

### *Chapter 3*

## **The Preconditions for, and the Nature of, Current Ukrainian Reforms**

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Ukraine's economic problems have historical roots: a chronic absence of fundamental institutional and structural changes has resulted in an inefficient economic system and a low level of international competitiveness. The potential of Ukraine's current economic model has been exhausted, therefore economic crisis has become inevitable.

The Revolution of Dignity became the signal that Ukrainian society would no longer tolerate the status quo. The changes that were demanded sought the large-scale political, economic, and social modernization of the country. The necessity of deep structural and structural reforms has been publicly acknowledged by all successive governments. Yet while many declarations of intent to launch reforms have been issued, the country has failed to produce, much less implement, any real reform strategy. As a result, social and economic problems and imbalances have accumulated. Ukraine's economic slowdown began in 2012, and in 2013 the country experienced a real economic crisis (Table 1). Domestic economic problems, in turn, were exacerbated by negative external economic and political developments.

To better understand the scope and peculiarities of the challenges facing Ukraine, the following points should be taken into account.

First, Ukraine entered the current crisis following a period during which there was systemic postponement of fundamental institutional and structural changes. Ukraine's economic and political system has been characterized by a high level of monopolization, which resulted in overall economic inefficiency and state capture. The prevalence of large-scale corruption generated such phenomena as a corruption tax and exacerbated the inefficiency of public institutions.

Increasingly, the government been unable to meet its social obligations; the unreformed social welfare system has been unable to serve societal needs, while the crisis of the "pay as you go" pension system became chronic as the Pension Fund demanded growing direct budget transfers from the central government. In addition, Ukraine is suffering through a

**Table 1. Ukraine's Economic Dynamics**

Year	2010	2011	2012	2013	2014	2015	2016
GDP (hryvnia, billions, current prices)	1079.3	1300.0	1404.7	1465.2	1566.7	1988.5	2383.2
Volume change (%)	4.1	5.5	0.2	0.0	6.8	-9.8	2.3
Export, goods, %, year change	3.9	2.7	-5.6	-8.1	-14.2	-13.2	-4.6
Import, goods, % year change,	11.3	15.4	3.8	-3.5	-22.1	-17.9	4.6
GDP deflator, %, year change	13.8	14.3	8.1	3.1	14.8	38.9	17.1
CPI, as of the end of the period	9.1	4.6	-0.2	0.5	24.9	43.3	12.4
Government and government-guaranteed debt, % of GDP	40.5	36.3	36.6	40.6	70.3	80.3	80.9

Not including temporarily occupied Autonomous Republic of Crimea, city of Sevastopol and non-controlled eastern areas.

Source: State Statistical Service of Ukraine (Ukrstat); World Bank; estimates of the Institute for Economic Research and Policy Consulting.

comprehensive set of security challenges, ranging from security of property rights and social security to cybersecurity and personal (physical) security.

Second, Ukraine has already implemented the strategic task of transitioning from a planned economy to a market economy; the market economy is in place. But now Ukraine must “upgrade” its market system making it more efficient economically and better able to provide for societal security.

Essentially, this upgrade must be a large-scale, three-fold modernization of the economic policy-making process, the production and technological foundations of the Ukrainian economy, and the social security system.<sup>1</sup> Two quantitative indicators of success over the medium run could be whether Ukraine can narrow the gap between its GDP per capita and the EU average (or other indicator of the same kind), and whether it can rank higher on the Human Development Index.

The key to modernization is to implement so-called “second generation reforms” (SGR), a concept originally presented by former IMF President Michel Camdessus. This is a very useful tool to develop policies enabling “middle and low income countries to grasp the opportunities presented by the globalization process.”<sup>2</sup>

<sup>1</sup> Модернізація України. Визначення пріоритетів реформ. Проект для обговорення, [https://gazeta.zn.ua/SCIENCE/modernizatsiya\\_ukrayini\\_prioriteti\\_reform.html](https://gazeta.zn.ua/SCIENCE/modernizatsiya_ukrayini_prioriteti_reform.html).

<sup>2</sup> Michel Camdessus, “Fostering an Enabling Environment for Development, Address at the High Level Meeting of the UN Economic and Social Council,” Geneva, Switzerland, 1997, <http://www.imf.org/external/np/speeches/1997/MDS9710.HTM>.

