UKRAINE: Improving its Business Environment

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UKRAINE -- Economic Highlights

- Few countries can show the following combination of economic achievements over the last three years:
  - High average rate of economic growth of about 9% pa
  - Low average annual inflation rate of less that 7% pa
  - Low average fiscal deficit of about 1% of GDP
  - High current account **surplus** of more that 8% of GDP
  - Fairly stable foreign exchange rate
  - High international reserves (currently $9.5 billion) in excess of three months of imports
  - Very low ratio of external debt to GDP of 20%

Economic Performance

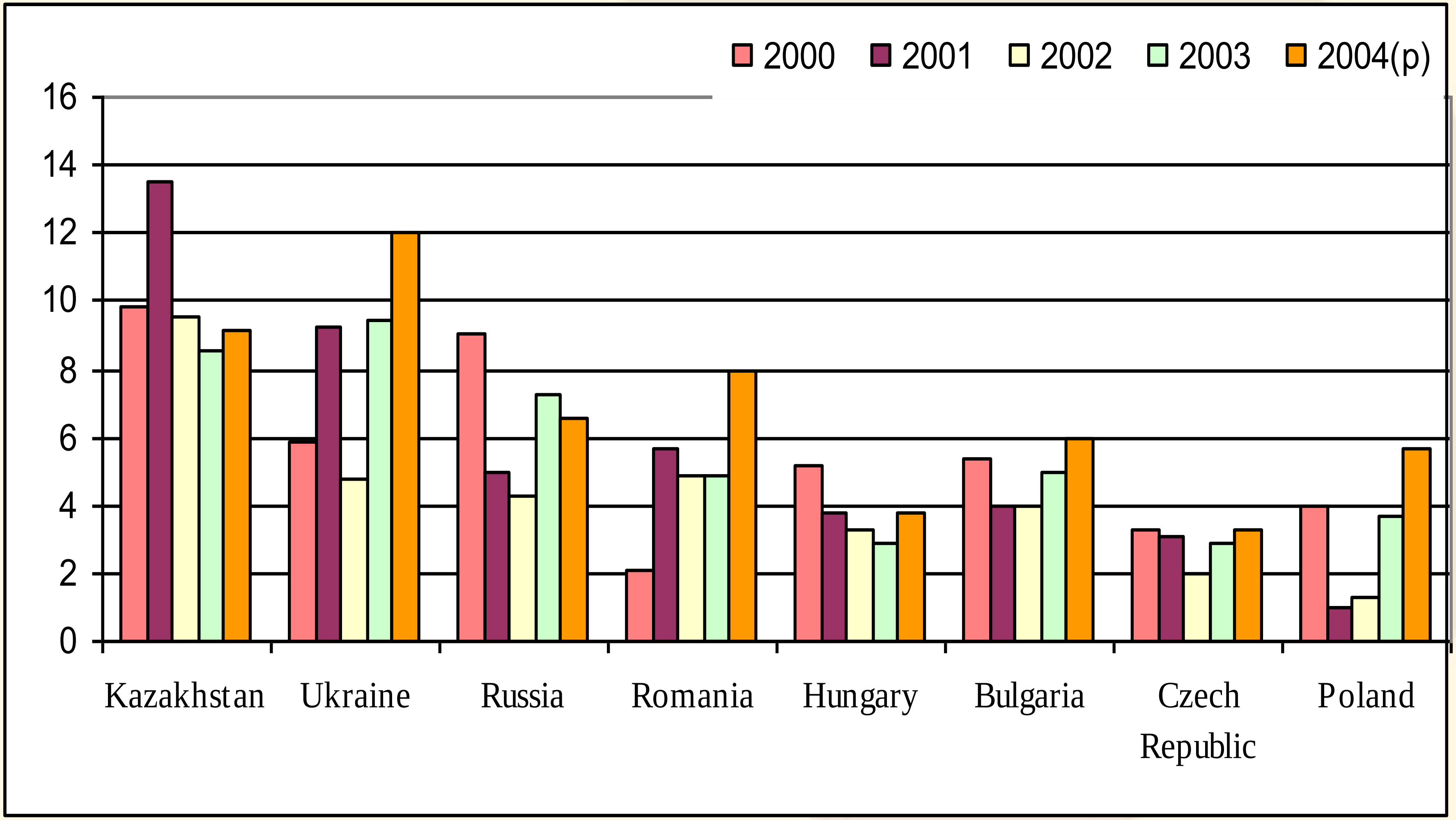
	2000	2001	2002	2003	2004	2005 *
Real GDP Growth	6.0%	9.2%	4.8%	9.4%	12.1%	5.5%
Fiscal Balance (% GDP)	0.6%	-0.3%	0.7%	-0.5%	-3.3%	2.0%
Consumer Inflation	25.8%	6.1%	-0.6%	8.2%	12.3%	13.3%
Exchange Rate (Hr/$)	5.4	5.4	5.3	5.3	5.3	5.29
Current Account ($bn)	1.2	1.4	3.2	2.9	7.0	N/A
(as % of GDP)	3.7%	3.7%	7.7%	6.3%	11.%	N/A
International Reserves ($bn)	1.6	1.7	4.4	6.9	9.5	11.0
Foreign Debt/GDP	32%	27%	24%	22%	23%	20%

*Data as of January-February 2005

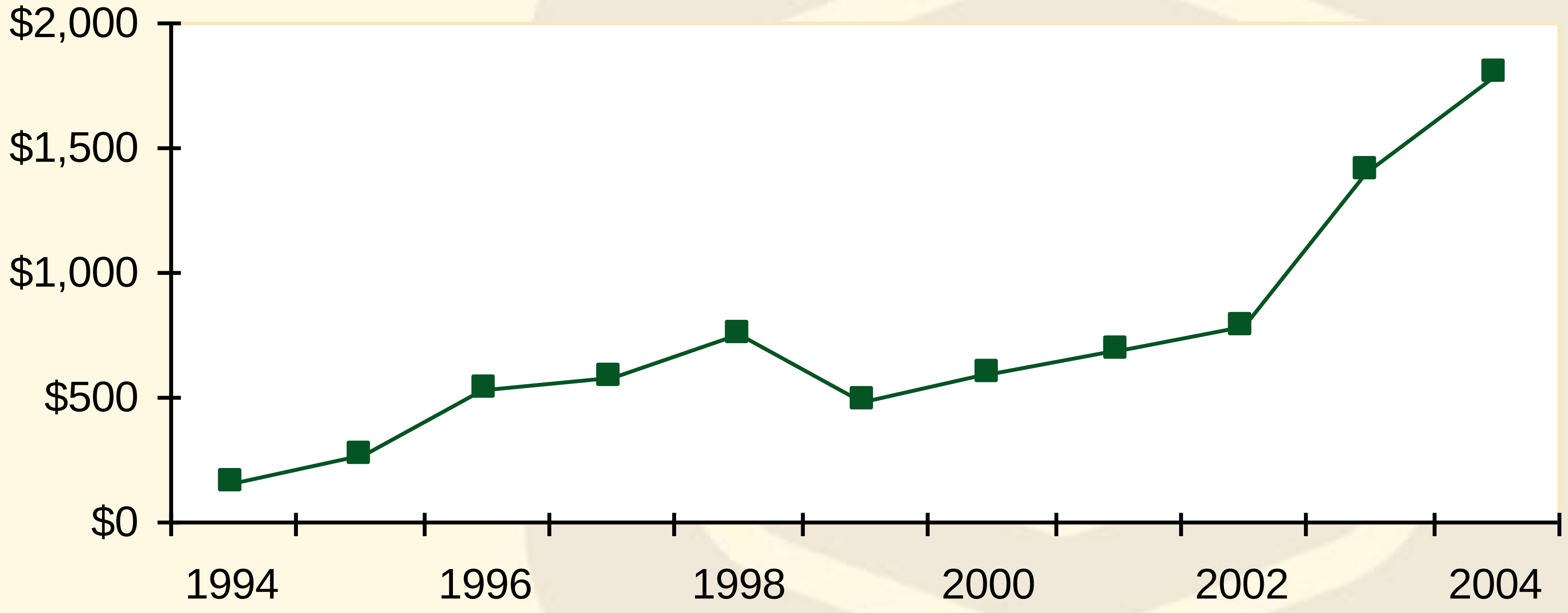
Recent Economic Developments

- In Q1/2005, real GDP grew by 5.4% yoy supported by 7.1% and 6% expansion in industry and construction, respectively
- Inflationary pressures have continued; the consumer price index increased 14% yoy in March
- The banking system fully recovered from the liquidity crisis occurred at the end of 2004. Commercial banks managed to restore their deposit base as deposits growth sped up to 42% yoy in February.
- Good export performance and foreign investment inflow allowed the NBU to replenish its gross international reserves to $12.0 billion by the end of March.
- The surplus in the Goods Trade Balance reached $917 million in January-February, equivalent to 9.6% of period GDP

