

## **Review of EU policy for Ukraine**

Tymofiy Mylovanov, Yuriy Zhukov and Yuriy  
Gorodnichenko

Paper commissioned by the Human Security Study Group

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**SiT/WP/02/16**



**Tymofiy Mylovanov** is a native and citizen of Ukraine. He was born in Kyiv and in 1999 received a Master's degree in Economics from the EERC Program at the Kyiv Mohyla Academy. Tymofiy earned his PhD in Economics at the University of Wisconsin Madison in 2004. He has taught at the University of Bonn, Penn State University, University of Pennsylvania, and University of Pittsburgh. Tymofiy's focus is on game theory, contract theory, and institutional design. He is a cofounder of VoxUkraine.org, a group of global economists working on the policy problems in Ukraine and a member of the academic advisory board of the Kyiv School of Economics.

**Yuri Zhukov** is an Assistant Professor of Political Science at the University of Michigan, Ann Arbor, and a Faculty Associate with the Center for Political Studies at the Institute for Social Research. His research focuses on the causes, dynamics and outcomes of conflict, at the international and local levels. Yuri received his Ph.D. from the Department of Government at Harvard University and also holds degrees from the Graduate School of Foreign Service at Georgetown University (M.A.) and Brown University (A.B.).

**Yuriy Gorodnichenko** is an Associate Professor of Economics at the University of California Berkeley. His research focuses on a broad set of topics, including public finance, economic development, international economics, and econometrics. Yuriy received his Ph.D from the Department of Economics at the University of Michigan.

## **Contact**

Tymofiy Mylovanov: mylovanov@gmail.com

Yuri Zhukov: zhukov.yuri@gmail.com

Yuriy Gorodnichenko: ygorodni@econ.berkeley.edu

## **Security in Transition**

February 2016, London

## **Abstract**

This paper provides a review of the ongoing violent conflict in Ukraine and the contemporaneous economic and political crises. It uses big data on violence in the east of Ukraine to argue that the local variation in the violence is best explained by economic rather than ethnic or political factors. We also discuss the resistance of the Ukrainian public to the conflict-resolution strategy outlined in the Minsk I and Minsk II agreements. This resistance reflects the lack of legitimacy of these agreements, where the major stakeholder – the public – has been denied a voice in framing the terms of the agreements. The paper suggests that EU policy in Ukraine should be focused on creating economic opportunities for the general public (economic resolution) and using a bottom-up approach to include all sections of society in deliberations of how to resolve the conflict (political resolution). These actions should be complemented by strict conditionality of EU support that requires anti-corruption policies that address the state economy and, more importantly, dismantle rent-seeking networks of oligarchs and restore justice.

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## **1. Introduction**

This chapter provides a review of the ongoing security conflict in Ukraine and the contemporaneous economic and political crises. We use big data of the violence in the east of Ukraine to argue that the local variation in the violence is best explained by economic rather than ethnic or political factors. We also discuss the resistance of the Ukrainian public to the conflict resolution strategy outlined in the Minsk I and Minsk II agreements. This resistance is caused by lack of legitimacy of these agreements, where the major stakeholders – public – have been denied a voice in framing these agreements.

We start by describing the background of the conflict and remark that the early attempts at the crisis resolution during the Euromaidan protests in the winter of 2014 have not been successful because of the lack of legitimacy of the process. We then move towards discussion of Minsk II and resistance to these agreements among the Ukrainian public. Next, we make a data-based argument that the variation in the local violence in the east of Ukraine is best explained by the structure of the local economy. This finding suggests that the key to a resolution will lie in restoring economic and judicial justice. We then turn to the issue of radicals in Ukraine, arguing that the threat of right wing parties is not as high as is generally perceived. After that, we talk about Crimea, the political pressure on Crimean Tatars and the issue of blockade. We briefly discuss the role and effect of the Trade Association Agreement between the EU and Ukraine. Next, we comment on the social hardship imposed on the Ukrainian population by the crisis, the pervasive corruption, and success of conditionality requirements of the IMF and other donor programs. Finally, we conclude with some recommendations about policies for the EU with respect to Ukraine.

## **2. Background of the conflict**

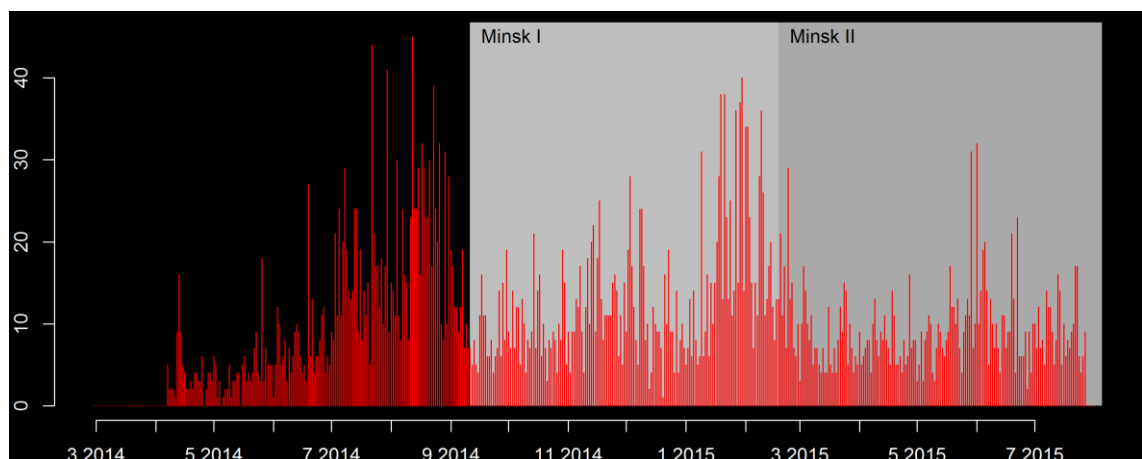
On the 21st of November 2013, a prominent Ukrainian journalist Mustafa Nayem posted a Facebook call for Ukrainians to come to the main square center of Kyiv. The objective was to protest a recent decision by President of Ukraine Viktor Yanukovich not to sign a EU association agreement.

Over the next few days protesters grew in numbers, but there was no violence. Everything changed on November 30th when police dispersed the protesters, arresting and injuring them in scores. The police brutality fueled the public support of the protests. The protests continued into late February 2014. At times, the number of protesters reached, according to some estimates, up to 1 000 000 people. The protests gradually turned more violent and culminated in multiple deaths of protesters and police. The regime collapsed. President Yanukovich fled Ukraine and the Parliament voted in a temporary government.

Following the change of the government in Ukraine, Russia annexed Crimea in the spring of 2014. Immediately after that, Russia and some of the Ukrainian political elites orchestrated a pro-Russian insurgency in the east of Ukraine. In the spring of 2014, multiple armed groups took over town councils and proclaimed two republics, Donetsk People's Republic and Luhansk People's Republic. These armed groups were partly consisting of Russian (officially former) troops, and partly of locals. The Republics have not been recognized by Ukraine, Russia, and the rest of the world.

By the early summer of 2014, there was a full-fledged war in Donetsk and Luhansk oblast between the separatists and the Ukrainian armed forces. In the late summer of 2014, the Ukrainian military was making steady advances on the territory controlled by the insurgents. In response, Russia offered military support and the Ukrainian troops suffered heavy casualties, and were pushed back in August of 2014. Intense fighting continued throughout the end of 2014 and the spring and summer of 2015. By the spring of 2015, there was a tentative ceasefire in place. The ceasefire continues to hold with sporadic violations. Figure 1 describes the time series of the violence in the east of Ukraine.

**Figure 1. Violence in the East of Ukraine. Minsk I and II are ceasefire agreements.**



In the meantime, Ukraine has restored legitimacy of the government and political process. It held presidential elections and chose a new president (Petro Poroshenko) in May 2014. A new parliament was elected in October 2014. A new coalition government was formed in late November. Local elections were held recently, in October and November 2015.

