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Inside Ukraine

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News of the Month

The transition of power is over

The transition of power after a presidential run-off about five weeks ago is over in Ukraine. Although former Premier Yulia Tymoshenko initially refused to recognize the victory of her rival, Viktor Yanukovych, it was a peaceful transition. As the third peaceful transition of power in Ukraine, the country's democratic achievements—rare among FSU countries—merits applause.

The executive now stands consolidated with President Viktor Yanukovych and Premier Mykola Azarov from the same party and supported by a majority in the Verkhovna Rada that is both pro-presidential and pro-Cabinet. This fact alone should improve the government's ability to reach decisions and to implement them, which will greatly improve Ukraine's short-term prospects.

Financial markets have reacted positively both in Ukraine and abroad to the swift transition:

- Risk premiums paid on external Ukraine's sovereign debt went down.
- Ukraine's stock market has gained 47% since the beginning of the year, one of the best results for world stock markets.[1]
- Credit ratings, both sovereign and some corporate, improved slightly.

However, the short-term benefits of the fast transition are counter-balanced by the lack of long-term stability in the current power set-up. The postponement of local elections, breaking the rules in cobbling a coalition, and the public uproar over some appointments are all factors that will undermine the long-term stability of the current Government, leaving the threat of a snap Rada election in the air.

[1] http://www.businessweek.com/news/2010-03-15/ukraine-stocks-climb-to-highest-since-june-2008-on-imf-budget.html

Coalition building: Mission complete

On 2 March, Speaker Volodymyr Lytvyn dissolved the "democratic coalition," as it failed to provide enough deputy signatures. The next day, the VR passed a vote of non-confidence in the Tymoshenko Government.

After a week of fruitless negotiations among factions, it became clear that neither BYT nor NU-NS, the second and third largest factions in the legislature, would join a coalition with Party of the Regions. But with individual members of each faction willing to consider such a coalition, the situational majority amended the VR Regulations to allow a coalition to be made not only of factions, as required by the Constitution, but also of individual deputies[2].

The "Stability and Reform" coalition was formed on 11 March, consisting of 235 deputies: the Party of the Regions (PR), Communist Party (CPU) and Volodymyr Lytvyn Bloc (VLB) factions in their entirety, plus 16 deputies who crossed the aisle—six each from BYT and NU-NS, and four others who had left these factions earlier.

Deputies from both ruling and opposition factions have requested the Constitutional Court of Ukraine to rule on the legitimacy of the new coalition. The President pledged to call snap elections should the Court recognize that the coalition-building approach violated the Constitution.

Moreover, the new coalition still has not proved its decision-making capacity, as there have so far been no votes on bills that might be divisive.

[2] Legislation states that a deputy, who leaves the faction should lose the mandate. However, voting against the faction is permitted. It is unclear why BYT and NUNS faction do not insist on implementation of this norm.

Silence of the oppositions

After the fall of her Government, Ms. Tymoshenko went into opposition and on 16 March, the three BYT bloc parties and the five NU-NS bloc parties signed an agreement to establish an official opposition. Since Yulia Tymoshenko is not a sitting deputy, she became head of the opposition's coordinating council and made Serhiy Sobolev, a BYT leader, premier in the shadow Cabinet.

Other groups within NU-NS announced that they would form "alternative" oppositions. After talks with Viktor Yanukovych about his possible role in a pro-presidential government went nowhere, Arseniy Yatseniuk, the third runner-up in the Presidential race, declared that in a matter of weeks he would present his own shadow Cabinet. Another NU-NS group Za Ukrainu led by Viacheslav Kyrylenko apparently has no intention of joining any of the opposition groups, remaining in a political limbo.

So far, no actions by the President or Government action has caused major opposition comment.

Appointments

Not only did the President manage to secure a PR-led coalition in the legislature, but he also had his close ally appointed as Premier. Mykola Azarov, a former tax czar, First Deputy Premier and Minister of Finance in both Yanukovych Governments, is a technocrat who will have to make a great number of unpopular decisions. This appointment brought a long-awaited end to the standoff and confrontation between President and Premier in Ukraine. Serhiy Liovochkin was appointed Chief-of-Staff in the Presidential Administration.

The new Cabinet of Ministers has a number of ministers with interests in big business. Andriy Kliuyev became First Deputy Premier, Borys Kolesnikov was appointed Deputy Premier for EURO-2012 preparations, and Yuriy Boyko is now Minister of Fuel and Energy. Somewhat unexpectedly, Serhiy Tihipko, who was second runner-up in the Presidential election, took up his new position as Deputy Premier for the economy. He did that not only to the contrary to his previous statements, but also agreed to a mandate with little capacity to implement his agenda.

Despite the seeming consolidation of the executive branch, some appointments could lead to competition between Presidential Administration and the Cabinet of Ministers, though to a lesser degree compared to what happened under Viktor Yushchenko. Moreover, there are different business groups and interests represented within the Cabinet of Ministers itself.

