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UKRAINE – Economic Evolution Since Independence

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UKRAINE – Evolution Since Independence and Future Prospects

Introduction

Over the last five years from 2000 to 2004, Ukraine achieved excellent macroeconomic performance. This performance provides now a unique opportunity for the implementation of structural reforms vital to the country's further economic and social development. The presidential elections held at the end of 2004 and the "Orange Revolution" provoked by vote fraud have became a turning point in the life of millions of Ukrainians. They made their choice to move Ukraine towards a democratic society with a stable and prosperous market economy that would substantially improve their living standards.

Mr. Yushchenko, who won the Presidency during the re-run of the elections on December 26th, has now an unrivalled 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's community and keep it on the road of prosperity. The renewed energy associated with an electoral win should be concentrated on translating political will into consistent policy actions and reforms aimed at creating favorable business and investment climate and maintaining sustainable economic growth.

Ukraine's road to economic success has not been easy. After collapse of the Soviet Union Ukraine declared its independence in August 1991 and had a large potential to rapidly transform into 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 significant engineering and scientific foundation. All this permitted Ukraine to supply much of the heavy industry of 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 quite structurally weak and highly dependent on the other former Soviet Republics economy. 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, Czech Republic and Hungary, Ukraine failed to perform radical reforms during the first years of transition. This was due to lack of political consensus and to opposition from some groups in Parliament and vested interests. This situation has 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 severe financial crisis of 1998 when there was a threat of not fulfilling public debt liabilities and the government had to negotiate the debt restructuring agreements.

Nevertheless, enormous developments have taken place over the last five years. In 2000, with Mr. Yushchenko as Prime Minister, after nine years of economic decline the economy began a strong recovery. Gross domestic product (GDP) grew by 6% in 2000, with the pace of growth accelerating to a historic maximum of 12% in 2004. Over the last five years, the average rate of growth has been about 9% per year. Initially spurred by a strong depreciation of national currency in 1998 and strong world prices on key export commodities, economic growth has later become domestic demand driven. The recent GDP growth was 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 post-communist decline.

In a rather short period of time, Ukraine has managed to significantly improve its major macroeconomic indicators: fiscal deficits were reduced; the current account moved to surplus; international reserves reached sustainable levels and inflation was brought down to single digits; private consumption and gross investment rebounded sharply. However, in spite of significant acceleration of economic growth in the country it is still based on utilization of existing capacity since Ukraine's GDP in 2004 equals to about 66% of pre-independence output. The large part of country's capacities is outdated and substantial investments are needed to renovate existing and build new capacities. Inflows of foreign direct investment (FDI) remained relatively modest comparing with other transition economies of the region. By the end of 2004, Ukraine attracted slightly more than $7 billion of FDI or some $165 per capita. This is extremely low number compared to the Czech Republic, Poland and Hungary whose FDI per capita is more than several times that of Ukrainian FDI. One of the reasons why Ukraine was underscored by international investors was 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.

This report is aimed at analyzing the recent economic history of Ukraine and future prospects for the economy in the light of the recent political developments. The latter gave grounds 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, favorable business climate, fair support for socially vulnerable groups and solid international reputation.

The Early Economic Reform Programme

The structural weaknesses of Ukraine during Soviet times meant that major corporate restructuring was needed after independence. In early 1990s domestic production was very energy intensive due to negligible energy costs during Soviet times, thus many enterprises were bound to 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 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 to mid-1998 was to a great extent attributed to 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, Mr. Yushchenko during his term as NBU Governor set the basis for healthy development of banking system through introduction modern accounting and electronic payment system. The system allowed to significantly increase efficiency of interbank transactions – the time for any transaction was cut from several days to minutes. Yushchenko has also led the effort to cancel the Kartoteka No. 2[1], which permitted the tax authorities to arbitrarily grab banking funds of 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 up to mid-1998 the Government continued to run large fiscal budget deficits, 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 stabilising 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 reach 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

