansk. [179]

By the end of 1999, Ukraine was a society where the Government, the various fractured political groups in Parliament, and the big oligarchs had a symbiotic relationship through which they continuously burdened aspiring entrepreneurs with new regulations while maximizing rent-seeking in an ever-shrinking economy. This equilibrium was interrupted after the Russian currency crisis spilled over into Ukraine. Fearing the consequences of a financial default, the oligarchic factions in Parliament urged Kuchma to appoint a reform-minded Prime Minister. [180]

Just before Christmas Day of 1999, Viktor Yushchenko was sworn in as Prime Minister. He set out to enact a radical program in his first 100 days of office which included the defeat of barter in the economy, a radical cleanup of the energy sector, the decolectivization of agriculture, and the privatization of numerous large enterprises. To accomplish his goals, he appointed an array of reformist ministers which included Yulia Tymoshenko as Energy Minister. [181]

After the economy was stabilized and Ukraine's GDP grew for the first time in its post-Soviet history, Yushchenko began to face opposition from the oligarchic blocs, the Communist/Socialist Left, and from Kuchma's own administration. The reform effort was going much further than the predatory oligarchic factions in Parliament and their otherwise unlikely bedfellows on the Left were willing to accept. Various members of the establishment joined forces to stage a coup against the reformists. [182] The most prominent victims of this putsch were first Tymoshenko, and then ultimately Yushchenko himself.

A former oligarch herself, nicknamed Ukraine's Gas Princess, Tymoshenko knew all the underhand dealings of the trade. The energy sector was by far the most contentious area because it generated the most rents and was dominated by politically powerful players. Many of them were either the heads of governmental departments or the leaders of parliamentary groups. [183]

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[179] Åslund*, How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1738
[180] Åslund*, How Ukraine Became a Market Economy and Democracy*, 2009, eBook, Location 1892
[181] Ibid., Location 1901-1909
[182] "Politics and Pressure Fuel Tymoshenko's Dismissal", StratFor, January 21, 2001
[183] Global Witness, April 2006, p. 25

Tymoshenko attempted to end the practice of barter in the energy sector, which was essentially a rent seeking activity allowing large sums of money to disappear into unknown pockets. In the end, the gas deliveries went unpaid and due to contract guarantees from the Ukrainian State, the Treasury had to foot the bill if some of the bartered goods fell off the truck. Famous cases involved trading galoshes, spruce trees, and outdated TV sets for Russian and Turkmen gas. [184]

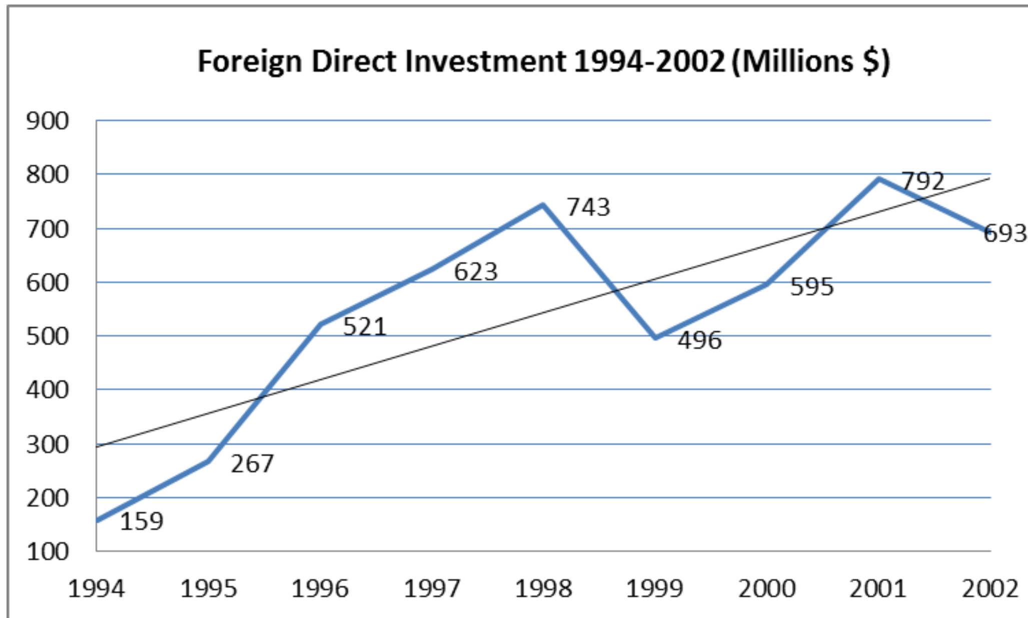
Tymoshenko's reforms brought her into direct conflict with Igor Bakai, the head of Naftogas, the national oil and gas company. [185] She eventually sacked him and he would become one of the key plotters against her. She successfully reformed the oil and electricity markets, forcing distributors to pay their debts and taxes on time and in cash, while lowering prices for consumers. [186] After trying to take on the powerful coal interests from Donetsk, which received hundreds of millions per year in subsidies, she was sacked by Kuchma in January, 2001. [187]

