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Open Economy or Protectionism: Ukraine's Dilemma

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ABSTRACT

Since 1991, Ukraine has had several economic crises (1991-1999, 2009, ongoing since 2014) and a period of economic boom from 2000 to 2008. The current crisis has external (the unfavorable situation in the world commodities markets) and internal (the military conflict with neighboring Russia) dimensions. The destruction of economic infrastructure and the unpreparedness of Ukrainian producers to compete globally explain its depth and complexity. Radical and non-orthodox measures may be needed to help Ukraine to return to economic growth. This article discusses pros and cons of an asymmetrical solution that involves a combination of protectionism and an outward-oriented strategy during the recovery period. It is argued that it may be more efficient than the country's reliance on foreign loans and aid. The analysis of regional-level data for 2013-2016 lends some support to this argument.

INTRODUCTION

The recent economic development of Ukraine is by no standard a success story. In 2014, the Ukrainian economy was still smaller than in 1990. Using data from the State Statistics Service of Ukraine (SSSU), the country's real GDP (its physical volume) in 2014 can be estimated at 98.8% of the 1990 level.[1] Nominal GDP per capita is even further from the 1990 level. "Ukraine's GDP per capita is still only 65% of what it was on the eve of the break-up of the Soviet Union. With EUR 6,500 at PPP, it corresponds to a mere 23% of the EU average, making Ukraine the second poorest country in Europe (after Moldova and followed by Kosovo)" (Adarov et al., 2015, p. 6).[2] In other

[1] Calculations of A. Valchyshen, the Head of Research and a Fixed Income Analyst at Investment Capital Ukraine LLC, using the SSSU data (https://eimg.pravda.com/files/4/8/4861068-state-budget.xlsx accessed February 27, 2018).

[2] This discrepancy between the nominal and real GDP can be explained by a significant drop in PPP since the early 1990s.

words, after 25 years of independence, the Ukrainian economy is still in worse shape than when it did not have an autonomous status.

The military conflict with Russia started in 2014 caused an additional blow to the Ukrainian economy. In addition to the losses of infrastructure, the military confrontation undermined the trade between the two countries (Russia was Ukraine's key trade partner from 2009 to 2012). According to one estimate, "*the military conflict in Donbas reduced Ukraine's GDP by 2.5% [in 2014], including 1.9% due to the decline in the Donetsk and Luhansk regions and another 0.6% due to contagion effects*" (Adarov et al., 2015, p. 14). Loans from the international financial institutions are partly alleviating the effect of the war, but the country is still expected to bear the full costs of confronting the military aggression. The payment of the price of the war is simply postponed to a later date and, thus, its economic effects will continue to be felt even after "freezing" the conflict.

The Russian case is used as a point of comparison. In addition to being the parties of the ongoing military conflict, Ukraine and Russia have the largest economies of all the countries of the former Soviet Union. The GDP in both counties followed a somewhat similar path since 1991 even if the Russian economy performed relatively better and now exceeds its 1990 level. Before the current crisis that affected both economies, the growth of the Russian economy has been propelled, on the one hand, by oil and gas rents and, on the other hand, by domestic consumption. Gaddy and Ickes (2005) noticed that oil and natural gas rents are correlated with Russia's GDP. The World Bank defines oil and natural gas rents as the difference between the value of crude oil and natural gas production at world prices and total costs of production (World Bank, 2018). In the 2000s, the share of oil and natural gas rents in Russia's GDP was between 10 and 15%. High oil and natural gas prices fuelled a boom in consumer spending, making domestic consumption a second source of economic growth in this country. By restricting and regulating access to two most dynamic sectors of the Russian economy, the oil and natural gas sector and the retail trade, the Russian power elite has been able to dominate businesses – national and foreign alike, by virtue of a constellation of interests in these markets (Oleinik, 2015a; 2011). In exchange for access to the markets and for the operation in the conditions of limited competition, businesses have been willing to contribute a part of the rents that they captured to group and individual endeavors of the Russian power elite.

What are drivers of the Ukrainian economy? Ukraine does not possess significant oil and natural gas deposits. Consequently, oil and natural gas rents did not exceed 3% of this country's GDP, even when world prices of these commodities were high. There is also a substantial difference in the institutional environments in which the two economies operate. Russia restricted access to the national market and extracts administrative rents (rents captured by a gate-keeper) in addition to natural resources rents. "*Ukraine has a more open economy than Russia, and its trade orientation outside of the old Soviet Union is substantial*" (Havrylyshyn, 2014, p. 180). This article discusses drivers, existing and potential, of the Ukrainian economy. More specifically, the goal of the article is to explore the potential of the national market as a driver of economic development in Ukraine. Since the article has an explorative character, formal hypotheses will be neither stated nor tested. A quantitative comparison of the internal and external sources of economic growth will be offered nevertheless.

It is argued that the strengthening of the national market may help change the negative dynamics of Ukraine's economy. Protectionist measures in this case have a temporary and forced character. Furthermore, the danger of the abuses of access control by the power elite has to be explicitly taken into account when adapting protectionist measures to the needs of nation-state building in Ukraine.

1. EXTERNALLY DRIVEN ECONOMY

Ukraine has a long tradition of open economy. In Kievan Rus', the first state on the territory of today's Ukraine, international trade provided a major source of income for its rulers and population (Hedlund, 2005). Kievan Rus' emerged at the cross roads of trade routes connecting, on one hand, Northern and Southern Europe ("from the Varangians to the Greeks" route) and, on the other hand, Eastern Europe to Asia. Modalities of transportation and trade routes have significantly changed since the 11th-12th centuries. Nevertheless, Ukraine still enjoys a central position in some transportation networks; for instance, in the network of pipelines connecting Russian oil and natural gas fields to the European customers. The network was built in the 1970s-1980s, when all key decisions were made in Moscow. The fall of the Soviet Union led to the emergence of several decision-makers on the post-Soviet space, namely, in Moscow and in Kyiv. Some actors in Ukraine attempted to use the situation of a bilateral monopoly (Russia has a monopoly over oil and natural gas fields whereas Ukraine – over the pipelines network) to their advantage, i.e. to capture a gate-keeper's rent (see Ericson, 2009; Oleinik, 2015b for a discussion of the organization of this market). In the 1990s and the early 2000s they were rather successful. The Ukrainian government did not control the gate-keepers, allowing the significant accumulation of resources in private hands (the owners of various intermediaries from *Itera* to *RosUkrEnergo*) and thus contributing to the spread of corruption in the country (Kuzio, 2012, p. 434) and to the conservation of energy inefficient businesses (Kuzmin et al., 2016). The construction of pipelines bypassing Ukraine, the *Blue Stream* and the *Nord Stream*, significantly weakened the bargaining position of the Ukrainian gate-keepers.

