III. ASSESSMENT OF UKRAINE'S POLICY REFORMS

MACROECONOMIC SITUATION AND OUTLOOK

Ricardo Giucci and Veronika Movchan[*]

Macroeconomic Situation

Ukraine's macroeconomic performance in 2001 was impressive and can be summarised thus: high growth; external stability; low inflation; and low fiscal deficit.

High growth - Economic growth in 2001 amounted to 9 %. Investment in fixed capital grew by 17.2% (Figure 1), accounting for almost one half of the total real GDP growth.[1] Contrary to the widely held view, net exports did not make a sizeable contribution to growth in 2001.

The largely investment-led growth was facilitated by increased credits, extended to enterprises by commercial banks. Outstanding credits grew by 46% in 2001. This lending activity was in turn made possible by an increase in deposits by 37%.

External stability - Both exports and imports grew significantly in dollar terms in 2001 (Figure 2). According to the State Committee of Statistics, the growth rate of merchandise exports was 11.6%, while imports increased by 13%. This rise is smaller in real terms, because of the real appreciation of the Hrivna relative to the US dollar in 2001.

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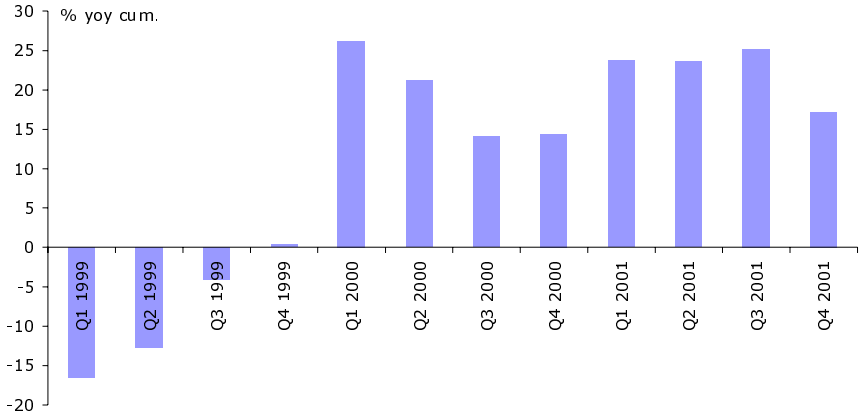
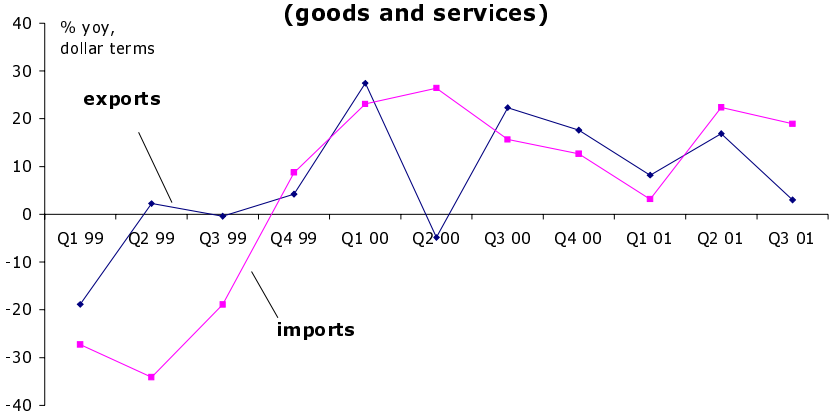
1 Exact figures on the contributions to real growth by private consumption, investment, government expenditures and net exports are not presented because of statistical discrepancies.

Figure 1. Investments in Fixed Capital



Source: State Committee of Statistics

Figure 2. Dynamics of Exports and Imports (goods and services)

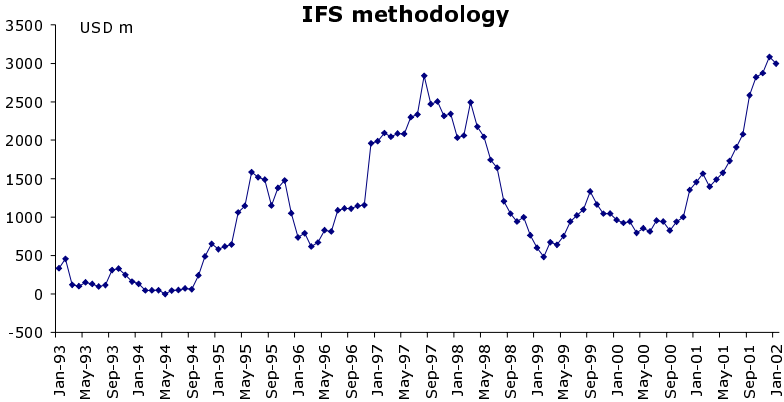


Source: National Bank of Ukraine, own calculations

The merchandise trade balance posted a surplus of $ 490 million[1], which helped the National Bank of Ukraine (NBU) to replenish its gross reserves of foreign exchange (Figure 3) and to keep the external value of its currency stable. An appreciation of 2.6% relative to the US dollar took place in 2001.

1 Source: State Committee of Statistics.

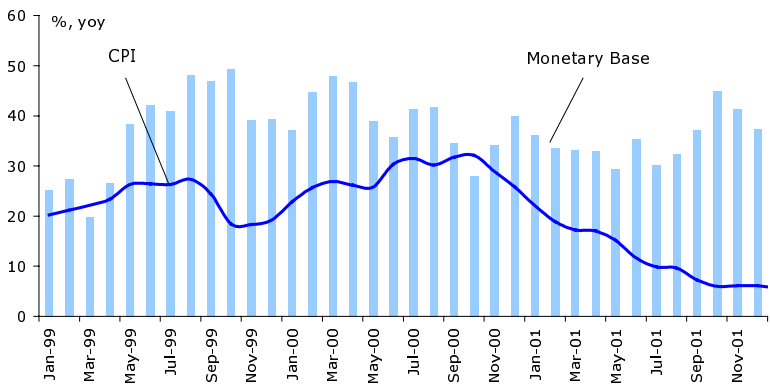
Figure 3. Total International Reserves minus Gold, IFS methodology



Source: International Financial Statistics (IFS), National Bank of Ukraine

Low inflation - The net purchases of foreign exchange by the NBU in 2001 resulted in a significant expansion of the monetary base (37.4%). Thanks to high economic growth and further monetisation of the economy, this monetary expansion did not produce a high rate of inflation, as was the case in 2000 (Figure 4). The inflation rate (CPI) came down from 25.8% in 2000 to 6.1% in 2001.

Figure 4. Monetary Base and Price Developments

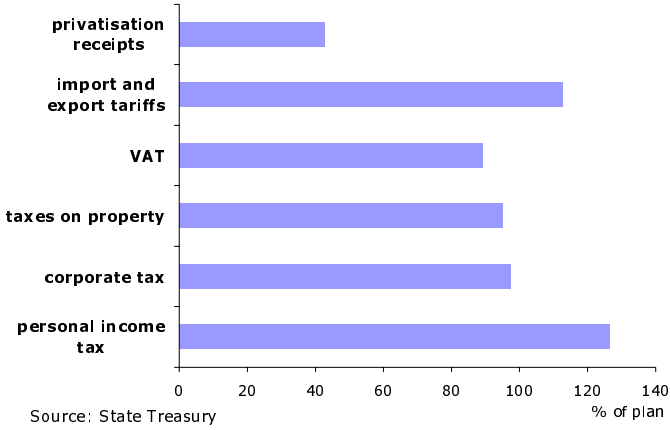


Source: State Committee of Statistics, National Bank of Ukraine

Low fiscal deficit - According to preliminary figures, the consolidated fiscal deficit amounted to 0.5% of GDP in 2001. Thus, the goal of a zero budget deficit was almost achieved. But behind this apparent success lie a number of

serious fiscal problems. In spite of higher than expected economic growth, corporate income revenues were under-executed, partly because of significant tax write-offs and restructuring. VAT revenues were also under-performing, despite a considerable build-up of state debt to exporters and other enterprises for VAT refunding. Privatisation receipts were also significantly under-performing. These shortfalls were partially compensated by a considerable over-execution of personal income taxes as well as import and export tariffs (Figure 5).

