

Chapter 2.

ECONOMY, STATE OF FINANCES

1. Macroeconomic situation in Ukraine

1.1 Gross Domestic Product. GDP Growth Rate

Post-Soviet stagnation of Ukraine's economy ended in 1999, when the negative trend of GDP growth rate was reversed. The first positive figure of 6% growth was demonstrated in 2000 when Ukraine reached \$31.261 billion of GDP and the trend has continued to this day.

Table 1. Gross Domestic Product, (in thousands of USD)¹

Year	2000	2001	2002	2003	2004	2005	2006
GDP (current, thousand US\$)	31,261,530	38,009,340	42,392,900	50,132,960	64,828,350	86,136,980	106,110,900

According to the World bank indicators where the growth rate is counted taking the previous year as the base, Ukraine's growth rate continued to increase until 2004 (12%), then dropped to 3% in 2005 but went up again in 2006 (7%). Within 7 years between 2000 and 2006, Ukraine's GDP growth rate averaged 7.28%, which is significantly higher then the corresponding figures in developed countries (US 2.86%, UK 2.71%). Ukraine was also ahead of most EU member states (1.3% in Germany, 1.86% in France, 2.86% in Sweden, 3.6% in Poland and 3.99% in Czeck Republic). On the emerging markets' side, Ukraine left behind Brasil (3.11%), Russia (6.7%), India (6.71%), as well as several "Asian Tigers" such as Indonesia (4.86%), Malaysia (5.29%) and Singapure (5.57%).

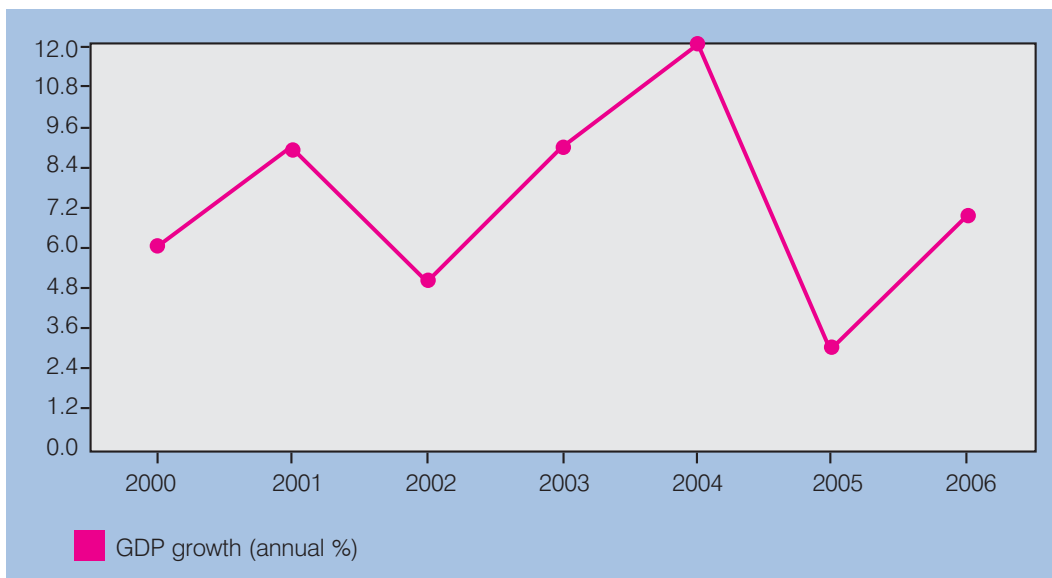
Such impressive performance, according to the OECD's economic assesment, was due to the growing domestic private consumption and low energy prices that Ukraine had enjoyed until the end of 2005, contributing to large output combined with low energy costs, this despite the fact Ukraine's industries, inherited from the Soviet days, are one of the world's most energy consuming. Ukraine also benefited from an increase in world prices of metals, which constitute 40% of Ukraine's total exports, whereas the devaluation of the currency made these exports highly competitive.

¹ Source: World Bank, World Development Indicators <http://devdata.worldbank.org>

Table 2. GDP Growth rate (annual, %)²

Year	2000	2001	2002	2003	2004	2005	2006	2007 (estimated)
Growth rate	6	9	5	9	12	3	7	7
GDP <i>per capita</i> growth	7	10	6	10	13	3	8	7

Chart 1. GDP Growth rate (annual, %)³



The 2005 figure of 3% growth following 12% in 2004 and 7% in 2006 is widely interpreted as a result of the rapid policy changes under Tymoshenko's and Yekhanurov's governments. However, the metals markets in 2005 experienced a precipitous fall in price, negatively impacting Ukraine's export revenues.

