

Ukraine: Economic Situation and Reforms In 2001

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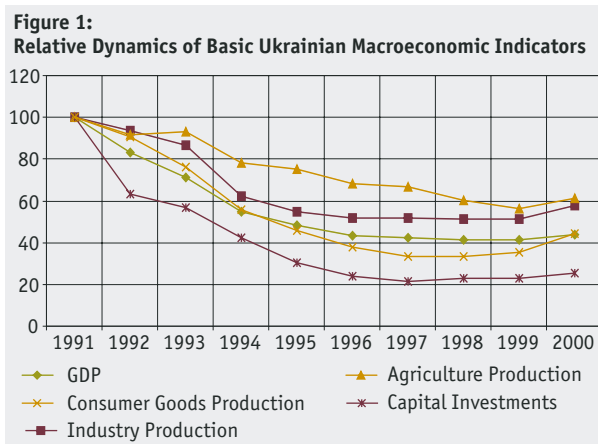
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I. Introduction

When Ukraine declared its independence in August 1991, it became the second largest European country in landmass and the fourth largest in population, with 50 million people. Ukraine's agricultural soil is extensive and rich: it used to be the breadbasket of the former Soviet Union, providing a large portion of all agricultural needs. Ukraine also has good mineral resources (iron ore, coal) and an adequate infrastructure. It has a well-educated and skilled labor force, with a significant engineering and scientific foundation. All this permitted Ukraine to supply much of the heavy industry of the former Soviet Union.

Despite these favorable conditions, Ukraine has had one of the most difficult economic challenges in Eastern Europe, with a long economic recession that lasted nine years. Figure 1 below illustrates the relative dynamics of some basic macroeconomic indicators of the Ukrainian economy since independence.



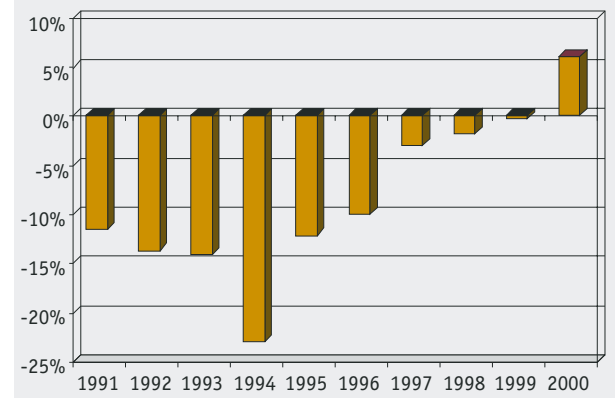
As noted above, over the last nine years, the cumulative decline in the indicators have been the following: GDP — 56%; industrial production — 42%; agricultural production — 39%; Consumer Goods Production — 56%, and Capital Investment — 74%. Nevertheless, the future looks bright with significant growth in industrial output and a rise in living standards during 2000.

The decline in Gross Domestic Product (GDP) that started in 1991 decelerated gradually over the following decade, becoming less negative, and finally becoming positive in 2000, as shown in figure 2.

For the first time since independence, GDP was positive during 2000 with a real rate of growth of 6%. The recovery was led by industrial sectors. It

was widespread, including ferrous and non-ferrous metals, chemicals, petrochemicals, wood and pulp, construction materials, food, and apparel industries.

Figure 2: GDP Growth Rates



The recession in Ukraine from 1991 to 1999 lasted so long, because the country's initial conditions after independence were quite unfavorable, with major structural weaknesses and an economy highly dependent on the other former Soviet Republics. The collapse of the Former Soviet Union cut these production and trade relations. In addition, the country had a large percentage of military industries (25% of all companies produced military goods), which found themselves without markets after the end of the cold war.

Furthermore, due to negligible energy costs during Soviet times, many industrial processes were very energy intensive (in the early 1990's, Ukraine consumed 6 times more oil per unit of GDP than in Western Europe). Energy imports are still important representing 15% of GDP. These high-energy firms became unprofitable when energy costs increased 5-10 times after independence. The cumulative decline in GDP since 1991 has been 60%, but about one-half of this decline was offset by expansion of the Informal Economy. This has helped to contain the decline in living standards.

Although the initial fall in GDP was amplified by unfavorable initial conditions, the slow economy recovery was due principally to a very slow, piecemeal, and uneven implementation of economic reforms. This was due to lack of political consensus and by opposition from some groups in Parliament and vested interests, as explained in the next section.

II. The Early Economic Reform Program

The structural weaknesses of Ukraine during Soviet times meant that major corporate restructuring was needed after independence. Unfortunately, from 1991 to 1995, very little was done; with the government following a "preservation" strategy. That is, it tried to maintain the status quo through the payment of large, direct subsidies.

Relying on government subsidies for their existence, state-owned enterprises had little incentives to restructure themselves and remained largely inefficient. These government subsidies led to large fiscal deficits, monetary financing of these deficits, and hyper-inflation (which peaked in 1993 at 10,160%). During 1992–1993, total fiscal expenditures reached 65% of GDP. The evolution of key economic parameters is shown in figures 3 and 4 below:

Figure 3: Fiscal Deficits/GDP

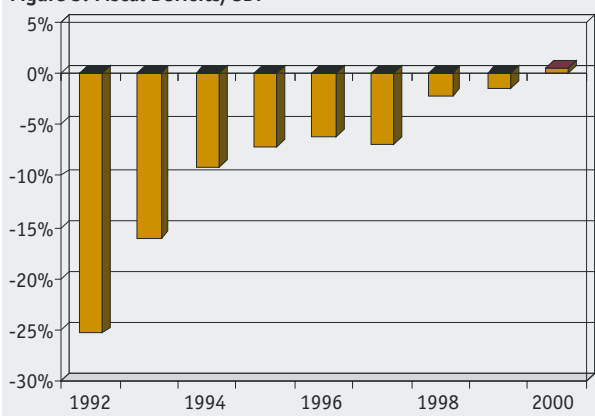
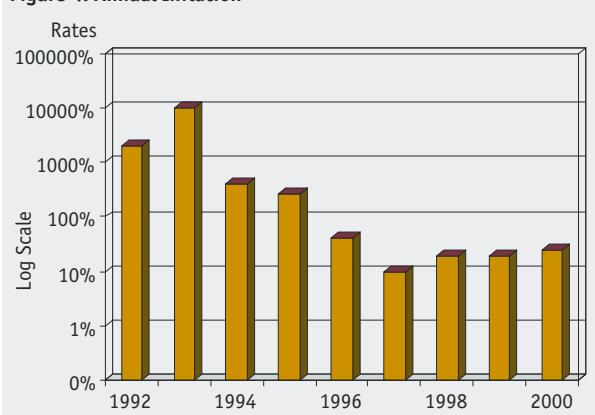


Figure 4: Annual Inflation



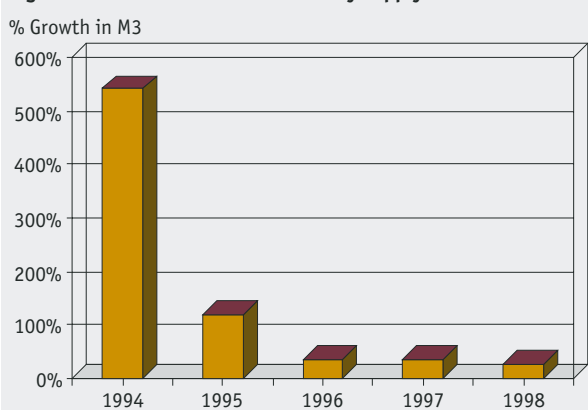
In 1994, Mr. Leonid Kuchma was elected President on the basis of a reform agenda. During 1996–1998, under President Kuchma, significant progress was made in many areas of economic reforms:

- Prices and international trade were liberalized

- Small & mass privatization programs were completed
- The National Bank of Ukraine (NBU) was strengthened and monetary policy was implemented wisely
- A new currency (Hryvna-UAH) was introduced successfully in September 1996, without confiscation
- Inflation was reduced to 10% by mid-1998
- The exchange rate was maintained within a narrow corridor around 1.9 UAH per dollar from 1995 to mid-1998
- The NBU's international reserves increased to \$2.3 billion by the end of 1997
- Ukraine accepted IMF obligations under Article VIII (which requires foreign exchange convertibility for current account payments)
- A new Constitution was approved in 1996, which guaranteed private property and market-based principles for the country's economy

Tight monetary policies of the NBU were responsible for the significant progress made by Ukraine towards financial stabilization from 1995 to mid-1998. In fact, the annual rate of growth for money supply (broad money — M3) declined from 540% in 1994 to 25% in 1998, as shown in figure 5 below. These monetary policies brought annual inflation from 10,160% in 1993 to 10% by 1997 and by 7.5% per annum by mid-1998.