Figure 5. Consolidated Budget Execution in 2001



Source: State Treasury

Macroeconomic Outlook

Economic growth - The Ukrainian economy is expected to significantly slow down in 2002. The government forecast of 6% used in the budget 2002 should be seen as optimistic. One major factor in the slowdown will be the recession in the world economy. In particular, the expected slowdown in the Russian economy, which takes 23% of Ukrainian exports, might negatively affect growth in Ukraine.

Turning to internal factors, structural reforms slowed down in the second half of 2001 and are not expected to increase significantly in the first half of 2002. A further bottleneck for economic growth is the rather poor state of infrastructure in Ukraine. A substantial inflow of FDI into this sector would facilitate sustainable growth in Ukraine. But the low level of financial intermediation by commercial banks also remains a brake on further economic growth.

The first signs of a slowdown of the Ukrainian economy have already appeared. In January 2002, economic growth and industrial output decelerated to 3.2% and 1.7%, respectively. The Ukrainian policy makers are well advised to resume reforms as soon as possible. Especially they should ensure investment in infrastructure and further growth in financial intermediation by commercial banks.

External position - The maintenance of external stability should be a major priority for Ukrainian economic policy. For this purpose, a number of measures should be taken.

Exports constituted about 57% of GDP in 2001 and were by far the main source of foreign exchange in Ukraine. The stability of exports is crucial for growth and for the external stability of the country. Unfortunately, Ukrainian exports are quite sensitive to trade disputes: metallurgy accounts for 41% and agriculture for 11% of exports. Thus, Ukraine should strive to defend itself in case of trade conflicts. The most urgent step in that direction is to become a member of the World Trade Organisation (WTO). In the medium-run, building a more solid institutional basis for the economic relationship with the European Union should be a major goal.

The role of the National Bank in maintaining external stability has to be emphasized. At present, lacking sufficient capital inflows, current account surpluses are necessary to service the foreign debt of the country. Thus, the NBU should avoid an unsustainable real appreciation of the Hrivna, which would in turn hurt net exports. It should be noted that the positive effect of a real devaluation on the trade balance only shows up after two to three quarters.

Inflation - The annual inflation rate (CPI) in January 2002 was 5.6%. Thus, the decelaration of inflation of 2001 seems to continue. For a projection of price development this year, several factors should be taken into account.

On the one hand, the net purchases of foreign exchange by the National Bank should be significantly lower this year than in 2001. As a consequence, the National Bank will be in a better position to control money creation and keep inflation at a low level. On the other hand, the expected slowdown in economic activity and in the speed of monetisation means that the inflationary pressure of a given money expansion will be that much more intense. Furthermore, some administered prices, such as community services, are expected to rise. The net effect of all these factors should be slightly inflationary. But as long as the inflation rate remains in the single digit realm, its negative effects on the economy will not be significant.

This projection for the inflation rate assumes, that the Finance Ministry fully complies with its financial obligations vis-a-vis the National Bank. Should this assumption turn out to be wrong, than a significant increase in money supply and inflation would result. Keeping inflation low is a joint task of the National Bank and the Finance Ministry.

Public finance - Public finance remains the most critical aspect of Ukrainian policy. There are many potential reasons for a considerable rise in the public deficit. The rather optimistic forecast of 6% real growth used in the budget 2002 is one major risk for lower than expected revenues. Furthermore, the continuation of tax write-offs and restructuring could make public finance less transparent, intensify rent-seeking activities, and reduce the ability of the government to execute planned revenues. The extension of the state subsidisation of enterprises, including the experiment in the ore mining and metallurgy complex, is also a serious threat for the fiscal soundness. The same applies to the extension of social privileges in the 2002 budget.

A failure to privatise Ukrtelecom and the energy distributing companies (oblenergos) would not only have a negative impact on investment and growth, but also on public finances. Thus, a successful and speedy privatisation of these enterprises should be a political priority for this year. Also the problem of VAT refunding should be solved fairly and quickly.

Conclusions

The performance of the Ukrainian economy in 2001 was positive, combining high growth, external stability, low inflation and low fiscal deficit. But the inability of the central government to meet several revenue targets in spite of a much higher than expected economic growth revealed significant structural problems in fiscal policy. These problems will become more apparent in 2002, because of the expected slowdown in economic activity. A solution to these problems is urgently needed. A substantial fiscal deficit would put an end to the combination of internal and external stability, enjoyed by Ukraine for the last two years. We are confident that a workable solution can be found, with the government setting and sticking to realistic targets.

INVESTMENT PROSPECTS IN UKRAINE

Lorenzo Figliuoli and Maxim Kryshko[*]

Overview

Investment in Ukraine is projected to be an important factor in both short-term growth in 2002 and of sustained long-term growth over the next five years.

In the last few years, investment prospects have indisputably improved. In real terms, gross investment grew 14.4 % in 2000 and 17.2 % in 2001. This recent positive investment growth, however, may be insufficient to expand the capital stock of the economy.

The reasons behind this shortcoming are clear. Despite the fact that capacity usage in the Ukrainian industry is well below 100 %:

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

Sources of Investment

In 2001, investment activity exhibited positive real growth almost everywhere in Ukraine, with the cities of Kiev, Sumy, the region of Odessa, and most of the Western Ukrainian regions (Volyn', Zakarpattya, Rivne, Chernivtsi) being the leaders. However, this incipient geographical diversification remained modest

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in absolute terms. Total investment remained heavily concentrated in the traditional industrial areas (including the city of Kiev). Indeed, around 40 % of investment spending is concentrated chiefly in Kiev and two major industrial cities (Donetsk and Dniepropetrovsk). Specifically, the city of Kiev attracted about 18 % 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 realised in 2001 was financed by own funds of the enterprises, although this source of funds has gradually diminished 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 % of the total in 2001. This trend follows from the greater magnetisation of the Ukrainian economy, introduction of market forces in the agricultural sector, and the reduction of barter trade in economic transactions. In line with recent levels, about 11 % of investments were 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 %), manufacturing industry (19.8 % - mostly, food and metals), extracting industry (15%), and residential construction (14%).

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, compared with that in 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 promotes technological spillovers and helps enhance management practices throughout the economy. The recent privatisation of the first batch of oblenergos in April 2001 is a positive step in this direction.

Positive Developments

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

- The exchange rate of the Hryvna remained stable throughout 2001. This development consolidated market expectations and, against the backdrop of continuing growth and improved

consumer confidence, 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 report of Moody's for the year 2001 sent promising signals to investors by acknowledging the strong positive growth of exports, domestic demand and investment in Ukraine, noting the favourable external debt conditions, as well as commending 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 further enhance the investment climate in Ukraine, and to identify and overcome existing difficulties in this area.

What Needs to be Done?

The elements of progress listed above 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 privatisation** (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) 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 minimise 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 centre of the future co-operation between the Fund and the authorities.

INVESTMENT AND COMPETITIVENESS: A STRATEGIC MANAGEMENT PERSPECTIVE FOR UKRAINE

Ulrich F. W. Ernst[*]

Introduction

Ukraine's economic resurgence over the last two years has been accompanied by some recovery in gross investment. Increased investment levels are critical to continue and expand economic growth. At the same time, gains in investment levels must be accompanied by gains in investment productivity, as measured by value added per unit of capital, or by the economy-wide equivalent of "shareholder value", which describes the ability of assets to generate an income stream over time.

The key to raising investment productivity is the ability to compete in increasingly global markets, both at home and abroad, and to build competitive advantage in key sectors. In fact, the need to innovate constantly in order to achieve and sustain a competitive position is the central challenge to managers of individual companies as well as to local, regional and national economies. Fostering the emergence of competitive firms and sectors is becoming a key challenge of structural economic policy. This challenge is universal, but assumes even greater importance in countries that are not performing up to their real potential. For Ukraine, a Presidential Edict (19 November 2001) has underlined this crucial role of competitiveness as a guiding principle for economic development policies.

