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WORLD ECONOMIC FORUM
COMMITTED TO IMPROVING THE STATE OF THE WORLD

Extraordinary Ukraine Roundtable

Kyiv, Ukraine 2005

The Opening of Ukraine

President Viktor Yushchenko of Ukraine

Ukraine's Orange Revolution in the winter of 2004 captured the attention of the whole world. With the benefit of this broad sympathy and support, the hard question remains: can this transition economy continue rapid economic progress as the new democratic government struggles to cope with an inheritance of widespread corruption and bribery, a poor regulatory environment and the lack of an independent legal system.

Nearly 250 business and political leaders met at the World Economic Forum's Extraordinary Roundtable in Kyiv under the theme "The Opening of Ukraine" to assess the achievements and the weaknesses of the new government after its first six months.

The participants proposed a ten step action plan to President Viktor Yushchenko that emphasized the need for concrete and immediate action to seize what was described as a moment of opportunity and to make stronger efforts to accelerate reform and improve investor confidence (see page 3).

While acknowledging the remarkable reforms that have already begun, participants stressed several broad policy steps that still need to be implemented quickly by a coherent government programme if the business environment in Ukraine is to improve. Principal insights that emerged from the Roundtable include:

Geopolitics and international issues

- The substantial size of Ukraine, both in terms of geography and population, makes it larger than all its neighbours except Russia. Coupled with its location, these factors make it a potential regional superpower, and its avowed support for the EU and NATO could potentially assist Europe's safety and solidity.

- There are many existing and prospective disagreements across the region as well as diverse pressures which could make the EU's eastern borders vulnerable. The amount of international assistance that will be required to help Ukraine influence these factors favourably should not be underrated.

- The EU's desire to increase the amount of energy supplied from Russia via the Ukraine will need careful negotiation given that Russia, along with Belarus and Transdniestra, is apprehensive about encouraging any measures that would increase the regional importance of Ukraine.

- While President Yushchenko is clearly in favour of considerable further reform, there are powerful groups which are attempting to preserve their benefits from the old system of government and who must be prevented from continually delaying restructuring measures.

Economics and finance

- More than half of Ukraine's GDP is still accounted for by a shadow economy despite important increases in tax receipts, a firm currency and diminished corruption. A healthy banking system is required to encourage investment and savings and to boost per capita consumer lending which is currently only 7% that of the EU.

- The undeveloped nature of Ukraine's financial structure makes it difficult for businesses to obtain capital. International accounting standards are required, and the lack of clearing and settlement services in Ukraine's stock exchanges must be rectified as daily trading volumes are less than 3% of those in Hungary.

- International banks should be able to operate in Ukraine more easily in the future as a result of new laws. The insurance market must be controlled and tightened to prevent further misuse for tax fraud and money laundering. Ukraine would also benefit from the introduction of private pension plans.

Business environment

- The large population and an undeveloped, inefficient economy results in Ukraine having more cheap labour available than any other country in Europe; yet it also has an impressive level of higher education and a skilled labour force.

- The Ukrainian government and the parliament rely on diverse sources of support with differing interests, including those who are resisting the necessary restructuring measures that will remove their former privileges. Unless a pro-reform majority can be achieved in the March 2006 parliamentary elections, foreign investment is unlikely to increase appreciably.

- Foreign direct investment in Ukraine remains among the lowest in Eastern Europe. The new government's disappointment that it has not increased must be contrasted with the displeasure of existing investors caused by the sudden removal of special economic zones and lengthy delays in the reimbursement of VAT.

"Business, including foreign business, from now on will operate in accordance with the new rules of transparency and stability, no longer burdened with excessive regulations."

Viktor Yushchenko,
President of Ukraine

- Ukrainian industries still rely on aged technology, and productivity could be considerably enhanced by new technology, especially in IT. The use of personal computers, the Internet and advanced telecommunications are still at a very early stage and their increased use needs to be actively driven by the government.

