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## A short and medium-term comprehensive strategy for the new Ukraine

**Short-term: The next three to five months**
**Medium-term: The next three to five years**

## I. The Starting Point

1. **Putin prefers a financial collapse and political infighting that would destabilize all of Ukraine to a military victory that would give him control over part of Ukraine. This is corroborated by the fact that he twice converted a military victory to a cease-fire that recognized the facts on the ground without depriving him of his first mover advantage.**
2. **Minsk 2 brings Putin close to attaining his preferred outcome. He is now reverting to military de-escalation in the belief that he has accomplished his mission and in the hope that he can avoid a renewal of the economic sanctions when they expire in July.**
3. **The financial and political deterioration of Ukraine makes Putin the winner. This is doomed to continue or accelerate unless Ukraine and its allies can agree on a comprehensive strategy that will deprive Putin of his first-mover advantage. Just as Putin does not obtain Merkel's and Hollande's signature before executing his strategy, the same applies in reverse to the strategy below.**

## II. The Strategy

**Ukrainian and allied leaders should agree on the following principles:**

1. **In the absence of adequate support from its allies, the new Ukraine is no match for Putin's Russia.**
2. **It is in the collective self-interest of Ukraine's allies to enable the new Ukraine not only to survive but to prosper; and as long as they can agree on a way of providing adequate support without getting involved in a direct military conflict, they should be able to prevail against Putin's Russia.**
3. **While it would be more desirable to have Russia as a partner than an enemy, that is impossible as long as Putin persists in his current policies.**
4. **It will be much more costly, particularly for Europe, to defend itself against the threat that a victorious Putin regime will pose when the new Ukraine collapses, than to provide adequate support to the new Ukraine while it is still alive.**

5. Keeping the new Ukraine alive and helping it to succeed should take precedence over sanctions against Russia. Sanctions must be maintained and if necessary strengthened as long as Putin persists in overt military attacks on Ukrainian soil; but they harm not only the Russian but also the European and global economy. They also reinforce Putin's narrative that blames Russia's problems entirely on the implacable hostility of the 'West'. This helps him to retain the support of the Russian people and to consolidate his power. By contrast, a functioning democracy in Ukraine that manages to reform its economy even in the midst of Russian aggression would turn Putin's narrative into a lie that no amount of propaganda could cover up. More and more Russians would want to follow Ukraine's example.
6. Therefore Ukraine's allies should treat Ukraine as a defense priority, not as another Greece. They should declare that they will do whatever it takes to help the new Ukraine succeed short of getting involved in direct military confrontation with Russia or violating the Minsk agreement.

## III. The short-term: the next three months

### A. What Ukraine must deliver

1. Restore the fighting capacity of Ukraine without violating the Minsk agreement.
2. Restore some semblance of currency stability and a functioning banking system.
3. Maintain unity among the various branches of government.
4. Preserve the institutional integrity and independence of the National Bank of Ukraine (NBU)
5. Provide tangible evidence that the government knows where the leaks in the budget are and knows how to stop them.
6. Prepare and initiate a convincing economic and political reform program that both donors and investors would find attractive.
7. Present an impressive case at a donors' and investors' conference in three months time with two months leeway.

### B. What the allies must deliver

1. Help restore the fighting capacity of the Ukrainian army without violating the Minsk Agreement. The allies must imitate Putin in the practice of deniability to deprive him of his first-mover advantage.
2. Europe must reach a new framework agreement that will allow the European Commission to allocate up to €1 billion annually to Ukraine

**charging only 9% to the budget and to use it also for other than balance of payments support. This requires a political decision by Chancellor Merkel and President Hollande, as signatories of the Minsk Agreement, and the expenditure of considerable political capital to overcome legal hurdles and reach unanimity.**

3. **Be ready to commit some or all of these funds if the Ukrainian reform program justifies it. To turn the tables on Putin, Ukraine needs to be converted from a source of political risk to an attractive investment destination. That will require larger EFF's and reinsurance for political risk insurance at attractive rates.**