The EU has played an active role in mitigating the conflict. It has served as a mediator between the parties of the conflict throughout the entire period since the beginning of the Euromaidan. There were attempts to mediate a solution between the former president Viktor Yanukovich and the protestors during Euromaidan. After the violence in the east emerged, there have been two agreements, Minsk I and Minsk II, that are

aimed to stop fighting. The current ceasefire follows the Minsk II agreement. Second, the EU has offered technical, financial, and diplomatic support to the new Ukrainian government.

### **3. Sustainability and legitimacy of the Minsk II agreement**

The Minsk II agreement is currently the key political instrument intended to resolve the security crisis in Ukraine. It requires introducing changes into the Constitution of Ukraine that grants the separatists regions certain powers. These changes are not well understood by the Ukrainian public and are not uniformly supported by people and by the political factions in the Parliament. This is most evidenced by the deadly violence outside of the Ukrainian parliament on August 31, 2015 during the vote on the decentralization amendment to the Constitution of Ukraine, as required by the Minsk II agreement. The vote itself was highly irregular,<sup>1</sup> suggesting that the political leadership of Ukraine had to engage in non-standard means of persuasion of the members of the parliament to support the required changes. In addition, Western politicians were present in the Ukrainian parliament during the vote. Many observers remarked on intense pressure on the members of the parliament from the EU and the US leaders. Several factions voted against the changes and several members of the parliament who broke these parties' line were excluded from the respective faction.

In addition to being highly divisive among the Ukrainian public, Minsk II does not address the fundamental causes that led to the Euromaidan revolution: there is no serious effort to carry out fundamental and systematic reforms, to eradicate corruption and abuse of power by the ruling elites, oligarchs, and entrenched bureaucracy. The old kleptocratic/oligarchic system of power distribution in Ukraine mutated into a more polished and Westernized look. After nearly two years since the start of the Maidan movement, nobody from the top echelons of the previous regime responsible for corruption and violence was brought to justice. Furthermore, the people directly responsible for instigating, coordinating, and financing attacks on the Ukrainian public in Kyiv, Odessa, and the east have not been brought to justice. It is unclear whether the criminal and law enforcement networks that were involved in the violence have been dismantled. Consequently, the public has been becoming increasingly frustrated with the new government, providing a basis for political infighting, finger-pointing, and rising populism. As an example, the public support for the new prime minister is at record lows so that his political party has decided not to participate in the local elections held last month. The media and politicians are discussing the chances for the current government to survive in the medium term. Recent resignations from the Cabinet (Minister of Infrastructure) and the National Bank of Ukraine (a deputy governor) led to speculations of further exodus of the reformers from the government.

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<sup>1</sup>See the analysis of the voting in <http://voxukraine.org/2015/11/27/irregular-votes-in-rada/>

Similarly, Minsk II does nothing to resolve the issue that led Russia to intervene in Ukraine in the first place. Ukraine's sovereignty is challenged by Russia. The Budapest Memorandum signed by Russia, the US, and the UK served as a guarantee of the Ukrainian sovereignty. This Memorandum has proven to be ineffective. Minsk II also does not have any effective tools that would ensure that Russia respects the sovereignty of Ukraine in the future.

Thus, Minsk II does nothing to prevent escalation of the violence in the medium to the long run, while Ukraine finds itself under enormous external and internal pressure. Together, these factors may risk a continuation of the crisis with even more unpredictable consequences.

The external pressure from Russia and the West, including the EU, focuses on the political settlement outlined in the Minsk II agreements. The two main demands for Ukraine are to hold local elections at the territories controlled by separatists, and decentralization by granting autonomy to separatist territories.

A substantive part of the Ukrainian public resents this external pressure. Ukrainians feel insulted that their sovereignty has been blatantly taken away from them by Russia and that, in a sense, the West follows a similar approach. In addition the West does not require that Russia must withdraw from Ukraine, including Crimea, and pay the damages for the destroyed lives and property. Finally, there is no international pressure on Russia to release Ukrainian citizens it kidnapped, or that Russia lets Ukraine take control of its state border in eastern Ukraine.

This position is viewed by the Ukrainian public as fundamentally unfair. Any actions that can be interpreted as legitimizing the separatist regimes of Donetsk and Luhansk Republics risk causing more violence and destabilization of an already fragile political equilibrium in Ukraine.

Without public support in Ukraine, any political resolution will not be sustainable. Having Ukraine's political elites on board is not enough. A case in point is the political settlement between Mr. Yanukovich and the opposition leaders in February of 2014, mediated by the Western and Russian representatives. This settlement was rejected by the public and Yanukovich's regime fell just days after.

#### **4. Understanding causes of the conflict in the east of Ukraine**

At the time of the beginning of the insurgency in the east of Ukraine in April 2014, some observers predicted that the separatist movement would spread to other parts of southeast Ukraine, throughout the vast territory Russian President Vladimir Putin referred to as historical "Novorossiya".

Contrary to these forecasts, the insurgency remained surprisingly contained. No region outside Donetsk or Luhansk experienced large-scale armed conflict or fell under

separatist control. Not only were separatists unable to realize the project of a greater “Novorossiia” stretching from Kharkiv to Odesa, they failed to consolidate their grip even within the borders of the Donbas. Not more than 63% of municipalities in Donetsk and Luhansk oblasts were under separatist control at any time during the first year of the conflict, and less than a quarter of these territories showed resistance to Ukrainian government forces during Kyiv’s attempt to liberate them in the spring and the summer of 2014.

In order to design the best policy to resolve the conflict it is important to understand the causes for local variation in the intensity of the conflict.

The most common answers to this question in the press and policy analysis have fallen into one of two categories: ethnicity and economics. The first view expects insurgency to be more likely and more intense in areas home to large concentrations of ethnolinguistic minorities – in this case, Russians or Russian-speaking Ukrainians. According to this logic, geographically concentrated minorities can overcome some of the collective action problems associated with insurgency – such as monitoring and punishing defectors – while attracting an influx of fighters, weapons and economic aid from co-ethnics in neighboring states. Among others, Vladimir Putin too has cast the Donbas conflict as a primarily ethnic one: “The essential issue is how to ensure the legitimate rights and interests of ethnic Russians and Russian speakers in the southeast of Ukraine”.

An alternative explanation for variation in insurgency intensity is economic opportunity costs. According to this view, as income from less risky legal activities declines relative to income from insurgency behaviour, participation in insurgency should rise. As Maidan and the Revolution of Dignity proclaimed adherence to European values and set the path towards Europe and away from the Customs Union with Russia, the opportunity costs of insurgency declined in the Donbas. As a heavily industrialized region with deep economic ties to Russia, the Donbas was uniquely exposed to potential negative economic shocks caused by trade openness with the EU, austerity and trade barriers with Russia. A rebel fighter with the Vostok battalion summarized this view: “Many mines started to close. I lost my job. Then, with what happened during the spring, I decided to go out and defend my city”.