The gatekeepers in Ukraine never acted in concert since they were private businesses connected with competing political groups. For instance, Dmytro Firtash, who controlled *RosUkrEnergo*, was a creature of President Leonid Kuchma. Oleksiy Ivchenko, one of the key figures in *Itera*, supported Ukrainian nationalists and President Viktor Yushchenko, whose relationships with the predecessor, President Kuchma, were complex to say the least (Kuzio, 2012, p. 434). It means, first, that the rents captured by the gate-keepers have been neither controlled by the government let alone ordinary Ukrainians nor fully used in the interests of nation-state building. Second, the gatekeepers did not really restrict access to the market in Ukraine or through its territory. Since the mid-1990s, when President Kuchma implemented "shock therapy" policies, Ukraine has been among the most dependent on the international markets economies with the share of external trade (export and import combined) consistently exceeding the volume of its GDP (World Bank, 2018).[3] Kuchma's shock therapy is believed to be more radical and closer to the standards of neoliberalism than reforms carried out by the government of Boris Yeltsin and Yegor Gaidar in the early 1990s in Russia (Havrylyshyn, 2014, p. 175).

The exposure to the world market has undeniable benefits, increasing productivity as a result of a deeper division of labor and creating incentives to modernize. Veblen considers the case the German economy that was relatively backward in the 19th century compared with the other European economies. He notes that *"it is apparently in commerce and the improvements in transportation that contact with the more advanced countries of the West first provoke movements of adjustment to the new state of things*" (Veblen, 1964, p. 150). Today's Ukrainian economy also lags behind the developed economies and badly needs "*movements of adjustment*". At the same time, the high level of exposure of the Ukrainian economy to the international markets has also had

[3] In 2016, the value of this World Development indicator in Ukraine was 104.8% (119.9% in 2000), which places the country 46th out of more than 200 countries included in the dataset. The world average was 56.4% (51.3% in 2000). As a comparison, the share of external trade in Russia was 46.3% (68.1% in 2000). Slovakia and the Czech Republic have more open economies than Ukraine with the shares of exports and imports 185.7% (110.7% in 2000) and 151.6% (98.2% in 2000) respectively, but in these countries the relative growth of external trade has been more steady. Also, smaller economies tend to have a higher share of external trade, all other things being equal.

three other consequences that undermine black-and-white thinking: the weakness of internal economic actors, the dependence of the situation in the Ukrainian economy on the situation in the world commodities markets, and its vulnerability to the use of the market as a weapon in a conflict situation.

1.1 External and internal actors of economic modernization

The Ukrainian economy has been undergoing significant structural changes since this country declared independence in 1991. In 2001, the share of agriculture in the gross value added (GVA) was 16.1%; twelve years later – 9.3%. The share of real estate and services for businesses increased from 6.9% to 12.1% of the GVA. The share of industry in the GVA decreased from 30.2% to 25.7% (Kuzmin et al., 2012). Such changes seem to be indicative of the transition toward a service-oriented, post-industrial economy. In Ukraine, however, the process of economic modernization is totally externally driven. Internal actors, including the government and national businesses, have little say in this process, let alone control it.

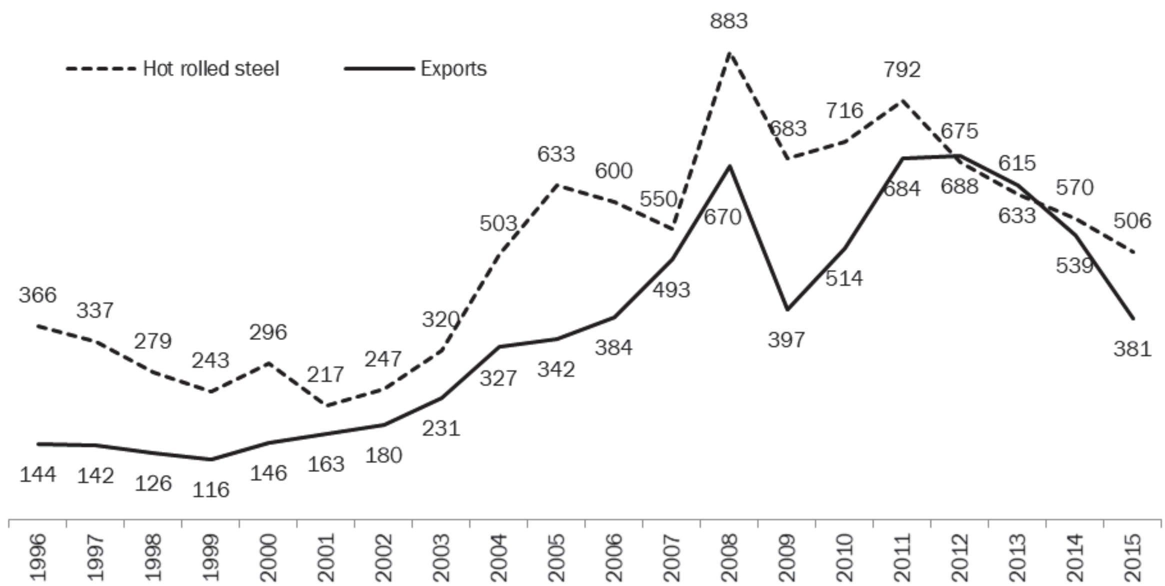
Two forces determine parameters of economic modernization in Ukraine: the international institutions, namely the International Monetary Fund, IMF, and the external markets – first of all, the commodities markets. The shock therapy in the mid-1990s was designed and carried out with assistance of the IMF. The IMF on more than one occasion gave conditional loans to the Ukrainian government. As of the end of February 2017, the Ukrainian government served as a guarantor of IMF's loans totalling to 6.28 billion USD and as a direct recipient of IMF's loans totalling to 6.88 billion USD (Ministry of Finance of Ukraine, 2017). Taken together, IMF's loans amount to 18.35% of Ukraine's internal and external debt or 14.5% of the country's GDP in 2015 (90.615 billion USD; World Bank, 2018). IMF's loans are conditional: the applicant is expected, in exchange, to implement specific policies ranging from the "*Washington Consensus, as formulated by John Williamson (1990), focusing on three basic IMF requirements: a fully financed budget, a realistic exchange rate, and a recapitalization of the banking system*" (Åslund, 2009, p. 377) to more far-reaching demands for structural reform.

