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How to Reconstruct Ukraine

KEY MESSAGES

- **The Ukrainian state budget needs about \$3.5 billion a month to keep afloat in 2023. The main donors must be the United States and the European Union**
- **Three key tasks need to be combined: reconstruction, EU accession, and completion of systemic reforms**
- **The collective West needs to set up a joint steering group with the Ukrainian government for the management of the reconstruction, EU accession, and completion of reform with good governance and eminent transparency**
- **The costs of the damages that Russia has incurred on Ukraine are enormous. Russia must be forced to pay war reparations. Fortunately, more than \$300 billion of currency reserves of the Central Bank of Russia has been frozen in Western central banks. They should be confiscated and used for Ukrainian reconstruction**
- **Reconstruction should be based on the principles of insurance, covering the costs of each person or entity that has suffered losses from Russian aggression. At the same time, the Ukrainian government and the EU need to reorient strategic infrastructure from Russia to the EU**

On February 24, 2022, Russia launched a full-scale invasion of Ukraine. President Vladimir Putin talked about denazification, that Ukraine was about to join NATO, and the stopping of genocide of Russian speakers in Donbas, etc., but neither existed (Putin 2021 and 2022). Putin's obvious aim was to conquer as much as possible of Ukraine to re-establish part of the Soviet Union or Russian Empire.

Ukraine surprised both Russia and the world by defending itself with valor. Kyiv never fell, and Ukraine defended Kyiv, Chernihiv, and Kharkiv and even recovered Kherson in the South.

As this is being written in January 2023, a slow Ukrainian offensive in the south and the east is proceeding.

The Russian attack on Ukraine had a major impact on the world. The whole West came together as never before. The European Union, NATO, the G7, and the UN General Assembly condemned Russia's war of aggression. The collective West reacted with far-reaching financial and

personal sanctions on Russia. As many as fifty countries engaged in the supply of arms to Ukraine. The West also provided financial assistance. The EU instantly opened its borders to Ukrainian refugees and allowed them residence and work permits and social benefits. Both governments and civil society provided Ukraine and Ukrainians with substantial humanitarian aid. The big future question is how to pursue Ukraine's reconstruction after the war has ended.

THE COSTS OF RUSSIA'S WAR ON UKRAINE

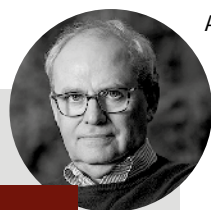
Ukraine has suffered tremendously from Russia's aggression and this suffering is growing. In 2014-15, Russia seized 7 percent of Ukraine's territory and caused Ukraine a loss of 17 percent of its GDP. Ukrainian private claims on Russia in international arbitration amount to more than \$10 billion, while common assessments of the costs in the Donbas amount to some \$20 billion (Åslund 2018).

In February 2022, Russia started a far greater military campaign. The immediate costs are material destruction, lost human lives, and reduced economic activity. The Government of Ukraine, the World Bank, and the European Commission have launched a joint Rapid Damage and Needs Assessment. The material and human losses from the Russian aggression are very substantial. As of June 1, 2022, the World Bank recorded direct damage of more than \$97 billion (World Bank 2022). By November 1, the Ukrainian government and the private Kyiv School of Economics had recorded losses of more than \$120 billion at original cost. With realistic assessment of the reconstruction cost, the amount is likely to nearly double to some \$200 billion. Most of the losses are buildings and infrastructure.

The Russians have killed tens of thousands of civilian Ukrainians and presumably three times as many have been injured. After Libyan officers planted a bomb on an airplane that blew up over Lockerbie in Scotland in 1998, Libya eventually agreed to pay \$10 million per victim.¹ If Russia has killed 50,000 Ukrainians, it would have to pay \$500 billion by the same standard.

To this comes the current Russian devastation of the Ukrainian economy. The Ukrainian Ministry of Economy assesses that Ukraine's GDP fell by 30 percent in 2022. Since Ukraine's 2021 GDP was \$200 billion, this means a loss of \$60 billion in 2022 for Ukraine, and this cost will continue in ensuing years.

