

# Economic Reform in Ukraine

The Unfinished Agenda

Edited by **Anders Åslund** and  
**Georges De Ménéil**



ECONOMIC  
REFORM  
IN UKRAINE



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# Part I

## Introduction

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# 1

## The Dilemmas of Ukrainian Economic Reform

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*Anders Åslund and Georges de Ménil*

On December 1, 1991, the Ukrainian population voted overwhelmingly for the independence of Ukraine. Hundreds of years of subjugation to Russia or Poland had come to an end. The new Ukrainian government faced all the challenges of a newly independent state at the same time that the country was in a grave and multifaceted economic crisis. (For an overview of key economic data for 1992–99, see Table 1.1.)

### **Ukraine's Starting Point**

Ukraine's choices were predicated on a number of factors. Possibly the most important was that, on the same day Ukraine voted for national independence, an absolute majority of voters elected Leonid Kravchuk as the first president of independent Ukraine. Kravchuk possessed several characteristics that were to be significant for Ukraine's economic choices. First, having previously been second secretary of the Communist Party of Ukraine, he was one of the foremost representatives of the old communist establishment, even though he formally parted with the communists and took the side of Ukrainian independence. Second, Kravchuk had been responsible for ideology within the Communist Party. Hence, having no real understanding of economics whatsoever, he was also singularly disinterested in it. Third, Kravchuk was a man of con-

Table 1.1

## Key Economic Data, 1992–1999

	1992	1993	1994	1995	1996	1997	1998	1999 preliminary
<i>Output</i>								
GDP annual growth (percent)	-9.9	-14.2	-22.9	-12.2	-10	-3	-1.9	-3.6
GDP in billions of US\$	24	...	37.6	37.1	44.5	50.2	41.9	30.8
<i>Inflation and budget</i>								
Inflation (percent end year)	2,730	10,155	401	182	40	10	20	19
Budget deficit (percent of GDP)	-24.2	-28.1	-8.7	-4.9	-3.2	-5.6	-2.7	-2.4
General government revenues	34.2	92.8	41.9	37.8	36.7	38	35.6	31.9
General government expenditures	58.4	70.9	50.6	42.7	39.9	43.6	38.2	34.3
<i>External sector (billions of US\$)</i>								
Current account	-0.6	-0.8	-1.2	-1.2	-1.2	-1.3	-1.3	-0.8
Trade balance	-0.6	-2.5	-2.6	-2.7	-4.3	-4.2	2.6	-0.5
Exports	11.3	12.8	13.9	14.2	15.5	15.4	13.7	12.5
Imports	11.9	15.3	16.5	16.9	19.8	19.6	16.3	13
<i>External Debt</i>								
External debt (billions of US\$)	0.5	3.7	7.7	8.1	9.2	11.8	11.7	11.9
External debt (percent of GDP)	—	11.2	20.5	23.6	21.1	23.8	27.9	38.6

Sources: IMF website ([www.imf.org](http://www.imf.org)); EBRD (1998); National Bank of Ukraine; "Restoring Growth with Equity: A Participatory Country Economic Memorandum"; IBRD (1999). Differences with numbers elsewhere in this book reflect differences in definitions and revisions.

sensus, which was an important reason for his election. He was seen as a man who could mediate between the Russified Eastern Ukraine and the nationalistic Western Ukraine as well as between the communist establishment and liberals. Fourth, in practice, however, Kravchuk tended to turn to his West Ukrainian roots. Finally, Kravchuk was a peaceful man, who prided himself on having become a democrat. At the time of formation of a nation, the leader's nature is greatly significant, and, for better or worse, Kravchuk's personal characteristics are reflected in Ukraine's early economic development.

To the man on the street, the most obvious and worrisome economic crisis was manifested in massive shortages. Toward the end of 1991, Ukraine's shops were virtually empty because prices were kept regulated by the state at an artificially low level, while the central Soviet government had all but given up control over the money supply. It was obvious that prices would have to be freed, but no leading politician was prepared to take responsibility for the inflation that would ensue. In the end, Ukrainian prices were liberalized to a considerable extent in January 1992, but this occurred as an agreement with Russia, whose reform government had advocated extensive price liberalization. Thus, it was received as a Russian imposition, and the new Ukrainian government neither had nor displayed any commitment to free prices and free trade.

