

# Ukraine's embattled reformers

04 March 2015

## Summary

*One year on from the downfall of Viktor Yanukovich, Ukraine remains in a state of chronic crisis. The mood in Kiev is bleak, however the last twelve months have seen the emergence of a small but potentially important set of individuals across government, politics and civil society who are taking on the old problems of bureaucratic inertia, incapacity and corruption. They are a minority, and face the daunting task of overcoming Ukraine's severe institutional weaknesses with little cover from a weak and compromised judiciary. Their success in bringing about reform will be important not only for Ukraine's economic future but also in signaling progress to a Ukrainian public which is impatient for change. Ultimately, the reformers will be reliant on Ukraine's politicians to allow them the political space to make the tough but necessary decisions, even as populist voices grow louder. Whilst it is hard to say what success will look like, we will know when we see failure.*

One year on from the downfall of Viktor Yanukovich, Ukraine remains in a state of chronic crisis. The mood in Kiev is bleak. However the period since the revolution has seen the emergence of a small but potentially important set of individuals across government, politics and civil society who are attempting to tackle the old problems of bureaucratic inertia, incapacity and corruption. Beyond war in the east and the economic crisis, they face the double challenge of pulling together an enormous reform agenda, while simultaneously building the government machinery with which to implement it. They will need time, and while the recent IMF package will provide some economic breathing space, the reformers will be reliant on Ukraine's politicians to give them the political

space to make the tough but necessary decisions.

## The reformers

The most high-profile of these reform-minded individuals are in the new Ukrainian cabinet, appointed in December. They include Finance Minister Natalie Jaresko, a former US diplomat and investment banker, who has been noted for her success in securing the latest IMF package. Economy Minister Aivaras Abromavicius, a Lithuanian by birth, speaks of taking a "guillotine approach" to cutting back Ukrainian government agencies and unnecessary legislation. Elsewhere the ministers of infrastructure, energy and agriculture and the new governor of the central

bank Valeria Gontareva all come from the private sector and have brought an outsider's perspective to their sclerotic ministries. They are mostly young, well-educated, and have outlooks formed internationally or in the private sector. In some cases these ministers are supported by groups of committed reformists within their ministries. But they are often poorly paid or working on a voluntary basis. And they are almost without exception a tiny minority within their institutions.

There are reformers in the parliament too, many elected for the first time in October last year. They are not overtly partisan, operating in a party system which remains largely defined by personalities and patronage. Among the coalition parties there is an inter-factional group of young MPs who are trying to bring their private sector experience to bear in reforming key sectors. But while these young MPs share an outlook and method, there is little sense of this as a political project, or the basis for a European-style policy orientated political party. For now at least, their initiative remains a predominantly technocratic exercise in updating Ukraine's outdated legislation.

Spread across different ministries, parties and civil society groups the reformists are by no means a cohesive bloc, but two things are notable. First, they are by and large from the 'post-Soviet' generation, those who began their professional lives after 1991 - including Prime Minister Arseniy Yatsenyuk. Second, they are motivated by a sense of Ukrainian statehood which has been deepened by the events of the last year and is largely, but not entirely, defined against a Russian interventionism personified in President Putin. In important ways this makes them different from what has gone before.

### The machinery of reform

The critical question is of course whether these new faces can have any impact addressing Ukraine's colossal challenges. Those seeking change in Ukraine are facing the double challenge of trying to implement reform while simultaneously creating the governance mechanisms with which to do so. Much of the Ukrainian bureaucracy is slow-moving and corrupt, and even basic tasks such as drafting laws routinely prove difficult. The government has plans to move towards fewer but better paid and more professional staff, with the National Bank of Ukraine (NBU) planning to cut the number of employees from 12,000 to 2,000. But this will require legislative changes and stiff resistance can be expected from those whose long-held sinecures are at risk.

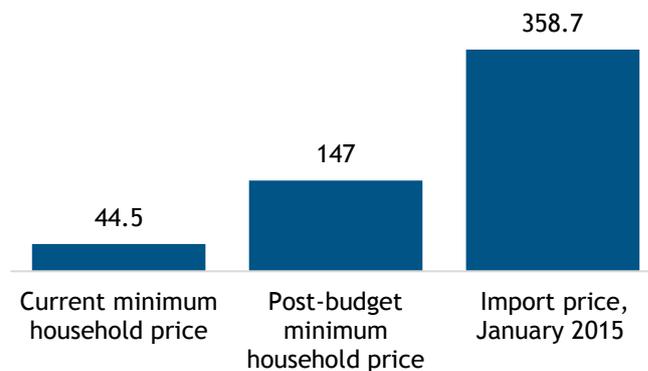


Fig 1: Ukrainian gas prices (USD per 1,000m³)  
Source: Economic Development and Trade Ministry of Ukraine

Outside the machinery of government there are also powerful vested interests with strong incentives in maintaining the status quo, as illustrated by the challenge of cleaning up the banking sector. Ukraine's economic shocks have left the banking system in dire need of consolidation and recapitalisation. Indeed the official 15% non-performing loan rate almost certainly understates the real extent of a problem, which may be as high as 25%. The IMF - which will finance much of the recapitalisation - has required that Ukraine first clears up the country's related-party lending rules to ensure that IMF money does not disappear into the pockets of the oligarchs who control much of Ukraine's fragmented banking system. The NBU is now struggling to unravel opaque regulatory and legislative frameworks that over the decades have been designed to hide, rather than to reveal. The passage through parliament this week of the Bank Owner Responsibility Act was an important first step in this regard.