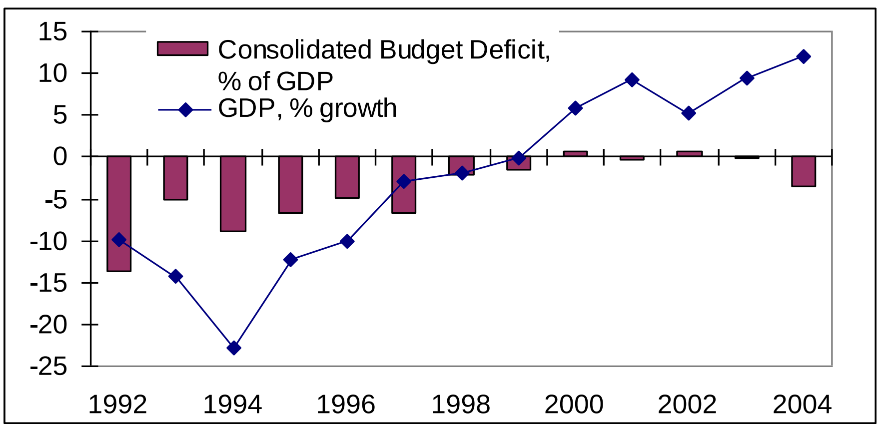
During the first half of 1998, with investor sentiments becoming more negative, capital outflows accelerated and the NBU had to sell a considerable amount of its foreign reserves to protect stability in the exchange rate. Foreign reserves declined from $2.3 billion at the beginning of the year to about $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.

[1] Kartoteka No. 2 was eventually abolished in 2001.

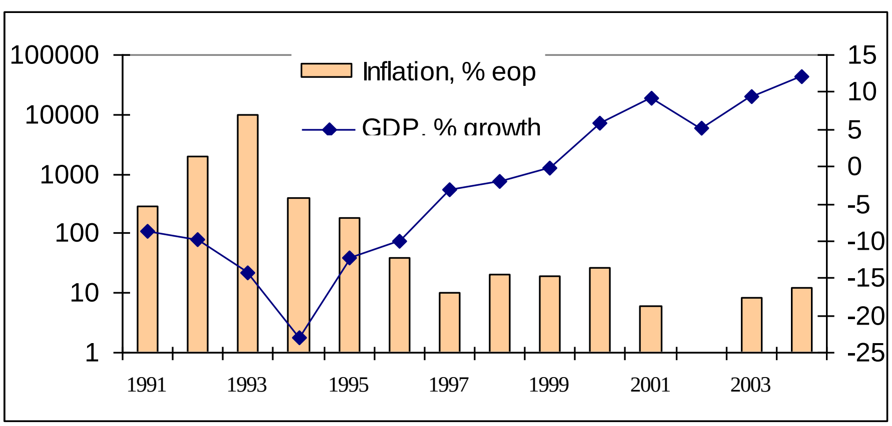
Following the Russian crisis of mid-1998, investors' sentiments about Eastern Europe became negative and foreign financing became unavailable to Ukraine. With international reserves declining rapidly, in September 1998 the NBU had to stop selling foreign exchange. The results of the financial crisis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

Evolution of Consolidated Budget Deficit and GDP Growth



Annual Inflation and GDP Growth



Source: State Statistics Committee

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 negotiate voluntarily 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, during 1999 the country went through a period of recovery and consolidation of its fiscal accounts. 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.

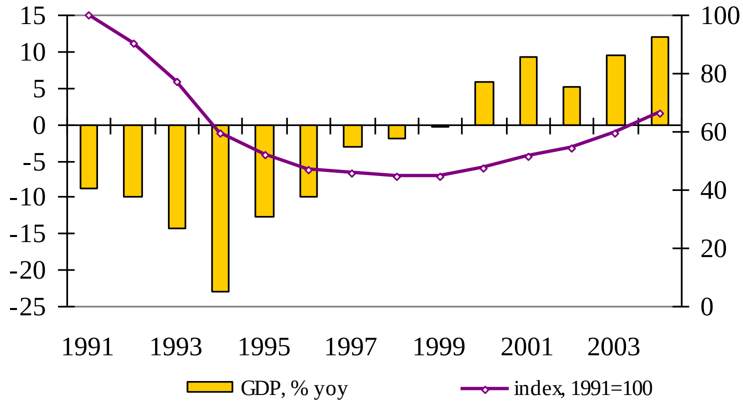
As noted earlier, weaknesses in public finance were at the core of the economic difficulties that Ukraine experienced from 1992 to 1998, despite the progress made in other economic areas. Since 1999, the execution of the Government’s fiscal budget has been improved significantly. Fiscal expenditures 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.

