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Does Ukraine Receive the Western Aid It Deserves?

Anders Åslund

Key Points

- Ukraine has now carried out radical economic reforms. In a single year, the government cut its budget deficit by eight percent of GDP. By letting the Ukrainian hryvnia depreciate by two-thirds, the government eliminated a large current account deficit.
- The next big tasks are to reform prosecution and the judiciary to establish reasonable rule of law and property rights, to implement the civil service reform and carry out a pension reform.
- The West has engaged intensely with Ukraine in its reforms since February 2014. While Western advice has been economically sound, Western financing has been quite limited. The West should boost Ukraine through substantial investment funding to offer the nation a reasonable chance of success.

A Severe Economic Crisis

The Revolution of Dignity in February 2014 culminated in the Ukrainian Parliament deposing President Viktor Yanukovich with more than two-thirds majority.¹ Major popular protests had started on November 21, 2013, after the Ukrainian government declared that it would not sign an Association Agreement with the European Union. The real issue, however, was not this free trade agreement, but increasing repression and pervasive corruption at the top level. It was also a question of whether Ukraine should turn to the West or to Russia. The ultimate cause of the ouster of Yanukovich was that he had ordered his security forces to shoot on demonstrators, killing more than 100 people. Yanukovich and most of his government fled to Russia.

At the same time as Yanukovich was dismissed, Russian special forces started occupying the Crimean peninsula, where Russia leased a large naval base in Sevastopol. The Russian troops encountered no resistance as a new Ukrainian government had barely been formed. On March 18, 2014, Russia formally annexed Crimea, to

¹ The author has followed Ukraine's economic developments quite closely since 1985, and discussed this topic in detail in two books (see Åslund 2009; Åslund 2015a). He served as an economic adviser to President Leonid Kuchma from 1994 to 1997, and has co-chaired two blue ribbon commissions on an economic program for the next president in 2004-2005 and 2009-2010. This policy brief is based on the author's Global Policy Forum talk in Ottawa, Ontario, on September 22, 2016.

About the Author

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general surprise. In April, attempts at “popular” uprisings led by Russian special forces without insignia were attempted in eastern and southern Ukraine. They took hold in half of the two eastern regions of Donetsk and Luhansk (Donbass), which are still held by Russian-sponsored rebels.

Crimea, which accounted for five percent of Ukraine’s population and four percent of its GDP, is no longer included in Ukraine’s GDP. The occupied Donbass is a rust belt dominated by mines and steelworks. Before the war, the occupied territory in Donbass accounted for only three percent of Ukraine’s territory, but 10 percent of its GDP and 16 percent of industrial production (Dragon Capital 2014). While the Ukrainian government has no control over this territory, it is still included in Ukraine’s statistics, and the big private Ukrainian companies there work in accordance with Ukrainian law, with the Ukrainian currency, the hryvnia, and through Ukrainian banks, paying Ukrainian taxes. By September 2016, about 10,000 people had been killed on the Ukrainian side, while no relevant statistics are available on the losses on the occupied territory.

The Ukrainian economy was in a severe financial crisis before February 2014. In 2013, the budget deficit was 6.7 percent of GDP, and Ukraine had no access to international financial markets. The current account deficit was nine percent of GDP, while the GDP was stagnant. Russia’s military aggression dealt severe blows to the Ukrainian economy. It is estimated that output in the occupied territory fell by 70 percent in 2015. The war also affected the rest of the Donbass. Harsh Russian trade sanctions that cut Ukraine’s exports to Russia by roughly two-thirds were a second blow to the Ukrainian economy (Russia had previously bought one-quarter of Ukraine’s exports). In addition, the war scared away all foreign investors — foreign direct investment had traditionally comprised four percent of GDP. The total effect was a GDP decline of 6.6 percent in 2014 and 9.9 percent in 2015 (see Table 1).

Ukraine has performed worse than almost all other post-Communist countries. According to the World Bank (2016), its GDP per capita in purchasing power parities has fallen by one-third since 1990.

