Peterson Institute for International Economics

Policy Brief

NUMBER PB14-24 NOVEMBER 2014

An Economic Strategy to Save Ukraine

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Author's Note: I want to recognize helpful comments from Adam Posen, Marcus Noland, Steve Weisman, and Basil Kalymon. Vijay Khosa and Vitaliy Shpak have provided me with excellent research assistance.

Ukraine has experienced a year of unprecedented political, economic, and military turmoil. The combination of Russian military aggression in the east and a legacy of destructive policies leading to pervasive corruption has plunged the country into an existential crisis. The West, meanwhile, has been largely paralyzed with uncertainty over how to assist Ukraine without reviving Cold War hostilities. Yet all is not lost for Ukraine. A tenuous ceasefire, along with the successful elections of President Petro Poroshenko in May and a new parliament in October offer an opportunity for economic reform. If the current ceasefire in the east holds, Ukraine has a great opportunity to break out of its vicious circle of economic underperformance. Yet, the window of opportunity is likely to be brief. The new government will have to act fast and hard on many fronts to succeed.

Ukraine's economic situation is desperate but not hopeless. GDP is forecast to fall by 8 percent in 2014, which would leave Ukraine with a budget deficit of some 12 percent of GDP. Roughly two-thirds of the output contraction derives from Russia's military aggression in the east, as coal production fell by half in August and September and steel production by one-third. The rest of the downturn has been caused by the predatory economic policies of President Viktor Yanukovych, who was ousted in February. The Ukrainian currency, the hryvnia, has depreciated by 80 percent, driving inflation up to 20 percent and rising. Half the banks are effectively bankrupt. The country is close to a devaluation-inflation cycle. The current International Monetary Fund program is underfinanced and not sustainable.

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Yet this is actually a propitious time for reforms thanks to Ukraine's democratic transformation in 2014. The Ukrainian nation has come together because of Russian aggression. Its people are prepared to accept a lot of suffering, but they want to see results. For the time being, Ukraine's powerful oligarchs, who reaped immense wealth from privileged trade after the collapse of communism, are seriously weakened. The new government should attempt all the big, politically difficult reforms, including controlling corruption, within its first 100 days in office.

Since September 5, a ceasefire has officially been in force between the Ukrainian troops and the Russian-supported rebels, which hold half of Donbas in the east. The ceasefire has not been maintained, but the front has barely moved. For the moment, militarily, the best Ukraine can hope for appears to be a continued stalemate. On the other hand, Ukraine cannot afford to take any financial responsibility for territories it does not control. On November 5, Prime Minister Arseniy Yatsenyuk laid down the government policy: "As long as the territories of the Donetsk and Luhansk oblasts are controlled by all kinds of imposters, the central government budget will not send any funding there."

In this Policy Brief I offer a strategy for how the economic reforms can and should be carried out in the immediate future, drawing on the experiences of other postcommunist countries.[1] In the current grave crisis, reforms have to be fast, radical, and comprehensive. Political reform must come first. Reform of the state comes next with closure of superfluous state agencies, lustration (i.e., purging officials of the corrupt old order), reform of public administration, and far-reaching deregulation. Ukraine needs to cut public expenditures sharply and simplify the tax administration. The key reform must be to raise energy prices to the market level and eliminate all energy subsidies because these have led to energy arbitrage, the worst source of corruption. The poorest half of the population should be given cash compensation. Excessive pension costs need to be reined in, while the quality and efficiency of education and health care need major improvement.

Ukraine cannot do all this on its own. It needs substantial international assistance, both credits and grants on the order of a Marshall Plan for Ukraine. Ukraine has ratified its European Association Agreement, so it should be able to count on the European Union as its main external reform anchor and donor. The other major creditor should be the International Monetary Fund.

WHY UKRAINE NEEDS TO REFORM FAST

Ukraine can draw on the experiences of postcommunist countries that have pursued successful reforms. The most relevant cases appear to be Poland in 1989 (Balcerowicz 2014), Czechoslovakia in 1990 (Klaus 2014), Estonia in 1992 (Laar 2014), and Georgia in 2003 (Bendukidze and Saakashvili 2014). All these countries pursued reforms that were radical, comprehensive, and front-loaded. Since the fall of communism, some critics have warned against the imposition of "shock therapy" in newly emerging states. No country has failed because it attempted too fast and radical reforms, but all gradual reforms in crisis situations have failed.