## IV. The State of Play

### A. Ukraine

**1. General Wesley Clark, Polish General Skrzypczak and a few specialists under the auspices of the Atlantic Council will advise President Poroshenko how to restore the fighting capacity of Ukraine without violating the Minsk agreement.**
**2. Through no fault of its own, the IMF's Extended Funds Facility (EFF) program came too late. The NBU started running short of reserves in the fall of 2014 and the currency was supported mainly by hope. But the deteriorating military situation undermined confidence and the currency broke free of its anchor at the end of February and dropped from 16 to 33 in a few days. The climax was reached on February 25th when the NBU introduced import controls and raised interest rates to 30%. Since then, the President's jawboning has brought the exchange rate back close to the 21.7 level on which the 2015 budget is based. But the improvement is extremely precarious. The temporary collapse has shaken public confidence and endangered the balance sheets of banks and companies with hard currency debts. It has also undermined the calculations on which the IMF programs are based. There is no way Ukraine can save $15.4 billion from restructuring its debt. The Extended Fund Facility is insufficient even before it is implemented. EU member states have shown no willingness to consider any additional bilateral help on account of their own fiscal restraints (which is why Ukraine's leaders are so hesitant in proposing the strategy outlined above). The new Ukraine is literally on the verge of collapse.**
**3. After nearly a year of preparations, all the ingredients of a radical reform program are available; they only need to be put together. The framework for bringing the various branches of government together has also emerged. The National Reform Council (NRC) brings together the presidential administration, the cabinet of ministers, the Rada and its committees and civil society. It was**

**established by presidential decree which has naturally caused some friction between the President and the Prime Minister. Yatsenyuk considered the NRC an unconstitutional encroachment by Poroshenko into economic policy. The performance of the Governor of the NBU has been another source of friction. Yatsenyuk and Poroshenko are leaders of different political parties and local elections in the fall are looming.**

**4. Nevertheless, the NRC is up and running. It functions quite well in setting the legislative priorities and the President and the Prime Minister have been working together pushing bills through the Rada. An unresolved conflict remained concerning implementation and the functioning of the Project Management Office (PMO) but it was resolved on March 5th. In short, the conflict between Poroshenko and Yatsenyuk has been greatly exaggerated both in Ukraine and abroad.**

**5. The International Renaissance Foundation which is the Ukrainian branch of the Soros Foundations was the sole financial supporter of the NRC until now and it will be one of the main supporters of the PMO, which is in charge of financing the NRC and implementing various reform projects, from now on.**

**The structure of the PMO is worth sketching out because it is quite new and not yet legally established, although it has had a small staff at work for the last couple of months. It will operate under the control of a three-member committee consisting of Dmytro Shymkiv on behalf of the president, Aivaras Abromavičius, Minister of the Economy, on behalf of the cabinet and Hanna Hopko or someone else, on behalf of the Rada. Minister Abromavičius will also be in charge of donor coordination and in organizing a donors' and investors' conference in three month's time. So everything seems to fit together very well. There is a stark contrast between the deteriorating external reality and the continuing progress in internal reforms.**

**6. The centerpiece of economic reforms will be the reorganization of Naftogaz and the introduction of market pricing for all forms of energy, replacing hidden subsidies with explicit subsidies for needy households. The PMO has engaged McKinsey Consulting to assist Naftogaz and the other interested parties in preparing the plan for presentation at the donors' conference.**

**7. Institutional reforms should include three major elements: First, set up the anti-corruption agencies, such as the National Anti-Corruption Bureau, and the National Agency for Prevention of Corruption, and finalize anti-corruption legislation according to the international standards. Second, implement the first stage of the judiciary reform, including setting up of the new High Council of Justice, and launching the re-appointment procedures for judges. Third, launch the Constitutional reform program with decentralization as the first goal. The**

**process has been slowed down by the insistence of the newly elected Rada on proper procedures and total transparency.**

**8. The distinguishing feature of the new Ukraine is that, while the oligarchs are influential in the political parties, ministers and other officials are selected not on the basis of party affiliation but personal integrity and professional qualifications. This feature needs to be preserved. Moreover, the budget is still a leaky container. The sources of the large leaks are well known- Naftogaz and the banking system; the government needs to stop these leaks in order to induce the donors to pour money into the container. It is essential for the government to produce a visible demonstration during the next three months in order to change the widely prevailing image of Ukraine as an utterly corrupt country.**

