

# Financial Chernobyl Threatens Kiev's Moderates

By [Vladimir Fedorin](#)

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The turbulent Ukrainian economy is chillingly reminiscent of Russia's economy in 1998. Ukraine's president, prime minister and National Bank chief recently called on the country's largest exporters and banks to help stop the attack on the national currency, the hryvna. According to one blogger writing for Ukrainian Pravda, President Petro Poroshenko told businesspeople that yes, he is a liberal, but the exchange rate should not exceed 12.05 hryvnas to the dollar.

The official exchange rate has fallen 18 percent since early summer to 13.9 hryvnas to the dollar, with some banks trading between themselves at 15 hryvnas to the dollar. Ukrainian Prime Minister Arseniy Yatsenyuk has already voiced the word "panic" and the National Bank of Ukraine has placed new restrictions on importers and banned individuals from selling more than \$200 per day.

If the public loses faith in the hryvna, even major gold reserves would prove unable to halt its fall — and Ukraine's reserves barely cover three months of imports. Banks have lost a third

of their deposits since the start of the year with no slowing in sight. The National Bank has used administrative measures to staunch the outflow, but so far it has only managed to cause the appearance of multiple exchange rates. That is not a sustainable solution to the problem and the International Monetary Fund, Ukraine's main creditor, is unlikely to permit the country to become a second Venezuela.

International donors and domestic depositors have lost confidence in Kiev's economic policy, the latter hurrying to convert their holdings into dollars. Earlier this week, the European Union's delegation in Kiev announced that Ukraine would not receive its next credit tranche aimed at stabilizing the macroeconomic situation until the authorities put the state's finances in order — and in particular, not until they publish a draft of the national budget for 2015. The Ukrainian authorities already missed a Sept. 15 deadline for submitting that draft budget to the Ukrainian parliament, the Verkhovna Rada.

I recently discussed the condition of the Ukrainian budget with a group of economists who write a blog called VoxUkraine. They raised the specter of a "financial Chernobyl" in which the Ukrainian budget suffers a total collapse and the IMF aid program breaks down. That scenario is looking increasingly likely: IMF specialists wrote in early August that Ukraine faces an external financing deficit of \$1.1 billion by year's end, even if all scheduled financial assistance stays on track. However, the EU already has doubts about supporting a government that cannot even prepare a budget on schedule.

To better understand the dynamics of the Ukrainian crisis, I looked again at the book "Great Revolutions: From Cromwell to Putin" by Irina Starodubrovskaya and Vladimir Mau. The authors describe how "moderates" often take power in a revolution's early days but are then unable to stabilize the state's finances. Then, after one or more attempts, radicals seize power and complete the revolution by balancing the budget.

Kiev's Maidan protests started out as a typical bourgeois revolution aimed at regime change, and not at a radical breakdown of the state. That brought "moderates" to power, in the terminology of Starodubrovskaya and Mau. What legacy did those moderates inherit from the previous regime? By the end of last year, Ukraine ranked 109th in the world for per capita gross domestic product (\$3,920), placing the country between Mongolia and El Salvador. But in terms of government spending, Ukraine ranked 18th, with 48.2 percent of GDP, placing it between Iraq and Portugal.

The monstrous imbalance between the level of development and the scale of state intervention is the main problem facing the Ukrainian economy. However, few were ready to formulate the problem in those terms in March 2014. The state budget is essentially a monetary expression of the political system, and the coalition government of former President Viktor Yanukovich, as part of that system, intended not to break that policy, but to reinforce it.

Interestingly, not only did the government fail to see that the budget was incompatible with reality, but even the IMF missed overlooked that crucial point, agreeing to support Ukraine in exchange for only very modest reforms.

Describing the stalemate situation in Russia in the second half of the 1990s, Starodubrovskaya and Mau write: "A situation very similar to previous revolutions arose: Unable to collect taxes,

the government tried to solve the problem by introducing new taxes. There are two ways to break that vicious cycle: Balance the budget based on realistic possibilities, or lower taxes enough to stimulate greater compliance."

Ukraine faces the same dilemma now. Just like the government of former Russian Prime Minister Sergei Kiriyenko in 1998, Ukrainian Prime Minister Yatsenyuk's Cabinet has raised taxes and is attempting to tighten fiscal discipline. However, these measures have not enabled Kiev to break the vicious cycle.

The budget crisis has forced the National Bank to print more money, exacerbating devaluation and the enormous difficulties banks are already facing. At some point, the government might have to bail out the banks with budgetary funds.

To their credit, the moderates have a good feel for the prevailing mood among the elite and society. Just look at the slogans and candidates of the political forces running for the parliamentary elections in October. As before, the contest involves two main schools of thought, only this time it does not pit left-wing socialists against right-wing socialists, but those intent on rapidly spending international assistance against those advocating slower spending. The list of candidates includes out-and-out sociopaths, civic activists, second-rate businessmen, career politicians, crooks of all kinds and even major embezzlers of state funds.

The one group missing is reformers — leaders who understand that you should not favor short-term relief measures over long-term economic development. That means the moderates will ultimately fail in the economic task before them, leaving it to radicals now waiting in the wings to complete the Ukrainian revolution.

Vladimir Fedorin is the founding editor of Forbes Ukraine. This comment originally appeared in Vedomosti.

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