The Economic and Financial Crisis: impacts on an emerging economy – Ukraine

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SEI Working Paper No 115

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First published in June 2010
by the **Sussex European Institute**
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Summary

The emerging economies of Central and Eastern Europe generally suffered more seriously in the financial and economic crisis of 2008-2009 than the developed economies of Western Europe. However the crash came after several years during which unsustainable credit bubbles had been built up. As the financial crisis entered its crucial phase with the failure of Lehman Brothers in September 2008, emerging markets plunged with sharp devaluation of currencies. The relatively sudden shift in the perception of risk meant that most of these countries found themselves cut off from international capital markets or with foreign capital being withdrawn. As the financial crisis turned into an economic crisis they also saw export demand contract sharply. The result was serious disruption to financial markets and deep recession.

Emerging markets in Asia, and notably China, recovered rather quickly. In general financial institutions in this region had been far more prudent in their lending following the Asian financial crisis of the late 1990s than those in Europe and the United States. Some of the worst affected states were the emerging markets in Europe, notably the three Baltic countries, Russia and Ukraine. Here economic growth in 2009 declined by between 9% in Russia and 18% in Latvia. This paper takes a deep look at one of these economies, Ukraine, and underlines the importance of political stability in determining the depth of the crisis.

The short-term outlook for Ukraine's economy is for a steady recovery through 2010 continuing on through 2011 as world markets recover. However this recovery will be weak with growth of only perhaps 2.5% in 2010 after the dramatic 15% fall in GDP in 2009. If the current recession turns into a double-dip recession then even this forecast is optimistic. This paper analyses the causes of the deep recession in Ukraine, the strength of the current recovery and the role which political stability may play in this recovery.

But the real challenges for Ukraine lie in structural reforms which will promote growth, employment and welfare in the medium and longer term. Very little progress has been achieved in even beginning to tackle some of these problems.

Two of these structural issues are becoming extremely urgent. The first, the pension crisis, is not discussed at any length here, but it should be noted that Ukraine spends a larger part of its GDP on pensions than any other country in the world. The energy sector, in which inefficiency, corruption, opacity and waste are an enormous burden on the economy, is discussed in full however. As in other areas, reform of the energy sector could be systematically undertaken if Ukraine were to continue on its path of integration with the European Union, in implementing both the Energy Community Treaty acquis and, when the negotiation finishes, the terms of the Association Agreement. Deeper integration with the European Union would be an effective way of modernising the Ukrainian economy and delivering a better quality of life to its citizens.

The Association Agreement which is being negotiated today will give Ukraine a road map to the modernisation of its economy. Considerable progress would be made in increasing the efficiency of the economy through the introduction of serious competition and state aid policies and a transparent and fair public procurement system. However there are powerful forces in Ukraine which benefit from the current rather corrupt economic system which will work to undermine any agreement with the EU, which affects their private interests.

The Economic and Financial Crisis: impacts on an emerging economy – Ukraine

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A. The financial and economic crises in emerging Europe

As the financial crisis entered its crucial phase with the failure of Lehman Brothers in September 2008, emerging markets plunged with sharp devaluation of currencies. The relatively sudden shift in the perception of risk meant that most of these countries found themselves cut off from international capital markets or with foreign capital being withdrawn. As the financial crisis turned into an economic crisis they also saw export demand contract sharply. The result was serious disruption to financial markets and deep recession.

Emerging markets in Asia, and notably China, recovered rather quickly. In general financial institutions in this region had been far more prudent in their lending following the Asian financial crisis of the late 1990s than those in Europe and the United States. Some of the worst affected states were the emerging markets in Europe, notably the three Baltic countries, Russia and Ukraine. Here economic growth in 2009 declined by between 9% in Russia and 18% in Latvia.

Of course each economy has its specific characteristics, but emerging markets in Europe also suffered a range of common problems before Autumn 2008. These included:

- Credit bubbles often financed by foreign borrowing – these frequently concerned the real estate sector
- Rising and unsustainable current account deficits
- Rising inflation, soaring wages and a loss of competitiveness
- In some cases fast rising government deficits in spite of strong tax income

With the onset of the global financial crisis and the recession these symptoms turned into major crises:

- Credit dried up as banks retrenched. Often a significant share of the banking sector was owned by foreign banks, which themselves were experiencing major problems in their home markets
- As a result asset prices, especially real estate, tumbled. Where the exchange rate was flexible, the domestic currency fell against 'hard currencies' causing domestic borrowers considerable pain. Domestic borrowers were private individuals but also banks and businesses. With fixed exchange rate systems, as in the Baltic countries, interest rates rose, exports suffered and the economic recession intensified.
- Exports retreated as the world economy tipped into recession and output slumped leading to higher unemployment. But imports fell faster reducing the current account deficits.
- Private consumption and public consumption fell as both households and government slashed spending and tax income collapsed

- Investment as a result tumbled.
- But inflation subsided

Country	GDP 2002-06 (ave)	GDP 2007	GDP 2009	Inflation rate 2008 (CPI)	Government deficit %GDP 2009	Current acc. 2007 %GDP
Estonia	8.4	7.2	-14.1	10.4	-2.6	-17.8
Latvia	9	10	-16.9	15.4	-10	-22.5
Lithuania	8	9.8	-15	10.9	-9.1	-14.5
Ukraine	-	7.9	-15	22.3	-11.4**	-7.1*
Russia	-	8.1	-7.9	13.3	4.1	+6
Slovakia	5.9	10.4	-4.7	4.6	-6.3	-5.7

source: World Bank/IMF April 2010
*2008 ** EBRD

This paper analyses the financial and economic crises in one of these emerging economies, Ukraine.

B. Ukraine and the financial and economic crises

This working paper studies the case of Ukraine, which was exceptionally hard hit by the financial and economic crises, but which illustrates many of the problems which other European emerging markets suffered.

1. The background

The real GDP of Ukraine grew by 36% from 2003 to 2008. In the single year 2009 it declined by around 15%. And the outlook for 2010 and 2011 is for mediocre, low single-digit GDP growth.

Ukraine is a relatively open economy with a large industrial sector. Around 40% of its exports in 2007-8 were in the metals sector, essentially steel. With the steel sector booming and rising foreign direct investment, confidence in the economy strengthened. However in the absence of Government measures to curtail the expansion, major credit-fuelled bubbles developed in several markets. Much of the credit was from abroad. So the scene was set for a dramatic economic crisis once the world economy turned down sharply.

2. The entry into the crisis

Ukraine's economy was expanding rapidly until the middle of 2008. The dramatic deterioration occurred essentially in the third quarter of the year. That the rapid rate of growth reflected expansionary bubbles in various markets had been obvious for some time and was reflected amongst other things in the extraordinarily high rate of inflation of around 30% year-on-year (CPI) in mid-2008, the booming construction and real estate sectors reacting to rapidly rising prices, and remarkably strong private consumption on the back of soaring wages.

However from the middle of 2008 a global recession grew on the back of the disastrous crisis in the global financial sector. The depth of the recession however only became apparent in the first quarter of 2009. Even the IMF was over-optimistic about the depth of the recession as late as October 2008, as figure 1, which was published in May 2009, indicates.

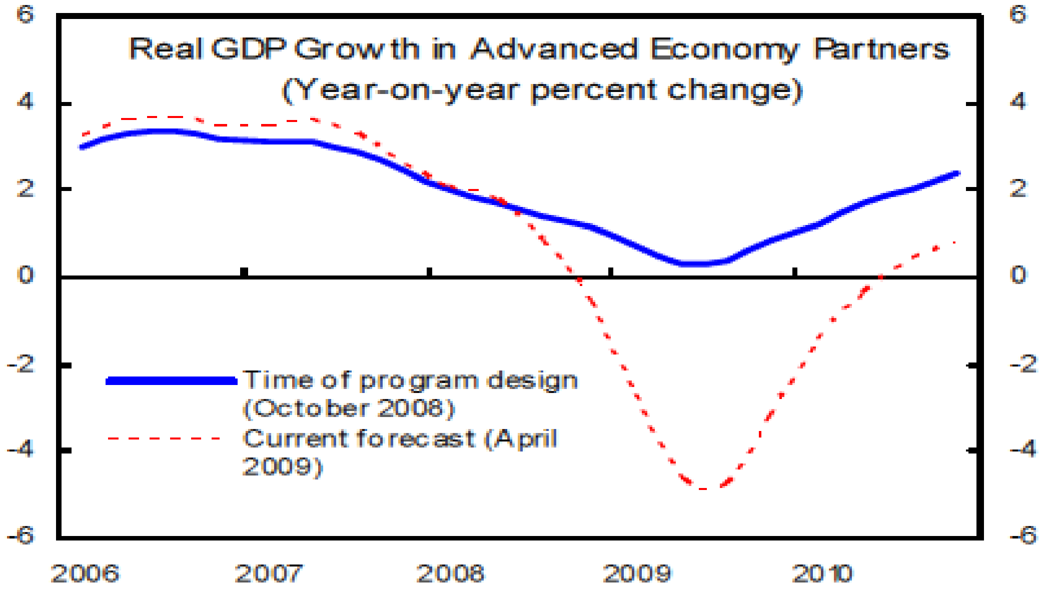
Ukraine has been especially badly affected because of the economy's high external dependency (see page 15-17). This external dependency had several facets:

a. The rapid growth in Ukraine's economy in 2006, 2007 and the first half of 2008 had been financed extensively through foreign currency borrowings.

b. In the same period, foreign direct investment in Ukraine had risen steeply and was an important support to economic growth.

c. Ukraine's exports, like many emerging economies, covered a relatively narrow spectrum of industrial products: the main component of exports was steel. (fig 2)

Figure 1: real GDP growth forecasts for the industrialised world in October 2008 and April 2009



Sources: IMF, *World Economic Outlook*; and IMF staff estimates.

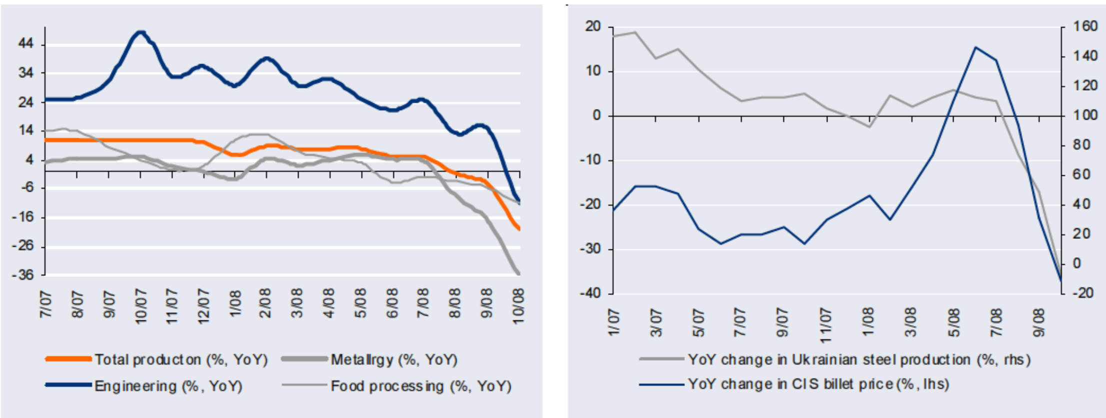
The domestic economy deteriorated sharply with declining industrial production and exports, rising unemployment, falling incomes, and the crisis in the banking sector as financing seized up and the hryvnia tumbled. Private consumption fell sharply as did investment and this reinforced the economic downturn.

a. The crisis in the real economy

The decline in Ukraine's steel and other heavy industries became extremely rapid in late summer 2008. Ferrous metal products made up around 40% of total export revenues. From January to September 2008 the value of exports of ferrous metals including steel rose strongly year on year. However the demand for steel abroad evaporated as world recession took hold while the steel price, which in June 2008 was still around 15% higher than a year earlier, fell precipitously so that by October 2008 it had fallen about 35% compared to a year earlier. The combination of the sharp fall in real demand and a deterioration in the terms of trade had a disastrous impact on the economy.

