

Ukraine

A Net Assessment of 16 Years of Independence

A Report Prepared for the U.S.-EU Partnership
Committee for Ukraine

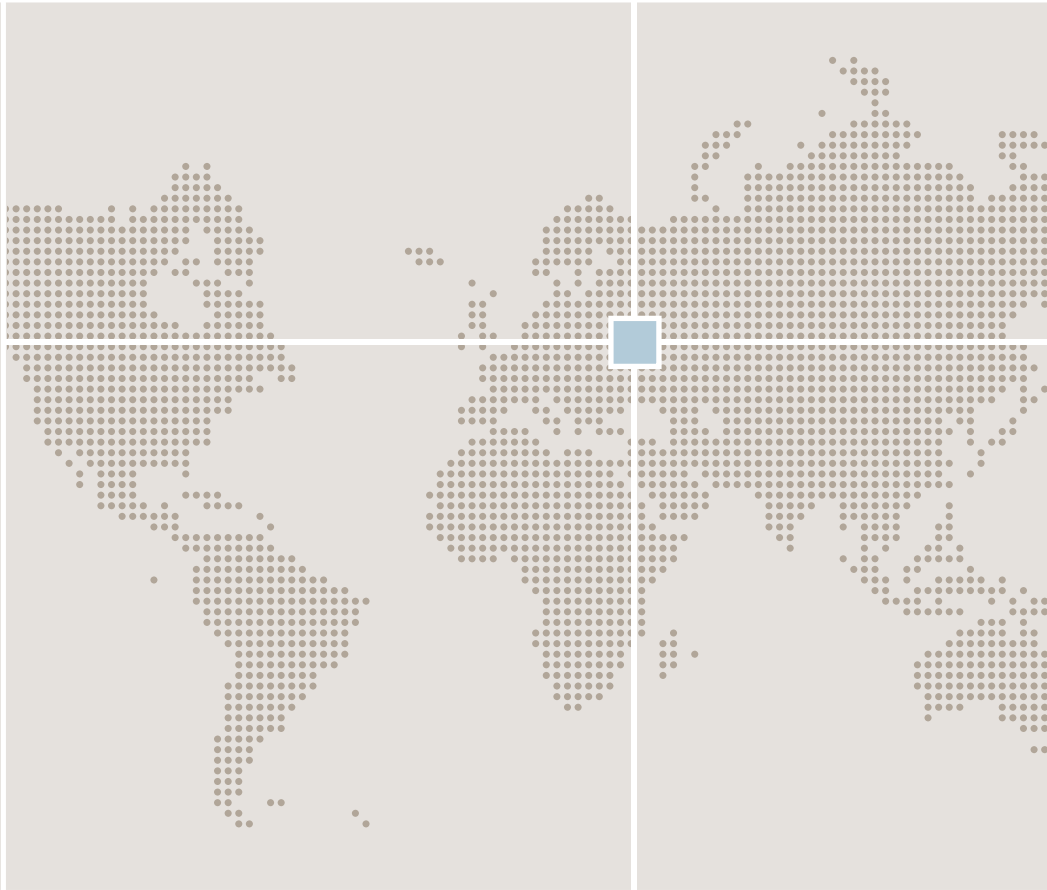
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Foreword by

Zbigniew Brzezinski
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FOREWORD

For Ukraine's friends in the West, 2007 was not the easiest year. We watched the political leadership become mired in a months-long political crisis in the spring. We applauded the free and fair nature of the September Rada elections. But we then waited—along with the Ukrainian people—for more than 11 weeks for confirmation of a new prime minister and cabinet. One result of the internal political turmoil was the sluggish development of relations between Ukraine and the West. Like many Ukrainians, we found the political process agonizingly slow and frequently frustrating.

At times like these, it makes sense to step back and take a broader view of Ukraine's development and gain some context for the news of the day. In the fall of 2007, we therefore commissioned a net assessment of Ukraine's achievements and shortcomings since it regained independence in 1991. The report was prepared for the U.S.-EU Partnership Committee for Ukraine, an international initiative that we cochair. The directors of the four task forces supporting the committee authored the assessment. We feel it is a first-class product. While not necessarily agreeing with every recommendation, committee members generally concur with the assessment's analysis and the bulk of its conclusions.

In the following pages, you will read about the numerous accomplishments of the Ukrainian people and their government over the past 16 years, both in terms of political and economic reform and in building constructive foreign relations with the West and Russia. The record is impressive, perhaps the most impressive of any state that emerged from the defunct Soviet Union, excluding the Baltic nations. There have also been many shortfalls

and setbacks, both domestic and foreign, which the assessment details.

We believe that it is useful, when facing the frustrations of day-to-day Ukrainian politics, to recall the long path that Ukraine has already successfully navigated. It gives hope that the Ukrainian people, with focus and political will, can complete the transformation of their country into a modern and democratic European state.

We also asked the authors to suggest priority reform tasks for the Ukrainian government, as well as suggestions for the European Union and United States as to how they might help Ukraine further develop its process of reform and integration with European and transatlantic institutions. We believe that this assessment offers a strong set of recommendations that merit full consideration in Kyiv, the EU capitals, and Washington.

Zbigniew Brzezinski
Volker Rühle
February 2008

EXECUTIVE SUMMARY

This net assessment examines Ukraine's accomplishments and shortcomings since regaining its independence in 1991. The assessment concludes with recommendations targeted at the Ukrainian government, the European Union, and the U.S. administration.

Progress

Ukraine has recorded significant achievements since 1991:

- The Ukrainian people have strengthened their statehood and developed democratic institutions.
- The Ukrainians have laid the foundation for a robust market economy and reversed the economic decline of the 1990s.
- Ukraine has established itself as a sovereign and internationally recognized state, with a deepening engagement with the European Union, a distinctive partnership with NATO, and a robust relationship with the United States.
- While relations with Russia remain both cooperative and conflictive, Ukraine has made progress in building a stable state-to-state relationship with its eastern neighbor.

Shortcomings

Ukraine still has a significant path to travel to complete its transformation:

- Domestic political problems include an inability to find political compromise, pervasive corruption, and lack of a generally accepted constitutional framework.
- The country's economic development has been hindered by government intervention in the markets, oligarchic interests, and confusing and often-contradictory legislation.

- Ukraine faces particular challenges in the energy sector, which is of crucial importance to the economy and where dependence on Russia creates a potential political vulnerability.
- Russia's more assertive foreign policy poses other challenges for Ukraine.
- While opinion within Ukraine is coalescing in favor of integration with the European Union, the country lacks a unified view on its ultimate relationship with NATO.

Thus, Ukraine still has much to accomplish, and the U.S. and EU governments have much to do if they want Ukraine to consolidate itself as a stable and prosperous country that helps shape a more stable and secure Europe, a goal that is in the interest of Ukraine, the United States, and Europe as a whole.

Key Tasks for Ukraine

There are a number of key tasks for the new Ukrainian government and Rada (parliament) at the beginning of 2008. Kyiv should consider steps that will not only mean better policies but also signal Ukraine's commitment to the path of integration with Europe.

Priority measures to improve governance should include:

- *Constitutional reform.* Ukraine's constitution and associated laws must be changed to eliminate ambiguities and draw clear delineations of authority.
- *Judicial reform.* Ukraine needs a judicial branch that can be relied upon to make fair decisions in criminal cases, business disputes, and other matters, as part of a broader effort to combat corruption.

- *Administrative reform.* Ukraine requires a modern bureaucracy, as well as territorial-administrative reform, to make *oblast* and local officials directly accountable to their publics.
- *Greater transparency and responsiveness.* All levels of government need to become more transparent and responsive to Ukraine's citizens.

Priority economic reform measures should include:

- *Commercial code abolishment.* The commercial code contradicts the more modern civil code and interferes with the ability of businesses to operate.
- *Free sale and transfer of agricultural land.* The Rada should pass legislation that will facilitate creation of a land market.
- *A modern tax code.* The government should propose and the Rada should enact a modern tax code to simplify taxes for both businesses and ordinary citizens.

Priority measures to reform the energy sector should include:

- *Market prices.* The government should move to use markets to set energy prices or, in the case of gas and electric power, move to full cost-recovery levels. Domestic producers of gas and oil should receive the same prices as foreign suppliers.
- *Restructuring of Naftogaz Ukrainy.* The government should restructure Naftogaz Ukrainy so that production, pipelines, and distribution are handled separately.
- *Dealing directly with Gazprom.* Ukraine should end its contracts with the unnecessary intermediary RosUkrEnergo and negotiate gas purchase contracts directly with Gazprom.
- *Tax reductions.* Taxes on exploration and development projects should be reduced.
- *Privatization.* Ukraine should restart the privatization of remaining energy assets.

- *Charters.* Ukraine should implement the transit protocol of the European Energy Charter and sign the Athens Energy Treaty to encourage more foreign direct investment.

Ukraine should pursue the following steps in its foreign policy:

- *WTO accession.* Ukraine should complete the remaining details for its accession to the World Trade Organization (WTO).
- *Enhanced agreement with the European Union.* Ukraine should press for early conclusion of an enhanced agreement with the European Union and then focus on implementation.
- *Focus on NATO relations.* Kyiv must demonstrate its commitment to transatlantic security and values and conduct an effective informational campaign to raise public knowledge about NATO.
- *Greater activism in regional initiatives.* Ukraine needs to be more actively involved in regional initiatives such as Black Sea Synergy and the Southeast European Cooperation Initiative (SECI).
- *Stable relations with Moscow.* While Ukraine pursues European integration, Ukraine and Russia should work together to build a stable and constructive relationship.

Key Tasks for the European Union

A Ukraine committed to transformation into a modern European democracy deserves full EU support. Priorities for the European Union should include:

- *Broader travel opportunities.* The European Union should broaden travel opportunities for Ukrainians, including expanded exchange programs and visa facilitation.
- *Technical assistance in the energy field.* The European Union should provide technical

assistance to help Ukraine meet its goals in the energy field, reform its central residential heating systems, and formulate a long-term energy strategy.

- *Support for direct contract negotiations.* The European Union should support Ukrainian efforts to negotiate direct gas purchase contracts with Turkmenistan and Kazakhstan.
- *An enhanced EU-Ukraine agreement.* EU officials should negotiate an enhanced EU-Ukraine agreement that encourages Ukraine's adoption of European standards and includes a rapidly negotiated EU-Ukraine free trade agreement.
- *Clarity on EU integration and process.* An EU signal regarding Ukraine's future membership would greatly spur the country's transformation. While it is unrealistic to expect the European Union to reach consensus on offering Ukraine a membership perspective in the next few years, EU officials should consider other inducements to encourage Kyiv to pursue deeper reforms.
- *Enhanced ENP and CFSP engagement.* The EU's European Neighborhood Policy (ENP) with Ukraine should be enhanced, and Ukraine's involvement in the EU's Common Foreign and Security Policy (CFSP) intensified.
- *NATO-Ukraine relations.* Those EU members that also belong to NATO should support the alliance in enhancing its engagement with Ukraine. The allies should extend a membership action plan (MAP) to Ukraine, recognizing that the objective of a MAP is to create the preconditions for consideration of membership but in no way prejudge a decision by Ukraine to request membership or by NATO to extend an invitation to join the alliance.

Key Tasks for the United States

The United States needs a reenergized policy that reflects the importance of a successful Ukraine to the U.S. goal of a broad, stable, and secure Europe. Priorities for the U.S. government should include:

- *High-level engagement.* The United States should resume active high-level engagement with Kyiv, including at the presidential and cabinet level.
- *Broader travel opportunities.* The United States should broaden travel opportunities for Ukrainians, including expanded exchange programs.
- *Dialogue with Europe.* The United States should continue its dialogue with the European Union and NATO countries on how to foster stronger links between Ukraine and Europe and the Euro-Atlantic community.
- *Free trade agreement.* The United States should consider the merits of a bilateral U.S.-Ukrainian free trade agreement.
- *Assistance on long-term energy strategy.* The United States should encourage the World Bank and the International Energy Agency to help the Ukrainian government formulate a long-term energy strategy.
- *Support for direct contract negotiations.* The United States should support Ukrainian efforts to negotiate direct gas purchase contracts with Turkmenistan and Kazakhstan.
- *NATO-Ukraine relations.* The United States should support NATO in enhancing the alliance's engagement with Ukraine. The allies should extend a membership action plan to Ukraine, recognizing that the objective of a MAP is to create the preconditions for consideration of membership but in no way prejudge a decision by Ukraine

to request membership or by NATO to extend an invitation to join the alliance.

