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## **Ukraine: From Fragile Stabilization to Financial Crisis**

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## **Abstract**

Ukraine is going through a very difficult and painful process of economic and political transition. After populist experiments in the first years of independence, some reform effort was launched at the end of 1994. In spring 1996, inflation was reduced, and the exchange rate stabilized. In September 1996, a new currency (hryvna) was introduced. In the second half of 1997, seven-year lasting GDP decline seemed to come to end. However, in the same time serious financial crisis started to threaten a fragile stability. Continuous outflow of investors from the T-bills market and significant losses in the NBU foreign reserves led finally to abrupt devaluation of hryvna in August and September of 1998, new wave of inflation and output decline, and liquidity problems in some commercial banks.

Monetary policy alone failed to guarantee sustainable macroeconomic stability and avoid devaluation crisis. Continuous high fiscal deficit could be financed from non-monetary sources only temporarily. Government and parliament were unable to solve fiscal problems on time. The deeper causes of the persistent fiscal crisis lay, however, in a slow pace of structural and institutional reforms.

## Introduction (Marek Dabrowski)

Ukraine, the second largest post-Soviet country, is going through a very difficult and painful process of transition from communism to liberal democracy and from a centrally planned economy to the market one. Due to many political obstacles, the process of the economic transition has been significantly slower, in comparison with many other post-communist countries including even some former Soviet republics. As a result, Ukraine experienced hyperinflation at the end of 1993 and a dramatic GDP decline, which was deeper than in many other transition economies.

Some reform effort was launched at the end of 1994 after Leonid Kuchma won the presidential election and became the second President of post-Soviet independent Ukraine. These attempts have been supported by the IMF, the World Bank and number of bilateral donors. They gave some results, mainly in the macroeconomic sphere. In spring 1996, inflation came down to a level comparable with leading reformers from the Central Europe and Baltic region, and the exchange rate stabilized. In September 1996, a new currency (hryvna) was introduced quite successfully. In the second half of 1997, seven-year lasting GDP decline seemed to come to end. However, in the same time the first signs of serious financial crisis started to threaten a fragile stability. They manifested themselves by continuous outflow of investors from the T-bills market and significant losses in the NBU foreign reserves. Change in investors' sentiment was partly provoked by the series of financial crises in the Asian countries but, as we will try to show in this volume, sufficient domestic causes of the panic were in place. Unfortunately, Ukrainian authorities were not able to respond effectively to development of a crisis situation. In the end of 1997 and first half of 1998 macroeconomic situation gradually deteriorated. Currency corridor had to be changed twice and hryvna was effectively devalued by ca. 7% in the first quarter of 1998. New borrowing of government became extremely difficult and costly.

Although some fiscal adjustment was observed in 1998 it was too limited and superficial and came too late to stop the crisis spiral. Parliamentary elections in the end of March 1998, strong position of anti-reform parties in the new parliament, and forthcoming presidential election campaign have not helped to work out the adequate anti-crisis package. Finally, financial and political crisis in Russia, entering its culmination phase after August 17, 1998 caused the similar developments in Ukraine. Although crisis developments in Ukraine in last four months of 1998 were less severe than in neighboring Russia<sup>1</sup>, they made enough damage to fragile macroeconomic stability achieved with so big pain two years earlier. Hryvna depreciated by approximately 75% in relation to US dollar through year 1998. Inflation being close to zero in the first eight month of 1998 jumped significantly in the last four months reaching 20.0% in the end of the year (in relation to the end of 1997). Monetization of the Ukrainian economy always very limited has decreased further as result of the credibility crisis. Banking sector went under the strong pressure of the depositors provoked by the Russian panics and changed perception of a risk connected with holding government bonds. GDP started to go down again in the second half of 1998 and this trend will continue at least through year 1999. Real incomes of population and its living standard decreased significantly as result of currency depreciation and the new surge of inflation. What is even more important, there are no guarantees that the crisis spiral reached already the bottom level and situation will not deteriorate further in the course of 1999.

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<sup>1</sup> Differences in early crisis developments in Russia and Ukraine and their causes are described by Dabrowski et al. [1998].

The basic question is why the macroeconomic stability in Ukraine occurred to be so fragile and unsustainable. To answer this question one must come back to the very interesting polemics between Jeffrey Sachs and the IMF related to strategy of primary macroeconomic stabilization in post-communist countries that took place in 1994 [Sachs, 1994a; Sachs, 1994b; Hernandez-Cata, 1994].

Sachs' point of view was that the IMF had adopted too tough (from the political point of view) fiscal stance in relation to Russia in 1992-1993<sup>2</sup> when stabilization package could rely more on the fixed exchange rate as the main anti-inflationary anchor and on non-inflationary sources of financing the remaining fiscal deficit (i.e. through treasury bills market and external financial assistance). Fixed exchange rate should bring inflationary expectations down relatively quickly and increase demand for domestic currency what would increase the room for maneuver in the monetary policy area. Of course, this kind of stabilization strategy needs a quite substantial external financial aid: both for partial financing the deficit, and for creating stabilization fund backing the fixed exchange rate (solution similar to the Poland's one in 1990).

In fact, those CIS countries that achieved disinflation success in 1995-1997 have followed Sachs recommendations. In almost all the analyzed cases stable exchange rate (*de facto, de iure* it has often remained floating) and significant reduction of deficit financing from the money emission (and quasi-fiscal operations of central banks) have been the main factors staying behind price stabilization. However, fiscal deficit has remained on the level of at least 5% of GDP and has been financed either from external sources or through T-bills emission. It was the fiscal factor that differentiated macroeconomic developments in CIS countries, including Russia and Ukraine on the one hand, and most of the Central European and Baltic countries on the other [see – Dabrowski, 1998].

Contrary to low-income countries such as Moldova, Georgia, Armenia, and Kyrgyzstan, Russia, and Ukraine could not rely on concessionaire financial aid. They have had access to the standard multilateral and bilateral aid of the IMF, World Bank, European Union, and some developed countries only. However, the size of this aid has been limited and usually linked with conditionalities related to the progress in different aspects of economic transition. Because reform process has gone slowly, approval and disbursement of the subsequent aid programs have been also very often postponed. It was exactly the case of Ukraine in 1996-1998.

It is worth to remember that financial aid of the IMF, World Bank, EU or bilateral available for countries such as Ukraine or Russia has the form of loans, which must be repaid in future. However, it differs from private borrowing in terms of lower interest rate premium, longer maturity, and the presence of a grace period.

An official financial aid could meet only part of the public sector borrowing requirements. The rest must come from the domestic and international private borrowing (assuming zero or very limited size of central bank financing). As the first step, Russia and Ukraine developed domestic market of T-bills and bonds. However, the limited level of monetization reflecting general lack of credibility and underdevelopment of the financial sector did not create a big room for maneuver. Approximately a year or year and half after

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<sup>2</sup> This critique was not correct as the most of the STF (Systemic Transformation Facilities) programs implemented at that time in CIS countries by the IMF contained rather very loose fiscal deficit target (even up to 10% of GDP when monetization did not exceed 20% of GDP) [see - Dabrowski, 1997].

launching a larger scale T-bill financing domestic market became already saturated what was reflected by the high T-bills yields.

Opening T-bills market to non-residents and issuing government bonds denominated in foreign currency placed on the international financial markets have become the next stages of easing up the fiscal constraints in CIS countries. It gave approximately one additional year for solving the fiscal problems. Situation which prevailed in the international financial markets in 1996 and in the first half of 1997, i.e. excess of free resources and readiness of financial investors to be engaged into emerging markets, made this form of deficit financing relatively cheap and easy (especially under relatively stable exchange rate).

However, this additional time was simply lost. Fiscal balance did not improve at all (the case of Russia) or progress in this sphere was too slow (Ukraine). International experience shows that massive domestic and external borrowing can solve fiscal problems and support macroeconomic stability in short run only [see – Markiewicz, 1998]. Increasing debt overhang (the pace of this process is particularly fast under continuous decline of GDP) led to explosion of interest payments and brought both countries to the situation of the debt trap and liquidity crisis of the government finances. The same happened in Bulgaria in the end of 1996.

Ukraine started its transition process in 1991 from the public debt equal to zero. Although its current level (close to 30% of GDP; much lower than Bulgaria or Russia) is still low by the international standards, it occurred to be excessive in respect to really existing financing opportunities. This means that some superficial and mechanical comparisons of the public debt to GDP ratio may be misleading if they neglect the real size of domestic financial market, international rating of the country or maturity structure of the debt. This last factor played a very important role in Ukraine where most of public debt instruments did not exceed 12 months maturity.

Series of emerging markets crises in 1997 (mainly in South East Asia) reversed the investor sentiments. This reduced drastically the availability of relatively cheap external financing and provoked the capital outflow from Russia and Ukraine considered as the next candidates for devaluation crisis.

Withdrawals of non-resident investors from the T-bills market brought immediately two kinds of problems: liquidity crisis of the government, and pressure for the official foreign exchange reserves. Government started to have problems not only with the new deficit financing but also with rolling over the existing stock of debt. In order to avoid immediate default on the T-bills market central banks were forced to actively participate in rolling over T-bills. This meant return to monetary financing of the fiscal deficit. Even if the overall size of the monetary base remained more or less stable as it was in the case of Ukraine between November 1997 and August 1998 its composition changed dramatically. Net foreign assets of the NBU declined rapidly and were compensated by the increase in net domestic assets, more precisely – in net NBU credit to government. It gave additional room for speculation against hryvna, this time of residents. The very similar developments were observed in Russia.

In the beginning of building the T-bills pyramid high yields and zero risk traditionally calculated in relation to government debt instruments made this kind of assets very attractive for the domestic commercial banks. Thus, they have become the main domestic holders of T-bills. They also used T-bills as collateral on the interbank credit market [see- Górski, 1999] and for foreign borrowing (the case of Russia). Additionally, Russian banks were strongly

engaged in forward type speculative transactions and kept open foreign exchange positions. Default on the government debt market in Russia and near-default in Ukraine (“voluntary” debt conversion under the danger of official default) changed dramatically the assessment of banks’ liquidity and solvency, and in fact froze an interbank market. Additionally, devaluation hurt these banks, which kept open foreign exchange position. Many banks’ clients started to withdraw their deposits. In Russia, it led to open panics and paralyze of the banking sector. In Ukraine, the scale of damage has been much more limited so far, due to avoiding open default on the T-bills market, better crisis management, and smaller involvement of banks in risky operations. However, a danger of systemic banking remains actual.

The above analysis shows the crucial role of fiscal imbalances in building the crisis potential. It was exactly the reason why disinflation success in many CIS countries occurred to be a short living. However, this gives only part of explanation related mainly to macroeconomic policy factors. The next group of questions addresses the microeconomic and institutional issues determining failure in fiscal adjustment.

Experience of transition process gives a lot of evidence that fiscal policy performance reflects a quality of economic policy and systemic reforms in the specific country. Any in consequence of the conducted policy, delay in transition on the microeconomic level, weakness of the government institutions, and favorable political climate for the intensive rent seeking negatively influence fiscal balances. Thus fiscal equilibrium depends not only on the fiscal policy itself but also on the speed, quality and consequence of the overall reform process.

In this respect, Ukraine’s record looks particularly bad. Delayed and insiders’ dominated privatization has brought very little restructuring on the enterprise and industry level. Collectivist approach to land ownership has brought agriculture sector to the deep depression and harmed creation of the effective land market.

Overregulation of various aspects of economic life combined with a weak, unreformed state apparatus has stimulated corruption and organized crime, hindering the development of a new private sector. Government has been unable to provide basic public goods such as public security, protection of private property rights, effective contract enforcement, and infrastructure services. Significant part of a business activity has moved to the unofficial sector, as costs of legal activity have been too high comparing to the potential benefits.

This has led to significant narrowing of the tax base. Tax system and tax administration themselves have created many microeconomic distortions and harassment of profitable business activity. Repeated unrealistic budgets have caused sequestration, budget arrears, and damaged financial discipline including tax collection. In addition, excessive and ineffective social safety net has put a heavy burden on the expenditure side of the budget.

This is only partial list of failures in the area of institutional and structural reforms. Slow progress in this sphere did not allow overcoming deep output decline in the official sector what additionally narrowed room for fiscal adjustment.

In the beginning of 1999, prospects of the Ukrainian economy are very unclear. Country badly needs a comprehensive and radical package of political and economic reforms, which could remove the existing obstacles of the legal business activity, return domestic and international credibility, solve the fiscal problems, and stimulate sustainable economic growth. The first step on this way is to make the adequate diagnosis what went wrong so far,

and why Ukraine experienced the financial crisis despite some earlier achievements in disinflation process.

The purpose of this volume is to make contribution to such a diagnosis. Five individual authors' studies analyze different aspects of the Ukrainian way from a fragile stabilization to financial crisis. Marta Dekhtiarchuk ("Monetary Stabilization in Ukraine: Difficulties and Results") gives a historical picture of Ukrainian stabilization attempts, and analyzes developments in the monetary policy, T-bills market, and external debt spheres. Urban Górski ("Banking System in Ukraine") concentrates on problems challenging commercial banks activity in fragile macroeconomic and institutional environment. Pavel Kovalev's study ("Some Fiscal Policy Problems") concerns fiscal disbalances, which have been the most important macroeconomic factor leading to financial crisis. Khwaja Sultan ("Ukraine's Travail with Tax Reforms") continues this topic analyzing weaknesses of the Ukrainian tax system and factors stimulating expansion of the unregistered business activity. Finally, Yurii Kuz'min ("Structural Roots of Financial Crisis?") tries to give the overview of political, structural, and institutional obstacles hampering the Ukrainian transition. Urban Górski helped in final editing work of this volume.

