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Ukraine's National Recovery: Opportunities and Challenges

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Executive Summary

- The time to plan for Ukraine's recovery is while war is still raging.
- The war caused extensive and, in some areas, apocalyptic damage.
- Kyiv School of Economics says infrastructure costs are $100 B.
- President Zelensky says 10-year recovery plan will cost $750 B.
- There's a lot to like in President Zelensky's national recovery plan.
- The challenge is to turn a good plan into concrete achievements.
- Ukraine's EU Candidacy paves the way for EU organizing funding.
- To attract investors, Kyiv needs a more market friendly economy.
- Ukraine needs to develop market laws & institutions, stabilization, liberalization, & privatization to pace and sequence this transition.
- Corruption is also a major obstacle to attracting more investors.
- Kyiv is making some progress to curb corruption & attract donors.
- But Chatham House is still critical of its pervasive corruption.

Introduction: The time is now

As the Ukraine military executes a counter-offensive against the Russian military in October 2022, some observers say postwar military planning needs to wait until war's end. They argue that postwar planning and reconstruction would only be a distraction from the current battle rhythm and the future is uncertain.

But uncertainty is no excuse not to plan. In fact, delaying planning and civilian reconstruction is arguably a mistake. Think back to World War II. Months of combat lay ahead in Europe and the Pacific when the U.S. and its partners met at Bretton Woods, N.H., in July 1944. They had the foresight to plan the global order that would follow the war. They visualized and then created such institutions as the IMF, the World Bank and the UN long before they could see final victory.

Thus, the lesson learned from World War II was the time to plan for Ukraine's recovery was while war was still raging. In retrospect, planning for the postwar environment was a potent symbol of Western unity. But that pleasant scenario was not inevitable. Delaying this planning would have meant mishandling actions which could have spelled disaster for Ukraine and European security.

Foresight is also important at tactical and operational levels. When guns fall silent, people are still vulnerable. So advance planning is essential to save lives. Planning to rebuild Ukraine and its place in Europe is not idle speculation. It has real effects. Consolidating social, economic, and political gains are vital to sustain postwar success.

Planning is critical to hold down costs, limit waste and help the Ukrainian people realize a brighter future. In fact, it's important to start reconstruction now in order to safeguard a seamless web between the war economy and the postwar economy. Otherwise, the longer-term financial burden on donor countries would be even higher.

Significant areas of the country are largely free from fighting. Rebuilding these areas now offers hope to a country blighted by death, destruction and fear. In addition, leaving them depressed would only discourage the return of refugees and prolong Ukraine's dependence on foreign aid.

Western support for reconstruction projects will also help the war effort by allowing the Ukrainian government to focus on providing basic services and keeping its troops supplied.

While it makes little sense to rebuild a structure that will just be shelled again, this has not stopped the Ukrainian government from starting to rebuild in parts of the country where fighting has ended. There is a continual race to restore vital services, rebuild housing and salvage productive capacity in the Ukrainian economy.

Having a light at the end of the tunnel is a huge morale boost for Ukrainians, especially for people in the occupied territory. Having a sense that the future will be better will make it easier to survive these dark days.

There is enormous willingness among much of the international community to support the war effort. There is also enormous willingness for them to invest in the rebuilding of Ukraine. But enthusiasm fades, so now is the time to tap into this passion as a force multiplier while it lasts.

Thus, there is plenty Ukraine's allies can do now:

- Repairing or bridging broken spans with modular bridge kids, expedient road repairs, and other temporary vital infrastructure can help move millions of pounds of grain out of the country.
- Farmers and agribusiness need support for planting this year as well as stronger storage facilities, such as temporary grain silos.

Where feasible, residential areas need reconstruction accelerated:

- Prefabricated housing for those internally displaced by the war and for returning refugees is needed to restore some normality.
- In areas where violence has sufficiently subsided, outside experts can help de-mine key routes and corridors to facilitate recovery of essential services.

- Large numbers of Ukrainians can’t return to their homes until these routes and areas are secure.

Russia Degrades Ukraine’s Economy

Russia’s attack on Ukraine included degrading Ukraine’s economy. Russia’s rocket attacks on the huge grain silo of Mykolaiv and the theft of grain stocks demonstrate this. Putin refused humanitarian corridors, blocked grain exports and attacked factories, plants and social infrastructure along with roads, ports and railways.

Ukraine’s GDP is expected to contract by 45% in 2022 and 99% of the companies in the country have reported losses. Roads, railways, grain elevators, telecommunication networks, real estate, schools and hospitals have been damaged, destroyed or seized by Russian forces. Maritime transports were shut down. Millions have fled the country and millions more have been displaced. A running tally by the Kyiv School of Economics puts key infrastructure loss at about $100 billion.

Over 7 months of fighting has brought staggering levels of destruction, from bridges to homes, hospitals, and shopping malls. With millions of Ukrainian citizens displaced and the country’s infrastructure in ruins, Ukraine will be unable to support itself for year, possibly decades to come.

An impoverished or dysfunctional state the size of and importance of Ukraine on Europe’s border would be vulnerable to future aggression and a source of economic and political instability. Preventing such an outcome will require the democratic world to finance much of the country’s reconstruction, just as the US did in Europe after WWII with the Marshall Plan.

The Cost of War

The war in Ukraine has caused extensive and, in some areas, apocalyptic damage. While some regions, particularly in the western part of the country, have escaped with relatively minor damage, the heavily industrialized eastern portion of Ukraine has seen levels of destruction reminiscent of scenes from the First World War. This is especially true in in areas where front lines were relatively static allowing for extended artillery and missile bombardments and of course heavy tit-for-tat ground fighting. Some of this devastation predates the Russian February offense.

Thousands of homes and businesses have been damaged or destroyed and the Ukrainian road, bridge, and rail network has been severely compromised. Indeed, 80% of the assessed physical reconstruction costs from the war are attributed to housing, transport networks, and commercial plant needs. Much of the damage is geographically concentrated in front line areas and logistical nodes.

The western Donetsk and Luhansk areas as well as urban centers in Zaporiza and Kherson are examples of the damage caused by the relatively slow moving and brutal slug fests that have highlighted much of the fighting. As one would expect, the combatants favored striking high value targets which included critical and expensive to replace infrastructure. Figure 1 illustrates the concentration of the damage in the eastern region. It should be noted that the most damaged areas are also Ukraine's industrial and mineral rich heartland.

