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## Leonid Kuchma's Reforms, 1994–96

*The period of romanticism is over.*  
—Dmytro Tabachnyk,  
Kuchma's chief of staff<sup>1</sup>

On July 10, 1994, Leonid Kuchma won the runoff against Leonid Kravchuk in Ukraine's second presidential elections. The elections were peaceful and orderly, free and fair. The challenger won, and the incumbent left the presidential office with his staff, allowing the newly elected president to move in. Ukraine had gone through its first democratic transition of power. Kuchma had run his campaign on change and economic reform, although his economic views remained somewhat hazy.

In November 1993 a friend and I drove through western Ukraine from Uzhhorod to Lviv. It was a dismal experience. To get into the right mood, we played Polish crisis songs from the 1930s. While crossing the border from Slovakia, we encountered a few hundred car thieves in track suits and sneakers or black leather jackets and blue jeans, who were prepared to bribe customs officials on both sides of the border to get through with their newly stolen German cars. I had never seen so many evident professional killers before. Since we were the only people in jackets and tie, we were quickly let through as long-forgotten remnants of an old civilization, or perhaps we just resembled the old *Nomenklatura*. In Uzhhorod, where Hungarians, Roma, and Russians are more common than Ukrainians in the streets, there was hardly any electricity and minimal heating. The shops were empty. Strangely, it was quiet and peaceful in misery.

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1. Quoted in Kuzio (1997, 90).

While traveling through Transcarpathia we made three observations. First, all the shops were just about empty. It was incomprehensible how people were surviving. Second, outside every little town single-family houses were being built. Some new businessmen were clearly making money. Third, in every village, two more churches were being built in addition to the traditional one, as people turned to competing churches, while they quietly gave up on politics and economics. In Lviv, we stayed at Grand Hotel, whose owner, a Ukrainian-American entrepreneur, had just been murdered in some business dispute. People quietly went about their routine. Order prevailed. But people were evidently becoming ever poorer.

The situation looked as precarious economically as promising politically. Three days after Kuchma's installation, I contacted George Soros, who financed a network of foundations in Ukraine. I told him that if he wanted to provide a team of international economic advisers to Kuchma, I would be happy to assist. One week later, Soros called back. He had an appointment with President Kuchma in Kyiv the ensuing week. He asked if I would like to accompany him. I said yes.

In mid-August 1994, Soros, his outstanding policy director John Fox, and I met Kuchma in his office in Kyiv, together with his chief of staff Dmytro Tabachnyk and Minister of Economy Roman Shpek. Soros and Fox had met Kuchma before the elections hoping that he would bring the badly needed determination to reform Ukraine. Kuchma appreciated this moral support, especially as the US administration and the North American Ukrainian diaspora preferred Kravchuk.

Soros praised Kuchma's economic reform plans and offered support with a team of international advisers. Kuchma answered curtly: "I am ready." Soros asked: "With whom should we work?" Kuchma pointed at Shpek. We had received a mandate. We sat down for a few hours and discussed what needed to be done. In the evening, Soros asked me to come to his hotel suite. As I had expected, he said: "You do what you think is necessary. I pay."<sup>2</sup>

In the next year, Kuchma was deeply engaged in economic reforms and shepherded the necessary legislation through with great tenacity (in sharp contrast with Yeltsin). He was surprisingly accessible and did not mind an argument, which tended to be challenging but worthwhile.

The economic policy environment in Ukraine differed greatly from Moscow, where we had worked previously. In Moscow the active players were many. Reformers and conservatives formed well-defined ideologi-

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2. Three days later, the International Monetary Fund mission arrived. At the same time, four economist-friends of mine flew in: Peter Boone and Simon Johnson, with PhD degrees from Harvard University and MIT, respectively, who had been involved in advisory activities in other postcommunist countries, and two of my graduate students from Sweden, Eva Sundquist and Elisabeth Hopkins. We freed ourselves from our ordinary jobs and worked intensely together with the Ukrainian reform team. Michael Zienchuk from Canada joined us.

cal camps, and they had staunch international supporters. Disputes sprouted everywhere, and competition was knife-sharp. Preemption was key: Your camp had to get a decision made before the rivals did.

In Kyiv, Kuchma and his reform team were the only game in town. Initially, they worked hard and fast, with great determination and little apparent opposition. Every reformist minister had a couple of close advisers, while the rest of the government staff seemed uninvolved, neither opposing nor supporting reforms, which few understood. It was peaceful and friendly. The issue was not rivalry or even what decision to make but rather to get the obvious decision made. Views were fluid. At a high-level internal government meeting I was struck by a deputy minister of economy initially opposing price liberalization but half an hour later concluding that it should be done instantly. Few policymakers had a clear ideology.

Ukrainian attitudes toward foreigners were amazingly positive. We were thanked ever so often. Senior officials were not bashful about asking us what they did not know and we tried to assist as we could, writing brief policy memos, which was not done much in the old Soviet system that administered rather than formulated policy. We received an office in the cabinet of ministers building and passes with liberal access, a world of difference from the security preoccupations that had taken hold in Moscow by 1993.

The Stalinist cabinet of ministers building was in a deplorable state. The parquet floors were falling apart. Computers, copiers, or fax machines were nowhere to be found except in ministers' offices. The staff was dignified and correct but poor. Years would pass before enrichment from corruption became noticeable. In the winter, Russia regularly cut off gas deliveries for alleged Ukrainian arrears, and the temperature in the government offices often fell below freezing, but the plucky staff worked in their warmest overcoats, drinking plenty of hot tea.

When Ukraine became independent, hundreds of Ukrainians from the diaspora hastened back to their motherland. Most were full of idealism to rebuild their native land from communist and Russian devastation, while others were hapless goldiggers. By 1994 they were disappointed, having realized that their idealized compatriots were often corrupt and not very truthful. They were politically not as prominent as the Baltic diaspora, although Roman Zvarych became minister of justice after the Orange Revolution. Bohdan Hawrylyshyn was a prominent adviser to President Kravchuk, and Oleh Havrylyshyn became deputy minister of finance. Yet the diaspora formed an invaluable network of competent professionals in all walks of life, and many prominent members have stayed in Ukraine since 1991. They were most helpful to us.

By 1994 many Western organizations and embassies were in Kyiv, but they still had the idyllic sense of pioneers. The slogan was public education on market reform. Through its resident representative Daniel Kaufmann, the World Bank took a public lead with weekly seminars for journalists.

George Soros was all dominant. Some of the leaders of the diaspora and the Ukrainian intelligentsia had approached him early on, and by 1994 he had developed a full network of institutions. The fund-giving International Renaissance Foundation was the centerpiece. Soros sponsored two of the best business schools (the International Management Institute and the International Institute of Business), later a graduate school of economics (Kyiv School of Economics), and several think tanks (the International Center for Policy Studies and the Legal Reform Foundation). Much of the new policy thinking arose from his institutions. The problem was his uniqueness. We set up the Soros International Economic Advisory Group as a complement to this Soros family of institutions.

The two biggest technical assistance donors were the United States and the European Union. The US Agency for International Development (USAID) was very active in Ukraine, especially engaged in privatization and the drafting of laws. Like most donors, it suffered from a lack of Ukrainian government counterparts for desired reforms, for example, social and agricultural reforms, but USAID was ever-present and relatively agile.

Through its Technical Assistance to the Commonwealth of Independent States (TACIS) program, the European Union spent a lot of money on Ukraine, but its mandate and procedures were construed in such a way that it could hardly do anything useful. For example, after Ukraine finally managed to break out of the ruble zone and bring inflation under control, TACIS sent a French Trotskyite into Kyiv with a project to restore a currency union with Russia and Belarus. The demand for such a proposal was limited and it quietly died.

From August 1994, the International Monetary Fund (IMF) played a central role in economic policymaking. The German government set up a qualified, ambitious, and well-connected German Advisory Group on Economic Reforms with the Ukrainian Government, which focused on supporting the National Bank of Ukraine (NBU) and its chairman, Viktor Yushchenko. In effect, it took the place of our Soros group when we wound down, and it remains active. By and large, cooperation was excellent between the foreign assistance projects. With the odd exception of TACIS, the question was not what to do but how to get the obvious tasks of postcommunist transition done.

One of the most auspicious chapters in Ukraine's history of independence was opening. The parliamentary elections in March 1994 did much to cement democracy. In July Kuchma won the presidential elections over Kravchuk, but no euphoria followed the election. Kuchma was determined to get things right and exploit his political honeymoon, which lasted from July 1994 until April 1995. On October 11, 1994, Kuchma made his great reform speech to parliament and declared his aim of radical market economic reform. By the end of September 1994 Ukraine had concluded its first IMF agreement that would lead to financial stabilization,

and in November 1994 Ukraine undertook its great trade and price liberalization. In March 1995 the Ukrainian parliament invalidated the Crimean constitution, ending its move toward separatism. In June 1996 Ukraine finally adopted a new constitution through consensus in parliament. In September 1996 the Ukrainian national currency, the hryvnia, was successfully introduced as a manifestation of completed stabilization. Simultaneously, Ukraine's long-stalled mass privatization program finally took off. But from June 1995 Kuchma had altered his tone. He no longer spoke of radical but evolutionary reform, and change slowed down.

## Parliamentary Elections, Spring 1994

Ukraine's parliament had been elected in March 1990, and its five-year mandate period was supposed to run out in March 1995, but the coal miners' strikes in the summer of 1993 led to a compromise on calling for early parliamentary and presidential elections.<sup>3</sup> The parliamentary elections were held on March 27, 1994.

