

New Challenges for Economic Policy in Ukraine: Proposals for Immediate Action

Speaker:

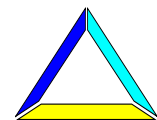
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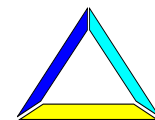


New challenges

- Surging social spending and thus large Pension Fund deficit
- Increasing energy prices, first of all gas
- Higher competition on world and domestic markets
- Lack of reforms in agriculture
- Unfavorable investment climate, in particular problems with protection of property rights

Most of these challenges have been previously latent and frequently not really perceived as challenges

The **combination** of these challenges resulted in lower GDP growth, sharp drop in investments, higher inflation, current account deficit, and higher fiscal deficit

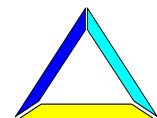


Role of the government

The role of the Government is to provide correct signals and framework to stimulate growth, and not to destabilize situation by unsustainable policies.

For this, the Government has to use **medium-term perspective in designing its policies in all sectors**. It concerns fiscal policy, energy, agriculture, investments, etc.

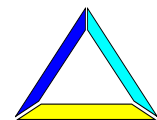
To have results, it has to start working immediately.



Five areas of economic policy

Responding to the new challenges requires **prompt, proper and consistent actions** mainly in:

- fiscal and social policy
- external sector
- energy and utilities
- agriculture and rural areas
- investments

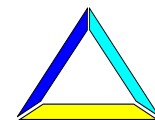


Fiscal and social policies: new challenges

- Structural imbalance in pension funds
Sharp increases in pensions
- Fiscal expansion since mid-2004
Sharp increases in minimum wages, pensions and social obligations (social protection expenditures are planned to increase from 4.9% of GDP in 2003 to 8.1% in 2006)

Result:

- Growing deficit in budget and pension fund
- Higher inflation

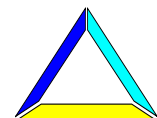


Fiscal and social policies: most urgent reform steps

- Restore fiscal stability
 - enlarge tax base (abolish privileges)
 - avoid targeting revenue increases to expenditures
 - ensure stable tax legislation
- Implement immediate steps to reduce the Pension fund deficit:
 - temporary abstain from further minimum pension increases
 - broaden the contribution base
 - match a fair participation in the pension payments by fair participation in contributions

medium-term goal

- Implement Medium Term Expenditure Framework

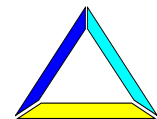


External sector: new challenges

Major changes:

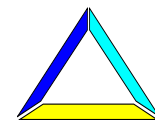
- increased competition and reduced prices on world metal markets
- sharp rise in import gas prices expected to continue in next years
- the growth of consumer-oriented imports stimulated by the continuous rise of households final consumption and a significant reduction of import tariff rates
- one-shot revaluation of hryvnia in April 2005

Result: Current account deficit after almost 7 years of a surplus



External sector: most urgent reform steps

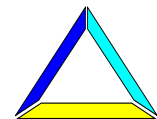
- Improve the sources of the CA deficit:
 - promote investment activity
 - conduct export-facilitating policies using WTO-compatible instruments
 - continue the policy aimed at improving access for Ukrainian exporters to markets of other countries, and to continue trade liberalization policy
- Improve the financing of the current account deficit:
 - attract more foreign direct investment
 - expand financing through loans from multilateral financial institutions
 - rely more on state debt denominated in domestic currency
- Conduct a more flexible exchange rate policy



Energy and utilities sectors: new challenges

- Increased gas prices
- Several so-far unsolved problems:
 - Depleted assets
 - Low efficiency
 - High losses
 - Not cost-covering tariffs
 - Low payments

Result: High energy consumption and low efficiency



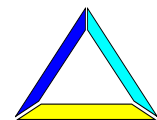
Energy and utilities sectors: most urgent reform steps

Economy must adjust to higher energy and utility prices

- Tariff reform and contract enforcement (100% cost-covering)

But: Simple increase of tariffs will not automatically solve all inherited problems

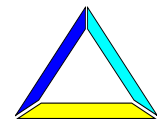
- Improvement of regulation in energy and utility sectors:
 - Promotion of competition in energy and utility services
 - Commercialisation and private sector participation
 - Promotion of energy-saving investments



Agriculture and rural areas: new challenges

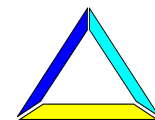
- Approach a new phase of its development related to the forthcoming WTO membership
- Number of so far unresolved problems:
 - lacking a business enabling and stable agricultural policy environment
 - mixing of agricultural support with rural development objectives
 - distortive, inefficient, non-transparent fiscal support
 - undeveloped land market

Result: Ukrainian agriculture is still far below its potential, while rural areas are characterized by ongoing depopulation, social and economic degradation



Agriculture and rural areas: most urgent reform steps

- Separate rural development policy and instruments from agricultural support policy goals and instruments:
 - draft and adopt separate strategy development programs for agriculture and for rural development
- Reform fiscal support to agriculture:
 - introduce a medium-term planning
 - introduce decoupled income payments instead of existing fiscal support measures
 - increase the share of “green box” measures
 - tax privileges to agriculture should be phased out leaving the simplified tax system only for small farms and enterprises
- Institutionalise and activate rural land markets



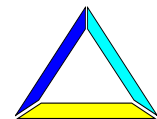
Investments: new challenges

- Almost two third of surveyed enterprises said that the need to replace depreciated equipment was an incentive for investment
- In 2005 the gross fixed capital accumulation reduced by 0.3%

Major reasons:

- property rights uncertainly provoked by reprivatization
- non-consistent tax policy
- poorly developed institutional mechanism for attraction foreign investments
- excessive regulation and corruption

Result: investments in Ukraine remained much lower than it is necessary for the stable development of the economy



Investments:

most urgent reform steps

- Provide private owners with the long-term guarantees of the security of their rights:
 - improve the procedure of the juridical and extra-juridical protection of the property rights of any size
 - develop the efficient and transparent mechanism of privatization and control for execution of investment obligations
 - Determine the legal status of the State Property Fund
- Continue a simplification of registration procedure of enterprises
- Reduce import tariffs on machinery and cancel pension fund duty
- Develop public-private partnership in infrastructure investments
- Develop pension system and life insurance as an alternative source of investment capital

