



Center for Social and Economic Research

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The Sources of Economic Growth in Ukraine after 1998 Currency Crisis and the Country's Prospects

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Introduction

The purpose of this study is to analyze the sources of economic growth in Ukraine, which has been observed from the second half of 1999. In addition, we intend to answer the question what is the sustainability of this growth, i.e. putting in other words, what are the chances and conditions for maintaining growth in the future.

Neither question is easy to answer. Analyzing sources of growth and growth sustainability in any transition country is a serious intellectual challenge, for a number of reasons. First, we do not have any comprehensive growth theory in transition economies so far. What is available, it is a couple of more or less empirically verified hypotheses concerning the influence of various macro and microeconomic factors on growth performance. Second, statistical data series in transition economies are still rather short and unstable as a result of various methodological changes in statistics and structural and institutional changes in the economy, which makes serious econometric analysis risky. This argument is particularly relevant to the Ukrainian economy, which entered structural and institutional changes with significant delay compared to other countries, and where the quality of statistics is below regional average. Third, most of transition economies, including the Ukrainian one, are open in terms of trade and financial flows. They have thus become sensitive to some external factors such as growth fluctuations in the world economy as a whole, varying conditions of Ukraine's major trade partners, changing attitudes of financial investors to emerging markets, etc. We have seen that even countries considered as having strong and sustainable growth potential can seriously suffer from adverse external shocks as it happened in 1998-1999 with the Baltic countries and Poland after the Russian and Ukrainian financial crises.

Nevertheless, we tried to make an in-depth analysis of both macro- and microeconomic factors, which might have influenced the dramatic positive about-turn in growth performance of Ukraine shortly after the 1998 currency crisis. Chapter I contains the macroeconomic outlook for this period. Małgorzata Jakubiak, Anna Myślińska and Artsem Boichanka analyze the growth dynamics and its decomposition, inflation trends, basic monetary aggregates, interest rates, exchange rate behavior as well as employment, wages,

and incomes of the population. Chapter 2 looks at the role of the external sector. Yuriy Kuz'myn analyzes export and import dynamics, the role of major export sectors and dominant export markets, energy import, trade and current account balance, and finally capital account developments. In Chapter 3 Vladimir Dubrovskiy makes a review of the progress achieved in the microsphere with a special emphasis given to privatization, hardening budget constraints and payments discipline, easing the entrepreneurial environment and development of the SME sector. Chapter 4 of Jacek H. Schirmer discusses changes in the agrarian sector. Chapter 5 of Inna Golodniuk reviews the progress achieved in the financial sector and its remaining problems. Chapter 6 deals with the very important area of fiscal policy and fiscal management. Małgorzata Antczak and Magdalena Tomczyńska present changes in trends of budget revenues and expenditures, budget deficit, dynamics of public debt, changes in tax policy and in the budget management system. In Chapter 7 Małgorzata Jakubiak and Anna Myślińska discuss alternative growth scenarios until the end of 2003 depending on the speed of the further reform process. Chapter 8 written by Marek Dąbrowski and Małgorzata Jakubiak contains general conclusions and policy recommendations.

The entire study has been prepared by a joint team of experts from CASE – Center for Social and Economic Research in Warsaw and its daughter organization – CASE-Ukraine in Kyiv. The authors benefited substantially from previous research and policy-advice projects, in the first instance, the USAID-funded Ukraine Macroeconomic Policy Project carried out in the period from 1996 to 2001. The regular analytical and forecasting work done for the purpose of the quarterly CASE publication 'Ukrainian Economic Outlook' has also helped in preparing the macroeconomic part of this study.

All the chapters were written between February and June 2002 basing on data available for the end of 2001. The study was then revised and amended in November and December 2002 in response to reviewers' comments. However, the basic statistical data and forecasts remained as in the first version completed in June 2002.

We want to express our deep gratitude to Luca Barbone, John Litwack, Mark Davis, Larisa Leshchenko and Iain Shuker who reviewed the first version of this study and whose valuable comments helped to improve our original analysis. However, the authors accept sole responsibility for the quality of each chapter and the entire study. It reflects only the authors' opinions and not necessarily those of the World Bank, CASE or other institutions where they are affiliated.

Marek Dąbrowski

Chapter I

Macroeconomic Outlook for the Period 1998-2001

Artsem Boichanka, Małgorzata Jakubiak, Anna Myślińska

This chapter gives an overview of the macroeconomic situation in Ukraine during 1998-2001. It provides a background for the more in-depth studies presented in the subsequent chapters, by analyzing dynamics of the components of Ukrainian GDP, monetary and exchange rate policies, as well as trends at the labor market.

1.1. The Pace of Transition

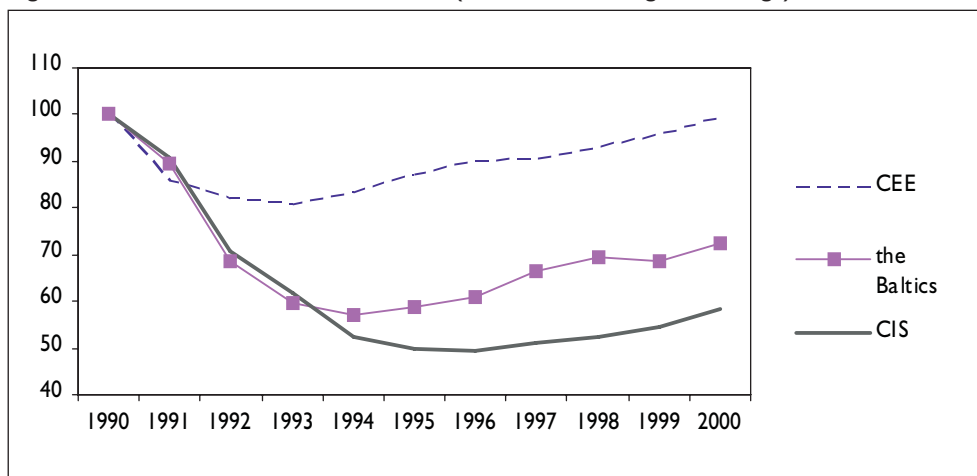
1.1.1. GDP Patterns in Transition Economies in the 1990s

All transition economies have experienced substantial decrease of real output during the first years of transformation. Comparison of different countries shows that the steepest output decrease tends to appear during the first year of transition and then the fall continues for a few years. According to the relative speed of catching-up, three distinct patterns of transitional recession and subsequent output recovery emerge. These are patterns typical for: countries of Central and Eastern Europe, the Baltics and the Commonwealth of Independent States. Average output decline was the smallest in CEE and the most pronounced in CIS. The decline in CIS also lasted longer accumulating over several years whereas countries of CEE and the Baltics started recovering after two years of transition (see Fischer and Sahay, 2000 for details). In countries of CEE and the Baltics official GDP reached its pre-transition level by 1998 whereas CIS did not managed to fully recover even in 2001 (World Bank, 2002).

It can be argued that the officially measured decline was artificially exacerbated by the inadequate measurement methods. Some of the economic activities might have been unnoticed, such as briskly growing private sector. Enterprises might have tried to hide their production instead of overstating it in order to meet plan requirements. Another possible

source of inaccuracies is using deflators anchored in pre-transition period while price structure was quickly changing (Blanchard, 1997). But although the size of the decline may be questionable, the fall in output seems to be out of question.

Figure 1.1. Real GDP in transition economies (1990 = 100, unweighted average)

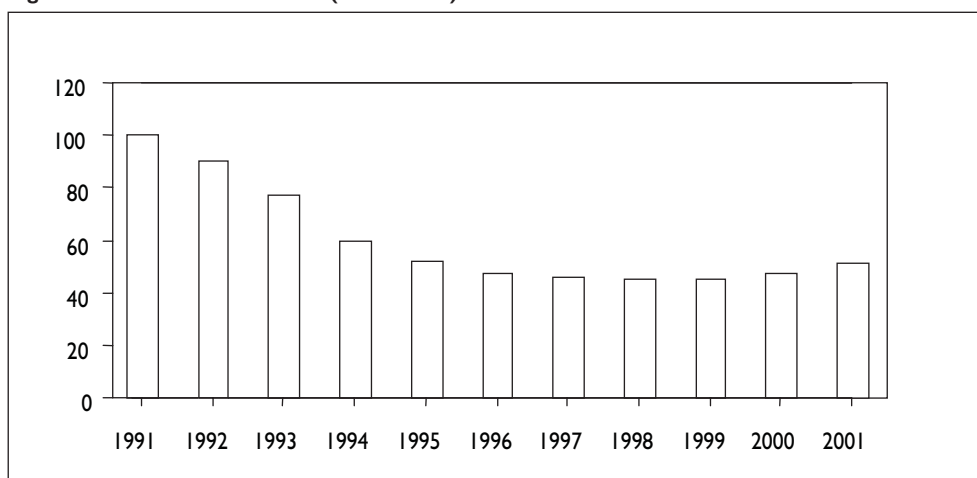


Source: IMF, International Financial Statistics.

1.1.2. Ukrainian GDP during 1991-2001

Ukrainian economy was the last among transition economies to show recovery. The fall in real GDP lasted from the declaration of sovereignty in 1990 to 1999. In 1999, real GDP equaled 44.7 % of the 1991 level (see Figure 1.2). Growth was registered only in 2000.

Figure 1.2. Real GDP in Ukraine (1991 = 100)



Source: NBU and Ukraine State Statistics Committee.

Actually, the first signs of recovery showed in the 2nd half of 1997 but the growth rates were too weak to balance the 1st half and the growth for the whole year remained negative. The moderate growth continued in March-June of 1998 and then upward trends rapidly reversed due to the Russian crisis. In 1999, the situation from 1997 was repeated. Finally, GDP began growing in 2000 reaching impressive rates.

In general, the decline of registered output connected with the transition may be explained by several factors (Aslund, 1994, and Blanchard, 1997), such as:

- Moving part of economic activities to unregistered sector;
- Cutting or removing subsidies to state enterprises;
- Change of production structure – reducing production in unnecessary branches;
- Foreign trade shock due to collapse of CMEA and USSR and worsening of terms of trade in exchange with Russia.

The first reason is probably true for the Ukrainian economy – estimates of the shadow sector were growing in the first years of transition. The size of shadow economy measured in percent of GDP that amounted to 16.3 in 1989-1990, increased to 28.4 in 1990-1993 and to 47.3 in 1994-1995¹ (Enste and Schneider, 2000). The hypothesis of changing structure also appears to be justified. The relation of value added generated by industry to GDP declined from 42.3% in 1991 (or even 43.5% in 1992) to 28.4% in 1997, which is to say that industrial production was decreasing much faster than GDP. The structure of industrial production was changing as well. The share of machine building and construction materials was declining. Light industry was declining as well. Reduction in foreign trade was unquestionable, although its exact size is difficult to estimate.²

The Russian crisis of 1998 led to the sudden and significant reduction of Ukraine's exports, first of all to Russia and then to the Western Europe. There was also a capital flight from Ukraine. As foreign financing became scarce, interest rates shoot up. Real interest rate increased by over 10 percentage points in the 3rd quarter of 1998. Following sudden capital outflow and worsening of the investment climate (risk of further devaluation and default), investments rapidly fell. Wages and salaries decreased sharply, which led to a decline of private consumption. Government also reduced consumption in an attempt to control fiscal deficit. The crisis influenced supply side as well. Financial sector was affected by definition – Ukrainian banks held non-indexed government bonds and made heavy losses when interest rates went up (World Bank, 2002). Industry and construction were hit by shrinking demand.

¹ These numbers are only estimates but given the same method used in calculations, one can assume that the direction of changes is showed properly.

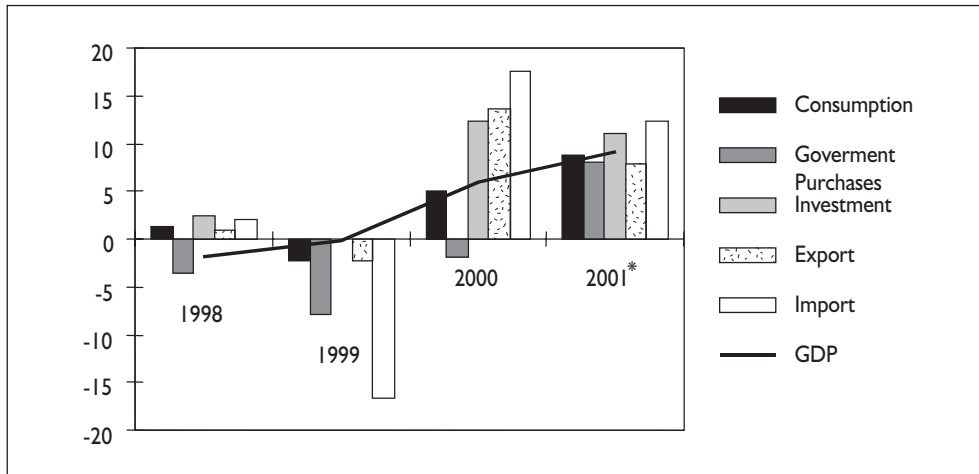
² Official BOP statistics report that only in 1992 exports to Former Soviet Union fell to USD 5.3 billion (from 42.7 in previous year), and imports - to 6.4 (from USD 43.4 billion). However, as Antczak (1996) writes, the official statistics on BOP in the first years of independence (after 1991) give only an approximation of trends in foreign trade, due to poor quality of statistical reporting (Antczak, 1996: 145-149).

At the end of 1999, all negative trends reversed and the country experienced the first year of economic growth for a long time.

1.2. Decomposition of Growth Trend by Components of Global Demand

As it has already been written, the currency crisis brought severe contraction of real activity in 1999. Domestic demand fell by over 6%. Trade volumes decreased as well. However, the devaluation of *hryvnia*, that made import fall by nearly 17% in 1999, led also to an import substitution. As a result, domestic demand rebounded already in 2000.

Figure 1.3. Growth of real GDP and its components, 1998-2001 (in percent)



Source: State Statistic Committee of Ukraine.

Note: * - CASE estimates.

Consumption – that accounts for nearly 60% of Ukrainian GDP – started to rise in the last quarter of 1999. But it was at the beginning of 2000, when household consumption jumped by over 9% following more than 10% rise in real incomes. Relatively high, although decreasing, rates of growth of consumption prevailed through 2000 and first half of 2001. This again was caused by growing incomes; wages and salaries, mainly.

Investment that stayed at the same level in real terms in 1999, have recorded very high rates of growth since the last quarter of 1999. Real growth rate of investment in fixed assets did not fall below 12% through 2000, and according to preliminary estimates was 11.0% in 2001. Such high rates of growth were the reason that investment was giving the strongest impulse to the growth of domestic demand in 2000 (see Table 1.1). When we look at the

Table I.1. Decomposition of real GDP growth, 1998-2001 (in percent)

	1998	1999	2000	2001*
GDP	-1.9	-0.2	5.9	9.1
Aggregate domestic demand	-1.6	-6.6	7.7	11.2
Private Consumption	0.8	-1.3	3.1	5.0
Government Purchases	-0.8	-1.7	-0.4	1.5
Investment	-1.5	-3.6	4.9	4.8
Exports	0.5	-0.9	7.4	4.6
Imports	-0.9	7.3	-9.1	-6.7

Source: CASE estimates on the basis of State Statistic Committee of Ukraine data.

Note: * Preliminary estimates.

gross investment data, it comes out that the highest growth rates in 2001 were recorded in transport and communication (23%) and manufacturing (almost 20%), while the growth of gross investment into mining (15%), construction (14%), and energy (9%) was slower. Taking into account the share of each of these sectors in the value added, we can conclude that the highest contributors into the growth of gross investment in 2001 were manufacturing, transport and communication sectors. However, these are only gross data, so it is not clear how much of these amounts can be attributed to net investment in each sector. But even bearing this in mind, high rates of investment growth in manufacturing (assuming that not all of this can be attributable to the metallurgy) seems to be promising.

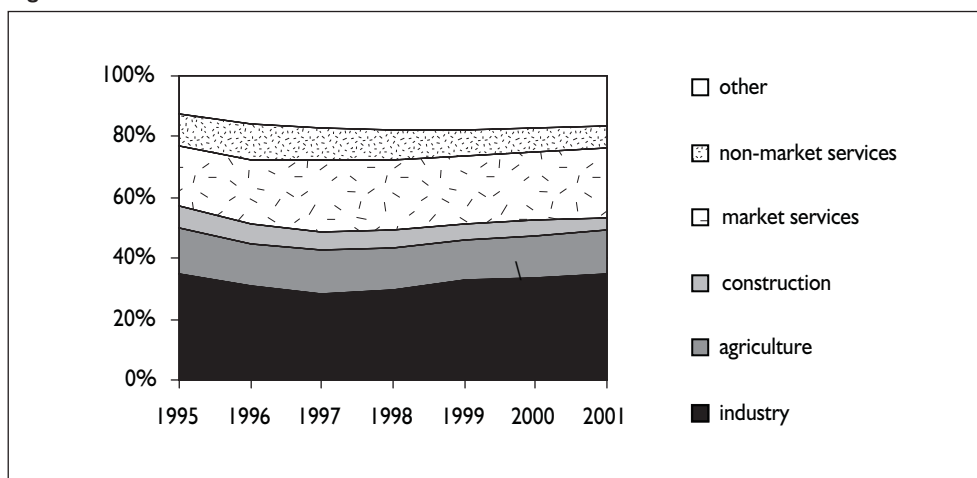
Government purchases (consumption) were still falling in 2000, following the same trend as in the previous years. This was probably the result of higher public spending discipline and limited budgetary resources.

A combination of various factors made export grow very fast, and allowed for trade surplus. Among these factors were: effects of *hryvnia* devaluation, favorable conditions on Ukraine's traditional export markets, and indirect subsidizing of the metallurgical sector. Exports surged by over 20% at the beginning of 2000, recorded a real growth of nearly 14% for the whole year, and gave a strong growth impulse to the economy. Growth of export slowed down in 2001, as the above mentioned positive conditions started to weaken. Import rebounded in 2000 as well, by 17.5%, and by 12% in 2001, as a result of growing consumer demand. However, trade surpluses have been recorded until the end of 2001.

I.3. Decomposition of Growth Trend by Sectors of Real Economy

Structure of Ukrainian value added changed after the 1998 crisis (see Figure I.4). The share of industry in GDP reached its minimum in 1997 and then started growing again to exceed its 1995 level. Services were showing reverse tendencies.

Figure 1.4. Structure of value added in 1995-2001



Source: State Statistic Committee of Ukraine.

Note: Data for 2001 are estimated by the authors in order to ensure comparability with earlier numbers in spite of methodological change.

Decomposition of the growth of value added (see Table 1.2) shows that commencing from 1999, the industrial sector started to give strong and positive growth impulse. Agriculture and construction contributed in 2000 and 2001 although their influence was not that strong. Other sectors had only minor impact. One should remember that industrial growth in 1998-2000 stemmed mainly from the growth in metallurgy (first of all ferrous metallurgy but non-ferrous metallurgy also had a big impact).

Table 1.2. Decomposition of value added growth, in percent, 1998-2001

	1998	1999	2000	2001
Total	-2.0	-0.4	5.4	8.7
Industry	0.0	1.3	4.2	4.1
Agriculture	-1.6	-0.6	0.8	1.4
Construction	0.0	-0.4	0.1	0.3
Market services	0.3	-1.1	0.7	2.4
Non-market services	-0.2	-0.1	-0.2	0.0
Other	-0.6	0.5	-0.1	0.5

Source: State Statistic Committee of Ukraine.

Change in the structure of output – a decrease in the share of heavy industry and an increase in the share of services was typical for a former centrally-planned economies. This kind of change could also be observed in Ukraine. Although the share of industry – especially heavy industries – stayed high – the contribution of services started to gain importance. Hence, growth of market services should be seen as a healthy sign and is expected to

continue. The same can be said about light, food, wood and paper industries that started growing in 1999.

What was specific for Ukraine, was that metallurgy has been the most important contributor to the output growth in the industrial sector in 2000-2001. However, as the demand for the production of this sector depends on the export demand for metals, this branch is likely to grow as long as there are favorable external conditions.

After several years of continuous decline of value added in agriculture, there is a considerable potential for growth. However, it will depend on weather conditions on the one hand, and on institutional changes on the other. The growth experienced in 2000 and 2001 was, to a big extent, accidental and stemmed mainly from temporary factors (see Chapter 4 for details).

1.4. Inflation and Monetary Policy

Before financial crisis in September 1998, the year 1998 was considered as a period of the lowest inflation rate (in Jan-July 1998 the cumulative price growth was equal to 2.1% compared to 5.4% in Jan-July 1997). The 50% *hryvnia* devaluation in September 1998 stimulated an acceleration of inflationary processes and led to a 17.7% (y/y) price growth in the fourth quarter of 1998 (compared to 9.9% y/y in Q4 of 1997). Consumer prices grew by 20% in December, and producer prices – by 35.4%. However, the average annual CPI inflation rate in 1998 was equal to 10.6% which was the lowest level in the period of 1996-2001.

Limited inflationary pass-through of *hryvnia* devaluation can be explained by restrained growth of money supply and better crisis management than in the case of Russia (see Dąbrowski, Górski and Jarociński, 1999). Due to the collapse of the government bond market (foreign capital outflow), the reduction of state subsidies and the absence of crediting of real sector through money emission, there was no significant increase in money supply. In 1998, annual growth rates of monetary aggregates were the lowest in the period of 1996-2001 (22% y/y and 25% y/y for a monetary base and broad money (M3) respectively). As a result, enterprises did not have enough resources to raise wage payments that ultimately led to a reduction in real incomes. From this viewpoint, the low demand for goods (as population was impoverished) may be considered as one of the reasons for the absence of the significant price increases in 1998. Another reason is related to the adoption of the special law by the Verkhovna Rada of Ukraine³ that imposed a restriction on price increases

³ The Law of Ukraine "On Temporary Ban of Increase of Prices And Tariffs For Communal Services And Public Transport Granted to the Citizens of Ukraine", 51-XIV, 23.07.98.

for communal services and public transport, which constituted 70% of the consumer services basket.

In 1999, the National Bank of Ukraine (NBU) turned from liquidity restrained policy to monetary expansion. During this period, money base and broad money (M3) grew by 39% and 41% respectively. The NBU conducted money emission in two ways. First, to service foreign debt payments and to rebuild international reserves, the NBU purchased dollars in the Inter-Bank Currency Exchange. Second, taking into account unattractiveness of OVDPs (domestic Treasury bills) for commercial banks, the NBU had to buy them to provide the Ministry of Finance with sources for financing budget deficit and rolling-over the existing debt stock (violating the provisions of the new NBU law being effective from mid-1999). At the same time, the NBU decreased discount rate and the rate of lombard credits (from 50% to 45% and from 55% to 50% respectively).

Acceleration in the growth of monetary aggregates together with the depreciation of *hryvnia* in 1998 and 1999, led to the increase in the average annual inflation rate from 10.6% y/y in 1998 to 22.7% y/y in 1999. In spite of the administrative price controls on some foodstuffs that were imposed in the eve of the President elections, poor harvest led to a 27.8% y/y rise in food prices (compared to 11.8% y/y in 1998). At the same time, prices for other commodities and services grew by 22.1% y/y and 13.7% y/y (compared to 7.5% y/y and 9.9% y/y in 1998). It could be explained by a shortage of oil products in Ukraine and an administrative rise in communal and electricity tariffs in line with the IMF requirements on tariffs increase to the producers' cost level. The inflation rate started to fall towards the end of 1999, and in December CPI grew by 19.2%, while PPI 15.7% on the annual basis.

Table 1.3. Inflation and monetary aggregates in Ukraine in 1997-2001

	CPI	PPI	Monetary base		Currency in circulation (M0)		Broad money (M3)	
	y/y	y/y	UAH mil.	y/y	UAH mil.	y/y	UAH mil.	y/y
1997	10.1	5.0	7058	44.6	6132	51.7	12541	33.9
1998	20.0	35.4	8625	22.2	7158	16.7	15705	25.2
1999	19.2	15.7	11988	38.0	9583	33.9	22070	40.5
2000	25.8	20.6	16777	39.9	12799	33.6	32084	45.4
2001	6.1	0.9	23050	37.4	19465	52.1	45555	42.0

Source: NBU data.

Note: CPI and PPI are end-year percentage changes.

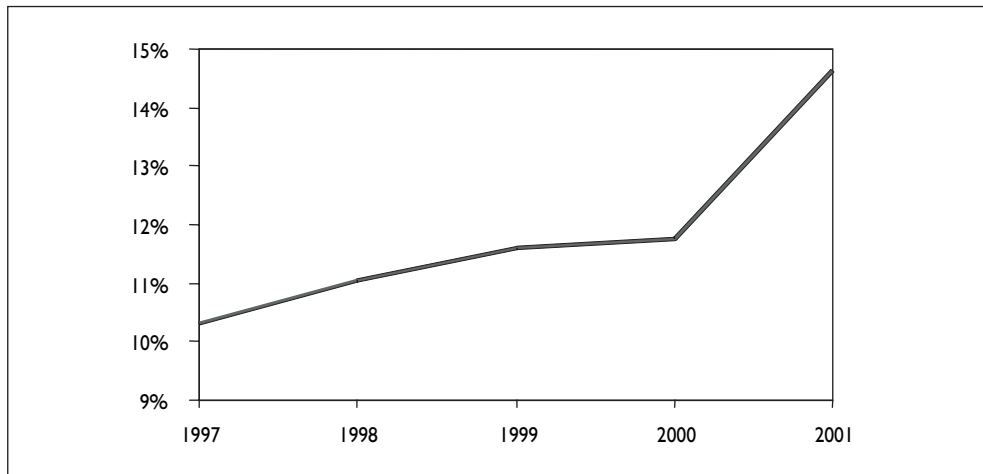
In 2000, the NBU continued conducting non-restrictive monetary policy aimed at increasing the liquidity of the banking system and its credit to the real sector. For this purpose, it decreased reserve requirements (from 17% to 15%) and diminished discount and lombard credits rates (from 45% to 27% and from 40% to 30% respectively). Such policy accompanied by the NBU's interventions in a foreign exchange market led to a 40% y/y and 45% y/y growth in money base and broad money (M3) respectively. Monetary

expansion contributed to a further acceleration of average annual CPI growth from 22.7% y/y in 1999 to 28.2% y/y in 2000. End-year CPI inflation was 25.8%. A 28.4% y/y rise in foodstuff prices recorded in December 2000 was induced partially by the poor harvest in 1999 and the relatively high demand on food and agricultural products that was stimulated by growing incomes of households. At the same time, several administrative rises in tariffs for communal and telecommunication services led to a 31.2% y/y increase in prices for services in December 2000 compared to 11.9% y/y at the end of 1999.

To stimulate further the increase of credit to the real sector by commercial banks⁴, the NBU kept its expansionary monetary policy in 2001 as well. The NBU's interventions in foreign exchange market along with the reduction in reserve requirements for commercial banks (from 14% to 6%) and of the discount rate (from 27% to 12.5%) contributed to a 37% y/y and 40% y/y increase in money base and broad money (M3) respectively. However, unlike the previous years, such increase in monetary aggregates was accompanied by lower rate of inflation. CPI increased by 6.1% in 2001, and PPI by 0.9%. This was much less than the end-year inflation for 2000 (when CPI grew by 25.8%) and 1999 (CPI grew by 19.2%). The increase in money supply was absorbed by an increase in the demand for domestic currency.

Changes in money demand in Ukraine are analyzed by looking at the level of monetization (ratio of monetary aggregates to GDP). Monetization can be considered as an indicator that reflects the degree of trust of economic agents and society into national

Figure 1.5. Monetization (M2 less foreign currency deposits to GDP) in Ukraine, 1997-2001



Source: Authors' calculations based on NBU data.

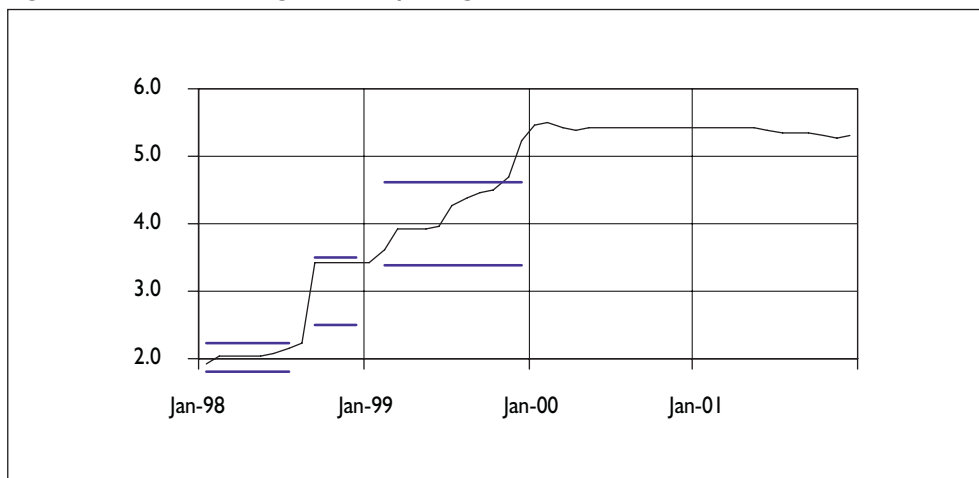
⁴ The actual rate of credit growth in 2001-2002 may prove excessive if one takes into account the limited absorption capacity of the banking and credit sectors – see Chapter 5 for the analysis of fragility of financial sector.

currency and monetary policy conducted by the central bank. Thus, an increase in monetization can be interpreted as an increase in the demand for money. A growth in monetization demonstrates the ability of the economy to absorb an increase in money supply without the pass-through on inflation.

Figure 1.5 demonstrates levels of monetization (as a ratio of broad money less foreign currency deposits to GDP) in Ukraine during 1997-2001. The first observation is that Ukrainian economy is monetized to a very small extent. Foreign currency deposits were subtracted from the M2 aggregate in order to give a better picture of the *hryvnia* demand. But even when we consider the usual indicator of monetization, that is M2/GDP, it still remains low for Ukraine. It reached the level of 22.3% by the end of 2001 (compared to 60-70% of GDP in developed countries). Nevertheless, it can be seen from the Figure 1.5 that there was a significant acceleration in the increase of the demand for domestic currency in 2001. Thus, the monetary expansion of 2001 was coupled with the considerable increase in the confidence to *hryvnia*. The high money supply growth in 2001 (52.1% y/y for M0 and 40% y/y for M3) was absorbed by the increased demand, and the country recorded one of the lowest inflation rates in 1997-2001 (6.1% y/y in December 2001). The trend of lowering inflation expectations continued through the first months of 2002, and CPI grew on the annual basis only by 2.1% in May 2002 (5.6% in January). The open question is whether the observed increasing demand for *hryvnia* reflecting higher confidence to a national currency will be sustainable in longer run.

1.5. Exchange Rate Policy

To overcome the financial crisis in August 1998 and to prevent significant *hryvnia* devaluation, the NBU introduced a number of restrictions in a foreign exchange market. In particular, it reduced a maximum allowed deviations of cash-market exchange rate from the official exchange rate, imposed a surrender requirement of 75% for export proceeds and restricted access to foreign exchange market for the so-called speculators. In 1998, the NBU's reserves went down by USD billion 1.579 to USD million 761.3. All this allowed the NBU to keep the official exchange rate at the almost constant level of UAH/USD 3.43 beginning from October 1998. Nevertheless, in 1998 *hryvnia* was devalued against US dollar by 80% (to UAH/USD 3.427), and the majority of this change took place during September 1998. Taking into account lower rate of inflation (about 20%) during the same period, it is clear that in 1998 *hryvnia* was devalued in real terms as well. This real devaluation was playing an important role in stimulating Ukrainian exports during the years that followed, which – together with import substitution – stimulated economic growth in 2000. The more detailed

Figure 1.6. Nominal exchange rate of hryvnia against US dollar in 1998-2001

Source: NBU data.

discussion on this issue can be found in Chapter 2. On the other hand, it contributed to the higher rate of inflation at the end of 1998 and 1999.

At the beginning of February 1999, the NBU announced the new band of UAH/USD 3.4-4.6 for 1999. At the same time, the NBU increased reserve requirements, striving for reduction of the speculative demand on the foreign exchange market. Following the agreement between Ukraine and the IMF, Ukraine had to abolish gradually foreign exchange restrictions. In particular, on March 19, 1999, the NBU allowed transactions on the Inter-Bank Currency Exchange, which contributed to the convergence of the official and black market exchange rates. During the first week of operations on the Inter-Bank Currency Exchange, the *hryvnia* depreciated from UAH/USD 3.76 to 3.93 (see Figure 1.6).

After expanding the maximum allowed deviations of cash-market exchange rate from official exchange rate from 5% to 10%, as the next step the NBU eliminated any remaining restrictions in this sphere. On the other hand, the NBU maintained the surrender requirement of 50% for export proceeds⁵. This contributed to the excess of the foreign exchange supply over importers' demand and the NBU obtained an opportunity to replenish its foreign exchange reserves. In 1999, they grew by USD 285.1 million and reached USD 1.046 billion level.

While in the first half of 1999 the NBU's interventions managed to maintain slight fluctuations in *hryvnia* rate within limits of UAH/USD 3.93 to 3.95, in the second half of 1999 both the domestic oil market crisis and the monetary expansion stimulated significant *hryvnia* depreciation from UAH/USD 3.95 to 4.46. Shortage of oil products led to the increase in

⁵ The NBU Board Resolution #139 "On the Introduction of Changes to the Rules of Operations on Inter-Bank Currency Exchange of Ukraine" as of March 24, 1999.

their prices and induced an increase in the demand for US dollars. At the same time, facing sharp *hryvnia* depreciation, exporters reduced the supply of foreign currency striving to make higher profits from further devaluation. As a result, the exchange rate overcame the upper margin of the UAH/USD 3.4-4.6 band and reached the level of UAH/USD 5.2 (see Figure 1.6). An introduction of the NBU's restrictions on the liquidity of the banking system and a decrease in dollar demand from the side of oil importers contributed to a gradual *hryvnia* appreciation at the initial stage. Nevertheless, during the whole year 1999 *hryvnia* depreciated by 52% (to UAH/USD 5.22). The 1999 inflation of 19% meant that the domestic currency continued to depreciate in real terms. This further stimulated import substitution and spurred the increase in Ukrainian export. As a result, in 1999 positive trade balance (USD 1.82 billion) was observed for the first time during the five consecutive years (trade deficit was usually around 3% of GDP).

An increase in Ukrainian exports (especially, in metallurgy sector due to indirect subsidizing and favorable conditions on Ukraine's traditional export markets) as well as foreign exchange inflows from privatization transactions led to a change in the exchange rate trends since the beginning of 2000.⁶ In 2000, the NBU maintained a *hryvnia* exchange rate at the almost stable level (around UAH/USD 5.44). Growing export revenues and foreign exchange inflows from privatization resulted in the excess supply of foreign exchange. At the same time, striving to prevent a decrease in Ukrainian exports due to the possible *hryvnia* appreciation, the NBU started purchasing dollars at the Inter-Bank Currency Exchange. As a result, the NBU's foreign reserves grew from USD 1.04 billion to USD 1.35 billion at the end of 2000, while *hryvnia* was devalued only by 4.18% compared to its 52% depreciation in 1999. At the same time, 25% annual inflation recorded in December 2000 reversed real exchange rate trend from real *hryvnia* depreciation to its real appreciation.