That Ukraine's predemocratic parliament of 1990 was not dissolved earlier reflected the absence of revolution in Ukraine, which allowed the old establishment to stay in power. Initially, 83 percent of the deputies had been members of the Communist Party of Ukraine (CPU), but most had become independent, though they wanted to maintain their privileges. Their desires of personal comfort coincided with President Kravchuk's aspiration to render the parliament weak and fractious. These establishment forces favored minimal change of the electoral rules and deliberate discrimination against political parties. By contrast, Rukh and other reformers sought to strengthen political parties by advocating proportional elections with party lists for at least half the parliamentarians.

The establishment prevailed on electoral procedure. As before, all the 450 parliamentarians were to be elected through majority elections in single-member constituencies. The only improvement from the 1990 elections was that political parties were allowed, but the nomination process discriminated against parties. The elections were deliberately made almost indeterminate because of high turnout requirements. In each constituency, a participation of 50 percent of the voters was required, and a candidate needed to obtain an absolute majority of the votes to win. Otherwise an infinite number of runoffs ensued. President Kravchuk expressed the not very democratic hope that he might be forced to introduce presidential rule if the elections failed because of less than 50 percent voter participation.

Due to these demands for a hypermajority, only 338 out of 450 seats were filled in the first two rounds on March 27 and early April. Tedious

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3. Sources of this section are Birch (2000a, 82–91) and Kuzio (1997, 11–38).

repeat elections were held in July, August, November, and December 1994, December 1995, and April 1996, aggravating voter fatigue. Twenty-five seats remained vacant because of ever lower participation. This election system was clearly not viable.

The election results produced three surprises. First, 76 percent participation was far higher than anybody had predicted, which was a rebuke to Kravchuk. Ukrainians showed they wanted their parliament, but they gave short shrift to the incumbents, throwing them out. Only 17 percent of the deputies were reelected. This was a vote for democracy and change.

Second, the reborn CPU became by far the biggest party with 84 seats, or 25 percent, while the Socialist Party of Ukraine with merely 14 seats saw its ambition to replace the CPU thwarted. Altogether, the hard left parties won 34 percent of the seats, forming a blocking minority. This was a protest against the disastrous economic performance and social suffering. The left won the economic votes, and public support for the as-yet-nonexistent market economy remained weak (table 3.1).

Third, Rukh and all nationalists were badly beaten. Rukh was decimated to only 20 seats. The extreme right received a paltry 2.4 percent of the votes, rendering it completely marginal for good. Only 50 percent of the seats went to parties, while the rest were taken by largely independent centrists, who were the real winners.

The parliamentary elections were held in the midst of hyperinflation. They amounted to a protest vote against the disastrous economic mismanagement and overly nationalistic policies by the odd combination of the left and the business community, which had mobilized the east and the south. These forces also wanted to improve the economic relationship with Russia to mitigate the economic crisis.

It took some time for the parliament to configure itself, but by the spring of 1995, 12 party factions had been formed. The three leftist factions—communists, agrarians, and socialists—held one-third of the seats, while an unwieldy center of six factions comprised 39 percent and three moderate right factions had 22 percent, leaving a balance of 34 unaffiliated deputies. In the end, this was a victory not for the left but for the centrists, as a result of their design of the electoral law. Yet the leftists were better organized and often attracted a couple of the centrist factions for specific votes. In May 1994 the clever socialist leader Oleksandr Moroz was elected to the powerful position of chairman of the new parliament.

The parliament represented insiders. No less than 29 percent of the deputies were senior state officials. Many deputy ministers had been elected deputies and could pass one vote in parliament and another in their ministry, creating considerable confusion among the branches of power. According to the amended Soviet Ukrainian Constitution of 1978, the only government executive with the right to be a member of parliament was the prime minister, but it took years before this rule was enforced (Kuzio 1997, 30).

**Table 3.1 Results of election to the Supreme Rada, March–April 1994 (after first and second rounds)**

Party	Vote share, first round (percent)	Seats won	
		Number	Percent
Total Left	18.6	116	34.3
Communist	12.7	84	24.9
Socialist	3.1	14	4.1
Rural	2.7	18	5.3
Total Center	3.4	12	3.6
Total National Democrats	9.2	32	9.5
Rukh	5.2	20	5.9
Total Extreme Right	2.4	8	2.4
All parties	33.5	168	49.7
Independents	66.3	170	50.3
Total seats filled in two rounds		338	100
Voter turnout (percent)			75.6

Sources: Birch (2000a, 84); official transcript of the first assembly of the Supreme Rada of the Second Convocation (1994–98), available at [www.rada.gov.ua](http://www.rada.gov.ua) (accessed on July 2, 2008).

Businessmen comprised another rising group, accounting for nearly 20 percent of the seats. Many greeted their surge as a positive sign, presuming that Ukraine’s long-suffering entrepreneurs had finally decided to go into politics to promulgate sound market economic legislation. Soon, however, these businessmen showed that they were more interested in rent seeking and blocked market economic legislation. The parliament had become a trading forum for the country’s wealthy businessmen, who abrasively called it Ukraine’s real stock exchange. State officials and businessmen, who were largely apolitical centrists, held the balance in the new Supreme Rada.

Foreign observers reported many violations of election procedures. Shockingly, a leading Rukh official, Mykhailo Boychyshyn, disappeared and presumably was murdered, but the crime was never solved. Yet, systematic fraud was not apparent. Ukrainians were proud of their peaceful democratic process and the high voter participation, which they compared with the shootout of the parliament in Moscow on October 3–4, 1993, when some 150 people were killed. Ukrainian democracy seemed to progress.

Kravchuk’s soft attempt to get rid of the parliament failed, but the old establishment successfully captured it. The threat of the hard left persisted but was contained, though the combination of a fractured center and a hostile disciplined left made legislative work close to impossible. Rukh had been severely weakened, never to recover. This parliament was

close to dysfunctional and was unable to adopt the hundreds of laws that the newborn state and budding market economy needed.

## Presidential Elections, June–July 1994

The 1994 presidential elections became an epic battle. The first round took place on June 26 and the runoff on July 10, 1994.<sup>4</sup> The two dominant candidates were Kravchuk, the incumbent, and Kuchma, his former prime minister. They were both middle-aged members of the old *Nomenklatura*, but they held contrasting views on the defining issues of Ukrainian politics, nation-building, and economic reform.

Kravchuk presented himself as the father of the Ukrainian nation and a master of peace, a unifier and conciliator. By so doing he appealed to Ukrainian nationalists, who were heartened because he was a native Ukrainian speaker from a west Ukrainian village, and he marked his distance to Russia. His shortcoming was that he had no economic policy and seemed unlikely to develop one. Just before the presidential elections, Kravchuk surprisingly appointed Vitaliy Masol prime minister, the old Soviet stalwart who had been ousted after a hunger strike by students in October 1990. This seemed a concession to the communists in the east, but it was too late and not consistent with Kravchuk's electoral appeal.

Kuchma built on his agenda as prime minister. He attacked Kravchuk's economic policies, calling the economy "catastrophic" and Ukraine "bankrupt." He demanded change and sounded as if he contemplated radical market economic reform without quite saying so. Instead, like Kravchuk, he spoke vaguely of the need for a "socially oriented economy." His second theme was the need for better relations with Russia, calling for a strategic partnership focusing on the economic rationale. His election slogan was: "Russia and Ukraine: Less walls, more bridges."<sup>5</sup> After his stint as prime minister, Kuchma became chairman of the Ukrainian Union of Industrialists and Entrepreneurs, which he built as the bulwark of the state enterprise managers, following the pioneering example of Arkady Volsky's powerful Union of Industrialists and Entrepreneurs in Russia. He campaigned as the leader of Ukraine's state enterprise managers and Russian speakers, but for political reasons he had learned Ukrainian, which he consistently used in public.

Yet, the similarities between Kravchuk and Kuchma prevailed. They were both former senior party officials. Their economic and political out-

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4. The main source of this section is Kuzio (1997, 39–66).

5. Anton Kriukov, "Ukraine-Russia: The Process Has Started," *Zerkalo nedeli*, October 15, 1994.

look was postcommunist as distinct from communist. Both favored stronger presidential powers. They advocated a strong, independent Ukrainian state and the retention of Ukrainian as the sole state language with Russian as a second official language. In the end, their differences boiled down to Kravchuk having established independence and being a Ukrainian speaker from western Ukraine and Kuchma being a Russian-speaking red director from the east focused on the economic crisis.

Two other candidates of note contested the first round, Oleksandr Moroz and Volodymyr Lanovyi. Socialist leader and speaker Moroz ran as the sole candidate of the hard left because communist leader Petro Symonenko yielded to him. His economic views were quite communist: He aimed for a “state-regulated market” with more state control than market forces. Yet Moroz also understood that the Soviet Union was gone and campaigned for an independent, socialist Ukraine.

Lanovyi was Ukraine’s first significant liberal politician. He advocated radical market economic reform and Ukraine’s withdrawal from the Commonwealth of Independent States. Although he was a Russian-speaking economist from Kyiv, Rukh supported him, opting for liberalism over nationalism.

The election excitement was unbearable. In the first round on June 26, Kravchuk won as expected, with 38 percent against Kuchma’s respectable 31 percent. Surprisingly, the sole left-wing candidate, Moroz, received a paltry 14 percent compared with the 33 percent the hard left had won in the parliamentary elections three months earlier (table 3.2). The east and south preferred Kuchma, who seemed friendlier toward Russia and the Russian language than Moroz was. This was the first indication that the east and south cared more about Russian issues than about socialism. Although Rukh supported Lanovyi, it was remarkable that a free marketer could win so many votes (9.4 percent). The contrast to the parliamentary elections three months earlier was baffling.

