COUNCIL on FOREIGN RELATIONS

Maurice R. Greenberg Center for Geoeconomic Studies

INSIGHTS FROM A CFR WORKSHOP

Rebuilding Economic and Political Stability in Ukraine

September 21, 2015

In June 2015, the Council on Foreign Relations' (CFR) Maurice R. Greenberg Center for Geoeconomic Studies held a workshop on the economic challenges facing Ukraine. The workshop was hosted by CFR Senior Fellows Jennifer Harris and Robert Kahn. The views described here are those of workshop participants only. ***The Council on Foreign Relations takes no institutional positions on policy issues and has no affiliation with the U.S. government.***

INTRODUCTION

Ukraine faces two severe and immediate challenges: armed pro-Russian separatists in the eastern part of the country and a sharp, nationwide economic deterioration stemming in no small part from that military threat. Ukraine's economy has contracted violently over the past year, and it is still burdened by a legacy of corruption and inefficiency that strains its fiscal balances, limits growth, and undermines fragile political unity. Reinforcing and sustaining the economic reform process currently underway is a crucial step toward consolidating the political gains that Ukraine has made since the Maidan uprising in late 2013, and presents a nonmilitary route for the United States and other countries to push back against Russia.

In that context, the Maurice R. Greenberg Center for Geoeconomic Studies at the Council on Foreign Relations (CFR) convened an international group of roughly thirty experts, including government officials, market participants and other practitioners in international finance, political economy, and Eurasian security for a half-day workshop in Washington, DC, in late June. This report summarizes the highlights of the discussion and the views of the workshop participants. Participants sought to understand Ukraine's economic challenges, explored obstacles impeding economic reform, and identified possible ways for outside actors to support Ukrainian policymakers more effectively during a vital period in the months ahead.

The United States has a profound interest in supporting the emergence of a new, reform-minded government in Ukraine—not just for the sake of the Ukrainian people, but for the sake of the broader American-led international system and for perceptions of the United States' ability to lead it. In the years ahead, U.S. leadership, not just in Europe, is likely to be tested in terms of its ability to enforce international norms in the face of abuses and coercion comparable to what is currently unfolding in Ukraine. Participants argued that by helping Ukraine's leaders catalyze Ukrainian economic recovery, the United States could help mount a robust defense of the existing order against revisionist threats—an effort that would pay geopolitical dividends across broad geographical regions.

Beyond the United States, international actors—including multilateral financial institutions and the European Union (EU) and its member states—also have a stake in helping Ukraine right its economic ship. However, over the past year, poorly coordinated international support has created an extensive set of overlapping initiatives and technical assistance—encompassing debt policy, macroeconomic adjustment, and far-reaching structural reforms—without always fully considering the domestic political costs of such efforts. Ukraine's opponents, in other words, are largely unified and single-minded, whereas Ukraine's supporters are much less so.

The United States has a profound interest in supporting the emergence of a new, reform-minded Ukraine—not just for the sake of the Ukrainian people, but for the sake of the broader American-led international system.

HOW SICK IS THE PATIENT?

Ukraine's economy is suffering from a deep recession and there is little evidence that growth will return soon. Ukraine also faces a crushing debt burden, which raises fear of a default and complicates efforts to secure the loans and investment needed to get the economy back on track.

Though the fears of an imminent meltdown, including a currency collapse and massive financial outflow, have receded since the spring of 2015, economic activity is severely constricted by the security situation in eastern Ukraine and by continued trade sanctions from Russia. Participants held a diverse range of views on the next several months: some argued that Ukraine's economic prospects "have not reached bottom yet," others pointed to indicators suggesting a rebound in growth and moderation in inflation in the second half of 2015. In addition, Ukraine's external liabilities (owed to foreign lenders including commercial banks, governments, or international financial institutions) have decreased and international reserves begun to recover. If Ukraine's efforts to renegotiate the debt it owes to private financial intuitions (a process known as debt restructuring) is successfully concluded and the current reform process is sustained—including deep-seated changes to the energy sector, reforms to pensions, agriculture, banking, and state-owned enterprises, and efforts to create a more attractive business climate—some workshop participants were optimistic about the economy's long-term potential. (At the time of the workshop, debt negotiations were still in progress; in late August, Ukraine announced a deal with its largest private creditors to reduce its debt burden by 20 percent.)

