

Ukraine Economic Situation and Future Reform Priorities

Dr. Edilberto Segura

Oleg Ustenko

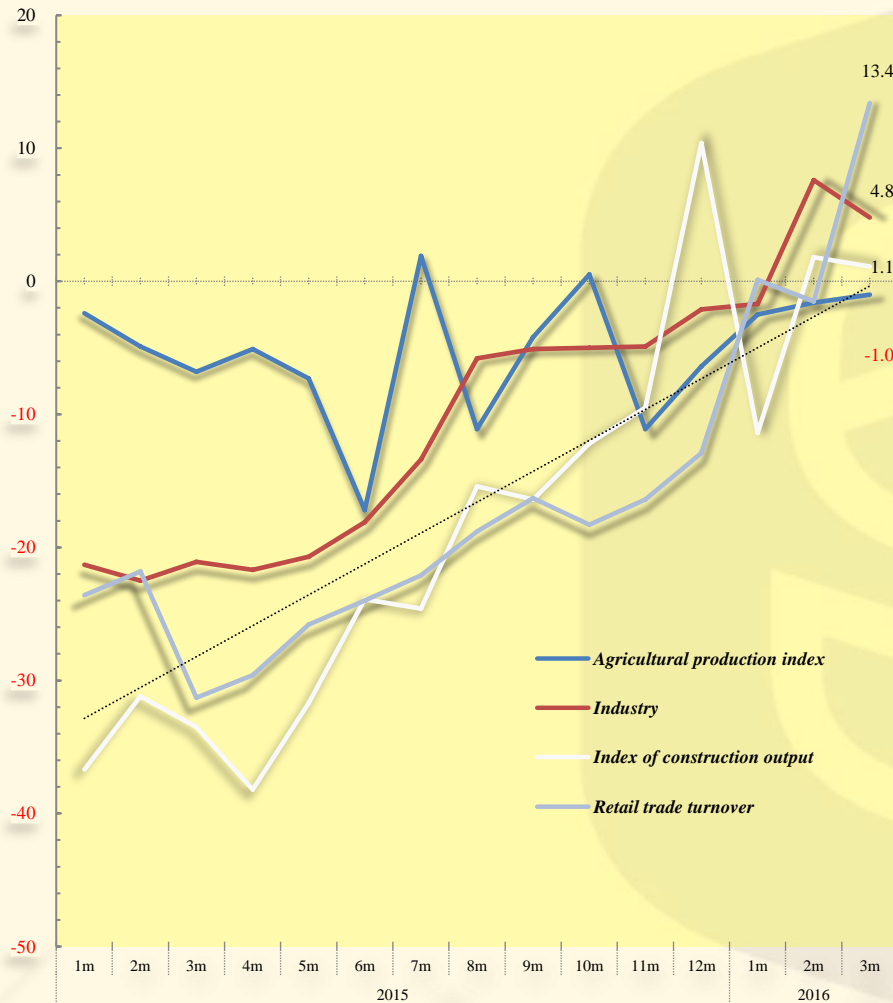
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Key Economic Indicators

<i>Main Macroeconomic Indicators</i>	2011	2012	2013	2014	2015f	2016f
<i>GDP, USD billion</i>	163	173	180	129	98	95
<i>Real GDP Growth, % yoy</i>	5.5	0.2	0.0	-6.8	-9.9	2.0
<i>Fiscal Balance (incl. Naftogaz & Pension Fund), % of GDP</i>	-4.3	-6.0	-6.5	-11.7	-3.5	-4.0
<i>Public Debt, External and Domestic, % of GDP</i>	36.4	36.7	39.9	70.3	94.0	89.0
<i>Consumer Inflation, eop, % yoy</i>	4.6	-0.2	0.5	24.9	43.3	12.0
<i>Hryvnia Exchange Rate per USD, eop</i>	8.0	8.1	8.2	15.8	24.0	25.0
<i>Current Account Balance, % of GDP</i>	-6.3	-8.2	-9.2	-3.6	-0.2	-2.0
<i>FDI, Net Annual Inflow, USD billion</i>	7.0	7.2	4.1	0.3	2.3	3.0
<i>International Reserves, USD billion</i>	31.8	24.6	20.4	7.5	13.3	17.0
<i>Public External Debt, USD billion</i>	33.3	32.1	31.7	34.9	47.0	55.0
<i>Private External Debt, USD billion</i>	84.6	92.0	99.2	82.0	70.0	65.0

