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ENGAGING UKRAINE IN 2009

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P R O C E E D I N G S

MR. BENJAMIN: Good afternoon. Welcome to the Brookings Institution. I'm Daniel Benjamin. I'm the Director of the Center on the United States and Europe, and I'm delighted to welcome you to this event on Engaging Ukraine in 2009. This is being brought to you under the auspices of our Frontiers of Europe Program.

You don't need to be a professional Ukraine watcher to know that Ukraine today is a troubled country and as such represents a significant policy challenge for the United States. As the *New York Times* wrote on March 1, "Ukraine, once considered a worldwide symbol of an emerging free-market democracy that had cast off authoritarianism is teetering and its predicament poses a real threat for other European economies and former Soviet republics."

Among its problems are a high level of government dysfunction bred by the continuing feud between the President Viktor Yushchenko and Prime Minister Yulia Tymoshenko, a quarrel exacerbated by an uncertain constitutional situation regarding the delegation of powers to different officials of the government. There is also a ferocious economic crisis which takes many of the characteristics that are afflicting countries around the world but is perhaps deepened by the near collapse of the export steel market that is the market for one of Ukraine's key

commodities. Then there is the difficult relationship with Ukraine's neighbor Russia whose antipathy toward the Ukrainian President and his Western orientation is quite deep and whose desire to keep the United States and the West out of its sphere of privileged interest is powerful. That too is compounded by Russia's economic woes and the difficult relationship over energy for which Ukraine serves as the main transit point between East and West.

Clearly this is a set of problems that cannot wait especially as the Ukrainian economy hovers near the edge of disaster, and it poses a serious challenge for a new administration. Fortunately, three of the very best Ukraine watchers are here and have put together a guide for us for navigating these perils. That guide which is on a table outside, and you haven't picked one up on the way in, you should pick one up on the way out, is the same title as this event, and I'm pleased to say that they will be discussing the key findings for us.

Let me introduce our speakers today. First, Anders Aslund who will discuss the economic crisis. Anders has been deeply engaged in Ukraine and in writing about its economy since 1985. He has written very extensively on the subject. Most recently, and that is very recently indeed, his book "How Ukraine Became a Market Economy and Democracy" came out just this February. Anders has been at the Peterson Institute for

International Economics all the way across the street as a Senior Fellow since 2006. He is also an alumnus of the Brookings Institution, the Carnegie Endowment next door, and number of other very distinguished institutions, and we're delighted to have him here.

To my right, Jonathan Elkind, is a Nonresident Senior Fellow on energy security issues here at Brookings. He is the founder and principal of EastLink Consulting, an independent consultancy focusing on energy, the environment and investment. Jon spent many years in the government including from 1998 to 2001 he served on the staff of the National Security Council as Director for Russia, Ukraine and Eurasia.

Finally, Steve Pifer is a Visiting Fellow in our center. He spent more than 25 years with the State Department. His assignments included Ambassador to Ukraine, Deputy Assistant Secretary of State with responsibility for Russia and Ukraine, and Senior Director at the NSC staff for Russia, Ukraine and Eurasia. Earlier this year Steve also published a Council on Foreign Relations special report "Averting Crisis in Ukraine." So these guys really know all the bad news there is to know about Ukraine and I'm delighted they're here to present their findings today. Anders, why don't you start?

MR. ASLUND: Thank you very much, Daniel, and it's a pleasure to be here at Brookings again. Many countries were very badly

hit by the financial crisis, but I would argue that Ukraine was probably worse hit than anybody else. I was actually in Ukraine at the end of September. This was massive overheating. The most difficult thing in Ukraine was to find office space at any price. Then I came back 2 weeks later and everything had just stopped. In particular, the construction sites, they looked as if they had been nuclear bombed. The machinery, the cars, the cranes were just standing there but there were no people because international finance had disappeared.

There are three peculiar things about Ukraine which made Ukraine so badly hit by the crisis. The first was that the steel industry in Ukraine is very important and the steel industry throughout the world has been very badly hit. So 42 percent of Ukraine's exports during the first half of last year was steel and with the price fall of two-thirds from July and a sharp decline in all exports, Ukraine lost a quarter of its exports only on steel. This year Ukraine's exports are down by almost half and this is not Ukraine's fault. This is really an external big blow.

The second reason was Ukraine's fault. Ukraine had a bad exchange rate policy as quite a few other countries, so Ukraine had a fixed exchange rate to the dollar which led to excessive capital inflows and this led to inflation which also led to a noncompetitive cost. But after all, Ukraine last year had a current account deficit of only 6.7 percent of GDP

which is not very much, too much but not very much. Several other countries had four times large current account deficit. So by that standard Ukraine was not that strange. Then messy policies that Steve is going to talk about later on which made the investors say that Ukraine is not a serious country, why should we talk to them if they don't talk to one another? I don't think that's a good argument. You rather look at what is actually happening to the economy.

But I must say that the international financial institutions have been quite good to Ukraine. The IMF came in quickly at the request of the Ukrainian government. Within less than 4 weeks in early November last year, the IMF had composed a substantial stabilization program for Ukraine. The financing was no less than \$16.4 billion, about what was needed. And the IMF was not (inaudible) these were three standard conditions, balance the budget more or less, abandon the pegged exchange rate for a floating exchange rate, and restructure the banks. Arguably Ukraine has done more about bank restructuring in a very good situation than most Western countries.

But what about the economic outcome? As everywhere else, everything becomes worse than expected today, and the Ukrainian numbers from the beginning of this year are truly shocking. In January industrial production fell by 34 percent over January last year, and GDP by

20 percent. In such situations you can't really keep up with what have intended to do.

