

Coercion and Financial Secrecy in Ukraine's Emerging Economy WHAT THE IMF APPROACH MISSES

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Much analysis of how Ukraine's economy operates takes place through the lens of International Monetary Fund (IMF) recommendations and reviews, which focus on budget deficits and anti-corruption efforts. Excessive emphasis on formal policy changes, however, and the "political will" to carry them out, ignores a number of forces at play in creating and maintaining real economic activity on the ground. While high-level discussions are occurring in Kyiv or Washington, people in Ukraine are creating new patterns of economic activity in practice. This memo examines some of these developments, demonstrating the ubiquity of both coercion and secrecy in market interactions. These characteristics are not unique to wartime Ukraine, although they are easier to see in that context. Likewise, within Ukraine, they are not confined to Crimea or the Donbas; they flourish throughout the country. The lesson, therefore, is that we need to think more about how to redirect and reshape these activities, rather than simply trying to eliminate them.

The Usual Story

Ukraine joined the IMF in 1992 and has signed no fewer than ten major agreements with it—two since the Euromaidan in 2014. The goals of macroeconomic stabilization and structural reform have remained remarkably stable over the years, and each new agreement has been signed amid renewed optimism because the IMF has routinely professed conviction that the government is ready to muster the "political will" to implement the required reforms.

In some respects, Ukraine has achieved extraordinary success in areas the IMF deems important. Most notably, the economy returned to growth in 2016, despite the ongoing fiscal and physical toll of the war. Although industrial growth was still negative, retail and agriculture led the economy to a 2.3 percent growth rate in 2016 after declines of 6.6

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percent in 2014 and 9.9 percent in 2015. The blockade against Donbas coal hampered industrial production in the first third of 2017, but an IMF statement in May continued to predict GDP growth of over 2 percent for the year. In addition, the annual inflation rate has remained under 10 percent; the Ukrainian *hryvnia* (which has remained free-floating, consistent with IMF recommendations) has avoided any precipitous drops, even though it has crept downward in value over the past year; and the government has remained up-to-date on payments on external debt, except on a disputed \$3 billion Eurobond owned by Russia.

On the structural side, Ukraine has made striking changes in its natural gas sector. In a policy change aimed directly at satisfying IMF demands, the country unified the tariff for gas beginning in May 2016. The old system included different price points for different consumers and, like any other multi-tiered pricing system, was subject to cheating: insiders falsified invoices to buy and sell at their preferred prices. In addition, Ukraine has eliminated its gas imports from Russia, relying instead on supplies from elsewhere in Europe. This change was not in response to IMF requirements, but it makes the country less vulnerable to Russia-imposed shocks in the gas sector.

Despite these successes, the standard drama with the IMF continued, albeit with characteristics unique to Ukraine's situation. On the macroeconomic side, budgetary brinksmanship captured the attention of observers for several months in the winter of 2015-16, when the IMF insisted on a federal deficit of less than 3.7 percent of GDP, but parliament refused to pass it. In February 2016, Ukraine's Latvian-born Economics Minister Aivaras Abromavičius resigned from the cabinet, prompting further concern from the IMF that appropriate reforms would not be undertaken. Prime Minister Arseniy Yatsenyuk barely survived a no-confidence vote in February 2016 but resigned in April and was replaced by Volodymyr Hroisman (see below). Throughout this political turmoil, the IMF continued to conduct its reviews of the Extended Fund Facility, but the evaluation was well behind schedule and the IMF did not approve releasing the next tranche of funds until September 2016. Another standoff occurred in 2017 over the governments' unwillingness or inability to end the rail blockade in the East, but the next tranche was released in April 2017.

The structural issue most consistently highlighted by the IMF in post-Euromaidan Ukraine has been high-level corruption. Indeed, many observers of Ukrainian politics saw corruption as the reason for untamed deficits and the resignations of favored reformers like Abromavičius. Any number of examples could be raised to show the extent of the problem, but four will suffice here. First was Yatsenyuk's narrow escape from the threat of a no-confidence vote in February 2016. His survival (for two months) was apparently tied to a deal among the country's leading oligarchs: it was a last-minute walkout by parliamentarians connected to those oligarchs that saved him. Second was the political drama that played out around General Prosecutor Viktor Shokin. For several months in late 2015 and early 2016, accusations grew that Shokin was blocking

prosecutions of high-level corruption allegations, but he continued to hold his post. Even after President Petro Poroshenko ostensibly removed him from office in February, he remained in his post until March 29, when parliament finally voted to remove him. A third striking incident occurred in August 2016 when one office responsible for combatting corruption (the General Prosecutor) arrested two staff members from another office responsible for combatting corruption (the National Anticorruption Bureau of Ukraine). Finally, in March 2017, the government amended an anti-corruption law that required public servants to disclose assets, extending it to NGOs and journalists who report on corruption – an action many saw as an attempt to silence the watchdogs.

The Centrality of “Marginal” Activities

There is nothing inherently wrong with following the drama of budget debates, high-level resignations, or corrupt machinations in government. While high-level discussions are going on, however, citizens are developing a real economy across the country. This activity reveals important truths about economics that standard models typically do not highlight, namely the ubiquity of coercion and financial secrecy. Below are examples of these different sources of coercion in economic transactions in Ukraine, as well as a short discussion of the emerging financial system that provides context for those activities.