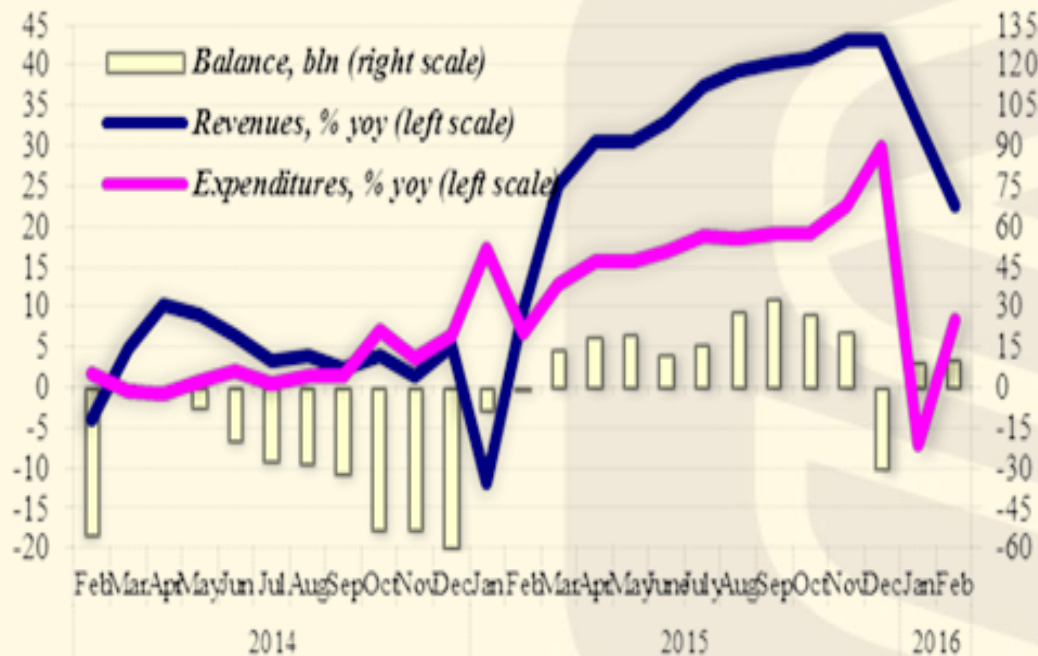
Economic Growth



- Despite the recent political crisis, the economy is showing signs of recovery, though from a low base.
- For the first time in three years, industrial output in February and March 2016 showed a positive rates of growth (7.6% yoy and 4.2% yoy, respectively) compared to the same month of last year.
- All three subsectors of industry, mining, manufacturing, and gas-electricity showed positive growth.
- Construction and retail trade also showed a positive growth rates.
- Following a decline of 9.9% in 2015, GDP is expected to grow by 2% in 2016.