According to Camdesuss, “second generation” reforms are aimed at “ensuring that the State fulfills its proper role in a market economy, by creating a level playing field for all sectors and implementing policies for the common good, particularly social policies that will help to alleviate poverty and provide more equal opportunity.”<sup>3</sup>

SGR consist of four fields of government interventions to achieve specific goals, geared to the particular circumstances of a particular country:

- ***Financial system:*** soundness of banking systems, greater transparency, better data dissemination and the liberalization of capital accounts.

To achieve these goals Ukraine must rid itself of insolvent banking institutions, take measures to ensure greater transparency of ownership structures, improve banking supervision, switch to inflation targeting, and other related activities.

- ***“Good governance”:*** reducing corruption, encouraging transparency of public accounts, improving public resource management and the stability and transparency of the economic and regulatory environment for private sector activity.

To achieve these goals Ukraine must make the fight against corruption comprehensive and sustainable by establishing proper law enforcement institutions, creating a modern system of public finance management, reforming the public procurement system, combining deregulation measures with the process of creating new regulations according to Ukraine’s international commitments. Special attention must be paid to modernization of the tax administration system.

- ***Composition of fiscal adjustment:*** reducing unproductive expenditures such as military spending and focusing spending on social sectors.

Since Ukraine must respond to Russian aggression, it must increase its military expenditures. Taking into account the fact that Ukraine has to rebuild its armed forces virtually from scratch, the country has to invest heavily in the development of its military capacities and military-industrial complex. At the same time the government has to ensure the best possible cost-efficiency ratio.

Ukraine’s social security system remains, in its basic design, a legacy system from Soviet times, which is simply not commensurate with

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<sup>3</sup> Ibid.

current social and economic realities. It is widely acknowledged that the system is financially unsustainable and difficult to manage technically, as it covers a large number of benefits operated by various governmental agencies.

The major challenge in this area is to implement comprehensive pension reform. The current “pay as you go” model has been virtually bankrupt for a long time. The pension fund has been unable to perform its functions without regular multi-billion hryvnia transfers from the central budget. The country has to properly address issues of pension age, types of pensions, pension financing schemes and related challenges.

- ***Deeper structural reform:*** civil service reform, labor market reform, trade and regulatory reform, agrarian reform.

The key challenge for Ukraine here is to fight corruption, which has become not only the barrier hampering “normal” development of the nation but poses a real menace to the very existence of the state.

In practical terms labor market reform implies adoption of a new labor code to reflect new economic, social and employment realities. The aim of trade reform is to elaborate and launch a full-fledged active trade promotion policy to assist national companies to enter global value chains. Regulatory reform should encourage the creation of an internationally competitive national business climate. In agriculture Ukraine must finally decide to permit agricultural land sales.

This list of problems is not exhaustive and can be expanded. The very nature of the problems enumerated shows that the fundamental essence of the reforms is a large-scale upgrade and fine-tuning of the current market economy system.

## **Economic Reforms: Strategy and Environment**

On the economic side, Ukraine declared its readiness to push forward an ambitious reform agenda. In 2014 Ukraine adopted a strategy for sustainable development entitled “Ukraine 2020.”<sup>4</sup> This document contained a list of 62 reforms and special programs to be implemented. Ten reforms and programs were defined as priorities.

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<sup>4</sup> Стратегія сталого розвитку, “Україна 2020,” <http://zakon2.rada.gov.ua/laws/show/5/2015>.

Analysis of this and other policy documents shows that very few issues have been left untouched. Three reasons stand behind this approach. First, the sheer quantity and magnitude of interrelated problems make it nearly impossible for the government to enumerate all issues to deal with. Second, Ukrainian society has demanded quick and comprehensive changes, and the government is under pressure to demonstrate that it understands what is to be done. Third, 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.<sup>5</sup>

Attempts to launch comprehensive reforms at full speed on all fronts simultaneously, however, have been doomed to failure. So the government objectively has to concentrate its efforts on a relatively limited number of problems. Taking into account the objective necessity to receive external financial assistance from international financial institutions (namely the IMF), the Ukrainian government and the National Bank of Ukraine have concentrated their efforts on implementing measures. Later, in order to manage the reform process more consistently, the Government drafted a special policy document—the Medium Term Plan of Government Priority Actions until 2020.<sup>6</sup>

In sum, the reform environment can be characterized as rather challenging and complicated. Five issues are particularly important to understand in this context.