The consequence today is that Ukraine in spite of the IMF program which is following reasonably well has a budget deficit of about 5 percent of GDP. Given that Ukraine's GDP not in real terms but in dollar terms is falling this year by no less than 40 percent because of a massive devaluation, 1 percent of GDP is \$1 billion and Ukraine today needs essentially \$5 billion. If you compare this with the stimulus program for the U.S. of \$787 billion where the U.S. budget deficit of 12 percent of GDP, these are small numbers, very small numbers. Moreover, all the international financial institutions are involved. The IMF, the World Bank, the EBRD, and the European Investment Bank are deeply engaged in Ukraine to do what they should. So this leaves probably \$2 billion left. And this is the issue today, to get the IMF program back on track with sufficient financing for the budget and that's what I've been arguing quite strongly for recently, and of course, the U.S. should make a contribution. This is a vital interest for the United States and for the West to contribute to Ukraine's stabilization because this is a question of what will happen to Ukraine.

Ukraine is now down and out. Good friends support friends in a serious situation. Most of its financing should come from Europe.

Europe is highly reluctant to do anything about Ukraine, but the U.S., the IMF, the World Bank, the EBRD, IDB, the European Union, and various European countries should all come together and fix this. It's too little to risk such an important country. Thank you.

MR. BENJAMIN: Jon, tell us all about energy.

MR. ELKIND: Ladies and gentlemen, Dan opened our program today by talking about some of the complexities of Ukraine. Certainly anybody who watched at all the energy-related events of the start of this year will also understand without a whole lot of further prompting the great significance of Ukraine when it comes to the energy markets of Europe and Eurasia.

In fact, Ukraine is the critical transit partner for natural gas in particular flowing from Russia and Central Asia to European customers. Eighty percent of Russia's gas exports transit across Ukraine going to the very best customers of Russian natural gas. By the same token, the European Union takes 20 percent of its gas demand in the form of gas that is imported from Russia and Central Asia again cross Ukraine. If you look at the numbers, what is striking but little recognized is that Ukraine therefore is the single greatest hydrocarbon transit country in the entire world. Those are the perimeters that define the importance of the country.

The bad news is that as Dan hinted, none of this comes without complications. In fact, today's energy sector in Ukraine is seriously hampered because of the fact that 17 years after independence Ukraine has yet to undergo serious and badly needed long-recognized, long-diagnosed energy-sector reform. As a consequence, Ukraine not only imperils its own position, its own energy security and the health of its own economy, but it also in doing this places under great strain the position of downstream partners and neighbors in Europe.

None of this is to say that Ukraine's position is simple. It should by now be clear to all of us in the room that regrettably policymakers to the East of Ukraine in Moscow are entirely intent to use energy as a political instrument in Russia's dealings with Ukraine and other neighbors, so my comments are not meant to ignore that fundamental aspect of the discussion and fundamental aspect in the context in which Ukraine located.

Nonetheless, even if that is the case, that does not mean that Ukraine couldn't improve its situation by conducting energy-sector reform. Unfortunately, it is the case today if one looks at the problems that are facing Ukraine, the way that decision are made, unmade and remade in Ukraine's energy sector, it's very easy to conclude that first and foremost the energy sector rather than being optimized for the national

good is optimized for use as a political trophy and this is as I say the thing that poses the great threats for both Ukraine, its wellbeing and downstream customers.

What is it that Ukraine and in my opinion should do in this very complicated year that is 2009? I'll state the obvious which is in countries that have much more stable political situations than Ukraine, let's include the United States as a prime example, pushing through energy-sector reform is not at all easy. It's a breadbasket issue. It affects people's pocketbooks in the most direct way. Consequently, under good circumstances it's very difficult to move energy-sector reform. Ukraine is not such a settled stable political entity, unfortunately. Steve will elaborate on this in his remarks in just a couple of minutes, but I mean from the outset to acknowledge the basic point which is in this year 2009 with the presidential election awaiting early next year, moving forward on energy reform might seem like a nonstarter. I would suggest that exactly the opposite is true, that if Ukraine does not move ahead with energy-sector reform, that Ukraine will not be able to take care of its other business in relation to its politics and its macroeconomics.

What does Ukraine need to do and what does the West need to do? First and foremost, in relation to natural gas which is where things really bite in Ukraine, the country needs to mobilize cash and stay

current. One of the key features of the new deal from January 19 with the Russians is that if Ukraine in any single month fails to pay for the gas that it has used in the previous month, sorry, there are lots of months in this sentence, then from that moment forward Russia has the right to require month-ahead payment, and if it's hard as it is in today's Ukraine to get people to pay for the energy that they use at the retail level, it's going to be even harder if ever that is required to be paid in advance.

Second point, the most fundamental point, Ukraine today has an underlying problem in that true costs of energy are not the basis for driving what people actually pay on a retail level. Every cubic meter of gas that is consumed in the country -- every cubic meter of gas that is coming from regulated sources that is consumed in the country is consumed at a discount of some sort that is borne by the Ukrainian taxpayer. Somebody has to pay in the end for the gas that is consumed in Ukraine. Today it is done through subsidies that are extensive throughout the economy. And people need to understand that this is a matter of the country's national security, that failure to pay for all of the gas that is used undermines the country's own stability and security.

A third piece of the agenda is to reduce import dependence. There are two ways to come at this. One is to move ahead with much more aggressive work in relation to energy efficiency for which there are

huge opportunities in Ukraine. Ukraine's energy intensity today is twice that of Poland. It's even greater than Russia's. So there's lots of fat that can be trimmed from the Ukrainian energy economy.

The other way to reduce import dependence, and again this will sound familiar to the Americans in the audience, is to increase domestic production. Ukraine has great opportunities to increase domestic production but has not to date been serious about employing the kinds of international standard approaches that have been demonstrated to attract investment in serious amounts upstream.