Fiscal Policies

*Dynamics of consolidated budget components
(from the beginning of the year)*

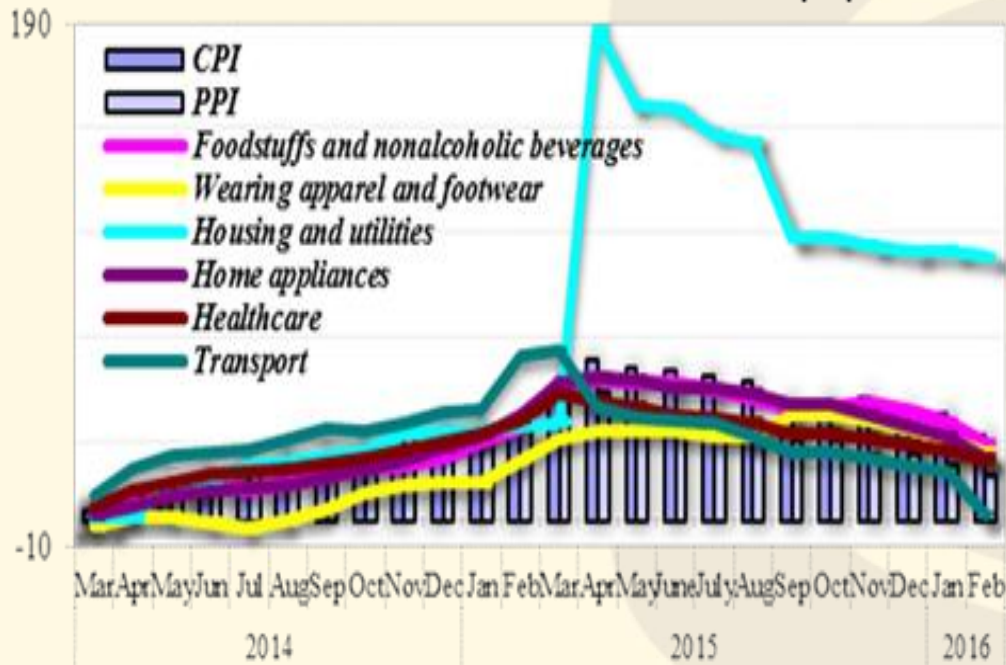


Source: The Ministry of Finance of Ukraine, The Bleyzer Foundation

- The consolidated fiscal budget surplus has been in surplus and further expanded in February 2016 on the back of a higher local budget surplus.
- Local budgets were executed with an overall surplus of UAH 5.7 bn, which fully covered the UAH 4.9 bn deficit of the state budget.
- As a result, the total consolidated budget surplus reached UAH 9.9 billion from the beginning of the year.

Inflation

CPI, PPI, and Growth of Prices for Select Goods and Services, % yoy

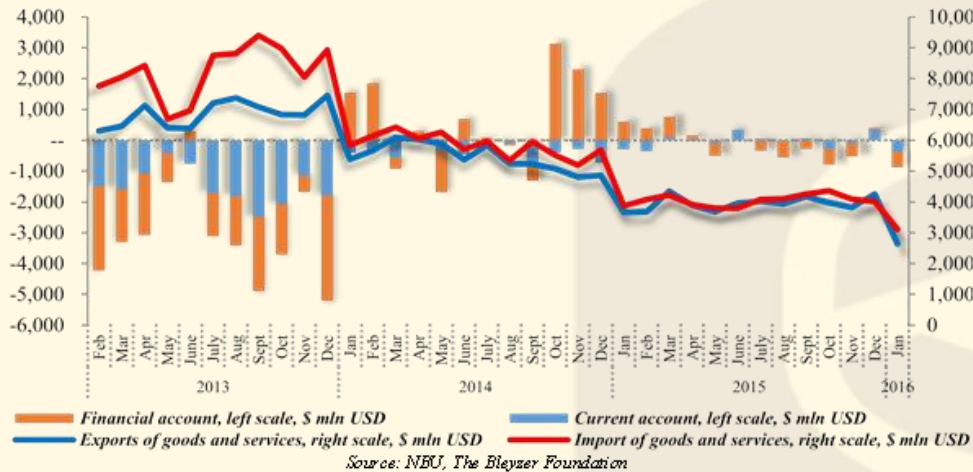


Source: State Statistical Service of Ukraine, The Bleyzer Foundation

- Consumer inflation has continued to decelerate, with inflation lowering to from 40.3% yoy in January 2016 to 32.7% yoy in February and to 20.9% in March.
- This CPI decline was mainly the result of an increased supply of whole foods and tobacco products which more than compensated for the impact of depreciation of the national currency in February.
- In 2016, inflation is expected to be 12%.

