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## Working Paper Series

### Eastern Voices: Europe's East Faces an Unsettled West

#### What Ukraine Should Demand of Itself and from the West

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Once again, the world is grappling with historic challenges, as it did when the Soviet Union fell in 1991, and once more, Ukraine is at the forefront of these challenges. The Kremlin's attempts to destroy Ukraine's European aspirations is simply one of Russia's many challenges to the post-World War II international liberal order. The actions of the Kremlin -- be they in Ukraine, Georgia, Moldova, and Syria; in the U.S. electoral process; or in the funding of far-right and far-left political parties throughout Europe -- have but one purpose: to destroy the transatlantic partnership and the principles of the post-World War II order and peace. Ukraine is simply one of the battlegrounds, but it is a key because it is in Europe. Unity of the transatlantic partnership and of the democratic nations is critical. Unity of support for the Ukrainian transition process is a serious part of this battle, because Ukraine's successful democratic, rule-of-law based transformation is key to ensuring a Europe whole, free and at peace.

#### Where we began

To understand the transition that is happening in Ukraine and where we go from here, one must fully understand the situation at the time I was asked to serve as Ukraine's Finance Minister in December 2014. The country was in the midst of a set of crises which, as some argued, would foretell the end of the independent Ukrainian state. Ukraine had been attacked by the largest standing army in Europe. 7% of our territory had been illegally annexed or occupied by the Kremlin's forces in Crimea and eastern Ukraine. This territory represented some 20% of our GDP. Key natural resources, including coal needed for the thermal power plants in Ukraine, were located in occupied territories. The Crimean Tatars, the indigenous people of Crimea, were forced from their homeland for the second time in a century. The numbers of internally displaced persons fleeing the war zones was growing, reaching almost 2 million today, and challenging our social, education and health systems even beyond the normal challenges of a transition state. We were reeling from the corruption and

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mismanagement of the previous regime, which fled only after the Revolution of Dignity, or Maidan, during which over a hundred citizens gave their lives for Ukraine's European, free future.

The economy was in a free fall, with less than one month's import coverage of hard currency in the nation's central bank, the majority of the banking system in dire straits as a result of related party lending and mismanagement, our currency fluctuating widely day to day, and unemployment was growing. A budget deficit of 6.7% of GDP in 2013 and no access to international financial markets meant a complete disarray in funding state obligations, be it pensions or wages in the state sector. The economic decline, which in essence began after the Lehman crisis in 2009, worsened with the trade and transit blockades instituted by the Russian Federation (exports to Russia declined some 65%). The war itself scared away many investors, domestic and foreign. Ukraine had to reckon with a \$40 billion balance of payments gap over the next four years. And finally, perhaps most critically, the social contract between the state and the people of Ukraine had been massively damaged by the actions of the previous regime, raising the question whether any of the institutions of governance truly were serving the interests of the Ukrainian people.

None of these critical challenges began with the Revolution of Dignity. They were a result of over two decades of incomplete reforms, corruption, and lack of clear political will to ensure the successful integration of Ukraine into an ever-more competitive global economy and the family of democratic nations. At the same time, the Revolution of Dignity was an important turning point, as the problems were magnified by the attack on Ukraine's sovereignty and territorial integrity. The Revolution of Dignity also marked an important positive inflection point in Ukraine's history – one in which civil society matured and became active as never before: demanding, proposing and identifying specific reforms, organizing reform implementation, and not allowing for reversal or deceleration of reform efforts. Civil society, as never before in Ukraine's history, is now acting as an all-important check and balance on state institutions and political will.

In the midst of perhaps the most difficult circumstances in European history, Ukraine must fulfill the desire and demands of the Ukrainian people during Maidan, to ensure that Ukraine is a democratic state governed by the rule of law, with a competitive economy able to succeed in an ever more competitive global economy -- and, I must underline, a nation at peace. The Revolution of Dignity and the sacrifice of Ukrainians then and now during the war in the east, reflects the Ukrainian people's declaration to stand for European values, where dignity and freedom -- political, social, and economic -- are truly inalienable rights.

**Table 1. The Ukrainian Economy**

## **What have we accomplished?**

We have accomplished a great deal in these three years -- more, in fact, than any other country has ever done in such dire circumstances and against such incredible odds. And more than any Ukrainian government has done in our independent history.

