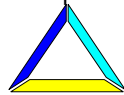


**THE FIRST 365 DAYS:**

**A CONSTRUCTIVE RETROSPECTIVE  
OF THE ECONOMIC REFORMS IN UKRAINE IN THE YEAR 2000**

Kyiv, January 2001

German Advisory Group on Economic Reforms



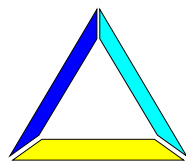
with the Ukrainian Government



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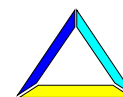


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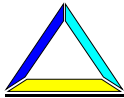
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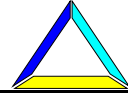


## Table of contents

<b>I.</b>	<b>INTRODUCTION: WHY A RETROSPECTIVE OF THE LAST 365 DAYS?</b> .....	<b>1</b>
<b>II.</b>	<b>IS THE CORPORATE SECTOR IN UKRAINE GETTING STRONGER AND HAS THE PROBLEM OF NON-MONETARY TRANSACTIONS BEEN RESOLVED?</b> .....	<b>3</b>
	1. REFORMS OUTSTANDING AT THE END OF 1999 .....	3
	2. AN EVALUATION OF THE STEPS TAKEN SINCE DECEMBER 1999.....	4
	2.1 <i>Withdrawal of the state from non-monetary transactions</i> .....	4
	2.2 <i>Financial re-orientation of companies and corporate sectors</i> .....	5
	2.3 <i>Restructuring the state's financial institutions</i> .....	5
	3. THE FIRST POSITIVE EFFECTS AT THE COMPANY LEVEL: ARE THEY GOING TO LAST? .....	8
	4. WHAT REMAINS TO BE DONE? .....	9
	4.1 <i>Status of the state's subvention policy</i> .....	9
	4.2 <i>Realisation of market withdrawals, while providing minimal social assurance</i> .....	9
	4.3 <i>More scope for private financing, removal of bureaucratic impediments</i> .....	10
	4.4 <i>Improved management of state property</i> .....	10
<b>III.</b>	<b>HAVE THE INVESTMENT CONDITIONS FOR DOMESTIC AND FOREIGN INVESTORS BEEN IMPROVED?</b> .....	<b>12</b>
	1. REFORMS OUTSTANDING AT THE END OF 1999 .....	12
	2. AN EVALUATION OF THE STEPS TAKEN SINCE DECEMBER 1999.....	12
	2.1 <i>Is efficiency more important than increasing investments?</i> .....	12
	2.2 <i>Foreign direct investments</i> .....	13
	2.3 <i>Liquidity situation of companies</i> .....	14
	2.4 <i>Development of foreign trade</i> .....	15
	3. WHAT REMAINS TO BE DONE? .....	16
	3.1 <i>Raising the payment discipline even further</i> .....	16
	3.2 <i>Strengthening property rights and the right to seize collateral</i> .....	16
	3.3 <i>Reform of the banking sector</i> .....	16
	3.4 <i>Tax reform and self-financing</i> .....	16
<b>IV.</b>	<b>WHAT MEASURES HAVE BEEN SUCCESSFUL IN THE AGRICULTURAL SECTOR?...</b>	<b>18</b>
	1. REFORMS OUTSTANDING AT THE END OF 1999 .....	18
	2. AN EVALUATION OF THE STEPS TAKEN SINCE DECEMBER 1999.....	19
	2.1 <i>Restructuring agricultural enterprises</i> .....	19
	2.2 <i>Redirecting the financing of the agricultural sector</i> .....	20
	2.3 <i>Regulating markets</i> .....	20
	3. EFFECTS OF THE REFORMS: GROWTH ON UKRAINIAN FIELDS? .....	21
	4. WHAT REMAINS TO BE DONE? .....	22
	4.1 <i>Enacting the land law</i> .....	23
	4.2 <i>Further liberalisation</i> .....	24
	4.3 <i>Developing a finance structure for rural areas</i> .....	24
	4.4 <i>Active regional and agrarian policies</i> .....	25
<b>V.</b>	<b>HOW FAR HAVE THE REFORMS IN THE ENERGY SECTOR PROGRESSED?</b> .....	<b>27</b>
	1. REFORMS OUTSTANDING AT THE END OF 1999 .....	27
	2. AN EVALUATION OF THE STEPS TAKEN SINCE DECEMBER 1999.....	27
	2.1 <i>Solving the problems of non-payment and of non-monetary payments for electric energy</i> .....	27
	2.2 <i>Reducing state intervention</i> .....	31
	2.3 <i>Designing a transparent and consistent privatisation strategy</i> .....	32
	2.4 <i>Removing the value-added tax exemption for energy</i> .....	32



3. WHAT REMAINS TO BE DONE? .....	32
3.1 Cutting off power.....	33
3.2 Social and regional economic programs.....	33
3.3 Sanctions for non-compliance.....	33
3.4 Raising the payment discipline of the central state organs.....	34
3.5 No offsets for payment arrears.....	34
3.6 Independence of the National Energy Regulation Commission.....	34
3.7 Admitting competition.....	34
<b>VI. HAVE THE MOST IMPORTANT STEPS BEEN TAKEN TO REORGANISE THE STATE FINANCES? .....</b>	<b>35</b>
1. REFORMS OUTSTANDING AT THE END OF 1999 .....	35
2. AN EVALUATION OF THE STEPS TAKEN SINCE DECEMBER 1999.....	35
2.1 Reducing payment arrears and offsets between enterprises and the state.....	35
2.2 Reducing state expenditures to compensate for reduced revenues?.....	38
2.3 Broadening the tax base and continuing tax reform.....	39
2.4 Other measures.....	40
3. WHAT REMAINS TO BE DONE? .....	41
3.1 Reducing payment arrears and improving the state's payment discipline.....	41
3.2 Improved budget implementation and control.....	41
3.3 Reducing some state expenditures, improving state expenditure efficiency and improving state revenues.....	42
3.4 Broadening the tax base and implementing tax reform.....	43
3.5 Other measures.....	44
<b>VII. HAS THE STATE DEBT PROBLEM BEEN SOLVED? .....</b>	<b>45</b>
1. REFORMS OUTSTANDING AT THE END OF 1999 .....	45
2. AN EVALUATION OF THE STEPS TAKEN SINCE DECEMBER 1999.....	46
2.1 Measures to solve the problem of accumulated public debt.....	46
2.2 Measures to solve the problem of excessive new public debt (flow problem).....	49
2.3 Unresolved problems.....	50
3. WHAT REMAINS TO BE DONE? .....	52
3.1 Solving the problem of accumulated public debt.....	52
3.2 Solving the problem of new public debt.....	52
<b>VIII. HAS MONETARY AND CURRENCY STABILITY BEEN ASSURED? .....</b>	<b>54</b>
1. REFORMS OUTSTANDING AT THE END OF 1999 .....	54
2. AN EVALUATION OF THE STEPS TAKEN SINCE DECEMBER 1999.....	54
2.1 Major liberalisation of the exchange rate.....	55
2.2 Stabilising the exchange rate.....	55
2.3 Implementing structural reforms.....	55
2.4 Managing moderate monetary policies.....	56
3. WHAT REMAINS TO BE DONE? .....	57
3.1 Ending the present inconsistent monetary policies.....	57
3.2 Introducing a currency basket as an anchor for the Hryvnia.....	57
3.3 Introducing a new exchange rate mechanism.....	58
<b>IX. FUTURE PROSPECTS .....</b>	<b>59</b>



## I. INTRODUCTION: WHY A RETROSPECTIVE OF THE LAST 365 DAYS?

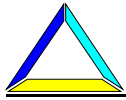
On November 14, 1999 Leonid Kuchma was re-elected President of Ukraine. Immediately after the election L. Kuchma declared himself in favour of a more consistent approach toward a market economy than had been practised so far. Emphasising this declaration was his proposal to install the former president of the National Bank, Viktor Jushchenko as Prime Minister. On December 22, 1999 the Verchovna Rada confirmed Mr. Jushchenko as Prime Minister of Ukraine. His comprehensive reform program was ratified by the Ukrainian parliament on April 6, 2000.

During the last twelve months Ukraine has taken steps towards reform, which prior to that time had often been demanded, but which always seemed to be unattainable. These newly introduced measures have met with opposition and criticism. For some they are too radical and too precipitous, for others they are not sufficiently decisive and consequent. The Ukrainian public is primarily preoccupied with the immediate and partly negative consequences. The advantages – which few had hoped ever to see realised – are rarely discussed.

It is indeed very difficult to achieve the politically necessary consensus in a few months, and thus to implement the important measures which are now essential for Ukraine after so many years of stagnation. After many years of mismanagement, the poor state finances do not offer any latitude to provide for the social measures, which should accompany any consistent program of reforms.

The public had for a long time been fed the argument that reforms now would lead to an immediate worsening of living standards, hence one would have to wait for 'stabilisation' before the reforms would be 'politically feasible'. This raised the false expectation that reforms could be achieved without painful consequences for some groups of society. At the same time certain interest groups attempt to continue to dominate large economic sectors in order to feather their own nests at the expense of the many who could partake of the possible general prosperity. They make use of the indecisiveness or of the backward orientation of many citizens to employ the profitable conditions which still exist in some sectors for their own benefit.

The present government is the first which has dared to break this vicious circle of self-interested arguments to cheat the masses, which allows a few to skim off all the profits. This evaluation of the reforms taken to date is meant to be a contribution in support of the path chosen.




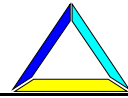
Seven economic areas will be evaluated:

- Is the corporate sector in Ukraine getting stronger and has the problem of non-monetary transactions been resolved?
- Have the investment conditions for domestic and foreign investors been improved?
- Which measures have been successful in the agricultural sector?
- How far have the reforms in the energy sector progressed?
- Have the most important steps been taken to reorganise the state finances?
- Has the state's debt problem been solved?
- Has monetary and currency stability been assured?

In none of these fields can success be registered in the sense that everything has been done that is necessary. Of course, to expect that within a single year would be to have quite unfounded and unrealistic expectations. Even critics of the present approach were unable to present realistic alternatives. In November 1999 we wrote: "Today the alternative to implementing these reforms means – unlike in 1991 – not stagnation, but decline of a potentially rich country and further impoverishment of its population. Any government which takes its responsibility seriously has no alternative to the proposed measures, but only this long and inevitable path before it."

Today, twelve months later, Ukraine – in our opinion – finds itself on a better path than during all the previous nine years. The first important steps have been taken and already show results.

With this contribution we want to pay critical tribute to what has so far been accomplished, what was possible under the existing circumstances, and what needs yet to be done. 



## **II. IS THE CORPORATE SECTOR IN UKRAINE GETTING STRONGER AND HAS THE PROBLEM OF NON-MONETARY TRANSACTIONS BEEN RESOLVED?**

*It is not by chance that this chapter has been chosen to be the first of the seven contributions. The analyses of the entrepreneurial sector, and the basic assessments and observations made herein can be extended to many fields and sectors of the Ukrainian economy. Those measures that are necessary today for consistent and successful economic performance are already summarised in this chapter. In this sense, this chapter provides the basis for an understanding of the present situation and for the problems discussed in the following contributions.*

### **1. Reforms outstanding at the end of 1999**

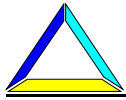
Stimulation of the entrepreneurial sector must stand at the centre of all reforms aiming at wealth and growth. This goal can only be achieved when the state ensures undistorted competition for all market participants. To this end, three components of competition are needed:

- the creation of equal conditions of competition for all companies, which in Ukraine is being achieved by the withdrawal of the state from financing and subsidising individual companies;
- the possibility of free access to and exit from (bankruptcy) the market;
- the creation of efficient ownership structures, which also includes an efficient supervision by the state of its ownership interests.

The preconditions for a dynamic entrepreneurial culture did not exist in Ukraine heretofore. The competitive situations of companies varied extremely widely, and the economic relationships of many sectors were characterised by a great lack of transparency. Aside from direct subsidies, a great range of implicit subsidies led to distorted, uneven and non-transparent competitive conditions. These implicit subsidies took many forms: non-equivalent barter at the expense of the state, acquiescence to non-payment of taxes and duties, concession of tax privileges, awarding of state guarantees without enforcement of payment obligations by the companies, etc. In most cases the giving out of subsidies to companies was tied to non-monetary transactions at the expense of the state. Often the subsidies were related to state ordered deliveries and the crediting of inputs which were furnished by the most disparate organisations.

The result was uneven starting conditions for the enterprises: The relationship between efficiency, individual effort and profitability was destroyed. With government concessions, inefficient firms could achieve better financial results than many an efficient competitor. Among others, the consequences of such policies were:

- Inefficient use of material and financial resources; no incentives for new companies to enter markets which are distorted by subventions;



- Non-transparency of the market operations and of the profitability of the companies in it. The difficulty with differentiating between viable and subsidised companies discourages creditors, or alternately makes high risk premiums necessary;
- Incentives for rent seeking, subsidy fraud and profit redirection into private pockets.

In addition to the creation (or the introduction) of a competitive environment a second component of competitive economies must be insured, namely that the success of an enterprise should be determined solely by its own efficiency. Companies, which in the medium term are not able to finance their own production, must leave the market or must change their product line. Competition also implies exit from the market (bankruptcy): Companies that consistently produce losses must leave the market and open the way for others who are more efficient.

As a third component – especially important for Ukraine – efficient owners must be created at all levels. In particular, this requires efficient management of state property. This is so very important because significant financial resources undoubtedly end up in private pockets through non-competitive processes. Rent seeking is one approach, where companies succeed in obtaining special conditions (e.g. local monopolies) from the government. In this way they achieve excess profits at the expense of the general economy, or by violating the rights of minority owners. The lack of transparency caused by extensive non-monetary transactions adds to the inefficiency of the management of state property.

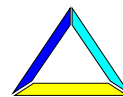
## **2. An evaluation of the steps taken since December 1999**

### ***2.1 Withdrawal of the state from non-monetary transactions***

The high proportion of non-monetary transactions has several causes and various consequences, which must all be considered when designing appropriate reforms. In the past non-monetary transactions have generally been seen to be a result of inadequate liquidity by the companies. Although true in some cases, any reforms solely based on this interpretation will be inadequate. The government has now started to change its method of viewing these cases:

- To a significant degree, non-monetary transactions are non-transparent subsidies borne by the state.
- They are likely to be misappropriated and to be used to cover up asset stripping, embezzlement and plundering of individual enterprises.

Withdrawal of the state from non-monetary transactions and reduction of special favours to individual companies (i.e. a reduction of subsidies) must therefore remain the foremost guiding principle for all reform policies; this in order to reduce distortions and non-transparencies in competition. The government has clearly enunciated these aims, and has even attempted



to realise these goals through the enactment of several regulations concerning the system of payment.

Most important have been the successes with eliminating pension debts and with reduction of wage arrears by the state. This approach has not only improved demand, it was also essential for the state's credibility in its battle to enforce payment discipline.