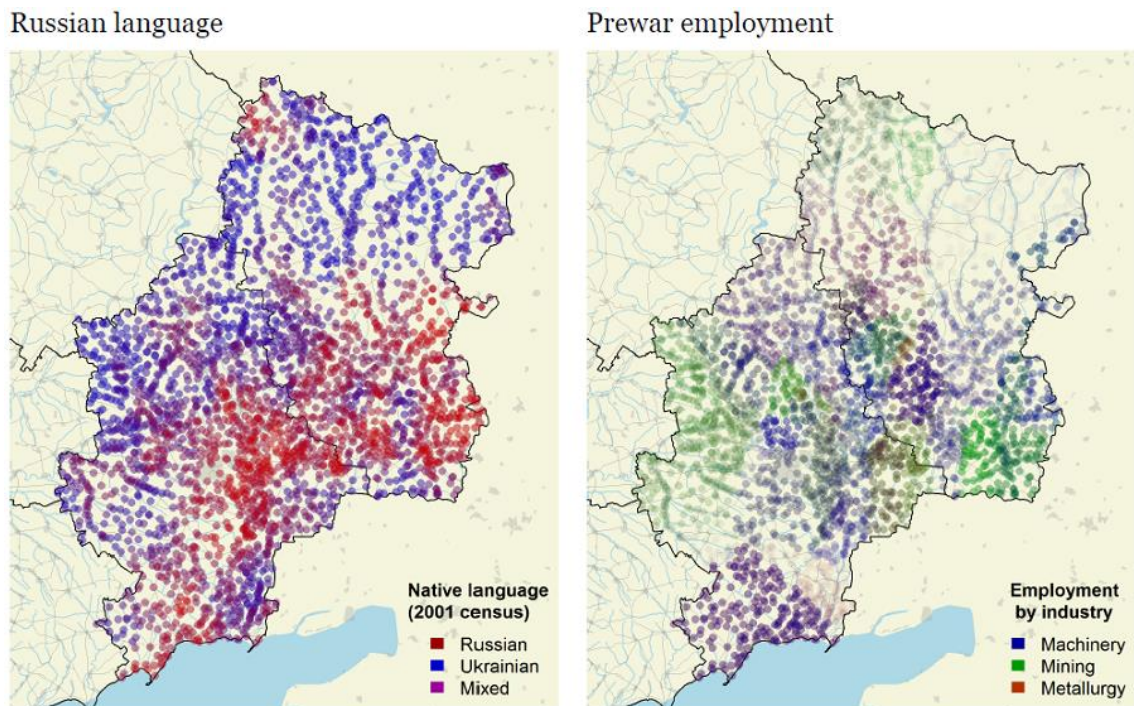
Micro-level data on violence, ethnicity and economic activity in eastern Ukraine allows evaluating the relative explanatory power of these two perspectives. The evidence suggests that local economic factors are stronger predictors of violence and territorial control than Russian ethnicity or language. Ethnicity only had an effect where economic incentives for insurgency were already weak. Separatists in eastern Ukraine were “pro-Russian” not because they spoke Russian, but because their economic livelihood had long depended on trade with Russia and they now saw this livelihood as being under threat.



The economic roots of the pro-Russian rebellion are evident from new data on violence and control, assembled from incident reports released by Ukrainian and Russian news agencies, government and rebel statements, daily 'conflict maps' released by both sides, and social media news feeds. The data include 10,567 unique violent events in the Donbas, at the municipality level, recorded between then President Viktor Yanukovich's flight in February 2014 and the second Minsk ceasefire agreement of February 2015. Figure 1 shows the geographic distribution of rebel violence and territorial control during the first year of the conflict.

To explain variation in the timing and intensity of violence and control, one can consider the proportion of Russian speakers residing in each municipality, and the proportion of the local labour force employed in three industries, differentially vulnerable to post-Euromaidan economic shocks. These included machine-building, which is heavily dependent on exports to Russia, highly vulnerable to Russian import substitution, and currently lacks short-term alternative export markets. At the other extreme, there is the metals industry, which is less dependent on Russia, and a potential beneficiary of increased trade with the EU. Finally, there is employment in the mining industry, which had grown dependent on Yanukovich-era state-subsidies, and became highly vulnerable to IMF-imposed austerity measures. Given the relative exposure of these industries to post-Euromaidan economic shocks, one should expect the opportunity costs of rebellion to be lowest in machine-building towns and highest in metallurgy towns, with mining towns falling in the middle. Figure 2 shows the spatial distribution of these variables. The analysis also accounted for a host of other potential determinants of violence, like terrain, logistics, proximity to the Russian border, pre-war electoral patterns, and spillover effects from rebel activity in neighbouring towns.

**Figure 2. Proportion of Russian speakers residing in each municipality, and the proportion of the local labour force employed in three industries**



A statistical analysis of these data reveals that a municipality's pre-war employment mix is a stronger and more robust predictor of rebel activity than local ethnolinguistic composition. In municipalities more exposed to negative trade shocks with Russia (municipalities with high shares of population employed in machinery and mining), violence was more likely to occur overall, and was more intense. For a median Donbas municipality, an increase in the machine-building labour force from one standard deviation below (4%) to one standard deviation above the mean (26%) yields a 44% increase (95% credible interval: a 34%-56% increase) in the frequency of rebel violence from week to week.

These municipalities – where the local population was highly vulnerable to trade disruptions with Russia – also fell under rebel control earlier and took longer for the government to liberate than municipalities where the labour force was less dependent on exports to Russia. On any given day, a municipality with higher-than-average employment in the beleaguered machine-building industry was about twice as likely to fall under rebel control as a municipality with below-average employment in the industry.

By contrast, there is little evidence of either a "Russian language effect" on violence, or an interaction between language and economics. The impact of pre-war industrial employment on rebellion is the same in municipalities where a majority of the population is Russian-speaking, as it is where the majority is Ukrainian-speaking. Russian language fared slightly better as a predictor of rebel control, but only under certain

conditions. In particular, where economic dependence on Russia was relatively low, municipalities with large Russian-speaking populations were more likely to fall under rebel control early in the conflict. The “language effect” disappeared in municipalities where any one of the three industries had a major presence. In other words, ethnicity and language only had an effect where economic incentives for rebellion were weak.

The seemingly rational economic self-interest at the heart of the conflict may seem puzzling, given the staggering costs of war. In the eighteen months since armed men began storming government buildings in the Donbas, over 8000 people have lost their lives, and over a million have been displaced. Regional industrial production fell by 49.9% in 2014, with machinery exports to Russia down by 82%. Suffering heavy damage from shelling, many factories have closed. With airports destroyed, railroad links severed and roads heavily mined, a previously export-oriented economy has found itself isolated from the outside world. If local machinists and miners had only known the scale of the destruction to come, the economic rationale for rebellion would surely have appeared less compelling. Yet when choosing between a high-risk rebellion to retain one’s economic livelihood, and an almost certain loss of income, many people chose the first option.

From a policy standpoint, the economic roots of the Donbas conflict should be seen as good news. Despite the ethnocentric media coverage of this war in Russia and the West, the data show that attempts to divide Ukraine along ethnic or linguistic lines are likely to fail. These results can also explain why the conflict has not spread beyond Donetsk and Luhansk. Home to a large concentration of enterprises dependent on exports to Russia, highly subsidized and traditionally shielded from competition, the Donbas became exposed to a perfect storm of negative economic shocks after the Euromaidan. No other region in Ukraine, or the former Soviet Union, has a similarly vulnerable economic profile. Without a compelling economic motive, a pro-Russian rebellion is unlikely to occur elsewhere in Ukraine.

## **5. Radicals in Ukraine**

The Euromaidan events have brought to prominence the previously marginal radical right party, All-Ukrainian Union Svoboda (the “Freedom Party”). Several other radical right wing groups have become more popular and powerful, among which Pravyi Sektor and several volunteer battalions. By now, most of the volunteer battalions have been integrated in the formal structures of the military and the police. However, their discipline and loyalty to the current government are uncertain.

This section assesses public and political support for the right wing movements in Ukraine, using the electoral results of Svoboda Party. Immediately after the Euromaidan revolution, representatives of the Svoboda party have occupied cabinet posts in the interim government. Yet in the presidential elections in May 2014, the two right wing

candidates, Yarosh (Pravyi Sektor) and Tyagnibok (Svoboda) have jointly earned less than 5% of the vote. Similarly in the October 2014 parliamentary elections, Svoboda's electoral support was minimal and, by a narrow margin, the party failed to cross the five percent threshold needed to obtain seats in the Parliament. In the local elections in the fall of 2015, the Svoboda party and radical candidates performed miserably. Despite the fact that over a dozen important mayoral seats across the country were hotly contested in the second round, and that protests broke out at least in two municipalities (Odessa and Kryviy Rig), they did not involve radical candidates. Furthermore, even though protests in Kryviy Rig attracted some of the politicians affiliated with the radical right and volunteer battalions, they did not play a leading role, nor has there been systemic violence. Foreshadowing the section on Crimea below, representatives of the radical right, and politicians and activists associated with volunteer battalions, have taken part in setting up the economic blockade of Crimea. But they have not played a prominent role, and have failed to gain political capital from these events. The question at stake is whether these developments merely represent a temporary setback for the right wing movement or if there are fundamental reasons why the radical right has limited popular support in Ukraine. If there are such reasons, then it is important to understand the future of the radical right and, specifically, of their leaders.