Ten action steps proposed to President Yushchenko by the participants of the Extraordinary Ukraine Roundtable

The participants in the World Economic Forum's Extraordinary Ukraine Roundtable proposed ten steps to be taken urgently to continue the momentum of Ukraine's Orange Revolution and to improve investor confidence.

1. Enact all legal changes needed for **WTO entry** before the parliament's summer break. Postpone summer vacation of the parliament if necessary.

2. Create a **unit** of specialists to support **foreign investors**. Its task would be to identify business opportunities, to connect investors with officials and business leaders and to help them with administrative procedures. This unit should be located in the offices of the prime minister or the president.

3. Implement a **one-stop procedure** for starting new businesses. This step will lower the entry barrier for foreign investors and facilitate the process for dynamic domestic entrepreneurs.

4. Eliminate excessive and overlapping regulation in order to create a **lean and viable legal framework** which ensures respect for private property ("Regulatory Guillotine" Law).

5. Repeal the Economic Code and enact the **Commercial Law Reform** Package in order to cut ambiguity about legal outcomes.

6. Enact the **Financial Securities Law** which is essential for shareholder protection.

7. Implement international **accounting standards** (IFRS) in order to create a transparent and open controlling process.

8. Pass necessary **tax reforms** which will increase Ukraine's competitiveness and generate, in the long run, higher tax revenues.
   - Social taxes should be reduced to drive domestic demand.
   - Business profit taxes should be lowered to ensure international competitiveness.
   - The VAT system should be reviewed, especially concerning refunds for exporters.
   - There should be a fair compensation for losses incurred by the abolition of the Free Economic Zones, particularly for investors who have acted in good faith.
   - Customs tariffs should not be detrimental to business development.

9. Efforts must be made to enhance management and **business skills** and to encourage the transfer of knowledge and technologies from abroad.

10. The fight against **corruption** should be targeted actively by:
    - Blacklisting companies which have been caught in bribery;
    - Basing future appointments to the civil service and judiciary on merit and not politics;
    - Raising salaries of civil servants to reduce incentives of corruption;
    - Moving to a new system of public procurement such as an efficient online system, which publicly manages the bidding process; and
    - Disclosing salaries and business affiliations of senior members of government, judges and legislators.

Identifying Ukraine's regional and international challenges

Big picture

- Ukraine occupies a geostrategic position at the heart of Europe. With vast outlets to the Black Sea, the country is a key area for trade with Western Europe, Russia and all the countries on the shores of the Caspian Sea, in particular in the field of energy transport. Following the introduction of travel visas to Poland, Hungary and Romania in 2003, Croatia, Montenegro, Cyprus and Turkey are the only European countries where Ukrainians can travel essentially visa free.

- President Viktor Yushchenko says Ukraine's "Euro-Atlantic Choice" is a choice of civilization. Ukraine is perceived as the regional superpower playing a central role in guaranteeing Europe's stability and security. The EU and the US have signalled strong support, promising to assist Ukraine in dealing with regional instability as the new government attempts to simultaneously improve governance, reduce poverty and raise living standards at home.

- Tensions resulting from last year's controversial presidential election have not improved ties with Russia, Ukraine's biggest trading partner. The contest also revealed the rift between the east and west of Ukraine, as well as between Ukraine and the former Soviet republics on its borders.

- Yushchenko's joint plan with Moldovan President Vladimir Voronin to settle a 12-year conflict in Transdniestria has not been accepted by the breakaway republic's leaders or Russia. Belarus has shown no inclination to ratify the Ukraine-Belarus border treaty, and there has been no progress in talks between Ukraine and Romania to agree on maritime borders, or with Russia to settle last year's dispute over water transportation routes separating the Sea of Azov and the Black Sea.