According to the recent data provided by the State Committee of Statistics, Ukraine reached 7.3% growth in 2007, which is close to the Fitch Rating forecast made at the beginning of 2007. Higher growth in 2007 was constrained by high inflation, the fast-growing but fragile banking sector and the increasing foreign

² Source: World Bank, World Development Indicators <http://devdata.worldbank.org>

³ Source: World Bank, World Development Indicators <http://devdata.worldbank.org>

debt that reached \$74.3 billion by the third quarter of 2007⁴ (57.7% of GDP). Just in the first 9 months of 2007, the external debt increased by 36.4% to \$19.8 billion.

Ukraine's government has forecasted 6.8% GDP growth in 2008 as stated in the 2008 budget. This benchmark was set by the previous government of Victor Yanukovich and has remained unchanged in Yulia Tymoshenko's revised version of the budget. The World Bank's forecast for 2008 is %5.5. The slowdown is a result of high inflation in 2007 (16.6%) and the expected 13.8% inflation in 2008. In order to make an increase in future GDP growth possible, Ukraine should adjust its energy consumption according to the increased prices for oil and gas in its largest industries such as metal, machinery, chemical and food production. However, the increasing domestic consumption, privatization, structural reforms and anti-corruption measures announced by Tymoshenko's government would, if implemented, give a boost to growth indicators.

1.2 Salaries and Income

According to the nationwide census held in 2001, the population in Ukraine is 48.457 million people⁵. The population structure broke down by age categories has not significantly changed since 2001: the share of population aged between 15-64 years old slightly changed from 68% in 2001 to 69% in 2006, share of population aged 0-14 years old decreased from 18% to 14% respectively, and the share of elderly population (65 and above) increased from 14% to 16%⁶. Additional 2% of pensioners and the further growing trend puts a burden on the economy that needs to increase pensions expenditures. In 2008 the State Budget of Ukraine foresees 3,7 billions for the pension payments. In 2008 the minimal pension has increased from 322-400 to 470 UAH per month in the first quarter. In the second quarter this amount will rise to 481 UAH, and to 482 and 498 UAH in the third and fourth quarters respectively.

At the end of 2007 the State Committee of Statistics reported on the Ukrainian average monthly salaries that amounted to 1675 UAH per person⁷ (approximately 332 USD). The data displays that in December 2007 on average the highest

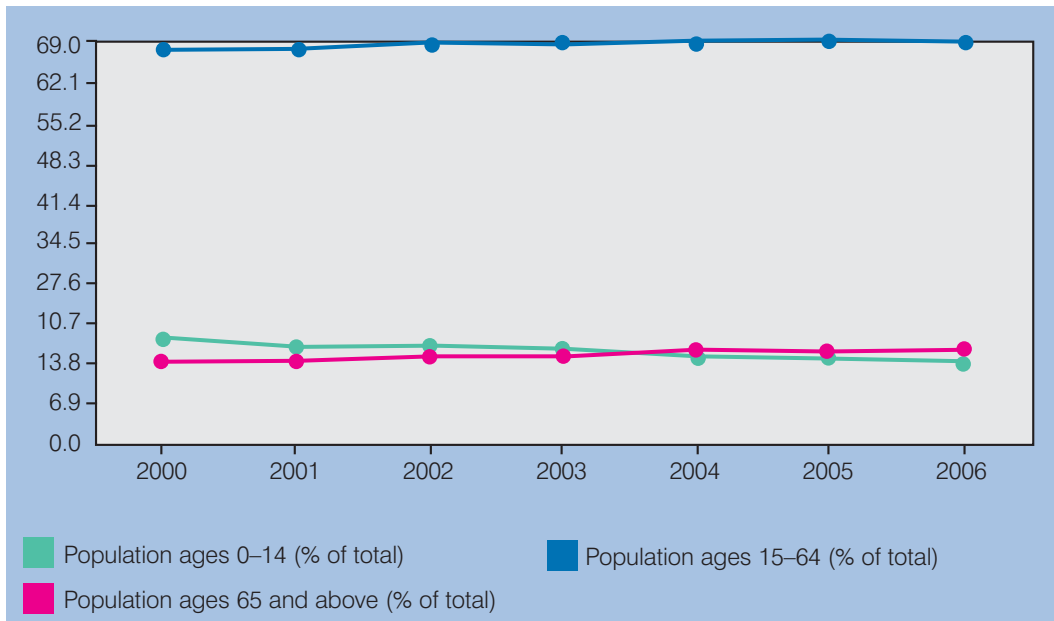
⁴ Source: National Bank of Ukraine/Statistics/ External Debt
<http://www.bank.gov.ua/Balance/Debt/index.htm>

⁵ Source: National Census of Ukraine 2001, <http://www.ukrcensus.gov.ua/results/>

⁶ Source: World Bank, World Development Indicators <http://devdata.worldbank.org>

⁷ Source: State Committee of Statistics of Ukraine <http://www.ukrstat.gov.ua/>, the salary figure stands for a average monthly salary in December