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# **Monetary Stabilization in Ukraine: Difficulties and Results (Marta Dekhtiarchuk)**

## **1. Difficult beginnings of Ukrainian independence**

After collapse of the Soviet Union in August 1991, Ukraine became an independent state. At that time almost nobody foresaw the fundamental problems, which Ukraine had to overcome to build prosperous state as well as there was little understanding what should be done to transform the Soviet type economy into the market one. As a result, Ukraine has experienced stagnation in reforms for more than tree years since independence.

Among transition economies, Ukraine reached a leading position in respect to the scale of macroeconomic destabilization. In some periods, monthly inflation exceeded 50 % what is considered as hyperinflation. For example, in September of 1993 the monthly rate of inflation was 80 %, in October – 66 %, in December – 91 %.

At the presence of hyperinflation there were no conditions for emerging new business activities, developing international trade, stimulating private savings and investment at the appropriate level, etc. This led to rapid increase in money velocity, dollarization ratio, to huge shadow economy, negative real interest rate, etc. Only at the end of 1994, some evidence of stabilization started to appear.

The purpose of this paper is to examine more closely the period of price stabilization, to consider the main policies that led to this outcome, to show particularities of Ukrainian reforms, to determine the costs of stabilization and reasons of why it has not been sustainable.

## **2. Long way to stabilization.**

Transition economies are not homogeneous, they have many distinctive features such as culture, level of industrialization, human capital, etc. Therefore, there are no strict recipes that lead to the prosperous economy. Every country has to find its own way of transformation. However, there are some general policies that need to be implemented. These are domestic price liberalization, liberalization of foreign trade, macroeconomic stabilization, privatization, and creation of conditions for emerging new businesses.

All these policies are important. Free prices determined by supply and demand conditions are the background of the market economy. This allows prices to reflect a scarcity of resources and allocate them efficiently. Therefore, their fast liberalization is so important. Consequently, liberalization of the foreign sector drives the economy to such a price system that reflects scarcity of the global resources and opens the economy to a world competition.

Monetary overhang was an inherited de-stabilizer in almost all transition countries. It arose because in all former socialist economies the public was forced to save- total wage bill was bigger than available volume of consumer goods at fixed administrative prices. Although in every period the difference was rather small, over time an excessive money supply achieved a significant size. Liberalization, besides its positive contribution, was bound to increase prices due to this excessive money stock and inherited price distortions. In some cases, it was the end of a story.

However, in some countries such as Ukraine prices continued to grow after corrective jump caused by their liberalization. This means that one of the following sources of inflation was in place: soft budget constraints of state owned enterprises (SOE); workers' claims of nominal wage increase; budget deficit, domestic credit expansion. In addition, until the system of government finance was reformed, only printing money could finance budget deficit.

Although more serious stabilization effort in Ukraine started at the end of 1994, there were some attempts of fighting against inflation before this date. Basically, they included price and wage controls and in some cases also restrictions in money supply growth.

Price controls included price ceilings and restrictions on profit margins. In addition, prices for food, fuel, and housing were subsidized and set administratively. Nevertheless, since money supply continued to grow, the non-regulated prices had to increase threefold to equilibrate the money market. The general price level continued to increase since it is a weighted average of all prices (not only regulated ones). Hence, increasing distortions of the relative prices were the only consequence of such regulations. On the other hand, enterprises had to be compensated for losses associated with price controls what caused larger fiscal deficit and increasing money supply.

During the period when Leonid Kuchma was the Prime Minister (1992-1993) a special decree forbade an increase in nominal wages without an increase in productivity. This was an attempt to beat inflation by limiting a part of aggregate demand. As a result, the unofficial sector began to grow employing labor with the appropriate level of nominal income.

A restriction in the money supply took a form of "stop and go" policy. At the end of 1993 the National Bank of Ukraine (NBU) decided to subdue inflation by tightening the money supply. Inflationary expectations were to remain high for some time. Therefore, prices stayed unchanged and even increased leading to wage inter-enterprise arrears. Enterprises effectively claimed additional subsidies to eliminate their indebtedness, the agricultural sector demanded credits for sowing and harvesting, and workers extorted their earnings. In this situation, the only way out was the increase in money supply that caused a new wave of inflation.

Table 1: Exchange Rate and Inflation.

Year/ Quarter	CPI (monthly change, %)	WPI (monthly change, %)	Official exchange rate	
			Hrn/USD	Monthly change, %
1993:Q1	39.7	43.3	0.014	
1993:Q2	39.4	50.6	0.033	33.08
1993:Q3	44.5	45.4	0.059	21.37
1993:Q4	66.4	46.7	0.086	13.38
1994:Q1	12.4	20.8	0.126	13.58
1994:Q2	5	3.6	0.141	3.82
1994:Q3	4	9.6	0.214	14.92
1994:Q4	39.5	50.2	0.786	54.29
1995:Q1	16.8	16.3	1.207	15.37
1995:Q2	5.1	6.9	1.347	3.73
1995:Q3	7.1	6.9	1.567	5.17
1995:Q4	6.6	5	1.771	4.16
1996:Q1	6.6	3.1	1.866	1.76
1996:Q2	1.1	0.9	1.845	-0.38

1996:Q3	2.6	0.7	1.767	-1.43
1996:Q4	1.2	0.7	1.839	1.34
1997:Q1	1.2	0.5	1.857	0.33
1997:Q2	0.6	0.5	1.849	-0.14
1997:Q3	0.4	0.2	1.858	0.16
1997:Q4	1.1	0.5	1.882	0.43
1998:Q1	0.6	0.8	1.967	0.11
1998:Q2	0.4	0.2	2.049	

Source: Ukrainian Economic Trends, March, 1998

There were also many foreign exchange restrictions such as existence of official over-appreciated exchange rate for exporters and privileged importers, a limitation of currency convertibility, various import and export tariffs and quotas, capital control, etc. Like other purely administrative policies, they were bound to fail, as they actually did. The only consequence of this policy was deterioration of the balance of payment position.

Only since 1995 successively tight monetary policy launched by Victor Yushchenko, a governor of the NBU resulted in the gradual disinflation (see **Table 1** and **2**). In the last quarter of 1994, average monthly inflation was 35.5%, in the first quarter of 1995, its rate fell to 16.8%, and after that, it was measured in a single digit.

Table 2: Monetary performance.

Year Quarter	Cash			M2			Required reserve ratio, %	Dollari- zation ratio, %	NBU discount rate	
	Bln. hrn., end of period	Monthly % of change	Velo- city	Bln. hrn., end of period	Monthly % of change	Velo- city			Official (% per month)	Actual (% per month)
1993:Q1	9		34.3	59		7.3	25	31.5		
1993:Q2	17	24.02	40.3	111	21.9	8.7	25	29.5		
1993:Q3	52	48.88	47.8	306	42.56	8.9	25	26.9	20.0	17.0
1993:Q4	128	35.67	42.5	481	16.17	11	25	58.8	20.0	-27.0
1994:Q1	230	21.75	33.8	681	12.48	13	20.3	48	20.0	6.8
1994:Q2	333	13.59	27.3	1082	16.73	11	15	41.2	20.0	14.3
1994:Q3	33333520	16.15	22.5	1863	19.88	7.7	15	32.7	13.6	9.2
1994:Q4	793	15.21	31.9	3216	20.07	11	15	48.5	24.1	-10.4
1995:Q1	1134	12.84	36.8	3935	7.10	15	15	47	20.0	2.7
1995:Q2	1782	16.85	30.7	5309	10.43	14	15	42.5	9.2	3.9
1995:Q3	2235	7.92	28.8	6387	6.51	13	15	42.7	5.6	-2.2
1995:Q4	2623	5.89	29.0	6846	2.48	14	15	37.7	8.1	1.4
1996:Q1	2800	2.30	27.2	7086	1.25	14	15	35.8	8.6	1.8
1996:Q2	3324	5.92	24.5	7522	2.01	13	15	34.6	5.4	4.4
1996:Q3	3330	0.47	23.8	7592	0.37	13	15	32.3	3.3	0.7
1996:Q4	4041	6.83	23.4	9024	6.03	13	15	34.5	3.3	2.1
1997:Q1	4306	2.16	18.2	9514	1.81	9.9	15	28.3	2.7	1.6
1997:Q2	5102	5.88	18.0	10971	4.88	9.9	11	28.8	2.0	1.4
1997:Q3	6031	5.96	16.1	12222	3.71	9.2	11	28.4	1.4	1.0
1997:Q4	6132	0.66	16.0	12447	0.73	9.2	13.3	26.5	2.1	1.0
1998:Q1	6365	0.33		12835	1.13	7.8		28.8	3.3	
1998:Q2	6390	0.33		13257	1.10	7.9		28.9	3.8	

Source: Ukrainian Economic Trends, March 1998

Also, the nominal exchange rate exhibited fairly small fluctuations in 1995 (the average monthly changes were 3.73 % in the second, 5.17 % in the third and 4.16% in the fourth quarter), except one relatively sharp increase in August.

Beginning from the last quarter of 1993 the monthly increase of M2 did not exceed 20 % and since 1995 - 10 %. This led to restoration of public credibility to the national currency and to increase in demand for the national currency. One can see from Table 2 that the dollarization ratio and velocity of currency in circulation as well as velocity of M2 began to decrease after the third quarter of 1995.

In September 1996, a new currency, hryvna, was introduced. This monetary reform had a non-confiscatory character: all stock of the “old currency” was exchanged into hryvna at the constant ratio of 100,000 karbovanetses for 1 hryvna. It is widely accepted that this reform was very successful and it further strengthened credibility to the national currency.

Stabilization can not be achieved without tightening budget constrains to the SOEs. In April 1995, the supply of natural gas was stopped for 3,250 industrial enterprises. Partially it happened because of problems with gas import from Russia but partially it was a disciplinary step to force enterprises to pay for their obligations. As one can see from Table 2 the spread between the actual and official discount rates became smaller after stabilization. This means that the NBU limited the volume of subsidized credits.

### **3. From stabilization to crisis**

Despite heroic attempts of the NBU to keep money supply under control and stabilize hryvna, this policy could not be fully successful due to problems with fiscal policy and structural reforms.

Beginning from the second quarter of 1995, the Treasury bills market started operating and private external borrowing became available. In 1995 financing of budget deficit looked as follows: 72.7 % by direct credits of the NBU, 19.8 % by the external credits, and 7.4 % by money raised on the T-bills market; in 1996 – 40.2 %, 22.8 % and 37 % respectively; and in 1997 – 1.7 %, 27.1 % and 71.3 % respectively. These figures are telling everything.

The introduction of T-bills market decreased the pressure on the monetary policy from the budget side. This respite should have to be used for carrying out fiscal reforms. Instead, it gave the government a mistaken impression that the possibility of easy financing the budget deficit will exist forever. Thus, the government began to build a financial pyramid. Eventually it had to lead to the financial crisis. The first signals of such crisis were seen in the autumn of 1997.

Under such circumstances, instead of sharp decreasing the consolidated budget expenditures to release resources for paying T-bills obligations, the government persuaded the NBU to take part in further building up the pyramid by extensive purchases of T-bills at the primary auctions. While value of the T-bills purchased by the NBU in 1997 was 1.1 billion UAH, in the first eight months of 1998, the value was ca. 3.8 billion UAH. In fact, the NBU has increasingly replaced private investors who have lost their confidence to government securities (see – below).

In market economies, purchasing T-bills by a central bank increases the money supply only temporary since at the redemption the opposite effect occurs. In Ukraine the situation differed as the NBU rolled over all amount of matured T-bills and, in fact, invested in this market more and more funds.

The effect of such the NBU's actions was twofold. At the beginning, the NBU performed sterilization of its open market operations by selling its international reserves. This depleted the reserves and rose the question of stability of hryvna/dollar exchange band. At some point of time, further sterilization became impossible because of the tiny amount of foreign reserves. Thus, T-bills operations led to increase in money supply and accumulation of the inflationary potential.

Another problem associated with functioning of the T-bills market was the method of stimulating demand for these securities. In November 1997, the NBU permitted Ukrainian banks to include funds invested in the primary T-bills market into their mandatory reserves, decreasing indirectly the reserve requirements. Resulted additional liquidity was used by the commercial banks for buying US dollars causing the additional pressure on the exchange rate. Very high yields on this type of securities and the possibility of holding them as required reserves led to the crowding out effect. Commercial banks lent to government instead of crediting the enterprise sector. However, in the second half of 1998 the NBU canceled the above provision.

There is also a question of the composition of reserve money. As one can see from **Chart 1**, in 1997 the reserve money increased by ca. 50%, basically because of the increase in net foreign assets of the NBU (this happened because of inflow of short-term international capital to the Ukrainian T-bills market). In 1998, reserve money did not change significantly. However, at that time net foreign assets decreased drastically: since the autumn of 1997 portfolio capital has been leaving Ukraine. As foreign and domestic (mainly of commercial banks) credit to the government was substituted by the NBU's credit to the government, the net domestic assets of the NBU substituted the net foreign assets of the NBU. The ratio of net foreign assets to reserve money decreased. As a result, the room for maneuver for monetary and exchange rate policies was drastically reduced.

Graph 1: Composition of reserve money

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The low level of monetization of the Ukrainian economy was the other factor that caused some difficulties. Although the ratio of M2 to the nominal GDP increased from about 7 % to 12.7 % in the monetary stabilization period, it was still far away from the appropriate level. The bigger is the ratio the less sensitive is the economy to increase in the money supply or perturbations on the financial markets. On the other side, the low level of monetization could be explained by the fact that policy performed by the NBU was not credible enough and people did not want to use the national currency as a store of value.

#### **4. Development of the T-bills market**

To date there are four types of securities issued by the central government: bonds of domestic borrowing (OVDP), an equivalent of T-bills, eurobonds, domestic state saving bonds, and special bonds. The T-bills market is the most developed segment of government securities market.