The NBU's efforts so far have served to illustrate the additional challenge of reform in a system where the judiciary provides little cover for those seeking to take on vested interests. Governor Gontareva, who is regarded as a competent professional and a genuine reformer, has already been the subject of corruption allegations, which many regard as motivated by those who have seen their banks be allowed to fail or stand to lose from her attack on related-party lending. Cleaning the judiciary will be a long and arduous but essential process, and the new Prosecutor-General Viktor Shokin will be critical. Shokin has been personally mandated by President Petro Poroshenko to reform the Prosecutor's Office, but his ability to effect the necessary change will have to be proven. With some parts of civil society already impatient, he will have to move quickly. That means high-profile corruption cases targeting all parts of the political spectrum sooner rather than later.

## The opponents of reform

The recent \$17.5 billion IMF package has bought the government time in terms of averting immediate economic catastrophe. For reformers the key question is how much political space the country's political leaders are willing to provide to push through unpopular decisions. The government has already shown some willingness to take hard decisions, this week passing a revised reform budget with a solid majority during a long and often fractious parliamentary session. The package incorporated a number of the key IMF requirements, including raising the minimum household price for gas during the 'heating season' of 1 October to 30 April by almost three and a half times, cutting 'working pensions' by 15% and restricting early retirement. The extensive energy subsidy system is being focused to protect the most vulnerable, but the price increases are likely to provoke significant consternation among those who will shoulder the burden. They will also not be the last as the government seeks to align domestic prices with import prices.

Government coalition  
(305 of 450 seats)

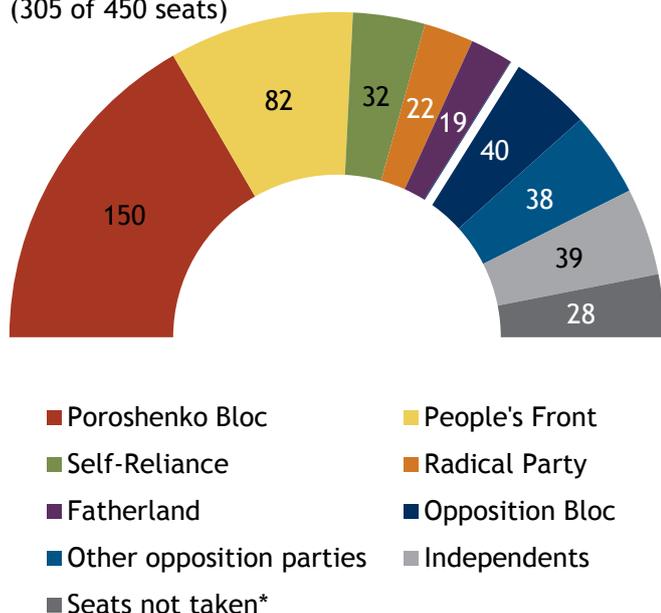


Fig 2: Ukrainian Parliament composition

Source: Verkhovna Rada of Ukraine

\*For areas under rebel control

There will be more unpopular decisions down the line, and as the cumulative economic impact on households grows the politics of reform is likely to get harder. Populist factions in Ukraine are already finding their voices, led by the Opposition Bloc, under former energy minister Yuriy Boyko. Within the government itself the Radical Party and Fatherland factions, the latter headed by

former Prime Minister Yulia Tymoshenko, are often criticised for being populist. Both factions saw MPs vote against the government's reform package. In the longer term progress in carrying out what remains an enormous legislative agenda will be hampered by the large number of MPs who see the parliament primarily as a source of political patronage and power rather than a legislative chamber. This includes the 100 or so MPs who are backed and influenced by the country's oligarchs, each with their own interests to protect.

For the reformers the hope must be that the president and prime minister can continue to resist the populist agenda. The personal relationship between President Poroshenko and Prime Minister Yatsenyuk is seen as increasingly uneasy, however most agree that the principals understand the importance of sustaining a working relationship and are for the time being committed to doing so. Certainly the dual external pressures of the war and the IMF are providing a strong incentive to keep the government together and Prime Minister Yatsenyuk's call for unity over the budget vote was largely successful. However, both their parliamentary blocs have shown populist instincts, Yatsenyuk's People's Front in particular. Among some observers there is a feeling that in time Yatsenyuk's presidential ambitions may ultimately outweigh his commitment to important but unpopular reforms. The risk of a politically populist 'race to the bottom' cannot be discounted, and would mark the beginning of the end for those seeking change.

Although parts of the current government have been in place as an interim administration since February 2014, the majority of the technocrats has spent fewer than 100 days in office. Despite this there are already rumblings from some quarters over a lack of progress and a critical civil society is watching the government keenly. Failure could be deeply destabilising, and few in Kiev think that a 'third Maidan' is out of the question. But what is not clear is what follows if this government fails. The risk of instability would be high, and possibility of disintegration and direct intervention of oligarchs - some of whom are funding and directing private militias - could not be discounted. For those in the West this would be a nightmare scenario. They must then hope that the small currents of change which have emerged in the last twelve months can in the longer term swell to effect broader change. Whilst it is hard to say what success will look like, we will know when we see failure.

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