

# Ukraine: the European giant

Ukraine has not been blessed with as many natural resources as nearby Russia or Kazakhstan, but nevertheless it has achieved remarkable results over the past eight years, writes *Philip de Leon*.



Ukraine engaged more heartily on the bumpier road of democracy western-style, and despite high visibility political bickering and crises culminating with the 2004 Orange Revolution, high returns have foreign investors flocking in with over US\$9bn of foreign direct investment in 2007. Since 1991, Germany represents a 20% share and Cyprus – mostly Ukrainian and Russian money being reinvested – another 20%.

With its 603,700 square km, Ukraine is the largest country west of the Urals before France. Its population of 46.6mn and its growing middle class, that enjoys generous increases in real wages and easier access to bank credits, have contributed to make domestic consumption a new factor of GDP growth since 2005. Until then, GDP growth had usually been export-led, and since 2006 investment-led.

Often referred to as the bread basket

of the Soviet Union, Ukraine remains a powerful agricultural country with tremendous growth potential. Grain production in 2008 is expected to reach 40mn tons compared to 29.3mn in 2007. Similarly, 2007 was also a year of strong industrial performance. Four industries distinguished themselves: machine-building, food-processing, chemicals and metallurgy, with steel being one of Ukraine's top exports.

Financial services, consumer goods and retail have drawn a lot of foreign direct investment. By the end of 2007, 47 banks operating in Ukraine were created with foreign capital participation, with 17 of these banks having a 100% foreign capital. The Ukrainian banking system, whose assets have nearly doubled since 2006, is going through a period of consolidation with no less than 24 mergers & acquisitions transactions since the

beginning of 2006.

Ukraine faces many challenges including pervasive and multi-layered corruption, a labyrinthine bureaucracy and a weak legal system but could nevertheless become a prominent European player if it plays the right set of cards.

## WTO – EU Partnership - Euro 2012

In December 2005, Ukraine was granted market economy status by the European Union (EU), followed in February 2006 by the United States. On May 16, 2008, Ukraine joined the WTO, becoming its 152nd member, which should reinforce its attractiveness by offering a more predictable trade environment, lowering trade barriers and facilitating the resolution of trade disputes. WTO membership will increase competition in Ukraine as protective measures such as tariffs and custom duties will be capped or eliminated.

Ukraine has a partnership and co-operation agreement (PCA), which constitutes the legal base of Ukraine's relations with the EU on a wide range of political, trade, economic and humanitarian issues. With the completion of WTO accession, negotiations are under way for a free trade agreement with the EU, which will be a core element of a new enhanced agreement that will replace the present PCA.

The prospect of EU membership could be seen down the road, though it is not to be expected in the foreseeable future in light of Ireland's rejection of the Lisbon Treaty which was designed to help the EU streamline the decision-making process after the union's enlargement to 27 nations.

In 2007 Poland and Ukraine were chosen to host the 2012 UEFA European Football Championship, commonly referred to as Euro 2012, a major sporting event that will be hosted in four cities across Ukraine (Kyiv, Lviv, Donetsk and Dnipropetrovsk) with two cities serving as backup (Odessa and Kharkiv). This will entail billions of dollars of investment in infrastructure to expand and modernise stadiums, airports, railways stations, highways, hotels and border crossings.

However, the UEFA has in late June shown concerns over the progress made for the preparations to host the Championship and warned that Ukraine could lose

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the right to host the tournament if the stadiums were not ready. A final decision is to be made at the end of September.

### The cast of characters

The Ukrainian political stage and the cast of characters are reminiscent of Italy's fast rotating governments and of its spaghetti westerns of the 60s and 70s. It is important to take a minute to study them because even though the majority of political forces are committed to improving the business and investment climate, interferences with business activities are not uncommon. The web of past and present connections of key politicians, if known, can help understand a complex scene.

Over time, three leading characters have emerged which could be referred today as the fallen star Viktor Yushchenko, the passionaria Yulia Tymoshenko and the friend of Moscow Viktor Yanukovich.

