THE BLEYZER FOUNDATION

UKRAINE — Economic Evolution Since Independence And Future Prospects

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Introduction

From 2000 to 2004, Ukraine achieved excellent macroeconomic performance. Although economic growth and inflation were less satisfactory in 2005, the overall economic performance of Ukraine since 2000 provides a sound basis for further economic and social development. In fact, there is now a unique opportunity for the implementation of structural reforms vital to the country's economic growth.

Politically, the presidential elections held at the end of 2004 and the "Orange Revolution" provoked by voting fraud became a turning point in the life of millions of Ukrainians. They have made their choice to move Ukraine towards a democratic society with a stable and prosperous market economy that would substantially improve their living standards. The country has the unrivaled opportunity to use the political goodwill earned from the "Orange Revolution" to make the difficult, but necessary, changes needed to fully integrate Ukraine into the world community and keep it on the road to prosperity.

Since independence, Ukraine's road to economic success has not been easy. After the collapse of the Soviet Union, Ukraine declared its independence in August 1991 and had the potential to rapidly transform into a modern democracy and free market economy. Ukraine is the second largest European country in landmass and the fourth largest in population with about 50 million people. Ukraine's agricultural soil is extensive and rich; it used to be the breadbasket of the former Soviet Union, providing a large portion of its agricultural needs. Ukraine also has good mineral resources (iron ore, coal) and an adequate infrastructure. It has a well-educated and skilled labor force, with a significant engineering and scientific foundation. All this permitted Ukraine to supply much of the heavy industry to the former Soviet Union.

Despite these favorable conditions, Ukraine has had one of the most difficult economic challenges in Eastern Europe, with a long economic recession that lasted eight years. From independence in 1991 up to 1999, economic output declined every year, with a cumulative decline of about 60%. The recession in Ukraine lasted so long because the country initially inherited an economy structurally weak

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country; support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

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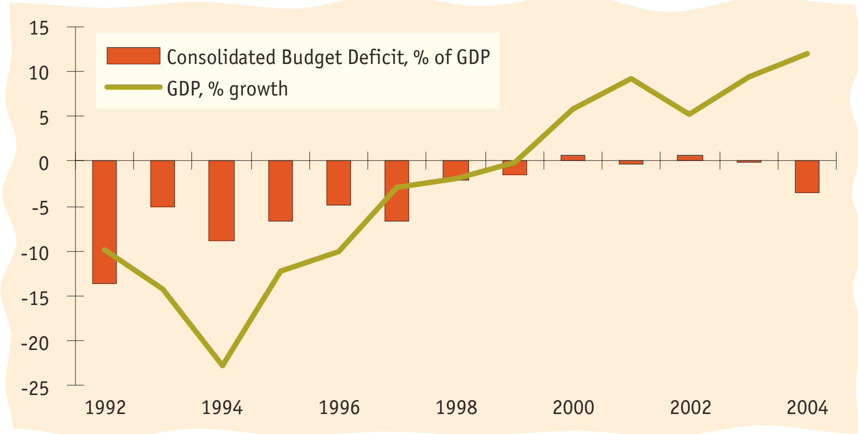
and highly dependent on the other former Soviet Republics. The collapse of the former Soviet Union cut these production and trade relations. In addition, the country had a large percentage of military industries (25% of all companies produced military goods), which found themselves without markets after the end of the cold war.

Although the initial fall in GDP was amplified by unfavorable initial conditions, the slow economic recovery was principally due to the very slow, piecemeal, and uneven implementation of vital economic reforms during the early years of transition. Unlike Poland, the Czech Republic and Hungary, Ukraine failed to perform radical reforms during the first years of transition. This was due to a lack of political consensus and to opposition from some groups in Parliament and vested interests. This situation led to a perception of Ukraine in the West as a country plagued by economic chaos, corruption, flight of capital, political infighting and an unstable legal environment. Moreover, Ukraine had to go through the severe financial crisis of 1998 when there was a threat of not fulfilling public debt liabilities and the government had to negotiate debt restructuring agreements.

Nevertheless, enormous developments have taken place over the last six years. In 2000, with Mr. Yushchenko as Prime Minister, the economy began a strong recovery after nine years of economic decline. Gross domestic product (GDP) grew by 6% in 2000, with the pace of growth accelerating to 12% in 2004. Economic growth slowed to about 2.5% yoy in 2005, mainly due to declining exports of metals and lower investments. Despite this slowdown, the average rate of growth has been substantial at about 7.5% per year over the last six years. Initially spurred by a strong depreciation of national currency in 1998 and strong world prices on key export commodities, economic growth has become domestic demand driven. GDP growth has been broad-based, supported by expansion in industry, agriculture and services. However, this impressive economic performance did not happen by accident. Macroeconomic stabilization policies, including sound monetary and fiscal policy as well as a significant number of economic reforms implemented over 1999–2002, finally produced the critical mass of economic changes needed to break a transition economy out of the doldrums of the post-communist decline.

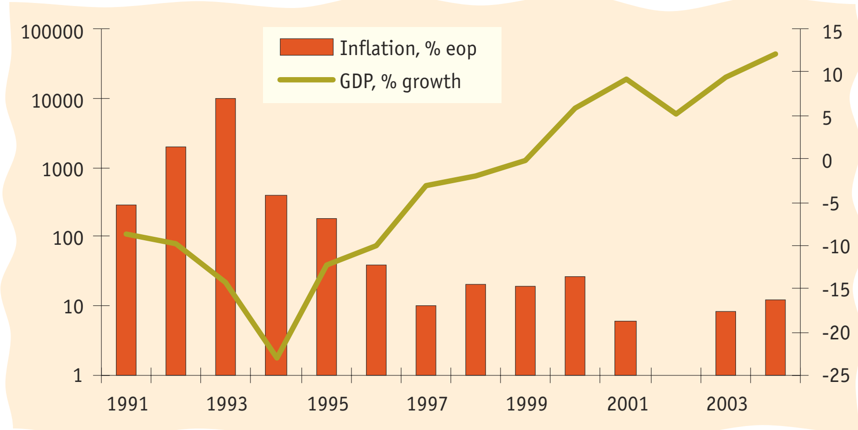
Between 2000 and 2004, Ukraine managed to significantly improve its major macroeconomic indicators; fiscal deficits were reduced, the current account moved into surplus, private consumption and gross investment rebounded sharply, international reserves reached sustainable levels and inflation was brought down to single digits. Although economic growth and inflation deteriorated in 2005, other indicators remain strong.

Evolution of Consolidated Budget Deficit and GDP Growth



Source: State Statistics Committee

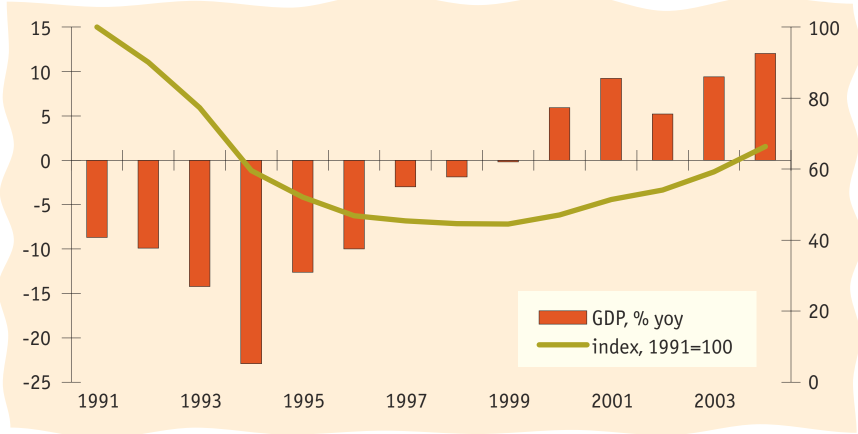
Annual Inflation and GDP Growth



Source: State Statistics Committee

A major issue for the future is the need to revive high rates of economic growth. This will require increasing the level of investments since the country's growth is still based on utilization of existing capacity. In fact, Ukraine's GDP in 2004 is equal to about 66% of pre-independence output. A large part of country's capacities is outdated and substantial investments are needed to renovate existing and build new capacities. Except for two major deals in late 2005, inflows of foreign direct investment (FDI) are relatively modest compared with other transition economies in the region. By the end of 2004, Ukraine attracted slightly more than $8 billion in FDI or some $173 per capita. This is an extremely low number compared to the Czech Republic, Poland and Hungary whose FDI per capita is more than several times that of Ukraine. One of the reasons Ukraine was avoided by international investors was the political risks due to its poor democratic credentials and deficiencies in its business environment generated by an excessively interventionist government. To secure sustained economic growth, Ukraine has to take measures to improve its business environment and accelerate the inflow of FDI.