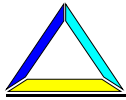
At the beginning of the year the Prime Minister announced his intention to have the state withdraw from non-monetary transactions, such as barter, account settlements, bills of exchange, etc. Tax privileges, which according to the tax administration amounted to about 4 bn UAH, were reduced. Aside from the hard to define extent of these subsidy reductions it was very significant that the government clearly spelled out its message that the praxis of 'state financing' would henceforth be handled in a much more restrictive fashion. Even the broader public is now starting to appreciate that the customary public financing/subsidisation is inefficient. The yield from many years of state guarantees has made it clear that they were in reality just a subsidisation of individual enterprises at the expense of the state and hence in the end of the common good, and could not be continued. A significantly more restrictive and restructured method of issuance of state guarantees has been introduced.

## ***2.2 Financial re-orientation by companies and corporate sectors***

The political decisions made require no less than a major redirection of the financing methods by companies and whole corporate sectors. This financial redirection is made more difficult by the fact that it has to be accomplished within an economy with weak liquidity. The reduction of subsidies must therefore go hand in hand with the creation of alternative financing approaches. It was impossible to strictly maintain the principle of cash transactions in all cases. There were some controversial decisions regarding state participation in non-monetary transactions. Real or imagined emergency situations have caused exceptions from the rule to be accepted. To a significant extent (though less than in 1999) payments in the energy sector have – since the summer – again been made by offsets. A large number of privileges is still being accorded in the form of special economic zones and so-called economic experiments. It has not been possible to abolish Kartoteka No. 2. There still exist considerable non-transparencies and subsidisations, it seems however that the obligation to economically justify such special treatment is increasing. A significant change in the financing methods of important economic sectors (i.e. a turning away from state financing) has begun.

## ***2.3 Restructuring the state's financial institutions***

To assure permanency for these new policies it is very important that the restructuring of those institutions, which for many years had been responsible for administering the non-monetary transactions, has started. The danger that these institutions would persist in their age-old ways –



even though this is contrary to the official policies – is very real, since a central control of all of them is practically impossible. In accordance with the administrative reforms (presidential decree No. 1573 of December 15, 1999) a start was made to abolish those institutions which used to administer and/or distribute state financing, or at least to reorganise them in the sense that their actions would distort market processes as little as possible. Institutions such as Derzhreserv or the Innovation Fund have started to be restructured from an organisational and a personnel point of view, such that they increasingly resemble financial institutions which work according to efficiency criteria. Other institutions, e.g. Derzhinvest, Ukrspezfin or the Investment and Clearing Committee of the Ministry of Industry have already been abolished.

In sum, one can say here too, that a positive start has been made, though the actual reorganisation progress is slower than hoped for. In spite of greater discipline in the ministries and of new control functions, an adequate transparency of the 'financing and control functions' has by far not yet been achieved in all institutions. On the other hand, it must be positively noted that the importance of institutions, which have the duty to assure competition and proper accounting practices – such as the Court of Auditors – has further increased.

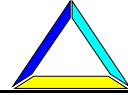


Figure 1

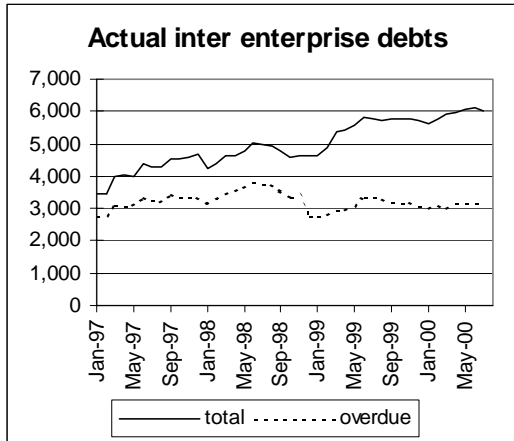


Figure 2

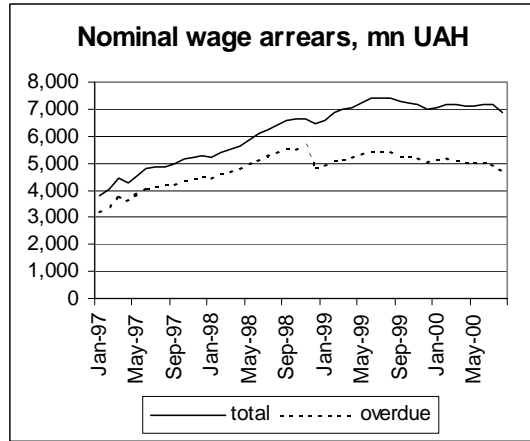


Figure 3

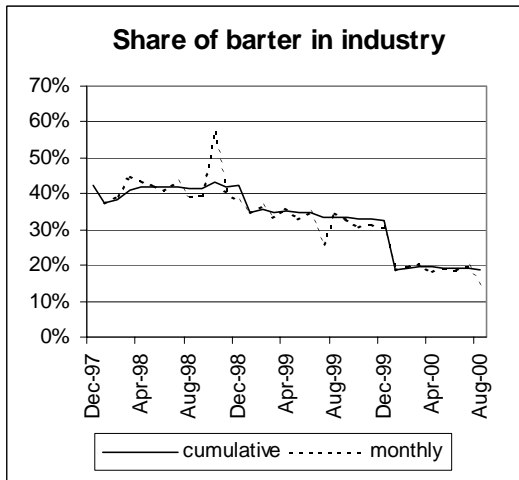
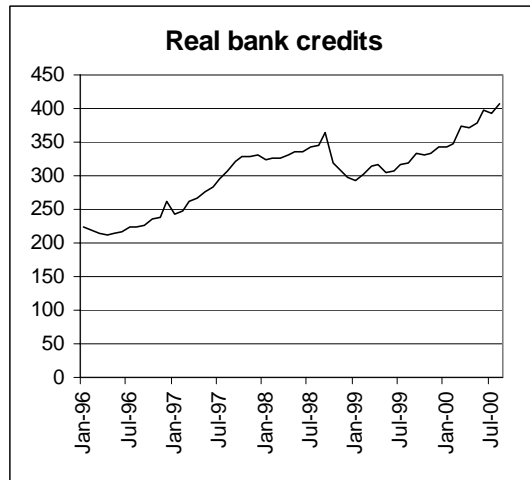
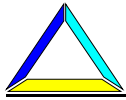


Figure 4





### 3. The first positive effects at the company level: Are they going to last?

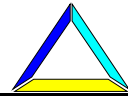
To draw quantitative conclusions from what the reforms have achieved so far is difficult for several reasons. For one, positive effects will show up in the medium term only, since the long standing 'payment mentality' changes only slowly. Also, it will be tested from time to time by the beneficiaries of the former system, to see with how much consistency the government will apply its principles. On the other hand, data to evaluate every individual action taken are lacking. Measured against individual aggregate indices, one can however make out weak, though clear improvements (see Figures 1 to 4):

- Economic growth, which initially had been based primarily on devaluation, remained at an unexpectedly high level even after the summer. This is an indication that the economic climate for companies has improved this year.
- The actual inter-enterprise indebtedness (payables) is clearly rising more slowly since the summer of 1999.<sup>1</sup> Even more important is the fact that the actual *overdue* payables have not risen since they decreased at the end of 1998.
- The percentage of barter in industrial production decreased steadily since 1999.
- The number of companies showing losses has stabilised, profits rise slowly.
- Real bank credits to the economy are rising continuously since they decreased in consequence of the economic crisis of 1998. They have already clearly exceeded the previous maximum of the summer of 1998.
- The ratio of bank credits to payables is rising again since the summer of 1999.

In sum, positive changes can be observed, though they are not yet sufficiently durable. When evaluating the results of the reforms it must be taken into account that the necessary subsidy reductions initially cause further liquidity problems in the Ukrainian economy before improved chances for the entrepreneurs can result in rising profits and financing (investments). On the whole, the success of the reform policies will be demonstrated only within the medium term of one to two years.

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<sup>1</sup> The available data do not contain the debt remissions applicable to agriculture. It is however possible that the debt remissions of other sectors are included.



## 4. What remains to be done?

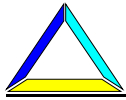
### *4.1 Status of the state's subvention policy*

The policy chosen was the necessary and correct start towards building a competitive economy. To further move along the withdrawal of the state and to increase the transparency of the economy it is necessary that the government prepare a comprehensive description and survey (inventory) of all public subsidy policies. This should include both governmental and quasi-governmental institutions. The survey should list all payment streams (within and outside the budget), and include a listing of the payables and receivables of all institutions. Although a complete inventory on the central and on the regional levels is probably illusory, a broadly based inventory would still help to create a climate, which would demand stricter justifications for subsidies. This would give support to the reforms vis-à-vis criticism from the beneficiaries of the former subsidy system. A rigorous annual efficiency test of the 'state finance institutions' is needed to evaluate the success of the administrative reforms and to prevent unsound developments.

### *4.2 Realisation of market withdrawals, while providing minimal social assurance*

Monetising the payment streams is only a means to an end. Its final goal, by reducing the implicit subsidies, is to force companies to earn their own finance requirements. Companies, which are unable to achieve this, must restructure their production, raise their cost efficiency or leave the market. Non-monetary transactions were the primary vehicle, which allowed them to continue to operate under soft budget constraints. Although the reduction of subsidies raises the pressure on companies, this can only be a successful strategy if supported by the credible threat that non-viable firms must close. Market exit is an essential part of competitively organised market economies. Without bankruptcy it is impossible anywhere to maintain compliance with supply contracts (payment discipline).

Although the bankruptcy laws have been improved, their actual enforcement can as yet not be assured. Large companies can still evade the official legal statutes. Establishing the organisational structure for market exits of non-viable companies must be one of the most important goals of the coming year. The execution of necessary bankruptcies must be accompanied by the building of stronger safety nets for the unemployed. A part of the state expenditures saved by reducing subsidies should be used for social ends. Other sources of revenue could be the claims against companies by quasi-governmental organisations such as funds and committees. These claims have in the past grown as part of state financing/credit operations; their reclamation was however never pursued in a consistent manner. The funds derived from collecting these claims could be used to partially finance the social measures arising out of the execution of bankruptcy cases.



#### ***4.3 More scope for private financing, removal of bureaucratic impediments***

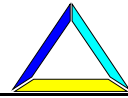
The counterpart to market exit, i.e. the creation of new enterprises, can be promoted by more scope for private financing and the removal of bureaucratic impediments. In both of these two areas some initial work has been done, the execution was however slower than planned. The most important impulse for creating new or expanding production lines come from markets with fair competition and limited state interference. It is therefore not surprising that especially production sectors close to the consumer, in which the state interferes fairly little, have had most success. These are also the sectors where most foreign direct investments ended up. It has been demonstrated that Ukrainian enterprises have quickly reacted to price and market changes, such as caused by the currency crisis of the fall of 1998, in spite of the well-known financing difficulties. The much-lamented trend towards de-industrialisation and degradation of Ukraine into being a supplier of raw materials only has not been true since the upturn starting in mid 1999. The prime exponents of growth were the little regulated consumer oriented industries, which financed and controlled their developments with their own resources.


#### ***4.4 Improved management of state property***

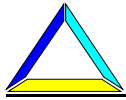
The second essential target to be achieved in the coming year, aside from market exit, is to improve the management of state property. The revenues derived from the considerable state ownership are minimal. Although exact data are of course not available, it can safely be assumed that significant assets are most unprofessionally and unprofitably employed, or that profits – without any justification – still end up in private pockets.<sup>2</sup> Transparent and quick privatisation is the best answer to this situation. Yet, since large property holdings will still have to be administered by the state in the coming years, Ukraine's economic growth will depend to no small extent on the organisation and judicial guarantees that provide for the efficient management of these assets. The amalgamation of state property managements into one privatisation agency is a good step. Other organisations should be integrated into this agency or should be dissolved, as for instance happened to Derzhinvest. In this process one must avoid allowing the proceeds from the transfer of a portion of the state property to be used to finance organisations with other goals (e.g. credits to SME). Only state owned enterprises, which are likely to remain the property of the state for some time, should possibly be allowed to be administered and controlled outside of the privatisation agency, possibly at the regional administrative level.

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<sup>2</sup> Assuming state capital assets at a conservatively estimated level of 20 bn UAH, and assuming a possible yield of 5%, then one is surprised that the total dividend from state owned property was claimed to be only 53 mn UAH in the 1998 budget, for instance.



The managers of state owned enterprises must declare any possible conflicts of interest between their management duties and their private interests. They must pledge themselves by contract to make their decisions in such a way that even the suspicion of a conflict of interest is excluded. An independent control and publication of the financial statements of state owned enterprises is required. The legal preconditions for this need to be created. 



### **III. HAVE THE INVESTMENT CONDITIONS FOR DOMESTIC AND FOREIGN INVESTORS BEEN IMPROVED?**

#### **1. Reforms outstanding at the end of 1999**

Public discussion has for a long time centred on the decreasing investments and the difficult liquidity situation which most companies face. They have generally been seen to be the primary causes of lacking growth. The size of investments and economic growth are closely related over the medium to long term. This reasoning explains the government's ambitious goal to achieve an investment ratio of 21.1% of GDP in the year 2000, and even 23% in 2001.

In spite of the rather high investment ratios of almost 30% (as compared with international levels), growth in Ukraine during the 1980s was small. Of course, during periods of restructuring of capital assets, growth is more defined by rising efficiencies of the available resources than by increases in the production factors (capital and labour). In the present phase of Ukrainian economic development, investment strategies should concentrate more on efficient use of the available capital than on quantitative growth of the capital assets. More efficient use of the existing capital stock can be achieved through better usage of capacities, reorganisation of the production processes, and modernisation whenever capital assets have to be replaced.

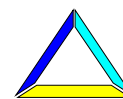
In view of the poorly functioning banking system, the majority of enterprise financing has to be derived from internal sources. This also implies that tax policies should leave companies sufficient room for manoeuvre in the financing area. At the same time, attempts must be made to improve the credit conditions for companies, to maintain low real interest levels, and to improve the banking system's strength. Attracting foreign credits and investments could be another significant part of financing and investment in Ukraine.

However, it is not only the scarcity of supply, an insufficient demand for credit and investment too, leads to a decline in investment. To date not only foreign investment has been limited; many domestic enterprises prefer to invest their funds in foreign countries rather than investing it in the domestic economy (capital flight). The preconditions for increasing the readiness of domestic and foreign investors to invest in Ukraine are stable economic policies, absence of erratic fluctuations in the taxation approach, and the creation of a level competitive playing field.

#### **2. An evaluation of the steps taken since December 1999**

##### ***2.1 Is efficiency more important than increasing investments?***

The economic growth now being experienced is primarily related to the greater efficiency with which resources are being used, which is proven by



the fact that the production factors labour and capital grew significantly less than production itself. This confirms the thesis that production tends to advance more quickly (over the short term) than capital assets increase quantitatively. At this stage of economic development, domestic and foreign demand – and particularly the reactions of companies to these market opportunities – is of prime importance.

When looking at capital investments one can observe that the slide in the investment rate, which started at a high level, has in the last years more or less stopped. This is different from inventory investments, which are decreasing more significantly since the summer of 1999. This should be seen as a positive development, though. Inventories had been excessively high in all socialist countries, and were being drastically reduced in most transformation countries. They were an insurance against production interruptions and served as 'means of payment' in barter trades. To the extent that companies switch to a money economy and accept delivery conditions practised in market economies, expensive inventory levels can be reduced.