The runoff on July 10 was quite different. To general amazement, Kuchma won a clear victory with 52 percent of the votes over Kravchuk’s 45 percent in an election that was considered free and fair. Ideology was thrown out. The country was mobilized into two linguistic camps: Ukrainian speakers in the west and center voted for Kravchuk and Russian speakers in the east and south for Kuchma. Rukh as well as the Ukrainian diaspora in the West supported Kravchuk, while the communists tacitly favored Kuchma.

Not having learned his lesson from the parliamentary elections, Kravchuk again hoped that participation would fall below 50 percent so that the presidential elections would be declared null and void. As if to calm his citizens, Kravchuk clarified that he would stay on as president in case of such a calamity. The Ukrainians were mortified by his threat and stormed to the ballot boxes with such enthusiasm that turnout exceeded 70 percent in both rounds.

**Table 3.2 Results of presidential election, June–July 1994**  
(percent of votes)

Candidate	First round, June 26, 1994	Second round, July 10, 1994
Leonid Kravchuk	37.7	45.1
Leonid Kuchma	31.3	52.2
Oleksandr Moroz	14.0	
Volodymyr Lanovyi	9.4	
Valeriy Babych	2.4	
Ivan Pliushch	1.2	
Petro Talanchuk	0.5	
Against all	3.4	2.8
Total	100	100
Voter turnout (percent)	70.3	71.6

Sources: Central Election Commission of Ukraine, [www.cvk.gov.ua](http://www.cvk.gov.ua) (accessed on July 7, 2008); Prizel (1997, 357).

The natural interpretation of the runoff was that Ukraine suffered from a serious linguistic division, but an alternative interpretation is that the westerners were consumed by state symbols and language, while the easterners cared more about the economy.<sup>6</sup> The election result could be seen as evidence of a centrist national consensus, since the two ideological candidates lost badly in the first round.

## Kuchma Proclaims Radical Economic Reforms

After his inauguration on July 19, President Kuchma could start with a clean slate. His victory had surprised most Ukrainians, so few had extracted any preelection promises from him.

The world looked at Ukraine with alienation, paying little attention to its elections. Yet on July 10, before the election results were announced, the Group of Seven (G-7) largest industrialized democracies concluded its summit in Naples, Italy, promising Ukraine financial support of \$4 billion, which helped focus the minds of the Ukrainian leaders.

Besides George Soros, the other great international activist for Ukraine was Michel Camdessus, the managing director of the IMF, who saw a possibility of reform with the election of Kuchma. He was the first international official to fly to Kyiv to see Kuchma immediately after his inauguration. Camdessus promised to send an IMF mission to Kyiv in mid-August to try to conclude an IMF program with financing.

6. I owe this insight to Oleksandr Paskhaver.

Kuchma assembled the best reform team he could find in Ukraine. He kept Minister of Economy Roman Shpek, who became the initial reform leader, and Viktor Yushchenko remained chairman of the NBU. Yuriy Yekhanurov, who had been Shpek's deputy, became chairman of the State Property Fund or minister of privatization. Soon Viktor Pynzenyk came back as deputy prime minister for economic reform, overtaking Shpek's role as reform leader. Ihor Mitiukov was appointed deputy prime minister for international financial cooperation. All these men were well-educated professionals of about 40 years of age, trained in Ukraine with limited international experience. At his side, Kuchma had a senior economic adviser, Professor Anatoliy Halchynskiy, a rare professor of Soviet political economy who understood the need for full-fledged market economy. He authored Kuchma's economic speeches and played an important, largely positive, role, even if radical reformers complained about his moderating influence.

However, Kuchma could not get rid of the old-style communist Prime Minister Vitaliy Masol, whom the parliament had just appointed, and Kuchma did not want to antagonize the left immediately. A striking anomaly was that the minister of finance was not part of the reform team, and that ministry continued to function as the agency for the distribution of public funds rather than as a policymaking entity.

Kuchma was soon accused of bringing in too many people from his home town, Dnipropetrovsk, but such allegations were always exaggerated, as he brought few collaborators from Dnipropetrovsk, and his government was geographically diverse. The dominant group was civil servants from Kyiv.

Kuchma was preoccupied with Ukraine's economic problems, focusing on its inability to finance its public expenditures and foreign payments. Unlike his predecessor, he faced these problems straight on. The budget deficit arose from excessive public expenditures on import subsidies, enterprise subsidies, subsidized credits, and price subsidies, which were of no social benefit. The foreign trade deficit was caused by dubious loans and arrears, and Ukraine's international reserves were minimal. A persistent problem was Ukraine's nonpayment of nontransparent purchases of natural gas from Russia and Turkmenistan, which were largely paid for with barter, such as agricultural produce and steel pipes. The European Union had delivered "food aid" to Ukraine in the form of large agricultural credits, which were not cheap and had to be repaid soon. This unnecessary "humanitarian aid" aggravated Ukraine's payments crisis. Kuchma realized that Ukraine had to cut public expenditures, discipline its imports, attract foreign grants and credits to form international reserves, defeat inflation, and introduce its national currency, the hryvnia (Kuchma 1994a, 1994b).

Today it is difficult to imagine how the Kyiv elite spoke about international financing in the summer of 1994. The dearth of international

financing was so devastating that Ukrainian officials dreamed of obtaining funds from the pope or the Maltese Order. The only evident alternative to the international financial institutions was Russia, but such financing approached treason. To cut public expenditures was declared impossible and contrary to the Ukrainian economic model that everybody talked about but nobody knew what it was.

Kuchma looked through this haze and saw the IMF as his savior. The Fund's mission had arrived to help Ukraine formulate a stabilization program, and it was backed by the G-7 promise of \$4 billion. The Ukrainian government, however, did not know what to ask for. Shpek asked our group to help, and Peter Boone, who had worked on IMF negotiations for the governments of Poland, Russia, and Mongolia, quickly wrote a two-page memo proposing which IMF demands Ukraine should accept and refute and what financing the government should ask for in return. Shpek took this memo to Kuchma, who made it an instruction to the government. The ministers now had a mandate from which they could negotiate with the IMF, and six weeks later Ukraine signed its first IMF agreement.

In the quiet months of August and September, Kuchma, his reform team, the IMF mission, and our group worked hard on putting together a stabilization program, which would also be a market economic reform program. The public and parliament were not involved at this stage, and Kyiv was very quiet. A harbinger of what was to come was an article by Kuchma himself in the *Financial Times* on September 30 (Kuchma 1994a), in which he laid out his reforms in considerable detail. The purpose of this article was partly to coordinate the domestic reform process in its final programmatic stages and partly to make the case for Western aid for the Ukrainian reforms.<sup>7</sup>

On September 29, the IMF mission and the Ukrainian government signed off on a Systemic Transformation Facility Program. It was a soft IMF program, especially designed for post-Soviet countries in transition, allowing them a budget deficit of as much as 10 percent of GDP. For the rest, Ukraine's stabilization program was sound and standard. An immediate target was to abolish import subsidies for oil and natural gas from Russia. Most prices were to be liberalized, which eliminated price subsidies. The prices of some sensitive goods and services, notably coal and rents, would be hiked only gradually. An important plank of Kuchma's reform program was privatization. At this stage, he focused on the privatization of small enterprises and the mass privatization of large enterprises, while he considered the privatization of land too politically sensitive.

Kuchma understood that Ukraine had no choice but to opt for a market economy and that Western financial assistance was important:

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7. I drafted this article on instructions from Shpek, who in turn received his instructions from Kuchma, and both significantly edited it. Kuchma, of course, approved the final version.

“Ukraine has taken a resolute step toward reform, and the west took a step toward Ukraine. . . . Without this help Ukraine will not overcome crises.”<sup>8</sup> Since Russia had taken over the entire Soviet debt, Ukraine was encumbered only with its new foreign debt of a limited \$7 billion in the fall of 1994. But most of this debt was instantly due because it consisted of unregulated arrears on energy deliveries from Russia and Turkmenistan and some short-term bilateral loans (“food aid”), which required years of tedious debt relief negotiations.

In a way, Kuchma looked upon his duty as president as that of a responsible national accountant. He wanted expenditures and revenues to match both for the government and for the country. He was committed to a market economy but favored extensive state regulation, particularly in foreign trade. In early 1995 the IMF failed to persuade Kuchma to abolish export controls on grain, whose prices were fixed at a low level on the domestic market. Since this was the main stumbling block for the forthcoming stand-by agreement with the IMF, I went to see Kuchma to try to convince him. The usually nice president was not happy with my plea for price and export liberalization. He shouted at me: “Don’t you understand that the whole country will be empty!” Kuchma eventually accepted the liberalization of grain exports but presumably only because the IMF made it a condition of financing.

On October 11, 1994, Kuchma gave his first presidential address to parliament. He decided to take this opportunity to present his full reform program in an hour-long speech. I managed to get a seat on the full balcony in the Rada. I could not believe my ears. The title of Kuchma’s address was “On the Road of Radical Economic Reform.” He explained that Ukraine needed radical market economic reform to survive as a state: “The overwhelming majority of the voters showed their commitment, not to fruitless talks about reform, but to their decisive and effective completion. . . . The acceleration of the market transformation of the economy is the only possible way out of the crisis and to economic stabilization. . . . Ukraine can confirm itself as a really independent and sovereign state only on the basis of a strong economic and social policy.” He specified his reform program in all its details (Kuchma 1994b).

