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"A nation must think before it acts." - Robert Strausz-Hupé

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ECONOMIC REFORM IS KEY TO UKRAINE'S FUTURE

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Last week's ceasefire negotiations in Minsk by Ukraine, Russia, Germany, and France have dominated headlines, but a different piece of news will be more significant for Ukraine in the long term. On February 12, the International Monetary Fund (IMF) announced a new financial support program for Ukraine. In addition to ensuring that Ukraine avoids bankruptcy, the deal also commits Ukraine to an array of economic reform measures that will stress its political system in the short run, but will improve the county's long-term economic prospects.

No one doubts that Ukraine desperately needed additional funding. The country had received an IMF bailout in 2014, but the Russian-backed separatist uprising in the country's eastern provinces dragged the economy further down, and necessitated additional aid. Ukraine's President Petro Poroshenko estimates that the war costs the government $8 million per day, and the economy has been hit by a sharp drop in production in areas where the war interrupted business. Ukraine's industrial production shrank by 17% in 2014, and its currency, the hryvnia, is worth less than a third of what it was twelve months ago. As its foreign exchange reserves declined during the early weeks of 2015, Ukraine faced a real chance of literally running out of money.

The new IMF deal is therefore crucial for the country's economy. The agreement has two main aims. The first is to improve Ukraine's ability to service its debt in the short and medium term. The second aim is to make Ukraine's economy more likely to grow in the long run. The IMF had pledged about $17 billion as part of a $27 billion package in April 2014 to support Ukraine's economy—but that was before the war in Eastern Ukraine dragged the country into a recession that was far deeper than expected.

1. Restructuring Ukraine's Debt

The IMF's new rescue package promises $40 billion in international funding for Ukraine over the next four years. That figure includes $17 billion from the 2014 deal that had not yet been disbursed, but the remainder of the assistance – around $23 billion – is from new commitments. $10 billion will come from new funding, half from the IMF and half from loans from the US, EU, and other donors. The bulk of the new 'assistance' for Ukraine comes from the private sector. With the IMF's support, Ukraine will restructure its sovereign debt this year, seeking to reduce its debt payments by around $12-13 billion over the four years of the IMF program.

The specifics of the debt restructuring have not yet been announced, but Kyiv will probably seek to extend the duration of its debt and to reduce interest payments. This is good news for Ukraine's economy, because it will let the government spend scarce resources on more productive uses, and because the country is less likely to be punished with punitive interest rates when it seeks to borrow again from international financial markets. Much of the country's debt was run up under the government of former President Viktor Yanukovych, whose rampant corruption sparked the Euromaidan protests of 2013 and 2014. Given that Ukraine is striving to cast off the corrupt system that the Yanukovych-era debt funded, there is little sense in adding to the country's suffering to repay it.

Kyiv should push for a steep reduction in the value of its outstanding debt, because the country faces little downside to restructuring. The West should welcome sharp debt cuts as a cost-free way of putting Ukraine back on a sustainable path. Debt restructuring will not, of course, be cost free to the financial institutions who own the country's bonds. Most at risk is Franklin Templeton, an American mutual fund firm that has accumulated $7 billion of Ukraine's debt. That is bad news for these funds' investors, but it is unlikely to dissuade Kyiv from pushing for a serious restructuring.

The most complicated facet of Ukraine's sovereign debt is $3 billion the country owes to Russia. When ex-President Yanukovych was still in power, the Kremlin promised him $15 billion if he refused to sign a trade agreement with the EU, and agreed to orient his country toward Russia instead. Only $3 billion of that loan was delivered before Yanukovych fled the country, but it has proved toxic for the Ukraine's debt management. The loan was written with a provision that allows Russia to demand early repayment of the loan if Ukraine's debt-to-GDP ratio exceeds 60%. Russia's Finance Minister Anton Siluanov has repeatedly insisted both that Ukraine is in violation of its covenants and that Russia demands to be paid in full when the loan comes due in December. It is unclear whether last week's ceasefire negotiations in Minsk also included a yet-undisclosed deal regarding the debt Ukraine owes to Russia, or whether this will remain a sticking point.

2. Restructuring Ukraine's Economy

New IMF funding and the debt restructuring should give Kyiv some short term breathing space. But most of the country's economic problems have long-term roots. The country's system of governance is a mess, failing to provide quality public goods such as health care and education while distributing public funds to politically privileged groups. IMF funding is conditional on Ukraine's ability to begin reforming its public finances and improving governance. The mostly commonly discussed policy changes would boost productivity and cut waste in the long run, but they may prove politically challenging in the short term.

Ukraine faces challenges in a number of key areas:

a) *Energy*: The country's energy market has long been a main source of corruption. Regulation keeps domestic energy prices low, often a tenth of the price of natural gas on international markets. This creates two problems. First, Ukraine's consumers and industries use far more gas than they otherwise would, since they don't face the full price of their energy consumption. Since Ukraine's government pays the difference between domestic and international prices, high consumption levels stress the government's budget.

More damaging, however, is that the steep difference between domestic and international prices fuels corruption. Corrupt businesses seek to buy gas at domestic prices and sell it abroad at ten times the rate. Given Ukraine's weak rule of law, the government has failed to eliminate this arbitrage trade, which has enriched some of Ukraine's most nefarious oligarchs.

