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Economic Assessment of Ukraine, 2007

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Summary

Real GDP growth averaged an impressive 7.4% during 2000-06, as the economy bounced back from the severe transition recession of the 1990s, buoyed by rising terms of trade, strong investment growth and booming private consumption. Yet there is more at work here than simply a post-crisis recovery supported by a benign external environment. The achievement of macroeconomic stabilisation together with the structural policies of the late 1990s did much to lay the basis for current growth, by hardening firms' budget constraints and unleashing at last the Schumpeterian processes of creative destruction that drive economic development. Like many CIS countries, Ukraine has lagged the more advanced transition countries of Central Europe with respect to market-oriented reforms, as governments have often focused more on preventing structural change than facilitating it. Hence, there is much still to be done in order to make strong growth more sustainable. One of the major emphases of this report is therefore on what more Ukraine can do to reduce the many remaining barriers to entry, exit and competition and thereby to stimulate a greater degree of dynamism and flexibility than its market economy has yet achieved. The potential benefits arising from such reforms are likely to be particularly great in view of the complementarities that exist among them, especially those involving regulatory reform, competition and privatisation. Improvements in the framework conditions for entrepreneurship will also be critical, not least in view of the need to increase private investment rates. Tackling these issues is all the more urgent now because, although Ukraine continues to grow strongly and the scope for catch-up remains considerable, a number of the factors that have underpinned growth since 1999 have exhausted, or will soon exhaust, their potential. ■

This Policy Brief presents the executive summary of the 2007 OECD Economic Assessment of Ukraine. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, discussed this Assessment. The starting point for the Assessment is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Secretary-General of the OECD.

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What has been driving growth?

When it first returned to growth in 1999, after a decade of contraction, Ukraine benefited from a sharp devaluation of the hryvnia and from the presence of substantial spare capacity. Throughout the period, Ukraine has also enjoyed comparatively low energy prices. Growth has been broad-based across sectors, with the largest contributions coming from services – the services share in total value added rose by 8.5 percentage points during 2001-06. On the demand side, growth since 2001 has been driven chiefly by booming private consumption, although the investment contribution has also been substantial. Rapidly growing household consumption has been supported by rapid increases in wages and social transfers, as well as spectacular growth in retail credit (Figure 1). Rising incomes have benefited the great mass of households, and both unemployment and poverty have fallen sharply since 1999. Demand growth was supported by a cumulative 17% increase in the terms of trade during 2002-06. This was primarily the result of strongly rising international prices for metals, which account for around 40% of exports. In 2006, metals price increases were sufficient even to offset the shock of a near-doubling of import prices for Russian natural gas.

Despite healthy productivity growth in manufacturing and steadily rising terms of trade, the non-mineral trade surplus has fallen rapidly in recent years. This is in part because Ukrainian industry has largely exhausted the post-crisis gains in labour-cost competitiveness. Productivity gains far outstripped wage growth in the first years of the recovery, but wages have been rising rapidly in recent years and this gap has now closed. The evidence also suggests that Ukrainian manufacturers find it difficult to compete on quality in non-CIS markets. In the coming years, moreover, the competitiveness of the export sector will be hit by further increases in the price of natural gas imports. The gas-price issue is particularly sensitive, given that Ukraine has a rather narrow range of revealed comparative advantages and that these are largely concentrated in energy-intensive manufactures. ■

What are the major challenges for fiscal and monetary policies?

The maintenance of fiscal discipline since 1999 has been a major achievement; keeping debt low and deficits in check has helped restore confidence and support growth. However, the degree of fiscal pressure has risen markedly since 2003 and is now probably excessive. A sizeable and highly consumption-oriented shift in fiscal policy during 2004-05 pushed the expenditure-to-GDP ratio above 43%, mainly as a result of a near-trebling of the basic pension in real terms. This left the country with a pension expenditure-to-GDP ratio in excess of 14%, one of the highest in the world. Given demographic trends, ensuring the long-term sustainability of the pension system is likely to be impossible unless current low retirement ages are adjusted upwards. The heavy burden of pension spending also limits the scope for reducing payroll taxes, which are exceptionally high and constitute a major incentive to under-report wages and salaries. The growth-impeding effect of Ukraine's high tax burden is reinforced by the distortions created by the structure of taxation itself. Despite evident progress in simplifying the corporate and personal income taxes and reducing tax exemptions, there is still considerable room for improving both tax administration and the design of the tax system while broadening the tax base. The distortions created by the overly generous simplified tax system are particularly problematic.