Fundamentally, though, what ails the Ukrainian economy is Russia. The separatist conflict in the east has depressed economic activity in important regions like the Donbass. Adding to the direct toll of war, Russian trade sanctions have curtailed Ukrainian exports. This undermines economic prospects and policymaking. As one participant noted, Russia will never strike a deal on Ukraine with Europe and the United States as long as Ukraine is vulnerable, yet Russian cooperation may be crucial to any long-term stabilization of the Ukrainian economy.

In terms of Ukraine's financing needs, there were sharply divergent viewpoints. Some participants, noting financial assistance from the International Monetary Fund (IMF) and governments, argued that Ukraine's program is adequately financed if policies remain on track and the global economy is supportive. Others argued that, given the pressures on the economy, there is a growing risk that even with successful efforts to restructure Ukraine's debt, a new financing gap would emerge in coming months. These participants felt that additional financial support should be made available to Ukraine in order to underpin the reform effort, especially during the crucial months after local elections later this year. Front-loading funds from the IMF facility or from new bilateral commitments could provide additional support in 2016. Such support measures would help provide Ukrainian policymakers with

Poland Did It. Why Can't Ukraine?

Many participants noted how countries such as Poland, Hungary, and the Baltic states successfully transitioned from Soviet-era economies to more market-friendly ones and asked, why can't Ukraine? Some participants even noted "Ukraine fatigue" in eastern Europe among veterans of past reforms frustrated with what they see as Ukrainian lassitude.

Although some examples from eastern Europe's experience were cited as lessons for Ukraine today—the creation of a Polish stability fund, for example—the consensus was that circumstances have changed dramatically in the past twenty-five years, making eastern Europe's experience less relevant. In the immediate months and years that followed the Soviet Union's collapse, post-Soviet Russia was consumed with its own political and economic transformation and was not acting to destabilize former satellites. Also important: the vested interests currently set on defending post-Soviet privileges in Ukraine have grown more powerful in the quarter century since the Soviet Union's collapse.

the financial cushion to withstand additional external shocks, such as a further intensification of the conflict in the east or continued trade barriers, and to fully pay for reform efforts.

THE OBSTACLES TO REFORM AND HOW TO OVERCOME THEM

In broad terms, opinions were split over the depth and ambition of Ukraine's economic reforms to date. For some participants, the steps already taken and on track for completion—such as steep increases in natural gas prices and reform to the pension system—represent "very radical" reform that goes further than the painful measures that helped transform post-Soviet states in eastern Europe in the 1990s. Particularly noteworthy, they said, were the initial phases of subsidies reform in the natural gas sector, which will save nearly $10 billion for the federal budget (an amazing sum, especially considering that the country's current IMF bailout totals $17.5 billion over four years), while also eroding one huge source of corruption. Other participants said that reform efforts sound better on paper than they do in implementation, and internal political opposition means that there is "not yet critical mass" for the reformers. Fundamentally, some participants noted, the uneven pace of political and economic reform simply reflects the fact that the Maidan uprising was a "leaderless" revolution, and that Ukraine continues to struggle with a leadership deficit to this day.

Nearly all sides agreed that international actors, including the EU and the United States, should increase their support for Ukraine's political and economic reforms in order to strengthen the country's hand against Russian aggression. Therefore there are two crucial questions: What specific factors impede reforms? And what steps can Western and other international policymakers take to eliminate or minimize them?

> *The distorted and opaque gas market has created space for oligarchs, many with ties to Russia, to make huge sums of money, much of which is plowed back into influencing Ukrainian politics.*