As a result of these measures, the fiscal budget deficit has been kept under control, reaching only 1.5% of GDP in 1999. In fact, the major benefit of the 1998 financial crisis was the adoption of fiscal discipline. This crisis brought wide recognition among most branches of government that the fiscal deficit had to be maintained within limits that could be financed on a sustainable and non-inflationary basis (around 1.5% to 2%f GDP).

Economic Developments in 2000 - 2001

The year 2000 started with a number of positive political and economic developments. President Kuchma was re-elected for a 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 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.

Gross Domestic Product Dynamics Since Independence



Source: State Statistics Committee

The period of 2000-2001 was featured by 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 major principles that lie at the core of the government's program were major free market principles: private property, entrepreneur freedom, stability and competition. Moreover, strong government's commitment to reforms improved business expectations for further liberalization, thus apparently stimulating economic activity in the country.

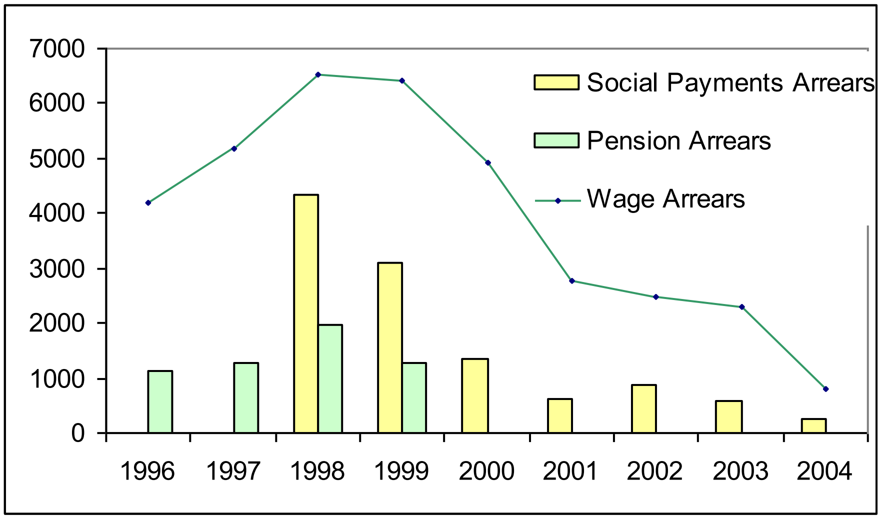
During 2000 the Ukrainian government led by PM Yushchenko implemented a number of crucial reform measures including tightening of financial discipline by eliminating budget arrears and barter, accelerating privatization, liberalizing of the monetary and exchange rate policy, progressing with land privatization, and initiating administrative reform. Strengthening financial discipline was one of the major pillars of the Yushchenko's government 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 cancellation of many previously granted tax privileges and subsidies. In the first half of 2001, the Budget Code has been approved by the Parliament introducing new principles of 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 this step was inconsistent with declared reform program, barter trade that drastically fell at the beginning of 2000 has 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 metallurgy, energy and telecommunication sector. Although not all enterprises targeted for sale in 2000 were actually privatized, the process of privatization accelerated significantly compared with the previous years. Total privatization receipts transferred to the state coffers amounted to almost \$2 billion, times of what the government got from privatization in earlier years.

In 2000, the 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 a previously depressed agricultural sector. In 2000 agriculture grew by a healthy rate of 9.8% and this growth continued to grow by 10.2% during 2001. In absolute numbers, grain output increased from 24.5 million tons in 2000 to output of 39.7 million tons in 2001.