Figure 5: Annual Growth Rate in Money Supply



Stabilization took place despite the fact that up to mid-1998, as noted earlier, the government continued to run large fiscal budget deficits, exceeding

6% of GDP in all years. From 1991 to 1998, fiscal budgets were prepared unrealistically, with over-estimated revenues and excessive expenditures. In addition, the tax base was reduced by innumerable privileges and exemptions. Up to the end of 1997, a large portion of the fiscal budget deficits was financed without recourse to borrowing from the NBU, because of the easy availability of foreign financing. Although foreign financing was key to stabilizing the economy in those years, the level of debt increased rapidly. External debt increased from \$4.4 billion in 1994 to \$11.5 billion in 1998. T-bills increased to UAH 10 billion (\$5.2 billion equivalent) during the same period. The deficit was also financed through the accumulation of wage, pension and budgetary arrears (such as non-payment of utilities by public entities).

In early 1998, the Asia Crisis and delays in implementing fiscal and structural adjustments in Ukraine began to change investor perceptions of Ukraine. Structural reforms did not reach the critical mass needed to revive confidence, investment, and growth on a sustainable basis. For example:

- Competition was limited by high barriers to enterprise entry and exit. In particular, excessive government regulations (such as

licensing & registration requirements) were slow to be simplified

- The government was unable to control its own interference, especially in agriculture and energy
- The legal system remained inadequate to protect commercial contracts/interests
- Privatization of important industries was stalled by Parliament
- Custom procedures (such as stringent quality standards) constrained trade
- The banking and capital market sectors remained weak
- Slow Public Administration reform retained an unwieldy government apparatus

Given Ukraine's large fiscal deficit, slow implementation of structural reforms, and large short-term debt repayments, the country was vulnerable to negative external events. This led to the Financial Crisis of 1998, as discussed in section III.

III. The Financial Crisis of 1998 and the 1999 Recovery

During the first half of 1998, with investor sentiments becoming more negative, capital outflows accelerated and the NBU had to sell a considerable amount of foreign reserves to protect stability in the exchange rate. Foreign reserves were supplemented by the placement of two large Eurobond issues for a total of \$1.1 billion. But it was the Russian crisis of August 1998 that triggered a financial crisis for Ukraine, which was already vulnerable as noted earlier.

Following the Russian crisis of mid-1998, foreign financing became unavailable to Ukraine. With international reserves declining rapidly, in September 1998, the NBU had to stop selling foreign exchange. The results of the financial crisis were far reaching, with the following outcomes:

- The exchange rate came under pressure with the Hrivna depreciating sharply from about 1.9 UAH/US\$ in December 1997 to 3.4 UAH/US\$ by the end of 1998
- International Reserves fell sharply from \$2.3 billion in December 1997 to \$0.76 billion in December 1998
- Large foreign debt service obligations, amounting to \$3.2 billion, that were due in 1998 could not be rolled over or repaid
- Capital inflows dried up completely
- The annual refinancing interest rate of the NBU increased sharply from 35% to 60% per annum
- The annual rate of inflation, which was running at an annualized rate of 7.5% during the first half of 1998, reached an annualized rate of 34% during the second half of 1998, for a yearly rate of 20% for 1998

Despite the severity of the 1998 financial crisis, Ukraine was able to deal with it successfully (much better than Russia did) and without resorting to the printing of money. The country was able to do the following:

- It voluntarily negotiate the restructuring of its public foreign debt
- Monetary policy was handled effectively with the aid of some exchange controls (particularly the obligation of exporters to sell 50% of their foreign currency proceeds at official exchange

rates), which were introduced as "temporary" measures

- In September, October and November 1998, the fiscal accounts were in surplus. The deficit for 1998 was contained at 2.1 % of GDP (compared to 6.8% in 1997)

As a result of these measures, by early 1999, Ukraine had overcome the risk of a financial collapse. Furthermore, during 1999, the country went through a period of recovery and consolidation of its fiscal accounts. In fact, the major achievement of the government in 1999 was its control over large fiscal deficit, the major source of Ukraine's economic imbalance in the past.

As noted earlier, weaknesses in Public Finance were at the core of the economic difficulties that Ukraine experienced from 1992 to 1998, despite the progress made in other economic areas. During 1999, the execution of the government's fiscal budget was improved significantly. Fiscal expenditures were better controlled and the transparency of government fiscal operations was improved with the strengthening of the Treasury, which took over the recording of most central cash and non-cash expenditures and gradually took over budgetary payments at the Federal and Oblast (regional) levels. Other important fiscal measures included the adoption of a new budget classification system, creation of an external fiscal auditing function, improved availability of fiscal budget information, and the prohibition of the NBU to directly finance the government. As a result of these measures, the fiscal deficit for 1999 was small at 1.5% of GDP.

In fact, the major benefit of the 1998 financial crisis was the adoption of fiscal discipline measures. This brought wide recognition among most branches of government that the fiscal deficit had to be maintained within limits that could be financed on a sustainable and non-inflationary basis (around 2% to 3% of GDP).

The Presidential elections of October 1999 led to increases in government fiscal and quasi-fiscal expenditures, principally to pay for wage arrears. Although the fiscal deficit was contained to 1.5% GDP for 1999, given the financial crises of 1998 and the lack of non-inflationary financing, these government expenditures led to loose monetary policies.

During the first three months of 1999, the NBU followed strict monetary policies, with a stable money supply (M3). As a result, exchange rate and inflationary pressures eased. However, monetary policy loosened after April 1999, with money supply increasing by 4%–5% per month for several months. As noted above, this monetary expansion was largely associated with increases in government expenditures during the month prior to the October 1999 Presidential elections. After the elections, monetary policy was tightened in October and November 1999. But in December 1999 it was loosened again due to the need for the NBU to issue Hryvnas to purchase foreign exchange (to serve foreign debt). The need to serve foreign debt from domestic resources arose because of the suspension of IMF and international lending in September 1999. For the whole of 1999, money supply (M3)

increased by 41%. This loose monetary policy during 1999 led to further depreciation of the Hryvna from 3.4 UAH/US\$ at the beginning of the year to 5.2 UAH/US\$ by the end of 1999. The inflation rate for 1999 reached 19.2%, similar to the 20% inflation rate for 1998.

1999 was a recovery year in the area of economic growth. Although GDP growth was negative during the first eight months of the year, starting in September 1999, the monthly rates of GDP growth turned positive. Given the highly negative rates of growth in the first half of 1999, GDP declined by 0.4% during 1999. But this was a smaller decline than previously anticipated. Industries oriented towards the domestic market performed well, as a result of the import substitution effect of the Hryvna's real depreciation.

IV. Economic Situation in 2000 and Prospects for 2001

The year 2000 started with a number of positive political and economic developments. President Kuchma was re-elected for a five-year term in November 1999 on a platform calling for an acceleration of economic reforms. In December 1999, a new Cabinet was appointed. At the same time, the President passed a number of important decrees relating to land privatization and administrative reform. In early 2000, eleven central and right-wing parties in Parliament announced a pro-government alliance that controlled the majority of seats in Parliament. All these positive factors led to increased expectations that 2000 would mark an acceleration of structural economic reforms. Although progress was made in several areas of reforms, they fell short of initial expectations. In particular, the government fell short of its objectives in the areas of business liberalization and deregulation, legal reform, public administration reform, and reform of the energy sector. The path to accelerated reforms has been more difficult than anticipated due to intra-government discords and opposition by vested interests.

Nevertheless, in terms of economic performance, 2000 was the most successful since independence. Some of the important achievements in 2000 included:

- (i) A rising economy, with 6.0% growth in GDP, 12.9% growth in industrial output, and 9.2 % growth in agricultural output.
- (ii) Growth in real incomes by about 8.5%.
- (iii) An improved trade balance, with a surplus in the Goods and Services accounts.
- (iv) A consolidated fiscal budget for 2000 with a fiscal surplus of 0.5% of GDP.
- (v) Approval of a deficit-free fiscal budget 2001, on time and at satisfactory levels.
- (vi) Major reduction in barter operations by industrial companies from 33% of revenues in 1999 to 18% by the end of 2000.
- (vii) Increase in commercial bank deposits by 45% since the beginning of the year.
- (viii) Elimination of government intervention in the agricultural market and its commercialization.

- (ix) Full settlement of pension debts and partial settlement of debts to budget employees.
- (x) Avoidance of major unemployment problems.
- (xi) Renewal of lending programs by the IMF, World Bank, EBRD, and European Union.
- (xii) Successful external debt restructurization.

On the other hand, monetary policies were loose with money supply increasing by 45% in 2000. As a result, the inflation rate for 2000 reached 25.8%.

Overall, the results of 2000 were positive, exceeding forecasts made in some areas, but falling short of expectations in others. A discussion of the evolution of these economic parameters in 2000 and the prospects for 2001 is given in the sections below. Key economic indicators for years 1997-2000 are provided in Attachment I. This attachment also provides projections for economic indicators in 2001.