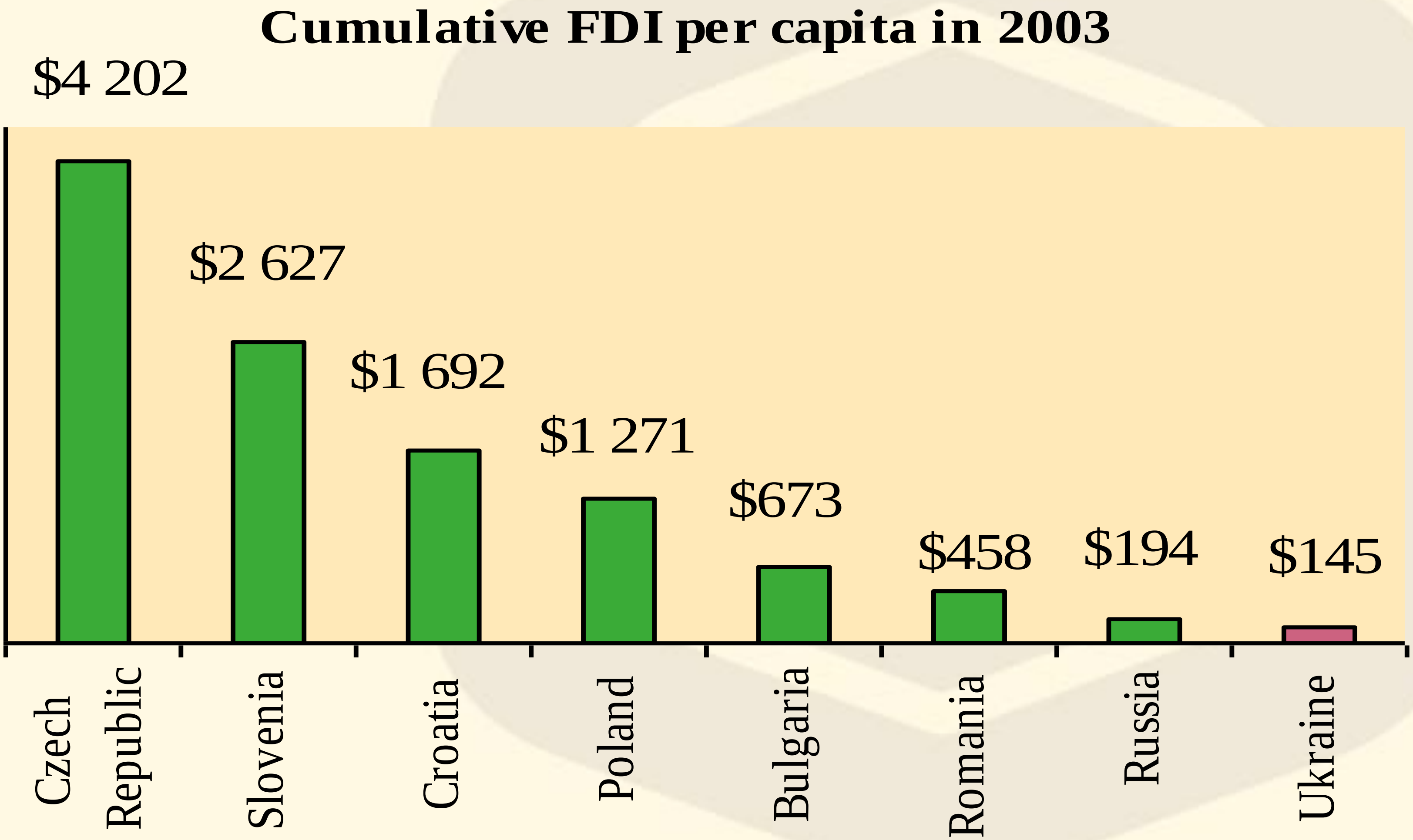
Real GDP Growth (%) in Ukraine compares favourably with other Transition Economies:



Ukraine- Net FDI inflows, US$ million are increasing…



Despite positive inflow dynamics, cumulative FDI in Ukraine is still extremely low compared to other economies in the region….



Possible Risks to Economic Growth

- Possible high fiscal deficit in 2005 – The amended budget for 2005 envisages high social expenditures approved by the previous government in late 2004; the Government target deficit of 1.96% of GDP may be hard to achieve.
- As a result, inflationary pressures could continue.
- Rapid credit expansion and low quality of credit portfolio make banks vulnerable to external crises.
- Risk of external shocks -- Ukrainian growth, to a great extent led by exports, has benefited from high metal prices as metal products represent about 40% of exports
- Implementation of structural economic reforms may be handicapped by Parliamentary elections in 2006.