Kostiantyn Hryshchenko, a former Ambassador to the US and to Russia, is now Minister of foreign affairs and Mykhailo Yezhel, a former Navy Admiral, is Minister of Defense, the two positions directly appointed by the President. The appointment of Dmytro Tabachnyk, who has been criticized for his views of Ukraine's history and for remarks about Ukrainians from Western Ukraine, as Minister of Education and Science created a national uproar.

Other important appointments include those of billionaire Valeriy Khoroshkovsky as chief of the SBU, the state security service, and Yevhen Bakulin as president of NAK Naftogaz, Ukraine's natural gas monopoly.

Governors have already been changed in 17 oblasts. Both the Speaker and the Premier of Crimea were also changed. The bosses of law enforcement agencies in many regions were replaced by representatives from Donetsk Oblast.

Like the 2006 Yanukovych government, the 2010 Azarov government has only men. However, some key positions in the Yanukovych Administration have been filled by women from PR, including: Iryna Akimova, First Deputy Chief-of-Staff and President's Representative in the Cabinet of Ministers; Olena Lukash, First Deputy Chief-of-Staff and President's Representative in the Constitutional Court; and Hanna Herman, Deputy Chief-of-Staff.

Visits West and East

President Yanukovych's first official trip was to Brussels on 1 March. Mr. Viktor Yanukovych succeeded in showing himself as a European politician and a potentially reliable partner for the EU. The President of the European Commission pledged to conclude the EU-Ukraine Association Agreement, provide macro-financial assistance, and introduce visa-free travel for Ukrainians. President Yanukovych confirmed the country's goal to deepen political and economic cooperation with the EU.

On 5 March, Mr. Yanukovych made his first official visit to Moscow. The Moscow trip lacked much of a working agenda, compared to Brussels, because of the long decline in relations between Ukraine and Russia. Russian Federation President Dmitri Medvedev promised to revive the interstate bilateral commission, promote cooperation in energy and economic areas, and support the Ukrainian diaspora in Russia. It is likely that more specific points in Ukraine-Russia relations will be decided at the level of Premiers, between Mykola Azarov and Vladimir Putin.

In both capitals, Viktor Yanukovych assured his hosts that he would seek pragmatic, neighborly relations with them, and, thus, launched his multi-vector foreign policy.

Testing President Yanukovych and his new team

European Choice. Although President Yanukovych's first foreign trip was to Brussels where he said that European integration was a key priority in Ukraine's foreign policy, he also added that Ukraine's other priority was to enhance relations with Russia. Moreover, there is not a single word about European integration in the new coalition agreement, while there is a paragraph on strengthening mechanisms for bilateral relations with the Russian Federation and a paragraph on economic integration in the post-Soviet arena based on Ukraine's national interests. The post of Deputy Premier for European Integration was dropped and the Cabinet Committee on European Integration and International Co-operation shut down. European integration is now the purview of Deputy Premier for the Economy Serhiy Tihipko.

Democracy. Enabling individual VR deputies to enter the coalition dealt a serious blow to the core of representative democracy in Ukraine, since deputies receive their mandate on the basis of proportional representation in Ukraine. However, President Yanukovych pledged to respect any decision of the Constitutional Court and to call a snap VR election if the coalition is ruled unconstitutional..

Rule of Law. Despite a 2008 official ruling by the Constitutional Court of Art. 83 of the Constitution of Ukraine about coalitions of factions, President Yanukovych signed a law amending the VR regulations to allow a coalition to be formed by individual deputies, rather than by factions alone. While this move was largely contrived in the name of stability, it sets a clear precedent for further disregard for the Constitution. The forthcoming ruling by the Constitutional Court should make clear what can be expected further.

Human Rights. In addition to the fact that there is not a single woman among 29 ministers in the Cabinet, Premier Azarov also stated publicly that it was "not women's business to implement reforms" in Ukraine. This remark from a top government official caused outrage among human rights organizations in Ukraine and accusations of gender discrimination. Premier Azarov, not known for his refined speech, later claimed that his words had been distorted.

Fighting Corruption. Among his first decrees, President Yanukovych established a National Anti-Corruption Committee. As strongly recommended by international organizations, President Yanukovych vetoed the law on state procurements, which was criticized for containing loopholes that would allow corruption by concentrating all state procurement functions in the hands of the Economy Minister. Premier Azarov also declared eliminating corruption as his priority and pointed out that a system without corruption could be established by following a "one-stop shop" principle for state registration of commercial activity, transparent state purchases, and the allocation of land. But just before the new Cabinet was appointed, the Verkhovna Rada again postponed the coming into force until 2011 of an entire range of anti-corruption laws adopted in June 2009.

Civil Service Reform. So far, President Yanukovych's efforts in this area have amounted to reducing the number of staff in his Administration and spending on the government machine. He also gave hope in one of his speeches by stating public administration needed to be reformed in Ukraine.