To answer these questions, let's go back to 2012 elections, prior to the Euromaidan events. In these elections, the radical right party Svoboda amassed over ten percent, which is a noticeable electoral result for a radical right-wing party. Scholars have attributed Svoboda's 2012 achievement in the parliamentary elections to a complex set of factors, including: dissatisfaction with the major parties, protest voting against President Yanukovych, anxieties associated with the 2012 language law, resonance of anti-establishment appeals with the voters, disappointment with economic and political corruption, xenophobia, economic downturn, and the re-emergence of pre-war legacies.

By now, some of these reasons have become obsolete (removal of President Yanukovich, anxieties associated with the language laws in 2012 and later), while others are again becoming more relevant (dissatisfaction with the major – new – parties, disappointment with economic and political corruption, and economic hardship). However, the Euromaidan events have opened possibilities for creating new parties and brought to public attention new faces recognizable en masse. Some of these parties and new political leaders appeal to many of the same reasons for support: frustration with the speed of reform, lack of justice, economic crisis, inability of the government to restore peace and order.

As a result, it is likely that the radical right will continue to face substantive competition, and there will be many more suitors for their original base of support. In response to these competitive pressures, radical right leaders and activists can respond in one of the following ways:

1. they can moderate their ideological position to appeal to a broader base of the electorate, aggressively competing with more moderate parties;
2. they can become even more radical in order to differentiate from the competition and appeal to their core supporters; and
3. they can become less politically active, and engage with the old and the new existing corrupt and power networks that are converting their political capital into power and economic rents that are protected from the electoral competition.

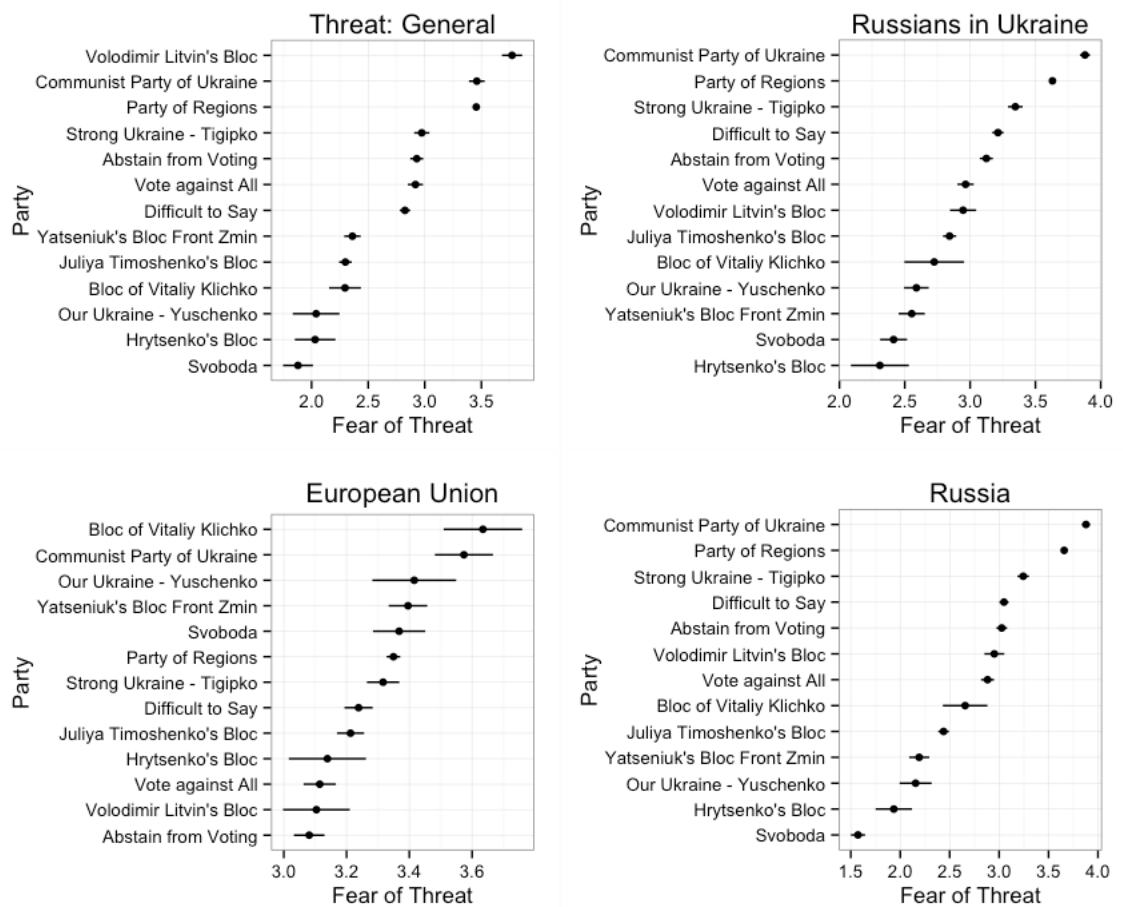
There is some evidence that the latter possibility is becoming a reality. Yarosh has resigned from the leadership of Pravyi Sektor and the public profile of the Svoboda leader Tyagnybok has dropped significantly. Similarly, the commanders of the volunteer battalions associated with radical right as well as those members of the battalions elected to the Ukrainian parliament have recently kept lower profile. At the same time, there are reports of contraband in the east of Ukraine and rumours of extortion undertaken by some new networks, possibly supported by the radical right. Some of these conflicts have become public. An example is a shootout between the government security forces and representatives of the Pravyi Sektor in Mukachevo in the west of Ukraine earlier this year. Allegedly, the incident started with a dispute between Pravyi Sektor and a local politician / businessman.

In order to assess whether the right-wing parties can move their political position further right, it is important to understand whether xenophobia played an important role in voting decisions. One might presume that anti-Russian sentiment drives Svoboda support. However a survey conducted in 2010 shows that support for Svoboda was rooted less in extreme levels of xenophobia vis-à-vis Russians, and more in economic anxieties and fears of losing sovereignty.

Figure 3 shows substantial differences across distinct sovereignty threats. Fear of general sovereignty threats was already high in 2010, at least among half of the parties. Figure 3 disaggregates sovereignty threats into three specific sources of threats, two from abroad and one domestic. Sovereignty threat from Russia (an external threat) polarized the respondents to a much greater degree than sovereignty threats from Russians in Ukraine (an internal threat), since voters embrace less centrist positions on threats and the extremes are further apart. The European Union is not feared at all: all respondents agree that the EU is not a danger to the Ukrainian sovereignty and this position holds for all types of political attachments.

Svoboda voters fear Russia, and fear Russians in Ukraine. However, heightened fears of Russia clearly separated Svoboda voters from all other voters (Figure 3). Svoboda voters are unique in their view of Russia as a sovereignty threat, but they are not extreme in viewing Russian citizens of Ukraine as a threat. Among Svoboda voters fear of Russia is high and unique, while their fear of Russians in Ukraine is high, but not unique, since voters of other, ideologically similar parties, exhibit similar levels of fear.