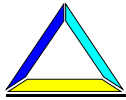
**Table 1: Percentage of investments in GDP**

	1997	1998	1999	1 H 1999	1 H 2000
Capital investment	19.8	19.6	19.8	17.7	17.4
Changes in inventory investments, yoy	+1.4	+1.1	-0.1	-1.7	-4.1

Source: *Derzhkomstat*

## 2.2 Foreign direct investments

The volume of foreign direct investment must be looked at quite differently, though. Here a close relationship exists between their volume and production and efficiency increases – even over the short term. As a rule foreign investment is directly tied to reorganisation of the production, thereby increasing the efficiency of already existing capital assets. Often a transfer of technical know-how is also involved, which causes further productivity increases. However, foreign direct investments in Ukraine are still extremely low, which proves that the investment climate in Ukraine is considered to be poor. As has been shown in all transformation countries, the influx of foreign direct investment is closely linked to the success of creating a market economy. The volume of foreign direct investment can therefore be seen as a 'litmus test' for the progress of the reforms. After the currency crisis Ukraine, too, had to accept an important reduction of these capital flows. As privatisation advances these flows should increase, however. So far the data show a small increase following the 1998 crisis. Foreign investors still have doubts however, whether the reforms of this year will be energetically continued, such as to lead to a permanent improvement of the investment climate.

**Table 2: Foreign direct investments in Ukraine (in mn USD), annual inflow**

1997	1998	1999	1 H 1999	1 H 2000
623	697	166	166	339

Source: National Bank of Ukraine, Balance of payment of Ukraine, various issues

### 2.3 Liquidity situation of companies

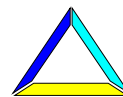
In the short term it is very important for growth to what extent the lack of liquidity impedes companies from expanding their production. Deficient ongoing financing was again and again mentioned as the cause for production reductions. This argument was then used as justification for the continuance of state subsidies to companies. The reduction of state subsidies must therefore also be looked at from the point of view of financing. In spite of the partial withdrawal of the state from company financing, there are signs that the liquidity situation of companies has not deteriorated. Notwithstanding the disappearance of a part of state financing, the financial situation of companies, surprisingly, has already slightly improved over the short term, which must have helped growth. Some indicators are shown in Table 3.

**Table 3: Selected indicators concerning investment financing**

	1998	1999	9 M 2000
Profits as %age of GDP	3.3	5.8	6.1*
Losses producing companies as a %age of all companies	55	56	48*
Bank credits to the economy as %age of GDP	8.6	9.3	13.8
- of these for investment purposes (in %)	10.1	8.8	6.3
Government revenues as %age of GDP	28.2	25.4	27.1
'Errors and omissions' in the balance of payments (mn USD)	-810	-954	229*

\* First half year 2000

The profit situation of companies, and hence their ability to finance themselves has not deteriorated. The percentage of profitable firms in the economy has slightly improved compared to the previous year. Gross profits during the first eight months of 2000 were 30% higher yoy, in industry even 43.6%, while wholesale prices rose only 20%. Nominal net profit in industry even rose 64% yoy within 8 months, meaning that losses were retrogressing. It must be kept in mind though, that the Ukrainian figures concerning profits are only of qualified use, since they contain many cost items and since other financial sources are not included.



The average tax burden on the economy has not risen. Although the tax rate at 25.4% of GDP<sup>3</sup> in Ukraine can be considered as low, the tax burden for some companies is extremely high. This is mainly due to the fact that – because of tax privileges and subsidies – the burden is very uneven. This unevenness probably decreased during the year 2000.

The state has drastically reduced its demand for credit, thereby making more bank credits available to the economy. Bank credits to the economy have clearly risen, both in nominal and actual terms. Long term credits, relative to all credits to the economy, have risen minimally. The founding of a micro-bank should help financing of small and medium sized enterprises.

There are signs that capital flight has slowed and/or that some of this capital is actually returning. During the first two quarters of 2000 the item 'errors and omissions' in the balance of payments, which can be seen as an indication for the volume of unregistered capital flows, has shown a capital inflow for the first time again.

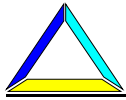
#### ***2.4 Development of foreign trade***

To be especially noted are the attempts of Ukraine to promote its accession into the WTO. Also, the EU's acceptance of Ukraine as a market economy was an important step for the country's integration into the world economy.

From a general political point of view, the financial situation has eased, due to an improved current account balance. However, almost all of the foreign trade surpluses had to be used for servicing the debt for foreign credits. Never the less, the financial situation of large enterprises should have significantly improved. The devaluation of the Hryvnia in 1998 and the expansion of exports in 2000 have caused the export volume in Hryvnia to rise substantially. The export share rose to an astounding 67.5% during the first half of 2000. Considering that the percentage of non-payments and barter is markedly lower for exports than in the domestic economy, liquidity must have improved significantly in the export sphere. As a consequence, by paying its suppliers the export sector must also have improved the liquidity of other economic sectors. However in its structure, the situation of foreign trade has remained practically unchanged. Exports are still mainly derived from the energy and raw material intensive sectors. Also, the profitability of some exports seems questionable, which is reflected by increasing anti-dumping suits.

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<sup>3</sup> 1999.



### **3. What remains to be done?**

#### ***3.1 Raising the payment discipline even further***

The questions, which were raised in chapter II, to a great extent also influence the investment climate, i.e. the willingness to invest in Ukraine. Only when it becomes possible to raise the payment discipline, and only when equal competitive conditions have been created by further reductions of subsidies, will investments increase. This applies particularly to the privatisation of the Oblenergos, which will only find major investors when a sufficient number of energy users can be persuaded to regularly pay for their usage.

#### ***3.2 Strengthening property rights and the right to seize collateral***

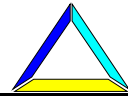
The readiness to make investment credits available will only increase when and if credit providers receive adequate securities. In the first place, this requires that companies have clear title to their property, particularly to real property. On the other hand, the creditor must have a right to the assets of the debtor in case the credit is not repaid. This requires that enforceable claims can be made in bankruptcy suits, processes which are still not available. Realistic enforcement of forfeiture and security rights – even vis-à-vis state owned companies – must be strengthened. An adequate legal basis for the protection of minority partners must also be created.


#### ***3.3 Reform of the banking sector***

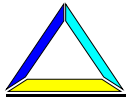
The involvement of the banking sector in production financing and investment is expected to rise only slowly. The danger that some banks become insolvent is increasing, which would endanger the ability of the banking sector to participate significantly in financing over the medium term. To avoid this possibility, it will be essential to start in 2001 with eliminating the greatest risks in the banking sector. This long standing obligation, which has also been pointed out by many international finance organisations, must now be attacked, so that at least those banks that are able, can fulfil their functions to allocate financial means. The state must not use its power, whether directly or indirectly, to force banks to issue credits. It is precisely these 'directed credits' which in years past have forced some major banks into the current predicament, with large unrecoverable loans endangering their existence.

#### ***3.4 Tax reform and self-financing***

When contemplating tax reductions, it must be kept in mind that the primary means of company financing over the coming years will remain self-financing. Thus, the profit situation of companies must take centre stage in the tax reform. A reduction of the profits tax and of the taxation of production factors is desirable. The depreciation regulations are another important component influencing the degree of self-financing.



The reduction of state financing of investments, which has (e.g. in the form of state guarantees) always proven to be exceedingly inefficient, should raise the average efficiency of economic investments. Strict control of the efficiency of institutions, which continue to provide state investment financing, such as the Leasing Fund, is essential in order to avoid further losses. 



## **IV. WHAT MEASURES HAVE BEEN SUCCESSFUL IN THE AGRICULTURAL SECTOR?**

### **1. Reforms outstanding at the end of 1999**

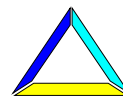
No country has probably ever protected and subsidised domestic agriculture as much as the Soviet Union. Input prices, such as energy, were way below the world market level and product prices were much higher. Production units, which were unprofitable even then, were kept alive with massive financial aid. After independence, Ukraine was not able to maintain this level of subsidisation. It became necessary to liberalise agrarian markets and to reduce state influence on local agricultural management. Until the end of 1999, Ukraine had however not been able to take decisive steps towards reform. As before, agriculture remained collectively organised, and hence farms – due to the organisational structures carried over from Soviet times – were not adapted to market economy conditions. State financing of agriculture, which carried on until 1999, had definite traits of a planned economy. This resulted in wholly unprofitable agricultural units continuing to produce. To collect the debts, which arose from state financing, the bureaucracy confiscated agricultural produce, which in turn impeded free trade within Ukraine.

These policies practised over the past years have ruined the Ukrainian agricultural sector. The results are well known: retrogressive production, falling profitability, and rising indebtedness. Ukraine did not keep up with the faster transformation countries. In spite of Ukraine's excellent natural gifts, its agricultural productivity fell way behind that of other transformation countries such as Hungary. Serious reforms were becoming indispensable.

However, it is probably in the nature of far-reaching reforms, that the public is mainly concerned with their immediate and in part negative implications rather than their advantages. This applies too, for the agricultural reforms instituted since December 1999. The media often emphasise production reductions of some important agricultural goods, or that this year the country has to import cereals for the first time. But is it reasonable to blame the poor harvest on reforms, which were only implemented after the crucial fall seeding? Such reforms, as experienced in other countries, only show results after two or three years.

A detailed review demonstrates that a series of measures were implemented which can be seen as fundamental for the development of the rural environment and for the growth of the Ukrainian agricultural sector. One year ago one could hardly have expected such rapid progress with the reforms.

If the agricultural sector is to be transformed according to market economy criteria, no special approach can be taken. Rather, it has always been evident that the adoption by the Ukrainian government of market



economic principles implies that henceforth decisions about the organisational structure of the economic subjects, the usage of the resources labour, real property and capital, and the marketing of the produce must lie solely with the agro-businesses and the people employed by them, rather than with the government. This understanding has finally been acknowledged in the reform year 2000. This approach must be continued in spite of dangers and resistance.

## **2. An evaluation of the steps taken since December 1999**

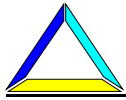
### ***2.1 Restructuring agricultural enterprises***

The key reforms in the agricultural sector started with Presidential Decree No. 1529/99, which defines the issuance of real property certificates to members of agricultural enterprises, and the transformation of collective farms into private family enterprises, natural and judicial persons. This decree allows the members to decide whether to work the land themselves, or whether to lease it out to successor companies of the collective farms or even to other investors. Some 5.4 mn lease contracts have been ratified following the issuance of about 6,258,000 certificates prior to May 12, 2000 (by this date, 97% of eligible citizens had received their certificates). Out of originally 10,700 collective farms, some 12,800 privately owned enterprises<sup>4</sup> had sprung by May 19, 2000. Especially noted should be the rapid development of family enterprises. Between January 1, and October 1, 2000 they had increased by nearly 5%, from 35,900 to 37,600. At the same time these enterprises have almost doubled the area under cultivation, from 1.16 to 2.06 mn hectares.

However, the crucial question is whether the internal organisational structures have changed. Has the multitude of decision-making levels been reduced? Have the decision-making structures of the enterprises improved? Have the possibilities for members and for management to illegally acquire assets of the enterprises been reduced in actual practice? Even though these questions cannot be answered comprehensively, and though there is a great variance between enterprises, there are indications that – following the initially purely formal restructuring, some organisational restructuring of the agricultural enterprises has occurred. Thus, the management has changed in a not insignificant part of companies: in May 2000, the Ukrainian Agricultural Policy Project has determined a ratio of 30% in a random sample. In many, mainly in newly founded enterprises the decision-making structures are now more clearly defined and managers are now confronted with economic incentives on the individual level, which is congruent with the macro-economic goal of optimal resource usage. Similar structures and incentives should be introduced as quickly as possible in all other enterprises.

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<sup>4</sup> We distinguish between privately owned enterprises, which as a rule are successors to the collective farms and private family farms, which derived from the enlargement of rural dwellings and hence represent new entities.



## ***2.2 Redirecting the financing of the agricultural sector***

In the past, one of the largest impediments to develop a profitable agricultural sector was the financing of collective farms by the state without any strings attached. The single-minded aim of maintaining production without considering efficiency caused earlier governments to offer financing to agro-businesses in the form of organised barter chains. These measures have proven to be exceedingly harmful. The state evidently was a poor credit provider, since credits were largely embezzled<sup>5</sup>, and since its claims were, as a rule, only very minimally serviced. Yet, in order to be able to secure access to agricultural output, in particular grains, the government or local administrations intervened in the markets, issued trade prohibitions, and confiscated agricultural produce.

By a series of measures these practices were changed at the beginning of the year. The only important unconditional state financial aid remaining is a 17.5% interest subsidy. The positive results of this change have already shown up in the year 2000. The importance of government in the financing of agricultural enterprises has decreased, and hence also its inclination to intervene in the market in order to collect payments due. Another advantage of the new system is that private credit providers, and not as before administrations, now decide whether and to whom credits will be given. This insures on the one hand that a financing system of the western type, and on a private economic basis, can develop. On the other hand, this now starts an urgently needed selection process. Non-competitive agricultural units will not be kept alive artificially anymore, and the land can be leased to other and better managers. It is also significant that entrepreneurial potential has been set free by these measures. Enterprises have also been able to finance themselves to a much greater extent than in previous years. This indicates that state credits to agricultural enterprises in past years, which were often never paid back, simply represented windfalls.

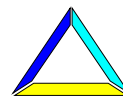
## ***2.3 Regulating markets***

Two measures however, decrees Nos. 767/00 and 832/00 and their implementing regulations, have done little to advance reforms in the agricultural sector. Even though the goals enunciated, such as improving the infrastructure of agro-markets or the creation of credit unions in rural areas, are important aims for Ukrainian agriculture, they cannot just simply be decreed. The state should create the legal framework, as for instance, it has still not done for credit unions in Ukraine. But simply to mandate when such infrastructure has to be in place is not really compatible with market economic principles.

Especially the timing and the format of decree No. 832/00 of June 29, 2000 were not helpful to strengthen the confidence of investors, who had

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<sup>5</sup> Court of Auditors of Ukraine 2000, No. 3.



hoped for effective and consistent reforms. This decree concerns the certification of exports and the introduction of a price support system, similar to the American Loan-Rate system (in Ukraine called pledge-price system). The certification of exports at the exchanges has caused great apprehension to market participants, since they fear that this could allow bureaucrats to regulate exports. Even if this was never intended, it gives the administration an instrument that they could use at some future date without requiring any further governmental decisions.

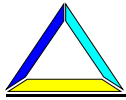
In its present form, the pledge-price system contains a component, which is similar to the intervention price system of the EU. Ukraine cannot afford and should not implement such an policy measures at this time. A guaranteed minimum price represents an enormous speculation for the state. Whenever the purchasing price for grain cannot be realised at the time the product is sold, the state would have to make up the difference. The EU has demonstrated that such a system can become extremely expensive. For instance, if the state bought 2 mn tonnes of grain and the price fell by only 100 UAH per tonne, 200 mn UAH (= 20% of the agricultural budget) would be needed.

The timing of the decree, i.e. when the grain harvest had just begun and while the government was insisting that it would not interfere in grain marketing during the year 2000, particularly damaged the confidence of the market participants. Even many government departments were utterly surprised by the decree. Also, some of the negative reaction can certainly be attributed to the fact that the intention of the decree had not previously been discussed in public or in the appropriate institutions, such as in the Presidential Commission for Agrarian Policy.