¹ "Lockerbie Compensation: Libyan officials Acquitted," BBC, June 17, 2013.



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Russia has imposed severe sanctions on Ukraine and blockaded all Ukraine's Black Sea ports, which means that Ukraine needs to build a new infrastructure to redirect its trade to Europe. The World Bank assesses that "disruptions to economic flows and production, as well as additional expenses associated with the war, are collectively measured as losses and among to some \$252 billion" (World Bank 2022, 2).

Moreover, Russia's aggression has caused both emigration and internal displacement. Measurement is complicated by Ukrainians both emigrating and returning. No less than 7.5 million people fled to the EU, while almost as many Ukrainians, probably 7 million, were internally displaced.

RUSSIA MUST PAY WAR REPARATIONS

Ukraine's Western allies need to force Russia to pay substantial war reparations to Ukraine. The Putin regime will not agree to pay any reparations, but the G7 froze the international currency reserves of the Central Bank of Russia held in the West immediately after its invasion of Ukraine.²

According to the public statistics of the Central Bank of Russia of January 1, 2022, these funds amounted to \$316 billion. Germany held \$96 billion, France \$61 billion, Japan \$57 billion, the US \$39 billion, the United Kingdom \$31 billion, Canada \$17 billion, and Austria \$15 billion (Hufbauer and Schott 2022).

The central bank reserves have many advantages. They are the indisputable property of the Russian state, which is directly responsible for the war crimes in Ukraine. They are perfectly liquid and require a minimum of administrative and legal work. The countries that hold and have frozen these funds should confiscate them through national legislation because of Putin's unprovoked war of aggression against Ukraine (International Working Group 2022).

On November 14, the UNGA adopted a strong resolution with 94 votes against 14 with 73 abstentions to hold Russia accountable and compel it to pay war reparations to Ukraine (United Nations 2022b). It "recognizes that the Russian Federation must be held to account for any violations of international law in or against Ukraine, including its aggression in violation of the Charter of the United Nations, as well as any violations of international humanitarian law and international human rights law, and that it must bear the legal consequences of all of its internationally wrongful acts, including making reparation for the injury, including any damage, caused by such acts" (United Nations 2022a). It can form the basis for an international tribunal against Russia to extract war reparations from Russia.

The principle is clear: Russia must be made to pay substantial reparations to Ukraine after the war

(Åslund 2022). Sticking to international law, the G7 should confiscate Russian state funds in Western countries. The G7 should announce their intention to do so now and tell the Kremlin that it will have to pay for everything that it destroys in Ukraine. The more damage Russia inflicts on Ukraine, the larger the amount of funds that will have to be confiscated.

Canada has taken the lead, adopting a law in late June to confiscate the assets of both individuals and states that are linked to violations of international peace and security, as well as gross violations of human rights. Canadian legislation could serve as a useful model for other countries currently holding Central Bank of Russia reserves.

Another potential source of financing for Ukraine's reconstruction are assets of sanctioned Russian oligarchs that have been frozen abroad because of their assistance to Putin's criminal regime, but it is unlikely to offer much financing within a reasonable time period because of the tremendous legal obstacles. The culpability of various oligarchs will be hard to prove, and they will defend themselves vigorously in court with the best lawyers in the world. Actual ownership is often hidden in layers of 20-30 anonymous shell companies registered in a dozen secretive offshore tax havens, and the owners may transfer property. The declared frozen assets are limited, and few of these assets are liquid. The prices of superyachts and palaces are very low at executive auctions.

Instead, each country that holds Russian Central Bank reserves should adopt a special law for the confiscation of these assets and their transfer to Ukrainian reconstruction. There is no other way in which Russia can be forced to finance war reparations to Ukraine in the short term.