Table 1: Ukraine – Key Economic Data, 2013–2017

| | 2013 | 2014 | 2015 | 2016F | 2017F |
|---|-------|-------|-------|-------|-------|
| Real Economy | | | | | |
| Real GDP growth (year over year %) | 0.0 | -6.6 | -9.9 | 1.5 | 2.5 |
| Nominal GDP (in billion current US\$) | 183 | 133 | 91 | 87 | 98 |
| Nominal GDP/capital (current US\$) | 4,249 | 3,108 | 2,120 | 2,029 | 2,286 |
| Consumer Price Index (end of period, year over year %) | 0.5 | 24.9 | 43.3 | 13.0 | 8.5 |
| Unemployment rate (International Labour Organization definition, %) | 7.2 | 9.3 | 9.1 | 9.0 | 8.7 |
| Public Finances (% of GDP) | | | | | |
| Overall government balance (including Naftogaz) | -6.7 | -10.0 | -2.1 | -3.9 | -3.1 |
| Public expenditures (including Naftogaz deficit) | 50.0 | 50.3 | 44.1 | 43.6 | 41.9 |
| Total public debt (US\$ billion) | 73.1 | 69.8 | 65.5 | 68.2 | 73.2 |
| Total public debt (% of GDP) | 39.9 | 69.4 | 80.1 | 80.1 | 74.9 |
| External Sector | | | | | |
| Current account balance (% of GDP) | -9.0 | -3.4 | -0.2 | -1.7 | -2.7 |
| Exports (US\$ billion) | 82 | 65 | 48 | 44 | 46 |
| Imports (US\$ billion) | 97 | 70 | 50 | 47 | 50 |
| Gross international reserves (US\$ billion) | 20.4 | 7.5 | 13.3 | 16.0 | 16.0 |
| Net foreign direct investment inflow (% of GDP) | 2.2 | 0.2 | 3.4 | 3.0 | 1.0 |
| UAH/US\$ exchange rate (end of period) | 8.0 | 15.8 | 24.0 | 27.0 | 27.0 |

Data sources: International Monetary Fund (IMF) (2016a); IMF (2016b); Dragon Capital (2016).

The key problem was that Ukraine pursued no economic policy for the first three years of its independence, which led to hyperinflation and severe rent seeking (Åslund 2009; Havrylyshyn 2014). The persistent issue was that privileged gas trading between low state-controlled prices and market prices became the main source of wealth of the few truly rich (Balmaceda 2015).

Ukraine has gone through three brief periods of serious reforms. The first occurred in 1994–1995, when Ukraine carried out macroeconomic stabilization. The second period was in 2000, when Ukraine pursued far-reaching structural reforms leading to high and sustained economic growth — an annual average of 7.5 percent from 2000 to 2007 (Åslund 2009). The third, and most substantial, period of reform is the present, 2014–2016.

Radical Economic Reforms

After President Yanukovich fled the country in February 2014, the Ukrainian Parliament elected in 2012 became the central political actor. Roughly half of Yanukovich's parliamentarians defected to the opposition, which formed a new government under Prime Minister Arseniy Yatsenyuk. On May 25, 2014, presidential elections were held, and another opposition leader, businessman Petro Poroshenko, was elected president with a majority in the first round. However, the old Parliament was not ready to vote for serious reforms, rendering it necessary to hold early parliamentary elections in October.

The Yatsenyuk government quickly concluded a two-year standby agreement with the IMF in March 2014. Officially, the IMF would contribute US\$17 billion and other international creditors would contribute US\$16 billion, but this was really a stopgap measure. In fact, the IMF disbursed only US\$4.6 billion under this program, whereas Ukraine paid back US\$3.6 billion in 2014 (IMF 2014; Åslund 2015a, 159; Schadler 2015a). Ukraine's international reserves slumped scarily by US\$13 billion in 2014, reaching a low of US\$5 billion in February 2015. One major reason for this decline was that the European Union forced the Ukrainian government to pay Russia's Gazprom US\$3 billion of disputed arrears at the end of 2014 without providing any additional financing. In parallel, Ukraine's public debt plunged from US\$73 billion in 2013 to US\$65.5 billion in 2015, showing that Ukraine received no net international financing (Dragon Capital 2016).