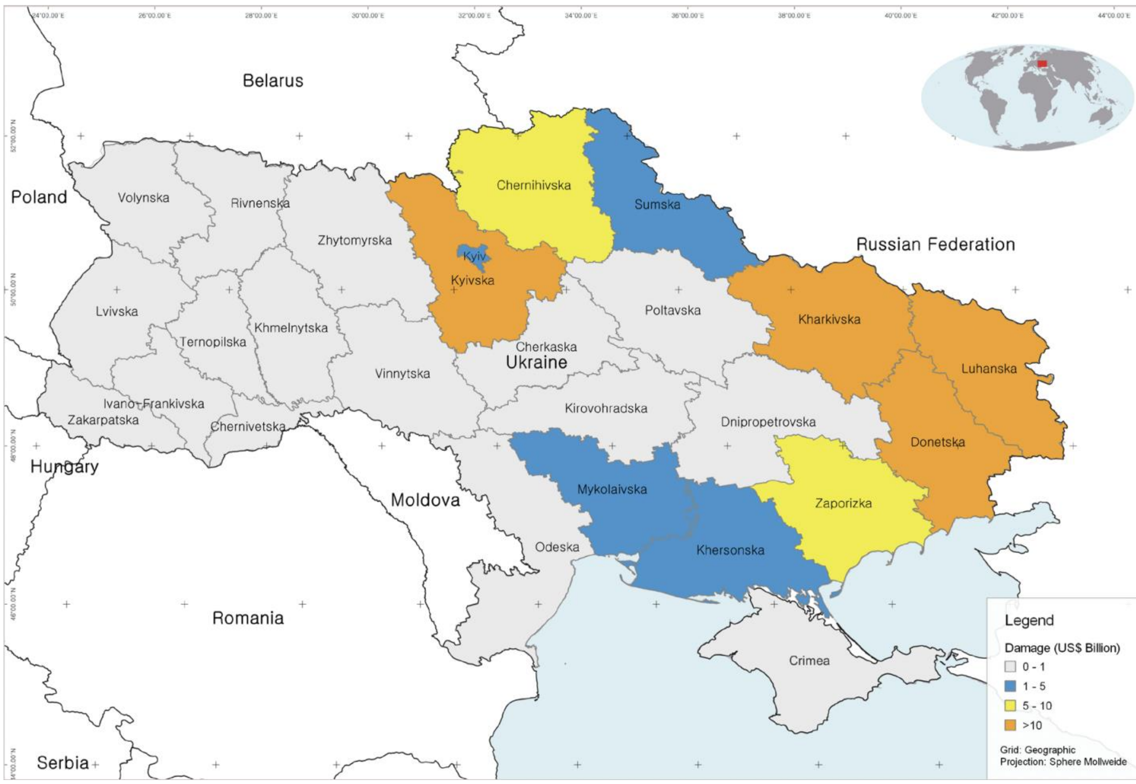

Figure 1. Extent of damage by region as of June 1, 2022. World Bank assessment team. *Aside from the concerted assault on Kyiv, the eastern mineral rich industrial areas were the scene of the most intense fighting.*

Damage Assessment

To gauge the damage caused by the war to date, the World Bank sent assessment teams to capture its scope and scale. Through 1 June 2022, the teams assessed approximately $97 billion in damage with the housing, transport, and industrial sectors hit the hardest. Ukraine's eastern oblasts were the hardest hit with Donetska, Luhanska, and Kharkivska suffering the most. Indeed, close to 60% of assessed damage occurred in those three oblasts. Destruction has been particularly acute in urban housing with over 800,000 homes and apartments being affected, almost 40% of which are destroyed beyond repair.

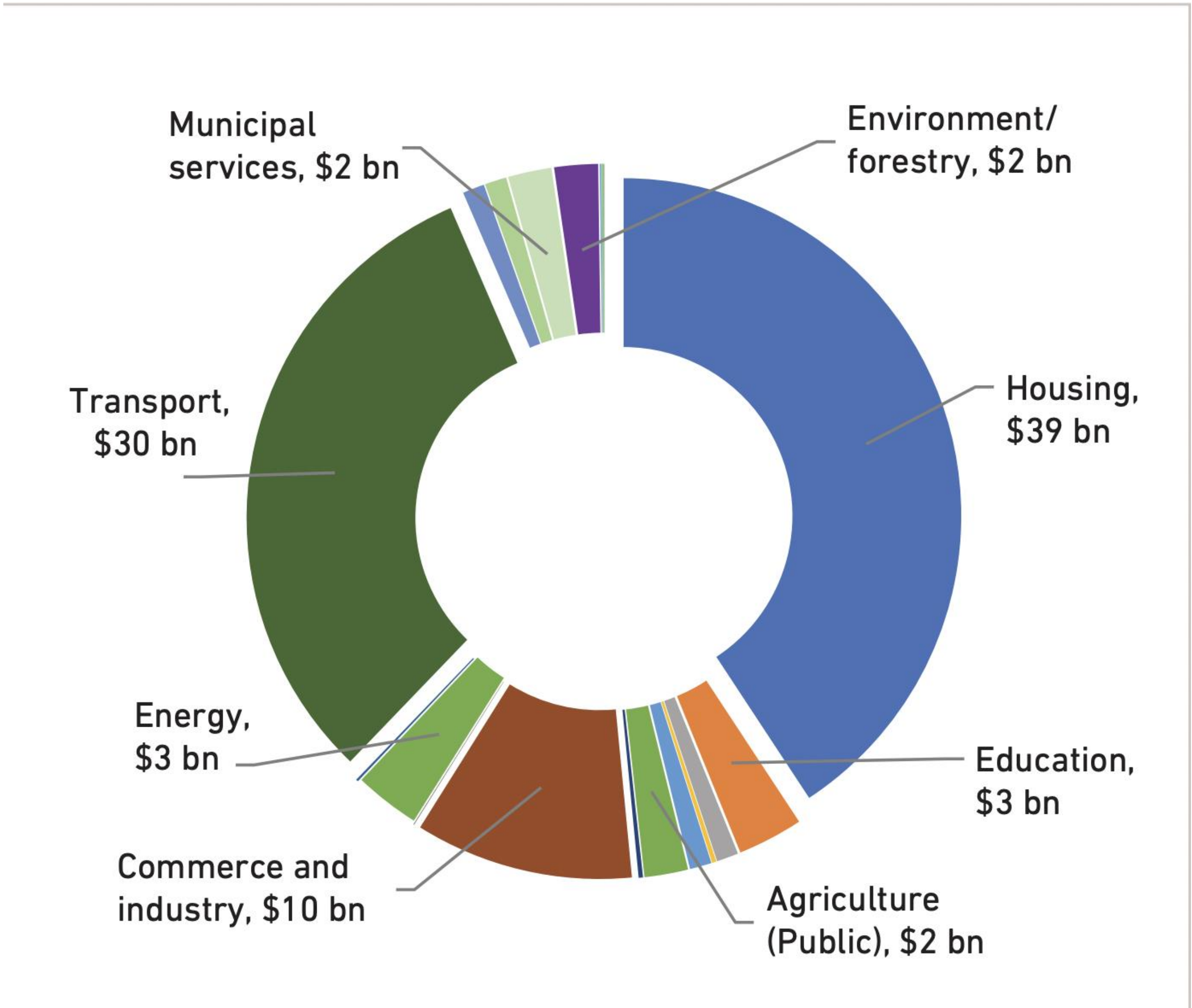

Figure 2. Total damage as of June 1, 2022: US$97 billion. World Bank assessment team.

The Housing, Transport, and Commerce & Industry sectors sustained over 80% of the damage.

Losses Due to the War

In addition to battle related damage, the World Bank team assesses aggregate loss remediation of almost $252 billion- that is, restoring economic activity lost as a result of the war. As an example, widespread land contamination due to mines and dangerous ordnance has significantly impeded economic activity. Large parts of Ukraine require land decontamination to return to normalcy.

