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The Economics of Limiting Russia’s Expansion

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In the United States and Western Europe, discussion is focused on stopping Vladimir Putin from further expanding Russia’s territory. On present course, the West’s strategy looks set for more failure; only a major shift in economic strategy by the Ukrainian government is likely to make a significant difference. Giving or lending lots of money to Ukraine is unlikely to help and may even be counterproductive.

Ukraine’s economic failure over the last two decades is astounding. When the Soviet Union broke up in 1991, Ukraine’s gross domestic product per capita was greater than Romania’s, slightly higher than Poland’s and about 30 percent less than Russia’s. Today, Poland and Romania enjoy more than twice Ukraine’s income per person and Russia nearly triple.

This dismal performance reflects partly a lack of natural resources, but also self-interested leaders who have lined their pockets rather than focus on growth. The Orange Revolution of 2004 brought Viktor Yushchenko to the presidency,
after more than a decade of pervasive corruption, but this episode proved to be a great disappointment. The Yanukovych years that followed were even worse.

Ukraine’s economic situation has recently become more desperate. If Ukraine is to pay all of its bills, the amount needed over the next two years to make debt payments and cover the budget deficit on its current trajectory add up to nearly $40 billion. These bills are growing daily because of the severe disruptions caused by the loss of Crimea, the continuing instability in eastern Ukraine and the nonpayment for gas deliveries from Russia. Because of the West’s unbending support for the current Kiev government, many Ukrainians expect large and generous support to help the nation out of this mess.

Western diplomatic actions in recent months have created nothing short of a fiasco for Ukraine and some of its neighbors. Diplomats overtly welcomed the change to an anti-Russian government in Kiev, and they celebrated the flight of the pro-Russian President Viktor Yanukovych. We were all pleased to see some highly corrupt politicians toppled, yet, in the midst of all these intrigues, some news organizations and diplomats lost sight of the end game with Russia.

With no credible military threat and an unwillingness of politicians to inflict pain by applying sanctions against Russia similar to those imposed on Iran, Western politicians proved toothless. The Germans do not want to disrupt the supply of gas from Russia, the British do not want to undermine their status as a financial haven, and the Americans are concerned about reprisals against their companies with large exposures in Russia (e.g., PepsiCo, Exxon or Citigroup).

In a series of moves that appear to have been planned carefully, Mr. Putin has taken Crimea, won huge popular support in Russia and in much of Crimea and left the West holding financial responsibility for the rest of Ukraine.

There is no doubt that Russia may seek to annex more parts of Ukraine. Russian military intervention is possible, but the Crimean strategy has proven much easier. Time and momentum are on Russia’s side, so Mr. Putin can be patient. If Ukraine’s eastern and southern regions continue to flounder while
Russia grows richer, it is only a matter of time before large separatist movements will develop in these areas.

Russia will make a success of Crimea as an example for others: pensions, government wages and other incomes can roughly double to meet Russian averages. The experience of debate and referendums in Quebec, Scotland, Catalonia and other regions all point to plausible democratic routes to exit that Russia can encourage.

A stable Ukraine, with an economy that catches up to its neighbors, is the best defense against disintegration. There is a chance to keep Ukraine united with its current borders (less Crimea), but it would require a striking change in Ukrainian economic strategy – something very hard to pull off with so many levers of power in the hands of the established political elite, who remain well entrenched.

Russia controls many of the levers for Ukraine’s success. It is Ukraine’s largest trading partner. Ukraine is heavily in debt to Russia and relies on Russia for most of its energy imports. Russia has been selling Ukraine natural gas at well below world prices. Russia also has substantial ability to promote riots, political intrigues and general instability. In short, unless Ukraine can normalize relations with Russia, it has little hope for growth.

In contrast with Russia’s influence, the West’s ability to affect Ukraine’s success is highly limited. The idea of providing Ukraine with a big loan from the International Monetary Fund and other forms of external financial assistance will not help much and may even make things worse. Given the financial state of Ukraine, such money could easily be wasted before Ukraine turns again, as it eventually must, toward better relations with Russia.

Greater integration of Ukraine into Europe, through the European Union, could set the institutional framework better placed for growth. Yet the potential for such an association agreement is one reason Russia has chosen to bring more pressure. However, a trade pact does not resolve Ukraine’s entrenched corruption, and any success still relies on Russia’s cooperation. The European Union needs to engage with Russia as much as possible, but events in Crimea make this hard.
One thing that Ukraine could do soon, to encourage growth and harness the goals of the Maidan revolution, would be to move quickly, and in a high-profile manner, against all forms of corruption. In 2004 Georgia fired all its traffic police, then hired new officers, with higher salaries, better equipment and less inclination to accept bribes (see this Princeton case study for more detail). Simplification of the tax system, changes in regulatory policy and changes to the judiciary can also reduce corruption.

But to take all these actions requires political legitimacy, and this can only be acquired through new presidential and parliamentary elections. The European Union pact, any kind of I.M.F. program and large-scale moves against corruption require a government that can make long-term commitments and demonstrate political strength.

The current government was selected after violent street demonstrations and early on revealed an anti-Russian stance that is at odds with keeping the nation unified and with harmonizing relations with Russia. Until there is political capacity to achieve significant reduction in corruption, Ukraine’s growth prospects and its ability to remain unified, remain limited.

This post has been revised to reflect the following correction:

**Correction: March 20, 2014**

Because of an editing error, an earlier version of this post misidentified the leader brought to power in Ukraine in 2004. It was Viktor Yushchenko, not Viktor Yanukovych.