In the ensuing disorganization and confusion—which are characteristic of a crisis economy that has been only partially and halfheartedly liberalized—inflation quickly took hold. Even before prices were liberalized, Ukraine probably experienced about 200 percent inflation in 1991. After prices had been freed, they rose by some 2,000 percent in 1992.

Initially, inflation was also largely perceived as a problem stemming from Russia. Much of the early economic discussion in Ukraine focused on how to isolate Ukraine from Russia's inflation and to establish an independent currency. Indeed, as early as January 1992, Ukraine introduced its own coupon—the karbovanets (krb)—a parallel Ukrainian currency to the old Soviet ruble, which continued to circulate.

Instead of bringing reason to public finances and the conduct of monetary policy, the introduction of the karbovanets had the opposite effect. It was as if the authorities thought either that having a national currency was magic because it cost nothing to produce and could be distributed with largesse, or that the karbovanets, because it was a transitory “coupon,” could be abused with impunity. Whatever the mixture of illusion and cynicism, the fact is that Parliament pushed through a distribution

of cheap credits to agriculture and industry equal to almost a third of GDP in 1993. Ukraine's uncontrolled emissions were even larger relative to GDP than Russia's. The predictable result was classical hyperinflation. By the end of 1993, when prices were doubling every month, there was no way that Ukrainian inflation could be blamed on Russia. From December 1992 to December 1993, prices rose by 10,200 percent. Russian inflation in the same period had fallen to 840 percent.

In the midst of this disorder, the leaders of the country were trying to build new national institutions. Although Kyiv had formally been the capital of the Soviet Socialist Republic of Ukraine, it was in reality only a provincial capital. Some national institutions existed in a rudimentary form, for example, the Ministry for Foreign Affairs, while the Central Bank and Ministry for Foreign Economic Relations were missing altogether. For natural reasons, the newly independent state was preoccupied with the establishment of its national symbols and many Ukrainians wanted national institutions to be as strong as possible but they did not give much thought to what this actually meant. Thus, it became a virtue to build up bureaucracy and regulations as long as they were national. The most disturbing example was Ukraine's recreation of Soviet-type foreign trade regulations in an attempt to ensure that the Ukrainian state had control over the country's foreign trade. The stage was set for cementing a massive centralized bureaucracy.

Economic science and the social sciences generally had been weak in Ukraine ever since the founding of the Soviet Union. The principal reason was that the Soviet authorities had (for good reasons) always been particularly afraid of Ukrainian nationalism. Therefore, Ukraine was subjected to much more control and repression than Russia. The natural consequence was that Ukraine suffered from an especially great shortage of the essential skills for building a new state. The country had little real economic education and research, and few economic reformers were coming to the fore. Incredibly, this country of 52 million citizens had only one economic journal, and that was totally dominated by old-style communists. Moreover, as Ukraine had been highly isolated from the outside world, few people in Ukraine spoke English or other foreign languages, which made it more difficult to open up to the West. The situation was so bad that Ukraine hardly had a critical mass of sufficiently well-educated economists for launching radical economic reforms.

The fundamental problem, however, was an overabundance of continuity in the Ukrainian establishment. The transformation of the Com-

munist Party of Ukraine's second secretary for ideology to the first president of independent Ukraine was emblematic of this continuity. The primary problem was perceived as excessive dependence on Russia, while the inheritance of a communist system, although universally recognized, was not given sufficient attention. In effect, much of the old Soviet establishment persisted in Ukraine. The old communist elite or *nomenklatura* simply changed their party cards for the national insignia.