It was the greatest speech Kuchma ever made. To a considerable extent, it corresponded to Boris Yeltsin’s great reform speech three years earlier, but Kuchma provided more specifics and less rhetoric, reflecting the differences between their personalities. The chief author was Halchynskiy, who had invited contributions from the reformers in the government, but Kuchma had approved its details. The Ukrainian parliamentarians were stunned, but they greeted Kuchma’s oration with thunderous applause. Liberal Deputy Serhiy Holovatiy commented: “We’ve

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8. “New Chief in Ukraine to Toughen Austerity,” *New York Times*, October 31, 1994.

just heard a revolutionary speech of the first leader of Ukraine who really cares about our future.”<sup>9</sup>

Kuchma mastered the moment and put his reform program to a parliamentary vote. The Rada delayed its decision, but on October 19 it approved the presidential reform program by a majority of 231 votes (Kravchuk 2001, 64). This was a comprehensive market reform and financial stabilization reminiscent of the Balcerowicz program that Poland launched in January 1990 and the Yegor Gaidar program of Russia in January 1992. The IMF endorsed the program it had already negotiated, and so did the G-7 nations. Kuchma had established a firm base for his economic reform.

Pynzenyk commented: “Skeptics may ask if society can handle more reforms. . . . But for the last seven months, when inflation started to fall, there were no strikes or other social outbursts. When we started fixing the economy the social tension appeared to ease. It is dangerous when the illness starts to sore, but it is much more dangerous to keep it inside your body without a cure. . . . Our only chance is tight monetary policy with restructuring of economy and liberalization of wages.”<sup>10</sup>

In the fall of 1994 Kuchma seemed unstoppable, and he passed a large number of reform decisions. Most were issued as presidential or governmental decrees, but some required legislation. The most important law, on the unification and freeing of the exchange rate as well as the liberalization of almost all prices, was promulgated on November 9 with a small majority of 216 votes (Kravchuk 2001, 64).

Although Kuchma won these parliamentary votes, each was a struggle. The parliament put up the greatest resistance in two areas. It blocked the privatization of most large enterprises and intermittently decided to increase public expenditures, usually large state-subsidized credits to industry or agriculture or increased public wages and pensions. No parliamentary coalition in favor of reform had been formed, and the parliament remained as floating as ever, so it could capriciously vote for or against a proposal.

The Ukrainian economic reforms in the fall of 1994 were undertaken under the immediate direction of Kuchma, who conscientiously scrutinized and approved every significant reform. His reform team ably assisted him with their preparation. Prime Minister Masol was largely bypassed by Kuchma because Masol openly opposed the reforms and sometimes mobilized the parliament against them. Kuchma used First Deputy Prime Minister Yevhen Marchuk, who was a KGB general and former chairman of the Security Services of Ukraine, as his ally and counterweight to Masol.

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9. Aleksandr Makarov, “Leonid Kuchma Suggested to Follow New Way Avoiding the ‘Right Direction’,” *Zerkalo nedeli*, October 15, 1994.

10. Viktor Pynzenyk, “We Have No Choice,” *Zerkalo nedeli*, October 8, 1994.

The population and public opinion played no role in this reform drama, although Ukrainian public opinion favored market reforms because people realized that Russia was much better off with its market reforms and that poverty was becoming devastating in Ukraine.

## Financial Stabilization and Liberalization

In December 1993 Ukraine's hyperinflation peaked at 91 percent a month.<sup>11</sup> The chairman of the NBU, Viktor Yushchenko, had just issued money as requested by the parliament. He suddenly realized that this was wrong and that he could stop it. He halted issuing credit without explanation or policy declaration. Monthly inflation fell to 2.1 percent in July 1994. In August 1994 the mischievous parliament realized what was going on and forced the NBU to issue large credits to agriculture as it had done every August, and these credits boosted monthly inflation to 23 percent in October.

Yushchenko's credit squeeze was a curious incident. No public or major political discussion preceded it, but it lasted for seven months. It was a silent act by one powerful individual. High inflation could be defeated, and the dwindling inflation tax had been dissipating the interests favoring high inflation (Åslund, Boone, and Johnson 1996). Otherwise Yushchenko would not have been able to beat them single-handedly. Yet to last, a stabilization program had to be comprehensive, with liberalization and fiscal adjustment (De Ménil 2000). Yushchenko had made his political reputation as the first hero of Ukrainian stabilization.

Kuchma's stabilization, initiated in November 1994, was a logical follow-up. The biggest step was the liberalization of almost all prices. Until November 1994, Ukrainian shops were nearly empty because of unrealistically low regulated prices. To buy something one usually had to go to one of the free markets. As everywhere else, the population calmly accepted price liberalization, although prices skyrocketed by 72 percent in November 1994. Prices that were socially very sensitive were hiked gradually, namely rents, energy prices for households, and public transportation. By 1996 these prices had been raised 15 times to a cost recovery ratio of 60 percent. The liberalization was so far-reaching that shortages ended almost instantly, and the agricultural market was reinvigorated (Shpek 2000, 31). Domestic trade was basically free, even if the old state-owned wholesale organizations persisted and initially reduced competition.

Another important step was to unify the exchange rate and liberalize currency exchange. Kyiv was suddenly full of exchange booths. In old

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11. Major sources of this section are De Ménil (1997, 2000), Kravchuk (2002), Kuzio (1997), Pynzenyk (2000), Shpek (2000), and Yushchenko (2000).

Soviet fashion, as Shpek (2000, 31) put it, “Ukraine had a number of widely differing exchange rates, with large subsidies going to those least in need, in particular to major importers of energy.” Incredibly, the state subsidized natural gas imports from Russia, which boosted imports and Ukraine’s foreign indebtedness, and the subsidy went into the offshore accounts of a few gas traders. The abolition of this subsidy also reduced the budget deficit. In the absence of significant reserves or any stabilization fund, the exchange rate was allowed to float, and the currency was traded daily on the Ukrainian Inter-Bank Currency Exchange. Money came alive.

Formally, Ukraine already had a rather liberal import regime without any quantitative restrictions on imports because, as in other postcommunist countries, everybody yearned to overcome the dearth of goods, and the very low exchange rate was an effective barrier to imports. However, Kuchma liberalized imports further through a presidential decree that created the Commission on Import Regulations, which was authorized to change import rules. The average import tariff was only 5 percent, although tariffs for a few goods were as high as 60 percent. Unfortunately, this regulation of customs tariffs through decree allowed for arbitrary and frequent changes in tariffs.

As in other postcommunist countries, export tariffs and quotas were far more difficult to abolish because powerful rent seekers exploited them for their foreign trade arbitrage, particularly in the important steel exports. The government issued a decree on the liberalization of export operations, which drastically reduced the number of goods subject to export quotas and licenses, but export controls were maintained for such essential goods as grain, coal, scrap metals, and pig iron. These few remaining export barriers have remained persistent bones of contention. The export quota for grain was eliminated in the fall of 1995, but it was repeatedly resurrected. The new Ministry of External Economic Relations was a fortress of rent seeking and corruption. Its senior staff were reportedly charging private commissions for the issuing of quotas and other services. It responded to the liberalization of exports by introducing bureaucratic and unjustified registration of export contracts, but it was abandoned at the request of the IMF at the beginning of 1996.

Tax rates were untenably high. Through a presidential decree, on September 13, 1994, Kuchma reduced the maximum personal income tax from 90 to 50 percent, which was still too high. As nobody paid this confiscatory tax, the revenue effect of the tax cut could only be positive. At the end of 1994, as the parliament promulgated a Law on the Taxation of Enterprise Profit, the equally confiscatory tax on the gross income of enterprises, which did not allow any deductions, was replaced with a moderate corporate profit tax of 30 percent for most enterprises. Yet the profit tax remained confiscatory because few business expenditures were deductible. On March 22, 1995, the parliament reduced the value-added tax

rate from 28 percent (the highest in the world) to 20 percent, but it maintained exemptions for the large privileged sectors, agriculture and energy (Dabrowski, Luczyński, and Markiewicz 2000, 123). These tax rates were still far too high for such a poor and corrupt state.

Reforms, however, did not touch the social sector. Education and medical care costs kept up as a share of GDP, but no structural reforms were undertaken, so the overcentralized, inefficient Soviet system persisted. The intention was to introduce a targeted social safety net, but because of the near absence of reformers in the social sphere, little could be done. Kuchma tried to hold back on social expenditures, but the parliament hiked wages by four to six times, doubled pensions, and tripled social security payments in opposition to him in October 1994 (Kravchuk 2002, 64; Malysh 2000).

Kuchma exceeded all expectations with this reform. He was elected on the same day that Aleksandr Lukashenko was in Belarus, and some Western commentators drew parallels between them, arguing that they reflected pro-Russian and populist sentiments in the region, but they chose different paths. Kuchma's liberalization of trade and prices went further than that in Russia in January 1992. His deregulation of November 1994 marked Ukraine's decisive transition to a market economy.

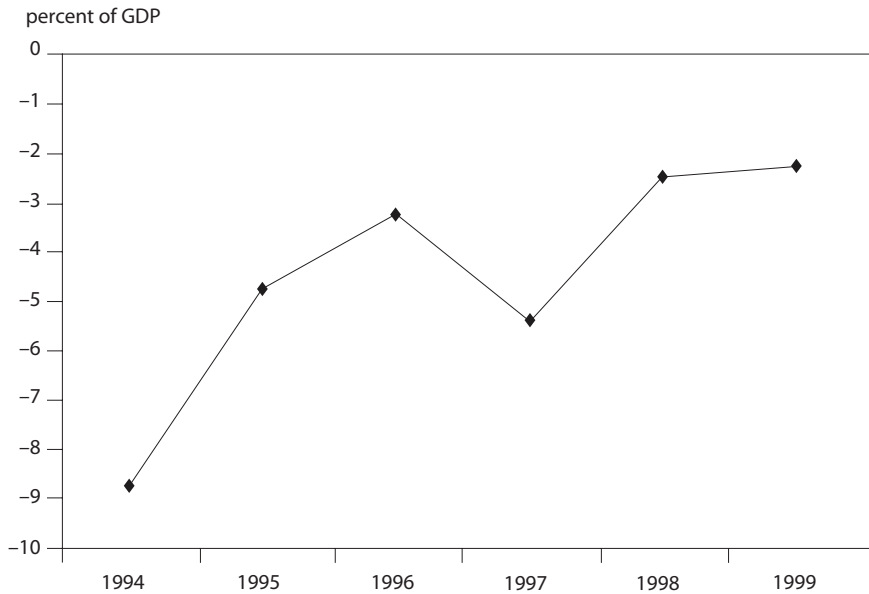
The budgetary adjustment was impressive. Public expenditures declined by no less than 11 percent of GDP from 1994 to 1996, and the budget deficit shrank from 8.7 percent of GDP in 1994 to an acceptable 3.2 percent of GDP in 1996 (figure 3.1). Inflation declined substantially but slowly from 401 percent in 1994 to 182 percent in 1995, 40 percent in 1996, and finally 10 percent in 1997 (figure 3.2). In effect, price stabilization was attained in June 1996, one-and-a-half years after its start. It could have been done faster, but it was accomplished.