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

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



Source: State Statistics Committee

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 that had an immediate positive effect on fiscal revenue collection due to reduction of the 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 Daewoo) was abolished as a result. The European import certification standards were introduced facilitating healthy development of foreign trade. The overall quality of legal environment in the country also improved due to approval of the Banking Law and the Criminal Code.

Important measures of the new government of PM Yushchenko towards macroeconomic stabilization were the implementation of satisfactory fiscal and monetary policies. The fiscal budget balance showed a small deficit of only 0.5% of GDP in 2000 and of about 0.3% of GDP in 2001. Monetary policy has been somewhat expansionary, with money supply increasing by 45% on 2000 and 42% in 2001. These increases in money supply were caused principally by the heavy purchases of foreign exchange in the inter-bank market made by the NBU to serve 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 led 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 nominal stability reflected substantial current account surplus and increase of the monetization of the economy that contributed to willingness of the public to hold Hryvnias. Reviving public confidence in national currency and the domestic banking sector encouraged 45% growth of the household's deposits. As a result, banking sector lending to the economy increased by one-third during 2001.

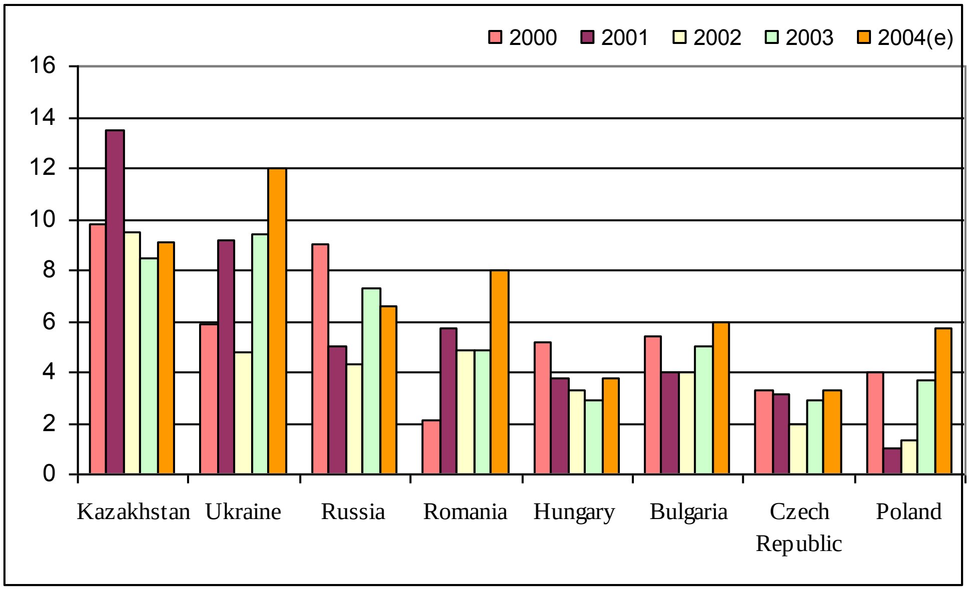
The control of the fiscal deficit and the implementation of the above mentioned economic reforms had a positive impact on the macroeconomic fundamentals. Also, favorable external environment did play a role in the overall economic recovery in 2000. As a result, real GDP grew by 6% in 2000, with the pace 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, representing now only 25% of GDP. In 2000-2001, Ukrainian government managed to successfully negotiate external debt restructuring with private and the 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