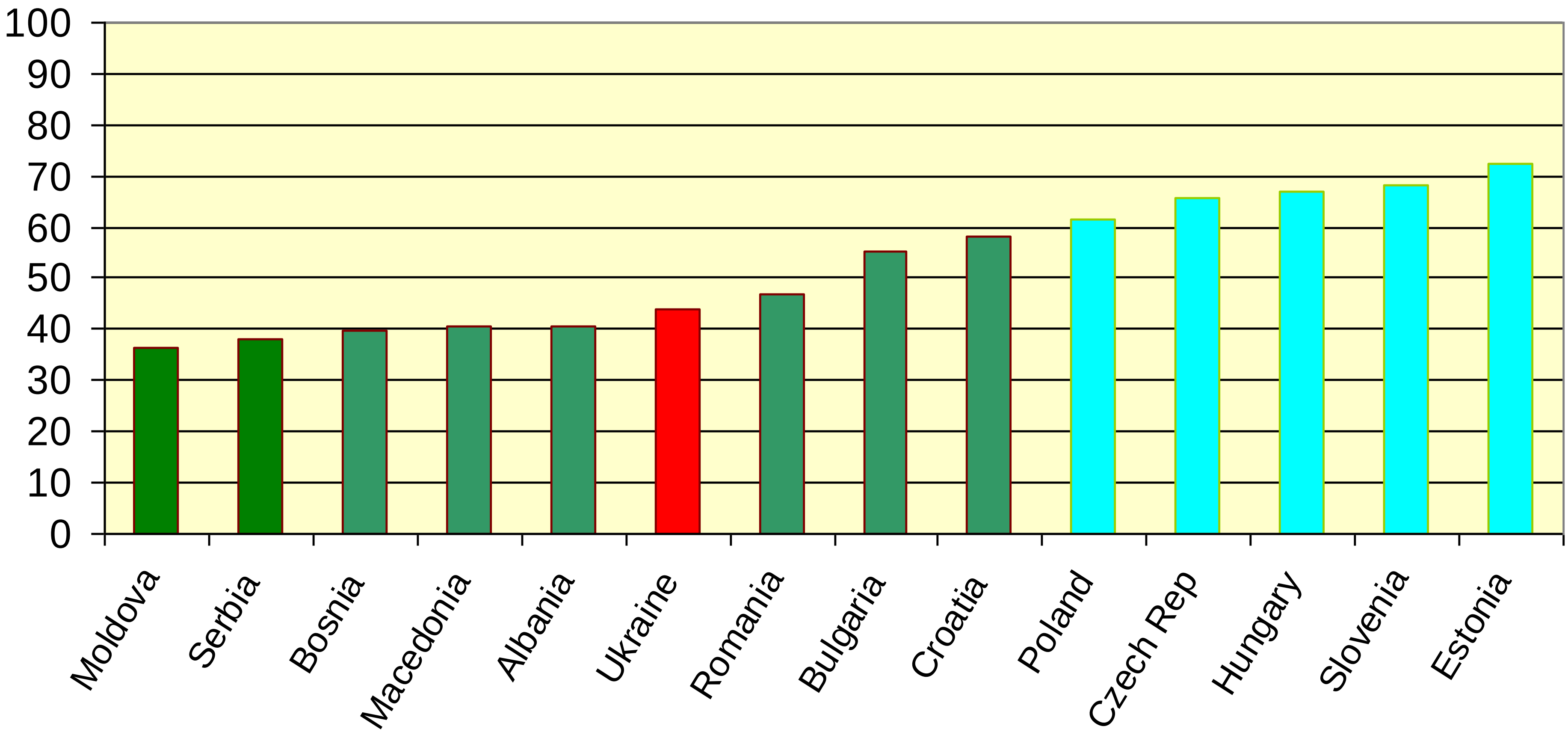
Policy Actions for Ukraine

Mr. Yushchenko is aware that to ensure sustainable economic growth over the medium term, sound monetary and fiscal policies must be maintained and must be complemented by policies facilitating sustainable investment activity ("investment drivers").

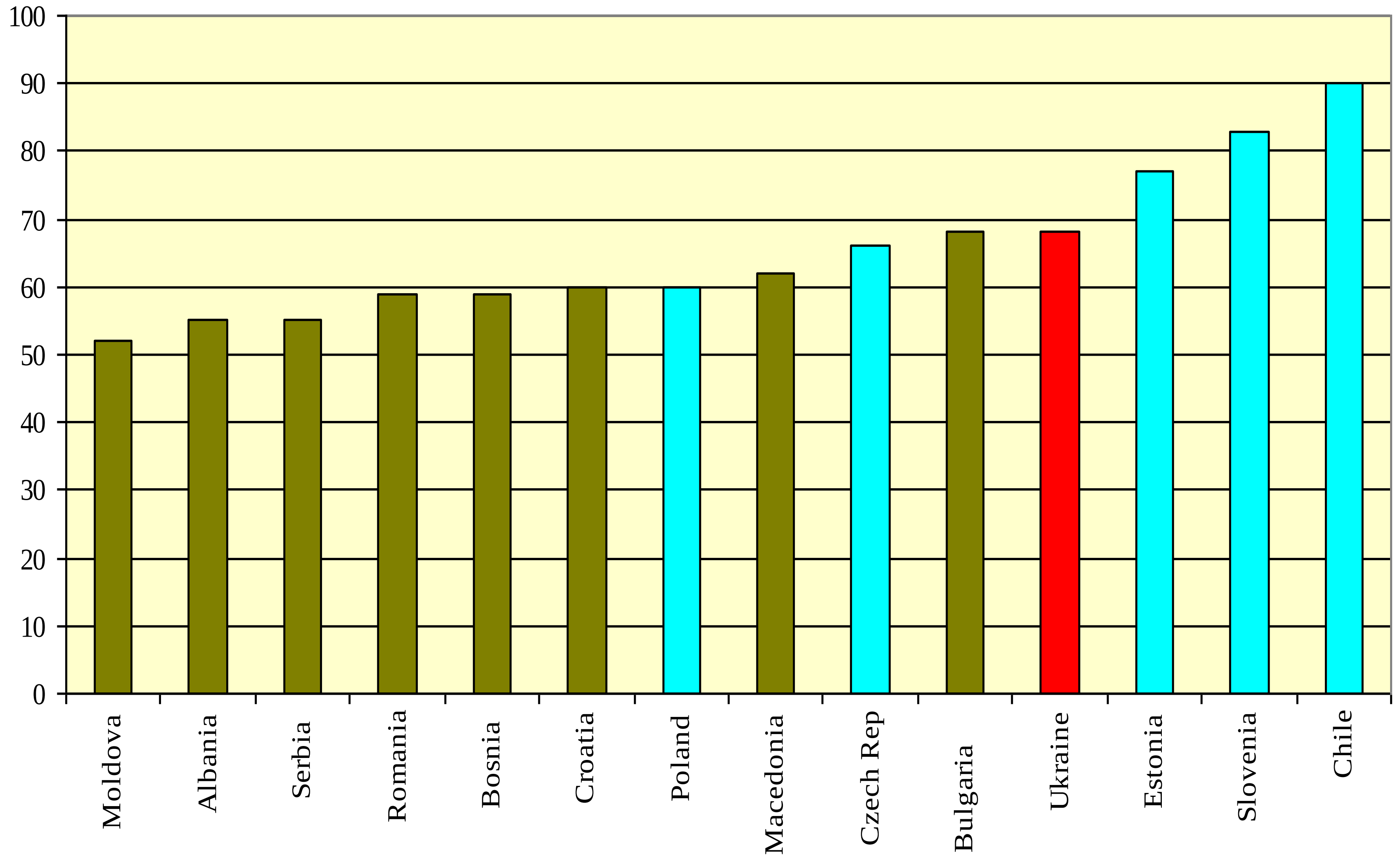
(1) Macroeconomic stability
(2) Business liberalization and de-regulation policies
(3) Stable and predictable legal environment
(4) Corporate and public governance
(5) Foreign trade liberalization and international capital movements
(6) Healthy financial sector
(7) Corruption
(8) Political uncertainties
(9) Country promotion and image

How does Ukraine compares with other regional countries on these investment drivers?

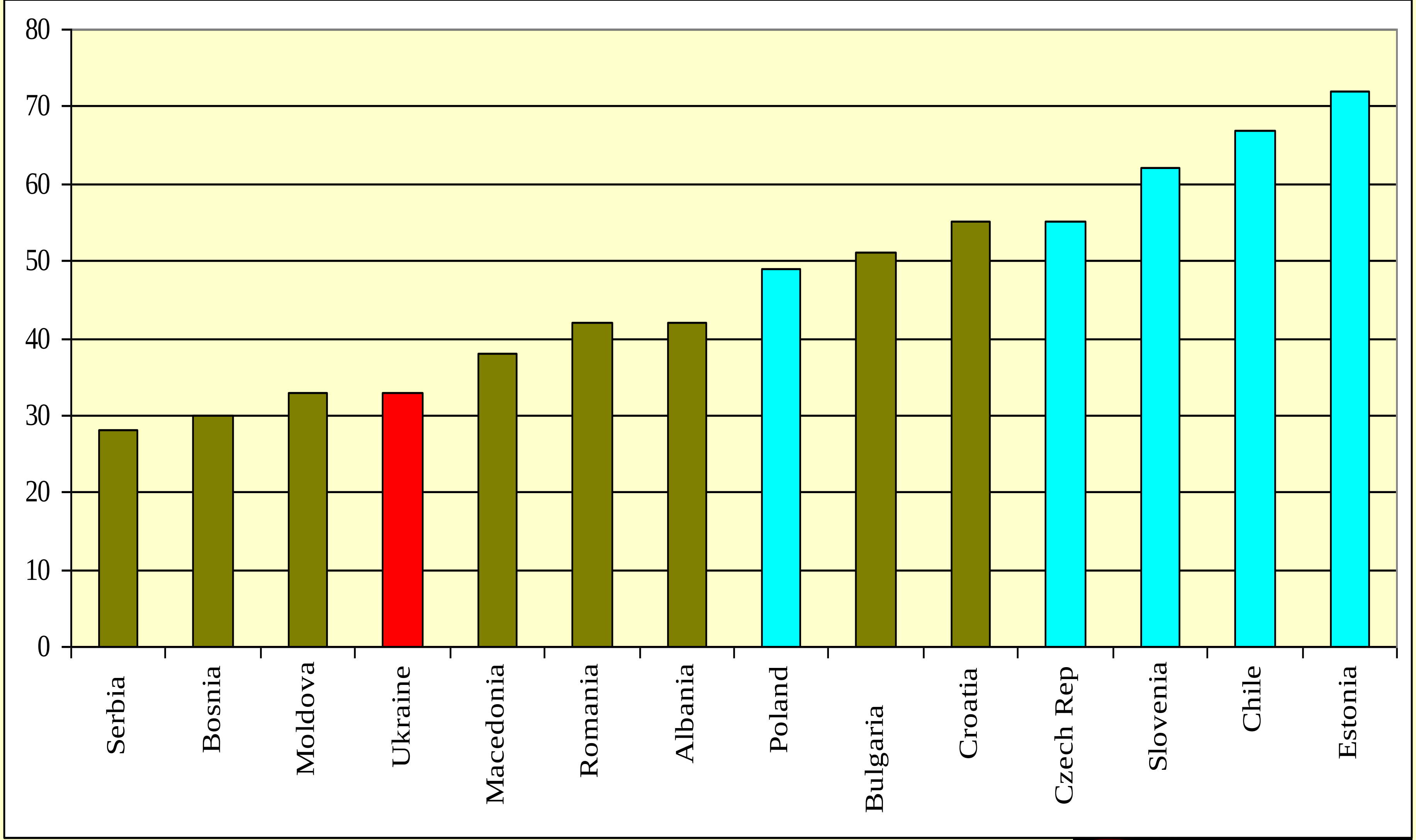
Aggregate Investment Attractiveness Ratings