I argue here that the most effective approach to designing and implementing investment policies to help companies, sectors and clusters build competitive

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advantage draws on strategic management principles. Reduced to basic principles, strategic management (unfortunately in many respects a "buzzword," which again should not detract from its importance) defines a systematic approach to articulating and pursuing goals or directions when many stakeholders are involved. It emphasises participation by all stakeholders in establishing goals and priorities, in defining measurable objectives and benchmarks, in forging a strategy and mobilising needed resources to reach these objectives, in carrying out the activities, and in monitoring achievements and revising and adjusting goals, objectives and strategic activities as needed. In the present context, the goal is of course an improved investment climate and a more competitive Ukrainian economy, with objectives and benchmarks being defined in terms of both "hard" (observations) and "soft" (perceptions) indicators.

Levels of Competitiveness

Many observers, including Michael Porter and Paul Krugman, have pointed out that only firms, not nations, compete.[1] Ultimately, it is up to the management of each firm to ensure competitiveness and gain competitive advantage through continuing innovation. However, success in the quest for competitive performance depends also on forces in the firm's environment. Understanding competitiveness at the firm, or micro level, therefore requires a broader view, taking into consideration both economy-wide factors at the macro level, and forces that shape the firm's immediate environment at the intermediate, or meso level.

A firm forms part of a value chain. For example, the food processing value chain includes soil preparation, cultivation, harvest, post-harvest handling (storage and transport), processing, packaging, marketing, and consumption.[2] Even "vertically integrated" operations usually link into other activities, for example, through their use of social or physical infrastructure services, How successful individual firms are in achieving competitive performance depends, therefore, not only on their own ability to innovate, but also on the performance of both upstream and

1. Even so, Porter's work actually seems to assign greater weight to country competitiveness, thereby blurring this distinction. His 1990 book on the determinants of the competitive performance of industry clusters is entitled *The competitive advantage of nations (emphasis added)*; he also has taken a leading role in ranking the competitiveness of countries in the Global competitiveness report issued by the World Economic Forum.

2. In most industries, the value chain should also include the post-consumer phase, that is, disposal or recycling.

downstream links of their respective chains. These linkages, which are not captured in the traditional concept of an economic sector, have become a major focus of development policies in many countries. The industrial clusters defined by these linkages are critical to understanding and promoting competitiveness and building competitive advantage in an economy.

Both the macro and meso level perspectives on competitiveness are critical to effective policies to promote growth and development. At the macro level, policies focus on the creation of an attractive investment climate, especially for small and medium-sized enterprises, to spur innovation and competitive performance. At the meso level, focused policies and effective private-public sector partnerships promote innovation and facilitate competitive performance.

Macro Level: The Investment Climate

While there may be agreement at one level that firms, not nations, compete, there appears to be a growing interest in assessing the competitiveness of countries. Several sources are compiling country rankings or "benchmarkings" on the basis of indicators that describe the investment climate and the competitive performance of the economy as a whole. These rankings can be of great help to the policy maker, since they in effect provide a ready tool for the strategic management approach to investment and competitiveness policies. These rankings, and in particular the indicators they use, can be used for:

- Tracking the position of the country vis-à-vis competitors: it is important to know where the country is seen in a global context, even if there is disagreement about some of the measures – in particular any "soft" criteria or perceptions;

- Setting priorities: by understanding the relative strengths and weaknesses of the country's investment climate, as seen by outsiders, better targeting of policies can leverage strengths and mitigate weaknesses more effectively;

- Keeping score: using indicators related to country competitiveness rankings, it becomes easier to assess the effectiveness of policy initiatives in improving the overall investment climate;

- Making the case: understanding the perceived strengths and weaknesses of the country as seen by outsiders can provide valuable guidance in designing more effective outreach and information strategies.

The attempts to compare macro level competitiveness across countries – competitiveness competitions – include initiatives like the World Competitiveness Yearbook (WCY) or the Global Competitiveness Report of the World Economic Forum (WEF). The WCY, for example, uses 286 criteria (118 "hard" criteria used in rankings, 62 "hard" criteria used for background information, and 106 criteria from survey data) to rank 49 countries, including 30 OECD members and 19 newly emerging and transition economies. The rankings do not include Ukraine.

The competitiveness factors comprise several groups: economic performance (68 criteria), government efficiency (84), business efficiency (60), and infrastructure (74). The Global Competitiveness Report covers a broader range of countries (75 in its 2001 edition), including Ukraine (ranked No. 69 in growth competitiveness and No. 60 in current competitiveness for the year 2000). Table 1 shows these rankings for the 75 countries included in the Global Competitiveness Report. Other studies have used smaller sets of criteria to establish competitiveness benchmarks for a range of countries.

A related example are the international business environment rankings carried out by the Economist Intelligence Unit (EIU), using a model that "seeks to measure the quality or attractiveness of the business environment and its key components by using quantitative data, business surveys and expert assessments. The EIU used this model recently to assess business environments in 27 transition economies, including Ukraine, both retrospectively for the period 1996-2000, and prospectively for the period 2001-2005. The prospective ratings served as a basis for projecting foreign direct investment (FDI) inflows.

As it turns out, while the rankings for Ukraine are somewhat sobering, there is some encouraging news: the country occupies only rank 19 (out of 27) for the period 2001-2005, but it shows the best relative improvement in the EIU's business environment score from 1996-2000, after the special case of the Federal Republic of Yugoslavia. This relative improvement is projected to raise foreign direct investment from a paltry $12 per capita for 1996-2000 to $21 for 2001-2005, which amounts to less than 20 % of the projected average for the 27 countries. In fact, only the Kyrgyz Republic, Tajikistan and Uzbekistan are projected to have lower per-capita FDI over the period 2001-2005 than Ukraine.

Table 1: Country rankings by growth competitiveness (GCI) and current competitiveness (CCI)

	GCI ranking	CCI ranking		GCI ranking	CCI ranking
Finland	1	1	China	39	47
United States	2	2	Slovak Republic	40	39
Canada	3	11	Poland	41	41
Singapore	4	10	Mexico	42	51
Australia	5	9	Lithuania	43	49
Norway	6	19	Brazil	44	30
Taiwan	7	21	Jordan	45	44
Netherlands	8	3	Uruguay	46	46
Sweden	9	6	Latvia	47	42
New Zealand	10	20	Philippines	48	54
Ireland	11	22	Argentina	49	53
United Kingdom	12	7	Dominican Republic	50	59
Hong Kong SAR	13	18	Egypt	51	45
Denmark	14	8	Jamaica	52	40
Switzerland	15	5	Panama	53	48
Iceland	16	16	Turkey	54	33
Germany	17	4	Peru	55	63
Austria	18	13	Romania	56	61
Belgium	19	14	India	57	36
France	20	12	El Salvador	58	64
Japan	21	15	Bulgaria	59	68
Spain	22	23	Vietnam	60	62
Korea	23	28	Sri Lanka	61	57
Israel	24	17	Venezuela	62	66
Portugal	25	31	Russia	63	58
Italy	26	24	Indonesia	64	55
Chile	27	29	Colombia	65	56
Hungary	28	26	Guatemala	66	69
Estonia	29	27	Bolivia	67	75
Malaysia	30	37	Ecuador	68	72
Slovenia	31	32	Ukraine	69	60
Mauritius	32	52	Honduras	70	74
Thailand	33	38	Bangladesh	71	73
South Africa	34	25	Paraguay	72	70
Costa Rica	35	50	Nicaragua	73	71
Greece	36	43	Nigeria	74	67
Czech Republic	37	35	Zimbabwe	75	65
Trinidad and Tobago	38	34			

Source: Global Competitiveness Report 2001. The GCI is a combination of “hard” and “soft” (perceptions from a survey of 4,600 executives in 75 countries) criteria; the CCI is based entirely on the survey of perceptions.