First, the Revolution of Dignity generated high expectations within Ukrainian society of real changes for the better. But current economic hardships, coupled with the absence of visible reform progress, are affecting the mood of population. Therefore there is a danger that public support for reforms could evaporate, potentially setting the stage for another political crisis.

Second, the Revolution of Dignity and de facto Russian aggression against Ukraine resulted in an unprecedented level of international readiness to assist Ukraine politically and economically. Such efforts, however, were also tied to high expectations by the international community that

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<sup>5</sup> Pierre Vimont, “Ukraine’s Indispensable Economic Reforms,” Carnegie Europe. April 29, 2016, p. 4, [http://carnegieendowment.org/files/Vimont\\_Ukraine.pdf](http://carnegieendowment.org/files/Vimont_Ukraine.pdf).

<sup>6</sup> Середньостроковий план пріоритетних дій Уряду до 2020 року. Проект, [http://www.kmu.gov.ua/control/uk/publish/article?art\\_id=249628355&cat\\_id=244274130](http://www.kmu.gov.ua/control/uk/publish/article?art_id=249628355&cat_id=244274130).

Ukraine could quickly advance comprehensive reforms, even though tangible results could hardly be expected within a short period of time.

Third, the government turned out to be weaker and more corrupt than had previously been considered. In essence, Ukraine must advance its functional reforms at the same time it carries out a wholesale vetting and recasting of the very public service that must administer such reforms. The strength of pro-reformist elements varies considerably by government agency. The acute shortage of both in-house technical expertise and policy-making skills in a number of agencies has limited the government's ability to elaborate, pass, and implement strategic decisions.

Fourth, *de facto* Russian aggression has demanded proper political, military, diplomatic and financial responses that compete for the time and attention of leading officials. The annexation of Crimea and the occupation of a number of Luhansk and Donetsk regions have caused social and economic losses. The nature and scale of these losses has yet to be fully understood, which generates additional political and economic uncertainty. Ukraine's internal political and economic developments depend in part on the strategy of Ukraine's Western allies of containing Russia's aggressive policies in general and its approach to Ukraine in particular, and also in part on the ups and downs of Ukraine's troubled economic relations with Russia.

Fifth, the political situation in the country remains unstable due to quite complicated relations among democratic forces, and consequently the weakness of the democratic coalition in the Parliament. Under these circumstances the government very often does not enjoy the political support it needs to carry out reforms.

## **The Consequences of the War**

The economic and policy implications of the war require special attention. A full analysis is beyond the scope of this chapter, therefore I will just briefly mention a few issues.

In macroeconomic terms, we can speak of physical losses and losses due to the contraction of economic activities, diversion of financial and material resources to the military, and military-related needs. The list of these effects is rather impressive, taking into account the fact that Russia's aggression took place when Ukraine was experiencing severe political crises (Box 1).

### **Box 1. The Macroeconomic Effects of Russian Aggression**

1. Direct military expenditures.
2. Social benefits to military personnel and their families, financing the establishment of psychological and social rehabilitation system.
3. Support to internally displaced persons.
4. Costs of reallocation of governmental agencies and budgetary organizations from occupied territories.
5. Economic losses due to disruption of traditional commercial links between the companies.
6. Destroyed infrastructure (dwellings, transportation networks, water and electricity supply).
7. Destroyed industrial capacities in the zone of conflict.
8. Diminished corporate workforces as personnel were called to military service. In a number of cases the mobilization of qualified personnel and managers-owners of small and medium-sized enterprises resulted in closure of the business.
9. Mobilization of companies' resources for military use.

The microeconomic dimension can be illuminated by business opinion polls. In 2015, 53% of respondents stated that the war negatively affected their economic and financial standing, while 29% of respondents did not experience any impact. In 2016 these figures were 41% and 34%, respectively.<sup>7</sup>

As far as the political dimension is concerned, the war in a very brutal way simply revealed the real scale of institutional and economic problems that had accumulated. Generally speaking, the impact of war on the reform process is threefold.

First, the country has to accelerate the process of reforms in order to increase the positive capacities of the government. At the same time, the necessity to counteract Russian aggression affects the content and timing of policy decisions.

