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Economic development in Ukraine: a test case for European solidarity

Report
Committee on Economic Affairs and Development
Rapporteur: Mr Andrea Rigoni, Italy, European People's Party

Summary

While Ukraine's economic development since independence in 1991 has been relatively slow, and often troubled, there are now new grounds for optimism. Ukraine has come through a series of political tests and its economic recovery has been underway for several years, in particular through strong growth between 2000 and 2004. With the election of a new President and more recently a new Parliament, a newly-confident society has high hopes for political and institutional reform, so that the country can assert itself as a modern democratic state with a well functioning market economy. As European countries are Ukraine's main partners, Europe as a whole shares an interest in Ukraine's success.

The report reviews key political and economic developments in Ukraine over the last decade and highlights the main challenges that need to be addressed to ensure enhanced welfare through a dynamic, growing, diversified and competitive economy. It calls on the country's leaders to ensure the continuity of reforms and the integrity and efficiency of all levels of government. Special attention should be devoted to structural improvements in the energy sector, privatisation of large state enterprises, greater fiscal discipline, support for small- and medium-sized enterprises and the streamlining of taxation, tax administration, customs procedures and corporate legislation.

The report also calls on the Council of Europe member states to facilitate Ukraine's integration into the World Trade Organization and the European Union, assist in the reform of its public administration and efforts to enhance good governance, and foster co-operation in the fields of corporate ethics, energy efficiency, social cohesion and environmental protection.

A. Draft resolution

1. While Ukraine's economic development since independence in 1991 has been relatively slow, and often troubled, there are now new grounds for optimism. Ukraine has come through a series of political tests and its economic recovery has been underway for several years, in particular through strong growth between 2000 and 2004. With the election of a new President and more recently a new Parliament, a newly-confident society has high hopes for political and institutional reform, so that the country can assert itself as a modern democratic state with a well functioning market economy. As European countries are Ukraine's main partners, Europe as a whole shares an interest in Ukraine's success.

2. Political competition and fiscal loosening throughout 2005 and early 2006 combined with a less favourable global environment for the country's main industrial exports, resulting in a substantial slow-down in economic growth. At the same time, progress in economic reform, legislation and multilateral negotiations has been recognised by the European Union and the United States in granting Ukraine market economy status which is a major step forward towards World Trade Organisation (WTO) membership and a proof of the country's improving investment profile. The Parliamentary Assembly welcomes this development and hopes that Ukraine will be able to join the WTO in 2006.

3. The Parliamentary Assembly salutes the launch by the Government of Ukraine, in February 2006, of a Long-Term Development Strategy, setting governmental priorities for 2006-2007. It commends the main traits of this strategy, in particular its emphasis on enhancing human development, the quality of life and social welfare through a dynamic, growing, diversified and competitive economy. It is to be hoped that the newly elected parliament and new government will use this development road-map as a basis for their work and will further elaborate it.

4. Implementing these ambitious development goals requires, first and foremost, that the country's ruling elite ensure the continuity of reforms and the integrity and efficiency of its own ranks and that of the entire civil service. This calls for a thorough reorganisation of public administration to match the needs of a changing and ever more demanding Ukrainian society.

5. In order to boost the country's economic development potential Ukraine still needs to improve the overall business environment, accelerate the privatisation of big state enterprises and strengthen corporate governance in line with international benchmarks, notably the guidelines set by the Organisation for Economic Co-operation and Development (OECD). A clear and effective separation between political power and private economic interests should be properly enforced and monitored. Stronger credit policies in favour of enterprises and the population at large could be instrumental in reducing the scope of the informal sector of Ukraine's economy. The Assembly welcomes EU-Ukraine-Moldova co-operation on improving border control between Ukraine and Moldova with a view to curbing smuggling, trafficking, corruption and customs fraud, especially through the Transnistria region.

6. Energy is the life-blood of the Ukrainian economy. However, its production, distribution and consumption remain very inefficient, with energy intensity per production unit being five to six times higher than in western European countries. This strongly undermines the competitiveness of the country's industry. Moreover, as the recent gas imports crisis has demonstrated, it is high time for Ukraine to review its energy policy and rationalise its energy use. This is all the more necessary in order to render the Ukrainian economy more competitive in a global context and more resistant to any future energy shocks.

7. The international community is looking forward to timely and full implementation by Ukraine of global nuclear safety measures. With its help, Ukraine has strengthened the old containment unit around Chernobyl's damaged reactor and has started the decommissioning of the entire power station. The Assembly hopes that the Ukrainian government will clear the remaining legal, regulatory

and administrative obstacles in order to proceed rapidly with the construction work foreseen under the Chernobyl Shelter project.

8. The Assembly regrets that Ukraine is not yet a member of the Council of Europe Development Bank (CEB). It believes that the country could benefit considerably from the Bank's resources and expertise in financing a wide range of socio-economic projects and should consider becoming a CEB member at the earliest opportunity.

9. The Assembly, reiterating its recommendations contained in Resolution 1466 (2005) and Recommendation 1722 (2005) on the honouring of obligations and commitments by Ukraine, invites the newly elected Ukrainian parliament and the newly formed government to:

9.1. build their economic policy on the basis of the February 2006 Long-Term Development Strategy and expand it to include specific objectives and timetables for their implementation, as well as stronger practical measures to support research and innovation;

9.2. seek greater fiscal discipline in order to tackle inflationary trends and the budget deficit;

9.3. accelerate structural reforms, notably in the energy sector, and the privatisation of large state enterprises while giving due consideration to ensuring the smooth provision of services of general interest;

9.4. continue streamlining the taxation system, tax administration, customs procedures and corporate legislation with a view to creating a fair, transparent and stable legal environment for all economic actors;

9.5. review and clarify the mission of the country's civil service and to accelerate the reform of the public administration;

9.6. introduce tax incentives encouraging enterprises to carry out energy audits and to invest in appropriate adjustments in their energy use;

9.7. strengthen investment in the development of renewable energy sources and energy efficiency projects;

9.8. co-operate fully with the European Bank for Reconstruction and Development (EBRD) on the Chernobyl Shelter Implementation Plan and to facilitate joint energy-saving projects;

9.9. accede to the revised European Code of Social Security (CETS No. 139) and the European Convention on Social Security (CETS No. 078), as well as the related agreement (CETS No. 078A) and protocol (CETS No. 154), and to speed up the ratification of the European Convention on the Legal Status of Migrant Workers (CETS No. 093) and the revised European Social Charter (CETS No. 163);

9.10. re-examine the question of enhanced Council of Europe presence in Ukraine, notably through a special representative for the co-ordination of Council of Europe co-operation programmes;

9.11. continue simplifying regulations for entrepreneurs, with special attention to the needs of small- and medium-sized enterprises (SMEs);

9.12. adopt further measures to ensure transparency in public procurement and privatisation;

9.13. strengthen credit policies in favour of SMEs and the creation of new enterprises;

9.14. encourage the development of tourist facilities and infrastructure.

10. The Assembly also calls on the Council of Europe member states to:

10.1. facilitate Ukraine's integration into the WTO and closer partnership with the European Union, including by entering into bilateral free trade agreements, extending Trans-European Transport networks in Ukraine and simplifying the conditions for the free movement of persons;

10.2. assist the Ukrainian authorities in modernising the country's public administration and building up the good governance capacity of the state institutions;

10.3. work bilaterally and through international organisations in order to ensure the smooth implementation of co-operation programmes, international accounting standards and enhanced corporate ethics in Ukraine;

10.4. enhance co-operation in favour of energy-efficiency, social cohesion and environmental protection projects, notably by offering their know-how in these fields and increased access to financial assistance through relevant financing instruments.

B. Explanatory memorandum by Mr Rigoni, Rapporteur

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I. Introduction

1. Ukraine has a fascinating, turbulent history: the country's very name can be translated as 'borderland', and perhaps it is no surprise that the earliest-known maps were discovered here, dating back about fourteen thousand years. Originating in settlements along the Dnepr and Dnestr rivers, Ukraine grew up amidst successive waves of occupation, coming both from east and west. The Scythians of Near Asia gave way to the Goths and subsequently the Varangians of Scandinavian origin, who in 879 founded the Kievan Rus, making this the centre of the first Slavic state. In 1187, the name of 'Ukraine' is first mentioned – but not until the 17th century did the country gain autonomy, and then it would be short-lived. In fact, for most of the last millennium, Ukraine has been occupied, partitioned and fought over by - amongst others - the Mongols, the Ottoman Empire, the Lithuanians, the Poles, Imperial Russia, the Austro-Hungarian Empire and latterly, the Soviet Union.

2. Today's Ukraine shares frontiers with seven countries and has more than 2,000 km of coastline. A glance at the map shows its geopolitical significance. Three of its neighbours are now members of the European Union (Poland, Slovakia and Hungary), and a fourth – Romania – is due to join in 2007; and while Ukraine (like its other three neighbours – Belarus, Moldova and Russia) is a member of the Commonwealth of Independent States, it has a special relationship with NATO and a long-reaching goal of EU membership.

3. Ukraine has long been an important part of European strategic thinking. But Ukraine is much more than the crossroads of east and west. After Russia, it is the largest country in eastern Europe, with a population of some 47 million (larger than that of Spain and Poland). Since independence in 1991 its territories are united and its diverse population is free to determine the nation's destiny.