Thus, the impoverished Ukrainian government was forced to pay back more of its foreign debt than it received from international creditors in the midst of the crisis, when it should have benefited from ample international support. Because of the limited international financing, Ukraine was compelled to overperform in its fiscal tightening. In March 2015, the IMF (2015, 22) concluded: "The cash budget deficit for 2014 is estimated at 4.6 percent of GDP, lower than the targeted 5.8 percent of GDP."

The parliamentary elections in October 2015 brought about propitious political change. Of the new parliamentarians, 54 percent were elected for the first time. Five pro-Western parties gained a two-thirds majority and formed a coalition

government under Prime Minister Yatsenyuk. This was a government of young professionals, notably fund managers. Three ministers were foreign nationals. Finance Minister Natalie Jaresko was a US citizen, and Economy Minister Aivaras Abromavicius was Lithuanian. The new government adopted a focused and radical reform program, although the reforms were limited to some areas: the Ministry of Finance, the National Bank of Ukraine (NBU), the Ministry of Economic Development and Trade, the state oil and gas company Naftogaz, the Ministry of Transportation and Infrastructure, and the Ministry of Agricultural Policy. Little happened in the judicial or social spheres or in the state administration.

The keystone of these economic reforms was a four-year Extended Fund Facility that was agreed with the IMF in February 2015 and approved by the executive board on March 11. This program was more substantial than the 2014 program that was cancelled. The nominal IMF funding was almost the same at US\$17.5 billion, but it was supposed to be more front-loaded because Ukraine's international reserves were dangerously low. The total program was supposed to amount to US\$50 billion, but US\$15 billion of this was restructuring of the private debt, whose service was largely postponed to 2020. Key IMF demands were floating exchange rate, reduction of the budget deficit, increased energy prices, bank restructuring and a variety of structural reforms. By and large, all this was done.

In 2015, Ukraine carried out its most radical reforms ever. The fiscal adjustment was most impressive, and far more severe than the IMF program had requested. The IMF had called for a reduction of the overall budget deficit, including the Naftogaz deficit from 10 percent of GDP to 7.4 percent of GDP, but the government cut it to 2.1 percent of GDP (IMF 2016a, 44). Rarely has a country in severe crisis and war demonstrated such fiscal discipline. This was mainly accomplished by cutting public expenditures from 50 percent of GDP in 2014 to 44 percent of GDP in 2015. This could be done, although the war with Russia forced Ukraine to raise public expenditures on defence from one percent of GDP to five percent of GDP (see Table 1).

As a consequence of sharper expenditure cuts and less international financing than anticipated, Ukraine's public debt in 2015 did not rise to 94 percent of GDP as the IMF had anticipated, but stopped at 80 percent of GDP (IMF 2015, 47; IMF 2016a, 42). Many small changes were

made to the tax system. The most substantial was a cut in the payroll tax from 45 percent to 22 percent, which came into effect in 2016 and, it is hoped, will reduce the extensive practice of paying half of the salary in cash in an envelope without any tax payments (Åslund 2015b).

For years, Ukraine's public expenditures had lingered around 50 percent of GDP, while most countries in its neighbourhood stopped at 35 percent of GDP. Ukraine's excessive spending derived from two items, energy subsidies and public pension costs. By unifying energy prices, Ukraine eliminated its energy subsidies of about eight percent of GDP from 2014 to 2016. Gas prices for households were hiked 11 times. As a result, well-connected gas traders could no longer make vast windfall profits on gas arbitrage. This was the most important measure against corruption. Experience from other post-Communist countries shows that after energy prices have been unified, they usually stay market-oriented.