SHORT-TERM FINANCING, 2023

The dominant topic of financial discussion is the medium-term reconstruction, but Ukraine needs substantial support also in the short term in order to escape high inflation (Ferguson 2022). In 2022, the Western funding was unfortunately insufficient, so inflation reached 27 percent in October 2022 because of the shortage of financing caused by the sharp fall in GDP and thus in tax revenues. The international budget support stopped at \$32 billion (Dragon Capital 2023). Yet, the government financial system continued functioning remarkably well.

The Ukrainian government has specified its needs for 2023, presuming that the war continues with the current somewhat lower intensity. In October, President Volodymyr Zelensky stated that Ukraine would need \$55 billion of foreign support next year, including \$38 billion for the budget and \$17 billion for the rebuilding of critical infrastructure. He expected an IMF program of some \$20 billion.³

² DiCamillo, N., "The G7 Has Frozen All of Russia's Reserve Assets in Their Countries," Quartz, February 28, 2022.

³ Shalal, A. and D. Lawder, "Ukraine's Zelenskiy Appeals for \$55 bln to Cover Budget Gap and Reconstruction," Reuters, October 12, 2022.

The two dominant donors to the Ukrainian budget are the United States and the European Union. Hopefully, each will offer \$1.5 billion a month in 2023, which should suffice if their disbursements occur on time. The US Congress has adopted a program of assistance for Ukraine of \$45 billion for the first nine months of 2023. Most of it goes to military assistance, but it also contains \$14 billion in budget assistance, that is \$1.5 billion a month. The European Union intends to match the US financial support and has adopted a package of €18 billion macro-financial assistance for the Ukrainian budget for 2023 (Dragon Capital 2023).

UKRAINE'S RECONSTRUCTION

In April 2022, eight economists from the respected Centre for Economic Policy Research (CEPR) released a substantial and useful report, "A Blueprint for the Reconstruction of Ukraine." They distinguished between three stages of reconstruction. The Ukrainian government has adopted a similar periodization, an emergency response, while the war continues, 2022-23, reconstruction for 2023-25, and development and modernization, 2026-32 (Becker et al. 2022, Ukraine's National Recovery Council 2022).

The CEPR report formulated nine pertinent principles for the international aid for the reconstruction, which have become widely accepted. The aid should be rapid but conditional. The aid should consist of grants rather than loans. Given the multitude of aid sources, close coordination between the different funding sources and the recipient is necessary. The aid should be administered by an independent EU-affiliated or authorized agency. Ukraine must "own" the reconstruction. The reconstruction should be combined with EU integration. The reconstruction must also involve modernization. The hopefully vast amounts of funding require a major role for the state in the economy. The reconstruction should be conditioned on measures to reduce corruption.

The current focus is the reconstruction phase for the three years 2023-25, for which the Ukrainian government requests \$300 billion. Ideally, all of it would be covered by confiscated Russian Central Bank reserves as discussed above.

It is vital that a common coordination mechanism is being agreed upon among the Western donors. Traditionally, the international financial institutions, led by the International Monetary Fund, have played this role, but currently the main donors are the United States and the European Union. Other issues are the balance between reconstruction and EU accession, the balance of power between donors and recipient, and the seat of a secretariat (Kubilius 2022; Ganster et al 2022; Zelikow and Johnson 2022).

The driving force of the Western support for Ukraine has become the informal G7, which also includes the EU. At its virtual meeting on December 12,

2022, the G7 agreed on some principles. They stated: "we are determined that Russia will ultimately need to pay for the restoration of critical infrastructure damaged or destroyed through its brutal war." They agreed to "establish a multiagency Donor Coordination Platform" that the World Bank formed days later. Finally, they agreed to "set up a Secretariat for the Platform. We will each designate a senior government representative to oversee the set-up of the platform and ongoing coordination efforts, and ask them to convene as soon as possible in January 2023" (Gv.UK 2022). The basis for a common coordination mechanism had been formed and the emphasis on speed appears reassuring.