- Ukraine's new government appears keen to exploit other economic opportunities, together with EU member states, to transit energy supplies to Europe. Yushchenko has invited Turkmenistan, Kazakhstan, Azerbaijan and Georgia to participate in plans to upgrade, modernize and manage Ukraine's existing natural gas and oil transportation infrastructure and build new pipelines. The European Bank for Reconstruction and Development estimated the market value of Ukraine's gas transportation system at around US$ 26 billion in 2002 including US$ 3 billion worth of underground facilities.

Context

Ukraine has declared that it is fully supportive of the EU's current European Security and Defence Policy and has been actively seeking to promote stronger trade and diplomatic ties with European and US leaders, emphasizing the country's commitment to democracy and market reforms. Ukraine's neighbours belonging to the EU, especially Poland and Slovakia, have enthusiastically supported Ukraine's Euro-Atlantic integration objectives.

Ukraine's foreign policy priorities in 2005 include joining the World Trade Organization and obtaining free market economy status from the EU and the US. It remains doubtful, however, whether the new government and legislature can modernize trade practices and adopt legislation quickly enough to achieve these goals. Lawmakers in parliament remain loyal to

Ukrainian financial industrial groups, which maintain close trading ties with the Russian state and commercial enterprises. New parliamentary elections are scheduled for March 2006.

The EU has conditioned granting free market status to Ukraine on fulfilment of a three-year action plan aimed at bringing the country's corporate governance and trade practices in line with EU standards. The EU Commission rules out starting talks with Ukraine on associate member status until 2008 and refuses to make specific reference to the country's membership hopes before then. The action plan, signed in February 2005, was a compromise between Ukraine's expectations of the EU and what the EU felt it was able to offer for the moment.

Ukraine is seeking to join the World Trade Organization ahead of Russia, changing the previous strategy of synchronizing accession with Russia, Belarus and Kazakhstan, co-founders of the Common Economic Space (CES), a loose economic alliance established in 2002 to boost free trade between the former Soviet states. While still involved in some of the activities of the Commonwealth of Independent States (CIS), Ukraine has not signed the organization's charter or made any collective security arrangements.

Strategic insights

- Strong domestic and international support will remain indispensable for Ukraine's new leaders to achieve their stated Euro-Atlantic integration goals and deal with manifold threats to the EU's eastern neighbourhood, including political conflicts, economic crises, cross-border crime and illegal immigration.

- The region remains a source of real and potential disputes. While military conflict is unlikely, the political and economic complexities of negotiating with Russia to increase energy supplies to EU consumers via Ukraine should not be underestimated.

- Increased trade between Russia, Ukraine and the EU can only develop if agreements are systematically given strong political support, and if the companies involved show a readiness to pool their markets rather than reasoning in terms of technological competition.

- Recent political changes in the region appear unlikely to persuade Russia to reduce its influence in Transdniestra or Belarus, where entrenched leaders appear to resent Ukraine's growing geostrategic and economic importance.

European Commissioner of Economic and Monetary Affairs Joaquín Almunia, President Arnold Rüütel of Estonia, President Mikheil Saakashvili of Georgia, World Economic Forum Executive Chairman Klaus Schwab, President Viktor Yushchenko of Ukraine, President Aleksander Kwasniewski of Poland, President Ilham Aliyev of Azerbaijan, President Vladimir Voronin of Moldova

Assessing the economy, financial system and investment potential

Big picture

- The economic outlook for Ukraine has brightened in the wake of the Orange Revolution which brought democracy and reduced corruption. Tax receipts have risen; the fiscal deficit has been eliminated; and Ukraine's currency, the Hryvnia, remains stable.

- Despite recent positive trends, Ukraine's economy remains undiversified and tied to a few industries such as steel, chemicals and agriculture. Falling global demand could lead to a marked reduction in GDP growth, already forecast to fall to 5% to 7% this year from 12% in 2004. The country's trade surplus is projected to shrink to US$ 1.3 billion this year, down from US$ 3.7 billion last year.

