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## **Russia's strong arm tactics may do Ukraine a favour**

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Kudos to Russia for promoting reforms in Ukraine. A year ago, Russian involvement in presidential elections played a big role in mobilising Ukrainians to take part in the Orange revolution, Ukraine's leap towards democracy. The current gas dispute can do the same for Ukraine's economic reforms and push it closer to western Europe.

Addiction to cheap Russian gas is the worst handicap of Ukraine's economy. Every year since 1991, Russia has subsidised it with several billion dollars' worth of cheap gas. How much this subsidy is worth is hard to say. If Ukraine buys 25bn cubic metres of Russian gas at Dollars 50 for 1000 cu m, as it did in 2005, it owes Russia Dollars 1.25bn (Pounds 719m). If Russia charges Dollars 200 per 1,000 cu m, as its state-owned monopoly, Gazprom, has demanded, Ukraine has to pay Dollars 5bn. The difference amounts to a Dollars 3.75bn subsidy. According to the US State department, US assistance to Ukraine in the 2005 fiscal year was about Dollars 174m.

Cheap Russian energy has been a crutch that has kept Ukraine's economy from learning to walk on its own. Its industry is dominated by iron and steel, which accounts for nearly a quarter of industrial output and a third of exports. Cheap Russian energy imports and high commodity prices worldwide have benefited this sector economically and politically. Metallurgical plants make up the core of big Ukrainian business groups - oligarchies - that wield enormous influence in Ukraine's notoriously corrupt domestic politics.

Their wealth and power have cost Ukraine dearly. According to a recent World Bank study, Ukraine's metallurgical sector is wasteful, with energy consumption 25-30 per cent higher than elsewhere in Europe. Much of this sector is obsolete, environmentally unsafe and in need of technological upgrades. But take away Russian energy subsidies and the picture begins to change. Ukraine's industrial heartland would have to face reality: modernise or die. This would create pressure for a more welcoming investment climate.

Russia's demands seem to have a political rationale as well. Ukraine's leadership is facing a tough test in March, when the country will hold parliamentary elections. A poor showing at the polls would complicate the already difficult domestic agenda. To the extent that Russian logic can be discerned here, a sudden jump in energy prices would send a clear message to Ukrainian voters that their new leaders were failing and that the Orange revolution was a mistake.

If that is Moscow's political logic, it ignores the main lesson of the Orange revolution - that external interference can have unintended consequences. Ukraine's industrial base is concentrated in the east, which is home to many ethnic Russians. The burden of the gas price hike is bound to fall disproportionately there. Why this would endear Gazprom or the Russian government to the residents of those regions, or anywhere else in Ukraine, is not clear. Russian actions are just as likely to backfire, as they did during the Orange revolution.

For Ukraine, the removal of Russian energy subsidies would have a liberating effect. It would weaken Russian leverage in its domestic and foreign affairs; it would undercut the influence of corrupt oligarchs in Ukrainian domestic politics; and it would create powerful incentives for long overdue structural reforms of its economy. With its vast resources, enormous human capital and location in Europe, Ukraine would be poised to leapfrog into the post-industrial age.

But as long as Ukraine pays for Russian gas a fraction of what it is worth, Russia will have Ukraine over the barrel or, more appropriately, over the pipe. Ukraine's friends on both sides of the Atlantic should keep in mind that energy independence is even more important for Ukraine than Nato membership. Russia's move to restore deliveries to European customers may partly ease the present controversy, but the longer Ukraine's leaders wait to devise plans to cut dependence, the harder it will be to kick the habit.

Europe and the US should help Ukraine develop a viable energy strategy. An emergency fund established by the US and the European Union to stave off disruptions in the work of the country's utilities would make it clear to Ukrainian voters who their real friends are. In the long run, stepped-up assistance for Ukraine's structural reforms, some of which are already being undertaken with funding from the World Bank, would help complete the work of the Orange revolution.

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