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Ukraine facing bankruptcy

By Richard W. Rahn

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Ukraine will likely go bankrupt within the next few months. This past Friday, it was reported that the country has less than \$10 billion in foreign-currency reserves. My sources (who have been spot on the Russian/Ukrainian situation over the last couple of years) tell me the situation is actually worse than the official reports in that Ukraine is now losing foreign reserves at a rate of \$3 billion a month and that rate is accelerating. Even worse, some of the reserves may be "illiquid" - which likely means they have already been spent or even stolen.

Russian President Vladimir Putin very well understands the situation in Ukraine; hence, he may sit back and not try to grab any more territory for the moment and just wait for the Ukrainian economic collapse. The big unanticipated drop in oil prices is hurting Russia and so Mr. Putin has an added incentive not to take on additional military expenses at this time.

Last April, the IMF approved a \$17 billion dollar support agreement for Ukraine. The announcement was made with all the typical pledges to reform and, most importantly, to reduce corruption. The managing director of the IMF, Christine Lagarde, said at the time: "Showing unprecedented resolve, the authorities have developed a bold economic plan to secure macroeconomic and financial stability and address long-standing imbalances and structural weaknesses to lay a firm foundation for high and sustainable growth." Specific necessary changes were detailed out, including greatly reducing corruption. Virtually none of the pledges have been met, and many knowledgeable observers argue that corruption has not diminished. So much for "unprecedented resolve."

Where has all the money gone? The ongoing, low-level, war with Russia is often given as an excuse, but the fact is that Ukraine is now spending less than one percent of its gross domestic product on the military. (The United States currently spends 3.5 percent of its GDP on the military, and Russia now spends about 4.1 percent of its GDP on the military.) Much of the Ukrainian budget appears to have been spent on various vote-buying schemes and old-fashioned graft.

The Ukrainian army is now being largely supported by civilian efforts, including individual citizens sending food and clothing to the soldiers on the front lines, and various business people buying weapons, including some heavy weapons. Bizarre as it may seem in the modern world, volunteers are to a large extent funding the defense of the country. (The American army during the time of the Revolutionary War, under Gen. Washington, was also heavily supplied by the efforts of civilians, including leading businessmen, because the states were often well behind in funding their pledges, which were insufficient to begin with.)

This past week, Ukraine's parliament appointed a new pro-Western government that includes three foreign-born experts in an effort to stave off financial collapse. The new finance minister is the well-regarded former U.S. diplomat and private-equity fund manager, Natalie Jaresko. But all of this may be too late. Last spring, a number of experienced foreign economic advisers, including the late Kakha Bendukidze, the principle architect of the Georgian economic miracle, developed a recovery plan for Ukraine, which has been largely ignored. Ukraine has no shortage of good economists who know what needs to be done - but that is far different from getting the political actors to do what is needed, particularly when they perceive the necessary economic reforms being contrary to their own short-term economic interests. Having been an economic adviser to top officials in the Russian and Ukrainian governments, and others, during the transition period of more than two decades ago, I well understand the difference between providing a road map to economic growth and seeing it implemented.

As the Ukrainian government runs out of money, what will be the response from the United States and other western governments, and the international institutions like the IMF? Providing more financial aid without reform is a waste of money and will not lead to an improved situation. Doing nothing and letting Ukraine fall totally under Mr. Putin's direct or indirect control will only encourage him to continue nibbling away at his neighbors. Based on past history, what we can expect from the Obama Administration, the Europeans, and the IMF are a number of half-way measures that are unlikely to work.

Ukraine and its neighbor, Poland, were in much the same situation a quarter of a century ago. The Polish people and their leaders had the resolve and wisdom to make the necessary economic political reforms, including getting rid of most of the corruption. Too few Ukrainians demonstrated the resolve, nor did they elect quality leaders. As a result, Poland is a free country with three times the real per capita income of Ukraine. Until the Ukrainians show the resolve and wisdom of the Poles, there is little that outsiders can do to help.

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