In 2001, Ukraine experienced a significant inflow of foreign currency (in a form of large export earnings and increased amount of financial transfers into Ukraine in the eve of the parliamentary elections). As in the previous period, foreign exchange supply exceeded demand. In the first half of 2001, significant foreign exchange supply was stimulated by the expected shift from origin to destination principle of VAT in Russia's trade with Ukraine (beginning from July 1, 2001). Trying to avoid negative effects of the new mechanism, the exporters increased their supplies to Russia and tried to meet their quotas (on products of metallurgical sector) during the first half of 2001. Imposition of administrative restrictions on the foreign exchange market allowed avoiding the panic accompanied by the growth of speculative operations that were caused by the New York tragedy in September 2001. At the same time, revenues from agricultural exports of new harvest and foreign exchange inflows from abroad that were associated with financing the parliamentary election campaign

⁶ Average daily volume of transactions on the Inter-Bank Currency Exchange was amounted to USD 30-40 million; and so, even a slight change in either output volumes or prices in export-oriented sectors strongly affected the *hryvnia* exchange rate.

could be considered as factors that stimulated an increase in foreign exchange supply during the second half of 2001. In general, the excess of foreign exchange supply over demand made it possible for the NBU to enlarge further its foreign reserves. As a result, at the end of 2001, the official NBU's foreign exchange reserves reached the record level of USD 3 billion. At the same time, the NBU allowed for nominal *hryvnia* appreciation by 3% (to UAH/USD 5.27) contributing to further strengthening of the real exchange rate.

From the analysis of monetary and exchange rate policies, it is clear that, notwithstanding continued monetary expansion in 1999-2001, inflation went down in 2001. Growing money supply was absorbed by increased confidence to the domestic currency (stable exchange rate and economic growth were probably the most important factors here). As to the factors that contributed to this economic growth, the post-crisis devaluation and hence real depreciation of *hryvnia* were driving the 1999-2000 exports expansion. However, real appreciation of *hryvnia* in 2000 and 2001 demonstrated that future economic growth in Ukraine would depend more on improvements in productivity than on price advantages due to a real depreciation as it was observed earlier.

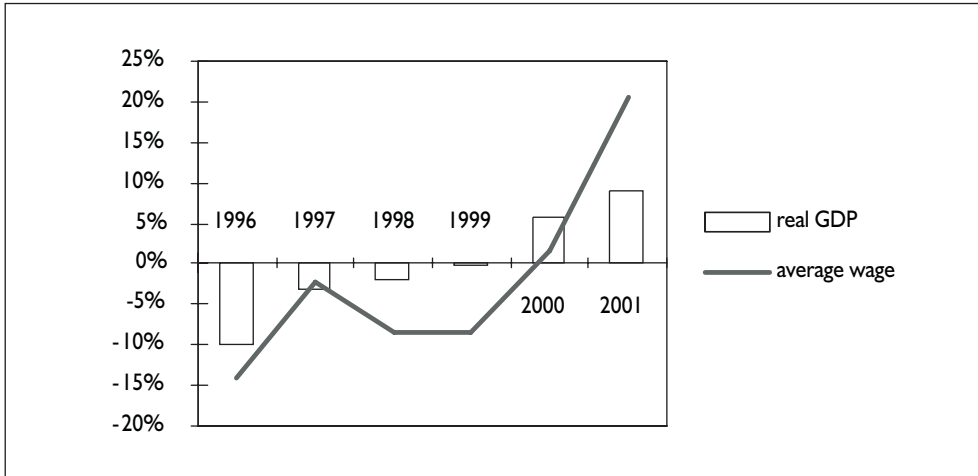
1.6. Labor Market Developments and Incomes of the Population

Labor market adjustments in the 1990s followed the pattern typical for a CIS economy. Decline in employment was significantly smaller than the fall in production and labor demand. This was not the actual employment that absorbed the shock connected with the collapse of the centrally planned economy, but lower real wages, together with growing wage and pension arrears. As a result, the ratio of employed to the working age population remained practically unchanged. Unemployment rate dynamics have not been moving together with output.

The similar pattern prevailed after the 1998 currency crisis. Neither the actual employment, nor its structure changed significantly during 1998-2001. These were mainly movements of wages that absorbed the shock and the catch-up that followed. The number of employed⁷ to the working age population was gradually falling throughout 1996-2000, and was unresponsive to changes in overall economic conditions. Employment in agriculture accounts nearly for 30% of official total employment, and employment in industry has a slightly higher share. The rest of employment is accounted for services and people working in other sectors of the economy.

Unemployment rate that stabilized in 1999-2000, decreased a little in 2001, and according to the employment office records, was 3.7% at the end of 2001. However,

⁷ Officially registered.

Figure I.7. Growth of GDP and average wage, in real terms, 1996-2001

Source: State Statistic Committee.

findings from the Labor Force Survey suggest that the true unemployment rate is much higher, and that in 2001 it was on average above 10%. The still existing discrepancy between the two numbers indicates the persistence of hidden unemployment and shadow labor market. The hidden unemployment may take various forms, such as shortened work days, unpaid leaves, and partial employment. The unemployment benefit – although increased from 50 UAH per month on average in 1999 to 85.23 UAH in 2001 (which is less than 16 USD, without taking into account purchasing power differences) – is still very low, and it does not create enough incentives to become registered as unemployed. Instead, people still prefer to be registered as employed, benefit from the ‘employed’ status, and use their free time to engage in unofficial activities (Zhurzhenko, 1998). Data on unemployment suggest that we still have the situation where the significant part of the population supplements its official income with the secondary, informal job, revenues from which are often higher than from the ‘registered’ occupation.

The other important issue associated with Ukrainian labor market is labor migration. It was estimated, that the total number of labor migrants from Ukraine was no smaller than

Table I.4. Employment, labor force, unemployed, 1996-2001

	1996	1997	1998	1999	2000	2001
Employment (in thousands)*	20868	19835	19415	18790	18063	-
Employment/working age population	73.2%	70.0%	68.8%	66.3%	63.5%	-
Officially registered unemployment rate	1.6%	3.1%	4.8%	5.8%	5.8%	3.7%
Labour Force Survey unemployment rate	7.6%	8.9%	11.3%	11.9%	11.7%	10.3%

Source: State Statistic Committee, own calculations.

Note: * - Annual average, excluding self-employed.

one million of persons in 2000 (Libanova, Poznyak 2002), which was equal to 4.3% of the economically active population (aged 15-70). The majority of migrants (81%) declared to hold no constant work in Ukraine at the time of their migration, and only 7% of them were on unpaid leave. The migrants were mainly young people with some working experience (30-34 age group was most frequently represented), with secondary education, and coming from rural areas. More than one half of them traveled to Western and Central Europe (among them 1/3 to Poland, then to the Czech Republic and Italy), and over 1/3 to Russia (mainly older workers).

1.6.1. Incomes of the Population

Total reported incomes of the population amounted to nearly 109 UAH billion in 2001 (61.9 UAH billion in 1999). Although their growth during the last two years was significant, their structure has practically not changed. Around half of this comes as a revenue from employment, and next 21% (in 2001; 25% in 1999) is accounted for by pensions. Sale of foodstuffs – that increased during last three years – and falling incomes from the sale of foreign currency represent around 5% of total incomes. The rest – 15-20% is classified as ‘other income’.

Real incomes of the population started to grow (at the annual basis) in the first months of 2000, and in 2001 they were already higher in real terms than in the crisis year of 1998. After falling by 1.6% in 1998 and by 9.1% in 1999, they grew by 9.6% in 2000 and by 12.4% in the following year. The largest growth impulse came from the earnings from wages and salaries, then from the income from the sale of agricultural products, and in 2001 even real incomes from pensions and stipends rose. Income from foreign currency sales was still falling in real terms in 2001, indicating gradual de-dollarization of the economy.

There is the hypothesis saying that the growth of incomes of the population has been highly stimulated by the repayment of wage and pension arrears. And that it gave a strong growth impulse to the domestic industries producing ‘first-need’ commodities. The argument was supported by the fact that around $\frac{3}{4}$ of the population income is spent on the purchases of goods and services. However, when we look at the aggregate figures, it comes out that the repayment of budgetary social arrears was only a fraction of the total income of population from wages, pensions, and the like (around 2% on average during 1999-2000). Also the nominal increase in income is explained in major part by other factors. Even in 1999, the repayment of social arrears was not able to provide a strong enough impulse for the growth of real incomes. Thus, the repayment of these arrears, although contributed directly to the growth of incomes, played rather a minor role.

It is also worth noticing that the relative size of unreported incomes of the population shrank in 2000. It probably reflects the decline of unregistered economic activity in the

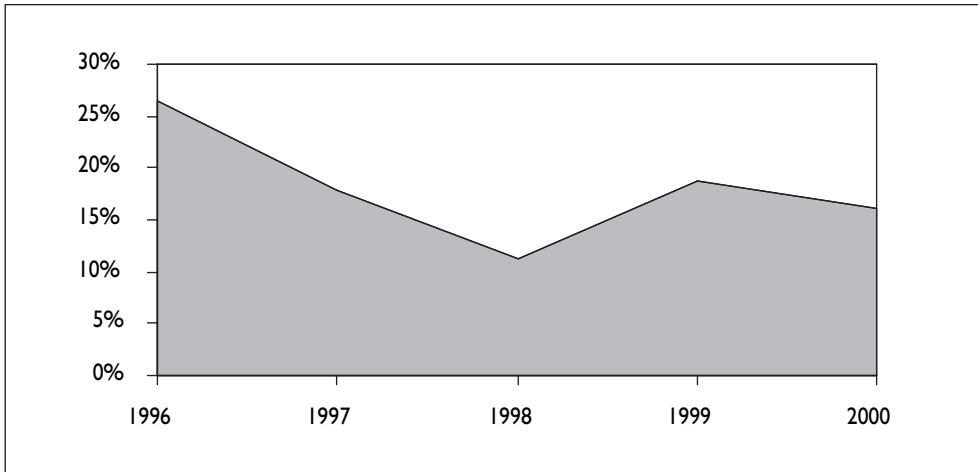
Table 1.5. Incomes of the population and repayment of budgetary social arrears, 1998-2001

	1998	1999	2000	2001
Total incomes (UAH mil.)	55 322	61 865	86 859	108 835
Real growth (in %)	-1.6	-9.1	9.6	12.4
Repayment of budgetary social arrears* (UAH mil.)	-	816	1 607	773
in % of nominal income growth	-	12.5	6.4	3.5
in % of nominal growth of incomes from wages, pensions, stipends, etc.	-	12.5	11.0	4.2

Source: State Statistic Committee and Ministry of Finance, own calculations.

Note: * - Difference between social arrears of the consolidated budget at the end and at the beginning of a specified period.

household sector. The reasoning that stands behind this argument is as follows. If we compare total incomes of the population with household consumption, it turns out that registered incomes are significantly lower than the value of consumption. This situation occurs because people do not report all their incomes, but these amounts are nevertheless counted when being spent, as household consumption expenditure⁸. Therefore, if we estimate household savings, and add it to the household consumption, we obtain the

Figure 1.8. Difference between estimated disposable incomes and reported incomes of population, in % of official consumption of households, 1996-2000

Source: CASE estimates on the basis of data from State Statistics Committee of Ukraine and NBU.

Note: Disposable income of households was calculated by adding household consumption expenditures and the estimate of household savings. Savings were calculated as a sum of change in the amount of cash (UAH and hard currency, the latter estimated as the difference between purchases of foreign currency by households and people's income from foreign currency sales) and household deposits, change in the amount of household credits, and household investment in fixed assets and change in inventories from NA. For the year 2000, it was assumed that household saving rate was equal to the 1999 rate, i.e. that it was 5.6%.

⁸ In National Accounts.

estimate of the disposable income of households, which can be then compared with 'total incomes of the population' as reported by the State Statistic Committee. This difference – between the approximation of disposable incomes of the population and reported incomes – is shown in the Figure 1.8. The 'income gap', expressed in terms of household consumption, was falling up to 1998, grew in the post-crisis year of 1999, and narrowed again in 2000. Thus, the unregistered economic activity of the household sector decreased in 2000 as compared to the previous period.

Chapter 2

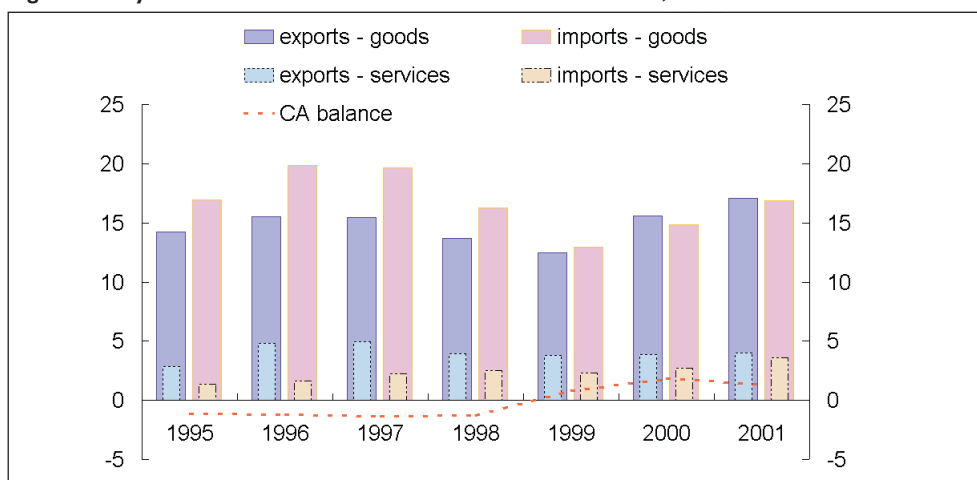
Role of External Sector

Yurij Kuz'myn

2.1. Developments of Merchandize Exports and Imports

Many observers consider the change in the pattern of Ukraine's current account as a positive result of the 1998 currency crisis. Negative CA, at least from the moment when the NBU started to compile Balance of Payments, was regarded as an indication of saving-investments imbalance, a normal feature for the economy in transition. Up to 1998, imports of goods permanently exceeded exports, with negative merchandize trade balance varying from 2.7 USD billion in 1995 to 4.3 USD billion in 1996 and to 4.2 USD billion in 1997. On the other hand, Ukraine continued to hold a positive balance of services, which allowed to compensate sharp negative balance of goods and to keep CA at the level of -1.2 USD billion on average during 1995–1997.

Figure 2.1. Dynamics of Ukrainian merchandise trade in 1995-2001, USD billion



Source: National Bank of Ukraine (BOP statistics).

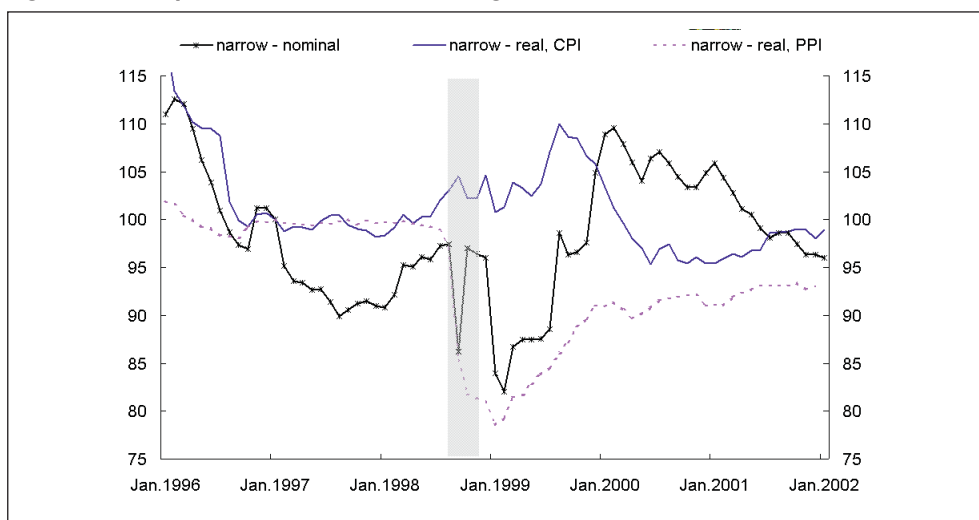
Subsequent years brought, however, a considerable improvement in the balance of goods. Merchandise imports fell by 1.2 USD billion in 1998 and by 0.9 USD billion during the first half of 1999. This fact – despite shrinking balance of services – caused a positive CA balance of 0.8 USD billion in 1998. A fast growth of exports, starting in the second quarter of 1999 insured a positive CA during the next three years after the crisis.

One might think of at least two main factors contributing to the improvements in the CA after 1998. The first is the post-crisis depreciation of *hryvnia* and the second is increased external demand. We will now turn to the discussion of these two possible factors influencing the pattern of trade flows in 1999-2001.

2.2. Evolution of Exchange Rate

Indeed, a series of crises in the world economy, mainly the Russian one, resulted in the sharp devaluation of *hryvnia* against USD (56% for August-November, 1998) and against all the major currencies, but less than the devaluation in Russia which happened earlier. Considering the overwhelming share of trade with Russia, nominal appreciation against Ruble wiped out the effect of devaluation against other currencies and resulted in nominal appreciation of *hryvnia* if measured against a basket of currencies of main trading partners (see Figure 2.2).

Figure 2.2. The dynamics of Real Effective Exchange Rate indices, 1996-2002

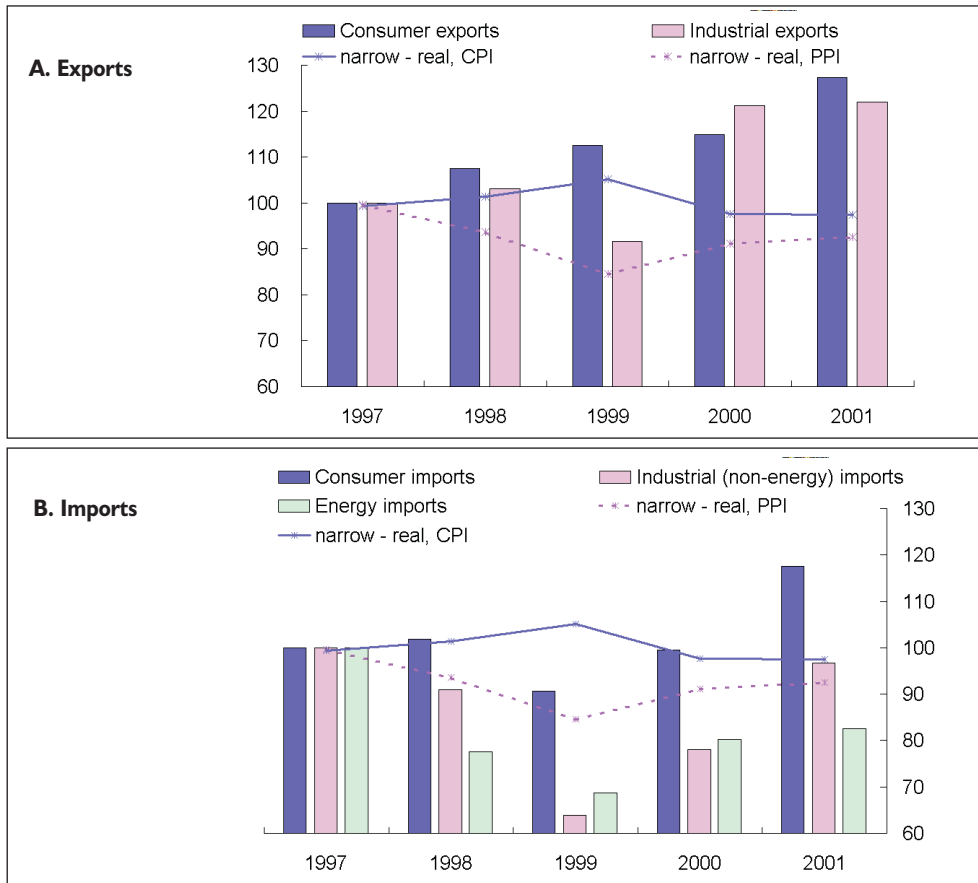


Source: Author's calculations.

Note: An upward movement of the index represents a depreciation of *hryvnia*. Indices cover a narrow group of 10 major trading partners of Ukraine, which accounted for about 65% of Ukrainian foreign trade in 1995-1999.

Since consumer and producer prices reacted differently to changes in exchange rates, the indices of real effective exchange rate (REER) based on PPI and CPI exhibited different behavior, and, subsequently, articulated reallocation effects of exchange-rate changes differently. As a result, a situation had improved for the Ukrainian producers of consumer goods and adversely influenced the importers of these goods to Ukraine as *hryvnia* measured in terms of consumer goods slightly devalued in 1999. On the other hand, sharp real appreciation of *hryvnia* in terms of producer goods had worsened significantly the external competitiveness of Ukrainian industrial producers while relatively improving the position of importers of these goods to Ukraine. Although further real depreciation in the after-crisis period has mitigated this fall in competitiveness, one should observe that at the end of 2001 *hryvnia* measured in terms of producer good prices was still about 6% stronger than before the crisis.

Figure 2.3. Dynamics of Ukrainian foreign trade in 1997-2001 (index, 1997=100)



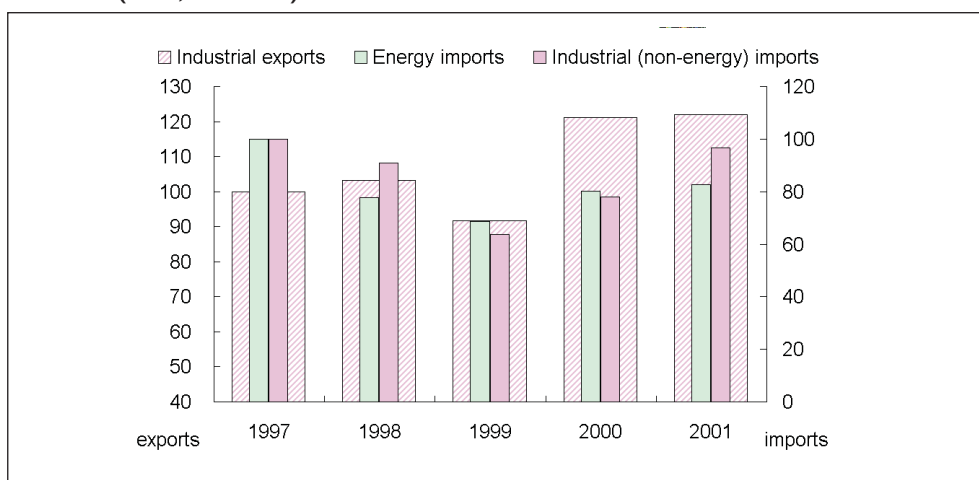
Source: State Committee of Statistics.

Note: Author's calculations; Industrial exports constitute about 80% of merchandize exports; Industrial (non-energy) imports – 40%, energy imports – 45% of merchandize imports. An upward movement of REER index represents a depreciation of *hryvnia*.

A year 1999 revealed theoretically predictable increase of exports and decrease of imports of consumer goods (see Figure 2.3), given real depreciation of *hryvnia*. Real devaluation, however, might have played a role of unintended ‘expenditures-switching policy’, which resulted in the decline of consumer imports in 1999. This switched peoples’ demand towards domestically produced consumer goods and stimulated the development of consumer industries, like catering, food-processing and light industries. Agriculture was also under the spillover effect of such stimulation. One cannot distinguish, however, whether it was devaluation or something else that defined the path of exports and imports of the consumer goods after 1999. During 2000-2001 it was no longer possible to track the correspondence between real appreciation (2000) and relative stability of REER (2001), on the one hand, and increasing exports, on the other. Similarly, even if increased import of consumer goods in 2000 was a result of real appreciation, this explanation does not work for the sharp increase of consumer imports in 2001.

Applying the same line of arguments to the explanation of trade in industrial goods, one should agree that the exchange rate movements were among the factors that influenced this part of trade. Real appreciation depressed exports in 1999 and subsequent depreciation stimulated it in 2000 and 2001 (see Figure 2.3 A). On the other hand, imports of industrial goods as well as imports of energy during the whole period of 1997-2001 were conforming not to the real exchange rate movements (see Figure 2.3 B), but rather to the movements of industrial exports (see Figure 2.4). These patterns are easily explained if one recalls the energy-intensity of Ukrainian industry and the existence of barter schemes used to avoid taxation and for other reasons.

Figure 2.4. Relationship between industrial exports and industrial and energy imports of Ukraine, 1997-2001 (index, 1997=100)



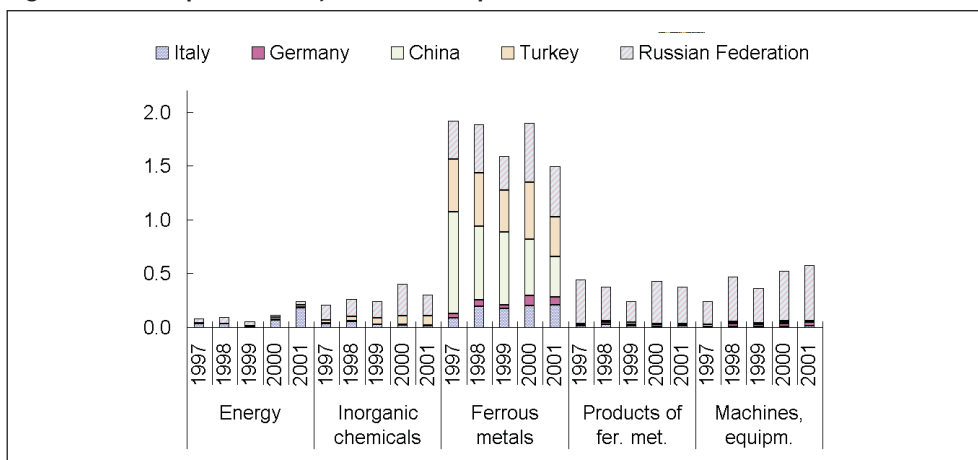
Source: State Committee of Statistics, Author's calculations.

Conclusion: While real devaluation of *hryvnia* boosted exports of consumer goods in 1999, we did not find substantial support for the hypothesis that real depreciation stimulated exports of consumer goods afterwards. Despite devaluation of 1999 has also resulted in the growth of import-competing consumer-oriented industries, considering the whole post-crisis period, we conclude that RER could explain only a minor portion of fluctuations in foreign trade flows, and, therefore, can hardly be named among the major factors influencing Ukrainian foreign trade. Therefore, one should be cautious when changing the exchange rate to promote exports before knowing the factors influencing the pass-through of the exchange rate on consumer and producer prices.

2.3. Evolution of External Demand

Although Ukraine made some progress in diversifying its trade partners, its exports can still be considered as highly concentrated, thus making the country vulnerable to different shocks on the demand side. Major trade partners that import goods from Ukraine are the following: Russia (22% of Ukrainian exports for 1997-2001), Turkey (5.8%), China (5.6%), Germany (4.3%), Italy (4.2%), United States (3.8%), Belarus (3.1%) and Poland (2.9%). Taking into account the competition at the third markets, Russia, Germany and the United States are the most influential partners of Ukraine, with Russia accounting for more than 50% of influencing power and the other two countries – for 15% and 9%, respectively.

Figure 2.5. Developments of major Ukrainian export markets, 1997-2001, USD billions



Source: State Committee of Statistics.

Note: The graph represents about 20% of Ukrainian merchandize exports.

Main groups of goods exported from Ukraine include: ferrous metals (33.5% for 1997-2001), machines and mechanical equipment (6%), mineral fuels (5.8%), products of ferrous metals (4.6%) and inorganic chemical products (3.9%). Russia, which is ranked the first at four out of five major exports markets (see) along with Turkey and China consume more than a third of Ukrainian exports. Since export to these countries is very likely to shape the total exports of Ukraine, below we will briefly follow their role and perspectives.

Despite the continuing economic growth, China, the biggest single market for Ukrainian ferrous metals, reduced its consumption substantially (see Figure 2.6). This contraction was the result of China's industrial policy aimed at the development of domestic industries, whose products would replace imports by the time this country joins WTO and opens its market.

Similarly to China, various protectionist measures in Russia and Germany resulted in the decrease of ferrous-metal exports to these countries in 2001. These measures were implemented soon after the successful expansion of Ukrainian exporters into these markets in 2000. The other reason for such a tightening was a downturn in the world metal market. Italy and Turkey are the only markets in this field, where exports reflected the developments of demand, and not of protectionist policies.

As can be seen from Figure 2.6, the most significant groups of Ukrainian exports (all of which are industrial goods) were not responding to changes in foreign demand in a theoretically predictable way. On the other hand, all 'other exports'⁹ (which include also all consumer goods) has shown a relatively nice reaction to foreign demand. These differences make us think that factors that determine development of the particular sectors of Ukrainian economy also shape its foreign trade.

Without going into details (see Chapter 3), we can only suggest that economic results of the largest Ukrainian export-oriented industries are determined by domestic micro factors (undeveloped and monopolized infrastructure,¹⁰ incomplete redistribution of property rights,¹¹ selective provisions of tax privileges, etc). Besides, Ukrainian government frequently makes efforts to create favorable environment for domestic producers and exporters (often under tough lobbyist pressure). A famous example of such policy was the 'experiment in metallurgical sector' – provision of implicit subsidies to metal producers.¹² Its implication for

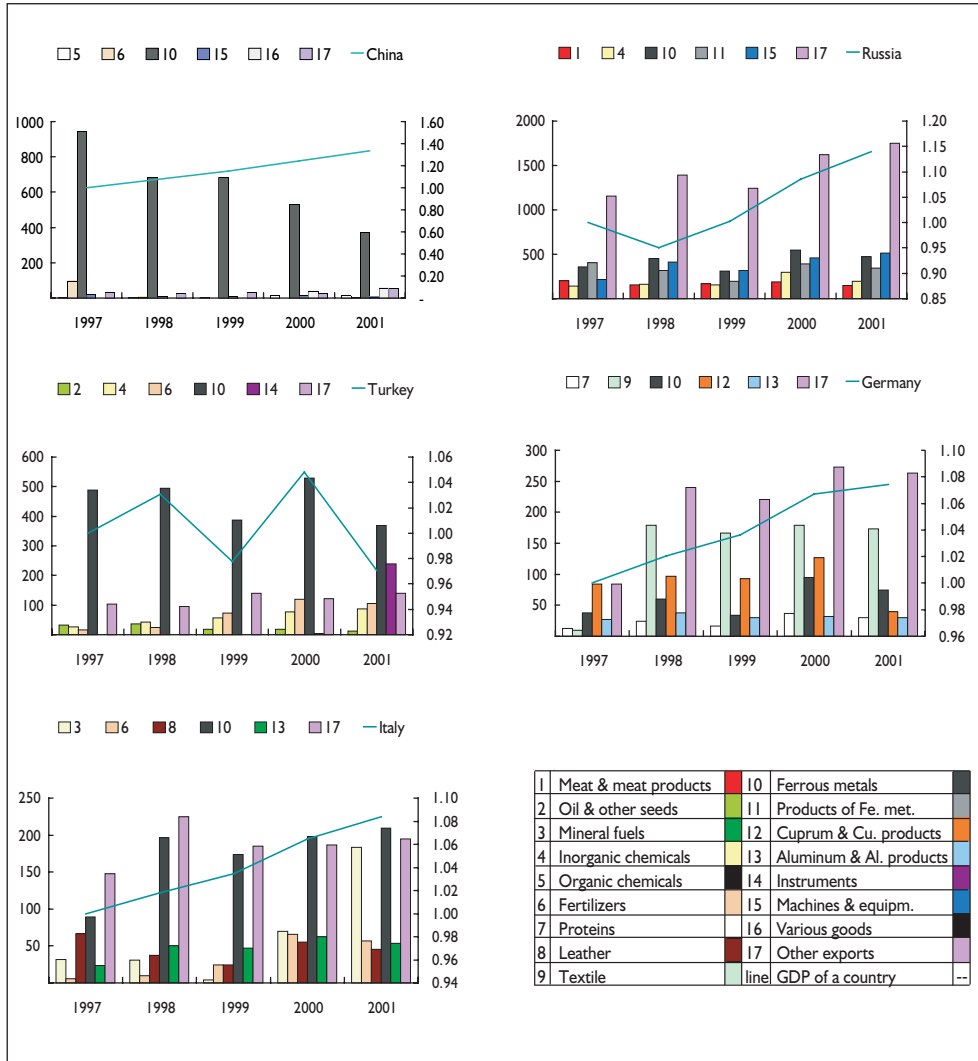
⁹ Under 'other exports' we mean a large number of small provisions of various goods to the foreign markets.

¹⁰ Monopolized railroad transportation continues to adversely influence the exporters. The prominent example of this influence was the case when one of the largest metal works in Ukraine had to switch from railroad to truck haulages of its products to the seaport. The denial of Railroad Company to deliver cargo for the specific grain exporting company was another case of monopolistic influence.

¹¹ It is not a rare situation (see for example exports of instruments to Turkey in 2001) when an enterprise starts exporting only because it starts producing as a result of completed redistribution of property rights (privatization) or restructuring.

¹² According to the law 'on experiment' adopted in July 1999, metal factories were subject to: a) half of the tax to the state innovation fund; b) 70% of penalties for nature pollution; c) elimination of their indebtedness to the state budget accrued before July 1, 1999; also granted the right to pay half of the penalties on the tax and duties' arrears accrued during the period of the 'experiment'; d) were exempted from charges for the construction and maintenance of the roads; e) for the involved enterprise the rate of corporate profit tax was established at 9% (vs. 30% for the majority of other enterprises). To be eligible to participate in the 'experiment', the metallurgical enterprise had to meet two out of three requirements: a) produce not less than 2% of the goods of metallurgical industry; b) have the assets worn out at least by half; c) export not less than 8% of the goods it produces.

Figure 2.6. Foreign Demand and Exports to major trading partners of Ukraine (exports: USD million, foreign demand: real GDP, index, 1997 = 1)



Source: State Committee of Statistics. World Bank, J.P. Morgan Chase & Co.

Ukrainian foreign trade is dubious. First, volume of ferrous metals export increased substantially (by 27% and 13% in 1999 and 2000). However, due to decreasing world prices, export revenues decreased in 1999 (by 7%)¹³ (see Figure 2.5). Second, according to the State Tax Administration of Ukraine, “positive impact of the ‘experiment’ on the state budget was close to zero” by the end of 2000. Third, ‘experiment’ clearly dumped feeling of a

¹³ Increased revenues (by 29%) of 2000 can hardly be attributed to the ‘experiment’ but were rather a result of higher world prices.

market in the involved enterprises, as there were weak correlations between the world demand and exports from Ukraine. One should expect that enterprises, which increased capital investments into metallurgy as a result of the experiment (by 60% over year in 2000) under depressed world demand will require additional donations from the budget. Fourth, boom of metal exports from Ukraine, as it was already mentioned, resulted in several anti-dumping investigations and protectionist measures brought up by Ukrainian trade partners. As a result of the above factors, volume of metallurgical exports from Ukraine decreased by 9%, while revenues decreased by 8% in 2001.