Issuing government debt instruments is a usual mean of financing budget deficit in all developed countries. They borrow in one point of the time and return the loan somewhat later. Since the growth rate of these economies is positive and the rate of return on government securities is small, the redemption of matured bonds is not a big problem. The other factors

that contribute to stability of government bonds markets are political stability, confidence of investors to a government, and development of financial and currency markets.

In Ukraine, the situation differs substantially. There is no great confidence to government actions. Therefore, in order to attract investors the authority had to set very high yields on its securities. Since the economy does not function appropriately, the only way to redeem the mature securities is to issue new securities with bigger value. As every investor understands that this process has to collapse at some point, the smaller and smaller numbers of investors were eager to buy Ukrainian T-bills, worsening the public finance stance.

The T-bills market was created in the second quarter of 1995. Offered maturity periods were 1-, 2-, 3-, 6-, 9-, 12- and 18-month. However, since the spring of 1998 the government has continued issuing bonds with only 12- and, to some extent, 9-month maturity. Instead, so-called bonds with fixed redemption date [BFRD] have started circulating. The period of such bond circulation is the difference between the date of issue and the fixed date of redemption set by the emitter for each separate tranche. BFRDs could be divided on the short-term securities (114-140 days of maturity) and long-term ones (287-366 days of maturity). Overwhelming majority of long-term BFRDs were purchased by the NBU.

Graph 2: T-bills revenues, redemption, and yield

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Starting from the very beginning of T-bills market functioning, the government built the financial pyramid. There were no plans for the size of new tranches of T-bills and no idea how to repay them in future. The government officials followed the rule: the more, the better. Therefore, in order to attract new financing they had to increase gradually T-bills yields. Following this way, 304.1 million UAH was raised in 1995, 3145.1 million UAH in 1996, and 4360.6 million UAH in the first half of 1997 (see - **Chart 2**). A very high rate of return attracted foreign investors (nominal effective rates of return were 143.25 % per annum in 1995, 102.5 % in 1996, and 42.9% in the first quarter of 1997).

However, at the beginning of 1997 the government started to decrease gradually the rate of return and in August it reached 22-23 % only - the lowest level since the T-bill market was opened. This was not satisfactory for foreigners, main participants of this market. They started to take away their capital. In addition, in this period (August 1997) the government decided to partially repay wage arrears. Credit from the Bank of Luxembourg was spent on these purposes leading to the increase in the money base. This increase in domestic money supply and fall in demand of non-residents for hryvna forced currency to depreciate (see **Table 1**).

Investors took a drop in hryvna exchange rate as the beginning of a new trend. This resulted in accelerated outflow of non-residents' capital from the T-bill market. There were also other factors reducing foreign investors' interest in this market such as government's difficulties with implementing the IMF stand-by program, an increased political risk due to forthcoming parliamentary elections in March 1998, inability of Ukraine agent-banks or the NBU to hedge the exchange rate risk caused by the lack of 1998 exchange rate corridor, etc. As demand for T-bills declined and the government faced the problem with paying matured T-bills, it had to increase the rate of return by 5%. It is not so easy to go out from the pyramid!

This could be the end of the story. However, the financial crises in the East Asia and unwillingness of the government to tighten its belt worsened the situation. International investors were threatened and lost credibility to all emerging markets including that of Ukraine. Therefore, the outflow of capital from Ukraine continued in October and November of 1997.

In order to prevent the collapse of hryvna, the NBU decided to increase supply of dollars at the Ukraine Interbank Currency Exchange. It costs \$0.8 billion of foreign reserves spent during 4 months (from August 1997 to January 1998). At that time, the rate of return on T-bills became twice as much as it was before the Asian crisis.

The stock market reflected one to one difficulties of the T-bills market. There was a sharp fall in the stock index: from October to the end of 1997 it decreased by more than 30 % [Visnyk NBU, 1998, p. 34].

In such a situation the discount rate increased from 17 % to 25 % on November 17, 1997 and then to 35 % on November 20, 1997; reserves requirement – from 11 % to 15% in the early December 1997. In addition, it was very difficult to defend the old exchange rate corridor: it could deter investors from the market since they would not believe that the NBU could maintain it. Therefore, on October 31, 1997 the NBU announced the change in the corridor: in the new version the range was supposed to be from 1.75 UAH/\$ to 1.95 UAH/\$ for the first half of 1998. These steps have allowed stopping market panic for a few next months.

The first eight months of 1998 could be characterized as a hidden crisis. The government did not launch radical structural reforms and changes in the fiscal policy. Non-residents continued the process of withdrawing their money from the government securities market. They did it as calm as possible understanding that any panic would led to the default of the government. In such a situation, the NBU became the more and more important player at the T-bill market. In fact, almost all long-term (more than 200 days of maturity) T-bills were bought by the NBU. In addition, majority of redeemed T-bills was rolled over by the NBU.

In summer 1998 the outstanding domestic debt amounted to ca. 12 billion UAH or 12% of GDP. In such countries as Belgium or Italy, it amounts to more than 100% of GDP. However, in the above mentioned countries GDP grows, monetization ratio is much higher comparing to Ukraine (59 % in Belgium and 60 % in Italy in 1994) and it is rather easy to repay the accumulated debt.

## **5. External Debt**

An increasing share of external financing of budget deficit rises the question of the acceptable level of external public debt. The Ukraine's foreign debt stood at about \$8.8 billion in late 1997 and at \$10.7 billion on June 1, 1998. At the end of 1995, about half of Ukrainian debt was owed to Russia and Turkmenistan, primarily for gas deliveries, while the remainder to Western creditors, mostly to the international financial institutions and bilateral export credit agencies. The proportion of debt to Russia and Turkmenistan is continuing to decline, since Ukraine is no longer building up significant arrears for fuel deliveries.

The Ukrainian government has also borrowed at international markets through issuing three tranches of eurobonds. The first one, amounting to DEM 732 million began floating on



February 1, 1998. The bonds were floated on the primary market with an annual yield of 16% in D-marks (ca. 18% per annum in dollar terms). Before the bonds were issued, the Moody rating agency had assigned Ukraine a credit rating of B2 for long-term government bonds denominated in foreign currency. Second, Ukraine received ECU 488 million from EURO denominated bonds floated on March 17, 1998. The borrowing rate for Ukraine was 15.94% per annum in ECU or approximately 17.5% per annum in dollar terms. Third, on May 6, 1998 the second tranche of D-mark-denominated three-year Eurobonds gave DEM 259.35 million.

According to terms of the bond issue, the amount of DEM 255 million was raised by selling bonds to investors at 102% of nominal value. In addition, investors refunded DEM 7.7 million to the Finance Ministry from their annual coupon yields over 70 days. According to the terms of floatation, investor yields in the primary floatation was 14.99% per annum.

However, the above mentioned Euro-loans (as well as other means of borrowings) are expensive for the Ukrainian government because of, among other factors, Ukraine's low credit rating caused by unstable domestic economic situation. In addition, the loans were primarily used for current needs (to pay wage arrears, to cover budget deficit) and for external payments, but not for reforming the economy or investment. So, there are some doubts about Ukraine's ability to return this money.

Ukraine has used extensively the IMF resources, starting with a Systemic Transformation Facility loan in the fall of 1994. It was continued by the Stand-by loan in spring 1995, which was extended in spring 1996 to the end of this year. On August 25, 1997, another 12-months Stand-by Arrangement of SDR 389.92 million was approved. In September 1998, the IMF approved the Extended Fund Facility loan for Ukraine of 2.2 billion USD. Ukraine has also made extensive use of the World Bank structural adjustment lending.

According to international standards, the size of Ukraine's external debt (18% of GDP) in 1997 could not be considered as dangerous. However, the short maturity of most of the debt and low credit rating made Ukraine very vulnerable. Therefore, even this amount of debt occurred to be unsustainable.

## **6. Conclusions**

We can draw some lessons from the recent crisis. First, a small economy such as Ukraine cannot rely on short-term capital inflow to the T-bills market. In such a situation the exchange rate is very vulnerable and can fall either because of the speculative motives of market agents or because of sensitivity of this kind of capital to temporary difficulties. Second, the maturity structure of T-bills should be improved. It is better to issue more securities with relatively long maturity and less with the short one to get more time for maneuver. Third, without positive changes in the real sector of the economy and without serious fiscal adjustment, the T-bills market eventually will collapse. Finally, the T-bills markets in Ukraine and Russia have occurred to be interdependent; in fact, they have competed for the same foreign investors. Therefore, when Russia increased the rate of return on its securities, Ukraine had to do the same.

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# Banking System in Ukraine (Urban Górski)

## 1. Overview

In the period of 1996-97, the Ukrainian economy experienced first signs of macroeconomic stabilization mainly as a result of introducing hryvna, its stable exchange rate and limited direct monetary financing of reduced budget deficit. The inflation rate decelerated from more than 10,000% in 1993 to around 40% in 1996 and 10 % in 1997. This gave a chance to the Ukrainian banking system for reorganization and restoring its intermediation function in redistributing credit to the economy. Unfortunately, this chance was largely missed due to inappropriate economic policy, political reasons, and lack of determination in implementing reforms. In particular, a macroeconomic policy mix (proportions of monetary and fiscal adjustment) was not properly chosen restraining consistency and credibility of overall economic policy.

Additionally, many problems concerning legal framework of banking system operation did not obtain sufficient attention in the parliament. There is still evidently a high “politicization” of financial sector. All large state-owned and former state-owned banks are still used for direct lending to loss-making enterprises for “social” reasons under political pressure. At the same time, however, Ukraine slowly started developing infrastructure of a market-based financial system and succeeded in implementing arguably one of the best funds payment system in all the Central and East Europe and former Soviet Union. Apart from the above, for last three years, Ukrainian commercial banks have markedly increased their statutory capital as a result of new regulations issued by reorganized banking supervision department of the National Bank of Ukraine (NBU).

## 2. Sector Structure

As of January 1, 1998, the Ukrainian banking sector consisted of 227 organizations registered as commercial banks. A large number of banks do not operate due to poor financial stance. More than 30 banks are classified for liquidation or are in various rehabilitation programs, which means that approximately 189 banks effectively work in Ukraine and regularly report to the NBU (see **Table 1**).

Table 1: Distribution of Banks by Statutory Capital

<i>US\$ Million</i>	1994	1995	1996	1997
	<i>Number of Banks</i>			
Under 0.5	193	102	20	2
0.5-1.5	20	81	100	67
1.5-3.0	4	16	35	51
3.0-5.0	1	3	17	33
5.0-40.0	2	7	13	33
Above 40.0		1	3	3
<b>Number of reporting banks</b>	<b>220</b>	<b>210</b>	<b>188</b>	<b>189</b>
Number of registered banks	228	230	229	227

(end of year)				
Number of new registered banks	28	3	10	8
Number of liquidated banks	11	1	11	10
	<i>Cumulative Statutory Capital for a group of banks (US\$ Thousand)</i>			
Under 0.5	28.041	20.153	5.062	0.515
0.5-1.5	15.156	68.525	99.58	80.722
1.5-3.0	7.792	31.895	71.728	102.218
3.0-5.0	4.799	12.209	68.005	121.383
5.0-40.0	27.878	108.865	145.462	347.304
Above 40.0		59.894	167.444	208.776
<b>Total</b>	<b>83.666</b>	<b>301.541</b>	<b>557.281</b>	<b>860.918</b>

Source: "Monthly Bulletin", National Bank of Ukraine

The large number of registered banks comes from the fact that, following independence, low entry costs (no minimum statutory capital requirements) and limited banking supervision created friendly conditions for many new private entrepreneurs to open banks. In February 1996, the NBU acquired the full authority to license banks and began to re-license all the banks and increased the minimum statutory capital requirement.<sup>1</sup>

Banks, which have been operating in the financial system for a longer period, attempt to overcome a problem of non-performing loans in their portfolio by building new capital. Table 1 indicates that banks are gradually improving their statutory capital position.

New regulations stopped the virtually costless entry into the sector while the re-licensing procedure started eliminating marginal weak banks from the financial sector. As a result, the growth in the number of banks has stopped. The sector now comprises two state-owned banks (Oschadny Bank and Eximbank), three former state-owned banks (Prominvestbank, Bank Ukraina, Ukrsofsbank), two large private banks (Bank Aval and Privatbank), eight operating foreign banks, and a large number of small and medium banks.

The main indicators of the banking sector structure can be found in **Table 2**. The total assets of the Ukrainian banking system are equivalent to those of a medium-sized Western bank (USD 11.5 billion). The small size of the banking system is partly due to the high inflation episode of 1993-95, which eroded the assets, and liabilities of the banks.

Table 2. Overview of Banking Sector Structure: January 1, 1998 (in UAH million)

	Statutory Capital	Total Capital	Total assets	Total lending	Profit for year	Deposits
State/Formal State-Owned Banks (except Eximbank)	259.62	1531.88	10746.76	3442.24	259.46	1591.76
Share of Total	20.9%	45.9%	47.6%	47.2%	28.2%	51.2%
Private Banks Share Capital above 20 mln	276.53	573.81	5774.27	1681.97	260.12	668.27
Share of Total	19.6%	17.2%	25.6%	23.1%	28.2%	21.5%
Private Banks	430.7	739.05	3992.37	1411.81	278.48	526.14

<sup>1</sup> From January 1, 1997 all banks were required to have at least ECU 0.5 million of capital; from July 1, 1997, ECU 0.75 million; and from January 1, 1998, ECU 1 million. These are the latest of several increases in the minimum capital requirement.

