

UKRAINE'S INDISPENSABLE ECONOMIC REFORMS

PIERRE VIMONT | APRIL 29, 2016

Economic reform is central for today's Ukraine. The capacity of the Ukrainian nation—leadership and population together—to deliver a modern and efficient economy, if achieved, would constitute the winning asset in the West's current struggle with Russia in Eastern Europe. Success on the economy would represent the most convincing argument Ukraine could offer to all those who doubt the country's ability to stand as a modern and efficient state. Producing tangible economic results is the best way to dispel these doubts.

The economic challenge is one of the most pressing as Ukraine strives to stabilize its internal and external accounts, relaunch its productivity growth, and engage in the long-term process of modernizing its manufacturing sector. Yet, far from being a lost cause, economic reform in Ukraine is one of the domains of government policy in which some optimism can be nurtured. Indeed, in spite of current ups and downs, achieving a prosperous economy in a reasonable time span remains a realistic prospect for Ukraine.

Progress is on its way with some first positive results in Ukraine's macroeconomic stabilization program. But modernization of the economy is lagging behind. Renewed efforts are necessary to ensure the implementation of newly adopted laws, and the country must consider its priorities and strategic goals with a special emphasis on building up substantial state capacity. In addition, a focused plan aimed at achieving some quick wins is essential both to convince the population to throw its support behind the government and to progressively remove the obstacles that inhibit a business-friendly atmosphere.

To fulfill such objectives, Ukraine should use its new sense of national identity and concentrate its energy on building up a solid economy rather than looking back at the country's confrontation with Russia. Ukraine's international partners, especially the EU, should not wobble in their support of Kyiv's economic reform, which is the area where they can deliver the most tangible and direct assistance. Achieving this reform will have implications far beyond the Ukrainian domestic scene: by helping Ukraine at last secure a recognized and stabilized status in Europe, it will make a substantial contribution to the future stability of the whole continent.

AN UNFAVORABLE CONTEXT FOR REFORM

Recent history has left Ukraine with two lost opportunities: in 1991, when the country was enjoying its brand-new independence, and in 2004, at the time of antigovernment protests that culminated in the Orange Revolution. In both cases, the country could have experienced a significant transformation of its economic structures and processes. But this



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didn't happen, and for the twenty years up to the 2013–2014 Euromaidan revolution, Ukraine was stuck with an economic system that couldn't choose between the free-market and post-Soviet worlds.

The post-Euromaidan phase must therefore be seen as a new and hopefully successful attempt to break with the rules and habits that have emerged since the end of the Soviet order and that have been too accommodating of Ukraine's new oligarchy. One of the difficulties is the current set of circumstances, which are far from favorable to major changes: while Ukraine has chalked up some qualified successes, growth remains sluggish in Europe, raw material prices are down, and the conflict in Ukraine's eastern Donbas region, while evolving into a low-intensity crisis, is still preventing any return to normal life. This situation has direct implications for reform efforts.

A sustained buildup of military capabilities of the sort Ukraine has been promoting since 2014 takes its toll on the overall economic choices of the government. Ukraine's armed forces in 2015 had a total of 280,000 soldiers, who were supported by an ambitious program of security equipment. In 2014, military expenditure amounted to 3.1 percent of GDP. Such a budgetary commitment may be unavoidable in the present circumstances, but it still represents a price to pay for the whole of Ukrainian society.

Additionally, the current stalemate in Donbas has important economic spillover effects. The region's traditional industries—coal, steel, and military equipment—have been unsettled by the conflict. At the same time, the flow of refugees moving out of eastern regions either to other parts of the country (some 1.6 million as of February 2016) or to Russia (almost 2 million as of March 2016) represents an important loss in terms of manpower. As for the disruption to public services—social security benefits, healthcare, education—or the damage and destruction of public infrastructure, an accurate assessment is difficult to make, but these interruptions definitely have an impact on the national economy at a time when all resources should be focused on reform priorities.