Again, in our opinion, supply-side factors, which determine the evolution of domestic industries, shape also (and, possibly to the major extent) Ukrainian exports. Governmental policies aimed to promote exports by explicit or implicit subsidies to the producers so far might be called as effective only in the short run, while over the longer period their positive impact is not determined.

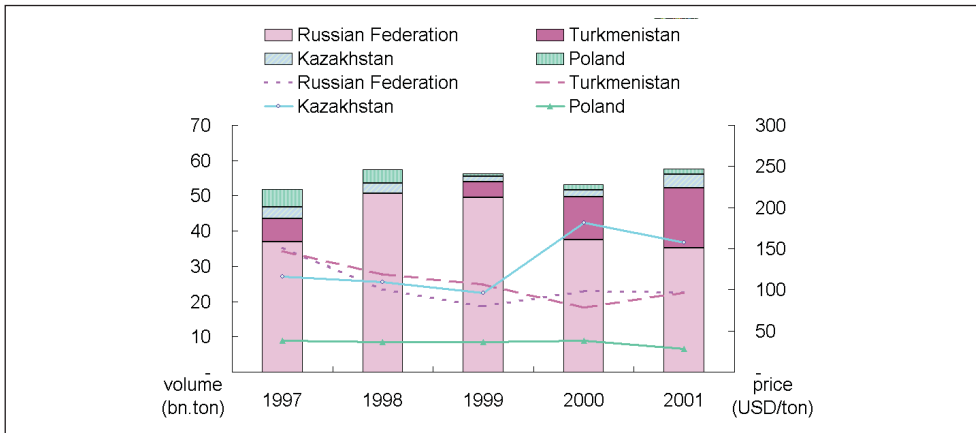
2.4. Energy Imports

The crisis of 1998 had positive impact on Ukrainian energy imports in a sense that it resulted in lower prices for the imported natural gas (see Figure 2.7). This is, probably a reason that, despite economic downturn in 1998 and 1999, Ukraine has not significantly decreased its consumption of this resource.

When Ukraine started to shift from Russian to Turkmen gas in 1999, Russia further decreased its price. The lowered prices were major reason for the decreases of nominal energy imports in 1998-1999. While Ukraine continued to increase the share of the Turkmen gas in its imports in 2001, it became unable to decrease the price further because Russia, managed to establish control over gas transit through its territory. Also, the Government of Ukraine lacked political will to deal with the Ukrainian monopolies being in charge of gas imports to Ukraine.¹⁴ Another reason for the weak bargaining power and slow progress in this sphere is huge debt before Russia for a gas supplied in previous years.

Economic growth in 2000 and 2001 has not brought, however, proportional increase of natural gas imports. This is either an indication for more efficient use of energy by Ukrainian enterprises or is merely a result of a shift towards the official economic activity in Ukraine. The latter argument favors the hypothesis that economic growth in Ukraine was due to change in proportions between shadow and official sectors of the economy.

¹⁴ According to the report of the US Embassy in Kyiv, in 1998-99, Ukraine was buying Russian gas at \$80 per 1,000 cu m, Turkmen gas at \$72 per 1,000 cu m, while Russian Gazprom was selling it at \$30 to Belarus and at no more than \$56 to European countries.

Figure 2.7. Dynamics of energy imports in Ukraine

Source: State Committee of Statistics.

Note: Bars represent volumes, lines – price. Main energy resources imported from Russia are oil and natural gas; from Kazakhstan – oil; from Turkmenistan – natural gas; from Poland – coal.

Therefore, these are political and supply-side factors (rather than world price or exchange rate) that determine the volumes of energy imports to Ukraine and their development will have the greatest influence on the most significant part of Ukrainian foreign trade in the future.

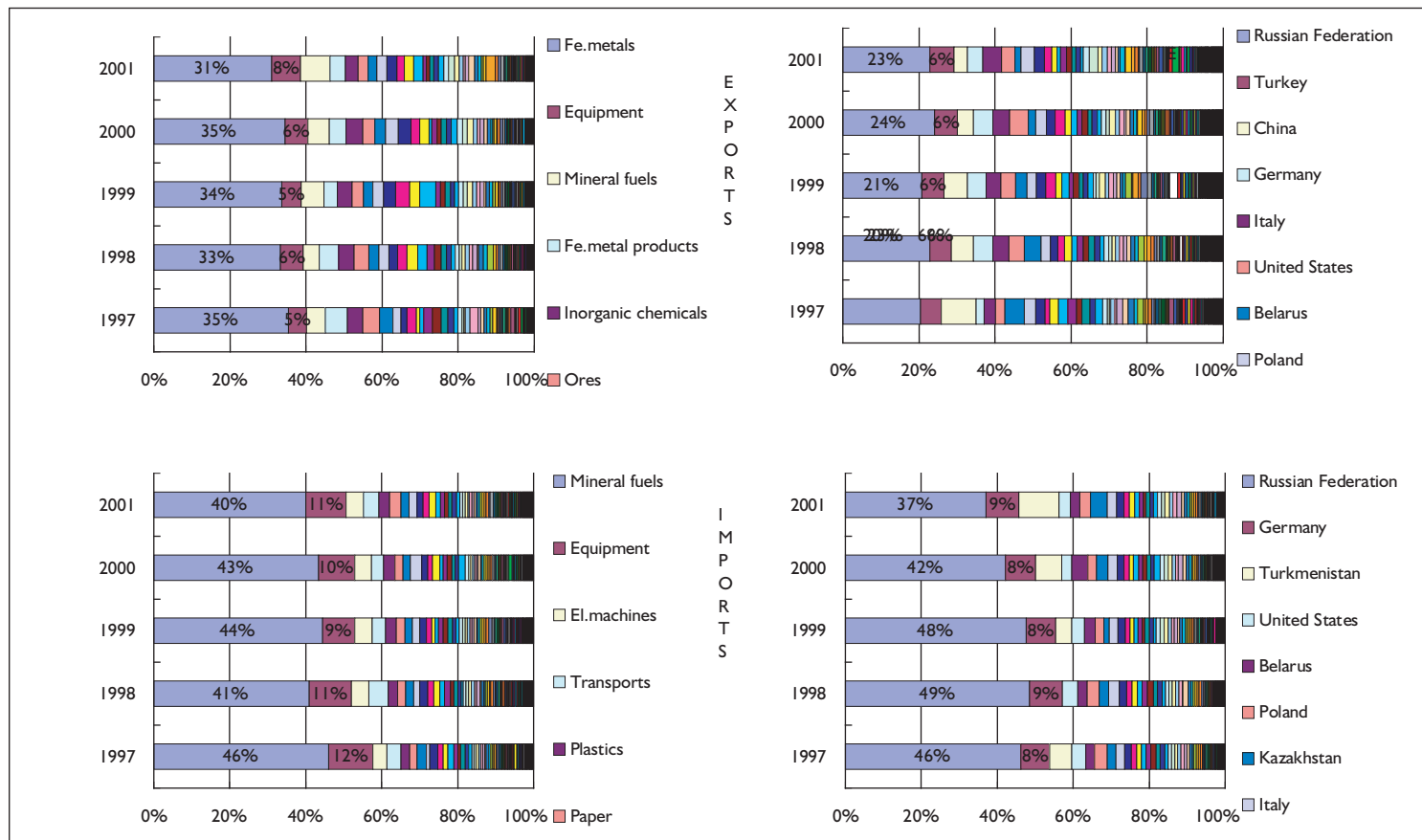
2.5. Diversification of Foreign Trade

Changes in the structure of foreign trade in the post-crisis period (see Figure 2.8) does not allow to conclude that Ukraine succeeded in reorientation to the new markets. From the above sections one can conclude that the main reason for this was the virtual lack of understanding of market forces by the government (recall, for example, an ‘experiment’ in metallurgy): instead of conducting a policy towards development of sectors with higher value-added, Ukrainian government promotes metallurgical sector (currently taking the largest share in exports). While Ukraine managed to divert its exports from former USSR countries, its dependency on Russian demand remains substantial. Moreover, although Ukraine managed to shift its energy imports towards Turkmenistan, Russia continue to control Ukrainian energy supply via control over transit pipelines.

Therefore, the ability of Ukraine to withstand asymmetric foreign shocks has not improved as much as the need for it – properly assessed by the policy makers.

A weak reaction of the largest industrial export sectors (as opposite to a reaction of consumer exports) to changes in the foreign GDP, as well as in the exchange rate, makes us

Figure 2.8. Structural developments in foreign trade, 1997-2001, %



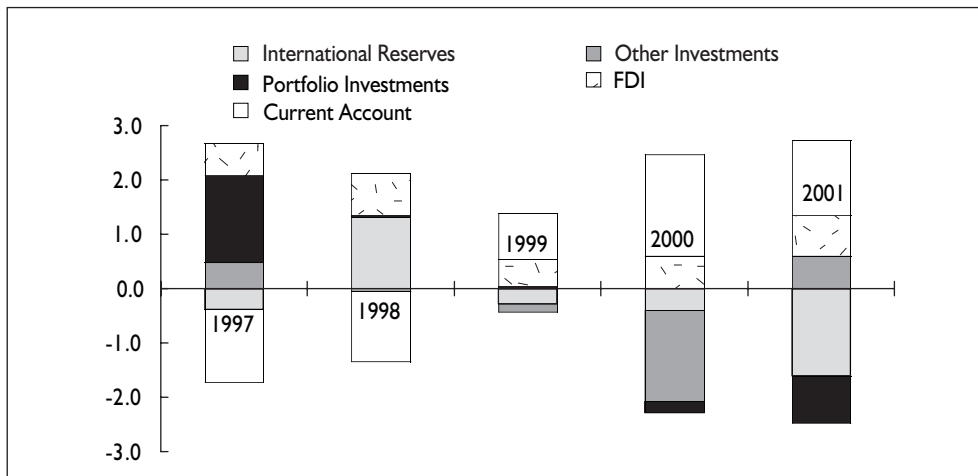
Source: State Statistical Committee.

looking for other than macroeconomic factors. It is well known that the development of transition economies are restricted not by demand, but rather by supply side factors (incomplete distribution of property rights, restructuring, weak infrastructure, etc.). Since we have not found enough arguments in support of traditional theories of foreign trade, we tend to believe, that these supply-side factors determine the evolution of Ukrainian foreign trade along with the development of Ukrainian economy as a whole. While not minimizing the merits of the classical theories of trade, they (theories), in our opinion, cannot explain the major fluctuations of foreign trade of Ukraine. The analysis of income and substitution effect should, most probably, shed some more light at the dynamics of particular traded goods. This, unfortunately, cannot be performed at more general level. Having in mind that there is no official statistics even for the unit values of foreign trade flows, this analysis would require additional research.

2.6. Financial Account Developments

A variability of the financial account of the Balance of Payments of Ukraine during 1997-2001 was rather a function of portfolio and other investments than foreign direct investments (see Figure 2.9). Current account surplus (834 USD millions) registered in 1999 (according to our data for the first time since independence) and two subsequent years (1.9 and 1.4 USD billions respectively) was used to acquire international reserves (substantially depleted during 1998) and service external debt, which was especially heavy in 2000.

Figure 2.9. Dynamics of Financial Account, 1997-2001, USD billions



Source: National Bank of Ukraine (BOP statistics).

2.6.1. FDI

Permanent increase in FDI is often perceived as a sign of irrevocable changes in investment climate of a home country, and thus, a sign of sustainability of economic growth. In Ukraine, FDI has shown modest positive development. First of all, the stock of FDI in Ukraine is low: \$89 per capita at the beginning of 2002, compared with \$253 in the Czech Republic and \$239 in Hungary in 1998. Second, the inflows of FDI are moderate. In the case of a country that has initially low level of foreign-capital engagement and pursues deep and comprehensive reforms, one might expect a sharp increase in FDI. This was not the case in Ukraine. As one can see from Figure 2.10, a year after the 1998-crisis FDI inflows decreased sharply (which was not surprising). Also in 2000 and 2001, when Ukraine experienced economic growth, FDI did not increase drastically.

The reasons for such development lie in excessive regulations and investor doubts concerning sustainability of the reform progress in Ukraine. According to the Heritage Index of Economic Freedom, Ukraine has bad conditions for attracting FDI: the index is 3.¹⁵ The best overall rank that Ukraine received was in 2000 (116 out of 155), when the growth has started. Since then, the rank has deteriorated, which might be a sign of the beginning of the reverse trend.

Table 2.1. Selected Indices of Economic Freedom in 2002

Overall Rank	Country	Fiscal burden	Governmental interventions	Banking and finance	Property rights	Regulation	Black markets
45	Poland	4.5	2	2	2	3	3.5
108	Bulgaria	4.5	3	3	3	4	3.5
116 ↑	<i>Ukraine-00</i>	4 ↑	3	4	4	4	4
122	<i>Ukraine-97</i>	4.5	3	4	3	4	4
131	Russia	3.5	2.5	4	4	4	4
137 ↓	<i>Ukraine-02</i>	4.5 ↓	4 ↓	4	4	4	4
148	Belarus	4.5	4	4	4	5	5

Source: The Heritage Foundation.

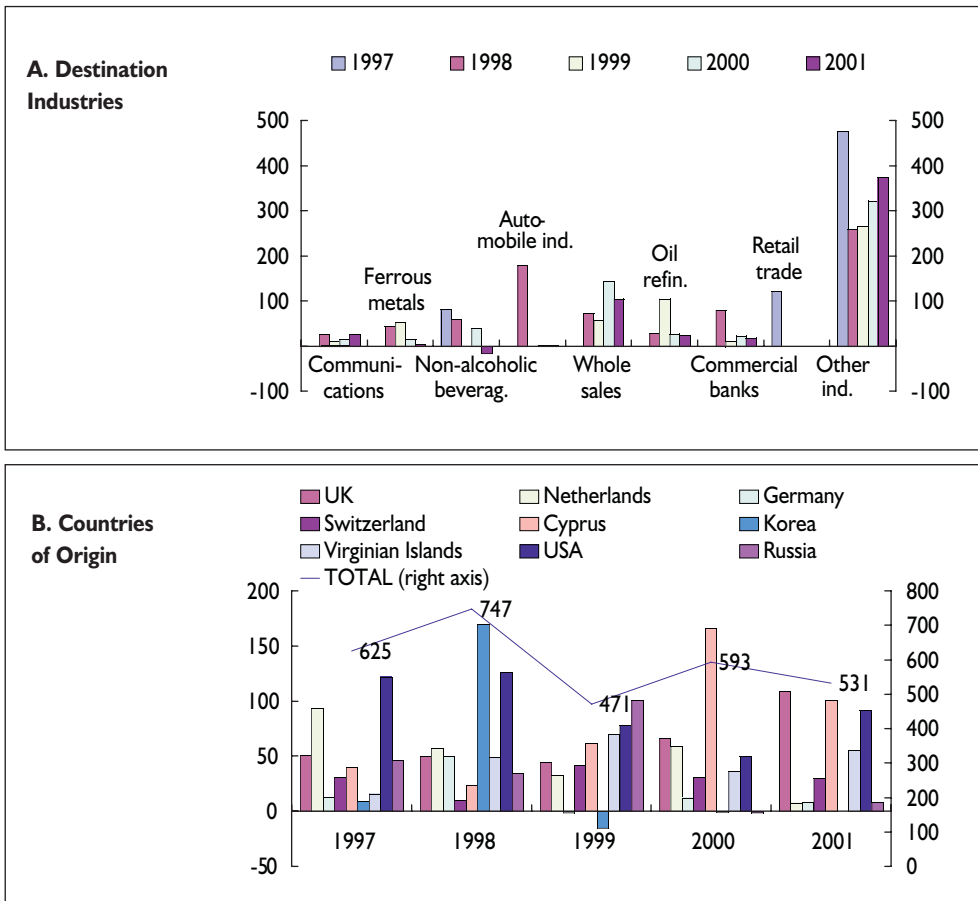
Note: Overall rank out of 155 countries, which were assessed. The smaller is the number, the better are the conditions.

The low level and negligible inflows of FDI persist in Ukraine, because the domestic situation is still perceived as unstable. Therefore, FDI cannot be regarded as a factor, which contributed to the economic growth of 2000-2001, but rather as a by-product of the other growth-related factors. As can be seen from Figure 2.10, there was a decline in the FDI inflows for the majority of activities regarded as competitive (catering, wholesales, financial

¹⁵ 1 for very good conditions, 5 – for very bad and this component of index does not change from 1997. The index also includes such factors as fiscal burden, government interventions, banking and finance, property rights, regulation and black markets, which also have substantial impact on FDI.

services) in 1999. When the situation became more predictable (2000), FDI into these industries increased significantly. The opposite developments took place in industries, which could be regarded as less competitive. The predictability of economic conditions was not a concern for those investing into less competitive industries, which happens, probably because they are (or at least they expect to be) powerful enough to keep the situation under control. For example, Korean investors were a major investor into the automobile sector (DAEWOO), Russian – into oil refineries and Ukrainian oligarchs into ferrous metallurgy (see Figure 2.10 and footnote¹⁶). While appreciating the fact that any investment is better than no

Figure 2.10. Dynamics of FDI in Ukraine by industry of destination and country of origin in 1997-2001, USD millions



Source: State Committee of Statistics.

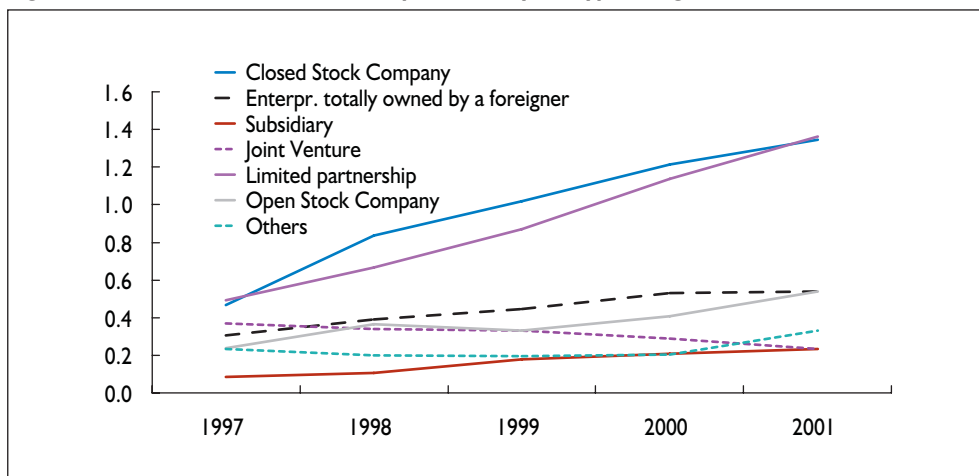
¹⁶ Korea invested about 160 USD millions into AUTOZAZ-DAWOO in 1998, Russia – 30 USD millions and 100 USD millions in oil refineries in 1998 and 1999, Virgin Islands (British) – 40 USD millions and 100 USD millions in ferrous metallurgy in 1998 and 1999 respectively.

investment, we should stress here that the importance of FDI for the country lies not only in the amount of capital invested, but also in the managerial skills, technological innovations, and business culture brought along with. Taking into account the closed nature of the above industries and the origin of FDI, one should doubt ‘quality’ of the above-mentioned inflows. Controlling for this type of investments, one could claim that FDI inflows slowed down even in the pre-crisis period (to about 610 USD millions in 1998) and further decreased in 1999 (to about 270 USD millions). Investments into these ‘less-competitive’ industries practically stopped after 1999, most probably, as a result of increase in hard budget constraints imposed by the government of Yushchenko.

FDI inflows from the offshore zones (presumably domestic capital which flowed out of the country in the previous periods) have continued in 2000 and 2001. However, this capital (from Cyprus) has been invested in the wholesale business – a more competitive industry comparing to metal and oil ones. The fact that this type of investors started to enter into competitive industries, but not monopolized ones (subject to possible ‘governmental intervention’) has been the result of equal treatment of investors. The fact that direct investments increased in 2000 and decreased in 2001 underlines the importance of this equal treatment, together with political and economic stability and predictability for potential investors.

Although there are no available statistics on the so-called ‘Greenfield’ investments in Ukraine, our indirect estimates suggest that only about 10-15% of all FDI for the period 1997-2001 had a ‘Greenfield’ character.¹⁷ This is an indication that investor with a long run intentions

Figure 2.11. Distribution of investor’s capital stock by the type of organization, USD billions



Source: State Committee of Statistics.

¹⁷ We estimate the level of ‘Greenfield’ investments by assessing a share of enterprises (recipients of FDI), which are established in the way that allows for entire control over the activity of the enterprise, i.e. those having a legal status of ‘Enterprise totally owned by the foreign investor’ (see Figure 2.10).

do not consider Ukraine as a prospective country. Considering that about one third of all 'Greenfield' investments in Ukraine were made by one company (Coca-Cola), we cannot expect them to contribute significantly to the economic growth in the observable future.

A popularity of 'closed stock companies' remains high mainly because investors want to limit the possibility of hostile takeover from domestic partners, which is also a reason for a reduction of capital invested into 'joint ventures' during the whole period. The increase of FDI into 'open stock companies', in this respect, is a result of acquisition of a stake in state enterprises, which are required to go 'public' before they can undergo privatization.

To sum up, the situation with FDI did not change much despite recent economic growth: (1) level of FDI per capita in Ukraine is much lower than in other transition economies, (2) FDI inflows during the years of economic growth were not boosting (despite large increase of FDI in 2000 compared to 1999, they decreased already in 2001), (3) substantial share of FDI comes into 'sub-competitive' industries and from 'offshore zones', thus, bringing little positive externalities into the country, (4) share of 'Greenfield' investments remains low. Therefore, the analysis of FDI in Ukraine reveals neither clear evidence of sustainability of economic growth, nor enough reasons for its continuation in the short run.

2.6.2. Capital Flight

The estimates of capital flight from Ukraine are as cumbersome as the issue is. Mirror statistics (see Table 2.2) suggests that during 1997-2001 Ukrainians involved in foreign trade were constantly over-invoicing its imports and exports (except for 1998) at Ukrainian customs comparing to the customs of the partner countries. While over-invoicing of imports is an indication of capital outflow, the over-invoicing of exports suggests the reverse transfer. This no longer comes as a surprise if one recalls that exporters in Ukraine obtain VAT refund, thus, higher exports means also higher refund. A combined estimate provides some evidence of the capital outflows, which are decreasing over time. According to mirror statistics, there is a proof, however, that capital outflow increased during the crisis year of 1998.

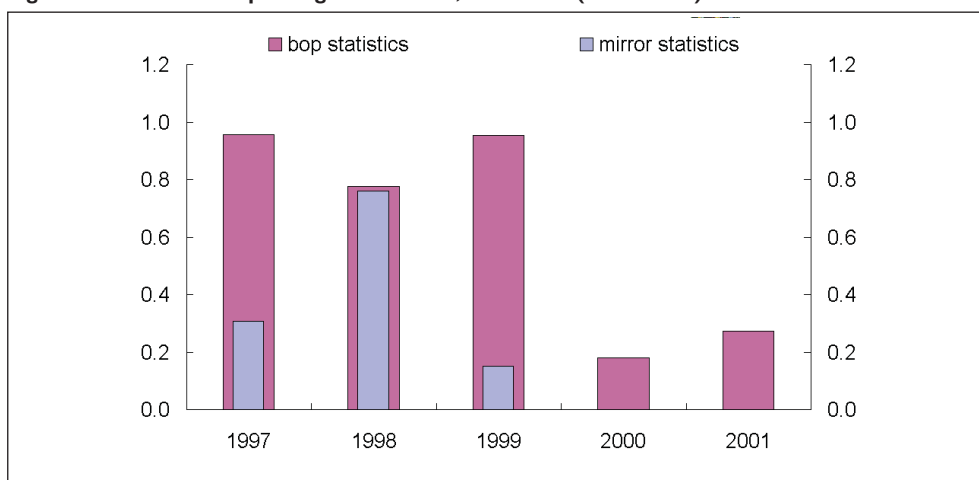
Table 2.2. Scope of capital flight in 1997-2000 (USD thousands)

	1997	1998	1999	2000
Imports - partner	16 178	14 184	11 350	
Imports - domestic	17 114	14 676	11 844	13 956
Capital outflow (inflow)	936	492	494	
Exports - partner	13 602	12 904	11 238	
Exports - domestic	14 232	12 637	11 582	14 572
Capital outflow (inflow)	(630)	267	(344)	
Total capital outflow (inflow)	306	759	150	

Source: IMF DOTSY 2000.

The guesstimate of capital flight from Ukraine, measured by net errors and omissions of the BOP is higher than those measured by mirror statistics (see Figure 2.12). According to the BOP statistics, capital flight from Ukraine has decreased considerably in 2000 – the first year of economic growth – and increased slightly in the following year.

Figure 2.12. Extent of capital flight in Ukraine, 1995-1999 (USD billion)



Source: IMF DOTS, National Bank of Ukraine (BOP statistics).

Capital flight, as well as the existence of shadow economy, cannot be abandoned simply by imposing further restrictions. The only factor that might decrease capital flight besides policies aimed at the improvement of domestic conditions is the confidence of economic agents in the effectiveness and continuity of these policies. As one can see from Figure 2.12, domestic investors, similarly to the foreign ones, perceived investment climate in 2000 as promising, which was reflected in the decrease in capital flight. During the next year, the vision of economic development held by domestic investors coincided again with the vision of the investors abroad, despite a continuation of economic growth registered in the country. Therefore, similarly to our conclusions on FDI, the same factors that lead to economic growth also induced a decrease of capital flight in 2000. However, considering the developments of 2001, we cannot conclude on the sustainability of economic growth in Ukraine.

Chapter 3

Microeconomic Prerequisites for Growth

Vladimir Dubrovskiy

Economic growth seems to be the natural state for a market economy. Rather the permanent eight-years decline of about 60% GDP¹⁸ that Ukraine suffered after the USSR's decay in 1991 should be considered as abnormality. Consequently, the elimination of at least some factors that caused this unprecedented decline should lead, and not surprisingly has led, to the releasing of market forces resulting in rapid growth. Although not so many research works were done on the identification of such impediments at the micro level particularly in Ukraine, we may generalize factors common for all transition countries as follows: weak and vague formal and informal property rights, state's paternalism, especially in the form of soft budget constrains, lack of competitive market selection, high barriers for the market entry and exit. Respectively, privatization combined with the discipline imposed on the 'old sector', and encouragement of the 'new sector' (World Bank, 2002) should be, and actually was, a remedy. In this Chapter we will analyze the effect of all these measures and their mutual interconnections in Ukraine.

3.1. Privatization and Its Effects on Growth

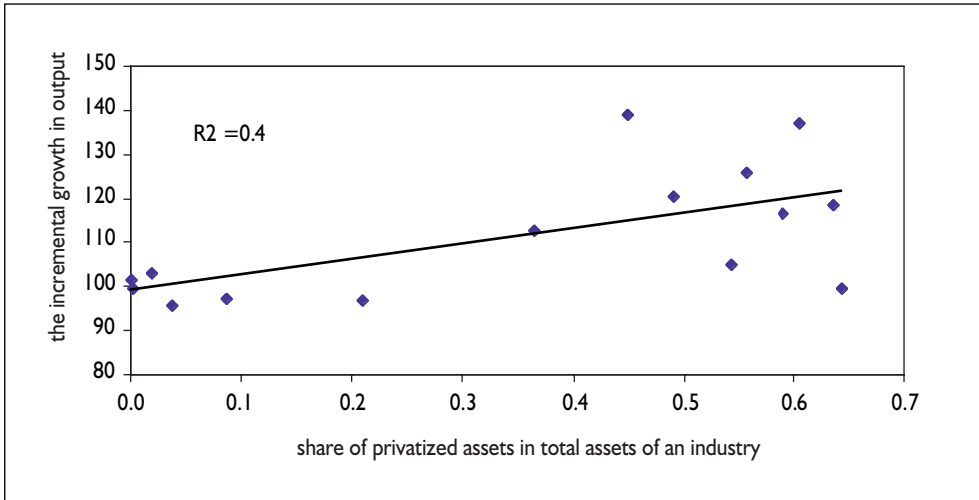
Privatization started in 1992 with the adoption of the first law that allowed for the insiders' buy-out through leasing and the legislation for commercialization of state-owned enterprises (SOEs). These procedures were limited just to the small and medium-sized firms in the 'non-strategic' industries. But the executives with some entrepreneurial skills used this opportunity, and in 1995 the privatized or commercialized firms of the same industries already outperformed fully state-owned ones judging by some important indicators

¹⁸ By official data. See Chapter I.

(Szyrmer, Dubrovskiy and Shygayeva, 1999). At the same time the cross-section correlation between output growth and the depth of privatization by industries was still negative. However, according to the same study, these positive signs disappeared in 1996. Estrin and Rosevear (1998) conducted their survey of Ukrainian industrial firms that year as well, and found almost no positive impact of privatization, and strongly negative one – of the commercialization.

Then, for 1997 Szyrmer, Dubrovskiy and Shygayeva (1999) using the same methodology detected some positive, although rather marginal effect again. At least for 1998 (the earlier data are not available) Dubrovskiy and Shygayeva (2000) reported the substantial differences between SOE and non-state medium and large industrial firms¹⁹ in some important indicators characterizing the quality of management and economic behavior, and this difference upholds in further years (Figure 3.13 in the Appendix). Starting from 1999, non-state firms outperformed SOE by the aggregate profit. Finally, in 2000, four years after the launch of the mass privatization, the regression between the level of privatization of an industry and its rate of growth became positive (Shygayeva, 2001b), which means that the most privatized sectors actually led growth (Figure 3.1, Table 3.1). At the same time, the intra-industry effect of privatization's depth²⁰ was insignificant in 2001 (Shygayeva, at Dubrovskiy et al., 2001b).

Figure 3.1 Rates of growth (decline) as a function of the depth of privatization by industries, 2000



Source: Shygayeva, 2001b.

¹⁹ Here and after – excluding the energy sector that is subject to special consideration. The data actually used in this work and a number of subsequent studies, although representative, are not by individual firms, but at the lowest level of aggregation available in Ukraine. See Dubrovskiy et al. (2001a) for the detailed description of data and methodology.

²⁰ This result is not fully comparable to the opposite tendency observed in 1995 and 1997 because of the difference in methodologies.

Table 3.1 Correlations between the incremental increase in output and share of the state property – on the cross-section of industries

The way of assessment of the share of state's property	First half 2000		2000 as a whole	
	Pearson's Correlation	P-value	Pearson's Correlation	P-value
By total assets	-62.0%	1.4%	-78%	0.1%
By the fixed assets	-54.8%	3.4%	-76%	0.1%
By the liquid assets	-66.4%	0.7%	-78%	0.1%
By sales	-61.8%	1.4%	-79%	0.0%
By costs	-58.9%	2.1%	-77.2%	0.1%

Source: Shygayeva and Golovanenko, in Dubrovskiy et al., 2001a.

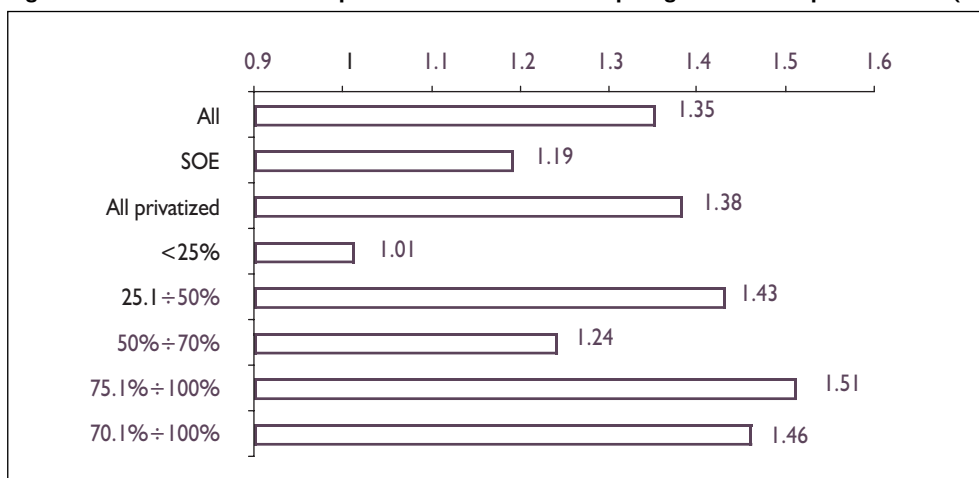
We suggest the explanation for this story as follows. Before 1996 the voluntary privatization to insiders strongly dominated. The most attractive firms and these having the most entrepreneurial management were self-selected in this process. Not surprisingly, they looked better comparing to the general picture of their industries. The insider-oriented procedure of privatization used during the first years was more successful, at least in the short-run, than it is usually considered to be. Contrary to the theoretical arguments developed and supported with empirical evidence for the matured market economies, the problem of informational asymmetry and related difficulties in exerting corporate control in Ukraine seems to be more severe than the conflict of interests. Estrin and Rosevear (2000), and other scholars admitted that insider-owned firms are on average more successful in Ukraine.

On the other hand, this method could hardly be used for the further, much more extensive, privatization and had to be succeeded with the voucher one – despite all of the notorious disadvantages of the latter.

The mass voucher privatization was actually launched in 1996, and mixed the newly privatized firms with the ones, which already enjoyed this status for a few years. The positive improvements brought by the voucher privatization have not been visible for the next few years. In addition, the voucher privatization, while being a rapid change in the formal institutional arrangement, was not fully supported by the change in people's perception about the new distribution of property rights.²¹ In addition, it was compensated by an increase in the informal residual property rights exercised by bureaucracy.²² 1996 was probably the worst year in terms of administrative burden imposed on the firms, but the best time for the rent- seekers, at least those related to Dnepropetrovsk clan led by Pavlo Lazarenko. For instance, the development of SME was also heavily suppressed this year (see Figure 3.2).

²¹ For example, even now the society continue to treat the production assets not as the private property of their owners, but also as a sort of 'public goods' (since "they were worked out by all of us", or "they provide us with the working places", or "they are the state's proud", etc.)

²² In the form of excessive intervention, regulation etc.

Figure 3.2. Indexes of industrial output for 8 months of 2001 comparing to the similar period of 2000 (%)

Source: Shygayeva and Golovanenko, at Dubrovskiy et al., 2001b.