### **3. Effects of the reforms: Growth on Ukrainian fields?**

The creation of wealth and production in the Ukrainian agricultural sector have been much lower in this year of reform than many had hoped. The poor grain harvest of the year 2000 – with an average of 2.1 t/ha for wheat, as compared to 2.4 t/ha the previous year – cannot be blamed on the reforms, since its basis had already been laid in the year before. And yet, it must be seen as positive that gross agricultural production, and even the agricultural GDP, will in all likelihood remain at the previous year's level or might even rise slightly (see Table 1).

In fact, the positive overall development of the Ukrainian economy in the year 2000 has affected the agricultural and food processing sectors as well. The latter particularly has benefited from the currency crisis in the fall of 1998 and the ensuing devaluation of the Hryvnia in 1999, and has been able to profit from its competitive advantage on the Ukrainian market vis-à-vis foreign competitors. This has caused an import substitution, which however would not have been possible if the quality of Ukrainian products and their marketing had not risen at the same time. Given these conditions, the Ukrainian food processing sector has been able to raise production in the first ten months of the year by 25%,



compared to the same period last year. This in contrast to the 3.1% rise for all of 1999 (see Table 1).

**Table 1: The development of production in various sectors of the Ukrainian economy**

	1996	1997	1998	1999	2000
Industrial output, % change yoy	-5.9	-1.8	-1.5	4.3	11.9*
Food processing industry, % change yoy	-16.8	-21.7	-10.0	3.1	25.0*
Agriculture, % change yoy	-9.5	-1.9	-9.8	-5.7	3.7*
% of production by private companies	54.6	55.7	58.8	59.9	68.7**

Remarks: \* in the first 10 months of the year; \*\* in the first 6 months of the year

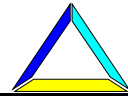
Source: *Ukrainian Economic Trends; UkrAgroConsult; Ukrainian Committee for Statistics; personal calculations*

These positive developments for agriculture and for the food processing sector can however only partially be attributed to the reforms, because the price level developments for important agricultural commodities have also played a role. In December, because of the poor harvest of 1999, the grain market experienced a switch from exports to imports. Domestic prices are derived from world market prices. While the country exports, the domestic price approximately equals the world market price less marketing costs. In November 1999, the world market and domestic prices were about 110 and 80 USD/tonne respectively. When grain was first imported during the first months of the year 2000, Ukrainian grain millers had to pay the marketing costs and an import duty in addition to the world market price. This suddenly raised the domestic price from 80 to about 150 USD/tonne while the world market price remained nearly steady. The higher prices also raised the nominal GDP, since prices rose faster than production decreased.

The next grain harvest in 2001 might well be better by several mn tonnes than the previous. Certainly, larger areas have been seeded than last year, and the condition of the fields is as good as it has ever been. A good harvest would also mean that Ukraine returns to be an exporter. Prices would then return to 1999 levels, and the nominal GDP would likely fall in spite of the improved harvest. Not least for these quite likely developments, must further measures be taken to consolidate the reforms and to increase the competitiveness of Ukrainian agriculture.

#### **4. What remains to be done?**

The important question for the Ukrainian government now is: What are the next reform steps to be taken? There are many proposals being presented. For instance, the Grain Program 2001 to 2004 has defined many ambitious goals for the year 2001: Grain production should be raised by several mn tonnes to between 34 and 40 mn tonnes, the



material basis of the enterprises should be improved, and the grain market should be reorganised.

Defining so-called 'strategic' products and the execution of measures such as the Grain Program are incompatible with market economic principles. They correspond to agro-political models, which have quite evidently failed, and which can simply not be afforded under present circumstances.

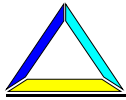
Any moneys which are used for direct subsidies to the agricultural sector – such as the Leasingfond, the pledge-price system, or Grain Program 2001 –, would not be available for other purposes. With the limited funds available no measures should be taken which are oriented towards narrow goals such as the provision of machinery, the production of grain, or price stabilisation. Instead, following the reforms of the year 2000, an overall political strategy for rural areas needs to be formulated.

Up to now, economic structures in rural areas focussed only on agricultural producers. They provided the social sphere and other services. They also took care of many aspects of communal self-government. Restructuring of the enterprises means however, that they must from now on concentrate on production. All other functions will have to be performed elsewhere. Appropriate communal structures must hence be created. These measures are essential to further structural changes in rural areas and thus essential to make growth possible.

Therefore, the government must concentrate on primary concerns, which can basically only be performed by the state: The cushioning of social hardships brought about by the essential structural changes, and the creation of an urgently needed infrastructure. To further the general acceptance of such political measures, it is important to avoid the errors of the year 2000. Policies must become more transparent, hence draft laws should be made public, communicated and discussed.

#### ***4.1 Enacting the land law***

Beyond the reform progress so far, Ukraine has taken some important legislative initiatives. Among these is the law on land which is before parliament at this time, and which will define the constitutional right of citizens to own land and to transfer it by sale, donation, exchange, etc. It is not surprising that the possibility of trade in farm land, which for the past 80 years did not exist or existed only to a very limited extent in Ukraine, causes some parts of the population to feel uneasy. The fear that land ownership could become too concentrated is also justified, since most of the population has insufficient knowledge about the value of farm land, or would not be able to withstand the (not only) financial pressures which will likely be put on them by some market participants. It is therefore essential that the land law be soon enacted, so that regulations defining its implementation can be worked on. A three to five year moratorium on purchases and sales of farm land would be desirable, coupled with an aggressive campaign to inform land owners about their rights and duties.



In any case, a well functioning lease market is more useful under the present circumstances.

#### ***4.2 Further liberalisation***

The present high prices for agro-products and the ensuing favourable market situation for producers have distracted Ukrainians from the still existent important structural weaknesses in the marketing and processing sectors, for instance in the grain field.

For one, it is important that free trade is assured within Ukraine. This requires that administrative incursions on the oblast and rajon levels must be completely eliminated.

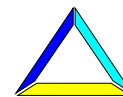
For another, it is necessary that new political approaches be taken for insuring food supply. Food supply assurance has little to do with availability of food-stuffs, full warehouses do not insure that the poorest parts of the population receive the different kinds of food necessary for a healthy life style. Instead, it must be assured that these population groups have sufficient incomes. Payment of rental arrears, which were made by the government this year was the correct policy and contributed far more to assuring food supply, than any administrative warehousing policy could have done. This warehousing must be eliminated in future, it is inefficient and regionalises the Ukrainian agro-markets to the disadvantage of consumers and producers, even causing artificial shortages in some regions.

Another priority is external liberalisation, i.e. free access from and to world markets, which in turn is a precondition for WTO membership. The expected grain production increase will lower prices again. Whether the low level of previous years will be reached again, depends to a large extent on the free access to world markets. All export taxes and other non-tariff export and import impediments should be eliminated. It must finally be recognised that the oft-lamented monopolisation in the agricultural and alimentation sectors cannot be removed by stronger monopoly laws and other regulations, but only by competition. This also implies that inefficient enterprises must not be protected, and that competitors must not face bureaucratic impediments on the state and regional levels whenever they want to enter the market.

#### ***4.3 Developing a finance structure for rural areas***

The creation of rural financial markets is of great importance for the further development of rural areas. This job cannot be done by decrees or by the creation of governmental financial institutions. However, the state has to create the important preconditions for the deployment of private initiative.

Highest priority must be given to removing the moratorium on bankruptcies of agricultural enterprises. Credit providers will not furnish agricultural enterprises with significant funds if no adequate creditor



protection exists. Other preconditions for the development of rural financial markets are, of course, profitable enterprises, clear management structures, and opportunities to market the production freely. Only free marketing assures that agro-businesses can sell their products at the best possible prices. Credit institutions in rural areas must be strengthened. International institutions could execute such projects, once the Ukrainian government has created the legal basis for such credit institutions. A law concerning credit unions and rural credit associations is still lacking.

#### 4.4 Active regional and agrarian policies

The decline of gross agricultural production and of wealth creation in the agro-sector is often blamed on the so-called price disparity in Ukraine. This completely disregards the fact that many inputs – e.g. diesel fuel, fertiliser and primarily the soil and labour – are considerably cheaper in Ukraine than for instance in Germany, and that the prices for many agricultural outputs are higher. A price disparity exists in Ukraine only relative to Soviet times, not relative to other countries (see Figures 1 and 2).

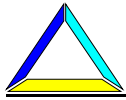
Figure 1



Figure 2



The political discussions also pay no attention to the fact that even during Soviet times no small proportion of farms made losses, and the fact that the price relations between agricultural and non-agricultural products changed more quickly and more strongly against agriculture in other countries (e.g. Poland) than in Ukraine. Yet, the gross agricultural production declined much less in Poland and most other transformation countries than in Ukraine! The reason is that in these countries productivity has risen strongly. In these fast transformation countries agricultural labour productivity has risen quite strongly since 1989, for instance in Slovakia by 20%, in Poland by about 40%, and in Hungary by more than 100%. In Ukraine by contrast, labour and area productivity have both declined strongly in past years. A necessary precondition for increasing labour productivity is labour migration away from agriculture. For instance, in the new federal provinces of Germany more than 80% of the membership of the former collective farms left between 1990 and 1994. A significant reduction of labour is unavoidable in Ukrainian agriculture, too.




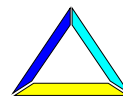
Non-agricultural jobs are however almost nonexistent in Ukrainian villages. Also, a social sphere outside of the agricultural enterprises has not yet developed in most villages. For most workers dismissal therefore means unemployment, with the only source of income the private plot around the house. Socially cushioning the effects of the structural changes should therefore be the central objective of agricultural policies in the coming months and years.

Those limited funds, which are available to the agricultural sector, should therefore be employed to further structural changes and labour migration away from agriculture. The following measures might be employed:

Farms and food processing enterprises should be unburdened by completely removing their social obligations in the villages, and transferring them to the communal administrations with the help of the state.

Other opportunities for work in the rural environment will determine to what extent workers can leave agriculture. In this the creation of small and medium sized enterprises (SME) in rural areas will play a central role. Even though state support to promote SMEs is limited, many important initiatives can be taken, such as educational measures, improving the infrastructure for small enterprises, and improving marketing opportunities in co-operation with international donors.

The creation of rural financial systems is also central to the promotion of employment opportunities in rural areas. Countries such as Moldova have successfully demonstrated that this is possible even under the difficult conditions imposed by transformation. In the coming months conditions will be favourable for taking a new path in agricultural policy. This chance should not be missed. 



## V. HOW FAR HAVE THE REFORMS IN THE ENERGY SECTOR PROGRESSED?

### 1. Reforms outstanding at the end of 1999

For a country like Ukraine, which is poor in energy resources, and which at the same time is the most energy intensive economy in Europe, lowering the energy intensity of GDP and saving energy are goals of the highest priority. Lowering the energy intensity would reduce the negative effects on the balance of payment, and at the same time would become a major factor in increasing the international competitiveness of Ukrainian producers. The prime incentive for saving energy would be cost covering energy prices. To make this incentive effective, however, the energy must be paid for. Hence, the following reforms for the energy sector were still outstanding at the end of 1999:

- solution of the non-payment problem,
- introduction of market oriented prices, and
- creation of effective, profit creating enterprises.

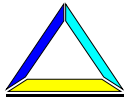
To reach these goals state interventions must be ended, the responsibility of companies and public institutions for their own performance must be strengthened, assets liability must be enforced, incentives for energy savings must be created through the installation of energy consumption meters, subsidies must be reduced, tax exemptions removed, privatisation of power companies advanced, and the debt for energy imports must be paid off.

### 2. An evaluation of the steps taken since December 1999

#### *2.1 Solving the problems of non-payment and of non-monetary payments for electric energy*

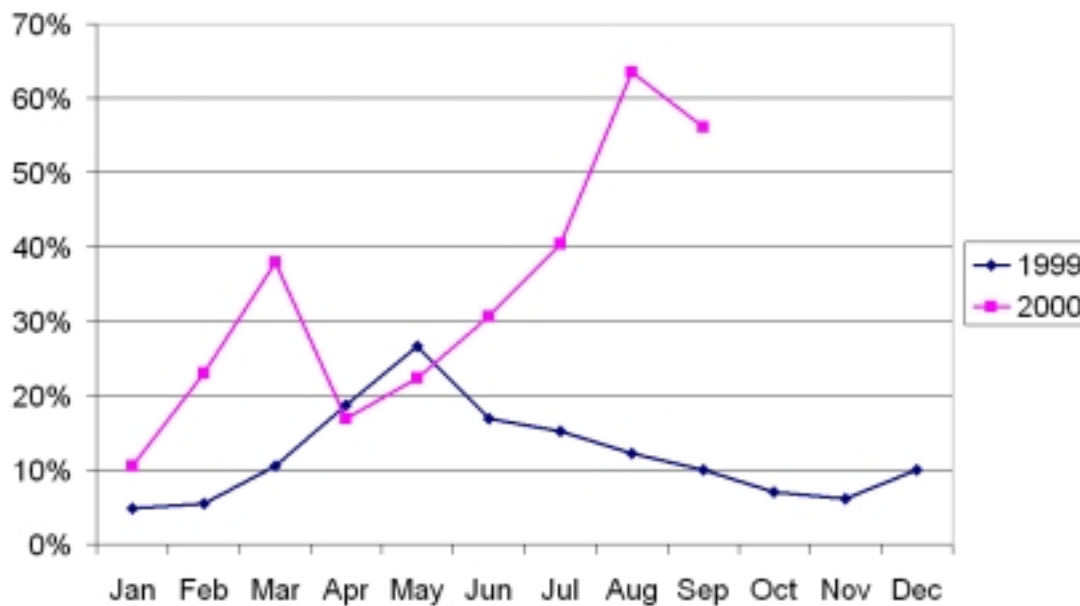
After taking power, the Ministerial Cabinet made solving the non-payment and the low monetary payment problems its foremost topic for the energy sector. A whole series of regulations were issued with the goal of insuring that the contracts are honoured and the payment obligations of the state are fulfilled. It became clear that partial success was being achieved during the year 2000. This concerns primarily the electric power sector.

Thus cash payments for deliveries from the electricity wholesale market (Energorynok) have significantly risen since the beginning of 2000. The rate of these payments relative to total power deliveries rose to 34.4% for the period from January to September 2000, as compared to 17.5% for the year before. Total cash receipts by Energorynok have more than tripled, rising from 839 mn UAH (January to September 1999) to 2,707 mn UAH (January to September 2000). In spite of strong monthly variations, the



trend towards increased monetary payments during the year 2000 is clearly discernable (see Figure 1, which shows only the monetary payment receipts of the Energorynok clearing account).

**Figure 1: Rate of monetary payments by the Oblenergos**



Source: NERC, monthly payment receipts

This has led to a slight increase in monetary receipts by the electric power producers and hence to a partial easing of their fuel procurement problem. It should also be noted, that attempts have been made to provide economic incentives for greater payment discipline.<sup>6</sup> However, the extent of monetary payments is still too small to insure security of supply in the electric power sector.

The overall payment rate (e.i. the sum of all payments independent of the mode of payment) declined by about 5% in the period from January to September 2000 compared to the year before.<sup>7</sup> The total indebtedness for electric energy rose (see Table 1). Monthly payment rates varied widely. For August and September the payment rate reached nearly 130%, which means that not only the current supplies were being completely paid for, but some debt repayment also occurred.

<sup>6</sup> A rebate of up to 20% is allowed for cash pre-payments. However, these payment conditions also cause the wholesale market pricing structure (algorithm) to be overturned.