I have given a lot of comments in the last couple of minutes about things that Ukraine needs to do and the topic of today's discussion includes also things that the U.S. needs to do, and I would submit that the answer to that question comes in the form of watching very carefully the actions that are taken in Kiev supporting very proactively the impulse to move ahead with energy reform advocating that kind of reform if it is not happening of its own accord, and certainly in the political context of today as Steve will elaborate, that's complicated. But in short, to be proactive and push for long overdue energy reform, and if I hope when Ukraine starts to move in that direction, then to move very closely together with European colleagues and to make sure that the U.S. puts its weight behind the kinds of rational reforms in the energy sector that are long

overdue and that I would suggest are an existential question for what faces Ukraine today.

MR. BENJAMIN: Steve, the political shimmy?

MR. PIFER: I'll talk for a couple moments about the politics and then the foreign policy. The problem that Anders described in terms of coming to grips with this major economic crisis and the problem that Jon described in terms of how do you reform an energy sector which is wildly out of kilter in terms of how it should be performing, dealing with both those problems is greatly complicated by the fact that you have a virtual political war going on in Kiev between the President on the one hand, Viktor Yushchenko, and the Prime Minister Yulia Tymoshenko on the other. This broke out within weeks after Tymoshenko was named as Prime Minister back in December 2007. The first assaults came from the presidential administration on Tymoshenko and her performance, but really by last March you had a situation where the government was increasingly deadlocked because of this exchange going back and forth. A large part of the initial effort against Tymoshenko was driven out of a political concern which was that in the presidential election which will be held at the end of this year there was concern in Yushchenko's inner circle that Tymoshenko was probably his greatest challenger and that fed a lot of this political feuding which continues now, even though if you look at

polling, it would suggest that there's not much competition between Tymoshenko and Yushchenko. Most polls have Yushchenko down around 3 to 4 percent. But the political impact of this fight is Ukraine didn't get very much accomplished last year in a year that people were saying this is an opportunity for Ukraine to consolidate economic reform and really move forward in some important areas.

It also weakened Ukraine's ability to deal with challenges. First and foremost during the gas war in January it was very clear to all including the Russians that there was a difference between the President and the Prime Minister, and certainly Moscow played on that. This also complicates Ukraine's foreign policy challenge which is strike that right balance between drawing closer to the West and maintaining a stable relationship with Russia. Two factors this year make this more complicated. First of all, in Europe the enthusiasm for Ukraine is dropping. It's dropping for a variety of reasons. Part of it is simply Ukraine fatigue because of the political conflict in Kiev. It simply makes it difficult to engage with Ukraine. The second factor is to their East, Ukraine has a much more sort of Russian neighbor which has pursued over the last year a much more assertive policy with regards to Ukraine. Relations between Kiev and Moscow are probably at one of their most difficult points since 1991, problem issues including NATO, Ukraine's support for Georgia, the

energy war which we all say, and just a long litany. And it's complicated further by the ability of Russia to play on some of the internal frictions, some of the internal tensions within Ukraine, and certainly the Kremlin seems this as in its interests because to the extent that you have a divided politically messy Ukraine, that kind of Ukraine is not going to be an attractive partner for either NATO or the European Union, and also it's not going to present a political model that will be attractive to the population in Russia.

In this context, what should U.S. policy be? We suggest in the paper that as frustrating as watching things in Kiev are, as difficult as it may be to engage with the country where there is this much internal political turmoil, the United States government does not have the luxury of sitting back to wait because the situation then is only likely to get worse and if the U.S. does not engage now, it will have to engage 6 or 12 months down the road with greater time, greater resources and greater energy. A big purpose of the engagement is to try to see if we can knock some heads together and get the President and the Prime Minister to cooperate on at least some things. They haven't responded to external pleas, but can the outside community mobilize this in conjunction with the crisis which hopefully would force them to come together at least on a few key questions?

So among the recommendations, we think it would be appropriate for Secretary Clinton to pay an early visit to Kiev with the message not only of American support for Ukraine, but also a tough love message, making sure that unless Ukrainians get their act together, it will be hard for the United States to help on questions such as energy security, such as dealing with the economic crisis, such as finding the right policies to help it navigate between its desire to move toward the West and some of the pressures it encounters from Russia.

It might be useful for Secretary Clinton to travel in the company of the E.U. Special Representative for the Common Foreign and Security Policy Javier Solana, because to the extent that we can get a joint U.S.-E.U. message, it may have greater impact in Kiev.

Looking more toward the long term and how you structure U.S.-Ukrainian relations, we suggest recreating the Binational Commission that operated and was chaired by Vice President Gore and President Leonid Kuchma between 1996 and 2000 as a mechanism to ensure high-level attention to keep the relationship going forward, to break deadlocks at lower levels and to ensure that Ukraine gets the level of engagement that it needs and at a level where there's a greater chance where the Ukrainian leadership may pay attention to American messages. As we think through how to structure this, something has changed in 10

years, a lot of things have changed, but 10 years ago it made sense for there to be a Gore-Kuchma commission because Kuchma controlled executive power. Today executive power in Ukraine is divided between Tymoshenko and Yushchenko and a Biden-Yushchenko commission is not going to get cooperation from the Prime Minister, a Biden-Tymoshenko commission is unlikely to get cooperation from the President. So we would suggest having both Yushchenko and Tymoshenko as Ukrainian co-chairs to try to force them into some coherent policies that we could engage with, while acknowledging that the risk here is that if the tensions that we've seen over the last year cannot be overcome, it makes that commission much less effective. But the main message to the Ukrainians politically needs to be you have to get your act together to tackle these difficult economic questions and urgent issues of energy reform.