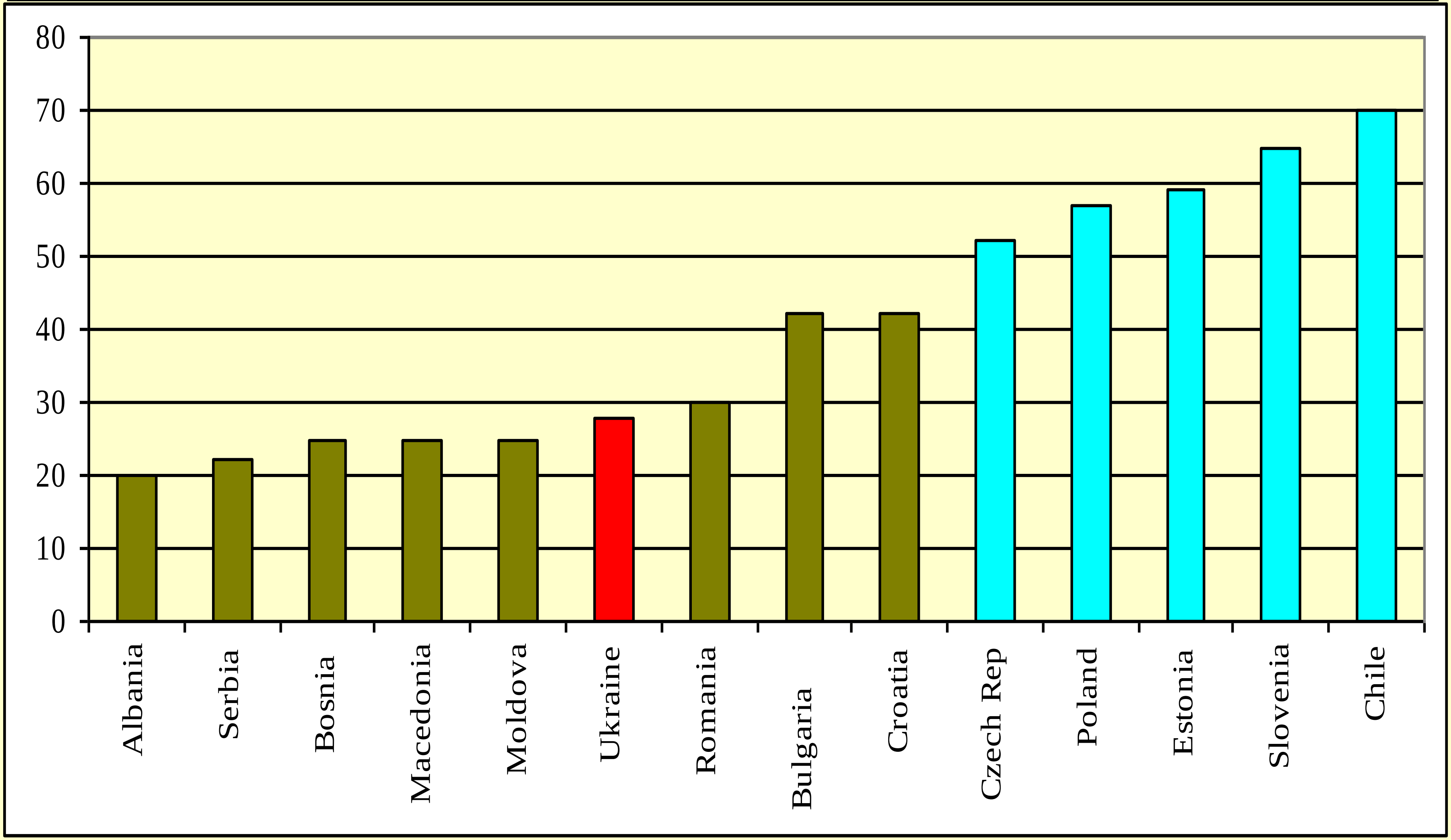
Driver #1: Macroeconomic Stability



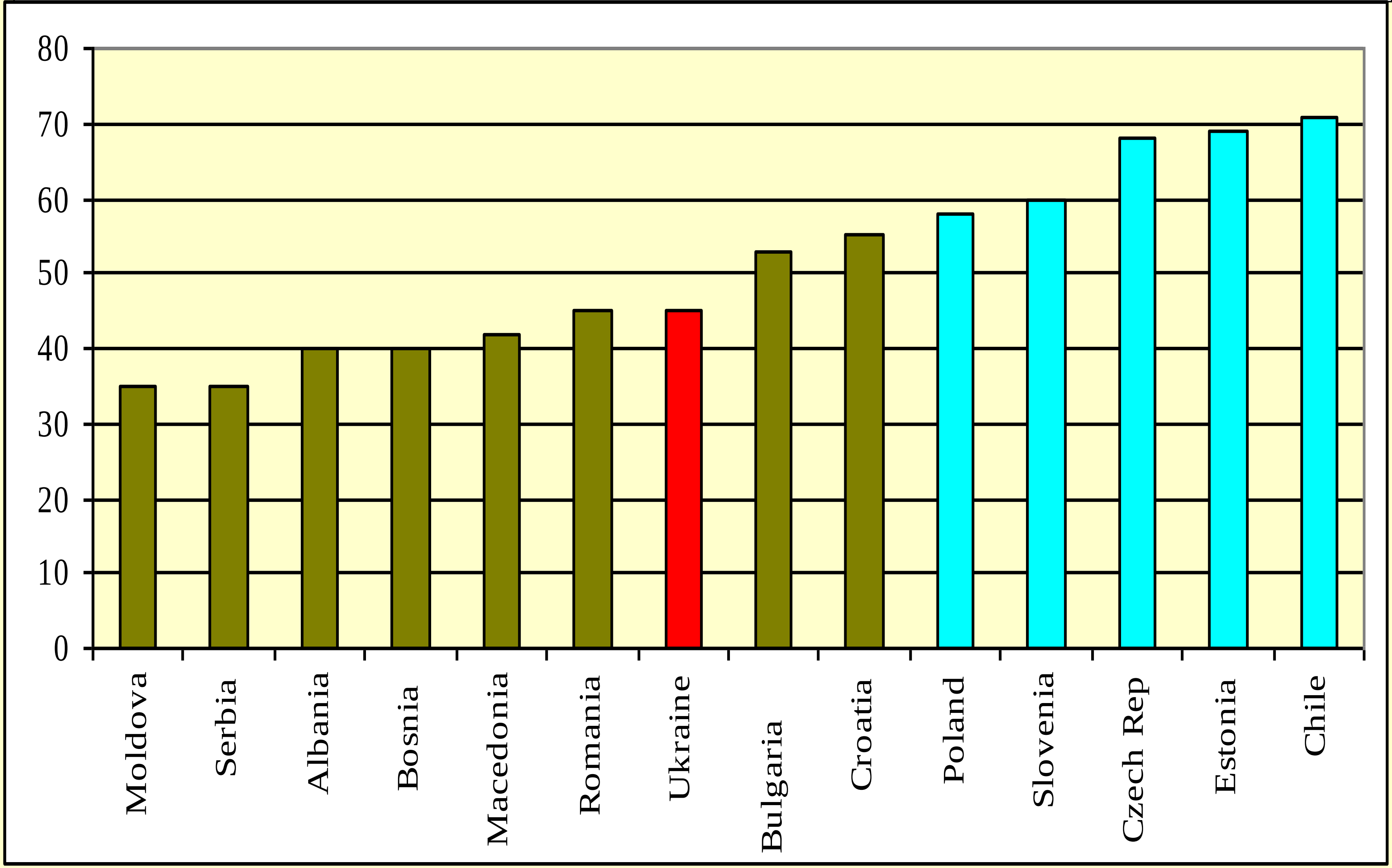
Driver #2: Liberalization and Deregulation of Business Activity