Ukraine had easily the highest public pension costs in Europe at 17 percent of GDP in 2013, while the EU average is nine percent of GDP. In 2011, the Yanukovich government had already started raising the retirement age for women from the very low level of 55 years, while it remained 60 for men. The Parliament resisted any further hike in the retirement age, but special pensions for the old privileged and early pensions were tightened. The main measure, however, was not to index the pensions fully to inflation, which rendered the pensions tiny. Pension costs fell to 13 percent of GDP in 2015 and are set to decline further to 11 percent of GDP in 2016 (IMF 2016a, 44). Still, Ukraine has far too many young "pensioners" who work, while most pensions are too low for subsistence.

Ukraine also overperformed with regard to foreign payments. By floating its exchange rate, Ukraine could balance its current account in 2015, while the IMF had expected a deficit of 1.4 percent of GDP. However, Ukraine did so through a larger-than-anticipated depreciation. The value of the hryvnia has fallen from UAH8/US\$1 in late 2013 to the current rate of UAH26/US\$1, while the IMF had predicted an exchange rate of UAH23/US\$1 (IMF 2015, 47; IMF 2016a, 42).

The NBU under Valeria Hontareva has carried out a major cleansing of the banking system, closing 83 out of 180 banks. Under Yanukovich, a common practice was that a bank owner gave himself

80–90 percent of the loans of his bank, and did not pay them back. Yet, creditors' rights are very limited, rendering it difficult to force big debtors to pay. Because of minimal reserves, the NBU has pursued both strict currency regulations and a very strict monetary policy. As a consequence, annualized inflation, which rose with energy tariff rises and large depreciation, has been brought down from a peak of 61 percent in April 2015 to eight percent in September 2016. Ukraine's international gold and currency reserves have risen from a low of US\$5 billion in February 2015 to US\$16 billion in September 2016 (Dragon Capital 2016).

In addition, a fair amount of deregulation and transparency has been introduced. The most important measure was the introduction in August 2016 of compulsory electronic public procurement for all state purchases of significance. Substantial steps were also taken to improve corporate governance at the large state corporations, with the introduction of external audits, supervisory boards with independent directors and competitive selection of chief executive officers. All banks have been compelled to reveal their beneficiary owners. A number of other public Internet registers of property owners have also been established.

By October 30, 2016, 100,000 government officials were obliged to declare their and their families' assets and income in considerable detail in novel e-declarations. The surprise was that they actually complied, and an astounding amount of wealth was revealed. Of 423 parliamentarians, all but seven made their declarations. They declared that they held an average of US\$700,000 in cash at home. Several parliamentarians announced fortunes exceeding US\$100 million (Åslund 2016). These extraordinary revelations are likely to drive the further struggle against corruption.

This is Ukraine's third wave of economic reforms, and it is by far the most radical. In 1994-1995, Ukraine defeated high inflation. In 2000, the government pursued so much deregulation that high growth ensued. The current wave of reform could lead to a break in the pervasive corruption and high growth, but the country is not quite there yet.

What Remains to Be Done

Ukraine's greatest drawback is its pervasive corruption. Transparency International (2015) rates it as number 130 out of 168 countries on its Corruption Perception Index. Its ranking has changed little for the last decade. The unification of energy prices is the most important anti-corruption measure. In addition, the cleansing of the banking system has been an important step, as well as the introduction of open electronic state procurement and the public registries of owners.

The greatest stumbling block has been judicial reform. The Parliament adopted laws on the reform of prosecution and the lustration of key state bodies in September 2014, but the first round of the reform of prosecution brought it to nil. In the summer of 2016, a substantial judicial reform was legislated through constitutional amendments, but it is supposed to take three years, and Ukraine's clever judges will offer severe resistance against their cleansing. Nonpayments by big creditors remain notorious and creditors' rights need to be reinforced.