As stated in the introduction to this article, the Ukrainian economy has yet to reach its 1990 level. The next subsection contains some additional material suggesting that policies inspired by the Washington consensus did not work quite well in the Ukrainian case. The reliance on external actors as the only drivers of economic modernization may cause the weakness of the internal actors or even suppress them. Ukraine did produce quite a few business empires – all owned by so called "oligarchs", but none of them appears to be willing and prepared to become an *agens movens* of economic modernization and nation-state building. Åslund (2008, p. 157) rightly observes that compared to Russia, where "*the Russian state under Putin has defeated the oligarchs and reimposed a strong (albeit highly corrupt) centralized political control", Ukraine "is a competitive oligarchy, and accordingly a much more lively and open society*". The Ukrainian oligarchs compete for influence on the government. The problem is that under the currently existing arrangement the government has a quite limited capacity for developing and implementing economic policies. It plays a mostly technical role in implementing blueprints prepared by the external actors or reacting to external shocks. Furthermore, these oligarchs have opposing interests and views on the country's future. According to one account, an "*Eastern-Ukrainian oligarchy of Russian identity, who are interested in increasing exports and would like to achieve increasingly strong positions in the international markets... The other major economic interest group is more interested in the commercial, financial and food industry sector connected with international capital. As for their identity, they are Ukrainians who – contrary to the first group – mainly support growth in imports. Their natural allies are foreign producers exporting to the Ukraine, multinational companies and the population with purchasing power to consume*" (Virág, 2012, p. 627). Lastly, interests of the Ukrainian oligarchs tend to be highly circumstantial and changing in function of the situation in the external markets (Åslund, 2009, p. 384). No oligarchic group has a vested interest in modernizing the Ukrainian economy as a whole and regardless of the global market dynamics. Neither in Russia nor in Ukraine have internal economic actors emerged as leaders in nation-state building. In the former case, they are suppressed by the all-mighty State. In the latter case, the oligarchs have more leeway but the overwhelming influence of the external actors on the country's economic policies simply make their and the government's input in policy making optional at best.

1.2 Dependence on the situation in the world commodities markets

The dependence of Ukraine's economy on the world market made it vulnerable to the cycles in its dynamics. The economy either tends to unexpectedly overheat, as in the mid-2000s when the GDP's growth rates reached a two-digit level (112.1% in 2004), or suddenly collapses, as in the wake of the 2008 global financial crisis when Ukraine's GDP contracted deeper than in most other countries of the world (85.2% in 2009). These ups and downs are unpredictable since they remain outside the control of any particular actor, which complicates the matters even further (Adarov et al., 2015, p. 33; OECD, 2014, p. 32). Åslund (2001, p. 314) admits that no one had predicted the economic boom in Ukraine in the first half of the 2000s. A few years later, it became clear that a cycle in the global steel market has to be given most credit for this boom (Åslund, 2008, p. 374). The Ukrainian export that accounts for almost a half of the country's GDP closely follows the dynamics of the world prices for metal scrap and hot rolled steel (Dovbniak, 2009, p. 67), as Figure 1 confirms.

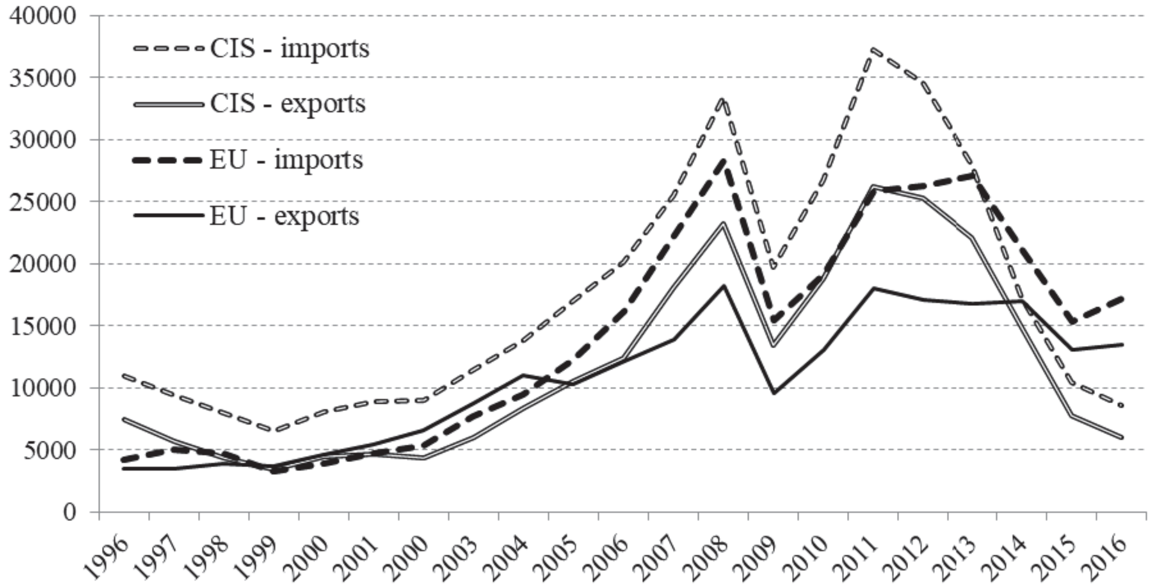
Figure 1.. Comparative dynamics of the value of Ukrainian exports, in hundred million US$, and hot rolled steel prices, in US$, 1996-2015



Source: Index Mundi (http://www.indexmundi.com/commodities/?commodity=cold-rolled-steel&months=300&commodity=hot-rolled-steel), the Economist Intelligence Unit (https://store.eiu.com/article.aspx?productid=960000296&articleid=1282943712) and the State Statistics Service of Ukraine

The geographical breakdown of Ukrainian exports and imports (Figure 2) shows that the volume of trade with the EU has been exceeding that with the CIS countries since 2014, i.e. after the start of the military conflict with Russia. Ukrainian imports exceed Ukrainian imports with both of these trade partners, which suggests that Ukrainian producers are prepared to compete successfully neither with the Eastern neighbors nor with the Western neighbors. The country consumes more than it produces. A short period of time between 1999 and 2004 during which Ukraine had a positive trade balance with the EU does not change the overall pattern since it coincides with the above mentioned boom in the global steel market.