1

INTRODUCTION

Ukraine has recorded significant achievements since regaining its independence in 1991. The Ukrainian people have strengthened their statehood. They have developed democratic institutions. They have laid the foundation for a robust market economy and are well on the road of recovery following the severe economic contraction of the 1990s. Ukraine today is a very different country from the one that emerged from the wreckage of the Soviet Union.

Ukraine has established itself as a sovereign and internationally recognized state. It has made substantial progress in reforming its armed forces. It has fully developed relations with its neighbors, deepened its engagement with the European Union, forged a distinctive partnership with NATO, and established a robust relationship with the United States. While relations with Russia remain multifaceted, in large part due to historical legacies, Ukraine has made progress in building a normal state-to-state relationship with its large eastern neighbor.

The assessment, however, is far from a picture of unmitigated success. Ukraine still has a significant path to travel to complete its transformation into a modern, democratic, European state. The inability to reach workable political compromises, the pervasive corruption, and the lack of a generally accepted constitutional framework hold back Ukraine's political development. Government intervention in the markets, oligarchic interests, and confusing and often contradictory legislation impede the consolidation of a strong market economy. Corruption and poor policy choices

plague the energy sector particularly: Ukraine wastes huge amounts of energy, retards domestic production, and faces a political vulnerability due to its heavy dependence on Russia for much of its energy. Russia, in view of its more assertive foreign policy, poses other challenges to Ukraine's sovereignty as well. Looking toward the West, while opinion within Ukraine increasingly favors integration with the European Union, the country lacks a unified view on its ultimate relationship with NATO.

Thus, Ukraine still has much to do, as have the U.S. and EU governments if they want Ukraine to consolidate itself as a stable, prosperous country that helps shape a more stable and secure Europe—a goal that is in the interest of Ukraine, the United States, and a wider Europe.

2

UKRAINE'S ACHIEVEMENTS

Developing the Ukrainian State and National Identity

Ukraine's fundamental achievement in the 1990s was to establish a sovereign, independent, and internationally recognized state following the disintegration of the Soviet Union. An overwhelming majority of the Ukrainian population voted for independence in the December 1991 referendum. Since then, each successive administration in Kyiv—under the leadership of Presidents Leonid Kravchuk, Leonid Kuchma, and Viktor Yushchenko—has been committed to defending and consolidating the country's statehood. State building is a long, complex, and arduous process, and Ukrainians faced three principal challenges once they had regained their independence: (1) forming modern democratic institutions to govern Ukraine; (2) putting in place the institutions of a sophisticated market economy to replace the previous command economy model; and (3) developing an international presence and independent foreign and security policies at a time of major transformation within Europe and Eurasia. Ukraine has achieved much progress in each of these areas.

The development of the Ukrainian state was by no means a given. In 1991, many analysts and policymakers worried that Ukraine would not survive as an independent entity. Skepticism about Ukraine's sustainability was fueled by the country's close ethnic, linguistic,

and religious ties to Russia; its brief history as an international subject separate from Russia; the substantial Russian ethnic population in Ukraine; and the integration of Ukraine's politics, economy, and military with Russia as a consequence of the Soviet period. In fact, the U.S. intelligence community in 1994 produced a national intelligence estimate entitled "Ukraine: A Nation at Risk." That study questioned whether an independent Ukraine would exist in 10 years. Today, no serious observer would ask that question. Ukraine has developed independent, if flawed, state institutions, and it has created a broadly recognized and accepted international identity.

While the Ukrainian national and state identity traditionally has been strongest in western and central Ukraine, the population in the east has increasingly come to share that identity. At the height of the 2004 Orange Revolution, some local leaders in eastern Ukraine suggested a referendum on autonomy. That call fell on deaf ears among most eastern Ukrainians (where many of Ukraine's ethnic Russians reside) and instead provoked a countervailing backlash, as various local councils denounced any suggestion of separatism. Whatever problems Ukraine faces today, its citizens will deal with them as Ukrainians, even if ethnic heritage remains a consideration. While differences persist between eastern and western Ukraine, they have significantly decreased in the 16 years since Ukraine regained its independence. Ukraine increasingly has appeared as, and acted as, one country.

Central government authorities in Kyiv have skillfully avoided or, when necessary, managed ethnic tensions. When Ukraine achieved independence in 1991, all residents, regardless of ethnic background, were treated as full and equal citizens. The largest non-Ukrainian group consists of ethnic Russians, who now make up about 17 percent of the population, although many more Ukrainians speak Russian on a regular basis. While Ukrainian is the only official state language, Russian speakers face few practical difficulties in everyday life. Government offices deal in Russian, Russian-language schools are commonplace, and many media outlets broadcast or publish in Russian. The issue of conferring official status on the Russian language arises periodically, generally as an issue during election campaigns. While the Russian language question was raised during the summer 2007 campaign leading up to the September Rada preterm elections, it was not a hot-button issue. The Regions Party, whose power base lies in eastern Ukraine, made little effort to polarize the electorate with it.

Crimea posed the single greatest challenge to Ukrainian statehood. In 1994, Crimean leaders advocated autonomy from Kyiv and closer linkages to Russia (prior to 1954, Crimea was administratively part of Russia). The Ukrainian government deftly contained the crisis, and separatist tensions on the peninsula abated. The Crimean Tartars, who began returning from forced exile in Central Asia in the late 1980s, have made clear their support for remaining part of Ukraine. The Tartars' return has raised a number of difficult issues, particularly the question of the return of land and property appropriated by the Soviet regime when Stalin deported the population in 1944, most of which has been occupied by others for over 60 years. But these issues do not carry a charged interethnic edge. While the ethnic situation in Crimea is complicated, at this point it poses no internal threat to Ukrainian statehood.

Ukraine has scored high marks for its treatment of minority religions. Although many Jews left Ukraine for Israel or the United States in the 1990s, a number of Jewish communities thrive in Ukraine. In recognition of Ukraine's positive record on open emigration and creating conditions for the free practice of religion, the U.S. Congress passed legislation in 2006 graduating Ukraine from the provisions of the Jackson-Vanik Amendment.

Developing Modern Democratic Institutions

Ukraine has made considerable progress in developing democratic institutions and consolidating democratic practices. After years of being ranked "partly free" by the Freedom House annual survey of political rights and civil liberties, Ukraine achieved a ranking of "free" in 2005, 2006, and 2007, the only post-Soviet state other than the Baltic countries to be so graded. In particular, free, fair, and competitive elections have been established as the means by which the population chooses the president and the political parties seated in the Rada.

Ukraine's election standards have improved dramatically. Throughout the 1990s, they were marked by significant shortcomings: abuse of administrative resources in favor of one candidate or party, pressure on opposition supporters (for example, through tax audits), and restricted access to the media. Some of the worst examples occurred during the 2004 presidential election. Opposition candidate Yushchenko's campaign faced continuous harassment; state resources were put at the disposal of his opponent, then-Prime Minister Viktor Yanukovich; and during the November 2004 runoff election, hundreds of thousands—perhaps as many as 1.5 million—fraudulent votes were added to the count.

This blatant fraud triggered a national awakening in the form of the Orange Revolution, when hundreds of thousands of

Ukrainians took to the streets to assert their right to elect their leaders. Demonstrations broke out immediately after the runoff returns were announced; the resolution achieved 17 days later provided for a rerun of the runoff ballot under an amended election law that reduced opportunities for fraud. In what was the most closely monitored election in Ukraine's history, Yushchenko won a vote that was assessed by credible domestic and foreign observers as free and fair.

Since that election, Ukraine has held two more national ballots, also judged to be free, fair, and competitive. In the March 2006 Rada elections, the opposition Regions Party, headed by Yanukovich, was able to campaign freely and won the largest number of seats in the Rada even though Yushchenko was president and controlled the government. The September 2007 Rada preterm elections also scored positive assessments from domestic and foreign observers. This record of free and fair elections contrasts markedly with the practices in neighboring Russia and Belarus.

The Ukrainian media has become increasingly balanced and professional over the past 16 years, particularly since the Orange Revolution. While the country has always enjoyed a diverse media, cases of government abuse were common prior to 2004. These included instances when the government closed opposition press outlets, targeted tax inspections at broadcasters or publishers who did not support the government, and provided *temniki*—state-authored themes—to guide major broadcasters' reporting on certain individuals or events. Most horrifically, several independent journalists were murdered.

To its credit, much of Ukraine's media revolted during the Orange Revolution, providing the population with continuous and unbiased coverage of the protests and demands of the demonstrators. Since then, the media has enjoyed an open environment in which reporters may freely pursue any story and publishers may print them, including articles

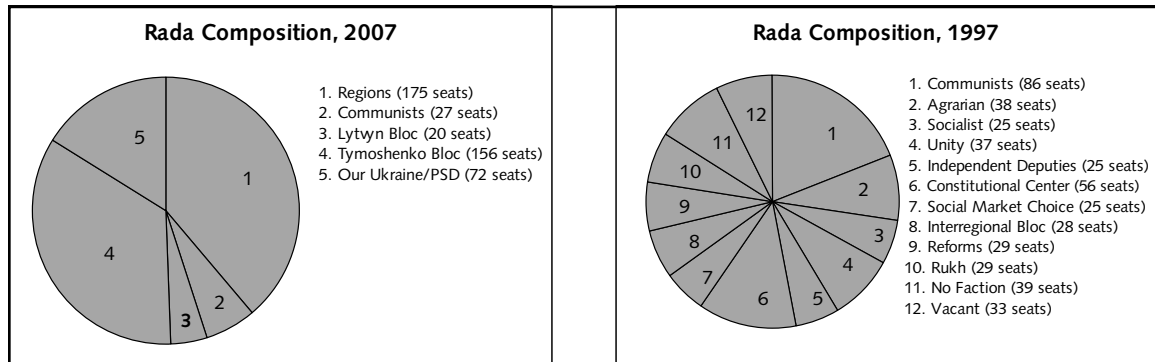
that directly attack senior political figures, without fear of government retaliation. While some papers and broadcasters adopt editorial lines that may skew or bias news coverage, publishers and owners generate those editorial lines, not government officials.

Nongovernmental organizations (NGOs), especially those dedicated to civic activity, have flourished since 1991. They were the bedrock of support and organization leading up to the Orange Revolution, despite largely ineffectual attempts by the Kuchma government to curb their activities. In the past two years, some offices of the Ukrainian government have set a good precedent and have welcomed the advice of civic organizations and analytical centers in their work. In order to continue and strengthen the contributions of Ukraine's nascent civil society, the government should create a legal and tax-friendly environment for NGOs of all kinds—from charitable service providers to analytical think tanks and civic organizations.

Ukraine has moved away from the super-presidency model of government that evolved during the Kuchma years. The Rada has gained power vis-à-vis the president in the aftermath of the Orange Revolution, establishing a more even balance of power between the legislative and executive branches. The Rada has also become a more coherent body. In the past, it was composed of many small parties, with often shifting alliances. As a consequence, throughout the 1990s the parliamentary scene bordered on political chaos. For example, 10 parties were represented in the Rada in 1997, grouped roughly into leftist, nationalist, and centrist factions, although no faction controlled a majority of the 450 seats. The largest party, with some 80 deputies, was the Communists, who opposed market reforms, rejected European integration, and advocated closer ties with Russia.

The Rada that was elected in 2007 constitutes a far more coherent body, comprising just five parties. And the three major parties

Figure 2.1. Rada Composition



agree on key policy questions. The Regions Party, the Bloc of Yuliya Tymoshenko, and Our Ukraine/People's Self-Defense, which together won almost 80 percent of the votes and control more than 400 of the 450 Rada seats, all advocate a market economy, steps to improve the business and investment climate, and integration into Europe, including membership in the European Union. This represents a degree of agreement on Ukraine's strategic direction previously unknown in the Rada.

Developing a Robust Market Economy

Over its 16 years of independence, Ukraine has put in place important elements of a market economy. Markets, not central planners, now allocate and set prices for most goods and services. Ukraine's borders are open, and international trade flows are a key source of economic growth and goods for Ukrainian consumers and businesses. Ukraine has rapidly developed a modern financial system: following the patterns of Central Europe, Western European banks have acquired substantial stakes in the Ukrainian banking system, integrating it with the European financial system. Ukraine's regulatory and legal systems have evolved, and many provisions are compatible with a market economy.