Balance of Payments

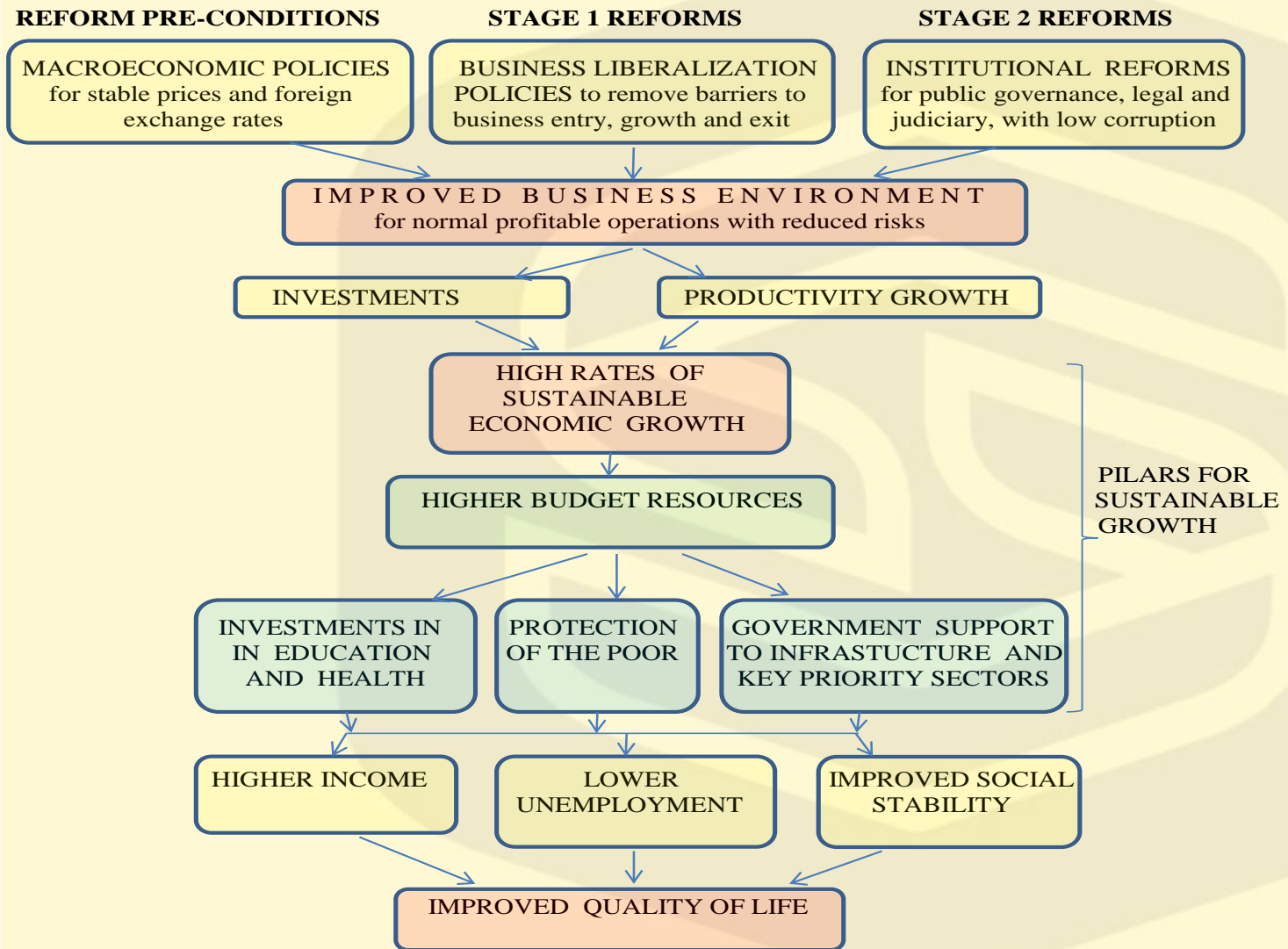
Ukraine's External Balance of Payments, mln USD



- In February 2016, the current account deficit of the balance of payments amounted to USD 251 million.
- But a surplus in the financial account more than compensated for the current account deficit and led to stability in international reserves at about USD 13 billion.

- Europe and Asia have become the largest buyers of Ukrainian products with shares of 40% and 34% of the total. Russia now represents 6.9% of Ukrainian exports.
- The IMF has reiterated its decision to hold the third tranche from the IMF support program until Ukraine satisfies a number of conditions, including concrete anti-corruption measures, reform of the banking sector, tax reform and others.

How to create a NORMAL country



Need for Substantive Reforms

- Current crisis may be the last opportunity for Ukraine to implement a **radical reform agenda** and move the country away from past Soviet structures, policies and institutions, revitalize economic growth, and allow it to remain an independent country.
- Only a substantive **Economic Reform Program** would ensure rates of economic growth of at least 7 % p.a. over the next 5 years, or longer.
- To achieve these growth rates will require major increase in domestic and foreign investments, as well as improvements in productivity.
- International experience shows that the best way to accelerate investments and productivity is to make fundamental improvements in the country's investment/business environment.
- A number of international studies have shown that a limited number of **“investments drivers”** can achieve large improvements in the investment/business environment of a country.