Figure 2: steel production and steel prices, 2007-2008 (ING)

Steel production   Steel prices



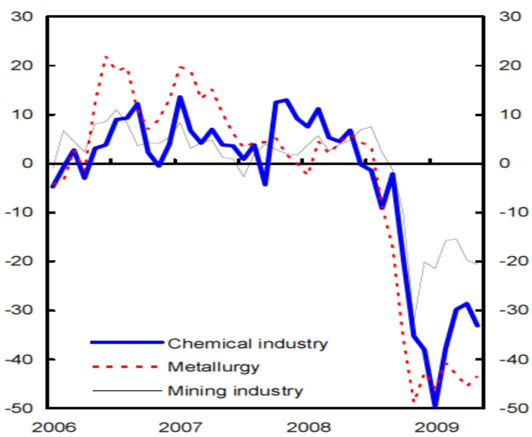
Source: State Statistics Committee

Source: State Statistics Committee, Bloomberg, ING

The decline in the steel industry naturally led to recession in upstream industry such as coke production. Other heavy industry also suffered a sharp contraction as a result of a slump both in external and domestic demand. The chemical industry was particularly affected (figure 3).

Industrial production fell over the whole year by 21.9% according to the State Statistics Committee.The only sector of the economy to resist this downward trend was agriculture which ended the year with a small annual growth rate.

Figure 3 Output growth (% yr on yr) in selected industries in Ukraine



Source: IMF

The industrial recession (industrial production declined sharply in the first half of 2009 by 34% year-on-year) was of course a major cause of the fall in private consumption, as unemployment rose and wages and salaries stagnated or declined. In the first quarter of 2009 consumer spending was down 11.6% year-on-year. As disposable income fell more sharply, this was a somewhat better performance than generally expected, indicating that people were drawing down savings.

In these circumstances the most negative component of GDP growth was, as expected, investment. Fixed investment fell by around 40% year on year in the first quarter of 2009 and by 43% in the period January to June 2009. Over 2009 as a whole the decline was around 50% year on year. Public investment fell very sharply, as did private investment particularly in the construction and real estate sectors. The construction sector, which had been a major pillar of the economic upswing, suffered a disastrous downturn in the first half of 2009. Promisingly, foreign investment appears to have held up far better than domestic investment, indicating that most foreign investors continued to put capital into their existing investments although probably not engaging in any new investments.

The decline in domestic demand and a deterioration in the terms of trade led to a sharp fall in Ukraine's imports. Exports declined by around 18% but imports fell much faster by around 35% in 2009, leading to a recovery in net exports.

The overall impact of these changes in the components of growth led to a fall in GDP of 20.3% year on year in the first quarter of 2009, and 18% year-on-year in the second quarter. The GDP of Ukraine is estimated by the Ministry of the Economy to have declined by 15% in 2009. Statistically this has taken Ukraine back to where it was in early 2006.

The rapid decline in domestic activity obviously had a significant impact both on the rate of inflation and on the current account deficit.

Inflation (CPI) which reached close to 30% per annum at one point in 2008 fell steadily to reach 13% by the end of 2009. A variety of factors will operate to slow this disinflation, including the rise in domestic oil and gas prices to reflect the true cost and a certain recovery in food prices after the summer. A further weakening of the hryvnia would also tend to slow the decline in inflation.

The current account deficit amounted to over 7% of GDP in 2008. The slump in domestic demand, leading to much lower imports, led to a rapid move towards balance, in spite of the fall in exports mentioned above. The overall deficit for 2009 declined to only 0.6% of GDP in 2009.

Fiscal policy was relatively expansionary in 2008 with a deficit of 3.1% of GDP. The impact of the economic crisis, even without bank recapitalisation, as in most other countries led to a rapid rise in the government deficit which reached 7% of GDP in 2009, excluding Naftogaz restructuring. This was an obvious result of the economic crisis but in addition some expenditure was election related. The need to reduce the public deficit in 2010 will have a negative effect on growth prospects.

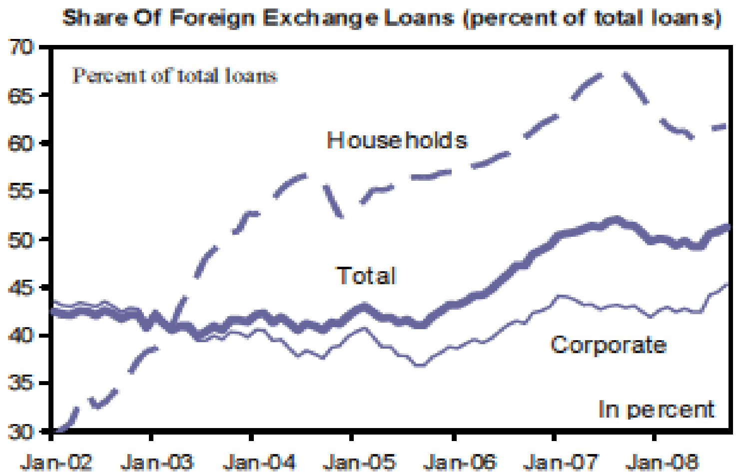
The stock of public debt also rose sharply in 2009 and will continue to rise throughout the coming year, partly through the payment of the last tranche of the IMF loan, if disbursed. Debt remains however at a relatively low level (around 37% of GDP) in international comparison.

This very strong recession has undoubtedly had a significant influence on the labour market, although the official level of unemployment is meaningless. The economic crisis led to a sharp rise in part time working, in officially granted longer leave, and the various other systems which avoided layoffs. Overall however the crisis was alleviated in the labour market through a significant reduction in real wages (figure 9 below).

b. *The financial crisis*

The financial crisis - the potential bankruptcy of many of the major banks in Ukraine and the extremely high level of foreign and domestic indebtedness of many households - exacerbated the downturn in the real economy (fig 4).

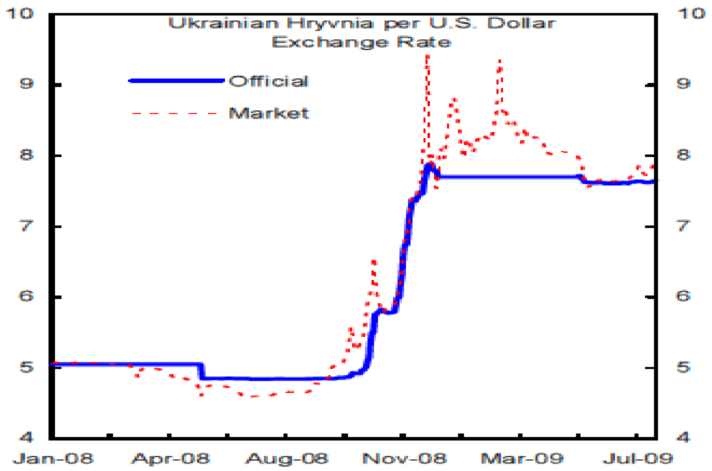
Figure 4: Foreign exchange loans in total loans (Source: IMF)



The apparent strength of the hryvnia combined with far lower interest rates in foreign currencies, especially the Swiss franc and the euro, encouraged banks, corporates and especially households to borrow in foreign currencies. The world financial crisis, especially after the Lehman Brothers bankruptcy, combined with the rapid downturn in the domestic economy, led to a severe fall in the value of the hryvnia against hard currencies (figure 5).

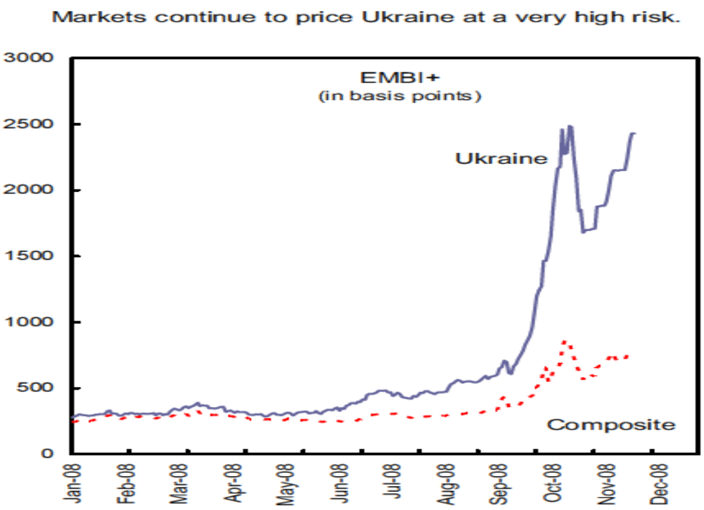
At the same time international lending to emerging economies dried up as bank lending entered a very restrictive phase (figure 6). This was reflected in the astonishing rise in the risk margin on credit default swaps. The impossibility of refinancing foreign loans meant that many of the banks were unable to meet their obligations. Bank lending to individuals and companies dried up completely and there was a rush on the banks as individual depositors tried to withdraw their money. The banking crisis reinforced the downturn in the economy.

Figure 5: hryvnia/US dollar exchange rate (Source IMF)



Source IMF

Figure 6: Emerging market bond index plus spread



Source: IMF

In these circumstances it was vital for Ukraine to obtain new foreign loans to keep the financial system afloat. The key support came from the IMF which agreed to a two-year standby loan of around $US16 billion to be disbursed in four main tranches, of which three were disbursed in 2009.

The IMF loan was vital both from a financial point of view but also as an indicator of confidence in Ukraine's capacity to master the disastrous economic and financial situation. The conditions attached to the loan were initially very tight but have progressively being weakened as the depth of the recession became fully appreciated by the IMF. It was obviously difficult to implement all of the changes required by the IMF in the run-up to a major election where the President and the Prime Minister were bitter opponents. As a result the IMF did not disburse the final tranche of the loan in November 2009 and postponed negotiations with Ukraine until after the election. These negotiations have now restarted.

A key element of the IMF programme has been the recapitalisation of the banking sector. While some of the smaller private banks remain to be satisfactorily dealt with, the recapitalisation of the seven major systemic banks, two state owned, has proceeded at a considerable cost to the state and to shareholders. The IMF estimates the initial public cost of restructuring the five private banks has amounted to approximately 3% of GDP, while that of the two state banks represents an additional 2% of GDP.

c. Social impact of the crisis

Relatively little information exists on the social impact of the crisis. However the dramatic fall in overall economic activity in one of the poorer countries of Europe must have had a severe impact on certain regions and certain groups within society. Social impacts of the recession in the three Baltic countries have been extremely serious too.

Declared unemployment has risen from an average of around 6% of the labour force (ILO definition) in recent years to close to 10% today, although this undoubtedly underestimates the real effect of the recession. Many enterprises have tried to keep their workforce through reducing working hours but also through negotiating wage cuts. Obviously the longer the recession continues the more difficult it will be for enterprises to avoid redundancies.

The hardest hit areas are undoubtedly the industrialised areas of eastern Ukraine, where the sudden decline in demand for the products of heavy industry had particularly severe effects on employment and therefore on poverty. The impact is perhaps the least marked in rural areas as agriculture has experienced continual expansion during the crisis.

A particularly badly affected group consists of those people who had borrowed heavily in foreign currency, often for real estate purchase. Even without a deteriorating employment situation or falling real wages, persons in this group have suddenly found that the cost of interest and capital repayments on their loans has risen rapidly and in many cases people have had to try to sell their homes on a falling market.