A month after Tymoshenko's removal from office, she was arrested on charges which would be dismissed years later. In April, 2001 a coalition of leftists and oligarchs would remove Yushchenko at the behest of Kuchma. Tymoshenko's clean sweep of the energy sector generated billions of dollars in extra revenue, which were used to alleviate the country's large public sector wage and pension arrears. [188] Yuschenko's overall reform program laid the foundations for what could have become a truly dynamic economy.

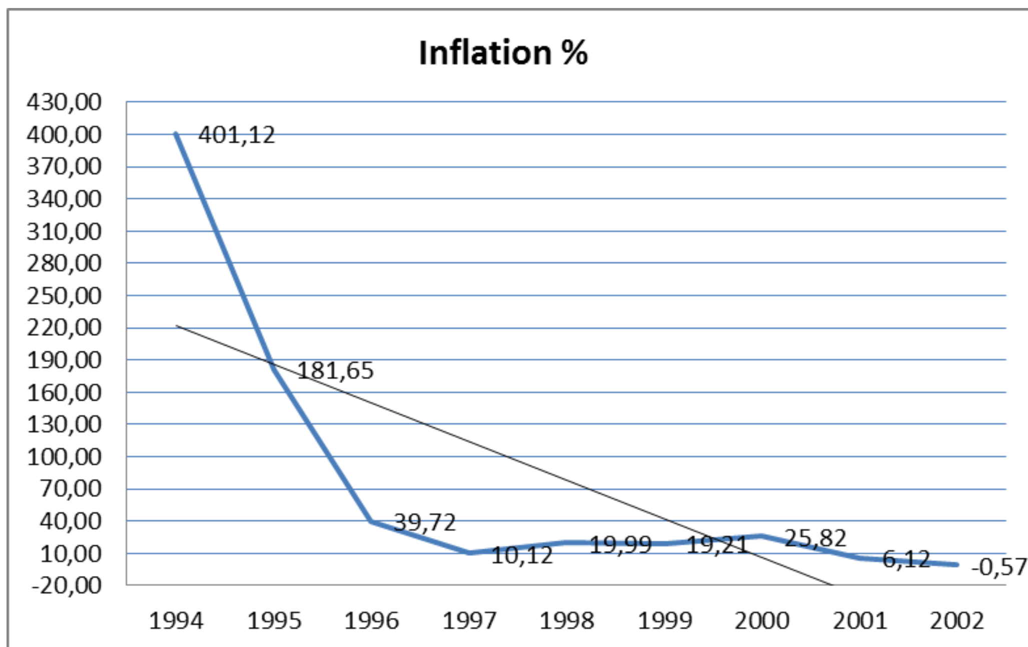
[184] Ibid., p. 26-27
[185] Katya Gorchinskaya, "Naftogaz chief quits, blames West", KiyvPost, March 30, 2000
[186] "Energy reforms depend on Tymoshenko", KiyvPost, Sept. 21, 2000
[187] "Politics and Pressure Fuel Tymoshenko's Dismissal", StratFor, January 21, 2001
[188] Ibid.