Figure 2. Comparative dynamics of Ukrainian exports and imports of goods to/from the EU and to/from the Commonwealth of Independent States, CIS, in million US$, 1996-2016.



Source: State Committee of Statistics of Ukraine, 2017b, pp. 13-14; 2014, pp. 28, 34; 2010, pp. 28, 34;, 2006, pp. 256-257 (The figures for 1996-1999 are reported by V. Dyatlova and O. Tkachenko, who also base their estimates on the SSSU data.)

It must be noted that Ukraine's economy depends specifically on the dynamics of the world commodity markets, i.e. the markets for products with minimal value added as opposed to processed products. The exposure of the country's economy to the world market at the early stages of economic reforms, when national producers were still in the process of adapting to a new market environment, made them uncompetitive. The competitive sectors of the Ukrainian economy do not radically differ from those that Kievan Rus' had: agriculture (grains, honey) and basic processing of raw materials (furs and wax in the past, metals today). This specialization represents a common feature of peripheral economies where "*with growing income, demand for imported machinery grows faster that the demand for exported primary materials*" (Prebisch, 1959, p. 253).

The structure of Ukraine's exports to, and imports from, the European Union is revealing. In 2016, Ukraine's exports to the EU were composed of base metals and articles thereof (22.1% of the total), vegetable products (16.1%), mineral products (12.8%) and machinery and appliances (11.5%). Ukraine imported from the EU mostly machinery and appliances (26.1%), then products of the chemical or allied industries (16.8%), transport equipment (10.7%) and plastic, rubber and articles thereof (7.1%; European Union, 2017).

1.3 Market as a weapon in a conflict situation

The dependence of a country's economy on the international markets may become a liability in the situation of an intensive conflict or a war of aggression like the one waged against Ukraine by Russia since 2014. The existence of imbalances and asymmetries in the trade between parties in a conflict enables one of them or both to use economic levers in addition to purely military means. Before 2014, Ukraine's dependence on imports of natural gas from Russia reached a critical level: they covered up to a half of all needs of Ukrainian businesses and households in natural gas (Zhylyaeva, 2010, p. 57). Russia has a record of price discrimination, i.e. charging different prices in function of the customer's readiness to align with this country's policies (Oleinik, 2015b). Needless to say that the price that Ukraine had recently been charged exceeded the average. The painful cuts in the consumption of natural gas and the costly re-orientation to supplies from the European common market contributed to increasing the costs of the war for Ukraine.

In the context of the military confrontation, the dependence of Ukraine's economy on the international markets also had less direct but nevertheless sensitive implications. Before 2014, Eastern Ukraine and Western Ukraine were traditionally oriented to the different external markets, Russian and European correspondingly (Adarov et al., 2015, p. 66). The conflict with Russia contributed to the aggravation of regional divides along these lines: the economy of Left-bank Ukraine suffered from the collapse of the trade with Russia particularly severely (Chuzhykov et al., 2014, p. 31). In other words, the Ukrainian experience suggests that the orientation of regions to different trading partners in an economy dependent on the world market coupled with the absence of policies of harmonization at the regional level has the potential to constitute an economic foundation of regional separatism.

2. THE NATIONAL MARKET: A SURVIVAL KIT OR AN ENGINE OF DEVELOPMENT?

In 2014-2016, the negative consequences of the dependence of Ukraine's economy on the international markets outweighed its positive effects. The world prices for hot rolled steel are in decline. The asymmetries that exist in the trade between Ukraine and Russia were used by the latter as an additional lever in the military confrontation. In response, Ukraine imposed restrictions on the trade with Russia, which in turn aggravated divides between the Western and Eastern regions of the country. In these circumstances, the national market, an institution that has been overlooked while exposing the country's economy to international competition, plays the role of a safety net preventing its total collapse.

2.1 Sources of data and methodology

Panel regional-level data inform this study, the SSSU being their key source. It is more common to use country-level data in econometric analysis. However, particularities of the current situation in Ukraine, especially the ongoing war, significantly complicate meaningful international comparisons. Since the number of units of observation is relatively small,[4] the regional-level data in Ukraine have to be used with caution. Several precedents show that the analysis of the Ukrainian regional-level data can provide valuable insights nevertheless (OECD, 2014; Masliy, 2014; Chuzhykov et al., 2014; Nosova, 2013; Grendash, 2012). The data cover the period after the start of Russia's military aggression, i.e. 2013 on.

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[4] 27 before the annexation of Crimea and the city of Sebastopol by Russia in 2014, 25 currently: 24 regions and the capital city.

The reader also has to bear in mind that the article is more oriented towards exploration than towards analysis, which involves assessing the comparative impact of multiple factors on the economic situation. The risk of running an excessive number of regressions (cf. Sala-I-Martin, 1997) was curbed with the help of shortlisting the list of predictors. They were selected in such a manner as to confront external and internal factors of economic development. A series of the linear multiple regressions, method “forward” (with the probability of F for entry set at a 0.05 level and for removal at a 0.1 level), were run in order to assess the exact contribution of the national market to the country’s economy and to compare this contribution with the effect of the other factors, namely, foreign trade and foreign direct investments (FDI). The Gross Regional Product, GRP, is used as an outcome indicator (originally in billion Ukrainian hryvnas, UAH; Lg10 transformed). Previous studies (OECD, 2014, p. 31) suggest that among key contributors to economic growth in Ukraine are domestic demand, consumption, investments and net exports. For instance, domestic demand decreased by 26.4% in 2009, which was partly offset by an 11.6% increase in net exports.

In the present study, the contribution of the national market was operationalized through the following indicators: disposable income (originally in billion UAH; Lg10 transformed), average monthly salary (in UAH, Lg10 transformed in 2014), and retail trade turnover (originally in billion UAH; Lg10 transformed). The contribution of investments was operationalized through financial results of enterprises before taxation (in billion UAH; Lg10 transformed in 2014), fixed capital investments (originally in billion UAH; Lg10 transformed) and foreign direct investments, FDI (originally in billion US$; Ln transformed), that of foreign trade – through total import of goods and total export of goods (originally in thousand US$; Ln transformed), export to import ratio (export coverage), import of goods from and export of goods to Germany and Russia (originally in thousand US$; Ln transformed), import of wood lumber and import of wooden furniture (originally in thousand US$; the latter was Lg10 transformed and the former – Ln transformed; the rationale for including these measures is provided in the next section). In addition, the impact of several other variables was controlled: accumulated total population, salary arrears (originally in billion UAH; Lg10 transformed), internet penetration (% of the population who reported using the Internet past 12 months), and % of the total surface covered by forests.