Share Capital 6-20 mln						
Share of Total	30.5%	22.2%	17.7%	19.3%	30.2%	16.9%
Private Banks Share Capital under 6 mln	323.36	395.14	1513.5	582.29	98.91	248.85
Share of Total	22.9%	11.9%	6.7%	7.9%	10.7%	8.0%
Banks with 100% Foreign Capital	88.01	94.56	554.11	178.72	24.21	75.56
Share of Total	6.2%	2.8%	2.4%	2.4%	2.6%	2.4%
<b>Total (mln UAH)</b>	<b>1414.22</b>	<b>3334.44</b>	<b>22581.01</b>	<b>7297.03</b>	<b>921.18</b>	<b>3110.58</b>
<b>Total ( mln \$)</b>	<b>725.2</b>	<b>1709.9</b>	<b>11580</b>	<b>3742.1</b>	<b>472.4</b>	<b>1595.2</b>

Source: "Ukraine: Financial Sector Risks," January 1, 1998.

State-owned and former state-owned Ukrainian banks (except the Eximbank) mentioned in the previous paragraph account for about 48 percent of the sector's assets and hold a dominant position in the financial structure of Ukraine. All these large banks, while still keeping monopoly power in their specialized sectors, have successfully started developing new products in order to become more universal. Additionally, these banks are tightly connected with different structures of the government through fulfilling quasi-Treasury functions (i.e. servicing budgetary accounts). Although those functions remain remunerative, the government connections also put pressure on the banks to lend to loss-making enterprises for political reasons, which seriously undermines their commercial role. As a result, the most successful of new-established small banks (free from any obligations to the state), as Table 2 indicates, gradually obtain larger and larger share of the market.

### 3. Sector Performance

Although some individual banks might perform successfully, the overall picture of banking sector did not reveal significant improvement in the period of financial stabilization. Results of the banking system basically reflect performance of a real economy. Therefore, the huge decline of real output in the official sector as well as growing informal sector negatively influenced performance of the banking system. Additionally, the high inflation episode through 1995 resulted in highly negative real interest rates on credit and deposits (**Table 3**). As a result, the volumes of real credit in the financial system substantially declined hand in hand with significant reduction of credit maturity. Decelerating inflation (resulting mainly from reduced direct monetary financing of budget deficit) laid the basis for certain price stabilization, and the introduction of a new denominated currency in September 1996. This, in turn, prevented commercial banks from taking advantage of a distorted, high inflation environment, which provided quick ways to profit through exchange rate speculations and high returns on domestic currency lending. Spread between credit and deposit rates of commercial banks decreased from more than 50 percent in 1995 to about 30 percent in 1997. As a result, banks had to expand their lending to offset declining interest margins. The ratio of loan to deposit increased from 95 percent in 1995 to 114 percent in 1997.

Table 3. Interest Rates (%)

Interest rates	1995	1996	1997
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NBU Refinance rate	110	40	35
Comm. Banks Deposit rate ( <i>weighted average</i> )	70.29	33.63	18.21
Comm. Banks Credit rate ( <i>weighted average</i> )	122.7	79.88	49.12
Spread	52.61	46.25	30.91
Inflation rate ( <i>Dec-to-Dec</i> )	181.7	39.7	10.1

Source: "Monthly Bulletin", National Bank of Ukraine

A strong statutory link between commercial banks lending rates and the NBU refinance rate was removed in the stabilization period. Now, interest rates are mainly market determined with the NBU refinance rate remained as the main reference rate in the systems. Through much of 1996 and 1997, interest rates on commercial loans exceeded the NBU refinance rate and both rates were positive in real terms. It concludes that directed credits by the government, which are seldom exercised yet, were priced at real positive values.<sup>2</sup> Although during a period of 1995-97 all nominal interest rates were decreasing, real interest rates remained high since inflation decelerated much faster and banks did not sufficiently improve its performance.

In the economic situation of 1996-97, the intermediation function of the banking system was limited. Excessive public expenditures did not leave room for market-based investment as a result of the crowding out effect. It means that financing the economy went through the public sector pushing up real interest on commercial credits. Indicators in **Table 4** prove that domestic credit to the government significantly increased in 1997 while credit to non-government institutions obtained only slightly higher level in 1997 than in 1995 (both indicators expressed as percentage of GDP).

Furthermore, banks were not able to attract new depositors to expand a base for further lending activity. Because the public has had a limited confidence in the banking system, deposits have not grown substantially in real terms. Domestic currency deposits stayed at the extremely low level of ca. 5 percent of GDP through much of the period of 1995-1997. With a limited deposit base and an increasing problem of non-performing loans, banks have constrained the expansion of credit to the enterprise sector (prolonged and overdue loans account for about 30 percent of total loans).

This is also closely related to excessive budget expenditures that kept high real interest rates preventing banks from reducing profit margins. Banks have invested their assets in the lucrative Treasury bills improving their profitability and reserves.

Finally, a large number of investment projects was financed through direct credit lines of large banks originally funded by the government and/or the central bank. The reason for persistence of direct and problematic loan approvals comes from interrelation between management of banks, enterprises, and governmental agencies. In a process of banking system formation, large state enterprises acquired majority of shares in banks servicing particular sectors. Through various channels, those shares were further transferred to employees of banks and enterprises as well as to their clients including members of the government. As a result, decision-making process regarding crediting different sectors heavily depends upon "connections" and is sensitive to political pressure. This procedure eliminated "healthy" refinancing of the banking system and market mechanisms for investment, as well.

<sup>2</sup> Although rates on directed credits refer to the NBU refinance rate probability that those credits would be paid off remained very low. Therefore, in fact, those credits were not properly evaluated in terms of involved risk.

The main indicators of financial sector activity presented in Table 4 clearly show that banking intermediation is extremely shallow and process of remonetization was going very slowly. In particular, both broad money and its domestic currency component remained low relatively to GDP. Additionally, cash accounts for approximately more than 50 percent of the domestic money supply and exceeds deposits component.

Table 4. Monetary Survey.

Monetary Aggregate	1995		1996		1997	
	Mln UAH	% of GDP	mln UAH	% of GDP	mln UAH	% of GDP
<b>Domestic Credit</b>	<b>8459,8</b>	<b>15,5%</b>	<b>12041,1</b>	<b>14,8%</b>	<b>15949,6</b>	<b>17,2%</b>
Net credit to Government	3988,6	7,3%	5974,2	7,3%	8106,5	8,8%
Credit to non-government	4471,2	8,2%	6066,9	7,4%	7843,1	8,5%
<b>Broad Money</b>	<b>6913,4</b>	<b>12,7%</b>	<b>9361</b>	<b>11,5%</b>	<b>12535</b>	<b>13,6%</b>
Hryvnia broad money	5353,2	9,8%	7802,4	9,6%	10899,2	11,8%
Cash	2623	4,8%	4041	5,0%	6132	6,6%
Domestic currency deposits	2730	5,0%	3605	4,4%	4737	5,1%
Foreign currency deposits	1560,2	2,9%	1558,6	1,9%	1635,8	1,8%

Source: "Monthly Bulletin", National Bank of Ukraine

#### 4. Building legal and technical infrastructure

Periods of high inflation and administrative regulations (e.g. "kartoteka 2")<sup>3</sup> seriously undermined household and enterprise confidence to the banking system and saving. The NBU tries to restore faith in saving in banks by forcing implementation of a deposit insurance fund. Unfortunately, preparation of laws and the legislative process are going very slow. Furthermore, credible implementation of a system of deposit insurance require transparent accounting standards and the NBU authority to handle liquidation (or rehabilitation) of insolvent banks. While the International Accounting Standards (IAS) are in a process of implementation, the amended banking laws are unlikely to be passed by the Ukrainian Parliament in a form that would be consistent with market oriented reforms.

This lack of clear legal base for operation of the NBU, in turn, forces a large dose of discretion in formulation of both monetary policy and banking supervision. Banking sector suffers from unclear formulation of monetary policy targets and instruments, holding relatively large precautionary balances that in turn limits the growth of credit to the real sector. Because progress on the legal base is problematic, the NBU tries to extensively use its own regulations to improve performance of the banking system. It mainly concerns supervision department, which significantly strengthened its capacity under foreign technical assistance [see – Landy, 1997].

#### 5. Fragile stability of banking system

Deteriorating stance of public finance, problems with rolling over short-term maturity and high interest rates T-bills had to undermine credibility of economic policy and to jeopardize stability of the banking system. In the middle of 1998, Treasury bills accounted for 12 percent of total banking assets and for about 30-40 percent of liquid assets (see **Graph 1**). Additionally, Treasury bills constituted the only acceptable form of collateral for interbank

<sup>3</sup> This regulation does not allow enterprises opening more than one bank account.

credit operations. Thus, when the government started facing problems with servicing its obligations and tried to induce T-bills restructuring, most of small banks, which had more resources involved in T-bills (about 30 percent of assets), remained short of liquidity. At the same time, uncertainty in the financial system prevented “liquid” banks from lending since there was no credible information about solvency of other banks and no form of collateral available. As a result, banks that usually met prudential regulations of the NBU failed to do so and turned to the central bank to support their liquidity. Fortunately, foreign exchange positions of commercial banks looked much favorable and the NBU only occasionally intervened to help banks.

In anticipation of domestic currency devaluation, banks took long open foreign exchange positions. Although the NBU did not allow keeping foreign exchange open positions, in the critical period approximately half of banks managed to increase those positions. Furthermore, the structure of foreign exchange liabilities was favorable. The foreign exchange liquidity ratio was around 15 percent which means that on average high liquid F/X liabilities accounted for only 15 percent of high liquid F/X assets. It implies that banks had enough liquid assets to meet further unexpected withdrawals of F/X liabilities.

Paradoxically, banks have avoided serious financial problems in the F/X market due to the fact that they have not been involved in off-balance sheets operations (i.e. futures) like Russian banks. Low international rating of Ukrainian banks did not allow them borrowing in international financial markets significantly reducing exposure to F/X risk. As a result, devaluation did not hurt Ukrainian banks to such an extent as it did in Russia.

The overall picture of banking system liquidity, however, was mixed. Liquid assets were increasing mainly due to foreign exchange revaluation. While on the liabilities side, only hryvna-denominated corporate deposits remained stable and many other categories were decreasing. **Graph 2** presents the structure of banking system liabilities in the end of June 1998.

## 6. Summary

Despite obvious problems of low profitability, limited statutory capital, and insufficient loan loss provisioning, the Ukrainian banking system has avoided so far serious financial stress.

The Ukrainian banking system is still strongly concentrated, but becoming less so. Seven largest banks have decreased its share in the total banking assets. Banks increasingly resist the political pressure for direct lending. Nevertheless, they continue to enjoy large government deposits that come with their quasi-Treasury functions. With the country’s efficient payment system, banks can operate with limited liquidity. The closure of few medium-sized banks has taken place without system-wide implication, due to limited interbank activity.<sup>4</sup>

Some building blocks of “healthy” financial system are being developed and others are already working in Ukraine. Progress in improving a structure and overall performance of the financial sector is not, however, sufficient. A lot of important issues have to be still addressed, among them how to deal with problem banks, how to consolidate the fragmented banking

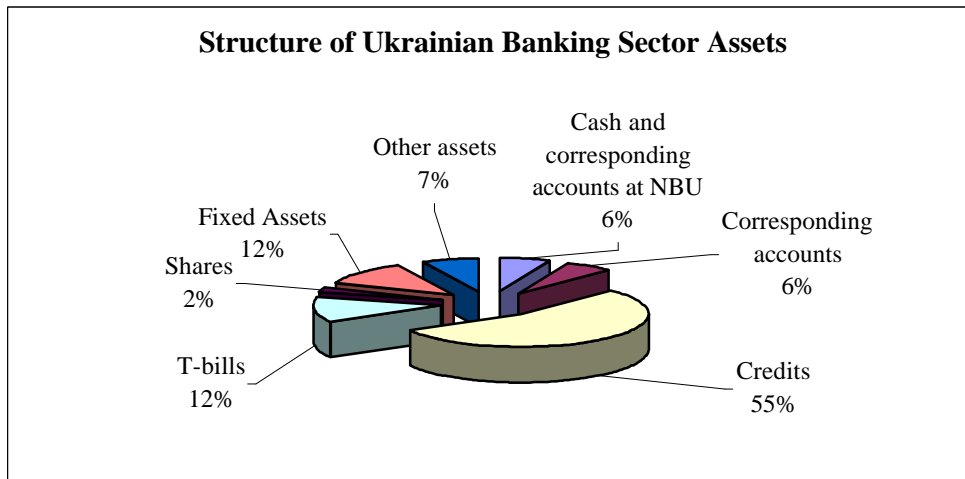
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<sup>4</sup> For more detailed discussion of the Ukrainian interbank market, see Górski [1999].



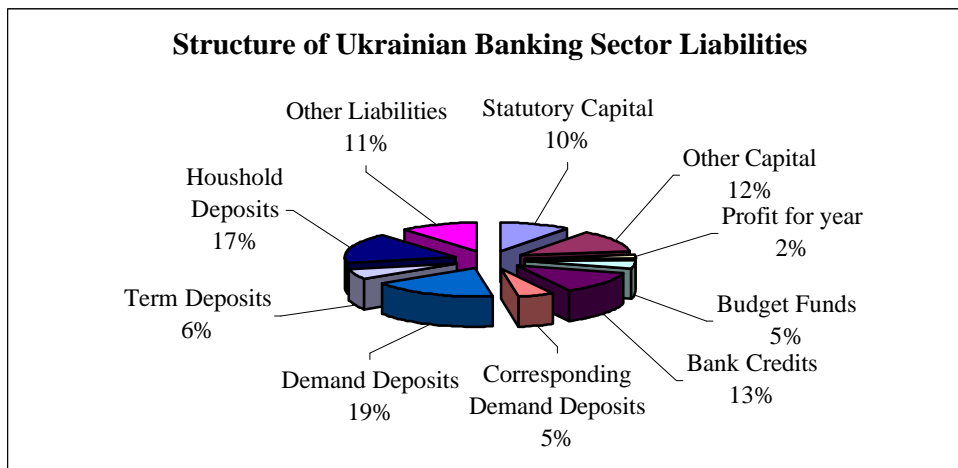
sector and finally how to restore main functions (i.e. intermediation) of the market-based financial system.