Graphs:

Economic Indicators:



Self-Generated Graph. Data Source: World Bank



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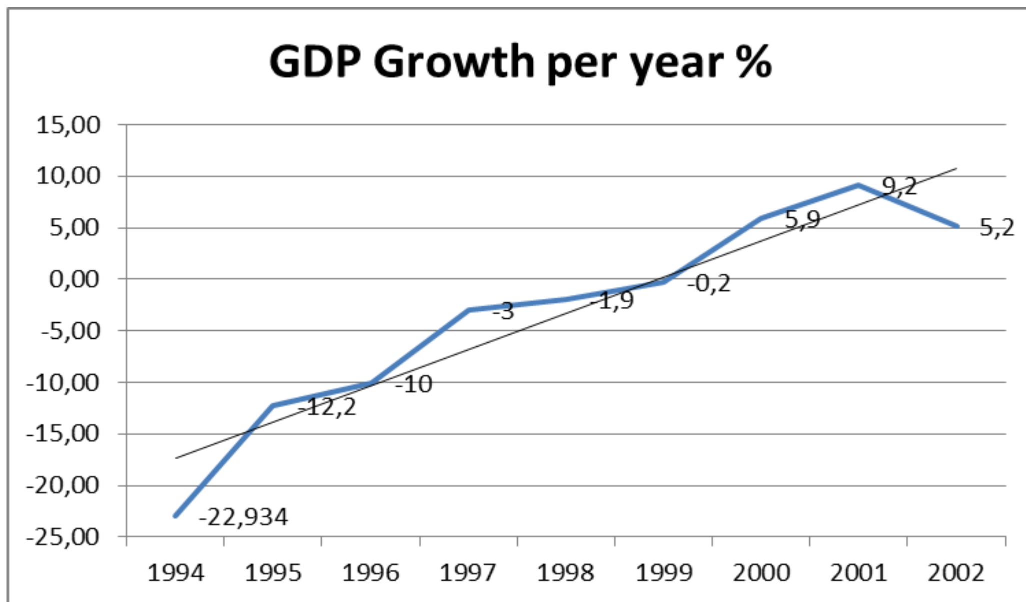

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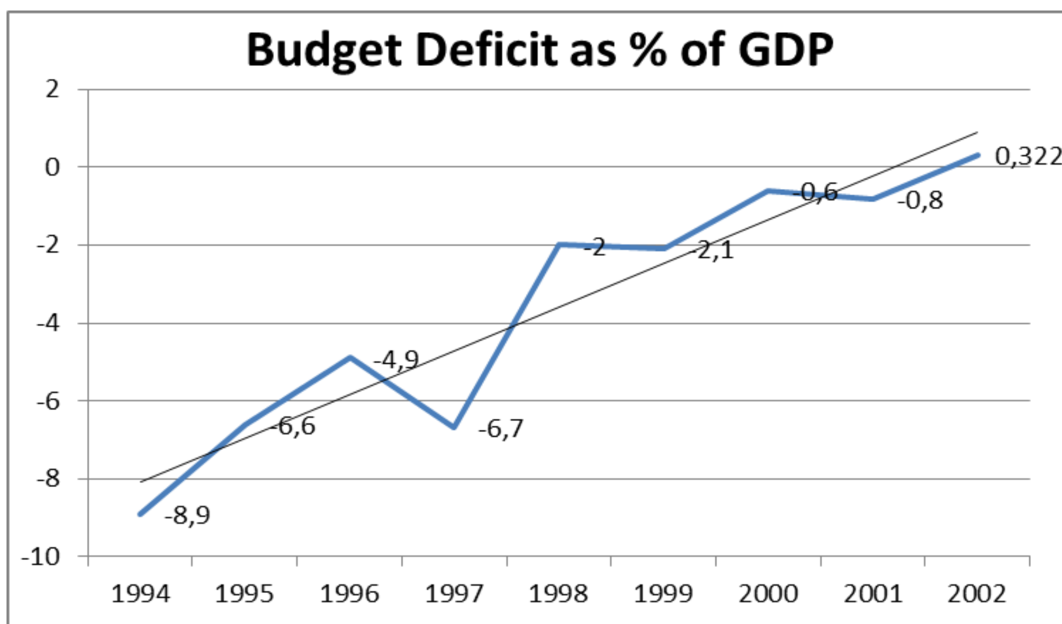
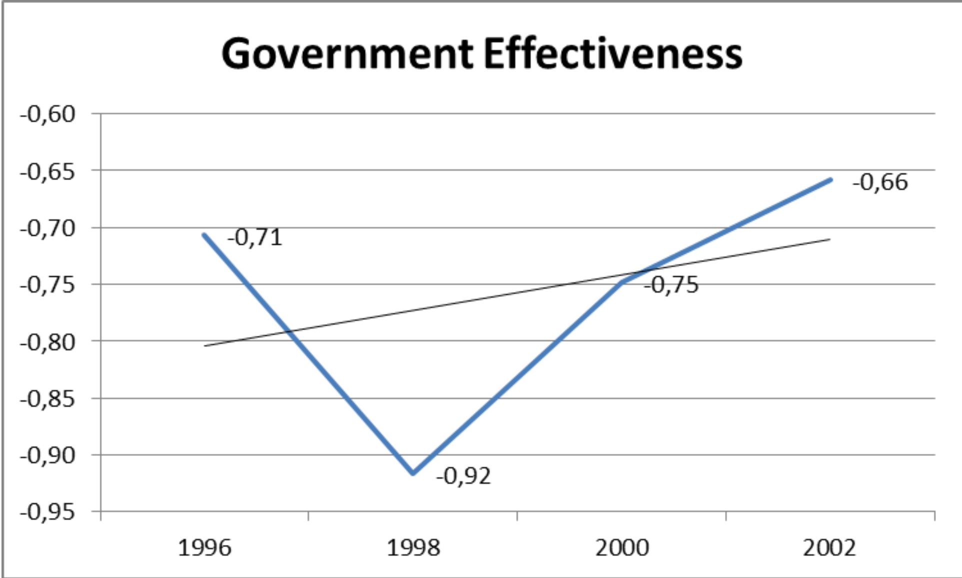