The stage was set for extraordinary rent seeking. Radical reforms had been dismissed as characteristic Russian rashness that was incompatible with Ukrainian peacefulness and moderation. The old establishment, which remained largely intact, wanted to transform its power into material benefits. A cumbersome bureaucracy and regulatory system were being built as a manifestation of the Ukrainian state. Soon enough, these conditions bred severe corruption and rent seeking. In the winter of 1993–94, the Ukrainian government was dominated by a group of so-called red directors, enterprise managers from Eastern Ukraine who had joined the government to maximize their personal revenues through cumbersome regulations that allowed few but themselves to make money. Their head was acting Prime Minister Yukhym Zviahilsky.

In the spring of 1994, a leaked CIA report questioned whether the Ukrainian state could persist, or whether it would break into a Western part and an Eastern part. The coal miners' strikes in the summer of 1993 prompted early elections in 1994. Elections for the Rada—Ukraine's Parliament—were held in the spring in several rounds, and presidential elections were held in June and July in two rounds. The outcome of these elections was the routing of the centrist establishment. President Leonid Kuchma replaced President Kravchuk in July 1994, and Ukraine went through its first democratic transition of power without any particular tensions. Suddenly it appeared as if Ukraine could recover lost ground and undertake serious radical reforms.<sup>1</sup>

### **The Reform of 1994–1995**

Many things started happening. An International Monetary Fund (IMF) mission began working on a financial stabilization program as early as August 1994; one month later, Ukraine had adopted its first program with the IMF, a so-called Systemic Transformation Facility, which was less demanding than an ordinary stand-by agreement. Such an agreement was concluded in March 1995. The IMF assisted Ukraine in re-

structuring its foreign debt so that international arrears were partly turned into state debt and partly paid for with international financing.

President Kuchma retained the reformers who were already in government—Minister of Economy Roman Shpek and National Bank Governor Viktor Yushchenko—and gradually appointed a few other serious economic reformers: Minister of Privatization Yuri Yekhanurov, Deputy Prime Minister for Economic Reforms Viktor Pynzenyk, and Deputy Prime Minister for External Finance Ihor Mitiukov. On October 11, 1994, President Kuchma made a major reform speech to the new Parliament. Soon afterward, he put his reform proposal to a vote and a sizable majority adopted it. With a reform team in government, a serious reform program, parliamentary approval, an IMF program, and substantial international financing, Ukraine seemed set for a serious economic reform.

The reform started very well. In late 1994, major price liberalization was undertaken and Ukraine's budget deficit was sharply reduced in line with the IMF program. Viktor Yushchenko consistently maintained a strict monetary policy, which led to a gradual reduction in inflation, and, in 1996, inflation finally fell to 40 percent a year. Privatization was initially slow, but it took off in 1996. Yet, growth remained a distant target, and the focus moved to other problems. The years of slow or no reform had bred a number of problems that were not to go away quickly. One problem was the very functioning of the state, which was haphazard at best and usually corrupt and excessively bureaucratic. Taxes remained higher than in any other country of the Commonwealth of Independent States (CIS). While stabilization took hold, arrears and barter did not go away, but multiplied. In particular, in the energy sphere, a number of monopolies stayed put, generating especially difficult arrears. Privatization was under way but behind schedule, and the quality of privatization was poor in the sense that enterprises went primarily to insiders, which did not promote new, strong owners who undertook serious enterprise restructuring. Although the government continuously spent large amounts on social expenditures, the social safety net was miserable and the "social" expenditures tended to be showered on the wealthy rather than the poor.

While all these problems existed from the beginning of the reforms in the fall of 1994, the new administration failed to get a handle on them. The reasons were many and the causes, naturally, disputed. The government has persistently blamed Parliament, and it is certainly true that Parliament has not pushed for reforms.

Like Russia, Ukraine had inherited a Soviet constitution, which gave Parliament enormous powers (including the power to force the national bank to distribute unlimited cheap credits), and left the relationship between its powers and those of the president in limbo. In Russia, the president asserted control by subduing Parliament with tanks and submitting a new constitution for ratification by referendum two months later. Ukraine resolved the constitutional conflict in a typically more peaceful manner. Presidential threats to conduct a referendum and dissolve Parliament were eventually sufficient to cause the parliamentary factions to pass a new, highly presidential constitution of their own accord. Until that decisive moment in late June 1996, the conduct of reform was hampered by constant constitutional conflict and an unclear sense of the legitimacy of presidential power.

