

Remarks SFRC Hearing October 8, 2015

By Clifford G. Bond

It is a pleasure to appear before the Committee today and join my fellow panelist.

I returned only a few weeks ago from Kyiv where I worked for 17 months on expanding and coordinating our assistance program to Ukraine.

Over those months our assistance grew by more than four times and included a significant security component. I arrived as the aggression was beginning in eastern Ukraine and as a humanitarian crisis developed.

My work was focused on technical and humanitarian assistance, not the security aspects of the program.

I will make some comments on the state of economic reforms and transition in Ukraine that our program is meant to support.

I have past experience in economic transitions. I witnessed a successful transition in Eastern Europe in the early 1990's when I served in Prague during the Velvet Revolution and later worked in Washington implementing our Support for East European Democracy or SEED assistance program. Later in the 1990's I saw a failed transition when I worked at our Embassy in Moscow.

What I have to say now is informed by this experience. It should not be viewed as criticism, but as a hardheaded approach to what needs to be done if Ukraine is to succeed in an economic transition to a well-functioning market economy.

First off, the current Kyiv government is the most reform-minded and technically most competent team in post-Soviet times, but its goals are not ambitious or radical enough, and the process of reform has only begun.

There have been important successes: energy tariff rate increases and meeting other IMF conditions, the recent roll out of a new patrol police in Kyiv, a reform now being repeated in other cities, and agreement on debt restructuring.

But reformers face increasing resistance to change in key areas such as anti-corruption. The Prosecutor General's Office (or PGO) should be ground zero for the fight against corruption, but the PGO has yet to carry out a corruption prosecution against a senior Yanukovich-era figure. The PGO is divided between reformers who want to work with our FBI and DOJ advisors (and need full political support from the top), and an old guard that is frustrating and seeking to intimidate them.

A new Anti-Corruption Bureau is being formed, which will rely on the PGO to prosecute any criminal investigations it concludes. But, as I said, the PGO is not doing its job.

In the Health Ministry efforts to change corrupt procurement practices are being resisted by domestic pharmaceutical interests - even in the face of low levels of vaccination and immunization among Ukrainian children (a direct result of past corrupt practices) and the first outbreak of polio cases in western Ukraine.

In some areas, such as privatization and de-regulation, reforms are only getting started.

What the Ukrainian economy needs is fundamental liberalization and de-regulation to include broad privatization of its approximately 2,200 State-owned Enterprises (SOEs).

What economists call the factor markets of production in the economy for land, labor and capital are simply not functioning because of structural impediments and rigidities built into the system or because of corruption, past and on going. This means an entrepreneur or SME finds it extremely difficult to buy the real estate (there is no market in farm land), raise capital (the banks are not lending) or hire the people he/she needs to start up or expand a business.

Lack of Macro-Economic Coordination

Importantly from a macro-economic perspective, there is no overall coordinator of market reforms. Some ministers are out there doing important work, but there is no central figure overseeing and coordinating the process with a strategic vision in mind to pull the pieces together.

In east European transition economies the senior Deputy Prime Minister who was usually double hatted as Finance Minister played this role. Poland's Leszek Balcerowicz and the Czech Republic's Vaclav Klaus were key to the success of economic reform in their countries.

The Prime Minister and President need to empower an individual with real reform credentials to fill this function and step out of the way to let him or her get the job done.

Need for Strategic Communication

Part of the problem is also lack of understanding on the level of the general public and a lack of communication by political leaders of what a market economy is and how it should operate. Public surveys, such as

a recent IRI poll, show that two-thirds of citizens believe investment and job creation are the responsibility of the government. **Less than 10 percent** understand this should be the role of the private sector.

Focus

Early cleanup of the business and investment climate was central to the success of the transitions in Eastern Europe. Poland focused on SME growth. This produced new businesses, jobs and investment, and gave government the political capital to move on to other reforms.

The GoU is focused on meeting the conditions required by the IMF and other donors. These are hard conditions and meeting them is essential to get the money to pay the bills. It is not a substitute, however, for a growth strategy that gets out ahead of the IMF-demanded reform curve.

Energy is an example of the problem. The GoU has done difficult things, like raising energy tariffs as the IMF required, but it has not fundamentally reformed the corrupt Ministry of Energy nor changed the sector, which is not a market, but a battleground of struggling interest groups. (This point was made at a recent Ukraine Foundation conference discussion of reforms.)

More International Assistance

We need to work with reformers to build institutions, fight corruption and create conditions for growth.

This will require a long-term assistance strategy coordinated with our partners and a commitment from Congress to multi-year funding and additional resources.

Visiting Congressional delegations repeatedly told us in Kyiv that they are ready to consider a substantial expansion in assistance to Ukraine.

They understand that our support to Ukraine is important, but is currently insufficient, particularly in comparison to our response to the Georgia crisis of 2008.

Ukraine's success is essential for the wider security of Europe and fulfilling the vision of a continent "whole, free and at peace."

How would we use additional money?

We should consider new forms of macro-economic support and link this to tougher, more market-oriented reforms. Our current use of loan guarantees is costly in terms of assistance dollars and is placing a heavy sovereign debt burden on Ukraine.

We should look to the sorts of things done under the SEED Act in the early 1990s. It will be easier for Ukraine's reformers to be more radical when they have a macro-economic cushion for the economy.

The government badly needs public sector and civil service reform. The current bloated and poorly paid bureaucracy is a brake on reform implementation, and a source of corruption. But this is an enormous and expensive task.

It is not a task a single donor or the Ukrainian government can assume alone. But with additional funding we could work with the EU and other donors to undertake widespread public sector reform.

We also need to support a massive privatization effort with the advisors and technical assistance to do the due diligence to prepare hundreds of state-owned enterprises for transparent privatization process that will attract strategic investors.

In addition to the conflict in the East and fighting for reform in Kyiv, Ukraine faces a humanitarian crisis, largely overlooked in the West.

This involves more than 1.5 million displaced persons inside the country, more than a million refugees outside it and millions more trapped and vulnerable in the area of conflict.

Neither we, nor our European allies are stepping up with an adequate response to the needs of these people, particularly as they face the onset of a second winter.

In conclusion, Ukraine needs to redouble efforts at reform and adopt deeper, more radical market-oriented measures, particularly by cleaning up the business and investment environment. The US and international community need to explain the stakes to their publics and think bigger and more strategically in terms of the level and types of assistance that can be made available.