Self-Generated Graph. Data Sources: World Bank, National Bank of Ukraine

Institutional Indicators:



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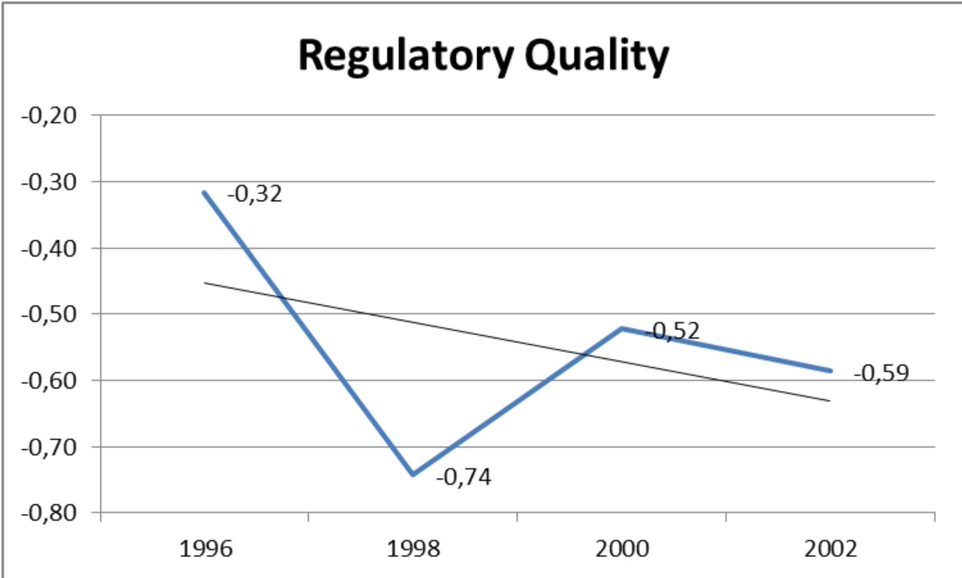