Investment Drivers

- Investment Drivers are focused on **reducing risks** faced by businesses, allowing them to **make normal profits** in a free and competitive market.
- The reforms are designed to provide businesses with:
 - (i) Reform Pre-Condition: **Macroeconomic stability** that would secure stable prices and stable foreign exchange rates.
 - (ii) Stage 1 reforms: A **liberalized business environment** that will result in lower costs of doing business, without corruption and undue government interferences, and with minimum barriers to business entry, exit and growth.
 - (iii) Stage 2 reforms: Formal **institutions** must be developed to ensure good public governance, a fair and unbiased judiciary, a positive county image, and low corruption.

Priorities in the Implementation of Economic Reforms

- The two most urgent actions for Ukraine are **dramatically reducing Corruption** and **reforming the Judiciary**.
- Without success in these two areas, other reforms will not be effective. Most of the actions in these two areas must be completed by year-end.
- During 2016, the government must demonstrate to investors that it has really achieved **macroeconomic stability** in the country, and the recent episodes of high inflation and rapid currency devaluations will not be repeated in the future.
- Improvements in **public administration** are critical since public administration has inhibited rather than supported reforms. The best approach is to significantly reduce the size of central government by transferring the bulk of its functions to local administrations, as was successfully done in Poland, Canada, New Zealand, and other countries.

Nine Investment Drivers for Sustainable Growth

The **three main areas of reform** can be executed through nine investment drivers:

A. MACROECONOMIC POLICIES

- 1. Anchor Macroeconomic stability to minimize capital and operating losses resulting from excessive exchange rate volatility and price fluctuations.*
- 2. Improve Taxation & Customs Administration to reduce the cost of doing business.*

B. INSTITUTIONAL REFORMS

- 3. Eradicate Corruption to protect businesses from abuse of power by public officials.*
- 4. Ensure the Rule of Law by reforming the Legal and Judiciary Systems.*
- 5. Improve public administration to provide public goods efficiently and without corruption.*
- 6. Reduce Political Risks and Improving Country Image.*

C. BUSINESS LIBERALIZATION POLICIES

- 7. Deregulate business activities to enable firms to operate freely in a competitive market and significantly reduce the costs of doing business.*
- 8. Develop the country's financial sector to facilitate investments and growth.*
- 9. Accelerate international trade and free movement of capital to convert Ukraine into an international production hub for supply to the West.*

1. Anchoring Macroeconomic Stability

1. Sound **fiscal and monetary policies** will ensure macroeconomic stability. On the fiscal side, the consolidated fiscal budget deficit of the government must be significantly reduced, aiming at a maximum deficit of 2% of GDP by 2018. On the monetary side, money supply and domestic credit should not expand by more than 5% per annum.
2. In order to reduce the fiscal deficit, **government expenditures** must be cut drastically from 45% of GDP to about 35% of GDP, a level consistent with those of similar and competing countries, such as Romania (36%), Bulgaria (34%), Turkey (34%), and Georgia (31%). In particular, the cost of subsidies (including energy) and the cost of the pension system must be reduced . This process can be facilitated by the introduction of Zero-Based Performance Budgets for all agencies, under which funds are provided on the basis of fully appraised programs, and not just additions to existing “departments”.
3. The implementation of the law on **public procurement**, including the use of e-government, should be advanced to all categories of government purchases, in order to minimize government expenditures. In particular, there is a need to remove inconsistencies between the law on public procurement and other laws and to establish clear regulations under the law.

2. Improving Taxation and Customs Administration

1. Although Ukraine has initiated tax reform, upgrading **Tax and Customs Administration** should be now a priority, including its structure, autonomy, governance, anticorruption, operating procedures for audits and tax compliance by large taxpayers, USC, VAT, etc.
2. There is also a need to **simplify taxation in general**. A more liberal tax Code should bring taxes to **internationally competitive**. This tax reform should aim at making Ukraine an attractive hub production country to supply the EU and should also aim at increasing the tax base by encouraging the de-shadowing of the economy.
3. On **customs administration** the following measures are recommended:
 - a. Introduce pre-customs electronic registration with post-entry inspection procedures, which will permit the shorter waiting lines and reduce the possibilities for corruption.
 - b. Introduce a “random IT-based” approach for checking containers.
 - c. Simplify the procedure for determining customs value and bring this procedure in compliance with WTO and EU requirements. The customs value of imported and exported goods should be only the transaction values, with data bases to deal with valuation fraud.
 - d. Operating management for customs should be outsourced from the well known and reputable international companies working in this field (such as Crown Agents of the UK which has performed this service in other Eastern European countries).

