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CHALLENGES AND POLICY REFORMS FOR IMPROVED INVESTMENT ENVIRONMENT IN UKRAINE

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PROGRESS AND PROSPECTS IN IMPLEMENTING POLICY RECOMMENDATIONS TO IMPROVE THE INVESTMENT ENVIRONMENT

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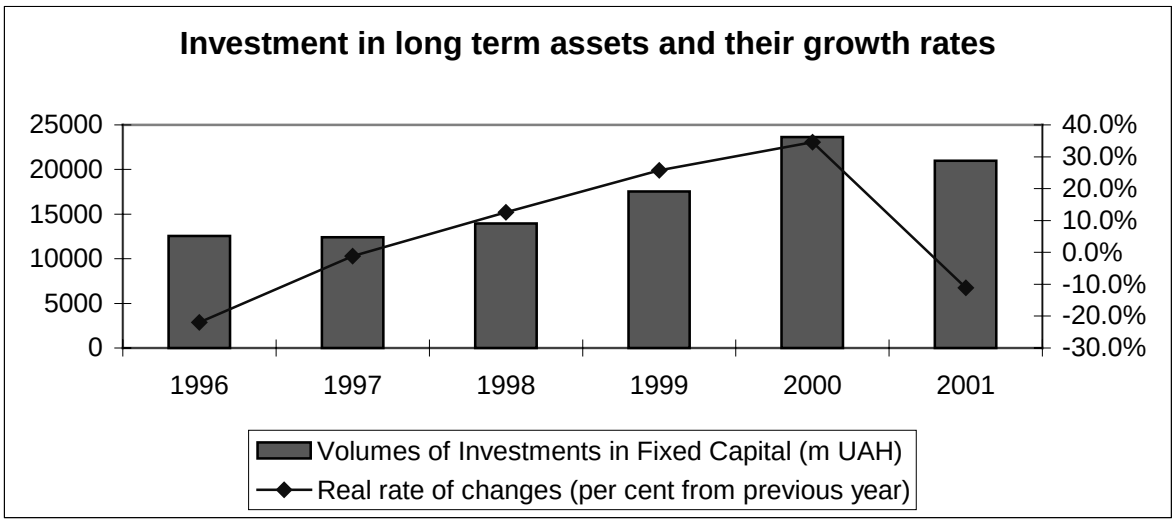
Macro economic considerations relevant to the investment environment

It has been frequently said that if the domestic investments are low then the country cannot be expecting the foreigners to put their money in the economy. The Figure below is depicting both a quite substantial rate of growth of the domestic investment in long term assets and the volume of investment for the last two years at the level of USD 4.5 billion per year. These yearly investment levels compare favourably with the accumulated Foreign Direct Investment (FDI) of USD 4.2 billion.



Source: Basic Indices of Economic and Social Development of Ukraine, February 2002

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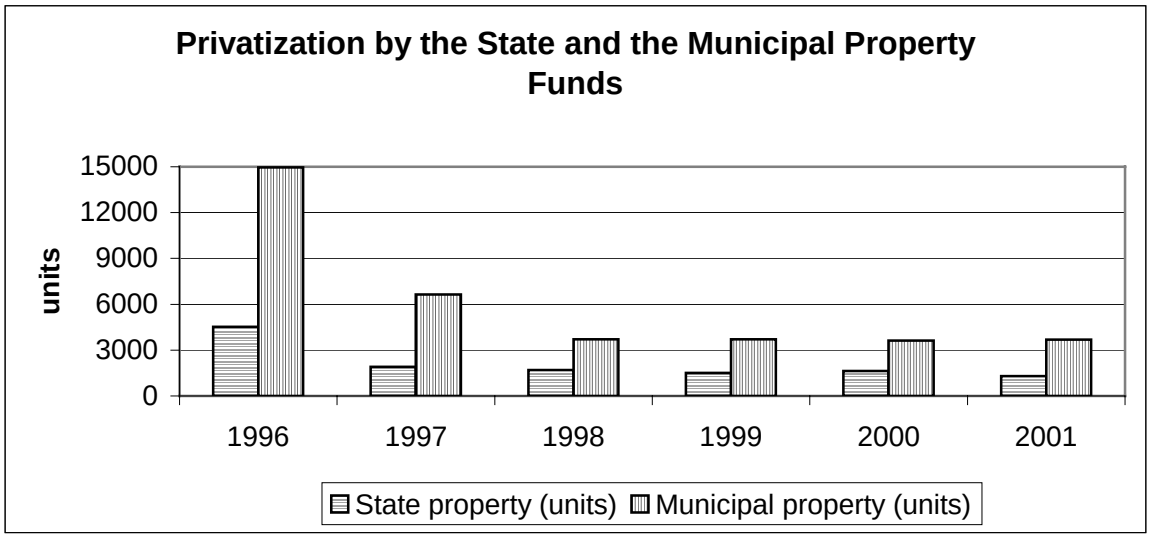
Another favourable, to my mind, indicator is the steady pace of the privatisation by the State and Municipal Property Funds. After the initial outburst of privatisation activities in 1996 and 1997 for the period 1998-2001 the level of the privatised units by both Funds has stabilised.