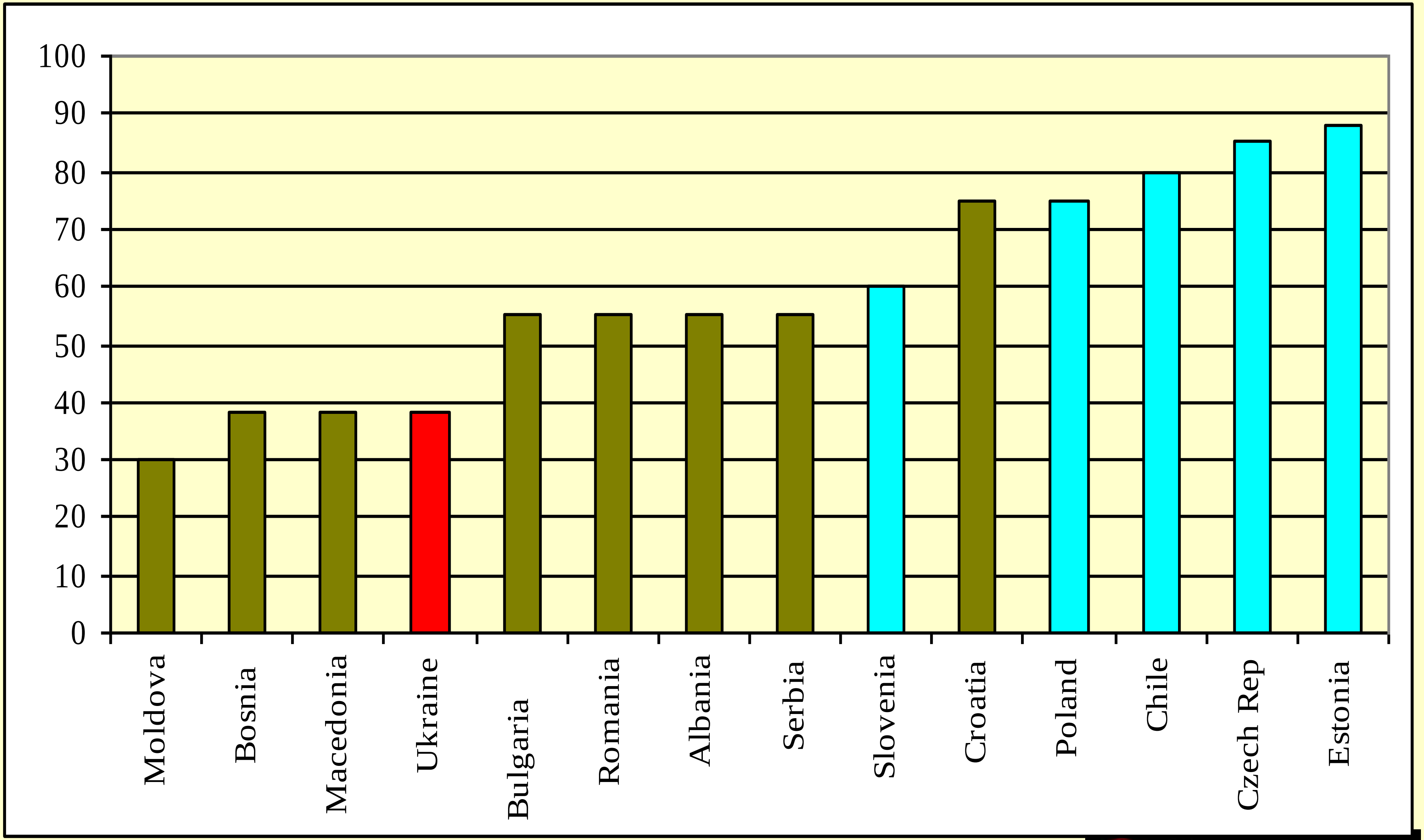
Driver #3: Stability and Predictability of Legal Environment



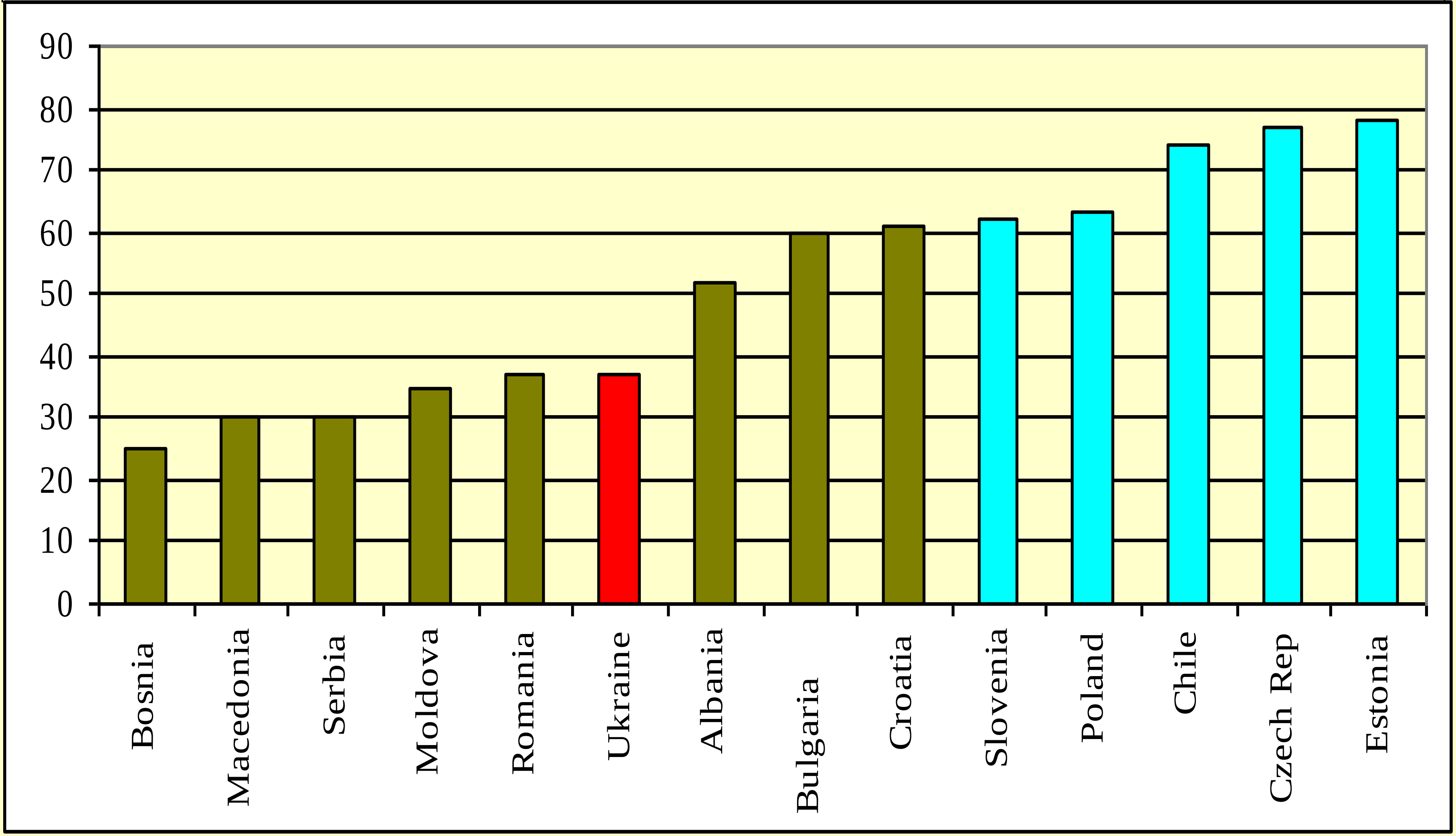
Driver #4: Corporate and Public Governance