### Viktor Yushchenko

Viktor Yushchenko became immensely popular in 2004 when he emerged as the de facto leader of the Ukrainian opposition coalition in the presidential race. During the campaign, Yushchenko became severely ill, with what would later be determined as dioxin poisoning. Then after an alleged electoral fraud that benefited his opponent Viktor Yanukovich, massive protests led to the Orange Revolution, which ultimately resulted in the Supreme Court overturning the results and Yushchenko being elected in a run-off election.

Expectations were high but over time Yushchenko has failed to deliver on his promises such as on fighting corruption. His efforts to reach a consensus on many issues while navigating a political scene where the division of power was further blurred by constitutional amendments in 2006 have hampered his ability to be more forceful in implementing much needed changes.

### Yulia Tymoshenko

Yulia Tymoshenko, an original ally of Yushchenko, recognisable because of her distinct plaited hairstyle, has emerged as the leader that is getting things done. Following parliamentary elections where she joined forces with Yushchenko to gain a majority over the party of then prime minister Yanukovich, she became again prime minister in December 2007 after

having held that position in 2005. Her political platform had unveiled a document entitled "Ukrainian breakthrough: towards a fair and competitive country" designed to put the country on a fast track towards future prosperity. It incorporated many recommendations by international organisations, NGOs and private businesses and advocates for a systematic programme to combat corruption, public-private partnership investments for

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infrastructure development, elimination of legal and regulatory contradictions, etc. That document was followed in January 2008 by the "Tymoshenko Transparency Initiative" aimed at improving the investment climate in Ukraine by introducing energy, investment tax and judicial reforms.

### Viktor Yanukovich

Viktor Yanukovich, who is more at ease speaking Russian than Ukrainian has been twice prime minister and is representative of a Ukraine more anchored eastward, where his support base is stronger. He was heavily supported by the Russian president Vladimir Putin during the presidential elections as his party wanted to restore closer ties with Russia and was rallying the votes of those suspicious of the pro-Western liberal policies pursued by his opponents. He is also a fierce opponent to his country joining NATO.

The 2004 Orange Revolution, where the Ukrainians demonstrated for two weeks following his election after reports of electoral fraud, has sent a strong signal that Ukrainians want to have a full-fledged



democracy and that free elections cannot be tampered with. In 2006, Freedom House, an independent non-governmental organisation that supports the expansion of freedom in the world, declared Ukraine a free country. Ukraine is the only country of the former Soviet Union to be considered free except for the Baltic States. Today's lively political debates and battles are a token of a democratic process in full swing. However, the constant political infighting since the 2004 elections coupled with short election cycles prevent the adoption of much needed legislation and the implementation of a consistent fiscal and monetary policy, reducing medium to long-term visibility so valuable to improve the investment climate. Furthermore, amendments to the constitution adopted in December 2006 have resulted in the lack of a clear power delineation between the president, the cabinet and the parliament which leads to bitter battles, some of them affecting commercial issues. This situation has probably cost Ukraine one or two points of GDP growth per year but has not prevented it from achieving a real GDP growth of 7.6% in 2007 while the average GDP growth for the 2000-2007 period reached 7.45%.

### Key challenges

#### • Inflation and exchange rate

According to the National Bank of Ukraine the key factors for inflation growth in 2007 as it reached 16.6% were: a rise in foodstuff prices, an increase in household income and the long-term political uncertainty. Surging energy prices are also a contributing factor.

Some solutions suggested by the International Monetary Fund are already being adopted such as broadening reserve requirements. Others such as a more flexible exchange rate, inflation targeting and restraining subsidies and social transfers are more challenging to implement.