Similarly, a law on civil service reform came into force in April 2016, but little has been done. The two bodies that have really been reformed are the NBU and the Ministry of Economic Development and Trade. The fiscal service and customs are in especially great need of reform. In particular, the salaries of civil servants need to increase so that they can live on their salaries. At the same time, harmful inspection agencies and regulations should be eliminated.

Curiously, Ukraine has failed to carry out a single privatization in the last two years. It has no fewer than 3,800 state enterprises on the books, although about half of them are little but factory ruins. The reason for the failure is, to a considerable extent, a focus on the biggest asset, the large Odessa Portside Plant, which produces fertilizer. One of Ukraine's most prominent businessmen, Dmytro Firtash, has an unpaid claim of US\$250 million. It would presumably be better to kickstart privatization by selling off most of the more or less worthless enterprises through auctions, starting with the small firms to get the process going, and then attract foreign

investors through the large, attractive companies, such as eight ports (Abromavicius 2016).

One of the most important reforms is to legalize private sales of agricultural land. Eighty percent of all agricultural land was distributed among workers on state and collective farms in 2000, but a moratorium was declared on their sale, and it has been prolonged by the Parliament every year. Agriculture has taken off through leasing. Ukraine has many giant farms of up to several hundreds of thousands of hectares, which are too big to be managed. Successful well-connected businessmen pay a pittance for their leases, while these *latifundistas* agitate against private sales among the population. Moreover, one-fifth of the agricultural land remains state-owned, and Ukrainians fear the rulers will steal this land for themselves.

Ukraine needs to prepare legislation for private sales of agricultural land that is transparent and reasonable so that it can become politically palatable. Then, the government needs to explain its plans to the population so that it becomes politically acceptable. One suitable approach would be to sell off the remaining public farmland gradually to Ukrainian citizens through open auctions and thus establish a land market so that people learn the value of their land.

Ukraine also badly needs pension reform. Naturally this will be a long-term and gradual undertaking, but the government should prepare a pension reform with a substantial share of mandatory private savings.

Ukraine has introduced proper corporate governance at several large state corporations, such as Naftogaz and Ukrainian Railways. It is important to continue this work with external public audits, independent supervisory boards and competitive selection of managers.

In early 2016, President Poroshenko made it clear that he wanted to get rid of Prime Minister Yatsenyuk. A long period of political infighting ensued, stalling most economic policy making. In April, Poroshenko managed to have his close associate Volodymyr Groysman approved as prime minister. All the top reform ministers were forced out, but the government had achieved a new level of professional competence that persists.

What the West Can and Should Do

The united West has played an important role in supporting Ukraine in the last two years. This assistance has had many components. The West has been strongest in declaring its support for Ukraine's sovereignty and imposing substantial economic and personal sanctions against Russia. The United States has provided significant non-lethal military assistance. The European Union has concluded an Association Agreement including a Deep and Comprehensive Free Trade Agreement. The IMF has provided the most important economic support with its four-year Extended Fund Facility of US\$17.5 billion from March 2015.

So far, the IMF has disbursed three tranches of a total of US\$7.7 billion. The United States, the European Union, the European Bank for Reconstruction and Development, the World Bank, the European Investment Bank and various bilateral donors are all offering international financial and technical assistance, but the total amount is hardly more than what the IMF provides.

Yet, looking back on the economic changes that were implemented from 2014 to 2016, an observer is struck by how the Ukraine government overperformed on all macroeconomic variables it could control, while the international community delivered far less funding than committed, although GDP fell much more than anticipated, entirely because of more Russian aggression (IMF 2015, 8). For 2015, the IMF had predicted a decline of 5.5 percent, but it became 9.9 percent, suggesting that Ukraine needed more — not fewer — resources. However, since it was on its tenth IMF program since 1994, none of which had been completed, Ukraine suffered from a poor reputation (Schadler 2015b). Ukraine stands out as the most open country to be pervasively corrupt, and it is difficult for international donors to justify support when the corruption is so overt. Ukrainian politics are messy since they are democratic and open, which scares donors, who, contrary to their self-perception, are more comfortable with corrupt countries that are closed and authoritarian. Ukraine's adoption of its budgets was late, and foreign donors were worried about populism. The reforms were uneven, with the judicial reforms making the least headway.