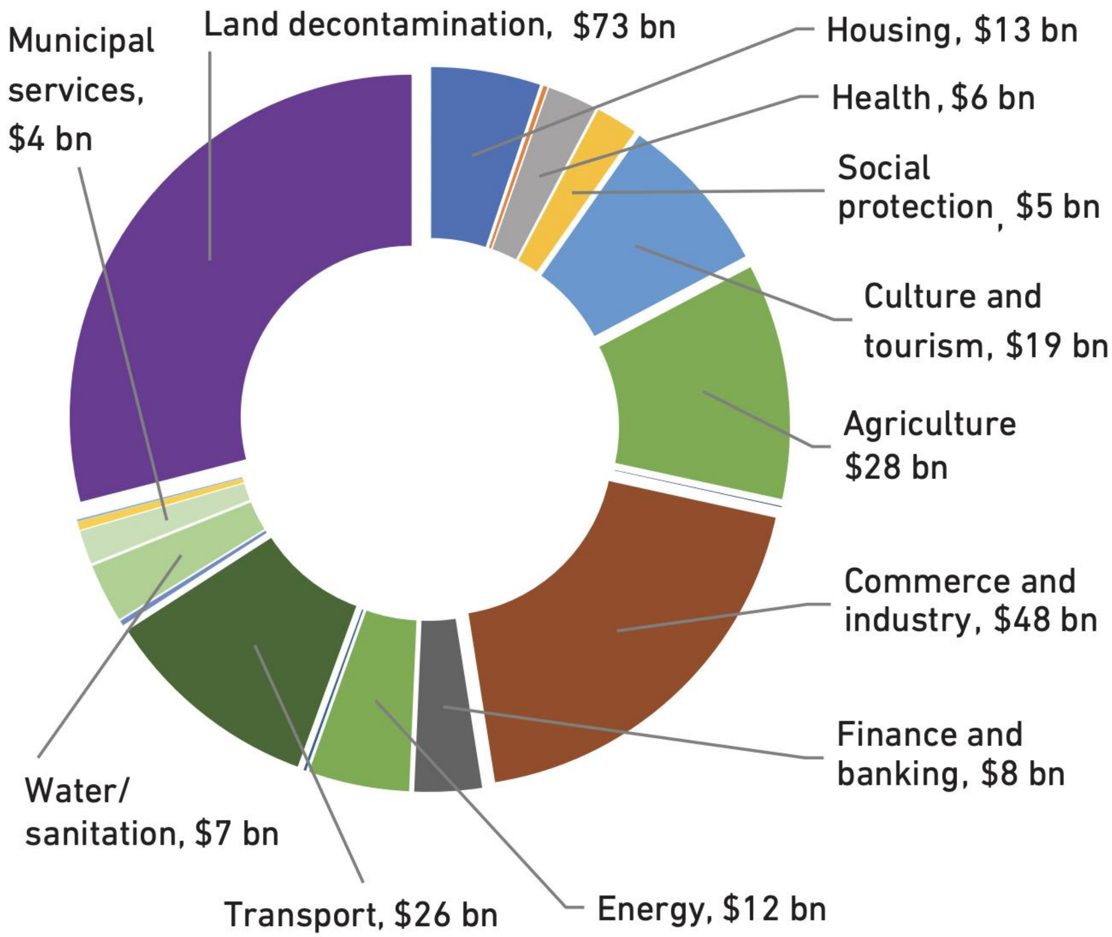

Figure 3. Total losses as of June 1, 2022: US$252 billion; World Bank assessment team.

Land decontamination is a significant obstacle to recovery and includes a deliberate campaign of prioritized assessment, surveying, and clearance of mines and removal of unexploded ordnance.

Total Damage and Loss

Altogether, the World Bank estimates that total reconstruction and recovery needs are about $349 billion. It should be noted that this cost does not consider damage inflicted after 1 Jun and does not take into account the lost economic activity that will occur as recovery and reconstruction timelines extend into years. Moreover, this World Bank assessment does not address the human capital lost via displacement, fighting, wounded, disabled, or dead.

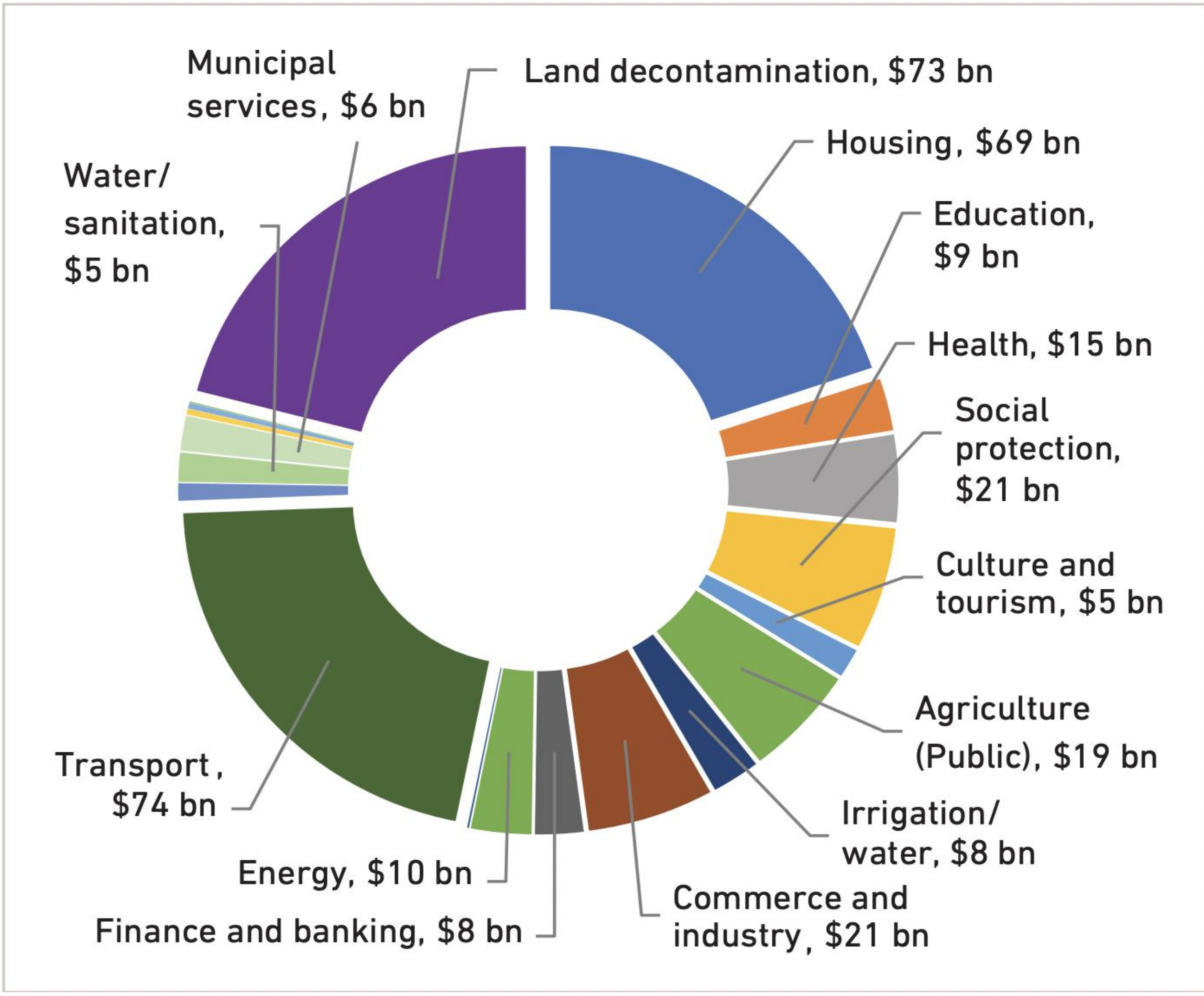

Figure 4. Total needs as of June 1, 2022: US$349 billion; World Bank assessment team.

President Zelensky's National Recovery Plan:

Ukraine's National Recovery Plan is comprehensive, coherent and rightly ambitious- to the tune of $750 billion over 10 years and an objective annual GDP growth rate over 7%. Well-structured and logically arrayed, the UNRP provides context, major objectives, guiding principles and implementation approach, establishes the National Recovery Council to coordinate efforts, and provides the NRC with a vision and tangible imperatives and objectives. The NRP further identifies 15 executable national programs to achieve its recovery and growth targets and assigns a timeline and budget for each. Each of the 15 programs are further broken down into individual projects, with estimated

funding need, performance criteria, related initiatives, time horizon and economic sector being addressed. There is a lot to like in this plan.
The UNRP begins not only by recognizing how much damage from the conflict but also highlighting Ukraine's historically poor economic performance vs. its Central European peers. Indeed, the plan that follows is about more than just fixing what was broken, but rather, building and restructuring institutions and economic modes of production which have been misaligned and stagnant since the days of inept Soviet central planning. Indeed, UNRP strikes an undeniably optimistic tone of a nation freed from Soviet style economic paradigms eager to embrace EU models of freer markets and transparency.

