U.S. Role in Assisting Ukraine's Economic Recovery

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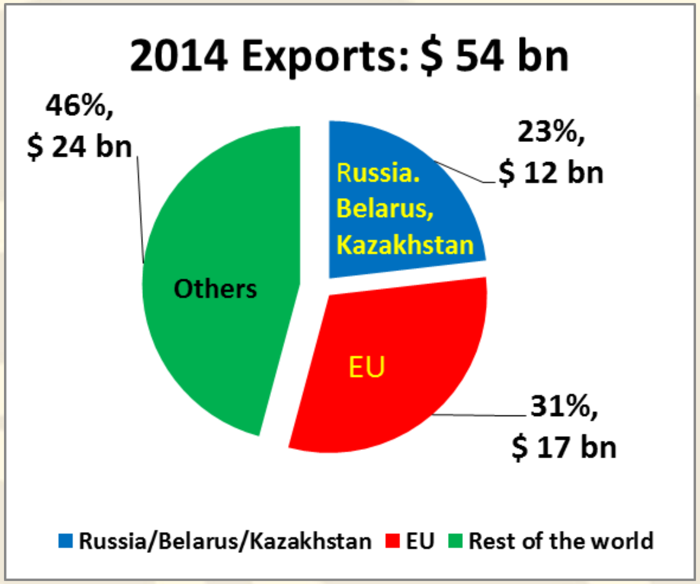
Current state of Ukraine

- Military hostilities in Eastern Ukraine are still ongoing, though at a slower pace, with Russia still attempting to destabilize the country.
- As a result, there is high turbulence in the Ukrainian economy:
  - Sharp decline in Ukrainian exports (by about 22% in two years).
  - As exports represent ≈ 45% of GDP, GDP dropped by 7% in 2014.
  - This led to: - devaluation of the Hryvnia (from 8 to 25 UAH/$ in 2014),
    - increase in inflation (i.e., 25% as the end of 2014),
    - increase in unemployment rate (to 9% at the end of 2014) with a high level of "hidden unemployment", and
    - increased problems in the country's financial sector (share of Non-performing Loans might be currently well above 50%).
- The fundamental economic problem has been the **drop in exports**.
- Social tensions have also increased, which may affect Ukraine's political stability and may move it away from its current democratic path.
- Instability in Ukraine will also increase instability in the region with a profound effect on Europe and the U.S. interests on the continent.

Shock to Ukrainian Exports



Source: State Statistical Service of Ukraine, The Bleyzer Foundation

- Hostilities have led to a decline in **Ukrainian exports** from $69 bn in 2012 to $54 bn in 2014, **a drop of $15 bn**, equivalent to a drop of 22%.
- Due to Russian restrictions, exports to the Russia's Customs Union decreased by 45%, the equivalent to $10 bn or 2/3 of the overall decrease in Ukrainian exports.
- About 80% of the drop in Ukrainian exports were in 3 categories: Machinery-Transport Equipment (60% of which went to Russia) , Metallurgy, and Chemicals.
- Although increasing their share, exports to the EU have reminded at about $17 bn.

Possible U.S. Support To Ukraine

- The above slides shows that the major economic support that Ukraine needs is to **diversify exports, both geographically and product-wise.**
- That is, Ukraine needs to secure alternative sources for export growth.
- Since exports to the USA only represent 1% of Ukrainian exports, the potential for export growth to the USA is huge.
- Larger exports to the US may compensate for the export fall to Russia and stagnant exports to the EU, due in part to EU's economic troubles.
- There are three forms how the US government may help in increasing Ukrainian trade with the USA:
    - The first one is to enter into a **Free Trade Agreement** with Ukraine
    - The second way is to facilitate **Foreign Direct Investments** to Ukraine, since export product diversification will require major investments not available in the country.
    - The third way is to provide **larger US financial and technical resources** to the country.