Judicial Reform. In March, President Yanukovych set up a Committee on judicial reform and the justice system within his Administration and put together a working group on judiciary reform. Chaired by Minister of Justice Oleksandr Lavrynovych, the group must submit its proposals by the end of April. However, critics warn that these efforts are only superficially aimed at an independent and efficient judicial branch, which will be simply yet another battlefield for the redistribution of powers, including cutting those of the Supreme Court of Ukraine.

Issue of the Month

From short-term risks to medium-term tasks

Burning roof or rotting basement?

When the roof of a house is burning and its basement is rotting, the best advice would be to extinguish the fire first and then tackle the basement. Ukraine is in a similar situation. Short-term risks generated by the fiscal gap have become too high and require the Government's immediate attention. These short-term risks can be dealt with using a series of stop-gap solutions that can be implemented in a few months.

Apart from dealing with such emergencies, Ukraine also needs a more strategic reform effort addressing the fundamentals of its future development. Strategic reforms will require much more effort, preparation and resolve than the stop-gap efforts needed to handle the challenges of today.

Ukraine's current situation requires a decisive government that should not care much about its immediate popularity. It would be better to concentrate on the next 12 months, as conditions make planning for a longer term meaningless. However, the government cannot afford a poor communications policy. Both its short-term and medium-term actions will need to be carefully explained to the public to be truly successful.

Ukraine needs one to two years to put its economy back on track. The window of opportunity for reforms is open right now for several reasons: the next Presidential election is five years off, voters are ready for change, the government is consolidated, and has declared its readiness to satisfy demands for reform from international financial institutions (IFIs).

The tasks are clear, the opportunity to implement them is there, and the risks of not stepping through the open door considerable. Other than the reforms of the Yushchenko Government in 1999-2000 and the half-baked Constitutional "reform" of 2004, Ukraine has not seen much in the way of reforms in the last decade. Officials keep paying lip-service to the reform agenda and making promises to western partners, who have spent millions of dollars on reform advice to Ukraine that has come at regular intervals but never been followed.

There is a risk that only superficial remedies will be applied to the current short-term problems Ukraine is facing. The reasons for Ukraine's problems today are rooted, not in the world economic crisis, but in Ukraine's malfunctioning institutions. For more structural solutions to take place, careful and honest analysis is necessary of why the ample advice and requests for reforms of the past nine years have fallen on deaf ears among Ukraine's policymakers.

Unfortunately, Ukrainian officials were further let off the hook by the West in 2009. They discovered that the IMF could step into the breach and finance a Budget deficit with no severe repercussions when Ukraine violated the conditions of the loan.

Any success in this coming year will have to be planted in this coming month. The Government has to show that it is ready to do more than hastily put out fires and to step up with a set of proactive reform measures. Also, a credible plan needs to be proposed for streamlining Ukraine's bloated public sector as part of any proposed reform agenda.

The Government has pledged to be professional, but it remains to be seen if it will adopt the approach necessary to implement changes under a democracy and market economy. IFIs will have to stand firm and require performance first to deliver rewards later. These preconditions seem vital for Ukraine to fast-track to a better development trajectory.

Step 1: Extinguish the burning roof

The main question facing the Government now is definitely not massive and strategic structural reforms. The questions for March are: (1) how to revise the 2010 Budget and reduce the deficit and (2) where to find the money to finance the fiscal gap in a non-inflationary manner.

Carrots for an unpleasant job

The 2010 Budget will be crucial in luring the IMF back into the country with its frozen tranche of US $3.8bn. The EU is ready to give Ukraine almost 610mn if the country reaches a new agreement with the IMF. The World Bank and other IFIs are waiting for the green light from IMF to restore their programs with Ukraine as well. This, in turn, means restoring the confidence of private investors and lenders and easier access for Ukraine to money on international credit markets.

Restoring shaken confidence in Ukraine's macroeconomic stability will not be easy. It will mean stabilizing public finances, curbing inflation and increasing efforts at stabilizing the banking industry. To achieve this, the Government will have to undertake stop-gap measures in a variety of sensitive areas.

The IMF mission arrived in Kyiv on 23 March and immediately started the negotiations on restoring co-operation with Ukraine. Premier Azarov said that he was interested in either restoring the previous program or starting a new multi-year program to support Ukrainian reforms. It is expected that a decision will be passed by the IMF after it reviews the draft 2010 Budget.

Mend those public coffers!

In 2009, Ukraine's Government undertook massive borrowing at high interest rates to maintain the level of spending of the boom years. Public debt soared from 19.9% of GDP in 2008 to 33% in 2009. This level is still within a tolerable range, compared to other CEE countries, but the idea of financing regular Budget commitments with incessant borrowing must be abandoned.