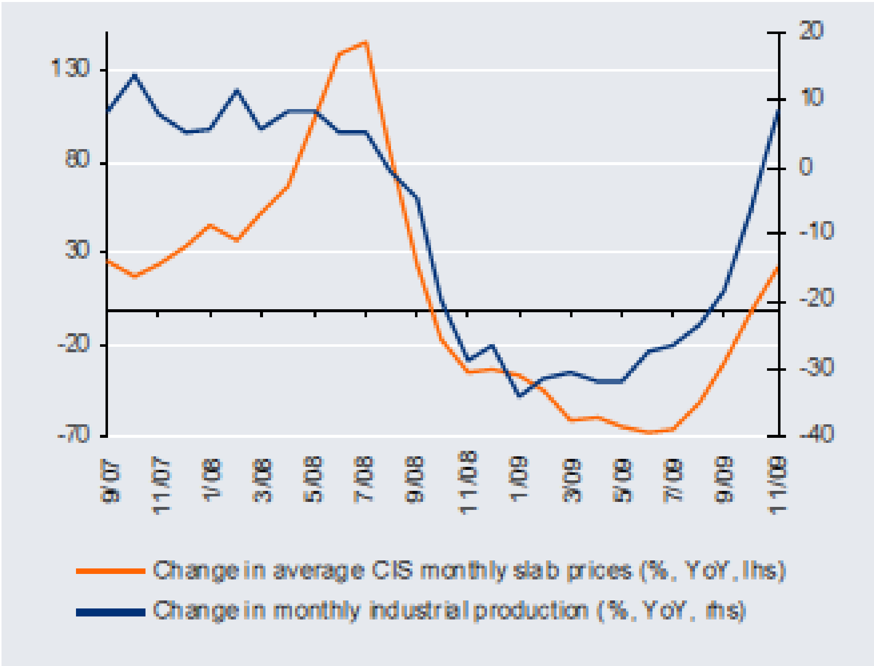
The government has increased its social spending, a partial explanation of rapidly rising government debt, but this can only provide for a minimal existence.

While social unrest has been avoided up to now, it is vital that the economy does not deteriorate further, pushing ever larger parts of society into poverty.

3. The strength of the economic recovery

The economic recovery began in summer 2009 as the banking sector started to stabilise and a slight recovery in steel demand and steel prices was recorded (fig 7). The recovery consisted initially simply of lower rates of decline. Industrial output which in March 2009 fell at an annual rate of 30.4% declined by only 18.4% in September and by November had turned marginally positive to record an annual

Fig. 7. Changes in steel output and prices



Source: State Statistics Committee, Bloomberg, ING

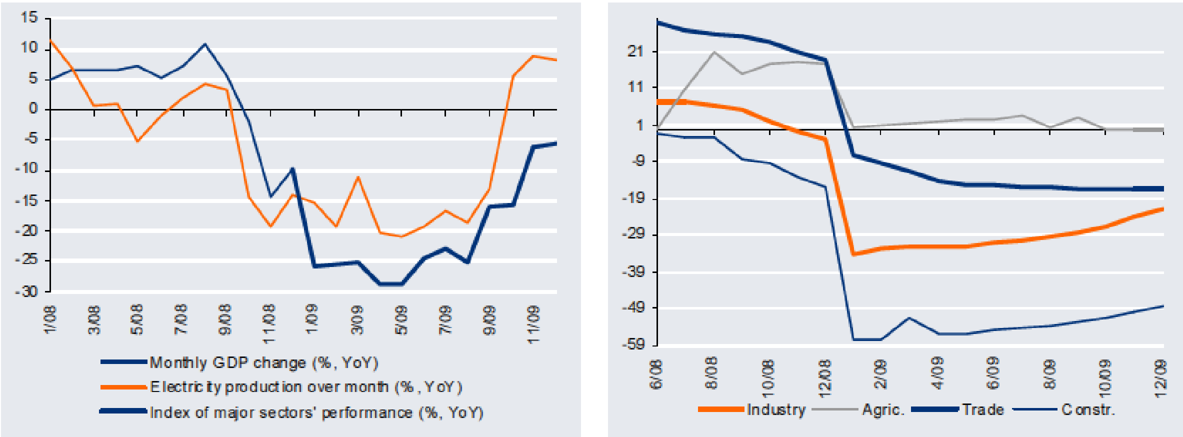
growth of 7.4% in December 2009. However given the depth of the recession any growth rate needs to be looked at as growth from a very low base.

The construction sector, which was hit hardest by the recession, is now registering somewhat lower rates of decline than in the early part of 2009 (figure 8). It is however unlikely, given weak domestic incomes and banks' reluctance to lend, that the construction sector will be a major contributor to growth in 2010. Agriculture continues to shows signs of slow growth into 2010. The retail sector, which obviously also suffered major losses has also been gradually recovering since the summer, although in December retail sales were still 17% lower than a year earlier.

While there is no doubt then that a slow recovery has begun in Ukraine, it would be very rash to assume that the country can get back to the high level of growth noted in the first half of the last decade. Forecasts for GDP growth in 2010 tend to concentrate around 2.5%, although the risks to this forecast are obviously extremely high. It is probably only from 2011 that a more sustained recovery can be expected.

There are clearly both positive and negative factors bearing down on the Ukrainian economy in the short term, and it must be expected that both public and private consumption remains subdued in 2010.

Fig 8. Output and electricity consumption 2008-2009



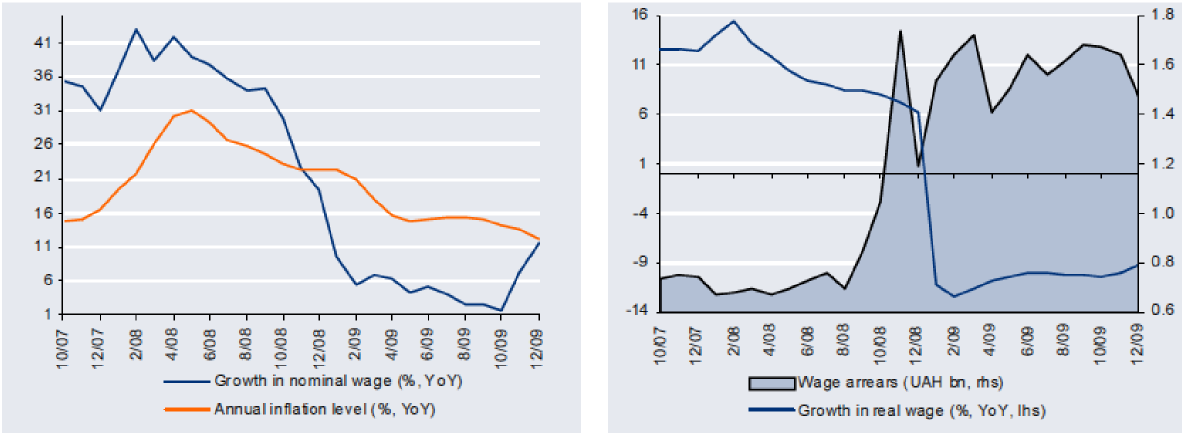
Source: State Statistics Committee, ING

Source: State Statistics Committee, ING

Private consumption will be restrained by the decline in real income that has taken place in 2009 and may well continue into 2010, as well as the indebtedness of the household sector. The former is reflected in stagnating real wages, declining employment and rising levels of unpaid salaries. Fig.9 shows the decline in real wages which began at the end of 2008 and lasted right up to the end of 2009. The recovery at the end of 2009 may well be partly due to the softer financing immediately before the presidential election. The right-hand graph of figure 9 shows wage arrears which also rose sharply at the end of 2008 and remained high to the end of last year. With the outlook for inflation being rather pessimistic for the coming months and only a gradual recovery in the labour market, it is unlikely that personal incomes will sustain a strong recovery in private consumption.

The indebtedness of private households rose during the period of easy credit before the recession set in. Many of the loans taken out on real estate and on consumer durables were in foreign currency on which lower interest rates were charged than on domestic hryvnia loans. With the declining incomes in 2009 the situation of many households became dramatic as they could not afford to repay these loans. This
high level of indebtedness, and the need to reduce it, will also of course limit private consumption in the short term.

Fig 9. Real wages and wage arrears 2008-2009



Source: State Statistics Committee, ING

Source: State Statistics Committee, ING

Fiscal policy in 2010 will need to be very prudent in order to bring down the need for government borrowing. Having in the past run government deficits of around 1%-2% of GDP, the fiscal deficit grew to over 3% in 2008. The 2009 fiscal deficit without bank recapitalisation is liable to reach 7.2% of GDP: however bank recapitalisation and subsidies to Naftogaz have probably taken it in reality to well above 10% of GDP. The financing of this fiscal deficit became ever more difficult towards the end of 2009 with the government scrambling to borrow from Russia and various other sources, and to obtain the last tranche of the IMF loan. The need to reduce the fiscal deficit in 2010 will also limit any growth recovery.

Investment is unlikely to be a major source of growth impetus in the coming months. Public investment will be restrained by the fiscal situation, while private investment will be limited by the depressed state of company profits and the restrictive lending practices of the banks.

The hope for recovery lies principally with net exports. The price competitiveness of Ukrainian exports has improved strongly with the decline in the value of the hryvnia and the cost reductions undertaken by major businesses.

Figure 10 shows how the rate of decline of imports exceeded that of exports throughout 2009, reducing sharply the balance of trade deficit. This rebalancing of the current account is shown in Figure 11 below.

The world recession modified the structure of trade quite markedly. Whereas exports in 2008 were driven essentially by the steel trade, which made up around 40% of total exports, in 2009 foodstuffs grew rapidly as a share of total exports reaching close to 25%. The share of engineering products in total imports declined sharply from 2008 to 2009 as a result of the domestic recession.

Whether net exports can drive GDP growth in 2010 depends however on recovery throughout Ukraine's major markets. Short-term economic growth in many countries relies on strong export growth. Unless there is a very strong recovery in global growth, relying on net exports to drive economic growth is likely to lead to under- shooting.