Of even more concern is the dire prediction that the Donbas conflict is probably here to stay for a long time. In spite of

ongoing diplomatic efforts to implement the Minsk ceasefire agreement in its entirety, the current trend is not moving in that direction. While military de-escalation has been observed on the ground, the reality is still a complete breakdown of confidence between the two sides. This gives little hope for any rapid implementation of the Minsk agreement provisions relating to the return of border controls between Russia and Ukraine, local elections, or the setting up of a decentralized administration. The prospect of one more frozen conflict in Europe cannot be totally dismissed, creating another negative impact on the Ukrainian national economy.

A MIXED REFORM PICTURE

In the midst of such a difficult environment, it is natural that the economic reforms launched at the time of the Euromaidan revolution still look very much like works in progress. A fair assessment of the current situation can only conclude with a mixed verdict: In the short term, macroeconomic stabilization has made significant progress, built mostly on Ukraine's IMF-inspired stabilization program. In the longer term, economic modernization is less of a success, as the transformation process is still undermined by different factors that have so far prevented more robust reform.

Stabilization on the Way

Parts of the Ukrainian economy are showing the first promising signs of some improvement, as certain macroeconomic indicators are moving in a positive direction.

The significant decline in Ukraine's GDP that began in the middle of 2012 slowed in the second half of 2015. The prospect now is for an increase in GDP of 1.5 percent by the end of 2016.

In terms of fiscal policy, there has been a clear reduction of the budget deficit, from 4.5 percent of GDP in 2013 to 1.6 percent in 2015. The reform of the state-owned oil and gas company Naftogaz, whose deficit of 5.5 percent of GDP in 2014 should be wiped out completely in 2016, is largely responsible for this improvement.

The reserves of the National Bank of Ukraine increased from \$6.4 billion in January 2015 to \$13.3 billion in January 2016, while the fall in the value of the national currency has by and large been stabilized.

Ukraine's foreign trade changed considerably between 2013 and 2015, with a decline in the Russian share due mostly to decreasing volumes of gas imports from Ukraine and Moscow's decision to apply restrictions on trade with Ukraine. During the same period, EU member states' share of both Ukrainian imports and exports increased.

Yet, these improvements at the macroeconomic level do not at this stage percolate down to the people. Falling incomes and increased poverty are deeply felt by the average Ukrainian citizen, particularly with regard to household energy bills, which increased by up to 450 percent from 2014 to 2015 after the government decided to introduce price transparency in the energy sector.

Modernization Still to Come

While stabilization has been encouraging, the in-depth reform of all components of the Ukrainian economy has been more laborious.

Ukraine's economic modernization efforts had an energetic start at the political level. The government put into motion an impressive legislative agenda, with a special emphasis on fighting corruption, changing the judicial system, and opening up state-owned enterprises to private capital. All these reforms are now under way after the adoption of significant legislation in the Ukrainian parliament. The legislative work undertaken by the government and the parliament has been further expanding over a wide range of other sectors linked to the economy, including deregulation, constitutional reform, decentralization, police reform, administrative transparency, energy, and taxation.

Yet, initial evaluations of these legislative changes by experts and opinion polls have produced mixed results that seem to make the political leadership hesitate over which course to follow. Experts tend to admit that reforms are proceeding in the right direction but too slowly. Moreover, adopted legislation has

often been prepared and discussed at an accelerated pace, which afterward leads to rectifications and amendments that are detrimental to a clear understanding of the reforms. Meanwhile, a vast majority of Ukrainians have little trust in the success of these reforms. Because of perceptions of corruption, the persistent power of oligarchs, incompetence, or a lack of real commitment, public support seems to be lagging behind.

At the same time, Ukraine's international partners have mobilized their traditional instruments to support the reforms. The EU has negotiated an agreement to establish a Deep and Comprehensive Free Trade Area, which should progressively open the trade gates and spur the necessary changes in rules and norms related to all economic sectors. In parallel, the EU has provided significant financial support, with around €11 billion (\$12 billion) of assistance, mostly in loans from the European Investment Bank (€3 billion) and the European Bank for Reconstruction and Development (€5 billion). Bilateral financial assistance from many sources, such as the United States and Germany, has been brought to Ukraine with the double purpose of promoting national exports and supporting investment efforts. Private investment has also been moving in, even though private capital outflows persist for the time being.

