Ukraine: A miracle in waiting?

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Ukraine is a large country of some 50 million people that shares a border with OECD member, Poland. It was also the Soviet Union's second largest republic after Russia. Like Russia, it has been rather slow since the Union's dissolution in undertaking decisive economic reforms. The economy is improving, though there is much to be done before Ukraine can fulfil its undoubted economic potential.

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Sky's the limit: Monastery of Caves, Kyiv

When Ukraine's parliament, the *Verkhovna Rada*, declared independence in July 1991, and confirmed it by a 90% majority in a referendum in December 1991, there was a widespread belief that as one of Europe's most ancient civilisations, Ukraine would quickly overcome the legacy of the Soviet Union, rebuild its economy, adopt western democratic values, and establish institutions that would support an open market economy.

There was also some fear that Ukraine's transition would be accompanied by unrest. However, the process has been unexpectedly smooth politically, with none of the conflict, invasion or insurgence that have so characterised Ukraine's turbulent history, or that of some of its neighbours. Democracy has been abused from time to time, but it is entrenched in law, and progress is being made in exercising and developing it. Three parliamentary elections have been held, most recently in March 2002. And a new constitution was adopted in June 1996 as a blueprint for developing a democratic and civil society.

All positive steps, yet there is some way to go before democracy and law become properly embedded and deep-seated corruption is stamped out. This would be helped by a stronger economy, and it is here that the going has been tougher than many expected. If Ukraine is to chase away the shadows of its history and secure its future, it really must get this dimension right too.

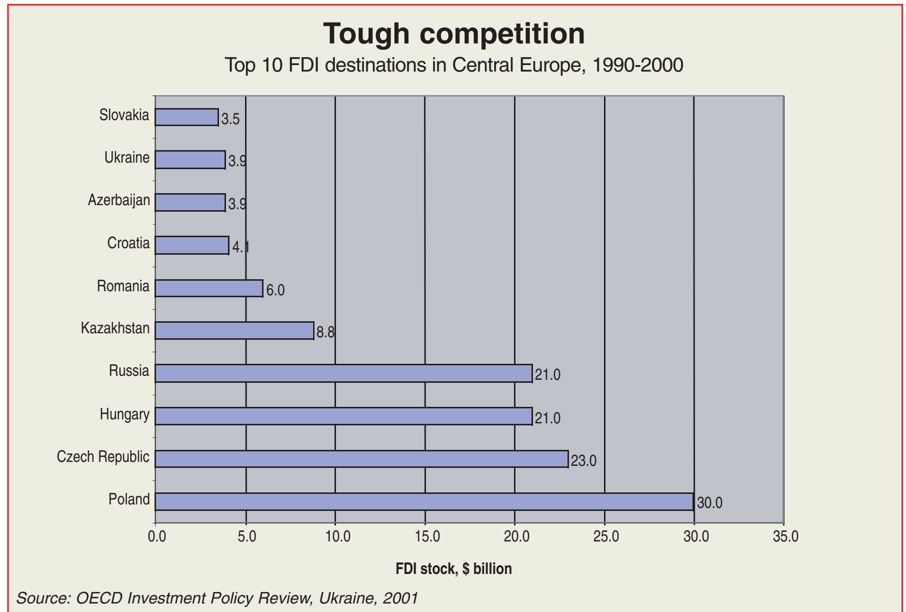
Partly to blame is nearly a century of suffocation under Soviet rule. Hangovers from that system, from cronyism to heavy bureaucracy, not to mention plain incompetence, have yet to be cured. But Ukraine's ills cannot be entirely blamed on past legacy and it too must shoulder some of the blame, as well as responsibility for change.

At last, there are encouraging signs. Ukraine's economic trends turned around in 2000 and record GDP growth of 9.1% was achieved in 2001 after a decade of decline. Inflation has also been curtailed and the national currency, the hryvnia (UAH), stabilised. These improvements have to be made sustainable.

Several factors triggered the recent impressive rate of growth. Obvious ones include devaluation of the hryvnia after the Russian financial crisis in 1998. This provided a major boost to exports of goods like metals and chemicals, taking advantage of a period of strong growth in world trade. A shift of small firms from the shadow to the formal economy led to growth in the private sector, which now accounts for about 65% of GDP.