2.2 On the brink of a collapse

Table 1 contains results of the three regressions, for 2013, 2014 and 2015 (The 2016 GRP figures were not released yet as of the time of this writing), showing the predictors whose contribution was statistically significant only. Two variables, disposable income and fixed capital investments, were removed from the models in order to address a collinearity problem. The case of disposable income is particularly relevant. This aggregate includes salaries and various transfers with the exception of taxes and other mandatory payments. Disposable income, a proxy for the size of the national market, was highly correlated with the dependent variable, GRP (r=0.979 in 2013), and with several predictor variables. Leaving the excluded variables aside, the contribution of the national market (domestic consumption) outweighed the effect of the other predictors and controls. The impact of financial results of enterprises, a potential source of investment, was significant in 2013 only, before most businesses went into the red in 2014. Neither export nor import helped Ukrainian regions to cope with the economic crisis in 2013 and 2014. The contribution of export and FDI became significant in 2015 only. Assessed separately, their impact did not exceed that of domestic consumption. The national market prevented a total collapse in the country’s economy.

Table 1. Results of linear multiple regressions to predict the Gross Regional Product (Lg10 transformed) in Ukraine, 2013-2015.

	2013			2014			2015		
	Unstandardized B	*Std. error*	*Standardized Beta*	*Unstandardized B*	*Std. error*	*Standardized Beta*	*Unstandardized B*	*Std. error*	*Standardized Beta*
Retail trade turnover, Lg10 transformed	0.995***	0.071	0.804	0.933***	0.097	0.726	0.469***	0.087	0.400
Average monthly salary, UAH	0.000099*	0.000036	0.165	0.000134**	0.000035	0.294			
Enterprises" financial results before taxation, UAH billion	0.000009*	0.000003	0.093						
Total exports, Ln transformed							0.105***	0.024	0.356
Foreign Direct Investments, Ln transformed							0.066**	0.018	0.295
Constant	-0.103	0.239		-4.189***	0.894		0.795*	0.297	
R^2	0.977			0.951			0.966		
N	25			25			25		

Legend: Results significant at a 0.05 level are marked by *, at a 0.01 level – by **, and at a 0.001 level – by ***.
Source: State Committee of Statistics of Ukraine, 2016a, Vol.1, p. 85; Vol. 2, pp. 15, 133, 374.

The national market plays the role of a life jacket in times of economic duress. Has it the potential to become an engine of economic development? The short answer is no. In its present conditions, the national market neither can absorb the redundant output in some sectors, for instance, the machine-building output which used to be exported to the Russian market (Adarov et al., 2015, p. 47), nor increase domestic consumption without simultaneously creating inflationary pressures (OECD, 2014, p. 33). The national market has been relegated to the back stage of economic development for too long, practically since the start of economic reforms in the early 1990s. However, it could potentially perform the role of a driver of economic development provided that the national market is first prepared for this role with the help of specifically designed and properly implemented economic policies.

These policies have some roots in protectionism, but go beyond its old, and to a significant extent, discredited version. In the Ukrainian case, given the high degree of exposure of the country's economy to the international markets and taking into account the lessons of implementing classical protectionist policies in some other countries, a new version of protectionism may be needed. On the one hand, this new version aims to protect the national market simultaneously maintaining and even increasing Ukraine's presence in the external markets, first of all in Europe and North America. On the other hand, the protectionist policies have to be temporary. Since their very beginning the task of re-opening Ukraine's economy in the progressive stages ought to be set. In other words, protectionism in Ukraine can work if it has a temporary character and is designed as a tool for making national producers more competitive in the external markets.

2.3 Goodwill to an asymmetrical solution

Prebisch and his fellow Latin American economists associated with the Programa Regional del Empleo para América Latina y el Caribe, PREALC, made the most recent attempt to formulate a comprehensive protectionist policy in the 1960s-1970s. Namely, they promoted import substitution as a strategy for protecting the national market and for correcting disparities that exist between the less developed (peripheral) economies and the developed (central) economies. Prebisch (1959, p. 253) defined import substitution "as an increase in the proportion of goods that is supplied from domestic sources" and considered it as "the only way to correct the effects on peripheral growth of disparities in foreign trade elasticity". The demand for imported machinery "on the periphery" increases faster than the demand for commodities exported by the peripheral economies, which creates those disparities.

In the present situation, Ukraine has a peripheral economy: this country exports mainly commodities and goods with low value added and imports machinery and goods with high value added. Not surprisingly, some Ukrainian economists show interest in the issues of import substitution. For instance, Yakymenko (2015, p. 156) from Kharkiv in Eastern Ukraine calls for meeting the country's domestic demand "mainly through the development of national production, … using protectionist policies". The process of import substitution was actually taking place in 2015, observe Check with colleagues from Lviv in Western Ukraine (2016, pp. 89-90), pointing out to the situation in some industries oriented to the national market, namely the textile industry and the food processing industry. Import substitution may be taking place indeed, but in a spontaneous, uncontrollable and, hence, unpredictable manner.

The other Ukrainian economists go even further, seeing in protectionist policies an element of national sovereignty understood as the government's capacity for formulating an independent economic policy guided by national interests (Melnik, 2015, p. 147). This argument echoes a definition of sovereignty in general and economic sovereignty in particular given by John Commons (1959, p. 384): "*sovereignty [is] the collective power of the concern laying down its working rules in the form of the common law, equity and administrative orders, for the purpose of better adjustment of men's transactions in a world of relative scarcity of resources*". Seen in this perspective, economic sovereignty constitutes an integral element of nation-state building. This process is still on-going in Ukraine, which provides an additional reason for being highly sensitive to the issues of this country's economic sovereignty. The national market represents an important element of a nation-state (Smith, 1991, p. 14).

In open economies, the governments have few levers for protecting or promoting particular industries. Governments in countries with the established, developed market economies do not necessarily need to intervene since the national businesses can compete globally and consider an open economy as their natural environment. In contrast, governments in countries with the less developed, peripheral market economies need to intervene and to protect the national market before their national businesses get prepared for global competition. The invisible hand of the market does not suffice in these circumstances and has to be complemented by the visible hand of the government.