Figure 10 Export and import growth rates 2008-2009

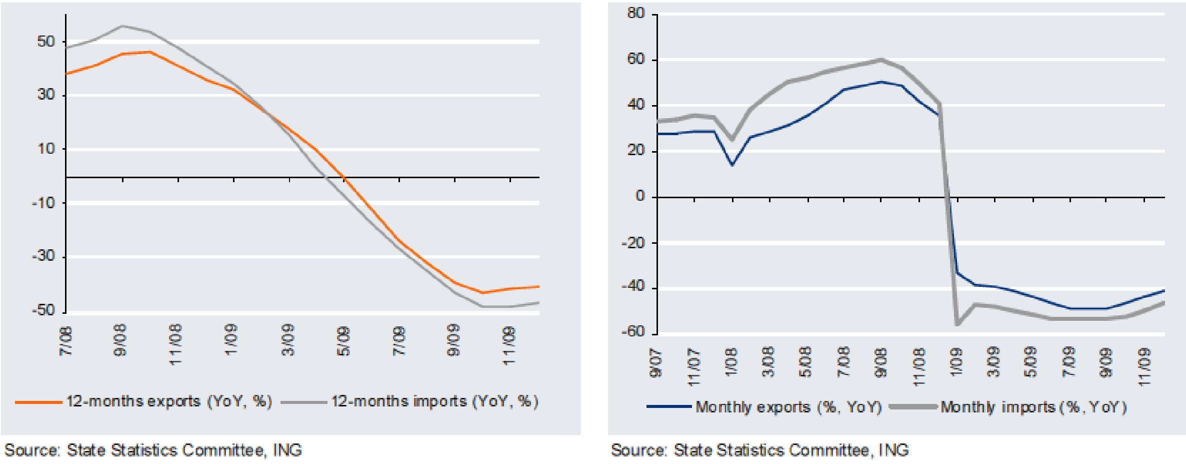
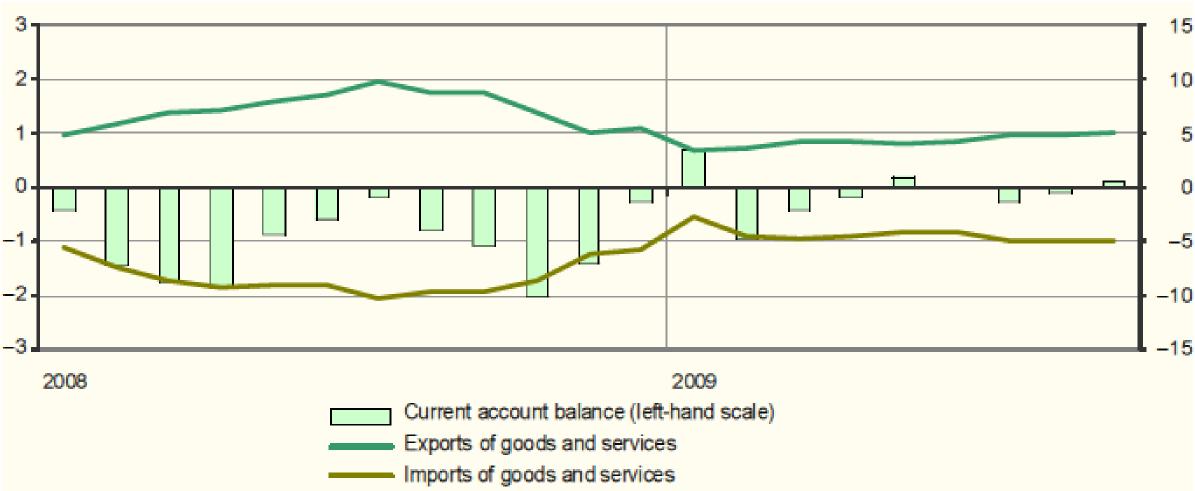


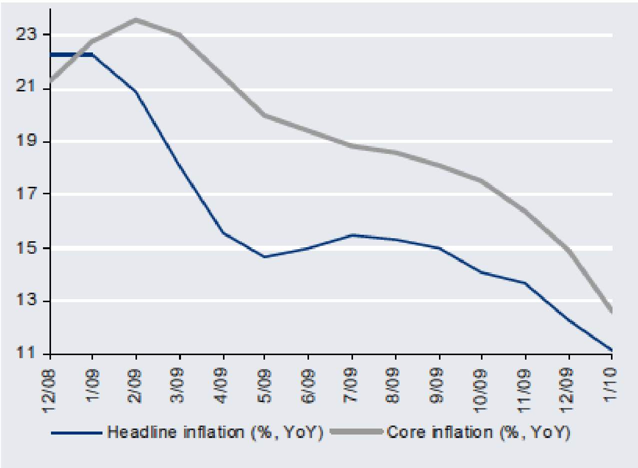
Figure 11: current account balance 2008-2009 (source NBU)



This rather sombre analysis of the components of demand in 2010 suggest that economic growth will be very modest, constrained by the need to reduce expenditure both in private and public sectors and to rebuild asset positions.

As mentioned above the recession reduced inflation from the very high levels recorded in 2008 (figure 12). The consumer price index in January 2010 was 11.1% higher than a year previously. This extremely positive trend may however not continue in the rest of 2010. Monthly inflation in January 2010 reached 1.8%, far higher than predicted. This was largely due to a surge in food prices, which may continue due to underlying shortages of some products. However new impetus for inflation in 2010 may well come from a rise in utility prices and from the effect of an increase in the monetary aggregates as the National bank of Ukraine relaxes its monetary policy; the utility element may recede slightly as a result of the Kharkiv agreements on gas prices.

Figure 12: the consumer price index and core inflation

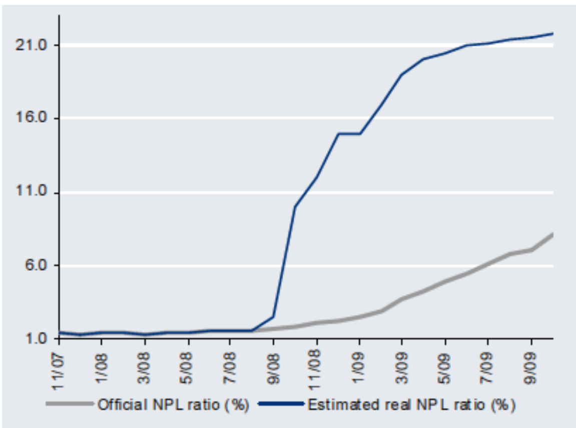


Source: State Statistics Committee, ING

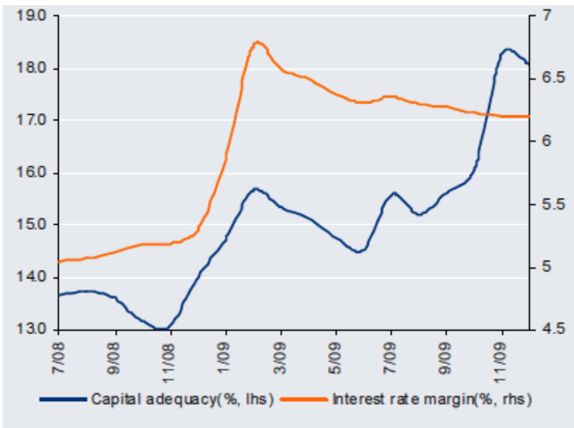
Major risks to recovery still exist in the financial sector.

The banking sector has been stabilised by a programme of recapitalisation and the closure of some banks. The beginning of the recovery will also help the banking sector as it begins to take in deposits again. However a combination of low domestic deposits, an inability, as yet, to borrow abroad and ever rising nonperforming loans on the balance sheet create major risks to the future (figure 13).

Figure 13: Non performing loans (left graph) and capital adequacy rates (right)



Source: NBU, ING



Source: NBU, ING

The official level of nonperforming loans (NPL) is around 10%, however the real figure is considerably higher than this (ING estimates it at between 20 and 25%). Banking losses have also reduced the capital base, which will affect the banks' readiness to recommence lending.

With the banking system still in a rather delicate state, lending to the private sector remains very restricted and this will undoubtedly slow the recovery. A return to more easy lending conditions depends partly on a relaxation of the NBU's tight monetary policy. This is only likely to occur if downward pressure on the value of the hryvnia eases with increasing political stability after the presidential election.

A particularly dangerous risk for Ukraine lies in the emission of short-term debt with very high coupons (frequently 20% or more), which the government has been selling to finance public expenditure. These bonds, sold domestically, have varying maturity but risk becoming a severe charge on the budget in the not too distant future.

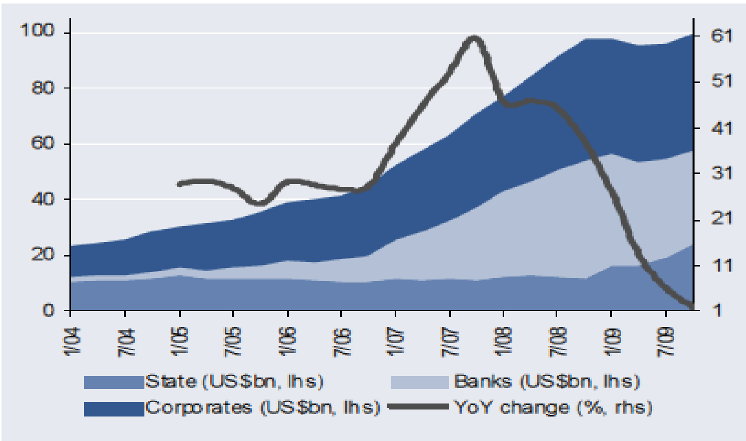
Finally the strength of the recovery in 2010 will depend partly on the restoration of reasonable political stability in Ukraine after the last year's tumult.

4. The external dependency of the Ukrainian economy

This discussion of the short-term economic outlook underlines the extent to which Ukraine is dependent on external factors.

The boom in consumption up to the summer of 2008 was to a considerable extent financed by foreign borrowings. With the Ukrainian currency stable against most hard currencies for some time, consumers, producers and banks were tempted to borrow at far lower interest rates in foreign currencies rather than paying the very high rates of interest on hryvnia loans (figure 14). With the decline in the value of the hryvnia and the impact of the recession, repayment of these loans placed an enormous burden on the economy. While foreign borrowings have been sharply reduced, the burden of repaying foreign loans remains and puts downward pressure on the national currency. However much of the recent increase in foreign debt was in the public sector with borrowings from the IMF, while for the private sector, banks and corporates, foreign debt is declining.

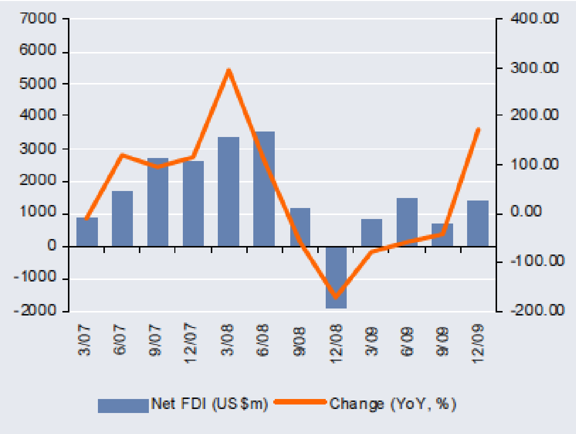
Figure 14: External debt 2004-2009



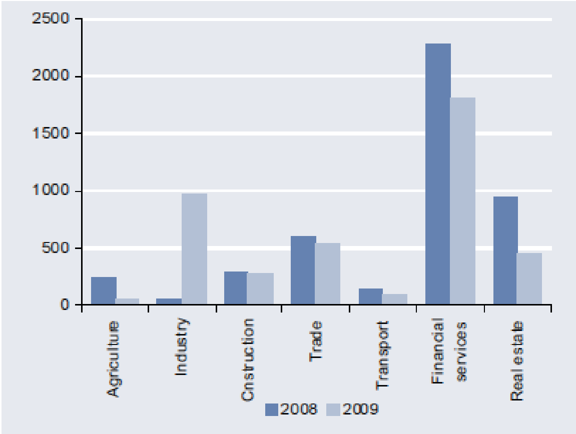
Source: Ministry of Finance, NBU, ING

Growth was also supported by strong and rising foreign direct investment in the years up to mid-2008 (figure 15). Foreign investment is vital not just for adding significant capital to the economy but also for its modernising impact on production and marketing. Net FDI came in briefly negative at the end of 2008 but returned to positive, though lower, levels in 2009. Overall FDI in 2009 decreased year-on-year by 30% though towards the end of the year it began to increase strongly. Foreign investors appear to have continued to invest in their existing operations in Ukraine but have not undertaken new investments.