While recognizing the importance of these cumulative efforts, international economic circles and private investors in particular still share an overall impression that the Ukrainian economy is underperforming. This view may be more gloom than doom, but there remains a sense of unaccomplished performance in the absence of clear-cut results.

Such a judgment should not come as a surprise. A fundamental overhaul of the economy of the sort Ukraine is experiencing cannot be implemented in a few months or even years. It requires strategic goals, long-term commitments, and a capacity to stay the course as long as necessary. Additionally, the logic of the free trade deal negotiated between the EU and Ukraine calls for a progressive and sustained transformation of all sectors of the country's economy as the EU's rules, norms, and standards find their way into Ukraine's industrial factories, workshops, and farms. Here again, time is of the essence.

A GRAY ZONE SYNDROME

A more significant shortcoming lies in the Ukrainian government's difficulty in making the decisive choices that could convey the perception of a country on a well-defined path to economic transformation. By stating openly their commitment to a catch-all reform that is permanently moving at an overheated pace while avoiding any painful confrontation with certain economic stakeholders, the country's leaders give the impression that they lack a clear vision of where they intend to go.

More fundamentally, the government seems all too often to be pushing back decisions on the priorities it should be promoting because of the political risks this might imply when tackling oligarchs and corrupt practices. Caught between hyperactivity and hesitation, Ukraine displays an uneasy combination of determination, on the one hand, and constant bargaining, on the other, prompting an overall feeling of a country stuck in the middle of the road or in a gray zone. There are several illustrations of this tendency.

Oligarchs Both Included and Excluded

Ukraine has a problem with its oligarchs. Since the fall of then president Viktor Yanukovich in February 2014, the government in Kyiv has been pondering whether oligarchs should be associated with political power or banned from any official post and even brought to justice. Some of these oligarchs have been appointed as heads of regional administrations, while others have been considered criminals—sometimes for very good reasons. Such a mixed evaluation may rest on solid ground linked to the past and present actions of the individuals concerned. But it is difficult not to relate this situation to a genuine hesitation over a more fundamental issue: the willingness of the oligarchy to accept economic reform and take part in the transformation of the nation.

No one can doubt the perilous nature of such change in a country's social contract, but what is specific about the Ukrainian case is the back-and-forth approach to the role of oligarchs, which nurtures the impression of a gray zone. The government could have set up a consultative body in which oligarchs would have been asked to deliver advice on economic reform; or it could have called on oligarchs to finance

contributions to Ukrainian solidarity or encouraged them to promote private foundations dedicated to national causes. Yet so far, uncertainty has prevailed on this issue.

Much Legislation but Limited Implementation

Since 2014, the Ukrainian government has not been shy in proposing and adopting an impressive load of legislation. But it is with the implementation of this long list of reforms that difficulties appear. As has been seen with judicial reform and anticorruption rules, the necessary human and financial resources are often missing; changes in administrative or judicial personnel are made sparingly, leaving much of the ruling elite in place; and the needed shift in mentality does not follow. New institutions like the Accounting Chamber of Ukraine have been set up, but the corollary to such a decision—namely, the development among the whole public administration of a new mind-set based on strict rules of accountability—is lacking.

Many Goals but Not Enough Strategy

Another limitation appears with the scope of the reforms the government has launched. On the economic side, very few issues have been left untouched, as if the government's overall policy were focused on speeding up the pace on all fronts at the same time. Many of the officials involved in the economic reforms openly admit their firm intention to push this transformation through at full speed in a sort of counterintuitive reaction to the failures of previous reform experiences.

Although the logic behind this choice of action may be understandable, establishing a clearer sense of priorities may be a more efficient solution. Prioritization allows for the elaboration of a strategy; it creates a narrative that the population can understand; and it gradually builds up a common vision of the country's needs that all can share.