Graph 1.



Source: "Herald", September 1998, National Bank of Ukraine

Graph 2.



Source: "Herald", September 1998, National Bank of Ukraine.

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# Some Fiscal Policy Problems (Pavel Kovalev)

## 1. Introductory remarks

Economic transformation in Ukraine was accompanied with the agony of old administrative - redistributive budget system. However, a lack of essential reforms and inconsistency in shaping a new system of public finance led to maintaining a huge fiscal deficit.

While dealing with a lack of revenue sufficient to cover excessive expenditures, the government used the means, which proved to be extremely destructive for the economy. In the beginning it was direct credit of the National Bank of Ukraine (NBU) to the government, connected with heavy inflationary tax put on population and enterprises. After 1994, the government switched to running budgetary arrears, and developing a system of borrowing on internal and external bond markets. The latter source of deficit financing became a crucial reason of the financial crisis in summer 1998.

The present fiscal situation is, to a great extent, similar to the one of 3-4 years ago, except of wasted time, delayed reforms, and accumulated debt problems. Like several years ago, balancing the budget or at least keeping “safe” level of fiscal deficit remains the most important and urgent macroeconomic problem.

## 2. Budget Revenues

During last seven years, the tax system inherited from the Soviet period was a subject of many changes towards the international standards. Introduction of VAT, PIT, excise tax, or foreign trade duties took place between 1993 and 1998. However, this process has still not been completed.

Weaknesses of the new tax system as well as a poor development of the whole economy are reflected in the fact that tax revenues in real terms (deflated with CPI) has been decreasing for the last three years. Total revenues in 1996 amounted to 78.5% of those in 1995. In 1997, they increased slightly to 82.0% comparing to 1995. Total revenues for January-September of 1998 constituted only 70.7% of revenues in the corresponding period of 1995, and 95.5% of 1997. The most significant decline is observed in VAT receipts (59.8% of 1995 level and 78% of 1997 level) and in enterprise profit tax (44.3% of 1995 level, and 94.7% of 1997 level). This negative trend also concerns other main taxes: personal income tax - at the level of 95.5% comparing to 1997, and excise duties – 95.8%.

**Graph 1** shows also the negative tendency of the tax collection in terms of percentage of GDP.

Graph 1: Main taxes, 199-1998, in % of GDP

There are several factors behind this negative tendency:

1/ Tax burden in Ukraine is extremely heavy.

The total fiscal burden can be estimated as potential revenues from taxes and obligatory payments according to the existing legislation. The following components should be taken into account as a basis for our analysis: taxes and payments actually collected, tax and quasi-tax arrears (due to the budget and extra-budgetary funds), arrears restructured or written-off, and tax privileges. Thus, the total fiscal burden would be actual payments plus all those due but not executed.

For instance, in 1997 enterprises accumulated overdue tax arrears of 3.6% of GDP. Additional UAH 5.4 billion, or 5.8% of GDP, *were* restructured. Then, according to the tax administration estimates, the budget missed UAH 5.83 billion or 6.3% of GDP in revenues as a result of tax holidays and exemptions. All together, these sources give losses to budget and extra-budgetary funds equal to 15.7% of GDP. The actually collected revenues of the consolidated budget and extra-budgetary funds were at the level of 40.7% of GDP in 1997. Assuming that all enterprises had fully paid their taxes and exemptions had been eliminated, the budget revenues (that is the total tax burden) would have amounted to over 56% of GDP in 1997. This proves an enormously high level of taxation, which can be hardly found in any country in the world.

It is obvious that high fiscal pressure does not create favorable conditions for conducting businesses, which in turn should be the main source of budget revenues. Moreover, Ukrainian enterprises have proved already the exceptional ability to evade from high taxation with help of different methods such as barter or cash operations.

2/ Tax system is diluted by many exemptions

Unfortunately, the practice of granting tax exemptions and writing off (or restructuring) tax arrears for selected groups of enterprises came into tradition in Ukraine. In 1997, the total amount of enterprises' tax arrears of UAH 5.4 billion (5.8% of GDP) was restructured and partially written-off by the special law of the Verkhovna Rada. That law proclaimed restructuring as a one-time measure to improve enterprises' position, creating expectations of the further indulgence with respect to non-payers of taxes. In 1998, the presidential decree restructured the debt of the agricultural-industrial enterprises of UAH 3 billion. In addition, it is likely that the new tax "amnesty" will be granted for the coal-industry enterprises soon.

Such an economic policy creates distrust to the government and destroys incentives for economic activity. Exemptions and privileges redistribute limited resources in favor of inefficient enterprises what in turn creates serious impediments to economic growth and reduces the revenue collecting capacity of the tax system.

Unfortunately, in the end of 1997 the process of granting exemptions started again, that time because of 1998' election campaign. This increased a number of beneficiaries of tax privileges by 5%, resulting in additional losses in revenues in 1998 of near UAH 6 billion, i.e. 20% of planned revenues.

3/ Tax evasion in Ukraine is significant.

No serious efforts were taken against tax evasion and in favor of improving tax collection. The overall tax and quasi-tax arrears continued to grow and increased by 78% during 1997-98 up to the value of UAH 16 billion. The mutual settlement (netting out)

schemes, which were introduced in order to decrease the stock of arrears, became a standard mean of tax evasion.

Wide practices of barter operations (which constitutes roughly 45% of the whole trade) supports badly tax evasion – taxes in fact do not cover barter transactions. The result was the loss of UAH 8 billion in budget revenues in 1997, i.e. about 30% of the collected amount.

4/ Lack of enterprise restructuring did not improve the tax base.

It is hard to say that enterprises in Ukraine are facing the really free market rules. Process of deregulation, and privatization is progressing very slowly. Bankruptcy and liquidation procedures against companies running losses and owing huge arrears to the budget are almost completely absent.

Very poor management of state owned equity in the enterprise sector is another problem. In 1996, dividend from enterprises owned fully or partially by the state transferred to the state budget amounted to only UAH 3 million, out of the total profit, which amounted to UAH 3 billion.

An increase in inter-enterprises accounts payable (from 30.5 billion UAH in 1995 to 114.2 billion UAH in 1998) and accounts receivable (from 22.2 billion UAH in 1995 to 87.1 billion UAH in 1998) gives a clear signal of distortions existed in the real sector. The outstanding receivable accounts amounted to 76% of accounts payable. Immediate institutional and structural changes should be made to escape such a "virtual" economy.

5/ Netting out operations between enterprises and budget continue to exist.

In 1997, netting out operations amounted to 47% of total revenues of the state budget while only 53% were paid in cash. In local budgets, this proportion was 64% and 36% respectively. The share of revenues in kind in 1998' budget was lower and was estimated as 20-25% of the total revenue.

Admitting mutual settlements, the government decreases the volume of cash revenue that it could easily control and direct towards priority needs. Thus, the practice of netting out operations reduces flexibility of budget planning and execution. At the same time, the lack of transparency during mutual clearing arrangements (regarding, for example, prices) makes a process of budget execution almost uncontrollable. Moreover, it provides possibility to increase some spending lines while others remain under-financed. For example, expenditure on construction 2.2 times exceeded the planned volume for the three-quarters of 1998.

6/ Frequent changes in tax legislation do not support an effective tax collection.

The sound budget system is impossible without stable legislation. During several years budget suffered from instantaneous changes in tax legislation. Adoption of non-transparent laws and regulations, introduction of numerous amendments significantly changing the essence of original regulations (like in case of VAT law adopted in 1997) decreased fiscal effectiveness of the tax system.

An attempt to introduce a complex tax law package among proposals on "Economic Growth 1997" submitted by the Deputy Prime Minister Victor Pynzenyk in November 1996 was in fact rejected by the Verkhovna Rada. Only two out of six law proposals were adopted,

and their final shape significantly differed from the original draft. What concerns the VAT law, the Verkhovna Rada postponed introduction of the accrual method of tax calculation until the beginning of 1999. So far, new VAT procedures have been delayed three times because of “currently improper legal framework” for VAT-law enforcement. Personal income tax and property tax laws have not been adopted at all. The law on strengthening budget constraints in relation to enterprises and imposing discipline on enterprise payments was rejected and returned for revisions in 1997 and 1998. At the same time, the law on debt restructuring (in fact, cancellation) was adopted in the middle of 1997. The draft laws on deregulation and social spending cuts met opposition of the Parliament, as they would require elimination of number of tax exemptions and social subsidies estimated around UAH 17.7 billion.

Presidential decrees from June, 18 and August, 7, 1998 on reduction of Social Insurance Fund contributions, increase of excise tax on alcohol and introduction of accrual method of VAT calculation, being rejected by the parliament, are one more example of ad hoc, non-complex changes<sup>1</sup>.

7. Execution of revenue plans goes badly with growing imbalance between the state and local budgets.

The share of the state budget revenue in GDP was decreasing during 1997 and 1998, while the share of the local budgets was growing. This happened due to a new inter-governmental structure of tax distribution introduced in 1997, and a better tax collection on the local level. Starting from the middle of 1997, total revenues from the enterprise profit tax were assigned to the local budgets, while VAT remained the main source of the state budget revenue, giving about 68% of its total amount. As a result, a poor collection of VAT (at the level of 70% of the amount planned for the first three-quarters of 1998), and growth of EPT collection to local budgets gave a significant inter-governmental disproportion in budget execution. Overestimation of projected central budget revenues and not fully settled schemes of revenue redistribution between budgets resulted in spontaneous budget sequestration and low effectiveness of central budget spending.

Table 1: Budget revenue collection (million of UAH)

Year	Type of budget	Planned	Actual	% of execution
1996	Consolidated	27090	23022	84.9%
1997	State	20598	15980	77.6%
	Local	11950	14615	122.3%
	Consolidated	30429	28118	92.4%
1998 (8 months)	State	12536	9080	72.4%
	Local		8635	110.2%
	Consolidated		16886	85%

<sup>1</sup> On June 18, 1998 President signed a number of so called "anti-crisis" decrees reducing contribution to Chernobyl Fund (from 10% to 5% of a wage fund), and Social Insurance Fund, introducing flat (unified) tax for small business and agricultural producers, granting power to change the excise rates and custom duties to Cabinet of Ministers, etc. Several of them were shortly after revised by the presidential decree "On some changes in taxation" of August 7, 1998. The later decree amended the previous measures with full elimination of Chernobyl Fund contributions, lowering the Social Insurance Fund payments to 4,5% (starting with 1999), introducing the accrual method of VAT calculation from October 1998. The parliament negatively responded to these decrees by rejecting Social Insurance Fund changes, revoking regulatory rights of the Cabinet of Ministers in respect to excise duties (the President vetoed this decision), and postponing the new VAT procedure until the beginning of 1999 again.

Source: State Treasury of Ukraine

### 3. Budget expenditures

Since the beginning of 1990s, Ukraine has had one of the highest levels of budget expenditures among countries with a low-medium income level. The total budget spending (including various extra-budgetary funds) constituted 45-50% of GDP. In terms of percentage of GDP, budget expenditures remained practically constants throughout 1996-1998 (**Graph 2**). The above concerns only cash expenditures actually spent by budgetary institutions. However, if we include accumulation of budget arrears we can obtain a quite different picture of budget spending in 1996-1997 (see **Table 2**). Thus, taking into account the accumulated debt, there was no any radical improvement in public finance, since no essential cuts in actual spending were made. Expenditures simply became less transparent by transforming them into arrears of budget and budgetary-financed organizations. Acceleration of arrears' growth started in 1996, after mutual settlements became a widely used instrument of financing government spending and overcoming non-payments crisis.

Graph 2: GDP, budget revenues, and expenditures (in real terms)

Table 2: Real Budget Expenditures and Deficit

<i>Item</i>	<i>1994</i>	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1998</i> <i>(9 months)</i>
<i>Consolidated Budget Expenditures in Cash, without the Pension Fund (% of GDP)</i>	<i>44.94</i>	<i>37.02</i>	<i>33.06</i>	<i>37.10</i>	<i>29.5</i>
<i>Budget Deficit on a cash basis (% of GDP)</i>	<i>8.93</i>	<i>6.63</i>	<i>4.86</i>	<i>6.70</i>	<i>3.1</i>
<i>Accumulated Budget Arrears (% of GDP)</i>	<i>1.46</i>	<i>1.80</i>	<i>3.22</i>	<i>3.98</i>	<i>n/a</i>
<i>Total Budget Expenditures on Commitment Basis (including arrears) (% of GDP)</i>	<i>46.40</i>	<i>38.82</i>	<i>36.28</i>	<i>41.08</i>	
<i>Budget deficit on commitment basis (including arrears) (% of GDP)</i>	<i>10.40</i>	<i>8.43</i>	<i>8.08</i>	<i>10.69</i>	

Source: State Treasury of Ukraine, State Committee of Statistics data, CASE calculations

Based on the above expenditure statistics, we may draw some important conclusions:

1. High level of budget expenditures depresses the official economy.

The high level of government expenditures in Ukraine produced a significant fiscal pressure on the official sector of the economy and stimulated its shift into the "shadow" economy<sup>2</sup>. Moreover, it complicated maintenance of an appropriate level of budget revenues, required significant toughening of tax laws, etc. This created the present situation of "vicious circle" when state' efforts to strengthen tax collection only result in narrowing the tax base, and, consequently, in further decreasing tax revenues.

<sup>2</sup> CASE/HIID estimates the size of the unofficial sector at the level of 40-45 % of GDP, while the official estimation is only 14 % of GDP.