The financial stabilization had multiple positive effects on the economy. Although the output contraction did not end, it slowed down. From late 1994, the real exchange rate of the national currency rose steadily, and in 1996 the nominal exchange rate stabilized. By March 1995 the financial credibility of the Ukrainian government had improved sufficiently to enable the Ministry of Finance to issue treasury bills, which partially financed the budget deficit (Pynzenyk 2000).

## Currency Reform, September 1996

The Ukrainian dream of a national currency, the hryvnia, remained unfulfilled, but the primitive printed coupon, the *karbovanets*, had in effect become a national currency. In the Kuchma team, NBU chairman Yushchenko and Deputy Prime Minister Pynzenyk conceptualized the currency reform. They wanted the hryvnia to be introduced as proof of the completion of Ukraine's financial stabilization.

**Figure 3.1 Ukraine's consolidated state budget deficit, 1994–99**



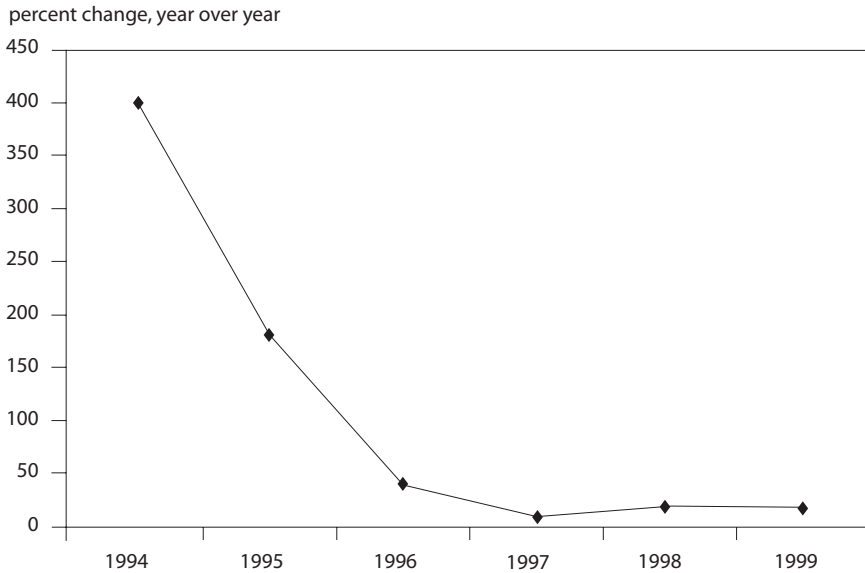
Source: European Bank for Reconstruction and Development online database, [www.ebrd.com](http://www.ebrd.com) (accessed on August 31, 2007).

To imbue confidence in Ukrainians about their national currency, it had to be ensured that money exchange was not confiscatory and that people had sufficient time to exchange all their money, whether on bank accounts or in cash. Ukrainians had repeatedly suffered from confiscatory currency reforms, in January 1991 and again in July 1993, when the ruble zone really ended. New, elegant hryvnia bank notes with historical Ukrainian personalities had already been printed in Canada in 1992 and were ready for use.

In July 1995 Kuchma announced that Ukraine would introduce the hryvnia no later than that October. The NBU had already accumulated international reserves of \$2 billion, which was considered sufficient. Inflation was still high but falling. However, Kuchma's statement was premature. It unleashed panic selling of existing *karbovantsy* as people bought dollars, presuming that not all *karbovantsy* would be exchanged for hryvnia. In order to calm the panic, the authorities had to delay the introduction of the hryvnia until 1996.

In the summer of 1996 monthly inflation approached zero, and the situation appeared ripe. On August 24, Ukraine's fifth anniversary of independence, Kuchma announced the introduction of the hryvnia and instantly issued a presidential decree that clarified all the details of its introduction to avoid new panic. From September 2–16, all cash *karbovantsy*

**Figure 3.2 Ukraine's inflation rate (consumer price index), 1994–99**



Source: European Bank for Reconstruction and Development online database, [www.ebrd.com](http://www.ebrd.com) (accessed on August 31, 2007).

could be exchanged in unlimited amounts at a rate of 100,000 *karbovantsy* for one hryvnia. Bank accounts were given two weeks of extra time. The exchange rate was chosen so that \$1 would purchase almost 2 hryvnia. The NBU had planned the distribution of the new currency well. It undertook a major propaganda campaign to make sure that everyone knew what to do, and the currency exchange took place perfectly (Kuzio 1997, 150–51; Kravchuk 2002, 71).

Economically, this exchange of currency meant little because the *karbovanets* had already assumed all the properties of a national currency, but the public perceived it as provisional. Like the *karbovanets*, the hryvnia was convertible on current account but not on capital account. Psychologically and politically, however, the introduction of the hryvnia was important. It showed that Ukraine was a permanent nation with a lasting national currency, not to be absorbed by the ruble zone.

At the same time, the exchange rate regime changed. Ukraine moved from a free float to a currency band within which the hryvnia was supposed to stay stable in relation to the dollar in order to moderate exchange rate fluctuation. The arrangement had been agreed with the IMF in line with the Russian example, and it was to last until the fall of 1998. Yushchenko emerged as the national hero who had given the country its national currency.

## Privatization Takes Off

Privatization aroused more popular interest and controversy than any other reform, and no reform was more complex.<sup>12</sup> As elsewhere, the public initially favored all kinds of privatization because they wanted to acquire public property at little or no cost, but popular expectations were exaggerated and contradictory.

People wanted privatization to be just, by which most meant egalitarian, transparent, and comprehensible, and they aspired to substantial personal revenues. Many enterprises had sharply reduced their production after the fall of the Soviet Union. The popular view was that privatization would raise their productivity and utilize their full production capacity, although an essential objective of privatization was structural change through bankruptcy and liquidation of obsolete, value-detracting factories. Finally, privatization was supposed to end the economic crisis within a couple of years and develop a new middle class of entrepreneurs. With such high expectations, people could be nothing but disappointed, and they were (Paskhaver and Verkhovodova 2006).

The first task was actually to nationalize all Soviet or all-union enterprises, transferring them to the Ukrainian state. It was quickly and effectively accomplished through the early adoption, on September 10, 1991, of the Law on Enterprises, Institutions and Organizations of Union Subordination Located on the Territory of Ukraine.

Privatization was subject to more early legislation than any other economic issue, but poor and contradictory legislation impeded privatization. In early 1991 two basic laws on private enterprise were promulgated. The Law on Entrepreneurial Activity was passed on February 7, 1991. The important Law on Enterprises of March 27, 1991 replaced a prior Soviet law and guaranteed state enterprise managers independence and quasi-property rights of “their” enterprises, so that all privatization had to be negotiated with managers.

On August 19, 1991, the first day of the abortive August coup in Moscow, the cabinet of ministers of Ukraine adopted a resolution to set up the State Property Fund of Ukraine, which was Ukraine’s ministry of privatization. It was given broad authority on both policy on and procedures for privatization. But since the State Property Fund was subordinate to both president and parliament, it was caught in a tug of war, which persists. The president appoints the chairman of the fund, but the parliament must confirm the appointment. This double subordination left the chairman accountable to nobody, which impeded privatization and generated corruption scandals.

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12. Major sources of this section are Frydman et al. (1993), Yekhanurov (2000), Paskhaver and Verkhovodova (2006), and Kuzio (1997, 153–64).

On September 19, 1991, the Law on Economic Partnerships (Associations and Organizations) was enacted and remained the only corporate law in Ukraine until the adoption of the civil code in 2003. It laid down the rules for joint stock companies and other legal entities but did so in a rudimentary and partially flawed fashion, which later facilitated corporate raiding. For example, a minority shareholder with one single share was entitled to all information about an enterprise, which could be used for blackmail.

In the spring of 1992 the Ukrainian parliament adopted a series of key laws on privatization. The fundamental Law on the Privatization of Property of State-Owned Enterprises was passed on March 4. It was followed on April 12 by the Law on the Privatization of Small State Enterprises. Another essential law was the Law on Leasing of State-Owned Enterprises and Organizations of April 10.

In July 1992 the parliament approved the first State Program for the Privatization of State Enterprises, which became the main policy directive. It stated three major goals of privatization: to change the ownership of the means of production, create a social group of property owners, and foster competition. The program divided enterprises into six categories depending on their book value and character, prescribing different methods of privatization for each category. It stipulated that privatization certificates or vouchers be issued for mass privatization, and the Law on Privatization Certificates was promulgated.

Despite all this legislation, little happened. Ukraine had no strong privatizer. The State Property Fund had little authority, and it took a long time for it to develop its regional and local administration. The parliament regularly interfered in privatization decisions, usually blocking them. Rules were complex and contradictory. The managers who controlled the state enterprises preferred to privatize firms through “leasing” to their own advantage. If no formal privatization took place, the managers gradually appropriated everything. Privatization was slow as a result, and most of it was *prikhvatizatsiya*, the grabbing of enterprises by their managers (Yekhanurov 2000).