The two most obvious successes are Poland and Estonia, where GDP has doubled in real terms after communism. Poland and Ukraine are striking contrasts. In 1989, they had similar GDP per capita in real terms. At present exchange rates, Poland's GDP per capita is four times larger than Ukraine's. It is high time Ukraine caught up.

The Ukrainian economy has suffered substantially because of the war with Russia. The loss of Crimea deprived Ukraine of 3.7 percent of its GDP; it is no longer included in official statistics, but Donbas is. In October 2014, the occupied territories accounted for 2.6 percent of Ukraine's area, 3.3 million people (7.3 percent of the population), 10 percent of GDP, and 15 percent of industrial output (Dragon Capital 2014). Roughly two-thirds of the 8 percent projected decline in GDP in 2014 derived from the war in Donbas, the old coal and steel region of Ukraine. In August and September, Ukraine's coal production was halved and its steel production down by one-third.

The formidable and multifaceted crisis in Ukraine leaves the new government no rational option but to undertake reforms as fast as possible for multiple reasons. Ukraine is running out of money. The International Monetary Fund (IMF) debt sustainability analysis of July 2014 clarified that Ukraine is on its way to defaulting on its debt. In a stress scenario, the IMF foresees Ukraine's public debt surging to 134 percent in 2016 (IMF 2014a, 49). Ukraine will default earlier, if it does not change course. It must cut public expenditures sharply in 2015.

Radical reform is a matter of national survival. Ukraine is at war with far stronger Russia. To build up its military strength, the country requires economic potency. Therefore, it needs to carry out the key reforms swiftly.

This crisis is Ukraine's best opportunity to break endemic corruption and oligarchic rule. At present, the oligarchs are weakened and the crisis offers a chance to break their power over the state for good. Yet if their main rent-seeking mechanisms are not eliminated soon, innovative and resourceful businessmen will find new ways of making money on the state.

In 1992, Estonia wiped out its metal-trading gangs by liberalizing exports and commodity prices, becoming the most honest and transparent postcommunist country (Laar 2002). Neighboring Latvia, by contrast, delayed its deregulation of oil prices and exports by one year, allowing three oligarchs to capture the political system until the crisis of 2008 exposed them. Only in 2010 and 2011, parliamentary elections finally cut them down to size (Åslund and Dombrovskis 2011).

In Ukraine, the most profitable rent seeking activity today is to buy natural gas cheaply for $30 per 1,000 cubic meters from state-owned companies and sell it on the market for $380 per 1,000 cubic meters. A couple of Yanukovych's oligarchs benefited from this trade. If domestic prices do not

1. I have summarized my own lessons in Åslund (2013) and Åslund and Djankov (2014). This Policy Brief draws on my forthcoming book Åslund (2015, forthcoming).

converge with market prices soon, somebody else will pick up this business.

Moreover, the Ukrainian people are impatient and want to see action. Fast reform is needed for domestic political stability. On September 16, the parliament passed the law on lustration with a single vote. Parliamentary Speaker Oleksandr Turchynov caught the public mood, shouting to the parliament: "If you do not vote for lustration, there will be castration instead." Popular suspicion runs high, and many threaten with a third Maidan if the current lot does not reform the state.

The old establishment is naturally opposed to change depriving them of power and wealth, but after Euromaidan and the elections they have been subdued. Reformers need to act before the old elite recovers and gathers new strength. Fast action is the best way of convincing the old elite that the rules of the game have changed.

The arguments are overwhelming for Ukraine to undertake key reforms as soon as possible now that a new parliament and government are in place.

People accept a paradigm shift much more easily than a partial change. In no postcommunist country have people protested against general price liberalization, unlike in the Soviet Union, which did not dare to raise meat prices after the bloody riots in Novocherkassk in June 1962. Similarly, much of northern Africa has seen protests after bread price hikes. If only one minor liberalization occurs, it draws fire as people ask why that specific liberalization took place. If most things are liberalized, people instead ask why the rest of the system has not been liberalized, because they have accepted a new paradigm.