- Ukraine's financial system is seriously underdeveloped, with the entrepreneurs and business people unable to gain ready access to capital. The banking industry remains fragmented and undercapitalized and the country's main PFTS stock exchange is highly illiquid.

- Poor transparency and disclosure and a lack of corporate governance discipline continue to hinder efforts to attract both foreign and domestic investors. Uncertainty about the pace and scope of future economic reforms also helps to foster a wait-and-see attitude held by many investors.

Context

The Orange Revolution which brought democracy to Ukraine and installed Viktor Yushchenko as president is also leading to the creation of a more fair and open free market economy. The main questions are how long this will take and how successful the country will be at competing with other emerging economies for a healthy share of global investment capital.

Ukraine intends to launch new privatizations, such as Ukr-telecom, and will welcome foreign bids. But there is still uncertainty about how many of the previous privatizations will be re-auctioned, causing further investor nervousness. The first will be the Kryvorzihstal steel mill, which was sold for US$ 800 million in 2004 to a consortium despite higher external offers.

"Ukraine is ready to open the door wide to you, and I appeal to all business in Ukraine that we operate in a fair way with no conditionalities."

Yuliya Tymoshenko,
Prime Minister of Ukraine

The effects of mismanagement and corruption by the previous regime were partly masked by booming global demand for Ukraine's two largest industries – steel and chemicals – over recent years. With China and India now increasing their steel production and prices softening, the country urgently needs to diversify the economy and retool its ageing industrial infrastructure to create more value-added products. Metal exports accounted for 40% of all Ukraine's exports in 2004, a sign of the economy's exposure to the welfare of a few industries.

In order to diversify, Ukraine must develop new sources of investment capital. While consolidation of the banking industry is already underway – mergers have reduced the number of domestic commercial banks from 330 to 161 – more work needs to be done. None of the country's stock exchanges provide clearing and settlement services. Most stocks remain highly illiquid and trading is thin. Total market capitalization of Ukraine's stock exchanges is currently around US$ 15 billion, with daily trading volumes ranging from US$ 1 million to US$ 5 million. By contrast Hungary, with around one-fifth of the population of Ukraine, has a total exchange capitalization of US$ 45 billion and daily trading volumes around US$ 200 million.

There are encouraging signs. A raft of recent and pending legislation should tighten disclosure requirements, increase market transparency, enforce international accounting standards and allow foreign banks to operate more freely in Ukraine. A few international investment houses are now running venture capital or private equity funds focused partly or wholly on Ukraine. But investor sentiment has recently grown more cautious following some months of post-Orange Revolution euphoria. The next year will likely be a crucial test of President Yushchenko government's ability to transform the economy and attract foreign investment.

Strategic insights

- The creation of a sound banking system is fundamental to Ukraine's ability to transfer capital from the shadow economy, which still accounts for 55% of GDP, and promote savings and investment. Further capitalization and consolidation of the banking industry are required. Greater disclosure is needed, including the naming of all beneficiary owners.

- Consumer credit remains largely unavailable. Foreign banks should be encouraged and incentivized to enter the consumer lending market, for which there is great demand and growth potential. Consumer loans now account for just 3.5% of Ukrainian GDP, as compared to 15% among the EU's new Central European members and 50% across the EU overall. Mortgages remain expensive in Ukraine and are not available to many.

- To encourage investment in Ukraine's stock exchange, clearing and settlement functions must be introduced, eliminating the need for a separate contract on each transaction. Legislation is required to protect minority shareholders and provide more stringent corporate governance through the introduction of more independent boards. The supply of long-term paper should be increased.

- Demand for both equity and debt instruments can only be driven by the introduction and enforcement of international accounting standards. Investors require access to a single set of universal accounts and a credible regulatory regime. Parliament should immediately draft a joint stock company law.

- The insurance market, once a haven for money laundering and tax evasion, needs to be strengthened and regulated. Private pension schemes should be developed as an alternative to existing state pensions.

- Further judicial reform will be required, leading to the appointment of competent judges conversant in commercial law and accepted codes of business practice and corporate governance.