Protectionist policies were extremely popular from the late 1960s into the 1970s. The World Bank not only tolerated them but actually "expressed considerable sympathy for the approach" (Bruton, 1998, p. 917). And this international organization had a good reason for sympathizing with protectionism since at that time it worked. Two factors help explain why protectionism started to subsequently fall out of fashion. The outward-oriented strategy of promoting export inspired by the experience of the Asian Tigers (Hong Kong, Singapore, South Korea and Taiwan) in the 1970s is one. National producers have no privilege at home. "*The basic notion is to keep the domestic economy open to foreign competition and foreign capital, and to ensure that exports are in no way penalized, if not specifically encouraged*" (Bruton, 1998, p. 904). The awareness of the risks of rent-seeking by the governments that heavily rely on the visible hand is the other (Rose-Ackerman, 2004).

Counter-arguments can be developed with respect to both of these reasons. First, the outward-oriented strategy also fell out of fashion. It produced expected outcomes mainly in relatively small open economies (given the size of Ukraine's population, 42.6 million as of February 2017, this country has a potentially very large internal market). Similarly to import substitution, the outward-oriented strategy does not create an environment conductive to learning. The latter strategy "fails to appreciate that learning requires conditions that are essentially internal and dependent on the basic characteristics of the society" (Bruton, 1998, p. 903). Second, rent-seeking has more to do with the lack of an adequate response to a more general problem that exists in all economies, namely, "who monitors the monitors" (Stiglitz, 1994, p. 78), than with import substitution as such.

Both problems with import substitution can potentially be alleviated by imposing temporal limits on protectionism and by re-opening Ukraine's economy in the progressive stages, after building the national market and strengthening, with its help, national producers. In parallel with policies of import substitution, efforts to promote export have to be made. The promotion of export, especially to the European Union and North America, will create incentives for learning. Is such an asymmetrical situation – a partial openness of Ukraine's economy – defendable and practical? After all, the proposed strategy requires that the country temporarily protects its national market while still having a free access to the key prospective external markets.

Several arguments can be used in defense of the asymmetrical openness. Prebisch (1959, p. 264) offers one. He argues that "protection has different meanings in the peripheral countries and in the industrial centers. In the former it is, up to a certain point, the instrument for correcting the effects of the disparity in income elasticity of demand for exports of primary commodities and for imports of industrial goods and does not hamper the rate of growth of world trade. In the industrial centers, by contrast, protection of primary production accentuates this disparity and tends to depress peripheral development and to decrease the rate of growth of world trade. The reduction or elimination of such protection at the centers has an implicit element of reciprocity". As paradoxical as it may seem, in a reciprocal situation there are no duties in the center, but duties and the other protectionist measures (tariffs, exchange rates, import licenses and so forth) may be simultaneously present in the periphery as a means to alleviate the disparities between the center and the periphery.

The implementation of such arrangement requires the good will of the Western partners of Ukraine, both in a literal and figurative sense of this word. The acceptance of temporary asymmetrical economic relationships with Ukraine will give the West an opportunity for expressing its solidarity with this country, especially since no new "Marshall plan" seems to be forthcoming, as of the time of this writing. Instead of (or in addition to) giving credits and providing technical assistance, both parties, Ukraine and the West, would potentially be better off by providing Ukrainian businesses with free access to the Western markets and by accepting Ukraine's protectionist policies during a transition period that may last from a few years to a decade or so. It terms of the costs for the West, both options may be comparable, but the acceptance of the asymmetric solution creates much more powerful incentives for learning.

In a literal sense, goodwill involves restrictions voluntarily taken by a party in a transaction. Commons (1959, p. 23) defines goodwill as a negative promise: a promise not to compete. He further adds that "*goodwill, being a social relation, implies reciprocity. It is the expectation of reciprocal beneficial transactions*" (1959, p. 220). In the circumstances of the case, the West promises not to compete with Ukrainian businesses in the national market of this country during a certain period of time in the expectation of reciprocal beneficial transactions in the future in the free markets.

In practical terms, the asymmetrical solution de facto currently exists. In spring 2015 the EU unilaterally abolished most trade barriers for imports from Ukraine, which particularly benefited agricultural products (Adarov et al., 2015, pp. 3, 10). The results of this unilateral abolition of trade barriers by the EU can be seen in Table 1: domestic consumption and exports emerged as two key drivers of Ukraine's economy in 2015. Nothing prevents the EU from taking a step further in formalizing the existing arrangements and appreciating that Ukraine needs to temporarily shelter the national market from the European competition. During this transition period the country will develop and implement "an industrial policy for the restructuring/conversion of sectors that are not likely to withstand competitive pressures and/or the potential loss of traditional markets also needs to be devised as an inherent part of the long-run economic development strategy" (Adarov et al., 2015, p. 52).

A separate problem refers to the fact that the asymmetrical arrangement discussed in this section conflicts with requirements of the IMF Extended Fund Facility (EFF) package and obligations that Ukraine assumed as a member of the World Trade Organization, WTO, since 2009 (Adarov et al., 2015, p. 50). However, it is a question of negotiation and the Ukrainian government's capacity to persuade these international organizations that special circumstances exist in the case at hand. The absence of organized groups or political forces making the strengthening of the national market their top economic priority represents a far more serious problem. Ukrainian wooden furniture producers make an exception. They lobbied a law that can be considered as a rare and rather successful example of protectionist policies in Ukraine.

3. CASE OF THE TIMBER INDUSTRY: TENSIONS BETWEEN OPEN ECONOMY AND THE NATIONAL MARKET

Before discussing some particularities of this law and its implementation, background information on the timber industry will help the reader to better understand the relevant context. Forests cover 17.6% of the Ukrainian lands: 10633.1 Ha of 60354.9 Ha (Derzhavna Sluzhba Statystyky Ukrainy, 2016b, p. 188). To compare: forest areas represent almost a half of Russia's territory. At the same time, forest rents extracted in Ukraine actually exceed those in Russia: 0.397% of

GDP against 0.346% of GDP in 2015 respectively (World Bank, 2018). The World Bank defines forest rents as roundwood harvest times the product of average prices and a region-specific rental rate. Forests rents in Ukraine have significantly increased since 2011, currently reaching a historic high (Figure 3). This reflects the intensification of the exploitation of forests, a scarce resource in Ukraine. The exploitation of forests tends to be particularly high during the periods of low prices of the other important export commodity, steel: before 2002 and after 2011 (see Figure 1). In a sense, lumber substitutes steel in the Ukrainian exports and vice versa.