(a) The Real Economy

The GDP growth in 2000 reached 6%, significantly above the 1-2% originally forecast by most analysts. Even though there are some concerns about the accuracy of this estimate, it is clear that 2000 saw a strong recovery and became the first year of positive economic growth in Ukraine since its independence.

In 2000, industrial production increased by 12.9%. Production increased by 39% in light industry, 37.1% in the wood processing and paper industry, 26.1% in the food industry, 20.7% in ferrous metals, 18.8% in non-ferrous metals, 16.8% in engineering and 5% in the chemical and petrochemicals industry. Output was down 4.1% in the fuel industry and 2.9% in the electricity sector. The evolution of these branches of industry over the last five years is shown in figures 6 through 11.

Figure 6: Industry Growth, %

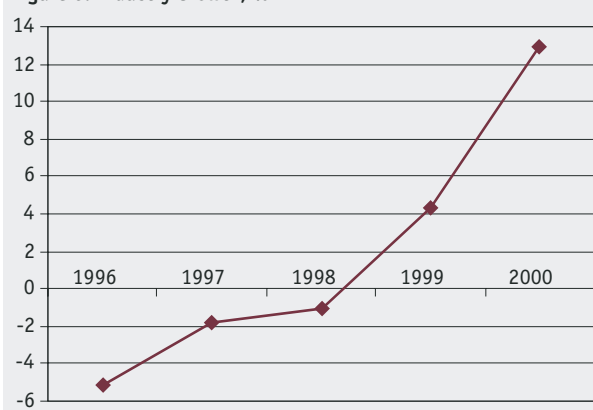


Figure 9: Chemical / Petrochemical Industry Growth, %



Figure 7: Electricity and Fuel Industry Growth, %



Figure 10: Machine Building and Metal Processing Industry Growth, %

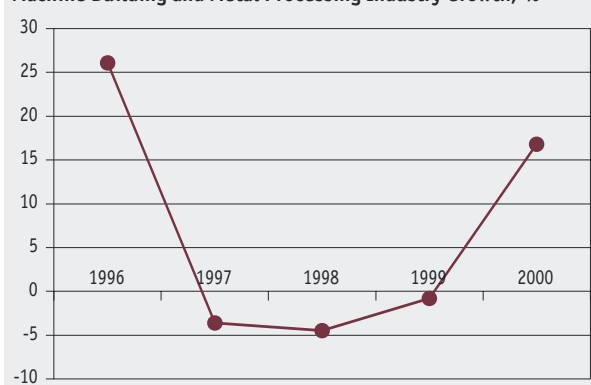


Figure 8: Ferrous/Non Ferrous Metal Industry Growth, %

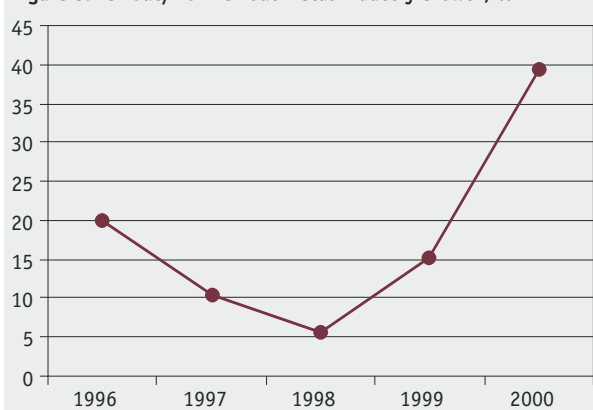
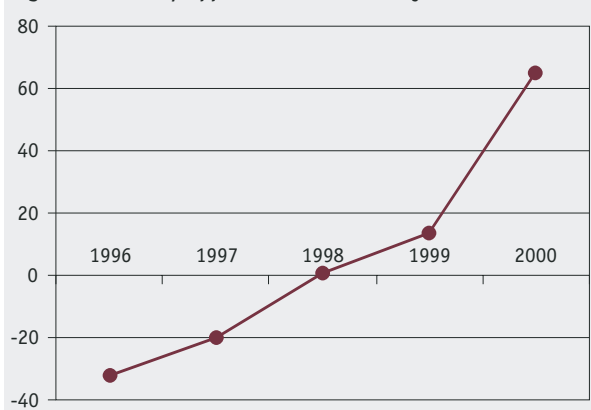


Figure 11: Textile / Apparel and Food Industry Growth, %



Source: Statistics Committee

In 2000, agricultural production grew by a surprisingly high rate of 9.2%. Agricultural output had its first positive rate of growth thanks to individually-owned private farms. The crops that showed the greatest increase were sunflower seeds, corn, and sugar beets, even though the traditional grain harvest actually declined to 24.4 million tons, the lowest level in Ukraine's history. According to a recent government report, individually-owned private farms possess 15% of the country's agricultural land, but account for as much as two-thirds of agricultural output.

This strong growth performance in 2000 was due to: (i) the favorable effects of the real devaluation of the Hrivna that took place since September 1998; (ii) favorable world market prices for key Ukrainian exports; and (iii) a strong recovery in trading partners, particularly Russia.

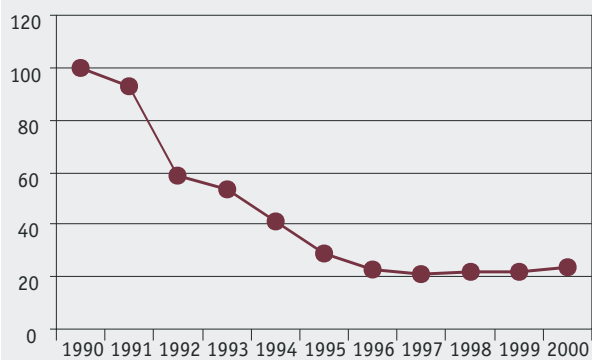
Prospects for 2001

In January and February 2001 the real economy continued to perform very well, with industrial production growing by 19.5% and 12.6%, respectively, compared to the same months of 2000. GDP

grew by 9.1% in January and by 6.2% in February compared to the same months last year. These figures give validity to the government's forecast that 2001 will be the second year since independence in which Ukraine will enjoy positive rates of economic growth.

Nevertheless, during the rest of 2001, the rate of economic growth is likely to decline, since some key sectors, such as steel and chemicals, may face export difficulties and others are reaching full capacity utilization. The expected reduction in the rate of growth in Russia, a major trading partner of Ukraine, from 7.6% in 2000 to 4% in 2001 will contribute to a deceleration in Ukrainian economic growth. Furthermore, despite an increase of capital investment in the Ukrainian economy by 11.2% in 2000, this represents only 19% of GDP. The level of foreign direct investment in 2000 was also low at only \$584 million for the year. The low level of investment is illustrated in figure 12 below, which shows the dynamics of volume indices for fixed capital investment since independence.

Figure 12:
Dynamics of Capital Investment in the Ukrainian Economy
1990=100

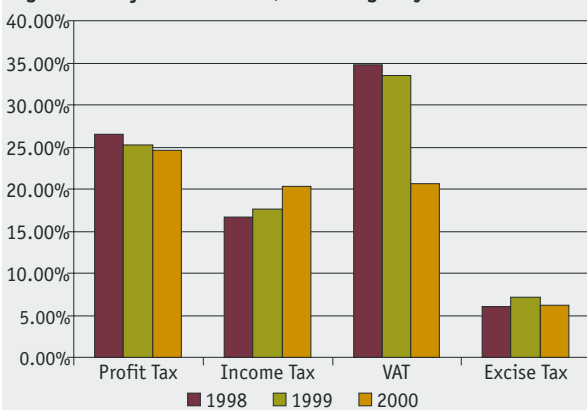


For 2001, the government forecasts a growth of 5.5% for industrial output and 3% for agricultural output. GDP is expected grow by 4%. These projections are plausible, given performance so far. But higher sustainable growth rates will come only from an increase in investment. This will require acceleration in the implementation of economic reforms to improve the business environment, particularly business liberalization, improvements in the legal framework, and in public and corporate governance. The government has expressed its intention to accelerate economic reforms in these areas, but it may find them hard to implement, given its poor implementation capacity and opposition by vested interests.

(b) Fiscal Situation and Policies

Fiscal results in 2000 were even more positive than in 1999. For the first time since independence, the consolidated government fiscal budget was fully executed, at the level of UAH 42 billion (\$7.7 billion equivalent). The fiscal budget balance was positive, with a surplus of 0.5% of GDP, according to IMF methodology (which excludes privatization proceeds as a revenue source above the line). This result was achieved partly because of strong fiscal revenues from a recovering economy and higher-than-projected inflation, which reduced real costs. Tax revenues exceeded the target figure due to income tax revenues. However, VAT and profit tax proceeds fell short of the planned amount principally due to tax remissions given to certain companies. The evolution of tax revenues during the last three years, by main categories, is given in figure 13 below.