Figure 15: Foreign direct investment, total and by sector



Source: State Statistics Committee, ING



Source: State Statistics Committee, ING

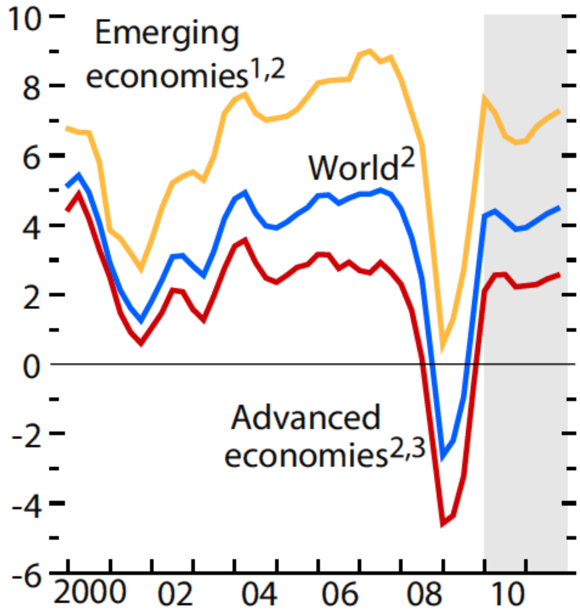
The hryvnia-dollar exchange rate reflected the sudden loss of confidence in the Ukrainian economy in late summer 2008, when the hryvnia suddenly depreciated by about a third against the US dollar (fig.5). Since the beginning of 2009, the National Bank of Ukraine has been relatively successful in keeping the exchange rate stable. Nevertheless in February 2010, the NBU was still having to sell dollars to support the hryvnia. Foreign exchange reserves in that month were at their lowest for three years, though of course they have risen in terms of import cover, due to the slump in imports. Reserves are being affected by the inability of Ukraine to borrow abroad, while existing foreign-exchange loans are still having to be repaid.

The stabilisation of the exchange rate is extremely important for Ukraine over the coming months but it does mean the NBU restricting the money supply and therefore exerting downward pressure on growth. The exchange rate however depends to a significant extent on the confidence which foreign operators have in the political situation in the country and the capacity of the government to run a macroeconomic policy aimed at stabilisation of the economy.

Finally, and perhaps most importantly, Ukraine depends heavily on overseas markets for its exports of steel and other heavy industrial products. With net exports the main hope of substantial economic growth in the coming year, the health of the world economy is a big factor in Ukraine's short-term future.

The latest forecasts for world growth for 2010 suggest that real output could expand by around 4% (fig. 16). However this growth is likely to be very uneven with the advanced economies barely growing, but sustained growth taking place in the developing world, especially in India and Southeast Asia. Even here there is a risk that the efforts of the Chinese government to rein back internal demand may lead to a somewhat lower growth rate for that economy in the future.

Figure 16: IMF forecast for global real economic growth (quarterly yr-on-yr data)



Sources: Haver Analytics; and World Economic Outlook database.
[1]Comprises China, India, Russia, South Africa, Turkey, and economies listed in footnotes 4, 6, and 7.
[2]Includes only economies that report quarterly data.
[3]Australia, Canada, Czech Republic, Denmark, euro area, Hong Kong SAR, Israel, Japan, Korea, New Zealand, Norway, Singapore, Sweden, Switzerland, Taiwan Province of China, United Kingdom, and United States.

For Ukraine, which sends roughly a third of its exports to the European Union and another third to Russia, this is not good news. The IMF forecasts that growth in the euro area in 2010 will be only 1% and in 2011 1.5%. For Russia too, growth is expected to be lower than in the pre-2008 period at 4% in 2010 and 3.3% in 2011, and this after a steep 8% fall in real GDP in 2009. On the other hand emerging and developing economies are expected to grow by over 6% in both years, with China at roughly 10% and India between seven and eight percent.

For Ukraine it is important to penetrate these faster growing markets while retaining its exports to its more traditional partners. However competition has grown sharper as many exporters of steel and other basic products have invested heavily to make their industries more competitive.

The lesson for Ukraine which comes out of the chaotic political situation of the last 12 months is that domestic political stability is extremely important when an economy is as open as that of Ukraine. Foreign investors, partner countries and the international financial community are not attracted by a country which is politically unstable, where fundamental reforms are not going forward and where corruption is rife.

5. The economy and political stability

With the course of Ukraine's economic recovery so dependent on political stability, it is important to ask whether the new President and Government will provide a more stable environment which will convince the rest of the world that Ukraine is a place to invest in and the hryvnia a stable currency.

With the changes which have now taken place in the Verkhovna Rada and the establishment of a new coalition government, the chances of more stability in policy-making seem somewhat higher, although the new government has a very slim majority in the Rada.

An indication of growing investor confidence in Ukraine even before the election is given by the reduction in the level above base of credit default swaps (figure 17). The margin halved between November 2009 and early March 2010. Standard and Poors has also raised its rating on Ukraine sovereign debt. The new Government is trying to convince overseas investors that there is no question of a Ukrainian default, even though this was a possibility which it raised while in opposition.

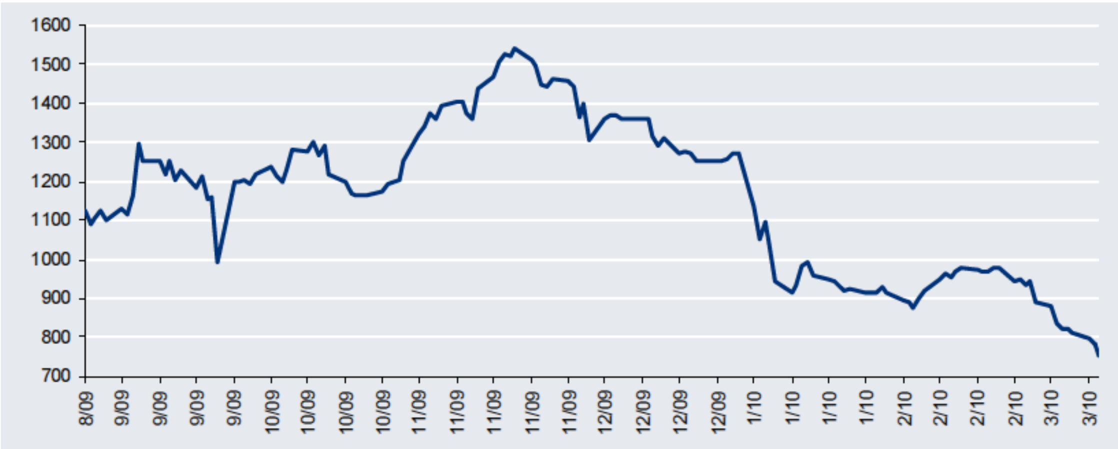
On external economic policy the new government promises a more constructive relationship with Russia, while not slowing down Ukraine's integration with the European Union. The absence of a real market economy in Russia and its increasingly state-controlled economic policy means that if Ukraine is to maintain its market access in that country, improved state to state relations are essential.

Good relations with Russia are above all essential to ensure some stability in energy markets in Ukraine. The last 'Gas War' between the two countries damaged Ukraine's reputation as a reliable transit country for Russian gas, while the agreement between the two countries negotiated by Prime Minister Tymoshenko appeared to be heavily biased towards Russian interests (see below). The recent agreement negotiated between new President Yanukovych and Russian President Medvedev, the Kharkiv Agreements, marked a new phase in Ukrainian Russian relations.

The developing relationship with the European Union has also been damaged by political instability over the past few months. As this relationship is crucial to a modernisation of Ukraine's economy, it is to be hoped that increasing stability in the post presidential election period will accelerate Ukraine's EU integration (see below).

However the new President and the new government will no doubt spend most of their time dealing with domestic crises. In the short term a vital first move should be to work towards the release of the final tranche of the IMF loan, or a new agreement with the IMF. If this can be achieved it will give greater confidence to other potential lenders to Ukraine and will much reduce the risk of very serious state financing problems arising.

Figure 17.   5 yr Credit Default Swaps (CDS) September 2009-March 2010



Source: Bloomberg, ING

However IMF conditions for the release of this money will pose severe problems for the government, which will have to raise utility prices to ensure that supply costs are fully met and will have to cut the budget deficit. The former would have a serious impact on families while the latter would also have to include a reduction in social transfers. The large rise in welfare payments which were promised before the election will almost certainly have to be cut back. None of this will make the new President more popular with the public, although the Kharkiv Agreements reduce the pressure somewhat.

The core of the Kharkiv agreements is a deal which trades lower gas import prices against the right of Russia to maintain its Black Sea Fleet in the port of Sebastopol for 25 years after the expiry of the current agreement in 2017. On the Ukrainian side, the worries about short-term economic problems appear to have dominated. It is essential to achieve a new deal with the IMF. The agreement to reduce gas import prices means that the IMF conditions can more easily be met with a lower degree of domestic pain while at the same time easing the financing of the budget.

The economic impact of the Kharkiv agreement in the medium term is less positive and the political cost of the agreement may be very severe, as it once again clearly demonstrates the fracture between western Ukraine and the south and east of the country.

However for foreign investors and for the EU it increases the degree of stability in the Ukrainian economy. The agreement on gas prices and gas supplies suggests that the EU will not have to worry unduly about winter gas supplies from Russia which transit Ukraine.

Party manifestos for elections in Ukraine bear little resemblance to the policy pledges made by parties in most western European countries; in Ukraine they are really just propaganda. We can therefore not predict the economic policy of the President or the new government on the basis of the Party of the Region's election manifesto. However one can judge the new regime by its actions the last time in power.

If the bureaucratic/domestic medium-sized business side of the Party of Regions determines policy, it is highly likely that serious reforms to modernise Ukraine's economy will not be taken. The insider economy may well thrive, with rather limited privatisation carried out in a rather non-transparent way. However even in this scenario the dramatic state of Ukraine's economy will force the government to become somewhat more open in its dealings.

On the other hand if the oligarch-wing of the party has a large influence on economic policy, economic reform may well stand a chance of progressing, as these businessmen seek to benefit from Ukraine's integration with the European Union to establish themselves in European markets.

Without a sustained attack on the all pervasive corruption in Ukraine however, the economic outlook in the longer term must look rather bleak. It is therefore to be hoped, that with more stability in government a serious attack on corruption can be mounted.

6. Structural reform in the Ukrainian Economy

While the short-term outlook for the Ukrainian economy is very important, the main challenges lie in structural reforms which are necessary for Ukraine to prosper in the medium and longer term.[1] The measures to tackle the short-term problems in the economy should, as far as possible, not compromise policies required to improve the medium and long-term economic outlook.

While policy has concentrated on the dramatic short-term problems of Ukraine's economy and the measures necessary for recovery, structural weaknesses persist and have tended to be pushed into the background by the urgency of short-term measures. The IMF programme attempts to tackle certain of these structural problems, for instance in the area of taxation or dealing with the crucial Naftogaz problem, but it too is mainly concerned with short-term stabilisation.

Structural reforms, aiming at the modernisation of Ukraine's economy, were obviously neglected in the 1990s, except in a negative sense as much old, redundant capacity went out of production.

However during the period of rapid growth after 2000, some key structural reforms did not make much progress. The oligarchic, insider economy remained very much intact until the Orange Revolution. In 2005 the new President and his government did attempt to reduce corruption in public procurement and other areas. A symbolic act at this time was the reprivatisation of Kryvorizhstal, the largest steel plant in Ukraine, for $4.8bn. This had previously been sold by the Government for only $800,000 to a relative of the President. However, while undoubtedly the attitude to brazen corruption between the private sector and government has become more severe, the position of the oligarchs remain strong as does their capacity to prevent competition in their areas of activity.