However impressive this turnaround, the short to medium-term outlook is for some slowing in line with that of the global economy. A recent wave of import restriction measures by Russia, the EU and the US (on steel particularly) will not help exports, which account for roughly 60% of Ukraine's GDP growth. Russia is Ukraine's largest single trading partner, accounting for 22% of exports and 34% of imports, and because the ruble is sensitive to fluctuations in oil prices, Russia's exchange rate policy will also directly impact on Ukraine's economy.

If Ukraine had a more robust economic foundation it might be able to deal with these problems. But substantial restructuring will have to be carried out if Ukraine is to achieve sustainable growth. At just US$720 per capita annual income is very low compared with US$1,750 in Russia and US$4,240 in OECD member Poland (World Bank estimates at purchasing power parties, 2001 exchange rate). Growth from this low base is surely feasible. With the right economic policies and provided political stability continues, the next 10 years could prove to be the decade of Ukraine's economic resurgence.



Source: OECD Investment Policy Review, Ukraine, 2001

Slow and uncertain transition

It would be foolhardy indeed to expect the legacy of over 70 years of distorted central economic planning, and all the institutional and cultural legacy that goes with it, to be removed overnight. Ukraine's economy was deeply integrated with that of the Soviet Union and its extensive military industrial complex.

Dealing with the complexities of a free market economy, and making sure institutions operate openly and efficiently, remain daunting challenges even today for some OECD countries. But the problems are deeper in transition countries, where institutions and government apparatus may be inadequate, especially experience in policy formulation and execution. Nor could Western institutions provide a magic formula, particularly as they too had to acquire experience of transition.

Change is inconvenient, even when for the better, and so pockets of resistance were always going to make Ukraine's transition difficult, particularly from those that benefited from the previous regime or profited from disorder and cronyism. Even where intentions have been honest, the instincts of functionaries and other policymakers were more disposed to control economic activity than to create mechanisms to support private sector development and initiative.

Thankfully, changes are now happening. Macroeconomic stability has been restored and reforms have begun to make operations in the electricity sector more transparent; barter and inter-enterprise arrears have been reduced substantially; wage and pension arrears have been mostly eliminated; corporate tax privileges have been reduced, and so on. All these have been major steps in transforming structure as well as minds, and probably contributed to the recent acceleration in economic growth. The new and challenging Land Code, which came into effect on 1 January 2002, has also been a catalyst, as it introduces a formal mechanism for private land ownership. And from 1 January 2005, it will allow agricultural land to be traded and used as collateral.

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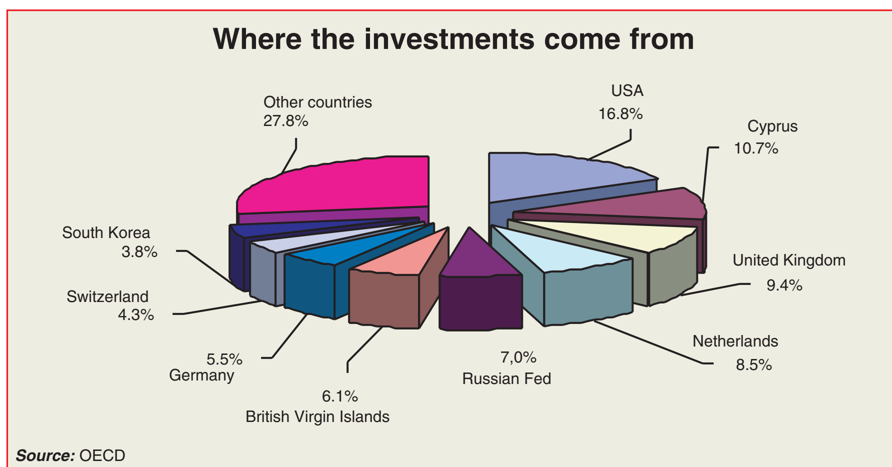
Further deep changes in the economy are inevitable. Restructuring is needed in heavy and light manufacturing industries to draw in new technologies, streamline existing capacity and generally improve cost, quality and competitiveness. Continued privatisation of large-scale enterprises is crucial, including in the energy sector, together with continued reforms of the agricultural sector, and strengthening of the weak and undeveloped financial services sector.

However, institutional and regulatory reforms are also needed, partly to squeeze out corruption and red tape, and to establish fair and transparent rules of the game. In addition, comprehensive bankruptcy, corporate governance, and securities laws must be implemented.