<sup>7</sup> The payment rate was 81.4% for cumulative payment receipts for January to September 1999 compared to only 76.6% for the same period of time in the year 2000. Perhaps this is related to the disallowance of barter trade.

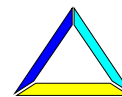
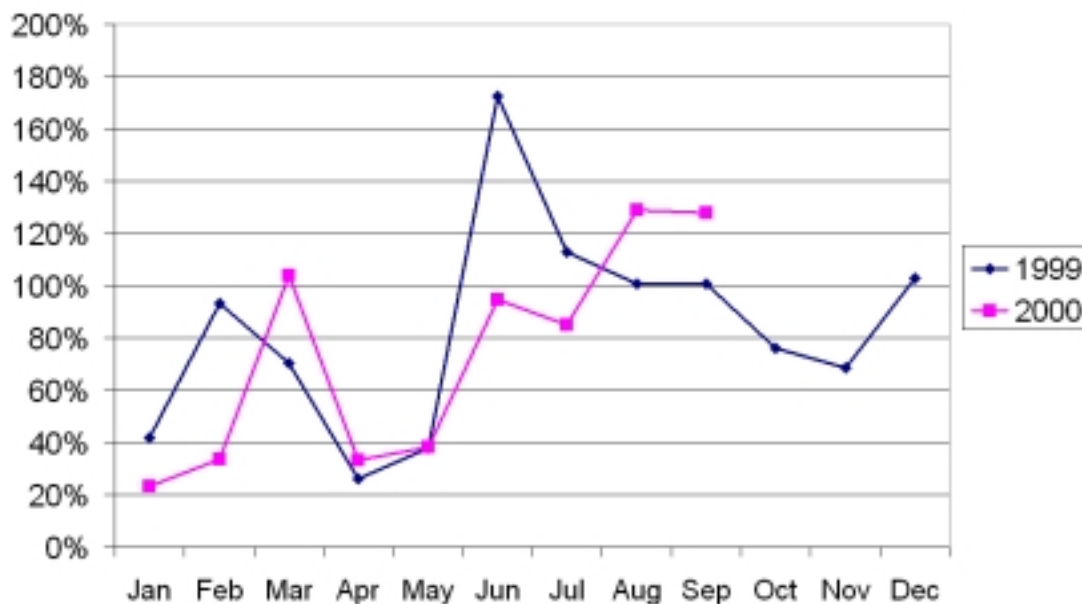


Figure 2: Payment rate of the Oblenergos



Source: NERC, monthly payment receipts

Since July 2000, the accumulated nominal consumer debt for electric energy has decreased slightly. Thus the payment behaviour of the Oblenergos tends to be similar to that of consumers.

The increased payment discipline does not apply to all consumers, though. Although the number of enterprises having payment arrears for electric power has reduced by about 15,000<sup>8</sup>, there are still about 30,000 companies remaining with outstanding debt for electric power.

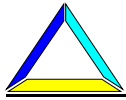
Large enterprises still suffer less from the cutting off of power. 24% of the remaining not cut-off debtors consume 66% of the unpaid power.<sup>9</sup>

The composition of debtors has changed but little (see Figure 3). Major debtors are industrial enterprises (about 40% of debtors), followed by communal service organisations (about 20%).

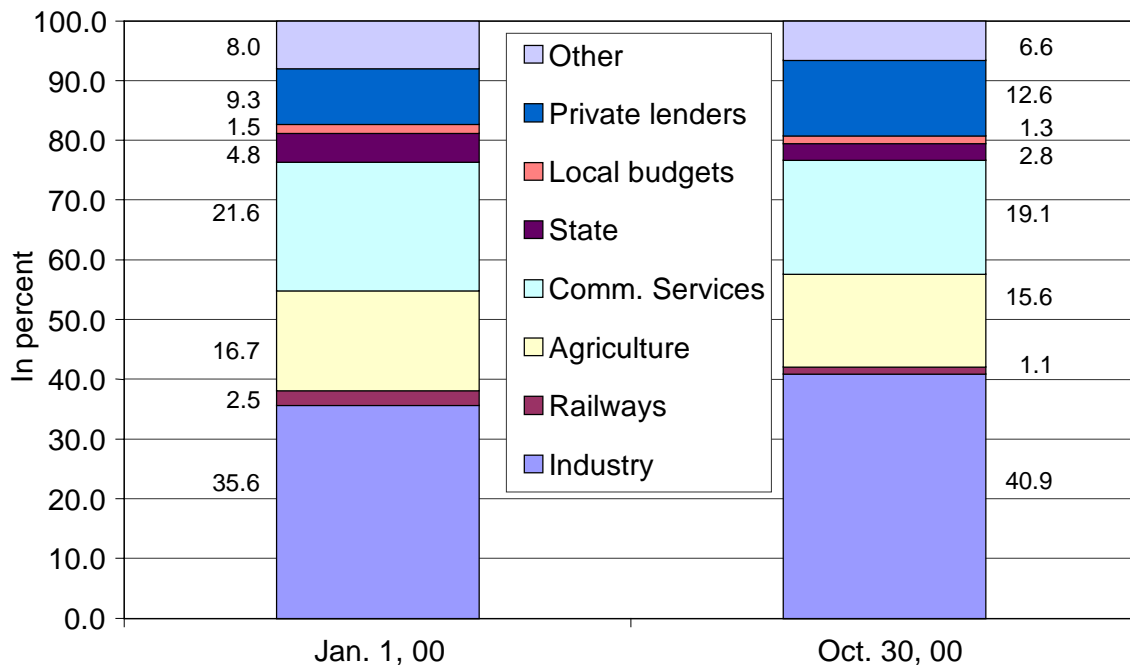
Sanctions based on asset liability have not been enforced vis-à-vis debtor Oblenergos, although various court judgements have declared such measures to be legal.

<sup>8</sup> Out of almost 50,000 in January to somewhat more than 30,000 in September 2000.

<sup>9</sup> Energobiznes (2000), No. 44, p. 55.



**Figure 3: Break down of the non-paying power consumers (Percentage of total payment arrears)**



The state does not reliably honour its own payment obligations. In the first nine months of this year alone, overdue payment arrears for electric power consumed by government organisations have increased by about 170 m UAH. The over-proportional increase of debt owed by organisations financed by the central government highlights the significant deterioration of the state's payment discipline for electrical power. The arrears of organisations financed by local governments declined in September 2000 for the first time, they were however still higher than at the beginning of the year (see Table 1).

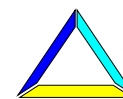
**Table 1: Overdue payments for electric power delivered to organisations financed by the state (in mn UAH)**

Organisations	Jan. 1, 1998	Jan. 1, 1999	Jan. 1, 2000	July 1, 2000	Sep. 1, 2000
financed by the central government	38.2	118.7	172.8	263.8	340.7
financed by local governments	42.4	56.8	74.3	133.8	108.4
Total	80.6	175.5	247.1	397.6	449.1

Source: Treasury department of Ukraine

The increased general indebtedness (see Table 2) is equivalent to an increase in indirect subsidisation. This seems to be related to newly issued authorisations for offsets (e.g. order No. 934 of the Ministerial Cabinet).

A reduction of receivables and payables happened only sporadically, and was then followed by renewed debt accumulation. Although the



authorisations to settle arrears for power supplies to state financed organisations always referred to debts accumulated in the past, they seem to have raised the expectation with the enterprises in question that such authorisations will also be forthcoming in the future. As a consequence more debts are being accumulated after each settlement (see also VI.2.1).

**Table 2: Growth of overdue\* receivables and payables in the electric power sector (compared to the previous quarter, in m UAH)**

Increase	Jan. 1, 1999	Apr. 1, 1999	July 1, 1999	1 Oct. 1999	Jan. 1, 2000	Apr. 1, 2000	July 1, 2000
Receivables	-955.3	4,461.0	3,093.8	178.0	1,229.5	-1,470.7 [6,017.7]**	12,374.7 [4,886.8]
Payables***	-597.1	2,988.0	3,218.2	1,169.4	1,717.9	730.6 [8,234.9]	13,469.3 [5,965.0]

\* More than 60 day old claims.

\*\* Data in square brackets [] are based on the Statistics Bulletin of May 2000, in which the April 2000 data were corrected. A different statistical data collection method applies as of April.

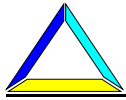
\*\*\* Due to a differing price basis (receivables are calculated according to factor costs, payables according to delivery prices inclusive of taxes) receivables and payables are not equal.

## 2.2 Reducing state intervention

The needed reinforcing of self-reliance for enterprises and public institutions has not yet been initiated. Though it is very welcome that local governments have now received more responsibility (first successes deriving from these measures can be seen in Table 1), this does however not apply to large enterprises nor to public institutions.

The budgeted moneys for financing the energy consumption of public institutions and enterprises are still not paid out to them directly. Transmitting these funds to the Energy and Fuel Department or to the responsible Oblenergos is not conducive to the consumers becoming more responsible and to giving them incentives to save energy.

The constant and sometimes indirect interference by the government into the operations of the National Energy Regulation Commission (NERC) must be criticised. In order to temporarily redirect the monetary funds in favour of individual market participants (e.g. power producers), the existing wholesale market pricing structure (algorithm) was frequently changed. This is often done by invoking a state of emergency. It is of course understandable, that such operative regulation of the electric power market might be used to relieve the acute monetary deficit of a given power plant operator in order to allow him to purchase fuel.



However, this also has significant negative consequences. The frequent use of state of emergency orders

- discredits the general payment system of the wholesale power market,
- encourages misuse, and
- merely leads to a redistribution of the lack of cash.

In the field of power generation there still is no competition. Selection of generating stations is not done according to criteria of merit (sequence of the lowest cost producers), but according to operative considerations such as availability of fuel or the need to purchase fuel.

### ***2.3 Designing a transparent and consistent privatisation strategy***

By means of public tenders, an internationally recognised company was selected to prepare and stepwise execute the privatisation of initially six Oblenergos to so-called strategic investors. The eventual privatisation of all Oblenergos is foreseen at a later stage. This has clearly demonstrated the will to privatise, at the same time defining consistent rules of procedure. At this time tenders for the sale of the six Oblenergos have been issued. The sales should be consummated in 2001. However, a series of overall conditions concerning the freedom of action of the Oblenergos are still to be more precisely defined. Among these are: the right to disconnect non-paying consumers and a consistent tariff policy.

Yet, it must be critically noted that privatisation in other areas of the energy sector (gas and coal) have hardly advanced. Even the ongoing discussion concerning privatisation versus licensing of the gas pipeline system does not yet show in which direction the restructuring of the gas sector might go.

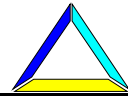
### ***2.4 Removing the value-added tax exemption for energy***

Removing the value-added tax exemption for energy resources early in the year 2000 was an important step toward eliminating distortions in resource allocation. On the other hand, value-added taxes were again removed from mineral oil products in order to counterbalance the price increases caused by rising petroleum prices on the world market.

## **3. What remains to be done?**

The engagement which the government has shown by improving payment discipline in the electricity sector, must not only be continued with more persistence, it must also be extended to other sectors in the energy field (gas sector, coal industry). A significant cause of the still inadequate payment discipline is the insufficient persistence with which governmental decisions have been implemented. The government is confronted with various contradictions when implementing its regulations and decrees:

Firstly, the implementation of legislated regulations is very important for the development of a stable and lasting system, but this is a long-term



process. In the mean time many a pressing problem needs an ad-hoc resolution. If these interventions happen too often, not only the functioning of the regulations is undermined, but even the credibility of the government is put into question.

Secondly, the government obviously meets much resistance from certain interest groups when trying to implement its regulations and decrees.

Thirdly, the government is obviously afraid of the negative social consequences of some of its measures, since programs for cushioning the social impact of unpopular measures have often not been provided for.

Fourthly, there still exist some shortcomings in the legislated regulations, and precise rules for implementation are lacking.

Therefore, the following approach seems in order:

### ***3.1 Cutting off power***

Power cut-offs have proven to be very effective to raise payment discipline. This measure must be implemented in a consistent manner. The largest portion of debt for electrical energy falls on industrial enterprises. Here non-payment must be punished with power disconnection, in order to halt the damaging implicit subsidies, which non-payments represent. Such subsidisation is not only a drain on the Ukrainian power industry, but this artificial protection of some industries sets the wrong signals for resource allocation. Supporting energy intensive industries impedes necessary structural change. This relationship should be more clearly enunciated in public.

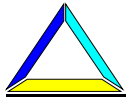
Precise measurement of the energy consumed is a necessary precondition for implementing sanctions. The program for installing gas meters and the modernisation of the metering points in the high-tension system, due for many years now, must be given high priority.

### ***3.2 Social and regional economic programs***

In addition to the disconnecting and asset liability approaches, which aim at adjusting debtors through restructuring or even liquidation, social and regional economic programs need to be developed and financed.

### ***3.3 Sanctions for non-compliance***

Now that the Oblenergos have been given freedom of action vis-à-vis non paying consumers, it is essential to punish any participants in the electric power market who do not fulfill contracts or comply with laws, even to the point of seizing assets or revoking licenses. The basic legal preconditions herefor are in place. Still missing are rules of implementation covering the concrete measures to be used, and their enforcement by the National Energy Regulation Commission (NERC), for example, by appointing an external management group until that time when licenses for electrical power supply are to be re-issued.



### ***3.4 Raising the payment discipline of the central state organs***

To raise its own payment discipline, the central government must:

- allocate in its budget the total funds needed for energy consumption for all its organisations, and not just a portion of these funds;
- completely pay out the budgeted funds. (Budget planning should allow for increases in tariffs, which are, after all, determined by the state itself). This also includes support payments to socially weak households;
- pay the funds to the actual energy consuming organisations, so that they will assume the responsibility for their consumption and receive an incentive for saving energy.


### ***3.5 No offsets for payment arrears***

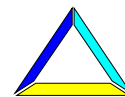
The repeated reversion of the government to measures permitting non-monetary settlements of payment arrears should be stopped. These measures are not only counter to the legal prescription to settle debts by monetary means, but also raise expectations with enterprises that future settlements will continue to be possible, too. This inevitably leads to a strategy of debt accumulation. Non-monetary settlements also lead to price intransparency, dependence on single supplier structures, and to insufficient cash flow, with which to pay wages, for instance.

### ***3.6 Independence of the National Energy Regulation Commission***

The independence of the National Energy Regulation Commission (NERC) must be judicially safeguarded through the enactment of a law. Interference by the state into the powers vested in the commission should only be possible under emergency conditions. Such conditions must be clearly defined and must not – as has happened several times this year – just simply be declared by the government in order to solve certain financial problems in the electric energy sector. Only the persistent raising of the rate of payment can overcome the financial deficits.

### ***3.7 Admitting competition***

It is important to allow actual competition for both the power producers and the power suppliers (Oblenergos and independent suppliers). Realistically, this can only be achieved through privatisation of the respective enterprises and through consistent implementation of the principle of asset liability. 