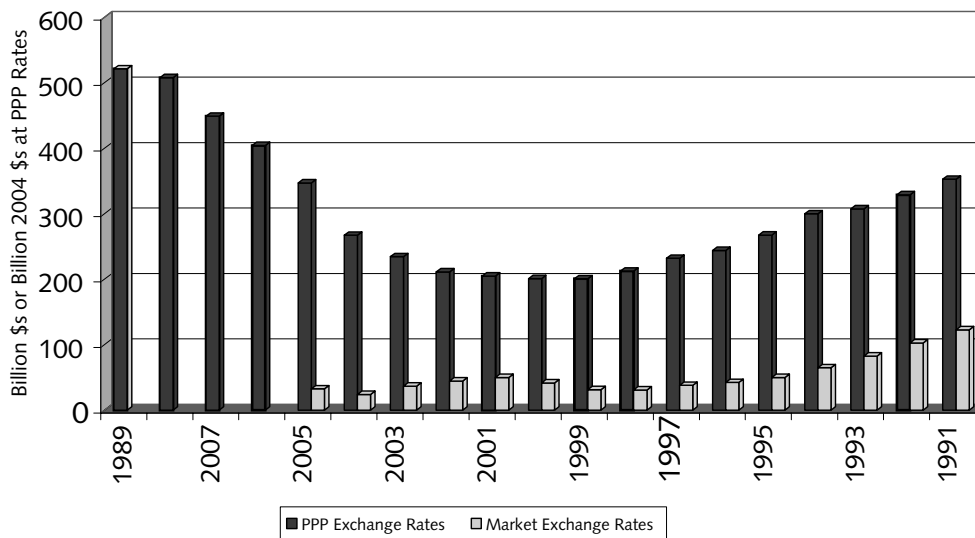
Ukraine has established a stable national currency, the *hryvnia*, and a competent central bank, putting an end to the scourge of the

1990s: inflation, which hit 10,000 percent in 1993. By 2001, inflation had dropped to single digits, although it recently surged to 15 percent. Both the Finance Ministry and the central bank have learned the value of fiscal and monetary discipline. The recent spike in inflation is not due to poor fiscal discipline (the state budget is close to being balanced) but to the *hryvnia's* peg to the dollar and a large influx of foreign currency that is monetized. The price of imported natural gas, which rose from \$130 per thousand cubic meters in 2007 to \$180 per thousand cubic meters in 2008, will contribute to inflationary pressures. Demands are rising to let the exchange rate gradually appreciate, because Ukraine's debt is small and its international reserves, which now exceed \$30 billion, are deemed satisfactory.

Much of the economy has been privatized. The private sector today generates an estimated 65 percent of gross domestic product, up from 10 percent in 1991 and 55 percent in 1999, according to European Bank for Reconstruction and Development (EBRD) assessments.

Ukraine has turned around its macroeconomic performance over the past 10 years. The difficult post-Soviet economic situation and government reluctance to rapidly implement reform measures in the 1990s resulted in nearly a decade of economic decline. Officially, the country's gross domestic product (GDP) in 1999 amounted to less than 40 percent of the 1991 level, though this may overstate the level of decline. In any event,

Figure 2.2. Ukraine's Gross Domestic Product



Source: State Statistics Committee of Ukraine, "National Accounts," reprinted from Keith Crane and F. Stephen Larrabee, *Encouraging Trade and Foreign Investment in Ukraine* (Santa Monica, CA: RAND, 2007), p. 10.

there has since been a notable turnaround: the Ukrainian economy is now enjoying its eighth consecutive year of growth, with increases in GDP since 2000 averaging more than 7 percent per year, making Ukraine one of the fastest growing economies in Europe and the former Soviet Union. Ukraine's GDP in 2006 stood at \$103 billion, or \$380 billion in purchasing power parity terms. Ukraine's economy is projected to continue growing at 5 to 7 percent per year over the next five years. This growth is stimulated in part by rising foreign direct investment, which was on a record pace in 2007, reaching \$6.8 billion in the first nine months of the year. Ukraine has a growing middle class, contributing to the increasingly high demand for consumer goods and automobiles; in 2006 for example, Ukraine was the sixth-largest market for new cars in Europe.

Modernizing the Energy Sector

Few parts of the Ukrainian economy are more important than its energy sector. The country

is fortunate in that it has significant reserves of oil and natural gas, both on and offshore, massive coal deposits (with Europe's best coal-bed methane prospects), and four nuclear power plants with 15 reactors, backed by a sophisticated nuclear industry. There is increasing awareness in Ukraine of the need to diversify the country's sources of energy, reduce domestic consumption through increased efficiencies, expand domestic production of oil and natural gas, and consider the possibilities of cleaner coal and new alternative energy technologies.

This is important because the Ukrainian economy remains heavily dependent on energy imports: more than 75 percent of its natural gas, 80 percent of its oil, and 100 percent of its nuclear fuel is imported, virtually all coming from or through Russia. With more enlightened energy policies and stronger rule of law to support contracts, Ukraine has the capability to cut its import dependency in half over the next 15 years and strengthen its position when negotiating energy import prices with Russia and Central Asian suppliers.

Despite widespread corruption, Ukraine has had some major accomplishments in the energy sector. Most of Ukraine's electric power generation, regional distribution and power companies, and oil-refining systems have been successfully privatized since 1991. The steel and chemical industries, important contributors to gross domestic product and Ukrainian export earnings, have achieved significant increases in energy efficiency. As a result, the country is about 20 percent more energy efficient today than it was in 1990. Recent price increases for natural gas imported from Russia and Central Asia—Ukraine paid \$50 per thousand cubic meters in 2005, with the price rising to \$95, \$130, and \$180 per thousand cubic meters in 2006, 2007, and 2008—have prompted major industries to invest in new technologies, which will further boost energy efficiency.

A slow but growing use of meters to more accurately gauge electric power consumption in some large municipalities can further increase efficiency. Several cities are now putting meters in all new apartments, which should result in significant energy savings over the long term and assist in domestic tariff setting. Metering systems are also slowly being constructed on the main gas lines from Russia, which will help Ukrainians to measure the real intake of natural gas coming from Russian and Central Asian suppliers and to answer charges that gas is being illegally diverted.

The World Bank, the EBRD, and the European Commission are anxious to help Ukraine modernize its energy infrastructure, develop a progressive tariff system, and integrate the country's energy sector with those of Western Europe. This assistance, however, will require a greater degree of transparency than appears desired by key elements of the political elite and those Ukrainian firms that have benefited from close ties to Gazprom, the giant, monopolistic Russian gas company, and other Russian businesses.

New nuclear power plants are now generating most of the electricity previously produced by the outdated RBMK-style reactors at the Chernobyl plant. Ukraine's robust nuclear power industry fulfills about half of domestic electric power demand, and the country is set to become a net exporter of electricity. Poland and Belarus offer significant electricity markets. Ukraine is close to completing the nuclear fuel qualification project with Westinghouse, an effort funded by the U.S. government. Once completed, this project will give Ukraine the ability to import fuel for its nuclear reactors from Westinghouse or qualify other suppliers, breaking the Russian monopoly. This will enhance Ukraine's energy security: even if Ukraine never buys fuel elsewhere, it will have substantially greater bargaining leverage with its Russian supplier.

Ukraine has the potential to expand its domestic production of natural gas and oil. The offshore production-sharing agreement between the American company, Vanco Energy, and the Ukrainian government, signed in October 2007, was the culmination of the country's first offshore energy production and development tender. Encouraged in part by Vanco's apparent success, Shell Oil Company has tentatively agreed to commit at least \$100 million for joint exploration and development activities, with the prospect of a considerably larger commitment once some of the present political and legal hurdles are overcome.

Ukraine's political elite favors retaining control of the pipeline system—at least until an open and transparent tender process can be put in place and Gazprom is prepared to play by internationally accepted rules of the energy market and not exploit its monopoly power to gain control over Ukraine's energy systems. The Rada acted in 2007 to ban any sale or transfer of control over the pipeline system without Rada approval. There is growing support within the Rada for identifying additional sources of revenue that could be earmarked

for the much needed renovation of the main gas and oil pipelines, which have the potential to move significantly greater volumes. Ukrainians recognize that improved maintenance and modernization of the pipeline system will undercut Moscow's claims that only Russia has the technical and financial ability to keep the pipelines in sufficiently good shape to guarantee smooth gas deliveries to Europe.

Building an Independent Military

Early in its development as an independent country, Ukraine achieved political and practical control over the military forces on its territory, which in 1991 were essentially a regional arm of the Soviet Red Army. Ukraine declined to subject its military forces to Russia's proposed joint Commonwealth of Independent States military force in early 1992. Kyiv instead required officers and soldiers to take a loyalty oath to Ukraine or to resign from the Ukrainian armed forces; an overwhelming majority chose Ukraine.

By July 1992, Ukraine's military independence was firmly established when the young country contributed military forces to the UN peacekeeping mission in Bosnia-Herzegovina. In 1999, Ukraine also provided troops—in the context of the Polish-Ukrainian peacekeeping battalion—for the NATO-led stability force, KFOR, in Kosovo. In 2003, the Ukrainian military deployed a chemical and biological weapons defense unit to Kuwait and later contributed three battalions, under Polish command, to the U.S.-led coalition stabilization force in Iraq.

In conjunction with its establishment of authority and control over its defense forces in the international arena, Ukraine has made significant progress in reforming its defense forces. In contrast to the forces of Russia and other post-Soviet countries such as Belarus, Ukraine has made dramatic advances in modernizing the command and organizational

structure of its military away from the Soviet model and toward European models and standards. Ukraine quickly reduced its ground forces and streamlined its defense capacity to shed Soviet–Cold War military doctrine. Thus, Kyiv became better positioned to participate in modern peacekeeping and combat operations than other post-Soviet militaries.

Ukrainian officers actively engage in NATO Partnership for Peace programs, as well as military-to-military exercises, training programs, and educational courses with Western militaries. As a member of the Conventional Forces in Europe Treaty, Ukraine's military has adopted modern European standards of transparency and cooperation in military affairs. This not only distinguishes the Ukrainian military from the Russian military, which remains mired in a post-Soviet limbo between the Cold War and modern military practices, it has disentangled the Ukrainian military from Russia's and increasingly links its future with Europe's. While Ukraine's future in NATO remains uncertain, there is no question that Ukraine's military is a distinct entity from Russia's.

Ukraine has no foreign military forces deployed on its territory that are not accepted and regulated by international and Ukrainian law. This is in clear contrast to the challenges to sovereignty faced by Ukraine's neighbors, Moldova and Georgia, which continue to host Russian military units despite their own governments' policies. Russia's Black Sea Fleet is based on Ukrainian territory, at the naval base in Sevastopol and other facilities in Crimea, but this basing is regulated by a 1997 lease agreement that provides for Russian lease payments and an end date of 2017. Although the issue occasionally is raised in Russian political discourse, the Russian navy has begun preparation for an expanded base for its Black Sea Fleet in Novorossiysk, in the Russian Federation, seeming to indicate Russia's acceptance that it will have to depart Crimea by 2017.

Ukraine's International Standing

Over the past 16 years, Ukraine has strengthened itself as a sovereign and independent country with control of its territory and sovereign membership in international organizations. In pursuit of its own interests, Ukraine's diplomatic stance on several key issues has increasingly diverged from that of Moscow. Ukraine had juridical independent membership in the United Nations during the Soviet period, a status of false independence meant to bolster Soviet diplomatic positions. Today, Ukraine is a full and independent member of the UN, as it is of other international bodies such as the Organization for Security and Cooperation in Europe (OSCE) and the Council of Europe. Ukraine has independent status in a number of important arms control agreements, including the Strategic Arms Reduction Treaty (START), the Treaty on Non-Proliferation of Nuclear Weapons (NPT), and the Conventional Forces in Europe Treaty.