- 1) We renewed our democracy with elections at every level of government and began the task of rebuilding the social contract. Presidential elections in May 2014, Parliamentary elections in October 2014 and local elections in October 2015 gave citizens the opportunity to choose their representatives at all levels and begin the process of renewing responsibility for the citizenry and communities.
- 2) We developed a vibrant, active and demanding civil society that acts not only as a check on the system, but also often is the initiator of systemic changes, from e-procurement to e-declarations. Fragmented and diverse, but unyielding, these non-governmental groups have focused on every element of life, from taxation to environment, from support for veterans to battling corruption.
- 3) We built an international coalition of support, which included support of the G7 and other partners, and was critical to not only fighting the war, but also putting together the necessary financial package to balance our forecast balance of payments gap of \$40 billion. The key role was played by the International Monetary Fund (IMF) which quickly concluded first a stand-by agreement in March 2014, then a deeper and more front-loaded Extended Fund Facility (EFF) of \$17.5 billion in March 2015. Our bilateral and multilateral partners committed to an additional \$7.5 billion in financial support, while the remaining \$17.5 billion gap was covered by successful restructuring of our external commercial debt. It was these funds, together with the most critical reforms enacted in 2015, that enabled the stabilization of the economy.
- 4) We restored macroeconomic stability and have achieved a moderate level of economic growth, avoiding the total collapse predicted by naysayers when I entered government in 2014. Real GDP growth year on year was forecast to reach 1.5% in 2016 and 2.5% in 2017. Gross international reserves have reached \$16 billion, or the equivalent of four months of imports. We reduced the total government budget deficit (including the Naftogaz deficit) from over 10% of GDP in 2014 to just over 2% of GDP in 2015. We were able to reduce total public expenditures from over 50% to just over 44%, despite the necessary prioritization of some 5% of GDP spending on defense and security to address the war on our territory.
- 5) We rebuilt and restored our military after years of decimation and destruction. The initial priorities included optimizing the command and control structure, but also included reform of the public procurement practices, enabling more efficient and targeted spending. More recently, these reforms have included transitioning toward a contract army, with more than 50,000 contracts for military service in the Armed Forces of Ukraine signed since the beginning of 2017. These reforms, and the efforts of countless volunteers in the process, have successfully stopped the aggressor in its tracks and recovered some 60% of territories earlier occupied. Moreover, with the help of our transatlantic partners, we have maintained sanctions in place, keeping the Kremlin at

the negotiating table to work through a diplomatic course toward peace and restoration of our sovereignty and territorial integrity.

6) We eliminated our dependency on natural gas from one single source and implemented substantial energy sector reform, and have begun the long process of reducing usage and becoming more energy efficient. For over a year, Ukraine has not imported natural gas from Gazprom. This was made possible as a result of comprehensive reforms and financial support for those reforms provided by our partners.

First, Naftogaz underwent anti-corruption corporate governance reform, implementing international audits, establishing a board of directors with independent board members, as well as moving out from under the direct authority of the Ministry of Energy. Moreover, it has committed to unbundling (reorganizing) operations for transportation and storage of natural gas in line with the European Third Energy package. It has ended its monopoly on the domestic market and a law on the natural gas market paves the way to deeper reforms.

Second, household tariffs for gas were united at import parity prices, eliminating the rent seeking opportunities that existed and were subsidized by the state. The savings from this measure alone totaled 8% of GDP. All of these reforms gave the international community confidence in the seriousness of our resolve in the energy sector, and they put together a \$1 billion in revolving financing for Naftogaz, which enables it to purchase natural gas when prices are lowest, utilizing our massive underground storage tanks, as well as to maximize usage of the reverse flow connections from Europe for the import of the gas.

7) We have engaged in one of the largest clean ups of banking systems in history. Some 80 of over 180 insolvent banks were closed by the National Bank of Ukraine. Related party transactions and mismanagement led to insolvency or illiquidity throughout the system, destroying trust in the banking system. Tackling these issues enabled the remaining banks to rebuild trust with both the retail and commercial sectors. For the liquidation done to date to have the appropriate effect on future owners, however, those bank owners who have deliberately used related party transactions or other means to defraud their depositors must be brought to justice.

8) We have begun the long and difficult battle against vested interests that over 20 years have captured much of the state and public policy, for example, by eliminating all intermediaries in our gas trade, which for a long time was the largest source of corruption in the country.