Second, the war diverts scarce institutional and financial resources from other activities. At the same time, war-related political, economic, and

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<sup>7</sup> Source: Оксана Кузяків. Війна на Сході України: виклики для соціально-економічної політики. Матеріал підготовлено за результатами опитування керівників промислових підприємств Інститутом економічних досліджень та політичних консультацій «Ділова думка», <http://www.slideshare.net/USAIDLEV/ss-65732609>.

social problems have become an issue of political competition and not a factor of political consolidation.

Third, the existence of non-controlled territories poses the question of how Ukraine can secure its economic sovereignty in general and structure economic and other relations with occupied territories in particular—should it fully isolate these regions (economic blockade)? Should it limit economic interaction to some extent? Or should it find some other arrangement? Needless to say, this problem has clear-cut internal and external political dimensions.

## Reforms to Date

Ukraine has already undertaken a number of bold and intensive political and economic reforms. The most significant ones are summarized here, together with the most important reform challenges still to be addressed.

**Planning reforms.** Institutional setting for elaboration and implementation of the reforms has been established but its efficiency leaves much to be desired. The Government has already adopted quite a large number of strategic policy documents defining the principles and priorities of reforms in different sectors, though their quality differs. At the same time there is an acute need for a strategic policy vision regarding trade facilitation, export promotion, SME development etc.

**Public service reform.** The Law on Public Service was adopted in 2015. The Law On Service in Local Self-Government Bodies was adopted in 2016. This law determined the principles of employment in the local self-government bodies transformed or created in the process of decentralization. Open competition to join public service was launched. A number of measures were undertaken to decouple political and public service positions within the Government.

**Public finance reform.** Formally, the priorities of public finance reform were formulated in the Strategy on Development of Public Finance Management System adopted by the Government of Ukraine.<sup>8</sup> This document envisaged quite radical changes in all the components of public finance management system. The aim of the Strategy is to build modern and public finance management system able to provide high quality public

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<sup>8</sup> Стратегія розвитку системи управління державними фінансами, схваленою розпорядженням Кабінету Міністрів України від 1 серпня 2013 р. № 774. Офіційний вісник України, 2013 р., № 82, ст. 3052.



services by means of efficient accumulation of financial resources and its (resource) proper allocation according to medium and long-term priorities of social and economic development.

The major results of can be summarized as follows:

1. **Public Procurement.** The Law on Public Procurement was adopted, mandatory procurement through a special electronic system was introduced, and the number of exemptions from competitive bids was reduced.
2. **Strengthening Control over Public Finance.** A Law on the Accounting Chamber was adopted that strengthened its independence and broadened its powers, particularly with regard to auditing the revenue side of the budget.
3. **Making the Budgeting Process More Transparent.** A Law on the Transparency of Public Financial Expenditures was adopted. This law ensures public access to budget information, and envisages the development of a single web-portal that would inform the public about budget expenditures of spending agencies, state and communal enterprises as well as mandatory social insurance funds and the Pension Fund.
4. **Tax Administration Changes.** The government suspended a number of tax privileges and implemented electronic VAT administration to reduce the number of VAT reimbursement-related fraud, and took steps to improve transfer pricing control. A number of measures were also undertaken to improve the system of state-funded investments management.

At the same time, parallel to implementing this strategy, the government had to concentrate its efforts on budget consolidation (i.e., strengthening budget discipline and optimizing expenditures), tax administration reform and budget decentralization (enlarging the powers and the resource base of local governments). A series of measures resulted in a reduction in the budget deficit from 4.9% in 2014 to 2.3% in 2015, while in 2016 the budget deficit made up 3.1%.<sup>9</sup>

In February the government adopted a new Public Finance Management Strategy for 2017–2020.<sup>10</sup> The problem of the quality of public

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<sup>9</sup> Стратегія управління державними фінансами на 2017–2021 роки, [http://www.kmu.gov.ua/control/ru/publish/article?art\\_id=249723040&cat\\_id=244276429](http://www.kmu.gov.ua/control/ru/publish/article?art_id=249723040&cat_id=244276429).

<sup>10</sup> Ibid.

finance management is considered to be key, as the level of general government expenditures is rather high; according to the IMF, these expenditures made up around 43.2% of GDP at the end of 2015.<sup>11</sup>

The strategy also calls for the implementation of medium-term budgeting. It is expected that budget resources will be allocated according to development priorities for the next three years; clear development goals over five years will be identified; and key indicators will be put into place to measure the efficiency of the strategy's implementation.