4. While Ukraine's development since independence has been relatively slow, and often troubled, there are now grounds for optimism. An economic recovery has been underway for several years, and with the election of a new President a newly-confident society has high hopes for political and institutional reform, so that the country can become a modern democratic state with a well functioning market economy. Russia and the EU are Ukraine's largest trading partners, and the EU is its largest donor. So Europe, as a whole, shares an interest in Ukraine's success. This is what led your Rapporteur, in January 2005, to introduce, together with numerous Assembly colleagues, a Motion for a resolution entitled "Europe's strong interest in rapid sustainable economic development in Ukraine" (Doc. 10434 revised).

5. Some economists have described Ukraine as a 'miracle in waiting'. This report will explore the opportunities and challenges that the country faces – both in coming to terms with its past and taking charge of its future. The nations of Europe have a significant role to play in this; and the Parliamentary Assembly welcomes the positive reception that the new government has received on all sides. For Ukraine, rapid and sustainable development may be, at last, within reach.

II. The rebirth of Ukraine

6. The circumstances of modern Ukraine were forged early in the 19th century when the country was partitioned along the river Dnepr into eastern Ukraine (including the Crimea) controlled by Imperial Russia and western Ukraine, part of the Austro-Hungarian Empire. Under Russian rule, serfdom was introduced in the east, an industrial base was established (based on coal mining) and colonisation encouraged. Ukrainian nationalism flourished; visions of the country's heroic past caught the popular imagination and were most famously expressed by the exiled poet Taras Schevchenko who wrote '*Such is the glory, sad and plain, the glory of our own Ukraine*'. Change would come after the First World War, when western and eastern Ukraine each declared independence and were briefly reunited. In the course of a year, the city of Kiev changed hands five times but by 1921 the Soviet Union had taken control of the east, while the west was ceded to Poland, Romania and Czechoslovakia.

i. Famine, persecution and war

7. There were compelling reasons for the Soviet Union to keep a grip on eastern Ukraine, not least its growing industrial base, its fertile soil and mild climate that would make the country their 'bread-basket', and access to the Crimea's deep-water ports on the Black Sea. So Ukraine became a test case of tackling 'harmful nationalism'. Through artificial famines, collectivised farming and the elimination of resistance via mass deportations and purges, the country was subdued – and in consequence, many Ukrainians welcomed the invading German army. But not for long: Nazi ideology was hostile to all Slavs. Much of the war's most intense fighting took place in Ukraine, as German advance was replaced by Soviet counter-attack. Overall, up to ten million Ukrainians were killed – perhaps 20% of the war's entire casualties.

8. During the first half of the 20th century, it is thought that famine, persecution and war killed half of the male and a quarter of the female population. Nationalist sentiments had been encouraged during the war; but integration was then resumed, with the introduction of a new and draconian five-year plan. The borders were redrawn, returning the western territories to Ukrainian – and direct Soviet – control. In 1953, Ukraine's General Secretary, Nikita Khrushchev, succeeded Stalin; and the following year the Crimea was transferred to Ukrainian control. This process brought about the ethnically diverse Ukraine that exists today. During Khrushchev's rule, Ukraine's prestige and influence increased, and his successor would be a native Ukrainian, Leonid Brezhnev, summoned from his post as local General Secretary.

9. After Russia, Ukraine was by far the most important component of the Soviet Union, with about four times the economic output of any other region. It generated more than a quarter of Soviet agricultural output and its farms provided substantial quantities of meat, milk, grain, and vegetables to other republics. Its diversified heavy industry supplied equipment and raw materials to industrial and mining sites throughout the Union. But national sentiment had not been destroyed, and from 1986 onward there was widespread discontent with Moscow's response to the Chernobyl disaster. When the Soviet Union began to disintegrate, Ukraine declared independence on 24 August 1991. Soon after, Leonid Kravchuk (the former General Secretary), was elected as its first President.

ii. Independent again

10. Few countries, in the 20th century, had suffered as much as Ukraine; but now it seemed that country was positioned to be one of the most successful former Soviet states. Endowed with good natural resources, rich agricultural land, a developed industrial base, a well-educated population,

ethnic peace and a strategic location, Ukraine seemed to have many of the components of a major European economy.

11. The reality was different. The heavy industry on which Ukraine relied was overwhelmingly inefficient and geared to a production system that had vanished overnight. Although Ukraine had reasonable oil and gas reserves, production had been declining for some time, with investment directed towards new fields in Siberia. Agricultural output declined, with markets disappearing but collective farming still in place. Ukrainian workers earned little, far less than Russian workers, and were often paid late. And after Chernobyl, the country faced a public health, environmental and energy production crisis.

12. On top of all this, Ukraine did not have the infrastructure of an independent country. It lacked, for instance, a currency, properly defined borders, and a national military service (instead, it was host to thousands of Soviet troops). Not surprisingly, there would be substantial agreement among Ukraine's post-independence leaders on the strategy for their country although there would be great difficulty in achieving it.

13. President Kravchuk called for economic reform and closer links with Europe. Amongst the members of the Commonwealth of Independent States (CIS), Ukraine wrestled with Russia over the status of the Crimea and the huge Black Sea Fleet stationed there, as well as over stockpiles of nuclear weapons (Ukraine was, briefly, the world's third-largest nuclear power). Ukraine joined NATO's Partnership for Peace, hoping for western security guarantees.

14. At home, steps were taken to deregulate prices, liberalise the economy and open it to outside investment, but in the face of a hostile parliament and with a Soviet-era civil service still in place, the pace of reform was insufficient. Continued reliance on central planning, together with loose monetary policies and the withering away of former Soviet markets, brought disaster. By 1993, inflation exceeded 10,000%, while in 1994 alone the GDP declined by 23%. At the end of that year, the presidency was won by Leonid Kuchma: a recent (and reform-minded) Prime Minister, who had once run the Soviet Union's largest missile factory, he was perceived as more sympathetic to Russia. He pledged to make Ukraine a market economy and to push through the measures needed to achieve it.

15. In itself, this peaceful transfer of power was a triumph for Ukraine's young democracy. Once in office, Kuchma did improve relations with Russia, compromising on the status of the Black Sea Fleet and negotiating a friendship treaty, while at the same time adopting a more arms-length relationship with the CIS (Ukraine refused to participate in its military alliance) and continuing to build links with NATO. He also continued Ukraine's overtures to the European Union, and joined other former Soviet republics in an American-backed regional group (GUAM), whose members (presently Georgia, Ukraine, Azerbaijan and Moldova) were keen to assert regional independence. In 1995 Ukraine joined the Council of Europe; in 1996 a new national constitution was agreed (whose first article defined Ukraine as a 'Social State'), and the following year Ukraine signed the European Convention on Human Rights.

16. Once more, there were some modest successes at home, mostly through the efforts of the central bank. Inflation was controlled (at the cost of wage cuts and high interest rates), the balance of payments stabilised, and a new national currency (the hryvnya) was successfully introduced. But hopes of fundamental change were again disappointed. Western financial support flowed – it would amount to around $10 billion during the decade – but against a continuing backdrop of institutional resistance, the reform agenda moved slowly, and in key areas such as agriculture it barely moved at all. Although most small and medium-sized enterprises were privatized, little was done to restructure politically sensitive sectors such as energy and telecommunications. In fact, a significant list of companies was formally excluded from privatisation.

17. Living standards fell as the economy continued to contract. By 1999, when Kuchma faced an old-style communist and won re-election, Ukraine's output was less than 40% of its 1991 level. One leading reformer described the poll as 'a choice between the death penalty and a very serious illness'. In fact, Ukraine faced economic collapse: after years of heavy borrowing and repeated failure

to meet IMF conditions, the debt payments due in early 2000 exceeded the country's entire foreign-exchange reserves. Ukraine was hugely – and increasingly – indebted to Russia, which supplied most of the country's primary energy. The energy position worsened due to the country's inefficient industrial stock and the failure to invest in domestic energy sources. Repeatedly, Ukraine failed to pay for the energy supplied (gas was even being stolen by the illegal tapping of pipelines). By 1999, it owed Russia over US$3 billion and the following year, winter fuel supplies would be guaranteed by striking a deal with Russia that allowed it to buy stakes in Ukraine's gas pipelines.

iii. 'Fight, and you shall overcome'

18. Under pressure from the West, Kuchma appointed Viktor Yushchenko – formerly central Bank governor – as Prime Minister, and parliament was persuaded to work with him, for a time. Yushchenko promised 'serious systematic reform', and initially he was able to deliver a tough-minded budget, drive administrative change via a cabinet secretariat and fend off anxious western bondholders. His abolition of barter taxes raised tax revenue by 30%, allowing him to reduce wage and pension arrears. But with lukewarm support from the President, he was confronted with Ukraine's increasingly powerful vested interests.

19. In Transparency International's Year 2004 'Corruption Perception Index', Ukraine ranked 128th out of 150 countries surveyed (or a third from the bottom among Council of Europe member states), just slightly up from ranking 87th out of 90 countries in 2000. Corruption permeated much of Ukraine's court system, police, civil service and regulatory system. While the State's economic monopoly had been prone to abuse, the bungling and half-hearted nature of reform made things even worse, with changes and wholesale transfers made without supervision or monitoring. Conflicts of interest abounded as public servants took on businesses while continuing to serve, and organised crime groups moved in. Increasingly, government bodies owned or had close ties to businesses in competition with those they were supposed to regulate. 'Off the balance sheet' techniques were used to pay for operations and expenses not funded by the state.