Gross Domestic Product Dynamics Since Independence



Source: State Statistics Committee

This report is aimed at analyzing the recent economic history of Ukraine and future prospects for the economy in light of the recent political developments. The latter gave reason to expect better transparency and cohesiveness of the political decision-making process. It is also anticipated that the new President and its government will maintain wise fiscal and monetary policy and accelerate implementation of needed structural reforms that will pave the way towards creation of effective public administration, a favorable business climate, fair support for socially vulnerable groups and a solid international reputation.

The Early Economic Reform Program

The structural weaknesses of Ukraine during Soviet times meant that major corporate restructuring was needed after independence. In the early 1990s, domestic production was very energy-intensive due to negligible energy costs during Soviet times. Thus many enterprises were bound for bankruptcy without either state support or restructuring. At the time, Ukraine consumed 6 times more oil per unit of GDP than Western Europe. Unfortunately, from 1991 to 1995, very little was done; the government followed a "preservation" strategy. That is, it tried to maintain the status quo through the payment of large, direct subsidies.

Relying on government subsidies for their existence, state-owned enterprises had little incentive to restructure themselves and remained largely inefficient. These government subsidies led to large fiscal budget deficits, monetary financing of these deficits, and hyper-inflation. During 1992 and 1993, with total fiscal expenditures at about 65% of GDP, the fiscal budget deficit reached 25% and 16% of GDP respectively. The monetary financing of these deficits led to very high annual rates of inflation, which peaked in 1993 at 10,160% and which remained above 100% per annum in 1994 and 1995.

In 1994, Leonid Kuchma was elected President on the basis of a reform agenda. During 1996–1998, under President Kuchma, significant progress was made in many areas of structural reforms:

- Prices and international trade were liberalized
- Small and mass privatization programs were completed successfully
- A new currency (Hryvnia or UAH) was introduced successfully in September 1996, without confiscation
- A new constitution was approved in 1996, which guaranteed private property and market-based principles for the country's economy
- Ukraine accepted IMF obligations under Article VIII (which requires foreign exchange convertibility for current account payments).

However, other structural reforms were slow in implementation and did not reach the critical mass needed to revive confidence and to improve the investment climate. Barriers to entry remained high due to overwhelming licensing and registration requirements. Privatization of large enterprises and restructuring in infrastructure sectors were slow. The government's interference at sector levels (particularly agriculture and energy) was widespread, while the legal system remained inadequate to protect commercial contracts/interests. The banking system and capital market remained weak. Reform of public administration was initiated but the expectation concerning its implementation has not been realized.

Significant progress towards financial stabilization during 1996 through mid-1998 was to a great extent attributed to the tight monetary policy imposed by the National Bank of Ukraine (NBU). Mr. Yushchenko, who was Governor of the NBU at that time, managed to strengthen the country's financial fundamentals by pursuing wise monetary and exchange rate policy. In fact, the annual rate of growth of money supply declined from 540% in 1994 to 25% in 1998. The exchange rate was maintained within a narrow corridor around 1.9 UAH per dollar from 1995 to mid-1998. Furthermore, Mr. Yushchenko led the program to introduce the Hryvnia as the national currency. These monetary policies brought annual inflation rates down from 10,160% in 1993 to 40% by 1996, to 10% by 1997 and to 7.5% by mid-1998. The NBU's international reserves increased to $2.3 billion by the end of 1997. In addition, during his term as NBU Governor, Mr. Yushchenko set the basis for healthy development of the banking system through introduction of modern accounting and an electronic payment system. The system significantly increased the efficiency of interbank transactions — the time for any transaction was cut from several days to minutes. Yushchenko also led the effort to cancel the Kartoteka No. 2[1], which permitted the tax authorities to arbitrarily grab banking funds of

1 Kartoteka No. 2 was eventually abolished in 2001.

companies that were deemed to be late in tax payments. During that period, businesses were permitted to open current accounts with a number of banks and freely chose the banks they wish to work with.

It is worth noting that financial stabilization took place despite the fact that the government continued to run large fiscal budget deficits up to mid-1998, exceeding 6% of GDP in all years. From 1991 to 1998, fiscal budgets were prepared unrealistically, with overestimated revenues and excessive expenditures. In addition, the tax base was reduced by innumerable privileges and exemptions.

Up to the end of 1997, a large portion of the fiscal budget deficits was financed by foreign borrowings. Although foreign financing was key to stabilizing the economy in those years, the level of foreign debt increased rapidly. External debt increased from $4.4 billion in 1994 to $11.5 billion in 1998. Domestic government short-term obligations (treasury bills) increased to UAH 10 billion ($5.2 billion equivalent) during the same period. Although the absolute size of foreign debt was not excessive, this debt was of short maturity. Therefore, the level of annual debt service payments was quite high, reaching $3.2 billion in 1998, and put heavy pressure on government finances. In addition to debt issuance, the fiscal deficit was also financed through the accumulation of wage, pension and budgetary arrears (such as non-payment of utilities by public entities).

In early 1998, the Asia Crisis, large repayments on foreign debt, and delays in implementing fiscal and structural adjustments in Ukraine began to change investor perceptions of Ukraine. Furthermore, structural reforms had not reached the critical mass needed to revive confidence, investment and growth on a sustainable basis. Given Ukraine's large fiscal deficits, and large short-term debt repayments, the country was vulnerable to negative external events. This led to the Financial Crisis of 1998.

The Financial Crisis of 1998 and Subsequent Recovery

During the first half of 1998, with investor sentiments becoming more negative, capital outflows accelerated and the NBU had to sell a considerable amount of its foreign reserves to protect the stability of the exchange rate. Foreign reserves declined from $2.3 billion at the beginning of the year to about $1.0 billion by mid-year. To protect the exchange rate, the use of foreign reserves was supplemented by the placement of two large Eurobond issues for a total of $1.1 billion. But it was the Russian crisis of August 1998 that triggered a financial crisis in Ukraine, which was already vulnerable. In August 1998, Russia simultaneously defaulted on much of its domestic government debt, declared a moratorium on debt principal payments to foreigners by Russian firms, and devalued its currency. These moves prompted a run on Russian banks, a sharper fall in the exchange rate (from 6 Rubles/US$ in mid-1998 to 22 Rubles/$ in March 1999) and an acceleration of inflation.

Following the Russian crisis of mid-1998, investors' sentiments about Eastern Europe became negative and foreign financing became unavailable to Ukraine. With international reserves declining rapidly, the NBU had to stop selling foreign exchange in September 1998. The results of the financial crisis were far reaching, with the following outcomes:

- The exchange rate came under pressure with the Hryvnia depreciating sharply from about 1.9 UAH/US$ in December 1997 to 3.4 UAH/US$ by the end of 1998.
- International reserves fell sharply from $2.3 billion in December 1997 to $0.76 billion in December 1998.
- Foreign debt service obligations (amounting to $3.2 billion) due in 1998 could not be rolled over or repaid.
- Capital inflows dried up completely.
- The refinancing annual interest rate of the NBU increased sharply from 35% to 60% per annum.
- The annual rate of inflation, which was running at an annualized rate of 7.5% during the first half of 1998, reached an annualized rate of 34% during the second half of 1998, giving a yearly rate of 20% for 1998.

Despite the severity of the 1998 financial crisis, Ukraine was able to deal with it successfully and without resorting to the printing of money. The success in handling the crises was due to the following measures:

- The country was able to voluntarily negotiate the restructuring of its public debt.
- Monetary policy was handled effectively with the aid of some exchange controls (particularly the obligation of exporters to sell 50% of their foreign currency proceeds at official exchange rates), which were introduced as "temporary" measures.
- From September 1998, the fiscal accounts were kept in balance. The deficit for 1998 was contained at 2.1 % of GDP (compared to 6.8% in 1997).

As a result of these measures, by early 1999 Ukraine had overcome the risk of a financial collapse. Furthermore, the country went through a period of recovery and consolidation of its fiscal accounts during 1999. In fact the major achievement of the government in 1999 was control of its large fiscal deficit, the major source of Ukraine's economic imbalance in the past.