Government officials have so far been reluctant to speak about public spending cuts. The populist Law "On raising social standards," adopted in the heat of the Presidential race will cost an additional UAH 24-28bn, which Deputy Premier for the Economy Serhiy Tihipko insists "will be in the 2010 Budget."[3] But the IMF had demanded of the previous President, Viktor Yushchenko, that he veto the bill.

The IMF has asked Ukraine's Government to keep the deficit under 4% in 2010. "We had a deficit of almost 12% of GDP last year, so to run a deficit of 4% this year will be impossible," says Iryna Akimova, First Deputy Chief-of-Staff. The government will most likely settle for a compromise on fiscal gap targets.

Mildly positive economic outlook for 2010

Item	Consensus forecast	Gov't estimates
GDP growth, y-o-y	3.5%-4%	3.7%
Inflation (CPI av y-o-y)	13.3%	13.1%
Budget deficit/GDP	4.4%-9.8%	4.5%-5.0%[4]
Public debt/GDP[5]	36%	?

An improving economic outlook could, unfortunately, relax Ukraine's public officials. The hryvnia has stabilized and the National Bank of Ukraine (NBU) started to buy up currency on forex markets. The recent 60% depreciation of the hryvnia and recovery on external markets for Ukraine's commodities have improved the country's overall growth outlook. Ukraine is slowly getting its international creditworthiness back. The banking system is not nearly as unbalanced as in 2009 after the Government's recapitalization drive, capital injections by foreign banks into their Ukrainian subsidiaries, and the recovery of deposit inflows.

This picture may be comforting, but the foundation is still too wobbly to depend on. The main risk factor now is Ukraine's fiscal gap. Hard decisions around

[3] http://www.interfax.com.ua/rus/eco/34207

[4] Excluding transfers to NAK Naftogaz.

[5] Raiffeisen Bank Aval, Monthly Economic and Risks Monitoring Review for March 2010.

public spending adjustments that were put off during the Presidential election are still waiting to be made.

O where, o where has my wee pension gone?

Ukraine is suffering from steep growth in pensions. Pension Fund expenditures grew from 9% of GDP in 2003 to 16% by the end of 2008, one of the highest pension spending ratios in the world, according to the OECD.[6]

World Bank in its suggested reform agenda for Ukraine[7] notes that Ukraine's current pension system is "unsustainable" in the long-term. If demographic trends remain as they are, by 2055 there will be 1.43 pensioners for every worker contributing to the system.

Yet serious risks are not that far away. The Pension Fund already runs short of cash in its day-to-day operations, which causes it to siphon money from public coffers. On 19 March, the State Budget transferred UAH 1bn as a loan to the Pension Fund.[8] The Ministry of Finance promises that pension payments will be according to a schedule from now on, but just how credible are such promises?

Ukraine's pension system must be rapidly rebalanced by:

- Abandoning the system of "special and privileged" pensions, a move that will require lawmakers to vote cuts to their own absurdly generous pensions.
- Indexing pensions only against inflation and not against levels promised in the heat of the recent Presidential campaign.
- Raising the retirement age, currently at 55 for women and 60 for men.
- Capping pensions for pensioners who are still drawing salaries, as well as capping pensions in absolute terms rather than calculating them as a multiple of the subsistence minimum.

"Gas attacks" on the public purse

Yushchenko-Tymoshenko reforms in 1999-2000 improved the situation in the gas sector considerably. Payment discipline grew, rates started to approach cost-covering levels. And the quasi-fiscal deficit—the hidden subsidies to consumers at the expense of state enterprises—started to dwindle.

Starting in 2006, however, the situation began to deteriorate again. Steeply rising prices for gas imported from Russia were not passed along to domestic users. NAK Naftogaz, Ukraine's state gas monopoly, which bought imported Russian gas at the new prices and sold it to consumers at a loss, found itself subsidizing consumers at an alarmingly growing rate.

NAK Naftogaz received overall 2.5% of GDP in support from the state to save the company from imminent default in 2009. The NBU began spending its foreign currency reserves to prop up Naftogaz, which was struggling to pay for the Russian gas.

In Q1'10, Naftogaz is scheduled to receive UAH 3bn or around US $375mn to cover losses from inappropriate gas rate policies.[9] With Ukraine among the Top 10 countries for gas consumption in the world, the luxury of hidden gas subsidies is too expensive to be afforded.

Residential gas rates were not revised since 2008. Today, the rates cover about 60% of what the gas actually costs to deliver. The difference simply falls on NAK Naftogaz and is siphoned out of the public purse, one way or another. Not only this situation prone to opacity, but it also increases Ukraine's fiscal gap and negatively affects the economy.