A Lack of State Capacities

Finally, the absence of an orderly reform process can run the risk of producing a dysfunctional state if the right levels of technical expertise, management knowledge, and human resources are not in place to ensure the follow-up to new laws. Ukraine today has taken insufficient preparatory action to train officials and allocate the necessary means to the state or local administrations to allow them to implement the reforms

they are supposed to carry out. Such a limitation rapidly creates bottlenecks and delays in the reform process. By leaving officials without clear guidelines, this weakness also reinforces corrupt habits. All in all, such shortcomings mean a lack of predictability and security that prevents the establishment of the proper environment for attracting foreign investment.

ANSWERS TO THE SHORTCOMINGS

Faced with such limitations, the current efforts to modernize the Ukrainian economy need to be upgraded. Four different but complementary paths could be pursued: concentrating the new sense of national pride on economic reform; promoting actions to produce quick wins; engaging in longer-term reforms; and making EU support more flexible.

A Refocused National Identity

Stuck between the necessity of harnessing all its energy to modernize the economy and the unavoidable confrontation with Russian interference, Ukraine seems to be struggling to perform a constant balancing act. There are without doubt painful choices to be made: because of Ukraine's deep frustration with Russian military intervention and, more profoundly, its history of confrontation over many centuries with czarist and then Soviet Russia, the current leadership in Kyiv understandably reacts strongly to Russia's interference and violation of international laws and principles.

But the amount of energy dedicated to this national cause—however honorable it may be—is inevitably leading to a diversion from other goals of the kind needed to put the country back on a sustainable economic path. At the same time, the Russian intervention in Crimea and Donbas has triggered a new national identity and a sense of common belonging that did not exist before in Ukraine on such a scale. This identity represents progress in the establishment of the Ukrainian nation's self-assertiveness, which needs to be supported and strengthened.

Hence, what Ukraine may need most urgently today is a kind of mental refocusing so that the nation's mobilization against Russia is directed less at the past than at the future. Such a change of mind-set could benefit the country by concentrating Ukraine's efforts on boosting the economy and making a success of this priority.

As a useful division of labor, it then could fall to Ukraine's international partners to support such reform by protecting the country from Russian pressure through diplomatic, military, economic, and financial efforts.

This double objective—pushing back Russia and achieving economic reform—represents two sides of the same coin and feeds a popular narrative in the ongoing effort to roll back Moscow's influence. Success for Ukraine in its economic endeavors could in the end be the most effective political answer to Russia's policy on Ukraine. For this to be achieved, the best path may well be for the Ukrainian people to concentrate on the more urgent need for reform.

Quick Wins

In applying this change of mind-set for the benefit of economic reform, Ukraine must be aware of the need to rationalize its current course of action and regain the support of the population. One of the obstacles the reform promoters may find most difficult to overcome relates to the deep frustration of the Ukrainian public toward the efforts launched by the government.

To respond appropriately to this frustration and retrieve some credibility, the government would need to work on a few options tailored to offering concrete and rapid benefits along the lines of the overhaul of the local police, by far the most popular reform so far in the country. The government should then deliver a coherent package of changes that could appeal to the population and act as a driver for the whole economy. A combination of measures centered on regulations and institutions, coupled with others attached to delivering tangible benefits for the population, could strike the right balance.

As an illustration, a package along these lines could include some of the following proposals.

The Civil Service

A law on the Ukrainian civil service was adopted in December 2015 with the purpose of establishing a professional and politically neutral service through transparent and competitive appointments. Other pieces of legislation currently being

discussed in the parliament deal with the transfer to local governments of administrative services and improved transparency of decisionmaking processes. All these draft laws aim to bring the administration closer to the public. The government should make a special effort to implement these measures rapidly and allocate the appropriate financial and human means to build a strong basis for the central and local governance of the country.