Energy: Fixing Ukraine's Natural Gas Market

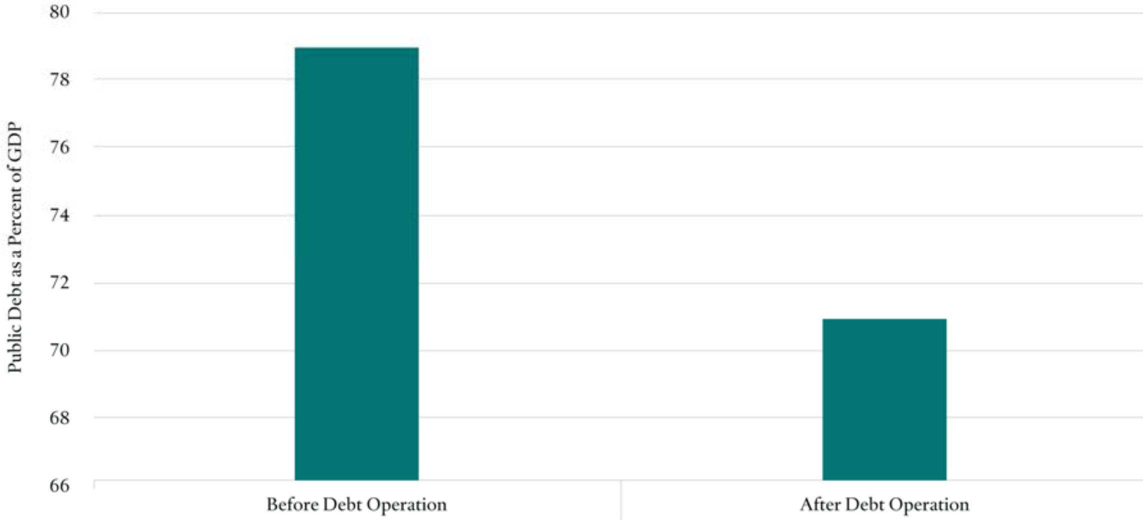
Fixing Ukraine's natural gas market is crucial because the country's distorted energy policies foster corruption, cost the state billions of dollars a year, and contribute to Ukraine's continued economic dependence on Russia. That is why gas market reforms have been at the center of EU accords and IMF packages. Ukraine has long subsidized the cost of natural gas for businesses and consumers; until recent reforms, household gas rates were about one-fifth the cost of importing that gas from Russia. (For more on this subject, see the recent CFR workshop report on reforming fossil fuel subsidies.) Artificially low prices encourage wasteful consumption, making Ukraine one of the least energy-efficient countries in Europe. Furthermore, buying gas at market rates from Russia to sell domestically at a loss costs state-owned gas firms about 5 percent of gross domestic product (GDP) per year. Inefficient gas use also cements Ukraine's import reliance on Russian gas, the supply of which Gazprom has used several times in recent years as a geopolitical weapon to pressure Kiev. The distorted and opaque gas market has created space for oligarchs, many with ties to Russia, to make huge sums of money, much of which was plowed back into influencing Ukrainian politics. Thus, Ukraine's efforts to bring natural gas prices up to market levels in three phases over the next few years could help it reduce corruption, dependence on Russia, and fiscal profligacy.

Europe's Other Debt Crisis: Ukraine's Unsustainable Debt Burden

Ukraine's immediate challenge is a large and unsustainable debt burden, now reaching 100 percent of GDP. Servicing that debt has drained the country's currency reserves and undermined confidence.

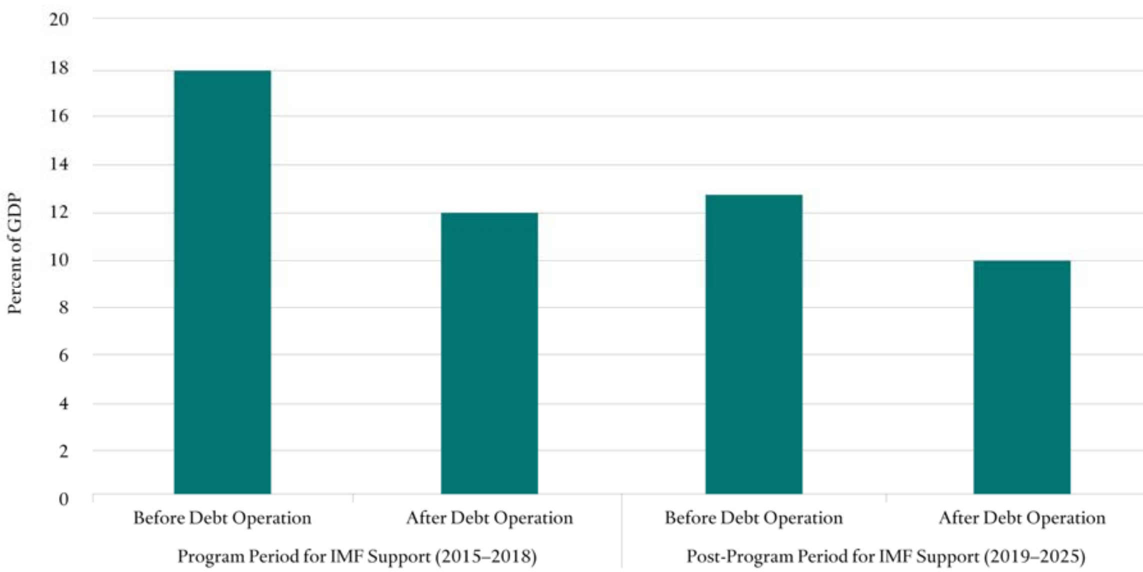
Ukraine's government aims through a restructuring of its outstanding debt to save $15.3 billion over the next three years, and is also asking creditors to take a 20 percent "haircut" in order to reduce debt to levels the IMF considers sustainable. Participants agreed that some form of debt restructuring was necessary to remove uncertainty hanging over the Ukrainian economy. Following the restructuring of its private debt, the government next should seek to restructure a $3 billion bond held by the Russian government and due in December 2015.