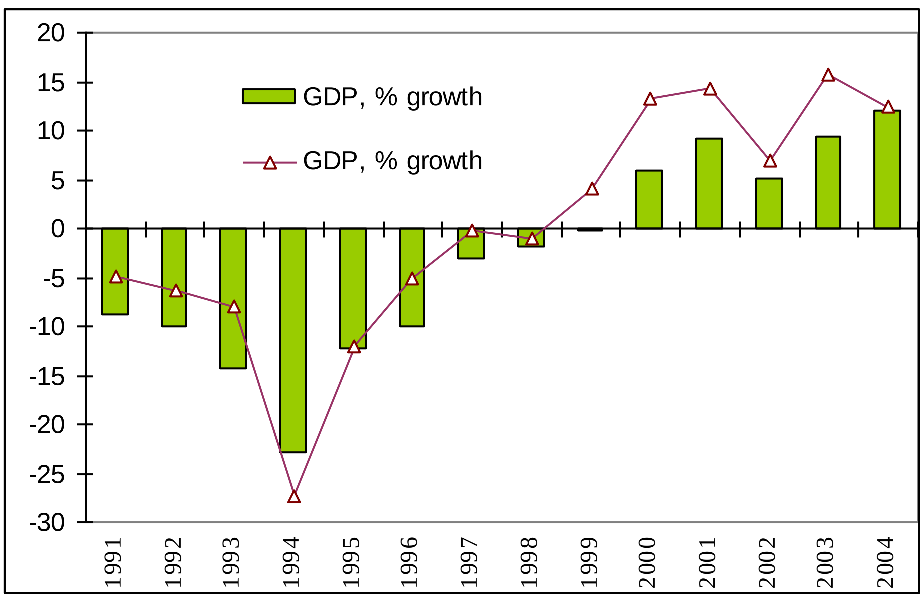
After the major economic adjustments that took place during 1990-2001, the Ukrainian economy maintained remarkable growth thereafter. Buoyant domestic demand, a favourable external environment and continuing investment expansion contributed to the country's robust GDP growth in 2002-2004. After a slight 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 also 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.

Real GDP Growth in Ukraine and Selected Transition Economies



Source: State Statistics Committee, IMF

Real GDP and Industry Growth in Ukraine

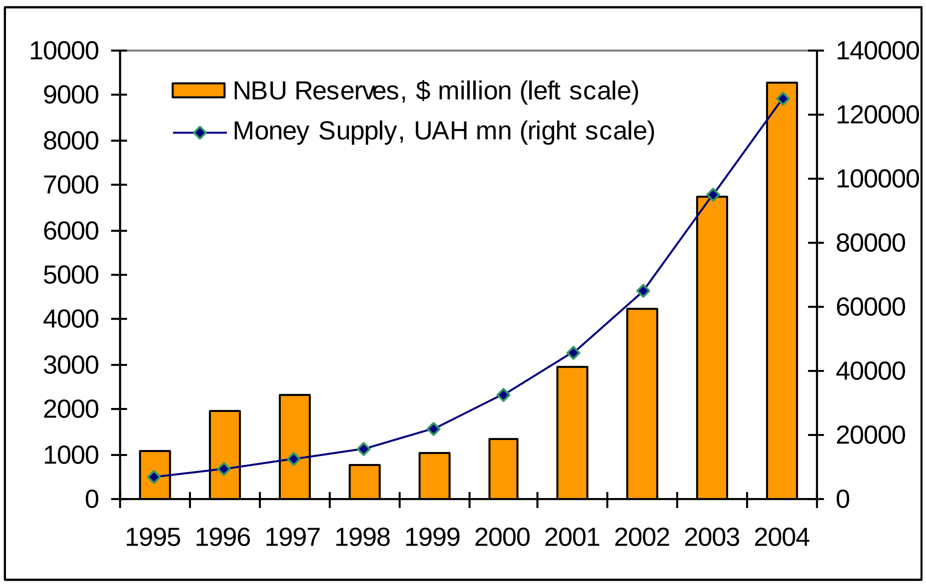


Source: State Statistics Committee

Over the recent years of booming economy, macroeconomic stability indicators remained remarkably strong. The government maintained prudent fiscal budget discipline throughout 2002-2003 and mid-2004. In 2002 the fiscal budget posted small surplus, while 2003 ended with 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 of 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 the year. Such level of fiscal deficit is unsustainable, even though the government had enough resources to finance it thanks to plentiful privatisation receipts and successful placement of sovereign Eurobonds. Relatively slow in 2002-2003, privatization process accelerated significantly in 2004 thanks to sales of giant enterprises as Kryvorizhstal and Ukrrudprom. 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.

Monetary aggregates growth has been relatively high in the last two years, excess of 40% per annum. These increases in money supply were fuelled by unsterilized purchases of foreign exchanges by the central bank. However, strong money demand 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 prices growth that reached 12.4% by the end of 2004.