For all these reasons it is easier to carry out big reforms early on even if they are unpopular. Latvian prime minister Valdis Dombrovskis realized that it was politically easier to carry out a fiscal adjustment of 9.5 percent of GDP in the midst of the crisis in 2009 than a minor budget adjustment of 1.5 percent of GDP in 2012. He concluded that he should have front-loaded the reforms even more. People are prepared to accept a lot of suffering for a year or two, but after that they do not understand why they should continue to tighten their belts.

People want to see not only action but also results reasonably soon. Therefore, an early return to economic growth is vital. In the 1990s, Ukraine pursued very gradual and tepid reforms. As a result, it had no economic growth for a decade. Even before the current crisis, Ukraine had not recovered its output level of 2007. By contrast, Estonia, Latvia, and Lithuania quickly returned to high growth after only two years from similar output contractions in 2009 because they carried out very radical fiscal adjustments together with structural reforms.

Many, perhaps most, reforms are popular among the public. Obvious examples are the elimination of red tape and cumbersome taxation. People want rule of law through good courts and honest policemen. Ukrainians are dissatisfied with the current provision of health care and education in the country. During the financial crisis in Latvia in 2009, Prime Minister Dombrovskis closed half the state agencies, sacked one-third of all civil servants and cut public wages by 28 percent. Somewhat to his surprise, he found that these actions were popular and he was reelected twice (Åslund and Dombrovskis 2011). In fact, only tax increases, which Ukraine does not need, cuts in wages and pensions, and price increases are unpopular with the population at large.

The Ukrainian parliamentary elections of October 26 offered a resounding mandate for radical economic reforms. The three parties with the most reformist programs, Self-Help, People's Front, and Poroshenko's Bloc, came out on top and are now forming a coalition government. Of the clearly populist parties, the Communist Party, nationalist Svoboda, and the Radical Party of Oleh Lyashko, only the Radical Party managed to just about cross the threshold for representation in parliament. Not only have the Ukrainian voters told their rulers that they are ready for reform but they demand it.

Except for some highly competent policymakers, notably President Poroshenko and Prime Minister Yatsenyuk, Ukraine lacks skilled policymakers. Reforms will require that a handful of competent and decisive managers take charge of economic policy on the basis of a democratic mandate and swiftly push through fundamental changes. The old corrupt elite will not be broken by consensus. Adverse decisions are by definition controversial.

Thus, the arguments are overwhelming for Ukraine to undertake key reforms as soon as possible now that a new parliament and government are in place (cf Åslund 2013, 41–44). Ukraine is suffering an existential crisis and radical reform is the only cure.

POLITICS MUST COME FIRST

Among postcommunist reformers, Estonian Mart Laar (2002) and Czech Václav Klaus (2014) best understood the importance of politics and democracy for successful economic reform. The old political establishment wants to preserve the old ideology and structures that should be abandoned. Therefore, a democratic breakthrough, as Ukraine experienced in February 2014, must be followed by new democratic elections.

Fortunately, Ukraine held free and fair presidential elections on May 25, electing Petro Poroshenko with a majority of 55 percent of the votes cast. On October 26, Ukraine held early parliamentary elections, which were won by three democratic, liberal, and pro-European parties.

A systemic change requires hundreds of new laws, which only a democratic parliamentary majority that supports reform can adopt. Without it little reform is possible because quality legislation requires an orderly legislative process. Parliamentary committees need to elaborate on legal acts to enhance their quality, and in the process a constituency in favor of each law arises.

Ukraine should also abolish the legal immunity of parliamentarians so that they become accountable. For successful parliamentary elections, three conditions are essential. Both candidates and political parties must be fully transparent about their finances so as wean out the large amounts of illegal funds that have characterized recent Ukrainian elections. Transparency can be effective only if it is accompanied by independent auditing of the financial statements. Moreover, to reduce the demand for campaign financing, strict limitations on electoral financing and advertising also need to be imposed. It should no longer be possible to purchase a safe seat in parliament.

A fully proportional election system with "open party lists," that is, free choice of candidate within the party in question, appears the best system to reduce electoral corruption. Ukraine embarked on this change but has not completed it because the members of the old parliament did not want to vote against their own interests. Now, the new parliament can take further steps.

By and large, Ukraine has maintained the stifling Soviet overcentralization. The essence of the constitutional reform currently being discussed must be to decentralize power to render Ukrainian politics more functional and democratic.