Chart 2. Population growth rate by age groups



salaries have been earned in the city of Kyiv (3038 UAH per month); regions of Donetsk (1840 UAH per month), Dnipropetrovsk (1694 UAH per month) and Kyiv (1671 UAH per month). The lowest earnings are reported in Ternopil (1191 UAH per month) and Chernigiv regions (1231 UAH per month). Also the average monthly salary as the Committee reports, have risen across 2007 from 1112 to 1675 UAH. The highest salaries are paid to those employed in financial sector (2770 UAH), air-transportation (2704 UAH), oil refining industry (2499 UAH), oil, gas and coal extraction (2308 UAH). While the lowest paid jobs are in agriculture (733 UAH), healthcare and social services (871 UAH), textile, leather and natural fur industry (933 UAH).

Citizens' income is comprised of salaries (42.9%), social benefits and other transfers (39%), profit and mixed income (15.3%), income from property (2.8%). This data leads to assumption that Ukrainians mostly benefit from their jobs and social programs. Entrepreneurship and profit on property, however, do not play a significant role as a source of income. This can be due to many factors such as existence of extensive shade economy, unfavorable conditions for medium and small business, lack of financial instruments, high interest rates, complicated loan procedures, etc.

In terms of income growth the State Committee of Statistics of Ukraine reports positive figures.

Table 3. Citizens' Income

	2001	2002	2003	2004	2005	2006	2007
Average monthly income, per person, UAH ⁸	203.8	244.8	283.4	372.4	527.7	647.6	813.0
Real income in percent to the previous year ⁹	110,0	118,0	109,1	119,6	123,9	111,8	112.5
Consumption price index (2000 = 100%) ¹⁰	112	113	119	129	147	160	228

Nonetheless, the positive real income growth is less dynamical than growth of the consumption inflation in the relevant periods. This dynamics can be dangerous for maintaining sustainable growth of real income if inflation continues to rise.

The country that reports high growth of real income yet fails to ensure all citizen' welfare. According to the ratio: cost of monthly minimal basket of goods and services/ minimal pension and wage, the least paid Ukrainians will be left behind the poverty line. In the first quarter of 2008, according to State Budget data, a minimal monthly basket of goods and services is estimated at 592 UAH per person while the minimal wage is set at 515 UAH. The following periods of 2008 also fail to set the minimum wage above the minimal basket costs. (Table 4)

Table 4. Minimal wage and minimal basket of goods and services in 2008

	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter
Minimal Pension, monthly, UAH	470	481	482	498
Minimal Wage, monthly, UAH	515	525	545	605
Minimal Basket of Goods and Services, monthly, UAH	592	605	607	626

The government program for 2008 ambitiously sets a banchmark of 17% citizen's income growth in real terms by maintaining a positive growth dynamics as well as improving social standards and guarantees. With the 13.8% inflation and

⁸ Source: State Committee of Statistics of Ukraine <http://www.ukrstat.gov.ua/>

⁹ Source: State Committee of Statistics of Ukraine <http://www.ukrstat.gov.ua/>

¹⁰ Source: World Bank, World Development Indicators <http://devdata.worldbank.org>

5.5% GDP growth rate in 2008 forecasted by the World Bank this will be a hard goal to reach.

1.3 Inflation

Having battled hyperinflation in mid-nineties, Ukraine faced a new wave of inflation after the Russian default of 1998. Since then, the stabilization of the economy, its growth and the policies of Ukraine's National Bank kept the inflation at an unprecedented 1% of CPI inflation rate (inflation of consumer price indexes) in 2002 and 5% in 2003. Since then, however, inflation flared up again due to a dramatic rise in pensions and social benefits. These policies, driven by political rather than economic motives, have been launched during the 2004 election campaign and their effect still continued throughout the following year.

Table 5. Inflation

	2000	2001	2002	2003	2004	2005	2006
Inflation, consumer prices (annual %) ¹¹	28	12	1	5	9	14	9
Inflation, GDP deflator (annual %) ¹²	23	10	5	8	15	25	13

Another factor accounting for this most recent rise in inflation was due to the mismatch between the diminishing growth of 2005-2006 and the growing government expenditures on social services and purchases. Despite Ukraine's sustainable growth, the annual CPI inflation in 2007 reached 16.6%¹³—the highest rate since 2000. Inflation in 2007 was mostly triggered by an increase in prices for the following goods: sunflower oil (by 70.4%), fruits (by 60%), eggs (by 54.4%),

¹¹ Inflation as measured by the consumer price index reflects the annual percentage change in the cost to the average consumer of acquiring a fixed basket of goods and services that may be fixed or changed at specified intervals, such as yearly. Source: World Bank national accounts data, and OECD National Accounts data files.