But difficult relations with Parliament were not the only factor to blame for the loss of steam in the progress of reform. Internally, the government was neither organized nor united. The long period of mismanagement bred a large group of government officials who favored corruption and persistently promoted decisions and legislation that would cause more corruption. The average tenure of Ukrainian prime ministers has been about one year and severe tensions between the president's administration and the Cabinet of Ministers has been the rule. Although President Kuchma launched the reforms, his support of reform could have been much stronger and more tenacious. As soon as the reforms began to show positive results in June 1995, the president made his unfortunate Uzhhorod speech, in which he called for a "correction" of the course of reforms, which instantly undermined those reforms. Ever since then, Ukraine has had persistent problems in sticking to its IMF commitments. The consequences have been larger budget deficits and chronic problems with budget financing, and the IMF has time and again interrupted its loan disbursements to Ukraine. The more profound structural reforms have been postponed. Ukraine only returned to economic growth toward the end of 1999.

### **The Stagnation of Reform, 1995–1999**

By and large, reform came to a standstill in June 1995, although some important reforms followed even later. First, Ukraine adopted a democratic constitution in a peaceful manner in June 1996. Second, Ukraine's permanent national currency, the hryvnia (UAH), was introduced at the

beginning of September 1996, as all karbovanets were exchanged at 100,000 karbovanets for one hryvnia. In one sense, the reform was a simple operation in which five zeroes were lopped off every denomination, but it signaled Ukraine's defeat of inflation and the hryvnia's introduction without confiscation or panic. Third, large-scale privatization was undertaken from 1996 to 1998. Fourth, in 1998, rampant financial crisis prompted the government to undertake some long-required, largely fiscal measures, such as substantial cuts in public expenditures, in the budget deficit, and in the payroll tax.

Even so, standstill rather than reform has characterized Ukraine's economic policy since June 1995. While this book outlines a multitude of ideas about how vital aspects of the Ukrainian economy should be reformed, the task is still to be done. In the spring of 1996, it was obvious that Ukraine would see no economic growth that year, but would see a decline on the order of 10 percent. The conviction, which he expresses in this book, that reform was a necessary precondition for growth, led then Deputy Prime Minister for the Economy Viktor Pynzenyk to launch that fall a large and radical program of tax changes, liberalization, and other measures aimed at promoting growth. Detailed drafts of these measures were worked out by a large group of experts, mainly Ukrainians but also some foreigners, working day and night, in October and November 1996.

The program for economic growth faced up to most of the problems discussed in this book. It argued for a limited budget deficit. A major aim was to cut unjustified public expenditures, while diminishing the number of taxes and the highest tax rates, notably the payroll tax. The number of taxes was to be sharply reduced, while the value-added tax and the profit tax were to be normalized. Unjustified tax exemptions were to be eliminated. It was hoped that the whole package would reduce the widespread use of barter. A liberalization of the payment system was supposed to further draw the gray economy into the open and make arrears less attractive. Bankruptcy was supposed to be reinforced. Far-reaching deregulation of enterprises, especially in licensing, was another part of the program. The patently weak Ministry of Finance needed to be strengthened with long-proposed treasury control and real macroeconomic forecasting. The regulation of the natural energy monopolies needed to be improved. The most controversial part of the program was a pension reform that, regrettably, was never completed, even in draft.