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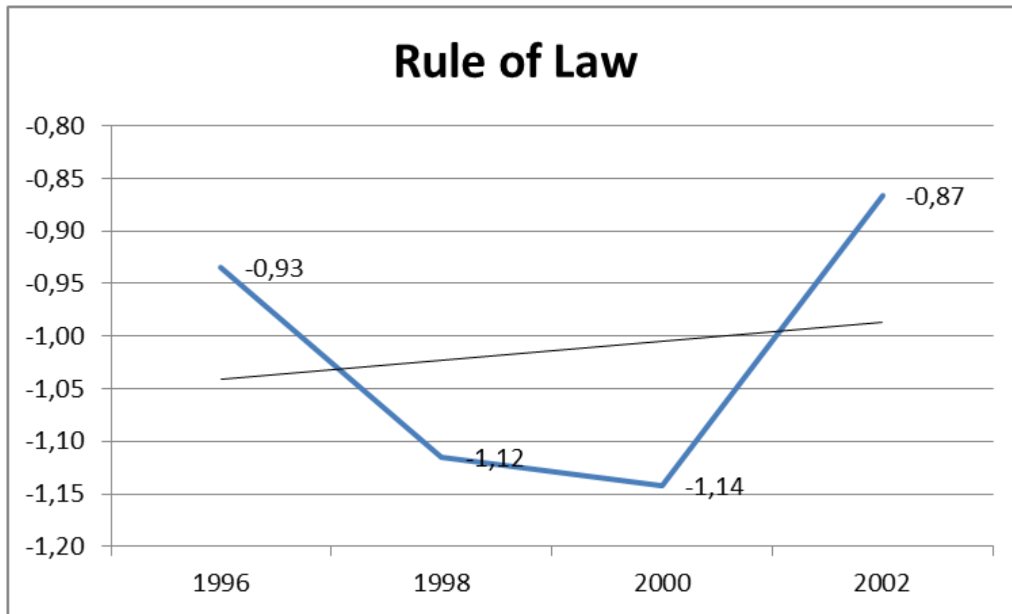

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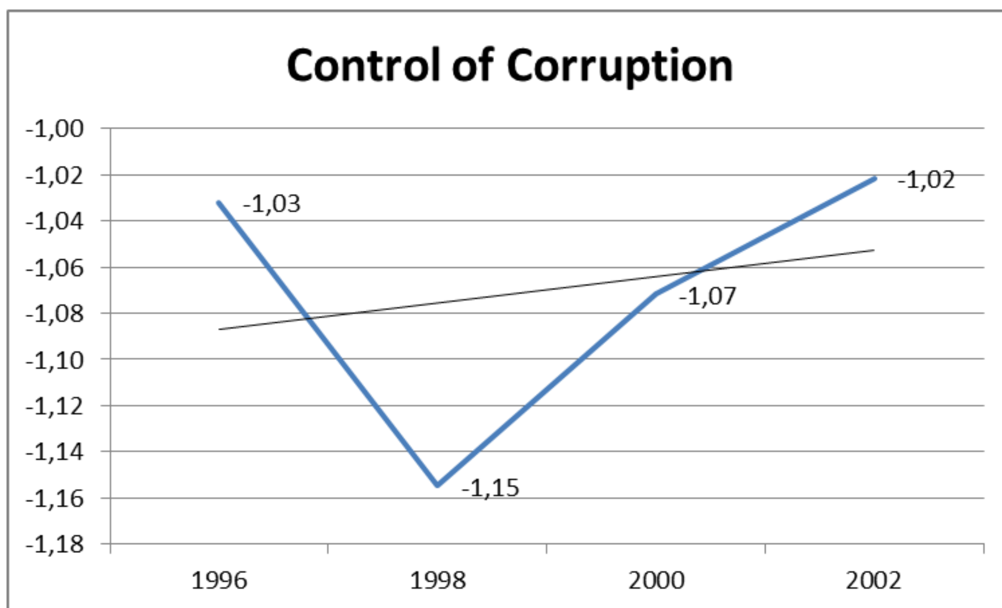

Self-Generated Graph. Data Source: World Bank

Evaluation of IMF Program:

An appraisal of an IMF package is a challenging task. In their survey of IMF programs, methodologies, and measurements, Ul Haque and Khan argue that taking a before and after approach to measure the impact of the Fund's role can present the interested parties with a largely artificial picture. This is because a before and after approach by default tends to attribute all changes in the country's economic performance to the Fund's conditionality, while sidestepping important external events such as global trade patterns, interest rates, and the overall health of the global economy. For example, if global commodity prices rise and the IMF borrower is also a big producer of raw materials, its economy will improve, seemingly making the program a success. The opposite will be true if there is a glut in the commodity markets.