Source: Basic Indices of Economic and Social Development of Ukraine, February 2002

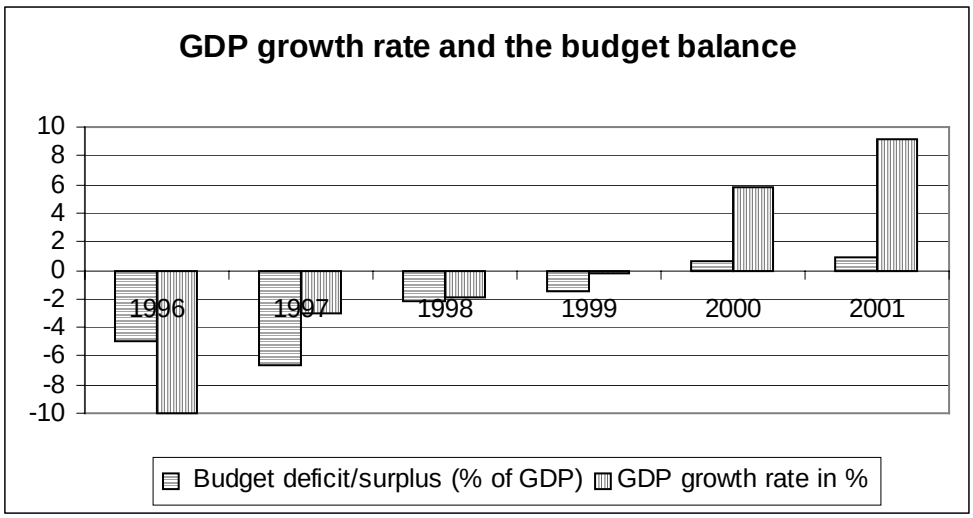
Other positive trends can be seen in the Chart below, namely, for the last two years the GDP was increasing at a pace between 6% and 9% per year and the state budget showed surpluses for two subsequent years.

To illustrate the sources of growth: for the period January-November 2001 industrial production increased by 16.1 per cent (by 12.2 per cent in 2000), including processing industry – by 19.6 per cent, mining industry – by 4.1 per cent, production and distribution of electric power, gas and water – by 2.4 per cent. The volumes of production of processing industry comprised 72.8 per cent of total industrial production. For the same period the highest rates of growth, compared with respective period of last year, were achieved in production of oil products and coke (by 57.1 per cent); wood and timber (by 25.9 per cent); engineering (by 21.7 per cent); pulp and paper industry, and printing and publishing (by 20.5 per cent).

Certainly the restrictive budgetary policy has its price, namely, arrears and non payments, e.g., the biggest share of debit indebtedness falls on enterprises of collective (54.7 per cent) and state (except municipal) (37.9 per cent) property forms as well as the biggest share of credit indebtedness – 57.7 per cent and 34.6 per cent respectively, as per November 2002 the arrears of payments remains significant: the total share of delayed debit indebtedness made up 41 per cent, credit indebtedness – 40.5 per cent.

From the other side the stability of the country's currency the Hrivna (UAH) has been demonstrated by UAH´s improving position at the currency markets – now one USD buys 5.3 UAH – the lowest level since several months, namely, the UAH has achieved a stability in nominal terms.

The inflation was also very low: for the period January - November 2001 the CPI made up 103.9 per cent while for the 2000 the CPI was 123.3 per cent.



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Hence, vastly improved fiscal management and performance have been key achievements.

Overall, however, fiscal flexibility is low. Sustainable progress requires effective and timely implementation of the just-legislated Tax Code.

Debt burden indicators improved significantly in 2001, reflecting higher growth and revenue and successful debt rescheduling.

There is also a positive dynamics in the Foreign Economic Activities, e.g., for the first 10 months of 2001 the turnover of goods and services increased by 12.2 per cent compared with 10 months of last year and reached USD 26.8 billion. The export of goods and services increased by 11.8 per cent (18.9 per cent last year) and the import increased by 12.6 per cent (21.1 per cent last year).

For the 2001 the positive foreign trade balance in goods amounted to USD 632.5 million against USD 421.8 million for the period January-November 2000.