Decentralization

The decentralization reform currently under way aims at different levels of action, based on a transfer of powers from the central to local governments with a parallel transfer of financial resources. The priority should be the swift implementation of the fiscal reform that intends to reduce the level of central subsidies to local budgets and reinforce the share of proceeds from local taxes. With this type of focus, such action could help create a more business-friendly environment with decisions made by local governments that wish to attract investors to their regions.

The EU-Ukraine Association Agreement

The Association Agreement between the EU and Ukraine, which includes the establishment of a free trade zone, aims at two objectives: enhancing trade relations between the two sides, and implementing economic reforms that will improve the quality and safety of food and industrial products as well as increase competition and deregulation with reinforced anti-monopoly rules. Under this framework, a special effort could be made through dedicated financial instruments, funded by both public and private sources (mixed loans), to accelerate the introduction of EU norms and standards, for instance in the farming sector. In parallel, additional trade concessions for some Ukrainian products could alleviate some of the pressure on the country's external accounts.

Healthcare

Healthcare seems to be one of the least advanced sectors in the overall reform process. Here again, Ukraine could undertake a well-focused effort with implications for the overall economic growth of the country. Giving more autonomy to local

healthcare establishments could be a first step that would be highly appreciated by local populations. This would also create the proper context for new companies, which need to provide their workforces with a range of social facilities. Linked to that action, European experts could assist their Ukrainian colleagues with advice on how to upgrade the quality and efficiency of the services delivered by the healthcare system.

Internally Displaced Persons

In the same vein, a specific program could be introduced for the benefit of the internally displaced persons who have moved out of Donbas to central and western Ukraine. As of February 2016, there were 1.6 million such people. The launch of a program funded by government and multilateral grants and combining job offers, a temporary healthcare system, and education facilities would not only fulfill a deserving humanitarian cause, but it would also inject supplementary purchasing power into the economy and send the right message to those Ukrainian citizens left behind in the eastern regions.

Industries in Donbas

With a similar objective, outreach to some of the industries currently based and still functioning in Donbas could open the door to fruitful cooperation and possible modernization of some of these corporations. The political sensitivity of such contacts would need to be properly assessed, but the offer of a program of this kind could only reinforce the assertiveness of the government in Kyiv and underline the driving force of the ongoing reform process.

These proposals are but a few examples of what could be done to give a more focused orientation to Ukraine's economic reform. Other fields of action—state taxation, the pension system, the judiciary, and anticorruption—could be pinpointed for the same concrete, bottom-up approach.

Longer-Term Structural Reforms

Such quick wins should not obscure the need for more substantial and structural changes. With the long haul in mind, the Ukrainian government could select a few sectors whose contributions to the future of the country would guarantee a

major impact, notably by inducing large investment spillover effects far beyond their own fields.

Energy

Energy is one of the areas in which a genuine reform effort could make a difference. Some action is already under way: basic legislation on elementary market mechanisms was adopted in April 2015, and an effort to diversify Ukraine's gas supply has reduced the country's reliance on Russian gas imports. More is also being done to increase energy efficiency and implement relevant norms of the EU's third energy package, which seeks to create a single EU gas and electricity market.

Yet, efforts to attract new investment in this sector have so far yielded limited success. Some large international companies have even suspended their investment plans for Ukraine, an indication that conditions are still not ripe for a game changer.

A genuine effort in this field could include renewed action to implement the EU directive on energy efficiency in addition to a comprehensive restructuring of Ukraine's main public-owned companies. Another possible action could focus on the development of domestic gas production, notably through new resources of shale gas with the support of foreign investors and international financial institutions.

Research and Innovation

Research and innovation could also benefit from public funds. Ukraine is already developing strong expertise in information technology, with highly qualified young researchers. The launch of one or two internationally competitive research centers in Ukraine could help create a new image of the country. Recent agreements with the EU on scientific and technological cooperation, allowing Ukraine to participate in the European Commission's Horizon 2020 research program, are important incentives for international collaboration on high-level research.