NEXT COMES REFORM OF THE STATE

The very state needs to be cleansed of corruption. The old Soviet state is still so pervasive. Ukraine needs a clear break from the old system, as Estonia and Georgia did most resolutely. The new Ukrainian government favors democracy and the rule of law. It needs to move fast to clean up the government from the top and render it more efficient and service oriented.

The first step should be to close or merge superfluous or even harmful state agencies. A large number of inspection agencies should be eliminated swiftly because they have no role to play in a modern free economy. It is better to close them all at once to avoid appearing partial. The government has started merging agencies and reducing staff, but it needs to do much more.

Another step is lustration, or purging of corrupt officials from the old regimes, especially of courts of justice and law enforcement. Ukrainian citizens perceive all judges and prosecutors as corrupt. They should all be replaced as was done in East Germany after German reunification. Ukraine needs to draw on international support and attract young lawyers to the bench. Law enforcement needs to be lustrated from the top down as well. Fortunately, Ukraine has adopted a lustration law, and this important cleansing has already started.

A full reform of the public administration should follow. Ministers must be made responsible and accountable. Preferably, one state agency after the other should be cleansed and reformed as was done in Estonia and Georgia. The EU twinning of state agencies is useful in this regard. A clear distinction should be made between political appointments, which should be limited, and civil service appointments, which should be based on merit rather than seniority.

Ukraine has far too many civil servants who earn too little. This is no way to attract qualified or efficient staff. Superfluous civil servants should be laid off, and their wage funds should be distributed among the remaining civil servants. Both skills and remuneration must be raised.

State regulation should be limited to what really has to be regulated given that the government capacity to pursue sensible regulation is so limited. The World Bank Ease of Doing Business Index is an excellent tool for how to proceed. The number of procedures, their cost, and their time should be minimized as many countries have done so successfully.

In 2000, Ukraine privatized agricultural land, distributing it to the members of collective farms and the employees of state farms, but private sales of land were not legalized. Such sales should finally be legalized. The main beneficiaries of the current system are large agricultural holding companies that lease the land for up to 49 years for very low prices. Only if private sales of land become legal can Ukraine develop viable family farms on a large scale. Otherwise, farmers cannot use their land as collateral and thus cannot raise much credit.

PUBLIC FINANCES MUST BE FIXED

Ukraine's budget deficit is too large and expanding fast. The public debt was 41 percent of GDP in 2013, but with a rising budget deficit, collapsing output, and the sharp depreciation of the hryvnia the IMF expects public debt to reach 67 percent of GDP, which might be excessive for Ukraine, given its limited credibility in financial markets.

Public expenditures are far too high at 52.7 percent of GDP in 2014 (IMF 2014a, 41). The Baltic countries have public expenditures in the range of 34 to 38 percent of GDP,[2] which appears to be the right level for Ukraine as well. The excessive public expenditures both depress economic growth and contribute to the corrupt enrichment of the rich and powerful in Ukraine. Like the three Baltic countries during their crisis in 2009, Ukraine should aim at cutting public expenditures by 10 percent of GDP in 2015. These cuts should focus on two items that stand out as inordinately large, namely energy subsidies of 10 percent of GDP and public pension expenditures of no less than 16 percent of GDP.

The tax system needs to be simplified. The number of taxes needs to be reduced to nine, as the government proposes, and the very high payroll tax must be cut, since it is not collected in any case. The flat personal income tax should be reintroduced to render Ukraine competitive.

Ukraine can neither combat corruption nor become a full democracy without eliminating energy subsidies, which have only enriched the powerful.

Strangely, state revenues have stayed quite high as a share of the official economy, partly because of high tax rates on labor creating a large underground economy and partly because of draconian tax collection. The tax code of 2010 should be substantially revised to reduce corruption and injustice. The proposed revision rightly calls for the restoration of simplified taxation of small entrepreneurs. The tax code also aggravated the already extensive transfer pricing of the large, well-connected companies that paid neither profit taxes nor dividends to minority shareholders because all their profits were transferred to tax-free offshore havens. The value-added tax refunds for exporters should be made automatic to clean up the racket of tax officials demanding commission on these refunds. The tax police should be abolished to shield taxpayers from lawless persecution.