FDI

One ingredient Ukraine needs plenty of is foreign direct investment (FDI) to boost capital, improve skills and raise its economic performance generally – just as in other successful transition countries. This goes for almost every sector of the economy, from agriculture to banking. FDI flows directly influence the balance of payments and constitute a major source of foreign currency, especially useful for servicing external debt.

Where the investments come from



Source: OECD

Unfortunately, Ukraine's record of attracting FDI has been very poor. From independence to the end of 2001, the stock of FDI reached only $4.4 billion or $88 per capita, less than 10% of per capita FDI in neighbouring countries like Hungary or Poland (see graph).

The need for investment capital is particularly acute since net outflow of capital from the economy has been estimated at $20 billion since independence, although some of it has slowly begun to come back.

Russia's influence is enormous in the context of FDI. Russian (and Ukrainian) businesses use offshore companies in Cyprus, British Virgin Islands, Switzerland and other countries to repatriate and invest their capital back home. Russian companies now control Ukraine's aluminum and oil refining sectors, while their presence is increasing in the processed foods, metallurgical and machinery sectors, banking and transportation.

Kyiv and its surroundings received a little over 40% of cumulative FDI, with Donetsk, Dnipropetrovsk, Odessa, Poltava and Zaporizhya accounting for another third. Crimea has attracted only 4% since independence.

Without reforms, Ukraine's prospects for FDI will not improve. Some of the key obstacles which confront investors were identified by the OECD in its recent publication *Ukraine: Progress in Investment Reform 2002.*

Poor and uncertain administration is a major disincentive. Foreign investors, even those used to poor service elsewhere, frequently complain that no one appears to be in charge to take decisions, resolve disputes or grant approvals. Investors shuffle from ministry to ministry in a seemingly endless bureaucratic maze, while facing the prospect of dealing with an onerous tax regime, and poor accounting standards and practices.

Governance is not up to scratch either. The lack of transparency in privatisation, not to mention asset stripping and insider dealing, are major disincentives for all investors. Corruption is also a real problem; according to Transparency International 2001 "Corruption Index", Ukraine ranks in 83rd position, ahead of only eight countries.

Rule of law is also a problem. Reform of the judiciary is under way to improve efficiency and transparency, and especially enforcement of judgements (particularly necessary to enforce contractual obligations).

Complex **tax laws and regulations**, combined with capricious administration, also top the list of investment disincentives. Unexpected changes to existing tax legislation have also damaged the government's credibility; for instance, in December 2001 parliament passed a new law abolishing tax privileges for enterprises with foreign investments in a bid to establish equal treatment between domestic and foreign firms.

Another area in need of action is the **banking system**. Despite a large number of banks (over 150 registered), the top 10 represent over 70% of all banking activities, worth

Ukraine: Key economic and social indicators

Capital:	Kyiv
Population:	49 million
Area:	604 thousand sq km
Currency:	Hryvnia (UAH)
Adult literacy:	98%
Urban pop.:	68%
No. of households:	8 million
Avg. no./ household:	6.1

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Key Economic Indicators:	2000	2001
Nominal GDP (current US$ bn)	31.3	37.6
Real GDP growth %	5.8	9.1
Inflation (CPI) %	25.8	6.1
Current account (US$ bn)	1.5	1.3
FDI (Net) (US$bn)	0.6	0.8
Gross international reserves (US$bn)	1.5	3.1
Fiscal balance, cash basis % GDP	-1.3	-1.6
Total public debt %GDP	45.3	37.9
Exchange rate US$ avg	5.4	5.4
Credit ratings: EIU: D		
Other:	**industry/GDP**	**40.6%**
	agriculture/GDP	**14.7%**
	investment/ GDP	**20.4%**

Sources: Derzhkomstat, Ministries of Finance and Economy, Institute for Economic Research and Policy Consulting ; World Bank/IMF ; EIU.