20. Increasingly too, a small elite, many of them the family and personal friends of the President, had come to dominate key parts of the government. Corrupt officials and criminal groups aligned themselves with these power-brokers, creating a network of profit and bureaucratic protection. For instance, Ukraine's top steel producer, Krivorizhstal, announced with impunity that it would not be paying back a government-guaranteed foreign loan. This abuse of power was most visible in the privatisation process, where the elite bought up companies at bargain prices, or took bribes from successful bidders. For them, the renewed privatisation programme was a bonanza, and they could even accommodate the Prime Minister's willingness to let outsiders participate. When the country's largest aluminium works were sold, all three bidders were tied to the same (well-connected) Russian company run by a businessman who was in a New York jail.

21. When personal enrichment and disrespect for the law were added to economic collapse, it was inevitable that the public would lose confidence in the system. After eight straight years of economic decline, the standard of living for most citizens had fallen more than 50% and in polls 40% called for the return of central planning. As Mr Yushchenko said himself at the time, 'how do you restore trust in reform among people for whom the term is a swearword?'.

22. International commentators began to speak of Ukraine's 'gangocracy'; but it is worth pointing out that violence and repression in Ukraine did not reach the levels experienced by some of its neighbours, particularly Belarus. Nor did Ukraine's tycoons attain the wealth of those in Russia (as one reformer jokingly put it, 'ours are vegetarians, theirs are carnivores'). For outsiders, Ukraine seemed cosmopolitan, friendly and relatively tolerant. But as the elite jockeyed for position, the mood became increasingly ugly. Already, in 1998, Yuschenko's political mentor had been assassinated and a prominent banker openly declared, 'the best thing Mr Yushchenko can do is leave us alone'.

23. Unsurprisingly, Ukraine's investment performance was bleak. Between 1990 and 2000, it secured less Foreign Direct Investment (FDI) than Croatia or Azerbaijan. On a per capita basis, investment levels over the decade were lower than any CIS country except Belarus, at about US$ 80

per head – less than 10% of the level for advanced transition countries such as Hungary and Poland. Worse still, while Ukraine secured about US$ 4 billion in foreign investment, there was at least US$ 20 billion of capital flight.

24. In 2000, President Clinton praised Mr Yushchenko and supported reform. Speaking in Kiev, he quoted the Ukrainian poet Schevchenko ("fight, and you shall overcome"), but behind the scenes, there were warnings. Already, the Council of Europe was worried about the proposed constitutional changes, and later that year, scandal erupted over the disappearance of a campaigning journalist, who had been investigating Ukraine's tycoons, and was later found murdered. At the time, such a thing was not unheard of; but in this case there was considerable evidence that those around the President – and perhaps even the President himself – were involved (the investigation continues to this day). The reaction, with street demonstrations at home and condemnation abroad, suggested that Ukraine was approaching boiling point. Worse would follow, when tape recordings that seemed to implicate the President in the journalist's murder also suggested his involvement in selling radar equipment to Iraq (in violation of UN sanctions). Contacts with the West diminished, and even Ukrainian involvement with coalition forces in Iraq did not repair the damage. His standing in Moscow declined too, when he published a book entitled 'Ukraine is not Russia'.

25. And yet, despite all this, in 2000 Ukraine recorded its first GDP growth since independence: 6%, a figure that astonished commentators (especially given a 12% rise in industrial production). This nearly matched Russia's performance – even though Russian industry had been boosted by the rouble's 1998 collapse, while the hryvnia (the Ukrainian currency) had dipped only slightly.

26. Although Mr Yushchenko, the country's most popular politician, was pushed out of office in May 2001, the economic resurgence continued. GDP rose 9% that year, and industrial output 14%. Growth slowed in 2002, reflecting the world economy, to 5.2%; but in 2003 it bounced back to 9.6%, with industrial output expanding by nearly 16%. This growth was essentially driven by domestic consumption, exports and investment. In 2004, despite renewed political turbulence, growth continued to surge, with GDP up by 12% (see the appendix) and a significant acceleration in domestic trade and construction.

27. In part, Ukraine's rebound was due to Russia's own unexpectedly strong growth but, just as in Russia, the key to continuing growth was increasing domestic demand. Wage growth was beginning from a low base, but increasingly supplemented by earnings from the 'unofficial economy'. Crucially too, consumer confidence was supported by lower inflation, higher real incomes and improved financial stability. Banking reforms led to an increase in deposits, decreasing interest rates and the introduction of new lending practices (including to micro and small enterprises), while non-cash transactions – previously a huge part of the economy – were reduced, even in the energy sector (where barter payments had been ruinously widespread).

28. The tax system was steadily reformed: corporate tax was cut from 30% to 25% and a new flat-rate personal tax was set at 13%, while exemptions were reduced. This package, completed in 2004, simultaneously lowered tax levels while broadening the collection base though significant loopholes remained. Further changes to the tax regime and the social security system for entrepreneurs were approved in 2005 leading to important reductions in various tax breaks. Any more successful tax collection was however adversely affected by the circumstance that over a third of companies reported losses in 2003-2005. There is also a problem with VAT refunds to exporters due to inefficiencies and fraud.

29. The improvement in public finances was also maintained: a series of prudent national budgets were set – and, increasingly, implemented – and the currency remained stable. Between 2000 and 2003, the government maintained a primary budget surplus and reduced its debts to the IMF and the World Bank, allowing for a significant reduction in public debt as a percentage of GDP (down to 29.4% in 2003 from the peak of 61% in 1999) and a large increase in foreign currency reserves (including gold). Access to international capital markets was restored, too: 10-year Eurobonds were successfully issued at relatively low interest rates. In 2003, major credit rating agencies upgraded Ukraine's sovereign ratings at 'B+ with a stable outlook'.

30. Meanwhile industrial productivity was rising sharply as, with even moderate restructuring, it was bound to do. Despite a poor harvest in 2003, agricultural productivity also rose, reflecting the beginning of land reforms and the reorganisation of collective enterprises. A start was made on judicial reform, with a new Criminal Code, Commercial Code, Customs Code, Civil Code and the Mortgage Law introduced to strengthen the legal framework and help prepare the way for WTO entry. Laws were also passed to combat money-laundering (Ukraine having been declared by the FATF (Financial Action Task Force) a non-compliant country) and Ukraine was finally removed from the blacklist of non-cooperating countries. In fact, an enormous amount of reforming legislation went through, and a range of international treaties ratified, although implementation remained noticeably weak. The OECD described the situation as 'much legislation, little system', and observers despaired at the lack of impetus for change. Even the government accepted that the pace of structural reform will have to be accelerated to ensure sustainable growth over the long term.

31. For Ukraine was still among the least advanced transition countries. Figures for 2003 showed its economy only three-quarters the size of Hungary's (though with a population five times larger), and its estimated GDP and FDI per head remained generally much lower than that of regional counterparts even though its average GDP growth for 2001-2004 outpaced that of all other countries in central and eastern Europe:

GDP estimates per capita, 2003, in US$

Ukraine	1,032
Russia	2,992
Poland	5,416
Turkey	3,199
Kazakhstan	2,050

(Source: Economist Intelligence Unit)

FDI per capita, 2003 and 2004, in US$

Ukraine	145	173
Russia	195	114
Romania	458	816
Poland	1271	1538
Croatia	1692	2405

(Source: UNCTAD; State Statistics Committee of Ukraine)

32. In March 2004, the government told the IMF: 'Our economic programme is aimed at moving towards a well-functioning market economy with an effective social safety net, based on EU standards of the rule of law and public institutions…in order to raise the living standards of the population and help lay the foundations for membership in the WTO and eventually the European Union'. The statement, while consistent with Ukrainian policy since 1991, was increasingly at odds with reality.

33. In the same document a new 3-year privatisation plan was promised, with a significant reduction in the list of excluded enterprises. 'We intend' it said 'to ensure that all sales of state assets are made under open and competitive conditions'. Three months later, the steel-maker Krivorizhstal was sold to the President's son-in-law for US$ 800 (€655) million - although foreign bidders, such as Russia's Severstal and US Steel, had offered twice as much. A western analyst then commented that Ukraine was 'off the track as an investment destination'.

34. So the Presidential election of late 2004 was bound to be contentious. Its course is well known, for as one of the most significant European events in recent years, it captured headlines all over the world. The Parliamentary Assembly has congratulated the Ukrainian people on the successful expression of their democratic will, the maintenance of their national unity, and their achievement of peaceful – and relatively rapid – change. The Rapporteur believes that the new government is aware of the need to reach out, not only to Ukraine's neighbours, but to all elements of Ukrainian society, to ensure the honest and successful administration that their people deserve, and so much desire.

III. Opportunities and challenges for today's Ukraine

35. The 2004 election was widely – and rather misleadingly – portrayed as a contest between East and West. In fact, Ukrainian policy has long involved a balance between East and West, and has consistently been concerned with defending national rights. It is interesting that, while the new President's approval ratings were above 60%, surveys found that 83% of Ukrainians had a 'good' or 'very good' attitude toward Russia and 75% thought that relations between the two countries were 'normal and friendly'. A similar number believed that 'the common features that united their countries would prevail in future relations' (and 69% of Russians agreed with them). Russian is still a widely spoken, and formally protected, language, and it seems fair to say that there is no general anti-Russian sentiment in Ukraine today.