3. Eradicating Corruption

Although the country has taken some actions to deal with corruption, results are not visible. Over the next six months, the country has to show results. It needs to:

1. Agree with the West to **target international sanctions against Ukrainians** involved in high-level corruption.
2. Remove the **blanket immunity** from prosecution currently enjoyed by members of Rada and the judiciary, to make them subject to legal actions against any corruptive practice. Also, as in most European countries, remove most “special” privileges and subsidies to Rada members and high level officials to establish the principle that they equal under the law to the rest of the society.
3. Immediate **increase in the number of corrupt officials and Rada members that are successfully prosecuted, convicted, and put in jail**. Punishment for corruption cases should be strong and non-selective. Otherwise, anti-corruption will have no credibility.
4. **Dismiss a number of public officials** for whom evidence of corruption may not be available, but whose past behavior may be questionable.
5. Following the recent privatization law, **proceed quickly to privatize state assets** and state enterprises, since asset stripping and control of the cash flows of state enterprises are among the main targets for high-level political corruption and allure their managers to seek rents for themselves.

4. Devolving Credibility to the Judiciary and Legal System

1. Carry out a **complete re-evaluation of all judges** (about 10,000), prosecutors (about 20,000) and key law enforcement personnel. These re-evaluations should be extensive and not limited to the selective lustration of only a few. Every judge, prosecutor and key law officer must satisfy a rigorous independent evaluation (with international participation) of their professional ability, integrity and financial assets.
2. Develop **international programs for the re-education** of members of the Judiciary.
3. Secure **greater involvement of the FBI and EU law enforcement agencies in both training and actual investigations by their agents of high-level corruption.**
4. The current inconsistencies between the **Commercial Code and the Civil Code** have been a major source of corruption in courts, allowing judges to permit illegal corporate raiding and unlawful transfer of business ownership. Right away, eliminate the Commercial Code and merge any necessary sections into the Civil Code.
5. The merge of the two codes during 2016 should be followed by the **replacement of the entire business/commercial legislation law environment** by a more business-friendly legislation, such as those of Poland, Georgia, Estonia, and Slovakia.
6. Although necessary, the dismissal of corrupt/incompetent judges, prosecutors and law officers will not be sufficient. As important is to **restructure and simplify** the judiciary and prosecutorial systems, and to ensure the real independence of courts/judges and prosecutors from any of the branches of political powers.

5. Improving of Public Administration

1. Since independence, deficiencies in public administration have been major causes of the poor implementation of economic reforms. Given the political difficulties in reforming public administration, the only option today is to **transfer the bulk to the central government functions and staff to local administrations**, as was successfully done in Poland, Canada, New Zealand, and other countries. Furthermore, the quality in the provision of public goods and services would be improved by decentralization, since this will bring the provision of services closer to the final users who can exercise better control.
2. This decentralization should be based on a clear re-definition of the **role of the government**. This role should be to support, not to compete with the private sector. The central government should retain only those functions which are not able to be transferred either to local authorities, to the private sector, or to the rapidly maturing civil society institutions. In principle, the central government should only be responsible for strategy, policy formulation and overall control. It should also be responsible of matters of national interest, such as defense and the military. The implementation of government services and provision of most public goods should be decentralized to local authorities, in order to bring their provision closer to the final users.
3. Following the redefinition of the government and the execution of functional reviews, there should be reviews of **civil service practices and the operational procedures** of all government agencies to improve efficiency, establish transparency and accountability principles. The extensive use of e-government should be implemented in all agencies.