[1] 'Proposals for Ukraine: 2010-time to reforms: a reform programme for a new president of Ukraine', Kyiv 2010. This document contains a long list of the areas where structural reform in Ukraine is necessary. It is unlikely that the new President will implement such an exhaustive and exhausting reform agenda, but the document gives the reader a good idea of the scale of the problem.

a) Ukraine and EBRD transition indicators

The EBRD ‘transition indicators’ give a good general idea of progress in reforming the structure of transition economies.[2]

The latest estimates of these indicators published in November 2009 show that the EU's new member states in Central Eastern Europe generally have 4 or 4+ for each of them. This is true for instance for Estonia which has 4 throughout apart from infrastructure reform where it has 3+. Poland, as Ukraine's neighbour in the West, has 3+ for large-scale privatisation, for competition policy and infrastructure, and 4 for the other indicators.

Ukraine scores better than one might expect. It scores 4 for small privatisation and price liberalisation and 4 for trade and the foreign exchange system. It however scores very badly in governance and enterprise restructuring, in competition policy and infrastructure, and these are key areas for future development.

These general statements can be unpacked to give a short list of key structural reforms which will be necessary if Ukraine is to recover strongly from the current recession and achieve substantial growth rates over the medium term future. This list is by no means exhaustive but includes:

- the business environment
- competition, state aid, and public procurement
- corruption
- pension reform
- agriculture
- energy

b) the business environment

The poor business environment in Ukraine, characterised by a high level of bureaucracy, is a major brake on recovery and future growth. The World Bank's ‘Doing Business 2010’ survey places Ukraine 142nd out of 183 countries, which are surveyed. This is only a minor improvement over the position 145 which Ukraine occupied in 2009. This puts the ease of doing business in Ukraine below that of Russia and Moldova, but also worse than Iran and Gaza and the West Bank!. In dealing with construction permits Ukraine is 181st. in the world and occupies the same place on paying taxes. It also ranks particularly badly as far as ‘investor protection’, ‘registering property’ and ‘closing a business’ are concerned. The only categories in which Ukraine ranked in the first 50 countries in the survey were in ‘enforcing contracts’ and ‘getting credit’.

The difficulty of working in Ukraine is well-known both to domestic and foreign investors. It impacts both negatively, holding back the development of Ukraine's economy. This again is connected to the political situation in Ukraine, where it is very difficult to tackle serious

[2]They have been calculated over the last 15 years for all of the countries of central and eastern Europe and the Central Asian economies. They rate progress in structural reform on a scale 1 to 4+, where 1 represents the state of the centrally planned economy and 4+ that of a modern industrialised market economy. These rankings are given across around 10 indicators, grouped under the headings enterprises, markets and trade, financial institutions, and infrastructure see EBRD Transition Report, November 2009.

problems in a very fundamental and long-term way. But without improvement here, the future for new dynamic business looks bleak.

The difficult business environment is combined in the minds of investors with other serious problems such as corruption and the problems of the judiciary. This ensures that the risk premium on an investment is extremely large; or put another way, only projects with a very high profitability, which incorporate this risk premium will be considered by foreign investors.

c) Competition, state aid and public procurement

Competition policy and the control of state aids were of course non-existent problems in the period of central planning. Unfortunately with independence, there was no systematic effort to introduce a modern policy in these areas. As the insider economy developed, it was not at all in the interests of the oligarchs to favour a policy which would limit their manipulation of the market. The same argument applies to state aids. The financially integrated groups, which had close relations with the government and many representatives as members of the parliament were able to attract state aids in a variety of forms for their own enterprises. Urgent action in both these areas is necessary if Ukraine is going to be able to implement the new Association Agreement with the European Union.

Public procurement has been an even more difficult area. The changes which have taken place have made public procurement less transparent and more open to corruption than it was before. This has happened in spite of a major effort from the international community to help Ukraine introduce modern transparent legislation in this area.

d) Corruption

On the corruption perceptions index of Transparency International, Ukraine ranks 134th out of 180 countries, equal with Pakistan but still better than Russia.

There are many levels of corruption in Ukraine. The close relationship of the financially integrated groups with the government and parliament ensured that there would be a high level of large scale corruption. The sale of the Kryvorizhstal steel works, mentioned above, was one of the most obvious examples of such political corruption.

However corruption exists at all levels in Ukraine. Corrupt practices in the administration are widespread, especially concerning the issuing of permits and licences. Combined with the very bureaucratic rules concerning much administration, corruption makes running a business very difficult, especially for foreigners.

While some progress was made in fighting large scale corruption early in the first Orange Government, these efforts appear to have waned as the political situation has become more complex. The new President and Government have put fighting corruption high on the political agenda. However the entwinement of politics with business, also in the new government, is unlikely to allow a fundamental change in the state of corruption.

e) Pension reform

Ukraine has a pay-as-you-go pension system, funded from current taxation. Pensions absorb around 16% of GDP, one of the highest proportions in the world. The demographic structure of Ukraine, with a rapidly ageing population, will progressively put further strains on the pension system. Without a thoroughgoing reform, the pension problem will put an impossible strain on public finances.

The mandatory retirement age in Ukraine is the lowest in Europe-55 years for women and 60 for men. However for many professional groups the retirement age is even lower. The general level of pensions is extremely low with perhaps half receiving less than the minimum standard of living, although some professional groups receive much higher pensions.

The current situation is therefore one in which pensions are becoming an unsustainable charge on government expenditure but which at the same time give an inadequate standard of living to most recipients.

The first change which is essential is to create a funded pension scheme, into which at least younger workers start contributing. This would not only put pension schemes in the longer term future on a more solid basis but would also tend to increase investment in Ukraine. Older workers would continue on the pay as you go scheme, which would however guarantee a minimum living standard.

Early retirement schemes should be radically reduced, while the normal retirement age should be gradually raised to 65 or 67 for men and women. This might be disputed in Ukraine, where life expectancy has hardly changed since the end of communism, but the state is left no real option.

f) Agriculture

In agriculture too, an extremely promising sector of Ukrainian activity in the future, little progress was made in the creation of a real land market, which would allow efficient farmers to expand their holdings. The liberalisation of sales of state-held land has been put off as part of the ongoing political battle in Kyiv.

Agriculture is also hampered by the very poor state of infrastructure in the countryside, which prevents farmers getting the produce quickly to market.

In the past the government also introduced measures to limit agricultural exports in some years in an attempt to keep down the rate of inflation. These restrictions reduced incentives in agriculture to increase efficiency and output. They have however since been lifted.

Ukraine has the natural conditions to be a major supplier of agricultural produce on a world scale. Progress has been made recently in some areas of sanitary and phyto-sanitary standards, opening more export markets for Ukrainian produce. However further progress is needed here.

Ukraine is under considerable pressure from the European Union to adapt its sanitary and phyto-sanitary rules to those of the EU. However this raises questions about the future access of Ukraine to EU agricultural markets. The future agricultural trade regime is being negotiated in the FTA negotiations, but it seems unlikely that the European Union will be very generous on market access.

g. *Energy sector reform (see annex 1)*

Reform of the energy sector is vitally important both for the Ukrainian economy and for the reputation of Ukraine in the rest of Europe.

Since independence, the energy sector, and especially the gas sector, has been totally lacking in transparency and a major centre of corruption. Various half-hearted attempts have been made to reform the situation, but with little success.

A comprehensive reform of the sector would yield major benefits to the Ukrainian economy, to its energy security, to its relations with neighbouring countries and in reducing corruption.

7. <u>The medium-term outlook: Can European integration help the modernisation of the Ukrainian economy?</u>

The medium-term outlook for the Ukrainian economy depends very much on the speed and magnitude of the world recovery and the capacity of Ukraine to undertake structural reforms. This paper has shown that the recovery has started but economic growth in 2010 may be rather flat as far as global growth is concerned. The recovery may also be slower than normal owing to the large financing requirements of government. This would be bad news for Ukraine's very open economy, as it would mean that demand for Ukraine's metals and semi-manufactures would only recover slowly. Living standards would also only recover gradually from the shock that they have felt in recent months.

However there are reasons to be more positive in the medium-term.

Ukraine has become more competitive through the devaluation of the Hryvnia, which does not help much today when world demand is flat, but which should put Ukraine in a good position when the recovery starts.

Demand for steel is already picking up and prices have been pushed well above those prevailing at the depth of the recession.

If the IMF conditionality is adhered to, some other positive advantages will accrue to Ukraine. The full pass through of energy prices will obviously negatively affect household budgets, but it will create a situation in which energy saving is given a major economic boost, leading to higher energy saving investment and lower imports of oil and gas.

In spite of higher energy prices, inflation should fall to single figures over the next three years, bringing a degree of stability to investment which has been missing in the past few years.

But undoubtedly the most promising development will be Ukraine's integration with the European Union realised through the negotiation of the Association Agreement.[3] The Association Agreement will introduce new market economy regulation into Ukraine. If properly implemented, this will help to make Ukraine an attractive home for FDI, with a much improved business environment and less scope for corruption. Above all it will help to re-establish Ukraine's reputation as a reliable partner and reduce country risk, leading to lower borrowing costs for companies and the State.

However Ukraine remains one of the most difficult countries in which to do business. All pervasive state aid and a lack of transparency in the public procurement regime create huge losses for the economy and support massive corruption. Agriculture, one of the most promising sectors for development in Ukraine, is still hampered by a lack of a real land market. The energy sector suffers from massive corruption.

To this list could be added reform of the administration, of the judiciary, of the social security system including pensions and of many other areas.

It is doubtful whether these reforms can be undertaken purely from within, because the different political and economic interests in Ukraine will tend to block any progress. Deeper integration with Russia is certainly not a way to achieve any reforms which will accelerate the modernisation of Ukraine's economy. Deeper integration with the European Union on the other hand is probably the best chance of creating some sort of external anchor for these reforms, although with the offer which the EU has made so far, this anchor is not very strong.

The Association Agreement offers a progressive opening of the internal market of the European Union as Ukraine adopts EU regulation. If implemented correctly this will eventually lead to the establishment of a regulatory framework for the economy, which will favour more transparency, greater competition and far greater efficiency.

This can be illustrated by taking the complex of competition policy, state aids and public procurement. State aids in Ukraine are distributed widely by politicians for political and sometimes personal reasons but without any clear economic logic. This is an enormous loss to the economy both from the point of view of the fiscal cost of state aid but also through the distortion in competition which is created. Inefficient but influential producers are frequently given state aids, which do not allow more efficient producers to compete. In 2009 there was a major increase in state aid to companies which suffered from the recession, but there appears to be no policy and no strategy on such assistance, and no real idea whether the large extra burden on the budget brings any benefits to the Ukrainian economy.

The adoption of EU rules on state aids and their correct implementation would ensure that competition-distorting state aids became illegal, all significant state aid would be notifiable and therefore transparent.

The reform of public procurement, a very major part of the Ukrainian economy, would also bring significant gains to public welfare and a clear reduction in the level of corruption. Unfortunately the work which was done by the OECD-Sigma Programme to design a

[3] for a detailed analysis of the Association Agreement see papers by Hillion and Mayhew on the website of the Wider-Europe Network: www.wider-europe.org

reformed public procurement regulation was not put into effect and so the area remains a source of major loss to the economy.

The Association Agreement will cover other areas of crucial importance such as company law, customs, sanitary and phyto-sanitary regulation, environment and sustainable development as well as all the elements necessary to implement the free trade area.

However other vitally important areas of reform will essentially lie outside the scope of the Association Agreement. These include reform of the judiciary, which is considered a vital element for integration with the European Union, reform of the Administration, which includes the central civil service, regional authorities, public order authorities and many others.

The Association Agreement will also leave largely untouched the area of social welfare, including pensions. Social services and social transfers are also not sufficiently targeted at those parts of the population most in need.

The structural reform agenda is so large that it must be a program stretching over several years. Implementing reform will strain the country's finances and it is therefore essential that the available public finances are used with maximum efficiency. But it is unlikely that the country can achieve the most important reforms without outside financial assistance. Once the political situation has been stabilised, international loans should be available for some of this work. However it would be appropriate for the European Union to accompany its requirements for legal and policy harmonisation with additional finance to enable the country to undertake what it requires.