36. Sworn in on 23 January 2005, President Yushchenko reaffirmed a strategy of economic and structural reform, with an ultimate goal of European Union membership. The key priorities were accelerated membership of the WTO, improved governance and transparency, a determined fight against corruption and renewal of privatisation policy, as well as social improvements and a reduction in the unofficial economy.

37. While 2004 data suggest that the effect of election-related instability was more limited than expected, Ukraine's position remains weak. Its economy is vulnerable to external shocks, with a continuing dependence on imported energy (see below a chapter on the energy sector), and a limited range of export markets. Ukraine's growth is expected to slow in 2005 and 2006, while the government will need to tighten public finances after the recent spending surge. Ukraine urgently needs to attract investment, both from private and public institutions, and to reverse capital flight so as to build up a legitimate, enterprise-based economy, where the rule of law and social values are respected. As an investor, and as a partner, Europe has a key role to play.

i. Changing attitudes to investment

38. Amongst the many businessmen who have recently flocked to Ukraine, the largest contingent is from Russia. As Prime Minister, Russian investors recall, it was Mr Yushchenko who regularised gas payments and halted the 1990s decline in bilateral trade (Ukraine is Russia's third biggest trading partner after Belarus and Germany). Also, he pushed for the inclusion of Russian companies in privatisations and tried to ensure transparency in the bidding process. If the new government can now create a 'level playing field', they seem confident that their investments can be expanded, even with more competition from the West. Moreover, investing in an EU-oriented Ukraine offers Russian entrepreneurs a means of diversifying their investments, while staying on familiar ground.

39. Western investors are also upbeat. The combination of an improving economy and falling margins in other emerging markets have made top-tier Ukrainian deals increasingly attractive to lenders. Potential investors note that Ukraine is rich in natural resources such as uranium and iron ore (whilst commodity prices on global markets are high); that its heavy industry costs are low (for instance, Ukrainian steel is much cheaper than that produced in western Europe); and that restructuring will reduce these costs further. The agricultural sector has great potential and has helped to create a booming food-processing industry. Strong education standards have enabled high-technology businesses to expand and with a population keen to spend sectors such as banking and retailing are ripe for development (Kiev, in particular, has recently seen a huge boom in retail activity). There is however also a legacy of under-investment in public projects: it is estimated that Ukraine needs $40 billion simply to repair its dilapidated infrastructure.

40. Among 114 countries that have so far invested in Ukraine, Germany, Cyprus, Austria, the United States, the United Kingdom, Russia, the Netherlands, the Virgin Islands and Switzerland provided the largest volume of FDI (about 83% of the total). The food industry and domestic trade have attracted most FDI (about a third of the total volume), while machine building and communications have recently gained in importance. The relative significance of investment originating from Cyprus (9.5% of the total FDI stock by 2006) suggests a gradual return of Ukrainian

capital that had earlier fled the country as well as higher activity on the part of Cyprus-registered off-shore companies of Ukrainian origin. The same could probably be said about the investment stock from the Virgin Islands. By 2006 it reached 4.2% - or nearly as much as from the Netherlands.

41. The international organisations[1], too, are responding to the changed environment:

- The World Bank, which supports a plethora of development projects in Ukraine, has focussed on structural reforms in both the public and private sectors. This includes the 'European Choice' programme, aimed at harmonising laws and practices. Since 1992, the Bank has approved around $4.5 billion in loans and grants for 33 projects. The Bank had allocated $3 billion in assistance between 2004 and 2007, and has indicated that because of a slowdown in spending in 2004, most of it is available to support the new government's programme. According to the World Bank's Country Director, this is a very promising and ambitious agenda, and the prospects have never been better.

- The IMF was a mainstay of Ukraine's economy during the 1990's, at one stage providing the funds that allowed energy import bills to be paid. In recent years, the country has continued to draw on an Extended Fund Facility. The IMF has consistently pushed for accelerated reform and was instrumental in the revision of the tax code. During 2004, they expressed concern at pre-election public spending levels, and while approving a US$ 592 million (411 million in SDR - Special Drawing Right) precautionary standby agreement, have continued to raise concerns about the inflationary aspects of the increasing budget deficit, as well as the accumulation of arrears on VAT refunds to exporters and structural problems in the financial sector. Meanwhile, in August 2005 the IMF suspended the programme because Ukrainian authorities had failed to meet a number of their commitments to the fund, essentially in the field of fiscal and banking policy. Since 1994, Ukraine has received a total of SDR 3.01 billion, or about US$ 4.3 billion, from the IMF.

- The EBRD, the biggest institutional investor in Ukraine, has focused on projects that promote energy efficiency, nuclear safety and infrastructure development. It has cumulative investments of nearly €2 billion for 71 projects, with almost as much mobilised by EBRD's other investment partners. In May 2005 the Bank put forward a new strategy for Ukraine, with emphasis on loans to local government agencies for infrastructure projects (such as for improving drinking water and energy supply, energy efficiency, nuclear safety and transport facilities) and credit lines for micro and SME financing, leasing and insurance. Thus recently, it has approved financing for the refurbishment of the main M06 motorway from Kiev to western Europe (part of the trans-European transport network corridors III and V), an SME credit line through Aval Bank, loans to the municipal water utility of the City of Dnipropetrovsk, Ukraine's Railways, AEGas Terminal, in the grain trading and food processing sectors, etc. The Bank also plans to be involved in the eventual privatisation of the Ukrainian telecommunications monopoly (Ukrtelecom) and parts of the banking sector. The Bank's President has told the new government that up to €1 billion could be made available annually to support their programme.

- As set out in the recent EU-Ukraine action plan, the European Investment Bank is to make available credits of up to €250 million for development projects.

There is a huge continued potential for increase in investment – if favourable domestic conditions can be created and sustained. Your Rapporteur is pleased to report that 2005 was a particularly good year for Ukraine in terms of attracting foreign direct investment which more than tripled on the year before.

[1] The Rapporteur is grateful to his colleagues Mr Jonas and Mrs Pirozhnikova, Rapporteurs of the Committee on Economic Affairs and Development, respectively, on the Bretton Woods institutions and the EBRD, for having shared with him information regarding the activities of these bodies in Ukraine.

ii. Good governance – the key to sustaining investment

42. At the time of the election, nearly 90% of Ukrainians described their own government as corrupt. Despite the adoption of many new laws and decrees, there was a fundamental lack of confidence in the will of the government to carry through reform, unless they stood to benefit from it. As events turned out, the election process itself sparked change, by challenging the Supreme Court, the security services and the media, but that can only be the beginning.

43. Persistent distortions in the tax regime and an unreliable legal environment were exacerbated by the open corruption of the judicial and political systems. Investors were unsure of their ability to secure property rights and enforce contractual obligations, and complained of complex and often ambiguous legislation, with a lack of financial transparency. Today, Ukraine still lacks a coherent, effective and transparent legal system – state power is, too often, arbitrary.

44. Following a series of resignations in September 2005, the first 'orange' government was dismissed by the President after several senior officials accused each other of nepotism and of taking bribes. The new government is therefore bound to give more force and credibility to previous reforms, by 'legalising' the state. President Yushchenko (a banker by training) is well aware of this. He defined a range of measures to promote good governance:

- Senior Government officials should have to report, in detail, the income and expenditures of themselves and their family members.

- The names of officials convicted of corruption should be released for publication in the press.

- The tax audit system should be reformed, with inspections limited to 30 days; the State Tax Militia should be abolished and its duties transferred.

- Salaries should be raised for law enforcement officers, while their duties and powers should be clearly defined.

- A reduction in company inspections and regulations should be mandated, and registration of new businesses should be simplified.

- A 'People's Control Committee' should be established, with local branches across the country, to monitor the way in which central and local government authorities look after citizen's rights and respond to appeals and complaints.

45. Since his early days in office, the President has been replacing officials and government officers. This process continues to the present day, especially after the appointment of new government in mid-September 2005 and the care-taker government in January 2006 following its unexpected dismissal through a no-confidence vote in the parliament.

46. After the 2004 election drama, significant and unexpected constitutional reforms were undertaken. In return for changes to the election rules, proposed by Mr Yushchenko, it was agreed that many of the executive powers enjoyed by the President would be transferred to parliament. This reform took effect in early 2006 although the political debate continues on the powers that would be shifted to the parliament after the March 2006 elections and the implications for executive-legislative relations against the background of a continuing stalemate in the functioning of the Constitutional Court. All political parties seem to agree that the country's constitution needs further amendments, in particular concerning the provisions that the Council of Europe's Venice Commission has repeatedly found incompatible with the principles of democracy and the rule of law. This series of constitutional and related legislative reforms should benefit Ukraine by putting in place a new political culture, strengthening the independence and impartiality of state institutions, and lessening the chance of any future 'gangocracy'. Your Rapporteur believes that these steps will prove to be in the long-term interests of Ukraine.

47. Through the TACIS National Programme, the EU has provided € 350 million and specialist expertise to help improve the fabric of civil society. Such assistance will now be more important than ever as Ukraine faces a long haul to overcome its legacy. In October 2004, for instance, Deutsche Bank provided the government with a US$ 700 million loan for the rebuilding of Kiev's main railway bridge – which has long been a traffic bottleneck. But in March 2005, half of the sum advanced was found to have gone missing, and the work has been suspended. Investigations were hampered by the suicide, just after Christmas of 2004, of the previous government's transport minister.

iii. Privatisation: past, present and future

48. While the mass privatisation of small and medium size enterprises was successfully completed in 1999 and these companies have contributed significantly to economic growth, the poor performance of large state firms has continued to restrain growth. As an immediate measure in 2005, the government has sought to ensure that new management be hired in open tenders, but the rapid resumption of privatisation remains a priority. The planned flagship of the new privatisation programme is Ukrtelecom, the state telephone group, whose sale has been under discussion for some time. A new schedule of upcoming sales is expected in 2006 – without the wholesale exclusions seen in the past. Privatisation revenues can certainly help the government, in what is proving to be a tight budgetary period. Given the history of the process and current investor optimism, care is needed if it is now to be successful.