**Figure 3: Sovereignty Threats by Parties**

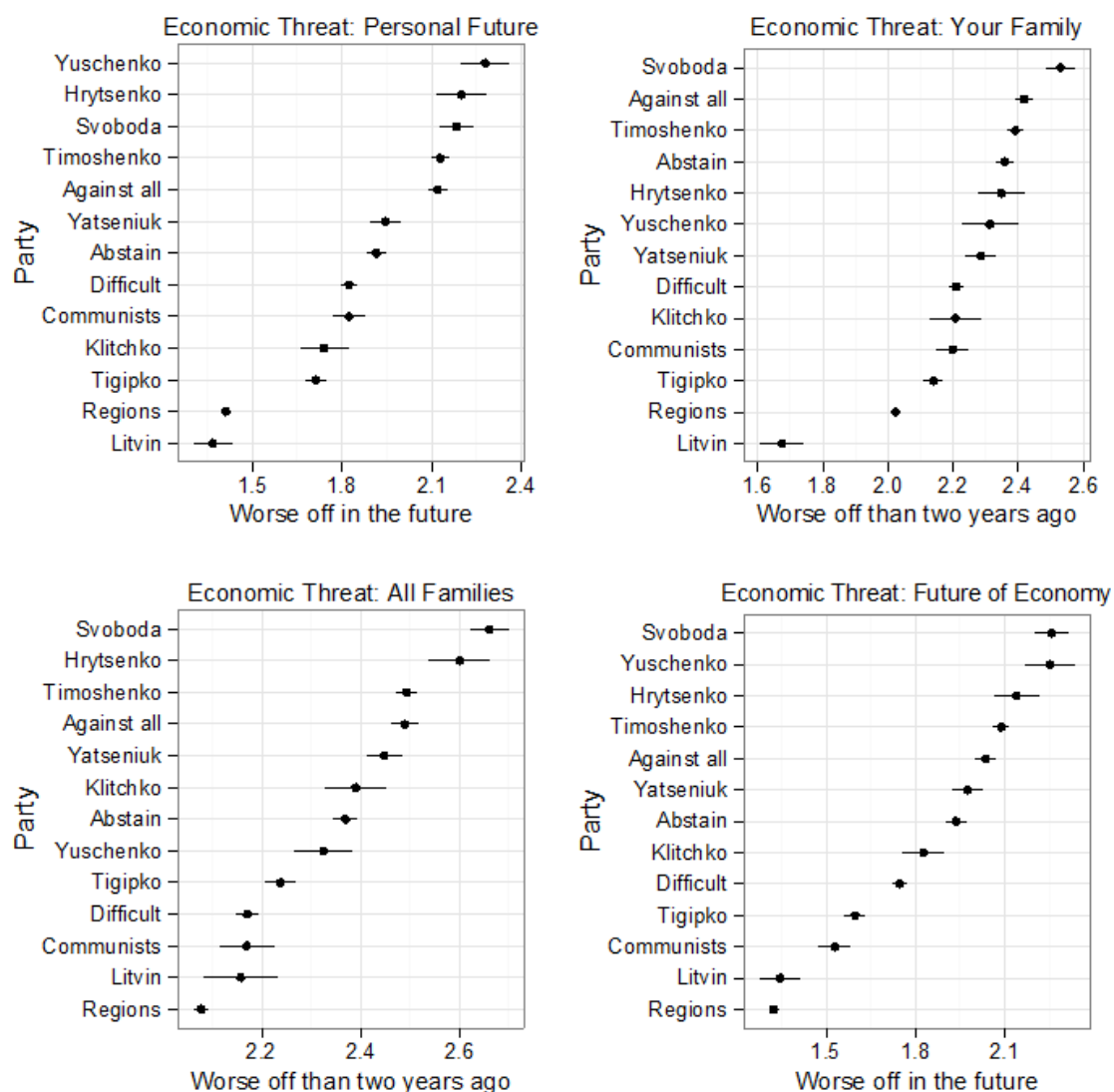


Means with weighted bootstrapped standard errors. Scale: 1 – agree that sovereignty is threatened, and 4 – disagree. Source: Bustikova, 2010

Is Svoboda support driven by economic anxieties? The results unequivocally show that Svoboda voters fear economic threats (Figure 4). Svoboda voters stand out in two aspects: they are distinct in agreeing that their family is worse off than two years ago, and that all Ukrainian families are worse off than two years ago. At a personal level, Svoboda voters expect to be worse off in the future.

The sense of economic depravity among the Svoboda voters is profound. There is a twenty percent gap between Svoboda voters and all other respondents in their (average) perception that their family financial situation has recently deteriorated. Responses to questions about economic threats indicate that Svoboda voters come from a pool of voters who deeply fear exposure to economic insecurity at the personal, familial and societal level (Figure 2). If support for Svoboda is driven in part by economic anxieties, we should expect that a deteriorating Ukrainian economy can potentially expand the voting base for the radical right. Nevertheless, there is aggressive political competition for that base.

**Figure 4: Economic Threat Perception by Parties**



Means with weighted bootstrapped standard errors. Scale: 1 – better, 3 – worse off.  
Source: Bustikova, 2010

The survey has shown that concerns about the state’s policies and fears about sovereignty threats trumped identity animosities. These findings should provide pause to claims that, at the core of Svoboda support, is a disproportionately high level of animosity against other ethnic groups in Ukraine, and that Svoboda represents an extreme xenophobic and “fascist” force in Ukraine. Although the levels of inter-group hostility were very moderate in 2010, the fact that they polarized the political system has contributed to the escalation of perceived identity threats.

The survey shows that Svoboda voters feared Ukrainian Russians more than the voters of other parties but, overall, the fear was very mild, yet in the case of Svoboda, distinct from other voters. During peacetime, this suggests that the Russian “fifth column” has strong potential to radicalize the radical right electorate. Given the outcome of 2014 elections and, in light of turbulent events, parties that demonstrated military competence and the ability to preserve Ukraine’s territorial integrity have the upper hand and have siphoned Svoboda’s supporters away. In times of crisis, physical security

issues force the electorate to coalesce behind strong-armed leaders, not parties with a niche appeal. Therefore, it is likely that the radical right leaders will see their political support waning over time. This will provide incentives for them to convert their disappearing political capital into positions within existing non-democratic power networks. If the Ukrainian government will succeed in rooting out such networks, the power of current leaders of the radical right will be diminished.

## **6. Crimea**

Crimea is a peninsula in the south of Ukraine which was annexed by the Russian Federation in March 2014 in the aftermath of the Euromaidan revolution. Since then the territory has been de facto administered by Russia. Crimea continues to be internationally recognized as Ukrainian territory.

Annexation of Crimea leads to several fundamental problems. First, it jeopardizes the viability of nuclear non-proliferation agreements. Second, annexation of Crimea resulted in political prosecution of Crimean Tatars and, more recently, in an economic blockade and disruption of electricity supplies to the peninsula. Third, Crimea appears to be a semi-legal channel to move goods from Ukraine to Russia.

In the mid-1990s, Ukraine abandoned its nuclear weapons it inherited from the Soviet Union and joined the 1968 Treaty on the Non-Proliferation of Nuclear Weapons (NPT). In exchange, three of the five permanent members of the UN Security Council, the US, Russia and UK signed, together with Ukraine, a Budapest Memorandum on Security Assurances. In this memorandum, US, Russia and UK assured Ukraine of its territorial integrity and political sovereignty. Annexation of Crimea and a hybrid war in the east of Ukraine has demonstrated that Russia abandoned the Budapest Memorandum. Despite the political pressure, the diplomatic, financial, and material support to Ukraine, and the sanctions imposed on Russia, the international community have not been able to ensure the sovereignty of Ukraine. In addition, the US and the UK have not taken an active role in mediating the conflict resolution in the east of Ukraine. These events undermine the ability of the West to credibly promise to protect sovereignty of the countries in exchange for joining and fulfilling the conditions of the non-proliferation treaty and similar agreements.

Even though the international community has not legally recognized the Russian control over Crimea, some of the EU politicians have offered indirect support. For instance in July 2015, a group of ten French parliamentarians visited occupied Crimea. The deputies were violating the western sanctions imposed against Russia for annexation of the peninsula.

The native population of Crimea is Crimean Tatars, and they constituted a majority of the population of the peninsula until mid-19th century. Today Crimean Tatars comprise approximately 12% of the population of Crimea. In 1944, the USSR resettled the majority



of Crimean Tatars from Crimea to Central Asia. From 1967, some of the population was permitted to return, and in 1989 the USSR parliament condemned the removal of Tatars from Crimea.

Following annexation of Crimea by Russia in 2014, Crimean Tatars have faced political prosecution. A number of Crimean Tatar leaders were not allowed to return to Crimea, many were arrested, their businesses raided, and their political / societal organizations and media outlets pressured. The Ukrainian government has failed to come up with a coherent and visible response policy to address the issue of Crimean Tatars, as well as other pro-Ukrainian population remaining in Crimea.