Ukraine's centralized public finances need to be significantly decentralized to regions and local authorities in line with the decentralization of political power. Finally, competitive public procurement must be introduced. A law on public procurement that insists on open public tenders for both Ukrainian and foreign companies has been adopted, and this time is should be complied with.

THE ENERGY SECTOR: UKRAINE'S CANCER OF CORRUPTION

For the last two decades, the main source of enrichment in Ukraine has been trading of gas between low state-controlled prices and high market prices. Each year a few operators have made a few billion dollars on such trade. The top gas traders have regularly bought Ukraine's politics to maintain such rent seeking. According to the IMF (2014b, 87), energy subsidies amounted to no less than 7.6 percent of GDP in 2012 and are likely to rise to 10 percent of GDP in 2014.

The new government should swiftly adjust the prices of gas, coal, and electricity to costs and markets, which would save the budget these large subsidies each year. Some of the saved amount should be given as social compensation to the poor. Each of Ukraine's nine IMF agreements has required regular increases in gas prices, but every government has increased the gas price once to receive the first tranche of IMF credits but then stopped, as the top gas trader has persuaded the government not to raise gas prices further. These failures show that it is time to abolish all energy subsidies instantly. Fortunately, the new CEO of state oil and gas holding company Naftogaz, Andriy Kobolyev (2014), advocates such a reform.

Energy subsidies are the main source of corruption at the top level in Ukraine. Naftogaz buys 17 billion cubic meters a year of natural gas domestically produced by partially state-owned companies at the extremely low price currently of $30 per 1,000 cubic meters, below the production cost, while the domestic market price is about $380 per 1,000 cubic meters. Deputy Prime Minister Volodymyr Groisman assessed that 40 percent of this volume was resold to the commercial sector for the market price. People close to Yanukovych thus made a fortune of some $2.5 billion a year.[3] Kobolyev (2014) characterized this policy as: "We give you gas for 100 hryvnia [$7], and you ignore that we steal $100."

Ukraine can neither combat corruption nor become a full democracy without eliminating energy subsidies, which have only enriched the powerful. Ukraine cannot afford these large energy subsidies, which do nothing for the welfare of the nation. Because of low, subsidized energy prices, Ukraine has the greatest energy intensity of production in Europe. No measure would enhance Ukraine's welfare more easily than energy savings. It is a matter of national security. Ukraine can live on its own gas and coal production. The low price cap on

2. Eurostat, "Total general government expenditure, % of GDP, 2013," http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tec00023 (accessed on August 1, 2014).

3. *Ekonomichna Pravda*, September 11, 2014.

gas produced by state-owned companies severely discriminates against domestic production in favor of expensive imports from Russia. Equalizing domestic prices with import prices would stimulate energy production in Ukraine. Energy subsidies, which account for 10 percent of GDP in 2014, should be abolished, and a limited share, 1 to 2 percent of GDP, would fully compensate the poorest half of the population. Cash transfers have worked in Latin America, and Ukraine has started operating such a system since July 1, 2014.

All state energy companies need proper corporate governance with effective boards of directors and external auditing that is made public. The energy sector should be unbundled, and the production companies should be prepared for privatization. The missing energy markets should be established.

SOCIAL REFORMS CANNOT WAIT

Social reforms are complex, involving the whole population and large inert bureaucratic systems. Ukraine has pursued minimal reforms in the social sphere. The social sector is both too important and too poorly run to be left for later.

The first question is the allocation of funding. Ukraine's pension expenditures are uniquely high at 16 percent of GDP, which should be reduced to a normal level of 8 percent of GDP. All other social expenditures, by contrast, are far too small, namely expenditures on health care, education, and family allowances. Resources should be gradually transferred to these areas.

Ukraine attempted a limited pension reform in 2011, but it had little impact. Many old Nomenklatura benefits are still in place and should be abolished. The retirement age needs to continue to rise, and the issuing of early pensions should be tightened. Ukraine should finally adopt a three-pillar pension system, which has been discussed for over a decade, with a minimal state pension, a second pillar of mandatory private pension savings, and a third pillar of voluntary private pension savings.

Another concern is the great inefficiency of service provision. Both in education and health care, less funds should be spent on real estate and more on services. As the number of schoolchildren has fallen sharply, the number of schools should be reduced accordingly and the superfluous real estate sold off.