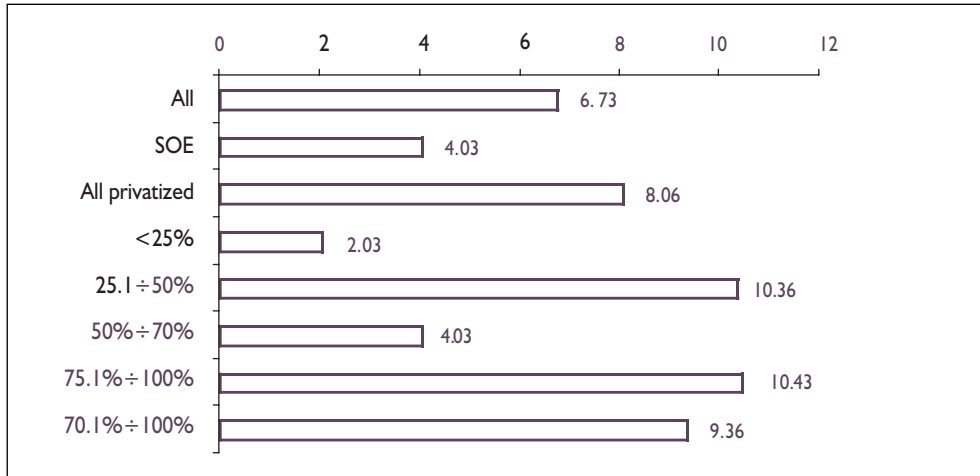
At the same time (up to 2000), the most privatized industries were to a larger extent exposed to market conditions. Actually, they were committed to privatization mostly because they were less exposed to the government's paternalism. The most important of them, food and light industries, were subject to relatively tough foreign competition, as the government failed (fortunately) to protect them with import barriers. Limited possibilities for extracting rents were actually one of the reasons for less paternalistic treatment of these sectors. Thus, the depth of industry's privatization can be a rough proxy for the degree of state paternalism. Finally, the manufacturing of the final goods that need marketing went in greater trouble with the crash of the central planning system. But as a result of all these adverse conditions, these firms restructured first and first started to grow. In the year 2000, one can see two visibly different groups of industries: mostly state-owned fuel and energy sectors that slightly declined (-0.8% of growth)²³ and the rest of industry – privatized more than average – growing at the astonishing rate of 20.4%. Concluding, this story suggests the paternalism and informal control rights were at least not less important than the titular ownership was.

The positive relationship between privatization and growth continues at least for the most of 2001 (see Figure 3.2). As Shygayeva (in Dubrovskiy et al. 2001b) has found, privatized firms were twice less capital intensive than SOEs and at the same time outperformed the SOE in labor productivity, have higher average wages and increased employment. Noteworthy, just as in the Central European countries 5-7 years ago, the least privatized companies perform even worse than the SOE, while fully privatized ones outperform all the rest. Based on the similar evidence, Frydman, Hessel and Rapaczynski

²³ This fact may be a sort of co-incidence. Below we discuss some other reasons for this sector to decline.

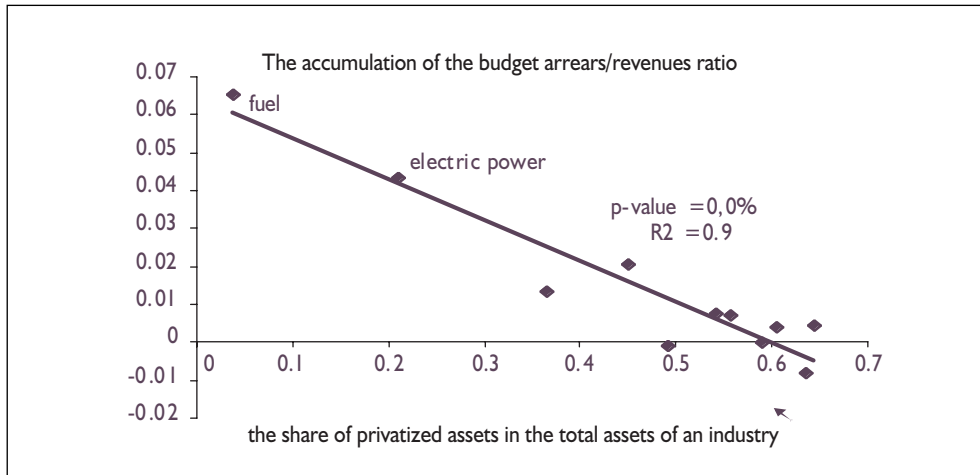
(1998) concluded that privatization turned to be the powerful remedy against the unfavorable outcomes of exposing firms to market forces (through price liberalization, competition, and hardening budget constraints), as output decline and unemployment. The same happened in Ukraine, although within the limited sector of the economy. For another part of the economy, however, the next factor seems to be more important.

Figure 3.3. Labor productivity growth (average for 8 months of 2001) compared to the similar period of 2000



Source: Shygayeva and Golovanenko, at Dubrovskiy et al., 2001b.

Figure 3.4. Ratio of accumulated budget arrears to revenues vs. share of privatized assets of an industry (for 1.12.2000)²⁴



Source: Shygayeva, 2001b.

²⁴ See the resume of other possible ways of measuring the same relationship and other kinds of arrears in the Appendix (Tables 3.3 and 3.4).

Another way through which privatization facilitated growth was rather indirect. As we can see (Figure 3.4, Tables 3.3 and 3.4 in the Appendix), the privatized and even just commercialized firms in the industrial sector (excluding the energy and fuel industries) almost ceased the accumulation of budget arrears at least by 1998. In the years of 1999-2000, SOE have accounted for 96% of the total accumulated budget arrears and for 100% of the outstanding payables to the budget and extra budgetary funds (Dubrovskiy et al., 2001a). Similarly, the most of outstanding payables and receivables belonged to the SOE (Shygayeva, 2001b)²⁵. Thus, re-monetization of the Ukrainian economy that occurred in 2000 became feasible mostly due to the activity of the non-state sector. Now (November 2002) this tendency seems to continue, with all of the major debtors of State Tax Administration belonging to the state-owned sector.

3.2. Decrease in Rent-Pumping²⁶ as a Source of Growth

The problems of arrears and barter were closely connected with the rent seeking, as they were concentrated mostly in the rent-pumping industries – the energy sector and its energy-intensive counterparts. The lion's share of arrears was accumulated in the energy sector mostly due to the weak discipline of payments and the wide use of barter schemes. For example, the plausible suggestive scheme of extracting rent in the case of an energy-intensive industrial enterprise seems to operate as follows. A firm accumulates arrears to the energy supply company (*oblenergo*) using, if necessary, the administrative power of its owners or managers. The *oblenergo* transfers these arrears to its suppliers, the power plants. Lacking funds to purchase enough fuel but having high bargaining power due to the critical importance of their production, the power plants (still state-owned) apply to the budget for the bailout that comes in various forms, from the appropriation of coal from the State Reserve to the ill-famous pocketing of Russian gas. If the arrears are transferred to the coal-mining sector, the budget covers them allocating extra subsidies “just to pay back wage arrears” in respond to the miners' strike. As the government cannot credibly commit to abstain from bailouts to avoid the technological meltdown of public infrastructure, such scheme allows to an indirect theft of public funds. The respective barter scheme operates in a similar way, but is even less transparent.

Unfortunately, privatization of the energy-distributing companies, which took place during 1997-1999, has not broken this scheme, if not made it even more operational. Using

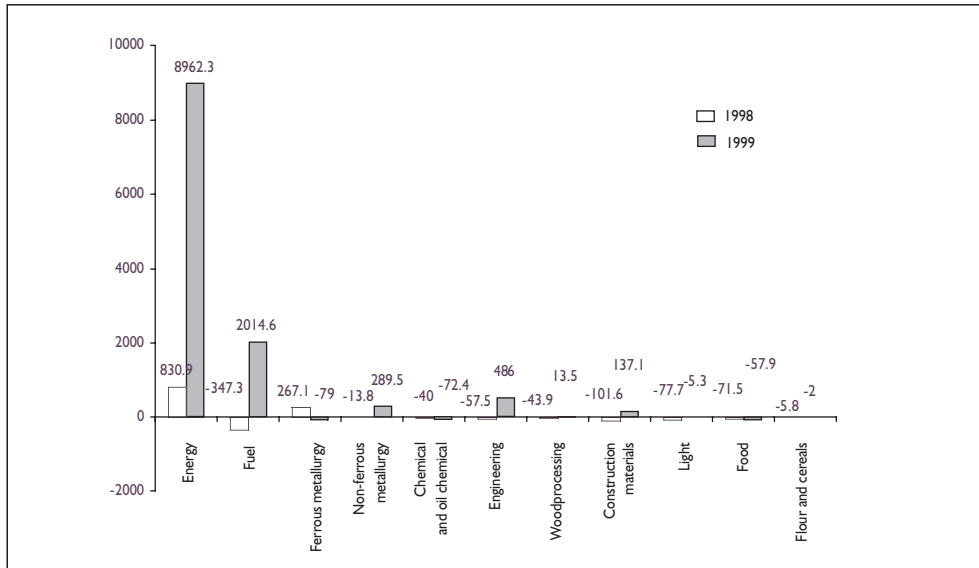
²⁵ Unfortunately, we cannot provide the same kind of evidence for the energy payments due to the unavailability of data. Some anecdotal evidence, however, suggest that this relationship is quite strong.

²⁶ Using an enterprise as a tool for collecting and tunneling rent that actually come from some external source, mostly the state budget. See Babanin, Dubrovskiy and Ivaschenko (2002) for the detailed explanation.

the opportunity that government could not allow the state-owned power plants to cease energy supply to the distributing companies, neither it could allow for a meltdown, they just stopped payments, kept money and transferred them abroad through various channels. The same were doing state-owned distribution companies de-facto controlled by the same clans. As a result, almost all arrears accumulated in 1999 were made in the energy sector despite (or even due to) the privatization of *oblenergo*. The preliminary inquiry²⁷ suggests that at least the depth of privatization measured in the remaining state's share have no effect on the monthly average shares of both non-paid energy and payments in the monetary form²⁸.

However, we have found clear evidence that the improvement of payment discipline was politically driven, as its initial bad performance was due to political reasons. The results of the analysis of Ukrainian legislation related to the energy consumption and saving made by Babanin, Dubrovskiy, and Ivaschenko (2002) are presented in Figure 3.6. It demonstrates the relative attention that Ukrainian authorities paid to three possible approaches to the energy problems: paternalistic (support of consumption), facilitation of energy saving, and the improvement of discipline and transparency. About more than 1,000 of all legislation documents concerning energy issues bring the signs of paternalistic treatment of the firms by the state. At the same time, just 230 of them can be qualified as hardening the discipline, of which 94 was adopted in

Figure 3.5. Overdue receivables by industry in 1998-99 (UAH million)

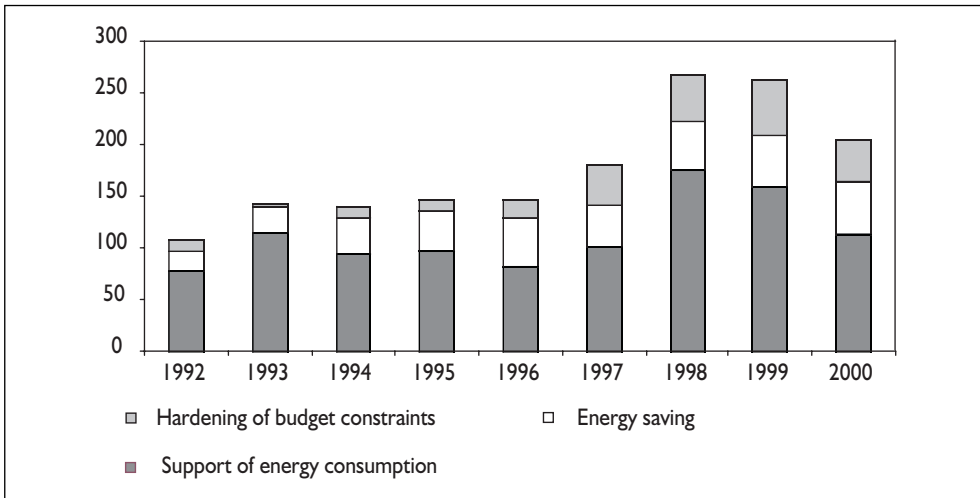


Source: Shygayeva, 2000.

²⁷ As of now we have data for 18 out of 31 companies (with possible bias) for Dec.1999 - Sep. 2001.

²⁸ Not surprisingly, these two shares are correlated at -70%.

Figure 3.6. Composition of energy-related legislation, 1992-2000



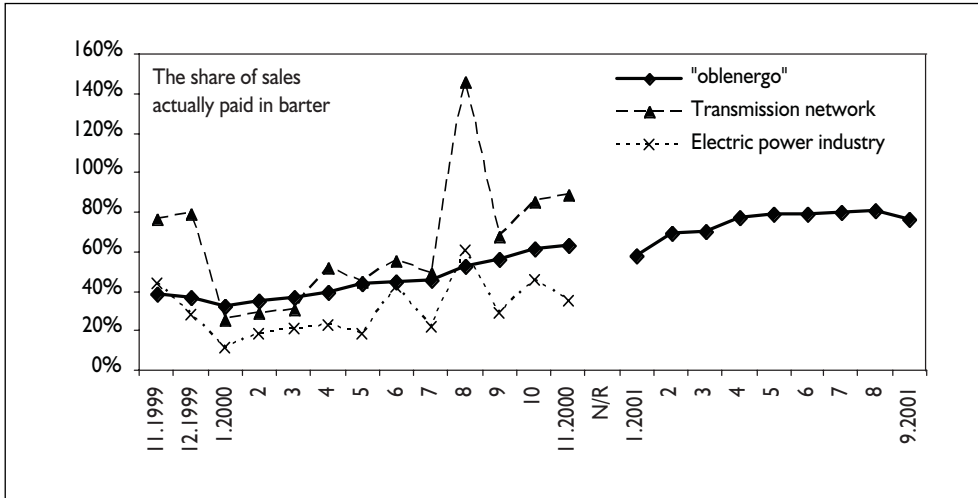
Source: Babanin, Dubrovskiy and Ivaschenko, 2002. Database of legislation given by the LIGA, Co.

1999-2000. Another 356 are devoted to the various kind of, often not supported with funds, attempts to facilitate energy saving. Thus, there is clear evidence that paternalism strongly prevailed in 1992-1998. The initial government's response to the crisis of 1998 represented the same manner. But later, under the threat of energy system meltdown, things started to change.

Surprisingly, the subsequent reform was not related to the quantitative increase in the legislative activity. However, the quality of legislation visibly increased with the appointment of Yuschenko's Cabinet, probably due to some administrative reforms (described by Aslund, 2001) that improved the transparency and effectiveness of a legislation process. The effectiveness of its implementation may have also improved. Anyway, as a result the level of payments for gas duplicated, as well as the share of electricity sales paid in cash, while the respective share of barter fall more than three times and non-payments share – more than two times. Due to such dramatic improvements the crisis in energy sector, at least in its most severe form, was overcome, and growth became more or less sustainable at least for the mid-run (see Figures 3.7 to 3.9). The positive tendency was once broken in January 2001 – probably due to some seasonal factors, but may be because of the Deputy Prime Minister Julia Timoshenko's dismissal and the criminal prosecution. Then, after the Yuschenko's Cabinet dismissal, the composition of payments got stabilized at the level, much better than it used to be, but still far from acceptable, and further improvements slowed down. It may reflect the fact that ruling elite having lucky escaped the energy crisis in the year of 2000 turned back to its usual reluctance to reforms.²⁹

²⁹ An alternative explanation in the spirit of the 'diminishing returns' principle is that further improvements in the level of payments require imposition of better discipline on the public utility sector (highly corrupted and equipped with outdated controls not allowing for the individual billing and switching off the individual non-payers), and hence on the population. Although the latter was the most disciplined payer in previous years, with 60-70% paid in time, and exclusively in cash; now this level is actually lower than the one of industrial firms, and is already regarded as unsatisfactory.

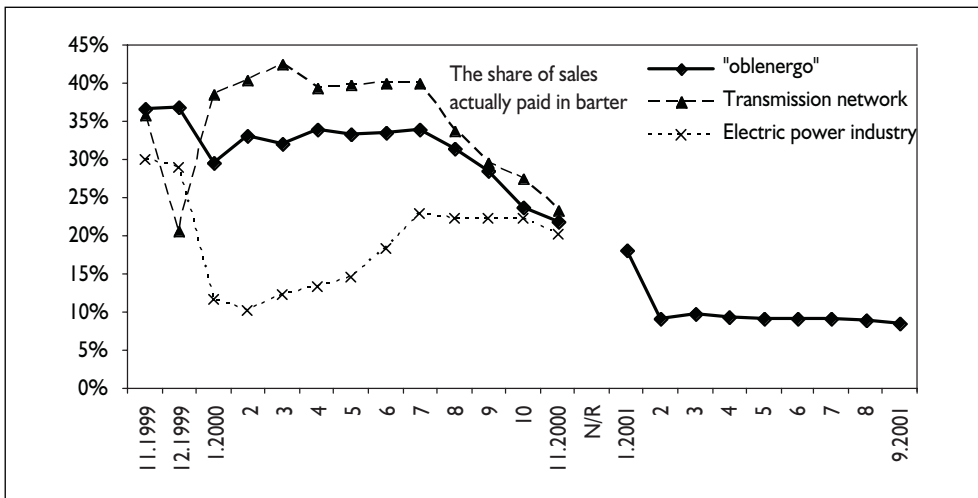
Figure 3.7. Level of payments for electrical energy, 1999-2001



Source: Author's calculations based on the State Committee of Statistics data.

Note: Two different databases were used: the one for 18 *oblenergos*, and another for the "transmission networks" (as a whole) and the "electric power industry" (as a whole). The latter has many errors, and covers a different period of time and set of indicators. At the diagrams these data are marked with thin dotted lines.

Figure 3.8. Share of sales of electricity actually paid through barter schemes in 2000-2001

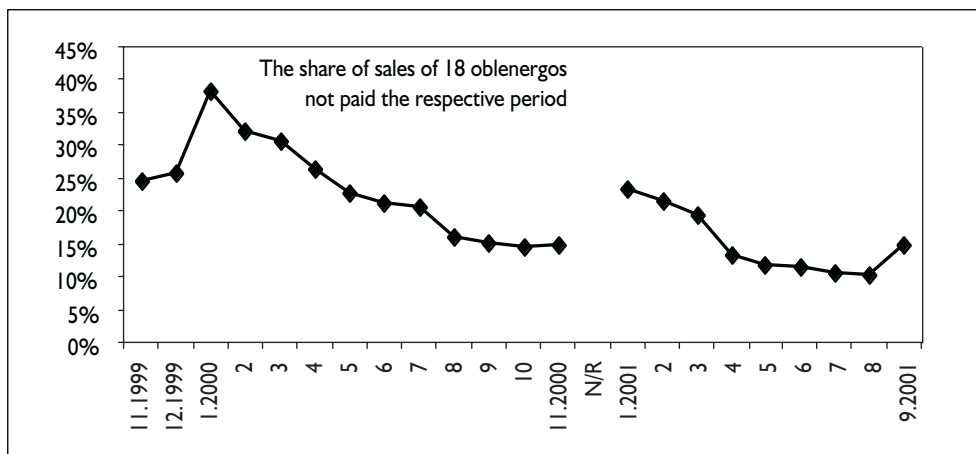


Source: Author's calculations based on the State Committee of Statistics data.

Note: See Figure 3.7

But there is another positive factor that may start working soon. With the beginning of growth and hardening budget constraints the tendency of worsening the industrial mix toward the most energy-intensive industries (Babanin, Dubrovskiy, and Ivaschenko, 2002) was mostly turned around. Moreover, the growth in manufacturing sector occurred together with a slight decline in the energy sector. This suggests two hypothetical explanations.

Figure 3.9. Share of sales of electricity actually not paid on time (the arrears' accumulation) in 2000-2001



Source: Author's calculations based on the State Committee of Statistics data.

1. We observe the beginning of the long-awaited structural changes. Last two years, the less energy-intensive sectors grew at two-digit rates although their share in GDP remained relatively small. But now, with clear signs of decline in metallurgy, their contribution to growth becomes crucial.
2. At least in some of the energy-intensive sectors we observe the increase in the reported figures, not in the actual output, as suggested by Paskhaver (2002). This explanation seems to be plausible for those sectors in which output growth should be technologically linked to the increase in consumption of energy and transportation services. With hardening payment discipline, the respective enterprises have fewer incentives to conceal their volumes of output, since they need more legally earned money to pay their bills in cash. The hardening of fiscal constrains should have the same effect.

On the other hand, nominal prices for electricity and gas have actually declined comparing to the pre-crisis period, while the effective ones have rather grown. This means the contraction in the price discrimination made by the energy and gas traders (Guriev and Ickes, 1999, Szyrmer and Besedina, 2001). Now it seems to be clear that such discrimination was just a tool for extracting rent, because official incomes of the respective companies seem to increase as a result of price leveling. In the meantime, increase in transparency and strengthening of incentives that came with such leveling were accompanied by economic growth and seem to be one of the main factors of it. We may suggest that the similar reform of taxation (cutting tax rates in exchange of elimination of tax exemptions and repeated writing off tax obligations in relation to selected taxpayers) would have the same effect. Noteworthy, in the energy sector prices were cut before, and then buyers were forced, and finally agreed, to pay them in cash.

3.3. Re-Monetization as a Result of Hardening Budget Constrains

Among the sources of barter phenomenon (comprehensively surveyed in Szyrmer and Besedina, 2001), one can distinguish the ‘exogenous’ or ‘defensive’ ones aimed to overcome certain unfavorable external conditions, like macroeconomic instability or weak contract enforcement, and another group related to the rent seeking with the non-transparency of transactions as a tool. The latter, in their turn, can be related to the shareholders’ expropriation (principal-agent problem) and to the rent pumping. For the last group of reasons Ickes and Gaddy (1998) suggested the mutual settlements with budget as the main source of rent. We may also add to this list the energy-related schemes similar to the one sketched at the beginning of the previous subsection. Which reasons actually prevailed in Ukraine?

As soon as both sources of rents became strictly limited during the year 2000, the barter has fallen drastically from near a half of transactions in 1998 to less than 10% in 2002. It happened partly due to the administrative measures, such as the direct prohibition of the barter settlements in the electric power industry. But contrary to the previous years, when any fall in barter was accompanied with almost the same increase in arrears (Shygayeva, 2000), in 2000-2001 arrears were also decreasing³⁰. Thus, in these years money payments have really crowded out the non-monetary ones, and the many-years trend of arrears’ accumulation was broken.

We want to suggest the following changes in the economic environment, which resulted in such a drastic fall of the share of non-monetary transactions:

1. Barter as a form of soft budget constraints – has fallen due to the abolishment of the mutual settlements, as Ickes and Gaddy (1998) predicted.
2. Barter as the compensatory mechanism to price distortions – mostly fallen due to the fall in energy prices.
3. As a form of price discrimination (Guriev and Ickes, 1999) – due to partial price leveling and imposition of hard budget constraint on energy suppliers, including the prohibition of the mutual settlements.

Concluding, we may generalize that at least in the case of post-1998 Ukraine barter was caused almost exclusively by the rent-seekers³⁰ and used mostly as a mechanism of rent extraction. As soon as major sources of such rents available to all were exhausted or ceased, it became unnecessary. On the other hand, the abolishment of some kinds of barter transactions, such as mutual settlements, state supply to agriculture in the barter

³⁰ Unfortunately, the official statistic does not distinct the write-offs and real paying back, thus a large part of this decrease may be just caused by the write-off combined with the elimination of “Kartoteka-2”.

form or barter deals in the energy sector, were among the major tools in fighting the respective rents.

To sum up, soft budget constraints were largely contracted during the past three-four years. However, this was partly compensated with the increase in the 'institutionalized' paternalism of the more conventional sort (as subsidies, privileges, especially tax exemptions, government purchases, and protectionism), usually conducted under the slogan of the 'support (defending) of a domestic producer'. It remains a source of rent, although far more controllable by the government, and less available for the majority of firms.

Coal mining sector and metallurgy seem to be the most illustrative examples. In the Donbass region where these sectors are primarily concentrated, the large vertically integrated companies closely tied to the authorities still widely use various non-transparent schemes of multiple barter transactions; enjoy tremendous state subsidies resulted from the political pressure including strikes and marches of the coal miners; and evidently gain huge rents. The Yushchenko's Cabinet attempt to launch a commodity exchange on coal at 2000 failed, and its initiator, Yulia Tymoshenko, soon dismissed – the rumors stubbornly associate these two facts. Noteworthy, now (November 2002) all key positions in government and parliament involved in income redistribution toward the coal mining sector are controlled by the persons originated from Donbass region.

Underpriced electric energy (tariffs do not cover costs of restoring fixed assets of the generation power plants, hence implying their irreversible depreciation) seems to be another possible source of hidden subsidies. Low prices for gas supplied in exchange for the partial cession of the sovereignty (like the preferential treatment of the Russian companies) can be named as another possible source of rent. Controlling the natural sources of rents, as the gas pipeline, oil and gas drilling, etc., seems to remain the source of rent too. For example, gas transit monopolized by Naftogas is paid exclusively in barter. The Ukrainian-Turkmen gas contract is paid in barter in 50%.

The structure of costs and benefits in the state-owned companies is not transparent. The larger is the company, the less transparent is its activity, since the internal transactions are not observable at all. Probably, it was one of the reasons for the creation of the giants like the Naftogas, Khlib Ukrainy, etc.

Further cutting the sources of rents needs a close attention on the state purchases – not only those made within the budget's execution, and hence subject to the Treasury's and the Accounting Chamber's scrutiny; but also the ones of the SOE. The process of such purchases should be transparent and strictly controlled, basically the subject of the same rules as the purchases made in budget sphere. As well, the complete prohibition of any non-monetary payments for the state-owned firms (including all of these where a government still holds major shares) seems to be a good idea. Further restructuring of the coal-mining sector and contraction of the respective subsidies would also help. The tariffs on electricity should be

audited, and if they indeed do not cover the costs they should be slowly (to let consumers adjust) but inevitably risen. The least but not last, improvement in the tax legislation with elimination of exemptions not justified with externalities, and simultaneous reduction in the tax rates would be a wise step.

3.4. Competitive Selection: Controversial Tendencies

Below we present some stylized facts that characterize the quality of factor allocation in the Ukrainian economy, as well as the intensity and direction of a competitive selection.

One can observe the mixed picture:

1. On the positive side, we see that in 2000, unlike the previous years, investments were allocated to the more successful firms rather than to the more capital intensive ones (Dubrovskiy and Belotserkovets, in Dubrovskiy et al., 2001b). On the other hand, we lack the most recent data to assess the sustainability of this tendency.
2. We have a confirmation that investment and growth are indeed associated with certain positive changes in management (Table 3.2 and Babanin, Dubrovskiy and Ivaschenko, 2002) measured by the enterprise survey. Not surprisingly, these positive tendencies

Table 3.2. Qualitative assessment of intensity and direction of the competitive selection of firms in the process of investment

Investments to be associated with:	The sign and strength of the association			
	Should be in a competitive economy with well performed selection mechanism	Actually in Ukraine		
		Non-State	SOE	Subsidized or subject to SBC
Performance (profitability, productivity)	++	+	+	0 ⁺
Output growth	++	++	0	0 ⁻
Business planning	++	++	+	0
Marketing	++	++	0 ⁺	0 ⁻
Enterprise restructuring	+	0	0	-
Arrears	--	--	-	n/a
Paternalism	-	0 ⁺	0 ⁺	0 ⁺

Source: Dubrovskiy et al., 2001b based on the data from IFC, 2000³¹ and State Statistics Committee of Ukraine.

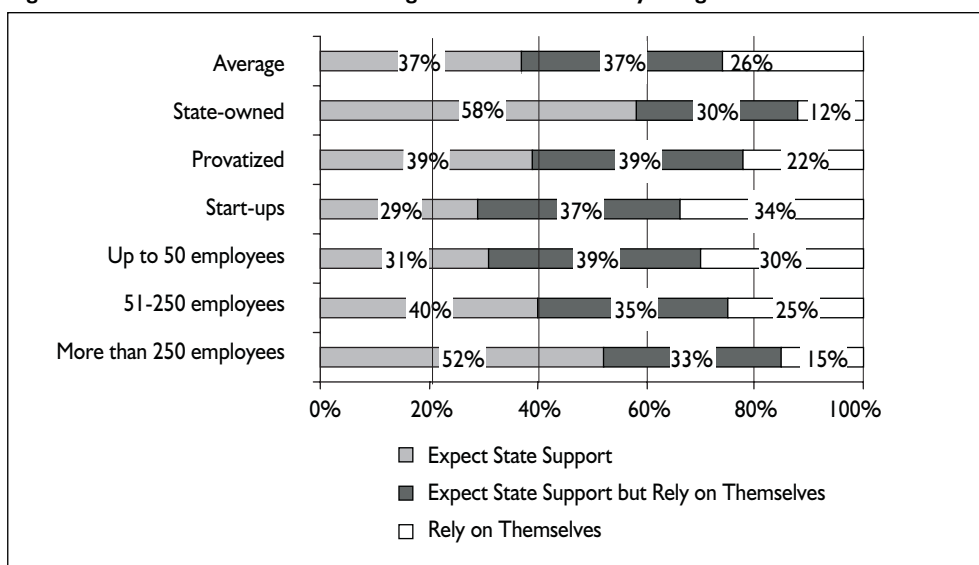
Note: The intensities and signs of connections are represented in the 5-grade scale from "--" to "++", with 0+ means "statistically insignificant, but always positive", and 0- respectively. "n/a" goes for the case where the selection criterion for the category of firms partly coincides with the variable (arrears were considered as hidden subsidies).

³¹ The database was provided by IFC for the work of Babanin, Dubrovskiy and Ivaschenko (2002) funded by EERC. Then the intermediate results and those not included into the main paper were further developed and used with the permission of EERC.

are concentrated mostly in the non-state sector, and firms reported as getting any subsidies or running arrears tolerated by authorities or utility (including energy) providers, appeared to be the worst by any meaning³². On the other hand, even these 'better' firms, which grow and invest, are not less paternalistic in their behavior than the remaining ones.

According to Yakoub, Senchuk and Tkachenko (2001), almost three out of four surveyed CEOs, and even two-thirds of the startup-businesses leaders among them believe that the government should support them if their businesses run into troubles such as losses or lack of investments. And more than one-third not only dream of such support but actually relies on it (see Figure 3.10). Although we have no data to compare these numbers with other countries, they seem to be dangerously high. Giving the absence of improvements in the process of competitive selection, Babanin, Dubrovskiy, and Ivaschenko (2002) suggest that the threat of returning to the paternalistic practices remains very tangible.

Figure 3.10. Paternalistic attitudes among the Ukrainian CEOs by categories of firms



Source: Babanin, Dubrovskiy and Ivaschenko (2002), based on the data from IFC Ukrainian business survey (Yakoub, Senchuk, and Tkachenko, 2001).

Actually, the paternalistic policy has been never ceased. Just during the years of 2001-2002, the government prohibited individuals to import the foodstuff for more than 50 EUR in order to strengthen barriers (which proved to be mostly ineffective before) protecting the domestic food producers from competition. The ill-famous AvtoZAZ-Daewoo car factory,

³² This fact may also be explained by the self-selection of the worst firms, which apply for subsidies or rest on the accumulation of arrears. 'Good' firms may have the same opportunities but they just have chosen to ignore them.

which failed to meet the conditions of the extremely protectionist law of 1997, should be deprived from its tremendous privileges. Instead it succeeded to lobby the corresponding amendments that allowed for the continuation of preferences. The 'experiment' in the metallurgy and ore sector³³ that initially was projected as a suspension of the 'Kartoteka-2' regime in exchange of strict fiscal discipline (although with substantial tax privileges) was prolonged despite the full abolishment of Kartoteka-2, as a mere tax privilege. The state support for coal mining still goes mostly to subsidizing output: from UAH 2,782,842 (around half a billion USD) assigned for such support in 2002 only 31% goes for the restructuring of this industry, and the same amount is assigned for direct state support of the coal mines. However, it seems to be some progress comparing to 1998, when the budget expenditures for restructuring were 30% of those for support.

3.5. SME Development

Despite the essential improvement that took place during the last years, market entry of small and medium size enterprises, as well as their business activity, is still impeded not so much by the high nominal rate of taxation but the bureaucratic pressure instead. Even in 1999, when situation essentially improved comparing to the years of 1996-97, Ukraine was the worst among all transition countries in terms of the 'time tax' imposed on the firms by the regulatory bodies (Hellman and Schankerman, 2000), and among the worst in terms of the 'bribe tax'. The high cost of tax compliance due to the unified standards of accounting (and the associated fines, up to the criminal prosecution for violations) for all businesses regardless to their size was another major obstacle.

Even though such enormous pressure was in place, SME sector in Ukraine was developing not worse comparing to other CIS countries, although in 1996 it became stagnating. Not surprisingly, even the initial efforts on deregulation that were undertaken in 1997-98 under the pressure of the IMF and the World Bank led to substantial improvements: the number of small businesses increased for more than 40%. The second leap in growth of small business occurred in 1999 due to the implementation of simplified taxation for small business and self-employed individuals.

The new system drastically reduced the discretionary power of tax administration and eliminated the very necessity of accounting (along with associated costs) for the entrepreneurs that have chosen the lump-sum taxation, and substantially simplified it for some other categories, at the same time increasing actual budget revenues. The first law amendment that introduced simplified taxation, although for the open-market retailers only,

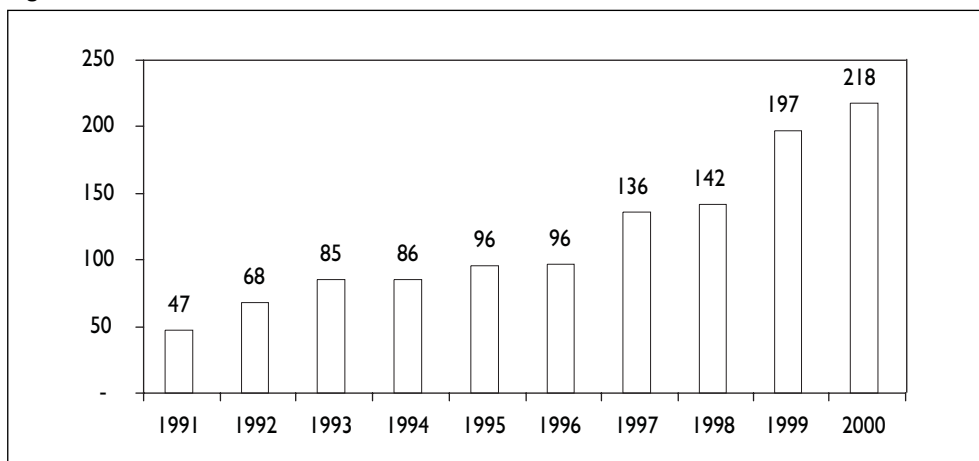
³³ More on the 'experiment' can be found in Chapter 2.

was adopted in 1998. Later on, the similar regime was extended for all kinds of micro-businesses (up to 10 employees). 10% turnover tax was introduced as an optional single levy including VAT for the small (up to 50 employees) legal persons with limited revenues; another option of that kind was 6%+VAT scheme. The respective Presidential Decrees were adopted in the mid-1999, after the dramatic stubborn struggle of entrepreneurs (including strikes and demonstrations) and probably in connection with the forthcoming presidential elections.