As noted earlier, weaknesses in public finance were at the core of the economic difficulties that Ukraine experienced from 1992 to 1998, despite the progress made in other economic areas. Since 1999, the execution of the government's fiscal budget has improved significantly. Fiscal expenditures are better controlled and the transparency of government fiscal operations has improved with the strengthening of the treasury, which took over the recording of most central cash and non-cash expenditures and gradually took over budgetary payments at the central and regional levels. Other important fiscal measures have included the adoption of a new budget classification system, creation of an external fiscal auditing function, and improved availability of fiscal budget information.

Economic Developments in 2000–2001

2000 started with a number of positive political and economic developments. President Kuchma was re-elected for a second five-year term in November 1999 on a platform calling for an acceleration of economic reforms. In December 1999, Mr. Yushchenko was appointed to the Prime Minister (PM) position, and this appointment led to the formation of a reform-minded government. The government led by PM Yushchenko realized that further postponement of decisive structural transformations could result in further deterioration of the country's economic situation.

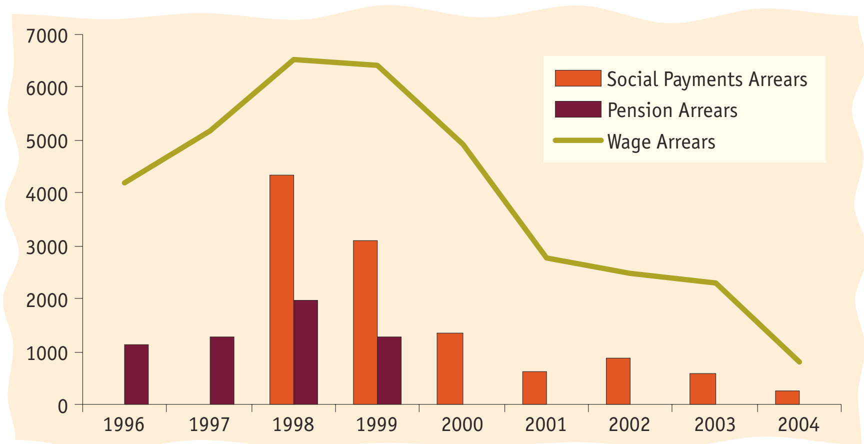
The period of 2000–2001 featured stronger and more committed reform efforts. For the first time since Ukraine's independence, the government developed a comprehensive reform strategy and action plan called "Reforms for Welfare." The principles at the core of the government's program were major free market principles: private property, entrepreneur freedom, stability and competition. Moreover, the government's strong commitment to reforms improved business expectations for further liberalization, thus stimulating economic activity in the country.

During 2000, the Ukrainian government led by PM Yushchenko implemented a number of crucial reform measures including tightening of financial discipline by eliminating budget arrears and barter, accelerating privatization, liberalizing monetary and exchange rate policy, progressing with land privatization, and initiating administrative reform. Strengthening financial discipline was one of the major pillars of Yushchenko's strategy. Restricting barter or non-monetary transactions in the energy sector and international trade and eliminating mutual offsets between the state and local budgets were important steps toward the hardening budget constraints within the whole economy. Early in 2000, the first deficit-free fiscal budget was adopted along with the cancellation of many previously granted tax privileges and subsidies. In the first half of 2001, the Budget Code was approved by the Parliament introducing new principles to the budget system, determining the fundamentals of the budgetary process and responsibilities for violation of the budget legislation. However, some of nontransparent debt settlement schemes were permitted again at the end of 2000 as poor payment discipline threatened budget revenue execution. Despite the fact that this step was inconsistent with the declared reform program, barter trade that drastically fell at the beginning of 2000 and never recovered again, thus pushing up money demand.

In early 2000, the government adopted an ambitious privatization plan envisaging the sale of large state enterprises in the metallurgy, energy and telecommunications sector. Although not all enterprises targeted for sale in 2000 were actually privatized, the process of privatization accelerated significantly compared to previous years. Total privatization receipts transferred to the state coffers amounted to almost $2 billion, about 2 times what the government got from privatization in all earlier years.

In 2000, Yushchenko's government took measures towards implementation of land reform by allowing transfer of agricultural lands to individual farmers. Government support to agriculture was changed from direct subsidization of loss-making farms to interest rate subsidies to commercial banks that provide loans to agricultural enterprises at their own risk. The change of the design of government support to agriculture opened access of agricultural enterprises to loans. Along with elimination of government intervention in the agricultural market, this gave impetus to a strong recovery in the previously depressed agricultural sector. In 2000, agriculture grew by a healthy rate of 9.8% and this growth continued to 10.2% during 2001. In absolute numbers, grain output increased from 24.5 million tons in 2000 to 39.7 million tons in 2001.

Dynamics of Wage and Social Payments Arrears Stock, eop, UAH million



Source: State Statistics Committee

The government of PM Yushchenko made efforts to eliminate pension and wage arrears. For instance, before 2000 pension arrears reached some 2% of yearly GDP. By September 2000, the government managed to fully eliminate pension arrears and to reduce public wage debt, which increased the population's purchasing power and stimulated domestic demand. The latter contributed to the recovery of economic growth.

On the wave of de-regulation and liberalization of business activity, the government introduced a simplified system of taxation and registration requirements for small and medium enterprises, which had an immediate positive effect on fiscal revenue collection due to the reduction of shadow market transactions. Also, the legal framework for foreign investments improved considerably after a corresponding law eliminating discrimination of foreign investors was adopted in February 2000. In particular, it introduced equal treatment of foreign and domestic enterprises with respect to taxation and currency regulations. Also, preferences for foreign investors established by international treaties were reviewed with regard to their expediency, and the protection against car imports (privilege granted to the South Korean company Daewoo) was abolished as a result. The European import certification standards were introduced facilitating healthy development of foreign trade. The overall quality of the legal environment in the country also improved due to approval of the Banking Law and the Criminal Code.

Important measures by the government of PM Yushchenko towards macroeconomic stabilization were the implementation of satisfactory fiscal and monetary policies. The fiscal budget balance showed a surplus of 0.6% of GDP in 2000 and a deficit of only 0.3% of GDP in 2001. Monetary policy was somewhat expansionary, with money supply increasing by 45% on 2000 and 42% in 2001. These increases were mainly caused by the heavy purchases of foreign exchange on the inter-bank market made by the NBU to service substantial amounts of foreign debt due during this period. During 2000, the NBU purchased over $1.4 billion to service external debt and replenish its official reserves. However, these increases in money supply did not lead to high inflation, as inflation was only 6.1% in 2001 after almost 26% in 2000. This was because the increases in money supply were absorbed by increases in money demand derived from reduction of barter trade and renewal of growth in the economy. The Hryvnia appreciated in both real and nominal terms over 2000–2001 despite significant foreign currency purchases by the NBU. The currency's nominal stability reflected a substantial current account surplus and increase of the monetization of the economy, which contributed to the willingness of the public to hold Hryvnias. Reviving public confidence in the national currency and the domestic banking sector encouraged 45% growth of household deposits. As a result, banking sector lending to the economy increased by one-third during 2001.

The control of the fiscal deficit and the implementation of the above mentioned economic reforms had a positive impact on macroeconomic fundamentals. Also, the favorable external environment played a role in the overall economic recovery in 2000. As a result, real GDP grew by 6% in 2000, with the pace of GDP growth accelerating to 9.2% during 2001. Industrial output expanded by 13% in 2000, and continued at an even higher rate of 14.2% in 2001.

Since the beginning of 2000, the country has had a positive foreign trade and current account balance. The foreign exchange rate has been quite stable at about 5.4 UAH/US$ since early 2000.

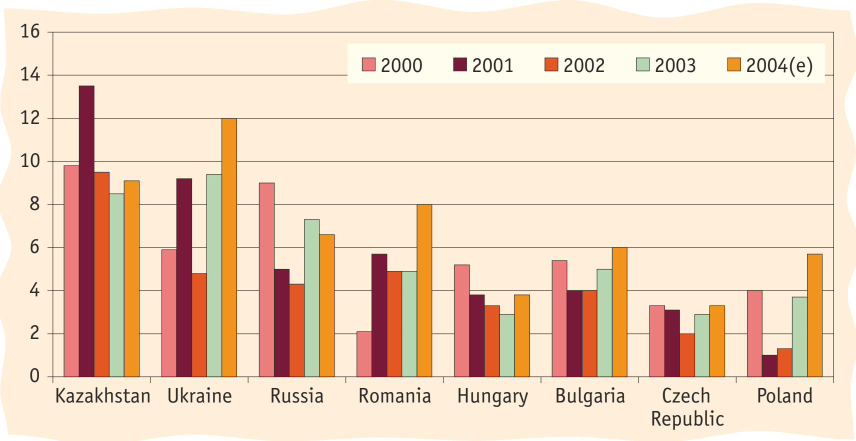
Foreign reserves increased from $1 billion in early 2000 to $3.1 billion in 2001. The size of external public debt declined significantly, now representing only 25% of GDP. In 2000–2001, the Ukrainian government managed to successfully negotiate external debt restructuring with private and Paris Club creditors and the gas debts to Russia and Turkmenistan. At the time, these restructuring deals were necessary conditions to improve the country's debt structure. In December 2000, the lending programs of the IMF, World Bank, EBRD, and European Commission were renewed.