Meanwhile, privatization vouchers were distributed through the state savings bank. About 50 million people, or 94 percent of the population, were entitled to receive privatization certificates, but they showed little interest. Most vouchers were distributed in 1995, but by the end of the year only 28.5 million or 55 percent of the population had received them (State Property Fund of Ukraine 1996). Citizens could either use these certificates themselves to bid in a privatization auction or transfer them to an investment trust licensed by the State Property Fund. Like the Czechs, but unlike Russians, Ukrainians were not allowed to sell their vouchers but could transfer them to a trust or investment fund. By 1996 the State Property Fund had licensed over 600 trusts, which eventually accounted for 40 percent of all privatization certificates invested in privatization.

The corporatization of state enterprises proceeded, and in 1993 the regional privatization administration was established. A momentum was building, and in 1994 privatization speeded up. Only 30 enterprises were privatized in 1992, 3,600 in 1993, and 8,000 in 1994, but State Property Fund Chairman Yuriy Yekhanurov assessed that 80 percent of these privatizations occurred through leasing at minimal cost. Curiously, privatization evolved faster in the more left-wing east than in the west, contrary to expectations, and relatively few small enterprises were privatized, which reflected the dominating insider privatization by managers (Kuzio 1997, 156–57; Yekhanurov 2000).

One of Kuchma's main goals was to expedite privatization, and Yekhanurov was his answer to Russia's Anatoly Chubais. During the following two and a half years, Yekhanurov secured the success of Ukraine's privatization.

Yekhanurov (2000, 194–95, 209–13) analyzed the main sources of resistance against privatization. The parliament was ardently left-wing, with a minority opposed to privatization. Local authorities were reluctant to privatize because of insufficient incentives, as most revenues went to the central government. The branch ministries were inevitable enemies, since privatization deprived them of their enterprises, so they had to be weakened and steamrolled. The state enterprise managers formed the most powerful and intricate force. They did not oppose privatization, but they wanted it to be slow to reap the maximum wealth from it. Yekhanurov tried to align the powers in favor of privatization.

On July 29, 1994, the parliament passed a moratorium on privatization out of spite, which lasted until December 7, when it instead issued a list of some 5,400 enterprises exempt from privatization. Yekhanurov argued that the communists had been emboldened by their success in the parliamentary elections. For the next few years, the government tried to slim this list down, but the parliament resisted, extending it to 6,000. Even in 1999, no less than 1,600 enterprises were excluded from privatization (ICPS 1999b, 42).

Privatization really took off in 1995, when privatization of 16,265 enterprises was started, 80 percent of which were small firms. Of the over 3,000 large and medium-sized enterprises that started selling shares, 1,445 sold more than 50 percent (State Property Fund of Ukraine 1996). After the resistance against the privatization of small shops was broken, it was quickly completed in 1996, as everybody wanted to get their piece of the action, which facilitated its completion. Employees bought predominantly small shops and workshops for a symbolic amount, though a significant share was auctioned to the highest bidder.

With considerable political skills and good technical assistance from numerous Western advisers financed by USAID and the World Bank, Yekhanurov untangled the many knots that hindered privatization. His foremost adviser was Oleksandr Paskhaver. As Yeltsin did in Russia,

Kuchma moved privatization forward through presidential decrees rather than legislation.

The privatization of large and medium-sized enterprises was technically more difficult and politically controversial. These privatizations occurred mainly through three methods: insider privatization, voucher privatization, and external sales. Most of the property was given away for next to nothing to managers and employees. In 1998 managers owned 17.5 percent of the stocks of privatized industrial enterprises and employees 47 percent, which was more than in Russia. In reality, the managers controlled a large chunk of the workers' stocks. The initial Ukrainian privatization did not promote new or strong owners intent on serious restructuring but nebulous insider ownership. As a result, even in 1999, no significant difference in performance between privatized and state-owned industrial enterprises was apparent (Estrin and Rosevear 1999, ICPS 1999a).

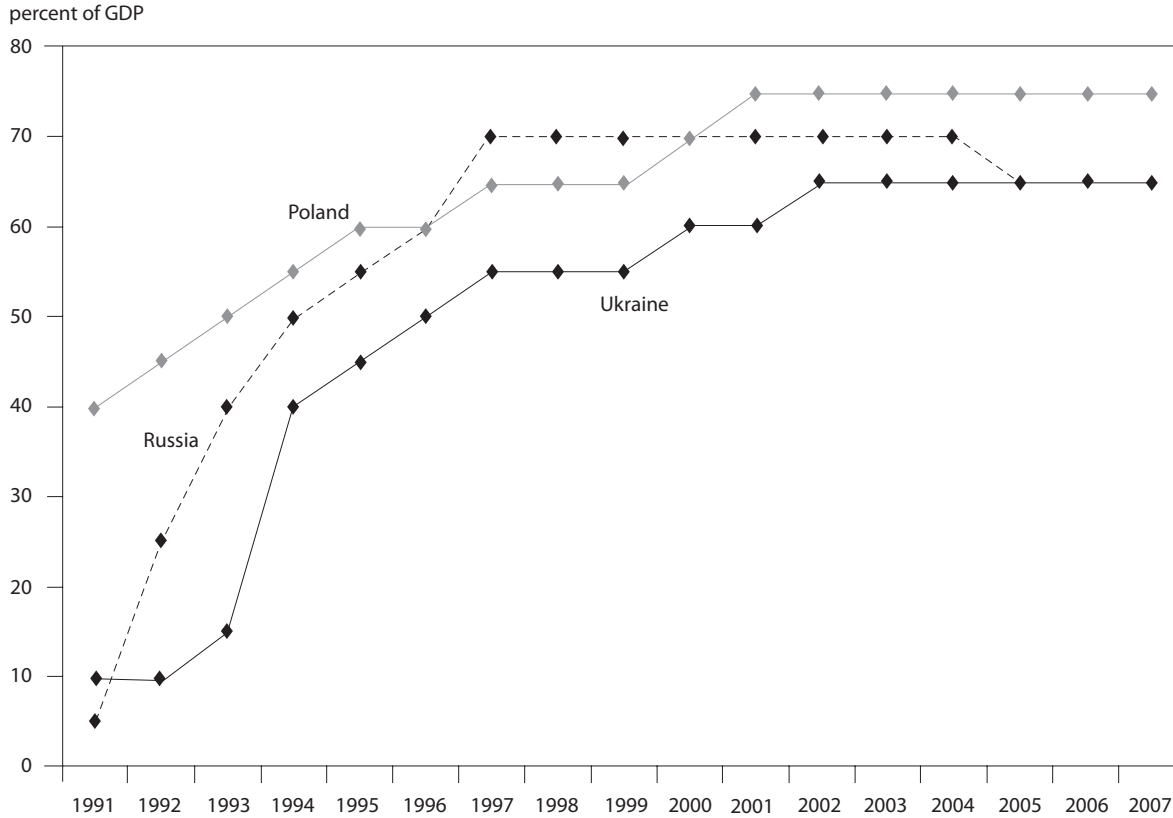
Voucher privatization officially ended in mid-1997. It was followed by cash privatization, with enterprises being sold to outside investors, domestic or foreign. Such privatizations were always slow and controversial, accused of intentionally too low prices and kickbacks (Åslund 2007a).

The European Bank for Reconstruction and Development (EBRD) assessed that the share of Ukraine's GDP originating in the private sector rose from 15 percent in 1993 to 55 percent in 1997 (figure 3.3). The predominance of private enterprise in Ukraine was secured. Ukrainian privatization started two to three years later than in Poland and Russia, and it persistently lagged behind, reaching Russia's level only in 2005, when Russia reverted to renationalization. This was no stellar performance, but a great catch-up started from 1994.

In the end, privatization worked. According to the EBRD, the private sector has accounted for 65 percent of Ukraine's GDP since 2002; the real number is probably significantly higher, on the order of 80 percent (Paskhaver and Verkhovodova 2006, 3). The Ukrainian government claimed that its privatization made 15 million citizens into shareholders. Yet, most of this ownership was illusory, consisting of only a few shares that could not be traded, returned no yield, and offered no influence. As in other postcommunist countries, privatization of large enterprises has steadily become less popular, while privatization of small enterprises is more endearing, and private entrepreneurship is increasingly appreciated. The investment trusts disappeared with few traces, but many scandals, enraging their victims. Privatization alone could not resolve the economic crisis but was a precondition for its resolution.

In the summer of 1994 many feared that Ukraine would fail in its efforts to privatize, as neighboring Belarus did. Three years later, however, the victory was evident. Through his exquisite political and administrative skills, Yekhanurov secured privatization, and unlike most ministers of privatization in the postcommunist world, he has not been seriously

**Figure 3.3 Share of GDP from private enterprise, 1991–2007**



Source: European Bank for Reconstruction and Development online database, [www.ebrd.com](http://www.ebrd.com) (accessed on September 16, 2008).

accused of corruption. He proved himself to be a major politician who was effective and a capable negotiator rather than a rousing orator.

Yet, enterprise restructuring did not take off for years. The main beneficiaries initially were the red directors, who mostly did not know how to run their enterprises under market conditions. We conducted an enterprise survey and found that many factories had lost both electricity and telephone connections, but substandard old managers remained.

In July 1996 I traveled around and looked at enterprises in Kherson oblast. It was a sad sight. Old managers had gained ownership control in most cases. I especially remember one old juice factory. It looked like a ruin and barely worked. The manager had ample stocks of unsold goods. His storage was divided into two parts, and in one of them he had stored salaries in kind for his poor staff, which they had not taken out. He also had ample uninstalled expensive Western equipment lying for years, but he refused to sell it, claiming it was the factory's future.