In terms of other messages to send, we think Washington should be approaching the European Union and saying we have a joint interest here in seeing Ukraine succeed. It makes sense for the European Union to pick up some of the slack now that the NATO Membership Action Plan issue has sort of moved to the back burner. The United States should work with Ukraine in terms of developing an annual national program with the alliance, this is what the alliance is now focusing on in place of the Membership Action Plan, to make sure it's a very substantive

agenda that allows Ukraine and NATO to deepen their relationship and keeps that option open for Ukraine should Ukraine at some future point desire to move closer to NATO.

We also think there are clear messages for both Kiev and Moscow in the context of trying to help those two capitals avert a major escalation in tensions. The message to Kiev here, really there are two pieces to it. One is do not pick unnecessary fights now with Moscow. You don't need it. If you get into a legitimate fight, you can count on American support, but don't provoke things. Second, there needs to be absolute clarity on the part of Washington with Kiev as to how much support Ukraine can expect should it get into a confrontation with Russia. It doesn't serve our interests and it doesn't serve the interests of Ukraine for Ukraine to get into a fight with Moscow based on a miscalculation of how much Western support it's going to have.

At the same time, there needs to be a parallel message to Moscow which should be that the Russians should not underestimate how damaging a Russian-Ukrainian crisis could be for Russia's relations with the West. It's hard for example for me to imagine how the U.S. effort to reset the relations between Washington and Moscow could survive a major Ukrainian-Russian conflict or crisis that's provoked by the Russians. I'll stop there then and turn it back to you.

MR. BENJAMIN: Thank you very much, gentlemen, for a comprehensive view of a somewhat gloomy situation. Steve, let me start off with a question for you picking up on something that we've discussed. It sounds great to start the Binational Commission. Beyond the attraction of having that kind of structural engagement with the United States, does there need to be another carrot put on the table to get these quarrelsome Ukrainian politicians to behave themselves and to do the things that they need to do? It seems that they've been pretty inured to all kinds of potential payoffs over the last year or so. Why should this work?

MR. PIFER: I can't tell you for certain that it will work.

MR. BENJAMIN: Honesty here at Brookings.

MR. PIFER: But what I can say is so far we haven't succeeded and it seems to me that the right message might have some impact combined with the point that our ability to help on economic questions, with energy-reform questions, with Europe and with Russia turns first and foremost on the existence in Ukraine of a coherent policy from the government and that means some kind of agreement between the President and the Prime Minister not necessarily on every question, but there has to be something more than we have now.

Even if we can't achieve that, I would argue that makes sense now to restart the Binational Commission because this is not just a

mechanism for 2009, this should be a mechanism that we can govern and direct U.S.-Ukrainian relations on into the future. So if you put the structure in now, even if you don't have as much success as you'd like in terms of bringing Yushchenko and Tymoshenko to the same page, you've got a structure that may be more effective in 2010 following the presidential elections when hopefully there will be more coherence between the President and the Prime Minister and you start building relationships now which give you more influence down the road.

MR. BENJAMIN: Let me ask you one more question. We've spoken about Russian sensitivities in this area and we have certainly seen them demonstrating whenever the discussion turned to Ukraine being in NATO. What kind of reaction do you expect the Russians would have to the creation of a Binational Commission? We are after all in a Putin-Medvedev era and no longer in the Yeltsin era and there is no U.S.-Russian Binational Commission at the moment.

MR. PIFER: There's a Russian-Ukrainian Binational Commission. The Russians in general I think still continue to view Ukraine in largely zero-sum terms, so any mechanisms that bring Ukraine closer to the West, closer to the United States, are not going to be popular in the Kremlin. But having said that, it's awfully hard to see how they can legitimately object to a mechanisms. It's up to two independent countries

really how to decide how they're going to organize and manage their relationship. So I think the Russian objections would be less to the mechanism and later on they would want to see actually what policies came out of that.

MR. BENJAMIN: Anders, from the Ukrainian policymakers you've spoken with, do you believe that if the U.S. took a leading role in at least organizing the filling of that funding gap that you spoke of, that that would provide in some way the carrot that we were talking about a moment ago as being something that might actually bring the Ukrainian leadership together or do they consider themselves too big to fail and therefore that would not be enough of an incentive?

MR. ASLUND: The Ukrainians are very humble. They don't consider themselves too big to fail. They are rather happy for any engagement with Ukraine. As we write in this report, the U.S. and Ukraine have no significant outstanding bilateral conflict and that's quite an achievement. You can also say that Ukraine is a true friend of the United States. It's also a true friend of Europe. And this is a country that is easy from a political point of view to interact with, easier than most. So I would rather say that any engagement from the United States will be welcomed in the Ukraine.

What should be done? You organize a normal donor's meeting and put a relatively small amount and the whole thing is put together. I would emphasize how much the Ukrainian government has actually done on the financial crisis. They got an IMF agreement together fast. They have managed so far to keep the budget deficit in spite of sharply falling income at the low level of 1-1/2 percent of GDP. The government has controlled this now, they need more financing, but this is an open discussion with the IMF. And they have let the exchange rate float. It has fallen by about 50 percent and stabilized at that level. As I emphasized, they have done a lot about bank restructuring. So this is not a government in stalemate. This is an active government even if the political acrimony is a bit more than most people like. I personally don't like this degree of personal acrimony. It's of course a bit disturbing when they are using the law-enforcement agents against one another. That's something that should not quite be undertaken.

MR. BENJAMIN: Jon, before we open it up to the audience for discussion, can you, as we would say in Washington, drill down a bit on the political economy of the energy sector? You mentioned that energy has become or energy assets have become a kind of political trophy and I was wondering if you could pack that a bit and tell us why 17 years after it has been impossible to get reform. Clearly there are some very deeply

entrenched and powerful interests which are preserving the status quo. How much of that is political cowardice and unwillingness to talk hard truths to the populace? How much is it special interests that are making a killing on it?