49. First and foremost, the bidding system needs to be transparent and fair (the new government's credentials are at stake). Proper information needs to be made available, too, so that valuations can be made. Extra reforms should be enacted (and previous reforms implemented) so that the new enterprises can succeed in a competitive environment. The regulatory system is corrupt and dysfunctional, with multiple exemptions and restrictions that protect favoured groups. The bankruptcy law, for instance, does not currently apply to all companies.

50. The government's plans might go further: as 2004 was marked by the hasty privatisation of several big enterprises, a major element of the end-2004 election campaign was a review of past privatisations deemed controversial. At the time of writing, it is unclear how many companies this will apply to. It seems that the review is focusing on about 30 of the biggest deals, although some say it may be more wide-ranging. Company values are likely to be re-assessed by independent audit, and current owners may be given first refusal in the case of a resale. This is however a delicate exercise: on the one hand, the correction of discredited sales should be positive economically and send out a powerful signal, at home and abroad. On the other hand, it is important that the process does not become too politically charged, or it risks alienating prospective investors; and agreement needs to be reached on the terms of potential repossessions.

51. The government should define the scope of the review as swiftly as possible. Above all, it will be important to ensure that the process is carried out on a scrupulously legal basis. Encouragingly, this has begun with the first case to come forward, the notorious sale of Krivorizhstal (the largest disputed privatisation: the steel mill was sold for €655 million). In early April 2005, to no one's surprise, a Ukrainian court annulled the 2004 sale and a few months later talks started with the two business groups that had been involved in the sale. Your Rapporteur is happy to report that in October 2005 Krivorizhstal was resold to Mittal Steel, in what was generally viewed as a fair and open bidding process, for US$ 4.8 billion (€4 billion), or for six times the amount paid in the previous privatisation.

iv. Encouraging trade and enterprise…

52. Even though much of Ukraine's trade has shifted in focus from east to west in recent years, Russia remains Ukraine's major trading partner – receiving 18% of Ukraine's exports and supplying 41% of its imports in 2004. Given the interdependencies of the two countries, especially in the energy sector, this is natural; but while the prospects are good for increased trade with Russia, Ukraine also needs to continue to diversify its trading base. There are positive signs here, with Ukraine's trade

showing strong growth in non-traditional markets. Germany is the second largest import and export partner, followed by Italy, Poland, the US and Turkey. In fact, EU countries now account for about a third of all Ukraine's trade (amounting to €17.6 billion in 2004), with the EU area receiving 28% of Ukrainian exports and being at the origin of 37% of its imports.

53. Most of Ukraine's exports still consist of commodities with a low degree of processing. Steel and steel products account for over 30% of *all* Ukraine's exports. Chemicals, fuels and petroleum products are also important, while the export of machinery, machine tools and food products is expanding. Ukraine's most significant import is energy resources (35%), followed by machinery, chemicals and consumer goods, mainly from western Europe. Energy, agricultural products and textiles make up about a third of Ukrainian exports to the EU, whilst machinery, equipment and chemical goods feature as main EU exports to Ukraine. Driven by the real depreciation of the hryvnia versus many world currencies (especially relative to the euro) and strong global demand, Ukrainian exports of metals and chemicals earned the country substantial foreign currency inflows over the 2001-2004 period, but their high share in Ukraine's exports also show the vulnerability of the country's trade to price swings for raw materials in global markets.

54. Membership of the World Trade Organisation would be an important boost to Ukraine's trade capacity. In addition, the country needs to develop a commercial base that is more capable of producing quality goods for export and that can respond rapidly to changing market conditions. Although Ukraine was formerly an advanced manufacturing centre, producing aircraft and rockets (and responsible for 40% of Soviet technology development), the Soviet system of regional part-production and central product finishing meant that there was no concept of marketing, or an individual finished product to show. After independence, businesses collapsed, as they kept producing in the same way, but without anyone to sell to.

55. Further development of the private sector is needed to create a responsive commercial base, to raise wage levels and increase employment. Although it has recently recorded strong growth, its contribution to GDP is still only around 65%, compared with 80% in Hungary and 75% in Poland.

56. There are several promising sectors. Technology has rebounded – Bill Gates recently described Ukraine as the world's fourth most important software development centre. Mobile telephony is also booming despite some dubious privatisation activity and the lack of an independent regulator. As with internet services, the market is beginning from a very low base (for instance, 2-4% internet penetration), so spectacular growth is now possible. The area thought to have strongest potential is food processing along with related services, such as transport and packaging. By some estimates, this sector has accounted for 75% of recent economic growth and has become the main target of foreign investment. The EBRD has been active in providing finance in this field (such as to a ketchup manufacturer founded by Swedish entrepreneurs, which is now a domestic market-leader; to a specialist glass-maker, that supplies bottles for multinationals across Ukraine and Russia).

57. In fact, multinational corporations have also begun to invest more heavily. Sun-Interbrew (an Indian-Belgian joint venture) has a 30% share of the country's booming beer market, ahead of Scandinavian Baltic Beverages Holding, who have invested US$ 200 million in brewery capacity. Coca-Cola and PepsiCo have both established plants, with European and local partners, and their success has generated Ukrainian competitors. Similarly, the popularity of McDonalds, who have more than 50 restaurants, has sparked a range of local alternatives (such as Mr Snack, Shvydko and Dva Gusya).

58. These success stories are highly encouraging for European business and lending institutions, and are helping to generate growth in light industry and small business. Until recently, small and medium-sized enterprises accounted for only 3.5% of Ukraine's employment, perhaps a tenth of their potential, given the size of the domestic market and its propensity to spend.

59. To build on this, the government will need to continue the effort to simplify the regulations for entrepreneurs. There has been some success in this field already: the cost of registering a small business fell from US$192 in 1994 to US$67 by 2001, and the registration processing time was

reduced from 35 days to 5. However, even small enterprises, such as hairdressers, still face too many regulations, and there are too many opportunities for bureaucratic corruption. Ukraine also has plans to bring its standardisation system into conformity with the European Standards System by 2011 as a part of efforts to develop closer partnership with the EU.

60. Many investors and entrepreneurs complain about the regulatory burden, tax administration and selective enforcement of tax policy to advance political or business interests of the few. Although in spring 2005 many tax privileges and exemptions were eliminated, generating substantial revenue to the state budget, tax evasion remains a serious challenge. Unfair competition arising from the shadow economy businesses, monopoly-related problems, effective protection of intellectual property rights, and privileges accorded to some companies by local authorities are also seen as important barriers to doing business in Ukraine.

61. As in Russia, service-related industries offer huge scope for growth. Tourism, for instance, offers great potential to Ukraine, with destinations three hours or less by air from most European cities. Its countryside and coastline, long favoured by Russians, are now becoming known in the West. Tour operators and hotel operators are beginning to see a future and demand for Black Sea holidays for tourists wanting to go somewhere ‘different’, according to Ukraine Airlines.

62. With so much recent media coverage, there is a hope that Kiev could follow the example of Prague. The city is traditionally hospitable and has a wealth of vast green spaces and fine architecture. Visitors today find the city in upbeat mood, festooned with orange souvenirs and ‘Orange Tours’. The staging of the 2005 Eurovision Song Contest has generated more good publicity. Investment in tourist facilities and infrastructure will be vital to build on this potential. In particular, additional hotel capacity is required as even Kiev remains desperately short of accommodation at international standards.

v. …and a legitimate economy

63. Encouraging a legitimately entrepreneurial society will help to address one of Ukraine’s most pressing problems: by Mr Yushchenko’s own estimate, 55% of the economy is unofficial. A disproportionate rise in electricity consumption over recent years suggests that much of the country’s economic growth has been unrecorded, which helps to explain the rise in consumer demand, when average wages hover around subsistence level and the estimated level of unemployment (ILO definition) is about 9% of the active population (official definitions erroneously show an unemployment rate close to 4%, one of the lowest in Europe).

64. This is disastrous for government revenues, and it leaves much of the workforce without proper social protection. We would hope that Mr Yushchenko’s team will tackle the problem: people may be more prepared to pay taxes to a more honest and effective state and may see more purpose in doing so. But additionally, the government will need to offer more opportunities for legitimate employment and further streamline the taxation system. Ukraine’s service and small business sector is probably far larger than it appears to be!

65. In addition, perhaps 4 million or more Ukrainians work abroad having left the country with tourist visas. A 2003 survey of Ternopil, a city in western Ukraine (where the unemployment rate is estimated at 50% but the housing market is booming), suggests that one in four of the local schoolchildren have one or both parents working abroad. The financial impact is enormous: remittances to Ternopil that year were estimated to be around US$ 100 million. However these remittances generate no tax proceeds for the state whereas expenditure for education, healthcare and infrastructure need to increase in order to match heightened public demand.