(1) Free Trade Agreement (FTA) with Ukraine

- The USA already has FTAs with 20 countries, including: Australia, Bahrain, Canada, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Israel, Jordan, Korea, Mexico, Morocco, Nicaragua, Oman, Panama, Peru and Singapore.
- A FTA with Ukraine should be a priority and could be modelled along the lines of the EU-Ukraine FTA.
- The expansion of exports in countries entering into FTAs with the USA have been significant: For example, since signing FTAs, export to the US increased by 122% in Chile in 3 years; by 97% in Morocco in 3 years; by 40% in Peru in 5 years; by 710% in Mexico in 6 years. The Central American countries are now exporting $30 bn to the US.
- FTA partners of the U.S. also benefited from imports of hi-tech goods, equipment, and technologies. For example, thanks to NAFTA Mexico transformed from a minor player to the second largest player in the North American auto sector with a share of 20%.

Possible Ukrainian Exports to the USA

- Ukrainian exports to the USA today represent only 1% of Ukrainian exports (about $900 million), 50% of which are in iron/steel products.
- Following the examples of countries that signed FTAs with the USA, it is feasible to increase Ukrainian exports in categories such as: vegetables and fruits, processed food, wood products, textiles and clothing, minerals, light metal-mechanics, and services such as computer software and tourism.
- In particular, a good potential may exist for fruits and vegetables as Ukraine is among the world largest producer of vegetables.
- In fact, according to the FAO, Ukraine is among the world's top 15 producers of the following fruits/vegetables: pome fruit, sour cherries, mustard seed, gooseberries, walnuts, raspberries, carrots and turnips, cucumbers, cranberries, cherries, peas, garlic, cabbages, blueberries, apples, plums and sloes, apricots, tomatoes, strawberries, etc.
- Among traditional Ukrainian exports, there may be room for increases in exports of iron/steel products; but for other major Ukrainian goods, such as cereals, the US market may be closed.

(2) Facilitating US FDI to Ukraine

- The product and geographical diversification of Ukrainian exports will require major investments, both public and private.
- The Ukrainian government may require international financial support to undertake public investments such as in transportation infrastructure and utilities required by the export sector.
- But the bulk of the investments must be undertaken by the private sector in order to be sustainable over time.
- But there is a role for international official support to attract private investments, given the uncertainties created by the hostilities in the East and the need to strengthen Ukraine’s economy to allow it to contain further Russian aggression in Eastern Europe.
- In particular, the US government could help in “facilitating” FDI’s by American companies.
- One option is to expand the credit facilities of the US Exim Bank to allow it to cover all types of US operations in Ukraine.

Risk Guarantees for US FDI to Ukraine

- A second option is for the US government to enter into join-ventures to provide "seed investments" to existing and successfully operating investment funds of U.S. origin.
- Another possibility would be for the US government to offer a wider and less expensive program of risk guarantees to US-led FDI's to Ukraine.
- This may include protection to US investors against risks such as political or judicial instability, social upheaval and violence or the resulting economic factors that may affect the investment viability.
- For export-oriented projects, it may include guarantees that their exports volumes will not be restricted by the government.
- The US and Ukraine have already signed a Bilateral Investment Treaty, under which Ukraine committed itself to offer US investors the same protection granted to local investors and offer other protections.
- But this is not enough guarantee given the uncertainties created by the war and the possible inability of the government to honor its promises.

Typical OPIC Guarantees

One solution is to expand the activities of OPIC made them more flexible and affordable The coverage of OPIC guarantees is broad and includes:

- ***Political Violence:*** Violence with a political motivation including: ***Terrorism, War Civil War, Riots, Civil Strife, Sabotage, etc.***
- ***Inconvertibility:*** Inability to convert local currency into hard currency or inability to get earnings, remittances, technical assistance fees, etc. out of the country.
- ***Expropriation* & Nationalization:** The wrongful taking of or interference with the investment-- a denial of the rights to the proceeds from that investment. Could be a discrete or series of events, including "*Denial of Justice*" (the governmental barring, blocking, refusing to take to court, arbitration or refusal to honor their awards).
- **Non-Honoring of a Sovereign Guarantee:** Particularly beneficial for infrastructure programs with a government guarantee of payment. This guarantee is rated by the rating agencies and financing through banks and capital markets is appreciably cheaper.
- **Business or Trade Disruption within the Entire Supply Chain:** Guarantee against disruption, confiscation, or destruction of goods, services and equipment essential to operations of the investment.
- **Intellectual Property:** Protection for breach of patent, trade mark, copyright involving contracts or guarantees with third parties.