Economic Developments in 2002–2004

After the major economic adjustments that took place during 1990–2001, the Ukrainian economy maintained remarkable growth in 2002–2004. Buoyant domestic demand, a favorable external environment and continuing investment expansion contributed to the country's robust GDP growth in those years. After a slight slowdown of economic growth to 5.2% in 2002, Ukraine's economy exhibited broad based economic expansion. During 2003–2004, real GDP growth reached unprecedented rates of 9.4% and close to 12%, respectively. Such growth records were among the best not only in transition economies but all over the world. The major sectors that drove economic growth during the period were manufacturing (in particular, metals, machine-building and food processing), construction, transport, and wholesale and retail trade.

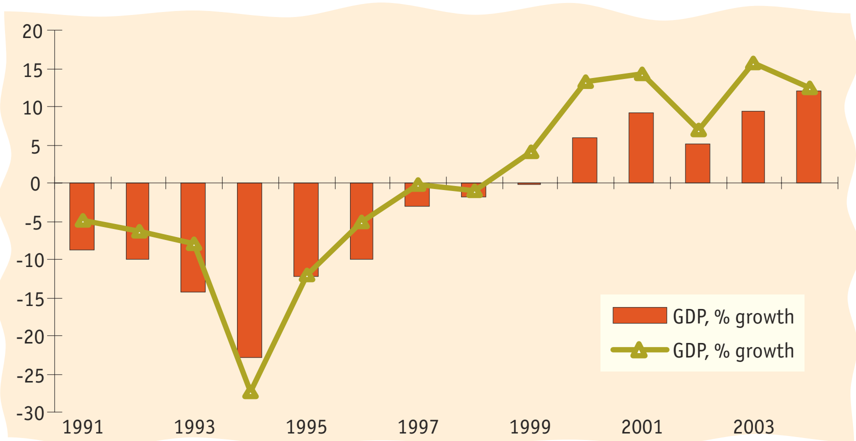
During the 2002–2004 booming economy, macroeconomic stability indicators remained remarkably strong. The government maintained prudent fiscal budget discipline throughout 2002–2003 and up to mid-2004. In 2002, the fiscal budget posted a small surplus, while 2003 had a small 0.2% fiscal budget deficit. Fully executed privatization targets, successful Eurobonds placements, and the finally unlocked adjustment financing from the World Bank also contributed to the solid fiscal results achieved in 2003. Throughout the first half of 2004, Ukraine's fiscal performance remained strong. But substantial increase in fiscal spending after September 2004 on the eve of presidential elections (including additional pension payouts) led to a deficit in excess of 3% of GDP by the end of 2004. Such a level of fiscal deficit was unsustainable, even though the government had enough resources to finance it thanks to plentiful privatization receipts and successful placement of sovereign Eurobonds. Relatively slow in 2002–2003, the privatization process accelerated significantly in 2004. In total, privatization receipts reached more than UAH 9.5 billion (or about $1.8 billion) in 2004, an amount considerably higher than in previous years.

Real GDP Growth in Ukraine and Selected Transition Economies



Source: State Statistics Committee, IMF

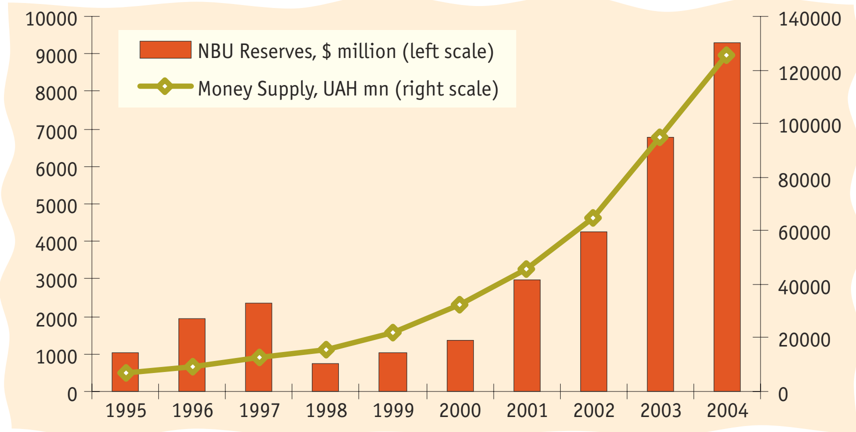
Real GDP and Industry Growth in Ukraine



Source: State Statistics Committee

Monetary aggregates growth was relatively high in 2002–2004, in excess of 40% per annum. These increases in money supply were fuelled by unsterilized purchases of foreign exchange by the central bank. However, strong money demand increases driven by remarkably high rates of economic growth absorbed excess money supply, and consumer inflation remained in single digits during 2002–2003. The growing working capital needs of the real sector were partly satisfied by a marked increase in commercial bank lending. In 2004, growing world prices for metals and oil coupled with pre-election fiscal expansion triggered consumer price growth, which reached 12.3% by the end of 2004.

Monetary Aggregates and International Reserves



Source: National Bank of Ukraine

Exports grew at impressive rates in 2002–2004, improving Ukraine's external account position. Strong foreign demand and competitive prices of domestic output generated current account surpluses of $3.2 billion (7.5% of GDP) in 2002 and $7 billion (10.5% of GDP) in 2004. Strong exports and a high level of transfers provided for a rapid accumulation of international reserves in recent years. The NBU consistently intervened on the market to buy up excess supply of foreign currency and to keep the nominal UAH/USD exchange rate stable in order to preserve competitiveness of Ukrainian exports.

The gross international reserves of the NBU almost doubled during 2003 to reach $6.9 billion, and then grew to $9.5 billion by the end of 2004. Nevertheless, due to the high availability of foreign exchange from exports, the Ukrainian currency remained stable against the US dollar, though it depreciated in real terms (following the depreciation of the dollar). Faced with increasing amounts of deposits and liquidity, commercial bank lending to the private sector also demonstrated a buoyant rate of growth. Commercial bank deposits and bank lending grew at high rates of about 65% yoy and 31% yoy in 2003 and 58% yoy and 41% yoy 2004, respectively. However, this high growth rate in lending raised concerns over the quality of the loan portfolios of commercial banks, and therefore the stability of the banking system. The central bank was aware of these risks and maintained particular control of the banking system to minimize the risks associated with its remarkable growth rates in the past few years.

Broad-based economic growth in 2002–2004 was supported by good progress in institutional reforms to improve the business environment. Ukraine passed a number of codes and laws that improved the business environment, including the Civil Code, the Banking Law, the Budget Code, the Law on the Judiciary, the Mortgage Law, and others. In addition, Parliament approved amendments to the Land Code to allow sale of non-agricultural land to non-residents under joint-ventures with Ukrainians. Starting in 2004, personal income was taxed at a flat 13%, rising to 15% by 2007, while the corporate profit tax was reduced from 30% to 25% in 2004.

The Presidential Elections in late 2004

During the two month period of November-December 2004, Ukraine held a series of three presidential elections (a first round on October 31 with a large number of candidates, a second round on November 21 between the two top winners — Prime Minister V. Yanukovich and opposition leader V. Yushchenko, and a repeat second round on December 26). Following the second round held on November 21st, the election results announced by the Central Election Committee (CEC) stated that Mr. Yanukovich was the winner with 49.5% of the votes, while Mr. Yushchenko had received 46.1%. This announcement was inconsistent with various exit polls that suggested that Mr. Yushchenko had won with about 53% — 58% of the votes. Furthermore, the opposition and international observers provided evidence of widespread fraud. Given the likelihood that the CEC intended to ignore these claims and planned to declare Mr. Yanukovich as the winner, a huge number of protesters went to the streets in many cities in the Center and West of the Country. Massive demonstrations became widely known as the "Orange Revolution." This led to a political crisis and the Supreme Court of Ukraine postponed the official publication of election results. The Yanukovich and Yushchenko camps attempted to negotiate with the help of international mediators, but the talks did not bring a compromise.