Consequently in the fall of 2015, frustrated leaders of Crimean Tatars started an economic blockade of the peninsula by manning the border check points with Crimea and preventing truck traffic between the mainland and the peninsula. The blockade was joined by some members of the radical right as well as by activists. There was no explicit action taken by the Ukrainian government to counteract the blockade.

The blockade is the first major development after the Russian annexation of the peninsula. Despite potential economic costs to Ukraine, the public seems to support the blockade. The main arguments for the blockade are political, including “political pressure against Ukrainians and Crimean Tatars. There are demands to cease political prosecution of Crimean Tatars on the peninsula.

Many of the supporters of the blockade also claim that most truck drivers do not have Crimea as their final destination, and so goods are further transported to Russia. A recent VoxUkraine article uses data on inbound/outbound ferry traffic between Crimea and Russia to show that a net outflow of trucks from Crimea to Russia was approximately 3000 trucks for the period of Apr-Aug 2015. This is consistent with massive smuggling of goods from Ukraine to Russia through Crimea.

This amount of traffic requires meticulous coordination at various levels. Whether the permission for this trade is tacit or explicit, motivated by profit or care for Ukrainian citizens in Crimea is an open question.

Currently Crimea is, according to Ukrainian law, a free economic zone. Therefore, goods supplied from Ukraine to occupied Crimea are treated similarly to exports, chiefly in terms of VAT payments and refunds. Prices in Russia for the majority of goods are higher than in Ukraine, and absence of double taxation makes the difference even larger, and this difference is the reason behind the ‘net outflow of tracks’.

What are the effects of the blockade on the economic situation in Crimea? Another recent article by VoxUkraine estimates that the blockade increased prices of grocery products in Crimea by approximately 10 percent more in Crimea than in mainland Ukraine. There is a likely further increase in prices in Crimea.

After initiating the economic blockade, Tatars announced that they plan to cut supply of electricity from mainland Ukraine to Crimea. Soon after, on November 21-22, there was

a complete blackout of the Crimean peninsula due to the damage of high poles of electric mains next to the border. No one has taken the responsibility for the action, although the persons manning the blockade have been keeping the engineers away from the site in spite of being confronted by the police.

This event has caused a number of discussions in the media on the possible consequences of such an action – from Russian retaliation (military and via energy supplies) to the serious technical difficulties in the Ukrainian Energy System. However, none of these adverse consequences have materialized up to the date of writing this article.

### **Internal security conflicts and risks of separatism in other regions**

Odessa and Kharkiv regions of Ukraine are potentially at risk of pro-Russian separatisms. Attempts to destabilize these regions took place at the time of the beginning of the insurgency in the East and, to a smaller extent, continue to occur up to the present.

Ukraine also borders with Moldova and, specifically, Transdnistria, its breakaway region. Recently, the government officials in Moldova reiterated the demand for the Russian troops withdrawal from the Moldovan territory to Russia's new military attaché. Moldova suspended its relations with the previous attaché after he attended a military parade in Transdnistria.

The evidence presented in this section on the causes of the insurgency in the east of Ukraine suggests economic roots. Other regions in Ukraine do not have a similarly sensitive economic profile. It is likely that a risky rebellion was a more attractive option right after the peaceful annexation of Crimea, and before the horrors of full-scale warfare in the Donbas. Any sympathizers in the Kharkiv and Odessa regions, and possibly in other regions, are less eager to join after they have observed the destruction (in terms materialized costs of a rebellion as opposed to thinking about costs without any experience of it) of the Donbas than they were in May 2014.

## **7. Trade Agreement between the EU and Ukraine**

On the 1st of January 2016, a Deep and Comprehensive Free Trade Area (the so-called DCFTA) should be established by the Association Agreement between the EU and Ukraine. With 486 articles, this is one of the most ambitious and comprehensive bilateral agreements the EU has ever concluded.

One of the key elements of the agreement is that it establishes a Free Trade Area (FTA) between the EU and Ukraine. This implies that tariff duties paid when selling goods between Ukraine and the EU will, in most cases (99% of present trade value), progressively decrease to zero.

Three specific features are important: First, the agreement is asymmetric. The EU will drop its tariffs almost immediately and fully after the DCFTA is established. By contrast, a phase-in period of up to 10 years will exist for Ukraine, in order to reflect the difference in industrial competitiveness between the two areas.

Second, in the context of a very challenging economic situation for Ukraine and Russia's pressure to undermine or delay the agreement, the EU has been unilaterally implementing the tariff part of the agreement since end of April 2014. This means that for most goods, Ukrainian exporters can already access the EU market duty free.

Third, one substantial exception to full tariff liberalization on the EU side is agriculture where certain exports are also duty free, but only up to certain quotas. This does not mean that exports are prohibited once the quotas are exhausted, but that duties have to be paid to export above the quotas.

A key characteristic of the agreement is that it does not prohibit a country from entering into free-trade relations with as many trade partners as it wishes to. This includes customs unions such as the EU. Therefore nothing legally prohibits Ukraine from maintaining its FTA with Russia while simultaneously at the same time implementing fully the DCFTA. This undermines the Russian narrative that because of the DCFTA, Ukraine would have to give up the existing preferred trade relations with Russia.

In addition to this FTA, which targets «tariff barriers», the DCFTA includes a normative part which envisages that Ukraine will progressively adopt a very substantial part of the «EU acquis» aiming at eliminating most «non-tariff barriers». It means that the rules of the EU internal market in a wide number of fields (technical standards, sanitary and phyto-sanitary rules, public procurements, competition, intellectual property, etc.), will progressively be applied in Ukraine, and be based on reformed Ukrainian legislation.

The DCFTA foresees that convergence to EU rules will happen over several years. Benefits of approximation for Ukraine are two-fold. On the external markets, it will give much easier access for Ukrainian companies to the EU, since rules will be the same as on the national market. On the internal market, it will increase the protection of Ukrainian consumers while at the same time favour a deregulation process to the benefit of companies, as European rules are much more business friendly and less burdensome.

A joint study carried out in 2011 by the German Advisory Group and the Institute for Economic Research and Policy Consulting (Quantitative Assessment of Ukraine's Regional Integration Options: DCFTA with European Union vs. Customs Union with Russia, Belarus and Kazakhstan) envisages that the welfare of Ukrainian consumers would increase by 11.8% over the medium run. This is substantial, but far from what is necessary to transform the Ukrainian economy.

However, there are good reasons to predict that the DCFTA could boost the Ukrainian economy far beyond these figures. Adopting EU norms and standards, combined with

duty free trade, will attract investors and technology transfers from Western Europe, and from other leading economies.

This will help to transform the Ukrainian economy from an exporter of mostly raw materials and agricultural products, to a player fully integrated into the EU and global value chains: a substantial leap in terms of added value of its production. However to achieve this, a key precondition for achieving this outcome is that the instability created by military and economic aggression progressively decreases, and that ongoing reforms deliver results on corruption, rule of law, etc., in order to improve the business climate.

The DCFTA itself should enter into force provisionally on the 1st of January 2016. The fact that this implementation will be «provisional» does not mean that the EU is reluctant to implement the agreement fully. It simply means that according to EU rules, an international agreement between the EU and a third country must not only secure the consent of the EU Parliament, but must also be ratified by the relevant authorities of all EU Member states. Today a majority of member states have already completed this step. On the 1st of January, the process will probably still be ongoing, and this is the reason why such a provisional implementation is foreseen, in order to avoid further delays.