¹² Inflation as measured by the annual growth rate of the GDP implicit deflator shows the rate of price change in the economy as a whole. The GDP implicit deflator is the ratio of GDP in current local currency to GDP in constant local currency. Source: World Bank national accounts data, and OECD National Accounts data files.

¹³ State Committee of Statistics of Ukraine

milk (by 44.7%) and bread (by 18%). The services included utilities, communication and transportation, which prices went up dramatically due to an increase in the cost of all types of fuel by 36.2% on average. Political uncertainty in 2007 blocked implementation of structural reforms and energy preservation program, also contributing to inflation. Finally, the domestic economy was affected by the recent poor performance of the US dollar, the cornerstone of Ukraine's monetary system.

The beginning of 2008 was marked by a dramatic government's campaign of implementing Tymoshenko's election program – compensation of the private savings that rapidly depreciated before the collapse of the Soviet Union. Each citizen who held funds in the Soviet Sberbank that has got depreciated during collapse of the Soviet Union is eligible for a compensation up to 1000 UAH (approximately \$190). Overall compensations will amount to 20 billions UAH (\$3.9 billions)

Tymoshenko's government set CPI inflation level at 9.6% for 2008, taking into account the new price of natural gas (\$179.5 for thousand cubic meters). It is a challenging task for the new government to ensure compensations for citizens' depreciated Soviet-era private saving while facing an increasing foreign debt and a sizeable budget deficit. To tackle these problems the government intends to implement an anti-inflation plan. Less optimism is expressed by the National Bank of Ukraine that forecasts at least 14.8% inflation if the state budget is not revised. The World Bank forecast raised the expected inflation for Ukraine from 9.6% to 13.8% in 2008, adjusting it to the reported inflation in 2007 and the expected GDP growth of 5.5%.

The inflation observed in January 2008 has already accelerated to 2.9%, as reported by Ukraine's State Committee of Statistics. In order to keep the annual inflation under 9.6% as aspired by the government, the exanti monthly rate that should be maintained can be computed with the following inflation rate formula:

$$1 + \pi \text{ annualized} = (1 + \pi \text{ monthly})^{12}$$
$$\pi \text{ monthly} = (1 + \pi \text{ annualized})^{1/12} - 1 = (1 + 0.096)^{1/12} - 1 = 0.0076 = 0.76\%$$

The government should ensure the maximum of 0.76% monthly average inflation in 2008, otherwise, if 2.9% rate will be observed each month the annual inflation for 2008 can hit the records:

$$\pi \text{ annualized} = (1 + \pi \text{ monthly})^{12} - 1$$
$$\pi \text{ annualized} = (1 + 0.029)^{12} - 1 = 0.409 = 40.9\%$$

This is only a theoretical however unrealistic scenario, if the government will accumulate sizable revenues, particularly from the planned privatization, as envisioned by the budget.

The rapid inflation took off in January and is now often regarded as a continuing effect caused by the last years policies implemented by the former government. Also, to a certain extent, the inflation could be fuelled by an increase of cash provided to the citizens through the programs of Tymoshenko's government. However, in order to hold the dangerous pattern of growing inflation, the Cabinet of Ministers and the National Bank should jointly apply urgent measures within monetary, economic, energy and social policies.

2. Main Restrictions of Ukraine's Economy

During its post-Soviet transition period, Ukraine significantly liberalized its economic policies and thus was granted a market economy status by the EU and the US. The ongoing privatization open to both national and foreign capital, liberalization of trade tariff and non-tariff barriers and emerging investment opportunities all characterize Ukraine as a country open for global business.

However, the World Bank's "Doing Business Report 2008"¹⁴ gave Ukraine a distant 138th place, an indication of a tough regulatory environment for business. Ukraine's rating index has not changed since 2007, leaving it far behind other countries of the region: Estonia (17th), Georgia (18th), Poland (74th), Russia (106th), and Belarus (110th).

The low rank in terms of business regulatory environment has been assigned due to unfavorable conditions in the taxation system (177th place), issuance of licenses (174th), and property registration (138th). Ukraine's highest score was received for enforcing contracts (46th) and obtaining credit (68th). However, the latter indicator has since been downgraded by 6 places.

¹⁴ World Bank, The Doing Business Project, Ranking 2008,
<http://www.doingbusiness.org/economyrankings/>

Table 6. Ease of Doing Business in Ukraine¹⁵

Ease of...	Doing Business, 2008 rank	Doing Business 2007 rank	Change in rank
Doing Business	139	139	0
Starting a Business	109	105	-4
Dealing with Licenses	174	174	0
Employing Workers	102	103	1
Registering Property	138	134	-4
Obtaining Credit	68	62	-6
Protecting Investors	141	141	0
Paying Taxes	177	177	0
Trading Across Borders	120	116	-4
Enforcing Contracts	46	46	0
Closing a Business	140	139	-1

The table shows that since the beginning of 2007, Ukraine's business environment has deteriorated in terms of starting a business, registering a property, obtaining credit, trading across borders and closing a business.