The results were astonishing. Although the turnover tax is not beneficial for trading (the most popular activity of SME – see figure 3.12) – about a half of all firms eligible for the simplified taxation actually used it in the year of 2000 and another 18.7% intended to shift to this form (Yakoub, Senchuk and Tkachenko, 2001). The revenues from the respective sectors of business, like open-market retailers, have grown six-fold in two years. At the same time, the number of inspections of small businesses has fallen from 78 for the year of 1997 to 11 in 2000 (IFC, 1997; Yakoub, Senchuk and Tkachenko, 2001)³⁴. The total number of small enterprises increased almost by another 40% (Figure 3.11), and more than 1.2 millions of individuals became registered as self-employed in 2000. Of course, most of them are not the Shumpetrian entrepreneurs, but rather highly paid professionals or small retailers willing to legalize their incomes. Some firms might have registered their activity that otherwise would have been conducted unofficially. Such an outcome should be definitely considered as the desirable one.

Despite so obvious success, this system has also some shortcomings that may be used as tax loopholes. For instance, as every kind of lump-sum taxation it does not account for the actual earnings. Such kind of tax is non-distorting from the perspective of economic

Figure 3.11. Number of small businesses in Ukraine in 1991-2000, thousands of entities*



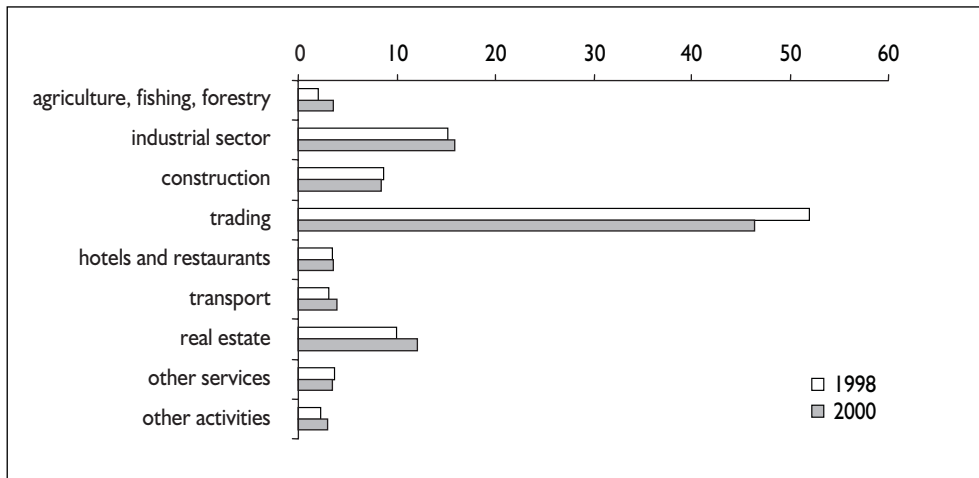
Source: State Committee of Statistics.

Note: * Before 1996 – “small enterprises” + “cooperatives”.

³⁴ The results may be not fully comparable due to the difference in samples and methodology used in different years.

incentives but allows some large firms for minimizing taxation by the alleged breaking-up into a number of small ones.³⁵ It also does not allow for personification of the pension accounts in the existing pay-as-you-go system. But as of now, its positive effects strongly dominate the negative ones. Nevertheless, the currently considered draft of the Tax Code does not include this system, so the SME lobby has to continue its struggle.

Figure 3.12. Distribution of small firms by sectors (as shares in the quantity of entities) in the years of 1998 and 2000



Source: *The Small Business in Ukraine: The Process of Development*. Edited by D. Lyapin, The Institute of Competitive Society, Kyiv, 2001.

Even despite so drastic simplification, taxation still remains the major impediment for the business development in Ukraine for all categories of officially registered enterprises (Yakoub, Senchuk and Tkachenko, 2001). But it is not the only one. In particular, the expansion of successful SME from trading to the industrial sector remains slow even despite the saturation of the market for retailing and obvious advantage of simplified taxation in both industry and services (see Figure 3.12). On the other hand, from anecdotal evidence we know that successful traders often do bring their marketing skills and knowledge to the production of the same kind of goods that they use to import. It is especially widespread in the light and food industries. But such activities are held mostly by the medium sized or even large (by Ukrainian standards) firms, more often with FDI component. For instance, the Ukraine-Canadian company that used to be an exclusive dealer of the world famous brand name vodka in Ukraine in the mid-1990s, later on started its own production line of fine vodka in Ukraine and now successfully sales it abroad. Some other firms were successful in establishing their own trademarks at the Ukrainian market with the fine clothes produced allegedly in Europe, whilst in reality they were made in Ukraine. For instance, one of them

³⁵ We know about such cases although we have no means for assessing the scale of this effect.

sales its production both at the large stores – under its own trademark, and the open-markets – as ‘Made in Italy’, mimicking for the famous Italian brands.

Unfortunately, there are still few cases when some firms that grown from the small traders to more powerful companies have bought or create the industrial plants or factories. For a long time the non-transparent insider privatization of medium-sized firms and inability of an outsider to buy their shares was considered as the main impediment for such expansion. But in the late 1997 *Rada* adopted an amendment that abolished the prohibition for shareholders of closed corporations to sell their shares to outsiders. This opened a way for the secondary re-distribution of ownership. As a result, many industrial enterprises, especially in the food, light, pharmaceutical and wood-processing industries were bought or took over and restructured by the domestic or foreign firms.³⁶ This process, although not well-documented due to the notorious non-transparency of the equity market, was one of the reasons for the fascinating growth rates in these industries. But we still cannot state that the process of the full-fledge entrepreneurship is in force, since the majority of the domestic firms engaged in such restructuring can be characterized rather as formal or informal financial-industrial groups, like UkrPromInvest or MERX.

Of course, such firms were in the early 1990s created from scratch, as small enterprises. But they have had to acquire substantial financial and political power first, and then expanded their activity to the industrial production. It could be owed to the effect of scale that is substantial in the industrial sector; or just a co-incident, for instance due to the general diminishing returns in trading caused by increasing competition, or improving conditions in the industrial sector. However, if this would be the case, one should expect the simultaneous shifting of activities of the business of every size. But as we see from another set of anecdotal evidence that the regulatory barriers, often excessive and closely connected to corruption (a ‘grabbing hand’; see Shleifer and Frye, 1997) impose quite strict constrains on such shifting of activity in relation to SME.

An entrepreneur from Ivano-Frankivsk oblast is the brightest example of the direct ‘scale discrimination’. She purchased a small (though certified) smokehouse and started production having all necessary permissions. But soon the local sanitary authorities recognized that there is an old Soviet standard determining the distance between the refrigerators for raw meat and finished products that exceeds the mere size of entrepreneur’s land plot, and started to

³⁶ The investments classified as ‘foreign’ are often made by the offshore companies in fact operating by the domestic owners (see Chapter 2). Although they certainly bring the necessary capital, the business culture and technologies that come with it remain doubtful. The same should be said about a large part of the Russian capital: while some really profitable and successful Russian companies expand their value-creating business to Ukraine; some others look at the country as the one having weaker and ‘cheaper’ government than it is now in Russia, so they can easier get and hide rent here. Some experts attribute the capital inflows of 1999 and subsequent years with desire of the Russian rent seeking business to diversify the political risks, and to its search for the sort of ‘preserve’ for the used oligarchs. Another motive for the expansion of Russian capital is vertical re-integration of the production links, initially built in Soviet era (as in the cases of pipelines – oil processing; alumina – aluminum works; etc.). This process may be beneficial or harmful for the economy depending on the strength of the government in persuading the country’s interests. Now it seems that corruption and/or political motives generally prevail.

press on her. In many other cases corruption based on the excessive or outdated regulations impose fixed costs unaffordable for a small business. The problem of premises is especially severe, since due to the specific of Soviet era priorities almost no small or medium size industrial structures were built. SME can just rent some parts of idle plant buildings, which makes them susceptible to the power of their owners (directors). Usually, the unofficial rent exceeds the official one many times.

However, the old Soviet regulation prohibits using any part of the house premises, even officially owned by entrepreneur, for the production activity unless this part is proved to be completely unusable for accommodation. But the officials that should assess the proofs and issue the permission usually require few thousand of dollars – directly or in the form of, say, an insurance fee that should be paid to the particular company. Without such permission an entrepreneur has either to work unofficially or remain the open-market trader, as, for instance two women – the professional garment designers that still prefer their legal open-market sites, though becoming less and less profitable, instead of a more promising sewing business because they cannot afford to legalize it. Many others chose to work illegally: by the estimation of Ksenia Lyapina, the head of the Private Entrepreneurs Council of Ukraine (who also kindly provided us both previous examples), about 80% of the garments at the Ukrainian open-markets are indeed of domestic origin, but produced illegally.

Not surprisingly, the small legally operating (up to 50 employees) greenfield firms value the obstacles related to the regulatory issues and corruption higher than other categories (Yakoub, Senchuk and Tkachenko, 2001). All of this further magnifies the scale effect in the production sector raising the barriers for market entry. And while the small firms report to be relatively less suffering from taxation than the medium-sized ones (*ibid*), most likely blessing to the simplified taxation, the necessity of shifting to the general taxation system creates an obvious disincentive for expansion as the general tax system remains complicated, heavy, discretionary and offensive. Babanin, Dubrovskiy and Ivaschenko (2002) analyzing the same database also found the firms using marketing were significantly more affected by intervention (regulation) of the local state authorities.

For all these reasons taken together, the flow of marketing skills from small trade business to the medium-sized industrial one in contrary to the expectations takes mostly the form of headhunting rather than takeovers. As a result, while in the early 1990s recruiting of a really good medium-level manager was difficult, since all ambitious and enterprising persons tried themselves in small businesses, now most of them finally rested to managerial positions in the larger companies. But they ultimately exploited their marketing skills, thus have augmented even oligarchic companies with a certain degree of the famous 'spirit of the free entrepreneurship' that makes them viable.

Chapter 4

Agriculture

Jacek H. Schirmer

4.1. Introduction

The aim of this chapter is to try to answer the following questions: (1) Has agriculture registered a real growth after 1998? (2) If yes, what were the sources or factors of this growth? (3) Moreover, does this growth mean an overturn of previous (downwards) trend in agriculture and the beginning of a new long-term positive growth pattern? As we believe that well-founded answers to the second and third questions are not possible without a disaggregation of general trends, we analyze the main branches of agriculture to get insights into the underlying structure of agricultural activities during the last several years. This analysis leads us to conclusions that help provide answers to these questions.

We should emphasize that there is only one source of almost all primary data concerning agriculture at the national level, namely the State Statistics Committee of Ukraine (UkrKomStat). The Food and Agriculture Organization of the United Nations (FAO) has produced its data on the basis of data furnished by UkrKomStat. Some differences result from aggregation methodology.

UkrKomStat recognizes two sectors: the enterprise sector and the holdings sector. The former sector covers 76.6% of agricultural land and provides 35.4% of gross agricultural product (in 2000; see AU 2000 pp. 33, 45 and 46). It contains collective farms created from former *kolkhozes* and *sovkhozes* (33.6%), including a small number of large individually owned farms (1.8% of production). The latter sector consists of single-family farms and small plots cultivated by individual farmers.

4.2. General Trends

Gross output in agriculture during the last decade is presented in Table 4.1 (FAO) and Table 4.2 (UkrKomStat). There are marked differences between data presented in

Table 4.1. FAO: Ukraine annual gross agricultural output, constant international dollars, 1989-91 average prices, 1989-91 (annual average) = 100

Item	Year									
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Agriculture	74.1	71.9	58.8	61.7	53.4	55.3	47.2	45.5	49.0	53.0
Crops	82.8	93.6	68.1	73.7	62.4	72.2	58.7	53.8	63.6	74.3
Livestock	77.9	67.9	66.4	62.2	55.1	48.4	45.6	45.6	45.9	47.9

Source: Faostat (updated April 19, 2002).

Table 4.2. UkrKomStat: Ukraine annual gross agricultural output, constant domestic 1996 prices, 1990 = 100

Item	Year										
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Agriculture	86.8	79.6	80.8	67.5	65.1	58.9	57.8	52.1	48.5	53.3	58.6
Crops	83.2	83.7	92.8	71.7	73.7	67.3	71.3	58.9	52.9	64.4	*
Livestock	90.4	75.5	68.8	63.2	56.4	50.5	44.3	45.3	44.2	42.1	*

Sources: AU 2000 pp. 25-27 (1991-2000); UKS AOI (2001).

* No data.

the two tables due to differences in methodology, definitions, index base year and price units.

Despite some differences between the data presented by these two tables, general trends are basically the same:

- total agriculture: a long term downward trend until 1999 and respectable growth in 2000-2001,
- crops: ups and downs related in most cases to weather conditions,³⁷
- livestock: gradual systematic decline through 1997, followed by output stabilization at a low level.

As both time series – by FAO and UkrKomStat – are based on the same data, there is obviously a possibility that output figures may be distorted by one common underlying factor. This could be a change in data collection methods or a shift of activities away from the shadow economy, i.e., the inclusion in the official statistics of a larger share of output (see Section 4.4). However, we have not found sufficient evidence³⁸ to support these hypotheses. It seems that the 2000-2001 growth was for real; it was not merely a product of 'deshadowization' or that of 'creative' statistics.

³⁷ As a rule the vulnerability to weather declines with capital intensity of agriculture. The large year-on-year shifts in crops reflect a declining capital use in the Ukrainian agriculture.

³⁸ According to Mrs. Olga Sikachina, Deputy Head of the UkrKomStat Agricultural and Ecology Statistics Division, the methods of data collection have not changed during the last several years. Other independent experts -- Dr. Sergey L. Feofilov, Director of UkrAgroConsult, a leading independent private consulting firm, Kyiv, and Mr. Ludwig Striewe, expert, German Advisory Group on Economic Reform, Kyiv, and professor, Agricultural Economics Department, The Göttingen University, considered these data as credible enough to be used as a valuable base for an analysis of agricultural dynamics in Ukraine.

4.3. Trends in Branches

To understand the underlying factors behind the growth in total agriculture we have to understand the mechanisms of changes in its particular branches. Table 4.3 provides data on contributions of branches to total farm output.

Table 4.3. Structure of gross farm output, 1996-2000 averages, constant domestic 1996 prices

Branch	Cereals	Pulses	Industrial crops	Potatoes +Vegetables(1)	Fruits	Fodder	Other crops	Cattle (meat+milk)	Pigs (meat)	Poultry (meat+eggs)	Sheep+Goats (2)	Other animals (3)	Total
%	15.7	0.4	6.9	24.6	4.4	5.3	0.9	25.3	7.7	6.2	0.5	2.2	100.0

(1) Potatoes stand for roughly $\frac{3}{4}$ of group.

(2) Meat+milk+wool.

(3) Horses, rabbits, bees, etc.

Source: Estimations of author based on AU 2000 (especially p. 32) and Faostat (updated April 19, 2002).

The total animal output represented 41.9% (meat 19.8%, milk 16.2%, eggs 4.0%, other 1.9%). Tables 4.4 and 4.5 provide data on output trends of the most important commodities during the last four years. "Industrial crops" are represented by sugar beet and sunflower seed, which account for about 90% of output of this branch.

Table 4.4. Agricultural production, products and branches, 1990=100

Year	Cereals	Potato	Vegetables	Fruits	Sugar Beets	Sunflower
1998	53.8	92.1	77.3	49.9	35.1	88.1
1999	50.2	76.0	77.8	36.9	31.8	108.7
2000	49.8	118.6	83.1	67.7	29.8	134.4
2001	81.3	103.4	83.8	49.8	35.0	87.4
Year	Beef and Veal	Cow Milk	Pig Meat	Poultry Meat	Eggs	
1998	40.0	56.2	42.4	28.2	51.0	
1999	39.9	54.5	41.6	28.8	53.7	
2000	38.0	51.6	42.9	27.2	54.1	
2001	37.0	54.8	38.6	26.7	56.7	

Note: For data for 1992-97, see Table 4.6 in Appendix.

Sources: Estimations of author based on AU 2000, Pidsumki... and Faostat (updated April 19, 2002).

The 2000-2001 growth was neither universal nor durable for individual items. Given the relative importance of particular branches (Table 4.3), we can argue that the growth of agricultural output in 2000 resulted principally from good harvest of potatoes and, to a much lesser measure, of fruits and sunflower. However, all items that registered a significant increase in output in 2000, suffered from output declines in 2001. The growth of 2001 resulted almost entirely from a bumper harvest of grain. The output of all other branches,

Table 4.5. Agricultural output, products and branches, previous year = 100

Year	Cereals	Potato	Vegetables	Fruits	Sugar Beets	Sunflower
1998	74.7	92.2	104.6	46.5	87.9	98.2
1999	93.2	82.6	97.8	74.0	90.6	123.3
2000	99.3	155.9	108.0	183.4	93.8	123.7
2001	163.3	87.2	100.9	73.6	117.3	65.0
Year	Beef and Veal	Cow Milk	Pig Meat	Poultry Meat	Eggs	
1998	85.3	99.9	94.1	107.5	100.7	
1999	99.7	97.1	98.2	102.1	104.1	
2000	95.3	94.6	103.0	94.5	100.8	
2001	97.5	106.1	90.0	97.9	105.6	

Sources: Estimations of author based on AU 2000, Pidsumki... and Faostat (updated April 19, 2002).

taken together, decreased by 3%. In the 1990s, there were years of good and bad harvests of cereals, but the general trend was negative³⁹. It's not surprising, if one takes into account that the inputs decreased much more (for instance, in 2000 the input of fertilizers per hectare of sown area fell to 7% of its 1990 level). Output decline did not reduce exports, as domestic consumption fell as well; smaller herds needed less feed and the impoverished population bought less grain-based products. Despite bad harvests, grain exports in 1998 and 1999 attained their record levels; this led to the decrease of national reserves by more than 9 million MT. The year 2000, instead of expected better yields, brought painfully low harvests. Finally, the harvest of 2001 attained a very high level as compared to several previous years.

Apparently paradoxically, however well in accordance with economics theory, the bad climatic conditions and low yields in previous years indirectly helped the farmers. Already since December 1999 Ukraine had to import substantial quantities of wheat and wheat flour.⁴⁰ It pushed up domestic grain prices: from 80 USD/MT in November 1999 to 150 USD/MT in the early 2000. At the same time, grain prices on the international market remained relatively stable and oscillated around 110 USD per MT. The large difference between domestic and world prices can be explained by a high, compared to initial price, cost of domestic transportation to and from the ports (German Advisory Group on Economic Reform, 2001 p. 23). Another factor pushing cereals prices up was the cheap *hryvnia*, thanks to its devaluation in 1998/99. As a result, farm profitability increased, but the prices of bread in December 2000 increased by 58%, as compared to December 1999, when they were higher by 18% as compared to December 1998 (StY, 2000 p. 76).

³⁹ The annual statistics on cereals output are shown in Table 4.7 in the Appendix.

⁴⁰ N.B., export still existed, but it was principally the export of grain for feed.

The collapse of the **grain** branch in 2000 had not only economic and social consequences, but also important psychological effects, and forced the authorities to change their agricultural policy (see Section 4.4). Higher profitability of grain and subsidized bank loans provided farms with funds, thanks to which the farmers could acquire the necessary inputs they could not afford for a decade. The profitability and new policy incited the farmers to develop the culture of grain. The increase in the area under cereals and in the use of fertilizers and plant protection chemicals, combined with favorable weather, resulted in the substantial increase in the harvest for 2001. Accordingly, during one month (August/September), domestic prices of grain plunged from ca. 900 *hryvnia*/MT (ca. 170 USD) to less than 500 *hryvnia*/MT (ca. 95 USD) (Striwe and v. Cramon-Taubadel, 2001). Finally, the income of farmers from cereals was smaller than in the previous, bad-harvest, year. The repayment of generous bank loans in the spring became doubtful. The exports cannot be used as a lucrative alternative for domestic market due to high internal transportation costs.

Are the results of 2001 a beginning of a long-term growth in grain? In 1997, its output was 50% higher than that in the previous year, which was followed by three consecutive years of bad harvests. The inauguration of the 2001/2002-culture cycle did not have the same economic situation as that in the previous year. Even the government predicted in March (N.B., before the elections) that the 2002 harvest would be smaller by 3 million MT (UDN March 12, 2002). Yet, in March 2000, the government forecasted the harvest of 30 million MT, though that year, it actually reached 23 million MT only (UDN March 22, 2000).

In contrast to cereals, where the average output in the last decade fell to two-thirds of the 1990 level (and one-half of this level in 1998-2000), **potato** output has increased if only slightly (Table 4.8 in the Appendix). The output of potatoes (second most important commodity after meat), as well as its sown area and its harvested area, has been relatively stable and did not reveal any long-term changes. The sown area amounted to about 1.5-1.6 million hectares. Annual shifts in output resulted from changing yields – not from sown area – depending on weather conditions. However, per-hectare yields did not register a long-term decrease in spite of a significant decline in the use of fertilizers (in 1996-2000 it was down to 28% of the 1990 level: AU 2000 p. 64). Every year, 6-7 millions MT were consumed as food and 4-5 millions were used as seed.

There were some similarities between the situation of potatoes and **vegetables**. Their sown area has not changed essentially in comparison to 1990 and remained relatively stable. The yields, after a decrease in the early 1990s, likely related to the shrinkage in the use of fertilizers (down to 18% in 1996-2000, as compared to 1990; AU 2000 p. 64), were also stable. The decrease in vegetables consumption in the early 1990s was not substantial. Thereafter, it has registered slight but systematic increase. Unlike with cereals, potato and

vegetables have been almost entirely produced by the holdings sector and their markets were almost closed to foreign trade. Foreign trade turnover in potato has never exceeded 0.3% of its domestic production; this turnover in vegetables amounted to 4% in 1995-97 and did not exceed 1% in 1998-2000.

This stability occurred in spite of a long-term deficit and substantial contraction of these branches in the enterprise sector (Table 4.8 in the Appendix). The holdings sector produced 95.8% in 1995 and 98.6% in 2000 of total potato crop. Its share in vegetables output expanded in the 1990s – to 67% in 1995 and 80% in 2000. However, in this sector, a large fraction of produce of these commodities is not directed toward market; it is used instead for household consumption, for feeding its herds and for neighbor-to-neighbor barter transactions (such as exchanging potatoes for apples).

Low price elasticity of supply and low demand flexibility in the case of some agricultural products should be emphasized. The following example is meant to illustrate this phenomenon. In the wake of a bumper potato harvest in 2000 – 56% more produce than in the previous year – the prices of potatoes declined in December by 61% as compared to December 1999 (StY, 2000 p. 76). Notwithstanding, the potato sown area in 2001 diminished only by 1.5%. Generally speaking, the increase in 2000 and the decrease in 2001 resulted principally from yield changes, provoked mostly by the changes in weather conditions, and did not seem to be related to market price shifts.

There are two important **industrial crops** in Ukraine: sugar beet and sunflower (Tables 4.9 and 4.10, respectively, in the Appendix). The cultivation of both crops was concentrated in the enterprise sector; however the role of the holdings sector in these branches has increased during the last decade. The area under industrial crops, as a whole, was stable, although the trends in the two crops were opposite. In 1990-1991 the areas of both were almost the same, when in 1999-2001 the area under sunflower was 3-4 times greater than under sugar beets.

Sugar beets registered systematic decrease of sown and harvested areas, yields and harvests. The capacities of Ukrainian sugar industry attain 5 million MT (UDN October 1, 2001) but domestic consumption cannot absorb this amount. Initially, the reduction in local consumption was partly compensated by exports. Yet, the bad conjuncture for sugar on the international market made this branch not profitable. Since 1996 the export of sugar has declined. In 1997 the profitability of sugar beet became negative. Consequently, in 1998-2000, the domestic production of sugar failed to meet domestic demand and Ukraine turned into a net importer of sugar. Finally, in 2000, the necessity of imports made this branch profitable again and the farmers expanded the cultivated area (the harvested area in 2001 was 14% larger than in 2000). Apparently, the situation of this branch resembles that of cereals. However, the Ukrainian refineries are old and inefficient, thus not competitive on the international market. For several years, the government has intervened on the sugar

market pushing the prices above the world market level. In the opinion of some experts, this policy serves the industrial lobby, but is contrary to the interests of consumers and farmers (see Benecke, and v. Cramon-Taubadel, 2001) and, in a long term, ineffective. Nevertheless, the government has intensified the interventions after the good sugar beet harvest in 2001.

The **sunflower** has been the only branch among the main crops, whose culture has remained highly profitable throughout the last decade (Table 4.10 in Appendix), thanks to large export opportunities. In fact, the sunflower seed and oil became the main agricultural export commodity; in 2000 they accounted for almost 30% of its total value and their export was 2.7 greater than that in the previous year. The harvests of sunflower seed during the last decade kept the same level as in the previous decade. It was obtained by the extensification of this culture – the increasing sown area compensated decreasing yields. The Government is against its expansion claiming that this culture sterilizes the soil, and supports soy instead. Yet, the farmers are reluctant to shift to this new crop. In October 1999, a 23% export duty was imposed on oil-bearing crops. The export of sunflower seed dropped by almost a half but the farmers did not reduce the sunflower sown area. In 2000, the harvest increased greatly, mostly due to favorable weather. And “... the companies found a way of exporting sunflower without paying the... duty... The International Monetary Fund is insisting on abolition of the export duty, but the Cabinet of Ministers and the Parliament have been unable to reach agreement...” (UDN Dec. 29, 2000). For the 2000/2001 crop cycle, influenced by the drop in prices and fear of an expected ban on export under a “give-and-take” arrangement, the farmers reduced the sunflower sown area. This, combined with a less favorable weather, resulted in a drop in the harvest by 35%.

The production and cultivated area of **pulses** and **fodder** registered a downward trend, even more significant in the second half of 1990s, and hence they do not look like good candidates for growth contributors. The systematic diminution of fruits plantations and vineyard areas excludes the candidatures of these branches.

Meat is the most important product of the Ukrainian agriculture, representing ca. 20% of its total output. Only three animal categories (cattle, pigs and poultry-hens) are important. Meat coming from all other animal categories (such as sheep, goats, horses, and rabbits) accounts only for 2.5% of total meat, i.e., 0.5% of total farm output (Table 4.11 in Appendix). Not only the total meat production, but also the output from all the branches taken separately, systematically decreased. The meat prices were not high enough for farmers – there was a structural deficit of meat branches in the enterprises sector – but too high for impoverished consumers. The very slight increase of poultry meat output in 1998-1999, and of pork in 2000, was only temporary. The last one was due to the drastic diminution of pigs stocks (for almost 1/4) resulting from substantial increase of feed prices (grain!) and not from the development of their breeding. Hence, the meat production cannot

be viewed as a contributor to agricultural growth in 2000-2001. However, since March 2001, in anticipation and then as a result of the good harvest, the pigs stocks have increased every month: - on May 1, 2002 they attained 110% as compared to the same date in 2001 (UKS AOI and UKS As). Today, it is too early to recognize in this increase a long term trend.

The **dairy** branch also registered a decrease in the number of cows, as well as of output and consumption of milk (Table 4.12 in the Appendix). This milk production became more profitable in 2001 (Striwe), among other things thanks to an increase in exports of dairy products. Nevertheless, the stocks of cows in the spring 2002 were smaller than in the same period previous year. On the other hand, this diminution was not so important as in 2001 or 2000.

The only animal product branch experiencing the overturn of previous declining trend was **egg** production (Table 4.5). Since 1998 it has slowly risen. But taking into account the share of eggs in total production (4%) and their increase rate (11% in four years), this phenomenon could not be a main source of growth.

To conclude, the situation on the markets of individual commodities confirms our initial hypothesis that the role of animal production was not an important contributor to the 2000-2001 growth.

4.4. Factors of Growth

In this section we evaluate, one by one, the hypothetical growth factors and confront them with the real reasons of growth of individual branches and commodities (see previous section). It should be stressed that we are not searching for the factors of all changes but for the factors of growth only, and specifically of the growth in 2000-2001.

The institutional changes, especially in the transition period, are often a main driving force for economic development. In Ukraine it can be privatization as a whole, and in particular, changes in the status of obsolete *kolkhozes* and *sovkhoses*, as well as the emergence of a market for agricultural land. However, until the end of 1999, these changes were rather formal in character and in most cases did not involve any real transformation in ownership and institutional status of farms. New names were assigned to an old content. The system of enterprise management and decision-making mechanism did not change substantially. Initial effect of these changes was destabilization and worsening of law and order. We do not deny the positive impact of certain reforms on agricultural production (for instance the gradual development of land rental market through the establishment of land share certificates); nevertheless, they were timorous and slow. And the slow adaptation of agriculture, especially of the enterprise sector, to countrywide economic and social transformations

during the last decade might well be the essential cause for the collapse of this branch of the national economy.

The 1999/2000 reforms, the presidential decrees affecting the status of ancient *kolkhozes* and the land market, have been singled out as responsible for the downfall of the grain production in 2000. This allegation seems to be of a political nature and does not seem to get support from the existing economic evidence. A production cycle for cereals is one year while these kinds of institutional reforms produce effects after a 2-3 year period. Yet, by the same token, they are unlikely to contribute significantly to output growth in other branches that year. Moreover, these decrees have directly affected the sector of enterprises, whose total output, according to UkrKomStat, declined by 5.3% in 2000. At the same time, the output of the holdings sector increased by 20%. A separate question is the effect of these reforms on the 2001 harvest. In fact, the most important step toward privatization was made in 2001 when, on October 25, the Parliament approved the Land Code. The effects in agriculture of the implementation of this law, however, are not likely to be noticed before the summer 2002 or may not even be registered before the summer 2003.

One of possible ways of output augmentation is an extensive growth, achieved due to an increase of production factors: capital, labor and/or land. However, the general trend in Ukraine has led to the systematic contraction of labor, agricultural land area, machinery and other inputs in agriculture. Those available are not often adapted to the actual needs. Capital investment diminished in the whole economy but agriculture was affected much more than other sectors. The share of agriculture in total capital investment in the whole economy decreased from 21.3% in 1990 to 7.9% in 1995 and 3.7% in 2000. In 2000 it amounted to 88% of 1999 level in agriculture (while 115% in the whole economy), 81% compared to 1998 etc. (AU 2000 p. 21 and own estimates). Some successful Ukrainian companies from other sectors have started investing into agriculture (Feofilov); however, the level of these investments is still too low to be noticed at the aggregate output level.

The diminution of demand was among the sources of the crisis in agriculture. It shrank as a result of the emergence of new state borders separating Ukrainian producers from their traditional markets in other former Soviet republics and the decline in domestic consumption of foodstuffs. So, the increase of demand, external or domestic, may stimulate growth. However, in 2000 total exports of agricultural products declined by 3.4%, compared to 1999 (Faostat, data of May 31, 2002). The branches whose output increased in 2000 (potatoes, vegetables, fruits, pork and eggs) exported insignificant quantities. The only exception was sunflower. But high production of the latter was not caused by an emergence of a new market, but rather by an adaptation of the enterprises to the existing conjuncture. And the proliferation of this crop was finally stopped by the governmental policy; already in 2001 its production declined substantially. As concerns cereals in 2001, they were mostly imported rather than exported in the wake of the 2000 harvest. The expansion of cereals, a driving

force behind the growth in 2001, was a response to increased prices caused by raising imports and not on account of production for export demand.

As far as the domestic demand is concerned, one should notice decline in the population of Ukraine by 2.6 million persons between 1991 and 2001 (StY, 2000, p. 316), or by about 5%. Another factor is the impoverishment of families which forced them to reduce food consumption. Among the main foodstuffs, there was only one, whose consumption has not decreased during the last decade – the potatoes. This could be an indicator of significant impoverishment and brings to mind the famous phenomenon of 19th-century Ireland, where the increase of potato prices caused the increase in potato consumption.

Some experts have argued that the increase in the urban population's incomes stimulated the increase of demand for food in 2000/2001. This claim is difficult to substantiate. The trends in production were often opposite to the previous year's trends in consumption of particular foodstuffs⁴¹. On the other hand, higher incomes usually lead to changes in the structure of consumption: more meat, less bread and potatoes. We could not perceive this phenomenon in Ukraine⁴². Yet, a mechanism preventing from falling below a certain minimum level has been quite effective. Probably it has maintained the potato output at a previous level, helped to stop the decline of vegetables and, eventually, of cereals production.

It seems, that the dramatic decline in food consumption during the 1990s (of meat, by 46%; of milk and milk products, by 51%; of eggs, by 58%; of fruits, by 59%; and of bread, by 84%; in 2000, as compared to 1990 (AU 2000, p. 96)) would be much lower, if the authorities implemented a real reform of ancient *kolkhozes* and *sovkhozes* and of the agricultural market. The fear of free market and of food price increases pushed them to control agriculture, which resulted in the decrease of output and high food prices, probably much higher than those produced by a competitive market if it were given a chance to operate. Finally, the grain crisis had its good aspects, as it forced the authorities to introduce meaningful reforms promoting real privatization and market liberalization. Thus, indirectly, the demand for agricultural goods augmented output and reduced prices. Therefore, the general scheme was as follows: decrease of supply → increase in prices → social pressure → reforms → increase in supply → decrease in prices.

To understand the changes in economic policy leading to those in the economic environment affecting agriculture, it is necessary consider first the agricultural policy prevailing in Ukraine before 2000. Since there was almost no cash in agriculture, farmers could not buy the inputs (machinery, seed, fertilizers, pesticides and other) they needed.

⁴¹ The consumption of fruits in 1999 was 22% smaller than previous year and their harvests next year – 83% larger. That year their consumption increased by 30% but the harvests next year were 26% smaller. The same for potatoes – 7% decrease of 1999 consumption and 56% increase of 2000 output; 10% increase of 2000 consumption and 13% decrease of 2001 output.

⁴² The increase of real incomes by 13% in 2001 (Shuker) can stimulate the demand for foodstuffs and consequently the agricultural production in 2002, but not in 2001.

Only those received from and rationed by the government were available. The farms, which arose out of the former *kolkhozes* and *sovkhozes*, received inputs from the state in the spring, for which they had to pay with grain in the fall. However, if they failed to produce grain, they avoided payments. Otherwise, if they were successful in producing grain, they had to pay by delivering grain to the state procurement agencies. Temporizing risked the confiscation of harvests, whereas the debts of enterprises in deficit were absorbed by the state. The same mechanism applied to taxes. They were high and often paid in grain. Moreover, the policy was to keep grain prices at an artificially low level to assure cheap bread for households. This system led to the situation, in which the farmers were not very interested in producing grain. To guarantee the supplies of grain and other commodities, the local authorities intervened in the decision-making process and in personal decisions. Directors, often installed and supported by the local authorities, exercised feudal-type control over the members of collectivities, formally the owners of farms. This policy led to the systematic decline in agricultural production. The grain crisis produced the shock, necessary to abandon these perilous policies, and sparked growth.