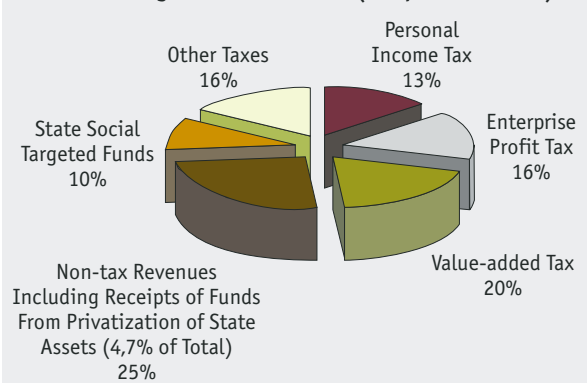
Figure 13: Major Tax Proceeds, % of Budgetary Tax Revenues



Source: The State Tax Administration of Ukraine, the Ministry of Finance, InvestGazeta

The structure of budget revenues during 2000 is shown in figure 14.

Figure 14:
Structure of Budget Revenues in 2000 (as a percent of total)



Source: Treasury Department and Fiscal Analysis Office

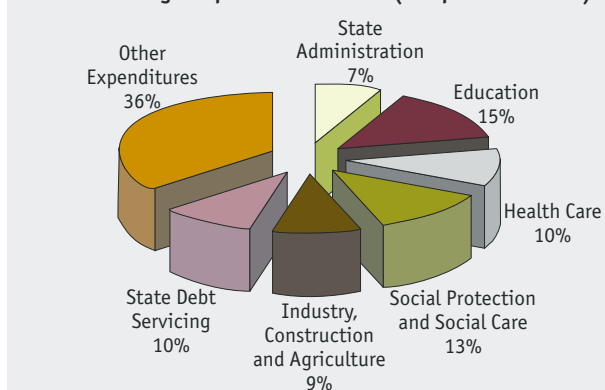
During 2000, the quality of budget activities also improved, as noted below:

- (a) After a ban on budget offsets introduced in May 2000, the share of cash revenues of the state budget increased to almost 100% from around 75% a year ago. Budget offsets had previously permitted government agencies to pay for goods and services by issuing "bills" which could be used by providers to pay for tax obligations. This mechanism had led to irregularities and corruption.
- (b) By September 2000, the government had completely eliminated pension arrears and had substantially reduced wage and social protection arrears.
- (c) The government also started to settle utility arrears (electricity and gas) with government agencies by developing a debt conversion program for those large debtors that could not settle their obligations right away.

On the other hand, privatization revenues did not materialize as expected during 2000. The government was able to raise only \$384 million in privatization revenues, against the original plan of \$480 million.

On the fiscal expenditures side, a major shift in the composition of expenditures has taken place over the last few years, away from subsidies to productive activities with more emphasis on social expenditures (education, health and social protection), which now account for about 40% of total expenditures. The composition of fiscal expenditures in 2000 is given in figure 15.

Figure 15:
Structure of Budget Expenditures in 2000 (as a percent of total)



Source: Treasury Department and Fiscal Analysis Office

Prospects for 2001

The fiscal budget prospects for 2001 are sound. On December 7, 2000, Parliament approved a fairly conservative 2001 fiscal budget, with revenues and expenditures set at UAH 52.0 billion (approximately \$8.5 billion, or 26% of GDP), including privatization revenues. According to the budget, tax revenues are expected to be reduced by approximately 3.75% compared to 2000. Non-tax revenues in 2001 are estimated at a level of 62% of the total. Increases in privatization revenues (up to about 14% of total revenues, compared to 4% in 2000) are expected to compensate for the reduction of tax revenues. The initial targets for privatization revenues were overly optimistic. At the insistence of the IMF and a number of Parliament Members the level of privatization proceeds originally projected at UAH 9 billion (4.6% of GDP) was reduced in the final budget version to UAH 5.9 billion (3% of GDP). This is still an ambitious privatization target. The approved budget deficit accordingly was set at 3% of GDP, a figure that is expected to be financed on a non-inflationary basis by foreign and domestic credits.

There are however a number of risks in the 2001 budget. One is the possibility of revenue shortfalls, given that the proposed Tax Code, if approved in this year, may lower tax rates. (The proposed tax code is described below.) The government has agreed with the International Monetary Fund to preserve stable tax revenues, with any cuts in tax rates matched by increases in the tax base and elimination of special privileges so as to ensure revenue neutrality. A second risk is that the ambitious privatization revenue targets for the year may not materialize.

During 2001, to minimize budget risks, the budget code adopted by the Parliament determined unified principles of the budget system, the fundamentals of the budgetary process, and responsibilities for violation of the budget legislation. To further minimize risks, the government is aware that it will need to take a number of fiscal actions, including:

- (i) Cuts in expenditures. In February 2001 the government notified the heads of all ministries and departments about the likelihood of a cut in budget expenditures in 2001 by 10% on average, to compensate for revenue shortfalls
- (ii) Better definition and alignment of authority and accountability of central government agencies

- (iii) Better definition of budget responsibilities between the President, the Prime Minister, the Cabinet of Ministers, and the core ministries.
- (iv) Simplification of internal budget procedures and in the organization of central and local government agencies, including less discretionary and more transparent transfers between different levels of government.
- (v) Acceleration of the privatization process for large enterprises.

In general, these measures will be undertaken with the support of international organizations, including the IMF and the World Bank.

The budget for 2002 is expected to be formulated on the basis of a new tax legislation, particularly the proposed Tax Code, which was already discussed by the Parliament in 2000 and was returned to the government for revision. The Tax system in Ukraine is very complex as described in Attachment 3. The new Tax Code should systematize and reduce the number of taxes, dues (obligatory payments), and their corresponding rates. On the other hand, revenue losses from these tax reductions are expected to be compensated by a broadening of the tax base. The draft Tax Code envisages that individuals' income up to the level of minimum wages would be exempted from taxation. It would introduce two individual income tax rates of 10% and 20% instead of the existing income tax rates of 10%, 15%, 20%, 30%, and 40% (three rates of 10%, 20%, and 30% for the first year when the code comes to effect).

The draft tax code also envisages a reduction of the corporate profit tax rate from 30% to 20%. In order to prevent a sharp decline of budget revenues, the tax rate will be reduced gradually. In the first year the rate will be 25%, and later 20%. The Tax Code also plans a reduction of the VAT rate from 20% to 15% (to 17% in the first year). The approach to the simplified taxation system has also changed. The tax rate for the uniform company tax (for small companies and individual entrepreneurs) would remain at the level of 6%, but the conditions required to switch to the uniform tax will be stricter. The tax code also introduces a number of new taxes, such as school taxes, property taxes, dues for organization of tour events, and local excise taxes.

(c) Monetary Situation and Policies

As was the case in 1999, the monetary situation in Ukraine continued to be loose during 2000, in spite of the fact that the fiscal budget deficit was under control. Monetary expansion resulted from purchases (by the NBU) of foreign exchange on the open market to serve foreign debt. Initially, official international lending was expected to cover a good portion of foreign debt service. But this did not materialize following the suspension of the IMF Program in September 1999, which also led to a halt of other international lending to Ukraine. In order to serve the country's international debt, the NBU had to purchase \$1.2 billion of foreign exchange on the open market. These purchases resulted in a relatively rapid increase of money supply (M3) by 33.7% during the first eight months (January-August) of the year.

During September, October and November 2000, monetary policies stabilized with a slight decline in money supply. But in December 2000, money supply again increased rapidly by a rate of 8.8%. The December expansion in money supply was caused by interventions of the NBU in the foreign exchange market to mop-up excess foreign exchange supply. This excess foreign exchange supply came from a sharp improvement in the current account surplus — to 5% of GDP — during the last quarter of 2000 and the resumption of lending from multilateral agencies. During the whole of 2000, Ukraine's monetary base and money supply increased by 40% and 45% respectively.

Inflation. The money supply increases in January-August 2000 led to a high inflation rate of 19.3% for this eight-month period, exceeding the government's target of 19% for the entire year. In September, October and November 2000 with a stable money supply, inflation followed a declining trend, with inflation in August-November 2000 at only 4.2% for this four-month period. In December 2000, however, in connection with monetary expansion, inflation picked up again, reaching a monthly rate of 1.6%. For the entire year, inflation was 25.8%. During 2000 foodstuff prices grew by 28.4%, nonfood prices by 8.9%, and prices for paid services by 31.2%. In addition to large money supply increases, other contributors to the high inflation rate in 2000 were increased charges for housing, utilities and communication services, and the introduction of market prices in the agricultural sector.