According to Indexes of Economic Freedom 2008¹⁶, Ukraine's economy is only 51.1% free, 48.9% of which, therefore, is accounted for by various restrictions preventing the economy from functioning fully. The restrictions have to do with business freedom, fiscal freedom, size of government, monetary freedom, freedom of investment, property rights, freedom from corruption and freedom of labor¹⁷.

The above-mentioned survey states that opening a business in Ukraine takes on average 27 days, compared to the world average of 43 days. Obtaining a

¹⁵ Source: World Bank, The Doing Business Project/ 2008/ Country Report
<http://www.doingbusiness.org/ExploreEconomies/?economyid=194>

¹⁶ Index of Economic Freedom, survey conducted by the Heritage Foundation and the Wall Street Journal

¹⁷ <http://www.heritage.org/research/features/index/countries.cfm>

business license is estimated to be longer and more labor-intensive than the world's average of 234 days and 19 procedures. On the positive side, the bankruptcy procedures are considered relatively straightforward. Entrepreneurship in Ukraine is open to all citizens (except military personnel, civil servants, security and law enforcement officials and state notaries public), as well as foreign nationals (except in cases of privatization of land for agricultural business purposes, alcohol production, natural resources exploration, and some others).

Raising the costs of trade are Ukraine's export restrictions, barriers on entry into the service market, import taxes and fees, import licensing requirements, restrictive sanitary regulations, cumbersome standards and certification regulations, non-transparent government procurement practices, and weak enforcement of intellectual property rights.

Ukraine has managed to lift the quota for metal exports to the EU, enabling it to increase its overall exports by 21%. As a Montreal Protocol member, Ukraine has imposed quotas on exports and imports of ozone-depleting products.

As part of its efforts to join the WTO, Ukraine has liberalized its trade mechanisms and adjusted its system of tariffs in compliance with the Organization's regulations. Lowering numerous import quotas for machinery and agricultural and textile products will increase imports by 23% in 2008. In order to offer protection to the domestic producers, the government has proposed a procedure of assessment of security of food procurement for Ukraine. This mechanism would allow for the imposition of import and export barriers which have been met with sharp criticism by the WTO as violating its charter. On the eve of Ukraine's accession to the WTO, the new government has been reluctant to give its approval to this initiative inherited from its predecessor.

Despite the complexity inherent in the tax payment process, Ukraine has adopted a progressive system characterized by low taxes. The top income tax bracket has changed from a flat 13 percent to 15 percent in January 2007, while the top corporate tax rate is currently 25 percent¹⁸. Other taxes include a value-added tax (VAT), a land tax, and a vehicle tax. In the last fiscal year, the overall tax revenue as a percentage of GDP stood at 35.4 percent¹⁹.

As to restrictions on investment opportunities, laws give equal treatment to media, energy, banking and insurance sectors. However, foreign insurance companies are subject to wider restrictions than domestic ones. Foreign funds are

¹⁸ Source: State Committee of Statistics of Ukraine

¹⁹ Source: State Committee of Statistics of Ukraine

also prevented from investing in the production of arms and alcohol. The country's financial sector may seem impressive with 166 registered banks as of January 2007, yet most of them are small. Two state-owned banks (*Oshchadbank* and *UkrEximBank*) together with 10 largest banks comprise over one half of all net assets. Foreign banks are not allowed to open their branches in Ukraine. However, ownership of a parity share in domestic banks is allowed. This regulation has allowed around 100 foreign-owned subsidiaries to operate in Ukraine²⁰.

A major impediment to the growth of Ukraine's economy remains a ban on land ownership. Most rural households are deprived of business opportunities due to the absence of a recognized property right. This ban has also prevented foreign investment from entering Ukraine's agricultural sector. Land ownership for agricultural business has been a highly contested political issue since the moratorium has been imposed in early nineties and then extended twice during the last 16 years. Land ownership is firmly opposed by the left wing parties (Communist Party of Ukraine, Socialistic Party of Ukraine). The last extension of the moratorium was also supported by the Party of the Regions (PR) and Block of Yulia Tymoshenko (BYT). The leftists believe that the right to own land will lead to monopolies, while foreign investment in agriculture would present a threat to national security. BYT, however, being a member of the democratic coalition and the European People's Party, is expected to reverse its position on land ownership. The ban is in effect until 2008.

Although Ukraine is a market economy standing on the doorstep of the WTO, endemic corruption is continuing to create significant obstacles to its economic development. Transparency International Corruption Perceptions Indexes 2007 ranked Ukraine 118 out of 163 countries. Corruption is widespread throughout both executive and judicial bodies. Corruption pervades all levels of social and governmental activities and all sectors of the economy. Although all political promises include efforts to fight corruption, the fight is yet to begin in earnest.