Table 2: EIU ratings of business environment

	2001-05	1996-2000	% change
Estonia	7.40	6.86	7.9%
Hungary	7.26	6.42	13.1%
Poland	7.07	6.22	13.7%
Czech Republic	7.01	6.18	13.4%
Slovenia	6.96	6.08	14.5%
Lithuania	6.95	5.74	21.1%
Latvia	6.88	5.87	17.2%
Slovakia	6.57	5.46	20.3%
Croatia	6.33	5.23	21.0%
Bulgaria	5.94	4.03	47.4%
Kazakhstan	5.59	4.30	30.0%
Russia	5.49	4.12	33.3%
Armenia	5.34	4.50	18.7%
Azerbaijan	5.28	4.35	21.4%
Romania	5.24	4.10	27.8%
Yugoslavia, FR	5.23	2.79	87.5%
Macedonia	5.21	4.47	16.6%
Albania	5.09	4.01	26.9%
Ukraine	4.95	3.27	51.4%
Georgia	4.87	4.01	21.4%
Moldova	4.78	4.04	18.3%
Kyrgyz Republic	4.77	3.75	27.2%
Bosnia & Herzegovina	4.66	3.98	17.1%
Belarus	4.16	3.91	6.4%
Tajikistan	3.55	2.81	26.3%
Turkmenistan	3.46	3.05	13.4%
Uzbekistan	3.18	2.80	13.6%

Source: Economist Intelligence Unit, as reported in Transition, Oct/Nov/Dec 2001.

A SWOT Analysis for Competitiveness Rankings

Overall country rankings on competitiveness show average scores across a wide range of indicators. By digging a little deeper to understand the makeup of overall competitiveness rankings, Ukrainian policy makers can develop a better sense of policies priorities. In a strategic management context, the data on the country's relative position for the different indicators used provide a basis for an analysis of strengths, weaknesses, opportunities and threats (SWOT).

In addition to the overall rankings in terms of current and growth competitiveness, the Global Competitiveness Report presents component

indices that summarise subsets of indicators. Its growth competitiveness index incorporates indices for technology, public institutions and the macroeconomic environment. Not surprisingly, Ukraine is doing better on the technology index, where it ranks 63rd, than on public institutions or macroeconomic environment, where it ranks 71st and 73rd, respectively, producing the overall rank of 69th.[1] It is likely that the gains in overall economic performance in 2001 would improve rankings with respect to macroeconomic environment. In the case of the current competitiveness index, the two component indices reported, "company operations and strategy" and "quality of the national business environment," are close together for a 62nd and 60th rank, respectively, yielding an overall rank of 60th.

In a very basic sense, policy priorities aim at building on strengths and mitigating weaknesses. But policies also need to take into account specific opportunities and threats. With respect to threats, the fact that Ukraine ranks significantly higher on current competitiveness than on growth competitiveness raises concerns for the future.

Disaggregating the more favourable score in the area of technology, for example, shows more specific threats that can undermine future performance. Ukraine ranks relatively high on measures such as the level of new technology development, quality of research institutions and their activities, and quality of exact science education. However, it scores low on factors shaping prospects for building on these strengths, such as the extent of the "brain drain," procedures for licensing new technologies, level of intellectual property protection, or potential for investing in education and research activities. For example, any strategy stressing technological innovation as a key to growth places a premium on effectively protecting intellectual property rights – aside from obligations under, say, WTO accession standards.

Conversely, the individual indicators can also serve as a guide for identifying or clarifying opportunities. Real gains in terms of building competitive advantage in Ukraine's economy require a clear sense of priorities, both with respect to macro level measures and with respect to industrial clusters or value chains. Obviously, clusters that take advantage of strengths (and are capable of reinforcing those strengths) or are less affected by particular weaknesses in the business environment should become a particular focus of strategic management approaches to improving investment climate and performance.

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1. Differences in component indices can be even more pronounced. Korea, for example, ranks 9th in technology and 8th with respect to the macroeconomic environment, but 44th for its public institutions, for an overall rank of 23rd.

Strategic Elements

An effective competitiveness strategy needs to combine macro-level efforts to improve the investment climate with initiatives aimed at building competitiveness in key industrial clusters. Efforts at the macro level can draw on the types of country competitiveness rankings discussed as both a handy scorecard for monitoring and a tool for strategic analysis. Complementing these with cluster-oriented development policies demands new tools for analysis and innovative approaches to economic policy making that cross traditional sectoral and administrative boundaries. The concept of an industrial cluster is central to such approaches.

The intellectual roots of the industrial cluster concept extend across several academic disciplines. Business economics, especially Michael Porter's work, has stressed that local factors matter greatly in establishing and maintaining competitive advantage in the global economy. Geographic proximity of competitors and complementors remains an important element. Mainstream economics has contributed a new body of growth theory built around models of increasing returns. Paul Krugman's work on trade and geography has highlighted the importance of economic clustering as a source of increasing returns. Related econometric studies have shown that innovative activity tends to cluster as a result of knowledge spillovers.

Regional science has of course long been interested in clusters as networks of innovation, as evidenced by the growth pole literature of the 1960s and 1970s. This interest has been rekindled by the recent industrial district literature — to some extent harking back to Marshall's analysis of industrial districts in 1890 - which focused initially on Italy and then on many other countries in Europe and elsewhere. Finally, the literature concerned with technological development has focused not only on the individual firm, but has also stressed the importance of interactions with customers, complementors (suppliers) and competitors, where competition does not exclude strategic, tactical or incidental co-operation. Both innovation and diffusion depend on networks of institutions that often define regional systems.

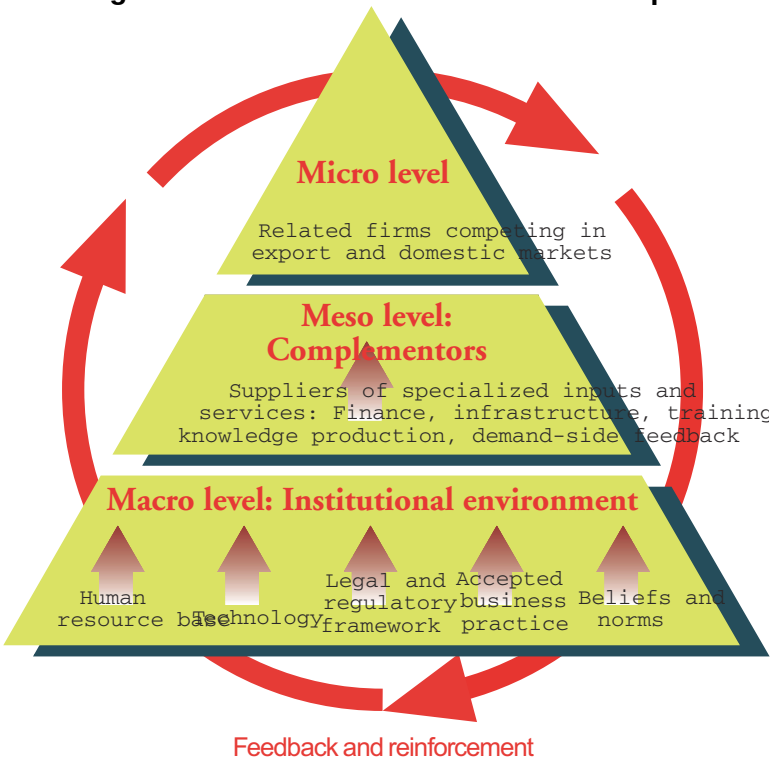
While geographic proximity matters because it facilitates both cooperation and competition, cluster-based policies operate at different levels. A 1998 OECD report summarising the experience with cluster-based policies focuses on the role of clusters as mechanisms of innovation and knowledge mobilisation:

> … networks of production of strongly interdependent firms (including specialised suppliers), knowledge producing agents (universities, research institutes, engineering companies), bridging institutions (brokers, consultants)

and customers, linked to each other in a value adding production chain. The cluster approach focuses on the linkages and interdependence between actors in the network of production when producing products and services and creating innovations.[1]

Figure 1 illustrates the concept of a cluster, with a focus on the regional dimension, and stressing exports. “Leading firms,” however, can also compete in domestic markets with imports.