The Exchange Rate. In spite of the above-mentioned increases in money supply and the relatively high inflation rate, the exchange rate for the Hrivna remained quite stable at approximately 5.4–5.5 UAH/US\$. This stability resulted principally from increases in money demand, associated with the high rate of growth in the economy. This stability followed two years of rapid currency depreciation: the Hrivna depreciated 50% in 1999, and it collapsed by 80% in 1998, following the Russian financial crisis.

International Reserves. Since the beginning of 2000, the level of gross international reserves of the National Bank of Ukraine was relatively stable at about \$1.1 billion. Since mid-December 2000, however, the level of reserves increased substantially to \$1.7 billion and stayed there. The current level of reserves represents a two-year record level. The increase in reserves was facilitated by the purchase of \$406 million in foreign exchange by the NBU from December 2000 to March 2001, and by the December 2000 transfer of \$248 million in loans from the International Monetary Fund.

Prospects for 2001

During 2001 the monetary base is expected to increase by 12% and money supply (M3) by 19%. On this basis, it is expected that inflation will be contained to 13.6% for the year (or about 1.1% per month).

In January 2001 the monthly rate of inflation was 1.5%, significantly above the target monthly rate. But starting in February 2001, the NBU has been conducting tighter monetary policy to restore monetary stability and control inflation. The inflation rates in February and March 2001 (0.6% in February and 0.6% in March) were consistent with the government's inflation target for the year. To ensure monetary stability the NBU has requested the government's support to reduce the amount of money in circulation. In particular, it has proposed that the government should purchase (with cash) the foreign exchange it requires to pay its external debts, instead of borrowing the money from the NBU. If these measures were to be insufficient, in order to reduce Hrivna excess liquidity, the NBU could raise interest rates, which have remained stable since August 2000. The NBU had its discount rate at 27% per annum and its Lombard rate at 30% per annum in August last year.

The relative stability of the exchange rate may continue during 2001, provided that the IMF/World Bank programs are renewed before large debt service obligations are due in mid-2001. For the entire year the government expects that the average exchange rate of the Hrivna will be 5.7 UAH/US\$ (6.0 UAH/US\$ by the end of the year). Low inflation should maintain the exchange rate's stability.

(d) Domestic Equity Markets

Solid economic growth and sound fiscal policies in 2000 had a positive effect on Ukraine's stock markets. For all of 2000, the PFTS index (Ukraine's stock market) increased by 42.1% to reach 55.53 by the end of the year. This is a remarkable achievement, considering how poorly markets performed across the globe. Because Ukrainian markets trade in almost entirely "old economy" stocks, Ukraine was less affected by the fall in technology stocks elsewhere. At the same time, trading volumes on the stock market were highest in 2000 compared against the last three years. The overall volume of transactions conducted on the PFTS in 2000 was \$279.36 million, which is 20% more than in 1999, and 83% more than in 1998.

The major growth of the Ukrainian stock market took place from January to March 2000, when the PFTS index increased by more than 50%. After a short correction it continued to grow, and from mid-April to mid-June gained another 14%. The market growth in the first half of the year was primarily due to the active performance of domestic investors. From mid-June until mid-November, market activity was insignificant. In November trading volumes shot up and by December the PFTS showed the largest monthly trading volume in its history, reaching \$45.6 million. For the last month and a half of the year the PFTS index gained 9.76%. Market operators attribute this growth to the appearance of foreign investor bids.

In general, 2000 was a success for the Ukrainian stock market. While the market is still below pre-1998 crisis levels, the market has made a significant step in the right direction. The sales volume by industry, the number of companies traded and the volumes of the ten largest market makers are given in the two tables below:

Table 1: PFTS Trading By Industry For 2000

Industry	Sales Volume (in \$ millions)	Number of Companies Traded
Utilities	10.9	32
Energy, Oil & Gas	65.3	13
Chemicals	22.4	12
Ferrous & Non-Ferrous Metallurgy	24.5	7
Food and Beverages	13.7	11
Finance and Promissory Notes	17.9	18
Pharmaceuticals	7.9	4
Machinery	4.7	27
Ore Mining	4.6	8
Piping and Building Materials	4.8	7
T-Bills	0.6	4
Others	2.1	11
Total	279.4	157

Table 2: Top Ten PFTS Volume Makers

Name	Sector	Volume
UKRNAFTA	Oil & Gas	\$51,045,338
KYIVENERGO	Utilities	\$22,457,446
STIROL CONCERN	Chemicals	\$16,404,787
KHARKIVOBL-ENERGO	Utilities	\$14,689,160
MARIUPOL ILLICHA STEEL	Ferrous Metallurgy	\$13,247,763
CHERKASYOBL-ENERGO	Utilities	\$10,517,968
LISICHANSK "NAFTORGSIINTEZ"	Oil & Gas	\$9,154,275
KYIVOBLENERGO	Utilities	\$8,777,133
MYKOLAIV ALUMINA WORKS	Non-Ferrous Metallurgy	\$8,347,257
VINNYFRUIT	Beverages	\$7,908,713

(e) International Trade and Capital

International Trade

In 2000, Ukraine's foreign trade for goods and services totaled \$33.4 billion, an increase of 18.3% over 1999. Exports of goods and services rose to \$18.1 billion, of which \$14.6 were goods (a 25% increase over 1999). The metallurgy sector accounted for 46% of overall exports, chemicals for 12%, machine building and metal processing for 12%, and agricultural products for 8%. During the same period, imports of goods and services rose to \$15.3 billion, of which \$14.0 billion were goods. The country's surplus in foreign trade reached \$2.7 billion. The current account had a positive balance of \$2.0 billion compared to a surplus of \$0.8 billion in 1999 and a negative balance of about \$1.2-1.3 billion from 1994 to 1998.

During the last two years there have been important changes in the composition of Ukrainian exports and imports. Exports to traditional partners (the former Soviet Union, particularly Russia) declined from 57% of total exports in 1995/96 to about 33% in 2000. On the other hand, exports to non-traditional partners (particularly China, Turkey, and Germany) have performed quite well, partly offsetting the shortfall to Russia. The importance of ferrous and non-ferrous metals, chemicals, and machinery continued to increase, while the share of agricultural exports continued its decline. Policy shortcomings in agriculture explain part of the decline in food production and imports.

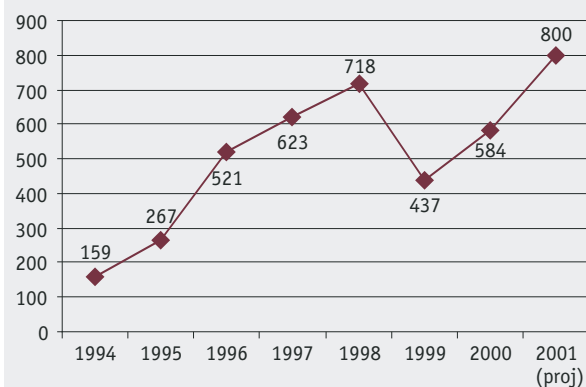
The direction of imports followed a similar pattern, with imports from the former Soviet Union declining from 65% of the total in 1995/96 to 59% in 2000. The major import items continued to be energy products (oil and gas), which represented about 41% of the total in 2000. Other leading imports include machinery and equipment, chemicals, and some food items.

International Capital

Foreign direct investment in the Ukrainian economy recovered somewhat in 2000 and reached \$584 million. Since independence the total foreign investment in Ukraine reached \$3.9 billion, an insignificant amount compared to the levels achieved in other transition economies. The following were the largest investors in Ukraine as of January 1, 2000: the United States — \$636 million; the Netherlands — \$362 million; Cyprus — \$373 million; Russia — \$314 million; and Great Britain —

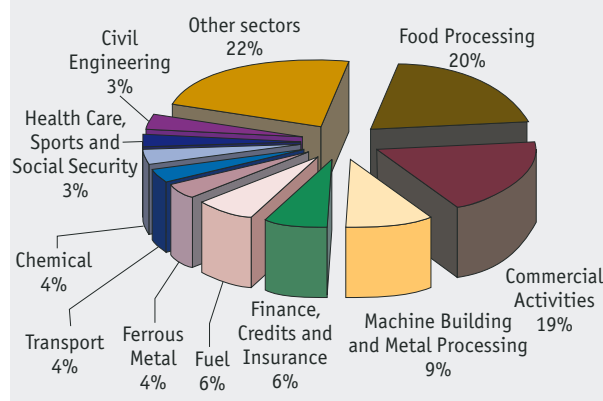
\$299 million. The evolution of foreign direct investment over the last seven years is shown in figure 16. The food industry is the largest recipient of Foreign Direct Investment with an approximate share of 21% (see figure 17).