The provisions of 2000 made significant changes in the way agriculture operated. Tax reform changed the way taxes were calculated and collected. The effective tax rate was significantly reduced. Farmers began receiving subsidized bank credits instead of state-supported in-kind loans⁴³ and were empowered to make purchasing decisions on their own, thus liberated from previous constraints imposed by state-sponsored deliveries. Barter was substantially reduced and monetization increased. Authorities softened price controls. Administrative controls over farm directors were significantly reduced.

In the context of economic policies of late 1990s we should mention the devaluation of *hryvnia* in 1998/99. This had a lesser role to play in increasing the access of Ukrainian products to foreign market in 2000-2001; yet, it played a positive role as a catalyst in the tendency towards import substitution, principally in the case of cereals. However, the devaluation did not permit a reduction in agricultural imports; their value did not change in 1999 and increased 8.5 % in 2000 (Faostat, data of May 31, 2002).

One suggested explanation for agricultural growth was the shift of output from the shadow to the 'official' economy. To address this question we should verify which sectors and branches were embraced by this phenomenon. The computation of the output of the holdings sector is not based on documents but is estimated, taking into account harvested area, yields, stock etc. So the existence of the shadow economy in this sector shall not influence the official data. The situation is different in the enterprise sector, whose production is computed on the basis of official reports. Apparently, a significant fraction of grain harvest is not registered and allocated to farmers, who use grain to feed their livestock. This serves as an additional unofficial salary. Yet, we lack evidence that in 2001 the amount

⁴³ Agricultural credit from commercial banks increased from 1.8 million *hryvnia* in 2000 to 5.8 million *hryvnia* in 2001 (Shuker).

of this 'gray' part of harvests substantially changed. As the grain prices declined, the farmers had even greater incentives to feed grain to their herds rather than sell the cereals.

The shifts in climatic conditions can explain most of the year-to-year yield changes observed during the period 1998-2001. And the changing yields had substantial influence on the output. Animal production, depending only indirectly on climatic conditions and more on the economic environment, was much more stable in its trends. This is so irrespective whether one analyses individual commodities or all its branches together. As if, growth was not very significant. The climatic conditions had also indirect impact on the amount of production, especially the weather of the previous year. The chain: harvest → prices → area under culture next year (+ often diverse inputs) → harvest next year, has been described above.

4.5. Conclusions

There seems to be enough evidence to claim that in 2000 and 2001 Ukrainian agriculture registered real growth, though the exact extent of this growth remains debatable. We lack evidence, however, to assert that the 2001 growth was a 'systemic' continuation of that in 2000. Each year saw growth in different branches and in different sectors. In 2000, growth occurred predominantly in the holdings sector in such branches as potato, fruits, and vegetables; in 2001, growth occurred mostly in the enterprise sector (cereals and sugar beet). Hence, one can argue that each case was driven by a different mechanism.

Doubtless, an important factor of the 2000 growth was the weather – more favorable for diverse crops than that in the previous year. In 2001, the mechanism of growth was much more complex and less transparent. Policy efforts to maintain low grain prices contributed to low grain harvests in 1998-2000. This in turn forced the authorities to liberalize price policy and promote privatization and development of a competitive market in agricultural inputs and outputs. This policy factor combined with good weather conditions for some crops (especially grain) can be taken as responsible for the 2001 growth.

Two other factors helped this mechanism – the high cost of transportation in Ukraine and the devaluation of the *hryvnia*. Nevertheless, they tended to play a role of catalysts rather than factors which had direct impact on agriculture. In foreign trade, they augmented the price of imported cereals, which in turn pushed up the price of domestically produced cereals and subsequently favored the extension of these crops. What concerns export, the impact of devaluation was not significant, since in many cases there are diverse internal barriers for export of agricultural commodities.

Will this growth be durable? It should be stressed that no important branch or important product managed to grow in both 2000 and 2001. The growth in 2000 could be a

readjustment after the decline of 1998 and 1999. The successful results in cereal production in 2001 turned against the farmers. And the profitable exports of sunflower have been restrained by the authorities.

If the trends observed in 1992-1999 do not change radically, Ukrainian agriculture cannot expect growth. Only radical reforms may enable it to continue its current growth. No large increase in the domestic demand can be expected. And, in its current shape Ukrainian agriculture is not ready to be able to successfully compete on the world market. It suffers from high production costs and very high domestic transportation costs. Another World Bank study has proved that Ukraine has highly inefficient agricultural marketing, input supply and transport chains. "This is a major problem for increasing exports, and results in large farm gate price swings as the country moves between import parity prices in deficit years to export parity prices in surplus years. This is a major source of price risk for primary agriculture and a major source of political risk for the Government in terms of keeping the agricultural lobby happy" (Shuker). Improvement of transportation infrastructure usually requires a lot of money and time. The state lacks funds to increase its investments in agriculture. Nobody from the outside will invest substantial means without high probability of returns – certainly not the banks. And agriculture itself cannot generate enough means unless further radical reforms will make it profitable. We shall not forget that the collapse of Ukrainian agriculture resulted from lack of essential reforms allowing this branch to meet the new economic and social conditions. So, only these reforms can facilitate growth. The cereal crisis spawned the reforms of last years. These reforms have not had yet enough time to bear fruit. But they should be pursued and amplified.

We can imagine two scenarios for Ukrainian agriculture. According to the first, the reforms will be continued and extended. Agricultural land will become entirely private property. The owners will enjoy a real right and real possibility to form producer associations or to operate individually. They will be enabled to decide whether or not to continue to farm, or to lease or sell their plots in an open land market. The authorities at a national, oblast' and rayon levels will not directly intervene into this decision-making process. The market of inputs, outputs and credits will not be controlled more than it usually is in the well-developed countries.⁴⁴ Agriculture will slowly recover from its collapse in the 1990s.

According to the second scenario, the better results and the elimination of a crisis situation incite the authorities to return to their previous policy of intervention. By executive regulations, new provisions 'correcting' the reforms would be issued and by practice, the reforms will end up deprived of their rationale. This will lead to a new crisis provoking the activation of a set of defense mechanisms leading once more to a new short-term liberalization. This might well replicate the style of the NEP strategy introduced in the Soviet Union in the 1920s.

Today, it is not possible to predict which scenario country leaders will choose.

⁴⁴ State intervention in agriculture must be much lower in Ukraine than in highly developed countries because the Ukrainian state has less financial resources at its disposal and therefore is not able to finance a far-reaching intervention.

Chapter 5

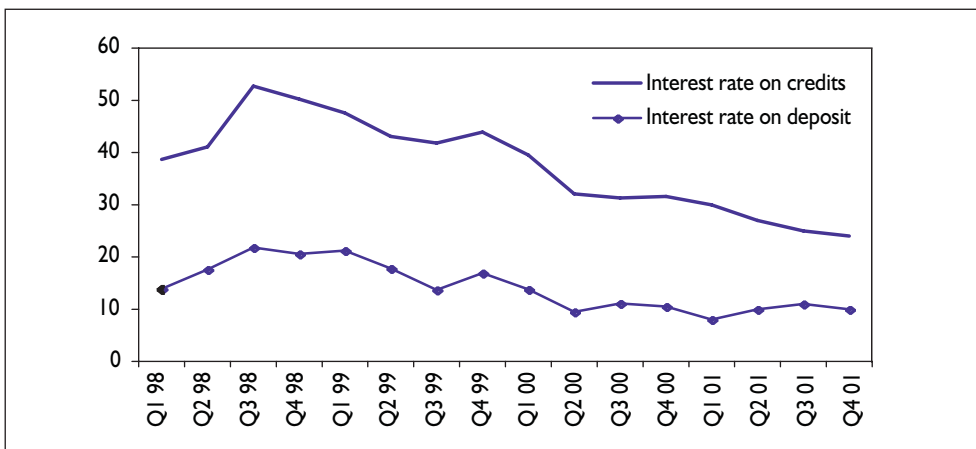
Continuing Fragility and Underdevelopment of the Financial Sector

Inna Golodniuk

5.1. Positive Trends in Financial Sector and Their Implication for Economic Growth

Past several years have brought some signs of revival and positive changes in the Ukrainian financial sector. First, banks and other financial institutions have become more efficient as financial intermediaries. This implies that the overall costs associated with transactions through the domestic financial institutions have been declining. Indeed, the spread between the interest rates on credits and deposits (widely used as a proxy for the degree of efficiency of a bank in acting as an intermediary between savers and borrowers) is shrinking (Figure 5.1), thus indicating that banks are becoming more effective in facilitating business transactions and channeling resources.

Figure 5.1. Spread between the interest rates on credits and deposits, percent, 1998-2001

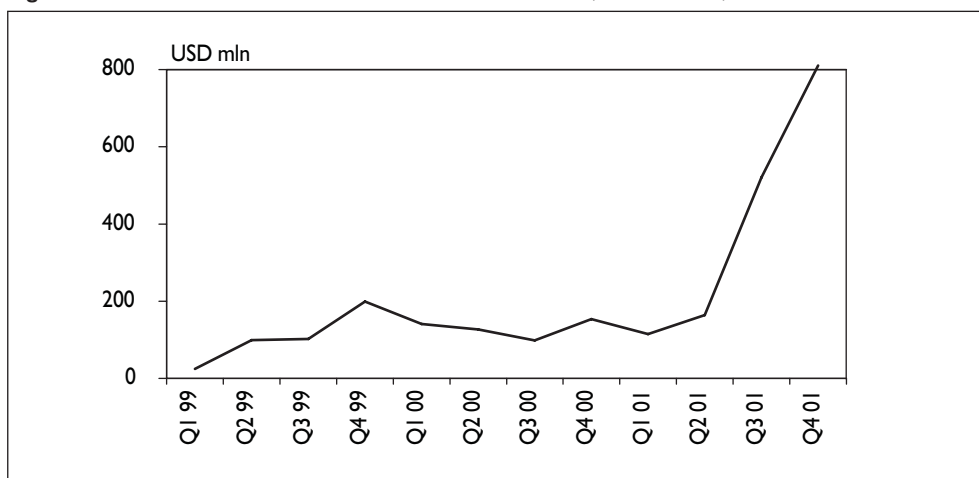


Source: National Bank of Ukraine.

The volumes of trade in the stock market have been expanding (Figure 5.2) implying, by the same token, reduction of the transaction and information costs related to the allocation of capital in the economy. This expansion also contributed to the overall transparency of the economic environment, since the stock market helps to create single price for each stock traded thus reducing market segmentation and creating favorable prerequisite for economic growth.

Another noticeable trend in the financial sector that contributed to the overall economic growth in the post-crisis years is the increased amount of credits to the economy and better allocation of credit resources. Consolidated credit portfolio of the Ukrainian banks has experienced quite substantial growth for the last three years. For example, in 2001 the overall volume of loans provided to enterprises increased by some 45% and in 2000 – by about 30% (in dollar terms). In parallel with substantial expansion in the “traditional” commercial lending, bankers also witnessed higher demand for more sophisticated credit services like overdraft crediting, credit lines and project finance lines.

Figure 5.2. Volume of trades on the Ukrainian stock market, USD million, 1999-2001



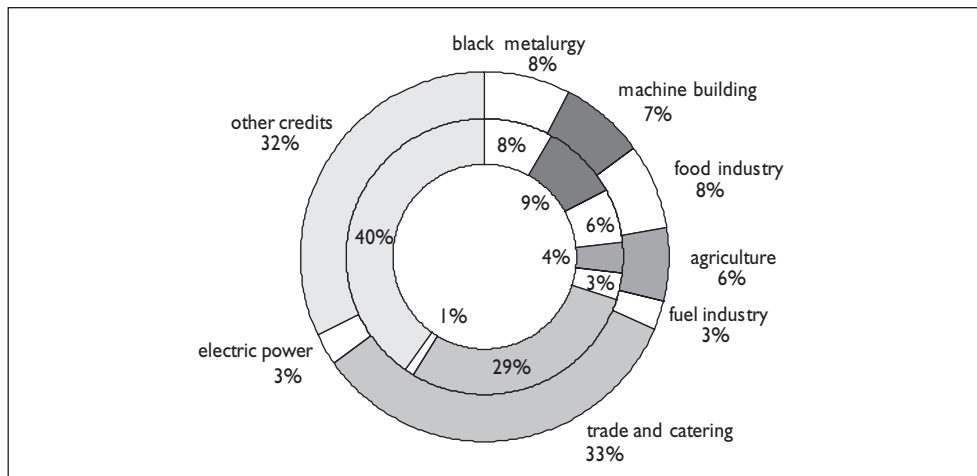
Source: State Stock Market and Insurance Commission of Ukraine.

At the same time, many measures indicate that allocative efficiency of credits has improved. For example, the share of problem loans in credit portfolio (defined as sum of bad, overdue and extended loans) has been diminishing (Figure 5.4). Banks have gradually and consistently turned to servicing private businesses, which proved to operate more efficiently⁴⁵ than state enterprises or enterprises having large share in state ownership. At the end of 1998, loans to the private sector constituted about 8% of GDP. By the end of 2001 this number went up to some 12%. This trend suggests additional positive implications for economic growth, since numerous empirical studies find positive nexus between credit to

⁴⁵ For more details see Szyrmer and Dubrovkiy (2001) and Chapter 3 of this study.

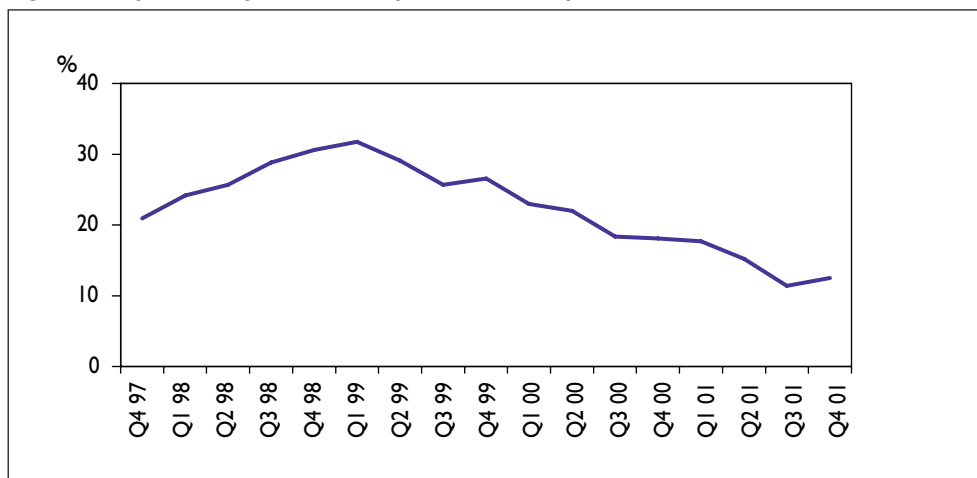
the private sector and economic growth (see Sultan et al., 2001). There are also changes in the pattern of credit allocation. Banks tend to focus more on industries processing agricultural products, food industry, and trade and catering (Figure 5.3). Loans in these sectors seem to be most efficient, since there is a low level of government intervention, and the banks allocate credit according to economic rather than political criteria.

Figure 5.3. Allocation of credit by sectors, percent, inner circle – end of 1998, outer circle – end of 2001



Source: NBU.

Figure 5.4. Dynamics of problem loans, percent of credit portfolio, 1997 – 2001



Source: NBU.

Therefore, reduced transaction costs and improved efficiency of the banking system in allocating credit resources coupled with the increased volumes of credits, appear to be the

prevailing trends in the financial sector that facilitated the economic growth observed in 2000-2001.

5.2. Major Determinants of the Positive Trends in Financial Sector

5.2.1. Growing Competition

Growing competition was one of the major reasons behind the discussed positive trends in the financial sector. Market share of the ten largest banks has dropped from 63% to 55% since mid-1998 (Table 5.1). Besides, the composition of the 'Big Ten' and ranking by the size of the ten largest banks underwent noticeable change (Table 5.1). One could also observe reduction in profit margins of these banks in the post-crisis years. While in 1998 return on equity (ROE)⁴⁶ of about 10% and in some cases much higher (most noticeable is the example of Pryvatbank) was considered typical, in recent years the situation changed. By the end of

Table 5.1. Total assets and ROE of Ukrainian banks and movement in rankings, 1998-2001, end-period

Bank	June 01, USD mln	N	June 00, USD mln	N	June 99, USD mln	N	June 98, USD mln	N	ROE, Jun 98	ROE, Dec 01
Pryvat	746	1	557	2	560	2	720	3	22.0%	9.6%
Prominvest	745	2	596	1	647	1	1155	1	7.0%	10.5%
Aval	725	3	401	3	371	5	459	7	8.6%	1.5%
Ukreksim	523	4	392	5	393	4	465	6	NA	3.5%
Oshchadny	507	5	287	7	324	6	576	5	6.2%	1.0%
Ukrsotsbank	404	6	297	6	320	7	599	4	9.2%	1.9%
Ukrayina	365	7	395	4	484	3	940	2	2.9%	NA
FUIB	257	8	204	8	138	8	200	8	NA	7.9%
Ukrsib	203	9	125	9	59	19	106	12	7.8	11.1%
Brokbiznes	160	10	117	10	113	10	148	10	NA	NA
Total assets of 10 banks	4633		3370		3408		5362			
Total assets of all Ukr. banks	8437		5940		5783		8509			
Ten largest, % total	55%		57%		59%		63%			

Source: NBU and Finansoviye Riski (Financial Risks).

⁴⁶ Calculated as net profits reported for a time period divided by bank's equity capital at the end of that period.

2001 almost all large banks experienced substantial reduction in profits and returns on equity. Table 5.1 provides illustration to this point. Although the ROE for 1998 and 2001 is calculated for different time points of a year (middle and end of the year respectively), the trend of shrinking profit margins can still be noticed. The latter fact is another evidence to the growing competitiveness within the banking system as the more competitive the market is, the thinner, *ceteris paribus*, are the profit margins.

Because of the increased competition, banks had to offer more attractive terms and a better service on traditional operations such as commercial lending, money transfers, deposits, etc. On the other hand, banks have been forced to develop new products and services. During the past several years fast expansion in volumes of banking cards, consumer loans, and microloans was recorded. For example, the total number of Europay and VISA banking cards issued by Ukrainian banks comprised some 2 millions as of January 1, 2002, which is almost 2.5 as much as that of one year before (the figure cited in *Kompanion*, #4 (206) of 2002). In 2001, almost all issuers of banking cards expanded their target markets; many of them started working with such clients as students and pensioners. Experts predict the market for cards can be growing by about 15% annually for the next 3-4 years.

One could also witness rapid spread in consumer lending. Consumer loans increased by some 70% in dollar terms (from USD 154 mil to USD 262 mil at the end of 1998 and 2001 respectively).

5.2.2. Ceasing of Sources of Speculative Profits

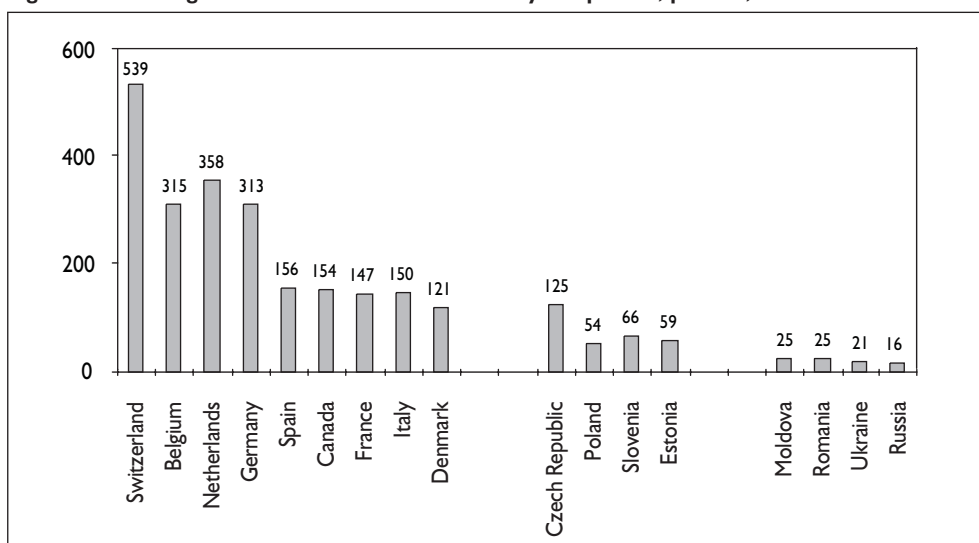
One of the exogenous factors explaining the positive trends in the Ukrainian financial sector is ceasing easy profits that existed in the pre-crisis years – that is arbitrage on hyperinflation and currency depreciation, T-bills operations, etc. Lack of the credibility to the domestic T-bills after the 1998 near-default exhausted a very significant source of speculative profits. Moderate inflation and stable exchange rate have had the same influence – banks, deprived of possibility to speculate, had to turn to traditional bank operations.

5.3. Limited Capacities of the Ukrainian Financial Sector

Despite the positive dynamics in the performance of the domestic financial sector discussed and analyzed in sections 5.1 and 5.2, the Ukrainian financial sector remains quite shallow and relatively inefficient in comparison to its counterparts in developed and even transition economies. The low capacity of the sector limited its ability to support economic

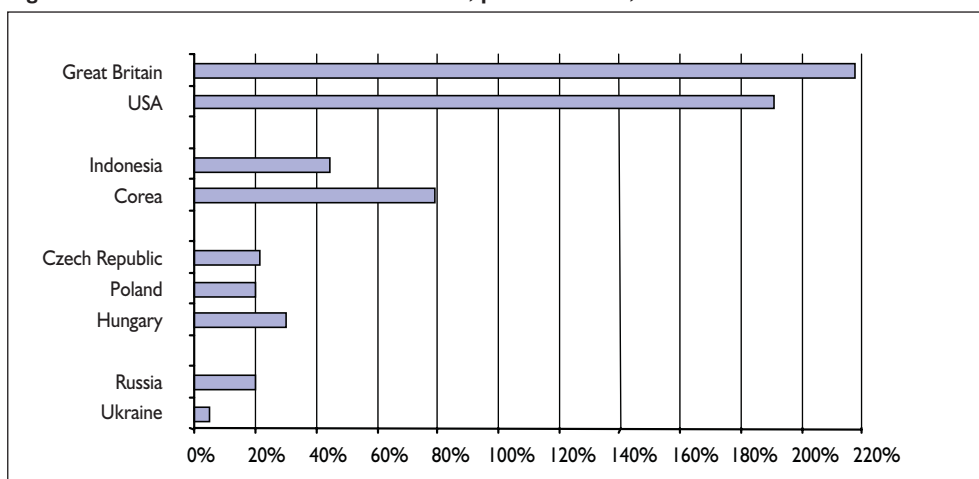
growth. The new net credit (increase of the volume of credits over a year) of the domestic financial institutions to the economy over the past five years stayed on average at the level of about 2% of GDP⁴⁷. Figure 5.5 compares relative capacity of the Ukrainian banking system to that of some other countries.

Figure 5.5. Banking assets to GDP ratio: cross-country comparison, percent, end of 2000



Source: Barth et al. (2001).

Figure 5.6. Volumes of the stock market trades, percent of GDP, end of 2000



Source: CASE-Ukraine database.

⁴⁷ On the other hand, the high pace of credit expansion in 2001-2002 reported in Chapter I involves the risk of deteriorating asset portfolio of many banks when economic boom comes to its end.

Likewise, the Ukrainian stock market and non-banking financial institutions are at the infant level of development (Figures 5.6 and Table 5.2 respectively).

Table 5.2. Assets of Non-Bank Financial Institutions, % GDP, June 2000

Country	Investment Funds	Pension Funds	Insurance Companies	Mutual Funds	Total
Czech Republic	6	2	9	2	19
Estonia	3	0	3	2	8
Hungary	4	4	3	8	19
Kazakhstan	2	3	1	0	6
Latvia	2	0	1	3	6
Lithuania	4	0	0	2	6
Poland	6	2	5	2	15
Romania	8	0	0	0	8
Russia	1	1	1	1	4
Slovakia	4	0	4	2	10
Slovenia	2	0	4	3	9
Ukraine	0	0	1	0	1
Germany	22.7	13.0	31.9	4.6	72.2
Mexico	-	2.7	1.7	3.6	8.0
Portugal	21.2	11.2	9.6	-	45.6
South Korea	19.5	1.8	15.9	-	37.2
Turkey	0.5	0.8	0.6	1.9	3.8
United Kingdom	29.3	101.0	88.9	30.4	249.6
United States	55.2	89.9	43.1	73.6	261.8

Source: Roe et al. (2001).

There are many factors, which stand behind the continuing fragility of the domestic financial institutions. In specific, operations of financial institutions in post-crisis years were most adversely impacted by the following factors:

- Directed lending by commercial banks. As it turned out, loans disbursed by commercial banks under administrative pressure or under government guarantees ended up being problematic. By estimates of bank managers 60% of problem loans of seven large banks in the late 90s were loans to support implementation of different government programs.
- Costs imposed by the State Tax Administration. Commercial banks have been forced to act as free-of-charge agents for tax administration (*Kartoteka#2*, obligation to submit a lot of papers to STA, etc.), which led to dramatic increase in the operational and non-operational costs. Besides, enterprises with tax arrears avoided transactions through financial institutions what contributes to outflow of funds from the system.
- Large size of shadow economy and pervasive non-monetary transactions. Banks still perform a wide array of controlling functions and households and businesses having unofficial earnings or avoiding/evading taxes prefer not to make transactions through the financial system and resort to non-monetary or cash deals (including foreign exchange cash).

- Low trust of population. Ukrainian financial institutions have long been suffering from the low trust of the population. Ukrainians lost almost all life-long savings deposited in banks during hyperinflation of the early 90s. The stained reputation was further undermined by the financial crisis of 1998 followed by bank runs and outflow of deposits from the banking system. At present, there still remains large disparity in the rights of tax inspectors and taxpayers. The disparity has many different manifestations, like already mentioned "Kartoteka", tax collateral mechanism, regulations forcing banks to provide tax officers with information on any bank account they need, etc. Such regulations have many depressing consequences for the banks, primarily further outflow of funds from the system and fading trust of population to the home banks.
- Ukrainian companies are non-transparent for stockholders and creditors due to inconsistencies in legislation, controversial instructions on tax accounting, and double accounting that make it possible to manipulate profit accounting. For this reason investors and creditors avoid the corporate securities, what undermines operations of the Ukrainian stock market.
- Unprotected rights of stockholders and creditors. The Ukrainian government has yet to develop the legal framework for regulating property rights, especially corporate property rights, and create an appropriate mechanism that allows shareholders to exercise their rights over corporate managers. Current regulations stipulate rather symbolic tools, through which stakeholders and creditors can monitor and control managers. This adversity is reinforced by weak property rights enforcement and unregulated rights of minority stakeholders. It is also very difficult, or almost impossible, for outsiders to obtain information about the owners of an enterprise because there is no single registry of corporate ownership.
- Overall scarcity and low mobility of information. For the sake of example, 2000-2001 saw improved business performance of many enterprises, whose shares are traded in the stock market, however, the latter fact did not influence the quotations of their respective stocks.

To summarize, the environment, in which Ukrainian financial institutions operate, has been and remains unfriendly, despite some positive trends in this sphere that one could observe in the past several years. To appropriately address the issue, the government has to put serious reform efforts to neutralize, or at least reduce, the detrimental impact of the above discussed factors. If successful, these reforms can substantially improve efficiency and capacity of the domestic financial sector, thus making use of its large potential and resources.

Chapter 6

Fiscal Policy and Attempts of Public Sector Reform

Małgorzata Antczak, Magdalena Tomczyńska

6.1. Introduction

Fiscal policy in Ukraine remained lax until 1998 with fiscal deficits constantly higher than planned and expenditures larger than available revenues. Tax arrears and non-payments of wages and other social benefits were notorious. Structural and institutional reforms have been implemented only partially. The change in fiscal policy, which happened at the end of 1998 and in 1999, could be seen as an important determinant of economic growth in Ukraine in the following two years. Fiscal deficits decreased because of better execution of the budget and relatively higher discipline, effectiveness, and transparency in the entire fiscal administration. All these factors are analyzed here first by commenting some fiscal indicators and then by referring to institutional reforms.

Table 6.1. Ukrainian Fiscal Statistics in 1998-2001, percent of GDP

	1998	1999	2000	2001
Consolidated budget revenues	27.7	24.8	28.4	25.6
Consolidated budget expenditure	29.7	26.3	27.8	26.4
Fiscal deficit (+)	2.0	1.5	-0.6	0.8
Deficit without privatization receipts	2.5	2.1	0.8	1.8
Public debt	51.5	56.3	43.5	35.5

Source: Ministry of Finance, Ministry of Economy, CASE-Ukraine "Ukrainian Economic Outlook", own calculations.

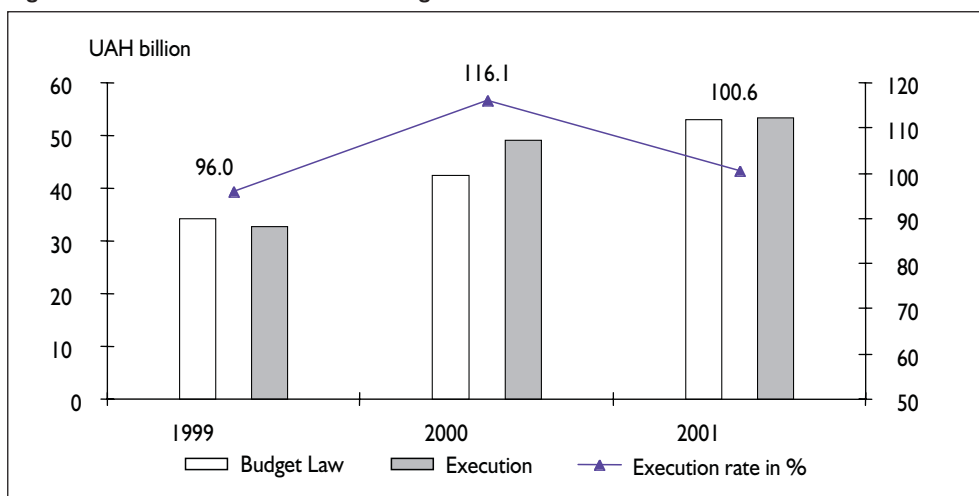
6.2. Indicators of Improvements in Fiscal Policy

6.2.1. Budget Revenues

The consolidated budget revenues increased from 25% of GDP in 1999 to 28% of GDP in 2000. In 2001, the revenue-to-GDP ratio dropped to almost 26% (see Table 6.1). After

the period of continuous decreases of real consolidated budget revenues (1997-1999), there was an impressive improvement (by over 21%) in 2000 (see Table 6.2). State budget revenues increased even stronger, by 23% that year (The Cabinet of Ministries of Ukraine, 2001). The most important factor influencing the fiscal stability in 2000 was the improvement in budget management. In comparison to the previous years, the execution rate of budget revenues (compared to planned ones) improved significantly. The execution rate of consolidated budget revenues reached the level of 116% in comparison to 96% in 1999 (see Figure 6.1). The significant improvement in income tax collection in 2000 was the most important factor staying behind this. In spite of meeting the revenue target set in the 2001 budget law, real revenues decreased slightly what (in line with a real expenditure increase) became reflected in a fiscal deficit at the level of 0.8% of GDP.⁴⁸

Figure 6.1. Execution of Consolidated Budget Revenues in 1999-2001



Source: Ministry of Finance of Ukraine.

Tax revenues

During 1999-2001 total tax revenues, expressed in percent of GDP, were decreasing, despite rapid economic growth. When we look at the real change of tax revenues of the consolidated budget – deflated by the GDP deflator – it comes out that tax revenues fell by nearly 5% in 2000, yet rose by over 7% in 2001. However, this real growth of tax revenues in 2001 took place almost exclusively due to the improvement of personal income tax collection. This fact indicates general weakness of Ukrainian tax system. It also has serious adverse impact on the budget, as total tax revenues constitute nearly 70% of all revenues of the consolidated budget.

⁴⁸ According to the Ministry of Finance methodology: including privatization receipts into the budget revenues.

The figures for the year 2001 probably reflect some positive changes in the sphere of tax policy that happened in 2000. However, frequent fluctuations in fiscal policy make any predictions of significant improvement in the tax collection very risky.

Corporate income tax receipts were falling in real terms both in 2000 and in 2001. This was the effect of continuous prevalence of the numerous tax privileges, such as tax exemptions for agricultural producers or the famous 'experiment' for enterprises of the metallurgical sector.⁴⁹

The poorest collection was observed in the value-added tax. During the analyzed period the government was unable to collect planned amounts. The execution rate of VAT worsened from 98% in 1999 to 89% in 2001. The VAT to GDP ratio declined over time from 6.2% in 1998 to 5% in 2001, and VAT receipts fell in real terms by over 12% in 2000, and were almost unchanged one year later⁵⁰. It should be remembered that VAT constitute one third of tax revenues and one fifth of total consolidated budget revenues. The broad tax amnesty enacted in 2001, implicitly enhanced nonpayment of this tax during the course of the year and the accumulation of arrears. VAT arrears constitute more than half of total tax arrears, and this can be potentially threatening to the future fiscal stance. Thus, the improvement of collection of this tax is crucial for the future fiscal position of Ukraine.

Only receipts from personal income tax were following a different trend, and reflected positive developments in the economy during 2000-2001. Personal income tax collection increased from 3.7% of GDP in 2000 to 4.2% of GDP in 2001 (see Table 6.3 in the Appendix). PIT receipts rose by 9% and 26% in real terms in 2000 and in 2001, respectively. This was probably the effect of the introduction of simplified taxation for physical persons. More detailed discussion on this subject is presented in section 6.2.1.

Non-tax revenues

Non-tax revenues constitute more than 25% of total budget revenues. In 2000, the non-tax revenues increased enormously in comparison to 1999 (in real terms). The execution rate of non-tax revenues amounted to 130% as a consequence of high capital revenues. Capital revenues were three times higher than planned in the budget law for this year (capital revenues were 1.5 times higher than expected in 2001). Proceeds from other non-tax revenues were also higher than expected in 2000 and 2001. The most important type of non-tax revenues were privatization receipts, which recorded an impressive growth in 1999-2000. After unexpected increase in privatization receipts in 1999 (execution rate of 114%) the target of privatization revenues was not met in 2000 (execution rate of 87%). In 2001 only less than half of planned privatization receipts was collected, which caused a decrease in total revenues and fiscal deficit. This trend was a consequence of the slowdown of the

⁴⁹ More on the 'experiment' can be found in Chapter 2.