Ukraine has already begun raising domestic gas prices, and has committed to further price hikes before receiving further IMF funding. It needs to go far further. The oligarchs who benefit from corrupt gas deals, however, can be expected to stonewall efforts at reform. At the same time, Ukrainian consumers may balk at price hikes if they are not well explained and coupled with support for low-income Ukrainians. However, in the past year, other middle-income countries such Indonesia and Morocco have succeeded in cutting energy subsidies. This suggests that with the right structure and communication, energy subsidies can eliminated in a politically consensual manner.

b) *The Budget*: Public spending as a share of GDP is higher than many comparable countries in Eastern Europe, but the crucial question is how public funds are spent. Here Ukraine performs poorly. Many social programs such as pensions disproportionately benefit wealthier Ukrainians. In the medium term, keeping the deficit under control is a necessity, but the main focus should be on redirecting public spending toward productive investments.

c) *Governance*: Ukraine's government does too many things, and does most of them badly. In crucial areas such as health and education, it has failed to provide quality services to the majority of the population. In the health system, for example, quality in many areas remains abysmal and many people only receive treatment by paying bribes. Health and education are not only morally important, they are also crucial if Ukraine's workforce is to increase its productivity and earn higher wages. Sorting out social services is thus a crucial aspect of the country's economic reform efforts.

While Ukraine seeks to improve the quality of social services, it should cut back in areas where it provides little value. Business regulation, for example, is widely recognized to be exceptionally onerous while providing only mediocre benefits in terms of consumer protection. Ukraine rates 96th on the World Bank's doing business survey, suggesting that it could do much to streamline regulation. Many Ukrainians point to Mikheil Saakashvili's government in Georgia as an example of how to reform. Saakashvili's legacy is mixed, but some of his economic policies—such as abolishing customs tariffs that raised almost no revenue but which obstructed trade and fueled corruption—would be worth considering in Ukraine, too.

d) *Corruption*: Ukraine's most difficult set of reforms will be to reduce corruption in the government and in the judiciary. Nearly all Ukrainians agree that fighting corruption is key to the country's success, but there is little agreement about how to reduce bribe-taking. Efforts thus far have focused on setting up an anti-corruption watchdog and on lustration—the process of removing officials associated with corruption from office. Both of these are useful efforts, but everything depends on implementation.

With regard to the new anti-corruption authority, the key question is whether it will have funding and political backing to root out high level corruption, and whether courts will convict corrupt officials. Lustration, meanwhile, risks turning into a technique for letting officials purge their enemies. In both instances, efforts to strengthen Ukraine's civil society are key, since the country's crusading journalists and activists represent a crucial tool for keeping government honest.

e) *Oligarchs*: Like many countries suffering from the legacy of the Soviet economy, Ukraine has long been plagued by a caste of oligarchs whose pursuit of wealth—often through scarcely disguised theft—has corrupted the country's politics and economy. Though the Maidan movement cleansed Ukraine of some of the worst abuses, especially those associated with figures close to the Yanukovych family, oligarchs remain immensely powerful. Some have used the war with Russia to increase their influence. Most dangerous is Igor Kolomoisky, the Dnipropetrovsk-based businessman who has funded efforts to contain Russian-backed separatists. Because Kolomoisky has played a crucial role in defending Ukraine, the government in Kyiv relies on his support and is unlikely to push back if he demands special privileges in expanding his business empire. Oligarchs such as Kolomoisky have also been alleged to fund extremist political movements that taint Ukrainian politics.

Containing the oligarchs is a crucial component of economic reform. The Maidan movement and the chaos of the war called into question many oligarchic networks, but if they are allowed to reconstitute themselves it will not only corrupt Ukraine's politics, it will also reduce the government's ability to provide a level playing field that is crucial for long term growth. One crucial tool in reducing the oligarchs' influence is to cut back on the regulations and bureaucracies that they exploit. The vast gap between domestic and international gas prices, for example, has enriched many if not most of Ukraine's oligarchs. Closing these loopholes would force the oligarchs to become 'normal businessmen' and to make money by improving the efficiency of their businesses and providing useful goods and services.

In addition to economic reform, however, containing the oligarchs will also require political will. Ukraine's newly awoken civil society is keeping a close eye on links between business and government, but the West could help too. In 2014 the US indicted Dmitryo Firtash, an influential oligarch, on corruption charges. It should not hesitate to bring charges against other oligarchs too. Western governments should support transparency efforts in Ukraine, both by helping to fund Ukrainian groups that investigate corruption, and by sharing information about potentially corrupt activities.

Indeed, the West should realize that it has been complicit in much of the corruption that takes place in Ukraine, because oligarchs have stashed their ill-gotten wealth in European cities such as London and Vienna. Western countries should consider how to reduce the ability of Ukrainians to hide corruptly-obtained wealth.

3. Putting Economic Reform at the Center

In recent weeks, debate about Ukraine has focused on whether the West should help arm Ukraine. The military aspects of the crisis cannot be ignored—this is, after all, a war—but they are only part of the issue. Regardless of where the border between Ukraine and the separatists eventually settles, economic questions will be crucial to determining how and whether Ukraine achieves peace.

Reducing corruption in Ukraine also threatens the tools that Russia has long used to maintain influence in the country. Moscow has close relations with many of Ukraine's oligarchs and some of its gas deals with Ukraine appear to have been structured to help enrich oligarchs. That benefits Russia because it gives Ukraine's oligarchs a strong financial incentive to heed Moscow's political line in exchange for support in pilfering Ukraine via crooked gas deals. Energy price reforms would eliminate one of the Kremlin's most powerful levers of influencing Ukrainian politics.

Indeed, corruption in Ukraine should not be seen simply as a Soviet legacy. Some corruption, especially at the lower levels was inevitable, and is visible across the post-Soviet space. But many of Ukraine's most odious fortunes in the energy business have been made with Russia's connivance. Cutting corruption, economic reform, and Ukrainian sovereignty are all interlinked. It would be especially tragic if Ukraine's partial successes in defending itself on the battlefield were undermined by continued economic chaos and corruption at home.