Figure 1: Illustration of the cluster concept[2]



1. Roelandt, Theo J.A. and Pim den Hertog (eds.), *Cluster analysis and cluster-based policy in OECD-countries. Various approaches, early results and policy implications*. The Hague/Utrecht, May 1998, p. 5.

2. This illustration borrows from a similar pyramid focusing on regional clusters copyrighted by the Economic Competitiveness Group.

The experience of OECD countries and others with cluster-based policies demonstrates that these approaches can successfully target increased competitiveness at different levels of aggregation. Countries in Europe, for example, have pursued policies that revolve around "mega clusters" like services (Netherlands) or forestry and telecommunications (Finland). At the same time, local and regional institutions have adopted cluster-based approaches to promote regional development.

Whatever the scale, successful cluster-based policies share certain features. The most important element is the creation of a focused public-private partnership. Such a partnership, in whatever institutional form, needs to work diligently to understand both strengths and weaknesses in the respective value chain, and to commit to a joint strategy to leverage strengths and address weaknesses. Such a public-private partnership has to transcend the traditional thinking of seeking advantages for a particular sector through direct and indirect subsidies. For the government, cluster-oriented competitiveness policies are not designed to achieve artificial and transitory cost advantages, but to complement efforts by the private sector to improve performance in key markets. Such policies focus on improving social capital and physical infrastructure in ways that support a clearly articulated strategy for building competitive advantage.

A focus on industrial clusters also provides specific strategic guidance across the full range of policy making. For example, it can serve to build a sound strategic context for privatisation policies, initiating a shift away from the traditional focus on individual transactions. Cluster-based approaches would view the enterprise to be privatised in the context of the value chain(s) to which it belongs, and formulate strategies accordingly.

Finally, cluster-based approaches need to be understood as real alternatives to traditional industrial policies. Their basic rationale is to complement special efforts and initiatives in flexible and coherent manner. Adopting such policies recognises both the dismal track record of governments in betting on industrial winners, and the need for clear criteria in making choices. Government policies simply cannot be neutral with respect to their impact on industrial (and geographic) clusters. Not making choices is therefore making choices – with unintended consequences.[1]

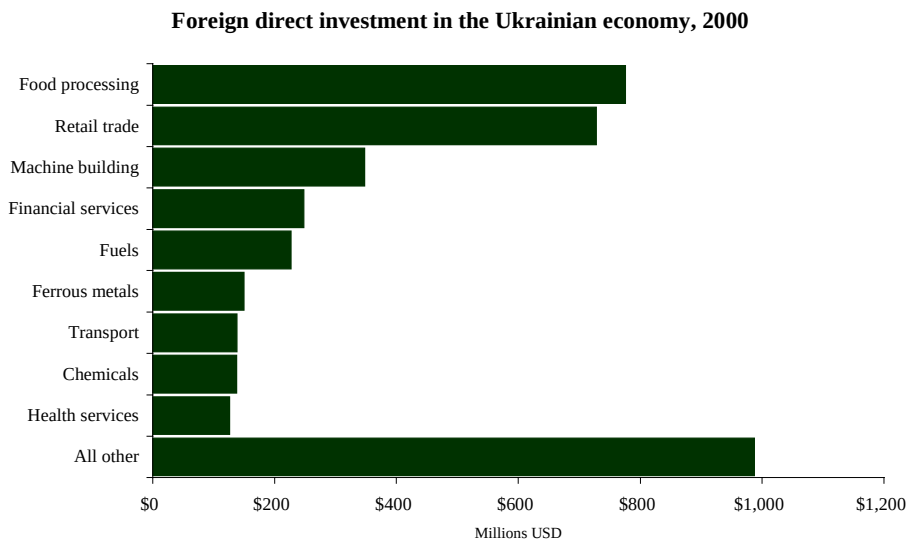
1. Michael Fairbanks and Stace Lindsay, *Plowing the sea*. Boston, 1997.

Cluster Criteria

The selection of industrial clusters as focal points for development policies is a complex process. Ultimately, it needs to be demand-driven, if it is to be an effective public-private partnership, but both intuition and analytical approaches can provide some direction. Intuition, based on a general knowledge of the economy and investment and performance trends, can be valuable. For example, in the case of Ukraine, virtually anyone familiar with economic trends and prospects is likely to cite the food processing cluster as a likely candidate for cluster-based development policies. Both investment trends, in particular foreign direct investment, and relative performance in terms of output growth patterns, provide some support for this view. But these points should be seen as strictly indicative. There are many factors that have shaped the performance of this cluster, including levels of protection inconsistent with an open economy. For articulating an effective strategy, the notion of food processing as a mega cluster will need to be broken down further to focus on individual value chains.

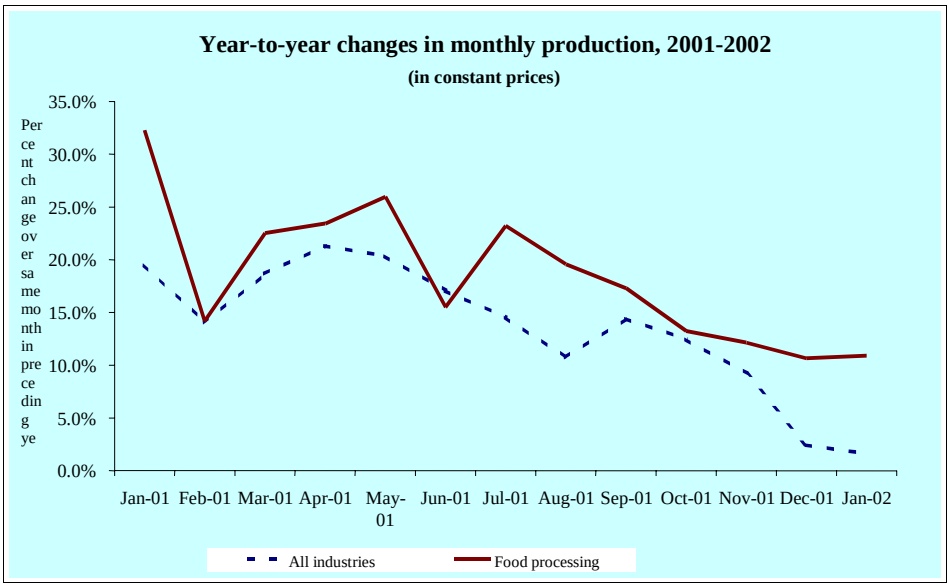
Other sectors generally thought to have competitive potential include pharmaceuticals, information technology and software development, and tourism. These indications may warrant further exploration, especially a more intense dialogue with the private sector, to gauge the suitability of these clusters as focal points for development policy.

Figure 2: Food processing is the prime target for FDI …



A more systematic approach to the initial assessment of competitive potential focuses on prospects in export markets. It is encapsulated in the "competitive analysis of nations (CAN)" method developed by the UN Economic Commission for Latin America and the World Bank. The method involves an adaptation of the venerable market positions analysis matrix (the "Boston matrix"), which combines market growth rate and relative market share (relative to the largest competitor) to define opportunities and threats. The CAN looks at the growth rate for various products in key export markets and links it to such measures as the exporting industry's growth in market share. Applying a variant of this approach to the relative performance of Ukrainian exports to the European Union, for example, suggests additional clusters for further exploration, such as wood products or leather goods.

Figure 3: … and it outperformed other industries



Source: State Statistics Committee

Outlook

While the competitiveness challenge looms large, a careful assessment of the situation and prospects at both the macro and the meso level can help in identifying priorities. A clear sense of priorities as the basis for building consensus is the precondition for a strategic management approach to improving Ukraine's investment climate and building competitive advantage in the economy.