FIGURE 1. UKRAINE'S PUBLIC AND PUBLICLY GUARANTEED DEBT, 2020



Source: International Monetary Fund

FIGURE 2. GROSS FINANCING NEEDS OF THE UKRAINIAN GOVERNMENT



Source: International Monetary Fund

The Corrupt Legal System: "There's No Justice"

Several workshop participants noted that Ukraine's corrupt legal and law enforcement system handicaps the reform effort—and could even scuttle it altogether. Powerful individuals, especially but not only the oligarchs, routinely bribe officials and otherwise evade the law.
Fixing the entire legal system—and the entire law enforcement apparatus of customs officials and intelligence officers—is challenging. Some participants pointedly invoked the example of current Crimean Governor Mikheil Saakashvili, who jailed scores of allegedly corrupt officials when he was president of Georgia. However, replicating Saakashvili's legal purges in a country the size of Ukraine is simply not an option, participants said.

Even a sweeping cleanup narrowly targeted to the judicial system—a blanket removal of prosecutors and judges, for example—is difficult. Although EU law prohibits the wholesale removal for suspicion of wrongdoing, some participants saw precedent in reform efforts in East Germany, where corruption sweeps involved the wholesale sacking of lawyers and prosecutors.

More modest options, said others, were recruiting Ukrainian- and Russian-speaking professionals from outside the country, promoting young legal professionals, and re-educating the best of the current bunch.

> *Who Can Do It?*
>
> Ukrainian officials could take further steps to clean up the legal system, though participants stressed the risk that efforts could be perceived as "selective justice." The EU and United States could help support legal training for younger Ukrainian- and Russian-speaking lawyers and judges.

Oligarchs: "The Greatest Threat to Ukrainian Sovereignty"

A related problem is the huge political and economic influence wielded by Ukraine's oligarchs, which one participant called the "greatest threat to Ukrainian sovereignty." Another called oligarchs "the single biggest challenge, the Gordian knot" to the entire reform effort. Simply put, as long as the oligarchs dominate the Ukrainian economy—especially in energy, but also industry, metals, and mining—they can derail nearly any governmental reform effort. Moreover, some participants argued, the oligarchs represent the sharp end of the Kremlin's influence inside Ukraine due to their political and financial links Russia. Frontal attacks on the oligarchs, their positions, and their assets could be problematic. Participants suggested such attacks could bring the economy to a standstill or foment armed unrest in the eastern parts of the country. Even a legal prosecution in the current Ukrainian climate could be difficult and potentially appear as "selective justice."

> *Who Can Do It?*
>
> The U.S. Department of Justice could indict corrupt officials, and the U.S. executive branch could air corruption information used for individual sanctions. Stronger EU countries could also use the legal system to press for asset foreclosure, travel bans, etc. Other EU countries, especially the United Kingdom, could reconcile anticorruption rhetoric with their welcoming attitude toward oligarchs' investments in their countries.