²⁰ Source: Heritage Foundation <http://www.heritage.org/research/features/index/countries.cfm>

3. Privatization and Globalization Processes in Ukraine's Economy

3.1. Privatization

In the context of Ukraine's economy, privatization has always remained a highly charged issue. Allegations of privatization of depreciated state enterprises during the turmoil of the 1990s are still invoked against opponents on Ukraine's political arena. The re-privatization of *Kryvorizhstal* steel giant became a precedent for revisions of "improper" instances of privatization, often referred to as "bribarization" policies of the previous governments. In 2008, the next expected target for re-privatization is *Luhanskteplovoz*, acquired by the Russian *Transmash Holding*, and *Nikopol Ferroalloy Plant*. If the *Luhanskteplovoz* deal is announced null and void by the court, it will appear on the privatization list for 2008. The destiny of *Nikopol Ferroalloy Plant* is still vague and will be subject to intense political bargaining.

These obstacles notwithstanding, privatization remains a key revenue in the national budget. In 2007, the previous government of Victor Yanukovich adopted a budget that forecast 10.59 billion UAH (\$2.1 billion) in revenues from the privatization of state owned entities wholesale or their majority stakes. However, by the end of the year, privatization had brought 1.73 billion UAH (\$342 million) only. The blame was assigned to the instigators of political uncertainty in 2007. *Ukrtelecom* and *Odesa Port Plant*, two main companies offered for sale in 2007, are now expecting their privatization to take place in 2008.

On 16 January 2008, the new Government under PM Yulia Tymoshenko approved a list of 28 companies that are subject to an urgent privatization. The list contains six regional energy suppliers (*PrykarpattyaOblEnergo*, *LvivOblEnergo*, *PoltavaOblEnergo*, *OdesaOblEnergo*, *SumyOblEnergo* and *ChernihivOblEnergo*) and several industrial giants *JTC Turboatom*, *Kyiv Automatics Plant* and others. The above-mentioned telecommunication monopolist *Ukrtelecom* and *Odesa Port Plant* are the list's main targets. Privatization of 67.79% of *Ukrtelecom* shares as announced by the Prime Minister is planned to be completed in a period of one hundred. The nominal cost of the state owned share is \$628 million,²¹ however the amount expected to be received for *Ukrtelecom* is in the region of \$4-\$5 billion. Overall, the government offers to sell its assets worth over \$926 million. President

²¹ Source: Cabinet of Ministers of Ukraine <http://www.kmu.gov.ua/control/uk/cardnpd>

Yushchenko has urged for cautious privatization process in order to avoid massive bargaining around the national wealth. For example, Yushchenko does not agree with the government's decision to privatize regional energy suppliers, believing that the state should maintain at least partial control over the Energy Company of Ukraine out of national security considerations. The President has urged the privatization to be conducted by an ultimately independent structure with full access to foreign investors.

In order to fight corruption during the privatization process, Prime Minister Tymoshenko has proposed a draft law that aims to cease procedures for artificial bankruptcy of state enterprises and limit all sales to open auctions. According to the proposed legislation, the state property will only be managed by the State Property Fund, excluding other central and regional authorities from the process. The currently decentralized and diversified privatization procedure, as Tymoshenko believes, supports corruption and other mechanisms that tend to depreciate the real value of privatized property. Moreover, Tymoshenko's government has required of each bidder to present detailed strategies for the development of the desired enterprises.

The opposition has accused the government of having initiated large-scale privatization in order to offset the \$1.18 billion budget gap as a result of the decision to compensate citizens for their lost Soviet-era private savings. The 2008 Budget allocates 8 billion UAH (approximately \$1.5 billion) of revenue from official privatization and additional 12 billions UAH from unforeseen privatization. Yet, privatization remains essential if the market is to attract foreign investment and to modernize Ukraine's industrial technologies. Privatization and consequent foreign investment are also expected to facilitate implementation of the energy preservation projects.

3.2 Globalization Processes in Ukraine

Today globalization refers to the acceleration and intensification of mechanisms, processes, and activities that are promoting global interdependence and, ultimately, global political and economic integration. Some of the measures of how globalized a country is include the presence of transnational corporations, levels of foreign investment, high-tech communication facilities, trade relations, openness of the economy, membership in international organizations, the number of tourists visiting the country, situation with human rights, and participation in tackling planet-wide afflictions such as global warming, HIV, terrorism and others.

The *Foreign Policy Magazine* produces its annual Globalization Index ranking²² where countries are assessed on the following: trade, FDI, telephone, travel, remittances, Internet users, Internet hosts, secure servers, international organizations, UN peacekeeping, treaties ratified, government transfers. According to this index, since 2006 Ukraine was downgraded by 3 places, being 42nd among 71 countries, behind Poland (rank 41). Ukraine's economic openness to globalization was rated at 17th place, while globalization on the interpersonal level at 49th only. As to foreign direct investment, Ukraine is the 17th most globalized country in the world but only the 53rd when it comes to technological globalization.