Figure 16: FDI Dynamics in Ukraine (\$ millions)



Source: State Statistics Committee

Figure 17: FDI by Sector in 2000 (as a percent of total)



Prospects for 2001

The government forecasts a positive foreign trade balance of around \$2.7 billion in 2001, a number similar to the one achieved in 2000. This forecast, however, may not be achieved as the growth of Ukrainian exports is expected to slow this year due to market limitations, especially in the metallurgy industry, and Ukraine's non-diversified export base. Furthermore, given the nominal stability of the Hrivna exchange rate together with a high inflation rate, the Hrivna has appreciated substantially in "real" terms (by about 20%). This will gradually erode export growth and encourage imports, thus reducing the trade surplus. The most likely scenario is that both the foreign trade and current accounts will be close to balance.

(f) Public Debt and International Lending

Domestic Debt

During 2000, domestic debt increased from \$2.1 billion (equivalent) to \$3.8 billion (equivalent). About 90% of this debt is held by the NBU. In early October 2000 the Ministry of Finance and the NBU agreed on restructuring UAH 10.5 billion of government debt maturing before 2004. This debt will be converted into bonds with maturities ranging up to 124 months. The Ministry of Finance made the first coupon payment at 17.01%. Later coupon rates will be adjusted for inflation (inflation rate plus 3%).

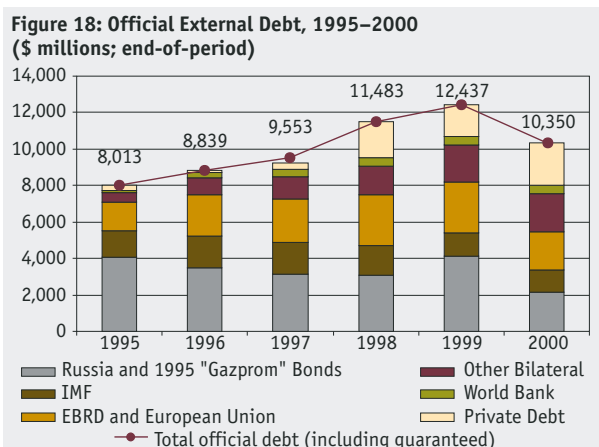
Foreign Debt

Ukraine's external state debt declined by 17% (or \$2.1 billion,) to \$10.3 billion as of December 31, 2000. This foreign debt represents about 33% of GDP, a reasonable amount for a country the size of Ukraine. The main holders of Ukraine's foreign debt at the end of 2000 are given in table 3 below:

**Table 3: Official External Debt, 2000
(In millions of U.S. dollars; end-of-period)**

	\$ millions
Multilateral	
IMF	2,111
WB	2,095
EBRD	115
EC	319
Bilateral	
Russia, Direct Government Credits	1,974
Russia, Gazprom	178
Turkmenistan	281
Germany	340
USA	317
Japan	165
Other European	108
Private	
Eurobonds denominated in US\$	1,129
Eurobonds denominated in Euros	1,054
Foreign commercial banks	155
Total Foreign Debt	10,350

Figure 18 shows the evolution of external debt over the last six years. As noted earlier, foreign debt declined in 2000. Offsetting mutual debts with Russia related to power resources, the repayment of foreign commercial loans, and repayments to the IMF were the main factors in this reduction.



Source: IMF; Ministry of Finance

Although the absolute size of Ukraine's external debt is reasonable, annual debt service obligations are large. In 2000, Ukraine's external payments amounted to \$1.7 billion, of which about \$930 million were for the IMF. This figure excludes the servicing of about \$500 million of bilateral debt, which is currently under suspension and is expected to be rescheduled following the renewal of the EFF Program. Foreign debt service obligations were met partly through private debt restructuring, debt reduction agreements with Russia, and repayments of debt in cash.

Ukraine's debt service in the next two years will continue at a relatively high level of approximately \$1.8 billion per year. This represents a high percentage (12%) of export revenues. The government expects to serve this debt from privatization revenues, multilateral lending, rescheduling of Paris Club debt, and current account surpluses expected in both 2001 and 2002.

Private Foreign Debt

With the agreement of its private creditors in April 2000, Ukraine completed the restructuring of \$2.6 billion of its foreign private debt. This debt was converted into two seven-year eurobonds, one denominated in euros and the other in dollars. As a result of this restructuring, total debt service for 2000 fell from \$3.2 billion to \$2.2 billion, including bilateral debt of about \$500 million. The success of this debt-restructuring program was a necessary, but not sufficient condition to address the country's debt issues. It gave Ukraine some breathing

room on its external financing issues. But current debt service obligations — at \$1.8 billion for 2001, including \$610 million due to the IMF, but excluding bilateral debt — are still large when compared to its international reserves of \$1.6 billion. The resumption of IMF lending will be an important element to maintain financial stability. Otherwise, lack of IMF financing will result in weakness of the Hrivna, as the NBU would be obliged to increase its purchases of foreign exchange to serve debt.

The IMF Program

In December 2000 the International Monetary Fund agreed to re-initiate its EFF lending program to Ukraine after a 15-month suspension. In early October 1999, the IMF took the decision to postpone the release of a \$90 million tranche due to Ukraine's decision to introduce certain export restrictions (including export taxes for sunflower seeds) and lack of action on agreed upon price increases for utility and communal services. Following the re-initiation of lending in December 2000, it disbursed \$248 million. It was also agreed that if economic performance were to progress according to the IMF Program, Ukraine would receive seven quarterly tranches of approximately \$190 million each, after each successful IMF mission review, for a total of \$1.3 billion. The first tranche of \$190 million was expected at the end of March 2001.

An IMF mission visited Ukraine in early February 2001 to review progress under the EFF. The IMF noted that the Ukrainian economy is recovering. However, the IMF mission felt that future recovery was in jeopardy due to the slow implementation in needed economic reforms and conditions agreed upon under the EFF Program. The IMF has indicated that the government will need to comply with certain conditions before disbursing the March tranche. These conditions include:

- (i) The modification of the recent tax law that provides for tax amnesties and other privileges that would reduce the tax base.
- (ii) The enactment and announcement of adequate procedures to ensure transparency in the privatization of State enterprises.
- (iii) The acceleration of financial sector reforms and the restructuring of troubled banks (in particular, the Ukraina Bank and the Savings Bank.)
- (iv) The reduction of the sunflower export duty from the current level of 23%, leading to its eventual elimination.

- (v) Progress in the tightening of payment discipline in the energy sector by increasing cash collections.

As noted earlier, in 2001, the government will need to serve significant amounts of foreign debt (about \$1.8 billion in principal and interest). The new government will need to take quick action to deal with these repayments in a non-inflationary manner. The current expectation is that the EFF may be continued in May/June, at the earliest, if an IMF mission expected for May 2001 were to find that the government has implemented the above mentioned measures. The government is aware of the need to keep the IMF Program alive and has announced that it will meet the IMF conditions.

World Bank Programs

During 2000, the lending activities of the World Bank were limited, due in part to the suspension of the IMF Program. Following the revival of the IMF Program in December 2000 and enactment of the Banking Law, in February 2001, the World Bank made the final disbursement of \$60 million from a tranche of \$100 million under the Financial Sector Adjustment Loan (FSAL). The equivalent to \$40 million was canceled since Ukraine did not meet other conditions, including the enactment of the Law on Deposit Insurance and the restructuring of the Savings Bank.

In May 2001, the World Bank expects to submit to its Board of Directors a Programmatic Adjustment Loan (PAL) for \$750 million. The World Bank is also considering three investment operations in 2001, including a \$100 million loan to ease the social hardship caused by restructuring of the coal sector, \$24 million for water utility projects in Lviv, and \$28 million for the modernization of the district heating system in Sevastopol.

European Bank Programs

In early March, the government held discussions with EBRD management on a proposed loan of \$243 million to complete the construction of two nuclear power plants. The discussions were successful and Ukraine will be able to receive these funds once it has created an independent regulatory body for the nuclear sector and has successfully negotiated the restructuring of its bilateral debt with the Paris Club.

The EBRD has also agreed to permit Ukraine to utilize the \$100 million balance-of-payment loan for fuel imports, which was not used during winter of 2000–2001. This loan was extended through the following winter. In addition, Ukraine is expected to receive a \$100 million loan from the EBRD to upgrade its power plants and a \$65 million loan to construct a gas pipeline in the Odessa region.

Bilateral Debt

On March 6, 2001 Ukraine started negotiations with the Paris Club of bilateral creditors to re-schedule \$1.0 billion of bilateral debt due in 2000–2002. Ukraine had suspended payments to the Paris Club in early 2000, in conjunction with the rescheduling of \$2.6 billion of foreign private debt. Ukraine submitted its official proposal for Paris Club restructuring in December 2000, following the resumption of IMF disbursements. Although there was an initial round of discussions in February 2001, further discussions were postponed due principally by disagreements among bilateral donors on the handling of individual loans. It is expected that further discussions will take place in May 2001. A final agreement with the Paris Club is not expected until later in the year.