The opposition appealed to the Supreme Court, accusing the executive authorities of widespread fraud in the second round of the presidential election. On December 3rd, in a dramatic announcement supporting the rule-of-law, the Supreme Court declared the November 21 run-off election between the top two candidates invalid because of voter fraud and declared that the election had to be re-run on December 26, 2004. However, the Supreme Court decision did not resolve the political crisis in the country. This was resolved only on the 8th of December, when Ukraine's Parliament approved a compromise package of laws calling for changes to the constitution and special provisions to the election law to reduce the possibility of fraud. These laws were immediately signed by President Kuchma. In 2006, the constitutional reform will turn Ukraine into a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament.

The re-run of the presidential election on December 26, 2004 was fairly calm and was deemed by most international observers as fair and democratic. As expected, Mr. Yushchenko won a majority of 52% of the votes, with Mr. Yanukovich receiving 44% of the votes. Although Mr. Yanukovich challenged these results, these legal challenges were considered invalid by the Central Election Committee and the Supreme Court. Mr. Yushchenko was inaugurated as the third President of Ukraine on January 23, 2005.

These political events have had a profound and lasting impact on the civil, political, governmental and business structures in Ukraine. With the fair and positive results of the last elections, Ukraine has improved its international stance. It is now seen as a country where the majority of its population will not stand for corruption and unfair practices, where its political leaders are prepared to take dramatic measures to ensure that the law is preserved, where many medium sized domestic businesses have reached a "critical mass' to finance and support rightful political outcomes, and where the legal framework is independent enough and sufficiently fair to enforce law and order.

Economic Performance in 2005

As noted above, Ukraine demonstrated excellent macroeconomic performance over 2000–2004. However, since the beginning of 2005 it experienced a dramatic slowdown of economic growth. Over January-October 2005, GDP grew by only 2.8% yoy. In October alone, GDP grew by only 2.2% yoy. By the end of the year, GDP may grow at a slightly higher rate of 2.5% yoy, given lower growth rates in November-December 2004.

The main reason for this year's economic growth deceleration is not a reduction of consumption. On the contrary, consumption continued to increase reflecting generous social payments to the public, which increased real disposable income by 21% (yoy) during January-October 2005, which led to a nominal increase in expenditures of 34% during the period. This means that the majority of the population did not experience nor did they perceive a decline in living standards as a result of the slowdown in GDP. The main reasons for the decline in GDP growth this year are (1) an abnormally high GDP base in 2004; (2) a sharp deterioration of exports, with a merchandise trade deficit of about $750 million in January-September 2005 (compared to large surpluses in the last few years); and (3) a decline in investments. Declines in exports and investments explain about 70% and 30% of the GDP slowdown, respectively.

The poor export performance and low investments are reflected in a substantial slowdown in the growth of the processing industry (particularly metallurgy and machine building), a lower rate of growth in agriculture, a contraction in construction, and a decline in wholesale trade. In fact, of the overall decline in GDP of about 10 percentage points between 2004 and 2005, these sub-sectors accounted for 80% of the total decline.

Poor export performance is partly attributed to lower international prices for steel and rising energy prices. However, another very important reason is a substantial contraction in the exports of vehicles, machinery and equipment particularly to the CIS countries, as major orders in these countries were concluded. The vehicles, machinery and equipment sector was unable to diversify and capture new markets, in part due to inadequate investments in technology and plant modernization. The considerable slowdown in investment activities is related to political uncertainties and mixed signals given to the private sector during the first half of the year (re-privatization issues, attempts to introduce price regulations, plans to establish new state enterprises, etc.)

Over January-September 2005, the consolidated fiscal budget was actually in surplus (2.0% of period GDP) due to better tax collections and elimination of tax exemptions and privileges. However, due to the fact that many budget expenditures are incurred in the last quarter of the year, the government anticipates that the fiscal budget deficit for 2005 will amount to 2.2% of GDP.

As a result of the increases in disposable income, increases in money supply and higher fuel prices, Ukraine experienced inflationary pressures in 2005. However, consumer price inflation has decelerated over the last two months of the year. By the end of October 2005, inflation was running at about 12.4% yoy. By the end of 2005, inflation is likely to be at about 10.5%, a rate lower than the 12.3% experienced in 2004. However, the fiscal budget loosening that may occur at the end of the year will put inflationary pressures in 2006.

The substantial decline in merchandise exports and large increases in imports originated a merchandise trade deficit of $750 million in January-September 2005. However, thanks to a positive balance in the trade of services of $2,400 million, the trade balance for both merchandise and services showed a surplus of $1,600 million during this period. For the entire year 2005, the current account balance is also expected to show a surplus of $2.7 billion, or about 3.3% of GDP. Despite its reduction in exports from last year, a current account surplus of 3.3% of GDP is quite satisfactory and reassuring. As a result of a favorable balance of payment situation, the hryvnia appreciated from 5.30 UAH/USD to 5.05 UAH/USD since the beginning of the year. The NBU replenished its gross international reserves to $14.5 billion by the end of October and reached $19.4 billion by the end of the year due to recent privatizations.

During 2005, the government did implement a number of measures to improve the economic climate. The following reforms and changes were taken by the new government since the beginning of 2005:

- On March 25, 2005, an amended Fiscal Budget for 2005 was approved by the Rada, eliminating most tax privileges and exemptions, and reducing privileges of free economic zones.
- 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 results, with the State Customs Committee collecting more customs duties than originally targeted.)
- These measures reduced the potential fiscal deficit from 5% of GDP to an envisaged deficit of 2.2% of GDP for 2005.
- 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.
- On April 29, 2005, the NBU cancelled its regulation #482, which required multiple conversions of currencies for non-residents investing in Ukrainian enterprises
- The privatization strategy was revised, with resales limited to the successful Kryvorizhstal sale, which brought in $4.8 billion. Except for two other contested privatization cases that could be renegotiated, any other disputed privatizations will be settled by the judiciary.
- In connection with WTO requirements, a number of reductions in import duties and changes in customs procedures are being made.
- The country has developed a stronger working relationship with the West.
- Increased interest and support from international institutions was achieved (WB, IMF and EBRD).

Outlook for 2006 and Beyond

Despite the current economic difficulties, Ukraine is still one of the most attractive countries in Eastern Europe for investments. This is because it has a highly educated labor force (60% university enrollment, compared to 34% in the Czech Republic, 44% in Hungary, 32% in Slovenia, 29% in Moldova, 50% in Italy, 55% in France), low workers' wages (average monthly wage of US$153), political risks are already reduced, and inefficiently run companies provide significant opportunity for value creation through improved operations, marketing, finances, customer and quality focus — bottom line growth.

Nevertheless, some economic risks remain. The major risks are a slowdown in economic growth, a revival of inflationary pressures, and some depreciation of the Hryvnia. These risks stem from the recent significant increases in gas prices agreed upon with Russia. In fact, until recently most analysts forecasted GDP growth at 5–6% for 2006, an inflation rate of 10%, stable exchange rates, and a consolidated fiscal deficit at 2.5% of GDP. These relatively optimistic forecasts were based on the belief that domestic demand would be robust next year, investment activity would rebound after the April 2006 Rada elections, and export steels prices would stabilize and remain at a fairly high level.

However, the almost twofold increase in imported gas prices for Ukraine at the beginning of 2006 has affected these prospects for the country's economy. Ukraine inherited a very energy intensive industrial sector from the Soviet period. Being one of the largest consumers of natural gas in the world, Ukraine did very little to reduce its gas consumption since independence. Although Ukraine has its own gas resources, domestic gas production accounts for about 25% of the demand. The remainder is imported from Russia and Turkmenistan (about 35% and 40%, respectively). According to a barter arrangement with Russia, in 2005 Ukraine received about 24 billion cubic meters (m^3) of gas each year at a price $50 per thousand cubic meter as a payment for transit of about 125 billion m^3 of Russian gas to Europe. The transit fee was set at $1.09 per thousand m^3 per 100 km. According to the new agreement between Ukraine and Russia, starting January 1st 2006 the new gas price for Ukraine will be $95 per 1000 m^3 at the Russian-Ukrainian border. Although a higher gas import bill for Ukraine will be partially offset by the increase in the transit fee to $1.6 per 1000 m^3 per 100 km, the increase in gas prices will have a significant impact on Ukraine's economy in the short run. In particular, GDP may show little growth in 2006 as the import bill will increase and a number of export-oriented industries (such as chemicals and metallurgy) will be affected. In addition, the hike in gas prices will lead to higher inflation, a larger consolidated fiscal deficit and a reversal of current account balance from surplus to a small deficit.

