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10 Steps Ukraine Should Take Toward Reform

By Anders Aslund

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Ukraine has just gone through orderly and democratic presidential elections, and a new government has been formed. The big question today is whether the new government will carry out badly needed market reforms.

Ukraine has established an open market economy with predominantly private ownership. From 2000 to 2007, the country enjoyed an average economic growth of 7.5 percent, but last year, its gross domestic product slumped by 15 percent. Economically, Ukraine is not performing up to its potential. In 2009, the International Monetary Fund assessed Ukraine's per capita gross domestic product at only $2,540, placing it 110th in the world. (To compare, Russia ranks 54th on the IMF list with a per capita GDP of $8,874.)

The main problem is that Ukraine is a relative laggard among the post-Soviet countries in economic and institutional reforms. For one, it never experienced the types of fundamental reforms that were carried out in Russia in the early 1990s by liberal economist Yegor Gaidar.

The World Bank's Doing Business index ranks Ukraine in the shockingly low 142nd spot out of 183 countries by business environment. Similarly, Transparency International ranks Ukraine 146th out of 180 countries on its 2009 corruption perception index, on the same level as Russia.

To date, Ukraine has experienced two waves of substantial reform. The first wave started in the last quarter of 1994, after Leonid Kuchma was elected president. The second wave was in the first quarter of 2000, when Kuchma was re-elected and Viktor Yushchenko became prime minister. These reforms occurred immediately after a presidential election and in the midst of an economic crisis.

Today, Ukraine finds itself once again in this situation. The combination of a new presidential mandate, a recent severe economic crisis, mass discontent among the people and the early formation of a new government creates ideal conditions for successful reforms. The Independent International Expert Commission, which I co-chaired, submitted a program in early February titled "Proposals for Ukraine: 2010 — Time for Reforms" to help guide the next president.

The commission believes that Ukraine's top 10 priorities for 2010 should be:

1. Carry out gas reform

2. Make the central bank more independent

3. Move toward inflation targeting

4. Cut public expenditures

5. Deregulate enterprises

6. Conclude a European Union Association Agreement to strengthen political, trade, social, cultural and security ties between Ukraine and the EU

7. Return to privatizing state enterprises

8. Legalize private sales of agricultural land

9. Adopt a law on public information

10. Complete the new, post-Soviet commercial legislation

Ukraine benefits from a broad policy consensus, but actual policymaking often ends up in gridlock. Therefore, the commission's third conclusion was that Ukraine needs to use its international leverage or external guidance to break through the domestic logjam. Three anchors can guide Ukraine to realize its commitment to reforms: The IMF, the EU and the World Bank. All these organizations are ready to engage with the new Ukrainian administration.

The top priority is to reform the gas sector. At present, Ukraine is subsidizing imported Russian gas by almost 3 percent of GDP a year. This must stop. The government needs to adopt a realistic energy pricing policy, bringing all energy prices to the level of full cost recovery. The new government claims that it can negotiate a lower gas price with Russia, which would make sense since European gas prices have fallen sharply. Higher energy prices would prompt enormous energy saving and reduce the massive corruption in the energy sector. The new government has also committed itself to privatization of the four remaining state-owned power-generating companies in 2010.

Like Russia, Ukraine should move toward inflation targeting within the next three years, which presupposes a floating exchange rate. The transition period should offer the central bank enough room to bring down inflation to the 2 percent to 3 percent range and provide guidance to the public on the future development of the exchange rate, as well as foster a reduction of dollarization. With inflation falling precipitously and an already realistic exchange rate, this should be relatively easy to accomplish now.

Last year, the IMF assessed that Ukraine's budget deficit was 9 percent of GDP without bank recapitalization costs. Ukraine needs to balance its state budget in the medium term by cutting public expenditures. State revenues remain surprisingly large, so it would be both unrealistic and harmful to try to increase their level further. Three public expenditures stand out as excessive: energy price subsidies, discretionary enterprise subsidies and pension expenditures. Price subsidies and enterprise subsidies should be minimized. Ukraine spends no less than 16 percent of GDP on public pensions, about twice as much as in Western Europe, mainly because of extensive early retirement. Extensive pension reform is needed.

Both economist Irina Akimova, who is first deputy head of the presidential administration and Sergei Tigipko, former head of the central bank who was recently appointed as deputy prime minister for economic reform, have committed themselves to an early and radical deregulation of the business environment. It must become much easier to start and close a business, to acquire construction permits, licenses and permits and to pursue foreign trade. Tigipko has called for the abolition of half of the 86 inspection agencies. The state's interaction with private enterprises needs to be reduced and simplified.

All these measures are vital and can be implemented within one year. The IMF will play a central role in implementing the gas reform and the macroeconomic policies in return for a two-year standby agreement with substantial financing. The EU is currently negotiating a substantial association agreement, including a comprehensive free trade agreement. The EU is also deeply involved in reforming the gas sector, a project that the United States and the World Bank are deeply committed to.

Akimova's reform committee has taken the bull by the horns, launching no less than seven working groups on the key reform issues. Each of the groups is led by an official with ministerial rank and have been ordered to complete their work within 60 days. This is a very promising start.

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