In January 1994, Ukraine demonstrated its role as a responsible international player by signing the Trilateral Statement and agreeing to transfer the strategic nuclear warheads it inherited from the Soviet Union to Russia for their elimination, a process that was completed in 1996. With assistance from the United States, Ukraine has also eliminated the intercontinental ballistic missiles, missile silos, and strategic bombers that were deployed on its territory, as it had agreed to do under the terms of the 1992 START I Lisbon Protocol. Ukraine acceded to the NPT as a nonnuclear weapons state in December 1994. By giving up what would have been the world's third-largest nuclear arsenal, Ukraine played a major role in promoting the NPT's indefinite extension at the treaty's 1995 review conference.

Ukraine skillfully used the Trilateral Statement and its NPT accession to obtain assistance in eliminating its nuclear systems and infrastructure, to broaden reform assistance,

and most importantly, to receive security assurances designed to bolster its sovereignty and ability to withstand potential Russian pressure. In conjunction with its accession to the NPT in 1994, Ukraine formally received security assurances from the United States, the United Kingdom, and Russia regarding its independence, sovereignty, and territorial integrity in the Budapest Memorandum. That document obligated the signatories to refrain from the threat or use of force and from acts of economic coercion that could undermine Ukraine's sovereignty. France and China subsequently extended Ukraine parallel assurances.

Regional Relationships

Since regaining independence, Ukraine's bilateral ties with most of its neighbors have developed positively. Overcoming their historic conflicts and animosities, Ukraine and Poland established a close relationship in which Warsaw has become the main promoter of Ukrainian interests within the European Union and NATO. Good relations have also been forged with other Central European countries that have entered the European Union and NATO. Ukraine has no outstanding territorial disputes with any of its neighbors, although several land and maritime border demarcations still need to be finalized with Russia, Belarus, and Romania.

At a multilateral level, Ukraine is a member of the Commonwealth of Independent States (CIS), but it has resisted close military and security integration in the Russia-centered organization. It does not take part in CIS military structures and has considered canceling its funding for the organization. Instead, Kyiv was instrumental in the mid-1990s in developing GUAM (Georgia, Ukraine, Azerbaijan, and Moldova) as a Western-oriented grouping. At a GUAM summit in Kyiv in May 2006, Ukraine assumed the chairmanship; the organization was renamed GUAM—Organization for Democracy and Economic Development; plans to establish its headquarters in

Kyiv were announced; and Ukraine proposed closer cooperation between GUAM and the European Union and NATO.

Kyiv has been a leader in developing other regional organizations, but Ukraine and its partners need to avoid overlap and confusion, as may be the case with the decision by Yushchenko and Georgian president Mikhail Saakashvili to create the Community of Democratic Choice (CDC). There has been a lack of clarity on how CDC complements or contrasts with GUAM and what countries are to be included, as not every post-Soviet state is a functioning democracy.

Relations with the European Union and NATO

Ukraine's leadership since 1991 has become increasingly committed to EU integration and has steadily deepened the country's engagement with the European Union. Today, most of the political spectrum in Kyiv supports EU integration and favors Ukraine's ultimate membership. Moreover, the majority of Ukrainian citizens support EU accession. An EU-Ukraine Partnership and Cooperation Agreement (PCA) was completed in 1994 and entered into force in 1998. The PCA has formed the legal basis of EU-Ukraine relations, providing for cooperation in a wide range of arenas, including political dialogue, trade and investment, legislation, culture, and science. Talks on a new enhanced agreement, the successor to the PCA, were launched in Brussels in March 2007, and several negotiating rounds have been held in Brussels and Kyiv. In addition, Ukraine has won agreement from the European Union to begin negotiations on a free trade agreement once Ukraine has finalized its World Trade Organization (WTO) accession process, which should happen in early 2008. Concluding a free trade agreement with the European Union will be an important achievement for Ukraine.

In February 2005, the EU-Ukrainian Cooperation Council endorsed a joint EU-Ukraine Action Plan, and Ukraine was included in the EU's European Neighborhood Policy (ENP), which is designed to draw several countries closer to the European Union and promote democratic reform. In 2007, the European Neighborhood and Partnership Instrument (ENPI) was launched to provide the framework for technical assistance in trade, science, technology, and nuclear energy. In addition, the European Union has also contributed over €1 billion since 1991 in aid to Ukraine.

Ukraine has steadily involved itself with NATO at both institutional and practical levels. Soon after achieving independence in 1991, Ukraine joined the North Atlantic Cooperation Council, later renamed the Euro-Atlantic Partnership Council. Ukraine has been an active participant in NATO's Partnership for Peace program, being the first post-Soviet state to join. Ukraine sought in the mid-1990s to develop a special relationship with NATO. The Charter on a Distinctive Partnership between NATO and Ukraine, signed in July 1997, recognized the importance of an independent and democratic Ukraine for European stability. Among other things, the charter identified areas for consultation and cooperation and established the NATO-Ukraine Council.

Ukraine has engaged in several peacekeeping operations led by NATO, including in the Balkans, since the mid-1990s. In November 2002, the NATO-Ukraine Action Plan was approved at NATO's Prague summit and established long-term objectives for broader cooperation. In April 2005, at the request of Yushchenko in the aftermath of the Orange Revolution, NATO launched an Intensified Dialogue with Ukraine, signaling that the allies were supportive of Ukraine's integration aspirations and that NATO remained committed to providing assistance and advice. In January 2008, Yushchenko, Prime Minister

Tymoshenko and Rada Speaker Yatsenyuk sent NATO secretary general Jaap de Hoop Scheffer a letter requesting a membership action plan (MAP). However, the Intensified Dialogue and, if agreed, a NATO MAP do not guarantee Ukraine's candidacy for membership. An invitation to accession will be based on receipt of a request for membership from Kyiv, which the Ukraine government has said will only follow a national referendum, and on Ukraine's performance in meeting key political, economic, and defense reform goals.

Relations with the United States

Kyiv has viewed the United States as a strategic partner that can strengthen Ukrainian security and assist the country in its progress toward Western institutions. In November 1994, the Charter of American-Ukrainian Partnership, Friendship and Cooperation was signed during Kuchma's visit to the United States. Washington offered support in Ukraine's transition to a democratic market economy and its integration into the global economic system. In 1996, Ukraine achieved U.S. agreement to establish a strategic relationship, and the Gore-Kuchma Binational Commission was created to oversee a broad range of foreign policy, economic, security, and assistance issues. Unfortunately, the bilateral relationship was set back in 2002 when the Kuchma administration violated important democratic norms, and evidence emerged suggesting that Kuchma had approved the transfer of the Kolchuga early-warning system to Iraq.

Relations markedly improved after the Orange Revolution. A Bush-Yushchenko meeting in April 2005 produced an action plan to guide the development of U.S.-Ukrainian relations, most of which had been fulfilled by summer 2006. At that meeting, President George W. Bush confirmed U.S. support for Ukraine's eventual membership in

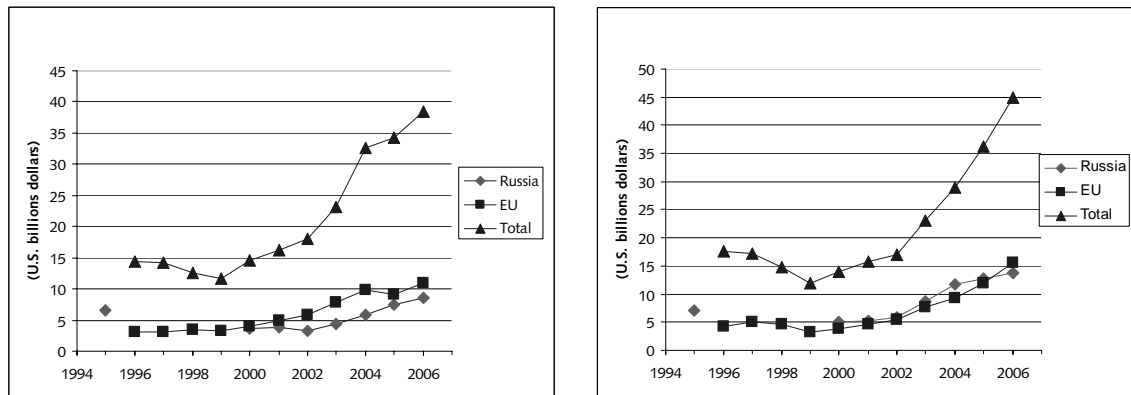
NATO. Of particular importance to Kyiv, in March 2006 the U.S. Congress passed legislation to graduate Ukraine from the provisions of the Jackson-Vanik Amendment and grant permanent normal trade relation status. In November 2006, Ukraine was selected as an eligible state to receive assistance from the Millennium Challenge Corporation. Washington has also consistently supported Kyiv in its civil-military reforms and in its overhaul and modernization of the Ukrainian military.

International Economic Relations

In March 2006, U.S. and Ukrainian negotiators concluded bilateral negotiations on market access issues related to Ukraine's pending WTO accession. The agreement confirmed Ukraine's commitment to broad-based reform and economic liberalization, as well as Kyiv's resolve to join the international trading system. With the signing of its accession agreement, Ukraine is now at the final stage of the WTO accession process; its entry will unblock several avenues of economic development, including negotiation and completion of a free trade agreement with the European Union.

Ukraine has also established itself as an independent international economic presence, which increasingly trades globally and attracts foreign investment from a range of European and American investors. The integration of the Russian and Ukrainian economies in 1991 was substantial. Russia was by far Ukraine's main trading partner; perhaps the strongest argument at the time against Ukraine's independence was the price the country might have to pay in shifting from a common currency and the freedom from normal international trade costs such as customs, as well as the potential loss of the Russian market. In fact, the Russian economic collapse affected the demand for Ukrainian imports, which in turn contributed to Ukraine's economic contraction in the 1990s, with both economies

Figure 2.3. Ukraine's Exports and Imports



experiencing GDP declines of more than 50 percent. As late as 1998, the financial crisis in Russia generated a parallel mini-crisis in Ukraine.

Yet Ukraine's economy has diversified and become less dependent on Soviet-rooted trade patterns and ties. Over the past six years, Ukraine's main export partner has been the European Union. In 2006, the European Union took 25.6 percent of Ukraine's total exports, while Russia was in second place, taking 21.3 percent. Despite the importance of Russia as a source for Ukrainian energy imports (and the rising prices of Russian energy), the European Union by 2006 had overtaken Russia as Ukraine's largest source of imports. Ukraine's important trading partners are diversifying, including China (source of 7.1 percent of Ukraine's imports), Turkey (recipient of 6.9 percent of Ukraine's exports), and the United States (destination of 4.1 percent of Ukrainian exports).

Investment patterns are shifting as well. The primary source of investment in the Ukrainian economy is Germany, which had 23.5 percent of total foreign direct investment in Ukraine at the beginning of 2007. Russia had fallen to seventh on the list (at 5.1 percent), although one can assume that the level of foreign direct investment provided by Cyprus (17.1 percent, which puts it in second place) reflects some Russian-controlled

investment volumes. More generally, given Russian nontransparent business practices, it is a fair bet that Russian investment in the Ukrainian economy is even higher. Nonetheless, the third, fourth, and fifth sources of foreign direct investment are European states. The United States (with 5.7 percent) occupies sixth place (for tax reasons, some U.S. foreign direct investment also flows to Ukraine via Cyprus).

Thus, the overall trade and investment trends are toward a Western integration and orientation of Ukraine's economy. This should not only support economic modernization and a shift from nonmarket practices, but it will reduce the political vulnerability of Ukraine to Russian policies. Ukraine's economic independence from Russia will never be complete, but the trends suggest that the relationship is moving toward a more normal balance of interdependence. Ukraine's negotiations for membership in the World Trade Organization have proceeded independently of Russia's. Ukraine has not joined Russia's preferred Single Economic Space (SES); while Kyiv has expressed interest in an SES free trade area, Moscow wants the SES to be a customs union as well. The Ukrainian government indicated in 2006 that it would not join a customs union, as that would impede its negotiation of a free trade agreement with the European Union.

Relations with Russia

Relations with its large neighbor to the east have posed special challenges to Ukraine since 1991, but Kyiv has made significant progress. Issues that once seemed to create core vulnerabilities for Ukraine—including recognition of Ukraine’s territorial integrity, the status of the Russian language, and the Russian Black Sea Fleet presence in Crimea—have receded in salience or been skillfully managed.