To be effective, a strategy involves choices, especially in a complex environment like the Ukrainian economy. The SWOT analysis of Ukraine's relative position on the basis of competitiveness rankings, in terms of both statistical descriptors and perceptions in the global business community, can provide a useful perspective in this process. A dispassionate assessment of the strengths and weaknesses in the country's investment climate is needed to answer the question of what to do first. Improving the investment climate across the board will take time. A focused approach built around selected clusters that offer competitive opportunities and can demonstrate the real commitment of the private sector can yield real achievements within a shorter timeframe, and thereby send a powerful message to the international investors community.

TWO YEARS OF ECONOMIC GROWTH: MORE QUESTIONS THAN ANSWERS

Alexander Paskhaver[*]

Are the Recent Two-Year Economic Growth Statistics Realistic?

There has undoubtedly been some growth in Ukraine's economy.However, I would advise some caution and care in analysing the quality and size of growth estimates.

Value and Physical Volume Growth

On the basis of the government's 2001 Statistical Bulletin, growth rate of the value and physical volumes of the most important products in six industrial sectors (the share of which in the overall industrial production amounts to 60 %) have been compiled in a simplistic manner. On the basis of rough estimates, in four out of six sectors (i.e. food industry, textile/apparel, chemistry and metallurgy) value and physical volume growth rate estimates were quite close. In two sectors, the scenario was as follows: as regards extraction of fuels, increment of production in comparable prices of 2001/2000 was 4.8%; in physical volumes (simple average for coal, gas, oil) it was 0.3%. Building materials, respectively, 11.4% – in value and –1% in physical volumes (simple average of increment for 9 products).

It should be emphasised that these are rough and ready estimates . However, it might be useful for the government to have a more precise assessment and check the accuracy of physical volume part of its value indicators, as well as comparable prices and computation procedures.

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* Center for Economic Development, Kiev.

Real Growth or Getting out of the "Shade"

First comparison: More than 15% of GDP growth over the recent two years was achieved without any increment of the production of electricity (1999 – 172.1 billion kW/ hour; 2001 – 172 billion kW/hour). Data on energy consumption is available only for 2000. With 5.9 % growth of GDP, electricity consumption has reduced by 1.5 %, or in broader terms consumption of all energy resources for production needs to be reduced by 1.4 %.

Second comparison: 29 % growth of industrial production over a two- year period and almost 21% growth of agricultural production have resulted in a mere 2.6% increase in freight-ton-miles.

Third comparison: The only available data refers to 2000: 6% GDP growth occurred accompanied by a decrease of employment by 0.5 million people or by 2.3%; in industry, 13.2% growth coincided with a decrease of employment by 0.4 million people or by 6.8%.

It goes without saying that the squeezing of the "shadow" economy will result in a growth of the legal economy. But the question is whether the economic behaviour in the coming years could be forecast if implications of this process are not accounted for properly. Does the government consider this factor and if yes, then in what way?

Similar questions could be raised with regard to the data on domestic market growth and population income. The changes in the value need to be monitored via indirect indicators of physical volume.

Internal Reserves or New Capacities

Has there been any real structural reform going on over the last couple of years? The answer is yes, if the judgement is to be made using the striking difference in the growth rates in extraction and various processing industries.

If the judgement is to be made on the basis of the indicators of production capacities upgrading, then this data is not all that clear. On the one hand, investments have been channelled into production. Moreover, capital investment growth rate over the last two years has been 2.2 times higher than the GDP growth rate. They basically went into reconstruction. The share of capital investments into the new enterprises declined from 53.9% in 1985 down to 24.4% in 2000, in other words, they experienced a twofold decrease.

On the other hand, disposal and PP&E upgrading ratios in 2000 were 2.5 times lower than in 1991 although 1991, as we remember, was far from being a year of aggressive reconstruction.

Non-Capital Factors

Considering a lag between the time when the capital is invested and when the impact of these investments could be experienced, accretion to the capital investments works to a considerable measure for the future. Real economic growth during last two years seems to be rooted mainly in the low capital intensive factors of an adaptive nature. Primarily, it is the adaptation of the population as a whole, businesses and managers to the new social and economic roles. For the social indicators (such as mortality including that caused by unnatural reasons), life expectancy, crime, relative number of day time students, and so on) 1995 was crucial; for economic indicators they were years 1997-1998, when plummeting of the most important of them was rapidly terminated.

It should be emphasized that it is not the reality that changed, just the opposite is the case: red tape was continuously increasing its pressure on the business community. However, there was nothing unusual about the situation, and a new pattern of behaviour has consequently been elaborated. After two or three years of mass and small-scale privatisation following year 1998, the new owners have begun seeking new markets, modifying their products, and better organising their businesses. These improvements also coincided with a number of favourable external circumstances, which contributed to the overall economic growth.

It is natural that non-capital factors of growth come into play prior to the significant investments being made and this way stimulate them.

However, these adaptation factors will very soon deteriorate unless new and strong signals – incentives are sent by the government. The latter should regularly produce such stimulating signals for the economy, for instance, by tightening tax burden, protecting ownership rights, and enhancing deregulation. A strategy of the signals' optimal sequence and their concentration has to be developed.

Need for Strong Signals-Incentives from the Government

One such signal is, in my opinion, of the utmost importance. I am talking about unpredictability of what the government is doing in the economy. It means that

under identical business situations one could expect that the government could make different decisions, which are impossible to predict. I would dare to pronounce a provocative thesis: predictable corruption is acceptable in business, unpredictable corruption will paralyse it. Doesn't it explain the uniqueness of this very situation when foreign capital does not flow into the fast growing economy?

Ill-thought, so-called "exclusive" interference into the business processes not only reduces the flow of investments; all operating capital will also depreciate as a consequence of the growing risks.

Consistent adherence of the government to the rules it has once established and, consequently, reduction of political risks paving the way to the greater values of national wealth (which from the economic perspective is on par with its accumulation), these are the issues to be addressed. Circulation of more costly components of the national wealth such as means of production, land, mineral resources, housing will immediately lead to higher incomes of all subjects of economic activities. A rent component of taxes will also grow allowing for less pressure on the income and labour. Reduction of political risks appears to be a one-time resource we are crying for in Ukraine.

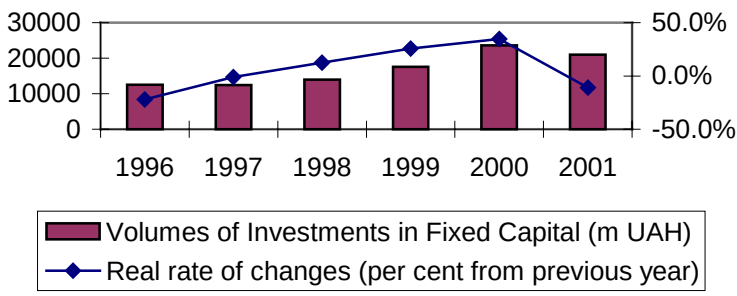
LATEST IMPROVEMENTS IN THE INVESTMENT ENVIRONMENT AND SOME VIEWS ON THE NEED FOR REGIONAL MONITORING OF THE INVESTMENT CLIMATE

Todor Balabanov[*]

Macroeconomic Considerations Relevant to the Investment Environment

It has been frequently said that if the domestic investments are low then the country cannot expect foreigners to put their money in the economy. Figure 1 depicts both a substantial growth rate of the domestic investment in long term assets and the volume of investment. Over the last three years domestically generated investment reached $ 14 billion or more than three times total Foreign Direct Investment (FDI) of $ 4.2 billion.