Ukraine's emerging commercial opportunities

Big picture

James Gallagher, Senior Vice-President, Central and Eastern Europe, Nestlé, Switzerland and Prime Minister Yuliya Tymoshenko of Ukraine

- Ukraine is one of Europe's largest countries, covering 604,000 square kilometres, with a population of 48 million and a high economic growth potential. It is strategically well located close to the biggest markets in Europe and Russia. It has an educated labour force which is currently very low-cost with a per capita income of US$ 1,380 in 2004, which is expected to rise to US$ 1,780 by the end of 2005.

- The share of foreign direct investment in Ukraine since independence in 1991 is one of the lowest in Eastern Europe at US$ 8.8 billion. This compares to up to US$ 10 billion per year in Poland where the population is one-fifth smaller. The Ukrainian government has expressed disappointment that inward investment since the Orange Revolution has been slower than hoped.

- Many foreign investors have identified suitable ventures but have put their money on hold as they are concerned about possible conflicts and the different directions being shown by the government. This included the introduction of petrol price caps by Prime Minister Tymoshenko which were removed shortly afterwards by President Yushchenko.

- Widespread fraud by some companies in making false claims for VAT refunds has made the government reluctant and sluggish to make VAT repayments, causing problems for legitimate businesses. Similarly 24 special economic zones which offered tax breaks and customs privileges to both domestic and foreign investors were abruptly abolished in February 2005. The government argued the zones were being heavily misused by companies operating in the shadow economy to avoid regulations and taxes.

Context

The Ukraine mining and metals industry accounted for 27% of Ukraine's industrial output in 2004. It benefits from having raw materials close to production facilities and can produce at low cost. Recently, increasing world demand and rising prices for steel have allowed the sector to increase output, but increased production by China and India could reduce prices and make aggressive Ukrainian expansion plans look flawed.

Ukraine has one of the highest levels of education in Eastern Europe and has a far more than average number of physicists, chemists, mathematicians, biologists and computer specialists, as well as a high potential for innovation. Massive foreign investment will be required to exploit these assets and to maintain a healthy growth rate of 7% or more per year.

Achievements such as a significant reduction in corruption and important increases in tax collection and customs duties have also been offset by inflated expectations following the Orange Revolution despite the fact that the new government is only six months old.

Strategic insights

- The draw of a highly educated labour force, which will remain relatively cheap, gives the Ukraine enormous potential to diversify from basic materials such as minerals and metals that are dependent on price cycles. Using its engineers and scientists, the country has a latent talent for great technological growth which should include the updating and enlargement of existing technical institutes and plants.

- Ukraine should heavily increase its focus on areas such as value-added consumer products, finished steel goods, aviation and high-tech but this will require a drastic increase in foreign investment. A further driver of new growth should be as a “near shoring” centre for Europe, the practice of moving work to countries that cost less but are not too far away.

- Economic reforms such as a much-needed reduction in bureaucracy, which started to show that the business environment was improving, have been spoilt by justified complaints from existing investors about receiving arbitrary treatment. The honeymoon period is ending and further reform is needed quickly to reassure business that they will face a predictable, stable and fair operating environment in the future.

- It is not necessary for Ukraine to reinvent the wheel. It can duplicate the successful economic restructuring of the Baltics and Eastern Europe and use the experience and know-how of those who have already created solutions elsewhere as the basis for the new and broader legislative reform needed for growth and job creation.

- Most foreign investors do not agree with the insistence of the government that potential economic rewards already outweigh the risks. There is a considerable pent-up supply of money available from overseas but if there are not substantial improvements, including competitive taxation rates, by the time of the parliamentary elections in March 2006 much of it is likely to fade away.

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Understanding the complexity of Ukraine's political landscape

Big picture

- Expectations at the beginning of 2005 that Ukraine's government would become more customer-friendly remain, but there are questions about the capacity of the country's public institutions to bring about the necessary changes.