## **VI. HAVE THE MOST IMPORTANT STEPS BEEN TAKEN TO REORGANISE THE STATE FINANCES?**

### **1. Reforms outstanding at the end of 1999**

At the end of 1999 the four most pressing reforms required to reorganise the state finances were:

1. Incremental reduction of the state's payment arrears, an absolute payment discipline by the state, and no more offsets between the state and enterprises;
2. No raising of taxes and fees to balance state expenditures, but rather reduction of some state expenditures;
3. Broadening the tax base and implementing a tax reform;
4. Other measures, particularly:
  - Improving planning, implementing and controlling the budget;
  - Improving the transparency through a consolidated budget;
  - Improving the control of the state's interest in enterprises;
  - Extending the control responsibilities of the Court of Auditors;
  - Creating a finance judiciary (Courts which are only concerned with taxation questions);
  - Improving the financial relations between the central and lower government levels (financial federalism), in particular creating relatively stable and adequate sources of income for the lower governmental levels in order to provide incentives for them to promote local economic growth and tax income.

Significant progress has been made since December 1999 among all four above-mentioned reforms, though inconsistencies in the implementation have reduced some of their positive impacts. More successes than failures were experienced with items 2. and 3. With items 1. and 4. negative effects dominated, though these could be remedied if firm measures are taken in the near future.

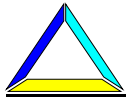
### **2. An evaluation of the steps taken since December 1999**

#### ***2.1 Reducing payment arrears and offsets between enterprises and the state***

The first eight months of the year 2000 saw the complete elimination of pension arrears (which were 1.3 bn UAH at the beginning of 2000).<sup>10</sup>

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<sup>10</sup> The payment arrears of the budgetary organisations did however continue to rise, see below.



The prohibition decreed by the government in December 1999, to disallow offsets between the state (including state organisations) and enterprises, must also be valued positively. These offsets involve a renunciation by the state of tax claims in return for the cancellation of the payment arrears of state organisations. These settlements did indeed decrease significantly until the late summer of 2000, and tax receipts reached planned levels until that time.

**Table 1: Payment arrears of the state between 1998 and 2000 (in bn UAH)**

	Jan. 1, 1999	Sep. 1, 1999	Jan. 1, 2000	Sep. 1, 2000
Payment arrears of the budget organisations:				
– Wages	1.05	1.31	0.93	1.08
– Social assistance	0.76	1.49	1.47	1.50
– Goods	0.51	0.66	0.79	1.53
– Communal services and energy	1.25	1.32	1.45	1.81
– Other	1.36	1.74	1.65	1.31
Total	4.93	6.52	6.29	7.22
Pensions	not available	not available	1.26	0.00
Grand total	not available	not available	7.55	7.22

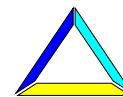
*Source: Ministry of Finance*

So far the payment discipline of the state has not been permanently assured, however (see Table 1). Offsets between the state and enterprises have expanded since the fall of 2000 – in spite of the prohibition of December 1999 – so that the budget is again quite intransparent.<sup>11</sup>

Only the pension arrears were reduced, not however the payment arrears of the budgetary organisations. This can be traced back to the still existing fundamental problems with budget planning, implementation and control:

Planning for the consolidated central government budget and for the budgets of the local governments, which are responsible for communal services, police, health and education, are not co-ordinated. The local

<sup>11</sup> Offsets amounting to 3.1 bn UAH were executed during August. These probably rose by another 1.5 bn UAH during the year 2000, as wage arrears in the coal industry were cancelled by offset. The payment arrears of the budgetary organisations shown in Table 1 for September 2000 amounting to 7.22 bn UAH would be higher by another 3.1 bn UAH, had there not been these offsets. They are officially termed 'subsidies to local budget' and their precise usage can only be guessed by us.



governments don't yet control the budgetary organisations reporting to them, or do so inadequately. At the same time the Court of Auditors has no mandate yet to control these organisations and local finances. Thus the central government plans lower expenditures than the local governments for the same items, which causes the latter – because of insufficient cash receipts – to make expenditures in the form of payment arrears.

The budget still shows only cash payments, i.e. it does not include any obligations entered into by the budgetary organisations, which means the latter can raise their expenditures and increase their indebtedness without this showing up in the state's (cash) deficit.

Ministers are not personally responsible for the current over-expenditures in the communal services field.

Offsets between the state and those enterprises which have claims against budgetary organisations are still being permitted and raised, in spite of the prohibition of December 1999. Offsets in the amount of 3.16 bn UAH were made in August 2000, to cover payment arrears for the police, communal service organisations, the military, and other state institutions. In consequence and in spite of the continuing real economic growth, the state received only 80% of the planned tax receipts during September 2000, compared to nearly 100% between January and August (see also footnote 11).

These offsets are very harmful primarily for four reasons:

Firstly, they probably are more costly to the state than cash payments, since the prices used for the settlement contain a premium for the uncertainty of payment and interest for late payment, and are often too high.

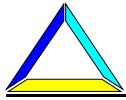
Secondly, they allow the budgetary organisations and the local administrations, which are responsible for communal services, police, health and education, to spend more money than planned for in the consolidated budget.

Thirdly, in this manner the vicious circle of non-payments and non-monetary payments in the economy is kept in motion and reinforced by the state itself.

Fourthly, offsets perverse incentives to enterprises and budgetary organisations alike, since they undermine expenditure discipline, improved expenditure efficiency, transparency, and competition. Another disadvantage is that offsets particularly support inefficient enterprises.<sup>12</sup>

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<sup>12</sup> Especially inefficient enterprise are usually ready to supply goods under any circumstances, and to accept payment in the form of offsets, i.e. tax remissions. This is especially true where these companies, by means of such 'settlements', can charge excessive prices and pass the tax remissions on to other enterprises.



## ***2.2 Reducing state expenditures to compensate for reduced revenues?***

The reduction of the budget deficit continued, even a budget surplus was achieved. Expenditures of the state sank from 30.4% of GDP in 1998 to an estimated 27% in the year 2000. This was achieved because the proportion of unproductive or even harmful state expenditures was reduced somewhat, for instance expenditures for state reserves, and subsidies for agriculture, industry and the energy sector.

A start was also made with reducing over-employment in the state bureaucracy, police and military. (Total government employment is slated to be reduced by 100,000 persons in each of the years 2000 and 2001).

Nevertheless, state expenditures for 'administration' have gone up further, and actual expenditures (in cash and rising indebtedness) differ greatly from planned expenditures in many areas:

### **Excess expenditures:**

The greatest excess expenditures (here expenditures include the offsets amounting to 3.2 bn UAH) were made

- for the funding of the 'state administration' (the cash expenditures after eight months alone almost amount to the planned cash expenditures for the whole year),
- for police and state security, and
- for the funding of communal services.

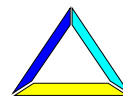
Should the authorisation for payment of wage arrears in the coal industry, amounting to 1.5 bn UAH, be implemented, the substantial excess expenditures for these subsidies would have to be added to the total.

### **Under-expenditures:**

Large under-expenditures in cash (without considering the payment arrears created) occurred in the first nine months of the year 2000 in the fields of science, education and health (budgetary organisations).

The local governments, which are responsible for these areas, evidently pay out less cash than the central government's proposed budget plans foresee. The reaction by the local budgetary organisations is to enter into payment arrears, which will then – at some distance in time and whenever the central government so decides – be balanced against tax claims of the state by means of offsets. The lack of co-ordination in budget planning between the central and local governments still continues and is a very grave problem.

The central government too, has to answer for some very large under-expenditures during the first nine months of the year 2000, particularly on interest payments for domestic debt. Contrary to the 2000 Budget Law, only 472.3 mn UAH were spent during the first nine months, although 1.9 bn UAH had been budgeted for the whole year.



### ***2.3 Broadening the tax base and continuing tax reform***

Broadening the tax base was achieved by employing the following measures:

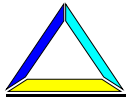
- Raising the sales tax for energy from nil to the standard rate as of January 2000 (exempting mineral oil products);
- Eliminating the list of so-called 'critical imports' that are exempt from sales tax. According to some estimates this list alone has been responsible for tax shortfalls of 600 mn UAH;
- An immediate end to consider individual claims for tax relief (Decree of the Cabinet of Ministers of December 30, 1999);
- Eliminating special tax treatment for enterprises with foreign investments (Law No. 1457 of February 17, 2000 applies to these companies);
- Eliminating the majority of special tax treatments for certain companies. With the Decree of May 5, 2000 'concerning the granting of tax privileges', the Cabinet of Ministers declared invalid 259 tax privileges previously granted to companies. In July 2000 another 59 previously granted tax privileges were eliminated;
- Lowering the number of tax privileges granted to Special Economic Zones from 899 to 477 (Decree by the Cabinet of Ministers of May 26, 2000);
- Prohibiting tax rescheduling, tax remission and tax postponing (by adjunct clause 15 of Budget 2000).

A comprehensive tax reform greatly reducing the number of existing taxes to only 15, and of the tax rates to a very moderate level has been developed by the government and proposed to parliament. At this time the tax reform package is still being discussed.

Important elements of the tax reform package, which can be seen as very positive for future economic growth and for lowering administrative costs, are:

- Equalising the tax rates for profits and personal income taxation, and lowering both;
- Making income up to the subsistence level free of personal income tax, and simplifying the tax structure by reducing the number of tax brackets to two;
- Very moderate taxation of capital gains;
- Reducing the number of local taxes;
- Reducing the number of goods subject to excise tax.

The reduction of tax rates promotes self-financing of companies, which is very important for financing investments and hence for economic growth.



The "Road Building Levy" was eliminated. Also scheduled for elimination during the year 2001 (as part of the budget for the year 2001) are:

- the levy for the "Innovation Fund",
- the levy for the "Road Building Fund",
- the levy for "Wine and Hops Cultivation",
- the tax on depreciation applying to state enterprises, and
- the coefficient rule applying to depreciation.

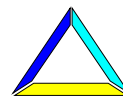
The following measures diluted these positive beginnings: a new sales tax exemption for mineral oil products was created; a drastic tax reform was announced, but its implementation is still in doubt, which raises the uncertainty of market participants; and the sales and real estate tax exemptions for agriculture were not removed.

#### ***2.4 Other measures***

The government showed persistence with the following measures:

- Administrative reforms: Changing the responsibilities and reorganisation of some departments and state agencies, reducing their number;
- Improving budget planning: The quality of the macro-economic prognoses has clearly improved;
- Budget implementation: The state's accounts were transferred from commercial banks to the National Bank. This allowed better liquidity management;
- Budget control: A change to the constitution was requested to broaden the control function of the Court of Auditors to cover all revenues of the central government;
- Partial improvement of the transparency of the consolidated budget: Funds, which were previously not included, are now part of the official budget. On the other hand the very high level of offsets reduces transparency;
- Creation of a finance judiciary (Courts which will be exclusively responsible for taxation matters): A start was made to create sections within some courts, which are specialised to handle tax matters;
- Improvements in the financial relations between the central and the lower level governments (fiscal federalism). Among other items, a so-called 'budget code' must be developed to regulate the financial relations between the different levels of government. The suggested budget code has important advantages, especially regarding the freedom of decision making for local administrations. But it also contains shortcomings, which will be briefly discussed below.

To complete the budget reforms, the following items need still to be addressed:



Control of the state owned enterprises still appears inadequate. No new proposal has been developed, which would assure a comprehensive and continuing control of every state ownership interest.

The planned extension of the control functions for the Court of Auditors apparently only concerns the control of state revenue, not however the necessary control of the regional (oblast) finances. Assuring the Court of Auditors' financial independence has also not been implemented; the Court of Auditors remains dependent on the Finance Department.

The proposed new 'budget code' has many positive aspects, particularly with respect to the clear division concerning the duties and the revenues of the central and regional governments, the introduction of a formula for calculating the transfers to the regions with more objectivity than heretofore, and limiting the possible deficits of the regions to the level of their investments. But it also has important drawbacks. In particular, the own revenues of the regional governments appear to be insufficient to finance their enlarged scope of duties, and the high proportion of transfers of their total revenues limits their independence. Another deficiency is the fact that larger cities still can take on debt in foreign denominations, although as a rule they have no significant income in foreign currency, and hence would have to carry an exchange rate risk.

### **3. What remains to be done?**

Action is required in the following five areas:

#### ***3.1 Reducing payment arrears and improving the state's payment discipline***

By setting up a new cost centre in the budget, the state must gradually eliminate its payment arrears.

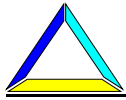
Prohibition of offsets between the state and enterprises must be strictly enforced.

Finally, the state must maintain a strict payment discipline. New payment arrears of the budgetary organisations can only be avoided by improved budgetary planning.

#### ***3.2 Improved budget implementation and control***

The planning of the consolidated budget by the central government must be in agreement with the planning of the regional and local budgets and with the expected state revenues. To achieve this a co-ordination council should be created with the responsibility to assure such agreement, and also responsible for continuing medium term financial planning for the consolidated budget.

Regional governments (oblasts and communes) must insure that the budgetary organisations they finance (police, hospitals and other health facilities, schools, universities, etc.) do not become indebted. This can



only succeed once personal responsibility for payment arrears is introduced at the regional government level and at the budgetary organisations.

The central government must insure that the military and the communal service organisations, which report to the umbrella organisation called the "Committee for Housing and Communal Economy", which in turn reports to the Cabinet of Ministers, do not enter into payment arrears. The same applies to the railway, which is a responsibility of the central government.

The Court of Auditors, who will require additional funding to set up regional offices, should control the regional administrations (oblasts). The financing of the Court of Auditors must be arranged such that its political independence is assured, i.e. for its financing it should be less dependent on the Department of Finance than it is now.

Clear rules about responsibility (for the competent minister, for instance) and of personal consequences should be defined for spending beyond budget limits and similar acts.

### ***3.3 Reducing some state expenditures, improving state expenditure efficiency and improving state revenues***

Raising taxes and fees to balance the budget should be prohibited, instead some state expenditures could be reduced, the efficiency of state expenditures should become better, and revenues should be improved:

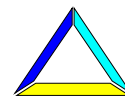
#### **Reducing some state expenditures:**

The state's employment level must be reduced, especially in the police, the administration and the health sector. Subsidies to the coal industry must also be reduced, and the credits offered by the World Bank for social assistance to coal miners should be accepted.

#### **Improving state expenditure efficiency:**

Every state expenditure must have one or several goals, which the expenditure is meant to achieve. These goals should at regular intervals be defined in writing by the ministries, should then be presented to the Prime Minister for acceptance, and finally it should be checked at least once a year whether they were reached with minimal effort. The definition of the goals and their verification must be the responsibility of the central government minister concerned, or of the member of the oblast administration in charge.

An important standard for the regular verification of the efficiency of expenditures should be regional and international comparisons of per capita expenditures. A precondition for this is that every expenditure can actually be allocated to a consumer. For instance, gas consumption by individual institutions, military installations, hospitals, schools, etc. must be measured.



State investments above a certain limit should be subject to thorough checks of their long term cost and revenue consequences on state finances. These verifications should be proscribed by law.

#### **Improving state revenues:**

The tax base must be broadened (see below).

Offsets to pay for state payment arrears must be renounced.

An action plan must be developed for the effective control of state owned companies and of enterprises with state participation, including representation of the state at the annual meetings and on the board of directors of these companies, and sanctions for enterprises which produce losses.

### ***3.4 Broadening the tax base and implementing tax reform***

#### **Broadening the tax base:**

The sales tax exemption for mineral oil products should be eliminated.