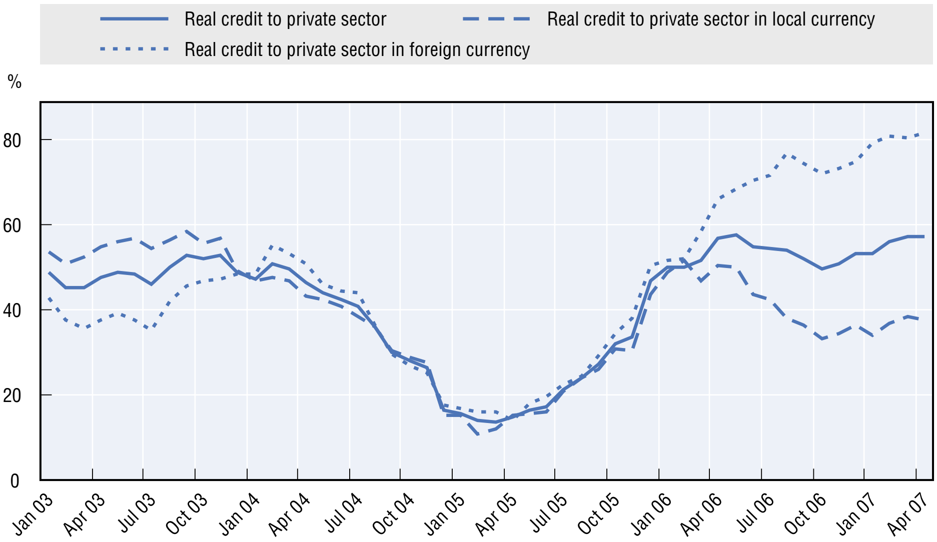
A *de facto* nominal dollar peg remains the cornerstone of monetary policy. While this nominal anchor helped Ukraine achieve macroeconomic stability in the aftermath of the 1998 financial crisis, it is now contributing to increasing inflation volatility and the risks associated with growing dollarisation of households' and firms' assets and liabilities. The current exchange-rate regime, combined with more attractive interest rates on foreign currency loans, constitutes a particularly powerful incentive to borrow in dollars (Figure 1). Allowing the exchange rate to fluctuate more freely could make exchange-rate risks more apparent to agents and thus help to reduce dollarisation. Greater exchange-rate flexibility could also serve as the first step in a phased transition towards an inflation-targeting regime. Any transition to a new monetary policy framework will of necessity be gradual, given the underdevelopment of financial markets, the relatively low level of monetisation and the consequent weakness of the interest-rate channel. Yet the authorities could begin by making greater use of the exchange-rate channel, which appears to be relatively strong, to reduce the level and volatility of inflation. Macroeconomic conditions now appear to be broadly favourable for such a change. ■

Why is an improved business environment so important for sustaining growth over the long term?

The economy has now built up considerable momentum, and Ukraine still has considerable scope for "catch-up" growth. Nevertheless, some of the factors underlying recent growth are transitory: the terms of trade are expected to deteriorate this year; energy prices are set to rise further; the period of "easy" productivity gains via labour shedding and increases in capacity utilisation has come to an end; and consumer credit growth is bound to slow. If Ukraine is to sustain strong growth over the medium-to-long term,

Figure 1.

REAL CREDIT GROWTH



Source: National Bank of Ukraine.

therefore, it will need to make the transition to a pattern of self-sustaining investment- and innovation-led growth. In addition to capital deepening and more efficient resource allocation, this will require maintaining robust total factor productivity (TFP) growth at a time when production factors are being used more intensively. Poor framework conditions for business currently constitute the principal obstacle to increasing the level and efficiency of investment. High levels of legal, regulatory and policy uncertainty make any long-term undertaking highly risky. The uncertainty and unpredictability of state action stem in many cases from a lack of transparency, which, in turn, fuels widespread corruption and undermines property rights. Improving the quality of public administration and strengthening the rule of law thus remain critical priorities. Further deregulation could also do much to reduce opportunities for corruption and arbitrary bureaucratic action, but in many spheres, Ukraine needs *better* regulation rather than simply less regulation. ■

What is constraining processes of creative destruction in Ukraine?

Stimulating robust productivity growth and increased innovation will also require a profound reform of product markets in order to enable the process of creative destruction to unfold. Because the restructuring of large state-owned enterprises (SOEs) is fraught with difficulty and often subject to considerable delay, reducing barriers to *entry* and allowing the growth of new activities has been a crucial engine of transformation in the more successful transition economies. Barriers to entry and exit are still substantial in Ukraine. The economy is still dominated by energy-intensive heavy industrial sectors, and this is one reason why so much past policy has been oriented towards averting rather than facilitating needed structural change. Empirical analysis of entry and exit confirms the impression that Ukraine has particular problems with exit.