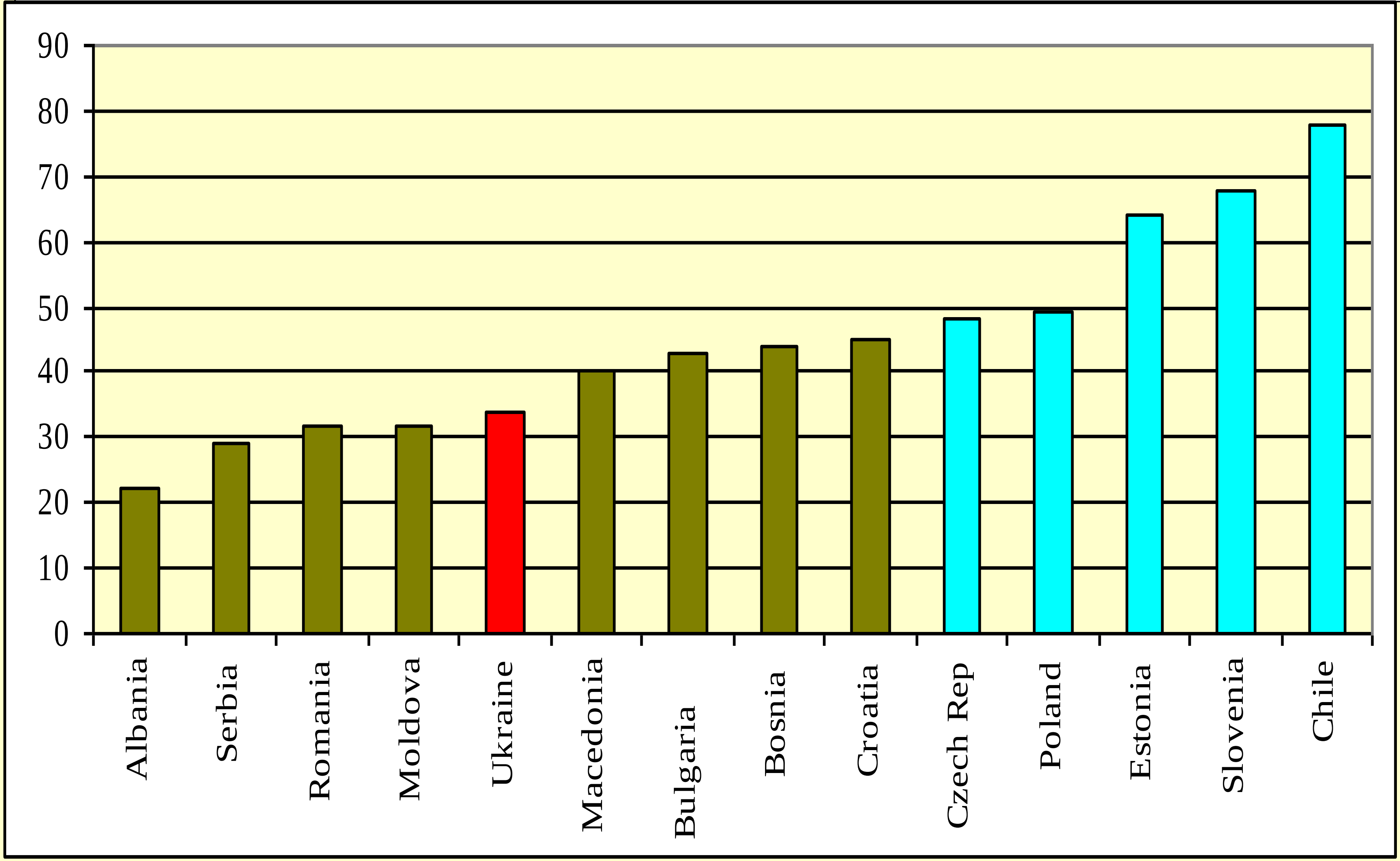
Driver #5: Liberalization of Foreign Trade and Capital Movements