On a positive note, an increase in gas prices will stimulate investments in energy-saving technologies and hasten the adjustment of tariffs to cost-recovery levels. In the medium-run, it should lead to a diversification of the economy and improvements in energy conservation.

The IMF believes that to control inflation, the government will need to keep the fiscal budget deficit for 2006 under tight control. It will also have to implement monetary and foreign exchange policies consistent with low inflation. That is, growth in money supply will need to be maintained at low levels even if this means that the foreign exchange rate may appreciate somewhat. The government will also need to control the rapid credit expansion of the banking system, not only to control inflation, but also to make banks less vulnerable to the low quality of their credit portfolio and to external crises.

What can be done to revive growth?

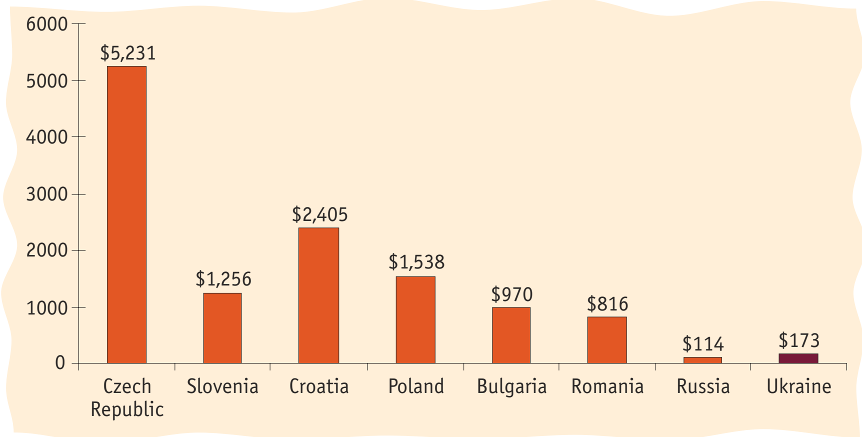
Ukraine needs to increase the level of investments, both domestic and foreign, not only to revive economic growth, but also to diversify its production and exports and reduce energy intensity of domestic products, which is currently one of the highest in the world. The substantial progress in recent years led to an increase in foreign direct investment (FDI) inflows, underlining an improved investor attitude toward the country. Ukraine received the largest amount of net FDI since its independence in 2003 ($1.4 billion) and 2004 ($1.7 billion). In 2005, thanks to recent privatizations, Ukraine may receive as much as $7 billion in FDI.

As noted in the chart below, despite recent significant progress in attracting FDI, the total volume of FDI in relative terms lags behind the majority Eastern and Central European countries.[2]

Since independence through the end of 2004, Ukraine had only managed to attract a total of $8 billion in foreign direct investment, or a FDI per capita of only $173. This is extremely low compared to the Czech Republic and Slovak Republic, whose FDI per capita is more than 30 and 15 times Ukrainian FDI, respectively.

Ukraine needs a considerable acceleration of investment inflow in order to sustain high rates of economic growth in the future. According to estimates, Ukraine needs at least $40 billion in FDI over the next decade if it wants to maintain a significant level of sustainable growth.

Net FDI Stock per capita in 2004



Source: UNCTAD, State Statistics Committee of Ukraine

In addition to maintaining good macroeconomic performance, Ukraine needs to further improve its business environment in order to attract increased levels of FDI. Studies carried out by The Bleyzer

2 The fact that Russia showed even lower net FDI stock per capita is explained by considerable FDI outflows, which account for more than 80% of the FDI inflows. For comparison the respective ratio in Ukraine constitutes negligible 2%.

Foundation have outlined specific policy measures to attract more foreign investment into Ukraine. These studies recommended a number of specific measures in nine policy areas, which were ranked according to their statistical impact on the flow of foreign direct investments. The individual impact of these policy measures was quantified from statistical analyses carried out in a sample of 50 countries. The nine policy areas are as follows: (i) ensure macroeconomic stability; (ii) liberalize and deregulate business activities; (iii) provide a stable and predictable legal environment; (iv) enhance governance and reform public administration; (v) remove international capital and foreign trade restrictions; (vi) facilitate financing of businesses by the financial sector; (vii) deal with corruption; (viii) minimize political risks; (ix) expand government business promotion.

The studies also compared the performance of Ukraine in these nine policy areas with the performance of other benchmarked countries, and concluded that Ukraine could increase the flow of foreign direct investment substantially. It recommended a number of concrete measures that the country could take to put the economy on a sustainable path of growth. A summary of these recommendations is as follows (details about these recommendations are provided in Annex 1 and in various documents available from SigmaBleyzer's website at www.sigmableyzer.com):

Short Term Reforms :

- Clearly define the objectives/role of the government and improve access to government information
- Enact key pending legislation (e.g., the Joint Stock Companies law) and abolish the Commercial Code while amending the Civil Code
- Perform quick deregulation and liberalization of business activities (permits, licenses) by implementing a "regulatory guillotine"
- Clarify the government's policy on privatization
- Staff the recently created Investment Promotion Agency and implement specific promotional activities for large investors (identify major projects, carry out targeted promotional campaigns, identify niches/sectors) and for small/medium firms (access to bank credit, better information on laws and the business environment)
- Resolve the gas pricing/transmission issue with Russia

Medium Term Reforms:

- Implement a fundamental public administration reform by undertaking a comprehensive "audit" of government activities (this will help to improve administrative efficiency, deal with corruption and also bring equilibrium to the fiscal budget)

- Improve the legal environment (particularly by ensuring the independence of the judiciary)
- Strengthen the financial sector
- Strengthen monetary and foreign exchange rate policies (to abandon the exchange rate anchor, techniques for inflation targeting must be developed — open market operations, forecasting models)
- Liberalize trade, join the WTO and sign free trade agreements with the CIS, EU, US, and other countries.

The government of President Yushchenko realizes that the key to attract investments will be improvements in Ukraine's investment climate along the above lines to complement the unique political goodwill earned from the Orange Revolution. Ukraine has already taken many of the steps required to put its economy in order. The government realizes that there is now a window of opportunity to implement further reforms and to break through its past economic difficulties and sustain growth.

Annex 1: Proposed Measures to Revive Investments and Growth

Ukraine needs to increase the level of investments, both domestic and foreign, not only to revive economic growth, but also to diversify its production and exports and reduce the energy intensity of domestic products, which is currently one of the highest in the world.

In order to build sufficient private sector confidence to revive investments, the government will need to give stronger signals that it is addressing the main concerns of the private sector: that is, the concern that the Ukrainian government still retains many of the characteristics of Soviet public institutions overloading the private sector with heavy and unpredictable demands and requirements, including heavy interventions in the workings of the market. In fact, the appropriate and desirable **"role"** of government institutions has changed significantly during the last decade, with a shift towards more market-oriented development strategies. These new strategies imply a re-orientation of many public agencies from a focus on rigid and detailed control and regulations to that of monitoring and support. These changes in the role of the government suggest the elimination of many institutions in the public sector and the establishment of private ones, and the restructuring of others to operate in liberalized and more competitive environments. These changes, however, have been slow in Ukraine. Despite some progress, decision-making remains cumbersome, with unclear and overlapping responsibilities among government agencies. These issues, together with widespread red-tape and government agencies' interference in private sector activities, have driven foreign investors away from the country while local firms also reduced their investment plans.

Thus, the reform of public administration is the key reform that is needed to facilitate liberalization and de-regulation of business activities in a free and competitive market. This reform is also needed to make possible the implementation of all other economic reforms. In fact, the lack of capacity of public institutions to actually implement economic reforms is one of the main reasons why progress in reforms has been slow.

We realize, however, that comprehensive public administration reform can not be carried out in the short-term. But some initial actions in this area are possible and are important to send a clear message to business that the public administration will be improved. These measures plus a short set of other quick measures would help in reversing the current negative perception about the government.

