UKRAINE: WHAT EMERGENCY MEASURES AND WHAT LONG TERM CHANGES NEEDED?

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Although it is only a few days after the successful February revolution and the country is still in a state of flux, a new government is needed to deal with emergency economic measures. The country is days away from facing a $2bln payment to international bondholders. The provisional Ukrainian government does not have the necessary legitimacy to make all the changes demanded by the Maidan protesters. The country is in transition. The new government is inheriting a political system and a government administration that are in need of fundamental change. Because of this weakness, the new government needs to focus on a set of emergency measures that are both urgent and immediately feasible. In the long run, establishing a well functioning democracy necessitates a new constitution and a popular referendum on a constitution, but that takes time. What must be done now? What needs to be changed in the long run?

First, the Ukrainian currency Hryvnya should be switched to a float and it should depreciate significantly: the current account deficit (about 10% of GDP) is clearly unsustainable. This should stimulate the economy and preserve precious foreign currency reserves. Barriers to export should be removed.

Second, the banking system badly needs liquidity and capital. Raising these in the international financial market has become nearly impossible. The government should inject capital (for example, use a program similar to the TARP in the U.S.). The Central bank should provide liquidity. Some form of temporary capital controls and temporary limits on withdraws of deposits appear unavoidable given the current ongoing bank run(deposits fell by a third in the last few weeks and are falling further on a daily basis). Banks should “reopen” after the infusions of capital and liquidity.

Third, the government must immediately present a plan to address fiscal imbalances over a period of several years. Given the deeply depressed state of the economy, now is not the time to implement deep budget cuts. But fiscal authorities can still lay out a budget plan for a gradual decline in deficits to restore confidence in the long-run solvency of the Ukrainian government. Stricter monitoring of spending to minimize corruption and waste of public functions must be implemented immediately to make the eventual fiscal consolidation less painful and restore confidence.

Fourth, external payments are a heavy burden on the collapsing Ukrainian economy of Ukraine. One step is to bring in the International Monetary Fund as well as other donors (European Union, USA, etc.) to bridge the short-term gap in foreign currency reserves. These funds are essential to avoid a drastic immediate fiscal contraction in the immediate future. They are necessary to enable authorities to inject capital into Ukrainian banks. The amount of required support is likely to be in tens of billions of dollars. Moreover, a restructuring of some of Ukrainian debt is necessary to avoid outright default. Most of Ukraine’s external debt was accumulated under the previous corrupt regime. The new leaders have little moral obligation to commit to reimburse that debt, and creditors have little moral standing to demand repayment: they knew who they lent to. On the other hand, the amount of Ukraine's external debt is not that high, and costs of defaulting—exclusion of Ukraine from the bond market for 5 years or so—are not-zero. Ukraine badly needs immediate breathing space to introduce reforms and relieve the burden imposed by the Yanukovych government. The main risk here is that the absence of primary fiscal surplus makes an immediate fiscal consolidation or monetization of spending unavoidable in case of outright default. But Ukraine had a nearly zero inflation rate for two year. Some inflation could be a stimulating force if it can be kept under control later on. The new provisional government of Ukraine must weigh the costs and benefits of these scenarios. But right now, it should not exclude the option of default if external support is not coming. An external default would then not alienate Ukraine from the international community, despite the short run disorder it might create.

Fifth, a possible trade war with Russia and increased energy prices are looming. Ukraine should prepare to obtain energy from alternative sources (including reversing the gas flow to get energy from the West).

Sixth, some people and businesses will be hit very hard. The government should prepare short-term relief for all those likely to fall into temporary poverty: guaranteed minimum food, heating, electricity and water, all supplied on a lump sum basis.

Last and not least, the EU and Ukraine should sign the association agreement. This will anchor economic and political forces toward reforms and growth as well as provide credibility to the new government.

These emergency measures will not address the need for fundamental long term change. Once there is a legitimate government, elected on the basis of a Constitution approved by referendum, fundamental long term reforms can be implemented. These include a fundamental overhaul of government administration to root out corruption, fiscal decentralization to give more power to the regions, regulatory reform to break up monopolies, opening up entry to foreign firms and small private business, and securing a stable supply of energy by exploiting Ukraine's large reserve of shale gas.

The need to act fast now does not mean one should not also begin in the necessary process of constitutional change. The people of Ukraine demand it. Ukraine had two revolutions in the last ten years. Both expressed people's discontent with the status quo and aspirations for democracy. It needs to build a consolidated and participatory democracy. There will likely not be a third chance.