6 Dmitriy Sologoub, "Ukraine: A story of boom and bust".

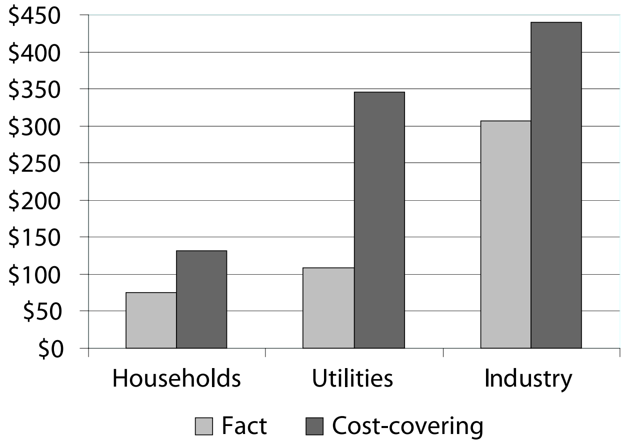
7 Making Ukraine Stronger Post-Crisis, http://siteresources.worldbank.org/INTUKRAINE/News%20and%20Events/22505904/PolicyNotesFinalEng.pdf

8 http://www.minfin.gov.ua/control/uk/publish/article?art_id=244779&cat_id=53608

9 http://ua.bgcapital.ge/en/news/1490/

Actual vs cost-covering[10] gas rates

USD/1,000 cu m



Fortunately, there seems to be consensus on the need to raise both gas and heating rates. World Bank experts recommend an immediate 100% rise in rates, avoiding gradualism as there is no time for incremental improvements anymore.[11] Serhiy Tihipko, Deputy Premier for the economy, also admitted that rates needed to be raised. However, he announced that rates would be raised for the rich, that is, "for those who are able to pay them." At the same time, Deputy Premier Kliuyev noted that if Ukraine set up a gas consortium with Russia, gas rates could remain unchanged.

The critical point of payment discipline is missing in all this discourse. Rates for gas and heating can be raised, but what will happen if people simply stop paying their bills? In January 2010, residential users paid only 69.9% of what they owed for residential services. Arrears for public utilities rose 11.1%[12] in January.

Local elections may become another barrier to raising utility rates. Adjusting heating rates requires unpopular decisions by local councils, a step that they will find difficult to make. World Bank suggests that this barrier could be overcome by setting up a central regulator in the utility sector just for 2010.

The rate policy question lays bare the ineffectiveness of state regulation on monopoly markets. The notion that Ukraine's government should raise gas rates is absurd. Nobody seems to remember that the National Energy Regulation Commission (NERC), an "independent" regulator on the gas and electricity markets, is supposed to automatically adjust rates to costs. But the NERC and other regulators have never managed to overcome their status as an appendage to the Cabinet of Ministers.

Watch out for failing banks!

Ukraine's financial system was saved from collapse in 2009, but it still requires constant attention from policy-makers. Only a handful of banks have honestly acknowledged the level of bad loans in their portfolios. More banks may require recapitalization or begin liquidation procedures in 2010 and Ukrainian Government and the NBU will have to act swiftly to maintain stability in the banking system.

A solution is still to be found for the ailing Nadra Bank, the biggest problem haunting the banking industry now. Nadra has not found an investor so far and the Government is not keen to put public money into this venture. So Nadra continues to malinger, the butt of continuous horror stories in the press.

Instead of moving fast with recapitalization and liquidation, sometimes Ukrainian banks enjoy months and months of "temporary" administration, which decreases the value of their assets and raises suspicions of vested interests and corruption in play.

The Government needs to increase the speed and decisiveness of its actions with problematic banks: they should be either quickly recapitalized or quickly liquidated. The Government should also undertake some measures to reduce the vulnerability of the banking system to vested interests. Ownership of banks should be disclosed and the central bank should be insulated from political influence.

Indeed, the NBU's reputation needs improvement. Rumors around opaque recapitalization policies and suspect interventions on the forex market all have

[10] According to NAK Naftogaz.
[11] http://www.epravda.com.ua/news/4ba8b88e05449/
[12] http://www.ukrstat.gov.ua/express/expr2010/03_10/50.zip

come short of direct accusations, but still this damages the reputation of the country's central bank.

Insulating the National Bank from political influence would contribute greatly to restoring faith in Ukraine's macroeconomic stability. The main step on this road would be to banish politicians from the NBU's Council, central bank supervisory body. This Council consists of 15 members: the NBU Governor, 7 members appointed by the President, and 7 appointed by the Rada. Currently, the chair is Petro Poroshenko, whose term is running out.

Amendments to legislation aimed at depoliticizing the NBU Council recently failed to pass in the Rada.[13] It is hard for politicians themselves to give up their quotas on the Council. Some politicians on the NBU Council are also very closely tied to commercial banks in Ukraine. Eliminating vested interests from the NBU Council is a must to start restoring the independence of Ukraine's central bank.

Taxes: Close loopholes, resist extortion

Tax breaks were increased from 2008 to 2009, with half of the volume lost due to VAT breaks. The new Government has begun to talk about announcing tax holidays on profits for hotels and small businesses.

The Government will have to rethink its tax policies and cancel old while not announcing new breaks. The simplified tax regime should be restricted to small businesses as many enterprises currently use it to reduce their tax burden.