V. Economic Goals and Reforms for the Future

The goals of the government for the future are to retain the country's external and internal stability and to revive economic growth. The country will need to maintain sound monetary policies to contain inflationary pressures, maintain stability in the exchange rate, and complete foreign exchange convertibility. It needs to provide the basis for sustainable economic growth. For this, the country has two major tasks:

- The government has to deal successfully with relatively large foreign debt service payments of \$1.8 billion in 2001.
- The government has to continue accelerating implementation of economic reforms to build private sector confidence and revive investment.

Regarding debt service, the government will need to assure re-initiation of IMF lending by mid 2001 by dealing successfully with its foreign debt obligations (in a non-inflationary manner). The measures needed for this have already been discussed and are clearly understood by all parties.

As to reforms, the government fully recognizes that, following the current economic and financial stability, the next step is to focus on measures to revive investment, since it would be the engine for future sustainable development. For this purpose, the government has given priority to improving business conditions in 2001, particularly by reducing state intervention in the economy. It believes that a serious liberalization of regulatory policy will generate a lot of interest for corporate financing. Furthermore, this liberalization policy will encourage a change in the structure of production to favor an increased share for small and medium business, which will expand the middle class of the country.

Furthermore, given low levels of domestic savings, the government is aware that the only way for Ukraine to sustain growth is to accelerate the inflows of international private equity capital to the country. To assist in this regard, at the request of the government, SigmaBleyzer chaired a Task Force to review and propose measures to improve the business climate in Ukraine and accelerate the inflows of international capital. The study was carried out by a team of SigmaBleyzer professionals and the Thunderbird Corporate Consulting Group. To provide guidance, a Steering Committee was formed, which included representatives from

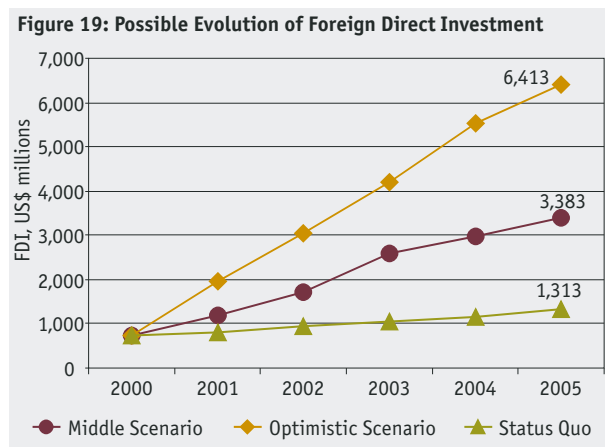
many international agencies and businesses operating in Ukraine.

The Study showed that Ukraine is receiving only a small fraction of its potential flow of international private capital. Based on the forecasting model developed in this Study, for the next few years Ukraine has three likely scenarios for its level of foreign direct investment depending on the depth of economic policy reforms aimed at improving the business climate in Ukraine. Assuming different scenarios for the depth and speed of improvement in the key factors that may affect foreign investment, the Study reached the following conclusions:

- If Ukraine were to continue its current policies — status-quo scenario — the level of capital inflows would not increase significantly from its current level — except for ad-hoc flows related to large privatization. By 2005, FDI could reach about \$1.3 billion per year.
- Under the middle scenario, if Ukraine were to take policy actions to reduce 50% of the policy level differential with the most advanced Emerging Markets, Ukraine could increase foreign direct investment to about \$3.4 billion per year by 2005, an increase of 150% over the status-quo scenario.
- Under an optimistic scenario, with stronger policy actions to reduce 80% of the policy differential with the most advanced Emerging Markets, the level of foreign direct investment into Ukraine could increase to \$6.4 billion per year.
- Liberalization of Business Activities, followed by improvements in the Legal Framework and improvements in Governance were the three most important policy actions that the country could take to increase capital inflows today. If reforms in only these three areas were to be undertaken, their implementation would increase capital flows to \$2.5 billion in five years, or by 92% compared to the status-quo scenario.
- However, in order to attract more significant increases in capital flows over the next five years (i.e., between \$3.4 billion to \$6.4 billion per year), strong measures on the following nine factors affecting the business climate are necessary:

1. Liberalize and Deregulate Business Activities
2. Provide a Stable and Predictable Legal Environment
3. Enhance Governance & Reform Public Administration
4. Remove International Capital & Foreign Trade Restrictions
5. Facilitate Financing of Businesses by the Financial Sector
6. Eliminate Corruption
7. Reduce Political Risks (non-economic country risks)
8. Expand Country Promotion
9. Rationalize Investment Incentives

The possible evolution of foreign direct investment under these three scenarios is given in the chart below.



The flow of foreign direct investment will have a multiplier effect on GDP growth. Under the Middle Scenario, the incremental Foreign Direct Investment would generate an incremental GDP growth of 4.8% per year.

The study starts from the premise that macroeconomic stabilization, achieved by sound fiscal and monetary policies, is the essential pre-condition to achieve a favorable business climate and attract foreign direct investment. Within this macro framework, in order to achieve the above increases in international capital inflows the study identified three key policy actions that had a stronger impact on foreign direct investment. These policy actions were the following:

Priority 1: Liberalize and Deregulate Business Activities.

- Finalize and communicate widely the government's De-regulation Policy, consistent with international standards, and rapidly implement it to simplify and facilitate registration of new businesses, the operations of existing businesses, and import/export of goods.
- Establish an appropriate on-going mechanism to liberalize business activities, establish deregulation priorities, and continuously review all existing and new regulatory legislation.
- Eliminate current incentives to excessive government intervention, such as the right of some agencies to retain part of the fines they impose on businesses.

Priority 2: Provide a Stable and Predictable Legal Environment

- Create an independent and incorruptible judiciary, separate from the Executive Branch.
- Pass well-conceived new laws or modify existing legislation as needed to provide a more favorable framework for business, including the civil code, the labor code, the criminal code, and the tax code.
- Establish an efficient legislative process to coordinate and expedite the drafting of laws and regulations.
- Provide adequate funds from the fiscal budget for the judiciary, including resources for training and for computers with legal databases, internet access, and web sites with compilations of court decisions and academic treatises.

Priority 3: Improve Corporate and Public Governance and Eliminate Corruption.

Corporate Governance

- Demonstrate corporate financial discipline by closing 10-20 big loss-making state companies within next two years.

- Enact the Joint Stock Company Law of Ukraine to modernize Ukrainian corporate governance legislation.
- Require all publicly traded (listed) companies to use international accounting standards and to submit regular reports and audited annual financial statements.

Public Governance

- Continue public administration reform to reduce the size of state agencies, raise salaries of key civil servants, and redefine the government's role as that of supporting — not replacing — the private sector.
- Extend administrative reform to local state bodies.
- Reduce shadow economy activities by drastically cutting red tape and lowering cost of compliance with legislation in effect.

Privatization

- Secure the early approval and implementation of the Land Code to promote private ownership and registration of land.
- Encourage the independence of the State Property Fund (SPF) by passing the Law on the State Property Fund and subordinate it to the Executive Branch.
- Take early actions to prepare state companies for privatization (including actions to protect

minority shareholder rights and transfer social assets to local authorities) and complete expeditiously the privatization of the energy sector and other major enterprises under clear and transparent procedures.

Corruption

- Implement an intensive, sustained and visible anti-corruption campaign, with a strong emphasis on corruption prevention to make corruption more difficult and more expensive to undertake, starting with key areas such as barter and the energy sector.
- Develop the legal framework needed to ensure better enforcement of anticorruption measures and impose visible, harsh, swift, and certain penalties for corruption of government officials.
- Get public support for anti-corruption programs by making people aware of their rights and the rules of the game.

Although the above priority actions would have a significant impact on the flow of foreign direct investment, in order to secure a significant and sustainable flow of investment, the study shows that all nine policy areas discussed in the report are essential. In fact, the experience of many other countries shows that only a comprehensive program addressing all nine policy areas would lead to significant and sustainable capital investment, both foreign and domestic. Details about these policy actions are presented in Appendix II.