The lack of a real counterfactual, namely what would have happened in the same time period had Ukraine not asked the IMF for help, also makes it difficult to evaluate the effectiveness of the Fund's conditionality. [189] Even computer generated simulations carry a wide range of shortcomings as explained in Ul Haque and Khan's paper. [190]

Ul Haque and Khan suggest that a more thorough case study of a particular borrower's Fund-sponsored program can minimize the challenges identified above. [191] Most scholars emphasize various macroeconomic metrics and their changes over a period of time. While this study includes four such metrics, it also incorporates four measures of perceived institutional capacity. This is due to the importance of institutions as identified in the Theoretical Framework section. Since it is impossible to run a controlled experiment, which accounts for the impact of all exogenous and endogenous variables, I have attempted to give some weight to such influences by using the IMF's own evaluations and by describing some of the most relevant political events.

The results show strong support for the two hypotheses. There is a significant correlation between the implementation of IMF-backed reforms and improvements in the indicators measured in this study. Furthermore, the fluctuations of all the macroeconomic metrics and three of the four institutional indicators correspond closely to the domestic developments in the three significant political periods during the time of the Fund-negotiated programs.

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[189] Nadeem Ul Haque and Mohsin S. Khan, "Do IMF-supported Programs Work? A Survey of the Cross-Country Empirical Evidence", *International Monetary Fund*, 1998, p. 9

[190] Nadeem Ul Haque and Mohsin S. Khan, "Do IMF-supported Programs Work? A Survey of the Cross-Country Empirical Evidence", *International Monetary Fund*, 1998, p. 12-13

[191] Ibid., p. 20

The first period, lasting from 1994 to 1996, was the first serious attempt at economic reforms in Ukraine. They were implemented by Kuchma, in close coordination with the IMF. Annual inflation declined significantly from over 401% to a more manageable 39.7%. The budget deficit narrowed, though it did not reach the targets that were negotiated with the Fund. The severe contraction that the economy experienced was arrested, with the drop in output slowing down from more than 22% a year to 10%. Finally, annual FDI nearly quadrupled from 150 million in 1994 to 521 million in 1996. There is no data from the institutional indicators for that period since the World Bank began to publish them in 1996.

The second period began with the appointment of Pavlo Lazarenko, an oligarch with ties to organized crime, as Prime Minister in 1996, and finished with the promotion of Victor Yushchenko, then President of the NBU, as Premier. This saw the stagnation and even the reversal of many economic reforms since Kuchma needed to placate his oligarchic allies and leftist opponents in order to retain power.

Inflation kept on decreasing and eventually stabilized under the prudent management of Viktor Yushchenko's monetary policy at the Central Bank. The economy continued to contract, though GDP declines were much smaller than before. The budget deficit widened significantly in 1997, though it was stabilized after Kuchma fired Lazarenko and Ukraine became heavily dependent on the IMF for assistance during the fallout from the Russian Currency Crisis. Growth in FDI slowed significantly and by 1999 foreign investors were running for the gates.

The most notable aspects of that period were the severe declines in perceived institutional capacity, as is shown by the severe deterioration in the four governance indicators. Governmental effectiveness, regulatory quality, rule of law, and control of corruption all decreased substantially. It was in this period, where the state was simultaneously ineffective at protecting the common citizens and effective at extorting them through high taxation and frivolous regulations, that Ukraine's oligarchic class cemented its grip on power.

On the one hand, oligarchs plundered and consolidated the commanding heights of the economy, while siphoning billions through the highly corrupt gas and electricity trade. On the other hand, the economy kept on contracting as the government suffocated legitimate entrepreneurial pursuits. As a result, a small group of astonishingly wealthy individuals effectively seized control of the government, while life for the populace became more and more miserable as the time passed.

The only effective opposition to their rent seeking, predatory tactics came from the Left. Ironically, both the oligarchs and the Communist/Socialist alliance agreed on high taxes, intrusive regulations and subsidies for big business. Their only point of disagreement was on the ownership structure of the big enterprises, since the former favored private enterprise, as long as the enterprises were in their hands, while the latter advocated for public ownership.

The Russian Currency Crisis was the event that punctured the predatory equilibrium and ushered in the third period of significant domestic change. The oligarchs, fearing the existential threat they were suddenly faced with, allowed Viktor Yuschenko to pursue the most comprehensive structural reforms since Kuchma's initial efforts in the 1994-1996 period.

Though his tenure was short, lasting from the end of 1999 to the middle of 2001, his cabinet managed to significantly overhaul the workings of the government, to clean up the nebulous energy sector, to carry out significant privatizations, and to lay the foundations for the end of collectivized agriculture. Yushchenko's brief tenure in office resulted in the two most positive evaluations from the IMF during the entire duration of the Fund's involvement with Ukraine between 1994 and 2002.