66. While clearly important to Ukraine, this source of income is increasingly vulnerable, as immigration and visa regulations are revised by its neighbours. The government will need to boost domestic opportunities to offset this trend, particularly as it seeks to move toward accession negotiations with the European Union.

vi. Agricultural reform

67. With its rich soil and vast open spaces, agriculture still represents more than 10% of Ukraine's GDP. After years of political delay, the sector remains underdeveloped and so, with land reform finally in progress, the potential is huge. The approval of the Land Code and subsequent amendments gave a major boost to the privatisation of land and allowed land sales to foreigners through joint ventures with Ukrainian nationals. The World Bank, having supported the restructuring of agricultural enterprises, is now extending finance to help ensure a fair distribution of land plots, to consolidate ownership titles (nearly 7 million certificates have been issued), encourage land-leasing, and refurbish the country's agricultural universities.

68. Production levels and rural living standards are up. Grain production has been an early success: by 2002, Ukraine had become the world's 3rd largest grain exporter. Agricultural output shrank in 2003 (given the worst grain harvest in fifty years) due to bad weather but rebounded in 2004 and remained stable in 2005.

69. The food-processing industry is founded on Ukraine's agricultural wealth. A few foreign companies have established themselves in agriculture. Cargill, for instance, has set up a corn research institute and buys sunflower seeds from local producers. The EBRD has supported Toepfer in setting up a similar programme for grain. Both companies export their produce via ports on the Black Sea. For bold investors, similar opportunities abound. Despite a decline in preference at home, Ukrainian vodka exports are booming. We should note that Ukraine was once the world's second largest wine producer and, although the Soviet regime destroyed most of the best vines, there are hopes of a revival.

vii. The energy sector

70. The energy supply sector has been notoriously difficult to manage and is still in difficulties. It remains largely under state control. Traditionally, there were substantial subsidies, and with poor payment levels by consumers, its deficits have soared. Payment by consumers was often made in barter form – and late, or not received at all. While the situation has improved, significant structural challenges remain. The previous government embarked upon an Energy Debt Restructuring Plan, in collaboration with the World Bank, the EBRD and the EU. There are also projects underway to improve the quality of audits, financial reporting and governance at Naftogaz, the key provider. Despite some breaking up of monopoly control and a few sales of electricity suppliers, substantial work is required to prepare the sector for comprehensive privatisation.

71. Restructuring continues in the coal-mining industry though its pace is slow. It is estimated that only a small fraction of Ukraine's mines are commercially viable. Production has nearly halved over the last decade but given that the reduction of subsidies is politically sensitive and considering the shortage of alternative electricity sources, coal is still the mainstay of electricity production.

72. Large deposits of uranium supported the growth of nuclear power. Today, despite Chernobyl's closure, nearly half of the country's electricity supply is nuclear-generated. Many western organisations (including the EU and EBRD) have been involved in helping Ukraine to apply better safety standards to its plants and in inciting it to introduce a new generation of reactors with enhanced safety standards. Diversification has been another approach, with the World Bank supporting the development of hydro-electric power. Yet Ukraine imports electricity to meet its domestic requirements and is highly reluctant to reduce its current nuclear capacity. However, many of its aging nuclear power stations will have to be modernised over the coming decade in order to ensure their steady and safe performance.

73. Despite having good reserves of oil and natural gas, investment in production was redirected during the Soviet era, and has been slow to restart since independence. Today, Ukraine imports around 90% of its oil and 75% of its gas demand. Russia ranks as Ukraine's principal supplier, and Russian firms now own and/or operate the majority of Ukraine's oil refining capacity (often in joint ventures with western companies such as British Petroleum). Under recent agreements, Russia

delivers natural gas as a barter payment for Ukraine's role in transporting Russian gas to western Europe. To diversify supply, Ukraine also imports gas from Turkmenistan and oil from Kazakhstan.

74. In fact, Ukraine is one of the world's major gas trans-shippers, and transit fees have traditionally been a major source of revenue. 90% of Russian gas exports to western Europe cross Ukraine (as do most of the deliveries to southern Russia). If managed effectively, this sector offers enormous potential, especially as Europe becomes more reliant on imported gas and as new capacity becomes available (there is particular interest in fields around the Caspian Sea). President Yushchenko has put forward plans to create a consortium that would manage gas supplies to Europe from Turkmenistan, with Ukraine, Russia and Kazakhstan building the pipelines. Russia's Gazprom has recently formed a joint company with Ukraine's RosUkrEnergo (a Swiss-registered gas trading firm that is controlled on a 50-50 basis by Gazprombank, a banking branch of Gazprom, and a trust fund administered by Austria's Raiffeisen Zentralbank on behalf of unnamed beneficiaries) to handle this type of transit capacity.

75. Ukraine has a goal of supplying 50% of its own energy demand by 2010, which is to be met by encouraging foreign investment in exploration and extraction. The basic laws for this are in place, but the government needs to pass enabling legislation to make it effective. Of even greater importance is the huge potential for energy savings through enhanced efficiency in energy use. According to the EBRD, energy intensity per GDP unit in Ukraine is 5 to 6 times higher than in western Europe. Domestic experts believe that Ukraine could save about US$ 38 billion by 2020 by cutting energy waste. As the wide differences in energy efficiency between European countries amply show, energy savings lower energy consumption and prices, as well as ensuring steady supply much more efficiently than does additional energy production. The Ukrainian government should encourage enterprises to carry out energy audits and to invest in adjustments as may be appropriate.

76. Bold revisions seem to be needed in Ukraine's overall energy policy in the light of the latest political tension (when the Prime Minister was dismissed by a parliamentary vote) as a result of the January 2006 gas deal with Russia. According to the terms of that agreement, Ukraine will import most of its natural gas through RosUkrEnergo, paying, for at least the first six months, US$ 95 per 1000m³ (or nearly twice as much as the US$ 50 it paid until the end of 2005 but still well below the US$ 230 price that Gazprom was demanding[2]); the Russian side has accepted to pay US$ 1.6 per 1000m³ (a 47% increase) of gas transported for every 100km in transit through pipelines on Ukrainian territory. The average price hike for imported gas is therefore estimated at about 42% for 2006. This equation has been made possible by the fact that the bulk of gas to be supplied to Ukraine originates from the central Asian states of Turkmenistan, Kazakhstan and Uzbekistan at a low price (about US$55 per 1000m³). Although many uncertainties remain, one thing is clear – Ukraine's industries and households will have to face gradually rising prices for gas as these eventually approach the average European market rates.

77. In the short run, this trend worsens the outlook for economic growth **–** with an expected negative effect of 2-3 percentage points on GDP growth in 2006 – but in the long run the structural adjustments leading to more rational energy use and closer integration of domestic industries into global production chains will render Ukraine's economy more competitive and resistant to energy shocks. Energy saving policy is long overdue. The Rapporteur therefore urges the Ukrainian government to give the highest priority to reviewing its energy policy in order to provide clear signals and incentives, including through tax benefits, for the promotion of energy conservation, efficiency and diversification in both industrial and residential sectors. UkrESCO (Ukrainian Energy Services Company), set up in 1998 by Ukrainian government with the financial support of the EBRD and the EU, does very useful work in the energy-efficiency field and should be further strengthened.

[2] The average European gas price is 240 US$ per 1000m³.

viii. Developing the financial industry

78. Ukraine has one of Eastern Europe's least-developed and most insular banking systems. Although there are around 150 'active' banks in Ukraine (many are linked to industrial groups or belong to the state), the largest ten banks hold more than 60% of all banking assets. With financial stability increasing in recent years, bank credits have been growing at an annual rate of over 50%. The bank liquidity crisis due to a panic run on bank deposits at the end of 2004 (during the presidential election campaign) was successfully wiped out by early 2005 and lending activity restored to normal levels. The national currency slightly appreciated in 2005 and the National Bank of Ukraine was able to replenish its foreign currency reserves.

79. However, lending activity is still affected by the lack of corporate transparency; poor quality of auditing makes lending a risky activity and interest rates have reflected this by remaining relatively high. So while credit cards have become a highly popular means of borrowing, the country has substantial reserves of idle savings. And while there is a functioning stock market (which has recently seen huge surges), the lack of protection for minority shareholder rights restricts portfolio investment activities.

80. Access to credit is vital for commercial development, particularly in the SME sector, and for tackling the scale of the unofficial economy. Ukraine needs structural reforms to build confidence and encourage long-term lending, particularly by strengthening creditor rights, increasing disclosure requirements and improving supervision (rather than relying on labyrinthine regulation). Success will depend, as in so many sectors, on judicial and administrative reform. The World Bank has in the meantime started to implement a broad project on expanding access to financial services.

81. Currency controls are strict and complex in an attempt to curb the illegal export and import of valuables, goods, services and the transfer of funds abroad. These regulations should, at the least, be streamlined so as to encourage legitimate trade. The National Bank of Ukraine has recently made proposals for amending the decree on currency regulation and currency control with a view to facilitating Ukrainian citizens' remittances through bank accounts abroad and legalising billions of cash inflows by bringing them out of shadow circuits.

82. Several foreign banks are represented in Ukraine, including Credit Lyonnais (now LCL), ING and Raiffeisen. In 2005, Raiffeisen International of Austria acquired Aval, Ukraine's second largest and best performing bank, making the new formation Ukraine's leading banking group. With the purchase price of US$ 1.028 billion, this is the first large foreign investment in the sector. In addition, the year 2005 was rather successful for Ukrainian banks' fund-raising on international financial markets: eurobond emissions drew over US$ 650 million (or almost three times more than in 2004) into the country. In early 2006, the French banking group BNP Paribas acquired a majority stake in the UkrSibBank, Ukraine's fifth largest bank.