A. Short-Term Measures

The actions below are recommended as relatively quick and concrete measures to restore investor and business confidence. However, to reach consensus and facilitate implementation, the government should create an effective **Task Force** under the Prime Minister/President's Secretariat as an initial step, with the participation of private as well as government experts. This Task Force would evaluate and sort out the main issues for investors with both short term and long term implications. The Task Force must be able to review and further elaborate points of recommendations with immediate and longer term issues. It should define "how" to implement these recommendations, which agencies and persons would be responsible for their execution and the deadlines for their completion. The Task Force would also identify the International Agencies (EC, World Bank, EBRD, USAID, UK, Canada, etc.) that can provide foreign expertise to implement the reforms. However, the work of the Task Force must be done in conjunction with the appropriate Verkhovna Rada Committee in order to insure effectiveness in passing the required reforms. One of the glaring failures of the past has been the inability to create consensus on reform and to forge ahead on real implementation.

The main recommendations for the short term are as follows:

1. Clearly Define the Objectives and Role of the Government

As a first initial step to reform the public sector, the President must make a clear and firm Policy Statement on the main objectives and role of the government. To make it more credible, this statement must be endorsed by the Prime Minister and the Chairman of the Rada. The President should state that the government will concentrate only on those activities that warrant government involvement because of their "public interest." The government role will be based on the premise that productive and revenue-earning activities will be carried out essentially by the private sector in a free and competitive market environment. The role of the government will not be to compete with the private sector in revenue generating activities. Its role will be to support the private sector in these activities. The government will also deliver essential services that are not normally provided by the private sector, such as:

- public goods (goods that would not normally be delivered by the private sector due to externalities)
- non-commercial activities in education, health and the environment
- protection of the poor
- market-oriented regulations of trade, communications, labor and other private sector activities

- law enforcement
- foreign affairs
- national security and defense
- similar non-commercial activities

This clear definition of the role of the government would be the basis for the activities of ministries and public institutions and would orient the subsequent reform of the public sector (see more below). This clear Policy Statement should discourage some of the recent previous government "initiatives" such as the creation of new state enterprises to "complement" the private sector in such markets as oil refining, titanium production, grain distribution, etc. It would also discourage excessive interventions of the government in businesses. Some of these interventions — such as price controls — interfere with free market pricing and destroy business confidence, thereby discouraging investments.

2. Increase Public Transparency and Access to Government Information.

As a second step in the reform of the public sector, the government should immediately make government information more transparent and available to the public, except for national security reasons. This can be achieved by expeditiously passing legislation on "Free Access to Government Information" on any non-national security matter. Public procurement procedures should also be made more transparent.

These steps are needed because public institutions are not subject to the test of the marketplace to ensure accountability and evaluate performance based on a more clearly defined role for the government. In the absence of a market test, transparency and openness of information and public processes are the best ways to ensure accountability. Open and transparent processes should be developed to define agency performance, outputs and financial information, and to measure, monitor and publish them widely. Agency management would be held accountable through "open files" involving the publication and monitoring of such information. Lack of performance should be meaningfully penalized, including dismissal of those responsible. Emphasis should also be given to enhanced accounting and auditing processes in the public sector. In particular, the government may want to introduce an "external audit" of public sector activities, examining not only the accuracy of financial accounts, but also identifying whether resources were allocated to priority areas and in compliance with the agency's purposes, assessing the overall effectiveness of the decision-making process, practices and procedures. The results of the "audit" should be made available to the public.

Improving information transparency and openness will also be an important weapon to combat corruption, which is a major cause of distortions in public sector behavior. Information disclosure should also aim at building popular support — among businesses, unions, students, the press, the civil service — for policy reform and for the role of the government.

3. Enact Key Pending Legislation for Business Activities.

The government can give a clear message that it is acting boldly by pushing some key business legislation through the Rada, particularly:

- Enact the Join Stock Companies law — in a form that complies with OECD Corporate Governance Principles.
- Remove conflicts between the Civil and Commercial Codes by eliminating the Commercial Code and passing some of its provisions to the Civil Code. The Commercial Code retains many Soviet provisions that conflict with the Civil Code, creating uncertainties.
- Enact the legislation required to gain access to the WTO, as this access will show the commitment of the government to move towards western standards and practices.

4. Accelerate Implementation of a Program of Quick De-Regulation of Business Activities

The business environment can be markedly improved by quick deregulation through the adoption of a regulatory guillotine process by the government. The regulatory guillotine is a means of rapidly reviewing a large number of regulations, and eliminating those that are no longer needed without the need for lengthy and costly legal action on each regulation. It is clear, decisive, and fast. It can be used to create a comprehensive and central regulatory registry with positive security. Results could be achieved within a short period of time as the "guillotine date" may be set a few months ahead. In general, the guillotine works like this:

- The government instructs all government agencies to establish lists of their regulations by a certain date;
- As the lists are prepared (involving consultation with the private sector and oversight from a central body), unnecessary, outdated, and illegal rules are identified, and excluded from the list;
- A centralized list is created by adding all the ministries' lists together. When the deadline is reached, any regulation not on the list is automatically canceled without further legal action (the guillotine drops);
- The list becomes a comprehensive registry of all regulations in force, and is recognized in law as the legal database of regulations for purposes of compliance;
- In the future, all new regulations and changes are entered in the registry within one day of adoption and/or publication. The registry should have

legal security — any regulation not in the registry can not be enforced against a business.

A guillotine has been used successfully in a number of countries such as Sweden, Taiwan, Mexico, and Moldova to "clean the dirty pool" of existing regulations. The guillotine is effective because it places the burden on the regulatory agency (generally answerable to a ministry in Ukraine) to justify which current regulations should be retained, not which ones should be eliminated. Ukraine could implement any scope of guillotine it chooses through amending the current Law on Regulatory Policy in the Sphere of Economic Activity (RPL) and creating a commission to undertake it.

The government should also de-regulate the creation of enterprises by appointing local and foreign experts that would take measures to ensure that the current "One-Stop Business Registration" process does in fact work at the local levels.

5. Pass Clear Signals that Property Rights will be Respected

These signals may include the following:

- The government should enact a law on privatization amnesty to resolve the re-privatization issue, which is considered one of the main reasons for the worsening of Ukraine's investment climate and international image this year.
- It should make a clear policy statement on its privatization strategy and make the privatization program for next year transparent and available to the public in advance.

6. Improve the Country's Image: Public Communications, Openness and Transparency

The government can increase confidence by making more periodic and regular communications with the population. Starting immediately, the President should communicate directly to the country about the actions that the government is taking and the results achieved. These communications should be at least once a week on a specified evening of the week so that the population would look forward to them. Press conferences should also be scheduled on a regular, predictable and timely basis, such as on a given time on a specific day of the week. TV, radio and newspapers should be encouraged to attend these press conferences.

In addition, senior government officials should participate in large regional seminars in the Oblasts to maintain a direct dialogue with the public and obtain feedback about their views and concerns. Confidence can also be enhanced by increased transparency. For this purpose, the government should expeditiously pass legislation on "Free Access to Government Information" on any non-national security matter.

Transparency in business should be improved by requiring all companies filing tax returns to prepare financial statements based on International Financial Reporting Standards (IFRS) starting in January 2007. This should help in reducing corruption and the size of the shadow economy.

7. Activate the Investment Promotion Agency

The government should activate the Investment Promotion Agency to promote Ukraine as an investment location. The agency should include a team of highly skilled professionals that will coordinate the existing government capacities in investment promotion. A cost-effective way of expanding investment promotion activities abroad is for the agency to involve embassies and consulates overseas. Many countries employ their diplomatic service for investment promotion purposes after a specific training performed for the diplomatic staff in investment promotion and investor targeting.

B. Long-Term Measures to Eliminate Barriers to FDI

After April 2006, the government could initiate more fundamental and time-consuming reforms, which may be politically sensitive. In the meantime, the above-mentioned Task Force should elaborate the detailed plans for the implementation of these reforms immediately after April 2006. The following long-term reform measures are needed to attract foreign direct investments to Ukraine:

1. Implementing Fundamental Public Administration Reform

Public administration reform is needed to de-sovietize public institutions and ensure the successful and long-lasting implementation of administrative decisions and policy changes. Today, the inadequate government apparatus is one of the main constraints to the implementation of economic and social reforms. International experience suggests that without it, policy changes may not be implemented and if implemented, they may be reversed soon thereafter.