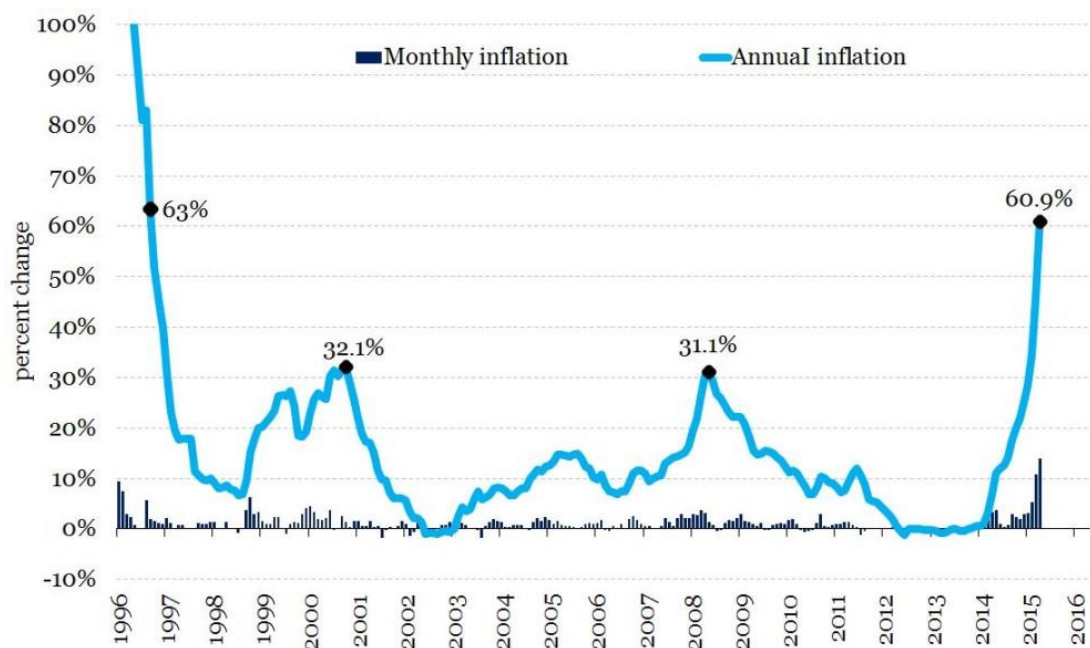
## **8. Social hardship**

The Euromaidan revolution and the consequent annexation of Crimea and the war in the east have plunged Ukraine into an economic crisis. Ukraine has experienced a double digit contraction in GDP, high inflation and increased unemployment. This imposed a substantive burden on many people and businesses in Ukraine.

With high inflation and high unemployment, inequality rises sharply as nominal incomes of different groups of population adjust differently to a new price level. In Ukraine, growing inequality already becomes evident from official wage and pension data. Average monthly wages went up by around 14% year-on-year in March 2015, with some sectors with traditionally low salaries (like healthcare, education, public administration) registering growth of 3-5% only; and others having relatively high salary level (namely trade and IT,) seeing a rise of over 40%.

On May 6, the State Statistics Service of Ukraine (Ukrstat) published inflation figures for April, which showed that Consumer Price Index, a standard measure for inflation, accelerated to a multi-decade high of 60.9% year-on-year (Figure 6). The last time Ukraine had such a high annual inflation was in September 1996, the birth month of the Hryvnia. After the adoption of the Hryvnia, Ukraine never had annual inflation higher than 30%, except for two brief periods, in late 2000, and mid-2008.

**Figure 6. inflation rates in Ukraine using the Consumer Price Index**

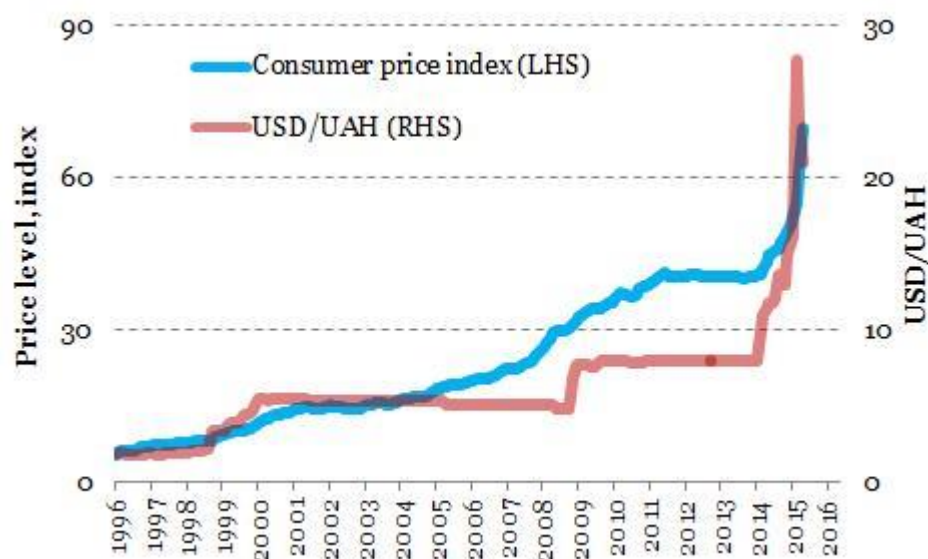


Source: State Statistics Service of Ukraine (Ukrstat)

### Drivers of inflation

There were two fundamental factors behind the rise of inflation. First, Hryvnia devaluation (Figure 7). Since the beginning of the crisis in early 2014, Hryvnia devalued by approximately 200 percent, roughly two-thirds against the US dollar (Figure 7). This increased the cost of imported goods and materials, and given Ukraine's high dependency on imports (which constitute roughly half of GDP), the depreciation fed through into prices. Second, over the past year energy tariffs increased massively, as they were brought closer to cost recovery levels.

**Figure 7. Hryvnia devaluation**



Both of these shocks are one time events and, thus, persistently high inflation is unlikely. However, if the government fails to contain inflation, inflation will be highly destructive for the economy as it leads to planning uncertainty, inefficient allocation of resources, distortion in economic incentives, and redistribution of income and wealth. If inflation pressure intensifies beyond the low and stable level, especially as a result of external shock, it becomes destructive for the economy for many reasons, such as planning uncertainty, ineffective capital allocation, distortion in economic incentives, redistribution of income and wealth, menu costs.

**Figure 8. Average salary in different employment sectors**

	average salary/ pension, March	year-on-year increase	share of population	
<b>Sector:</b>				
Manufacturing	4578	17%	7.2%	
Financial services	8008	9%	0.7%	
Trade	4261	24%	10.0%	
Health care and social assistance	2473	5%	2.8%	} <b>ca. 40%</b>
Education	2728	5%	3.7%	
Public administration	3765	3%	2.3%	
Pensioners (as of beginning of 2014)	1526	4%	29.7%	
Inflation (April)		61%		

Because most low- and of middle-income households typically have fixed incomes in local currency (pensioners, budget sector employees, students, etc) and limited savings, these household suddenly become impoverished. At the same time, high-income wealthy households and individuals usually have larger and inflation-protected incomes and savings ( in the form of real estate, and foreign currency), and thus suffer little or even gain. Their consumption is unable to compensate for the loss of consumption by

the poorer population. This aggravates the contraction in the economy and creates social tensions.

The current crisis is more painful than anything Ukraine had in recent decades, and has already exacerbated this challenge. For instance, during the 2009 crisis that followed several years of credit-led boom, household consumption declined by almost 15% year-on-year, led by the 42% drop in households' spending on transport, mainly through purchases of imported vehicles. However, other types of spending experienced relatively minor contractions. The economy thus endured necessary adjustments following several years of overconsumption. The pattern of consumption decline is different during this crisis. For example, food consumption, which accounted for around 37.5% of total household spending in 2014, dropped by 14.2% year-on-year last year and was the leading factor of 9.8% decline in households' consumption, signalling that consumers are economizing on basic goods.

Rapidly rising inequality urges for quick adoption of targeted and means-tested social assistance. This assistance may need to be increased to sustain minimum necessary consumption levels by the poor. Extraordinary budget revenues obtained due to high inflation should be used to enhance assistance to those who are poorer.