The sales tax exemption for agriculture should not be extended under any circumstances.<sup>13</sup>

The land tax exemption for agriculture should be abolished.

The sales tax law contains other exemptions, which must be reconsidered. In particular, this includes the sales tax exemption for the local transport of people and the 'cheques' for sanatoriums.

The tax privileges for the Special Economic Zones, for domestic producers of television apparatus and agricultural machinery, and for metallurgical enterprises should be eliminated.

#### **Implementing tax reform:**

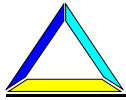
The proposed tax reform measures should be examined to determine whether they can actually be financed. In our opinion, the prime revenue source – aside from broadening the tax base – is better control of the state owned enterprises (which could raise state revenues by several bn UAH) and the prohibition of offsets.

The tax reform should go ahead after this examination of revenue sources, taking into account the following important elements:

- Reforming income tax (tax-free minimum up to the subsistence level, lowering the highest tax rate down to the level of the profits tax);

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<sup>13</sup> Tax exemption for agriculture was instituted about three years ago. The rationale given was that this was the only means to halt production decline, i.e. that production could be stabilised this way. In fact, agricultural production continued to decline. Tax exemption is an impractical approach for stabilising agricultural production (see chapter V).



- Reforming the profits tax (abolishment of the coefficient rule for depreciation, abolishment of the tax on depreciation, also for state owned enterprises, symmetrical handling of currency losses and gains, acknowledgement of tax deductions for operating costs as practised in the West, disallowance of tax deductions for the companies' social spheres);
- Reforming excise taxes (The incentive for smuggling from neighbouring countries must be taken into account when determining excise tax rates);
- Reducing the number of taxes to 15, as planned.

### **3.5 Other measures**


The financial relations between the central and lower level governments must be improved.

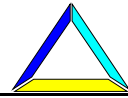
The 'budget code' must be reworked; particularly two important changes are needed:

- Financing the extended range of responsibilities of the local governments should be improved, and should primarily be achieved through revenues raised by the local governments themselves. A significant part of these local revenues should be raised via oblast and communal taxes, which the central government shares with the oblasts and communes. The amounts transferred from the central governments to the oblasts and communes should be low;
- The oblasts and communes should not be permitted to take up debt in foreign currencies, since – as a rule – they have no foreign currency income.

The government should, for its own 'protection' against attacks by interest groups, prepare and publish an annual report on subsidies, which is based on a broad definition of 'subsidy' (see chapter II).

As planned, an extension of the control functions of the Court of Auditors, publication of its reports, and establishing its financial independence must also be instituted.

A finance judiciary must be instituted by creating courts which are exclusively responsible for tax matters. 



## VII. HAS THE STATE DEBT PROBLEM BEEN SOLVED?

### 1. Reforms outstanding at the end of 1999

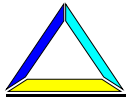
At the end of 1999 Ukraine was at the brink of being unable to service its debt. The economic limit of indebtedness had long since been reached. Too long had the state spent more than it had taken in, in order to satisfy those demands which the Ukrainian economy could not meet out of its own resources, which however needed to be satisfied for 'political reasons'. At the end of 1999 the indebtedness in foreign currencies amounted to 12.4 bn USD, but no adequate source for repayment deriving from within the Ukrainian economy was in sight. Two aspects of the problem had to be solved, for which the following solutions were proposed:

#### **Solving the problem of accumulated public debt (stock problem):**

- Reducing the list of enterprises, which are not allowed to be privatised, also sales of state assets;
- Buying back state debt in return for state assets;
- Collecting claims by the state (e.g. arising out of guarantees, payables to the state reserve, etc.);
- Rescheduling of domestic and foreign debt with the goal of considerably lengthening the average remaining term;
- Introduction of a legal upper limit for state indebtedness, e.g. at 60% of GDP as applies to all EU countries which are members of the European Currency Union.

#### **Solving the problem of accumulating new public debt (flow problem):**

- Observing the previously explained principles of budget planning, implementation and control;
- Comprehensive definition and cataloguing of all new public debt, i.e. taking into account the deficits in all budgets (including state reserves, social insurance, budgetary organisations);
- Introducing a legal requirement to make a cost-benefit calculation which lists all future revenues and expenditures mandatory for every state investment above a certain amount;
- Introducing a requirement into the constitution, which prescribes that the consolidated state deficit may not exceed state investments, while clearly defining these investments, and providing for exceptions only in case of massive disruptions of the general economic development;



- Defining verifiable criteria for issuance of state guarantees, and limiting these guarantees to projects which meet these criteria and which have bank financing and bank guarantees.

## **2. An evaluation of the steps taken since December 1999**

The new government realised the threat of insolvency due to over-indebtedness and, hence, applied several of the above mentioned recommendations, and even reduced the total foreign debt.

### ***2.1 Measures to solve the problem of accumulated public debt***

Rescheduling foreign debt: A restructuring of the 'Euro-Bond' credits, which the state had taken up and which would have been due in 2001, was accomplished in April 2000. The same applies to 'Gazprom-Bonds'. This debt represented only about 20% of total foreign debt at the end of 1999, however the 'Euro-Bonds' carried a much higher rate of interest than the rest of the foreign debt. The average term of the rescheduled 'Euro-Bonds' was lengthened significantly to between one and seven years (i.e. until 2007) and the interest rate was greatly lowered (to 10% for bonds denominated in Euro, and to 11% for those in USD).

Servicing foreign debt: The central bank used the foreign trade surplus resulting from the strong real devaluation at the end of 1998 and 1999 to increase its currency reserves. Only in this manner was it possible for the government to service its foreign debt, including the net payments due to the IMF, which were caused by the latter's stop of further credit issues.

Collecting the claims of the state (arising e.g. from guarantees, payables to the state reserve, etc.): A decree by the Cabinet of Ministers dated 27 September 2000 declares that overdue claims by the state on enterprises for which the state had issued guarantees and against which claim were executed, will be auctioned off. (By mid-2000 these overdue claims had reached 976 mn USD).

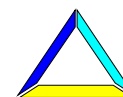
Repurchasing state obligations by offering state assets: The budget for the year 2001 provides for the repurchase of state obligations at the stock exchange.<sup>14</sup>

Legislated limitation of public debt: The proposed 'budget code' (financial constitution) contains the introduction of an upper limit for public debt at 60% of GDP. This corresponds to the rules applying in the EU-countries, which are members of the European Currency Union.

Limiting the budget deficit to the level of state investments: The proposed budget code includes a regulation according to which borrowing by the state may not exceed the level of the state's investments. This rule is

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<sup>14</sup> Repurchases amounting to 354.1 mn UAH of state obligations denominated in UAH, and 45.5 mn USD denominated in USD are planned.



particularly important so that future generations are not made to pay for the expenditures made by the present generation.

Recognition and conversion of old book credits of the NBU to the government dating from the years 1993 to 1996.<sup>15</sup> Although this caused public debt to rise by about 7 bn UAH in the year 2000, since these credits had previously not been included in the public debt figures, this action represents a definite improvement for the transparency of the public debt and of budget planning. The government increased its credibility by taking this step.

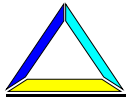
**Table 1: Public foreign debt in the year 2000 (in bn USD)**

	Jan. 1, 2000	Sep. 1, 2000
1. Debt owed to international financial organisations	5.2	4.5
– IMF	2.8	2.1
– Worldbank	2.0	2.0
– European Union	0.3	0.3
– EBRD	0.1	0.1
2. Debt owed to governments	4.3	3.2
– Russia	3.1	2.0
– Turkmenistan	0.3	0.3
– Japan	0.2	0.2
– Foreign credits with Ukrainian state guarantees	0.8	0.8
3. 'Gazprom' loans	1.1	0.2
4. 'Euro-Bonds' which were emitted prior to 2000	1.8	0.2
5. Converted 'Euro-Bonds' and converted 'Gazprom' loans of the year 2000	0.0	2.1
Total	12.4	10.2

*Source: Ministry of Finance*

Converting state obligations ('T-bills') held by the NBU: The T-bills held by the NBU amounting to 10.5 bn UAH have been converted into obligations with a term of between 16 and 24 months at an interest rate of 18.9% for the year 2001 and inflation rate plus 3% for the following year (Decree by the Cabinet of Ministers No. 1455, dated 22 Sep. 2000). This conversion also increased the credibility of the government and sent a positive signal to financial markets.

<sup>15</sup> In a law enacted for this purpose ("Concerning the restructuring of the debt of the Cabinet of Ministers vis-à-vis the NBU") the government recognises these previous credits as public debt (about 7 bn UAH). This debt was rescheduled and is now due in the years 2010 to 2035 (UAH credits) and 2002 to 2011 (credits in foreign currencies).



These measures have led to a reduction of the total amount of foreign debt (see Table 1)<sup>16</sup> and to a reduction of the average interest to be paid on it.

Concerning domestic debt, the distinct increase in nominal debt in the official figures only resulted from the fact that previous book credits of the NBU were added to the official public debt of the government. However this increase of domestic public debt was about equivalent to the rate of inflation, hence domestic debt in real terms and in relation to GDP rose only minimally (Tables 2 and 3).

**Table 2: Public domestic debt in the year 2000 (in bn UAH)**

	Jan. 1, 2000	Sep. 1, 2000
1. Treasury bills (including T-bills in the NBU portfolio)	11.5	12.2
2. Credits of the NBU	3.5	10.6
3. Payment arrears of the budgetary organisations for:	6.3	7.2
– Wages	0.9	1.1
– Social expenditures	1.5	1.5
– Property purchases	0.8	1.5
– Communal services and energy	1.5	1.8
– Various	1.3	0.0
4. Pension arrears	1.3	0.0
Total	22.5	30.0

*Source: calculated on the basis of data supplied by the Ministry of Finance*

This is the first time in the transformation history of Ukraine that the ratio of total public debt to GDP (debt quotient) has so distinctly decreased. The quotient even dropped below the planned upper limit of 60% of GDP (see Table 3).

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<sup>16</sup> The overall reduction in foreign debt is primarily explained by the debt reduction vis-à-vis Russia (related to the treaty for transferring parts of the 'Black Sea fleet') and a reduction of the debt to the IMF.

**Table 3: Public debt as a percentage of GDP in the year 2000**

	Jan. 1, 2000	Sep. 1, 2000
Domestic debt	17.7	18.7
1. Treasury bills (including T-Bills in the NBU portfolio)	9.0	7.6
2. Credits of the NBU	2.8	6.6
3. Arrears of the budgetary organisations and for pensions	5.9	4.5
Foreign debt	51.0	34.4
1. Debt owed to international financial organisations	21.7	15.3
2. Debt owed to governments	17.8	10.8
3. Debt owed to international commercial banks	7.3	0.5
4. 'Gazprom' loans	4.3	0.6
5. Loans from prior years which were converted in 2000	0.0	7.2
Total	68.8	53.0

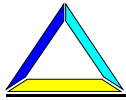
*Source: Calculated on the basis of data supplied by the Ministry of Finance, by the NBU and on personal estimates. To calculate the debt quotas at the beginning of the year 2000 the GDP of the year 1999 of 127 bn UAH was used. The debt quotas for September are based on an estimated GDP of 161 bn UAH for the year 2000.*

## **2.2 Measures to solve the problem of excessive new public debt (flow problem)**

Reducing the consolidated budget deficit: The deficit (cash payments) in 1999 of 1.5% of GDP was changed into a surplus of 1.2% of GDP during the first eight months of 2000. When taking into account the rise of the total known payment arrears of the public sector the surplus is even somewhat higher.<sup>17</sup> This was achieved because the planned state revenues were almost reached and because some state expenditures were reduced. The small reduction of subsidies to agriculture and for expenditures of the state reserve, and the fact that planned payments to the coal industry were not exceeded, must be positively noted. For the year 2001 a balanced budget is planned, while slightly reducing the state expenditures as a percentage of GDP. This will increase the confidence of the financial markets in the government, and make an important contribution towards lowering the interest levels and maintenance of the stability of the currency.

The abolition of (special) 'treasury bills' with indefinite maturity: These promissory notes were used to pay for payment arrears of budgetary organisations. They had been issued on instructions of the government by

<sup>17</sup> During this period of time, the budgetary organisations raised their payment arrears by 0.9 bn UAH, while pension arrears of 1.3 bn UAH were being completely eliminated. Hence the total payment arrears (including pension arrears) were reduced by about 400 mn UAH.



the "Ukrspetsfin" agency, which had been founded especially for this purpose. The existence of these instruments, and of the agency, caused growth of the payment arrears of the budgetary organisations and of the public debt. The agency also created unnecessary administrative costs. It has been shut down.

As of the year 2001, all transactions concerning the issuance of state guarantees will be included in the budget. They will be explained in the comments concerning the budget balances (deficit or surplus). State guarantees are intended to be issued only for credits by international organisations (e.g. EBRD, IBRD). State guarantees are not supposed to be issued any more for credits to organisations for the promotion of exports.

In sum, it has to be noted that the government was more successful with respect to limiting public debt than could have been expected. The total amount of foreign debt, dangerous because of the exchange rate risk, was significantly reduced, as was the amount of debt vis-à-vis GDP. With these measures, the government also accomplished important institutional reforms, which should serve to limit excessive future increases of indebtedness and to prohibit budget deficits to finance consumer spending.

Still, the burden of interest and principal repayment on the budget and on the balance of payment remains very high: Servicing foreign debt alone requires 1.7 bn USD to be made available annually through 2003 (Table 4). If currency reserves are to continue to rise (which is necessary), and if capital inflows due to foreign investment and foreign credit do not increase, then the foreign trade surplus will have to increase in order to permit the foreign debt to be serviced. To accomplish this, greater efforts will be required by Ukrainian exporters, which presumes structural changes in the economy and hence structural reforms.

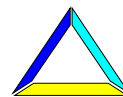
**Table 4: Servicing the foreign debt of Ukraine in the years 2000 to 2005 (in mn USD)**

	2000	2001	2002	2003	2004	2005
Obligations of the Department of Finance	831	1,100	1,349	1,493	1,382	1,342
– for principal	180	499	697	923	877	905
– for interest	651	602	652	570	505	437
Obligations of the NBU	866	606	302	214	201	109
Total	1,697	1,706	1,651	1,707	1,583	1,451

Source: Department of Finance, NBU

### **2.3 Unresolved problems**

Should the trade and service balances deteriorate, which could be caused by a real revaluation of the Hryvnia, then it becomes questionable whether the restructuring of foreign debt of early 2000 was sufficient to



be able to service it smoothly. Table 4 demonstrates the very high burden on the balance of payments.

In spite of the prohibition against offsets between budgetary organisations and companies announced in December, it proved impossible to reduce these non-monetary payments. On the contrary and as explained in the previous chapter, offsets rose strongly in the year 2000 to over 3.2 bn UAH. This not only seriously reduces the transparency of the budgets, but also greatly endangers the readiness of the regional governments to provide the necessary and planned financial means to the budgetary organisations. Thus, payment arrears of budgetary organisations are encouraged, as is the vicious circle of non-payments and excessive indebtedness. Moreover, the state loses more tax revenues than can be inferred from the amount of the settlements, since these transactions are usually based on over-stated prices.