Based on a clear and widely accepted definition of the role of the government as stated earlier, public administration reform will include (i) a re-definition of the **functions** of individual government agencies; (ii) improvement in their **operations** and modus operandi; and (iii) modernization of its **civil service**. In fact, the objective of public administration reform should be to implement the redefinition of the role of the government to support the private sector. Un-necessary functions would be eliminated. Other functions could be transferred to local administrations, which may be given the possibility of raising their own budget funds. Other functions could be transferred, outsourced or commissioned to the private sector.

The reform should also recognize that in Ukraine, the size of the central government is small in terms of the number of people. But there are an excessive number of central public agencies with unclear roles and overlapping responsibilities. There is therefore a need to clearly define the role of the government at all levels. This role should change from excessive intervention in productive and semi-commercial activities to a role compatible with a market economy, particularly improving the environment for private sector investors and producers. According to the European Commission's annual study of civil service capacities in various states, with continuous progress, it will take Ukraine several years to meet European standards in public administration.

The government should start the reform by approving a plan of action for the implementation of the concept of administrative reform. The plan of action should take into account the experiences of other countries, which show that a comprehensive and drastic reform of public administration has a better chance of succeeding than piecemeal or incremental reform. A number of countries have successful experience in reforming their public administration (such as Canada, New Zealand, Poland, and Ireland). Official bilateral contacts should be used to identify the possibility that those former government officials in countries such as Canada could be seconded to the Ukrainian government to provide guidance and experience in reforming the state administration.

2. Ensure Sustainable Fiscal Deficits and Low Inflation in the Long-Term

Fiscal deficits are of concern to investors because they are normally the main cause of inflationary pressures. High inflation discourages investments because it makes sales, cost and profits more uncertain and difficult to predict. For this reason, investors will require a much higher rate of return limiting the number of possible investments. A country experiencing high economic growth may afford a fiscal deficit in excess of 2–3% of GDP, but this may be done only in a few years. Otherwise public debt will increase, inflationary pressures will emerge and the economy will slow-down.

To address fiscal deficit concerns in 2005, the government took a number of measures to reduce the potential fiscal gaps, including elimination of tax exemptions and privileges, increases in excise taxes, further accumulation of VAT arrears, dealing with corruption (principally at customs), etc. Although these measures generated additional revenues, many of them have generated uncertainties that negatively affected the business environment. Many of these measures should be reversed, such as illegal elimination of exemptions in free economic zones, or accumulation of VAT arrears.

Despite the above measures, the remaining fiscal deficit may still be large (the IMF and other institutions such as JP Morgan have estimated that the deficit could be as large as 3% to 5% of GDP). This remaining deficit will need to be financed either by debt or FDI. But these solutions are unlikely to be satisfactory over the long term. Over the long term, the government will need to carry out a **comprehensive audit** of public sector expenditures in order to make them compatible with a "reasonable" level of taxation and revenues. This audit should be undertaken within the context of the execution of public administration reform, as noted earlier.

In fact, public administration reform is necessary to bring government expenditures more in line with revenues. Countries such as Canada found that only through comprehensive public administration reform were fiscal budget deficits brought under control. From 1985 to 1995, Canada tried to reduce fiscal deficits by adding some taxes and making budget cuts to individual ministries. But this just produced general unhappiness as the ministries had to provide the same function just with less money. The answer was in actually eliminating a large number of unnecessary functions from the government and transferring other functions to the private sector or local authorities. This was done by the execution of a comprehensive "audit" of government functions and activities. The government became smaller but stronger, and more efficient in the areas that mattered most.

3. Strengthen The Financial Sector and Monetary Policies

The NBU has to clearly enunciate its long-term monetary policy. If the monetary policy were to move towards inflation targeting, the NBU will need to develop the capacity to perform open market operations, including the capacity to predict the statistical relationship between changes in the holdings of securities, money supply and inflation. The development of this capacity should be a priority task.

The government should also enact the Financial Securities Reform Law and improve SEC membership. Draft legislation has already been prepared with the assistance of international advisers.

4. Deepen Trade Liberalization

Following Ukraine's access to the WTO, a Task Force should be established to prepare Ukraine to secure free trade agreements with the European Union and other regions. The Task Force should also carry out analytical work to demonstrate the benefits of FTAs for Ukraine and counterbalance any likely local opposition to them.

5. Remove Uncertainties in the Legal Environment and Enforcement of Business Contracts

The lack of a stable and predictable legal environment increases the cost and risk of doing business in Ukraine. Current legal uncertainties are of major concern to investors. Despite the enactment of the Law on the Judiciary, the judiciary is still weak and its lack of independence makes its judgments more unpredictable. In fact, Ukraine's weak judiciary is one of the main reasons for violation of property rights, as ownership rights and business contracts are difficult to enforce. Measures should be announced to strengthen the judiciary, including the development of concrete action plans. In particular, the government should provide adequate funds to the judiciary to raise salaries, train judges, develop legal data bases, and facilitate court actions.

The government should appoint a Task Force to secure the stability and predictability of the legal environment, particularly by (i) ensuring consistency of new laws with existing laws, (ii) better defining processes and responsibilities for drafting and reviewing new laws, and (iii) defining the required reform of the judiciary system to give it more autonomy and adequate financing and training.

6. Fully Staff the Investment Promotion Agency

The government should further strengthen the Investment Promotion Agency to identify policy barriers to investments and to attract large investors as well as small and medium firms. Some of its activities are suggested below:

Measures to Attract Large Investors. In order to attract major transnational corporations (TNCs), the Investment Promotion Agency should develop a comprehensive investor targeting strategy, which may employ a combination of a top-down approach (identifying large foreign investors) and bottom-up approach (offering opportunities in Ukraine.)

Identify transnational corporations that are planning Greenfield Projects in the region. The strategy should include a thorough identification of large transnational companies that are currently considering or planning major investments in Central and Easter Europe, with a view to attract them to Ukraine. Special promotional campaigns should be elaborated for each targeted company to be followed by visits to the countries of origin to meet with key people of these specific TNCs by high-ranking Ukrainian officials. To identify large potential investors, some countries have found it useful to use their existing network of embassies. In particular, such a strategy was used by Israel's Investment Promotion Center (which only had a staff of 10 people) over more than a decade.

Prepare a general promotional campaign to encourage investors to consider Ukraine as a suitable investment location. A special program should be developed with the objective to reach un-identified investment decision-makers in TNCs and inform them of the unique opportunities in Ukraine. The campaign should explain why Ukraine is a better location than other economies in the region. The program should include specific promotional materials about the country and in-depth research analyzing the sector opportunities existing in the country in comparison with other countries in the region. It should also prepare articles for international publications and arrange visits and meetings of government officials with representatives of TNCs to initiate the first visit to the country.

Identify specific sectors in Ukraine that could be of interest to large investors. The Investment Promotion Agency should prepare or coordinate the preparation of in-depth sector reports that identify the existing investment niches or advantages in Ukraine. For instance, among Ukraine's advantages are its rich agricultural land that favors agro-industries, an educated and low cost labor force, a location at a strategic crossroads, and a large and rapidly growing domestic market. Investors need reliable and detailed information about the country and its opportunities. The list of specific sectors that may be targeted include high-tech (software development, bio-technology, telecommunications, agro-technology), agri-business, food processing, consumer services, etc.

Measures to Attract Small and Medium Investors. Unlike large TNCs, which have relatively easy access to capital and have a wide-ranging marketing network at their disposal, small & medium investors are interested in easy access to bank financing and to reliable information about the country. The Investment Promotion Agency should:

Facilitate access to bank credit. One of the most important things for small and medium investors to set up and develop a business is easy access to bank credit. At the current stage of development, the Ukrainian banking system could not satisfy existing demand for loanable funds due to prohibitively high interest rates and a poor system of credit risk assessment. Small and medium investors can not wait until the banking system will be developed enough to satisfy the investment needs of their growing businesses. Therefore, it is necessary for the government to launch a lending program aimed at providing medium and long term debt financing for foreign equity investors that are planning to come to Ukraine. For the implementation of this program, the government should negotiate with international agencies (such as the IFC and the European Bank) to provide large lines of credit to support potential foreign investors. Such lines of credit could be provided through a state-owned bank (for instance, UkrEximbank) or through a group of creditworthy commercial banks.

Provide reliable information about the business environment. Small and medium investors find it difficult to obtain information about a country. This information includes data about the country, the economy, pertinent business laws, licensing and registration requirements, etc. An Investment Promotion Agency may perform this task by maintaining a website, preparing leaflets, brochures and articles in international periodicals, holding lectures and organizing seminars for prospective investors.

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