**B. The European Union**

**1. Since member states don't have adequate financial resources, a way has to be found to use the AAA credit of the European Union itself. The search has zeroed in on a well-established financial instrument, the Macro-Financial Assistance (MFA) facility. The MFA has an unusual feature: only 9% of the allotted funds are charged to the budget of the European Union; the EU borrows the rest from the market, using its AAA credit. This makes it very popular. The European Commission used it to contribute to the first IMF rescue package and also to the EFF. They had great difficulty in scraping together 2.5 billion euros for the EFF because the 2015 budget was already over-committed.**

**2. The European Commission will undertake a mid-term review of the EU budget in 2016 and intends to allocate 1% of the budget or one billion euro to Ukraine.**

**3. If the entire amount were channeled through the MFA it would make 11 billion euros available to Ukraine annually starting 2017. Unfortunately, that is not possible because the framework agreement that determines the size of the MFA guarantee fund has expired at the end of 2009. Since then the Parliament and the Council have taken legislative decisions on individual MFA operations under the ordinary legislative procedure (co-decision), resulting in a lengthy decision-making process. The Commission tried to introduce a new framework regulation in 2011 to streamline decision-making, but it was withdrawn in 2013 because the co-legislators could not agree. Since then, the EU operates in a legal limbo when extending assistance to non-EU Member States.**

**4. In order to increase the guarantee fund, the European Commission needs to introduce a new MFA framework regulation and get it approved by the Council. Unfortunately that requires unanimous consent. The political leadership needs to reach a political decision and use up considerable political capital to make it**

**unanimous. Once that is done the allocation of €1 billion to Ukraine from the European budget could be introduced in the form of a supplemental budget that requires only a qualified majority and could become effective in 2016.**
**5. A €1 billion annual allocation to Ukraine with only 9% charged to the budget would make €11 billion available annually. This would be more than sufficient to make comprehensive political risk insurance available in addition to providing budgetary and other support to Ukraine. The insurance would be sold through the established national and international institutions like Euler Hermes in Germany, OPIC in the US and MIGA at the World Bank, but these institutions would be reimbursed by the EU through the MFA to make the insurance commercially attractive. Using MFA for purposes other than balance of payments support and using it to make political risk insurance commercially attractive runs into a number of legal hurdles that need to be overcome in the next three to five months.**
**6. The larger the volume provided, the less likely that the guarantee fund would be invoked. But the European Union cannot be expected to take on the additional risk unless Ukraine demonstrates its determination and ability to fulfill all the requirements listed above. Ukrainian reformers strongly support conditionality and accountability.**
**7. Once the insurance is available, I am prepared to invest up to $1 billion in Ukrainian businesses. This is likely to attract the interest of the investment community. As stated above, Ukraine must become an attractive investment destination. The investments will be for-profit but I will pledge to contribute the profits to my foundations. This should allay suspicions that I am advocating policies in search of personal gain.**
**8. If possible, both the insurance scheme and my investment fund should be announced at the donors' conference. That would come as a surprise to the business community and transform Ukraine's economic outlook for the better.**

## V. A Winning Scenario

**1. Putin is likely to be impressed by a 'whatever it takes' declaration. His main constraint has been that he could not afford to let down the Russian nationalists because they would return to Russia and accuse him of betraying them; but he discharged that obligation with the second Minsk agreement. Therefore, he is likely to abstain from military escalation until July in the hope that the economic sanctions will be allowed to expire.**

**2. By July, Ukraine will have presented a convincing reform program and the allies rewarded it by planning additional budgetary support and announcing their intention to introduce a political risk insurance scheme. Constitutional reform will likely be stalled because the separatists will insist on a federal constitution and Kyiv will resist it.**
**3. The allies will then make the expiration of sanctions conditional on Russia agreeing to Ukraine depositing the $3 billion in a facility that would be used to underwrite the political risk insurance scheme. If there is a covered event during those five years, then the injured party is indemnified by the facility. If there is no covered event, then the Russians get their money back, but only after five years.**
**4. At the same time, the allies will offer face-saving measures short of accepting the illegal annexation of Crimea and parts of eastern Ukraine.**
**5. Since military re-escalation is liable to run into military resistance from Ukraine and strong domestic opposition in Russia, Putin may well accept the face-saving measures. The tables will be turned and Ukraine would become an attractive investment destination.**

**George Soros**
**A self-appointed advocate of the new Ukraine**
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