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## Ukraine – 2015 Performance, Reform Agenda and Future Prospects

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### 2015 Performance

2015 was an important transition year for Ukraine. From an economic point of view, the results were unsatisfactory, with a large decline in GDP of about 11%, a high inflation rate of 47%, and a currency devaluation of over 50%.

As we have reported in the past, it is now well-known that the main causes of these outcomes were the military and economic actions of Russia that led to a collapse of Ukrainian exports and production.

On the other hand, during the year, Ukraine set the stage for future recovery. During the year, there were significant economic and political developments and a number of important reforms were carried out, including the following:

- (a) a comprehensive free trade agreement with the EU was arranged, which should bring FDIs and improve market efficiency, and negotiations on a FTA with Israel and Canada were advanced;
- (b) in November, Rada approved legislation that may permit Ukrainians to travel to Europe without visa;
- (c) Ukraine's international competitiveness has improved thanks in part to large recent currency devaluations;
- (d) partly as a result of currency devaluations, the current account of the balance of payments is roughly in equilibrium;
- (e) the financial account of the balance of payments is also favorable, thanks to the restructuring of public and private foreign debts, with reductions in principal amounts and postponement of repayments;
- (f) a large IMF program was approved which includes agreed upon reform measures and provides financing to cover any necessary future requirements;
- (h) the energy sector has improved with increases in energy prices, reduction of Naftogaz deficits from more than USD 8 billion in 2014 to around USD 1.5 billion in 2015, and enactment of the Gas Market (de-monopolization) Law in April 2105;
- (i) business deregulation was supported by the cancellation of a number of license requirements;
- (j) the payroll tax have been halved and brought to more reasonable levels thanks to introduction of amendments to the existing Tax Code at the end of December 2015;
- (k) reform of public administration has been advanced, resulting in reductions in personnel and government expenditures in some areas;

- (l) the large government fiscal budget deficit was brought under control in 2015 and should not exceed 3.7% of GDP in 2016;
- (m) the online procurement system and the Law on Public Procurement approved in September 2015 should reduce purchasing costs and curb (or at least decrease) corruption in government purchases;
- (n) the solvency of the banking sector has been improved with better banking supervision and with the closure of 43 insolvent banks in 2015, which brought the number of operating banks down to 120;
- (o) the legal institutions required to combat corruption have been put in place and staffed, though real action is still pending;
- (p) the inflation rate has been declining since April 2015, when it peaked at 61% yoy, and should go down to 12% by end of 2016;
- (q) the economy has been stabilized on a month-to-month basis since mid-2015 (though it still remains below one year ago) and will have positive GDP growth in 2016;
- (r) local elections held in October 2015 have given more resources and responsibilities to local officials and will set the stage for future deeper administrative decentralization.

On the defense and military situation, Ukraine was able to contain Russia's military aggression. It built a stronger defense, with the size of the armed forces increasing from 180,000 two years ago to 250,000 in 2015, according to the International Institute for Strategic Studies and statements by the Ukrainian Defense Ministry. The Ukrainian armed forces have now overtaken France, Germany, Italy and the UK (which have armed forces of 220,000; 190,000; 180,000, and 170,000 men, respectively,) as the largest in Europe, excluding Russia. Ukraine was also able to double its military budget which should reach 5% of GDP in 2016. As a result, despite continued pro-Russian military hostilities, the conflict in the East may be frozen at current levels, with high probability that Russia has abandoned plans to take further Ukrainian lands. Although Russia has the military capacity to win a confrontation with Ukraine, its cost would be high. Although not an ideal situation, a frozen conflict may enable Ukraine to proceed with its future development agenda.

## **Future Reform Agenda**

Despite progress made, most analysts report that the pace of implementation of structural reforms in Ukraine remains slow. In particular, there is dissatisfaction with actual results in improving public governance and in fighting corruption, with negligible action against perpetrators. Lack of progress in the reform of the judiciary is another area of concern. The pace of de-regulation is also too slow. For Ukraine to significantly improve its reform credibility and improve its investment climate, the country will need to undertake the following actions in the nearest future:

- (a) **Public Governance:** Ukraine needs to accelerate public administration reform. Current plans to reduce the size of the central government and decentralize will not be sufficient to improve public governance. The illusion that lower number of the government employees should automatically imply increase in efficiency is mistaken. This is due to the fact that the cumbersome functional modus-operandi of government bodies will remain the same. In order to make real progress, a more comprehensive reform is needed. International experience shows that a pre-condition for successful public reform is reaching a national consensus about the functions and role of the government: which should be to support, not to compete with the private sector. Ideally, this should be embodied in the Constitution. The goal should be to retain in the central government only those functions which are not