Figure 1. Investment in long term assets and their growth rates



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

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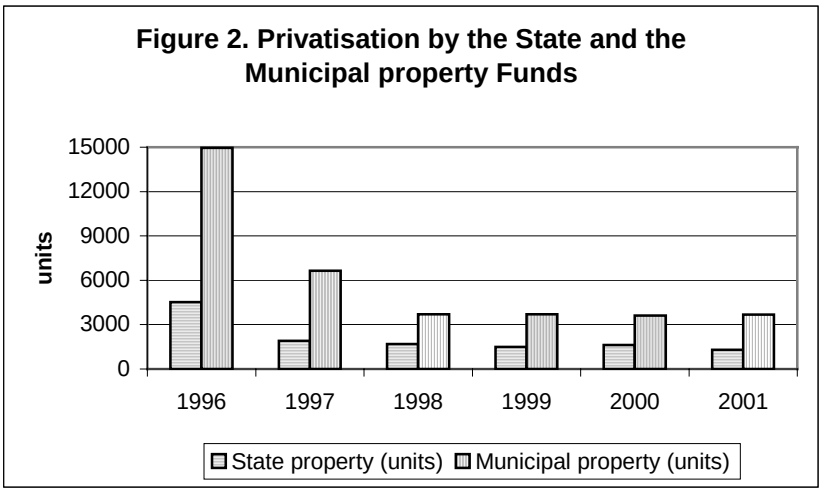
* Institute for Advanced Studies, Austria. This paper benefited from the inputs and comment provided by the Ukrainian Embassy in Vienna. Kevin J. Daly from Standart&Poor‘s kindly permitted to use the latest credit rating analysis for this presentation.

Another favourable indicator is the steady pace of privatisation by the State and Municipal Property Funds. After the initial outburst of privatisation activities in 1996 and 1997 the level of the privatised units by both Funds stabilised during 1998-2001.



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

Other positive trends can be seen in Figure 3, namely, for the last two years GDP was increasing at the rate of 6% to 9% per year and the state budget showed surpluses for the two subsequent years.

To illustrate the sources of growth: for the period January-November 2001 industrial production increased by 16.1 % (by 12.2 % in 2000), including processing industry – by 19.6 %, mining industry – by 4.1 %, production and distribution of electric power, gas and water – by 2.4 %. The volumes of production of processing industry comprised 72.8 % 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 %); wood and timber (by 25.9 %); engineering (by 21.7 %); pulp and paper industry, and printing and publishing (by 20.5 %).

Certainly the restrictive budgetary policy exacts a price, namely, arrears and non payments, e.g., the biggest share of debit indebtedness falls on enterprises of collective (54.7 %) and state (except municipal) (37.9 %) property forms as well as the biggest share of credit indebtedness – 57.7 % and 34.6 % respectively. As per November 2001 the arrears of payments remain significant: the total share of delayed debit indebtedness made up 41 %, credit indebtedness – 40.5 %.

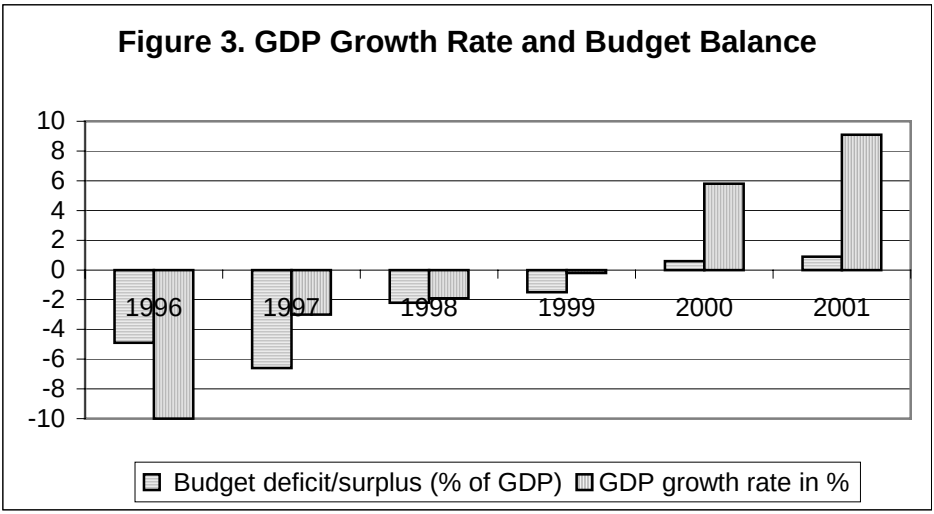
On a positive note the stability of the country's currency the Hrivna (UAH) has been demonstrated by UAH´s improving position at the currency markets – now one US dollar buys 5.3 UAH – the lowest level since several months, namely, the UAH has achieved stability in nominal terms.

Inflation was also very low: for the period January - November 2001 the CPI was at 103.9 % while for the 2000 the CPI was 123.3 %.

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 legislated Tax Code.

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



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

There is also dynamism in Foreign Economic Activities, e.g., for the first 10 months of 2001 the turnover of goods and services increased by 12.2% compared with 10 months of last year and reached $ 26.8 billion. Exports of goods and services increased by 11.8 % (18.9 % last year) and imports increased by 12.6 % (21.1 % last year).

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

Foreign Direct Investment

By the end of October 2001, total volume of direct foreign investment in Ukraine amounted to $ 4.194 billion, that is $ 85 per inhabitant. For the first 10 months of 2001 the total volume of registered FDI amounted to $ 529.4 million, that is by 10 % less than for the year 2000.

Table 1. Principle Source Countries of Foreign Investment

Country	**%**
United States of America	16.8
Cyprus (probably Russian and/or Ukrainian indirect investment)	9.5
The Netherlands	8.8
United Kingdom	8.7
Russian Federation	7
Germany	6.3
Virgin Islands	5.8
Switzerland	4.5
Republic of Korea	4.1
Austria	3.3
Total	71.5 %

Table 2. Sectoral Distribution of Foreign Investment

Sector	**%**
Food processing	19.5
Wholesale and commercial intermediation	14
Engineering	8
Financial activities	8
Transports	7
Chemical and oil industries	5.4
Real estate transactions	4
Oil products and nuclear fuel, production of coke	4
Metallurgy and metal processing	3.9

Ukraine's very strong growth recovery during 2000-2001 will be hard tested in 2002, given the global slowdown, an appreciating 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 aluminium 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 ie to be constrained to 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 prices continue to decline, Russia might be hard pressed to abandon its strong rouble policy, with 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 an impressive growth rate 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. Finances available to farmers tripled in 2001 compared to 2000, reflecting 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 a modest 3 - 4% GDP growth over the next two years has occurred in Ukraine. The contribution of the dynamic private-sector, accounting for about 65% of GDP, has been increasingly important. It is conceivable that less harassment, better taxation administration, and a cut in barter transactions have all helped to reduce the shadow economy (still estimated at about 50%) and brought some Ukrainian capital back into the country.

Over a longer-term, Ukraine's growth potential will crucially depend upon continued reform and its effective implementation. Comprehensive bankruptcy, corporate governance, and securities laws are 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 has also 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 politically supported large bank may be a welcome step.

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 the 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., 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 are being eliminated only very slowly. As a result, the country continues to endure a highly

centralised decision making process and is yet to develop democratic cultural and political institutions.

- Shallow institutional and legal systems, including 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.

Latest developments

Admittedly, the Ukrainian government is very much aware of the shortcomings of the investment climate in the country. In order to ensure a workable 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 introduce a coherent set of measures aimed at further improvement of the investment climate in Ukraine, namely: further deregulate and liberalise 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, rationalise and increase transparency of tax administration procedures, improve and increase the effectiveness of public governance, further strengthen the banking system of Ukraine, encourage implementation of the judicial reform and ensure unconditional execution of court decisions.

The intentions are quite in line with the OECD recommendations but, as is well 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. These 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 the creation of computerised networks to the initial direct financing of courts and judges. This ambitious project tentatively called "Support to the Reform and the Restructuring of the Ukrainian Juridical System and Law Enforcement Agencies" 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, first it makes sense for the Government to approve the proposed Code of Corporate Conduct. 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), should offer a Program of Education tentatively called "Corporate Director" for the Members of the Boards of Directors and the Top Managers. This program should be designed to assist in the transformation of the board of directors into an effective organ of control and governance and, thus, enhance the effectiveness of the operation of the company as a whole. The target groups for training would include: executive/non-executive board members, company managers, representatives of the central and regional authorities in the boards, major shareholders.