Monetary Aggregates and International Reserves



Source: National Bank of Ukraine

Export grew at impressive rates in 2002-2004, improving Ukraine's external account position. Strong foreign demand and competitive price of domestic output generated current account surpluses of $3.2 billion (7% of GDP) in 2002 and $7.0 billion (10% 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 63% and 35% in 2003 and 2004, respectively. However, this high growth rate in lending has raised concerns over the quality of the loan portfolios of commercial banks, and therefore the stability of the banking system. The central bank is aware of these risks and maintains 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 since 2000 was supported by good progress in institutional reforms to improve business environment. Since then, Ukraine passed a number of Codes and Laws that improved the business environment, including the Civil Code, the Commercial 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 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 corporate profit tax was reduced from 30% to 25% in 2004.

The Presidential Elections in 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 (PM) 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 Messrs. Yanukovych and Yushchenko, 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 about one year, the constitutional reform will turn Ukraine into a parliamentary-presidential republic, reducing presidential power and giving more authority to the Parliament.

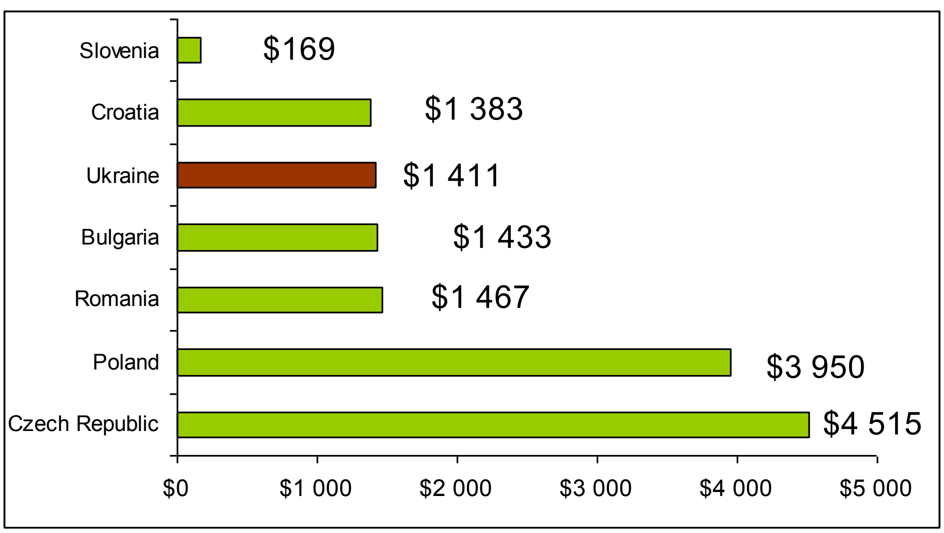
The re-run of the presidential elections on December 26th was fairly pacific and was deemed by most international observers as fair and democratic. As expected, Mr. Yushchenko won a majority of 52% of the votes, with Mr. Yanukovich receiving 44% of the votes. Although Mr. Yanukovich challenged these 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 recent 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.

Current Performance and Outlook for FDI Inflow Into Ukrainian Economy

An essential condition for sustained economic growth in Ukraine is a substantial increase in investments and foreign direct investments (FDI) in particular. Substantial progress in the country's macroeconomic indicators and business environment conduced to an increase in FDI inflow in recent years, underlining an improved investor attitude toward the country. Ukraine received the largest amount of net FDI since its independence in 2003 and 2004. In these two years, foreign investors transferred $1.4 billion and $1.8 billion, respectively, of net FDI into Ukraine. These amounts represent about 3% of Ukraine's annual GDP. Foreign investment inflow has been rising steadily over the last 3 years after the drastic decline in 1999, caused by the financial crisis of 1998 and political uncertainty due to the 1999 presidential elections.