MR. ELKIND: As people in this room will be well aware already, there are indeed organizations that have profited substantially and without particular relation to functions that are required in the Ukrainian energy economy. The poster child of this idea is a company called RosUkrEnergo which defies all analysis of people knowledgeable about the energy sector as one looks at how they ended up in the role that they've been in in over the last several years. They own their assets. They have no technological capability. Suddenly Gazprom agreed to have them be the critical agent selling to one of the critical partners of Gazprom in the form of Ukraine, and by the same token, the Ukrainian leadership also consented to have that organization without any kind of a tender or any competition be at the very heart of its economy. When asked about the nature of the function and why RosUkrEnergo has existed over the last several years, each party kind of does this and says blame them. RosUkrEnergo it's also important to note is not the first such organization that has operated in that manner. Before it there was Ural-Tans-Gas, before it there was Etera. So this is a by now well-established pattern in

the Ukrainian energy sector. One hopes that different market circumstances that exist today and the power of the spotlight that has come on that kind of middleman organization from analysts across Europe, in the United States and also very much in Ukraine where one of the outcomes of the Orange Revolution is a lively free press, that one hopes that with time that kind of attention will drive some of the most egregious practices away. Why has it existed? That's probably in that zone of conclusions that we can all reach without a whole lot of prompting that go to personal benefit, benefit for the right political groupings, the right industrial plans, et cetera.

MR. BENJAMIN: Do you want to explain the political trophy concept?

MR. ELKIND: The pattern that one can see in looking back at the last several years is that certain projects move forward and other ones don't. It is often the case that the ones that do move forward are the ones that have affiliations of one sort or another with the right industrial groupings. Then when there's a change of political leadership, all of a sudden projects that were moving swimmingly under government A no longer move swimmingly under government B. As one talks with people in the Ukrainian energy industry and as one talks with companies that have tried to invest in that industry it becomes quite clear that involving the right

partners takes on a very clear political overtone that is a matter of whether or not one can succeed. It doesn't speak positively at all about decisions being made on the basis of economic or commercial benefits either for individual companies, transparent investors or for the national welfare, rather, it speaks to the importance of good connections as a determining factor.

MR. BENJAMIN: Just to be precise, the way you've described RosUkrEnergo, it's one guy, a fax and a computer more or less.

MR. ELKIND: What has been printed in the Western press on numerous occasions is that it is a couple of so-called investors and those in the audience who are interested in learning more about this topic I would commend your attention to some work that was done by the "Wall Street Journal" a couple of years ago on the origins and affiliations of RosUkrEnergo, and similarly some very, very interesting work that was done by the British transparency NGO called Global Witness that has done some excellent sleuthing looking at who is positioned to profit very handsomely from that organization.

MR. BENJAMIN: At this point it makes sense to open it up to the audience. I saw one hand shoot up here. Let me just ask that you identify yourself, keep your questions brief and ensure that there's a question mark at the end of it.

MR. KARAMAZOV: I'm Vladimir Karamozov with RTVI Television. A question to all the panelists about the reset policy that the Obama-Biden Administration has announced toward Russia. Some people are suggesting that what's being talked about in fact is some kind of a Realpolitik exchange, that Washington stops criticizing the Kremlin for human rights and democracy practices and basically gives up on Russia's neighbors like Ukraine, and in exchange the Kremlin cooperates on issues like the Iranian nuclear program. What do you think of such an exchange if that were to take place and do you think in fact it would yield what its supporters want, and just what's your opinion of it?

MR. BENJAMIN: Who would like to go first? Let's start with Steve.

MR. PIFER: First, I don't read the reset policy that way. I think if you go back and you look at the first articulation of that which was by the Vice President when he was in Munich at the beginning of February, he made very clear that the Obama Administration would like to change the substance and the tone of U.S.-Russia relations and over the last several weeks I think we've seen ideas coming about strategic nuclear arms reduction. It seems also that the administration has suggested perhaps it's more we need to take a fresh look at the missile defense idea than its predecessor. But when the Vice President was in Munich he also

made a couple of other points. One, the United States would not recognize a sphere of influence on the post-Soviet space. And he also said that the United States would continue to support the right of independent countries as sovereign states to determine their own foreign policy course, and I think those are messages aimed very much at countries such as Ukraine and Georgia. So it seems to me that there is this balance. I would also note that when Secretary Clinton was in Brussels about 10 days ago for a meeting of NATO Foreign Ministers she made virtually the exact same point. So the reset policy as I understand it has been described so far is, yes, there is going to be an effort to try to change the relationship between Washington and Moscow and I think it will focus on issues like nuclear arms reduction, perhaps a different approach on missile defense, maybe doing some things in the commercial area, but it hasn't been defined in a way that suggests that there is a tradeoff and that somehow now Ukraine and Georgia are going to be pushed away.

I just would say on the question of Ukraine and its relationship with NATO, if you go back and you look at 2008, there were several reasons why Ukraine didn't get a Membership Action Plan, and one reason was the concern on the part of some of our European allies about not provoking Russia. But I think an equally reason, two reasons

really related to Ukraine, one was this Ukrainian turmoil within Kiev which played out. In October you had at one point the President looking like he was going to call for a new round of elections, and the other point with regard to Ukraine is that there hasn't been an increase in public support to drawing closer to NATO. So there are I think also some Ukraine related factors that have impacted on how Europe has looked at Ukraine and it may be more sensible now with the annual national program between Ukraine and NATO, Ukraine could do all the substance that it was going to do under a Membership Action Plan but without the Membership Action Plan title which seemed to be the focus of concern on the part of the Russians, but also the focus of tensions within Ukraine's own politics.

MR. BENJAMIN: Anders, you wanted to add to that?