able to be transferred either to private sector, to the rapidly maturing civil society institutions, or to local authorities. In principle, the central government should only be responsible for policy formulation, with implementation of government services and provision of public goods being decentralized to local authorities. Following a redefinition of the role of the government, there will be a need to carry out reviews of government functions and programs across agencies, with a view to eliminate overlapping or conflicting roles, and to establish clear responsibility and accountability for government actions. This would also lead to reductions in the number of government agencies and employees. These “horizontal” functional reviews should be followed up by “vertical” functional reviews within each agency in order to eliminate unnecessary roles, privatize some activities, and decentralize functions related to delivery of government services. Without these deep horizontal and vertical functional changes, there will be conflictive and overlapping roles between the center and the lower levels that will lead to chaos. These functional reviews should then be followed by “operational reviews” of each institution, to improve government procedures at all levels, to reduce the number of regulations, and to improve transparency, predictability and efficiency. Finally, civil service should be reformed to conform to the new governance system and to improve the professionalism and competence of government officials. The philosophy of the proposed approach should change the emphasis in public administration reform from simple reductions in the number of people to increasing the efficiency of the government and the decision-making machinery. Implementation of this initiative should require the formation of a special Commission with a high level of authority either under the office of the President or Verhovna Rada. The Commission should include representatives of the expert community and civil society institutions. Creation of such commission under the office of Prime Minister is generally not recommended, since this might significantly diminish its effectiveness due to the natural conflict of interests which exists within the Cabinet of Ministers.

- (b) **Corruption Fight:** Ukraine needs to accelerate its fight against corruption, which has damaged the trust of the general public and businesses on state institutions. Currently, the absence of such trust is a significant risk factor for future investments and Ukrainian development. Estimates show that in 2015 around USD 20 billion or almost ¼ of the Ukrainian annual GDP were wasted through different corruption schemes. The crucial efforts in fighting corruption should be concentrated on several important directions including (i) prevention, (ii) enforcement, and (iii) public support. **Prevention** should aim at reducing opportunities for corruption and making corruption more expensive. It should be the key in fighting corruption. Clearly, prevention success depends on deregulation of the economy, reducing the number of government agencies, and decreasing the role of the government in business activities. Wages of government officials should be increased to a reasonable level, which will allow them to have a decent life style comparable with Ukrainian middle class. Other preventive measures include the elimination of multiple prices, tariffs and rates which provide too much discretion to officials; the elimination of product subsidies, such as energy subsidies, to eliminate re-commercialization schemes at higher prices; and the privatization of state enterprises whose managers are likely to seek rents for themselves. Prevention should be followed by strong **Enforcement**. For this, all newly established anticorruption agencies should be in-place and fully operational as soon as possible. Enforcement requires the insulation of these new anticorruption agencies from political pressures. The President and Cabinet should have nothing to do with the operations of these agencies or the appointment of officials. Otherwise, political interference will emerge. Furthermore, there must be an immediate increase in the number of corrupt oligarchs and corrupt officials that are prosecuted and put in jail. Punishment for

corruption cases should be strong and non-selective. Otherwise, enforcement will have no credibility. The third element of the anticorruption program should be securing strong **Public support**. This requires a much better publication of government activities and much better transparency in government actions. These would permit higher levels of surveillance by NGOs and the general public of decisions made by government bodies and officials. Furthermore, the level of transparency of government activities should be increased by broad introduction of the e-government. Anticorruption institutions should deepen their close cooperation with civil society representatives to ensure broader public control over government officials. Public information campaign about these initiatives should help to revive the trust of the society on state institutions.

- (b) **Judiciary and Prosecutorial Reform:** There is an urgent need to reform Ukraine's court system which today does not ensure equal and fair treatment to citizens under the law. This requires a judiciary that is independent and accountable and which has integrity. But today's "Soviet style" judiciary acts principally to protect the financial and political interests of powerful and corrupt special interests. There is now an urgent need to implement and show results of the Lustration process to separate corrupt judges. But although necessary, the dismissal of corrupt judges and the hiring of a new judges' corpus, may be disappointing if the judiciary system is not revamped. Simple changes in names will not provide a society with the expected results. As important is to ensure the real independence of courts/judges from any of the branches of political powers. This can be achieved by removing the rights of the Parliament and the Cabinet to appoint or remove judges or make decisions about the judiciary's salaries and budget. The new judges might be elected by people (i.e., as in some Western democracies) and not assigned either by President or Verhovna Rada as it is now the case in Ukraine. It is also important to improve the transparency of court decisions by posting them online in the internet as soon as possible. Judges should then be accountable for unjust or unethical decisions. Together with judiciary reform, there is an urgent need to reform the prosecutorial system, which today is working poorly and even without the necessary integrity.
- (c) **Business Deregulation:** The government should accelerate the processes of reducing excessive regulations for business activities, including government agency inspections/controls. Although the government recently rejected the use of a "regulatory guillotine" approach, this decision should be revisited as it has had proven effectiveness in many countries. All business regulations should be reviewed by experts with the goal of defining those which are business unfriendly or even damaging. Only those legal acts which are able to pass "an expert community test" should remain. All the rest should be abandoned by "one-time voting" in Verhovna Rada. This initiative should be implemented under the office of the newly established Business Ombudsman's office. Participation in these efforts by all interested business associations is a must.
- (d) **Tax Administration:** Ukraine needs to further simplify its cumbersome tax administration and significantly reduce the tax burden on business. The large size of the shadow economy, which is around 50% of GDP, is symptomatic of the poor investment climate in Ukraine and the significant tax pressures on local businesses which try to avoid them. The existing tax pressure makes Ukraine an unattractive place for opening new businesses and blocks Ukrainian businesses from competing for global FDIs. Verhovna Rada should immediately start discussions on a new liberal Tax Code. Along with initiatives on fighting corruption, there would be a need to secure necessary funding of any temporarily shortage of budget revenues.