It is still unclear where the secretariat will be located. The European Commission has offered to host it. So has the World Bank, and the Ukrainian government wants it in Kyiv. The degree of coordination with EU accession remains moot and the very governance has not been settled.

The post-war rebuilding of Ukraine must not become mechanical reconstruction. Instead, the reconstruction funding should be an insurance covering the losses made by the owners of assets that have been destroyed by the Russian warfare, which will lead to a natural decentralization. At the same time, the Ukrainian government and the EU need to modernize and reorient strategic infrastructure from Russia to the EU.

REFORMING UKRAINE THROUGH EU ACCESSION

In June 2022, the European Union offered Ukraine the important status of EU candidate. The next step is that the EU Council decided to open accession negotiations. It can do so in early 2023 or delay it for years. The actual accession negotiations last three to four years in the best case. It involves the adoption of hundreds of new laws of a candidate country. After that, all EU members have to ratify a country's membership, which take an additional two years.

Ukraine has already adopted a substantial part of the legislation the EU requires because of having concluded an extensive Association Agreement with the EU. As the European Commission acknowledged: "Ukraine has worked since 2016 on the implementation of the EU-Ukraine Association Agreement, including a Deep and Comprehensive Free Trade Area (AA/DFCTA). These agreements already capture an unprecedented amount of the EU acquis. Ukraine has gradually approximated to substantial elements of the EU acquis across many chapters. It has an overall satisfactory track record of implementation, while in some sectors the country is more advanced than in others" (European Commission 2022a).

While the EU accepted Ukraine as an EU candidate, it did so with seven conditions, and the Commission will monitor Ukraine's progress in fulfilling these steps. The first four conditions are legal, while the three others are democratic principles. They concern

somewhat abridged selection procedure for judges of the Constitutional Court; the integrity vetting of the candidates for the High Council of Justice members; further strengthening of anti-corruption investigations, prosecutions and convictions; appoint a new head of the Specialized Anti-Corruption Prosecutor's Office and a new Director of the National Anti-Corruption Bureau of Ukraine; implement the Anti-Oligarch law; tackle the influence of vested interests in media; finalize the reform of the legal framework for national minorities (European Commission 2022a).

STRUCTURAL REFORMS

Many, but not all, new EU members have excelled with eminent growth rates soon after they became members. In the 1990s, Ireland and Poland, and in the 2000s, Estonia, Latvia, and Lithuania excelled with sustained growth rates of 7-8 percent a year. But success or failure depends on reforms.

A broad and clear understanding has arisen about what major reforms Ukraine requires (European Commission 2022b; Åslund 2015). Ukraine has already come far in its reforms, especially in macroeconomics. The EU has rightly focused on the rule of law and anticorruption, but economic freedom remains insufficient. Four areas requiring significant reforms should be pinpointed, namely reform of the state administration, completion of market reforms, speeding up of privatization, and improvement of corporate governance of state-owned enterprises.

Interestingly, in July 2022, First Deputy Prime Minister and Minister of Economy Yuliya Svyrydenko (2023) published an article sensibly calling for 7 percent growth a year for the next decade by cutting the tax burden from 45 percent of GDP to 30 percent of GDP, by radically liberalizing the economy, and by imposing the rule of law. This was a clear policy advice in line with what has worked in the recent winners in the EU, but it remains to be seen what policy will win.

POLICY CONCLUSIONS

This study highlights the following three important points related to how to reconstruct Ukraine. First, in the short term, it is vital that the Ukrainian state budget receives about \$3.5 billion a month to keep afloat in 2023, essentially from the United States and the European Union. Second, the three key tasks for the country after the war are reconstruction, EU accession, and completion of systemic reforms. They

should preferably be combined, and the collective West needs to set up a joint steering group with the Ukrainian government for the management of these three processes with good governance, efficacy, and eminent transparency. Third, the costs Russia has incurred on Ukraine are enormous and Russia must be forced to pay war reparations. The only good way of doing so is to confiscate the more than \$300 billion of currency reserves of the Central Bank of Russia that Western central banks have frozen.

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