In spite of Ukraine's openness the West tends to misperceive it in a few regards. The main concern is no longer the "oligarchs," the openly wealthy big private businessmen, but the parliamentarians who control state corporations and tap their financial flows from their seats on parliamentary committees, as the e-declaration has shown. Naturally, these officials blame the oligarchs rather than themselves. In fact, many of Ukraine's biggest businessmen have fled the country and those who remain, for the most part, lost two-thirds of their fortunes from 2013 to 2016 according to *Forbes* assessments.

A rising concern is that the Ukrainian public may conclude that the Western support is not sufficient for the country's economic success, and the reform endeavours might once again dissipate. Since the international community is taking money out of Ukraine rather than adding net funds, the balance toward sustainable reform and high growth may not be reached. Ukrainians would, by and large, feel that they, the most pro-European nation, had been let down by the European Union. Specifically, the European Union is offering Ukraine too-limited market access, and the Ukrainian disappointment could be devastating if the European Union does not offer visa freedom in the near future. Parallels may be drawn with Russia's disappointment with the West after its pro-Western peak in the 1990s. Conversely, Western donors are afraid that Ukrainian politicians will stop their reforms when they see that little Western support is forthcoming.

The narrative and the perspectives on both sides need to change. In the economic sphere, the West should do three main things. First, after the acute financial stabilization has been accomplished, the West should mobilize its resources for investment funding for the next half decade. Former Finance Minister Natalie Jaresko has proposed US\$5 billion a year for the next five years for investments (Haring 2016), which sounds right. Because of Russia's military aggression against Ukraine, foreign companies are highly reluctant to invest in Ukraine, feeling unable to assess this political risk. Ukraine used to have four percent of GDP in foreign direct investment, about US\$6 billion a year, before Russia's aggression. Disregarding bank recapitalization, this has fallen to zero since 2014. Ukraine's investment ratio is very low at only 15 percent of GDP in 2015 (Dragon Capital 2016, 15).

This is a typical market failure that calls for a mobilization of resources from the international community — the United States, the European Union, the European Bank for Reconstruction and Development, the World Bank, the European Investment Bank and various bilateral export credit agencies. They should help Ukraine raise its investment ratio to 20 percent of GDP, which ought to rise to 30 percent of GDP in the medium term, given Ukraine's level of economic development.

The second big step that the West can and should take is allowing visa-free travel for Ukrainians in the European Union. The two parties are close to reaching an agreement. The European Union is rightly calling for certain legal standards with which the Ukrainian government should comply, but the European Union has leverage enough to make sure that this really happens. This step alone could salvage the European Union's positive standing among Ukrainians.

The third issue is more arcane: that the European Union expands or abolishes its 36 import quotas for Ukraine. These cover all of Ukraine's most important export goods, notably all significant agricultural products. For a key product such as chicken meat, the EU quota comprises only one percent of Ukraine's total production, so that the two top producers ignore the EU market, which leads to EU arguments that Ukraine does not even utilize the quotas they have (Giucci, Ryzhenkov and Movchan 2016). Fortunately, the European Union has expanded several quotas in 2016, and the share of Ukraine's exports going to Europe, which used to be 10 percent in 2000, increased to 39 percent in the first half of 2016. It should rise to two-thirds, as was the case with the Central and Eastern European countries by 1995 (Åslund and Warner 2004).

Having enticed Ukraine to join the West, the West cannot afford to abandon it. Moreover, the costs required are very small by any standard, in particular if comparing what the European Union has spent on Greece, and the United States on Afghanistan and Iraq, and the bulk of the Western support would consist of credits that will be paid back.

