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Investment Climate in Ukraine

by Lorenzo Figliuoli[1] and Maxim Kryshko[2]

Investment is projected to be an important factor of both short-term growth in 2002 and of sustainable long-term growth in the next 5 years.

In the last few years, **investment prospects have indisputably improved**. In real terms, gross investment grew 14.4 percent in 2000 and 17.2 percent in 2001. At the same time, **this recent positive investment dynamics seems to be still insufficient to expand the capital stock of the economy.** The reasons behind this shortcoming are quite clear. Despite the fact that capacity usage in the Ukrainian industry is well below 100 percent:

- production assets are often worn-out and technologically obsolete;
- net investment was negative in 2000 and remained almost nil in 2001, which implies that capital consumption is relatively high.

In 2001, investment activity exhibited positive real growth almost everywhere in Ukraine, with the city of Kiev, Sumy, the region of Odessa, and most of the Western Ukrainian regions (Volyn', Zakarpattya, Rivne, Chernivtsi) being among the leaders. However, **this incipient geographical diversification remained modest in absolute terms.** Total investment remained heavily concentrated in the traditional industrial areas (including the city of Kiev).

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[1] Senior Resident Representative of the IMF in Ukraine.

[2] Economist at the Resident Representative Office of the IMF in Ukraine.

Indeed, around 40 percent of investment spending concentrated chiefly in Kiev and two major industrial cities (Donetsk and Dniepropetrovsk). Specifically, the city of Kiev attracted about 18 percent of total national investment, which was spent mostly on reconstructing the central railway station and building (or renovating) metro stations and urban squares or streets.

Two thirds of the investment realized in 2001 was financed by own funds of the enterprises, although the importance of this source has been gradually diminishing over time (in 1997, this source represented three quarters of the total). **The second most important source of investment financing was constituted by bank credits**, the share of which has grown considerably over the last three years and reached 14 percent of the total in 2001. This trend follows from the greater monetization of the Ukrainian economy, introduction of market principles in agricultural sector, and the reduction of barter in economic transactions. In line with recent levels, **about 11 percent of investment was financed by the state budget** (either central or local authorities).

It should also be noted that, as regards sectoral allocation, capital outlays were directed toward transportation (23 percent), manufacturing industry (19.8 percent - mostly, food and metals), extracting industry (15 percent), and residential construction (14 percent).

A regrettable finding is that **the share of foreign direct investment (FDI) in total investment, as well as the per capita level of FDI, remains quite modest**, if compared to other Central and Eastern European transition countries. In order to transform successfully to a market economy and to secure stable long-term growth, FDI is very important, well beyond its direct, immediate impact on the amount of capital spending in a given country. It likely promotes technological spillovers and helps enhance management practices throughout the economy. The recent privatization of the first batch of oblenergos in April 2001 is a positive step in this direction.

Among recent positive signs that appear to support, or to be evidence of, an improved investment climate in Ukraine, we can enumerate the following:

- **The exchange rate of the Hrvynia remained stable throughout 2001.** This development consolidated market expectations and, against the backdrop of continuing growth and improved consumer confidence, surely facilitated the importation and installation of new equipment.

- **Long-term credits from the banks grew rapidly**, while the share of bad loans shrank

- **The annual 2001 report of Moody's sent promising signals to investors** by acknowledging the strong positive growth of exports, domestic demand and investment in Ukraine, noting the favorable external debt conditions, as well as praising its cautious monetary and fiscal policies. As a result, Moody's upgraded the ratings of Ukraine's sovereign debt and of FX deposits to "B2"and "B3" respectively, and announced a stable forecast for future ratings.

- **The Presidential Decree "On Measures to Improve the Investment Climate in Ukraine" (July 2001) provided a solid foundation** to enhance further the investment climate in Ukraine, and to identify and overcome existing difficulties in this area.

The elements of progress listed provide evidence of a potentially attractive investment environment in Ukraine. However, we believe these developments and the efforts of the government would be much more effective and purposeful, if the authorities of Ukraine would:

- **Continue privatization** (including UkrTelecom and the oblenergos) in a transparent and competitive way.

- **Introduce a "one-stop" window** for all legal and regulatory requirements, particularly to promote FDI. This will help; (i) simplify operations, reporting and control; (ii) reduce costs (and also stem the burden of corruption); and (iii) will improve regulatory efficiency.

- **Strengthen capital adequacy and Central Bank supervision** of the banking system. Strong and healthy commercial banks will permit to narrow interest spreads and fees, and thus promote further investment and growth.

- **Safeguard stable and predictable "rules of the game,"** including in tax policy and tax administration.

- **Promote greater transparency** in public decision-making and broaden the practice of public hearings before adopting vital regulatory decisions.

- **Implement tax reform**, simplifying the system, eliminating privileges, reducing rates, and ensuring a level playing field. We are convinced that the efforts of the Ukrainian authorities to speed up parliamentary passage of the long-awaited Tax Code are an important step toward improving the investment environment. Bringing the widely dispersed tax legislation of Ukraine into a single comprehensive document, which is to embody internationally accepted principles of good tax design, would minimize efficiency losses and likely confer the required stability to the tax system, greatly stimulating domestic and foreign investment. In particular, the elimination of arrears on VAT refunds will eliminate a major obstacle to exports. However, in order to preserve macroeconomic stability, that is still fragile and very sensitive to domestic and external shocks, the provisions of the new Tax Code need to be carefully balanced. **Reduction of the tax rates is welcome, provided it is accompanied by the cancellation of the numerous tax exemptions and special treatments**, which have eroded substantially the tax base in the last few years. This is an area well within the core mandate of the IMF, and will be at the center of the future cooperation between the Fund and the authorities.