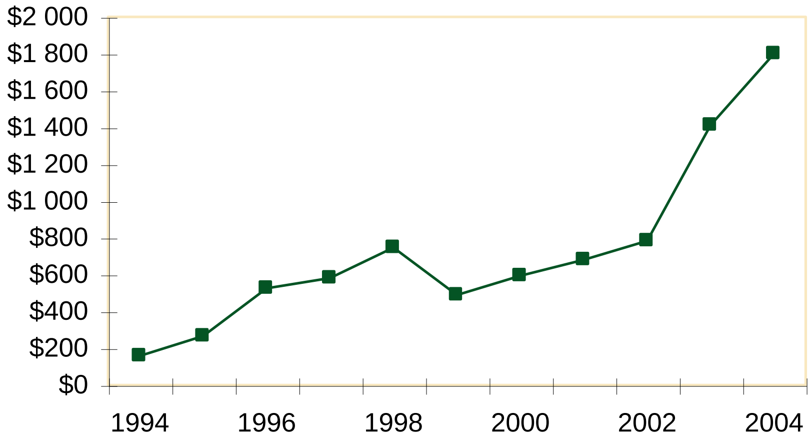
Net FDI Inflow into Ukraine and Selected Transition Economies in 2003



Source: State Statistics Committee, UNCTAD

Despite significant progress in attracting FDI, the total volume of FDI in relative terms lags behind Russia and other countries of Eastern and Central Europe. Since independence, Ukraine has only managed to attract a total of $7 billion in foreign direct investment, and the highest levels of FDI per capita reached only $165 as of September 2004. This is extremely low compared to the Czech Republic and Hungary, whose FDI per capita is more than 40 and 20 times Ukrainian FDI, respectively. Traditionally, the food processing industry and internal wholesale and retail trade have been the most attractive to foreign investors. These sectors usually give investors a quick return on investment and lower risk compared to other industries. Other sectors received much less attention of foreign investors.

Net FDI inflows, US$ million



Source: National Bank of Ukraine

So far, foreign capital inflows to Ukraine have been insignificant in terms of Ukraine's needs and economic potential. 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.

In addition to maintaining good macroeconomic performance, in order to attract increased levels of FDIs Ukraine needs to further improve its business environment. Studies carried out by The Bleyzer Foundation, with the support of the International Private Capital Task Force (IPCTF)[2], 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)

[2] The Steering Committee of IPTCF included representatives of private sector companies in Ukraine, international bilateral and multilateral agencies, economic NGOs and the Government.

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, including Poland, Hungary, Russia, Chile and Argentina. The statistical work on 50 countries shows that Ukraine could increase the flow of foreign direct investment from its current annual level of about $1.0 billion to $3.4 billion per year in five years, if it were to narrow the policy differential with the best of the benchmarked countries by 50%. Under more optimistic policy scenarios capital inflows to Ukraine could increase to $6.0 billion per year in five years. These levels of capital inflow would make the current economic recovery sustainable over time, adding several percentage points to GDP growth.

Therefore, the implementation of the IPCTF measures should provide the basis for maintaining the economy on a sustainable path of growth. These recommendations have now been updated and will be presented to the new Government. They are discussed in the next section.

Prospects for the Future

The first months of a new administration are an unrivalled opportunity to use the political goodwill earned from the elections and Orange Revolution to make the difficult changes needed to keep Ukraine on the road of prosperity. The renewed energy associated with an electoral win should be concentrated on translating political will into specific policy actions. It is evident to the new President and his team that the all his steps will be carefully monitored by the electorate, international community, and political opposition. President Yushchenko is fully aware that the main priority of Ukraine's economic program for the new government in the coming year is to maintain the recent macroeconomic gains and the current momentum by implementing growth-oriented structural reforms. In fact, additional significant improvements are still needed to sustain long-term growth. In particular, there is a need to revive the level of investment in the economy. Given the high level of unutilized capacity, over the short term economic growth can be based on better utilization of existing investments. Current levels of capacity utilization suggest that economic growth should be able to continue for a while. However, over the medium term, growth based on improved utilization of existing capacity will slow down. Therefore, in order to continue the high rate of growth new and significant additional investment will be necessary, particularly foreign investment since domestic savings are low.