8. Conclusion

The financial and economic crisis brought to a sudden end a period of rapid economic growth in Ukraine, which had led to general increases in the welfare of the population but had been accompanied by unsustainable asset bubbles and foreign borrowing.

Political uncertainty in the run-up to the presidential election contributed to domestic and international loss of confidence in the ability of the government to deal with the crisis. It was only when the IMF agreed a standby credit that some degree of confidence returned. Political uncertainty has declined since the election and rating agencies have reduced their assessments of sovereign risk.

It is however the underlying structural problems of the Ukrainian economy which are preventing its modernisation. These include all pervasive corruption and the classic characteristics of an insider economy alongside objective economic challenges such as dealing with the pensions overhang and reforming the energy sector.

Integration of Ukraine with the European Union and the progressive opening of the EU's internal market would provide a regulatory framework which would, over time, promote economic modernisation and rising living standards.

ANNEX 1: Energy policy reform

a. The legacy of the Soviet Union

The problems of the energy sector in Ukraine stem largely from the lack of reform undertaken on Ukraine's independence from the Soviet Union.

Ukraine provided almost half of the gas produced in the Soviet Union in the 1950s. Output increased up to 1970, when Ukraine was still providing one third of the Soviet Union's gas. However from the mid-1970s the Ukrainian fields went into decline and Ukraine received gas from the Siberian fields.

As the supply of domestic gas declined, the intensity of gas usage in the Ukrainian economy rose, encouraged by its extremely low price. By the time of Ukrainian independence, the country was an intensive user of gas most of which had to be imported from Russia.

The 1990s saw the development of many of the problems which still today bedevil the energy sector. The problems are essentially problems of gas supply, transit and distribution. Electricity generation and distribution had their own problems which are essentially domestic, while the oil market has been relatively free since Ukrainian independence.

During this decade the supply of Russian gas to Ukraine was organised through agreements between the two countries. With the political relations between them often acrimonious, this meant that the negotiations were never easy. Russia had the aim of extending its ownership of the Ukrainian energy sector, while unfortunately, on the Ukrainian side, the gas trade was regarded as a way of enriching a handful of enterprising and powerful individuals. The absence of a relatively transparent market in gas allowed numerous practices to grow up which had an extremely negative impact on the Ukrainian economy.

Russia continued to supply Ukraine with gas, at times at prices lower than the price for gas in Western Europe. Ukraine was not alone in Eastern Europe and Central Asia in paying lower than world prices for gas. The subsidised gas helped the Ukrainian economy to survive the very deep recession which lasted until 1998. In addition to this subsidy, Russia did not immediately try to extract the payments for gas supplies and so Ukraine gradually built up a very large debt to Russia. In the early 1990s the practice of illegally withdrawing gas from pipelines and from storage grew up in Ukraine, a complaint which Russia continued to have right up to the gas crisis of 2008-2009.

In order to eliminate some of the malpractices of the early 1990s, President Kuchma introduced reforms to the gas industry, which in the end proved to be unsuccessful, and indeed led to the development of various opaque companies operating in the gas sector and living from the rents they had appropriated. The gas trading concession scheme, which aimed to eliminate the accumulation of sovereign debt to Russia, in the end led to the creation of several wholesale gas trading companies which operated in a totally opaque manner and which, through debt for equity swaps, managed to appropriate large parts of Ukrainian industry and commerce. The gas trading concession scheme was dropped in 1998 and replaced by Naftogaz Ukrainy, a state-controlled vertically integrated monopolist, which still to this day does not always produce complete accounts.

During this time the system of cross subsidy between businesses paying realistic charges for gas supply and households paying very low prices developed. Indeed throughout the energy sector the maintenance of administrative prices below cost recovery is a principal cause of structural problems in the energy sector.

Throughout the whole period up to the Orange Revolution, the gas trade between Russia and Ukraine and within Ukraine itself was not only an economic issue but one of high political interest and intrigue. Russia attempted to use gas supply to obtain concessions on other issues from the Ukrainians, while there is a strong suspicion that politicians in Ukraine were using rents from gas to support their political parties and groupings.

The main problems for the reform of the energy sector today can be seen to have arisen essentially in that pre-2004 period. The period after the Orange Revolution was one of growing tensions between Ukraine and Russia and the determination of Russia to raise gas prices to Ukraine to West European levels and to use gas as a weapon to extend its interests, both economic and political, in that country.

The main challenges for reform of the energy sector include:

- the creation of market mechanisms in the gas sector and the introduction of greater competition throughout the sector
- the introduction of full cost recovery pricing (including a profit margin) for the supply of energy to households and businesses, eliminating subsidies and cross subsidies. This measure should be accompanied by targeted social measures to protect the poorest families.
- the raising of tariffs on the transport of oil and gas and on its distribution and delivery. Together with the introduction of full cost recovery pricing, this measure should serve to support investment in the sector.
- the promotion of energy efficiency especially in the household sector contributing to reducing the energy intensity of Ukrainian GDP
- increasing transparency in the gas sector with the aim of eliminating corrupt practices which raise the cost of gas to consumers while enriching political elites. Giving greater independence to energy regulators
- upgrading gas transit pipelines and other parts of the infrastructure which distribute Russian gas to the EU and beyond in order to become a totally reliable transit country for gas from Russia to the rest of Europe
- enabling foreign investment in energy exploration and supply
- the improvement of energy security for Ukraine itself.

b. The current energy situation in Ukraine

The 2007 energy balance for Ukraine produced by the International Energy Agency (IEA) gave the following picture of energy consumption in Ukraine: (figure 18)

- Coal 30%
- Oil 11%
- Gas 41%
- Nuclear 18%

- Renewables 0.6%

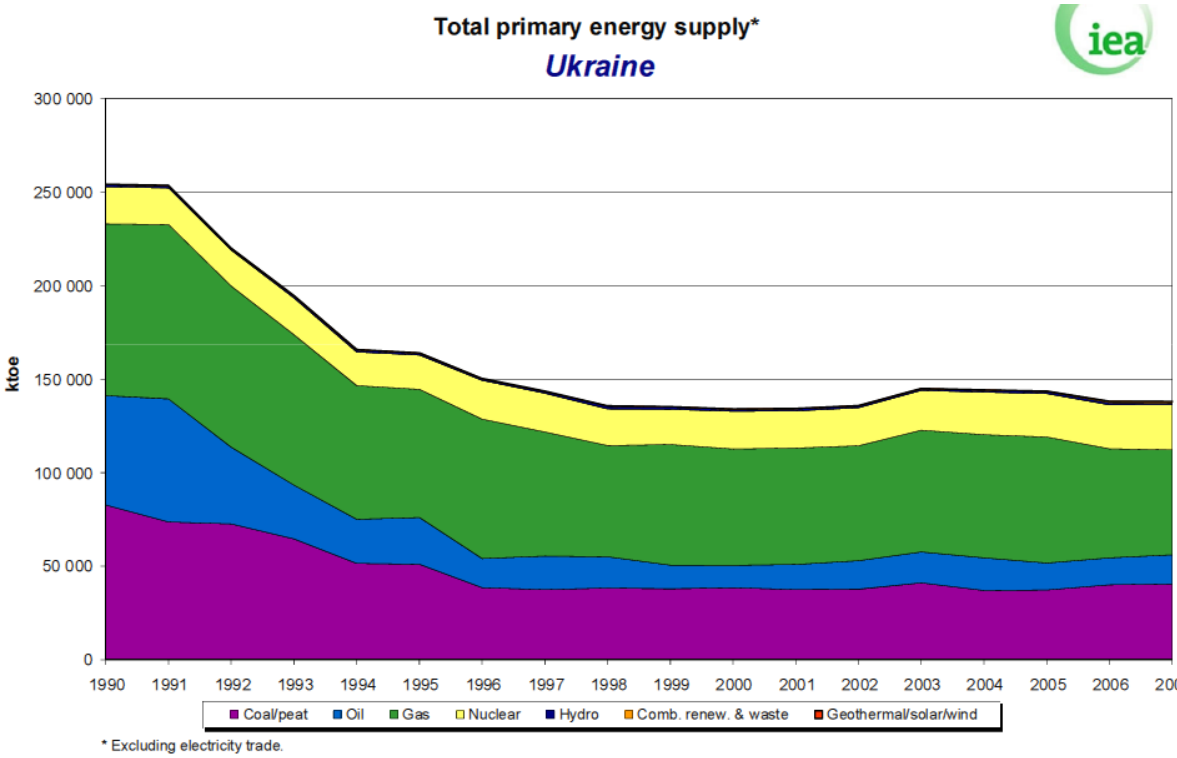
Net imports made up just over 43% of the total consumption. Imports of gas made up three quarters of total gas consumption and 30% of total energy consumption.

Ukraine has one of the largest gas storage capacities in the world, with a total capacity of around 40% of annual gas consumption. Much of this storage capacity is used in connection with the transit of Russian gas to Western Europe.

Ukraine is the most important country in the world for gas and oil transit. Around 80% of Russian gas exports and around 15% of Russian oil exports to Europe transit the country. Hydrocarbon transit is an important contributor to Ukraine's budget and it also serves as a guarantee of its energy security.

Ukraine is a very intensive user of energy, a fact partly explained by the history of the country briefly outlined above. In 2006, according to the International energy agency, energy intensity (in other words the consumption of energy per dollar of GDP) in Ukraine was 3.7 times higher than in Germany and 25% higher than its neighbour Russia.

Figure 18 Total Primary Energy Supply to Ukraine



Source: IEA

c. Reform of the energy sector

1. *the creation of market mechanisms in the gas sector and the introduction of greater competition throughout the sector*

Reform of the gas sector is important not simply in order to increase efficiency in the economy, but because through administrative pricing, massive corruption and total opacity, it creates an image of Ukraine internationally and domestically as a corrupt and ill governed state.

The sector is completely monopolised and the state company Naftogaz Ukrainy is itself lacking in transparency and has become a very major burden on the state budget.

Negotiations with Russia are always shrouded in secrecy and in 2009 there occurred the absurd situation in which the President of Ukraine could not get a copy of the contract which had been signed between Gazprom and Ukraine's state monopolist. The only sensible solution for Ukraine is to pay Russia a price for gas which does not imply a Russian subsidy for Ukraine, which otherwise gives Russia a weapon to use against Ukraine and creates scope for massive corruption within the country. Unfortunately the Kharkiv Agreements tend in the opposite direction.

Introduction of competition within Ukraine for gas supply, transit, delivery and storage should be a priority. Indeed a draft law was submitted to the Verkhovna Rada in autumn 2009, which if put into effect would achieve the objective of introducing competition into the sector.