***Private banking sector reform.*** 2015 became a pivotal time for banking sector development. The process of cleaning balance sheets was completed, and banks began to implement capitalization plans. While most had already managed to implement three year plans earlier, growing reserves resulted in record high losses for the banking sector as a whole.

***Government-owned banking sector reform.*** Government-owned banks accounted for 51.3% of net assets as of the beginning of 2017 (from 28.1% as of the beginning of 2016) and 59.1% of household deposits.<sup>12</sup> Such a dramatic growth of the government's presence in the banking sector resulted from the nationalized rescue of Privatbank, Ukraine's biggest commercial bank, in an effort to prevent a full-blown banking crisis. This situation immediately created a number of challenges for the government and forced the National Bank of Ukraine to draft a special policy document entitled "Basic Approaches to the Strategic Reform of the State-Owned Banking Sector."<sup>13</sup>

It is widely acknowledged that the low efficiency of state-owned banks is due to the persistence of two problems. The first is political influence over internal decision-making processes. Here we can speak about a specific form of state capture in which various political-economic groups compete for the management of state enterprises and banks in order to secure various economic privileges for their businesses. The second problem is the absence of proper corporate management. Government banks were managed more or less directly by governments and were used to finance governmental policy actions.

<sup>11</sup> Ukraine. IMF Country Report No. 16/319, p. 44, <https://www.imf.org/external/pubs/ft/scr/2016/cr16319.pdf>.

<sup>12</sup> НБУ. Огляд банківського сектору. Випуск 2, Лютий 2017.

<sup>13</sup> Засади стратегічного реформування державного банківського сектору, [http://www.minfin.gov.ua/uploads/redactor/files/SOB\\_strategy\\_01-15\\_11022016.pdf](http://www.minfin.gov.ua/uploads/redactor/files/SOB_strategy_01-15_11022016.pdf).

Today, all government-owned banks may be classified as follows:

- Traditional government-owned banks (Ukreximbank and Oschadbank). These banks are slated to become privatized in the short term. The government will determine clear principles regarding their development and the strategic goals that are to be incorporated within the individual strategies of these banks. It is expected that implementation of best managerial practices and the achievement of strategic goals will create necessary preconditions for their privatization between 2018 and 2020.
- Nationalized banks (Ukrzazbank, Rodovid, PrivatBank). In each of these cases the government does not intend to be the long-term owner. An “exit strategy” will be elaborated for every bank individually.

**Privatization.** In 2016 the State Property Fund failed to launch large-scale privatization due to political and economic uncertainties. Privatization revenues generated 300 million hryvnia, only 1.9% of the total anticipated.

**Decentralization.** Certain powers have been transferred to local communities, and the process is off to a promising start: due to financial decentralization, local budget revenues increased 41.6% from 2015 to 2016, while the local share of total revenues increased to 21.8% in 2016 from 18.5% in 2015.<sup>14</sup>

**Trade and trade-related reforms.** The provisional application of the Deep and Comprehensive Free Trade Agreement started on January 1, 2016, in addition to other parts that had already been applied provisionally in November 2014. A Strategy and Action Plan for the Development of the Technical Regulation System until 2020 was adopted in August 2015. Ukraine revised and adopted a number of laws and implementing acts related to horizontal quality infrastructure and sectoral technical regulations. In 2015 the National Standardization Body was established. Ukraine is now working to adopt EU harmonized standards and has already introduced conformity assessment procedures based on EU principles and practices.

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<sup>14</sup> Звіт про хід і результати виконання Програми діяльності Кабінету Міністрів України у 2016 році, р. 193.

## Ukrainian Reforms and International Assistance

Given its serious macroeconomic, structural and institutional problems, Ukraine is seeking external assistance of three kinds: financial resources it cannot mobilize through markets; expertise that it can compensate at below-market rates; and an external commitment to compensate for weak domestic political institutions.<sup>15</sup>

The active engagement of the international community in the Ukrainian reform process raises six principal issues:

1. ***The Ownership of Reforms.*** It is clear that the country that initiates reforms has to be the owner of reform policy. In fact, as Willem Buiters has noted, “country ownership is a property of programmes, processes, plans, or strategies involving both a ‘domestic party’ (generally a nation state) and a foreign party.”<sup>16</sup> At the same time, the international community also has its stake in Ukrainian reforms, so to some degree we may speak about “co-ownership of reforms”—but this also implies a certain level of co-responsibility for the results of the reforms.
2. ***Scope of Assistance.*** The scope of international assistance is determined on the supply side by the agenda of international financial institutions, donor countries, and donor non-governmental institutions. From the demand side it depends upon the scope of problems the country has to deal with as well as recipient country absorptive capacity.
3. ***Efficiency of International Assistance.*** Efficient implementation of donor programs depends on the assistance priorities and ways of providing assistance, donors’ coordination schemes as well as a nation’s institutional capacity to formulate its needs with regards to international assistance, and its ability to ensure necessary pre-conditions.
4. ***Mismatch between Donor-Driven and Country-Driven Demand for Good Governance and Democracy.*** This mismatch appears to result from poor “external” understanding of the nature of problems to be solved, as well as selfish and irresponsible approaches by specific recipients of international assistance.

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<sup>15</sup> Willem H. Buiters, “‘Country Ownership’: A Term Whose Time Has Gone,” in Andrea Cornwall and Deborah Eade, eds., *Deconstructing Development Discourse Buzzwords and Fuzzwords*. Practical Action Publishing in association with Oxfam GB, 2010, p. 225.

<sup>16</sup> *Ibid.*, p. 223.

**5. Sustainability of Donor-Supported Activities, Institutions, and Policies.** Ukrainian (and not only Ukrainian) experience proves that donor-financed activities, institutions, and policies (good practices) start to decline when the central or local governments cannot take over full financial and managerial responsibility for them.

**6. The Problem of Proper Selection of Best Practices.** Different donors providing technical assistance in one and the same field may have different understandings when it comes to what practices are to be implemented. It is natural that foreign experts base their advice on their experience, but it is also true that proposed policy interventions usually have taken place “in different contexts, with different purposes, different population groups, and significantly different opportunities, involving challenges within widely varying cultural, political, and resource environments.”<sup>17</sup> As Vimont states, “More comprehensive knowledge among EU experts of current bottlenecks on the ground could bring an added value to the reform efforts.”<sup>18</sup> And this comment is true for all foreign experts in Ukraine. At the same time, local peculiarities cannot be an excuse for inability to introduce generally acknowledged principles of relevant policy interventions or regulatory standards.

The role of the international community in supporting Ukrainian reforms deserves special study. Meanwhile, it is worth mentioning that international assistance plays both a political and an economic role.

The political role is performed through co-participation of the international community in the formulation of policy and the implementation of reforms, as well as the transfer of best political experience and regulatory practices. The economic dimension is closely related to the political one: the international community provides financial resources to support the elaboration and implementation of agreed policies (conditionality principle).<sup>19</sup>

International political and economic assistance is of critical importance for Ukraine, and today Ukraine enjoys an unprecedented level of such support. At the same time, Ukraine today requires not only dialogue on

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<sup>17</sup> See Warren Feek, “Best Practices,” in Cornwall and Eade, *op. cit.*, p. 232.

<sup>18</sup> Vimont, *op. cit.*, p. 7.

<sup>19</sup> Co-participation can assume various forms, ranging from structured cooperation with the IMF and EU (conditionality regime) to less rigid programs (technical assistance) that do not envisage any explicit formal commitments from the Ukrainian government in terms of policy changes.

the essence and timing of the reforms but also various discussions of a number of strategic issues. As Pierre Vimont rightly states, “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.”<sup>20</sup> The other issue could be the role of Ukraine in the new international security architecture. These discussions are very important, not only for Ukrainian politicians but for Ukrainian society as a whole. Ukraine’s active engagement in such discussions could help to alleviate the public feeling that Ukraine is only a passive recipient of assistance and advice, whose priorities are imposed from the outside, and demonstrate that Ukraine is a welcome member of the international community, whose opinion matters.

## Challenges and Risks Ahead

Macroeconomic stabilization can be achieved relatively quickly, and Ukraine managed to do it in 2016. In my view, we may speak about the first signs of economic recovery. Other things being equal, the economic recovery will further persist and even slightly strengthen.

The recovery is rather fragile, however, and fundamental conditions for long-term sustainable economic growth are yet to be put in place. Therefore the government and the National Bank of Ukraine have to continue working in this direction. At the same time, large-scale modernization of the economy is a more lengthy process and requires more efforts.