In late fall 1996, the government presented its program for economic

growth to Parliament in a large package of draft laws. Parliament discussed the reform package intermittently with great hostility. All kinds of absurd formal objections were raised. President Kuchma pressed hard for it in public, while Prime Minister Lazarenko seemed lukewarm at best, and other ministers let Pynzenyk fight alone. His only apparent supporter in a high place was Governor Viktor Yushchenko of the National Bank. Even other reformers were cool toward Pynzenyk and his reform package, of which they did not feel they were a part. In early March 1997, it was clear that the reform program had been jeopardized and hardly anything of it was adopted. Viktor Pynzenyk resigned in frustration. He was replaced by Serhyi Tyhypko, who pushed to carry the program forward but had no greater success than his predecessor. Ukraine has had one of the worst growth performances in the post-communist world.

On the whole, reforms not only stood still but even went backward. Because no reform of the payments system occurred, arrears and barter proliferated. In 1995, a far-reaching deregulation of agricultural trade took place, but, in the summer of 1996, Prime Minister Lazarenko instigated rigorous regulation of agricultural trade by enticing regional governors to prohibit exports of grain from their regions and by prohibiting exports of grain through ports or by rail. Although Ukraine had put forward proposals for the regulation of energy companies in a market-economic fashion, none of these was adopted, and rent seeking and arrears proliferated, particularly in gas trade. The bureaucratic control of enterprises did not diminish but grew worse. It became the subject of innumerable anecdotes, until people found bureaucratic repression so prevalent that they stopped telling jokes about it. Foreign trade regulations became ever more complex. Naturally, minimal enterprise restructuring occurred under these conditions. Instead of a second phase of economic reforms, Ukraine saw the reversal of market economic reforms.

In the fall of 1996, the IMF actively participated in the reform package designed by the Ukrainian government and the National Bank of Ukraine (NBU), and it made these reforms the basis for its so-called Extended Fund Facility (EFF), a three-year loan program aimed at both macroeconomic and structural reforms. The program document was worked out in early 1997, but, because neither the Ukrainian government nor Parliament displayed serious intentions of adopting the necessary prior actions, the program turned into a dead document. In parallel, the World Bank worked out a number of Structural Adjustment Loans, which were loan programs conditioned on various structural reforms,

but little was disbursed from them because the Ukrainian government rarely complied with the mutually agreed upon conditions. In late summer 1997, it became apparent that the prior actions required by the IMF for the EFF would not be fulfilled. Then, the IMF concluded a minor one-year stand-by agreement, with little money and limited conditions, but Ukraine largely failed to comply even with them. By the end of 1997, the stand-by was dead. Having no approval from the IMF, Ukraine was also blocked from World Bank funding.

In the summer of 1997, Valery Pustovoitenko replaced Prime Minister Pavlo Lazarenko. Lazarenko had made a name for himself as the most blatantly self-seeking politician in Ukraine. Pustovoitenko was seen as Kuchma's loyal chief aid. He had been, for three years, the minister of the Cabinet of Ministers, a bureaucratic apparatus of 700 people that more frequently than not blocked reform.

Also in the summer of 1997, the Ukrainian authorities had been strangely seized by a sense that financial constraints were easing. Rather than trying to comply with the hard conditions set by the IMF, they sold large amounts of short-term treasury bills to foreign investment bankers and placed some large Eurobond issues. The nascent Ukrainian stock market started booming in the shadow of the buoyant Russian stock market. Ukraine's political leaders perceived that they no longer needed to listen to the unpleasant conditions demanded by the IMF and that they could tap private international capital markets instead. The Ukrainian budget deficit rose in 1997 to almost twice what the IMF had demanded. None of the reforms having been adopted, GDP fell officially by 3 percent in 1997, and the paralyzing bureaucratization grew increasingly worse.

The reformist minister of justice, Serhyi Holovaty, attempted a "clean hands" anti-corruption program, strongly encouraged by the World Bank and the United States. However, the program was never really launched because strong interests within the establishment thrived on corruption. Holovaty was soon sacked from the government and a more pliant minister of justice was found.

The miserable economic policies of 1997 can partly be explained by the long-planned parliamentary elections in March 1998, which set the political agenda far in advance. The central stage of the elections campaign was dominated by a vicious struggle between two competitive establishment parties, Prime Minister Valery Pustovoitenko's National Democratic Party (NDP) and former Prime Minister Pavlo Lazarenko's

party, Hromada. They might both be described as centrist, but they really represented competing bureaucratic business groups rather than any ideology. Both these parties thought that the elections were about obtaining as much money, media, and administrative clout as possible, while they paid little attention to the population or economics.