MR. ASLUND: Just briefly. On U.S. policy on Russia, Steven has written a wonderful policy brief for Brookings on this and the caption -- CSIS policy brief which is very much in the same spirit. I would just like to summarize what Steve just said with regard to U.S. policy on Russia during the Bush Administration, too little, the wrong questions in the wrong fora, and therefore no impact or positive results. That's the problem, not the other things.

MR. BENJAMIN: We have a hand up back there.

SPEAKER: Thank you (inaudible) I actually have a follow-up question to Steve. Steve, you mentioned about the importance of clear messages to Moscow from Western countries, but could you tell us what are the real tools of Western countries to prevent the aggressive policies toward neighboring countries? And if there are some tools, could you tell us how Western countries could choose whether to use them or not in the neighborhood of the Russian Federation? Thank you.

MR. PIFER: I think certainly in the aftermath of last August there has to be thinking going on as to how the United States and how Europe build relations with Ukraine and Georgia because it won't be good for American policy or for European policy if Russia comes to believe that it can red line and it can basically define a red line and say Ukraine and Georgia are East of this line, there will be no institutional engagement. So we've got to be I think more creative in terms of looking at ways. Some of the ways that we saw with regard to your country, Georgia, with the Bilateral Assistance Program that was announced with bipartisan support last fall. But again it does seem to me that there was an understanding reached by NATO Foreign Ministers in December that you can do almost everything with an annual national program that you can do with a Membership Action Plan and so that there are those ways to continue to develop relations between the alliance and Ukraine and Georgia.

Also I think again this is the case where we should ask the European Union to pick up some of the slack here. In many ways the European Union offers things that are important to a country like Ukraine and having the European Union move forward with regard to Ukraine. For example, accelerate the negotiation of the Association Agreement which was announced last year and that will include among other things a free-trade arrangement. Look at ways to use the E.U.'s newly announced Eastern Partnership to promote new links to countries like Ukraine and Georgia. So there are a host of things I think that can be done that would send very clear signals to Ukraine and Georgia that there's going to be continued robust engagement from the West.

MR. BENJAMIN: Steve, now that you've spilled the beans repeatedly on the ability to do as you said everything you want in a national plan that you would do in a Membership Action Plan, how do you explain the Russian relative quiet on those activities as opposed to MAP?

MR. PIFER: I think there's a couple of reasons for it. One is I think the main objection of the Russians was the Membership Action Plan, it was just the term. They weren't focused on the substance. And it's probably compounded by the fact that I think in many quarters in Moscow the idea of the Membership Action Plan has become conflated with an invitation to join the alliance, whereas NATO always saw it as two

separate events. There was a decision on the Membership Action Plan and at some point later on down the road you would make the decision about whether to invite a country to join. I think in the case of the Russians they've actually come to see that as the same decision so that's what drew the focus of their ire. But since the alliance in December announced moving on the basis of an annual national program, you really haven't seen much negative reaction coming from the Russians.

MR. BENJAMIN: Historically speaking there may been two decisions on the Membership Action Plan and members, but there haven't been any Membership Action Plans that didn't ultimately result in membership.

MR. PIFER: That's true, but in some cases it too a long period of time, and in the case of Ukraine, the Ukrainians actually put I don't want to say a brake, but the Ukrainian government last year said we want a Membership Action Plan but before we actually ask to join the alliance we would conduct a national referendum to make sure it's supported by the population. So I think at least in the minds between NATO and Ukraine there were two distinct decisions that had to be taken.

MS. NIEDERMEYER: Meg Niedermeyer ABA -- this may be best addressed by Mr. Anders Aslund. You mentioned that it's imperative of the E.U. and the U.S. to come together to fix the debt problem in

Ukraine and that we should come together to take over the remaining \$2 billion in debt. My question for you is how can you expect that this aid money will be capable of being absorbed by the institutions in Ukraine efficiently with limited externalities? AIG in the U.S. comes to mind, also the prevalence of corruption throughout the country. Secondly, assuming that there is the capacity to absorb funds, how can we approach European and U.S. leaders to make Ukraine a focus when there are so many other priority areas in Europe, other sectors, other regions?

MR. ASLUND: Thank you. The first thing is quite easy. Take the numbers. Ukraine's GDP in dollar terms this year is likely to fall by 40 percent, in real terms 10 percent or so. This is a major catastrophe. What do you do then? You provide humanitarian assistance. This should be looked upon as humanitarian assistance. Of course what Jon is saying about energy reform is also necessary to do and frankly it's a good pressure from the crisis to get it done, but you want people to survive and you want the systems running together. So you should just look upon this as humanitarian assistance. Essentially this goes to pensions and social safety of the people who are suffering hard. Unemployment in Ukraine is likely to swing up to 15 percent, and Ukrainian guest workers abroad to the tune of 2 million are likely to come home. So this is a major humanitarian catastrophe that Ukraine is being hit by. And if you don't

want to alienate people by not doing any program at a time of extreme hardship, people normally don't like cold-hearted people, they're not considered friends, then you should do something. So that's the humanitarian argument. It's not the USAID argument or ordinary due to conditionality. If you think of what Ukraine has done in terms of capping public expenditures and mobilizing their republic revenues in this time of hardship, it's quite impressive.