There is room for this optimism. Ukrainian GDP growth is largely occurring in the western part of the country and not in areas or sectors of historical growth. Modernizing the economy has occurred for some time and the recovery plan will only accelerate this.

Some background is in order. Ukrainian industrial output has historically been in the iron and coal rich eastern oblasts. Much like industrial complexes in the US such as Detroit and Pittsburgh, the proximity of energy supplies, input ores, and suitable water transport made heavy industry in Donetsk and along the Azov coast a natural choice.

The Soviet Union embraced the physical and mineral gifts of the region, and the eastern oblasts of Ukraine grew into a significant center of production for the Soviet state. It is no coincidence that those very regions host large ethnic Russian populations as generations of Soviet technicians, engineers, miners, machinists, administrators, and others flocked (or were assigned) to what was a growing center of industry.

In a story familiar to many Americans who grew up in the Rust Belt, these once thriving areas are no longer the growth areas they once were. The UNRP recognizes this and as Americans do not prioritize the rebuilding of the steel works in Bethlehem, the Ukrainians are not prioritizing pouring their recovery funds in revamping Soviet era machine shops. Rather, they are emphasizing revamping the legal, financial, and regulatory structure which allows capital to choose where best to go.

The figure below (5) highlights the westward growth trend in Ukraine. Even as early as 2013 when this data was collected, urban areas in western Ukraine were growing both in population and economic production. The eastern oblasts, in stark contrast, all show a shrinking population, a shrinking economy, or both. While Ukraine in general suffers from economic growth issues and a dismal demographic outlook, what bright spots there are reside in the western half of the country. The exception appears to be Crimea, but since 2014 it has been occupied and data is hard to validate.

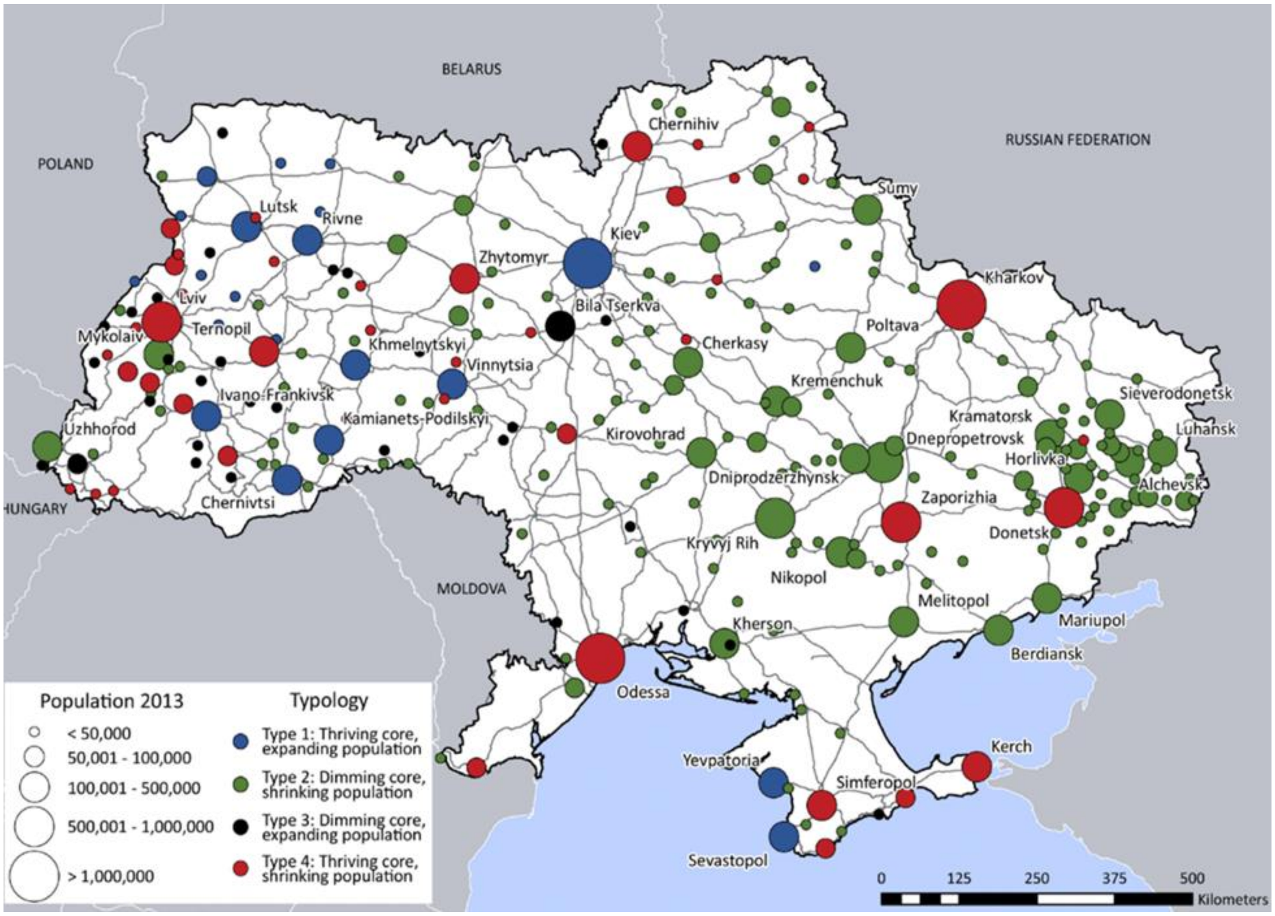

Figure 5. *"Cities in Europe and Central Asia". UKRAINE. World Bank; Advisory Services and Analytics (ASA) work developed by the Urban, Social, Rural and Resilience Global Practice (GPSURR).*

Interestingly, the UNRP places Resiliency as the first of three objectives for the plan, the other two being Recovery and Modernization and Growth. This is telling as aspects of the plan foretell a sundering and overhaul of existing regulatory systems, economic structures, trade patterns, and modes of industrial operation. Resiliency considering the dramatic changes called for in the plan is rightly placed as the premier objective. Resiliency often comes at the cost of efficiency. Maximally efficient economic systems are not always resilient, but they are more secure. This leaves planners room to place efficiency below economic, social, and environmental resilience. This may manifest in what might be considered protectionist policies, an increased emphasis on regulatory oversight, and of course a national security focus.

The plan also lays out several guiding principles which inform the various recovery programs and projects. The first principle is to "Start now, ramp up gradually" which is to say, get moving with what you can now where you can, even when the conflict is ongoing. This follows a number of successful reconstruction efforts dating back to the French recovery efforts early in WWI.

The next principle is to “grow prosperity in an equitable way”. Again, another effective principle from past reconstruction efforts which seeks to ensure that uneven recovery efforts do not plant the seeds for future social agita. “Integration into the EU” is next and is perhaps the most daunting as it implies the execution of a series of very concrete actions and perquisite conditions such as adherence to the Copenhagen Criteria and elusive institutional capacity building.

Next is “Build back better (for the future)” which acknowledges that Ukraine cannot simply repair damage to dying industries but rather must prioritize recovery in areas of future growth, to include a digital and green economy. Ukraine has dying but profitable legacy industries in the east and growing and profitable sectors in the west, especially in the large urban centers. Ukraine has an opportunity to not build back but build new for the future needs. No need to re-build legacy industry; better to build infra of the future).