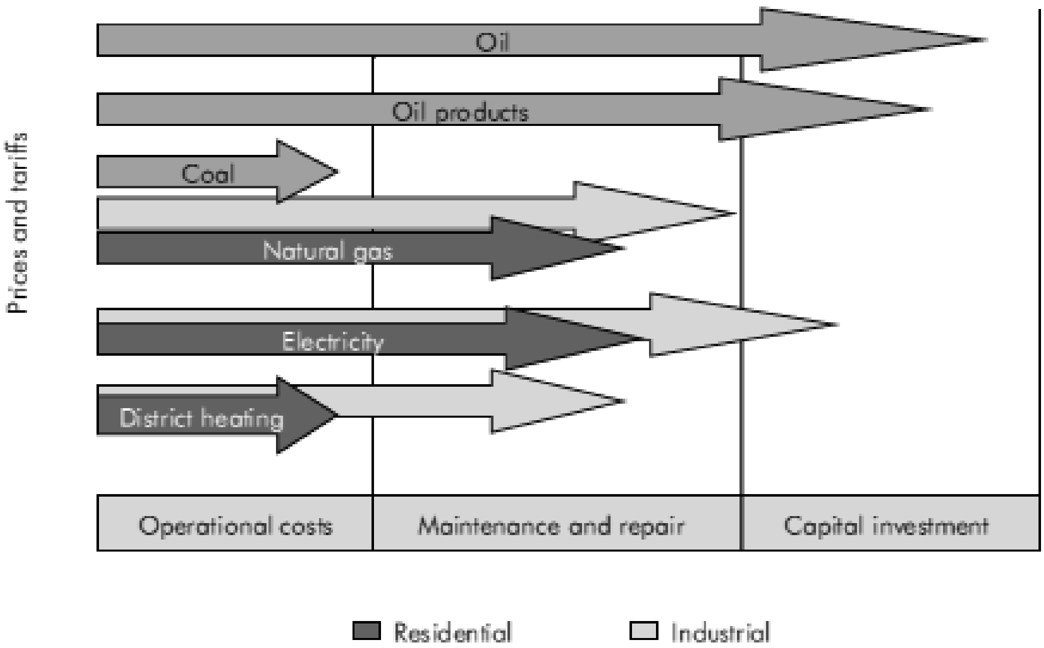
As the gas sector has in the past been a lucrative source of funding for political parties and individual politicians and businessmen, the introduction of real competition into the sector, which would benefit Ukraine considerably, will be resisted by these rent seekers.

The Kharkiv agreements mentioned above, which promise Ukraine a major reduction in gas import prices, will certainly not work in the direction more competition and less corruption.

2. *the introduction of full cost recovery pricing (including a profit margin) for the supply of energy to households and businesses, eliminating subsidies and cross subsidies. This measure should be accompanied by targeted social measures to protect the poorest families.*

While oil, oil products and to some extent electricity are supplied at prices which cover operation and maintenance costs as well as capital investment, the administrative prices charged for gas and electricity for households do not even cover maintenance costs fully while district heating charges do not even cover operational costs (figure 19).

Figure 19: Energy prices and tariffs compared to costs, June 2006



Source: IEA estimates based on information provided by the government and mass media.

This is a crucial area of reform for the new government in Ukraine and is one of the conditions attached to the IMF loan, the fourth tranche of which was held back partly because this reform was not pushed through before the election.

The resulting deficit which accrues to Naftogaz means that the company can not undertake essential investment, and can also only raise finance to pay Gazprom for deliveries with great difficulty. Over the past few months, one of the great questions in Ukraine has been whether Naftogaz can pay its Russian invoice in time and therefore avoid Russia cutting off gas supplies to Ukraine and to Western Europe. This absurd situation has to end as it contributes to the image of Ukraine as an unreliable partner.

The degree of subsidy for district heating is even higher than that for household gas. The result again is that there is a grave lack of investment in district heating, with old equipment, badly maintained and leading to not infrequent outages.

Raising prices to full cost recovery will of course mean hardship for the poorest sectors of the population in Ukraine. It would therefore be essential for the government to introduce a targeted social welfare policy to ensure that these families could still procure gas for heating and cooking. This has also been underlined as an essential element by the IMF.

3. *the raising of tariffs on the transport of gas and on its distribution and delivery. Together with the introduction of full cost recovery pricing, this measure should serve to support investment in the sector.*

In a similar vein, administrative pricing for the transport of gas, has led to under investment in the transport network. Much of this network is state owned and budgetary expenditure has also not been available.

4. *the promotion of energy efficiency especially in the household sector contributing to reducing the energy intensity of Ukrainian GDP*

As noted above, energy intensity in Ukraine is amongst the highest in the world but has been declining. It fell from a peak in 1996 to 2006 by 40%. This has been achieved largely by the industrial sector, as new more efficient plant has been installed, and a significant share of plant has become redundant. The rise in energy prices which has generally been passed through to industrial consumers has also accelerated the decline in energy intensity.

There is however a major problem in the household sector for which the highest level of implicit subsidy exists. The household sector demand is only slightly lower than that from industry, where energy savings have been far more marked. The incentives for energy saving in this sector are not strong because of the general lack of metering and the low levels of prices charged for energy for residential use. A substantial investment would be needed over the next decade to gradually improve energy saving in this sector.

Energy saving policies have been in place since the middle of the 1990s, but they have frequently achieved little, partly because of half-hearted support from senior ministers in the government. Yet the scope for energy saving in Ukraine is truly vast and properly implemented could radically improve Ukrainian energy security, especially by substantially reducing the demand for Russian gas. It is to be hoped that the new government makes this policy one of its priorities.

As noted above, the Kharkiv agreements, keeping gas prices well below world level, are not helpful in terms of raising energy efficiency.

5. *increasing transparency in the gas sector with the aim of eliminating corrupt practices which raise the cost of gas to consumers while enriching political elites. Giving greater independence to energy regulators*

The gas crisis between Russia and Ukraine in the winter of 2008-2009, brought the totally opaque world of the Ukrainian gas trade to the attention of the public in the European Union. Up until the contract between Gazprom and Naftogaz eliminated it from the wholesale trade, the Swiss registered RosUkrEnergo, jointly owned by Gazprom and two Ukrainian businessmen, had profited enormously from buying Central Asian gas from Gazprom and selling it on to Western Europe and large enterprises in Ukraine. It is suspected that many leading politicians have benefited financially from the gas trade.

The complete opacity of the gas trade has led to major losses for consumers in Ukraine and has seriously damaged Ukraine's image abroad. Creating greater transparency will therefore not only benefit Ukraine's economy directly but will also serve to improve the country's reputation.

An important part of increasing transparency would be to strengthen national regulation exercised through an independent regulator.

6. *upgrading gas transit pipelines and other parts of the infrastructure which distribute Russian gas to the EU and beyond in order to become a totally reliable transit country for gas from Russia to the rest of Europe*

Gas transit is an extremely important part of Ukraine's economy and a major contributor to the country's budget. A series of disputes between Russia and Ukraine, together with the lack of investment in the pipelines which have led to a variety of technical problems, persuaded the Russians to look for alternative routes to deliver oil and gas to its customers in the rest of Europe. The loss of supplies particularly in Central Europe including Germany also encouraged consumers of Russian gas to cooperate with Russia in building these alternative routes. The Nordstream pipeline which will run directly from near St Petersburg to Germany by- passing Ukraine, Belarus and Poland and the South Stream pipeline planned to cross the Black Sea both hold out dangers for the use of Ukraine's own transit network. Nordstream is already under construction and will be completed; South Stream is still at the planning stage. The way in which Russia has ruthlessly used its energy supply for political ends means that not only Ukraine but also other countries such as Poland are extremely worried by this development.

Two things are essential to maintain Ukraine's position as a transit country for hydrocarbons. The first is that transit must become a totally transparent and reliable activity. The second is that Ukraine must make considerable investment in upgrading pipelines and other infrastructure related to the transit.

In the past, information on transit, and on storage which is an integral part of this transit system, has been withheld from Ukraine's partners. Indeed on various occasions Russia has complained that Ukraine has illegally removed gas from transit to customers in Western Europe. It is obvious that information must be readily available both to the suppliers of gas to the pipelines and the consumers in the rest of Europe.

Ukraine’s gas transit system consists of 37,600 km of pipelines, together with compressor stations and underground storage! The poor state of the infrastructure of transit is a worry to all of Ukraine's neighbours. In March 2009, agreement was reached between the EU and Ukraine to make €2.5 billion available for upgrading the transit infrastructure. However the disbursement of this finance depends on Ukraine thoroughly reforming its energy sector, including the separation of the transit business into a separate company from Naftogaz.

7. *enabling foreign investment in energy exploration and supply*

The poor business environment in Ukraine is a major hindrance to foreign investors wishing to invest in the energy industry. Ukraine itself is an important producer of energy including coal, gas and nuclear. Foreign investment in each of these energy sources accompanying liberalisation in the sector could be an important factor in the modernisation and development of energy sources. The bureaucratic problems, which foreign investors meet, is leading to gas and oil exploration companies investing far less in Black Sea exploration than they had planned.

8. *the improvement of energy security for Ukraine itself.*

All of the above reforms in the energy sector would lead to improving energy security for Ukraine itself, which must be one of the objectives, if not the objective of energy policy reform.

d. European Union integration as a roadmap to energy reform

The European Union has a very obvious interest in reform of the energy sector in Ukraine, partly because many of its member states depend on energy sources transiting Ukraine and partly because it would like to see stable and reliable regulation of the sector to create a business environment similar to that which exists in the EU. It is also aware that this is perhaps the main problem area which underpins the view among some Member States that Ukraine is an unreliable partner. The Union also has an obvious interest in the upgrading of nuclear facilities in Ukraine.

In the energy sector there are three main legal documents which should eventually govern relations between the EU and Ukraine in this area.

The first is a Memorandum of Understanding which was signed in December 2005. This document stated that:

'The Ukrainian energy sector is strategic for the economic and social development of Ukraine and constitutes also a substantial potential external source of revenue. Its gradual convergence with the EU's internal energy market, aiming ultimately at its integration, remains a shared priority for the EU and Ukraine'.

The Memorandum of Understanding established roadmaps in four sectors:

- nuclear safety
- the integration of electricity and gas markets
- enhancing the security of energy supplies and the transit of hydrocarbons
- structural reform, enhancing safety and environmental standards in the coal sector.

This agreement envisaged many of the reforms which have been outlined above, as well as the harmonisation of regulation of the energy sector in Ukraine to that of the European Union. The reforms included the creation of an energy regulatory authority, an independent gas transmission operator, the interconnection of the Ukrainian electricity system and the UCTE system, and the granting of observer status to Ukraine in the Energy Community.

A regular monitoring update of the memorandum of understanding is undertaken and gives some idea of the progress in energy reform, at least from the point of view of the EU. The latest joint monitoring report (September 2009) gives a rather positive review on the area of nuclear safety. However on the integration of the electricity and gas markets, the report could notice progress on the drafting of laws sent to the Verkhovna Rada but little in the way of progress in the Rada or in implementation generally. Reporting on the 'road map on the security of energy supplies and the transit of hydrocarbons', the report could note the offer of the joint EU-Ukraine international investment conference on the modernisation of the gas transit system to support Ukraine, but it also notes the conditions established by the donors (essentially the EU and the IFIs) which must be fulfilled for financial assistance to be released. To date these conditions, similar to the reforms mentioned above, have not been met.

Ukraine has submitted a gas transit system master plan, which identifies projects which can be financed by the external donors. This plan is still being examined by the donors. The EU has indicated that support could be provided from the new Neighbourhood Investment Facility established under the Eastern Partnership.

Ukraine has also recently joined the Energy Community Treaty. The Energy Treaty aims to create 'an integrated market in natural gas and electricity based on common interests and solidarity' and 'a single regulatory space for trade in gas and electricity'.

The members of the Energy Community Treaty are obliged to harmonise their legislation concerning gas and electricity markets to the energy acquis of the Union. If Ukraine goes ahead with the implementation of its obligations under the treaty, a considerable reform agenda would be programmed.

Finally, the negotiation of the Association Agenda between the EU and Ukraine will require harmonisation which goes even beyond that required by the Energy Community Treaty.

The outstanding question is therefore whether Ukraine will implement the agreements which it has signed up to or is likely to sign up to in the coming months. Implementation of these agreements with the European Union would be of enormous economic benefit to Ukraine and Ukrainian citizens and would enhance its credibility with the rest of the world.

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