Regional Cooperation

Through cooperation with neighboring countries, Ukraine could upgrade its whole industrial sector and embrace the

industries of the future. Current commercial trends already show a change of course in favor of partners like Belarus, Germany, and Poland; Ukrainian electronics manufacturers, for instance, have significantly increased their exports of components to the German car industry. This new pattern has to be encouraged, as it will stir a new wave of industries based on updated technologies and innovative processes. In the agricultural sector, where Ukraine has been a major world producer of raw products like corn and grain, an effort to diversify and upgrade farm products to sell Ukrainian brands on international markets could be a successful initiative.

More Focused and Flexible EU Support

All of these initiatives should be accompanied by strong European support, which is crucial not only for the Ukrainian economy but also for the stability of Europe as a whole. Today, Ukrainians have a mixed assessment of European assistance. On the one hand, they appreciate EU mobilization and support the conditionality approach introduced by Brussels that makes EU aid dependent on the success of Ukraine's reforms. On the other hand, Ukrainians call for more flexibility in EU processes, more coordination with civil society organizations, and a better understanding of the difficulties they face. To answer these calls, the EU could reinforce its contribution to Ukraine's economic reform with several improvements.

More Focused Expertise

EU experts should be more in touch with their Ukrainian partners. Obstacles to reform are deeply rooted in Ukraine's administration and state-owned corporations. More comprehensive knowledge among EU experts of current bottlenecks on the ground could bring an added value to the reform efforts. More frequent visits by EU officials to Ukraine's regions, and even some extended stays in the country, could make a real difference.

Ukrainian officials also insist that their EU partners voice more opinions about how to proceed with reforms in their country. They want less neutral experts and more hardheaded partners who speak their minds and are ready to defend their points of view.

More Flexible Conditionality

The conditions the EU attaches to its assistance should remain but should become more flexible. Conditionality should be based on a more strategic view of what the EU is looking for in Ukraine and should be in line with priorities that the EU and Ukraine agree on together. The scrutiny imposed by the conditionality process should not lead to a mere box-ticking exercise. If the government in Kyiv were to show some readiness to define its priorities more realistically, the EU should be ready to adapt its conditionality accordingly. This would imply an application of conditionality less reliant on Brussels and more fed by on-the-ground experience, with a bigger management role for the EU delegation in Kyiv.

This decentralized approach could make a distinction between short-term reform (such as visa liberalization for Ukrainians traveling to the EU), where conditionality would be strictly applied, and long-term reform (such as energy), which could benefit from a less stringent application. In the same way, some EU financial support could be front-loaded if Ukraine were to act with determination on its reforms. The logic behind such a pragmatic approach would be that the EU should be able to react positively and rapidly every time Ukraine engaged in a sound reform action.

A Clearer EU-Ukraine Relationship

Finally, Europe should not ignore the question of Ukraine's future relationship with the EU and should engage in an open and honest conversation with Ukraine on this issue. Such an exchange would not pretend to start negotiations on EU accession. Rather, it would dispel misunderstandings

and thoroughly explain the difficulties that lie ahead not only for potential candidate countries but also for EU member states, such as the fallout of the nonbinding referendum in the Netherlands on April 6, when voters rejected the EU-Ukraine Association Agreement. While avoiding the impression that this issue is an embarrassment for the EU, an honest debate on Ukraine's future relationship with the union could do more to boost the self-confidence the country needs to engage wholeheartedly in its reform process.

CONCLUSION

Economic reform in Ukraine must succeed. This is in the interests of all Western partners, as the outcome of these reforms will be crucial for the stability of Eastern Europe. If only for that reason, Ukrainian leaders must act in the economic field with decisiveness to come out of their gray zone and channel the country's new national pride along the road to reform.

As for the EU, it must support Ukrainian efforts without hesitation and be ready to deliver more efficient and flexible assistance. In the end, this is about mutual trust, and if Ukraine is to succeed, international partners in general and Europeans in particular must show confidence in the success of this economic change. Reform in Ukraine goes far beyond merely the economic dimension. It is also about convincing the Russian leadership to return to cooperation and partnership rather than persisting in confrontation. Hence, there is a need for all partners—Ukrainians and foreigners alike—to live up to this challenge.

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