While closing loopholes, the Government should also stop running VAT arrears. Currently, the volume of VAT arrears is around UAH 25bn. The practice of advance tax payments should also be terminated.

Premier Azarov, who originally established Ukraine's tax administration, gave rise to the term *azarovshchyna*, meaning a pushy, arbitrary approach to raising taxes. On one hand, that experience can help increase Budget revenues; on the other, this could push businesses back into the shadow economy.

On 2 March, then-Premier Tymoshenko signed a Cabinet resolution adopting a Plan to bring employee income out of the shadows.[14] Among other things, this plan provides for such measures as monitoring salaries in job ads and comparing them to officially paid salaries. This plan basically risks turning into a tax extortion campaign by the tax authorities and social funds. It is also likely that the burden of this campaign will mainly fall on SMEs.

The Government faces a difficult task. It has to resist two powerful magnets—rents from interest groups and tax loopholes—and the temptation to resort to tax extortion and running VAT arrears.

Step 2: Clean up the rotting basement

Window of opportunity: closing fast

The best time for reforms was last year, when the economic crisis was at its peak. Such times are best for administering radical and even unpopular decisions, as voters are ready for change and interest groups are weakened by the economic decline.

Ukraine's window of opportunity for reforms is closing fast. Local elections loom, the economy shows signs of recovery, and interest groups are eager to get payback for what they invested in the Presidential race.

The cost of wasting the current opportunity will be truly immense. The country is finally stable enough to allow for reforms and voters are still willing to embrace them. Wasting the opportunity to put Ukraine on track for sustainable growth now means losing potential benefits for years and years to come.

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13 http://www.uabanker.net/daily/2010/02/021810_1630.shtml

14 http://news.yurist-online.com/laws/14293/

International rankings: Economic freedom is a must!

Last in the region for economic freedom. Ukraine won political freedoms during the Orange Revolution, but now it needs to conquer the second height, economic freedoms. In the Index of Economic Freedom, Ukraine occupies a shabby 162nd place—between Togo and Liberia—and comes last on the continent.

Corruption dragging development. The country is bogged down in corruption, with public officials perceived as the most corrupt group in Ukrainian society, followed by elected deputies and the judiciary. On the Corruption Perception Index (CPI), Ukraine has plunged from 99th in 2006 to 146th in 2009.

Sustainable growth under doubt. Ukraine's prospects for sustainable economic growth driven by productivity gains are not promising at the moment. In the Global Competitiveness Index (GCI), Ukraine fell from 73rd place in 2007 to 83rd place in 2009. The GCI assesses institutions, policies and factors that determine the level of productivity that, in turn, sets the sustainable current and medium-term levels of economic prosperity.

Where's that rotten smell coming from?

The causes of the current rot in Ukraine's economy are hidden mainly in the bad policy choices the country's leaders opted for during the growth years:

- Based not on growing productivity but on expanding existing capacities and easy credit, economic growth was not made sustainable.
- The governments immediately spent any money generated during the economic boom on consumption rather than invested in infrastructure or created a cushion for a possible recession.
- The vulnerabilities of Ukraine's economy were never addressed: the high dependence on steel exports made the country's economy hostage to external commodity market conditions.

To address these problems, the government needs to be determined to address the roots and not the symptoms of economic problems. Unfortunately, there is a high risk that pretend reforms and half-measures will be the path of the Azarov Government as well, once the most urgent current problems are alleviated.

Successful strategic reforms require the Government to move swiftly and to fulfill at least two conditions: get the priorities right and have the capacity for reform.

Right now, there are many reform proposals on the table, but most of them boil down to four:

- Set up an executive agency to manage reforms.
- Build capacity to implement reforms.
- Redefine state involvement in the economy, such as in the gas sector.
- Get Ukraine on track for sustainable growth.

Who will do the cleaning up?

It is irrational to expect a corrupt and inefficient bureaucracy to reform itself. So there is little alternative but to set up a separate body to manage with reforms. Such a body, the Committee for Reforms, has already been set up, but not under the Cabinet of Ministers as would be expected, but under the Presidential Administration. Moreover, the Committee has so far functioned, not as an executive, but as an advisory body.

Who's in charge of the reforms?