## 2. Structure of budget expenditures in Ukraine does not support a market economy.

The large portion of GDP that is directed to the budget is redistributed inefficiently. This inefficiency means, for example, supporting unprofitable enterprises (in the coal industry, agriculture and agricultural-industrial complex). Subsidies and transfers to population are not really targeted to those really poor, and thus simply wasted. .

The government is still trying to keep control over the whole economy and intervene in order, first of all, to "support" domestic producers. Apparently, the government has only changed a form of such a support from direct budget subsidies to enterprises into "indirect" methods such as granting tax exemptions and privileges, writing-off, and restructuring debts and allowing accumulation of budget arrears.

## 3. Lack of political will to limit the role of the budget to financing mainly public goods.

Even if the executive power (which formulates budget proposals) was ready for expenditure reductions (the example of so-called Pynzenyk's package from the end of 1996), the legislative one (which confirms budget proposals) did not agree upon the issue. Continuous fighting around subsidies and state support has been reducing efficiency of budget allocation. In effect, government consumption (component of GDP equaling to budget expenditures minus all kinds of transfers, government investments, and debt service costs) has increased from 17.5% to 22.1% of GDP between 1994 and 1997. It is much above the international standards: 14% of GDP in lower and middle income countries (1,600 USD per capita) and 17% for high-income economies (on average 23,400 USD per capita).

## 4. No significant reform has been undertaken in relation to social transfers.

More than one third of all transfers (over 9% of GDP in 1997) is related to Pension Fund expenditures. The Ukrainian population is aging. The pension reform, which should shift part of the pension system into the private sector and assure higher returns from pension savings, is urgently needed. However, no pension reform has been started yet. Deficit of the Pension Fund has been covered from the state budget and effectively burdens public finances, so far.

The Chernobyl Fund, accounting for 5.1% of the central budget expenditures<sup>3</sup> in 1997, used to be a questionable expenditure item. Necessary medical treatment, but also luxury services (not always devoted to the addressed people) have been kept on unchanged level for all those years. Only recent cuts in the budget touched also this line.

Subsidies to the economy, even if reduced significantly from over 18% of GDP in 1994 to over 8% in 1997 (**Graph 3**), still account for much higher level in comparison with other transition economies (below 3-4% of GDP in countries of the former Soviet Union).

Graph 3: Selected budget expenditures in Ukraine

Table 3: Composition of Ukrainian Government Expenditures (million UAH)

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<sup>3</sup> The local budgets spent another 2.8% of GDP on the social programs related to the Chernobyl disaster consequences.

Item	1994	1995	1996	1997
Nominal GDP	12038	54516	81519	92484
Cash Budget expenditures (Incl. Pen. Fund)	6307	24303	34183	41823
%GDP	52.4	44.6	41.9	45.2
Government Sector Consumption (SNA)	2101	11600	17700	20400
%GDP	17.5	21.3	21.7	22.1
Total Transfer Payments	4206	12703	16483	21423
%GDP	34.9	23.3	20.2	23.2
Pension Fund	897	4119	7234	8478
%GDP	7.5	7.6	8.9	9.2
Other Transfer Payments	3308	8584	9249	12945
%GDP	27.5	15.7	11.3	14.0

Source: NBU Bulletin.

5. Part of expenditures cuts have resulted from sequestration rather than from a real reform of the public sector.

Such practices were always caused by the shortage of budget revenues. During 1995-1998, they resulted in accumulating essential amount of budget arrears in payments for consumed goods, services, accrued pensions, and wages. These arrears can be considered as an additional (hidden) deficit of the budget (see above), which is financed at the expense of population's savings and by suppliers to budget institutions.

On January 1, 1996, arrears of central and local budgets amounted to 1,756 million UAH and one year later – 3,194 million UAH (2,563 million UAH by the local budgets, and 631 million UAH by the central budget). In 1997, additional indebtedness that constituted about 4% of GDP was accumulated. In 1998, the government did not succeed in decreasing this amount.<sup>4</sup>

#### 4. Budget Deficit

When analyzing the Ukrainian budget deficit one should distinguish between the official cash deficit, and the accrual deficit (i.e. added with arrears accumulated during the given period).

The high level of budget deficit was observed during the first half of 1990s (average magnitude of 8-9% of GDP between 1992-1995). Since the beginning of reforms at the end of 1994, Ukraine has constantly encountered a similar high level of budget deficit. Throughout this period, the quarterly average of official budget deficit accounted for 7,7% of GDP, reaching in some periods 10-20% of GDP (see – **Graph 4**). Such a deficit considerably exceeded deficits, observed in the majority of medium- and low-level income countries (2-4% of GDP). In addition, in any economy fiscal deficit cannot bring a sustainable economic growth in a longer run, because it means absorption of a certain portion of private savings.

Graph 4: Budget revenues, expenditures, and deficit

<sup>4</sup> In 1998, pension arrears increased by UAH 308 million, wage arrears slightly decreased (by UAH 108 mln). Changes of other arrears remain unknown because the government has discontinued publishing this information since the beginning of 1998.



High fiscal deficit may be sometimes justified by the rapid structural transformation and adjustment to the new market conditions. However, it is not certainly the case of Ukraine, where deficit has been resulting from maintaining Soviet-type social and administrative expenditures. Disregarding the level of available revenues, budget resources have been usually spent for covering excessive current needs, for example, consequences of price controls, subsidizing ineffective sectors, satisfying interests of different industrial lobbies, and ineffective and too generous system of social protection.

The high level of fiscal deficit in 1992-1995 was financed by the NBU money emission (approximately 90% of all credit issued by the NBU in 1993 was directed for covering budget requirements). As a consequence, Ukraine had faced hyperinflation. Fortunately, since 1995 the volume of credit issued by the NBU have been sharply reduced due to replacing NBU financing by borrowing in internal and external bond markets (see – **graph 5**). It allowed reducing inflation down to 10.1% in 1997 (December-to-December). The success of a prudent monetary policy was widely acknowledged. However, fiscal adjustment has been still missing. In the beginning of 1997, the official deficit was reduced to 4% of GDP (disregarding the hidden deficit from arrears accumulated at the same time). Nevertheless, this tendency was reversed, and deficit continued to grow during in the rest of 1997. Thus, lack of fiscal discipline, unwillingness to cut expenditures, and poor tax collection brought fiscal deficit to the level of 6.7% of GDP in 1997.

Graph 5: Sources of financing fiscal deficit (including budget arrears), 1993-1998, in percent of GDP

As result of the Asian crisis, investors started to withdraw their money from emerging markets, including Ukraine. Their outflow was speeded up by lack of structural reforms and finally by the IMF refusals to disburse remaining tranches of the Stand-by loan (mainly due to excessive fiscal deficit). Due to difficulties with the T-bills financing and external borrowing, the government returned again to the NBU credit. The NBU began to participate in the primary T-bills market "helping" the government to roll over its obligations in relation to private investors. The share of T-bills purchased by the NBU constituted 40 % at the end of 1997 and as of October 1, 1998 - over 75% of the existing T-bills stock. Thus, the NBU speeded up possible inflationary consequences and considerably reduced foreign reserves. Although such a behavior was forced by political circumstances, it was conducted under constant pressure of the government as well as a fear of the government default. As a result, fiscal deficit that appeared in 1997 created macroeconomic ground for financial crisis and postponed time of economic growth resumption. The lack of structural reforms limited any financing available under acceptable rates (Eurobonds denominated in USD issued in February 1998 were offered with 18% return, T-bills yields exceeded 50%).

In the first quarter of 1998, collection of the main taxes (VAT and profit tax) dropped significantly, and cash deficit amounted to 7.6 % of GDP (12% for March 1998, during the election campaign). Being without any financial resources for debt repayments and encountering practically desperate situation, the Ministry of Finance was compelled to resort to random reduction of current budget expenditures.

The government asked the IMF to start the EFF program. The new revised budget for 1998 was prepared and adopted by the President's Decree, as the Parliament has not yet been constituted. Short-term measures undertaken to reduce expenditures (the new variant of the

1998' budget has not affected a number of "protected" items) allowed decreasing the official cash deficit to 3,3% of GDP in the first 9 months of 1998.

In the beginning of August 1998, Ukraine owed 22.1 billion UAH to foreign and 16,4 billion UAH to domestic creditors. The significant part of domestic obligations (owned by others holders than the NBU, about 40% of total amount) presented extremely short-term maturity and very high yields. In August - September 1998, expenditures on servicing public debt exceeded revenues by about 240 million UAH. Wage and pension arrears began to grow again. Foreign and domestic debt was repaid at the cost of the NBU. However, limited foreign exchange reserves put Ukraine in the situation of financial crisis. Debt restructuring, which was carried out in October 1998, shifted danger of open default until years 2000-2001. Fiscal adjustment within next two years is crucial in order to avoid future serious crises.

# **Ukraine's Travail with Tax Reforms (Khwaja M. Sultan)**

## **1. Introductory remarks**

Reformers in the government and in parliament have been struggling with only partial success to move ahead with economic reforms. Until the first half of 1997, the government tried to push a package of reforms through the parliament (Verkhovna Rada) that would have given some headway in the areas of tax reform, structural reforms deregulation, fiscal policy and financial sector reforms. Unfortunately, only a few tax measures could get through, and these too have been riddled with frequent backtracking. There was very little support for reforms in parliament. Even within the government, commitment to economic reforms was weak and half-hearted. Unlike Poland, Ukraine has not had a reform-oriented parliament. The parliament has not had any group or coalition of parties that holds a majority and, therefore, presents the characteristics of a direction-less body. The left has remained the biggest group, though without a majority. There is, thus, no pressure from the parliament to move ahead with reforms. On the contrary, the parliament has very often blocked the few economic reform measures that come its way.

## **2. Reform and Public Choice**

The willingness and the desire for reform have to come from within the country. Reform is a matter of public choice. If people want reform, they elect a reform-oriented parliament, which forces the government to carry out reforms. The policymakers have, in turn, to convince the people that the reforms they are embarking on are good for the country in the long run, even though they may cause pain and difficulties in the early years. Countries that have taken up reforms with a resolve to change the existing system, and to break from the past, include Poland, the Baltic states, Hungary, and recently Bulgaria. On the other hand, reforms in Ukraine have been made without conviction, and for extraneous reasons, such as, the need to fulfill IMF conditionalities in order to get loan from them. Such reforms tend to be direction-less and haphazard half-measures.

Progress with structural reforms and deregulation has been slow in Ukraine. Without them, there is little hope for economic growth. Without economic growth, there is little hope for improvement in tax collection. In 1998 alone, tax arrears have jumped from about UAH 2 billion in the beginning of the year to about UAH 9 billion in November. Large state-owned enterprises continue to produce goods that do not have a market. Since they cannot sell their goods, barter is the only way they are able to pay wages to their employees, dues to their suppliers, and taxes to the government. Subsidies keep such enterprises alive and prevent their restructuring. Many privatized enterprises continue with the same management, and operate quite like the old soviet enterprises. Their condition is, thus, quite similar to the state-owned enterprises. A modern tax system needs a thriving private sector where the enterprises work for profit. This basic structure seems to be fragile in Ukraine.

### **3. Ukraine's experience with Tax Reform**

Ukraine made a determined effort for reform between 1995 and mid-1997. After that, the momentum for reforms seemed to have got lost. This is apparent from the procrastination that has been witnessed over the course of the last fifteen months.

Take the case of the value added tax (VAT). A good VAT law based on the EU model was instituted in April 1997. Instead of keeping it stable, there have been periodic changes that have diluted its essential features:

In October, an essential aspect of VAT - liability on accrual basis - was replaced by liability on cash basis.

Some exemptions were removed, but exemptions/zero rate was continued for energy sector.

Exemption was extended to "critical imports" which consisted of a list of goods approved by the Cabinet of Ministers.

Accrual method was re-established from 1<sup>st</sup> October 1998. However, its application for energy supply to households and to government has been postponed until the year 2003.

A system of advance payment has been introduced. This is generally not done for VAT, since the tax is already collected at every stage of value addition.

In the case of enterprise profits tax (EPT), the law was passed in late 1997, but amendments on depreciation allowance continued to be debated. Several adjustments have been made in budget laws to restrict the depreciation to only a part of what is allowable under law.

A new Depreciation Law was passed by the previous Parliament but vetoed by the President. The law contained several features that were different from the EPT law, especially with respect to inflation and indexation and accelerated depreciation.

The draft law on real estate tax has been in the parliament for the last one year, but has not made much headway. The absence of private ownership of land, and of land market, have made the introduction of real estate tax difficult.

The draft law on a new personal income tax has been in parliament for more than a year and has been through one reading in the last Parliament. It has not been given taken up by the new Parliament.

A new Unified Agriculture Tax has created a sector specific tax, which instead of harmonizing the tax system has segmented it further. It undermines the effort to have uniform taxes that do not cause sector-wide distortion and it makes tax administration more cumbersome.

### **4. Problems with the tax structure**

Ukraine's economy is characterized by a high fiscal burden, a large shadow economy, and large-scale price distortions created by high payroll taxes.

#### 4.1. Fiscal burden

Ukraine's fiscal burden (budget revenues plus extra-budgetary levies) has stayed at around 37% of GDP. This is too high for a country like Ukraine. Fiscal burden is closely related to the income level of the country. High-income countries tend to have a higher fiscal burden relative to GDP (between 35 and 45%), while low-income countries tend to have much smaller fiscal burden (15% to 25%). Over the last eight years, Ukraine's per capita GDP has slumped to about 40% of the level in 1990. At less than US \$ 1000 per capita, the income is too small to support a fiscal burden of 37%.

Graph 1: Overall fiscal burden (budget revenues plus extra-budgetary levies) in Ukraine, in % of GDP.