Foreign Direct Investment:

As per end of October 2001, total volume of direct foreign investment in Ukraine amounted to USD 4.194 billion, that is 85 USD per a inhabitant. For the first 10 months of 2001 the total volume of registered FDI amounted to USD 529.4 million, that is by 10 per cent less than for respective period of 2000.

71.5 per cent of total volume of investments falls on the following countries:

USA	16.8 %
Cyprus (probably Russian and/or Ukrainian indirect investment)	9.5 %
The Netherlands	8.8 %
United Kingdom	8.7 %
the Russian Federation	7 %%
Germany	6.3 %
Virgin Isles	5.8 %
Switzerland	4.5 %
Republic of Korea	4.1 %
Austria	3.3 %

The most attractive investing destinations seem to be the following economic activities:

food processing	19.5 per cent
wholesale and commercial intermediation	14 per cent
Engineering	8 per cent;
financial activities	8 per cent
transports	7 per cent;
chemical and oil industries	5.4 per cent
real estate transactions	4 per cent
oil products and nuclear fuel, production of coke	4 per cent
metallurgy and metal processing	3.9 per cent

Ukraine's very strong growth recovery during 2000-2001 will be hard tested in 2002, given the global slowdown, an appreciating Ukrainian Hrivna, and possible protectionist measures by Russia. Expansion has been driven, to a large extent, by strong exports (60% of GDP). Russia is Ukraine's largest single trading partner, accounting for 25% of exports and 40% of imports as well as for a lion's share of foreign direct and portfolio investment. The Russian companies now have almost total control over Ukraine's aluminum and oil refining sectors and an increasing presence in its metallurgy and machinery sectors.

Ukraine's growth over the next two years will, therefore, be strongly correlated with that of Russia and its exchange rate policy. Standard & Poor's growth projection for Russia in 2002 (2.5%-3%) implies that growth in Ukraine will likely be constrained at 3.5%-4% in 2002, somewhat lower than either official or IMF projections. Domestic demand will become a major source of growth. Downside risks to this scenario are various, including possible Russian quotas on Ukrainian goods and lower world price for steel and chemicals (the country's main exports). If oil price continue to decline, Russia might be hard pressed to abandon its strong ruble policy, with possibly dire consequences for Ukraine.

Looking beyond 2002, growth in Russia and helpful external conditions will, needless to say, continue to matter. Increasingly, however, structural reform—including industrial restructuring, privatisation, reform of the agricultural sector, and strengthened financial conditions—will be crucial. Structural reform implemented in 1999-2001 has permitted growth in amazingly high growth over the past two years. An assault on barter transactions and inter-enterprise arrears within the state's productive sector, repayment of wage and pension arrears and legislative improvement all supported expansion of the real economy. In particular, long-overdue reform in the agricultural sector began to bear fruit, with farmers allowed to own shares in de-collectivised farms beginning in 1999. Financing available to farmers tripled in 2001 compared to 2000, reflecting this de-facto privatisation of agricultural land. The new Land Code, approved in November 2001, allows agricultural land to be bought and sold, with land used as collateral (effective as of 2005), which should facilitate farmers' borrowing.

In summary, it appears that a critical mass of restructuring sufficient to support modest 3%-4% GDP growth over the next two years has occurred in Ukraine. Relatively dynamic private-sector accounting for about 65% of GDP has been increasingly important. It is also quite conceivable that less harassment, better taxation administration, and a cut in barter transactions have all helped to reduce the shadow economy (still estimated at up to 50%) and brought some Ukrainian capital back into the country.

Longer–term, Ukraine's growth potential will be crucially dependent upon continued reform and its effective implementation. Comprehensive bankruptcy, corporate governance, and securities laws have yet to be implemented. The financial system, as in Russia, is extremely weak. A substantial part of the country's industrial base is obsolete, and the energy sector is extremely inefficient. A number of state regulatory bodies are still lucrative and therefore subject to corruption, and red tape and bureaucracy remain a formidable obstacle to an efficiently functioning market economy.

Ukraine also has one of the world's smallest banking and monetary systems, unable to provide the productive sector with the credit and other financial support services necessary to ensure sustainable long-term growth. The system suffers from a high degree of politicisation, overt favouring of selected banks, and protects both depositors and shareholders from the consequences of failures. The recent bankruptcy of Ukraine's most problem-ridden and political large bank is a step ahead.

Overall, Ukraine's financial system is seriously inadequate relative to the requirements of the economy, particularly given the country's massive need for infusion of capital.