Members of the Committee on Economic Reforms:

Viktor Yanukovych, President and Chair

Mykola Azarov, Premier

Borys Kolesnikov, Deputy Premier

Andriy Kliuyev, First Deputy Premier

Volodymyr Semynozhenko, Deputy Premier

Viktor Slauta, Deputy Premier

Viktor Tikhonov, Deputy Premier

Serhiy Tihipko, Deputy Premier

Kostiantyn Hryshchenko, Minister of Foreign Affairs

Oleksandr Lavrynovych, Minister of Justice of Ukraine

Anatoliy Tolstoukhov, Minister of the Cabinet of Ministers

Serhiy Liovochkin, Presidential Chief-of-Staff

Iryna Akimova, First Deputy Chief-of-Staff, Presidential representative to the Cabinet, Executive Secretary

Olena Lukash, First Deputy Chief-of-Staff, Presidential representative to the Constitutional Court

Hanna Herman, Deputy Chief-of-Staff

Volodymyr Stelmakh, Governor of the National Bank of Ukraine

Mykola Derkach, Chair, VR Budget Committee

Oleksandr Tkachenko, Chair, VR Economic Policy Committee

Valeriy Hayets, Director, Institute of Economics and Forecasting

Valeriy Hladkiy, Director, Bureau for Economic and Social Technologies

Andriy Yermolayev, Director, National Institute of Strategic Studies

Ella Libanova, Director, Institute of Demographics and Social Studies

Dmytro Leonov, Dean, Ukrainian Institute of Stock Market Development

Anatoliy Pavlenko, Dean, Kyiv National Economic University

Ihor Mitiukov, Director, Morgan Stanley Ukraine

President Yanukovych himself chairs the committee. During the first meeting, he set five areas of reform that he sees as priority:[15]

- Focusing on sustainable economic development, positive business climate and investment appeal;
- Updating technologies across the economy and developing infrastructure;

[15] http://www.president.gov.ua/news/16760.html

- Setting suitable conditions for regional development;
- Launching a new level of international integration and economic co-operation;
- Reforming the social sphere.

Right now, these priorities are not enough to determine whether a serious reform plan will be drafted by the Committee. The President has given it 60 days to do so.

Deputy Premier Tihipko is to be the counterpart of the Committee within the Cabinet of Ministers in dealing with issues of sustainable economic development. Mr. Tihipko occupied the very same position in 1997-1999 and resigned at the time, stating that he could not affect the course of events in the Government. It is not very likely that this time anything will drastically change with this same position.

The position of Deputy Premier is horizontal in nature and entails only "political supervision" of the Ministry of Economy and Ministry of Finance. Economy Minister Vasyl Tsushko was previously Minister of Interior in the Yanukovych Government of 2006-2007. Himself an ex-socialist, he occupies the position on the Communist Party quota. Finance Minister Fedir Yaroshenko is known to be loyal to Mr. Azarov and previously headed Tax Administration.

Overall, the new team has stated its intention to undertake reforms. Alas, Ukrainian Governments have become so skilled in the pretense of effort that only actual performance will offer something to evaluate and trust.

Get the state back on track!

For any Government accomplishing a task requires a working state. Ukraine is hardly a failed state, but it is definitely failing in the services it is supposed to deliver to its citizens and its private sector.

Even if the central government comes up with a masterpiece of a plan for deregulation, it is likely to be buried. It could go down in the corridors of power or at the implementation stage in individual agencies and local officials.

Political power, whatever its color, usually loses elections to its opposition, often undermined by the bureaucracy's inability to deliver the improvements in quality of life that voters expect. Despite willingness to engage in reforms, the current team could well underestimate the danger that an unreformed civil service poses to the tasks the politicians hope to accomplish.

President Yanukovych stated in a recent interview[16] that he understands the danger a corrupt civil service poses to his initiatives and stressed that a special anti-corruption bureau armed with brand-new anti-corruption powers will soon be in place. It remains to be seen if this bureau will understand that fighting corruption means removing opportunities for corruption rather than catching and punishing corrupt bureaucrats. The Advisory Anti-Corruption Committee created by Presidential is currently working on the concept for an anti-corruption campaign.

The problem with the public service is its inefficient organization. It is reminiscent of the vertical USSR structure. The only big difference from the Soviet Union is that the chain of command are now linked to strong interest groups.

[16] http://unian.net/ukr/news/news-368121.html

The Constitutional "reform" of 2004—an unhealthy compromise with the Orange Revolution—was one of the reasons why the Orange team failed. Public officials learnt too well how to simulate activity and avoid scrutiny on behalf of politicians.

The new team understands the need to "get the state back on track." They are likely to try to streamline bureaucracy through the soviet method of increasing discipline. These efforts are at high risk of failure: at best, they will lead to temporary high-profile improvements but to a restoration of the status quo in the long term.

Streamlining the judiciary branch is on the priority list of the new Government. A Committee on judiciary reform headed by Justice Minister Lavrynovych has already been set up by the President.[17] The task is of foremost importance for Ukraine, but the effectiveness of this group can only be verified by time.

Without a system of institutionally independent control over the government bureaucracy, all reform efforts risk failing. Just trying to improve politicians' management of the state machine will not be enough. Only a change in the principles underlying the civil service can make it results-oriented and compatible with the reality of democracy and private property.

Redefine the state's role in the economy!

In Ukraine, the state is still far too involved in the economy and that involvement is hardly positive. State monopolies such as railway giant Ukrzaliznytsia, gas monopolist Naftogaz, highway agency Ukravtodor, and fixed-line provider Ukrtelecom were all on the verge of default recently because of problems servicing their debts.