Figure 3. "Forest rents (% of GDP) in Ukraine and Russia, 1991-2015"

Source: World Bank, 2018

The intensive exploitation of forest resources in the country in which they do not abound attracted policy-makers' attention well before the current crisis and the rise in forest rents resulting from attempts to substitute lumber for the other export commodities. A first version of the Law of Ukraine "On particularities of government regulation of businesses specializing in sale and export of wood lumber (*lisomaterialiv*)" was promulgated in September 2005 under President Yushchenko.[5] The most recent additions to the Law were initiated by a group of MPs representing the entre political spectrum, from *Samopomich* to *Radikal'na Partiia Lyashka*, from the West (5MPs from Lviv and one from Ivano-Frankivsk) as well as from the East (2MPs from Dnipro) and the Center (3MPs from Kyiv), in October 2015. They involve a 10 year ban on the export of lumber wood of all

[5] http://zakon2.rada.gov.ua/laws/show/2860-15.

kinds except Pine effective November 1, 2015 and a similar ban on the export of Pine lumber effective January 1, 2017. No single vote against this ban was cast.[6]

The promulgation of the Law led to a series of controversies and public debates that have an international dimension: representatives of the EU actively contributed to them. Ecological concerns constitute the officially stated rationale for imposing the ban. Precious and rare wood, for instance, oak and the European beech, are particularly affected by the intensified lumber wood production. In addition to the large-scale legal lumber wood production, criminal logging abounds,[7] especially as the other opportunities for making a living shrink in times of economic duress. Both these problems seem to be exaggerated nonetheless. As a result of efforts aimed to forest restoration, Ukraine has even slightly increased (+0.7%) the surface of forest areas since its independence. According to various estimates, the extralegal logging amounts to 0.1 to 2.3% of the legal lumber wood production.[8]

An analysis of the structure of the Ukrainian trade with the EU suggests a more likely reason for imposing the ban. A key trend in the EU sawn hardwood trade in recent years has been increased dependence on imports of lower value product from Eastern Europe, notably Ukraine, Belarus, Russia, Bosnia and Serbia. In 2015 there were higher deliveries from the Ukraine (+37% to 350,000 cubic meters). This country exported more hardwood to the EU than Russia, Belarus and Serbia taken together (Global Wood Market Info, 2016). The major importers of Ukrainian lumber are Romania, Slovakia, Poland and Austria (De Micco, 2015, p. 23), more specifically – furniture and home décor, namely, parquet, producers in these countries. A portion of their products is subsequently exported to Ukraine whose national producers cannot compete with their European counterparts. In other words, Ukraine exports a commodity, lumber wood, and imports a processed product with high value added, wooden furniture.

The ban in these circumstances aims less to solve ecological problems than to temporarily protect the national market and Ukrainian producers of wooden furniture and wood processing businesses. By restricting exports of wood lumber, the Law facilitates the national producers' access to this resource. As a result, the national producers of wooden furniture and other products of wood processing are temporary sheltered from international competition. The true objective of the ban cannot be officially acknowledged since it clearly conflicts with Ukraine's obligations as a WTO member and a participant in the programs of economic integration with the EU. The Ukrainian government is simply not prepared yet to state and protect interests of national producers through the process of difficult negotiations with the international organizations.

[6] 233 votes 'for', no abstentions, no vote 'against', 80 MPs did not take part in the voting, see http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=52828.

[7] Article 246 of the Criminal Code of Ukraine criminalizes logging without permit without imposing heavy penalties nevertheless.

[8] The head of the State Forest Resources Agency of Ukraine estimates the volume of criminal logging at 24 thousand cubic meters in 2015, which represents approximately 0.1% of the legal logging (http://ukurier.gov.ua/uk/articles/hristina-yushkevich-shob-zupiniti-chornih-lisorubi/). A government sponsored study conducted with the help of GIS technologies in Zakarpattia, one of the most affected by criminal logging regions, suggests a higher figure: the total surface of areas of criminal logging is 2.3% of that of the legal logging (www.kmu.gov.ua/document/249450793/lis.pdf, see also an on-line map at http://texty.org.ua/d/deforestation/).

Table 2. Results of linear multiple regressions to predict the merchantable wood volume (Lg10 transformed) in Ukraine, 2013-2016.

	2013			2014			2015			2016		
	Unstandardized B	*Std. error*	*Standardized Beta*	*Unstandardized B*	*Std. error*	*Standardized Beta*	*Unstandardized B*	*Std. error*	*Standardized Beta*	*Unstandardized B*	*Std. error*	*Standardized Beta*
% of the total surface covered by forests	0.016**	0.005	0.431				0.015*	0.006	0.406			
Total export, Ln transformed	-0.185**	0.053	-0.376	-0.297***	0.058	-0.546						
Lumber wood production, Lg10 transformed	0.376*	0.136	0.363	0.684***	0.088	0.728				0.458*	0.173	0.467
Imports of furniture, thousand US$				0.000006**	0.000002	0.381						
Forest restoration, Ha							0.000126**	0.000035	0.529	0.0001*	0.00004	0.441
Constant	4.228***	0.805		5.618***	0.830		2.007***	0.109		1.644***	0.233	
Adjusted R^2	0.744			0.807			0.696			0.702		
N	25			25			25			25		

Legend: Results significant at a 0.05 level are marked by *, at a 0.01 level – by **, and at a 0.001 level – by ***.
Source: Derzhavna Sluzhba Statystyky Ukrainy, 2017a, Vol. 2, pp. 264-265, 396-397, 399-476; Derzhavna Sluzhba Statystyky Ukrainy, 2016a, Vol. 1, p. 261; Vol. 2, pp. 250, 319-320, 357-359, 426-594;

In spite of the government's lack of resolution and unwillingness to produce and implement a comprehensive set of policies to strengthen the national market, the ban on the export of lumber wood seems to be working, at least so far. The linear regression analysis of the region-level data, method "forward" (with the probability of F for entry set at a 0.05 level and for removal at a 0.1 level), shows that in 2013 and 2014 the logging was driven by the demands of export and import. In 2015 their impact became insignificant (Table 2).