In the first years following the Soviet Union’s breakup, Russian leaders took a tough approach to issues of sovereignty and political independence in negotiating with Ukraine. Moscow extended security assurances to Kyiv as part of the 1994 Trilateral Statement and Budapest Memorandum, primarily driven by Russia’s desire to secure the transfer of nuclear weapons and Ukraine’s accession to the NPT. The Russian authorities dragged their feet on signing an overall bilateral agreement recognizing Ukraine’s sovereignty and territorial integrity. Although the two countries agreed relatively quickly to a division of the ships belonging to the Black Sea Fleet, reaching agreement on basing part of the Russian fleet in Crimea proved much more difficult, as Russia sought rights not just to basing facilities in Sevastopol but to all of Sevastopol itself. The Ukrainians held to their positions and in spring 1997 achieved a bilateral agreement signed by Kuchma and Russian president Boris Yeltsin that explicitly recognized Ukraine’s sovereignty and territorial integrity, as well as a basing agreement that provided for the lease of facilities to the Russian navy for 20 years, on terms acceptable to Kyiv.

The Orange Revolution triggered considerable concern that such a popular revolution might be possible in Russia and generated intense Russian interest in Ukrainian political developments. The extraordinary Russian interference in Ukrainian politics during the presidential campaign of 2004 has not been replicated in subsequent elections. While

one would be naïve to conclude that there is no Russian influence in Ukrainian politics, the active involvement of Russian political “technologists,” reports of Russian financing of anti-Orange candidates, and active direct involvement in Ukrainian media were not repeated in Ukraine’s 2006 and 2007 parliamentary elections, despite the considerable stakes for Russia in Ukraine’s leadership orientation. Other than Ukraine’s achievement of formal sovereignty, the country’s practical achievement of political sovereignty is among its most important accomplishments.

Ukraine’s political independence has been constructively supported by an active bilateral engagement at the official level. Ukraine and Russia have established regular and institutionalized discussions between government counterparts via the Russian-Ukrainian Interstate Commission. The commission has proven a pragmatic mechanism for engagement on a normal state-to-state basis between Russian and Ukrainian officials. The Russian foreign minister regularly meets with the Ukrainian foreign minister, and the Russian and Ukrainian presidents meet to discuss various issues and subsequently task their governments. This is in contrast to the situation earlier in this decade and the 1990s, when meetings occurred on an ad hoc basis, revolving around personal relationships and presumptions of close links between Russian leaders and Russia-focused Ukrainian leaders.

3

UKRAINE'S SHORTCOMINGS AND SETBACKS

Political Shortcomings

While Ukraine has made important strides over the past 16 years, setbacks and lack of progress on key political and economic questions have hindered the country's transformation into a modern, democratic European state. Ukraine has not moved as rapidly as many Ukrainians and the country's supporters in the West had hoped.

Successive governments have failed to deal decisively with corruption, which remains pervasive at virtually all levels of society. Transparency International's Corruption Perceptions Index in 2007 ranked Ukraine 118 out of 179 countries. Ukraine's ranking improved from 122 in 2004 to 107 in 2005 and 99 in 2006, before falling back in 2007. Freedom House and the World Bank give Ukraine similarly low marks for corruption.

An unhealthy lack of transparency persists in many areas of government operations, creating broad opportunities for corruption in government procurement, regulation of businesses, taxation, and privatization. The risk of exposure is low; virtually no major political or business figures have been brought to trial for corrupt activities. Anecdotal reports suggest that corruption increased in the handling of value-added taxation in 2006–2007, as exporters lacking connections often had to pay a 20 to 30 percent fee to middlemen to obtain rebates they were legally due on value-added taxes.

Corruption poses a particular challenge in the judicial branch, where courts are broadly perceived as open to the highest

bidder. Parties to lawsuits commonly “shop” for courts that will produce decisions in their interest. Ukraine's judicial system is ripe for bribery since judges have tenure for life and are almost impossible to remove, and because Ukrainian laws are often poorly written and sometimes contradictory, leaving wide latitude for judicial interpretation.

Ukrainian politics continues to suffer from the disinclination of the major political parties and actors to compromise or cooperate. This problem plagued politics in the 1990s, hindering the development of stable parliamentary coalitions and productive relations between the legislative and executive branches. The problem continues today: following the 2006 Rada elections, it took Ukraine's political leaders four months to put in place a majority coalition and select a prime minister. The “universal” document with key political principles signed in August 2006 by Yushchenko, Yanukovich, and others quickly lost relevance as a guide for cooperation among the Rada, cabinet, and presidential administration. Similarly, the country endured a months-long political crisis in the spring of 2007. Coalition formation in the aftermath of the September 2007 preterm elections took two months, and it took another three weeks for the Rada to confirm Yuliya Tymoshenko as prime minister. All this reflects the difficulty Ukrainian politicians continue to experience in setting aside differences and political considerations in order to compromise, cooperate, and enact good policy.

Ukraine suffers from the lack of a clear, generally accepted constitutional framework.

The 1996 constitution has been amended numerous times, including as part of the resolution of the Orange Revolution. Unfortunately, the constitution contains ambiguous areas and contradictions. A key task must be to provide clear legal rules for the functioning of government. In particular, the division of powers between the president and the Rada must be clarified. For example, the constitution provides that the majority coalition in the Rada propose a candidate for prime minister to the president. In July 2006, the majority proposed Yanukovich as prime minister and insisted that the president had no choice but to submit Yanukovich's name. Presidential administration officials cited language in the constitution giving the president 15 days to "consider" the majority's proposed candidate and argued that the revised constitutional language implied the president could reject the nominee. Yushchenko submitted Yanukovich's name, but constitutional ambiguities helped turn the 2007 political clash into a constitutional crisis that, in the end, was resolved on the basis of a political agreement among three of the four major political figures, not on the basis of the constitution.

State institutions in Ukraine have yet to adapt to the requirements of a modern European democracy and market economy. Administrative reform remains a priority requirement. Twinning Ukrainian ministries with counterparts in EU countries could do much to improve the situation. In particular, Ukraine has failed to develop regional and local governments that are accountable to their citizens. *Oblast* governors are appointed by the president and not popularly elected. Their accountability thus is to the president and not the local electorate. Although Ukrainian political leaders have talked about reforming the selection of *oblast* governors, there has been no progress. In this context, both regional and municipal governments should be given their own tax revenues and their own responsibilities.

Political parties are top-down organizations and remain based primarily on personalities, rather than representing platforms or large groups of people with shared political or economic interests. Most have yet to develop genuinely democratic internal structures. While the Communists can claim a party ideology, albeit one that is discredited in the eyes of most Ukrainian voters, the other four parties in the Rada (Regions, the Tymoshenko Bloc, Our Ukraine/People's Self-Defense, and the Lytvyn Bloc) center on party leaders and the interests of the major business groups that fund them. The influence of the senior political and business leaders is amplified by the fact that the Ukrainian electorate votes on the basis of closed party lists; in other words, it votes for the party list but without the opportunity to express a preference among those on the list. The Council of Europe's Venice Commission has recommended that, if Ukraine keeps the party list system, it should convert to open party lists. Between elections, there are few mechanisms by which the electorate can influence the Rada, individual deputies, or the political elite.

The three major parties, moreover, are limited in their geographic focus—Regions is mainly an eastern party, Our Ukraine/People's Self-Defense a western party, and the Tymoshenko Bloc a party of the west and center—and they reflect a division between Russophone and nationalist party identities. That said, both the Tymoshenko Bloc and Regions Party pursued cross-regional campaigns in the last two parliamentary elections, and the 2007 Rada election produced some indications that the Tymoshenko Bloc and Regions have begun to erode the political divide separating eastern and western Ukraine.

Social Problems

Ukraine suffers from unreformed and inefficient education, health, and pension systems. While the country inherited a talented and highly educated population, chronic

underfunding of the education system threatens to erode this advantage. Allegations that students can buy entry into universities or purchase grades have further undermined the system. The health care system, likewise poorly funded, struggles to cope with the problems created by poor diet, heavy use of tobacco and alcohol, and a lack of physical exercise. Rising rates of infectious diseases such as tuberculosis and HIV/AIDS have contributed to shorter life expectancies, especially for men, and a sharp demographic decline that has seen Ukraine's official population fall from almost 52 million in 1991 to 46 million today—some analysts suggest the actual Ukrainian population is even lower. The pension system barely meets the needs of a significant number of pensioners, even though it consumes as much as 14 percent of GDP, and the ranks of pensioners will swell over the next 30 years.

Economic Problems

Although Ukraine has put in place the basic institutions of a market economy and enjoyed eight years of strong growth, the slow pace of regulatory and other economic reforms has restrained the economy from achieving its full potential. In particular, the government has intervened in markets, preventing prices from sending the proper signals and thereby reducing economic welfare. The government has periodically intervened when prices have risen on key commodities, such as bread and gasoline, creating shortages and forestalling responses in supply. Energy prices remain controlled, encouraging the wasteful use of energy and reducing incentives for expanding domestic production of gas and oil. The government has also imposed export bans on wheat and other grains, impoverishing Ukrainian farmers and disrupting agricultural markets. And the economy remains plagued by extensive corporate raiding that goes beyond the legally permissible.

The government has passed two conflicting codes of laws governing business. It

has failed to abolish the commercial code, which is Soviet in orientation and often contradicts the economic language in the more modern civil code. Such contradictions impose severe costs on businesses and discourage investment. Frustration with this can lead individuals or businesses to operate in the informal economy, which is more vulnerable to corruption and denies the government tax revenue. Yet another problem that needs to be addressed is poor guarantees in legislation and weak protection in practice for property rights.

Ukraine has one-third of the world's black earth and should be an agricultural powerhouse. But the free sale and transfer of farmland is not permitted, hindering the development of a rural land market and depriving poor Ukrainian farmers from taking advantage of their most important asset and limiting their participation in the broader economy. The inability to buy and sell land is a key factor responsible for the undercapitalization of Ukraine's potentially rich agricultural sector.

Ukraine has achieved major progress in privatization, but the momentum seems to have slowed, as little has been offered over the past two years. Entities such as Ukrtelecom could attract great interest from investors, generating significant sales revenues for the government and new investment into privatized businesses. The government should act to put such assets up for sale in open, transparent, and competitive tenders.

Although Ukraine is in the final stage of its World Trade Organization accession process, it has taken far longer than expected. WTO membership will integrate Ukraine more closely into the global economy and give Ukrainian exporters the means to expand their market access. Ukraine should complete the process in early 2008.

Vulnerabilities in the Energy Sector

Ukraine remains a highly inefficient user of energy. In fact, Ukraine has the highest ratio of energy use to per capita GDP in the world, making the country the world's most energy-intensive economy. Ukraine uses, for example, more than twice as much energy per dollar of GDP output as does Poland.

Ukraine lags considerably behind other Eastern and Central European nations in modernizing its energy sector, particularly those now in the European Union. Although tariff reform has started, gas and electricity prices are still in many cases below the cost to the distributor, particularly for residential household use. Prices are among the lowest in Europe, reducing incentives to conserve energy. Urban heating remains particularly inefficient; absent individual apartment heating thermostats, an open window in winter serves as a principal method of regulating room temperature. An estimated 30 percent of the energy for district heating is lost, primarily due to lack of investment in maintenance and renovation, poor insulation of steam pipes, low tariffs, and lack of metering.

The energy regulatory framework remains weak and highly politicized. Favored industrialists and some energy-intensive sectors receive subsidized energy rates. Greater business transparency, coupled with tariff reform and energy efficiency gains, would help reduce or eliminate the constant buildup of payment arrearages to Russian and Central Asian gas suppliers. The country needs to gain and maintain a reputation for paying its energy bills in a consistent and timely manner.

Over the past year, energy firms involved in joint ventures or joint activity agreements extracting gas or oil within Ukraine, including foreign-owned energy companies, have had to sell their oil and gas at government-imposed prices that are significantly below production cost. This understandably has been a

disincentive to investment in Ukraine's energy sector. For example, Cardinal Resources, an American firm, found that the revenues received did not cover its costs and thus sold its interests in Ukraine to a Kuwaiti company to avoid bankruptcy. The alleged rationale for the government decree imposing the prices was to increase revenue to the state, but it has led instead to a decrease in production and a loss of overall revenue from the energy sector. It has also made other U.S. firms less willing to invest in Ukraine. This decree has inflicted long-term damage to Ukrainian efforts to attract Western investment in the energy sector.

Ukraine has become more dependent on energy imports. The number of automobiles in Ukraine is increasing very rapidly; while a strong indicator of the growing affluence of the middle class, this adds greatly to the country's energy import burden. There has been little action on the part of the government to decrease gasoline consumption.