At the top of the wealth pyramid are **oligarchs**, who face myriad threats – from the state, from other oligarchs, from would-be oligarchs, and from external shocks – but they also have access to a wide variety of coercive resources to defend against those potential threats and/or to strengthen their own position. The case of Ukraine’s richest man, Rinat Akhmetov, provides an almost limitless supply of examples of this process. When the Kyiv government tried to punish him for raising electricity prices in 2015, hundreds of workers from his coal mines picketed the Energy Minister’s office, and a parliamentary bloc understood to be financially supported by him walked out of legislative proceedings. His coal and electricity conglomerate had holdings in both eastern and western Ukraine, and for three years he was able to operate successfully in both regions, partly because he also ran a network of trucks delivering humanitarian aid in the Donbas. Doing so required the direct application of coercive power in the form of hired security forces, as well as negotiations with other powerful actors, notably the bodies attempting to set rules in Donetsk, Luhansk, and Kyiv.

After the imposition of the rail blockade at the start of 2017, however, the strongmen of the Donetsk and Luhansk “People’s Republics” began to seize his property (and those of other Ukrainian owners), and the tightening blockade stopped the flow of coal from the Donbas to the rest of Ukraine. Interestingly, Akhmetov was never able to defend his holdings in Crimea, where the self-declared parliament of the peninsula voted to nationalize his energy and telecommunications holdings and armed men took over the facilities. Likewise, several branches of his First Ukrainian International Bank were shut down on rebel territory, and separatists seized equipment from his television channel.

He is powerful, and his access to coercive power is significant, but even an oligarch's hold on productive assets is not unbreakable.

Another group of economic players in Ukraine are what might be referred to as **warlord businesspeople**: individuals who use their control over physical coercion in part to take desirable assets, operate lucrative trade routes, and directly enforce their claims to wealth. In other words, they are engaged directly in the creation and operation of an economic activity. One example is Aleksandr Zakharchenko, Prime Minister of the self-proclaimed Donetsk People's Republic, who commands 3-4,000 armed men and controls much of the regional retail trade, including the "nationalized" ATB supermarket chain. He and his men also allegedly control the gasoline trade in Donbas. Another example is Alexander Khodakovsky, the commander of the Vostok battalion, who allegedly provides protection to Akhmetov's trucks and controls the illicit trade across the separatist border with the rest of Ukraine. These phenomena are not unique to Donetsk and Luhansk, as leaders of the former "volunteer battalions" use their coercive resources to operate or protect businesses in western Ukraine. These figures, and others like them, face threats from other warlords and from any "state actor" that wants to impose "order" on them. Their main defense is the direct application or threat of force, which illustrates the role of naked coercion in the conduct of economic activity.

Similar to the warlord businesspeople, but without direct control over the means of coercion, are the entrepreneurs who operate **informal or illegal businesses** and need to protect their assets. One of the most common sectors for such work in Ukraine is amber mining and smuggling. To mine amber, groups of workers clear forest areas, pump high-pressure water into the soil, and skim the debris that floats to the surface. They need to protect the mining area from potential competitors and state authorities. When they transport their product illegally, they must protect it from confiscation—the greatest threat they face is from state employees, usually either police or border guards. These businesspeople generally cannot apply force directly and instead hire protection, pay off state actors, or both.

If business is impossible without coercion, it is also impossible without banking—not necessarily a system for connecting savers and borrowers, but simply a system for moving money. Furthermore, most business does not take place without **banking secrecy**—a system for moving money without being tracked by formal state institutions. In Ukraine, we see several strategies for moving money surreptitiously, which provides context for all other economic activity. In the self-proclaimed republics of Luhansk and Donetsk, so-called "Central Banks" were established to facilitate payments among businesses, to collect taxes, and to distribute rubles coming from Russia to pay pensions. Their activities are largely opaque to outside observers. In Crimea, hundreds of bank branches saw their premises taken over almost overnight and turned over to Russian banks. Interestingly, these were not the biggest and best-known Russian banks, probably because their Russian headquarters were afraid of international sanctions. The banks in

Crimea include one with an owner who has been investigated by both the FBI and the Russian Investigative Commission and one that was part of a \$20 billion money-laundering scheme. Like the use of coercion in economic activity, banking secrecy is not unique to the territories most affected by the war. Oligarchs, leaders of armed groups, illicit entrepreneurs, and corrupt officials throughout Ukraine make use of extensive offshore networks to hide both legal and illegal profits.

Conclusion

It may be tempting to see the phenomena described in this memo as resulting from Ukraine's particular situation of occupation and war, but that is not the case. Coercion and secrecy are ubiquitous in Ukraine not because of anything peculiar about Ukraine, but because of the simple coexistence of coercive power and desirable assets. These patterns appear in Kyiv-controlled Ukraine just as they do in Crimea and the Donbas, even if they take somewhat different forms in different areas. Indeed, they appear in economies around the world.

This observation suggests that the IMF's advice to Ukraine, while not entirely wrong, is quite limited in its likely effects. First, inasmuch as the advice is premised on the assumption that in a well-performing economy coercion would be applied only by a rule-of-law state and the movement of money would be transparent, its foundation does not comport with what we see throughout the world. Second, while no one should doubt that official corruption is a significant problem in Ukraine, that is only one version of coercion and secrecy (or one source of power to engage in them) that appears in real economies. While it may be theoretically possible to root out oligarchs, mafias, strongmen, bribes, and grey finance, that is not what we see in most settings. Instead, we see different forms of coercion and different strategies of financial secrecy. Research and recommendations therefore need to be aimed at channeling those tendencies in less harmful directions, rather than trying to eliminate particular types of them entirely.