The second part of your argument, how can we convince the U.S. and Europe to do this? For the U.S. I think that the big argument is Ukraine is one of the big geopolitical loose pieces on the globe. Ukraine can go in different ways and the U.S. has a geopolitical interest to get it right. If you think of it, Ukraine was at the end of the Soviet Union the third biggest nuclear power in the world and Ukraine happily and kindly did away with its whole nuclear force by 1996 and the Pentagon has always been very grateful to Ukraine for this tremendous effort. I think we should not forget that gratitude but let it -- but it's still not clear that Ukraine will persist in its very West-friendly attitude if the West doesn't do anything for Ukraine in the time of hardship. And for Europe the argument is rather economic. Somewhat more dramatically you could say that the fate of the European banking system is determined in Ukraine. Forty-five percent of the political banking system is owned by foreign banks, essentially

European banks. If the IMF agreement is not fully completed now because of insufficient financing, the Ukrainian hryvnia could not only fall as it has done now, but really collapse. Then the European banks and Ukraine would collapse as a result because the Ukrainians can't pay back their dollar loans to the banks and the banks can't refinance their hard currency loans in Europe. So for the European banking system, you can say that right now Ukraine is the weakest state. Seventeen Western banks just came together 2 weeks ago and promised to put up \$2 billion of new capital for their subsidiaries in Ukraine. So far they have shown responsibility. Ukraine has not lost all that much of its reserves essentially because they let the exchange rate go. So Europe has a much greater interest in saving Ukraine for their own welfare than is now generally understood.

MR. BENJAMIN: Anders, let me follow-up on that. That's a fascinating fact about the exposure of European banks in Ukraine. When you read things like the one I quoted from the "New York Times" about the implications of Ukraine tottering even more dramatically or perhaps defaulting for its immediate region it suggests that it's quite a great implication, but I was wondering if you or Steve or Jon could spell out exactly what that might look like, what the implications would be of things getting much worse in Ukraine for Eastern Europe.

MR. ASLUND: If we take the numbers, Ukraine's foreign debt today is about \$100 billion, about the level that GDP is expected to be this year. Of this, private banks account for about \$80 billions, and \$80 billion is a huge chunk of money for the banks in question. If you take to this that the European banking system as a whole is heavily overleveraged, this would be the amount that would put quite a few of them over the -- you can compare Ukraine to another AIG. AIG got \$170 billion of U.S. government financing so far and this is a smaller case but it's coming later and can therefore be quite effective. But of course if Ukraine goes, a lot of other countries with floating exchange rates will see their currencies collapse and then their banking systems will collapse. I'm careful now not mentioning countries. I could name them, but it's better not to do so. After that you will see the countries that have fixed exchange rates but do not have the euro. They will lose out in competition to the countries whose exchange rates have collapsed and you get a perfect mess. This is a snowball effect of financial collapse and this must not be allowed to happen. It's totally unnecessary. And in particular when we discuss such small amounts. Then you say we'll fix it, then we get the others done and the IMF is now, or the U.S. is requesting for the IMF \$500 billion more of money. This will very much be used for European countries, not only European countries, but most probably also E.U.

countries that need substantial programs. This doesn't mean that you should be careful with the money. It rather means that you should be careful to balance the financial system while you still can because if you don't, you'll get a snowball effect and we will see a total mess which should not be allowed to develop.

MR. BENJAMIN: Do you want to add anything, Steve, on the political implications?

MR. PIFER: I think the political implications are if you get a Ukraine that goes through this economic collapse, they're simply unpredictable. You've had I think a general consensus in Ukraine over the last 15 years emerge which is that although Ukraine may be divided on the question of NATO, most Ukrainians now I think want to be part of Europe and polling does show that they generally have majority support for example for joining the European Union. But what happens to that sort of political consensus if you have an economic collapse on the scale that Anders has just described I think is just unpredictable.

MS. RAFAEL: I'm Helen Rafael, from Resources for the Future. I was working in Kiev during the very happy Orange Revolution and then that sort of fell apart a few months after that because of the conflicts between Yushchenko and Tymoshenko. I'd like to know aside from personality, animosity, what are the explicit detailed policy

differences between the two? As I understand, they're both rather oriented toward the West and if Yanukovich wins, that would be more pro-Russia. Is that correct too?

MR. BENJAMIN: Steve?

MR. PIFER: This is actually I think one of the mysteries of Ukraine. What is the real reason other than just personality differences? I think a big part of it was concern on the part of Yushchenko's inner circle that in the election which will be held at the end of this year, I guess it will be held in January 2010, the presidential election, that Tymoshenko might challenge Yushchenko for the presidency, and Tymoshenko certainly in 2007 reassured the president she that wouldn't do that, but ultimately she couldn't prove it. And certainly a large part of the attacks that came from Viktor Baloha, the head of the Presidential Secretariat, were trying to knock Tymoshenko's rating down. The strategy at this point doesn't look like it's been very successful because Tymoshenko typically now polls between 17 and 20 percent and the President's polls are in the low single digits. But the frustrating thing about this is this difference and this jockeying for the presidential campaign and the political differences overcome -- a lot of it is they're basically in agreement. If you look at I think Yushchenko and Tymoshenko and their parties, they're basically parties that want to create better business conditions. They look at

Ukraine as in Europe. Tymoshenko signed onto the President's appeal for the Membership Action Plan although I think in terms of her focus on NATO she is not as committed as he is. But if you look at the orientation of the parties, they're not that different on issue after issue after issue, and I think that's been the frustrating thing both during the period of 2005 when Tymoshenko was Prime Minister for 8 months and now over the last 14 months where this personal animosity has prevented them from coordinating and working together on doing things that would be both consistent with the political philosophies that they put forward, and that would have been very good for Ukraine.

MR. BENJAMIN: Anders?