The national currency - the hryvnia - is pegged to the dollar within a currency

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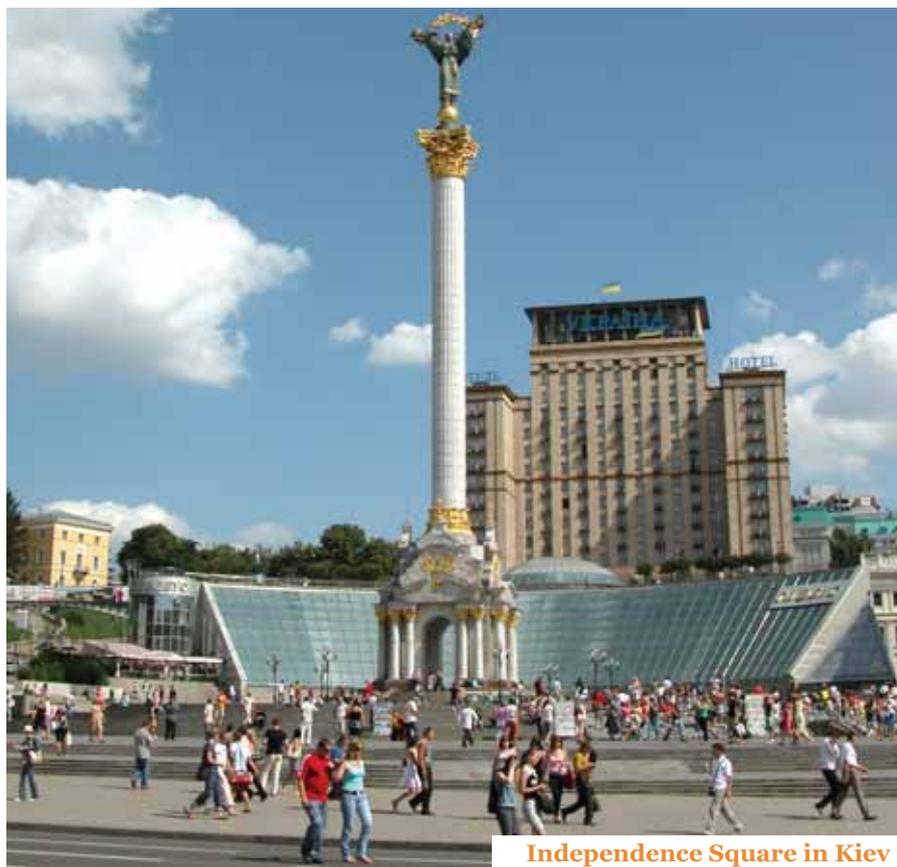
band officially set by the National Bank of Ukraine at 4.95 – 5.25 hryvnia per dollar. To maintain the exchange rate as the dollar has been falling, the National Bank of Ukraine has purchased foreign exchange resulting in the injection of billions of hryvnias into the economy. This has resulted into the rapid growth of the money supply allowing banks to grant more credits. Up to now the increased money supply happened concomitantly with high money demand but that did not prevent an inflation hike and a lower GDP growth could lead to even higher inflation. Ukraine needs to do more to get inflation under control, according to Morgan Williams, president of the US-Ukraine business council (USUBC) in Washington DC. The very high inflation rate is a real threat to the rate of economic growth Ukraine has achieved. Most economic experts are very worried about a potential major financial crisis in 2009.

#### • Corruption and high cost of doing business

In spite of an action plan by the government to improve the situation, doing business in Ukraine is far from easy. In the Transparency International's Year 2007 Corruption Perception Index published in September 2007, the situation worsened. Ukraine moved down to the 105th place in 2007 on the list of 180 countries from 99th place out of 163 countries in 2006. In the World Bank Group's Doing Business 2008 report, which ranks economies on their ease of doing business from 1 to 178, Ukraine ranked 139 after Iran, Syria and Uzbekistan and slightly ahead of Iraq. It also ranked almost last for the indicators of dealing with licenses and paying taxes.