83. Analysts expect the Ukrainian banking market to further expand strongly, especially in the retail sector. Rising incomes of the population and therefore increasing prosperity pave the way for products that are only marginally present in Ukraine today. According to market studies, the credit card business should grow by 38% per year until 2010 (which would result in a market nearly seven times larger by then), while car loans should increase by 34% and mortgage financing even by 56% per year. The Ukrainian authorities will need to control this rapid credit expansion in order to keep inflation in check and to make banks less vulnerable to bad loans and external crises.

ix. A free press, an accountable government

84. Without free and fearless media, Ukraine is unlikely to achieve lasting change. For some years, the Council of Europe has called upon Ukrainian authorities to respect the constitution, which guarantees civil rights. In 2003, President Kuchma signed a bill designed to protect the freedom of the press and abolish censorship. Oblique pressure on media continued, however, and much of it remained under government control.

85. For President Yushchenko, this was a major campaign theme (one of his first acts in office was to fire the director of the National Television Company). He pledged to ensure press freedom, and the course of the election campaign showed the media eager to take up the gauntlet. Encouragingly, there continues to be a great deal of critical scrutiny and comment. Freedom of speech and new media pluralism are now widely accepted as the greatest positive outcomes of the orange revolution. They have enabled further consolidation of the democratic process in Ukraine as the holding of ‘free and fair’ parliamentary elections on 26 March 2006 proves.

IV. Social and environmental issues

86. Ukraine faces a daunting array of social and environmental challenges, which rapid economic growth will help to address, and where Europe’s support is crucial.

i. Health, education and social protection

87. The national education and health systems are relatively well developed, though standards have declined in recent years as financial pressures have grown. Ukrainian schools have an enviably good record, with a national literacy rate of 99%. The supply of well-trained graduates is a key competitive advantage for the country. The government has sought, throughout 2005, to address the poor pay level of teachers (by maintaining their salaries at average industrial wage levels) and to increase access to higher-education grants and scholarships.

88. The health budget, although increasing, is under severe pressure. Though leading health indicators are above those in some neighbouring countries such as Russia, there are heavy ongoing costs from the Chernobyl disaster, and in recent years there has been a frightening rise in the prevalence of HIV/Aids. Early in 2005, the UN Development Programme warned that Ukraine was ‘on the threshold of an Aids epidemic’, with a 20-fold increase in cases reported over the last five years (400,000 Ukrainians are now HIV positive).

89. Though there have been some reforms, pension arrangements remain shaky, with only 0.5% of GDP being directed toward pension finance (whereas 20% is not an unusual figure in Europe). In early 2005, 6 out 7 seven pensioners were thought to be receiving benefits below the cost of living, and because of variable pension calculations, those in the countryside received dramatically smaller sums than those living in towns. While in the run-up to the presidential election in late 2004 the minimum monthly pension more than doubled from US$25 to US$53, the then new government pledged to further double pension levels by the end of 2006 and to introduce fair accounting procedures.

90. The government has also challenged previous cost of living indices, claiming that they do not include items essential for life, such as children’s clothes and medical expenses, and promising to restructure the basis of calculation. In addition, they have attacked the current minimum wage, which has fallen in recent years, and promised to restore it to a subsistence level. This is especially significant, since the salaries of many workers are set in relation to the official minimum wage. The average wage in the first half of 2005 was about 123€ per month – a growth of over 30% compared to the same period a year before. This allowed for a gradual retreat in poverty levels[3].

91. The World Bank has supported a unified social insurance database and the issuance of social identity papers. It is hoped that this will improve the distribution of benefits and allow better benefit targeting in the future. It should also assist the new government in auditing the calculation of benefits, to remove current anomalies, and in reducing the role of the unofficial economy.

[3] According to estimates of the World Bank, 23.8% of the population in 2002 lived below a poverty line drawn at 75% of median expenditure in 1999. This figure is likely to have declined since then but is still thought to be above 20%.

92. In keeping with 2004 electoral promises, the government considerably increased social spending in 2005. Consolidated budget expenditures thus grew by a nominal 40% (representing about US$ 28 billion) with a major share directed to financing social programmes, notably towards improving medical care services, with a particular focus on HIV/Aids, on the disabled and on mother and baby health, and increasing pay for medical staff, as well as minimum wages and pensions. Given tight budgetary conditions and in order to keep the budget deficit under the 3% of GDP threshold, the government will need to seek higher growth levels, accelerate privatisations and reclaim tax revenues from the unofficial sector.

ii. Environmental protection

93. Despite the ravages of intensive farming and heavy industry, Ukraine has a rich ecosystem. With World Bank support, it has been a leader in establishing conservation programmes. Bio-diversity projects have been launched in Transcarpathia, the Danube Delta and the Black Sea. The country however still faces the aftermath of the Chernobyl disaster. While the exact figures are unclear, it seems that Chernobyl may claim the lives of up to 10,000 people, with a further 7 million people affected (about 8% of Ukraine and 20% of Belarus was severely contaminated).

94. With international help, Ukraine has strengthened the containment unit around Chernobyl's damaged reactor and at the end of 2000 the Chernobyl power station was entirely shut down. The EBRD is helping to finance a plan (the Shelter project), with expected costs of over US$ 750 million, for a new 20,000-ton steel shell to encase both the reactor and the old containment structure. In November 2000, the EBRD also approved a conditional US$ 215 million loan to complete several replacement reactors at Khmelnitsky and Rivne. Due to disagreements over the EBRD's loan conditions, the financing still has not been granted and Ukraine has completed the two reactors by its own means[4]. As these lines are written, the EBRD is about to choose the winner of the Shelter project tender so that construction could start in 2007 and be finished by 2008-2009.

95. Chernobyl was a reminder of the transnational effects of environmental disasters, with casualties and contamination spread right across Europe. We therefore have a strong interest in helping to resolve the social and environmental issues regarding Chernobyl itself, which will persist for many years. It is also vital that we continue to work with Ukraine, and surrounding countries that still use Chernobyl-type reactors, to ensure that such a calamity cannot happen again.

iii. Minorities, migrants and trafficking

96. Under the constitution, religious and minority rights are generally well respected in Ukraine. Some ethnic minorities have reported harassment by law enforcement, however. Freedom of assembly is permitted (religious groups are required to register with authorities and this process is open to bias and delay). Some non-native religious groups have encountered difficulty in registering or acquiring property. The Rapporteur trusts that the new government will do all in its power to ensure that Ukraine's constitutional protections are enforced.

97. Ukraine faces a growing problem of west-bound Asian and African illegal migrants. It has responded by establishing a detention camp in Transcarpathia, to prevent migrants from reaching the western Ukrainian border. The migrant problem is expected to intensify with the EU accession of its western neighbours, and as it aims to open its own accession talks. On this issue, the EU provides financial assistance and advice via the Tacis cross-border programme.

98. Progress has been made against drug smuggling and money laundering (Ukraine is no

[4] See also Resolution 1246 (2001) on "Fifteen years after Chernobyl: financing a lasting solution" (Rapporteur: Lord Ponsonby; doc. 9017) at
http://assembly.coe.int/Main.asp?link=http://assembly.coe.int/Documents/AdoptedText/TA01/ERES1246.htm
and Resolution 1451 (2005) on "Contribution of the European Bank for Reconstruction and Development (EBRD) to economic development in central and eastern Europe" (Rapporteur: Ms Liudmila Pirozhnikova, doc 10571).

longer listed as non-compliant in this area). Sadly though, it is a significant source country for young women trafficked to central and western Europe and the Middle East. In 2001, the criminal code outlawed human trafficking, pornography, and sexual exploitation. However, weak enforcement has resulted in few convictions. Limited resources, corruption among law enforcement officers and organised crime still impede Ukraine's ability to eliminate or significantly reduce human trafficking or deal with its tragic consequences.

iv. Long-term development strategy

99. In early February 2006, Ukraine's acting Prime Minister unveiled a Long-term Development Strategy for Ukraine and governmental priorities for 2006-2007. This development 'road map' is meant to be a neutral strategy aimed at enhancing the quality of life and welfare through a dynamic, growing, diversified and competitive economy. Achieving the commendable stated goal of doubling real GDP by 2012 is not in itself an insurmountable challenge but the immediate prospects for economic growth look rather dim: the Ukrainian economy expanded at 2.4% in 2005, down from 12.1% in 2004, and many forecasts for 2006 have recently been downscaled to the level of 0 to 2%. Governmental priorities, that are an integral part of the overall development strategy, are mapped out with an emphasis on economic stabilisation, dialogue with the business community, the enhanced efficiency of state institutions and the need to reduce the country's dependence on energy imports. Their implementation however will be essentially in the hands of the new government to be formed after the March 2006 parliamentary elections.

V. Development through regional and international partnerships

100. The new government will need to make progress on a number of diplomatic fronts.

i. The World Trade Organisation

101. Ukraine applied for WTO membership in 1995. Progress on its application has been slow, given the lack of liberal trade legislation, large subsidies and the daunting task of restructuring in the agricultural and coal sectors. Negotiations had gained some momentum during 2003-2005, with nearly forty agreements on mutual market access signed with WTO members to date. The new President has made accession a priority, hoping to achieve membership in 2006, which could coincide with Russia's planned accession.