The saddest scene was in a village with a factory that produced construction elements of reinforced concrete. A concrete element as large as a room's wall stood in front of literally every house in the village, as compensation for unpaid wages, and the impoverished villagers hoped to hawk these elements to rare passers-by. No real restructuring could start until these useless owners sold the factories or were forced into bankruptcy.

In 1996 the Ukrainian government tried to innovate by killing two birds with one stone. A persistent public complaint was that bank savings had been inflated away from 1990 to 1993. At the same time, the demand for enterprises was limited. On November 24, 1995, inspired by Pynzenyk, Kuchma attempted to resolve both problems by issuing a decree that promised citizens of Ukraine a new kind of privatization vouchers—compensation certificates—for their lost savings. These certificates would be distributed starting in February 15, 1996. They would be freely tradable and could be used for the privatization of state property. However, these compensation certificates never gained popularity, and the actual compensation every year was minuscule. The government attained neither objective. Instead, it reinforced people's conviction that the state should reimburse their lost savings.

## **Adoption of the New Constitution, June 1996**

Since independence, Ukraine has suffered from an acute constitutional dilemma.<sup>13</sup> Its constitutional development has been path-dependent, determined by the starting point, the Soviet Ukrainian Constitution of 1978.

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13. D'Anieri (2006) offers an excellent analysis of Ukraine's constitutional order and evolution, while Kuzio (1997, 99–136) provides ample details.

In 1977 the Soviet Union adopted its new “Brezhnev” Constitution. Like other Soviet republics, Ukraine received a similar constitution designed in Moscow the next year. Since communism was contemptuous of law on ideological grounds, the exact provisions of the constitution were given little thought and were arbitrary. After the republican elections in 1990, the Ukrainian parliament assumed real life, and its rule book was the 1978 Soviet Ukrainian Constitution.

This constitutional design was quite peculiar. It confused legislative, executive, and judicial powers and rendered the parliament sovereign. In these regards, the Soviet constitution was reminiscent of mid-18th century aristocratic European constitutional order in Poland or Sweden, which led to corruption and paralyzed decision making. In Poland, the paralysis ended with the country’s partition in 1772, while corruption in Sweden led to a popular royal coup. Charles de Secondat Montesquieu [1748] resolved this dilemma through a clear division of powers, but Leonid Brezhnev ignored his wisdom.

Nor was the constitution stable, as two-thirds majority could change the constitution instantly. The salvation was that no group ever enjoyed a constitutional majority (unlike the Russian parliament under Speaker Ruslan Khasbulatov in 1993).

In the fall of 1991, the introduction of the offices of president and prime minister changed the situation. The two new posts brought about some checks and balances, and the political strife became a struggle between president, prime minister, and parliamentary speaker, although the dominant feud raged between president and parliament.

As a consequence of the strategic compromise between Rukh, which focused on independence, and the Nomenklatura, which nurtured its own power, Ukraine did not experience any revolution, only national liberation. The centrist Nomenklatura under Kravchuk maintained power. Apart from the president, the main elected officials were the parliament of March 1990, and that predemocratic election determined the nature of Ukraine’s post-Soviet polity (Roeder 1994).

The literature on democratization emphasizes the importance of early founding elections with a strong role of political parties to strengthen political parties, parliament, and democracy (McFaul 2001). Unfortunately, Ukraine held no new parliamentary elections until 1994. As Paul D’Anieri (2006, 72) notes: “This gave existing elites plenty of time to make the transition to the new system, and to put rules in place that would make it more difficult to oust them.” Consequently, the rules in the parliamentary elections in 1990 and 1994 remained essentially the same.

The outcome was a dysfunctional political order. After a political honeymoon in the spring of 1992, legislative ability dried up. The president, prime minister, and parliament ended up in an indeterminate quarrel that blocked both legislation and implementation. The same kind of

strife was reproduced at the level of regional governments, and the relationship between the central and regional governments was confused.

Throughout the Kravchuk period, futile attempts were made at adopting a new constitution. For Kuchma, the constitution was his top priority. To strengthen his own power, he wanted strong presidential powers with vertical executive command also in the regions and a unitary state, as did the national democrats, who aspired to a mighty Ukrainian state. The communists, with their impressive standing in the parliament and the east, on the contrary, wanted potent parliamentary and regional powers.

Kuchma was determined to bully the parliament into a constitutional compromise, and he persisted with repeated attempts. In November 1994 he presented a draft Law on State Power and Local Self-Government, which the parliament finally adopted after multiple amendments on May 18, 1995. In the process, two contentious clauses were removed—the right of parliament to impeach the president and the president’s prerogative to dissolve parliament—but the law did not solve much. In June 1995 Kuchma escalated his conflict with the parliament by issuing a decree on a referendum, but the parliament immediately vetoed his decree because Kuchma enjoyed greater popularity than the parliamentary majority. Some centrists resolved the impasse by pursuing a constitutional agreement, which was adopted by parliament and signed by both president and Speaker Oleksandr Moroz on June 8. It was described as a mini constitution.

Kuchma had recorded a minor victory, but he did not ease the pressure on the parliament because he wanted a real constitution. By threatening a referendum again, he managed to persuade the left-wing parliamentarians to compromise on a new constitution after an all-night session on June 28, 1996. No less than 316 deputies—that is, more than the necessary two-thirds majority—voted for the new constitution, although most communists and some socialists opposed it.

The 1996 constitution was a major victory for Kuchma. The cabinet of ministers was subordinate to the president, who nominated the prime minister, subject to approval by parliament. The president appointed all ministers and regional governors, while regional councils would remain elected. Controversially, the right to private property was inscribed in the constitution. The parliament maintained the right to legislate, but the president could issue wide-ranging economic decrees and veto laws. Ukraine would remain a unitary state. Russian was acknowledged as a minority language, but Ukrainian was the sole state language.

Russia’s 1993 constitution was frequently referred to in the Ukrainian constitutional debate. Both constitutions were “superpresidential,” concentrating powers with the president, but varied greatly. Unlike the Russian constitution, the Ukrainian one was referred to as “presidential-parliamentarian,” leaving a stronger role for the legislature. Ukraine was

a unitary state, while Russia was a federation, which meant that Ukraine was more centralized. In Ukraine, the president appointed regional governors, which President Vladimir Putin introduced only in 2005.

Kuchma claimed his main purpose with the new constitution was to intensify economic reforms but after his victory he lost interest in them. With reinforced executive power, he no longer needed to react to popular pressure. Moreover, executive control over law enforcement, especially the prosecutor general, was reinforced, and judicial reform received little attention. Nor was anything done to strengthen the weak political parties. Executive power was far too centralized in the old Soviet fashion, and Kyiv indulged in petty tutelage.

On the whole, Ukraine moved from political disorganization to excessive presidential powers. The country needed stronger checks and balances. A final problem was that the new constitution left many key questions to be determined by law. As a consequence, the parliament could change many constitutional conditions instantly through a two-thirds majority. Therefore they were never really resolved because the parliament could revoke any decision it made.

## Economic Policy Reversal

On March 1, 1995 Kuchma finally managed to retire Prime Minister Masol, who had persistently opposed his reforms together with the communists. In his place, Kuchma appointed his ally, First Deputy Prime Minister Yevhen Marchuk, as prime minister, whom the parliament easily confirmed.

Kuchma gave his second annual address to parliament on April 4, 1995.<sup>14</sup> He had many reforms to be proud of. His reform team had hardened on principled battle for market economy, financial stabilization, and privatization, but his speech marked a policy reversal.

Kuchma broke with his line starting in October 1994, criticizing backers of a “blind monetarist policy.” Instead, he returned to his old tune of “state-regulated transition to a social-market economy.” The economic reforms must be state regulated and generate a social safety net. None of these ideas directly contradicted the reforms under way, but the emphasis had moved from finances and deregulation to production and social goals.

In June 1995 Kuchma specified his policy correction. The IMF target of 1 to 2 percent monthly inflation at the end of 1995 was dropped for 4 to 5 percent. Admittedly, the IMF targets had been overoptimistic, but Kuchma’s weakening of the macroeconomic policy contributed to the de-

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14. The main source of this section is Kuzio (1997, 144–49).

lay of financial stabilization and renewed economic growth. Once again, top officials started talking about that mythical Ukrainian economic model, which was supposed to deliver everything and demand nothing. On October 11, 1995, one year after Kuchma's great reform speech, the parliament celebrated by approving a new government program on evolutionary economic reform. It was an old-style program of 116 pages that covered every conceivable aspect without identifying priorities.

Kuchma's reversal surprised his reform team. Why would he abandon a policy when it was succeeding? Three factors drove him in this direction. First, Kuchma was never a free trader. He believed in financial stabilization, private enterprise, and certain deregulation, but he was a mercantilist. He had gone further in liberal rhetoric than he felt comfortable with to get the main tasks done. Once he felt convinced of market economic success, he could revert to his real beliefs. After having averted the immediate threats, it was all too easy to revert to complacency. Kuchma (2003, 190) explained:

Sometimes I had to apply "manual management" to the economy and finances. It is not normal in theory, but it was a savior in reality. For example, to eliminate debts in pension payments we had to increase the tax burden on expensive and luxury consumer goods substantially. After a careful analysis I understood that it was the only way out and signed a decree.

After direct regulation was abandoned, the Ukrainian government couldn't find any tools to affect the economy that would be accepted in a market economy for a long time.