#### • Commercial Disputes

Despite repeated promises from Ukrainian officials over time, a dispute dating back to 1999 with the US Overseas Private Investment Corporation (Opic) remains unsettled. Opic which provides to US companies financing, political risk insurance and investment funds, had covered the non-payment of a state debt in the amount of US\$17mn and has since been unable to get reimbursed. The resulting standstill is that billions of dollars of foreign direct investment are estimated to have been lost since then. It is just unbelievable that Ukraine has not found the political will and ability to



**Independence Square in Kiev**

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resolve the Opic issue,” states USUBC’s Williams. “The problem just goes on and on with endless meetings and in the meantime jobs and income are being lost.” In May 2008, the government decided to revoke and terminate a production sharing agreement (PSA) - signed in 2007 with the US-based company Vanco by the previous departing government of Viktor Yanukovich - claiming lack of transparency regarding ownership and an unfavorable products distribution agreement of 65:35 with only 35% of extracted hydrocarbons going to Ukraine. The PSA was for deep-water oil and gas exploration in the Prykerchenska area of the Black Sea. Since then an international arbitration procedure has been launched against the Ukrainian government at the Stockholm Chamber of Commerce. The unilateral decision of the prime minister, whether justified or not and opposed by the president, casts of a negative light on the sanctity of contracts.

### West or East: can Ukraine have both?

Ukraine, and its capital city Kyiv, has been the centre of the first eastern Slavic state known as Kyivan Rus, considered as the predecessors of today’s modern eastern Slavic nations of Russia, Ukraine and Belarus. As a result, culturally and historically Ukraine is very close to Russia.

Its 1,576 km of shared borders with Russia makes is a natural and traditional trading partner but the enlarged EU has nearly 1,300km of common border with Ukraine. In 2006, Russia represented 21.4% of Ukraine’s exports and 28.35% of its imports but in 2007 The EU replaced Russia as Ukraine’s main trading partner both for exports and imports with a total trade in goods of €26.6bn.

Ukraine is torn between embracing the West and all it has to offer while not provoking its mighty Russian neighbour. Balancing its relationships with the EU, the United States, NATO and Russia is a tricky exercise as Russia sees its zone of influence challenged. Conveying that collaborating with the West is not turning its back on Russia is difficult to say the least.

Ukraine was bluntly reminded of Russia’s leverage when Moscow decided to cut off gas in late 2005-early 2006 over a pricing dispute. Though it is true that Ukraine needs to pay its energy at world market prices and pass on the price increase to the end users - Ukraine presently is one of the most energy inefficient and voracious countries in the region - the technique used did send a shockwave across Europe, which heavily depends from Russian and Central Asian oil and gas transiting via Ukraine.

The recent events in Georgia where

military force was used to solve a territorial and political dispute have the Ukrainians wondering if a spark in Crimea, where there is a large presence of Russian passport holders in addition to troops and the Russian Black Sea Fleet in Sevastopol – with a lease expiring in 2017 - could justify a Russian invasion to protect its citizens and interests.

Ukraine does however have a new weapon, which is its ability to block Russia’s accession to WTO, as each member must consent to the admission of a new one. Georgia, which has seen its wine and mineral water banned from Russia has been using it to block Russia’s accession. This weapon may be of limited effect for now: not being part of WTO does not affect Russia as its biggest exports – energy and raw materials – face little trade barriers worldwide. WTO accession here is more an issue of national pride than real economic gains.

Though there is a great potential for diversification, the economy remain vulnerable to the fluctuation of export commodity prices and higher energy prices. The current account deficit, rising external debt and inflation are a source of concern as well. Retail and the demand for new and renovated residential and commercial buildings, that are fueled by consumption, could be affected if Ukrainian banks that have heavily borrowed abroad to fund domestic lending operations are further impacted by the international credit crunch. In addition the need to tackle inflation with a reduction in the money supply could curtail economic growth.

To conclude we can say that Ukraine’s government has an ambitious programme to take the country forward. Being part of the WTO, greater collaboration with the EU and the preparation for the Euro 2012 could be major incentives to implement much needed reforms and see Ukrainian companies improve their corporate governance and transparency and operate without the shield of protectionism measures and cheap energy. The big question mark will be if the government will have the ability to implement all that it envisions.

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**Ukraine’s Central Bank**