The last principle aligns well with the previous four: “Enable private investment & entrepreneurship”. With an emphasis on small to medium sized business and creating the conditions to both allocate internal capital and attract foreign direct investment, adherence to this principle implies the establishment of trusted oversight mechanisms to ensure transparency and attract capital. It acknowledges the role of agile private equity over the dated and moribund state-owned enterprise model of the past.

Transforming the Plan into Concrete Achievements

Now that we have a) explained why we need to plan a recovery and start rebuilding in wartime, b) assessed the overall damage and costs from the Russian invasion of Ukraine, and c) explained the promise of President Zelensky’s National Recovery Plan, the challenge is to turn a good plan into success on the ground.

A number of questions come to mind. First, will enough donor money come from the International Community to implement the $100 billion infrastructure needs for the first year of the recovery? Second, will there be enough donor money and investment dollars from the private sector for President Zelensky’s $750 billion economic recovery plan for the first decade? Third, even if all the money comes as planned, how will the reconstruction be organized?

There is good reason to fear a disorganized melee of countries and international institutions all caring about their brand, their influence, and the visibility of their money. The risk is one of paralysis if no streamlined, centralized process to co-ordinate both donors and spending is agreed upon.

The Ukrainian government has increased this risk with a scheme to match individual donors with specific regions or cities in Ukraine. No one would be served by such an organizational mess.

Logic dictates that the money should flow through two entities:

- The Ukrainian government, which alone can identify the country's needs
- An agency of donors that can reassure them their money is being well spent.

The only good place for that agency is as part of EU, which inevitably should take the lead because Ukraine is located in the EU's backyard. Ukraine's EU Candidacy paves the way for EU organizing funding.

Needed: A Coherent Economic Transition

To be an attractive place to invest their money, the foreign investors want to know if Ukraine has a coherent strategy that makes the transition from a bloated public sector economy to a market friendly economy. At the moment, Ukraine has not developed a coherent economic transition strategy. To make matters worse, there is no textbook or school solution these days for a coherent economic transition strategy.

Without a coherent transition, donors will hold back because they will assume there Ukraine has no plans to orchestrate an economic transition to a market friendly economy.

So, to modestly fill the gap, we have created a coherent one that at least explains the economic challenges and opportunities of trying to roll out the pace and sequencing of one. It will be up to the Ukraine government to test the waters.

Finally, investors in the private sector are not just looking at whether the government has a coherent economic transition strategy. The answer to how much money will come from investors will also turn on whether or not the donors and investors can trust the Ukraine government. Based on Ukraine's history of endemic corruption, not much money would come.

A Market Friendly Economy for Ukraine

To promote economic stability as well as sustainable economic growth, we recommend a market friendly economic strategy for Ukraine. What's the big picture vis-à-vis the Ukrainian government and markets?

The Ukraine government should concentrate its interventions on areas in which markets prove ineffective. Otherwise, the market takes the lead. The World Bank cites four main aspects of the relationship between governments and markets. [1]

First, investing in people requires an efficient public sector. Markets alone generally do not ensure that people, especially the poorest, receive adequate education, health care, nutrition, and access to family planning.

Second, an enabling business climate is essential for the private sector to flourish. Climate needs to include laws and institutions which support competition, adequate infrastructure, and market friendly institutions. Competition fosters innovation, the diffusion of technology and the efficient use of resources.

Third, successful economic development requires the integration of countries with the global economy. While the pandemic raises questions about supply chain management, the openness to international flows of goods, services, capital, labor, technology, and ideas spurs economic growth.

Previous East European Reforms: Lessons Learned

No one knows when the war in Ukraine will be over. When that moment occurs humanitarian assistance and disaster relief will be the immediate concern. But free market planning still has to happen. The problem is there is no way of knowing how much of the free market will be left and how much of the Soviet era mindset will still be plaguing the economy. In short, there are many unanswered questions.

That said, Ukraine's situation is not unique. Ukraine's economic challenge is actually reminiscent of common economic challenges and opportunities which Ukraine's East European neighbors faced back in 1991. Understanding the nature and extent of these economic challenges and opportunities for East European economies back in 1991 will arguably help Ukraine avoid pitfalls and formulate a more sustainable market friendly economic strategy. The following is a drill down into the past to help Ukraine's future.

While each East European country chose their own economic reforms after the break-up of the Soviet Union in 1991, the most valuable lesson learned relates to the interaction between the state and the market in fostering stable and sustainable economic development. Economic success is most likely when East European public sector complements the markets. In contrast, dramatic failures occurred in Ukraine when a bloated state and the market collided and created financial crises.

When the Soviet Union broke up in 1991 East Europeans were euphoric. Armed with their new political freedom, they bravely set put to sweep away the old discredited socialist economies and replace them with sparkling new free market economies. Widespread popular support helped the economic reformers push through startling changes. The three leading reformers – Poland, Hungary, and the Czech and Slovak Federal Republics – freed most prices, lowered their trade barriers, opted for currency convertibility and opened the doors to foreign investors. Even Bulgaria and Romania enthusiastically embraced free markets and political freedom in word, if not yet entirely in deed.

Unfortunately, the euphoria back in 1991 was gone a year later. Gone two was the dream of prosperity coming to this region anytime soon. In its place was the grim reality of a socialist economic legacy that would be anything but easy to transform.

Disagreement and bitterness grew throughout Eastern Europe as hopes faded for a quick transition to a market economy. The problems East European faced by September 1992 were far more difficult than anything they could have imagined a year earlier.

While scores of small businesses sprung up throughout the region, Eastern Europe as a whole experienced a deep recession, with GDP falling about 8% in 1991 in the five reforming countries.[2] Industrial output in these five East European countries fell even faster, by 17% in 1991.[3] The fall in output led to a fast rise in unemployment. In Poland, Hungary, Bulgaria, and the Czech and Slovak Federal Republic, the number of jobless more than doubled during 1991.[4]

The UN Economic Commission for Europe compared Eastern Europe and the former Soviet Union to the Great Depression between 1929 and 1933. [5] Unemployment rose from about 3.4% when the economic reforms began in 1989 to almost 20% by 1992. [6] In addition, inflation was still far from being under control and was destructively 25% in Hungary in 1991.

East European economies also faced other challenges. For instance, East European economies were also devastated by the abrupt rise in energy costs since the Soviet Union began demanding market prices for its oil. The overall collapse of trade with h Soviet Union and the former East Germany hurt East European economies too. And as if things weren't bad enough, Poland –the boldest reformer in all of Eastern Europe back in 1992 – was rocked by a series of banking and corporate scandals. The bleak picture led Morgan Stanly to describe 1992 as Eastern Europe's "year of living dangerously." [7]

This growing pain in 1992 made the whole process of transforming these economies politically more difficult. Certainly, few East Europeans anticipated how long and complex would be the task of turning socialism into capitalism. Despite the complexities of the process, the transition to a market-oriented economy involves certain basic elements. This paper discusses these basic elements of economic transition in Eastern Europe and the difficult issues surrounding these elements. [8] In particular, the paper addresses the appropriate speed with which the elements of reform should be implemented as well as the question of what to do when, or what is called the sequencing of the reforms.

Most economic reformers would agree that the required economic reforms are so interlinked that even identifying the best sequencing is extremely difficult. It would be desirable, therefore, to do everything at once. But as a practical matter, some reforms take longer than others to implement. So, like it or not, choices have to be made regarding sequencing. [9] Choices also must be made regarding the pace of reforms. In other words, should we follow Jeffrey Sachs and pursue rapid "shock therapy," or follow Roland Paris in his book at War's End and pursue gradual transition?