Annual Foreign Direct Investment rose from $595 million in 2000 to $693 million in 2002. Inflation dropped from nearly 26% per year in 2000, to -.57% in 2002. The economy finally recorded its first year of positive growth in 2000. GDP increased every year, by 5.9% in 2000, 9.2% in 2001, and 5.2% in 2002. The already low budget deficit declined to .6% of GDP in 2000 and registered its first ever surplus in 2002.

Three of the four institutional indicators logged significant gains after the steep drops that resulted from Kuchma's preference for political survival over reform in the mid to late 1990s. Perceptions of governmental effectiveness, control of corruption, and the rule of law, as measured by the World Bank, improved significantly. Regulatory quality also saw substantial initial improvements, though some of the gains were reversed by 2002.

Summary and Conclusion:

This case study rests on certain theoretical foundations which had to be incorporated to ensure its effectiveness and to explain the nature of its findings. First, it described the macro-level challenges faced by post-Communist states during what Claus Offe has termed the "triple transformation". [192] The newly independent states would have to simultaneously create a polity, a market economy, and a democratic form of governance. The drive to establish the relevant institutional framework to support each element carries the potential to undermine their very formation. Second, the changing nature of IMF conditionality was examined. From the 1980s onwards, the Fund has moved from being solely a first respondent to economic crises, to incorporating more general developmental goals in its agenda such as long-term growth and the alleviation of poverty. Third, two technical sections detailed the approval procedure for IMF assistance and the lending facilities available to borrowing nations.

Another section addressed the challenges inherent in international development efforts. It includes Daron Acemoglu's criticism that the developmental efforts of international organizations fail because they prescribe macroeconomic adjustments without addressing the deeper political economy constraints. If the underlying political equilibrium, which led to the policies that created the particular borrowing country's economic problems, is not significantly altered, then it is inevitable that bad politics will continue to lead to bad economics. Governments have found skillful ways to continue their corrosive clientelistic policies, while still complying with the IMF's conditionality.

The Fund and economists who study its policy prescriptions are aware of the innate political economy shortcomings. Allan Drazen shows how special interests and internal conflicts within a borrowing state can undermine the successful implementation of an IMF program. He proposes two methods through which the Fund's conditionality can specifically target the borrowing country's political economy constraints. One aims to overcome the resistance of domestic veto-holding actors, while the other strengthens the hand of a reform-minded government against other informal agenda setters, such as power-wielding non-state actors. Overall, after its experience in helping Eastern European states on their path to marketization, the IMF has acknowledged that its insistence on macroeconomic stability is insufficient to overcome certain internal political constraints and that opposition from vested interests has often undermined the efforts to establish market-supporting institutions.

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[192] Offe, "Capitalism by Democratic Design?", p. 507

The theoretical framework concludes with a section detailing the importance of institutions for understanding the variations in economic development between countries and their role in the overall distribution of resources. Acemoglu argues that economic institutions are ultimately the result of political choices and the principal aim of those who design them is to maximize the rents they can extract from the general populace. Inclusive economic institutions would enhance economic growth, but could also empower various actors who may use what Acemoglu calls de-facto power to undermine the authority of the formal governing elite. Thus regimes that are more concerned about retaining power tend to opt for the safety of economically inefficient extractive institutions.

The Research Design section sets out the formal method of inquiry, the two hypotheses that were tested, and the variables whose fluctuations were observed. The method was primarily deductive as the validity of the hypotheses was tested in relation to the data. The hypotheses proposed were (1) that the IMF provided effective assistance to Ukraine to aid its transition toward becoming a market economy in the period between 1994-2002, and (2) that domestic political events in the same period seem to have a played far more significant role in the observed variations than the Fund's conditionality. The independent variable was the implementation of the IMF-negotiated reforms, while the dependent variables included four economic metrics and four measures of perceived institutional capacity.

The body of this paper commenced with a brief description of the key events that occurred before the IMF's formal involvement in Ukraine's economic affairs. The first section explained the victory of Leonid Kravchuk, a communist-turned-nationalist from the East, over Vyacheslav Chornovil, his chief nationalist rival from Western Ukraine. It gave a brief summary of Kravchuk's failure to pursue meaningful economic reforms and the impact of his inactivity on the general wellbeing of the country, in particular the hyperinflation that raged in the thousands. Finally, the section detailed the ways through which money was siphoned off from the state into the pockets of a small elite, who would eventually become the ruling oligarchic class.