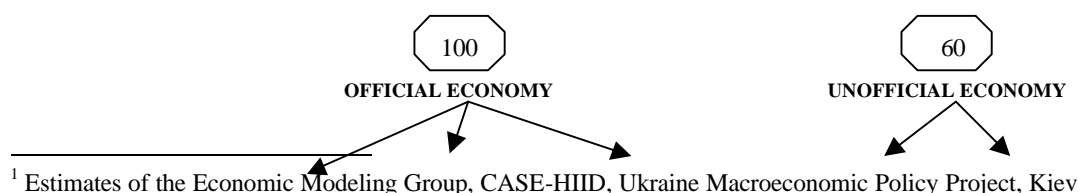
Source: Based on data from Ministry of Finance and on the Budget draft (#2) for 1999

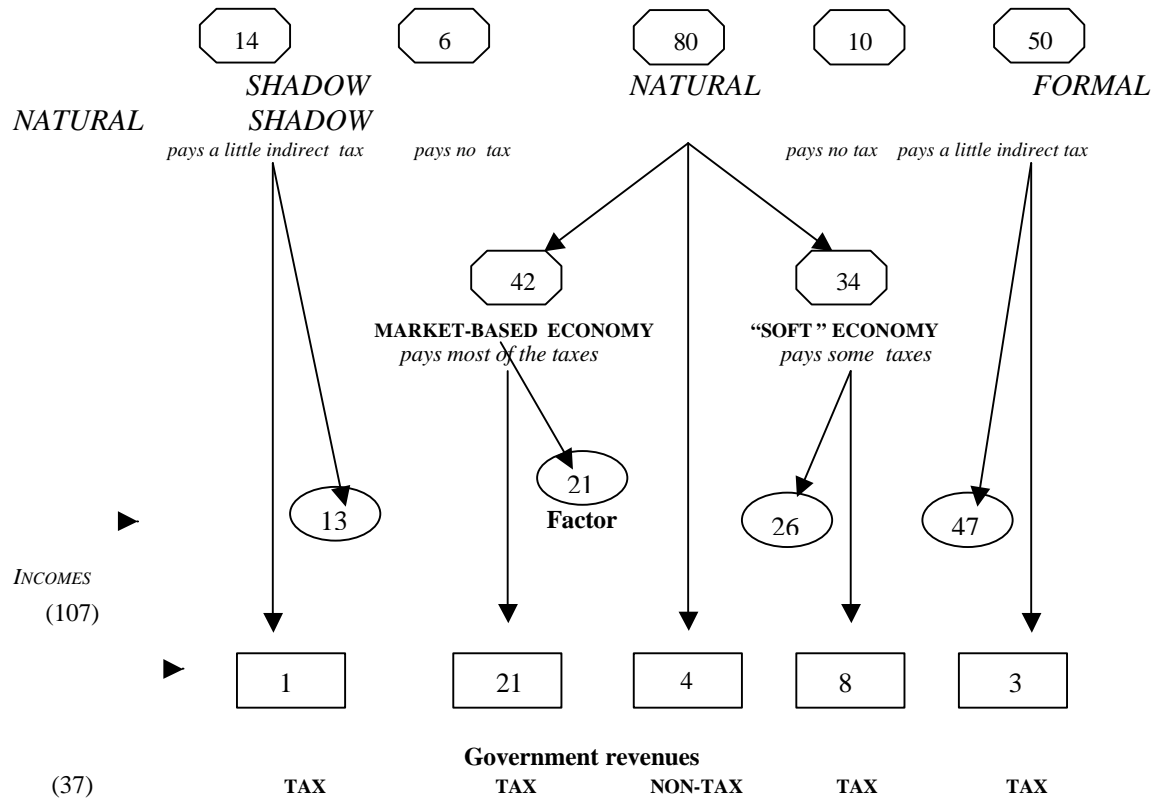
Countries with Ukraine's level of income normally have fiscal burden of about 25% of GDP. In Ukraine, the segment of the economy that operates on market principles, and that generates profits, is rather small. Accordingly, they pay their taxes in cash. This constitutes only two-thirds of revenues (25% of GDP). The remaining one-third is collected through mutual cancellation or barter, mainly from enterprises that are value subtracting and are not able to sell their goods for cash. Most of the tax paid through mutual cancellations and barter transactions are not at market-determined prices. Thus, very little value can be attached to revenues collected thus. Taking this into account, it seems that the limit of the tax capacity of the formal sector is less than 30% of GDP.

#### 4.2. Distribution of the Fiscal Burden

The fiscal burden is distributed unevenly. This is shown in the chart below, which provides estimates of tax paid by the official and the unofficial economy. For 1998, the official GDP will be about UAH 100 billion. This includes the formal sector, the part of the shadow economy that is included in the official GDP and part of the natural economy. In addition, we estimate<sup>1</sup> the unofficial economy to be another UAH 60 billion (UAH 52 billion in shadow and UAH 8 billion in natural economy). The natural economy pays no tax. The shadow economy pays some indirect taxes (VAT and excise) – about 7% of its value added. Within the formal economy, most of agriculture, mining, energy, and many state enterprises form the "soft" segment which is supported by direct subsidies, tax exemptions, preferential credits, and forgiven tax arrears. Their fiscal burden is small: about one fourth of their total value added. The normal, market-based enterprises, that face hard budget constraints and pay all taxes, end up paying a half of their total value added in taxes.

Graph 2: Distribution of the fiscal burden across different segments of the economy





This creates wrong motivations. It punishes those enterprises that are operating in the official economy and are profitable. By redistributing scarce financial resources from profitable enterprises to unprofitable enterprises, it promotes inefficient allocation and hampers growth. High tax burden and draconian tax procedures like *kartoteka 2*<sup>2</sup> force people to avoid keeping their money in the banks.

### 4.3. Large shadow economy

The high tax burden is an important cause for the growth of the shadow economy in Ukraine. In addition, excessive regulations make the transaction costs for doing legal business prohibitive, pushing many enterprises into the shadow.

Conceptually, a person would evade tax when the costs of evading are lower than the benefits of evading. This can be represented by the following formula:

$$B^{te} + B^{cc} < C^e + C^h + p^*i^* C^r + C^{pd} + C^{pp}$$

Where:

- $B^{te}$  the amount of tax that is evaded
- $B^{cc}$  compliance costs saved
- $C^e$  Direct costs of evading<sup>3</sup>

<sup>2</sup> *Kartoteka 2* is a system by which the tax authorities confiscate the bank account of an enterprise if the tax is not paid in time. This is done without recourse to the legal process and without giving the enterprise an opportunity to delay payments in case of cash flow problems.

<sup>3</sup> Costs involved in cash transaction, hiding inventories and sales, costs of keeping dual sets of accounts.

$C^h$	Costs of hiding evasion <sup>4</sup>
$p$	Probability/risk of being caught <sup>5</sup>
$C^r$	Value of the risk <sup>6</sup>
$i$	Certainty of the punishment if caught <sup>7</sup>
$C^{pd}$	Personal discomfort <sup>8</sup>
$C^{pp}$	Peer pressure or tax morality <sup>9</sup>

In Ukraine, we have both high taxes and high compliance costs. This makes the benefits of evading very high. At the same time, a weak administration makes the chances of being caught small and the corruption element makes it easy to get out if caught. There is also little peer pressure for paying taxes. Therefore, the costs of evading are not high. Overall, there is greater benefit in evading here. If, on the one hand, taxes are reduced and procedure made simpler and, on the other hand, the administration is made more effective and fair, the situation could reverse.

#### 4.4. Price distortions created by payroll taxes

A large part of the fiscal burden – about 10% of GDP – consists of the Pension Fund (Chernobyl Fund has been withdrawn from 1999). In addition, there are other payroll taxes (Employment Fund, Social Insurance Fund etc.), which together make labor heavily taxed. This discourages hiring, and prevents efficient utilization of labor resources in which Ukraine has a comparative advantage. On the other hand, energy, which is Ukraine's main import, is taxed very lightly. There are several exemptions and subsidies given to this sector, and excise on gasoline is very low. By making labor expensive through high taxes and energy cheap through subsidies, Ukraine is losing the comparative advantage it has in labor, and is wasting energy resources that it has to largely import.

Graph 3: Collection of main taxes, in % of GDP, 1996-1999

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<sup>4</sup> Cost of keeping blackmailers quiet, of bribing the tax inspectors and the Mafia

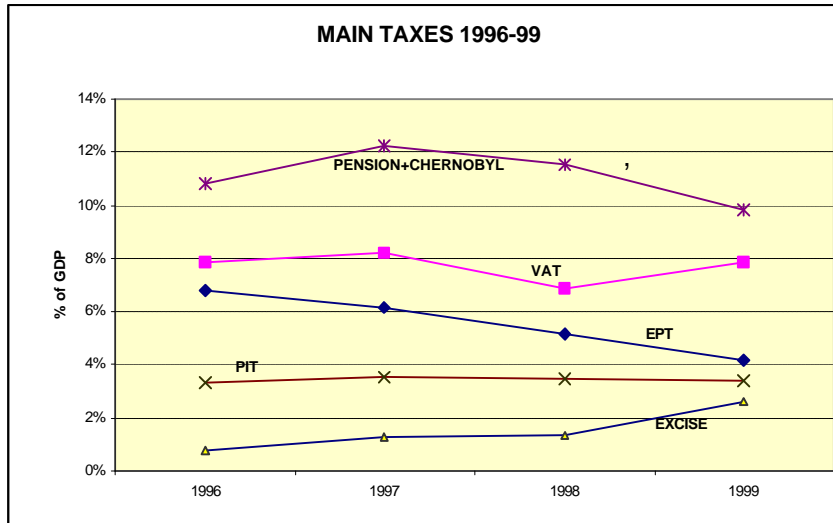
<sup>5</sup> This depends on how effective and vigilant the tax administration is

<sup>6</sup> Depends on the penalties and imprisonment and how much the individual value these punishments, (i.e. how risk averse a person is);

<sup>7</sup> Depends on the integrity and honesty of tax officials and how easy or tough it is to bribe oneself out of a situation

<sup>8</sup> Depends on how much guilt a person attaches to not paying taxes; also on how much worried one would be.

<sup>9</sup> This is partly a cultural aspect and depends on whether the society, friends, relatives, and colleagues do the same thing and consider it smart or whether they dislike tax evaders.



For better distribution of the fiscal burden, we need to increase the relative weight of indirect taxes, VAT, import duties and excise taxes (especially on goods that are consumed widely in the shadow economy). This will help increase the tax collection from the consumption that is derived from income generated in the shadow economy. This will also help widen the tax base. The increase in revenues from indirect taxes can help reduce the pressure from direct taxes - income taxes and payroll taxes.

Excise taxes and VAT on energy are very difficult to evade. Further, since energy is an important input in most business activities, taxing energy encourages compliance in downstream activities. Ukraine should further raise the rate of excise duty on petroleum products, so that the proportion of excise taxes to GDP can gradually be raised to about 4% - the average level in Eastern Europe.

In order to reduce the fiscal burden on labor, we need pension reform that will move from a Pay As You Go pension system to a fully funded system based on individual retirement accounts.

## 5. Three vicious circles

Ukraine's tax structure has three vicious circles that prevent easy escape from high taxes. These can be termed as 1. Exclusion effect, 2. Income effect, and 3. Liquidity effect. High tax rates increase the incentive to evade and create a large shadow economy. High taxes encourage different sectors to seek in pressure on the government to exempt certain sectors. The presence of a large shadow economy and of a large number of tax exemptions excludes a large part of the economy from the tax base. The narrow base forces government to tax the few taxpayers at high rates.

High taxes also reduce savings and investments, thus lowering the income generating capacity. In addition, by squeezing liquidity in an economy where the enterprises have not been restructured and are barely able to survive, high taxes force them to barter transactions and non-payment problems. These encourage the government to maintain high tax rates.



Graph 4: The vicious circles of high tax burden

### **INCOME EFFECT**

All of these make Ukrainian output very expensive and reduces the competitiveness of Ukrainian exports.

## **6. Privatization revenues**

Many countries in transition have used privatization as a means to transform their ailing economies. In Ukraine, privatization has been very slow. For 1998, the Budget had estimated revenues of about UAH 1 billion. Until the end of the third quarter, government could collect only UAH 383 million. For 1999, the target for privatization is very modest – UAH 640 million.

Revenues from privatization can help lower the fiscal burden and support the government budget, especially to finance the needs of transition – e.g., creating a social fund for people dislocated due to lay off. In addition, like Poland, privatization receipts can help finance pension reform.

Ukraine needs a serious agenda for fast track privatization. This agenda should include transparent procedures and open global tenders. Internationally reputed firms should evaluate the enterprises' assets and liabilities, and manage the sale. Privatization can help Ukraine significantly in transforming inefficient state-run, loss making, insolvent enterprises into enterprises that will be competitive and will only produce goods that have a good market. They will be motivated by profits and hence, on an aggregate national level, will generate growth.

## **7. Conclusion**

The general direction of tax reform in Ukraine should be to widen the tax base by shifting the main burden from enterprises to households. Tax neutrality across sectors encourages the development of private enterprise. The tax system should not create major distortions in consumption and production behavior. It should not favor one sector against another. The tax should foster savings and investment. In Ukraine, economic growth is difficult to achieve unless the tax burden is reduced significantly, to about 25-30% of GDP.

If tax laws fluctuate greatly as in Ukraine, it makes it difficult for the private sector to make long term investment plans. Taxes then become a source of risk. If compliance costs are high, there is greater tendency to evade.

The revenue base of the local authorities needs to be strengthened by establishing a stable real estates tax at the local level. This needs to be done in conjunction with allowing private ownership for land, which will help in the development of a land market.