Ukraine is advancing a four pronged-strategy to fight the vested interests' hold on the economy and the political system:

First, we have tackled vested interests by eliminating many of the privileges, preferences, and corruption schemes. We have implemented a series of reforms that have saved Ukraine up to \$5 billion:

- We rid ourselves of all trade gas intermediaries that stole billions of dollars without producing any added value for the country. This is the single most important decision Ukraine has ever taken to tackle corruption.

- We have equalized household gas tariffs to import parity, effectively putting an end to massive energy stealing and rent seeking behavior that coexisted with multiple prices in the marketplace.
- We have fixed many of the corrupt loopholes that allowed tax evasion, including the transfer pricing law, which puts an end to the largest tax evasion schemes used over the past 20 years.
- We introduced an electronic VAT system to put an end to the scandalous practice of fraudulent VAT refund claims, estimated in 2014 at up to \$1 billion per year.
- We have started to systematically audit and change the corporate governance at Ukraine's state-owned enterprises, with competitions for top positions and independent board members.

Second, we have started eliminating the space for corruption to reappear by fostering transparency.

- We have introduced an e-procurement system throughout the central and local governments, as well as state owned enterprises that improves transparency, cuts down on opportunities for corruption and saves public funding.
- We have given open access to state property registers to the public.
- We have implemented E-Data, a fully transparent Treasury system online.
- We have just completed the first e-declarations of all public servants, requiring full disclosure of all assets and income. Over 100,000 officials have already submitted these forms, while some 1000 judges reportedly stepped down rather than submit the information.

Third, we have started building new institutions, staffed with newly hired people paid at a market salary level, to bring corrupt criminals to justice.

- A new National Police force was established in over 30 cities as of today. In each city, masses of former officials have been dismissed.
- The newly established National Anti-Corruption Bureau has begun hundreds investigations of alleged corruption, including judges, prosecutors, civil servants, university rectors and more.
- The newly established National Agency to Prevent corruption will now investigate the sources of funding of the recently submitted e-declarations. False information results in criminal liability.

Fourth, finally and perhaps most importantly for the success of Ukraine's transition, we have just adopted constitutional reform of the judicial system. To ensure a state governed by the rule of law, there must be a free and fair judicial system. To ensure compliance with the law, there must be reverence for the law and fear of the consequences of breaking that law. Thus, this fourth element is absolutely key to completing the cycle of anti-corruption reform. The reform includes:

- Reduction of the number of levels of courts and opportunities to appeal, from four to three.
- The creation of a specialized Higher Anticorruption Court.
- Limitation on judges' immunity.

- Requirement for judges to submit e-declarations, with a mismatch between property and income a ground for dismissal.
- 8000 judges to undergo assessment before being reappointed.

This has been the longest and most successful reform process Ukraine has experienced in its 25 years, having lasted almost three years, spanning two governments, and three IMF tranches.

## **What we still need to do**

Despite the massive political will invested in these reforms to date, they are far from being irreversible. Moreover, the macroeconomic stability that has returned to Ukraine is far from being sufficient to create the improved living standards, consumer purchasing power, and real wage increases needed by the population after decades of decline. There is much to do to ensure the irreversibility and return to levels of economic growth that will serve the interests of the Ukrainian people.

To start, I suggest an effort to create a major investment paradigm shift for both domestic and foreign investors. Day to day, cumulatively effective reforms in all the areas above should continue, from anti-corruption to state-owned enterprise corporate governance reform. However, to enable a dramatic and urgent change in the frame of mind of investors, both domestic and international, bold and sweeping changes are necessary to bring the Ukrainian investment opportunities to the forefront of decision makers in a way that challenges them to put aside the past 25 years of marginal reform history and focus instead on the remarkably positive changes. There are many such possible investment paradigm shifts, but I will focus on just a select number.

**Land Reform:** Formation of a free land market is likely to be the single most awaited investment paradigm shift. Ukraine is the only democratic country in the world where this market does not exist. Moreover, given the natural agricultural advantages in Ukraine, this is one area very likely to spur new investments not only in basic agriculture, but in all the subsidiary sectors such as equipment, chemicals, and seeds, as financing becomes available and efficiencies increase. Moreover, with the already record level of harvest in 2016 of 64 mmt, enabling a land market and circulation of these assets, frozen to date, will enable investors to seriously consider investment in infrastructure, from ports to river transport to elevators and processing facilities. All these elements come together to give new impetus to the banking sector in Ukraine. EasyBusiness (Annual Report 2015, Deregulation in Ukraine) estimated that the result would be the eventual circulation of \$125 billion and employment of up to 1.5 million people.