In the end, however, the NDP and Hromada failed miserably. Each party won only about 5 percent of the vote in the proportional half of the elections. The communists also failed to capitalize on the economic misery prevalent across the country. They received 25 percent of the votes. They and the rest of the left—including socialists and agrarians—obtained a total 40 percent of the votes, slightly more than in 1994. The essentially West Ukrainian nationalist movement Rukh received 10 percent of the votes, while the badly split pure reform parties received few votes. The elections did not suggest any clear alternative to the prevalent lack of policy direction.

A few months later, the financial storms that ultimately swept across the developing world began in Asia. The international financial crisis hit Ukraine in late October 1997. Treasury bill yields rose sharply and remained at their new highs. For the next year, Ukraine largely failed to roll over its short-term treasury bills held by foreign investors. As a consequence, Ukraine's international reserves and state finances were severely strained. Month after month, Ukraine appeared to be on the verge of devaluation because of minimal and shrinking reserves. In late August 1998, Ukraine's international reserves had shrunk to \$1.1 billion—less than one month's imports.

Throughout 1998, the Ukrainian government struggled each month to meet its debt service requirements. The year started badly. While the 1998 budget adopted by Parliament foresaw a budget deficit of 3.3 percent of GDP, it was more than twice as large during the first quarter because the government used budgetary disbursements to appeal to various constituencies in the election campaign. After the elections, Parliament proved incapable of acting for two months because it could not agree on a new speaker. Ukraine received no international financing whatsoever in the first half of 1998. Most IMF targets had been missed and private investors had lost confidence in the bureaucratized and free-spending government. Ukraine appeared to have its back against the wall and to be close to default.

Finally, on June 18, President Kuchma decided to break the deadlock over economic reform. In a major reform speech to Parliament, he de-

clared that, in view of the fact that Parliament was paralyzed, he would adopt at least fifteen major legal acts as presidential decrees. These decrees included many of the major reforms from Pynzenyk's reform program. While the budget deficit for 1998 was cut, much of this was accomplished through arrears and sequestration, that is, the government simply did not pay what it had committed itself to pay. Licensing procedures were simplified and several taxes were reformed. A single simple tax for small entrepreneurs was introduced. The value-added tax was reformed so that exemptions were reduced, and the payroll tax was reduced. In Ukraine, presidential decrees become law after a month if Parliament has not revoked them. Parliament protested at first, but in the end did not revoke the decrees and seemed content to let the president take full responsibility for the reforms.

All of a sudden, in one month, Ukraine had adopted many of the reforms that had been discussed for years and drafted in detail in 1996. Somewhat surprised, the IMF recognized the reforms as sufficient for the conclusion of an EFF agreement at the end of July 1998 to replace the aborted agreement of spring 1997. However, the Russian financial crisis erupted in the interim. As the ruble sank, and as prices rose and output fell in Russia, the prospects for financing Ukraine's balance of payments deficit—which had looked reasonable in the context of the reform package—deteriorated again. Additional resources were required to fill the gap. Consequently, final acceptance of the EFF with Ukraine by the Executive Board of the IMF was postponed—but not for long. Ukraine has continued to scrape through. Repeatedly, it has been on the verge of default on its foreign debt service or has faced postponement in credits from the IMF or the World Bank because it has not fulfilled the agreed upon conditions. And economic growth remains evasive.

### **An Alternative Economic Policy**

Was all this economic and social damage necessary? Could something have been done differently? We were working as economic advisors to the Ukrainian government from August 1994 until 1997, and we certainly thought that something more could have been done. All along, Kyiv was bristling with various reform plans and proposals. In June 1996, we organized a major international conference in Kyiv, the theme of which was "The State of Economic Reforms in Ukraine." The con-