In health care, the number of hospitals should be reduced and consolidated and provided with better equipment. The number and structure of staff should be adjusted to actual needs, and the salaries for skilled staff should be increased. Decentralization and competition on the market with private providers should improve quality and efficiency of health care.

WHY EUROPE SHOULD OFFER A MARSHALL PLAN FOR UKRAINE

Ukraine needs substantial international assistance, not only credits but also grants. Its emergency calls for a Marshall Plan.[4] Now as in 1947, US Secretary of State George C. Marshall's words ring true: "It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health to the world, without which there can be no political stability and no assured peace" (Marshall 1947). But today, the onus rests on the European Union.

The need for a Marshall Plan was raised when the Soviet Union collapsed, but then there was no war destruction, no military threat, and no particular need for a new Western alliance. For too long, Europe ignored the wars in Yugoslavia in the 1990s, which is now seen as a big mistake. After the ouster of Yanukovych, several people have suggested that Ukraine needs and deserves a Marshall Plan.[5] In fact, a Marshall Plan looks much more appropriate for Ukraine today than it did for the postcommunist countries in the early 1990s—for five good reasons.[6]

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Ukraine is in the midst of a frightful financial crisis, primarily caused by the war the Kremlin launched against Ukraine on February 27, when the Yatsenyuk government was appointed. Russian arms have blown up the power stations in Donbas, stopping the pumps in the coal mines, which have been flooded. On September 13, Prime Minister Yatsenyuk assessed the war damage to physical infrastructure at $9 billion, which has now risen substantially. Donbas' humanitarian crisis calls for Western humanitarian aid.

Like Europe after World War II, Ukraine needs to rebuild its state and economy. After its democratic breakthrough in February, elections of President Poroshenko on May 25, and parliamentary elections on October 26, Ukraine appears to be ready for this gigantic task. If the European Union is serious

4. This section draws on Åslund (2014).

5. Kyiv Attorney Daniel Bilak (2014), philanthropist George Soros (2014), Deputy Prime Minister Volodymyr Groisman (2014), and French philosopher Bernard-Henri Levy (2014).

6. The primary sources on the Marshall Plan are Hogan (1987) and Milward (1984).

about its recently ratified Association Agreement with Ukraine, it needs to show so now.

If the needed capital is provided as credits, Ukraine will not be financially sustainable. Last April, the IMF concluded a two-year Stand-By Arrangement with a total international financial support of $33 billion for two years, of which the IMF itself will contribute $17 billion. The rest of the funding will come from the World Bank, the European Union, the European Investment Bank (EIB), the European Bank for Reconstruction and Development (EBRD), and various bilateral creditors. But almost all this "aid" consists of credits, which Ukraine will have to pay back. If Ukraine continues drawing on credits at the current speed, while output is collapsing, the country is likely to default on its international payments.

The ultimate aim of the Marshall Plan was to stand up against the Soviet threat. Once again the West faces such a situation, even though Vladimir Putin's Russia is much weaker than Joseph Stalin's Soviet Union. If the West is not prepared to support Ukraine militarily, it should at least provide it with appropriate financial and political support. Europe needs to stand up to this threat.

Finally, the West itself needs a new form of alliance. The North Atlantic Treaty Organization is not enough, and no other alliance involving both the European Union and the United States exists. For years, President Putin has repeatedly pursued aggression via gas supply cuts, trade sanctions, cyber campaigns, misinformation, and military force. The European Union, the United States, Canada, Japan, and other Western countries have all acted bilaterally to support Ukraine. They would all benefit from more profound multilateral cooperation. The West has to come together to stop Putin and should do so now in Ukraine. Why encourage him to proceed to Moldova, Georgia, the Balkans, etc.?

Ukraine needs all the foreign aid it can get, which should be coordinated. Therefore, in July 2014 the Ukrainian government formed a working group on a Marshall Plan for Ukraine, chaired by Deputy Prime Minister Volodymyr Groisman.

The main difference from 1948 is that the European Union would take the lead because it has the means. Former prime minister of Lithuania Andrius Kubilius has proposed that the European Union commit 3 percent of its €1.0 trillion budget for 2014–20, that is, €30 billion, in grants to Ukraine.

A Marshall Plan for Ukraine should be launched at a planned donor conference in December after the new Ukrainian parliament has opened and a new government formed.

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