Gazprom, acting through alleged joint stock companies, and with the acquiescence of Naftogaz Ukrainy, has over the past two years increased its control of Ukraine's domestic gas market. Indirectly, this has given Russia greater control over large parts of the Ukrainian economy, adding to the disincentives for Western competitors to invest in energy development in Ukraine.

Although Ukrainian officials sometimes talk about importing oil from the Caspian, most of Ukraine's oil continues to come from Russia. Ukraine has six major refineries, four of which are controlled by Russian oil companies (TNK-BP, Lukoil, Taftneft, and Alliance all own refineries). Refinery operators have found themselves in a difficult position on the Ukrainian market. On the one hand, Russian refineries receive cheaper crude oil because they do not have to pay the high export tariffs the Russian government imposes on crude exports going elsewhere. On the other hand, Ukrainian refineries are relatively unsophisticated and inefficient, so they have a hard time

competing with cheaper imported gasoline and diesel fuel from Central Europe.

Ukraine's energy sector benefits from, but is also complicated by, the country's role as a transit point for some 80 percent of Russian exports of oil and gas to the European Union. More oil and gas flows traverse Ukraine than any other country in the world. The gas transit trade is particularly opaque and open to corruption. In contrast to oil, where a number of Russian exporters compete with suppliers from the Middle East, a single state-controlled company, Gazprom, controls all the gas exports flowing from and through Russia. In the case of Ukraine, Gazprom channels exports through a company, RosUkrEnergo, jointly owned by itself and a "Ukrainian company." RosUkrEnergo generates huge profits, but there is little transparency about its operations, and the added value that it contributes for its profits is unclear. Within Ukraine, Gazprom collaborates with murky business interests to create a nontransparent energy distribution system that keeps out more transparent Western competitors, damaging Ukraine's energy and security interests. This system unfortunately has had the support of key Ukrainian officials. As a result, Ukraine remains highly dependent on decisions made in Moscow and has made far less progress than it should have on improving energy efficiency or developing competing supplies of gas and oil.

These vested interests, both political and business, have actively discouraged Western investment in the energy sector, leaving Ukraine with one of the lowest levels of foreign direct investment in energy in the region. Too many powerful individuals in Ukraine view foreign investment as a win-lose proposition, believing they and Ukraine would lose financially if Western firms were to increase their presence in the country's energy sector.

Even with the best intentions, Ukraine's unrealistic tariff system leaves little money with which to modernize its energy infra-

structure, including the major natural gas and oil pipelines to Europe. This adds credence to Russian charges that Ukrainians are unable to efficiently manage the major pipeline systems to European markets and Moscow's efforts to justify the construction of costly new pipelines bypassing Ukraine as necessary to guarantee the delivery of Russian energy supplies to Western Europe. Even Ukrainian energy observers concede that Ukrainian business groups—often with the support of the Russian distributor—systematically "divert" gas flowing into the trans-European pipeline system. As much as 22 percent of gas imported from Russia is estimated to "leak" out of the system in this manner. Some of the leakage may occur with the assistance of Gazprom's subsidiaries operating in Ukraine. This diversion creates enormous profits for both Russian and Ukrainian businessmen, but Ukraine is assigned most of the blame by the European consumer countries.

Uncertainties in Ukraine's Relations with the West

Despite Ukraine's international achievements, the authorities in Kyiv have failed to fully capitalize on their developing relations with key Western institutions. The core of the problem during the Kuchma era (1994–2004) was Ukraine's self-imposed "multi-vectorism" in its foreign and security policy. The evident search for balance between West and East was increasingly seen as neutrality, an effort to play one side off against the other, or even as isolation from the major international institutions. Multi-vectorism became non-vectorism, in which indecision and fence-sitting left the country vulnerable to Kremlin pressures, especially when faced with an assertive Russia following Vladimir Putin's assumption of power in 2000.

The period since the Orange Revolution has been marred by missed international opportunities on the part of the Ukrainian authorities, despite the openness exhibited by Washington and Brussels after the democratic breakthrough. Confusion over Ukraine's strategic orientation, especially after the appointment of Yanukovich as prime minister in August 2006, was compounded by the absence of decisive leadership and unified decision-making among the presidency, cabinet, and Rada. The ongoing struggle between different power centers over the role of the president in foreign policy—as evidenced by the struggle over the firing of the foreign minister in early 2007—and disputes over a revised constitution diminish Ukraine's effectiveness in the international arena and undermine Kyiv's security strategy.

Kyiv has sent mixed signals on the question of NATO membership. After a long period of favoring closer cooperation with NATO, in May 2002 Kuchma announced Ukraine's goal of eventual NATO membership. The Rada later approved a national security strategy including NATO membership. This position was reinforced by Yushchenko in the immediate wake of the Orange Revolution, when he specified NATO entry as a priority national goal. However, that strategic choice was contradicted by Yanukovich during his September 2006 visit to Brussels, when he supported close cooperation with NATO but said that he did not endorse early conclusion of a membership action plan as called for by the president.

Strategic confusion has been accompanied by unfulfilled expectations. Even when lip service has been paid to NATO integration, this has not been underpinned by a commensurate political commitment and an active public relations campaign among Ukrainian citizens. Public support for NATO remains slender (20 to 30 percent of those polled, little different from the level of support in the late 1990s), and the government has not been active in

explaining the benefits and costs of alliance membership. The government needs to take an active hand in explaining what NATO is today and in countering Russian propaganda, so that Ukraine's citizens can make intelligent, self-interested, and fully informed choices about their country's security relations. This is of particular concern as NATO will want to see evidence of public support, and the Ukrainian public expects a national referendum on NATO membership, before the government formally submits a request for membership. Yushchenko, Tymoshenko and Rada Speaker Yatsenyuk have called for conclusion of a membership action plan at the April 2008 Bucharest NATO summit, but it is not clear how much support this proposal has with the broader Ukrainian public. Such divisions are likely to prolong Kyiv's indecisiveness and could be further exploited by opponents of NATO enlargement.

Some of Ukraine's international setbacks are not solely Kyiv's responsibility. In principle, EU member states accept Ukraine as a European state; hence the country can qualify for accession. However, the EU approach toward Ukraine has contributed to stalling the progress of integration. Union officials and some EU government leaders claim that Ukraine has not met the Copenhagen Criteria for EU entry. In many respects Ukraine has reached or even surpassed the level of some western Balkan states, which are on track for EU entry through their Stabilization and Association Agreements (SAAs), but the Ukrainian government should devote close attention to full implementation of the Copenhagen Criteria.

The differentiation between Ukraine and the western Balkans may not be primarily the result of Kyiv failing to meet specific EU standards. Indeed, the Union itself appears unprepared and unwilling to give direct membership prospects to a country of 46 million people that would necessitate new internal voting arrangements, a revamped agricultural policy, and other structural changes, as well

as referenda on accepting Ukraine as an EU candidate in countries such as France.

The European Neighborhood Policy, its Action Plan for Ukraine, the Partnership and Cooperation Agreement, and the EU-Ukraine enhanced agreement currently under negotiation are important mechanisms for promoting reform and institutional engagement, but they have inbuilt limitations. Unlike the SAAs in the western Balkans, none of the Ukrainian processes was designed to facilitate a path to membership. In fact, the lumping together of the EU's Eastern and Southern Dimensions placed Ukraine (as well as Moldova and Georgia) in a similar category with Morocco, Tunisia, and other states that are not European.

The planned free trade agreement with the European Union following Ukraine's WTO accession is an important incentive, but it may not be sufficient to attract Ukraine westward in terms of consolidating efficient governance, institutional reform, and sustained economic performance. At the same time, Russia continues to be a major countervailing force, seeking a greater role in the Ukrainian economy and in dominating Kyiv's energy policy.

Ukraine has in recent years played a more active role in trying to find a solution to the Transnistria dispute. Kyiv can wield considerable influence and should intensify its efforts in this regard. Doing so would not only increase the prospects for resolution, but also would burnish Ukraine's credentials with the European Union and further the integration of Ukraine (and Moldova) into Europe.

Vulnerabilities in the Relationship with Russia

Although Ukraine has made progress in developing its freedom for independent maneuver, the country remains unacceptably vulnerable to Russian political and economic pressure as a consequence of its dependence

on Russian energy imports, as well as corrupt and nontransparent financial relationships.

This vulnerability is the single greatest threat to Ukraine's sovereignty and security. Whereas traditional security analysis focuses on military threat and power balances, any understanding of Ukraine's security vulnerabilities must place at the center Ukraine's elite entanglement in Russia's own corrupt political economy.

The problem is not the economic relationship itself. With an economy increasing in international integration and interdependence, Ukraine will always be vulnerable to normal disruptions and shifts in trade. However, the specific political vulnerability evident in Ukraine's energy relations with Russia, or the 2006 Russian boycott of Ukrainian meat and dairy products, stems not from the normal interdependencies of trade, but largely from nontransparent ownership and contract arrangements and the complicity of Ukraine's political and business elites in corrupt ownership and financial practices.

Ukraine would be vulnerable to Russian political pressure if it were to be unable to bring trade disputes to international mediation, such as provided by the WTO, or international contract law. Failure to make substantial progress in anticorruption efforts, in establishing the rule of law in commercial relations and contracts, and in advancing vigorously in integration with the European Union and other global economic arrangements, such as the WTO, do not merely constitute major setbacks in Ukraine's international economic prospects (deterring Western investment and undermining market mechanisms), they create fundamental security vulnerabilities. It is also important to keep in mind that, ultimately, Russian national interests will be best served by transparent, competitive, and commercially viable trade relations with Ukraine, because such relations would help to further integrate Russia into European and global markets.

The second major area of Ukraine's inadequate progression toward sovereignty and independence in its relations with Russia lies in an important set of unsettled disputes. First among these remains the problem of border demarcation. Ukraine's problems with Russia in the Sea of Azov and Kerch Strait are the clearest example, as illustrated by the fall 2003 mini-crisis between Kyiv and Moscow over Tuzla Island. The announcement in November 2007 that Ukraine and Russia have agreed on a demarcation of their border in the Sea of Azov is promising. If this specific area is successfully negotiated, Ukraine should press for a comprehensive demarcation of its border with Russia. Among other reasons for this priority, Ukraine's future relationship with NATO could be affected by an unsettled border demarcation status.

A related area where Ukraine has made some progress in its relations with Russia, but where there could yet be a challenge to Ukraine's sovereignty, is Crimea, home to a large number of ethnic Russians and, until 2017, a significant part of the Russian Black Sea Fleet. Local ethnic Russian political figures remain closely tied to Russia, actively seek Moscow's involvement in local politics, and receive financial and political support from Russian sources. Ukrainian political and security authorities should not interfere in the legitimate political activities of Ukrainian citizens, but they should monitor and prevent interference by Russian official sources in Crimea.

Ukraine has begun to make substantial progress on setting the historical record straight in order to establish a sound basis for Ukraine's political and security relationships, but more work is necessary. History looms large in Central and Eastern Europe, not least because of the unwillingness of nations in the region to confront honestly their past relationships. This is a complicated past, entangling guilt and victimization in Bolshevism, fascism, the Holocaust, Stalinism, ultranational-

ism, and modern ethnic conflict. Ukraine's past is no less complex and tortured than other countries in the region that suffered or allowed crimes arising from totalitarian rule or extremist ideologies.

Russia under President Putin seeks to deny the dark passages of its history, including Moscow's own complicity in crimes against its citizens during the Soviet period. Putin has sought to claim for Russia a status of aggrieved victim and to assert that Russia is unjustly criticized and insufficiently appreciated for its role in World War II. An honest accounting would recognize Russia's suffering and its role in defeating Nazism, but also would acknowledge the Nazi-Soviet pact that carved up Eastern Europe, the millions killed by Soviet rule, and the tens of millions more repressed and victimized before, during, and after that war. Only an honest accounting can allow Russians to be proud of their contributions yet hold the country accountable for the crimes of its leaders and some citizens as well.