## **9. Corruption**

The Euromaidan Ukraine has undertaken a serious anticorruption legislative effort. Multiple registries have been open, and new anti-corruption institutions created. However there are no high profile successful prosecutions of anyone implicated in corruption or abuse of power under the previous or the current government. During his visit in the beginning of December 2015, US Vice President Joe Biden delivered a fierce speech in the Ukrainian parliament, chastising the Ukrainian political elites for their failure to eradicate corruption. Surveys consistently show that corruption is considered to be among the top problems, by both the public and businesses, and there is no sign that the situation is improving. In early 2016, the Minister of Economy has resigned accusing a close presidential ally of corruption and political pressure. Shortly after, a Deputy General Prosecutor resigned accusing the General Prosecutor of blocking the reforms. These and other resignations have caused a major political crisis in Ukraine, with the President asking the General Prosecutor and the Prime Minister to resign. However, the parliament failed to express the vote of no confidence to the government. At the time of writing this chapter, the political crisis in Ukraine is unfolding.

However, corruption is not the cause of the problems in Ukraine but rather is a symptom of underlying institutional problems. Corruption occurs because of weak property rights, rent seeking activities of politically connected businesses and individuals, lack of transparency, and an uneven playing field, where the rules of the game differ depending on one's connections.

## **10.Success of conditionality of the IMF program with the new government**

Ukraine is going through a major transformation of its political and economic landscape. Because the main losers from key reforms (anti-corruption, deregulation, etc.) are the “old” elites, these players are interested in delaying and watering down reforms so that they can preserve their power, rents, and access to government contracts. As a result, the reform process has been painfully slow . Indeed, old elites continue to play a significant role in the government and thus they can create an effective barrier to rapid changes. For example, it took over four months to appoint a Chief Prosecutor to the National Anti-Corruption Bureau. Civil society puts pressure to proceed with reforms as quickly as possible. But the public’s efforts are dispersed and uncoordinated, and they lack resources (financial, media, etc.). In this environment, a central pro-reform force has turned out to be the conditionality of aid given to the Ukrainian government.

Ukraine badly needs financial resources to cover its fiscal deficit, recapitalize banks, etc. Given that the government does not have the capacity to borrow in domestic or international capital markets, the operation of the government critically depends on loans, grants, etc., it receives from the IMF, EBRD, WB, and other donors. Thus, international financial institutions (IFIs) and donor governments have significant leverage to influence domestic policy in Ukraine by making financial support conditional on progress made by the Ukrainian government.

The IMF is a leading example of using conditionality to achieve its goals. To a large extent, this approach is motivated by the history of the IMF-Ukraine relationship: before 2013, Ukraine participated in many IMF programs but it received only the first tranche from the IMF, and did not receive subsequent tranches because the Ukrainian government failed to meet the targets set by IMF programs. To ensure compliance, the IMF now uses quantitative targets and clear deadlines for completion for the post-Maidan government. In many cases, the commitment of the IMF to not disburse funds until a target is hit was the reason why the Parliament and the government pushed through legislation to further reforms. This “tough love” has proven to be one of the strongest incentives to implement measures unpopular among the current elites or the voters. For example, in July 2015, under threat of not receiving the second tranche of the IMF’s EFF program, Verkhovna Rada voted a law requiring local utilities to set prices above their costs. In private, some government officials admit that if a piece of legislation were not an IMF requirement, nothing would have happened.

## **11.Conclusions: Recommendations for the EU**

The EU policy with respect to the resolution of the crisis in Ukraine has focused on the following directions: mediating the security crisis resolution through the Minsk I and



Minsk II agreements, the trade agreement between the EU and Ukraine, financial assistance to Ukraine, and technical assistance with reforms.

The security risks in Ukraine include continuing pressure from Russia to undermine the legitimacy of the new government, the economic and security destabilization in the east and inside Ukraine, resurrection of the old kleptocratic power networks and the creation of new ones, economic instability, and frustration with the government and the situation in general by the public and businesses. These risks are aggravated by the weak institutional capacity of the government, and low competence and training of public officials.

If we accept the premise of this chapter that a key factor underlying the crisis is the economics, then the resolution of the crisis should address the issue of restoring economic and political justice. This requires rebuilding the economy and providing the general public with economic opportunities. Creating such opportunities will undermine the ability of the networks interested in maintaining the conflict to gather support.

Political stabilization and legitimacy of the new political institutions and resolution are also key for overcoming the crisis. Ukrainians perceive both the new and old ruling elites to be corrupt, and thus a top-down approach is unlikely to gain support among the population. Mistrust will continue to prevail, and the reforms and conflict resolution policies are unlikely to be effective. Any resolution requires an inclusive settlement, and not a pact of political elites that are fuelling the crisis. Active civil society should play an important role in aggregating demands and claims in such a process.

It is possible that civil society is more active in the areas where the economic hardship is weaker. Thus providing economic opportunities and financial support to disadvantaged areas, such as in the east of Ukraine, can have the added benefit of activating engagement of the civil society in the conflict resolution and political processes.

The Ukrainian political elites respond well to strict conditionality in assistance. This policy should continue to be exploited and strengthened in order to put pressure on the Ukrainian government to develop governance and political institutions in Ukraine. There are two caveats. First, the IMF is the locomotive of the assistance and conditionality for Ukraine. The IMF tends to require tight fiscal policies, which can exacerbate the economic recession in Ukraine. Second, the conditionality tends to focus, although not exclusively, on liberalization of the economy and dismantling the state control. This approach works well if the country can implement it. However, in the environment with weak institutional capacity, corrupt judiciary, uneven playing field, and insecure property rights, liberalization policies carry the risk of generating additional inequality and benefiting primarily the oligarch and the relatively well-to-do part of the society. If this happens, the legitimacy of the economic reforms, their long run sustainability, and the resolution of crisis in general will be undermined. Therefore, the conditionality should also include measures for restoring justice, and preventing corruption and abuse

of power. The EU does some of this in Ukraine but it is important to require the Ukrainian government to do more on the issues of prosecuting corrupt officials, introducing transparency and accountability of the government, cracking down on rent seeking and tax evasion. Finally the conditionality must be credible to be effective. The EU, the IMF and other donors should be ready to follow through on their promise to withdraw support if the Ukrainian government does not comply with the conditions.

Another critical risk is that pressure to implement the Minsk II agreements might backfire internally if the agreement does not gain legitimacy in the eyes of the Ukrainian public. We suggest that the effort to resolve the conflict at the top level through the Minsk II commitment should be complemented by initiatives that involve broader public and grassroots initiatives in conflict resolution processes. The crucial problem with Minsk II is that it does not address the threat to Ukraine of losing sovereignty. The EU can be much more vocal on this issue, insisting on including broad representation of the Ukrainian public in the conflict resolution process. It is up to Ukrainians to figure out how they should govern themselves, and how they should resolve the conflict in the east of Ukraine. Any resolution imposed from the top is unlikely to be viable as it will not be accepted by the people.

Finally, financial assistance to Ukraine is itself a security risk as the funds can be diverted or wasted, and can be used to increase the power of the politicians controlling the distribution of this assistance. In order to address this risk, we suggest that the EU should create effective competition among those in Ukraine who look for financial and technical support. In particular, the EU should identify watchdog initiatives outside of the government, and not rely on the government and their local offices to decide whom to fund. In addition, the EU can change the strategy from going top-down to bottom-up; that is, while it is relatively easier to give the funding to the government of Ukraine and let the government distribute the funds, a more effective way would be to fund grassroots movements to build a robust civil society, and put pressure on people in the government. It is a more work intensive approach, but it will be more effective: it creates more competition, gives resources to active parts of the society, and is less bureaucratic/more adaptive/responsive to changing environments. One of the concerns might be that this competition will create infighting among civil society groups. Nevertheless, we believe that this risk is not too critical since the groups today already compete for the resources handed out by the government. The governmental control (as an intermediary between Western assistance and the civil society) cover a substantive share of the funding for civil society initiatives, creating an agency problem that makes the civil society depend on the government.

In short, we argue for creating economic opportunities for the general public (economic resolution) and using bottom-up approach to include all parts of the society in deliberation of how to resolve the conflict (political resolution). These policies should be complemented by strict conditionality of the support from the EU that requires anti-

corruption policies that (a) dismantle the state economy, but (b) more importantly, dismantle rent-seeking networks of oligarchs and restore justice.