A second factor was corruption. When Kuchma took over power in July 1994, the profoundly corrupt Kravchuk administration marched out. Notable departures from the circle of power were Yukhym Zviahilskiy, the gas trader Ihor Bakai, and the metals trader Vadym Rabinovich, probably the richest people in Ukraine at the time. Soon, however, these corrupt characters returned, and Bakai became a pivotal power player. The substantial presidential powers aggravated corruption in Kuchma's circle as well, which was particularly noticeable in commodity trade.

A third reason for Kuchma's policy reversal was that the political pressure overwhelmingly came from the left in the parliament, which constituted the best organized and publicly most vocal group. Kuchma fought them but did not want to alienate them altogether and so compromised from time to time, thus finding his powers constrained. After most of the economic reform was done, Kuchma could turn his attention to constitutional reform, which required a compromise with some left-wingers.

This sudden policy reversal revealed five flaws in Kuchma's economic reforms. First, Kuchma's attitude toward market reforms was not an ideological commitment but a pragmatic one. He saw himself as a man who solved one problem after the other, and market reforms formed one set of tools. Therefore, he was not really concerned with the consistency of

the new economic system, which is most evident in his treatment of foreign trade.

Second, the reforms were undertaken by a small group of technocrats without major changes of the government or policymakers. The old *apparat* just waited for a moment of peace when they could reverse the reforms.

Third, many of the reforms were undertaken by decree and not legislated. Unlike laws, decrees lacked consistency and could easily be changed. Many were (Protsyk 2004; Remington, Smith, and Haspel 1998).

Fourth, the Ukrainian legislature remained a marsh that could be swayed in any direction, and its main director was not Kuchma but socialist speaker Oleksandr Moroz, who exploited any opportunity to take Ukraine to the left.

Fifth, the reforms had not been accompanied by any major public education campaign or broader public discussion. Kuchma had utilized his political capital from his presidential election victory, but nobody had really explained the reforms to the population. The World Bank and USAID actually undertook the main public education campaigns. The public neither understood nor believed in a market economy.

To conclude, the problem was not only Kuchma's wavering conviction but also that consistent market economic thinking stayed marginal and the political and constitutional foundation for comprehensive reform remained weak. Capitalist ideology was too weak, though no real alternative was apparent, and all along corruption was a dangerous underlying force.

## Limited but Effective International Assistance

Kuchma's rise enabled the Ukrainian government to utilize the international assistance on offer, but for international assistance organizations, Ukraine was a challenge. Few Ukrainian officials spoke foreign languages, and few foreign officials spoke Ukrainian or Russian. For most foreigners but the Ukrainian diaspora, Ukraine was *terra incognita*. Many Ukrainian officials did not know their new jobs very well—which was why they needed assistance—but few knew how to interact with foreign officials. The first three failed years of Ukrainian independence had left many Westerners cynical, but Kuchma's reform team revived Western interest.

The IMF took the lead in macroeconomic policy and liberalization through Managing Director Michel Camdessus's trip to Kyiv in July 1994 and his ambition to conclude an early stabilization program. The IMF provided substantial financing, disbursing \$356 million in 1994, \$1.2 billion in 1995, and \$777 million in 1996. Altogether the IMF disbursed no less than \$3.5 billion from 1994 to 1999, and it became the financial guardian of Ukraine (Åslund 2002, table 10.7).

The United States paid great attention to Ukraine for at least three reasons. First, Ukraine was a loose pawn geopolitically, which could go in

any direction, and it was a potentially powerful country strategically located in Europe. Second, Ukraine was a nuclear power that reneged on its nuclear forces to the enormous gratitude of the Pentagon. Finally, the Ukrainian diaspora comprised an important constituency in the United States, whose members were concentrated in the so-called swing states in the midwest that could vote either for a Republican or a Democratic US presidential candidate.

Hence, Ukraine received more top-level American than European visitors. US Vice President Al Gore took a special interest in Ukraine and visited it repeatedly, being the second major international visitor after Camdessus to go to Kyiv after Kuchma's election. The United States and Ukraine formed a high-level Gore-Kuchma Commission on the model of the Gore-Chernomyrdin Commission with Russia, signifying the great US official attention to Ukraine.

The United States gave priority to economic assistance to Ukraine, establishing a huge USAID mission in Kyiv. From 1994 through 2000, USAID committed nearly \$1.5 billion in grant assistance to Ukraine, slightly more than \$200 million a year (Åslund 2002, table 10.5). In 1995–96, Ukraine was the third largest recipient of US foreign assistance after Israel and Egypt. The main success of USAID in Ukraine was the revival of the privatization program under Yekhanurov, which required extensive Western consultancy and which the World Bank also assisted. Another major achievement of USAID was the drafting of hundreds of laws, most of which are still lying in the archives of the Rada. Yet when any draft law was requested, USAID had usually already produced one, which was quite convenient.

The World Bank was the key actor in Ukraine's structural reforms, but apart from privatization, not much happened. One odd exception was an electricity reform that was carried out before vested interests woke up (Lovei 1998b). The World Bank was supposed to provide the international lead in social reforms, but little could be done because of the absence of Ukrainian counterparts with any interest in reforms. By and large, officials in the social sector just asked for more money and no structural changes. The World Bank committed loans of \$2.8 billion from 1996 through 1999, but its disbursements might have been half that amount (Åslund 2002, table 10.8).

Ukraine also developed a substantial number of nongovernmental organizations, most of which were started with seed money from George Soros, who also cofinanced most major education and training initiatives.<sup>15</sup>

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15. I represented George Soros on the International Advisory Board of the Economics Education and Research Consortium from the outset in 1996, and I am currently co-chairman of its continuation, the Kyiv School of Economics. Soros has expressed his reasons for assisting postcommunist countries, for example, in Soros (1991).

Surprisingly little foreign government aid went into serious education, while many short courses for policymakers and legislators were undertaken. As a result, Ukraine suffers from a great scarcity of qualified labor.

The European Union could have been expected to play a major role in its backyard, but it did not. From 1991 until 1998, the European Union committed 422 million euros in technical assistance to Ukraine, though actual disbursement might have been about half that amount (Åslund 2002, table 10.6). Moreover, EU assistance was oriented toward political idiosyncrasies in EU member states and almost entirely spent on European consultants. Therefore, EU assistance was of minimal value to Ukraine.

Four entities assisted Ukraine with its international finance gap: the IMF, the World Bank, Russia, and Turkmenistan. The IMF and the World Bank organized Ukraine's debt rescheduling and assisted it with new financing, while Russia and Turkmenistan kindly accepted the rescheduling of substantial arrears of natural gas payments.

## Kuchma Saved His Country

In July 2008 I asked Kuchma to characterize himself. True to his personality, he answered with one word, "pragmatist." Oleksandr Paskhaver has elegantly summarized that Kuchma's greatest strength was what people did not like him for. He saw people exactly for what they were, neither worse nor better. His great realism helped him to act rationally, but people regretted that he did not think more highly of them.<sup>16</sup> Kuchma was no visionary but a deadpan realist, while Kravchuk appeared as a jovial romantic.

Kuchma has summarized his wisdom: "I know the history of Ukraine and I know the character of its people—both the strong and the weak sides. Ukrainians in general know themselves very well. We praise ourselves less than we curse ourselves. And what do we curse ourselves for most? For the fact that there are three bosses for every two Ukrainians. You know the old saying—in a struggle for power, people are ready to destroy one another and everything around them."<sup>17</sup>

"What was your greatest deed?" I asked. Kuchma responded: "I saved the integrity of our country." When Kuchma was democratically elected president in July 1994, Crimea was toying with separatism. Through complex negotiations in many small steps, Kuchma peacefully exhausted this disorganized attempt at secession.

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16. Conversation in Yalta, Crimea, July 12, 2008.

17. Radio Free Europe/Radio Liberty (RFE/RL), "Ukraine: Former President Observes 'Ukraine without Kuchma'," August 7, 2006, available at [www.rferl.org](http://www.rferl.org) (accessed on August 6, 2008).

“What else are you most proud of?” I queried. Kuchma stated the obvious: “The construction of a market economy in Ukraine and we brought about financial stabilization.”

Kuchma had a clear idea of what was important and what was not. When he became president in July 1994, he focused on five major goals: financial stabilization, privatization, the integrity of Ukraine, the adoption of a new constitution, and improved relations with Russia and the United States. Impressively, within two years he had accomplished all five goals, which looked almost unattainable in July 1994.

In the summer of 1996, Ukraine had no inflation, and in September 1996 the hryvnia was fortuitously introduced. However difficult privatization was, most Ukrainian enterprises were privatized. The separatism of Crimea was peacefully averted in 1995. In June 1996 Ukraine finally adopted the new constitution with a great parliamentary majority and without major political crisis. US President Bill Clinton devoted as much attention to Ukraine as it could possibly get, and President Boris Yeltsin, Ukraine’s best friend in Moscow, was reelected in July 1996. Kuchma was not only pragmatic and focused but also a remarkably successful problem solver. The Ukrainian people rewarded Kuchma with persistent support in public opinion polls, and he was an all-dominant politician.

Curiously, Kuchma satisfied the western Ukrainian constituency of national democrats far more than his original eastern and left-wing constituency. He had strengthened presidential and central state powers, he had reinforced the unitary nature of the Ukrainian state, and he did nothing to enhance the official status of the Russian language. In his books, Kuchma (2003, 2007) emphasized what he did for Ukraine’s nation-building and state-building. He secured the integrity of the nation more than what Kravchuk did.

Kuchma’s problem was that his political agenda was too short. His strength was a clear policy focus, but he paid little attention to topics outside his agenda. He did not seem all too disturbed by the continued economic decline. Corruption did not abate but probably grew worse, and media freedom started being undermined. Kuchma needed to renew and broaden his political agenda to make it more ambitious, but he succumbed to the temptation to rest on his laurels.