- While numerous measures to remove barriers to investment have been proclaimed, few have been implemented creating confusion among investors and an impression of incompetence.

- Former elites represented in parliament have resisted changes proposed by the new government to deprive financial industrial groups of privileges granted them previously.

Context

President Yushchenko came to power through the support of several different interest groups including constituencies with conflicting ideologies and agendas. While they did not all propose individual plans, each supported calls during the presidential campaign to fight corruption, eliminate unnecessary regulations, and make government responsive to local and foreign business.

The new government began by replacing 18,000 civil servants and increasing social benefits, with parliament supporting popular proposals to boost tax and customs receipts, and raise pensions and public sector wages. In June 2005, the president and prime minister announced their decision to simplify some government regulations but it remains unclear whether the acts have all been fully implemented. Lawmakers have hesitated in adopting legislation proposed by the government to improve the business climate for foreign investors, postponing dozens of amendments to laws designed to protect minority shareholder rights and improve corporate governance until at least September.

The sudden introduction of price controls to reduce soaring costs for fuel and a sharp rise in inflation has alarmed potential investors. Many were expecting less, not more, state intervention. Enthusiasm has been further dissipated by a month-long review of ownership rights to enterprises auctioned off under the previous administration. The ensuing dispute has led some high-ranking government officials to begin balancing interests within their own ranks in preparation for the parliamentary elections in March 2006.

Strategic insights

- Making government policies predictable, reducing regulatory requirements, protecting minority shareholders' rights, fighting corruption and reforming the nation's judiciary will remain the main barriers to foreign investment in Ukraine during the next several years.

- The ability of the president and the new government to deliver on many of their much-heralded pledges will depend on the creation of a pro-reform parliamentary majority in March.

- Failure to quickly close the gap between expectations will strengthen Yushchenko's opponents before parliamentary elections, thus discouraging investment and making it more difficult to implement reforms.

Improving national competitiveness and technology

Big picture

- Ukraine's new government inherited an economy based on outdated technology and heavy industry including steel, shipbuilding, coal and weaponry. Attempts to diversify have been held up by vested interests and political infighting.

- The competitiveness of Ukraine lags not only behind most of the rest of the world but also behind other emerging economies. It ranked 86th out of a total of 104 countries assessed in the World Economic Forum's Growth Competitiveness Index (GCI) carried out in autumn 2004.

- Substantial waste and an inefficient use of resources occurred with previous governments that were increased by corruption and bribery and which negated some of Ukraine's distinct advantages such as a well-educated and skilled workforce.

- The Ukraine is still missing out on the considerable productivity gains available from the widespread use of information technology and telecommunications (ICT) and has very low penetration rates for personal computers, the Internet and mobile phones.

Context

Ukraine's highest score on the GCI is for innovative potential where it ranks 39th out of 104 countries. This reflects a tertiary education level of over 43% and comparatively high levels of spending on research and development by companies.

This score implies that Ukraine's companies are well placed to develop away from old technology if they can aggressively implement modern technologies from abroad. Again a more favourable business environment that can attract FDI will be vital.

The Ukraine has the fourth largest number of computer programmers in the world, after the US, India and Russia, who are currently underutilized due to a shortage of modern IT equipment and widespread software piracy.

There has been progress. In June 2005, Prime Minister Yuliya Tymoshenko returned from meetings in France with 11 cooperation agreements in aviation, infrastructure and energy.

Strategic insights

- The need to improve competitiveness, particularly in technology, makes FDI's other benefits as important as the financial investment. These include the transfer of skills and technology that can be used to modernize and then often win further business from abroad.

- The government needs to become much more aggressive in promoting the acquisition and use of ICT and should provide incentives that will encourage businesses to update and use these technologies widely.

- In certain sectors Ukraine will find it impossible to match the nearly unlimited supply of cheap labour from competitors like China and India. One answer to this will be "near sourcing", especially in information technology.

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