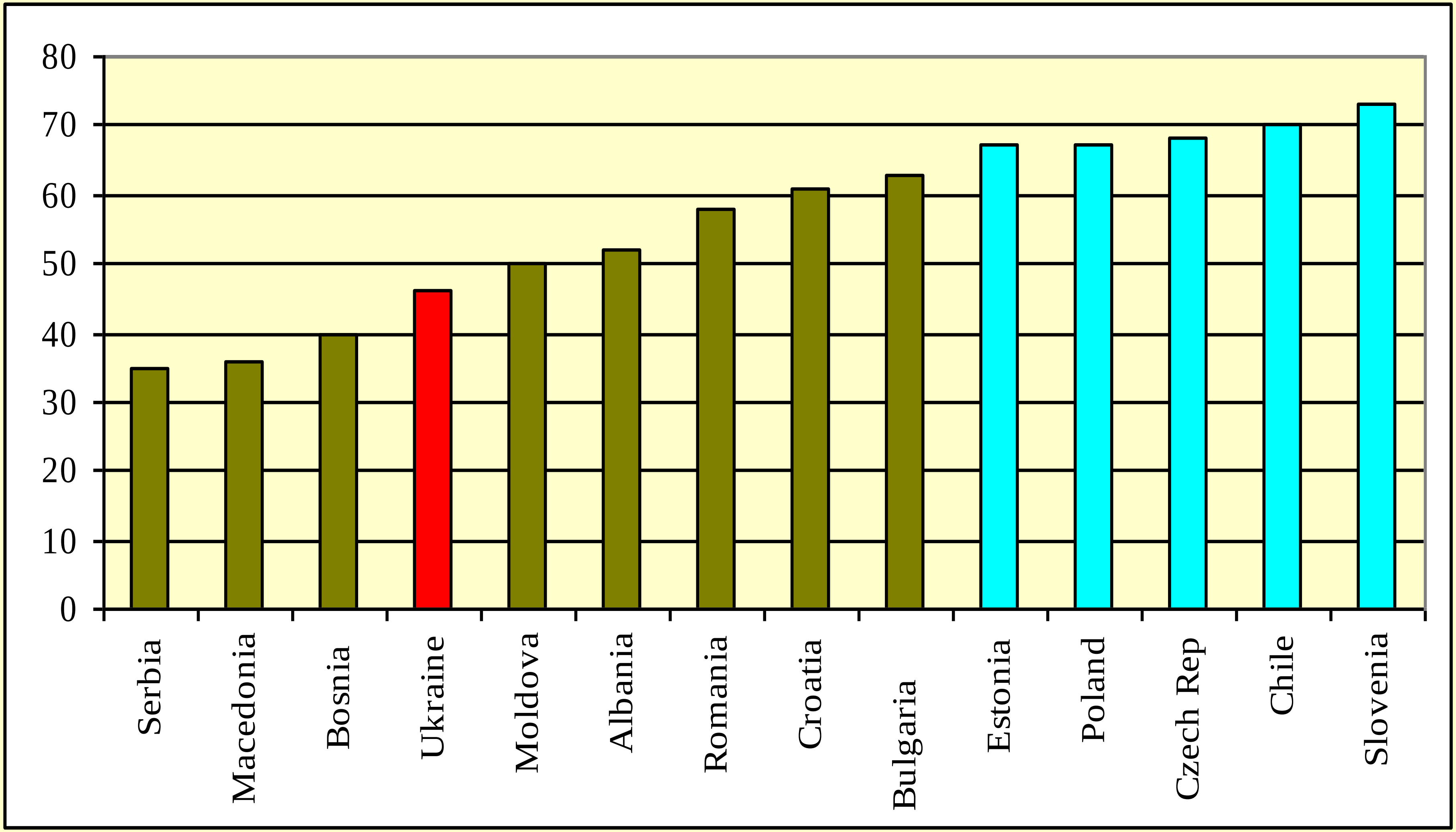
Driver #6: Financial Sector Development



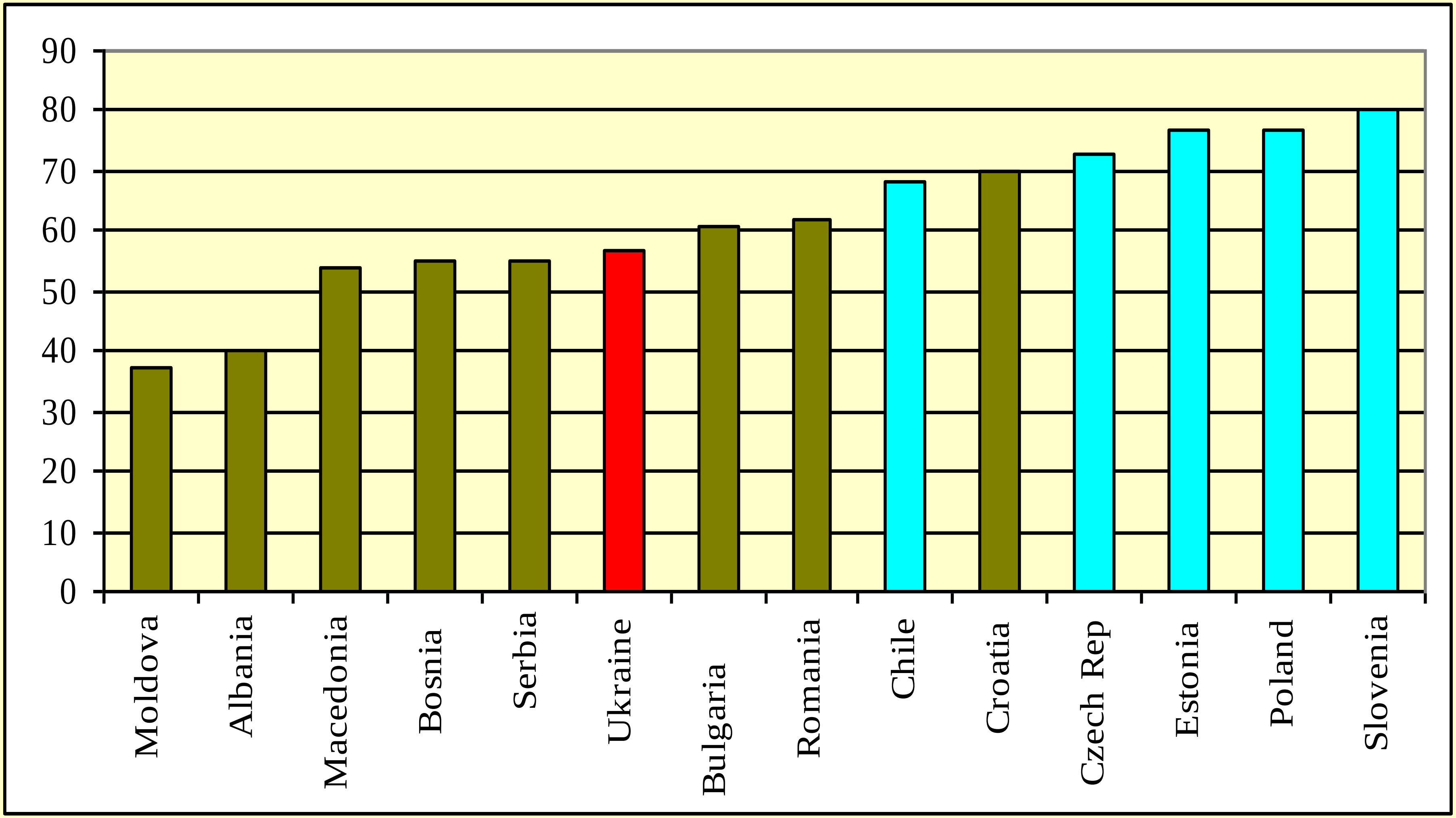
Driver #7: Corruption (100 – no corruption)



Driver #8: Political Risks (100 – no risk)



Driver 9: Country Promotion and Image



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Mr. Yushchenko's Presidency: First Steps

- Yushchenko's track record both as Chairman of the National Bank and Prime Minister set the basis for Ukraine's recent impressive economic performance, and bode well for Ukraine's future
- The following reforms and changes have been taken by the new government since the beginning of 2005:
  1. On March 25, 2005, an amended Fiscal Budget for 2005 was approved by Rada, eliminating most tax privileges and exemptions, and reducing privileges of free economic zones. The amended Budget envisages a 1.86% of GDP deficit. This deficit was calculated based on the following macroeconomic assumptions:
     - Real GDP growth 8.2% yoy in 2005
     - Consumer inflation 9.8% eop
     - Producer inflation 17.5% eop
     - Significant increases in tax revenues as % of GDP

…….Mr. Yushchenko's Presidency: First Steps

2. Steps were taken to reduce the size of the shadow economy (extensive anti-smuggling campaign --Smuggling-STOP -- performed by customs authorities). The campaign has yielded its first results. In March, the State Customs Committee collected 42% more customs duties than was targeted for the period, while import volumes did not increase significantly.
3. On the path to foreign currency market liberalization, the NBU abandoned its regulation requiring the mandatory sale of 50% of exports proceeds starting April 1, 2005.
4. Developed stronger working relationship between Ukraine and the West
5. Increased interest and support from international institutions (WB, IMF and EBRD)

……….Mr. Yushchenko's Presidency: First Steps

6. The Privatization strategy is currently under revision. Disputed privatizations will be limited in number. The Kryvorizhstal deal will be resolved soon (court proceedings are under way). Other disputed privatizations will be settle in the courts
7. The governmnet has submitted to Rada legislation to reduce a number of import duties and change customs procedures to streamline customs clearance of imported goods. These initiatives has yet to be approved by the Parliament

Need for Further Improvements in the Investment Climate

- Although Ukraine has demonstrated substantial progress in creating an enabling business environment for the private sector, the reform agenda is still largely unfinished.

- President Yushchenko has taken initial measures and has a strong backing of the electorate with a clear mandate to accelerate reforms and improve living standards.