Instead of providing infrastructure and energy services, state monopolies contributed to Ukraine's widening fiscal gap and became a drag on the country's economy. Indeed, these natural monopolies are likely to restrict economic growth in the nearest future as deteriorating infrastructure and lack of high quality energy services create bottlenecks for the growing private sector.

State giants fail not only because of virulent corruption that spreads from the bureaucratic machine. Lack of modern regulation is also to blame. Under the influence of interest groups that control the state monopolies and politicians who don't want to lose rents from these enterprises, Ukraine's regulators have never become properly independent.

Natural gas and other utilities should become the primary focus of reforms, as these sectors continue to rely on the public purse for unjustified support while angering consumers with the low quality of their services.

Increase productivity!

By 2008, Ukraine had recovered from the economic collapse brought on with the breakdown of the Soviet Union. Today, there is no spare production capacity that can demonstrate high growth rates. Sustainable economic growth must now become driven by growth in productivity of both capital and labor or Ukraine will be doomed to economic stagnation.

Studies show that Ukraine's growth is currently constrained not for lack of labor, capital or technology. The main reason for future suboptimal performance will be its market-unfriendly institutional environment.

Even such pillars of the market economy as the institution of property rights are of low quality. Raider attacks have become more frequent recently, with up to seven enterprises attacked a day.[18] With the state not able to properly protect property rights, it is hard to expect great economic results.

Ukraine's institutions remain like the mythical centaur: a Soviet body below the waist topped by a market-oriented torso. In other words, Ukraine's commercial laws and regulations are of poor quality and inadequate, so the problem is not lack of implementation. The Government needs to undertake serious

[17] http://www.president.gov.ua/documents/10736.html

[18] http://news.liga.net/news/N1006439.html

legislative work if it wants to improve the business climate in the country.

The economic cost of ineffective institutions is huge. According to IFC estimates, compliance with just three regulatory procedures—technical regulations, inspections and permits—cost Ukraine's economy US $1.55bn in labor, direct expenses and unofficial payments in 2008 alone.

Advice on how to deregulate the business environment is ample and has been on the table for many years. But due to the previous economic boom, the bureaucratic machine did not feel any incentive to change and lose a huge chunk of its profit from this growth—in the form of bribes.

Increasing the productivity of Ukraine's labor and capital and putting it on track for sustainable economic development should become the main priority of future reforms. Otherwise, Ukraine may not find resources for other reforms or for any improvement in the well-being of its citizens.

Turning patchwork into a roadmap

Ukraine's Government is feeling enough pressure to act swiftly in closing the huge fiscal gap and restoring macroeconomic stability. If this is done in a matter of weeks, the solutions will inevitably be a patchwork.

The risky side of finding quick solutions is the temptation to resort to tax extortion or to quick-fixes that will further shake weak institutional boundaries.

The patchwork of early days must be followed up by serious legislative work to prevent the same problems from recurring in the nearest future.

To get to the roots of Ukraine's problems, the Government needs to take a more strategic approach to reform, which it has pledged to do. Still, Ukraine's politicians are all too adept at mimicking reform, so only actual performance will bring the new team credibility.

There remains a chance that, even if the right priorities are chosen for reform efforts, they will be sabotaged by an inefficient bureaucracy and corruption.

Still, Ukraine now has a unique opportunity to move forward with reforms and get on track for sustainable development—an opportunity that, if wasted, might not be there for many years to come.

Key Events in April

April 1

Construction starts on the first line of Nord Stream.

April 5

EU Visa Code enters into force.

April 7–8

UEFA President Michel Platini visits Ukraine to inspect construction sites at hosting airports and stadiums.

April 12–13

President Yanukovych visits Washington DC.

The President will participate in the Global Nuclear Security Summit and meet President Obama, Vice President Biden and State Secretary Clinton, as well as the Heads of the IMF and the World Bank.

April 20–21

CIS Coal Summit takes place in Moscow.

April 22

UN Earth Day celebrates 40 years.

April 25

Local Elections take place in Belarus.

April 26

The 24th anniversary of the Chornobyl disaster is commemorated.

The Foreign Affairs and Defense Council of the EU meets.

April 27

The EU Commission presents its Draft Budget for 2011.

April 30

The European External Action Service, the EU's diplomatic service, is set up.

Dates unspecified

Ukraine's 2010 State Budget is adopted. (mid April)

President Yanukovych makes an official visit to Belarus.

Qatari Prime Minister Sheikh Hamad bin Jasim bin Jabr Al Thani comes to Ukraine—first official visit of a Qatari PM to Ukraine in the history of bilateral relations.

The committee for economic cooperation of the Ukraine-Russia interstate commission meets.

The section of the Readmission Treaty between Ukraine and the EU pertaining to Third Country Nationals comes into effect.

The next round of UN climate change negotiations take place under the UNFCCC.

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