**Deregulation:** Ukraine ranked 160th of 180 countries in the world in the Index of Economic Freedom in 2017, and 83rd of 189 countries in the world in the Ease of Doing Business Ranking. The objective of massive and sweeping deregulation would be a complete change in the business environment encouraging competition, eliminating excessive control and regulation, while reducing corruption massively at every level. To date, several laws have already been enacted,

including most recently a Cabinet of Ministers resolution cancelling some 100 regulatory acts. However, the type of comprehensive cancellation and reduction in state interference with business. Massive deregulation will get the positive attention of investors and result not only in savings from reduced corruption, but real economic growth and new investments.

***Complete the privatization process:*** Ukraine has approximately 300 state-owned enterprises that could be lawfully privatized, plus another 100 that could be removed from the list of strategic enterprises forbidden to privatize. There are an additional 1500 that are nearly worthless and could be privatized or liquidated. The value of completing all possible privatization in a short period of time would be a major signal to the investors' world. It would signal that the government of Ukraine is no longer interested in managing enterprises and wishes to create a level playing field, ensure competition and attract new investment. Completion of this privatization process, e.g. a selloff, after 25 years of half steps, would not only send a major positive signal to investors, but would also end decades of inefficient subsidies and a major source of corruption. Of course, the process would need to be simple, open, transparent and fair. However, completion of this drawn-out transitional step would be remarkably well viewed by investors and worth much more than the revenues that might be raised by waiting.

While we complete many of the economic reforms begun and ensure the investment environment maximizes interest among domestic and international investors, Ukraine must also focus on ensuring its longer term competitiveness in a world experiencing the fourth industrial revolution, the technology revolution. Technologies have become transformative at a rate that is unlike any of the previous industrial revolutions. The changes will be in the social and economic systems that shape our lives, such as artificial intelligence eliminating entire job classifications, but creating others. The role of government in this situation is to prepare society for this progress. Key in the preparation is education and training. Most of Ukraine's educational system functions in a traditional manner and is not prepared to prepare students today and in the future for the challenges of the changes being brought about by disruptive technologies. Public policy and funding need to enable the educational system to not only keep up with the needs of the job market, but keep up with global technological changes to ensure Ukraine's global competitiveness.

## **What we need the West to do**

Today, Ukraine's transition stands at a critical juncture. We have much work to do to ensure these changes and all these massive efforts result in irreversible change. We face three primary challenges -- fatigue, populism, and vested interests.

The success of the reforms themselves over the past three years have caused fatigue, given rise to dangerous populist rhetoric, and caused the vested interests to actively fight back to stop the interference with their cash flows. Moreover, the Kremlin continues to invest all its resources in this hybrid war in an attempt to destroy the New Ukraine and the example its success would serve in the region.

So now is the time to redouble our efforts. Ukraine needs to redouble its efforts to continue down this reform path and make the structural reforms that will improve the business environment, increase domestic and foreign investment. The international community, in particular the international financial institutions (EBRD, EIB, IFC, OPIC, DEG, FMO, etc), must redouble efforts to support the reformers in Ukraine and the continuation and strengthening of the reform process. In particular, I have suggested the creation of a \$25 billion, five-year international support consortium for investment into Ukraine's infrastructure, broadly defined, linked to key outstanding reforms. We need to develop a parallel stream of support for Ukraine to the existing IMF macro financial program. This second stream would be focused on those areas that would win over the hearts and minds of the Ukrainian people, roads, schools, hospitals, e-government services, and more. The consortium must be large enough to create and maintain political will for reforms, while modernizing the country to benefit the citizenry.

In sum, enormous work has already been completed in Ukraine's transition. It is crucially important to recognize these achievements to date. However, the transition process is clearly not yet over. The Ukrainian people deserve sustainable growth and prosperity. To accelerate and support the reforms underway, and support the reformers fighting fatigue, vested interests and populism, not to mention or underestimate the billions of dollars the Kremlin is investing in the hybrid war of military, economic, trade, cyber and propaganda, we must remain united, stay focused and engaged. Too much is at stake. There are no parallels to the challenges Ukraine faces today in European history. Ukraine is today at the forefront of the challenge to the international liberal order. Ukraine's success is the success of the Free World.