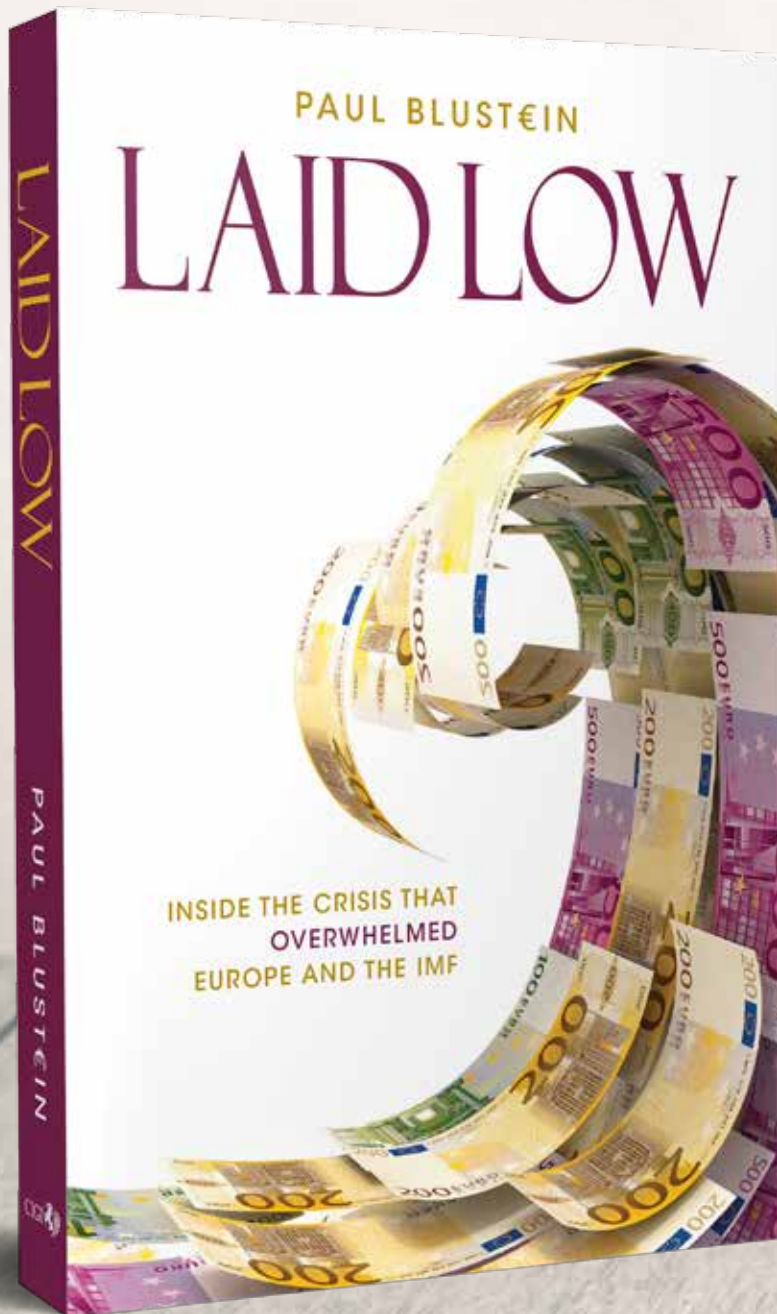
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Laid Low

Inside the Crisis That Overwhelmed Europe and the IMF

Paul Blustein

An absorbing account of the world's financial firefighters and their misadventures in the euro zone. The latest book by journalist and author Paul Blustein to go behind the scenes at the highest levels of global economic policy making, *Laid Low* chronicles the International Monetary Fund's role in the euro-zone crisis. Based on interviews with a wide range of participants and scrutiny of thousands of documents, the book tells how the IMF joined in bailouts that all too often piled debt atop debt and imposed excessively harsh conditions on crisis-stricken countries.

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