The tax administration needs to be less high-handed in its approach towards taxpayers. Systems such as the kartoteka 2 drive people into the shadow economy. It is a well-accepted concept that the greater the contact with the fiscal authorities, the greater there is resistance to paying taxes. The more the tax inspectors check, visit or audit taxpayers, the more people want to evade them. If, instead, tax authorities collect information from third party sources and try to catch tax evaders by matching information, and good evidence, there will be greater compliance. Also tax procedures have to be made simpler, so that the obligation for filing declarations are not too frequent, are not too expensive and not too complicated.

Finally, tax reforms have to be a part of a comprehensive set of structural reforms. It would be very difficult to transplant a modern tax system in an environment where markets are not well developed, primitive methods like barter continue, banking system is insignificant, and contract enforcement is not effective. Therefore, it is very important to complete structural reforms that would support tax reform.

# Structural Roots of Financial Crisis (Yurii Kuz'min)

## 1. Introductory remarks

Low effectiveness of the Ukrainian economy can be seen as a result of many different factors. Some of them had the common character for all economies in transition or at least for the countries of the former Soviet Union. First, collapse of the USSR caused severe disruption in economic cooperation on the inter-enterprise level. Nevertheless, most of these relations were established due to other than economic efficiency reasons and, thus, their change could also be considered as a very natural in the process of pro-market transition. Second, structural crisis of the Soviet economy that was progressing from the 1970's up to the collapse of the empire resulted in the poor industrial organization in Ukraine. Third, insufficient investment during the 1970's and the 1980's caused deterioration of technology. During 1992-1997, Ukraine has made no progress in this respect. Partially due to high inflation, that has distorted the cost structure. Multilevel overhead of many Ukrainian organizations and inappropriate depreciation system serves as an explanation for the rest of the issue. Fourth, energy crisis caused by the substantial price rise of imported energy resources, and by very high energy-intensity of the Ukrainian economy.

Individual factors have come from the government of Ukraine. This concerns mainly the absence of consistent program of economic reform that should have been established just at the beginning of transition.

## 2. Political Factors.

Despite the adoption of the new Constitution in 1996 prospect of creating the legal and economic environment for private business development is still uncertain. President Kuchma has declared several times his commitment to radical economic reforms, but this has not always been followed by the real actions. His economic reform program has met considerable resistance in the Parliament.

Frequent relocation of top governmental officials on demand of different influential groups from the Parliament (during 7 years of independence Ukraine was governed by 6 Cabinets, the 'longest' has been alive for less than several years). As result, subsequent governments have had to satisfy narrow group of interests and, therefore, have been corrupted and not effective in carrying out economic reforms, such as privatization, real and financial sector development, taxation and budget deficit management, etc. In a framework of a political and economic theory, it means that '*...different interest groups compete for rents. The outcome is inefficient as lobbying is wasteful, as income transfers cause dead-weight losses and as state is induced to be time-inconsistent.*' [Gros and Steinherr, 1995]. We can suggest that the current political regime in Ukraine involves a lot of instability. This, among other things, lowers the expected return on investment, thus, postponing the real sector development and inhibits economic stabilization and development.

Frequent amendments to the core economic legislation (principal Law on Business has been changed for more than 20 times since its adoption) and slow process of adoption of consistent legislative package (like tax code, business code, etc.) push economic agents to disappear from the official side of the Ukrainian economy.

### **3. Shadow economy**

A large GDP decline reported by the official statistics should not be considered as a decline in a new value creation. Some research based on independently collected data (i.e., via enterprise and household surveys, incomes and expenditures comparison, energy consumption and money demand studies) assert that the real GDP decline during transition in Ukraine is roughly about 30 % [Hoffman et al., 1997]. Comparison brings an existence of an unofficial or shadow economy. This factor initially caused by economic instability now can influence stability itself. The shadow sector of the economy became roughly equal to the official one after several years of transition.

Among the main reasons of this, we can mention heavy regulation of external and internal trade, problems with currency exchange, high inflation pressures, frequent amendments to tax laws, etc.

Results include shortfalls of tax revenues, budget deficit, and inefficient fiscal policy implementation. If the government were able to integrate only a quarter of shadow economy in the official sector, Ukraine would be able to cover budget deficit without internal and external borrowings. Under 20 % VAT rate a quarter of the estimated shadow sector, [Kaufmann and Kaliberda, 1995] would increase budget revenues by 5% of the current official GDP. This is more than originally projected budget deficit of 3.3% of GDP for 1998. Elimination of reasons for 'going shadow' and providing incentives to the official activity should include liberalization of administrative regulation, low inflation, and stability at the macro level. The policy towards shadow economy should be irreversible and believable. It might cause further problems with budget revenues, because time is needed to make business people trust their government.

### **4. Regulation of Economy**

Enterprises in Ukraine undergo excessive state regulation that places different obstacles on doing business and makes the idea of a competitive market almost nonsense. The government considers this regulation as a response to market imperfection and as an instrument, which protects consumers and producers. However, the latter complain about complicated procedures which perplex the process of decision, thus, not contributing to nation's welfare, economic growth and people's protection. Since regulations of any kind are costly to the state budget, they should be applied only in the very special cases (like nonexistent or imperfect markets, etc.), but not to a standard business environment as in the case of Ukraine. Thus, deregulation in Ukraine has to consist of general verification of the existing restricting rules and regulations. This should include simplification of entry and operating procedures, reducing the excessive number of administrative polices and inspections, development of financial and labor markets, simplification of tax rules and the development of unified tax and business code.

### **5. Structural reforms in industry, and agriculture**

The process of structural transformations in Ukraine, as well as in the other post-socialist counties took more time than it was expected. This can be explained by general misunderstanding of difficulties, which socialist enterprises have during adaptation to the market economy rules even if their ownership has been changed.

The main problems of the restructuring are the lack of strategic private owners, weak corporate governance, insufficient protection of property rights (especially of outsiders), weak financial sector, unsolved problem of land ownership, protectionism, soft budget constraints (lack of effective bankruptcy procedures), which mean lack of sufficient financial pressure on enterprises. The other problems of industrial restructuring are related to social consequences of unemployment that will appear after restructuring of machine building, coal, and metallurgical industries. The situation is worsened by the fact that these industries are distributed unevenly through the country. To deal with this problem a number of policies should be implemented. They should include the separation of social sphere institutions from the large parent enterprises and the creation of regional labor markets and encouraging labor mobility. The social cost of transition is among the most potentially destabilizing forces in Ukraine and is additionally augmented due to government's inability to reform the social infrastructure.

The other principal issue is an overall government policy concerning satisfaction of internal demand. This includes placement of different tariffs and quotas on export and subsidization of the enterprises, which produce goods for domestic consumption. These measures, looking necessary at the first glance, in the long run will depress domestic producers, which do not track changes in preferences at the world markets.

A lot of restructuring has to be done in the agricultural sector. Ukraine has traditionally been a net exporter of agricultural products and a net importer of fuel and such agricultural inputs as pesticides, herbicides, and fertilizer. In the recent past, however, the government of Ukraine had restricted agricultural exports in an unsuccessful attempt to reduce domestic food prices. These restrictions have now been removed, enabling agricultural producers to benefit from their comparative advantage and restore trade linkages needed to finance imported inputs. Unfortunately, the persistent risk of doing business in Ukraine has deterred input producers and distributors, trading companies and commercial lenders from financing commercially viable input-supply transactions as well as fixed investments into agro-processing and agricultural storage and handling.

The agricultural sector, as well as the industrial one lacks in structural reforms in a sense of development of institutions in production (transformation of big and inefficient state entities into private firms) and distribution spheres (establishment of merchandise exchange institutions).

## **6. Privatization**

According to the Ukrainian law each citizen of Ukraine was entitled to receive one privatization voucher ("Privatization Property Certificate" or PPC) to exchange it into shares of privatization auctions. In addition, each citizen who held a bank account as of January 1992 was entitled to receive one or more Compensation Certificates (CC) - to invest in privatization auctions - to compensate for lost savings as a result of past years' hyperinflation. Employees and managers were given initial preferential rights to purchase shares of their enterprises for PPCs. Following preferential sales, remaining shares have been sold to the public for PPCs and CCs, and to investors for cash and/or future investment commitments based upon share allocation plans approved by the State Property Fund.

According to the information provided by State Property Fund (agency responsible for conducting privatization program) in June 1998, since the beginning of the mass privatization

7,500 medium and large industrial enterprises (out of about 10,000 enterprises entitled for privatization) have been privatized (that is over 70 % of their shares were sold). Other 2,000 medium and large enterprises are currently undergoing preparation for conducting share sales. The nominal book value of shares sold before June 1998, under PPC auctions amounted to nearly US\$11 billion. However, the market value of these shares was only of US\$ 1.4 billion. SPF does not possess necessary sovereignty in conducting privatization. Its management has been being often publicly criticized by top government officials for its inability to raise assigned revenues from privatization to the state budget. This, in turn, serves as signaling device for the market: the high expected supply of property at the auctions (to provide necessary revenues) drives the price down and lowers the budget revenues.

It is expected that privatization process in Ukraine will help to collect revenue for the state budget. At the same time, the government slows down the pace of a large-scale privatization, partially, because of strong political resistance in the parliament. It seems that the government waits until powerful investors come to the stock market and the growing demand drives up prices of enterprises. However, large debts of big Ukrainian enterprises and the lack of restructuring process initiated by the state do not stimulate a 'coming in' of investors. Thus, it is more reasonable to suggest that some interested groups block privatization of large enterprises waiting for the appropriate moment to get them for themselves; inflation that might occur would significantly distort the value of these enterprises allowing for a cheap buyout.

We claim that 'mass privatization' has produced no positive results. Enterprises did not get real money for investment (what would be possible under cash method of privatization). In most of cases, efficient owners have not been created and former management (that is old socialist directors) has not been replaced. Enterprises have not become more attractive for strategic investors. The largest enterprises, most of which can not function because of the lack of financial resources and over-employment, have not been privatized. The government has not collected any significant budget receipts from privatization..

This failure can also be explained by the inability of the government to create appropriate conditions for further development of the new private sector. For example, during the year of 1996 a number of small enterprises has decreased by more than 6 thousands (-6.6%). The share of active businesses was 49.9% in 1992, 37.3% in 1994 and 32.6% of all registered enterprises in 1996 [K.Maidanyk, 1998].

## **7. Energy Sector Development**

Ukraine's electric power industry ranked as the world's twelfth largest in 1996. Over the past decade, nuclear energy's share of power output has steadily grown while thermal generation potential has been underutilized. Nuclear power plants are now working at full capacity and all state nuclear power programs have been frozen since 1990 as a response to Chernobyl accident.

Reforms in the energy sector are more progressive and extensive than reforms in any other sector or industry of the Ukrainian economy. The government's initiatives include promoting high priority investments that increase the security and reliability of energy supplies in a cost-effective manner.

The coal sector provides one-third of the country's energy needs and employs nearly a million of workers. The government has adopted a comprehensive reform program for this sector, which would include liberalizing coal markets, establishing new corporatized entities by merging economically viable coal mines; and providing social protection to displaced workers who lost their jobs in closed mines. However, due to the shortage of budgetary resources needed for the implementation of these reforms and the political resistance of the coal lobby, restructuring of the coal sectors is proceeding at a very slow pace. The interesting fact is that the Presidential Order 'On the decrease of the expenditures of the State budget' in 1998 did not consider the reduction of the expenditures on the support of coal industry (1 billion UAH) and its restructuring (300 million UAH).

While placing a high priority on reforming the Ukrainian power industry the government lacks funds for the financial strengthening Ukraine's power generation companies and the National Dispatch Center (NDC), the state-owned company in charge of administering the wholesale electricity market. It is also desirable if these companies have access to commercial sources of credit. Improving the quality and reliability of electricity supply, which is a basic input for production, will also facilitate Ukraine's overall industrial recovery.

Broad liberalization of gas and oil industries, which naturally have general competitive advantages in the energy sector, resulted in creation of efficient market. However, some problems still exist. Despite declarations of state officials, that state enterprise 'Energomarket' (a company that regulates the system of payments between suppliers and distributors of electricity) was established to initiate healthy competition among generating companies and remove artificial, fixed prices previously set for each distributing company (oblenergo), this company is virtually a monopsonist. It decides by whom and in what quantities electricity is to be produced. In fact it is a first degree monopsonist, since it pays generating companies prices at which they agree to produce electricity (in this way 'Energomarket' takes over all producer surplus). Next, the Ukrainian government has decided not to privatize nuclear and hydropower plants. This decision will not bring competition to the industry and, thus, tough work of anti-monopoly committee is highly needed. So, the Ukrainian energy sector remains monopolized to a great extent, and, despite declarations of government officials, is a source of monopolistic profit for the interested groups and a cause of deadweight losses for the economy.

## 8. Investments

The overall fall of the economy affected the level of investment. Moreover, investments diminished faster than the entire production. The 1997 GDP of Ukraine fell by 3.2% in comparison to 1996, whereas the amount of fixed investment decreased by 13%. The other fact is that, for the first six years of independence the outflow of capital from Ukraine totaled to 20 billion UAH. Foreign direct investments in Ukraine amount to less than 5 USD per capita (comparing to 1,200 USD in Hungary). This means that Ukraine is not attractive for investments, both internal and external.

The main reasons for this can be summarized as follows. First, heavy tax burden decreases part of the financial surplus, which could be invested. Second, undeveloped stock market limits opportunities of alternative financing. Third, availability of domestic credits is very limited because of high interest rates, 'crowding out' effect of excessive government borrowing requirements, and low efficiency of financial intermediation. Fourth, low

disposable income does not stimulate private investment. Fifth, economic and social efficiency of foreign credit allocation is very low because most of credits are not investment-oriented, while the international debt of Ukraine is still growing. Sixth, non-attractive investment environment, undeveloped legislation, the banking system, and infrastructure, unfinished privatization process, the absence of the risk insurance lead to low efficiency of foreign investment.

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