The transition process has many elements (such as institution building and attitudinal changes in Ukraine) that simply don't lend themselves to rapid transition, while others such as privatization of state-run banks and monopoly businesses must occur relatively fast if a market friendly economy is ever to get off the ground. In any discussion of speed and sequencing of economic reforms, the transitional costs of moving from a state-run economy to a market friendly is to be addressed. [10]

These transitional costs depend on the expectations of the Ukrainian people and the credibility of the transition process itself. Unfortunately, unrealistic expectations of the Ukrainian people regarding the ease and length of the transition are undermining the credibility of government transition policy in Ukraine.

The euphoric consensus that supported a dash to the free market faded and calls for a slower transition to a free market grew, both within the governments and among opposition parties. Unfortunately, the history of partial and slower transition away from socialism in Eastern Europe prior to 1989 was a history of stagnant, inefficient, non-competitive economies. [11]

Ukraine's only hope of achieving prosperity anytime soon depends on "how politically deaf and determined the country's reformers will be over the next year or two. [12] Economic reforms must be comprehensive and rapid enough (in those areas where speed of implementation is possible and prudent) to create a public constituency whose interest in a new market friendly economy is bigger than that favoring the old state-run system. Inevitably, therefore, the issues come down to when to do what and how fast to do it. [13]

The Sequencing of Economic Reforms

While some scholars argue that all the economic reforms must be initiated immediately and simultaneously, this approach is a political and practical non-starter for most Ukrainians. A more realistic approach is to adopt the economic reforms in a logical, economically sound sequence, which in turn minimizes the social shock. The phasing of Ukrainian reforms can be divided into four broad sequential categories:

- Macroeconomic stabilization
- Redefining the role of the state
- Liberalizing the economy
- Restructuring ownership and privatization [14]

Most reformers would agree that macroeconomic stabilization is a prerequisite for most other economic reforms. Successful stabilization come from balancing total domestic production so as to keep prices relatively constant and predictable.

This is especially important in Ukraine. At war's end there will inevitably be shortages which push up domestic inflation. To make matters worse, there is also global inflation which means a double whammy pushing prices up. Only after this inflationary pressure is checked is it responsible to initiate an economic liberalization plan. Should the liberalization plan begin without a solid stabilization plan in place, prices could skyrocket. This runaway inflation could be destabilizing, triggering social turmoil and political reversals.

An effective stabilization plan consists of tightening fiscal and monetary policies. [15]

- On the fiscal side, any sizeable budget deficit should be reduced. Austerity measures to accomplish this task include reducing government subsidies to sick and inefficient industries.
- On the monetary side, the growth of the money supply should be curbed, and commercial interest rates should be set at a rate equal to or above the inflation rate of public investment.

And since the Ukraine foreign exchange rate of the hryvnia against the U.S. dollar has been overvalued in a world market sense, the foreign exchange rate of the hryvnia should be devalued and pegged to the U.S. dollar. In short, overall macroeconomic stability must be created before liberalization can start. Otherwise, suppressed inflation will merely be replaced by runaway inflation.

The early Polish and Yugoslav stabilization programs in 1990 showed that inflation can be reduced, at least in the short run. Poland's monthly inflation during the six-month period from march through August 1990 was about 4 percent, compared to 30 percent in the last months of 1989. Similarly, Yugoslavia's inflation fell from 64% in December 1989 to 10 percent for the six-month period from March through August 1990.
Of course, initiating a stabilization plan is a lot easier than sustaining one.

This is particularly true when it comes to limiting wage increases. For instance, in January 1990 Poland implemented a tax to discourage wage increases while Yugoslavia froze nominal wages for six months at the start of its stabilization program. Wages fell in Yugoslavia about 45% from November 1989 to February 1990, but rose 25 percent in the three months after the wage freeze was lifted in June of 1990, which in turn caused inflation to jump in the third quarter of 1990. Similarly, wages fell in Poland 47 percent in the first half of 1990, but rose again in the second half of the year. [16]

The experiences of Hungary, Poland, and Yugoslavia also showed external stabilization measures can improve their competitiveness in the world marketplace. For instance, in 1990 Hungary devalued its currency 15 percent. Poland and Yugoslavia also devalued sharply in early 1990. Warsaw devalued by 46 percent and Belgrade devalued by 20 percent. In all three countries, exports rise significantly after the devaluations. [17] While nobody should underestimate the difficulty of implementing these macroeconomic stabilization programs, they can often be done relatively quickly. Take Poland, for instance. On January 1, 1990, Poland made dramatic changes in prices, the exchange rate, as well as in fiscal and monetary policies.

Redefining the Role of the Ukrainian State

But macroeconomic change is one thing. Changing attitudes and the role of the state is far more complex. In Ukraine, the amount of change needed is enormous. Just think of how long it has taken the market-oriented economics in the West to function relatively efficiently. Western economies rely on institutions and laws established over a century or more. These include market-oriented accounting and banking rules, tax codes, pension and unemployment systems, labor laws, bank, and financial market supervision and finally property and contract law and the courts to enforce them.

Although Ukraine broke away from the old Soviet Union over three decades ago, Ukrainians have just begun to think about these complex laws and institutions. And yet they are the essential bedrock of a market friendly governance. And so, Ukraine must create, virtually from scratch, a network of modern laws and institutions, without which a truly market friendly economy cannot function.

The legal and institutional changes take time to work through the parliamentary process because they involve no less than a complete restructuring of the economy. For instance, domestic factors of production – including labor services, land, machines, tools, buildings, raw materials as well as financial capital – must be transferred from state ownership to private hands.

Only when these inputs can be bought and sold in the marketplace will the economy begin to remove the economic distortions that keep it non-competitive. Similarly, parliaments must legalize the right to own private businesses, private property, commercial banks, and financial markets.

These legislative and institutional changes to a market friendly economy are inter-related and cannot easily be handled in a piecemeal way. For instance, let's suppose the Ukrainian parliament passes legislation that allows workers to be hired and fired at public as well as private enterprises. Most economists would argue that such a law is necessary to improve the allocation of labor resources in the economy. But a law compensating laid off workers must be in place and the money dispersed if these unemployed people are not going to suffer unduly.

In addition, enterprise managers must also have the right to raise or lower wages to attract good workers to efficient and promising businesses and to trim the payroll if recessionary cycles occur. But in order to attract better workers to higher paying jobs, there must be more labor mobility than presently exists in Ukraine.

Due to Russian destruction of civilian targets a severe housing shortage in Ukraine currently makes such mobility impossible. And that housing shortage will, in turn, will continue until recent controls are lifted, thereby giving private builders a financial incentive to construct new housing units. Furthermore, builders will not do anything until commercial banks are legalized, up and running and equipped with enough liquidity to make loans on commercial terms.

Lastly, legislative and institutional changes must include legislative and institutional legislative and institutional changes must include bankruptcy laws as well as anti-trust legislation. The former permits sick, inefficient industries a free exit and easy abandonment of capital. Anti-trust legislation is necessary to a) break up many of the oligarchies, b) increase competition and c) lower prices, thereby raising the purchasing power and standard of living for consumers.

Toward Price Liberalization

Once essential legal and institutional changes are in places, Ukrainian prices should be de-controlled. Price reform involves dismantling the complex system of centrally controlled prices and allowing them to reflect relative scarcities. Even with tough macroeconomic stabilization plans in place, price reforms tend to result in large increases in the official prices of "necessities" such as staple food, meat, and energy that were heavily subsidized under central planning. [18] While curtailing the heaviest subsidies on agricultural and energy prices is politically unpopular, it is also essential to remove some of the most pronounced distortions in the economy. [19]

Unfortunately, domestic price reform by itself tends to encourage domestic oligarchies to raise prices excessively. Therefore, the freeing of prices needs to be accompanied by the development of competition policies to offset oligarchy price hikes. Most importantly, a sensible set of relative prices will only occur if prices are "imported" from the world economy through trade liberalization. [20] Free and open international trade involves dismantling the state monopoly of foreign trade and reducing import restrictions. [21] Moreover, important measures were introduced to liberalize East European exports. [22]

Toward Trade Liberalization Again

Meanwhile, for the past six months, the ongoing war with Russia has severely affected the international trading system, preventing it from recovering from the shocks caused by COVID-19 pandemic. At war's end, every effort needs to be made to revive Ukraine's connection to the international trading system.