- Overall firm turnover rates in manufacturing (entry plus exit) tend to be rather low by OECD standards, although entry rates rose sharply after 1995. Exit rates, by contrast, remain extremely low and appear to account for most of the difference between Ukraine's turnover rates and those of OECD members.
- Entering firms in Ukraine are significantly more productive than incumbents – around 40% more productive on average, for the entire 1992-2005 period. This may reflect entrants' awareness of the difficult conditions in which they will operate – they will need to be exceptionally efficient to have a reasonable chance to survive and grow.
- The selection of firms for exit in Ukraine appears to be inefficient, as the link between productivity performance and exit is weak. Exiting new private firms are significantly *more* productive than the surviving privatised firms and SOEs.

The weak link between productivity and survival is largely the product of the wide array of explicit and implicit subsidies provided to particular sectors and enterprises. While these are not limited to "old" firms, it is fairly clear that such subsidies enable poorly performing incumbents to remain on the market far longer than they would otherwise. Continued support for a large population of SOEs constitutes yet another part of the problem with exit: on the official data, roughly 48% of the country's capital stock was still in the hands of the state or municipal authorities at the end of 2005, with a further 10-11% in mixed public-private ownership. The size of the SOE sector serves to limit both exit and restructuring; this, in turn, reduces the scope for new entry, both because lack of exit limits the resources available to new entrants and because SOEs often enjoy formal or informal privileges that make it harder for entrants to compete with them. Moreover, the weak corporate governance of most SOEs means that many are easy targets for rent-seeking by insider-managers or well connected outsiders. ■

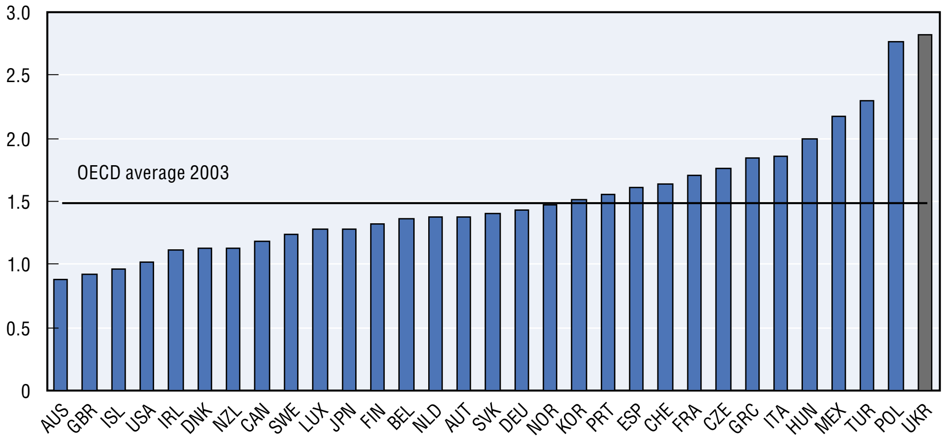
How does the regulatory burden in Ukraine compare to those of OECD members?

In Ukraine as elsewhere, barriers to entry, exit and reallocation are the product of excessive and often ill administered regulation. A systematic assessment of product-market regulation (PMR) in Ukraine using the indicators developed by the OECD Economics Department highlights the potential contribution that competition-enhancing regulatory reform could make to economic performance:

- The level of overall product-market regulation is higher than that of any OECD country in 2003 (Figure 2). While Ukraine scores relatively well on some of the sixteen individual PMR indicators, particularly in areas where reforms have recently been enacted, the burden of product-market regulation is well above the OECD average with respect to all three major components of the aggregate indicator: state control, barriers to entrepreneurship and barriers to trade and investment.
- Overall, barriers to business growth appear to be more constraining than barriers to entry. There has actually been considerable improvement with respect to market entry in recent years, but the regulatory impediments to growing businesses of whatever size remain extremely onerous. The burden imposed by the excessive application of licensing and permit regimes is particularly great, as is the cumulative cost of the bewildering array of rules and regulations governing issues like property registration and the conclusion

Figure 2.