These efforts should be concentrated in the following priority areas:

The business climate has yet to be dramatically improved: despite a number of bold steps undertaken by the government, corruption and a poor regulatory environment remain problematic. Political uncertainty, coupled with “traditional” problems of legal protection of investors’ rights, also negatively affects the investment image of the country.

Another problem is the quality of logistics; in 2016 Ukraine ranked only 80th in the world, according to the World Bank Logistics Performance Index.<sup>21</sup> In order to sustain and increase investors’ interest in Ukraine, the government has to virtually double its efforts to solve long-standing prob-

<sup>20</sup> Vimont. *op cit.*, p. 4.

<sup>21</sup> The World Bank, *Connecting to Compete 2016. Trade Logistics in the Global Economy and Its Indicators*, [https://wb-lpi-media.s3.amazonaws.com/LPI\\_Report\\_2016.pdf](https://wb-lpi-media.s3.amazonaws.com/LPI_Report_2016.pdf).

lems in order to create a business-friendly environment both in regulatory and physical terms.

Ukraine faces the challenge of how to combine leadership in reforms with public consultations. The Ukrainian government has yet to develop a proper system of public input, although formally such a system is already in place. The problem is how to make dialogue productive, representative, and timely. Despite the apparent simplicity of this idea, international experience has proven more than once that “it is only in a limited number of cases that there is a realistic prospect for putting together a consultative process (let alone a process that actually drafts the programme and designs the conditionality) that can make any claim to being representative of the interests, wishes, and views of the majority of the country’s population.”<sup>22</sup>

A realistic assessment of the perspective for Ukrainian reforms also requires adequate understanding of political and economic risks.<sup>23</sup> Eight are particularly important:

First, there is the risk of suspending cooperation with the IMF. IMF conditionality serves as the anchor for reform, while the IMF and other IMF-related funds are the principal source of financing the current account deficit until Ukraine regains access to international private capital markets.

Second is the risk of reform fatigue. Public frustration with the speed and results of the reforms carries the danger of non-democratic revenge, the rise of “traditional” and “patriotic” populism, and the loss of some reform results gained so far.

Third are financial risks. The failure of the banks to fully implement capitalization programs will undermine prospects of securing financial stability in the medium run.

Fourth, there are external political risks associated with changes in the domestic political agenda of donor countries, and attempts to decouple “economic” support of Ukraine from political pressure upon Russia. In pure economic terms, low rates of economic growth by Ukraine’s major trading partners could endanger Ukraine’s own economic recovery and growth prospects. There are also a number of economic and political risks associated with current isolationist trends in the world.

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<sup>22</sup> Buiters, *op. cit.*, p. 225.

<sup>23</sup> For a recent detailed overview of economic risks see НБУ. Звіт про фінансову стабільність, Випуск 2, грудень 2016, <https://bank.gov.ua/doccatalog/document?id=40819104>.

The escalation of Russian aggression against Ukraine poses the major political and security risk, and its mitigation critically depends upon the nature of actions taken by the international community. At the same time, virtually all risks related to economic cooperation with Russia have already materialized.

There is also major internal political risk associated with the political crisis in the country, accompanied by massive social unrest. This crisis will negatively affect efforts by civil society to promote reforms and monitor their implementation.

Seventh is the risk of corruption. Failure to launch a full-fledged anti-corruption policy and demonstrate tangible results will result in public frustration, slowing reforms and damaging the willingness of international community to support Ukraine's reform efforts.

Finally, there is the risk that the reforms of the judiciary and the public prosecutor's office will stall. These reforms are crucial to ensure that the rule of law prevails in the country at large and that it is seen as playing an indispensable role in fighting corruption. A corrupted judiciary cannot try corrupted persons.

## **Conclusion**

Ukraine has already undertaken a number of surprisingly impressive steps in the right direction. Today the country has to achieve a real breakthrough in reforms and make them irreversible. In other words, the point of no return has to be passed.

Economic reform in Ukraine must succeed. For Ukraine it will mean that the country is mature enough to finally emerge from the post-Soviet zone. The failure to ensure the success of reforms within a relatively short period of time possible will put at stake the entire country's democratic and developmental perspectives. For Western partners, it will mean that universal democratic and economic values are indispensable foundations of economic prosperity. Though it is Ukraine's responsibility to achieve success, its failure would have quite a substantial negative demonstration effect for other countries as they struggle to find the most appropriate model for their own political and economic development.