Most importantly, Ukraine and other European countries cannot allow Russia to manipulate the historical record in order to claim the role of aggrieved victim for political advantage in pressing Russian claims and demands relating to security and political relations in Europe. If this were merely a matter of truth and history, the issues would be serious enough. But establishing the truth about the Soviet Union and the Holodomor (the 1930s Stalinist state-engineered mass famine in which millions of Ukrainians perished), as well as Nazi Germany and the Holocaust, is also about Ukraine's ability to stand as a sovereign and independent country. Ukraine has a special role to play in establishing the true record on the collapse of the Soviet Union and not letting Putin's myth of the "greatest geopolitical catastrophe of the twentieth century" stand unchallenged. These historical interpretations are important because they are used to establish contemporary political legitimacies and interstate relations.

4

KEY TASKS AND RECOMMENDATIONS

For Ukraine

As the new Tymoshenko cabinet begins its first months in office, there are a number of key tasks for the Ukrainian government and Rada at the beginning of 2008. No government can do everything at once; the president and the Tymoshenko cabinet must set priorities. In view of its desire to integrate into Europe, Kyiv should consider steps that will not only mean better domestic and foreign policies, but that will also send a strong signal to EU capitals of Ukraine's commitment to reform and to the path of integration into Europe, particularly as negotiations on an enhanced EU-Ukraine agreement proceed.

Political, Economic, and Energy Sector Recommendations

Priority measures in the area of improving governance should include:

- *Constitutional reform.* Ukraine's constitution and associated laws, such as the law on the cabinet of ministers, need to be changed to eliminate ambiguities and draw clear delineations of authority between the president and the prime minister, and between the Rada and the executive branch. Until this is done, future political clashes will carry the risk of evolving into paralyzing constitutional crises.
- *Judicial reform.* Ukraine needs a judicial branch that can be relied upon to make fair decisions in criminal cases, business disputes, and other matters. Change is essential to curb corruption, to strengthen the

rule of law in general and public respect for law, and to improve the business and investment climate. Key issues include: use of precedence in determining court cases; organizational reform to clarify the hierarchy between different courts; and completion of judicial code reforms. Measures to remove corrupt and incompetent judges are needed: while judges should be given secure tenure, they must be made accountable to the collegium of judges. Judicial reform will be a long-term effort but needs to start immediately.

- *Administrative reform.* This is needed within the central government and between Kyiv and the regions. Ukraine requires a modern central government bureaucracy, staffed by a professional, honest civil service, to support a modern European state and a robust market economy. Territorial-administrative reform should make *oblast* and local officials directly accountable to their publics, producing more effective and responsive regional and municipal government.
- *Greater transparency and responsiveness.* All levels of government need to become more transparent. Too many government decisions are made behind closed doors, creating opportunities for corruption and contributing to public cynicism about the fairness of state policy. Officials of all levels of government should demonstrate greater responsiveness to Ukraine's citizens and look for ways to empower civil society.

Priority economic reform measures should include:

- *Commercial code abolishment.* The code interferes with the ability of businesses to operate. Due to its contradictions with the civil code, it creates a confusing legal environment and discourages investment.
- *Free sale and transfer of agricultural land.* The Rada should pass legislation that will facilitate creation of a land market and open up access to mortgages. It should stimulate an influx of private capital into the agricultural sector, which will help alleviate poverty in rural areas and be an additional stimulus to the economy.
- *A modern tax code.* The government should propose and the Rada should enact a modern tax code. This would simplify taxes for both businesses and ordinary citizens, reduce possibilities for corruption, and eliminate assessments that unfairly fall on certain, less-well-off groups and, in some cases, pose barriers to exports. Significant work has already been done on the draft of a new code.

As the new government sets its governance and economic reform priorities, it should communicate those priorities clearly to the European Union and the U.S. government. EU and U.S. assistance programs, while reduced from the levels of the 1990s, can be targeted to assist the identified priorities.

Priority measures to reform the energy sector should include:

- *Market prices.* The government should set in motion a program to use markets to set energy prices or, in the case of gas and electric power, move to full cost-recovery levels. Energy tariffs (prices) in both the industrial and consumer sectors should reflect real import and domestic production costs. Only with appropriate price signals will producers, importers, and consumers make the decisions that will result in the efficient utilization and production of

energy in Ukraine. The government should set a schedule to move households to prices that cover costs, supplemented with policies to cushion the impact of higher prices on the most vulnerable households. Domestic producers of gas and oil should receive the same prices as foreign suppliers.

- *Restructuring of Naftogaz Ukrainy.* The government should immediately make changes in the board of directors and management necessary to restructure Naftogaz Ukrainy so that production, pipelines, and distribution are handled by independent subsidiaries. Internal transfer pricing between these subsidiaries should be made at market or full-cost recovery prices. Transit and other prices should be set high enough to cover the cost of modernizing and renovating the existing pipeline system.
- *Dealing directly with Gazprom.* Ukraine should immediately repudiate its contracts with RosUkrEnergo and negotiate gas purchase contracts directly with Gazprom. This would increase transparency and weaken the power of oligarchs and politicians who benefit financially through collaboration with Russian state-controlled entities.
- *Tax reduction.* Taxes on exploration and development projects should be reduced to bring them more in line with Western levels. The law should also make it easier for holders of exploration licenses to also secure production licenses, thereby encouraging more foreign direct investment in the energy sector.
- *Privatization.* Ukraine should restart the privatization of the remaining assets in the energy sector through open tenders for all assets. Such a program should draw the interest of European and American companies, thereby bringing investment and more diversified ownership of Ukraine's energy infrastructure.

- *Charters.* Ukraine should implement the transit protocol of the European Energy Charter that stipulates the creation of a “common carrier” system. It should also sign and implement the Athens Energy Treaty to encourage more foreign direct investment in the energy sector.

Foreign Policy Recommendations

The new government should pursue the following steps in the foreign policy arena:

- *WTO accession.* Ukraine should complete the remaining details to finalize its accession to the World Trade Organization. WTO accession will integrate Ukraine more tightly into the global economy and reduce trade barriers for Ukrainian exporters. It will also satisfy the European Union’s prerequisite for negotiation of an EU-Ukraine free trade agreement, the conclusion of which will open further opportunities for Ukrainian businesses to export into Europe and for better and cheaper products for Ukraine’s citizens.
- *Enhanced agreement with European Union.* Ukraine should press for early conclusion of a forward-looking enhanced agreement with the European Union that provides a solid foundation for practical cooperation as well as opportunities for deeper integration with the Union. Once the agreement is signed, Ukraine should devote maximum effort to implementation; few things will make a stronger case in Brussels for creating a membership perspective than Ukraine’s progress in consolidating a political and economic system compatible with those of EU member states. Ukraine should strive for early completion of a free trade agreement with the European Union.
- *Focus on NATO relations.* In terms of its democratic and military reforms, Ukraine is increasingly prepared for a NATO membership action plan, but divisions remain among the political elite, and public support for NATO membership is low. If they wish to become a candidate for NATO, the Ukrainian authorities must demonstrate their long-term commitment to transatlantic security and values and explain to their citizens the nature and value of the alliance.
- *NATO information campaign.* An effective informational campaign needs to be conducted to raise public knowledge about NATO. The advantages and obligations of alliance membership must be explained to dissipate the Cold War stereotypes that still persist in Ukrainian society. While the alliance can help, a public information effort must be led by Ukrainian organizations in order to be credible with the public.
- *Greater activism in regional initiatives.* Ukraine needs to be more actively involved in various regional initiatives, including the EU’s newly launched Black Sea Synergy, the Black Sea Economic Cooperation, the South East European Defense Ministerial, the South-East Europe Brigade, the Southeast European Cooperation Initiative (SECI), Black Sea Harmony (the Turkish-led maritime Black Sea exercises) and the Central European Visegrad initiative. All of these initiatives can enhance Ukraine’s security, its regional role, and its engagement with both NATO and the European Union. They can also help reshape Ukraine’s image from a “post-Soviet” to “Central European” state.
- *Stable relations with Moscow.* While Ukraine pursues its course of European integration, Ukraine and Russia should work together for stable and constructive relations. This includes pragmatic solutions to bilateral problems and making clear that, though Ukraine seeks to draw closer to Europe, this is not intended as an anti-Russian move.

For the European Union

A Ukraine committed to transformation into a modern European democracy with a robust market economy deserves the full support of the European Union, as such a Ukraine is exactly the kind of neighbor, and potential member, that EU officials should want. A strong Ukraine, moreover, will be capable of more stable and predictable relations with Russia than a weak and undecided Ukraine that remains adrift from international institutions.

Priority tasks for the European Union should include:

- *Broader travel opportunities.* The European Union should broaden travel opportunities for Ukrainians to EU countries, including expanded exchange programs, particularly educational exchanges and visa facilitation. The better Ukrainians understand Europe, its values and political and economic systems, the more they can do to accelerate Ukraine's progress on its path to Europe.
- *Technical assistance in the energy field.* The European Union should provide technical assistance to Ukraine to meet goals in the energy field set by the International Energy Agency, World Bank, European Bank for Reconstruction and Development, and EU itself. The European Union can advise Ukraine on drawing up open tenders in line with international standards and containing provisions for Stockholm arbitration in awarding exploration, development, and distribution rights. The European Union should fund and support twinning programs and open audits involving representatives from the above organizations working alongside Ukrainians in the energy and industry ministries, in the state oil and gas companies, in Ukrtransnafta and Naftogaz Ukrainy, and in the oversight committees in the Rada.
- *Technical assistance on residential heating.* The European Union should encourage member states with efficient central residential heating systems, such as Finland and Sweden, to provide technical assistance to Ukraine. This assistance should include help in upgrading and metering all multiunit residential systems and small businesses tied into the energy system.
- *Assistance on long-term energy strategy.* The European Union should encourage the World Bank and the International Energy Agency to help the Ukrainian government formulate a long-term energy strategy and encourage the International Atomic Energy Agency to help Ukraine develop a more robust program to increase efficiency and safety at all its nuclear plants.
- *Support for direct contract negotiations.* The European Union should support Ukrainian efforts to negotiate direct gas purchase contracts with Turkmenistan and Kazakhstan.
- *An enhanced agreement with the European Union.* EU officials should negotiate an enhanced EU-Ukraine agreement that strongly encourages Ukraine's quick adoption of European political and economic standards. The centerpiece of the economic portion of this agreement should be a rapidly negotiated EU-Ukraine free trade agreement.
- *Clarity on EU integration and process.* An EU signal (perhaps in the enhanced agreement) regarding Ukraine's future membership as a desirable and attainable goal would spur the country's political and economic transformation and provide additional international protection against countervailing trends and pressures from inside and outside Ukraine. While it is unrealistic to expect the European Union to reach a consensus on offering Ukraine a membership perspective in the next few years, EU officials should develop other inducements to promote deeper reform in Ukraine; not offering even a long-term

membership perspective is shortsighted and costs the European Union significant leverage that could encourage Ukraine's more rapid transformation. EU officials must also clarify what delays to further enlargement are expected inside the European Union as the Reform Treaty is ratified and implemented and appropriate structural changes are undertaken. EU officials need not invent new mechanisms and processes for Ukraine, as these are more likely to be interpreted as means for keeping Ukraine out of institutional Europe rather than drawing it in.

- *Enhanced ENP and CFSP engagement.* The Union's European Neighborhood Policy with Ukraine must be enhanced with programs compatible with the SAA process in the western Balkans. A clear distinction must also be made between the EU's "European neighbors" such as Ukraine and "Europe's neighbors" in the Middle East and North Africa. Intensifying engagement with Ukraine should also entail its closer involvement in the EU's Common Foreign and Security Policy and participation in crisis management planning.
- *NATO-Ukraine relations.* Those EU members that also belong to NATO should support the alliance in enhancing its engagement and assistance programs in areas that will increase Ukraine's security. The alliance has helped Ukraine in developing civil emergency planning and disaster response capabilities. Further collaborative programs could be undertaken in such areas as security sector reform, counterterrorism, and countering organized crime. Such actions should be visible to the Ukrainian public so they can positively impact on perceptions of NATO. The allies should extend a membership action plan to Ukraine, recognizing that the objective of a MAP is to create the preconditions for consideration of membership but in no

way prejudice a decision by Ukraine to request membership or by NATO to extend an invitation to join the alliance.

For the United States

With a new Ukrainian government in place, the U.S. government needs to pursue a reenergized policy that reflects the importance of a successful Ukraine to the U.S. goal of a broad, stable, and secure Europe. The bilateral agenda is relatively free of problems at present, which means that focus can be devoted to promoting Ukraine's accelerated transformation and integration into the European and Euro-Atlantic institutions.