The dependent variable, the merchantable wood volume (originally in thousand cubic meters; Lg10 transformed), was predicted from a series of the independent variables, namely, forest area (% of the territory covered by forests), forest restoration (the area of new forests in Ha), lumber wood production (wood ripped or cut, divided into parts or peeled, 6mm plus thick, originally in thousand square meters; Lg10 transformed), total import of goods and total export of goods (originally in thousand US$; Ln transformed), export of wood (thousand US$), export of wooden furniture (thousand US$), import of wooden furniture (originally in thousand US$; Ln transformed) and total wooden furniture production (office, kitchen, living and dining room furniture, originally in units; Lg10 transformed).

The production of wood with low value added (lumber wood) had a positive and significant impact on the merchantable wood volume in 2013 and 2014 but not in 2015. The volume of total exports during the same period had a negative and significant impact, which may indicate that the lumber wood production tends to substitute the other commodities and products that Ukraine exports. The value of imports of furniture positively influenced the dependent variable in 2014 that immediately preceded the imposition of the ban. Ukraine produces and exports lumber wood importing at the same time wooden furniture. This situation is typical for peripheral economies.

The 2015 pattern is different. The contribution of exports and lumber wood production became insignificant. At the same time, forest restoration positively contributed to the inter-regional variation in the merchantable wood volume. The impact of forest restoration remained positive and significant in 2016. At the same time, the impact of the volume of lumber wood became significant again suggesting that the policy has to be more carefully designed and implemented. There was no association between the merchantable wood volume and the volume of total exports in 2016 nevertheless. Does it mean that the ban helped make progress both in solving ecological problems and in protecting the national producers of furniture? The tentative answer is yes, but the consideration of a larger period is needed to further confirm this assumption.

CONCLUSION

Ukraine currently lives in a period of economic duress. An unfavorable situation on the world commodities markets negatively affected the country's economy. The national processing industries are unable to compete globally and even in the national market, as the case of furniture production suggests. More substantially, the country bears all the costs of the undeclared war waged by Russia. A part of the industrial, agricultural and transportation infrastructure has been either destroyed (in Donbass) or lost (in Crimea). The military expenditures have significantly increased – at the expense of investments and consumption. The military conflict that still remains without solution in sight negatively influences expectations of businesses and households, which further undermines prospects of economic development.

In these circumstances, economic recovery will require massive public investment. "Since the cash-stripped Ukrainian government will hardly be able to come up with adequate funds on its own, the EU could potentially play a crucial role here – ideally by designing a sort of 'Marshall Plan' for Ukraine; similar plans have been advocated recently e.g. by G. Soros and Dmytro Firtash" (Adarov et al., 2015, p. 21). No new Marshall plan seems to be forthcoming, however.

As a better alternative to credits and loans that simply postpone the payment of the costs caused by the current crisis, this article proposes the asymmetrical arrangement that involves a combination of temporary protectionism and the free access of Ukrainian producers to the Western markets. Being temporary protected at home, Ukrainian producers will have more resources for competing globally. The unrestricted access to the Western market will provide them with powerful incentives to learn. In other words, Ukraine may need a combination of protectionism and the outward-oriented strategy.

At least three obstacles prevent Ukraine from moving in this direction. First, Ukraine has obligations to keep its economy open. Long and difficult negotiations will be needed to persuade the international organizations, first of all the WTO and the EU, that this country's special circumstances require non-orthodox, exceptional measures. Goodwill of the international organizations will help accept the asymmetrical solution and enforce its implementation (so, for example, no unilateral extension of protectionist policies is possible).

Second, Ukrainian businesses and political parties prefer to wait and see if the current crisis may end as miraculously as the crisis in the 1990s instead of acting proactively and promoting at least a discussion of alternative economic policies for this country. Ukrainian furniture producers make an exception that confirms the rule. Without healthy economic debates existing economic policies, neoliberal or protectionist, will not be adapted to the particularities of the economic and institutional environment in this country and, thus, will unlikely lead to the desired outcomes.

Third, protectionist policies create a risk of rent seeking and government representatives' opportunism in the other forms. Without solving the problem of incentives, not only for businesses but also for the government, any form of protectionism is doomed. "*Issues of incentives are at the core of economics: Some economists have gone so far to suggest that they are the economic problem*" (Stiglitz, 1994, p. 47).

The volunteer movement that emerged and strengthened in Ukraine from 2013-2016 provides some ground for optimism in this respect. This movement is not satisfied with the role of a service provider progressively assuming the function of an advocate and a watchdog controlling the government on a daily basis. The civil society's control over the government potentially creates much needed incentives for its representatives and serves as a guarantee against the appropriation of benefits of the gate-keeping by them, as it has been occurring in Russia.

The situation with the draft law tentatively titled "Buy Ukrainian, Pay Ukrainians" (Kupui Ukrain'ske, platy Ukraintsiam)[9] offers a good opportunity for comparing risks and benefits of protectionist policies, the Ukrainian style. The Law aims to make Ukrainian producers more competitive when bidding for government and municipal contracts. The draft was originally submitted in October-November 2017 and is scheduled for a second hearing, as of the time of this writing. The first draft was supported by MPs representing several political forces, from the centrist parties, such as Petro Poroshenko Bloc and People's Front to the opposition, Fatherland and Opposition Bloc.

The Law, if it eventually enters into force, has several features that potentially allow the civil society to exercise some control over the process of awarding contracts and, hence, to "monitor the monitors". Legislators have no intention to organize a separate competition for the Ukrainian bidders. All bidders will be taking part in the same tenders organized on *Prozorro* (literally – Transparent),, an on-line platform created in 2014 by a group of volunteers in an effort to increase the level of transparency in the operation of the Ukrainian government.[10] At the same time, price proposals from the national producers are expected to be corrected using a formula defined in the

[9] http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=62736.
[10] https://tender.uub.com.ua/.

Law: the more one uses local resources, including financial, the more his or her price bid is adjusted downward. The bids, formula for calculating the adjusted price and results are transparent and accessible on-line for everyone interested. However, Section 7 of the draft law says that only the government, a public body or a municipality may initiate the procedure for checking the validity of the information supplied by the bidders and entered in calculations. Without allowing the civil society to access and verify this information, the Law may well contribute to the continuous reproduction of rent-seeking behavior instead of helping to find a way out for the national economy.

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