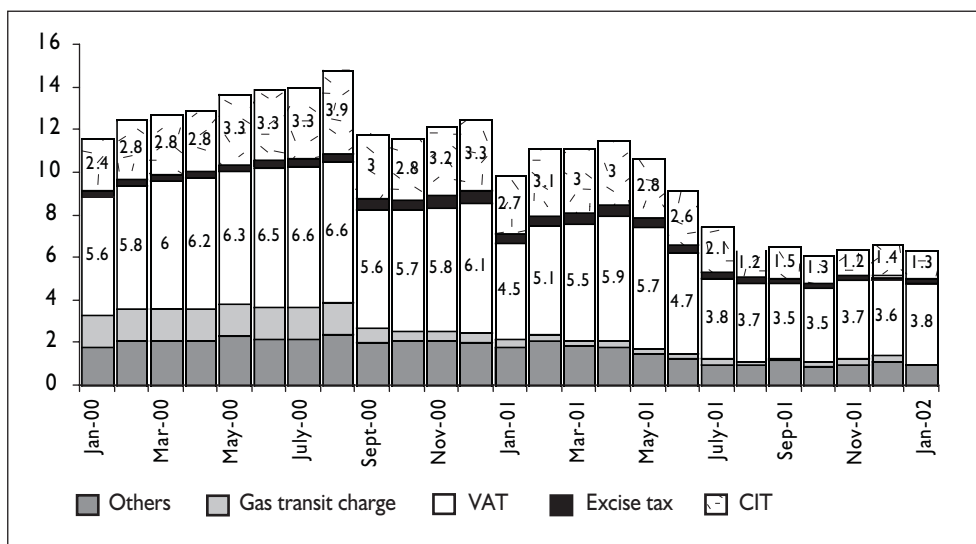
⁵⁰ Deflated by GDP deflator.

privatization process and substantial overestimation of this item in the budget plans⁵¹. However, it is agreed that six regional electricity distribution companies (*oblenergos*) sold in April 2001, were privatized in a transparent manner. The sale of several high-profile enterprises (including 49.9% stake in Ukrtelekom, for which government expected to collect about half of the total privatization receipts planned for 2001) and further sales of *oblenergos* have been temporarily suspended.

Tax arrears

Non-payment of taxes still remains a problem, although its extent is not as dramatic as it used to be in the second half of 1990s. Since August 2000 until January 2002, tax arrears had declined twice (see Figure 6.2). The biggest reduction was noticed in the corporate income tax arrears, which have decreased three times since August 2000. There was also a significant reduction in the excise tax arrears and VAT arrears. Arrears accumulated for gas-transit charges were almost eliminated. In the second half of 2001, the total tax arrears stabilized at the level of UAH 8 billion with increasing VAT share reaching UAH 3.8 billion in January 2002⁵².

Figure 6.2. Tax Arrears in 2000-2002, in UAH billion



Source: State Tax Administration of Ukraine.

⁵¹ The budget privatization receipts were smaller than expected also because of overestimation in book values calculation as it was in the case of Pipes plant in Kharkov and Crimea sodium plant. As a result of this overestimation in 2000 the privatization receipts were actually smaller by almost UAH 600 million. On September 12, 2000, a new book value calculation methodology was implemented. Following Western standards, the new methodology is based on market-oriented pricing mechanisms. To enhance transparency of the privatization process, ex-post review of operations in 2000 was carried out by independent experts. The comprehensive information has been placed on the website of the State Property Fund.

⁵² VAT arrears were almost equal to unrealized VAT refunds at the end of 2001.

6.2.2. Expenditures and Fiscal Deficit

In 1999–2001, the expenditure side of the state budget was never fully executed. The highest execution rate (98%) was observed in 2000, when the budget effectiveness and improvement in a budget discipline allowed for the fulfillment of the expenditure plan. This year, the consolidated budget deficit was limited to 0.8% of GDP (excluding the privatization receipts, see Table 6.1), below the program target. This was achieved primarily through strict expenditure control, especially during the first half of 2000. The increase of real revenues was accompanied by the positive dynamics of real expenditures (see Table 6.2). In the last quarter of the year 2000, in line with available financing (including privatization receipts and the World Bank loans) the strong increase of expenditures was observed. In the first quarter of 2001 the revenues performed very well but they started to weaken in May, as a result of a broad tax amnesty.⁵³ In the whole 2001, the revenues declined in real terms (by 2%), the real expenditures had still positive but strongly decreasing dynamics (by 1.6%), and as a result of this the growing gap between revenues and expenditures occurred. It is possible that this gap will widen in 2002.

Table 6.2. Real dynamics* of revenues and expenditures of consolidated budget in 1998-2001

	1998	1999	2000	2001
Real revenues	-7.1%	-8.7%	21.4%	-2.0%
Real expenditures	-15.3%	-9.8%	12.2%	1.6%

* - Deflated by GDP deflator.

Source: Ministry of Finance of Ukraine, State Tax Administration of Ukraine, Ministry of Economy, own calculations.

Social expenditures (financing social and cultural institutions, social protection) together with the debt servicing had the biggest share in total expenditures of the consolidated budget. In comparison to 1999 there was a significant improvement in the payments of social expenditures that in nominal terms increased almost twice and were almost fully executed.

Social arrears

Social non-payments accumulated over years became the substantial burden for the Ukrainian economy. At the beginning of 1999 the total consolidated budget social arrears (wages, pensions, scholarships, and social benefits) constituted 38% of the average monthly GDP⁵⁴, and over half of it was on wages. Successful steps toward its repayment were

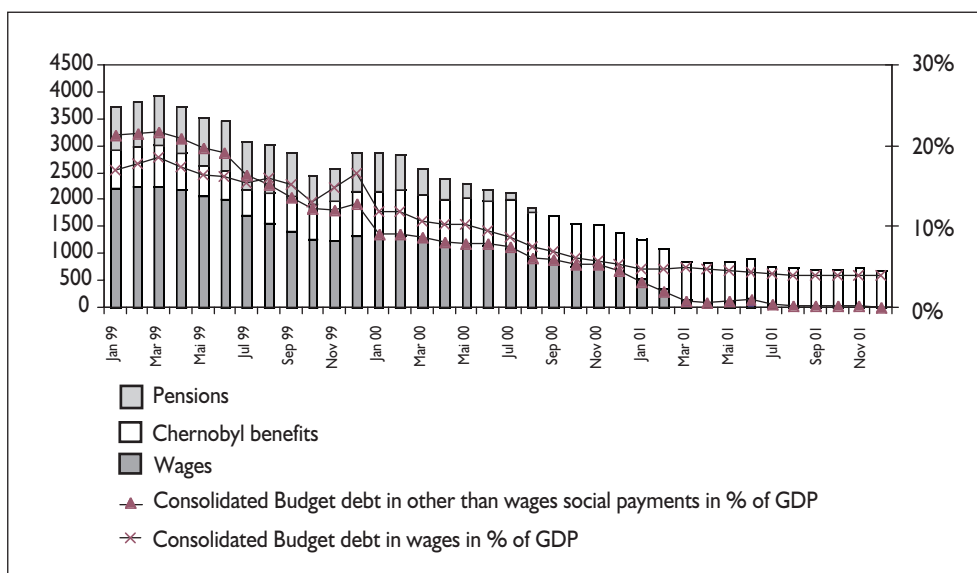
⁵³ "Kartoteka" 2 mechanism (see section 6.2) was replaced by modern tax collection procedures. Article 18 of this law, however, contained provisions for granting the write-offs of the tax arrears and related fines which arose prior to January 1, 2000 and accumulated in 2000. The amount of UAH 18 billion, that was equal to 72% of total outstanding arrears at end-2000 was written off in May 2001.

⁵⁴ In January 1999, social arrears of the consolidated budget totaled at 3.99 UAH billion (38% of GDP; divided by the 1/12 of the yearly GDP).

undertaken, and as a result pension arrears were fully eliminated by September 2000, and wage arrears constituted only 6% of the average monthly GDP (see Figure 6.3). Wage arrears were fully eliminated in December 2001. At the end of 2001, the only due non-payments were Chernobyl benefits that stabilized at the level of UAH 700 million (around 4% of monthly GDP).

The payment of overdue wages, pensions and disability benefits supported economic growth in Ukraine (see also Chapter I), primarily because of improved confidence to the state. At the same time, it should be stressed that the repayment of social arrears was possible due to higher than expected budget revenues, brought about by the revival of economic activity.

Figure 6.3. Consolidated budget social arrears in 1999-2001, UAH million

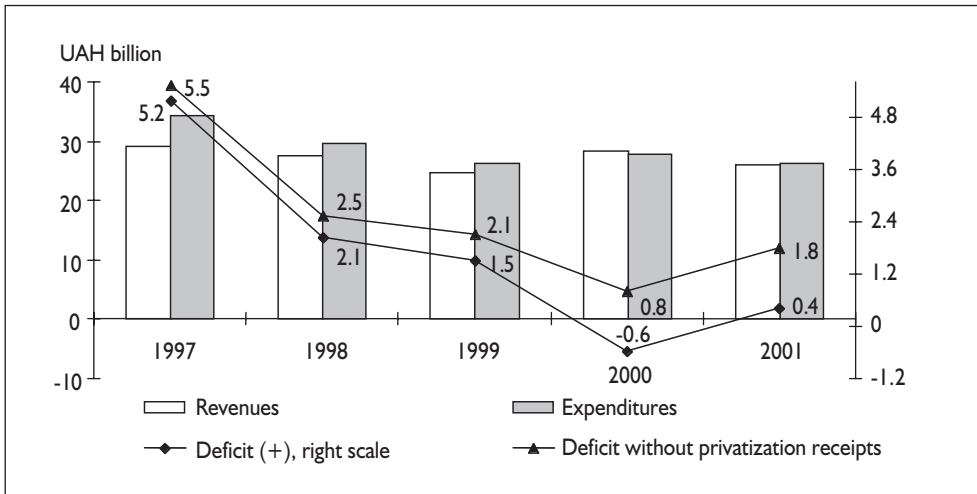


Source: Ministry of Finance of Ukraine.

Fiscal deficit developments

During the mid-1990s Ukraine experienced huge fiscal deficits of the consolidated budget ranging from almost 9% of GDP in 1994 to 5.2% in 1997. Poor tax collection and overestimated non-tax proceeds led to the lower than planned revenues, what resulted in permanent expenditures sequestration. This negative trend changed in 2000 when the Ukrainian economy experienced the outstanding and spectacular in its post-Soviet history budget surplus at the level of 0.6% of GDP⁵⁵. In 2001, consolidated budget deficit amounted

⁵⁵ According to the Ministry of Finance methodology. Following the IMF methodology (subtracting privatization receipts from the budget revenues, as it is indicated in Table 6.1, and Figure 6.4), there was still a deficit of consolidated budget at the level of 0.8% of GDP.

Figure 6.4. Fiscal Deficit Developments as a % of GDP in 1997-2001

Source: Ministry of Finance of Ukraine.

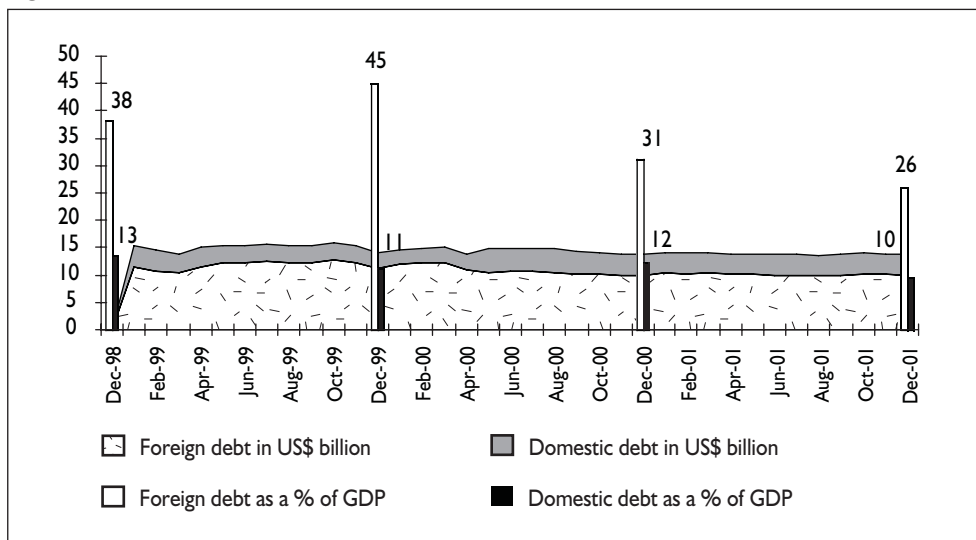
to UAH 1.9 billion (0.8% of GDP), which was a consequence of much lower than planned privatization receipts.

6.2.3. Public Debt Management

Foreign debt was 3 times higher than domestic one in 1999-2001. In 1999, the public debt to GDP ratio increased slightly to 56% of GDP comparing to 52% of GDP in 1998 due to increase in the volume of foreign debt (by USD 0.4 billion) and as a result of the currency depreciation. Permanent budget deficit did not allow for significant domestic debt repayments. However, in 2000 the public debt of Ukraine diminished by USD 1.2 billion (by 12% of GDP) and in January 2001 it amounted to USD 14.2 billion. As a consequence of commercial debt restructuring, foreign debt was slightly reduced, as of May 2000, (see Figure 6.5).

In the following months, public debt was continuously declining both in nominal terms and as the GDP ratio (by 12%). However, in USD terms the debts remained almost constant till the end of 2001 when it amounted to USD 10 billion (official reserves were 10 times smaller). Fiscal surplus of 2000 (according to Ukraine's budget classification at that time) allowed for gradual repayments of domestic debt in 2001. Domestic debt to GDP ratio declined from 12.2% in December 2000 to 10% in December 2001, but the total size of the debt denominated in USD did not decrease (high rate of GDP growth and real appreciation of *hryvnia* allowed the nominal GDP to "outgrow" the *hryvnia* equivalent of the public debt at current exchange rate).

Figure 6.5. Public Debt in 1999-2001



Source: Ministry of Finance of Ukraine.

Total public debt servicing in 2000 amounted to UAH 7.2 billion (UAH 3.3 billion domestic debt, and UAH 3.8 billion foreign debt), of which only UAH 2.6 billion was the debt repayment and the rest (UAH 4.6 billion) were the interest payments. The impressive dynamics of budget revenues in 2000 increased the solvency of Ukrainian budget and the capacity to service the public debt repayments from own sources. However the future schedule of debt repayments the continuous challenge to fiscal policy.

6.3. Institutional Reforms and Systemic Changes

6.3.1. Improvements in Tax System

Since 1998, considerable progress has been made in changing tax system. There have been also attempts to improve tax administration and collection. The first factor positively influenced environment and conditions for the entrepreneurial sector, the latter contributed to increased budget discipline, and effectiveness.

Most important measures were aimed at both broadening the tax base and equalizing tax obligations (for various groups of economic agents) and included the following:

- refraining from raising taxes and fees as well as from introducing new taxes to balance state expenditures;

- raising VAT rate for energy from zero to the standard level;
- elimination of special tax treatment of enterprises with foreign capital;
- elimination of the list of the so-called critical imports exempted from VAT;
- elimination of special tax treatment for selected companies (e.g., over 300 tax privileges granted previously to individual companies were abolished).

The following actions contributed to improved budget discipline:

- ban on mutual settlements schemes, which resulted in the decline of non-cash budget revenues and increase of cash revenues;
- prohibition of tax rescheduling and postponing;
- better tax enforcement and collection, which resulted in the reduction of tax arrears.

In addition, the following policies contributed to better collection of budget revenues and created more favorable conditions for the development of entrepreneurial activities (see also Chapter 3 on SME):

- Introduction of simplified taxation for small and medium sized enterprises. In 2000, the right to comply with simplified taxation was granted to 62.2 thousand juridical persons and 182.6 thousand physical persons (in 1999, 28.6 thousand and 66.2 thousand respectively). The share of tax revenues from this type of taxation in the total revenues increased more than five times in 2000.
- Elimination of “Kartoteka 2” mechanism⁵⁶, which is expected to result in the following positive developments:
 - more transparent tax collection practices;
 - significant limitation of negative influence of tax administration on the operation of the real sector of the economy;
 - curbing arbitrariness in taxation;
 - elimination of incentives for the growth of barter operations and shadow economy (e.g. tax debtors registered in the “Kartoteka 2” settled transactions on the barter basis).
- Gradual equalization of conditions for domestic and foreign enterprises through the elimination of tax privileges for the latter.

Shortcomings

The above mentioned developments had positive influence on organization of the public finances during recent years. However, majority of these undertakings took place in 2000⁵⁷

⁵⁶ The law On State Tax Authorities sanctioning the “Kartoteka 2” mechanism allowed the tax authorities to automatically withdraw tax liabilities from bank accounts of the indebted enterprises.

⁵⁷ Measures in the sphere of tax policy constituted an important element of the Reforms Program implemented by the Yushchenko government.

only. In addition, positive effects of some of them were reduced by the inconsistencies in the implementation process. Beneficial contribution of these measures to the economic performance was countervailed by the new arbitrary tax privileges. Thus, the record of tax policy changes was rather mixed, and 2001 saw mostly its worsening, which undermined the earlier achievements.

Moreover, political instability, increased pressure of lobbying groups, and forthcoming parliament elections directed backward steps. Practically, decisions deteriorating tax system were taken each month of 2001 with respect to the following most important issues:

- Creation of the additional free economic zones and priority development territories.
- Extending tax privileges in the already existing free economic zones. Fiscal incentives provided in the special economic zones proved to be very costly – when compared to their relatively moderate effectiveness. Their effects took the form of foregone budget revenues due to tax exemptions and tax holidays, significant administrative burden, and rather questionable increase in the activity being subsidized.
- Prolonging or extending tax privileges for agro-producers sector (it triggered situation, in which the increasing number of companies re-registered themselves as companies with predominantly agricultural production in order to be qualified for tax exemptions).
- Continuation of bad practices of writing-offs tax arrears⁵⁸, ban on restructuring tax debts⁵⁹ notwithstanding. At the beginning of 2001, the law stipulating forgiveness of tax debts owed as of December 31, 1999 came into force. Cancellation of tax debts took place also with respect to the tax arrears accumulated by agro-producers as of May 1, 2000. At the end of 2001, proposals to restructure debts between local and state budgets were put on to the agenda. The authorities explained the initiation of tax debt forgiveness by the willingness to free the real sector of the economy from the financial burden of overdue taxes. However, steps undertaken are expected to deteriorate tax payment discipline, trigger the accumulation of new tax arrears, and result in the eventual decline in budget revenues.
- Attempts to initiate restructuring of VAT refund arrears⁶⁰ accumulated by the state budget until September 2001. According to the State Tax Administration figures, the government's debt on VAT refunds to exporters totaled over UAH 4 billion as of

⁵⁸ In 1997 tax write-off and restructuring amounted to UAH 5.4 billion. In 1998 special decree allowed for writing-off tax debts incurred by agricultural enterprises.

⁵⁹ Introduced by Budget 2000 clause.

⁶⁰ The Cabinet of Ministers planned to pay part of VAT refunds it owed to metallurgical enterprises by offsetting VAT refunds against the electricity debts that metallurgical enterprises owed to energy enterprises. According to the Industrial Policy Ministry, about UAH 700 million is owed in tax refunds to exporters of metal goods.

September 1, 2001⁶¹. Discussions and eventual implementation of such measure would significantly undermine government credibility in the taxpayers' eyes. However, there are doubts that parliament will approve such scheme as exporters traditionally represent strong lobby groups.

Continuation of discretionary tax policy will pose a threat to the earlier progress in fiscal discipline and transparency.

6.3.2. Attempts to Comprehensively Reform Tax System

Steps were also taken toward the radical tax reform. The authorities aware of major weaknesses of the present tax regime (e.g. high tax burden, numerous loopholes and exemptions, complexity, lack of transparency, high administrative costs) undertook attempts to carry out a comprehensive reform of the tax system. Works on tax reform were among key objectives of fiscal policy after 1998 and resulted in drafting the new Tax Code.

The most important characteristics of the draft Tax Code were the following:

- reduction in the number of tax categories both on national and local levels;
- simplification and reduction of the personal income tax by decreasing the number of tax brackets to two: 10% and 20%⁶²;
- introduction of a tax-free amount (equal to subsistence level) in PIT;
- reduction of the burden of profit taxation by lowering tax rate from current 30% to 20%;
- gradual equalization of tax rates for profits and personal income;
- moderate taxation of capital gains;
- lowering VAT rate to 17% (from 20% now);
- limiting the list of goods subject to excise tax to only five main categories.

In general, works on the tax reform package should be evaluated as considerable step towards the improvement of the tax system, positively influencing its effectiveness, neutrality, transparency and simplicity. This, in turn, should strengthen growth capacities of the Ukrainian economy. However, the following factors diluted these positive beginnings: (i) continuation of generous and controversial PIT social-type exemptions combined with radical tax rates reduction, which would result in a very low effective tax rate; (ii) too early and extremely sharp VAT rate reduction, hence the threat of fiscally unbalanced outcomes of the reform; (iii) announcement of reforms but doubtful and delayed implementation, which raised the uncertainty of market participants.

⁶¹ Solution of VAT refund arrears is subject to dispute with the IMF and condition for the EFF program renewal.

⁶² There are currently five tax rates: 10%, 15%, 20%, 30% and 40%.

Shortcomings

Progress in the tax reform debate was too slow, because of the inability to reach consensus over the final shape of tax system. The complete draft Tax Code was ready in mid 2000 but accepted by the Parliament in the second reading at the end of 2001 only. There is a serious threat that prolonging discussions and controversies will further weaken the substance of the new tax system. One should hardly expect quick return to a serious discussion in this regard. There is even a threat that the new Tax Code might not be passed until 2004 and tax reform delayed so much may look completely different.

6.3.3. Improvements in Budget Management

Since 1998, persistent and considerable efforts have been devoted to improving planning and control over budgetary processes. It contributed to more realistic budget formulation, increased effectiveness of budget execution, and tightened budget discipline.

The improved quality of macroeconomic forecasts has created a basis for more adequate budget projections and limit uncertainty about economic developments. The use of relatively more prudent macroeconomic assumptions in planning budget revenues played a primary role in realistic determining the overall level of available resources and enabled actual meeting of the planned targets. Hence, the credibility of fiscal policy has been increasing year after year⁶³.

More effective control over budget implementation facilitated, to a large extent (however not fully), meeting budget commitments. Consequently, it was manifested in gradually diminishing necessity of arbitrary cuts of expenditures (sequestration) and attempts to find additional sources of revenues during the fiscal year. Practices of expenditures' sequestration practically ended in 1999.

Significant progress has been made to bring the budget deficit down since 1998. Moreover, attempts to use budget surplus in order to change the structure of the public debt, reduce its foreign component, and smooth timetable of debt repayments reduce the default risk for future.

In addition, a considerable institutional improvement has been visible in the sphere of public finance. Among others, the implementation of multi-year budget planning starting from 2002 appeared to be the essential one. The new multi-year approach should considerably improve the process of medium-term planning of consistent economic and social strategy. It is an important step toward bringing the annual budgets into consistency with acceptable fiscal objectives over years. Thus, it should create a kind of barrier to the

⁶³ The problems, that remained, were persistently overestimated non-tax revenues – in particular privatization receipts.

ad hoc decisions allocating resources and reflecting current political needs. There is no doubt that actual results and effectiveness of the multi year budget procedures will depend on the responsibility of policy makers' and governments' commitment and credibility.

Important side effect of the introduction of the multi-year budgeting was a meaningful change in the classification of privatization receipts. In the 2002 budget, for the first time privatization receipts were classified "below the line" as a source of financing and excluded from budget revenues (as being unstable and difficult to forecast). Thus, Ukraine harmonized its methodology of budget deficit calculation with international standards.

In addition, starting from 2002, the introduction of program principles into a budget planning process was expected to strengthen transparency, efficiency and discipline of public spending and allow for their future rational planning. However, the political consensus over the level and structure of future expenditures is needed to make this innovation successful.

6.3.4. Introduction of the Budget Code

Reorganization of public finances was complemented by the adoption of the Budget Code in 2001, which was expected to improve the inter-governmental fiscal relations. Particularly, the Budget Code defined the division of responsibilities and sources of revenues between the central and regional governments. In addition, it unified procedure of preparing drafts of central and local budgets, set objective criteria of transfers to the regions, and gave the State Treasury the sole responsibility in conducting settlements between state and regional budgets. Moreover, new legislation introduced deadline (until September 15) for any changes in tax legislation, which would constitute the base for budget revenues in the next year. Such solution would limit chaotic and discretionary changes in tax regulations and strengthen taxpayer's confidence. However, the inter-governmental fiscal relations were not fully defined, as the intention of parliament was to regulate comprehensively these questions in the new Local Self-government Code.

6.4. Conclusions

Tightening fiscal discipline, improvements in budget management, and attempts to reform the tax system were helpful and crucial in balancing the budget during the post-crisis

period. However, softening budget discipline in 2001, still substantial stock of public debt, its high servicing costs, poor collection of some taxes, accumulation of tax arrears, and real increase of public expenditures may deteriorate the future fiscal stance and growth prospects of the Ukrainian economy.

Chapter 7

Future Growth Challenges and Prospects

Małgorzata Jakubiak, Anna Myślińska

This chapter analyses prospects for achieving macroeconomic stability in Ukraine, and formulates projections about the short-term impact of economic policies for the economy.

It should be remembered that making any long- or even medium-term forecasts for an economy such as Ukraine is exceptionally risky. The country underwent radical changes, went through the prolonged recession that began in the last years of the Soviet Union, and finally started to grow. But since the base for this growth does not seem to be very stable, or – of the long-term nature – and given the mixed outlook when considering past economic policies, it is difficult to assess what tendency will prevail in the future – the ‘inertial’ or the reform-oriented one.

However, the outlook for the next two years will not change much, and we do not foresee any sudden economic downturn. This is for the set of reasons, but mainly because some positive changes that happened in 2000-2001 are irreversible. The growth impulse gave rise to the sectors of the economy in which Ukraine has probably a comparative advantage, and their development will most probably continue. Some positive changes in the sphere of fiscal policies and legislation seem impossible to be overturned easily. Higher confidence to the central bank and to the government already demonstrated itself in the higher demand for cash transactions, and financial sector is developing slowly but steadily. In addition, higher incomes of the population will stimulate domestic demand for some time.

Nevertheless, we considered two possible policy scenarios for the close future. As it is described below, they are broadly similar when considering their short-run outcomes. However, their consequences for the future of the economy are different. If the ruling elite decide to support present economic recovery by the next round of necessary reforms, then these reforms can create a basis for sustainable growth. It is clear that there is still lot to be done in the sphere of tax reform, legislation, reduction of state intervention, improvement of transparency, refraining from stop-and-go economic policies, enforcement of the property or shareholders rights, and so on. As examples of other transitional, yet more successful

economies show⁶⁴, only the strong commitment to reforms can assure the transition to a relatively well functioning market economy.

However, if the chance is to be missed, economic potential will not be used, and the growth will not continue in the long-term. And we can observe the cyclical pattern of prosperity and crises of the Latin American type (of the previous decades).

7.1. 'Some Reform' Scenario

There was not much change in structural policies during the years 2000-2001. Some of the growth impulses resulted from the reform effort undertaken before 1998. Moreover, the causality between positive policy changes that happened in 2000 and in 2001 (like balanced fiscal policy or improvements in cash payments) and economic growth is not clear. Positive structural developments surely enhanced growth, but at least some of them were possible because of the revival in economic activity. What is certain now is that subsequent reforms should follow. It is possible that during the next two years some progress in the field of regulations that improve investment climate and in the sphere of fiscal policy will be achieved.

It has been described in Chapter 3 and 6 what were the beneficial effects brought about by the introduction of simplified taxation. However, the impediments that hamper the growth of small firms still remain (non-transparent regulation, many ambiguities that provoke corruption, etc.). It is assumed here that some progress will be made towards the improvement of the legislation that regulates business activity. It is also presupposed that so much awaited Tax Code will become effective in 2003, although there are risks that it will not happen.⁶⁵ If effective, it will affect the collection of budget revenues.

Some progress has been achieved in making the privatization process more transparent. It is very feasible that this trend will continue in 2002-2003. As to the completing of the planned privatization target for 2002, it is assumed that it will not be met in aggregate terms. Nevertheless, it is assumed that fiscal policy will remain under control, and that consolidated budget will record the deficits of around 2% of GDP in 2002 and in 2003.

The relative efficiency and access to information in the financial sector should improve a bit. The government already in the first half of 2002 approved the regulation which should increase transparency of banking operations. However, it is not foreseen that the level of financial intermediation will jump high during the next two years; it will rather see a slow but gradual improvement.

⁶⁴ Central Europe and the Baltics.

⁶⁵ For details see Chapter 6.

Taking into account the situation in the agriculture (described in details in Chapter 4), and the insufficient political will of the ruling elite, it is not perceived that any substantial reform effort will be directed towards this sector during 2002-2003. As a result, Ukrainian agriculture will probably experience difficulties in adjustment to changing market conditions, and the growth of the agricultural value added recorded in 2000-2001 will not continue.

Ukraine's external position will remain stable and manageable during the next two years. The level of external debt, after being rescheduled, remains fairly constant at around 11 billion USD, which will probably amount to 28% and 26% of Ukrainian GDP in 2002 and in 2003, respectively.

It seems that with good performance criteria and some progress in economic policies, the country will receive next tranches under the Extended Fund Facility arrangement from the IMF, and the second tranche of the Programmatic Adjustment Loan from the World Bank. Financing from the European Union will also follow.

Official reserves will continue to grow as probably there will be positive (or close to zero) trade balance in 2002, privatization proceeds will flow in, foreign financing will be secured, and all of this will exceed the effects of capital outflows and external debt payments. The higher level of usable reserves should be covering short-term external obligations.

Net foreign assets will rise as reserves will be increasing, while net domestic assets will grow as credit is expanded. Therefore, notwithstanding current accommodation of the growth of monetary base by higher money demand – as the economy will continue to grow and as the cash transactions will be gaining more importance⁶⁶ – the NBU should curb fast credit expansion. We foresee that, due to limited budget deficit, the money supply growth will be controlled so that inflation in 2003 will increase only moderately and it will stay at low, single-digit levels (see Table 7.2 for details).

The above listed factors, primarily inflows of foreign capital, positive or close to zero trade balance in 2002, and foreign financing will create the appreciation pressure on the exchange rate. However, we foresee that with deteriorating net exports, the effect of the supply of hard currency will not be as strong as it used to be. Plus, the NBU will probably continue buying foreign currencies in order to boost exports, which – according to our calculations – should result in *hryvnia* exchange rate slightly depreciating, but at very moderate rates in 2002 and in 2003. The slight depreciation of domestic currency was already visible in the first five months of 2002.

When considering future external conditions for Ukrainian economy, special emphasis should be put also on the analysis of the situation in Russia, because of strong trade and financial links. Although the growth in the Russian Federation is perceived to continue (see Global Economy 2/2002), its rates will decelerate (see Table 7.1), as the domestic demand will not compensate for the deteriorating export performance in 2002.

⁶⁶ As opposed to barter.

Table 7.1. Actual and forecasted rate of real GDP growth of Ukraine’s main trading partners, 1999-2003 (% annual change)

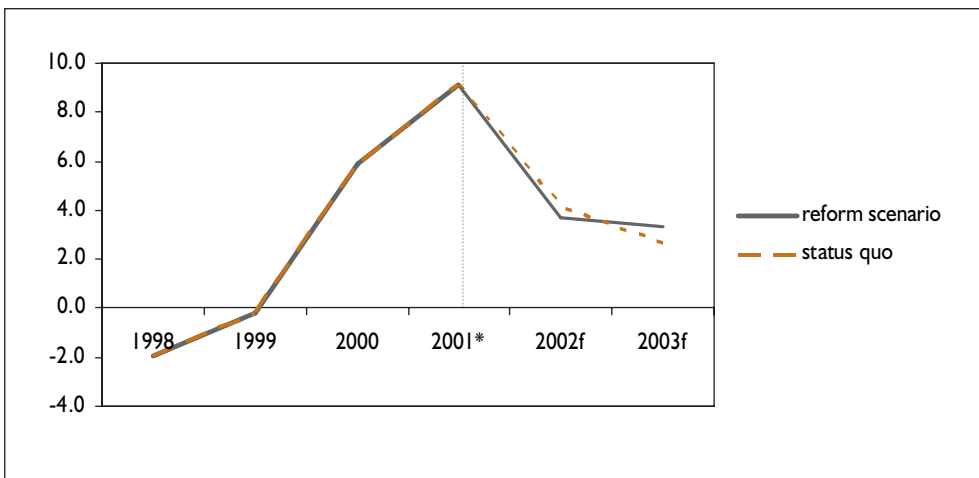
	1999	2000	2001e	2002f	2003f
Russia	5.4	9.0	5.0	3.8	3.7
USA	4.1	4.1	1.2	2.2	3.5
European Union	2.6	3.3	1.6	1.0	2.9
Germany	1.8	3.0	0.6	0.9	2.8
Italy	1.6	2.9	1.8	1.2	3.0
China	7.1	8.0	7.3	7.1	7.5
Turkey	-4.7	6.1	-7.4	2.9	4.5
Poland	4.1	4.0	1.1	1.9	3.0

Source: Global Economy by CASE (2002).

The slowdown of demand for Ukrainian exports is expected in 2002 from the side of European Union. This will be probably caused by the low economic growth in Italy and Germany, coupled by the restrictions put on traditional Ukrainian export goods (metals, grain). The outlook for the years 2002-2003 in the US is more optimistic – with the US leading global recovery – but the effects of steel war on the Ukrainian metallurgical exports to the US are not clear, yet.

Therefore, it is assumed that Ukrainian exports will grow by 6.2% in 2002 and by 5.6% in 2003. Thus, the role of exports as a growth engine will be smaller over time, and much different from the period 2000-2001. Negative trade balance is expected to occur in 2003.

Figure 7.1. Past and forecasted growth of real GDP, 1998-2003, in percent



Source: State Statistic Committee of Ukraine, CASE forecasts.

Note: * - estimate; f – forecast.

Ukrainian GDP will continue to grow both in 2002 and in 2003, according to the ‘some reform’ scenario (see Figure 7.1 and Table 7.2). However, the growth rates will decelerate, as the role of net exports as a growth engine will weaken and further expansion of domestic

demand will occur at a slower rate. The deceleration of the growth of investment in fixed assets has been already visible in the first quarter of 2002, when the growth rate was 9.6% yoy, compared to 23.7% yoy one year earlier. At the same time, real wages and incomes of the population continue to grow indicating that the growth of consumption can outperform the growth of investment for the whole 2002.

7.2. Status Quo

However, if not much in the sphere of economic reforms will be done, and the inertia already observed in 2001 prevails, the growth may slow down and even become negative in the foreseeable future. For the years 2002-2003, it is demonstrated in slightly higher growth in 2002, but then much lower growth one year later.

It is assumed that fiscal policy will be more expansionary under the 'status quo' than in the 'reform' scenario. Budget deficit is assumed to be higher by *hryvnia* 1.5 billion in 2002 and by 3 billion in 2003. Additional deficit is to be financed by increased emissions of OVDP (treasury bills) bought mainly by the NBU.