(3) Direct US Financial Support to Ukraine

- On March 11, the IMF Board approve a program of support to Ukraine of about $17 bn for 2016-16, of which $5 bn will be disbursed shortly.
- But Ukraine will require about $40 bn of external financing in these two years.
- A good portion of the financial gap is expected to be provided by significant roll-over of public and private debt, which recently had declined from about 90-100% before the hostilities to roll-over rates 50-70% in recent cases.
- USA financial support - through US guarantees to US banks - may be critical to achieve higher roll-over rates for Ukrainian foreign public and private debt. This guarantee program may be similar to the $20 bn of US bank guarantees that the US Treasury granted to Mexico during the 1994 crises, which enabled Mexico to recover rapidly and re-pay these guarantees in less than one year.
- Direct US Government financial assistance to the Ukrainian government may be also useful to allow it to maintain anti-poverty programs.
- Furthermore, US financial assistance may be needed to allow Ukraine to upgrade its defensive military capabilities.

Required Action on Reforms by Ukraine

- Ukraine and the IMF have already signed an IMF Program that will give Ukraine $17 bn in assistance and will commit the government to implement a number of stabilization and structural reforms to improve Ukraine's business climate. The Ukraine-IMF Memorandum of Economic Reforms list the following actions, with agreed upon timetables:
  - Anti-corruption Program to protect business from abuse of power by officials.
  - Improvements in the business legal environment and the judicial/court system to ensure just and unbiased judgments.
  - Further business de-regulation measures to minimize red tape and bribes.
  - Energy sector reform to reduce Naftogaz deficits and encourage energy self-sufficiency
  - Reform of public administration reform, including decentralization and local government reform, and reform of the tax system
  - Improvements in corporate and public governance that would protect ownership rights
  - Measures to restore the health of the financial sector

Timing of Reform Implementation

- Although in principle a fast and front-loaded (ii) reform program has worked better in many countries, and indeed tangible progress in the above reform areas would be necessary to secure FDIs and export possibilities**, the USA should recognize that in other areas of reform, progress cannot be as rapid,** due to the fact that Ukraine is still under the threat of war in the East and the population has been undermined by the war.
- In particular, poverty alleviation and military expenses should continue to receive government resources. The size of the government may not be reduced as drastically as earlier planned due to the need to maintain employment and minimize disturbances. Decentralization may also need to proceed at a slower pace to ensure that the integrity of the country will not be put in jeopardy.
- Therefore, the size of the fiscal budget deficit (12% of GDP in 2014) cannot be reduced as rapidly as in other countries that do not face hostilities. A fiscal deficit of about 6-8% of GDP may be inevitable in the near future.
- But this could be feasible only if the USA (and the IMF and EU) are prepared to give significant additional financial support to Ukraine.

Technical Support for Reform Implemantation

- The Economic Reform program agreed with the IMF is comprehensive and if implemented it should transform Ukraine's business environment.
- But the IMF Program does not contain and technical assistance to allow the Government to implement such as comprehensive Program.
- It is in the area of implementation of the agreed upon measures that the US can be of help.
- In particular, USAID should be given more financial and human resources to assist Ukraine to further implement key measures to improve its business climate.
- In relation to this USAID support and a bilateral US-Ukraine agreement for FDI/FTA, the US Government should enter into an agreement of support that would also include mre specific conditionality required to improve Ukraine's business and investment climate, to complement a similar agreement under the EU-Ukraine FTA.