102. The European Union supports Ukraine's application, as does the United States. This being said, all sides recognise that substantial work is still needed to bring accession negotiations to a successful conclusion. The European Union granted Ukraine market economy status in December 2005, as did the United States in February 2006, which is an important step forward, and is also helping to improve Ukraine's investment profile.

103. The Parliamentary Assembly for its part expressed its support in favour of Ukrainian membership in the WTO in its Resolution 1396 (2004) on "The Doha Development Agenda: world trade at a crossroads" (doc. 10278; Rapporteur: Mr Sasi). We believe that WTO accession will be a welcome and important step for the country's long-term development and look forward to it being achieved as soon as possible.

ii. The European Union

104. EU membership has been a stated objective of successive governments, but the election of President Yushchenko has given the idea new impetus. Since independence, the EU's support for efforts to strengthen democracy, civil society and the rule of law in Ukraine**,** as well as for encouraging economic and administrative reforms and improving nuclear safety, have exceeded € 1 billion. EU-Ukraine relations are currently based on the Partnership and Co-operation Agreement which entered into force in 1998.

105. The subsequent EU-Ukraine Action Plan, signed in February 2005 within the framework of the European Neighbourhood Policy, covers a range of bilateral issues:

- Measures to deepen trade and economic ties, including an agreement to liberalise steel exports. A textile agreement has recently been concluded.
- Preparatory work on establishing a free trade area between the EU and Ukraine, so that negotiations can begin as soon as Ukraine has joined the WTO.
- Agreement to examine the facilitation of a visa regime for Ukrainian citizens, while Ukraine will consider completion of a readmission agreement, to deal with the return of illegal migrants.
- Closer cooperation in foreign and security policy.
- Bilateral agreements on social security, health and education projects.
- Measures to improve cross-border cooperation, including integration of Ukraine with Trans-European transport networks.
- Enhanced co-operation in energy, transport, the environment and private sector development matters.
- Maximum access to funding from the EIB and increased financial assistance through other relevant financing instruments.

106. Observers note the uncertainties surrounding the EU's future course of action after the failure to adopt its Constitutional Treaty and the cautions frequently voiced on the need to avoid overly rapid enlargement. This makes the prospects of the EU starting accession talks with Ukraine more remote. In the short term, extended co-operation under the EU's Neighbourhood Policy and the conclusion of a free trade agreement may be more realistic objectives. There is no doubt that this would make an enormous contribution to Ukraine's long-term development prospects.

107. The Rapporteur welcomes important progress in strengthening Ukraine's partnership with the EU through a series of important joint undertakings last autumn. Thus, on 30 November 2005, the EU Border Assistance Mission[5] was launched to improve border control between Ukraine and Moldova. Although this mission, designed to provide on-the-job training and advice to Ukrainian and Moldovan officials, is primarily aimed at helping to prevent smuggling, trafficking, corruption and customs fraud, it is also part of an effort to seek a solution to the frozen conflict in Transnistria along the lines of the European Neighbourhood Action Plans agreed between the EU and these two countries.

108. In addition to granting market economy status to Ukraine during the December 2005 EU-Ukraine Summit and enhancing co-operation in security matters, the EU signed agreements on aviation and on the GALILEO programme, thus extending its 'open skies' policy and the framework for co-operation in satellite navigation. The parties also agreed on a Memorandum of Understanding on energy co-operation with a view to progressively integrating their energy markets including the electricity, oil, gas and coal industries. Twin negotiations on visa facilitation and readmission of illegal migrants are firmly on track and will hopefully be concluded soon.

iii. Russia and the CIS

109. Several of the new President's provisional decrees were aimed at reassuring Russian partners and the Russian-speaking population of Ukraine: he proposed, for instance, to safeguard the use of the Russian language by officials (the Russian language has constitutional protection), and to ensure continued travel across the Russian border using domestic passports. On his first trip abroad

[5] The Border Assistance Mission has a mandate of two years. It is funded by the European Commission (€8 million) and involves 69 experts seconded from EU member states, as well as some 50 local officials.

after election, Mr Yushchenko visited Moscow, where he described Russia as a 'strategic partner', and Mr Putin has since visited Kiev. Analysts find that, after the initial uncertainty generated by the elections, bilateral relations are back to normal.

110. There are, as we have seen, complex interdependencies between Ukraine and Russia. Perhaps the most important ones, in political terms, relate to energy supplies, and issues surrounding the Black Sea and the Azov Sea. Coastal borders in the area are notoriously ill-defined and the region is of immense importance to Russia: President Putin has described it as a 'zone of strategic interest', providing direct access to the most important global transport routes. In addition, it remains home to Russia's Black Sea Fleet, based in Sevastopol, which has been the subject of bilateral disagreements. A 1997 treaty allows the fleet to remain until 2017, but this has not stopped the political wrangling. It is clear that the situation calls for continued good relations and sensitive diplomacy by both governments.

111. For some years, the governments of Russia, Ukraine, Belarus and Kazakhstan have been discussing the possibility of a 'common economic space', incorporating some 220 million people, and the bulk of the industrial output of the CIS. Agreement on the precise structure has not yet been reached, and the new Ukrainian government has indicated that it will focus instead on relations with the EU. Analysts believe that Ukraine may still play a role in any free-trade agreement (its terms, of course, are yet to be defined) and recognise the importance for Ukraine of strong commercial relations with its CIS counterparts. This is particularly true for the successful exploitation of oil and gas in the CIS region.

VI. Concluding remarks

112. In his speech to the Parliamentary Assembly on 25 January 2005, President Yushchenko declared that he would do everything in his power to make the country's democratic changes irreversible, and he spoke at length on the economic challenges emphasising that Ukraine's future democracy will depend on their successful tackling. He faces a daunting task. Yet his election represented the second peaceful transition of power in Ukraine's post-independence history, and his government commands clear popular support. Ukraine now has an opportunity to meet its potential.

113. There is no doubt that Ukraine could become one of Europe's major economies, and that, given its location, it has a large and positive role to play in European affairs. With its war-torn history, and its people's low living standards, the country desperately needs to achieve strong, sustainable growth. Europe has a critical role to play in encouraging investment, providing expertise, and helping to develop the country's place in the international community. Strategically, economically, socially, Europe as a whole will benefit from Ukraine's success.

114. Ukraine is neither a western, nor an eastern European country: it is both. It now has the chance to build a national identity, based on confident relations with its neighbours. 'Only in one's own house,' wrote Schevchenko, can one find 'one's own truth'. The new President's website opens with words of his own that are, in their way, no less touching: "I can't be objective regarding Ukraine, because I love her too much".

115. Your Rapporteur, in presenting this draft report, feels conquered by the same affection for the country – an emotion which he hopes has not affected his sought-for objectivity in dealing with its economic situation and prospects. Underlying the present report is, in a way, the conviction that much more than Ukraine hangs in the balance as all of Europe tries to help – as if Ukraine at the present stage in its development provides a test case for our ability to assist any brave country in need of our support.

Appendix

Indicators of economic growth of Ukraine
(% change over the same period last year unless otherwise indicated)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP	-22.9	12.2	-10.0	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	2.4
GDP per capita, US$				856	828	612	555	720	859	1032	1454	1763
Industrial output	-27.3	-12.0	-5.1	-0.3	-1.0	4.0	12.4	14.2	7.0	15.8	12.5	3.1
Agricultural output	-16.5	-3.6	-9.5	-1.9	-9.8	-6.9	9.8	10.2	1.2	-11.0	19.1	0.0
Capital Investment	-22.5	-28.5	-22.0	-8.8	6.1	0.4	14.4	20.8	8.9	31.3	28.0	3.0*
Net FDI, US$ billions				0.6	0.7	0.4	0.6	0.8	0.7	1.3	2.2	7.3
Consolidated budgetary balance (% to GDP)	-8.9	-6.6	-4.9	-6.6	-2.2	-1.5	0.6	-0.3	0.7	-0.2	-3.2	-1.8
Foreign trade balance, US$ billions				-4.2	-2.6	-0.5	0.5	0.2	0.7	0.1	0.015	-0.02
Real incomes of population	-14.0	1.8	-17.1	6.3	-0.3	-1.6	…	-8.0	9.9	9.0	15.3*	20.1
Inflation (yearly %)	401.0	181.7	39.7	15.9	10.6	22.7	25.8	12.0	0.8	5.2	9.0	13.5
External debt, US$ billions**				9.6	11.5	12.4	10.4	10.1	10.2	10.7	12.9	13.7
External debt service, US$ billions				1.2	1.8	2.0	1.7	1.8	1.4	1.5		
Domestic debt, US$ billions				4.6	3.7	2.9	3.8	3.8	4	4.2		

Source: Ministry of Economy of Ukraine, the National Bank of Ukraine and the State Statistics Committee of Ukraine

* data for the first 9 months (compared with the same period of a year before)

** External debt by the general government and monetary authorities

Structure of Ukraine's GDP, %

	1998	1999	2000	2001	2002	2003	2004
Industry	36	38	35	38	38	45	44
Agriculture	14	14	18	18	18	10	12
Services	50	48	47	44	44	45	44

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N.B: The names of the members who took part in the meeting are printed **in bold**

Head of Secretariat: Mr Newman

Secretaries to the committee: Ms Ramanauskaite and Mr de Buyer