APPENDIX 1

Key Economic Statistical Information

	1996	1997	1998	1999	2000	2001 (Proj)
GDP						
Real GDP, %	-10	-3.1	-1.9	-0.4	6	4
GDP (UAH bn)	81	93	104	127	175	205
GDP/Capita (US\$)	870	856	828	612	555	720
Savings (%GDP)	20	19	18	22	20	20
Investments (%GDP)	23	21	21	20	19	20
Public Finances						
Fiscal Balance (%GDP)	-3.2	-6.8	-2.1	-1.5	0.5	-3
Revenues (%GDP)	37	30	28	26	28	26
Expenditures (%GDP)	40	37	30	27	27	29
Monetary Statistics						
Consumer Prices (%YoY)	40	10.1	20	19.2	25.8	13.6
Monetary Base (%YoY)	38	45	22	30	40	12
Money Supply-M3 (%YoY)	35	34	25	40	45	19
Exchange Rate (UAH/\$)	1.9	1.9	3.4	5.2	5.4	6
Balance of Payments						
Goods Exports (US\$bn)	15.5	15.4	13.7	12.5	14.6	12.5
Goods & NFSE (US\$bn)	20.3	20.4	17.6	16.2	18.1	16
Goods Imports (US\$bn)	19.8	19.6	16.3	12.9	14	12.5
Goods & NFSI (US\$bn)	21.5	21.9	18.8	15.2	15.3	16
Trade Balance (US\$bn)	-4.3	-1.5	-1.2	1	2.7	0
Current Acc. Balance (US\$bn)	-1.2	-1.3	-1.3	0.8	2	0
Direct Investments (US\$bn)	0.5	0.6	0.7	0.4	0.6	0.8
Gross Reserves (US\$bn)	1.9	2.3	0.8	1.1	1.6	1.7
Public Debt						
External Debt (US\$bn)	8.8	9.6	11.5	12.5	10.3	10.8
External Debt Service (US\$bn)	1.2	1.2	1.8	2	1.7	1.8
Domestic Debt (US\$bn)	1.3	4.6	3.7	2.9	3.8	3.8

APPENDIX 2

Action Plan to Accelerate the Flow of Foreign Capital to Ukraine

(a) Liberalize Business Activity

1. Finalize and communicate widely the government's De-regulation Policy, consistent with international standards, and rapidly implement it to simplify and facilitate registration of new businesses, the operations of existing businesses, and import/export of goods.
2. Establish an appropriate on-going mechanism to liberalize business activities, establish deregulation priorities, and monitor legislation to support business liberalization.
3. Eliminate current incentives to excessive government intervention, such as the right of some agencies to retain part of the fines they impose on businesses.

(b) Provide a Stable and Predictable Legal Environment

1. Create an independent and incorruptible judiciary, separate from the Executive Branch.
2. Pass well-conceived, new laws or modify existing legislation as needed to provide a more favorable framework for business, including the civil code, the labor code, the criminal code, the tax code, and others.
3. Establish an efficient legislative process to coordinate and expedite the drafting of laws and regulations.

(c) Enhance Corporate and Public Governance and Accelerate Privatization

Corporate Governance

- Demonstrate corporate financial discipline by closing 10-20 big loss-making state companies within next two years.
- Enact the Joint Stock Company Law of Ukraine to modernize Ukrainian corporate governance legislation.

- Require all publicly traded (listed) companies to use international accounting standards and to submit regular reports and audited annual financial statements.

Public Governance

- Continue public administration reform to reduce the size of state agencies, raise salaries of key civil servants, and redefine the government's role as that of supporting — not replacing — private activities.
- Extend administrative reform to local state bodies.
- Reduce shadow economy activities by drastically cutting red tape and lowering cost of compliance with legislation in effect.

Privatization

- Secure the early approval and implementation of the Land Code to promote private ownership and registration of land.
- Encourage the independence of the State Property Fund (SPF) by passing the Law on the State Property Fund and subordinate it to the Executive branch.
- Take early actions to prepare state companies for privatization (including actions to protect minority shareholder rights and transfer social assets to local authorities) and complete expeditiously the privatization of energy sector and other major enterprises under clear and transparent procedures.

(d) Reduce International Capital and Foreign Trade Restrictions

1. Liberalize foreign exchange transactions and eliminate restrictions on foreign direct investment in certain sectors — insurance, publishing, broadcasting, and telecom.
2. Reduce restrictions to imports and exports, including high import duties, the critical import list, export quotas, duties, indicative prices, ad-

vance deposits, and foreign exchange requirements.

3. Simplify and expedite custom services, including procedures for custom clearances and for certification of imported products.

(e) Facilitate Business Financing by the Financial Sector

1. Increase the independence of the banking sector, including the NBU; improve and enforce commercial bank supervision and prudential regulations.
2. Strengthen the Securities and Stock Market State Commission mandates in security-related activities of all financial institutions.
3. Accelerate the implementation of the Law On the Institutions of Joint Investments.

(f) Eliminate Corruption

1. Undertake measures to "prevent" corruption, reducing the opportunities for corruption and making corruption more difficult to undertake, starting with key areas such as barter and the energy sector.
2. Develop the legal framework needed to ensure better enforcement of anti-corruption measures and impose visible, harsh, swift and certain penalties for corruption of government officials.
3. Get public support for anti-corruption programs by making people aware of their rights and the rules of the game.

(g) Reduce Political Risks

1. Demonstrate an understanding of the importance that foreign investors place to expropriation, including "creeping expropriation".
2. Bring tax collectors and local authorities under the control of the central administration.
3. Government enterprises in competition with private business in the same sector should not get preferential treatment.

(h) Expand Country Promotion

1. Announce and disseminate widely the government's policy and commitment to implement strong market oriented policies and show implementation progress.
2. Vocally support foreign investment by changing the attitude of officials at central and local government levels.
3. Require all Ukrainian embassies abroad to have their commercial section strengthened, and to go on sales drives to better disseminate business opportunities.

(i) Rationalize Investment Incentives

1. Institute a level playing field by eliminating any special incentives for particular sectors, companies or geographical zones.
2. Enact the new Tax Code that would decrease the number of taxes and surcharges, reduce tax rates, eliminate tax privileges, and rationalize the value-added tax, personal income tax, and corporate income tax systems.
3. After a rational Tax Code has been passed, aim to minimize subsequent tax changes by imposing a moratorium.

APPENDIX 3

Types of Taxes and Dues

Major Taxes:

Tax	Rate
Value Added Tax	20% for sales of goods (works, services) in Ukraine; 0% beyond the customs borders of Ukraine
Legal Entities Profit Tax	30% of the profit of the legal entity; 15% for companies that are part of the experiment in ore mining and metallurgical complex; 3% of the profit from insurance activities; 15% of the profit obtained in Ukraine for non-residents (profit repatriation tax)
Obligatory State Pension Insurance Dues	1% for purchase and sale of currency; 3% for car purchase; 5% for sales of jewelry (excluding wedding rings); 5% for sales of tobacco goods produced in Ukraine; 1% for purchase of real estate; 6% of the amount of mobile communication services.
Uniform Profit Tax (for small companies using simplified tax system)	6% of proceeds if the company is a VAT payer; 10% of company's proceeds, in case VAT is included in the uniform tax UAH 20 to 200 (\$3.7 to \$36.8) per month for individual entrepreneurs.

Ukrainian taxes are divided into federal taxes and local taxes (and dues). Federal taxes are set by the Parliament of Ukraine. Local taxes and dues are set by local authorities within the limits of marginal tax rates stipulated by the laws of Ukraine. At present, there are about 50 taxes and dues (obligatory payments) in Ukraine. Many of them have a wide range of differentiation and use various calculation principles.

The rates of taxes and dues (obligatory payments) are set both as a percentage and in value terms. Sometimes they are related to the size of minimum wage and minimum, non-taxable, individual income, which are set by the state.

Small companies and individual entrepreneurs were allowed to switch to a simplified tax system and pay a uniform tax. The conditions required to switch to the uniform tax are:

- For legal entities: annual gross income below EUR 500,000; average number of employees up to 50;
- For individuals: annual proceeds from sales of products (goods, works, services) below UAH 500,000 (\$92,100); number of employees up to 10.

Such a taxation system allows companies to reduce the taxes and dues paid to the state and local budgets, as well as simplifying accounting. The introduction of the uniform tax has helped small and medium businesses develop in Ukraine.

Payroll Taxes

In the process of payroll accounting, taxes and dues are charged for the state budget. These are set both for employers and employees. Employers pay taxes charged by the wages fund:

- To the Pension Fund (32%);
- Obligatory social insurance (2.5%);
- Social insurance for the case of unemployment (currently 2%; 2.5% starting from June 1, 2001).

The employer deducts from wages and transfers to the budget the following taxes:

- Deductions to the Pension Fund. The percentage depends on the size of wages: 1% for salaries up to UAH 150 (\$27.6), 2% for salaries above UAH 150;
- Obligatory social insurance. The rate also depends on the size of wages: 0.25% for salaries

up to UAH 150 (\$27.6), 0.5% for salaries above UAH 150 (\$27.6);

- Social insurance for unemployment, 0.5% of salary.

Starting from March 1, 2001, a limit was set on the monthly employee's income, for which dues to social funds (36.5 to 37% to the labor remuneration fund) and personal deductions to social funds (1.75 to 3%) are charged. At present, the limit is UAH

1,600 (\$294.7). If the actual salary is above the limit value, the dues to social funds are calculated from the sum of UAH 1,600.

In addition to the dues listed above, a personal income tax is also deduced from the employee's wages. Its size depends on the wage limit and is 10% for salaries from UAH 17 to UAH 85 (\$3.1 to \$15.6) and up to 40% for wages above UAH 1,700 (\$313.1).