6. Reducing Political Risks and Improving Image

1. To contain social tensions and discontent in several Ukrainian regions adjacent to the Eastern war zone, there is a need to neutralize the constant bombardment of Russian propaganda that may lead them to be supportive of a further Russian invasion. This could be achieved by decisive measures aimed at improving socio-economic conditions in these areas. **One effective way to offer relief is to establish a Social Stabilization Fund** to provide emergency funds to enable local communities to implement micro-projects, such as improvements in local water supply, sanitation and sewage, improvements in schools, libraries, hospitals, local roads, and infrastructure. The Fund will also have a micro-finance program to provide credit to locals and may also include programs to provide temporary employment opportunities and re-training assistance for those displaced by the war. This fund could be funded by public or private resources.
2. To improve **country image**, the government should undertake the following measures:
 - a. Announce and disseminate widely the government's policy and commitment to implement strong market oriented policies and show implementation progress.
 - b. Require all embassies abroad to have their commercial section strengthened, and to go on sales drives to better disseminate business opportunities.
 - c. Assist in the establishment of a private investment promotion agency.

7. De-regulating Business Activities

- a. To accelerate business deregulation, introduce a “**regulatory guillotine**” review under which the costs and benefits of all business regulations (including regulations, business permits and licenses) will be assessed by experts by a given deadline date. Only those legal acts which are able to pass “this expert community test” would be approved and should remain in effect after the deadline. All the rest should be abandoned by “one-time voting” in Verhovna Rada.
- b. Following the completion of the above review, create an electronic, free and publicly accessible national registry of business regulations.
- c. In carrying out the above “regulatory guillotine” review, care should be taken to minimize the number of activities that require permits and licenses to establish new businesses, to reduce the paper work involved, and reduce the time require to secure them, and to introduce a “silent approval procedure” into the Permission Law.
- d. E-government techniques should be used to simplify and facilitate the provision to new businesses of necessary utilities, such as electricity, gas, water, etc.
- e. Remove administrative restrictions for new businesses to buy land or carry out construction activities in a fast and efficient manner.
- f. Introduce all necessary amendments to the Civil Code and the Law on State Registration of Enterprises and Private Entrepreneurs to simplify business liquidation procedures.
- g. Take adequate measures to enhance property rights, including intellectual property rights, and introduce strong sanctions for illegal corporate raiders.

8. Developing the Financial Sector

1. Enact laws to enhance the **independence and accountability of the NBU**, to enable it to operate without interference, and with the goal of securing internal and external stability.
2. Continue the rehabilitation of the local banking system by:
 - a. Finalizing the closure of insolvent and problematic banks
 - b. Introducing regulations to facilitate bank recovery of non-performing assets, including debt/asset restructuring and possibilities for repossessing assets.
 - c. Implementing banks' recapitalization programs to require all banks to pass minimum and more stringent capital requirements
 - d. Strengthen the banking supervision capacity of the NBU to prevent opaque and risky lending and deposit practices
3. Introduce new instruments for financial resources mobilization at the local level, such as:
 - a. Developing government and municipal bond markets
 - b. Developing alternative equity mobilization instruments and partial risk guarantee facilities for public-private partnerships
4. Improve legal framework for Capital Markets by:
 - a. Strengthening the responsibilities of the Securities and Stock Market Commission.
 - b. Requiring the use of international accounting standards (IAS/IFRS)
 - c. Bringing the regulatory legal framework for co-investing institutions and asset management companies in line with best international practices

9. Improving International Trade and Capital Flows

1. Expand the geographic Coverage of Ukraine's Free international trade

- a. Take any necessary actions to ensure that the FTA with EU is approved by all countries.
- b. Finalize ongoing negotiations on FTAs with Canada, Israel, Turkey and others.
- c. Promote and assist the participation of Ukrainian companies in international expositions.
- d. Develop in Ukrainian embassies abroad sufficient expertise to promote Ukrainian goods.

2. Improve the legal and economic framework for international trade and capital flows

- a. Remove restrictions to exports (including export restrictions, remaining indicative prices, advance deposits, and foreign exchange surrender requirements) and restrictions to imports (including excessive import duties, critical import list, and indicative prices.)
- b. Accelerate harmonization of Ukraine's certification and standardization system with EU and promote the advantages of implementing ISO standards in quality management.
- c. Remove sanitary and phyto-sanitary barriers on trade, particularly on animal products.
- d. Develop more consistent procedures for product certification requirements and standards
- e. Amend existing regulations to facilitate export loans and insurance schemes.

3. Ensure prompt and accurate refund of the VAT to exporters

4. Further liberalize Capital Flows

- a. Liberalize foreign exchange transactions and eliminate restrictions on foreign direct investments.
- b. Cancel all restrictions on purchase of securities in foreign currency.