Analyzing the incoming and outgoing FDI, Ukraine has undoubtedly increased its level of globalization as shown in the Table 7.

Table 7. Foreign Direct Investment²³

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007
FDI in Ukraine, \$ millions	2810.7	3281.8	3875.0	4555,3	5471,8	6794,4	9047,0	16890,0	21186,0
FDI from Ukraine, \$ millions	97.5	98.5	170,3	155,7	144,3	166,0	198,6	219,5	221,5

Still, Ukraine has many more investment opportunities to offer. In particular, as announced by President Yushchenko at the World Economic Forum in Davos, Ukraine plans to invest \$25 million of foreign investments for the *EuroCup 2012*, a European soccer championship, into infrastructure and recreational projects. *EuroCup 2012* itself will attract millions of tourists and international media, which will undoubtedly raise Ukraine's international prestige.

Table 8. Ukraine's Exports and Imports²⁴

	2000	2001	2002	2003	2004	2005	2006
Exports of goods and services (current US\$ thousand)	19,522,000	21,080,210	23,352,980	28,952,310	39,715,740	44,341,850	51,128,330
Imports of goods and services (current US\$ thousand)	18,116,000	20,462,020	21,496,080	27,664,220	34,840,760	43,620,490	54,043,630

²² Source: http://www.foreignpolicy.com/story/cms.php?story_id=3995

²³ Source: State Committee of Statistics of Ukraine

²⁴ Source: World Bank Development Indicators

International trade has been increasing measured both by its levels of exports and imports (Table 8) since 1999.

According to the World Bank Development Indicators, the number of internet users in Ukraine is growing, thus also contributing to Ukraine's global integration.

Table 9. International Tourists and Internet Users in Ukraine

	2000	2001	2002	2003	2004	2005
International tourism, receipts (current US\$)	563,000,000	759,000,000	1,001,000,000	1,204,000,000	2,931,000,000	3,542,000,000
Internet users	350,000	600,000	900,000	2,500,000	3,750,000	4,560,000

As a candidate for WTO's membership, Ukraine has done away with most of its tariff and non-tariff trade barriers and liberalized its trade regulations, thus opening its economy to free trade with the world. Restriction of export and import of ozone-depleting products effective from 2008 is not a free trade barrier but rather fulfillment of the commitments to Kyoto and Montreal Protocols Ukraine is signatory to.

4. Integration Processes in Ukraine's Economy

Ukraine actively participates in global and regional integration processes. The Commonwealth of Independent States inherited from the Soviet vision of regional composition failed to be a mutually beneficial framework for business operations and achieving sustainable growth. Another initiative to establish the Common Economic Space of Russia, Ukraine and Kazakhstan complied with Ukrainian interests but only to an extent of a Free Trade Area. Russia, on its side pursued more political rather economic goals in this project thus became reluctant to an idea of purely FTA cooperation without further integration into a customs union, common market and establishment of supranational authorities.

In fourteen years Ukraine has realized its integration into the World Trade Organisation ongoing the final stage the accession procedure. After the protocol on the membership in the WTO has been signed on 5 February 2008 it is to be ratified by 300 votes in the Parliament. Throughout the last decade the WTO issue has

been intensively charged in political establishment due to a blurry vision of losses and benefits from such integration. Struggling for the WTO took place on two arenas: domestic and foreign. Harmonizing the legislation has taken over 5 years of tense political and public disputes. The foreign dimension has been succeeded in 7 years after a number of tough bilateral negotiations with the WTO members. Since 2001 Ukraine signed 52 bilateral protocols on access to the market with the WTO countries. And even after the approval from “toughest” countries like Australia and the US achieved in the Spring 2006, Ukraine has been delayed until the end of 2007 by unsolved disputes with Taiwan and Kyrgyzstan. The latter counterpart extensively used issues of Soviet procurement debts that held Ukraine’s accession for more than a year.

Ukraine’s incentives to integrate into the World Trade Organization are to improve competitiveness of goods and services as well as to access the global market on the liberalized rules. As of today, WTO countries are a destination for 65% of Ukraine’s export and an origin of 45% imports. Liberalized conditions for the export will increase Ukraine’s revenues however the issue of offsetting losses caused by diminishing import barriers and losing revenues from domestic production has to be further estimated. In a long-term Ukraine is driven to the WTO by incentives to participate in the global trade club, modernize its economy and improve the domestic goods quality.