The next section dealt with the specific conditions of the IMF-negotiated programs. It detailed the Fund's assessment after each annual review as well as its role in dealing with exogenous events during that time period. For example, the IMF played a key role in helping Ukraine navigate the economic fallout from the 1998 Russian currency crisis. On the other hand, relations between the country and the Fund soured when it was revealed that the National

Bank of Ukraine had knowingly overstated its foreign currency reserves by engaging in impermissible transactions.

The key domestic events during the 1994-2002 period were subsequently outlined. They are grouped in three distinct periods. First, was the election of President Leonid Kuchma in 1994, whose administration oversaw a significant reform drive and the defeat of hyperinflation. The second period, from 1996 until 1999, was one of oligarchic consolidation, corruption, and predatory extraction. The most powerful oligarch at the time, Pavlo Lazarenko, hailing from his stronghold in Dnepropetrovsk, would become Prime Minister and a direct challenger to Kuchma. Five oligarchic political factions would hold the balance of power in the Communist/Socialist-dominated Parliament. Finally, the period between 2000-2002 saw the most energetic pace of structural reforms since Kuchma's early efforts in his first term. Prime Minister Victor Yushchenko, and in particular his Energy Minister Yuliya Tymoshenko, laid the foundations for a thriving market economy, while drastically overhauling the opaque energy sector.

The evaluation section tracked the changes in the eight dependent variables and interpreted the results. The data provided substantial support for the two hypotheses. It found a strong correlation between the implementation of IMF-backed reforms and improvements in the metrics utilized. The fluctuations of all the economic indicators utilized, and in the case of three of the four institutional ones, seemed to closely parallel domestic political developments.

The principal aim of this survey was to examine the impact of the IMF's conditionality on Ukraine during a highly tumultuous period in which the newly independent country attempted to make the difficult transition from a centrally planned autocratic regime to a fully functioning liberal democratic market economy. There are numerous limitations to the method used which have been previously identified in the body of this work. There is virtually no reliable way to show what the alternative would have been, if the Fund was not involved in assisting Ukraine.

If one is to simply gauge the success of the program by measuring whether there was positive change in the chosen metrics, from the initiation of the Fund's conditionality in 1994 to its conclusion in 2002, then Ukraine's macroeconomic position and institutional capacity improved significantly. Conventional reviews conducted by both the IMF and academics who study its programs would therefore likely conclude that the program was a success.

Nevertheless, the changes in the studied indicators coincide very closely with important domestic political events and seem to be much more influenced by such episodes rather than by the jointly negotiated terms of the programs. In fact, when the government saw it politically convenient, it departed from the mutually agreed targets. While the Fund tolerated many such divergences, it did discontinue aid on a few occasions.

Notwithstanding such considerations, the Fund's assistance, both technical and financial, seems to have played a vital role in Ukraine's uneven transition towards becoming a market economy. In 1994, the IMF helped Leonid Kuchma to kick start Ukraine's first structural reform drive since independence. While supporting the introduction of the Hryvnia in 1996, the Fund's resources enabled the NBU to finally put an end to the corrosive hyperinflation. Finally, the Fund's EFF bolstered Ukraine's currency reserves and thus mitigated the danger of an external default resulting from the fallout of the Russian Ruble crisis in 1998.

It is true that the IMF was unable to fix Ukraine's deep structural problems. Such solutions required wide ranging reforms, backed by political will which was never really available for the long haul. The arrangements that slowed growth down and caused pain to many also generated significant rents for the powerful and privileged few. Those few mobilized vigorously and sometimes violently, utilizing their vast resources, against significant structural adjustments that potentially threatened their positions of wealth and power.

In the end of the day, the IMF could only do what its mandate and capabilities allowed for it to do. It was able to help Ukraine defeat its rampant hyperinflation, to slow down and to eventually reverse its economic decline, as well as to regain the trust of foreign investors while improving some administrative sectors. Changing the country's political equilibrium towards one that generated the incentives to address the root causes of its economic malaise was far beyond its ambit.

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