- (e) **Customs Administration:** Ukraine needs to simplify and reduce the costs of customs procedures by introducing the world best practices including (i) pre-customs registration, which will permit the reduction of waiting lines in borders, and (ii) introduction of a “random IT based” approach for checking containers. The effectiveness of the reform efforts in this direction will be fully dependent on a success of fighting corruption in customs.
- (f) **Energy Sector Reform.** Ukraine needs to continue its efforts to (i) increase its energy consumption efficiency; (ii) diversify its energy sources including development of alternative energy; and (iii) develop local energy production capabilities.
- (g) **Political and Defence Risks:** Political risks have increased due to the military situation in the East and South of Ukraine. In fact, there is the risk that pro-Russian sentiments in these regions may be further increased due to disillusionment with the current pro-Western government that has done little for these populations in practical terms: there is still significant un-repaired damage to infrastructure, schools, health facilities, potable water, utilities, etc. This risk of disturbances and social tensions may inhibit FDIs and may inhibit economic growth. This highlights the importance of implementing the concept of a comprehensive and large Social Stabilization Fund in these regions. This fund would finance the most pressing social investment needs in these areas, such as school and hospital rehabilitation, water and sewerage improvements, road re-construction, etc. International experience shows that social stabilization funds are very effective in building confidence in the country and minimizing political risks.

## Future Prospects

The actions taken by Ukraine in 2015 have set the stage for recovery in 2016.

Ukraine is an open economy with merchandise exports currently representing 42% of GDP. Therefore, the recovery of exports will be fundamental to revive GDP growth. The new FTA with the EU and a possible agreement with both Israel and Canada may lead to significant increases in exports. The FTA with the EU will eliminate 97% of EU tariffs on Ukrainian exports and will reduce the average tariff on Ukrainian exports from 7.6% to 0.5%, according to government estimates. Ongoing customs reform should also facilitate non-tariff obstacles to trade.

On the other hand, exports may be negatively affected by the trade embargo imposed by Russia on food products and new tariffs on other Ukrainian exports starting January 1, 2016. The Ukrainian government estimates that Ukraine may lose USD 600 million in 2016 as a result of the trade embargo by Russia (this is about one-half of one percent of GDP). Other analysts have estimated that the loss for Ukraine may be as high as 1% of GDP, given the imposition of MFN import duties on other exports. Other Eurasian Common Market countries (Belarus, Kazakhstan and Armenia) have announced that they will not follow Russia's lead.

Nevertheless, new exports to the EU are likely to more than compensate export losses to Russia. Starting from a low base, Ukraine's exports should be able to increase by 4% to 5% in 2016 and GDP should be able to growth by 2% to 3% in the year.

Imports on the other hand are likely to be stable during 2016 due to the wealth effects of the recent devaluations with increased Hryvnia cost of imports, and low economic growth expected in 2016. The current account should therefore be balanced or even positive.

The financial account of the balance of payments should also be roughly balanced thanks to the recent renegotiation of private foreign debt, the financial support from the IMF/EU/WorldBank/EBRD, and

the likelihood that the population will not be buying excessive amounts of foreign exchange (due to still lower household incomes).

On the above basis, the level of international reserves may grow over the year and the Hryvnia exchange rate should remain relatively stable during 2016. In fact, stability to the Hryvnia foreign exchange rate would be achieved thanks to equilibrium in the current and financial accounts, and the availability of IMF financing. This equilibrium means that sources and applications of foreign funds should be in equilibrium in 2016, which will maintain international reserves above USD 13 billion (about three months of imports). This is adequate to secure stability in the exchange rate at about 25 UAH/USD throughout the year, assuming that indeed Russia will not renew significantly its aggression against Ukraine.

With stable foreign exchange rates and low population income growth, the inflation rate should continue to decline from the level of 43.3% achieved in 2015. Low economic growth will contain excessive domestic demand growth and inflation should go down to around 12% by the end of 2016.

In terms of fiscal policies, the consolidated fiscal budget deficit for 2016 is likely to be around the 3.7% of GDP agreed upon under the IMF program. This is based on the current plan to further increase energy prices during the course of 2016.

This scenario for 2016 may revive investors' interest in Ukraine, provided that the ceasefire holds. Accordingly, we could expect that FDI may also revive towards the second half of 2016.