Proposed Future Reforms

Our Proposed Reform Agenda for Ukraine is divided into three parts:

1. Quick Payout Actions to Show Commitment to Reforms
2. Fundamental Reforms for the First Twelve Months
3. Other Economic Reforms to Bring Sustainable Investment and Economic Growth

1. Quick Payout Actions to Show Commitment to Reforms

The following actions are recommended to demonstrate commitment:

- **Leadership, Communication and Transparency**
  - Establish open communication of government officials with the public
  - Increase transparency in government and business (provision of free public access to government information on any non-national security matter; businesses have to keep accounts on the basis of international standards)
- **Pending Legislation**
  - A number of pending laws and amendments including the Join Stock Company Law, the Administrative Court Procedure Code, etc. should be quickly enacted
- **Public Finance Discipline**
  - Eliminate tax privileges and free economic zones
  - Settle all remaining arrears on value added tax reimbursements
- **International Trade and Capital:**
  - Take prompt measures to get market economy status and WTO membership
  - Promote FDI by creating a small Foreign Investment Agency

2. Fundamental Reforms for the First Twelve Months

The following five key measures are needed facilitate the implementation of economic reforms:

A. Modernize and increase the efficiency of public administration
B. Secure the stability and predictability of the legal environment
C. Strengthen public finance discipline
D. Eliminate the government intervention into private sector activity and further deregulate business environment
E. Liberalize foreign trade and international capital movements

A. Modernization of Public Administration

Public administration (PA) reform is the key to the success of the implementation of other economic reforms, policies, programs and projects.

- The government should approve a **Plan of Action** for the implementation of the concept of administrative reform.
- **PA Reform Action Plan** would contain the following elements and should state specific timing to complete the Reform steps:
    - i. **Redefine the Role of the Government**
    - ii. **Undertake Functional Reviews**
    - iii. **Undertake Operational Reviews**
    - iv. **Carry out a Civil Service Review**
    - v. **Delegate More Power to Local Authorities**

…A. Modernization of Public Administration

i. Redefine the Role of the Government

- The Action Plan should start with a clear definition of the role of the government such as the following:
  - Its role is limited to non-commercial activities and the provision of necessary "public" goods (goods that would not normally be undertaken by the private sector due to externalities) and market-oriented regulatory services.
  - The main objective of the government is to support private-sector led growth, not compete with the private sector.

…A. Modernization of Public Administration

ii. Undertake Functional Reviews

- Review the role and functions of the President's Administration to convert it into a **small Secretariat** for the President
- Review the **structure of the Secretariat to the Cabinet of Ministers (COM)**, to change its role and structure and facilitate decision-making by the Prime Minister.
- Review the structure and **decision making of the Cabinet of Ministers** **(a)** by eliminating the current overlap of responsibilities between the COM as a whole and individual line ministries, and **(b)** by devolving functions of policy implementation to the line ministries.
- Consolidate and **reduce the number of line ministries and state agencies** in to avoid overlapping responsibilities and introduce a system of clear accountability.
- **Identify** those **public services** that could be **subcontracted or outsourced to the private sector**
- Continue the government's practice of **open public consultations** on issues critical to the business environment

…A. Modernization of Public Administration

iii. Undertake Operational Reviews

- Once the functional reviews have been completed, **operational reviews** of all ministries and government agencies should be undertaken **to simplify their internal processes, practices and procedures.**
- The review would **eliminate un-necessary regulations and licenses** of business activities.
- In order to increase the effectiveness of the government decision-making process, **policy formulation and analysis should be separated from policy implementation**.
- Legislation and **clear procedures** should be established **to improve transparency of government information**, making any non-national security information freely available to the public.
- Continue improving **procurement procedures** to make them more competitive and transparent.

…A. Modernization of Public Administration

iv. Carry out a Civil Service Review

The aim of Civil Service Review to **upgrade the quality of government staff**, including a clear certification system for personnel hiring, payment and advancement linked to good performance and dismissal rules for civil servants.

It would include the following:

- Introduce system of **incentives for civil servants** (review system of benefits to link it to performance)
- **Reduce the number** of civil servants while **increasing the salaries** of the remaining staff. This should make civil servants less prone to rent-seeking (corrupt) behavior
- Define roles and process for **monitoring performance for each operational unit**
- **Delegate authority to managers** to empower them
- Introduce **effective training programs** in order to increase civil servants' qualifications to EU standards
- Adopt legal regulations and policy statements in order to improve management efficiency of enterprises in which the state is still a shareholder

…A. Modernization of Public Administration

v. Delegation to Local Authorities

- The objective of decentralization should be to **bring decision-makers into closer contact with the intended beneficiaries** who can exercise more direct control over performance
- Functional reviews of central agencies should **identify those public goods and services**, provision of which may **be decentralized to the regional and rayon levels**.
- However, decentralization is one of the institutional reforms that may have the highest potential for failure. That is why, **in order to succeed decentralization should include:**
    1. A precise and clear definition of the functions, authorities and responsibilities transferred to local levels
    2. A clear identification of the local entities at the lowest possible level that would receive the delegated functions
    3. The mechanisms to provide adequate financing, technical assistance, and management training to enable local agencies to effectively assume their new responsibilities.

B. Stability and Predictability of the Legal Environment

To secure the stability and predictability of the legal system, the following actions are recommended:

- Ensure consistency of new laws with the existing legislation
- Improve enforcement of the existing Law on Intellectual Property Rights Protection by delegating the clear responsibilities to enforcement agencies
- Reform of the judiciary system:
  - improve financing of courts and increase salaries of judges and court employees to ensure their independence
  - encourage creation of “legal clinics”
  - enact the Administrative Court Procedure Code
  - abolish the practice of backdating any legal decisions
  - develop sound computerized databases for court decisions and legislation that can be accessed by judges across the country.

C. Public Finance Discipline

One of Ukraine's most significant achievements in economic policy-making in the past five years was taking control of the country's mismanaged fiscal budget system.

- Before 1998, lack of fiscal discipline and politically motivated decisions were at the root of the macroeconomic instability, with fiscal deficits in excess of 5% of GDP. After financial crisis of 1998 the government realized the need to curb fiscal expenditures, the authorities kept the fiscal deficit below 1% of the country's GDP.
- Unfortunately, the decisions made in September 2004 on pension payments and minimum wages have changed the outlook for the fiscal budget of 2005.

<u>In order to maintain confidence in public finances, the following is needed</u>:

- Ensure fiscal sustainability of the country
- Improve tax administration
- Decentralize fiscal relations (define budget programs which can be locally managed and financed)

D. Liberalization and Deregulation of Business Activities

- Despite significant progress in reduction of excessive government intervention in businesses activities, the major improvement is required in cutting still high costs of doing business in Ukraine
- The following measures are proposed:
  - Ensure widespread introduction of the one-stop-shop system of business registration across the country
  - Simplify and reduce the number of inspections of private businesses
  - Eliminate the current system of Tax Police
  - Develop transparent procedures for the liquidation of companies, including disclosure of information
  - Make The Law of Ukraine on State Registration of Legal Entities and Self Employed operational

E. Liberalization of Foreign Trade and Capital

- Since independence, Ukraine has significantly eased its foreign trade regime. However, to sustain export growth, Ukraine needs to act on four priority actions:
  1) Become recognized as a Market Economy by the EU and the US;
  2) Join the World Trade Organization (WTO)
  3) Sign free trade agreements (FTA) with the EU, the CIS countries, and the US
  4) Secure an agreement in principle with the EU to begin preliminary consultations on accession, including a date for the beginning of negotiations
- Sign free trade agreements with the country's main trading partners (EU, USA, CIS countries)
- Liberalize recently introduced regulation on foreign capital movements for foreign investors

3. Other Economic Reforms to Sustain Growth

- To ensure sustainable economic growth, actions should also be taken on the following additional "investment drivers":

  - Corporate Governance
  - Privatization Policies
  - Financial Sector Development
  - Corruption Level
  - Political Risks
  - Country Promotion and Image

Conclusions

- Although the future reform agenda is extensive, experience in other transition economies shows that only a “big-bang” comprehensive reform program will have chance to succeed!
- Step-by-step reforms do not work over time as too much resistance is created and vested interests are able to stifle reforms.
- Yushchenko’s track record both as former Chairman of the National Bank and former Prime Minister suggest that such reform agenda will be implemented in due time.