Turning to the international financial side, the Russian invasion of Ukraine put downward pressure on the Ukrainian hryvnia against the dollar. The official exchange rate of the hryvnia fell from about 29 hryvnia/dollar to about 36 hryvnia/dollar. More importantly, the banks don't want to convert hryvnia into a hard currency. At war's end, Ukraine needs to take decisive steps toward reviving currency convertibility. Currency convertibility involves the removal of restrictions on the use of domestic currency for international transactions. Currency convertibility is critical to Ukraine's transition to a market friendly economy for three reasons.

First, when combined with trade liberalization, currency convertibility on current account introduces world prices into the domestic economy and it curbs the power of domestic oligarchies. By doing so, it also allows Ukraine to specialize efficiently according to comparative advantage.

Second, currency convertibility on the current account (goods and services) in the balance of payments is an effective element in economic stabilization. When goods and services are exchange at a fixed rate, the exchange rate becomes an “anchor” for stabilization (or a disinflationary instrument).

Finally, convertibility on capital account (investment flows) as well as current account in the balance of payments are important elements in encouraging the import of foreign capital, technology and management skills to modernize the economy. If Ukraine is ever to attract foreign investors of any magnitude, foreign investors need currency convertibility in place. [23]

- Convertibility on current account allows foreign investors to repatriate interest, profits, and dividends.
- Convertibility on capital account allows them to purchase foreign assets initially with foreign exchange and in the end convert it back again if and when they decide to sell their investment.

Without convertibility, foreign investment in Ukraine will be minimal at best. [24]

Some economists argue that currency convertibility and trade liberalization shock the economy with excessive transition costs. They say foreign competition, though ultimately necessary, can be too sudden to allow domestic enterprises to adjust. These economists point to the general collapse of output and employment when East Germany was merged with the West German economy.

What these economists neglect to say is that the fall in output and employment in the former East Germany would have been significantly reduced had the East German currency not been so unrealistically overvalued at the time of German economic and monetary unification. The overvalued East German currency explains why the collapse in economic activity in the former East Germany was much greater than in Poland which carefully undervalued its currency when it implemented currency convertibility.

Privatization

Some reformers used to believe that market economies could be created merely by freeing prices. They conceded that private enterprise was desirable. But they saw no reason to rush. But most reformers now believe that you cannot have capitalism without capitalists. [25]

They also know that liberalization and privatizing state enterprises are inseparable. Freeing prices produces signals that tell the economy how its resources can best be used. But unless those resources (and above all the productive assets) are privately owned, those signals will be ignored. [26]

Privatization is also essential for other reasons as well. For instance, when the state owns an enterprise, the mangers of the enterprise face no financial discipline because a soft state budget can always bail out inefficient state enterprises. [27]

In contrast, private entrepreneurs have an obvious reason not only to preserve the value of their assets, but to enhance their value. [28]

Of course, establishing the procedures to transfer these state assets to private hands is complex and politically sensitive. Are the workers entitled to a share of the assets? If so, how much? How much should the old managers of the factories get? Do the people really want to reward these old communist elites? One thing is for sure. Somebody must run these new commercial businesses that has some capitalist knowhow and skill. If so, that means Western businessmen should be brought into the businesses.

But do the Ukrainians really want foreigners to buy up their country? Probably not to any great extent. While economic questions are involved here, ultimately questions of fairness are just as important. A market price for the business and a first-rate management team is important, but inequities in the initial distribution of assets could be socially disruptive and politically destabilizing.

How then do reformers evaluate these assets in the current state of flux in Ukraine? All agree that to create private ownership, there must first be a market – otherwise how are you going to evaluate the assets to be privatized? One answer to this chicken and egg dilemma is simply to conclude that the assets of these economies in transition really cannot be evaluated, and should therefore be given away to the citizens, whom in a socialist economy presumably own them anyway. That’s virtually what the Czech and Slovak Republic decided to do in 1992 with the biggest and quickest privatization ever seen up until that time.[29]

Still the question of which enterprises to privatize first must also be addressed. Ideally, the large inefficient state enterprises should be privatized first. But these enterprises are also the most difficult to deal with in a political sense. That’s why the tendency is to privatize the service sector first. The main thing is to get as many state enterprises as possible dislodged from the public sector. Once totally on their own, these new private enterprises need to focus on producing quality products at a low cost for the world market.

In addition, these newly privatized companies need to rely on loans from newly created commercial banks. The sooner all the enterprises in the country are freed from government subsidies (or central bank lending soft loans to them on a non-commercial basis), the sooner the country will see its standard of living rise toward Western standards.

And finally, most of the companies that cannot attract commercial bank loans and that are chronically unprofitable need to go bankrupt so that residual factors of production can be reallocated to those more promising companies desperately in need of financial resources.

The Pace of Economic Reforms

The emerging democracies in Eastern Europe all claimed to be moving toward market friendly economies. But each of these countries differed sharply on the means and speed with which they were proceeding. [30]

Initially at least Poland and Yugoslavia were the two East European countries on the fast track toward market-oriented economies. Unfortunately, the civil war destroyed the reform process in that unhappy place in the early 1990s. [31]

Hungary and Czechoslovakia opted for a more gradual path toward capitalism, although each country started to increase their pace a bit. Generally speaking, the slow track countries feared that moving full speed ahead risked popular unrest as voters lost their jobs or suffered sharp drops in their purchasing power.

In January of 1990, Poland and Yugoslavia opted for a fast track or big bang transition to capitalism. [32] Their tough stabilization plans aimed at imposing fiscal discipline and regaining financial control over their economies. They also hoped to create free market incentive for their factors of production as well as for their goods and services.

In many ways, the stabilization programs in Poland and Yugoslavia scored significant economic success. For instance, their inflation rates plummeted, their currency values stabilized following sharp devaluations, their budget deficits turned into budget surpluses and their hard currency reserves grew. [33] In other words, their economic gains occurred very quickly.

Unfortunately, these economic successes in Warsaw and Belgrade were attained at a very high social cost. In both countries, industrial output fell, unemployment rose and real incomes declined, notwithstanding some growth in the private economy. Some unemployment and a decline in the standard of living in moving from socialism to capitalism is unavoidable. But the social shock could have been softened in both Warsaw and Belgrade had the Poles and the Yugoslavs made all the necessary legislative changes and built the appropriate free market institutions (preparing the free market battlefield).

The point is that building appropriate free market legislation and institutions is mechanically difficult and time consuming. In contrast, a stabilization plan is sometimes politically socially and culturally difficult but is relatively easy in a mechanical sense. [34]

In legislative and institution building reforms, Yugoslavia had a head start in capital markets. But Yugoslavia was slow in enacting banking, property, and labor legislation, even before civil war broke out. Similarly, Similarly, Poland found creating market institutions slower process than opting for a stabilization plan. For instance, Poland did not pass a law to privatize large state enterprises until July of 1990. In short, mustering the political will for economic reform legislation was no easy matter.

Catch-22 sometimes occurs when a country like Poland decides that the stabilization plan is too austere and it opts to make some financial corrections (such as easing credit, higher subsidies, running high budget deficits or revaluing the currency upwards so that consumers can but more imports. Such a financial retrenchment may be politically attractive to populists.

But financial retrenchment recreates the very market dislocations that the stabilization plan was seeking to curb in the first place. Worse still, it sorely tests political support for economic reform legislation. And what initially might have begun as an understandable technical correction can easily degenerate into a fundamental rejection of market reforms.