Table 7.2. Comparison of baseline and pessimistic forecasts, 2002-2003

Variable	Unit	'some reform'		'status quo'	
		2002	2003	2002	2003
Nominal GDP	billion of UAH	216.3	235.3	219.6	243.0
Real GDP growth	% change	3.7%	3.3%	4.1%	2.7%
GDP deflator	% change	3.4%	5.3%	4.5%	7.8%
private consumption growth	% change	4.6%	6.1%	4.7%	4.4%
public consumption growth	% change	2.2%	2.8%	4.4%	4.7%
investment growth	% change	10.2%	9.0%	10.3%	7.3%
exports growth	% change	6.2%	5.6%	6.2%	5.6%
imports growth	% change	9.3%	10.0%	10.1%	9.6%
CPI	y/y	3.7%	5.8%	4.9%	8.0%
PPI	y/y	1.5%	2.6%	2.8%	5.1%
Money base	% change	22.1%	14.0%	24.7%	21.0%
M3	% change	23.6%	15.4%	26.3%	22.5%
CA	million of USD	744	-125	594	-201
gross reserves	million of USD, end of period	4594	5342	4445	5117
Budget revenues	% of GDP	26.6%	27.5%	26.8%	28.0%
Budget deficit*	% of GDP	-2.1%	-2.1%	-2.7%	-3.3%

Source: CASE forecast.

Note: * - According to the IMF methodology.

In comparison with the baseline scenario, increased purchases of OVDP by NBU will result in faster growth of monetary aggregates, which in turn will lead to higher inflation. Real growth of GDP in 2002 will be slightly higher due to enlarged government consumption. However, adverse effects of greater inflation will start to prevail in the next year, and the economic growth will decline. Higher domestic demand will stimulate growth of imports, which will worsen a bit current account and decrease gross reserves. Main indicators for both scenarios are presented in Table 7.2.

7.3. Conclusions

The short-term projections described in this chapter show that the Ukraine's outlook for the next two years will not change much. The growth will decelerate but still remain positive. However, if the chance for reforming the economy created by the favorable conditions of 2000-2001 is to be missed, and the inertia already observed in 2001 prevails, the growth rates can go down very quickly and even become negative after couple of years.

Chapter 8

Conclusions and Policy Recommendations

Marek Dąbrowski, Małgorzata Jakubiak

After almost a decade of deep output decline the high rate of economic growth of 2000-2001 came as a surprise to many analysts, including the authors of this study. Now looking back for this growth story and basing on a more detailed diagnosis elaborated in the previous chapters we can come to the following general conclusions concerning growth sources and its nature:

1. Already in 1997-1998 the long-lasting and deep output decline seemed to come to the bottom point and some signs of economic recovery or at least of leveling up of the growth trend were observed in the second half of 1997 and the first half 1998⁶⁷. Unfortunately, both the September 1998 currency crisis in Ukraine and earlier financial crisis in Russia broke down this new trend and output decline continued for another year. However, the above facts mean that decline potential (determined both by the structural distortions inherited from the Soviet economy and by slow pace of economic reforms in 1990s) was already mostly exhausted.
2. Similarly to neighboring Russia, the currency crisis itself, after the above-mentioned additional output decline, gave some growth impulses and helped to restore macroeconomic equilibrium although most of them had temporary and windfall character (affecting developments in 1999 and partly in 2000). First, the real exchange rate of *hryvnia* was depreciated. However, its positive expansionary impact should not be overestimated. It related mainly to decreasing consumer-good imports in 1999, and, therefore, stimulating import-substitution production, particularly in the food and light industries (these were the most advanced industries in terms of ownership and structural changes what helped them to exploit this chance). According to our analysis (see Chapter 2) depreciation itself failed to rationalize producer imports (particularly energy imports) and has rather limited impact on

⁶⁷ The similar developments were observed a half a year earlier in Russia and they gave a very modest 0.9% growth rate in 1997.

- export dynamics. Part of the explanation can relate to the fact that UAH/RUR exchange rate appreciated⁶⁸. Second, correcting saving-investment imbalances on the one hand, and cutting off Ukraine from the international financial markets, on the other, forced trade-balance and current-account improvement. As we mentioned before this unintended ‘expenditures-switching policy’ affected mainly consumer import and investments in 1999. In spite of the ‘windfall’ character of this particular factor (real depreciation) Ukraine’s economy managed to sustain the new external equilibrium for the next two years. Third, the inflationary consequences of *hryvnia* devaluation (although limited, comparing, for example, with Russia) and the lack of indexation mechanism allowed for correction of real wages and salaries, pensions, social benefits and other budgetary commitments at the end of 1998 and in 1999, helping to improve fiscal balance in 1999.
3. On the top of the ‘windfall’ factors we must mention the additional positive external and domestic circumstances, which helped in gaining a growth momentum, particularly in 2000. These are increase of international prices of metal products and good weather conditions in agriculture. Sometimes the ‘luck’ factor plays important role in economic developments. And this was partly the case of Ukraine in 2000-2001.
 4. The ‘luck’ factor also helped in avoiding negative inflationary consequences of a fast economic growth in spite of a quite loose monetary policy. Re-monetization of the Ukrainian economy occurred to be faster than one could expect two or three years ago and some positive microeconomic developments such as reduction of non-monetary transactions (see below) played a positive role here. The high rate of GDP growth in 2000-2001 meant, *ceteris paribus*, a serious additional increase in demand for money. Favorable balance of trade developments helped to stabilize UAH/USD exchange rate in 2000 and even appreciate it slightly in nominal terms in 2001. In addition, a good grain harvest in 2001 depressed food prices at the end of 2001 and in 2002.
 5. Ukraine is the open economy, at least in terms of its dependence on foreign trade. Among the major trade partners, Russia plays still a crucial role. Hence, it is not surprising that GDP developments in Ukraine have followed those of Russia with a 6-9 months time lag. Russia’s economy started to grow at very high rate in the second half of 1999 and 2000 partly as result of real ruble depreciation (similarly to Ukraine) but mainly due to high international prices of oil, gas and metal products. This external-demand factor certainly influenced the growth rate of the Ukrainian economy in the second half of 2000 and in 2001. Paradoxically, Ukraine being one of the biggest oil and gas importers indirectly benefits from increase of oil and gas prices. This is possible due to two important circumstances. First, effective prices of

⁶⁸ Depreciation of the Russian ruble was deeper than that of Ukrainian *hryvnia*.

energy resources imported by Ukraine from Russia and Turkmenistan depend very little on the international prices. Second, significant part of the Ukrainian industry is depended on Russian market and Russian demand for many Ukrainian producer goods is closely dependent on the dynamics of oil, gas, and metallurgy sectors in Russia.

6. In fact, Ukraine's dependence on Russian market (and, to lesser extent, on other CIS markets) is deeper than it can be illustrated by the official foreign trade statistics. Many goods exported to Russia/CIS are unsaleable on other markets due to their quality parameters, close cooperation (intra-industry) links between Ukrainian and Russian enterprises, and protectionist barriers against the Ukrainian export (for example, in relation to metallurgy products) in the Western markets. In addition, part of the export directed to Western markets has been subsidized by the means of the so-called 'experiment' (in the metallurgical sector) what must be considered as unsustainable under any future scenario.
7. Everything what was said so far does not mean that Ukraine's growth story of 2000-2001 can be explained mostly by the 'windfall' factors, external demand boom, natural 'take-off' after the prolonged output decline and simple 'luck' factor. Undoubtedly, economic reforms carried out in the previous decade although slow and sometimes inconsequent, finally started to bring their fruits. However, in order to have a clear picture of their influence, durability and future sustainability we will divide them into three groups.
8. The first group relates to the factors having one-off influence (sometimes important) on economic growth through a limited period of time only. Later on, this source can be simple exhausted. The best example is the observed process of moving part of an economic activity from the unregistered to official sector. In the analyzed period it affected mainly small enterprises (enjoying positive effects of a simplified taxation). In addition, the rest of the economy benefited in similar way from limiting barter and netting-out operations, particularly in relation with budget and energy suppliers. This also helped to bring a part of economic activity remaining earlier in the 'gray zone' to the 'surface'. These kinds of changes do not necessarily mean an increase in the entire (i.e. registered and unregistered) economic activity, at least as the first-round effect. However, moving from unregistered to registered sector and limiting non-monetary forms of transactions can help in improving fiscal and payment discipline, budget-revenue collection, economy re-monetization and de-dollarization, and create more room for further economic expansion.
9. Obviously, we do not want to claim that all reserves in the field of deregulation, elimination of obvious pathologies, etc. have been already exploited and that we cannot think about more informal activity moving to the official sector. However,

- every subsequent step going in this direction will need a more effort and will probably bring smaller marginal results and with a longer time-lag.
10. The second group concerns policy steps having a disciplining and deregulating character, which could be, however, easily reversed. Most of them have been already mentioned in the previous paragraph and relates to enhancing the tax and payments discipline, non-tolerating arrears, barter and other kinds of non-monetary or quasi-monetary transactions, imposing 'hard budget constraints'. By its nature, they need a continuous political will and effort to be enforced. This kind of political determination became stronger and publicly visible under Yushchenko's government and gave quite impressive results. After the change of government and the beginning of the election campaign in 2001 the disciplining course of economic policy came to a halt (energy sector) and even was partly reversed (in the sphere of fiscal policy).
11. The other area relates to price control. Relaxing this control in relation to agriculture products in 2000 gave a positive impact on grain production in 2001. However, there is a permanent political temptation to resort to this instrument, particularly before subsequent election campaigns.
12. The third group includes more durable changes, mainly of systemic and institutional character, which should bring positive effects in longer-term perspective. Privatization process, regardless all controversies around its speed, transparency and quality, seems to be the most important example here. The same can be said about the development of the financial sector, legislative changes concerning budget procedures, inter-governmental fiscal relations, and hopefully agriculture-land market. Nevertheless, the list of achievements in this sphere is not impressive enough and a large remaining agenda waits for government and parliamentary decisions.

The above general diagnosis makes a bit easier formulating hypotheses about the future growth prospect of the economy of Ukraine and factors conditioning this growth. What concerns the short-term perspective, i.e. end of 2002 and 2003 the growth momentum gained in years 2000-2001 will be probably continued although at much slower pace (what is already clear, looking at the growth performance from the last quarter of 2001). The 'windfall' and 'luck' factors are already gone, external demand weakened (apart from Russia), one-off systemic factors mostly exploited (at this stage), and other reforms need in sustaining and new political impulse after a stagnation in 2001 and 2002. If such an impulse does not come quickly, the growth trajectory will continuously decelerate and may come to zero or even negative rate already in years 2004-2005.

The analysis carried out in this study as well as a comparison with more advanced transition economies (those of Central Europe and the Baltic region) allow for finding the following policy area, which are absolutely critical for Ukraine's growth prospects in medium and long-term perspective:

1. In spite of some progress in deregulation in 1999-2000 the Ukrainian economy is still overburdened with bureaucratic barriers, which result in widespread administrative harassment, oligarchic rent-seeking and corruption practices. All these impediments are especially painful for SME sector and its part wanting to grow into bigger firms. The SME share in the officially registered employment and value added is still much below the level of Central Europe and Baltic countries.
2. Apart from overregulation the second critical area is the absence of the adequate legal and institutional base effectively protecting property rights, including minority shareholder rights, creditor rights, contract enforcement, etc. This relates both to shortcoming of material law and even more – to law enforcement. Progress in this sphere is absolutely critical for bringing more FDI to Ukraine, stopping the capital flight, and further development of financial sector and financial markets in Ukraine.
3. Privatization process must be revitalized, particularly in relation to big enterprises of heavy industry and technical infrastructure. Privatization must be much more open and transparent than before and maximally friendly in relation to foreign investors. In many transition economies it was privatization, which triggered the inflow of FDI. Where necessary privatization must be supported by the required regulation/ deregulation measures (particularly important in the energy and infrastructure sectors).
4. Government must finally and definitely give up its paternalistic policy and paternalistic practices resulting in direct and indirect subsidization of selected enterprises, tax exemptions and privileges, writing-off tax liabilities, tolerating non-payments and barter transactions, etc. Although some important progress in this sphere has been achieved, mainly in the year 2000, it cannot be considered as being complete and, what is even more important – as sustainable.
5. In spite of a high trade-to-GDP ratio Ukraine cannot be considered as really open economy, well integrated with the European and global markets. Moreover, the export profile does not guarantee high competitiveness and makes Ukraine heavily exposed to external shocks. From this point of view, accelerating Ukraine's accession to the WTO seems to be the highest priority task.
6. Looking at the situation of individual sectors, three of them need a special attention. First, energy sector remains the source of biggest pathologies and inefficiencies. The reform policy started in 2000 addressed only part of the existing problems (payment discipline) and its results cannot be considered as fully satisfactory and sustainable.

Second, progress in privatizing, restructuring and reforming agriculture is very limited yet. The relatively good performance of this sector in year 2001 does not necessarily reflect a fundamental reform progress in this sphere but rather good weather conditions and some ad-hoc deregulation steps (see Chapter 4). Finally, technically weak and heavily monopolized infrastructure services (transportation but probably also telecommunication) become increasingly the barrier of economic development, foreign trade expansion, creating the single and really competitive domestic market, etc.

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- Striewe – Ludwig Striewe, German Advisory Group on Economic Reform with the Ukrainian Government, Kyiv/Department of Agricultural Economics, Göttingen University.
- Feofilov – Dr. Sergey L. Feofilov, Director of UkrAgroConsult, independent private consulting company, Kyiv.
- Szyrmer – Dr. Janusz M. Szyrmer, executive director of Case Ukraine, Kyiv.

Appendix: Tables and Figures

Figure 3.13. Comparative analysis of some performance and behavior's indicators of the SOE and non-state sectors in the years of 1998-2000 (relative values of the non-weighted averages)

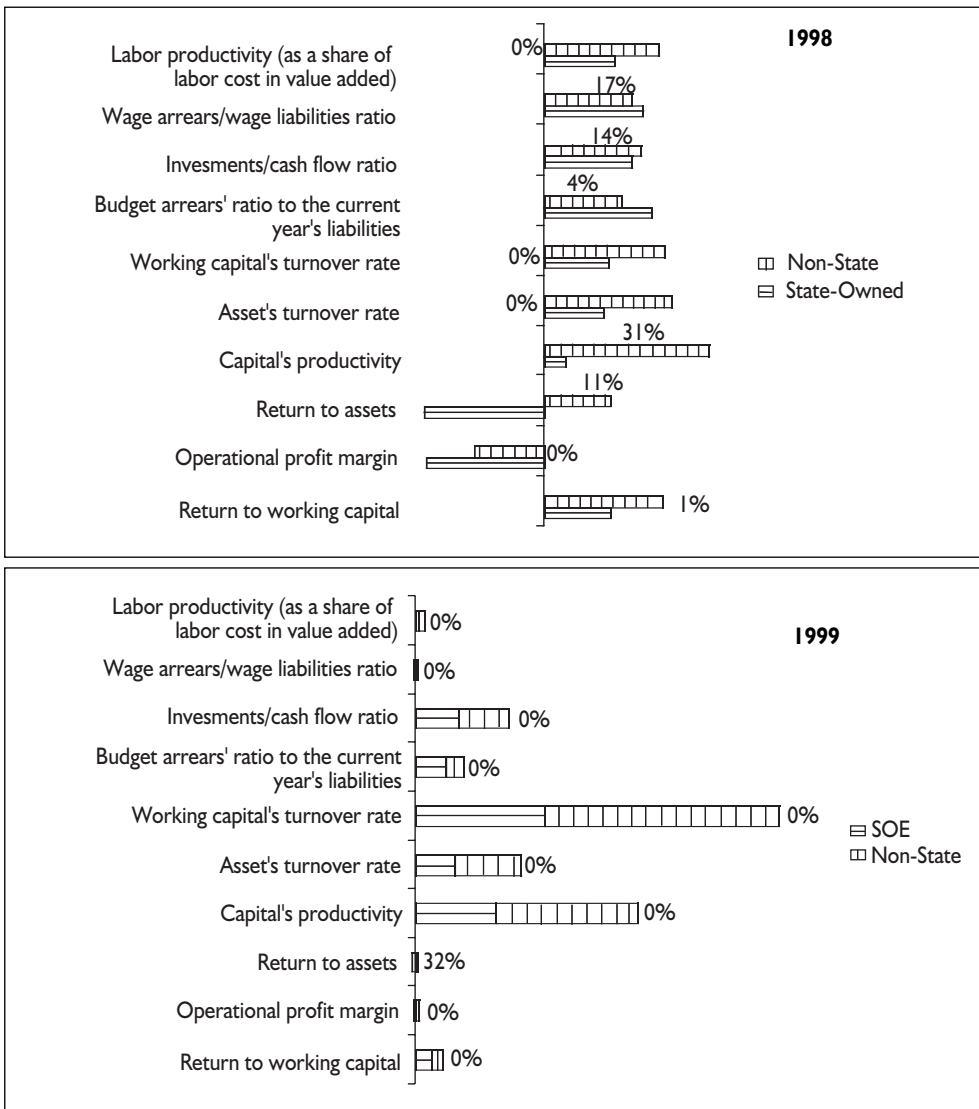
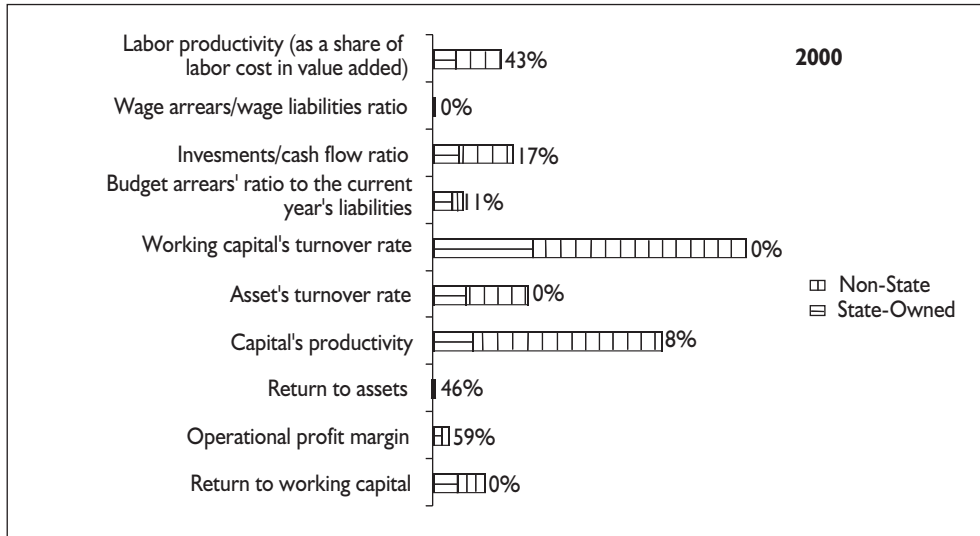


Figure 3.13. (cont'd) Comparative analysis of some performance and behavior's indicators of the SOE and non-State sectors in the years of 1998-2000 (relative values of the non-weighted averages)



Source: Dubrovskiy et al., 2001b. See the original paper for the detailed description of indicators and the data used.

Table 3.3. Increase in the budget arrears in the year 2000 as a function of the depth of privatization of industries, cross-section correlations

		Increase in arrears					
		State budget - receivables		State budget - payables		Off-budget funds - payables	
		total	outstanding	total	outstanding	total	outstanding
The share of privatized firms in the total assets	P-value	38.8%	12.6%	0.1%	0.0%	65.6%	35.7%
	Correlation rate	28.9%	49.0%	-83.3%	-94.7%	-15.2%	-30.8%
The share of privatized firms in the fixed assets	P-value	56.2%	32.8%	7.1%	0.5%	14.0%	4.6%
	Correlation rate	19.7%	32.6%	-56.4%	-77.2%	-47.5%	-61.0%
The share of privatized firms in the total sales	P-value	25.2%	8.9%	0.5%	0.0%	31.4%	9.2%
	Correlation rate	37.8%	53.6%	-77.8%	-90.4%	-33.5%	-53.3%
The share of privatized firms in the total costs of the sold output	P-value	32.5%	10.6%	0.9%	0.0%	35.6%	9.0%
	Correlation rate	32.8%	51.4%	-73.9%	-88.9%	-30.8%	-53.4%
The share of privatized firms in the liquid assets	P-value	14.3%	6.9%	0.3%	0.0%	32.6%	10.8%
	Correlation rate	47.2%	56.6%	-79.7%	-88.6%	-32.7%	-51.2%
The share of privatized firms in the wages	P-value	24.9%	8.6%	2.9%	0.1%	33.0%	4.0%
	Correlation rate	38.0%	54.0%	-65.3%	-85.6%	-32.5%	-62.3%

Source: Shygayeva and Golovanenko, at Dubrovskiy et al., 2001a.

Table 3.4. Increase in the non-budget arrears in 2000 as a function of the depth of privatization of industries, cross-section correlations

		Increase in arrears							
		Receivables (output)		Receivables (subsidiaries)		Payables (output)		Payables (subsidiaries)	
		total	outstanding	total	outstanding	total	outstanding	total	outstanding
The share of privatized firms in the total assets	P-value	5.5%	4.4%	3.8%	9.1%	1.3%	8.8%	2.3%	4.7%
	Correlation rate	-59.1%	-61.4%	-63.0%	-53.4%	-71.6%	-53.7%	-67.3%	-60.9%
The share of privatized firms in the fixed assets	P-value	10.3%	7.3%	9.0%	18.3%	8.5%	24.2%	4.0%	7.5%
	Correlation rate	-51.8%	-56.1%	-53.4%	-43.4%	-54.2%	-38.5%	-62.5%	-55.8%
The share of privatized firms in the total sales	P-value	5.6%	4.6%	6.5%	13.2%	2.5%	13.4%	2.7%	5.5%
	Correlation rate	-59.0%	-61.0%	-57.3%	-48.3%	-66.5%	-48.1%	-66.1%	-59.2%
The share of privatized firms in the total costs of the sold output	P-value	7.4%	5.9%	8.6%	17.2%	3.4%	16.7%	4.0%	7.8%
	Correlation rate	-55.9%	-58.4%	-54.0%	-44.3%	-64.0%	-44.8%	-62.5%	-55.2%
The share of privatized firms in the liquid assets	P-value	6.8%	6.7%	7.2%	13.2%	4.2%	16.7%	3.0%	5.5%
	Correlation rate	-56.9%	-57.0%	-56.1%	-48.4%	-62.0%	-44.8%	-65.0%	-59.2%
The share of privatized firms in the wages	P-value	20.7%	17.4%	24.0%	40.7%	7.5%	32.0%	12.5%	20.8%
	Correlation rate	-41.3%	-44.2%	-38.7%	-27.9%	-55.7%	-33.1%	-49.1%	-41.2%

Source: Shygayeva and Golovanenko, at Dubrovskiy et al., 2001a.

Table 4.6. Agricultural production, products and branches, 1992-1997*, 1990=100

Year	Cereals	Potato	Vegetables	Fruits	Sugar Beets	Sunflower	Beef and Veal	Cow Milk	Pig Meat	Poultry Meat	Eggs
1992	74.5	121.2	74.5	95.8	65.0	82.7	83.4	78.7	74.9	70.3	82.3
1993	89.5	125.6	83.4	119.4	76.2	80.7	69.5	75.5	64.3	51.1	71.8
1994	69.0	96.2	71.4	53.3	63.6	61.0	71.9	74.4	58.1	32.3	61.7
1995	67.8	88.0	84.4	81.1	67.0	111.2	59.7	70.8	51.2	33.2	57.7
1996	49.2	110.0	72.8	83.5	52.0	82.6	52.8	64.7	50.1	30.7	53.8
1997	72.0	99.8	73.0	107.3	39.9	89.8	46.8	56.2	45.1	26.3	50.6

* For 1998-2001 see Table 4.4.

Sources: Estimations of author based on AU 2000 and Faostat (updated April 19, 2002).

Table 4.7. Cereals*

Year	Sown Area	Area Harvested	Yield	Harvest	Exports	Imports	Change in Stocks	Profitability**
	1000 ha		hg/ha	1000 MT				%
1	2	3	4	5	6	7	8	9
1990	13 159	13 138	35.1	47 743				275.1
1991	13 295	13 200	23.5	36 709				166.2
1992	12 632	12 540	28.3	35 551	1 106	2 896		346.0
1993	13 066	12 987	32.9	42 725	164	2 279		361.1
1994	12 325	12 053	27.3	32 960	2 076	768		214.1
1995	13 032	12 878	25.1	32 360	2 263	591	- 757	85.6
1996	12 523	11 676	20.1	23 486	3 345	119	- 6 249	64.6
1997	14 319	13 813	24.9	34 396	1 684	74	+ 5 597	37.5
1998	12 963	12 198	21.1	25 689	4 074	77	- 4 530	1.9
1999	12 835	11 960	20.0	23 952	6 299	93	- 4 682	12.0
2000	13 238	12 212	19.5	23 780	1 287	1 021	+ 1 329	64.8
2001	15 200	14 230	27.3	38 837	5 000			

* Without pulses.

** Including pulses; enterprises only.

Sources: StY 1994 pp. 208-213 for 1990-94 (2, 3, 5); Faostat (updated Apr. 19, 2002), AU 2000 p. 50-51 and Pidsumki... (4) and for 1995-2001 (2, 3, 5); Faostat (updated May 31, 2002) (6, 7); UDN Jan. 21, 2002 for 2001 (6); AU 2000 p. 93 (8); AU 2000 p. 39 and UKS As (9).

Table 4.8. Potatoes and vegetables

Year	Potatoes				Vegetables*			
	Area Harvested.	Yield	Harvest	Profitability**	Area Harvested	Yield	Harvest	Profitability**
	1000 ha	hg/ha	Millions MT	%	1000 ha	hg/ha	1000 MT	%
1	2	3	4	5	6	7	8	9
1990	1 433	117	16.7	+ 27.2	559	133	7 458	+ 27.6
1991	1 533	95	14.5	+ 150.4				+ 60.3
1992	1 705	119	20.3	+ 233.8	523	106	5 556	+ 72.8
1993	1 534	137	21.0	+ 68.6	539	118	6 369	+ 39.4
1994	1 527	105	16.1	+ 112.1	497	107	5 324	+ 106.8
1995	1 531	96	14.7	+ 34.3	578	110	6 377	+ 12.8
1996	1 549	119	18.4	+ 6.4	530	102	5 432	- 26.5
1997	1 577	106	16.7	- 24.1	526	104	5 448	- 37.4
1998	1 513	102	15.4	- 18.6	503	114	5 756	- 25.2
1999	1 551	82	12.7	- 12.5	569	102	5 801	- 12.8
2000	1 631	121	19.8	+ 14.0	527	118	6 194	- 1.7
2001	1 604	108	17.3		563	111	6 246	

* Melons included.

** Enterprises only, open ground.

Sources: Faostat (updated April 19, 2002), AU 2000 p. 49, 60 and Pidsumki... (2,3, 4, 6,7,8) ; AU 2000 p. 39 and UKS As (5,9).

Table 4.9. Sugar beets

Year	Area Harvested	Yield	Harvest	Sugar*			Enterprises	
				Output**	Exports	Imports	Harvests	Profitability
				1000 ha	hg/ha	Mill. MT	1000 MT	
1	2	3	4	5	6	7	8	9
1990	1 605	276	44.3	5 388			100.0	+ 29.5
1991	1 550	234	36.2					+ 59.9
1992	1 485	194	28.8		345	362		+ 142.9
1993	1 519	222	33.7		993	368		+ 143.5
1994	1 467	192	28.1		1 200	8		+ 66.0
1995	1 449	205	29.7	3 500	2 119	332	97.4	+ 31.2
1996	1 260	183	23.0	2 702	1 548	607	95.5	+ 3.8
1997	1 005	176	17.7	2 034	760	5	95.6	- 10.4
1998	893	174	15.5	1 876	117	139	93.3	- 12.0
1999	900	156	14.1	1 640	109	320	90.0	- 14.8
2000	747	177	13.2	1 552	14	324	87.8	+ 6.1
2001	853	182	15.5	1 657			79.7	

* Total, raw equiv.

** From sugar beets only.

Sources: Faostat (updated April 19, 2002), AU 2000 p. 49, 60 and UKS AOI (2, 3, 4); StY 2000 p. 127, for 2001 UKS As (5); Faostat (updated May 31, 2002) (6, 7); estimations of author on the basis of AU 2000 p. 61, for 2001 UKS As (8); AU 2000 p. 39 and UKS As (9).

Table 4.10. Sunflower seed

Year	Area Harv.	Yield	Harvest	Exports	Imports	Enterprises	Profitability
	1000 ha	hg/ha	1000 MT			%	%
1	2	3	4	5	6	7	8
1990	1 626	15.8	2 571			97.6	+ 236.5
1991	1 588	14.5	2 309				+ 307.6
1992	1 630	13.0	2 127	61	80		+ 541.6
1993	1 629	12.7	2 075	81	100		+ 505.6
1994	1 725	9.1	1 569	325	8		+ 224.1
1995	2 008	14.2	2 860	85	8	95.6	+ 170.9
1996	2 026	10.5	2 123	866	9	95.1	+ 53.0
1997	2 002	11.5	2 308	1074	2	94.9	+ 19.4
1998	2 431	9.3	2 266	908	2	94.9	+ 22.0
1999	2 800	10.0	2 794	433	1	94.2	+ 54.5
2000	2 842	12.2	3 457	834	1	87.5	+ 52.2
2001	2 393	9.4	2 246			81.9	

Sources: Faostat (updated April 19, 2002), AU 2000 p. 49, 60 and Pidsumki... (2, 3, 4); Faostat (updated May 31, 2002) (5, 6); estimations of author on the basis of AU 2000 p. 61 and, for 2001, UKS As (7); UKS As and AU 2000 p. 39 (8).

Table 4.11. Herds and meat*

Year	Meat Total	Cattle total	Beef and Veal		Pigs	Pork meat		Poultry	Poultry meat	
	Output 1000 MT	Stocks 1000 heads	Output 1000 MT	Profitability** %	Stocks 1000 heads	Output 1000 MT	Profitability** %	Stocks Mill. heads	Output 1000 MT	Profitability** %
1	2	3	4	5	6	7	8	9	10	11
1990	4 358	24 623	1 986	+ 20.6	19 427	1 576	+ 20.7		708	+ 17.0
1991	4 029	23 728	1 878	+ 43.9	17 839	1 421	+ 36.0		654	+ 2.6
1992	3 399	22 457	1 656	+ 131.2	16 175	1 180	+ 95.4	234	498	+ 32.0
1993	2 814	21 607	1 379	+ 88.0	15 298	1 013	+ 67.0	206	362	+ 13.4
1994	2 676	19 624	1 427	+ 29.8	13 946	916	+ 31.0	182	264	- 2.3
1995	2 294	17 557	1 186	- 19.8	13 144	807	- 16.7	157	235	- 18.4
1996	2 113	15 313	1 048	- 43.1	11 236	789	- 42.1	143	218	- 32.8
1997	1 875	12 759	930	- 61.5	9 479	710	- 57.4	145	186	- 44.9
1998	1 706	11 722	793	- 59.3	10 083	668	- 47.4	138	200	- 43.4
1999	1 696	10 627	791	- 57.9	10 073	656	- 51.0	129	204	- 45.5
2000	1 667	9 424	754	- 42.3	7 652	676	- 44.3	144	193	- 33.2
2001	1 571	9 433	735		8 317	609		129	189	

* In slaughter weight.

** Enterprises only.

Sources: StY 1994 p. 230 for 1990-91 and Faostat (updated April 19, 2002) for 1992-2001 (2, 4, 7, 10); AU 2000 p. 68 for 1990-2000 and UKS AOI for 2001 (3, 6); UKS As and AU 2000 p. 39 (5, 8, 11); Faostat (updated April 19, 2002) (9).

Table 4.12. Milk

Year	Cows**	Cow Milk			Enterprises		
		Output	Consumption *	Exports*	Profitability	Cows**	Milk
	1000 heads	1000 MT			%		
1	2	3	4	5	6	7	8
1990	8 378	24 300	19 363		+ 20.6	73.9	76.0
1991	8 263	22 200	17 966		+ 21.7	74.9	
1992	8 057	18 955	14 835	253	+ 39.6	74.3	
1993	8 078	18 199	13 787	233	+ 42.0	69.6	
1994	7 818	17 935	13 304	653	- 5.2	69.6	
1995	7 531	17 060	12 549	1 002	- 19.8	61.0	54.7
1996	6 972	15 592	11 768	554	- 43.1	58.1	48.4
1997	6 265	13 540	10 669	290	- 61.5	53.4	39.5
1998	5 841	13 532	10 713	270	- 59.3	49.7	38.2
1999	5 431	13 140	10 478	278	- 57.9	45.6	35.3
2000	4 958	12 436	9 789	671	- 42.3	37.3	29.0
2001	4 918	13 207				34.1	27.0

* Milk and milk products, milk equiv.

** Stocks on December 31.

Sources: AU 2000 p. 68 (2); estimations of author and Faostat (updated Apr. 19, 2002) (3); UKS As and AU 2000 p.92 (4), Faostat, updated May 31, 2002 (5); AU 2000 p. 39 (6); estimations of author on the basis of StY 1994 p.229, AU 1994, AU 2000 and UKS As (7,8).

Table 6.3. Consolidated budget revenues, 2000-2001

Consolidated budget revenues in 2000 and 2001	2000				2001				Revenues dynamics 2001/2000
	Budget Law UAH mln	Execution		Execution Rate	Budget Law UAH mln	Execution		Execution Rate	
		UAH mln	% of GDP			UAH mln	% of GDP		
Tax revenues	29190.7	31317.5	18.1	107.3	35665.1	36585.4	17.6	102.6	116.8
Personal Income Tax	4942.0	6377.7	3.7	129.1	6930.0	8746.1	4.2	126.2	137.1
Profit tax	7109.7	7698.4	4.5	108.3	8487.8	8238.0	4.0	97.1	107.0
VAT	10065.8	9441.4	5.5	93.8	11628.7	10329.5	5.0	88.8	109.4
Excise tax	2070.6	2239.7	1.3	108.2	2855.4	2652.4	1.3	92.9	118.4
Other taxes	5002.7	5560.2	3.2	111.1	5763.2	6619.4	3.2	114.9	119.0
Non-tax revenues	9708.1	12652.5	7.3	130.3	16483.8	14881.1	7.2	90.3	117.6
Receipts from privatization	2643.3	2291.1	1.3	86.7	5970.4	2559.8	1.2	42.9	111.7
Stamp tax	262.1	268.9	0.2	102.6	290.0	237.8	0.1	82.0	88.4
Rent for Oil & Gas & Am. Trans.	1247.9	518.9	0.3	41.6	2714.1	2240.4	1.1	82.5	431.8
Other non-tax revenues	5554.8	9573.7	5.5	172.3	7509.3	9843.2	4.7	131.1	102.8
Capital revenues	23.0	68.7	0.0	298.8	290.6	453.8	0.2	156.2	660.3
State special-purpose Funds	3401.4	5079.2	2.9	149.3	422.4	1063.0	0.5	251.7	20.9
Total Revenues	42323.2	49117.9	28.4	116.1	52913.6	53204.6	25.6	100.5	108.3

Source: Ministry of Finance of Ukraine.