

Ukraine: Reset to a Future of Strength

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Flag of Ukraine

Hillary Clinton's visit to Ukraine over the July 4th holiday put a renewed focus on the political and economic state of that former Soviet Republic. In the last year, Ukraine nearly suffered bankruptcy at the hands of the financial crisis, and elected the pro-Russia Victor Yanukovich as president. There are two common misconceptions that now must be dispelled. First, while Secretary Clinton sought to reassure Kiev of America's support in the wake of its "reset" in relations with Russia, Ukrainians must realize that the Washington-Kremlin rapprochement is in their best interest too. Conversely, the U.S. should also realize that Ukraine's new pro-Russian government is good for Ukraine—and also for the West.

Since its independence from the Soviet Union in 1991, Ukraine has on occasion sought to serve as a bridge between Russia and the West (the U.S. and EU), but in reality the more appropriate image

is that of a tug-of-war. Ukraine is geopolitically important because it is the largest country in Europe outside Russia; a major transit route for European energy; strategically located on the Black Sea coast; and home to Russia's Black Sea fleet.

Russia sees Ukraine as a compliant and culturally-similar neighbor to anchor Russia's sphere of influence over the countries of its former empire. When former Soviet republics Estonia, Latvia, and Lithuania, along with Warsaw Pact states like Poland and Bulgaria, joined NATO, an angered Russia became determined not to lose any more of its former empire to the U.S.-led military alliance. (The fact that these countries have also joined the EU is less threatening to Russia, because it is not a military alliance, and is of greater strategic interest to Europe than to the U.S.) Russia's energy-driven growth this past decade has renewed Moscow's vigor to reassert influence in its "near abroad."

Equally, the West wants Ukraine to be Europe's final outpost in the East, to weaken Russian influence in the region, and to continue extending the borders of NATO and the EU. For the U.S., Ukraine is a staunch ally which sent troops in support of Operation Iraqi Freedom. For the EU, Ukraine creates an additional buffer between Russia and the core of Western Europe; and with EU membership, Ukraine becomes a more reliable conduit of gas transshipment. Until 2004, Ukraine had been ruled by two presidents who were closely allied to Moscow. After 2004, Kiev cemented good relations with NATO and EU countries during the pro-Western presidency of Victor Yushenko that expired in 2010.

The Washington/Moscow "reset button" has changed this calculus by further dissolving the vestiges of the Cold War divide. Ukraine is strongest when it enjoys close relations with both countries, as well as with Europe, and the U.S. needs a strong Ukraine. A strong Ukraine is an assertive country that acts in its own interest, refusing to be anyone's pawn. A strong Ukraine is a democratic and middle-income country whose people can decide for themselves where their future lies. With a reset in relations between the U.S. and Russia, Ukrainian voters can pay less attention to Cold War spheres of influence, and more attention to what will actually help their country, namely economic policies geared at rebuilding a middle class that has suffered deeply over the last two years.

But ironically and importantly, a strong Ukraine has a government that is very pro-Russia. For reasons of geography and ethnicity (about half of Ukraine is ethnically Russian and Russian-speaking), it is imperative that Ukraine remain close to Russia, or risk a tempest from the north, or from within its own borders. "We have to be pro-Russia," a Western-educated Ukrainian businessman, and strong advocate of democracy and free speech, told me. "Look where we're located." Ukraine has just experimented with its first pro-Western, anti-Russian president, and it failed the country terribly.

Western observers were giddy at the 2004 election of Victor Yushenko in the "Orange Revolution." Yushenko, an ardent opponent of Russia, saw Ukraine's future firmly ensconced with NATO and the EU. But over time, his

supporters grew restless. Corruption continued unabated, and while the economy worsened, Yuschenko's main domestic focus was perceived to be the divisive eradication of Russian cultural and linguistic influence in country. Yuschenko particularly needled Russia—by far Ukraine's largest trading partner—when he verbally stood by Georgia during its brief and ruinous war with Moscow in 2008. Russia responded in kind by temporarily cutting off natural gas supplies to Ukraine, a punitive action Russia took on a near-annual basis throughout Yuschenko's presidency. It was also during this period when for the first time in Ukraine's short history, foreign analysts spoke openly of the country splitting in two; the ethnically Ukrainian western regions would join the EU and NATO, while the Russian-speaking east would be a Kremlin satellite. Such a split would have been disastrous for a region that suffers no shortage of nationalist and ethnic conflict. By the 2010 election, Yuschenko's approval ratings were in single digits, probably the lowest of any elected head-of-state in the world.

The point that America must learn from this is simple: no matter how pro-American or pro-Western a country may seem to be, if the economy is poor and the people are divided, that country will never be stable, nor a reliable partner to the United States.

Enter Viktor Yanukovich. Ukraine's new President, a pro-Russian former auto mechanic with poor communication skills, was hardly the West's candidate of choice. The U.S. and Europe feared that Yanukovich would bring Ukraine directly back into the Russian orbit, thereby strengthening and emboldening an unpredictable Moscow. But since Yanukovich's February 25, 2010 inauguration, the price of Ukrainian credit default swaps (insurance that protects against sovereign risk) has fallen in half, from roughly 1000 to 500 basis points; this implies a 50 percent decline in the perception of Ukrainian risk. In June 2010, Fitch upgraded Ukraine's sovereign rating for the first time in over five years.

These improvements did not happen by accident. Yanukovich knows that repairing Ukraine's economy, which was shell-shocked from the effects of the financial crisis (GDP fell 15 percent, and the hryvnia currency depreciated by 65 percent from peak to trough—the highest amount anywhere in the world), is the utmost priority. Therefore, his first major action as president was to extend the Russian Navy's lease on their base at Sevastopol until 2042. While this move caused deep concern in Western capitals, it was more than geopolitical in nature: Russia responded with a 30 percent multiyear discount on the sale of natural gas, which is Ukraine's most significant import. This concession enables Ukraine to lower its yawning fiscal deficit. Yanukovich, spending his political capital on economics rather than cultural issues, also made the politically difficult decision to raise gas prices for households by 50 percent, in order to reduce the budget deficit of state-owned Naftogaz from 3 percent to 1 percent. Much work remains to be done on pension reform, tax reform, and asset privatization, but this initial move helped give the IMF enough comfort to announce on July 3, 2010 a much-needed \$14.9 billion loan to Ukraine through 2012. There is no surer sign of confidence than this. Investors are following closely behind.

To the extent that the U.S. and Russia have hit the "reset" button, and Ukraine has a Russia-oriented president, Ukraine's future is more secure than it has ever been. Kiev no longer must choose its loyalty between Washington and Moscow, and will also not be in a position to play the two countries off one another. Ukraine's experience could serve as a model for Georgian voters, who may come to realize that their economic and security prospects will also improve if they vote out the nationalist and fervent anti-Russian Mikhail Saakashvili in 2013.

Secretary Clinton should have left Ukraine feeling optimistic about a self-assured ally that is comfortable in its two most important foreign relationships. 2010 GDP is on pace to be positive again, at 3.5 percent. And by no means has Ukraine turned its back on America and the West. The Yanukovich-friendly parliament, after extending the Russian naval lease, also voted to continue annual military exercises with NATO countries. All Ukrainian government ministries currently fly the EU flag outside their buildings, in hopes of an association and free trade agreement with the bloc, and eventual membership. The "reset button" between Washington and Moscow, far from leaving our former Soviet allies in the cold, has enabled a country like Ukraine to pursue interests and alliances with new vigor. And this is positive for all parties involved.

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