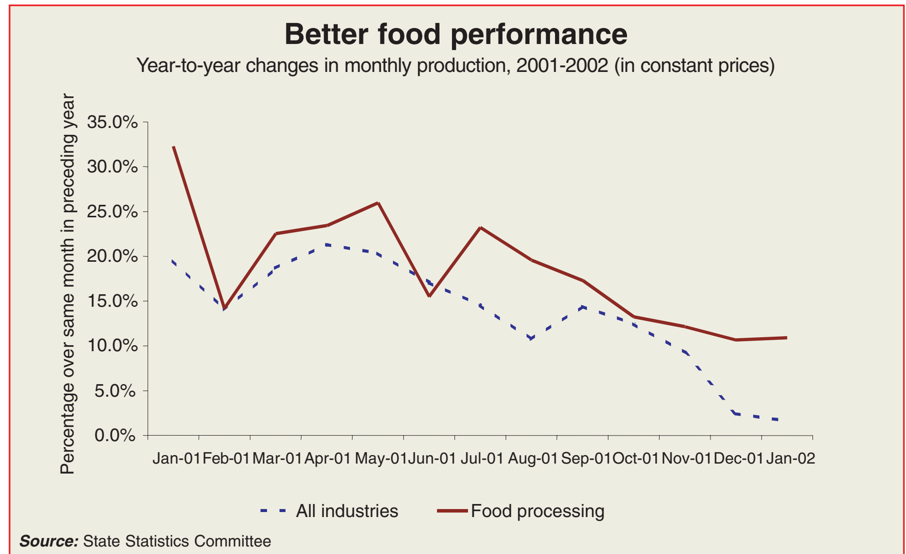
some UAH58 billion in mid-2002. The total capital of the banking system at UAH8.7 billion is very low, as are household deposits, despite double digit growth which has taken them to UAH15.2 billion at mid year 2002. While major regulatory and legislative improvements have been made, and improved bank supervisory and monitoring standards are being developed and implemented, the banking system still has not won over the full confidence of the public at large.

Privatisation trouble

The 2000-2002 privatisation programme clearly illustrates Ukraine's problems. The programme aims to sell off most of the 200 large enterprises holding over 80% of assets in the industrial and utilities sectors by attracting long-term strategic investors and foreign investors in particular. Naturally, the government sees privatisation as a way of bringing in not just capital, but new management and know-how, as well as being a major source of revenue. In 2001, revenues from privatisation constituted 11.3% of the total consolidated planned revenues to government and FDI generated some 60-70% of total privatisation receipts.

A major problem is how to manage the powerful, sometimes corrupt, economic power groups that privatisation has bolstered or created with control over metals, chemicals, gas, etc. Tax exemptions and the discretionary application of regulatory requirements clearly cannot continue, especially if the government is to improve the country's fiscal position. Receipts from recent sales of large companies have been disappointingly low, generating only UAH3 billion (about US$566 million) in 2001, which is half of what was planned. Prospects of meeting the 2002 target of UAH5.5 billion are remote since privatisation of the remaining nine *oblenergos* (regional electricity distribution companies) and the energy generating companies is still under review, while privatisation of the national telephone company, Ukrtelecom, has been postponed because of poor market conditions.

The Ukrainian government recognises the shortcomings in the investment climate. Its "Programme on Development of Investment Activity in Ukraine in 2002-2010" which introduces a complex set of measures aimed at further improvement in the investment climate, including further deregulation and liberalisation of business activities; creation of a stable and predictable legal environment; better banking and improved bankruptcy procedures.



The programme is in line with the **OECD investment policy recommendations** for Ukraine, and it is clear that more work is needed to advance private sector development, for instance, and put privatisation on to a predictable and stable, case-by-case, footing. The benefits and costs of investment incentives have to be better assessed and distorting tax privileges stamped out. International arbitration of disputes is needed, as are courts of appeal for economic disputes. And Ukraine's accounting and auditing practices have to be aligned with international standards, in particular for publicly-traded companies. Other initiatives like a "one-stop-shop" agency to facilitate foreign investor licences, approvals and so on, would also be valuable.

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With a list like this, it may appear as an exaggeration to call Ukraine a "miracle in waiting". But it is a large and untapped market. It has a highly educated, yet inexpensive, labour pool; over 1,300 scientific and technical institutes specialising in artificial intelligence, metallurgy and aerospace, to name just a few areas. The country is endowed with vast mineral deposits, including 27% of the Earth's most arable and fertile top soil (chernozem). And, its location straddling central Europe, the Black Sea and Russia provides an important crossroads for the region and also a gateway to Asia. These are all attributes the country will no doubt be putting on the table in present entry talks to the WTO and in a future bid for EU membership.

Ukraine might not quite be a miracle economy now, but by taking advantage of favourable growth and following a course of aggressive reforms, it has the potential to become one in the future. ■

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