Mass privatisation, and the so-called shadow privatisation process, created powerful economic groups that continue to exert pressure through a variety of corrupt practices and benefit from large quasi-rent activities generated by key industries (metals, chemicals, gas). As a result, various favours (such as tax exemptions and the discretionary application of regulatory requirements) have been prevalent, with all their dire consequences for the country's fiscal position. While there has been tremendous improvement in the fiscal sphere over the past two years, in some other areas political influence has continued to be damagingly strong.

On the positive side, the transparency of privatisation has increased since mid-2000, when, for the first time since independence, all political participants agreed to accelerate the privatisation of large-state owed companies to strategic investors, with assistance of Western firms and for cash. (The three-year program (2000-2002) has a US$ 2.75 billion target.) While actual privatisation receipts were close to their 2000 targets, in 2001 they were just above half of what was planned (i.e., Ukrainian Hrivna (UAH) 3 billion (US$ 500 million).

Based on the above analysis Standard & Poor´s recently (26-Dec-2001) assigned to Ukraine a Stable B rating. An even higher rating is constrained by:

- Major political distortions, which have been reformed only very slowly. As a result, the country continues to endure a highly centralized decision making process and still–developing democratic cultural and political institutions.
- Shallow institutional and legal systems, including the lax enforcement that continues to foster powerful vested interests and widespread political patronage and corruption.
- A weak economic structure, including the challenges of downsizing and privatising politically sensitive large mining and heavy industry as well as restructuring and privatising an inefficient energy sector.
- A recent track record of local currency and foreign currency debt defaults and rescheduling with both official and commercial creditors.

Some recommendations

Certainly, the Ukrainian government is very much aware of the shortcomings of the investment climate in the country. In order to ensure a complex approach to creation of friendly investment environment in Ukraine and stimulate investment activity the President of Ukraine decreed the ratification of a "**Program on Development of Investment Activity in Ukraine in 2002-2010**". The Program should be introducing a complex set of measures aimed at further improvement of the investment climate in Ukraine, namely: further deregulate and liberalize business activities, complete the creation of a stable and predictable legal environment, ensure transparency of the procedure of the decision-making process of central and regional executive bodies, improve the mechanisms of corporate rights management, improve effectiveness of bankruptcy procedures, rationalizing and increasing transparency of tax administration procedures, improving and increasing effectiveness of public governance, further strengthen the banking system of Ukraine, encourage implementation of the judicial reform and ensure unconditional execution of court decisions, etc.

The intentions are quite in line with the OECD recommendations but, as known, the devil hides in the implementation.

Let us just take the last part of the envisaged set of measures, namely, to complete the creation of a stable and predictable legal environment and the intention to encourage implementation of the judicial reform and ensure unconditional execution of court decisions. This are certainly very complex issues and I do believe that for a real efficiency improvement of this “third power” of the governance structure, beyond the political determination to support the full independence of the legislative branch, there should be a extensive know-how transfer from the OECD member states, combined with financial assistance for a broad range of measures ranging from creation computerised networks to the initial direct financing of courts and judges. In this respect one of the recommendations for improved investment climate may be the launching of OECD financed project on “Support to the reform and the restructuring of the Ukrainian Juridical System and Law Enforcement Agencies”. This to my may mind should go together with the introduction of an extensive monitoring of the law enforcement practices.

A related development may be the largely overdue improvements in the Corporate governance practices.

To my mind it makes sense for the Government, under the OECD guidance, to draft a Code of Corporate Conduct.

This Code may be containing the following main chapters:

Chapter 1. Principles of Corporate Governance
Chapter 2. General Shareholders' Meeting
Chapter 3. Board of Directors of the Company
Chapter 4. Executive Bodies of the Company
Chapter 5. Secretary of the Company
Chapter 6. Major Corporate Actions
Chapter 7. Disclosure of Information about the Company
Chapter 8. Supervision of Financial and Business Operations of the Company
Chapter 9. Dividends
Chapter 10. Resolution of Corporate Conflicts

The implementation of the principles included in the Code will have to be entrusted to a specialised self-financing institution, similar to the Russian Institute of Directors (http://www.rid.ru/) which, beside keeping track of the corporate governance index (based of methodology currently under development by Standard & Poor´s), is maintaining a Program of Education called "Corporate Director" for the Members of the Boards of Directors and Top Managers. The program is designed to assist in the transformation of the board of directors into the effective organ of control and governance and, thus, to enhance the effectiveness of the operation of the company as a whole.

The training courses are primarily targeted at the following professional audiences:

- Executive board members – company managers
- Non-executive board members (who are not the company managers)
- Managers who want better understanding of the board practices mechanism and improve communication with the board
- Representatives of the central and regional authorities in the boards
- Prospective board members
- Major shareholders striving for their companies' effective board work

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