Some recommendations

I do believe that the key recommendation should be to establish a permanent monitoring of the main facets of the process of improving the investment environment in Ukraine. This can include monitoring of the Law Enforcement and Corporate Governance practices but also bringing to the public attention regional ratings of these parameters, e.g. in the form of corporate governance indexes.[1]

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1 References: Decree of the President of Ukraine On Measures to Improve the Investment Climate in Ukraine, 12 July 2001, Kyiv; International Trade Club in Ukraine, Information catalogue N 1 (January, 2002), Development of Economy of Ukraine over 11 Months of 2001 and Macroeconomic Indices Forecast for 2001-2002; Basic Indices of Economic and Social Development of Ukraine, State Committee for Statistics, February 2002; Investment Climate in Ukraine, International Trade Club in Ukraine, January 2002.

SEVEN YEARS OF REFORM: WHAT HAVE WE LEARNED?

Serhiy Moskvin[*]

What was written seven years ago:

“ Normal investment activities are impossible without the stock market” - this is the opinion expressed by Serhiy Moskvin, Deputy Head of Foreign Investment Division of Agency for International Co-operation and Investments (“Delovye novosti” May 31, 1994).

The current situation in Ukraine is not favourable for foreign investments, which is in large measure due to economic and political developments in the following fields: political situation, legal guarantees, hard-currency regime, foreign trade regime, taxation, and privatisation.

What is written today:

Currently, assessment by experts of Ukraine’s investment climate is not favourable. According to “Euromoney” magazine analysing investment attractiveness in 169 countries, the degree of risk in capital investments to Ukraine is constantly increasing. As of March 2000 in terms of reliability index Ukraine was in the 149th place, whereas in 1994 it was ranked 122nd.

Senior executives of foreign companies doing business in Ukraine have identified the following factors, which have a negative impact on Ukraine’s investment climate: unstable legislation, corruption, and excessive government’s interference into entrepreneurial activities. Positive changes are

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* National Deputy of Ukraine’s Parliament and President of the Association of Financial Analysts.

as follows: stabilised economy and political situation, improved qualifications of the staff, and development of the private sector.

Why are we the way we are…

Ukrainian enterprises did not experience any competition in the past. Now they are facing competition with the world's leading producers of various goods and services. Most of Ukrainian producers are unable to meet world competition due to the lack of efficiency in the following three areas:

- Technology- it is much easier to export raw materials, have it processed and bring it back as a ready made product instead of setting up the production process in Ukraine;
- Restructuring - a lot of existing production capacity will never be used in the future, and those required to service internal market are absent;
- Management –old organisational structures of enterprises have proved ill-equipped to function in the market environment.

Substantial reduction of domestic production and total drying up of investments in the real economy proved to be a logical consequence of the above-mentioned circumstances. Growth of domestic investments has begun only in 2000.

What we understood:

- Freedom is the price to be paid for investments
- Investments cause redistribution of ownership rights
- Redistribution of ownership rights leads to redistribution of power

Which investor is better: Ukrainian or foreign?

Portfolio foreign investments have a major drawback: in times of financial crises foreign portfolio investors desinvest capital rapidly, leaving domestic investors behind to deal with the problem of the lost money on their own.

Not all foreign investments are genuine foreign investment. Much of it may be Ukrainian capital finding its way back to Ukraine in the guise of foreign capital.

Many domestic investors may be operating in Ukraine's shadow economy. We should not forget the average investor – Ukrainian citizens who are actually hiding their savings. It is the average investor who is able to boost the economy if the government authorities and banking system succeed in winning his/her confidence.

Is all what they say about us is true?

Unstable political situation **-** Ukraine's choice of democracy is the cause of its unstable political situation for several years. An autocratic regime is always more stable and (if there is a wish) it may provide a favourable investment climate. In spite of many obstacles Ukraine has evolved into a State, which in itself is a miracle. Born out of a political compromise Ukraine's Constitution is naturally imperfect. Competition between political forces is a regular phenomenon testifying to competitive environment in politics. Such competition promotes future stability, which is a pre-requisite for economic growth. A strong President, well-structured Parliament and sound Government –all constitute a precondition for political stability.

Business interests of the State and corruption **-** Was a different course of development possible in the new country with primary capital formed on account of cheap resources owned either by the government or some unidentified entities? Officials are not willing to live on miserable salaries when they are in position to exercise control over huge volumes of funds. They are looking for more or less legal means to ensure their children's future. They insure their risks by acquiring more power. Businessmen who started their careers in different types of co-operatives are seeking seats in the Parliament. Bureaucrats used to allocating resources under socialism are founding their own private firms.

The rules of the game were developed by interest groups not on the basis of the world experience. None of the world's countries has experienced this. Foreigners who took the trouble to learn these rules have succeeded. However, things are changing rapidly, and developments should be watched closely. The level of corruption in Ukraine is considerably overstated. And corruption is a consequence of both the supply and demand for bribes.

Lack of legislative clarity about investment conditions **-** Some experts believe that Ukrainian laws are passed by certain outsiders and not by the 450 members of Parliament, each of whom has his/her own opinion on the draft law. Don't forget that ten years ago Ukraine did not have any legislation at all. Creation of a post-socialist economy was something like a *terra incognita*. 1992 saw the

passage of law on foreign investments with special tax privileges granted to joint venture enterprises, which was a drain on the budget and was eventually annulled in 2002.

It is the democratic law making process that poses problems. Mistakes are inevitable. Legislative development is moving ahead. The Law "On the Joint Investment Institutes" and the changes introduced into the system of taxation of corporate and share investment funds have moved funds into tax-free zones.

***Tax rates* -** No one will claim the Ukrainian tax rates are low; but European rates are even higher. Tax rates are not an issue (it is hard to believe that lowering them will make everybody pay the taxes). The core issue is that investments are being taxed according to the Law "On Enterprise Profit Tax". As a result, investments are either not undertaken or are hidden. Progressive taxation scale is applied to natural persons. Salaries are also taxed. For this reason, a lot of them are paid below the counter, and not accounted for in official payrolls. The budget is being enriched by the value-added tax. The conclusion is that tax reform should not center on lowering tax rates and the passage of Tax Code, but rather it should aim at improving the investment climate.

What are we "poor" at doing?

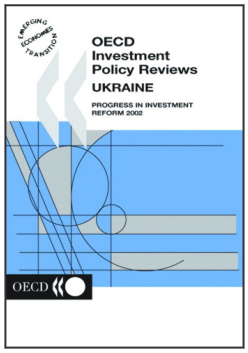
First of all, to attain steady economic growth, domestic investments and savings should reach 17-25% of GDP. Currently, it is 6-9 %. Such a level of investments is a pre-requisite for improving the investment climate. Secondly, Ukraine's economic growth should be fuelled primarily by domestic investments, and foreign investments should only follow the investment activities with domestic capital. Finally, absolute amounts of investment per se do not guarantee successful economic growth. Structure of the economy, investment efficiency, management quality, also play a crucial role.

Laws, decrees, resolutions and instructions may only impact a certain aspect of investment process but they may not induce people invest their money if they are not willing to do so; stimulate domestic investors to enter the open economy and exit from the hidden economy; and teach managers to work if they are not able to do so.

Recommendations

Let me briefly discuss my suggestions on how to increase investment flows in Ukraine:

- ***Political and economic stability*:** Encourage who are thinking of how to improve business climate. The more centrist deputies we have the easier it will be to pass the required laws and place professional, competent people in the government.
- ***Privatisation***: Privatisation should be completed by 2003.
- ***Liberalisation***: Adjust to the current state of the market and do not demand from the authorities more than they are able to give.
- ***Corporate Governance***: Analyse the composition of shareholders in Ukraine's 35,260 joint stock companies. Determine how they differ from the stockholders in other countries, and then judge which system of corporate governance suits them.
- ***Foreign Capital***: Do not give any unnecessary privileges to foreign capital, for it is already competing with national capital.



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