This pattern of a big bang approach followed by financial retrenchment can be avoided if East European economies opt for a more gradual path to capitalism. While social shocks can theoretically be avoided with an economically logical sequential approach, the practical problem in the real world is to sustain the momentum of the transition to capitalism.

Too often, a country will start on this slow and incremental path only to equivocate and finally stop the process altogether. Some Eastern European countries simply have a very low pain threshold. Some, like Czechoslovakia, were reluctant to swallow any bitter economic reform pill immediately after the Velvet Revolution of November 1989. Since then, Czechoslovakia picked up the pace of reform while Poland retrenched. [35]

Perhaps the country that best typified the gradual economic reform strategy was Hungary. Historically, Budapest had lots of experience in soft-core economic reform and they had notable success in attracting foreign investment. [36]

So, a lot of people thought Hungary would be the pacesetter in pushing through hard-core or radical economic reforms. But Hungary has been very cautious ad not at all eager to match the pace set by the Poles.[37]

In fact, the IMF which helped finance the Hungarian economy, was very critical of Hungary for its “slow boat to China” approach. The IMF put increasing pressure on

Hungary to tighten its monetary policy, slash subsidies and raise prices in an attempt to create a more integrated and economically logical program. [38]

To some extent, IMF was successful in getting Budapest to move off the starting blocks. But generally, the Hungarians had an emotional preference for a slower pace of institutional reform. They wanted to spread the social pain over as long a period as possible. This was particularly true when it came to privatization. Many Hungarians criticized uncontrolled privatization as sellouts to either former communist managers or sellouts to foreign investors.

This gradual path to capitalism appears to be the model which Romanians and Bulgarians would follow at some point in the future. Of course, any difficult questions such as privatization, liberalization and stabilization had to be deferred until their volatile political disorder was stabilized. But Romanian and Bulgarian leaders continued to extol the virtues of free markets as the ultimate goal and began to pick up the pace of economic reform themselves.

Why did all the East European advocates of gradual reform keep one foot on the brake? Fear. They worried that rapid economic restructuring risked widespread labor unrest and severe recession. They therefore preferred to move a bit slower because it reduced short-term economic and social disruption.

Unfortunately, this gradual approach had a serious downside. As stated earlier, it risked equivocation because it allowed time for groups opposed to reform to coalesce into effective blocs. By and large, these were the communist beneficiaries of the old command economy who saw their vested interests being eroded. So, they worked to sabotage any change and cling to the economic status quo.

On the international front, gradualism can result in a country losing out in the fierce competition for critical foreign direct investment funds. In a broader sense, the slow boat to China approach risked upsetting any chances the country might have for integrating its economy into the world economy.

What would cause the gradual school advocates in these countries to lift their foot off the brake and accelerate the pace of economic reforms? If fear of losing out in the competition for Western capital among the different East European countries begins to offset more immediate fears of rising unemployment and plummeting standards of living, then some acceleration in economic reforms may occur. In a broader sense, the desire of these East European countries to join a wider EU could also be a positive inducement for an accelerated pace.

But any kind of all-out rush to free market economies in Eastern Europe in all areas of economic reform is highly unlikely. Each government will probably preserve a sizeable publicly owned sector. That even includes Poland. Prague also claims that tit wants to retain a large public sector.

In comparing the fast-track economic reform strategy with the gradual strategy, a number of things stand out. The full speed ahead school believes that economic reform is really an all or nothing proposition. They admit that the big bank causes more short-term social pain in terms of falling real income and rising unemployment. But they believe such a short-cut is worth it.

In contrast, the "slow boat to China" gradual school argues that gradualism minimizes social pain and social costs. Gradualists want to avoid the risks to political stability from too hasty reform. So, they tend to focus on one issue at a time, which in turn can sometimes slow down the pace of reform to a crawl, or what some say is marginal incrementalism. [39]

The Importance of Anti-Corruption Reforms

Now let's turn to Ukraine's economic future. Will money come to Ukraine so that President Zelensky can turn a good plan into concrete achievements on the ground? Earlier, we explored what Ukraine must do to create a market friendly economy that will attract foreign investors. Whether Ukraine can attract enough financial support turns on whether donors can trust Ukraine. In other words, the other great obstacle to donor confidence is the country's record of corruption. That record warrants skepticism among potential donors.

Before the war, Ukraine ranked 122 out of 180 countries in Transparency International's Corruption Perception Index. Estimates in 2021 showed that Ukraine's budget was losing $37 billion a year due to corruption and transparency problems. Not surprisingly, a report by the European Court of Auditors in September 2021 found that "grand corruption" and oligarchies' success at "state capture" harmed the democratic process and hindered free market competition and growth.

That said, Ukraine has made significant progress in transparency, including through the digitalization of city planning and public procurement, and monitoring of public officials' assets and lifestyles, corruption remains a challenge.

In addition, bank reform has begun as well as public procurement reform. Ukraine also has a vibrant civil society that is active in pushing for more anti-corruption reforms.

Progress toward integrity notwithstanding, there is still much more to do. Transparency is not self-reinforcing. Therefore, it is essential that the Ukrainian state improves enforcement of clean governing, taxation, and spending standards.

The Ukraine government itself included a detailed legislative and enforcement roadmap in its reconstruction plan. And the EU's granting of candidate status to Ukraine was made on the explicit understanding of specific further progress such as fully staffing new anti-corruption entities.

During unprecedented times of conflict in the past three months, Kyiv has returned to relying on oligarchs for government funding of both immediate assistance and future reconstruction, which opens the door for oligarchs to be able to promote their self-interest through the government.

For donors and foreign companies to invest in Ukraine, the business environment will need to be strengthened through judiciary reforms, tax enforcement, securing private property rights, and most importantly, enforcing the rule of law. A critical piece to disincentivizing corruption will be the West monitoring whether assistance is reaching its intended target or ending up in the hands of oligarchs.

Conclusion: A Window of Opportunity for Better Governance

If all goes well, a window of opportunity will open for President Zelensky that will lead to a market friendly economy as well as more integrity, legitimacy and mutual trust between Ukraine and the International Community. If Zelensky can surround himself with the most professional people, the Ukraine president will be in a position to sweep away the oligarchs and institutional incompetence and malpractice that have frustrated reforms in the past.

It's in this context that the EU must see Ukraine's ultimate application for EU membership. As a wartime hero, there will never be a better chance for President Zelensky to capture the national spirit of the Ukrainian people to "upgrade" its governance and make the transition to a market friendly economy. The task is now to map out a viable path into EU membership for a free Ukraine.

Our study argued that the time to plan and start rebuilding Ukraine's economy is while war is still raging. Admittedly, the challenge is daunting. The war caused extensive and, in some areas, apocalyptic damage. The Kyiv School of Economics says infrastructure costs for the first year of recovery will be upwards of $100 billion. And President Zelensky says the recovery plan for the first decade will cost $750 billion. There's a lot to like in President Zelensky's national recovery plan.

The challenge now is to turn a good plan into concrete achievements. Will the money come? That turns on how the reconstruction effort will be organized. If the bankrolling effort is an organizational mess the first year, that will turn off donors. Assuming the EU can provide adult supervision, Ukraine needs to make the transition to a market friendly economy. A history of Soviet era socialism is still a major obstacle to attract foreign investors. Our study explains how Ukraine can attract investors by developing market-oriented laws and institutions as well stabilization, liberalization, & privatization to pace and sequence this transition to market friendly economy.

Despite significant obstacles, to include horrific war damage and a history of pervasive corruption, Ukraine stands at an historic crossroads where a path to a bright future is open. If Ukraine can seize this moment favorable to positive change, they may indeed prove naysayers wrong.

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