Priority recommendations for the United States include:

- *High-level engagement.* The U.S. government should resume active high-level engagement with Kyiv, including at the presidential and cabinet level, particularly the secretaries of state, energy, and commerce.
- *Broader travel opportunities.* The U.S. government should broaden travel opportunities for Ukrainians to the United States, including expanded exchange programs, particularly educational exchanges, in order to arm more Ukrainians with education, expertise, and experience that will help them more rapidly transform their country.
- *Dialogue with Europe.* The U.S. government should continue its dialogue with the European Union and with NATO countries on how to foster stronger links between Ukraine and Europe and the Euro-Atlantic community.
- *Free trade agreement.* As Ukraine enters the WTO and negotiates a free trade agreement with the European Union, the U.S. government should consider the merits of a bilateral U.S.-Ukrainian free trade agreement.

- *Assistance on long-term energy strategy.* The U.S. government should encourage the World Bank and the International Energy Agency to help the Ukrainian government formulate a long-term energy strategy and encourage the International Atomic Energy Agency to help Ukraine develop a more robust program to increase efficiency and safety at all its nuclear plants.
- *Support for direct contract negotiations.* The U.S. government should support Ukrainian efforts to negotiate direct gas purchase contracts with Turkmenistan and Kazakhstan.
- *NATO-Ukraine relations.* The U.S. government should support NATO in enhancing the alliance's engagement and assistance programs in areas that will increase Ukraine's security. The alliance has helped Ukraine in developing civil emergency planning and disaster response capabilities. Further collaborative programs could be undertaken in such areas as security sector reform, counterterrorism, and countering organized crime. Such actions should be visible to the Ukrainian public so they can positively impact on perceptions of NATO. The allies should extend a membership action plan to Ukraine, recognizing that the objective of a MAP is to create the preconditions for consideration of membership but in no way prejudge a decision by Ukraine to request membership or by NATO to extend an invitation to join the alliance.



APPENDIX: UKRAINE FACTS AND FIGURES

General

Total area	603,700 sq km
Land boundaries	total: 4,663 km
Border countries	Belarus 891 km; Hungary 103 km; Moldova 939 km; Poland 526 km; Romania 169 km (south), 362 km (west); Russia 1,576 km; Slovakia 97 km
Capital	Kyiv (pop.: 2.6 million)
Administrative units	24 provinces (oblasts), plus Kyiv, Sevastopol, and Crimea
Natural resources	iron ore, coal, manganese, natural gas, oil, salt, sulfur, graphite, titanium, magnesium, kaolin, nickel, mercury, timber, arable land
Population	46,299,862 (July 2007 est.)
Median age	39.2 yrs.
Population below poverty line	26.7% (2006 est.)
Age structure	0-14 yrs.: 14% (male 3.3 million / female 3.1 million); 15-64 yrs.: 69.6% (male 15.4 million / female 16.8 million); 65 yrs.+ : 16.3% (male 2.6 million / female 5.0 million) (2007 est.)
Population growth rate	-0.675% (2007 est.)
Languages	Ukrainian 67%; Russian 24%; other 9% (Romanian, Polish, and Hungarian minorities)
Literacy	99.7%
Ethnic groups	Ukrainian 77.8%; Russian 17.3%; Belarusian 0.6%; Moldovan 0.5%; Crimean Tatar 0.5%; Bulgarian 0.4%; Hungarian 0.3%; Romanian 0.3%; Polish 0.3%; Jewish 0.2%; other 1.8% (2001 census)
GDP by sector	agriculture: 17.5%; industry: 42.7%; services: 39.8% (2006 est.)

Investment (gross fixed)	22.9% of GDP (2006 est.)
Industrial production growth rate	6.3% (2006 est.)
Current account balance	-\$1.933 billion (2006 est.)
Exports	\$38.88 billion (2006 est.)
Exports—commodities	ferrous and nonferrous metals, fuel and petroleum products, chemicals, machinery and transport equipment, food products
Imports	\$44.11 billion
Imports—commodities	energy, machinery and equipment, chemicals

Source: CIA, *The World Factbook*.

Economy, 2004–2008

	2004	2005	2006	2007	2008
GDP growth	12.1%	2.7%	7.1%	5.0%	4.6%
GDP, U.S.\$ billions	64.88	86.04	106.07	122.80	137.67
GDP per capita, U.S.\$	1,372	1,833	2,273	2,648	2,987
GDP, PPP per capita, U.S.\$	6,594	7,023	7,636	8,059	8,567
Inflation	9.0%	13.5%	9.0%	11.3%	10.0%

Source: International Monetary Fund; shaded cells are IMF estimates.

Political

Type of government	Parliamentary-presidential system
Chief of state (five-year term)	President Viktor Yushchenko
Head of government	Prime Minister Yuliya Tymoshenko
Governing parliamentary majority	Our Ukraine/People's Self Defense and Bloc of Yuliya Tymoshenko
Independence day	August 24, 1991
Parliament	Verkhovna Rada, 5-year terms, 3% threshold

Party Representation in the Rada

Political Parties	2007 %	Seats	2006 %	Seats
Party of Regions	34.37%	175	32.14%	186
Bloc of Yuliya Tymoshenko	30.71%	156	22.29%	129
Our Ukraine/People's Self Defense	14.15%	72	13.95%	81
Communist Party of Ukraine	5.39%	27	3.66%	21
Lytvyn Bloc	3.96%	20	2.44%	--
Socialist Party of Ukraine	2.86%	--	5.69%	33
Others/Against All	8.56%	--	19.83%	--
Total		450		450

2004 Presidential Election Results

Candidates—Nominating Parties	First Round 10/31/2004	%	Final Round 12/26/2004	%
Viktor Yushchenko—self-nominated	11,188,675	39.90	15,115,712	51.99
Viktor Yanukovich—PR	11,008,731	39.26	12,848,528	44.20
Oleksandr Moroz—SPU	1,632,098	5.82		
Petro Symonenko—KPU	1,396,135	4.97		
Nataliya Vitrenko—Progressive	429,794	1.53		

Source: Central Election Commission of Ukraine.

Largest Investors in Ukraine (percentage of total FDI)

	2004	2005
Germany	7.2	33.6
Cyprus	12.2	9.5
Austria	4.0	8.7
United States	13.2	8.4
United Kingdom	10.6	7.1
Russian Federation	8.0	4.9
Netherlands	7.0	4.4
Virgin Islands (British)	6.4	4.2
Switzerland	4.9	2.7

Source: InvestUkraine.

Energy

Electricity consumption	181.9 billion kWh (2006)
Electricity exports	10.44 billion kWh (2006)
Electricity imports	20 billion kWh (2006)
Oil production	90,400 bbl/day (2006)
Oil consumption	284,600 bbl/day (2006)
Oil exports	17,880 bbl/day (2006)
Oil pipeline transmissions	934,000 bbl/day (2005)
Natural gas production	20.85 billion m ³ (2006)
Natural gas consumption	73.94 billion m ³ (2006 est.)
Natural gas exports	4 billion m ³ (2006)
Natural gas imports	57.09 billion m ³ (2006 est.)
Natural gas proven reserves	1.08 trillion m ³ (2006 est.)

Sources: CIA, *The World Factbook*; and BP Statistical Review 2006.



APPENDIX: THE U.S.-EU PARTNERSHIP COMMITTEE FOR UKRAINE

The Center for Strategic and International Studies (CSIS) announced on January 22, 2007, the launch of the U.S.-EU Partnership Committee for Ukraine. Cochaired by Zbigniew Brzezinski, CSIS counselor and trustee, and Volker R u he, former defense minister of Germany, the project supports the consolidation of Ukraine’s democracy and market economy and encourages joint U.S.-EU policies that enhance Ukraine’s integration into Euro-Atlantic institutions.

The Committee is composed of a select group of senior policymakers from the United States and European countries, including former U.S. secretary of state Madeleine Albright, former Polish foreign minister Bronislaw Geremek, former Estonian prime minister Mart Laar, current ranking minority member of the U.S. Senate Committee for Foreign Relations Richard G. Lugar, former U.S. secretary of defense William Perry, former Norwegian foreign minister Jan Petersen, former UK foreign secretary Sir Malcolm Rifkind, and former national security adviser Lt. Gen. Brent Scowcroft.

The Partnership Committee has offered strategic advice and practical recommendations to the governments of Ukraine, the United States, EU member states, and to EU institutions on the most effective policies for ensuring Ukraine’s progress toward political pluralism, the rule of law, market openness, and strong linkages with Euro-Atlantic institutions, while also maintaining a constructive relationship with Russia.

The Partnership Committee is supported by the analysis and policy advice of four CSIS

task forces structured around four key challenges facing Ukraine: political and economic transformation, energy security, Ukrainian-Russian relations, and Euro-Atlantic integration. CSIS task force directors include Steven Pifer, former U.S. ambassador to Ukraine and CSIS senior adviser; Keith Smith, former U.S. ambassador to Lithuania and CSIS senior associate; Celeste Wallander, professor at Georgetown University and CSIS senior associate; and Janusz Bugajski, director of the CSIS New European Democracies Project and senior fellow in the Europe Program. In addition to working with U.S. scholars, CSIS has reached out to experts in Europe, including the German Council on Foreign Relations (DGAP) in Berlin. CSIS also collaborates with Chatham House in London under the guidance of its director, Robin Niblett, former director of the CSIS Europe Program, to integrate and coordinate European perspectives on Ukraine.

ABOUT THE AUTHORS

Janusz Bugajski is director of the New European Democracies Project and senior fellow in the Europe Program at CSIS. He chairs the South-Central Europe area studies program at the Foreign Service Institute (FSI) at the U.S. Department of State. His books include *Atlantic Bridges: America's New European Allies*, with Ilona Teleki (Rowman & Littlefield, 2007); *Cold Peace: Russia's New Imperialism* (Praeger, 2004); *Political Parties of Eastern Europe: A Guide to Politics in the Post-Communist Era* (M.E. Sharpe, 2002); *Ethnic Politics in Eastern Europe: A Guide to Nationality Policies, Organizations, and Parties* (M.E. Sharpe, 1994); and *Nations in Turmoil: Conflict and Cooperation in Eastern Europe* (Westview, 1995).

Steven Pifer is a senior adviser with the Russia and Eurasia Program at CSIS. He has offered commentary regarding Russia and Ukraine on CNN International, Fox News, CNBC, BBC World, NPR, and VOA, among others. A retired Foreign Service officer, his more than 25 years with the State Department included assignments as deputy assistant secretary of state in the Bureau of European and Eurasian Affairs (2001–2004), ambassador to Ukraine (1998–2000), and special assistant to the president and National Security Council senior director for Russia, Ukraine, and Eurasia (1996–1997). He also served at the U.S. embassies in Warsaw, Moscow, and London, as well as with the U.S. delegation to the Intermediate-Range Nuclear Forces negotiations in Geneva.

Keith Smith is a senior associate with the Energy and National Security Program at CSIS. He retired from the U.S. Department of State in 2000, where his career focused primarily on European affairs. From 1997 to 2000, he was U.S. ambassador to Lithuania. Additional posts in Europe included Hungary (twice), Norway, and Estonia. In addition to several other State Department assignments, he served as director of policy for Europe and senior adviser to the deputy secretary of state for the SEED Program. His articles have appeared in the *International Herald Tribune*, *Economist*, and *Georgetown Journal of International Affairs*, and he has appeared on BBC World, CNN, and CSNBC. His recent CSIS publications include “Russian Energy Pressure Fails to Unite Europe,” *EuroFocus* (January 2007) and “Current Implications of Russian Energy Policies,” *Issue Brief* (January 2006).

Celeste A. Wallander is a nonresident senior associate with the Russia and Eurasia Program at CSIS, as well as a visiting associate professor at the Center for Eurasian, Russian, and East European Studies in the School of Foreign Service at Georgetown University. She is the author of over 70 scholarly and public policy articles on security affairs, in addition to *Mortal Friends, Best Enemies: German-Russian Cooperation after the Cold War* (Cornell, 1999.) She is also the editor, with Eugene Rumer, of *Russia Watch: Essays in Honor of George Kolt* (CSIS, 2007) and, with Robert Legvold, of *Swords and Sustenance: The Economics of Security in Belarus and Ukraine* (MIT, 2004).