AGGREGATE PRODUCT-MARKET REGULATION INDICATOR



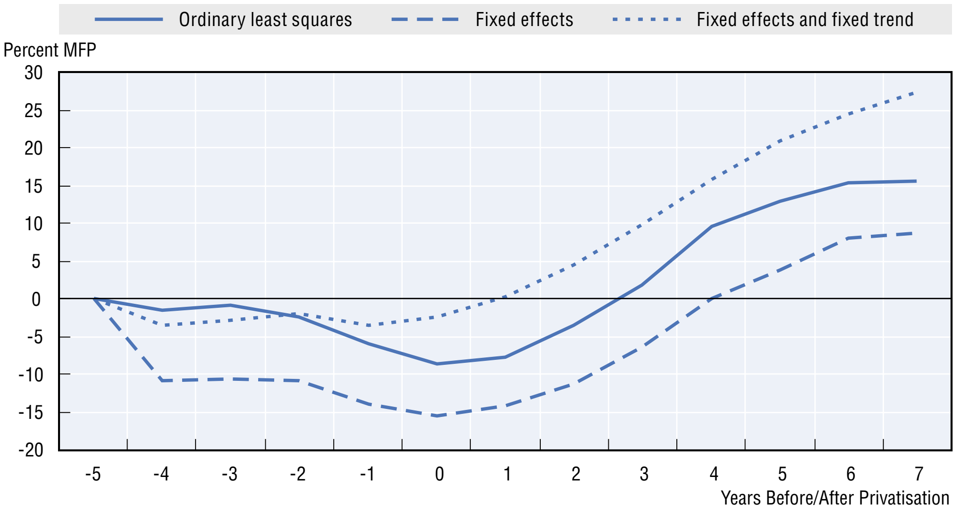
of contracts. These serve little purpose except to raise transaction costs, in terms of both time and money.

- Regulatory *process* is in some respects as much of a problem as the substance of regulation. Ukraine scores rather poorly on indicators concerned with such issues as the formulation of regulatory policy and effective communication with the business community. This reflects in part a failure to define with clarity the various roles that the state is to play in the economy or to differentiate between them in ways that avoid undesirable conflicts of interest.

One of the major disappointments of Ukraine's performance to date has been its relative failure to attract foreign direct investment (FDI): the stock of FDI per capita reached only 372 USD in 2005, just over 16% of the corresponding figure for neighbouring Poland. This would appear to be far below Ukraine's potential, given its human capital endowments and the comparative advantages conferred by relatively low wages, proximity to EU markets and the size of the domestic market. The institutional and regulatory problems identified above appear to constitute the major reasons for low FDI inflows. While the economy is very open in many respects, the PMR benchmarking exercise highlights the exceptionally high regulatory barriers to trade and investment in Ukraine. However, one should not exaggerate the degree of discrimination: the main barriers to investment are rooted in the overall institutional and regulatory framework encountered by *all* firms, foreign and domestic. Given the potentially substantial positive effect of FDI on domestic TFP growth, Ukraine is missing a major opportunity to facilitate industrial modernisation. Steps to address regulatory and institutional weaknesses could therefore bring significant benefits. Accession to the World Trade Organisation (WTO) is likely to help. The direct benefits of WTO accession, via tariffs changes and improved market access, are likely to be limited, but the welfare gains arising from the reduction in formal and informal barriers

Figure 3.

MULTI-FACTOR PRODUCTIVITY IMPACT OF PRIVATISATION



Source: Brown and Earle (2007).

to foreign investment, the strengthening of property rights and the overhaul of technical regulation are expected to be substantial indeed. ■

Why are enhanced competition and further privatisation such critical priorities for Ukraine?

The results of the PMR exercise suggest that regulatory reform could contribute to greater efficiency of both resource allocation and production, accelerating Ukraine's convergence with its more advanced neighbours. Indeed, the potential benefits of increasing competition are likely to be greater in Ukraine than in most OECD members or in many neighbouring countries, because competition in Ukrainian markets, though increasing in recent years, is relatively weak overall. The positive effects of enhanced competition find confirmation in an econometric analysis of the impact of competition on labour productivity, using enterprise-level data for 2000-05. The following conclusions emerge from this analysis:

- Concentration has a negative and highly significant effect on labour productivity growth.
- These results are robust for manufacturing as a whole, and there is evidence that the relationship is stronger when import- or export-competing industries are considered separately.
- For market services, the effect is found to be weaker but still substantial.
- Import competition has a positive impact on domestic firms' productivity. The effect is stronger where foreign penetration is lower, which may suggest that the initial opening to imports has a particularly strong effect in stimulating local firms to raise productivity.

Private enterprises generally respond more readily to increasing competitive pressures than do SOEs and that the gains from privatisation tend to be greater where privatised enterprises are subject to competition. This complementarity between competition and privatisation suggests that competition-enhancing reforms would achieve greater impact if accompanied by a reduction in the role of SOEs in the economy. The loss of privatisation momentum in Ukraine is therefore particularly unfortunate. The defects of Ukrainian privatisation *processes* cannot be denied, but they should not deflect attention from the positive impact of privatisation on enterprise performance. An analysis of longitudinal, enterprise-level data on manufacturing firms finds that in the case of privatisation to domestic owners, total factor productivity increases by between 10 and 25%, depending on the specification used, during the seven years following privatisation (Figure 3). The impact of privatisation to foreign owners appears to be even stronger, though the results are less robust, owing to the sample size. This suggests that the contribution of privatisation to aggregate manufacturing productivity growth in recent years has been substantial. ■

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