The new government of President Yushchenko realizes that the key to attract investments will be improvements in Ukraine's investment climate. A more recent Bleyzer Foundation publication, titled "Ukraine Odyssey: Economy 2004 and Investment Climate" (found at www.sigmableyzer.com), had identified the key policy measures to improve the investment climate in Ukraine. There are widespread indications that the domestic and international business community can expect to see improvements in the following areas within Ukraine under the leadership of President Viktor Yushchenko during 2005 and beyond:

1. In order to sustain macroeconomic stability, the new Government will need to revise the recently approved Fiscal Budget for 2005 with the aim of reducing the planned fiscal deficit. Without this revision, the fiscal deficit would be unmanageable at 4%-5%. To increase fiscal

revenues, the new Government is likely to eliminate tax privileges and exemptions and the free economic zones which today benefit a few firms.

2. The new Government is likely to liberalize and deregulate the business environment to make it more friendly to small and medium size business. It would decrease the level of involvement of government structures and eliminate the incentives of state agencies to carry out excessive government intervention in businesses. It would also phase out special favors to large monopolistic business structures controlled by insiders. There will also be a strong decline in the use of the tax inspector's office and/or the prosecutor general's office and other agencies at all levels of government against private businesses for political, governmental and personal reasons. As stated by Mr. Yushchenko, there will be a strong effort by the government to implement programs to bring the large shadow economy into the mainstream business community.

3. The new Government will aim at creating a stable and predictable legal environment, with a court legal system that will operate under the rule-of-law and implement a much more level-playing-field approach to legal decisions. There should be a dramatic decline in lawsuits and judgments against international businesses and investors by those in Ukraine who merely wanted to run someone out of business or take-over their business and used bribes to gain the decisions favorable to their position.

4. To develop sound corporate governance, the new Government is likely to push for the approval of legislation, such as the proposed Joint Stock Company Law. It would also establish adequate procedures to ensure that the privatization process is transparent and competitive.

5. The new Government will further liberalize foreign trade and improve its international relations. There will be positive cooperation regarding Ukraine's progress towards integration into Euro-Atlantic structures such as the EU, support for Ukraine's membership in the WTO, and possibly NATO. Over time, Ukraine expects to sign free trade agreements (FTAs) with the EU and the CEA, which are the country's main trading partners. The Ministry of Economics and European Integration is likely to concentrate on the design and implementation of measures to further integrate Ukraine to the EU. Mr. Yushchenko Government expects to go beyond the EU's Good Neighborhood Policy and reach the status of EU Associated Country in a few years. The new government is expected to work positively with Russia in a way that will not result in a decline in the economic and business relationship.

6. Following his experience as Chairman of the National Bank of Ukraine, Mr. Yushchenko is likely to further develop a healthy financial sector by further improving banking supervision, including stronger prudential regulations (capital adequacy, lending to related companies, etc.) and facilitating the development of private pension funds.

7. The Government will take measures to prevent corruption including public administration reform to improve transparency of the decision-making process, the reduction of ambiguity of government regulations, raising the accountability of public servants and strengthening the internal audit office.

8. In order to minimize political risks for business activities, the Government will give high priority to unite the Eastern and Western regions of the country, which were highly divisive during the election crises. It is likely to decentralize to the Oblasts more fiscal budget authority and take measures to eliminate power abuses at different levels of the authorities.

9. Among the priority actions to promote business opportunities in the country the Government is likely to encourage a larger involvement of international financial organizations such as OPIC, US EX-EM, EBRD, IMF, World Bank, IFC and others. It will ask for increases in their activity levels over time designed to assist in the improvement of the economic and business numbers. It would also ensure the effective functioning of the investment promotion agency.

In addition to the implementation of the above measures, in order to ensure future sustainable economic growth, Ukraine will require the support of Western Governments and institutions. Ukraine has taken many of the steps required to put its economy in order. There is a window of opportunity now to implement further reforms. It is now time for the West to provide the moral and financial support necessary to ensure economic stability and growth over the medium term. In fact, the extraordinary economic performance of Ukraine in the recent past has given the country a unique opportunity to break through its past economic difficulties and sustain growth. The West should embrace this possibility since a strong and economically independent Ukraine is critical to stability in Europe.