The payment arrears of the budgetary organisations have risen by almost 1 bn UAH in the year 2000, due to the persistent problem of offsets. What is worse, all participants assume that these 'settlements' will continue in the future. Based on this expectation the regional authorities often do not even furnish the budgetary organisations with the planned funds. Consequently, the budgetary organisations often have no other choice but to incur payment arrears. This also reduces the incentive to practice strict discipline of expenditures.

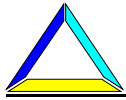
Whether the state should have assumed the debts for energy imports from Gazprom for the years 1999 and 2000 in October 2000 is questionable. This sends the wrong signal to the actual private debtors.

Servicing the state obligations held by the NBU (including the converted obligations) was not performed according to the contracted conditions. High arrears accumulated for principal (over 1.7 bn UAH at the beginning of July 2000) and for interest (over 400 mn UAH at the beginning of July).

Collecting claims by the state (especially resulting from guarantees and payables to the state reserve) showed almost no success. For example, the state reserve received almost no returns for claims arising out of its very high payments to companies prior to the end of 1998 (annually far more than 1% of GDP). Either these very high claims are unrealisable, or the will to collect them is lacking.

Concerning the activities of parliament one must note that the list of several thousand enterprises which may not be privatised, has only been insufficiently shortened. Also no criteria were established for deciding which companies should be on the list and which not. The maintenance of this list without defining the grounds upon which prohibitions against privatisation are maintained for individual companies seems quite unconvincing in light of the continuing high operating losses and the lack of desire of some companies to restructure.

It was impossible to continue the IMF program. Political questions (e.g. cautious behaviour by the IMF prior to the US elections), which Ukraine



cannot influence, may have played a role in this. However, other reasons (such as the removal of export taxes on oil seeds demanded by the IMF) did lie within the Ukrainian sphere of influence.

### **3. What remains to be done?**

The measures listed hereafter derive directly from the unresolved problems listed in section 2.3:

#### ***3.1 Solving the problem of accumulated public debt***

Further rescheduling of debt, particularly of foreign debt, may become necessary if economic growth does not continue. However, we do not foresee this scenario, unless the structural reforms are not accelerated, or a real revaluation of the Hryvnia takes place over the longer term.

An agreement with the IMF to continue its credits would greatly help with servicing foreign indebtedness.

Reducing the stock of payment arrears, especially those of the budgetary organisations without offsets presumes developing a plan for the state to gradually pay off these arrears and to enter into negotiations with the creditors.

An important source for financing the debt repayments due in the next years will be receipts from privatisations. To increase these receipts, the list of companies which cannot be privatised should be shortened further. This in turn requires that parliament first understands what the consequences of its prohibition of the privatisation of such a large a group of companies really are. To induce parliament to discuss this problem, the government should prepare a list of criteria according to which state enterprises may or may not be privatised. This list should then be discussed in parliament in order finally to enact these criteria.

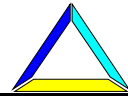
Considering the high payments needed to service the public debt it would be justified to allocate a portion of the privatisation revenues to the repurchase of some state obligations below par.

Collecting payables due to the state and its agencies (particularly the 'state reserve' and for executed state guarantees) must finally be seriously and vigorously pursued.

Debts vis-à-vis 'Paris Club' members could also be reduced by 'debt-equity swaps', rather than by cash payments, since the 'Paris Club' has already accepted this form of debt reduction in several cases.

#### ***3.2 Solving the problem of new public debt***

Although the government is not planning any budget deficit, a great risk for rising budget deficits remains if the payment arrears of the budgetary organisations continue to rise and are paid off by offsets. This would lead to decreasing cash receipts by the state, thus endangering the state's revenue plans.



The problem of increasing payment arrears by the budgetary organisations can only be solved if offsets between the state and companies are strictly forbidden (with exception of a few legally defined cases).


It is essential that personal consequences for infringement of expenditure plans be instituted in order to prevent budgetary organisations from accumulating further payment arrears. The rule should apply that every regional or communal administration is responsible for not exceeding expenditures, including not raising payment arrears by budgetary organisations which belong to their respective administrations. This responsibility should be enforced in personal terms.

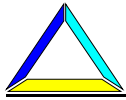
Lower state levels responsible for financing budgetary organisations, must have adequate sources of finance which should not primarily depend on transfers from the central government. Instead local taxes and tax revenues which are shared by various state levels should be available. This would require changes to the budget code and to the finance equalisation formulae to define these sources and make them sufficiently large.

As planned, control of the regional budgets should be done by the Court of Auditors, which must establish regional offices for this purpose and will require additional funding. The method of financing the Court of Auditors must insure its independence from the government.

Having reformed the issuance of state guarantees must be counted as an important victory. However, an additional precondition for issuing a state guarantee should be that each recipient produce a surety bond from a commercial bank covering for example at least 40% of the credit amount.

The ongoing raising of foreign public debt by taking over private energy debts must be stopped. Enterprises should be subject to more strict liability for their own debts.

Deriving profits from the activities of state owned companies must be more strongly pursued. Managers in these companies must be subjected to more pressure and must be controlled (see Chapter II). 



## VIII. HAS MONETARY AND CURRENCY STABILITY BEEN ASSURED?

### 1. Reforms outstanding at the end of 1999

The major currency related challenge at the end of 1999 was restructuring the exchange rate system. In our opinion, the new regime needed to focus on the real exchange rate for the Hryvnia and help to stabilise public expectations. To achieve this, we proposed one year ago to establish a system which would combine both aspects. A crawling-peg system would have met these requirements.

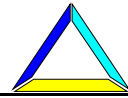
However, the preconditions for a successful introduction of a new regime were not in place a year ago. At that time the Hryvnia was overvalued and hence was under pressure, and the situation on the foreign currency market was unstable. Hence, the immediate introduction of the new regime seemed inappropriate. Instead, stabilisation of the foreign currency market by means of four measures was indicated.

In particular:

- This concerned firstly the dissolution of the old exchange rate system – a horizontal corridor –, and floating the exchange rate for a short period to allow the market to establish its equilibrium value. This in turn assumed the removal of restrictions on current account transactions.
- Following this the National Bank was supposed to reduce currency fluctuations by means of interventions on the foreign exchange market, of course without permitting major losses of currency reserves.
- Thirdly, the need to respect the relationship between the exchange rate and general economic conditions required that a critical mass of reforms be announced, and if possible be implemented, to support the new exchange rate system.
- Finally, the necessity of a moderate monetary policy was stressed, in order to prevent that a strong nominal devaluation potential for the Hryvnia would arise.

### 2. An evaluation of the steps taken since December 1999

We will now look at whether and to what extent these four proposed measures were implemented by the government and the National Bank, and in particular whether the time for introducing a new currency exchange rate regime has come.



### ***2.1 Major liberalisation of the exchange rate***

Between November 1999 and March 2000 the National Bank in effect largely liberalised the exchange rate of the Hryvnia, and at the same time removed important restrictions for current account transactions. As expected, the price of the US-Dollar rose strongly, from 4.6 to 5.4 UAH. This process allowed the true exchange rate to be established, which could now serve as the starting point for a new exchange rate system. The *first* step was thus successfully taken.

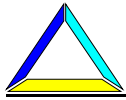
### ***2.2 Stabilising the exchange rate***

This was also true for the *second* step, namely stabilising the exchange rate. Since March 2000, the price of one US-Dollar has fluctuated only minimally around the 5.4 mark thanks to foreign currency market interventions by the National Bank. At the same time the amount of international currency reserves has hardly declined. It was even possible to reduce foreign debt during the year from 12 to 10 bn USD. These measures not only greatly quietened the situation on the foreign currency market, they also further raised the reputation of the National Bank. Both steps are of decisive importance for the credibility and the chances of success of the proposed new exchange rate systems.

### ***2.3 Implementing structural reforms***

The previous chapters have already reported in detail about the *third* precondition, namely the implementation of structural reforms. In the context of monetary and currency policies, an increasing distinction between monetary and fiscal policy can as of late be observed. This division is demonstrated in the planned balanced budgets for the years 2000 and 2001, and in the successful restructuring of debt by the government vis-à-vis the National Bank. The ability of the National Bank to influence the development of prices and the exchange rate has enormously increased, due to the this fiscal unburdening. This has greatly raised the credibility of announcements concerning future exchange rate developments which would have to be made by the National Bank under the proposed new currency system. The fiscal unburdening of monetary policies also contributes decisively to the prospects for success of the new system. The independence of the National Bank should be further strengthened.

The positive developments in the agricultural sector must also be noted in connection with the monetary and exchange rate policies. It can be expected that agricultural reforms will bring about higher investments. This will raise production in the primary sector in the medium term. Future exports of agricultural goods and the foreign direct investment expected in this area could lead to a sustained and quantitatively important supply of foreign currency, which would improve the stability of the foreign currency market and lead to the success of the new currency system.



In addition, reference must be made to the reform efforts in the energy sector, which are of major importance for the balance of payments and for the foreign currency market. It is to be hoped that these efforts bear fruit and especially that the management of the transit gas pipeline can soon be improved. The lack of stability and predictability of this sector hampers the prognosis of exchange rate goals for the future and therefore reduces the credibility of the new currency system.

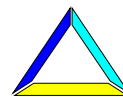
The rescheduling of the Ukrainian 'Euro bonds' at the beginning of the year included the equal spacing out until 2007 of the payment obligations of the state vis-à-vis private foreign investors. The new amortised loans were so designed that they can be serviced under realistic assumptions concerning Ukrainian economic development. One can therefore assume that proper servicing of foreign debt will continue in the coming years, as has already happened this year. This assumes however, that the National Bank will not permit a real revaluation of the Hryvnia, and that the actual surplus in the trade and service balance is maintained in future. In this case, another important precondition for a successful implementation of a new exchange rate system would be met. A corresponding restructuring of the claims by other foreign states can be expected next year.

In sum, during the past twelve months many structural reforms were announced and in part implemented, all of which are required for successfully implementing monetary and currency policies. If we assume an accelerated continuance of the reform process in 2001, the third precondition for introducing the new exchange rate system will have been fulfilled.

#### ***2.4 Managing moderate monetary policies***

The first three preconditions for introducing the new exchange rate regime have after one year been more or less been accomplished. The *fourth* precondition remains problematic however, namely the implementation of moderate monetary policies. The monetary aggregates have risen at rates of over 40% in the past year; correspondingly high was the rate of inflation with about 30%. Stabilising the exchange rate is not possible over the medium term given such an inflation rate. The prospects for the success of the new system depend however not only on past developments, but primarily on those, which can be expected for the monetary aggregates and the inflation rate in the future. Therefore we need to estimate whether the expansionary monetary policy is likely to continue in the future.

Two main reasons existed for the monetary expansion last year: The net purchases of US dollars by the National Bank in order to pay interest and principal on foreign debt, and the non-servicing by the Ukrainian government of its debt vis-à-vis the National Bank. The expected return of credits from the IMF should reduce the net intervention requirements of the National Bank and the related creation of money during the next year. The successful restructuring of the government's debt vis-à-vis the National Bank and the agreed to and now occurring servicing of this debt



by the government will also keep the creation of money in bounds. Furthermore, the eventual recovery of the market for government loans would definitely improve the sterilisation potential of the National Bank, and also contribute to less money creation. Thus one can assume that the coming year will bring a significantly moderated expansion of the money supply and much lower price rises than this year. Assuming this, the fourth precondition for the introduction of a new exchange rate system has also, at least potentially, been accomplished.

Hence we can assume that all *four* aforementioned conditions for the successful introduction of a new exchange rate system can soon be fulfilled.

### **3. What remains to be done?**

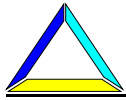
It remains to discuss – given Ukrainian monetary and currency practices of the past year – whether the immediate introduction of a new exchange rate system can be recommended under present circumstances.

#### ***3.1 Ending the present inconsistent monetary policies***

The present 'system' combines the net purchase of foreign currencies with an undeclared fixed currency exchange rate vis-à-vis the US dollar and an expansionary monetary policy. The de facto fixing of the exchange rate since March 2000, using foreign currency interventions, was logical for the short term, since it achieved a calming of the exchange market. However, as a medium term strategy this approach is not suitable for two reasons. Firstly, the thus resulting real revaluation of the Hryvnia cannot be maintained in the long run. Secondly, expectations concerning the external value of the Ukrainian currency are being stabilised in an insufficient manner, due to lacking binding notifications by the National Bank. In any case, the now practised system must soon be changed. Hence, this would be an opportune moment to make a virtue out of necessity, and introduce a new exchange rate system.


#### ***3.2 Introducing a currency basket as an anchor for the Hryvnia***

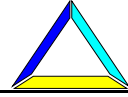
The large fluctuation in the exchange rate between the US dollar and the Euro in the last two years clearly demonstrates that an exclusive linkage to the US dollar does not make sense. We therefore consider it practical to tie the Hryvnia to a basket of currencies containing an equal proportion of US dollars and Euro. The new system should be announced before its introduction, and for the time being its corridor should be wide enough to assure success. The composition of the currency basket can be adjusted later on to meet needed new requirements. We are convinced that such a system would have definite advantages over the extreme solutions of 'fixed' or 'flexible' exchange rates. A fixed exchange rate system would be difficult to maintain in future and hence will not be credible; floating exchange rates do not stabilise expectations. A sliding exchange rate can be maintained due to its flexibility, and is therefore credible. The



expectations of the economic players are stabilised at the same time, which causes foreign trade and foreign direct investment to grow. The proposed currency system could therefore play an important part in increasing economic growth and raising the standard of living in Ukraine.

### ***3.3 Introducing a new exchange rate mechanism***

In summary: Developments in the field of monetary and currency policy during the past twelve months have to be assessed as very positive. The policies of the government and of the National Bank have created conditions which are propitious for introducing a new exchange rate system. Also, this is an opportune time for the introduction of a new regime, since current monetary and currency systems are not sustainable in the medium term. The proposed new exchange rate system should (as with a crawling-peg system) be oriented towards the real exchange rate, and market participants should be informed about any planned developments. This new system should be introduced soon. 



## IX. FUTURE PROSPECTS

On the foregoing pages we have attempted to present all that remains to be done. To implement all these items to the maximum extent possible is the real political challenge for Ukraine. There is opposition by powerful interest groups, both public and not public. However those who should have a real vital interest in the reforms and who in the final account will profit from them are the citizens who are not organised in a group. All too often they are used as an excuse to retard reforms. That can only happen so long as they are kept in the dark about what – in spite of short-term pain – the reforms can do for them in the longer term in terms of growth and general welfare. Therefore it is very important at the present stage of reforms to inform the population, and to create a counter-lobby, a 'lobby of the masses'. People must be addressed directly and not only via the representatives of partisan interests.

Support from the people can also be won by letting them benefit from all already existing legal rights to social measures, and by extending the social system. A very important step taken in 2000 was the payment of all pension arrears and of part of the wage arrears. Consistently continuing the reduction of subsidies will free up further means to finance these measures. There are also offers by international donors to support the reforms now underway with suitable social programs.

The first 365 days are perhaps the most difficult during a period of noticeable change. Overall, the year 2000 was a success, more so than all other years since independence. Today it is clear in what direction Ukraine is going to move. All this is not a question of satisfying the interests of international organisations, multinational corporations or neighbouring countries. What is at stake is how to respond to the interests of the citizens of Ukraine, those who see their future in this country. Many Ukrainians have already joined on the path which the present government has taken. Many others can still be won over. This is the essential legitimisation and the opportunity which opened up at the end of the year 1999.