However, international actors do have some options. Noting past difficulties in prosecuting corrupt businessmen, one participant cited the example of the U.S.-led investigation of the Fédération Internationale de Football Association (FIFA), the world soccer body. The reach and strength of the U.S. Department of Justice could do to oligarchs what Ukraine's and other European countries' justice systems cannot. Others called on the U.S. Treasury Department to make public at least some of the corruption-related evidence it is already required to share with Congress as part of the process of enacting sanctions against individuals. There was also a call to "overwhelm the system," flooding bad actors with challenges from Western aid donors and civil society, thereby making it harder for vested, entrenched interests to sustain the back-scratching, get-out-of-jail culture that has characterized Ukraine.

Several participants spoke of the need for Ukrainian politics to embrace "good populism," meaning support for political leaders willing to target oligarchs and take them down to public acclaim. "The public is willing to bear the costs, but they're not willing to bear the costs if nothing is being done," one participant said. People "want to see heads on spikes, but no one goes to jail," said another.

Ukraine's Challenging Political Climate: All Politics Is Local

Arguably the most pressing obstacle for reform, however, is the broader political climate. The current coalition government—almost certainly the most credible and capable collection of reformers Ukraine is likely to find—is losing support in the polls, and appears unlikely to survive the upcoming regional elections in its current form. And that matters, because as one participant noted, "The reform effort has not passed the point of no return. . . . Reformers do not have critical mass yet." Political blocs in the Ukrainian parliament have reverted over the past year to focus on regional concerns, rather than the big-picture questions of national unity and economic recovery.
Private sector consulting firms could advise on communications campaigns for Ukraine. Multilateral financial institutions and private creditors could give ground on debt restructuring or front-load more assistance to provide money for civil-servant pay and broader fiscal space. Technical bodies, such as the European Energy Council and the U.S. Bureau of Energy Resources, could advise on energy reforms, especially efficiency and infrastructure for EU gas networks.

The Ukrainian government could embrace "good populism" and accelerate reforms that are highly visible and likely to shore up popular goodwill. This includes energy efficiency; the Ukrainian public is keenly aware of both the magnitude of the current inefficiencies in the energy sector and the way in which these inefficiencies serve to line the pockets of oligarchs. Moving quickly and visibly to close corrupt banks and address judicial corruption would go a long way toward restoring public confidence in Ukrainian institutions and the reform agenda.

These efforts require a larger cadre of top-flight civil servants than the Ukrainian government has so far managed to recruit. Insofar as most recommendations turn on building the momentum and might of the reformers, participants urged a top-up fund for civil-service salaries, potentially financed in part by outside aid. They also were unified on the importance of more concerted efforts on communication and education campaigns, both internally (selling reforms, past and future, to Ukraine) and externally. This, participants noted, is one area particularly suited to Western know-how and resources.

NO PARACHUTES, PLEASE: A FLURRY OF ADVISORS

Although there are certain areas, like strategic communications, that would lend themselves to Western assistance, not all forms of Western aid are helpful. One major obstacle to successful reform in Ukraine is, paradoxically, the proliferation of advisors, consultants, and international actors who are trying to assist Ukrainian authorities, but who lack coordination and a consistent message. A related problem, some said, is the tendency for outside advisors to drop into Ukraine on "missions," unload a flurry of detailed policy prescriptions, and depart before those policies can gain traction in ministries or in a deeply skeptical and divided parliament.

Participants agreed that improving coordination among the flurry of international actors present in Ukraine is crucial, both to avoid duplication of effort and expense and to better craft a coherent, unified message for Ukrainian officials. Some participants suggested bringing together lending institutions, civil society, and Western governments every few months to share experiences. However, there was little support among workshop participants for a single, high-level coordinator for international efforts; one dismissed the utility of "another layer" of oversight.

To avoid the perils of "parachute advisory," some participants hearkened back to the nuts-and-bolts implementation of efforts such as the Marshall Plan to suggest that international missions be led by people on long-term assignments, on the ground in Ukraine, in order to maximize follow-through of reform efforts. Participants acknowledged that the main responsibility for the success of these reforms lies with the Ukrainians themselves, but most agreed that the government deserved strong international backing to address these challenges. A rejuvenated economic reform process represents the Ukrainian government's best chance to consolidate the post-Maidan revolution, an important prerequisite for stability in a region grappling with Russian aggression.

Cover Photo: Valentyn Ogirenko/Reuters