MR. ASLUND: If I may add here a little bit. If you look upon the party programs of the three big parties, they are almost identical. These are three center-right parties and both Yulia Tymoshenko's bloc and Yushchenko's are Ukraine, are members of Europe People's Party which is the European Parliament that gave us all the center-right parties in Europe. So the differences are totally insignificant on the economic issues. It's really when it comes to NATO and to the standing of the Russian language that you can find any difference between these three parties. Then you look up on who do they represent. All three big parties, and also the two smaller, are financed by big businessmen and these big

businessmen shop around before each election and look up on which party right now suits their consumer profile the best. So they frequently change what party they support and it's quite difficult to keep up with which businessman is supporting what politician right now so there are on firm divisions between them. I would emphasize the Constitution which countries like this that I think Steve talked about the beginning are quite unclear. So the President has only power if he says no and it appears to me that Yushchenko after being too timid during the first couple of years as President realized that the only sensible strategy from his point of view was never to be reasonable again. So it was particularly striking in April last year when Tymoshenko very kindly suggested law after law that Yushchenko had long campaigned for. For example, private sales of agricultural land, lots of privatization, after which Yushchenko vetoed his own long-standing proposals and nothing came out of it in terms of -- the exception was WTO accession where Yushchenko actually agreed with his old policies which was quite an achievement -- the Constitution. I think that the solution here is to move toward a full parliamentary system and then the Prime Minister takes the full responsibility as it is in virtually all European countries and both Tymoshenko and Yanukovich want to go in that direction. So I think we shouldn't be surprised if we all of a sudden see that there is a constitutional compromise with more than two-thirds

majority which will fix this problem. I hope this will happen before the presidential election in January next year.

MR. BENJAMIN: Jon?

MR. ELKIND: If I could just jump in here, Dan. It seems to me that your question though important, in a way this takes us away from any even more important question and this is in this kind of moment of truth that 2009 amounts to, will these different political forces in Ukraine find the wherewithal to band together. There was this comment that was made by Secretary Clinton or ascribed to her about a week ago of not wasting a perfectly good crisis. This is that kind of moment. This is the kind of time when it is essential for Ukrainian leaders to come together in the interests of their country. I think that Anders's point about the shifting sands of Ukrainian politics is a particularly significant point. It is really striking the degree to which the differences between the spoken objectives of these parties is truly trivial. It's also quite striking that four-plus years after the Orange Revolution the tolerance among the Ukrainian public for minutia that sidesteps from the critical issues facing the country, that that is diminishing. So I guess I would argue that one of the core points that we tried to get at in this paper is that 2009 as complicated as it is is precisely the time when Ukraine needs to move ahead with some of the critical pieces of reform that have been delayed for so long.

MR. BENJAMIN: You've been very patient.

MR. JOHNSTON: I'm Rick Johnson with Citigroup. I have a question regarding a project that might be not a silver bullet that something that might be able to rally a number of the forces for the panelists to discuss this afternoon and it's something near -- well, it may be not so near anymore, but dear to your heart, Steve, the Odessa-Brody Pipeline. It strikes me that as an energy transit country of such huge proportions and with the energy needs of the country as they are that an independent source of energy, of oil particularly from the Caspian whether it's Kazakh or Azeri or others, would be a very strong strategic move for not only Ukraine but for the Europeans, Eastern Europe, Poland particularly, as well as for the United States to support through perhaps World Bank funding, through some sort of a project finance where there's control over the funding by multilateral development banks but to the benefit of Ukraine and to ultimately let's call it more of a balance for Ukraine in that push-pull between Russia and Europe. Is this a pipedream?

MR. PIFER: For better or for worse, the Odessa-Brody Pipeline exists today as you know, I'm not sure others in the room will know that. For a long time, friends of mind in the energy industry referred to it as the world's longest mushroom farm in the period when it had been

built and sat unused. The problem with the Odessa-Brody Pipeline is that unlike almost every other pipeline that one finds around the globe, it was built on the "Field of Dreams" basis, build it and they will come. Typically pipelines are built as a utility, as a cost center, not a profit center, and there was the vision in the minds of some people associated with that pipeline that this would be different. Unfortunately it's a case in point of energy infrastructure being used as a political trophy, as a play thing of political leadership. First it was meant to be operated in the south to north direction. Then it was operated in the north to south direction. Now there is discussion about yet another change to bring it back to going south to north. Were I an investor I would want to see legal obligations that made it entirely clear to me that politically motivated future changes would not be in the cards because having been reversed once, why should it not be reversed a third time if you were to do it again?

So I am meaning to express a certain I would say healthy skepticism about the Odessa-Brody Pipeline. I'm not meaning to say that I think that the project could never work in the northward direction, but at this point I would say that most energy investors, most companies with barrels of oil to ship would be imprudent not to look at the project and say how do I have a commercial certainty that the thing is going to operate in

any particular mode for the kind of decadal timeframes that are required typically for pipelines.

MR. ELKIND: I might just add a little bit on the history because I was in Kiev and back in Washington during the formative years of Odessa-Brody. From the perspective of the U.S. government, we thought that there would be some potential there because you had for example the CPC, the Caspian pipeline bringing oil out of Kazakhstan to the Black Sea then being put on tankers and set out to the Bosphorus and the Turks were increasingly nervous about having large quantities of energy pass basically right by downtown Istanbul. We also learned that some of that energy was going to the Adriatic and then being pumped to refineries up in Southern Germany and the Czech Republic. So we thought there may be something here. But unfortunately the way the Ukrainian government handled this is they didn't go out and they didn't go and say do we have a supplier of oil and a buyer of oil and let's see if we can make it, they went out and they built the pipeline first, and it would have far more sensible to in fact have engaged and found that there was that interest and made it a commercially viable operation. Since then of course as Jon said, you now have the pipeline actually pumping oil in the reverse direction, it's moving oil to Odessa, and that of course I think is an additional impediment to potential use of the pipeline because they're

wondering if they're going to make that investment to move that oil into Central Europe, how can they be assured that in fact the pipeline will always be available to go in that direction? There's I think something to be done there but what the Ukrainian government needs to do is they need to approach it much more as a commercial proposition rather than just let's build a pipeline and the oil will come.

MR. BENJAMIN: Unless there are any final questions, we will bring this session to a close. We promised you the best Ukraine watchers around and I think that they have delivered impressively, and I hope you'll join me in thanking Anders Aslund, Steve Pifer and Jon Elkind.

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

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