In the short-term the WTO membership will enable Ukraine to ease access to the global markets, protect national interests on the WTO markets in accordance to the Organization’s regulations, lower commercial risks through establishing more stable terms of trade²⁵. Decreasing prices for the Ukrainian goods might be positively perceived in terms of improved competitiveness on the WTO market and intensification of export flows. The Ukrainian exporters will benefit from a WTO’s principle of non-discrimination for internal actors. As a non-member Ukraine annually suffers an estimated loss of 2-3 billions USD²⁶. Domestic customers will enjoy lower prices and wider variety of products. Ukraine will also run into less transportation costs due to lower restrictions on transportations through the WTO countries. In a longer term, the WTO accession is expected to accelerate structural reforms and economic modernization. Overall the WTO

²⁵ Criteria for Membership in WTO, EU and NATO, Institute for Euro-Atlantic Cooperation, Konrad Adenauer Foundation, Kyiv 2007

²⁶ Source: Ukraine in the World Trade Organization: Expectations and Real Perspectives. Articles, Edited by Zhalilo, Kyiv 2002

membership will facilitate additional 200 million dollars revenue from exports, as forecasted by the Ministry of Economics of Ukraine.

Since 2001 Ukraine signed 52 bilateral protocols on access to the market with the WTO countries. After a long lasting negotiation process and legislative harmonization Ukraine is ready to enter the Organisation.

According to the accession agreement, Ukraine will hold its import duty at 10.66% for agricultural and 4.95% for industrial products. Generally the tariffs envisaged by the accession documents range from 0 to 50%, with some restrictions to be gradually diminished within the five years period. The highest tariffs can be imposed on sugar – 50% and sunflower oil – 30%. The products that will meet 25% tariffs include some radio technologies, synthetics and conveyor /engine belts. Among the category with liberalized tariffs are civil aircrafts, construction equipment and machinery, distilled ethanol, some sorts of fish, certain chemicals, oil products, medical equipment, medications, woods, paper products, some textile, metals and steel, IT products, furniture and toys.

Ukraine also agreed to the WTO requirement of not subsidizing its agricultural sector. The country is obliged to limit its support of agriculture to 601 millions USD that is 5% of production costs. However, Ukraine will not be restricted in other subsidizing programs, as long as they are not subject to agricultural restriction.

As to the agreement, Ukraine will introduce 260 thousand tons annual quota for raw sugar on “first come-first served bases” increasing it to 267 thousand tons in 2010.

In terms of market access, the WTO regulation will pertain to 11 key sectors including business services, communications, construction and machinery, distribution, education, environment, finances, insurance, banking and healthcare. The list is completed by social services, tourism, recreation, culture and sports, transport services and beauty services. Ukraine’s accession key documents are the 890 pages list of tariffs, quotas, restrictions on agricultural subsidies and gradual tariff diminishing plan.

Besides, these documents include Ukraine’s 40 pages obligations in services sector that ensures non-discrimination and regulates foreign access to the market. The last regulative document is a 240 pages long working paper on institutional structure that are meant to provide administering to some aspects of trade, particularly those that involve reporting.

The WTO accession informally has been stated as a prerequisite for launching negotiations on establishing a Free Trade Area with the European Union. The FTA

with the EU is an element of the so-called “political association – economic integration” policy of Ukraine’s European dimension. Establishment of the FTA is conducted through the new “enhanced” agreement between Ukraine and the EU called for replacement of the expired Partnership and Cooperation Agreement (PCA) signed back in 1994.

The EU-Ukraine FTA will enable the following:

- Enforcement of null tariffs for goods and services.
- Extensive restriction of non-tariff barriers in trade of goods and services through harmonization or mutual acceptance of technical standards.
- Compliance of competition policy corporate management and domestic market policies according to the EU regulation and environmental standards.
- Supply of necessary technical assistance, investments into infrastructure, professional training²⁷.

Similar to the WTO accession, the EU-Ukraine FTA will ease access for the Ukrainian goods and services into the European market. Also it will provide the European standards of goods, service and expertise for Ukrainian consumers. However, in a direct way the Ukrainian producers will suffer extensive losses from competing with the European products. Some industries, particularly agriculture, textile and chemical, will be challenged to reduce prices and catch up with the EU quality standards. In a longer term, the Ukrainian producers will inevitably be required to restructure production and modernize the technology. Certain industries, nonetheless, are expected to benefit from liberalization of the export barriers. In particular it pertains to Ukraine’s metals industry that until 2007 constituted 21.2% of Ukraine’s exports to the EU. Ukraine’s quota for metals export to the EU have been recently boosted by 1.353 millions tons after Romania’s and Bulgaria’s accession. Still, quota on steel exports remains to be one of the most principal EU’s restrictions towards Ukraine. In general steel imports are subject to quantitative restrictions in the EU (Ukraine, on its side, levies duties on metal scrap exports). The EU and Ukraine have negotiated an agreement on steel products that remained in force until 31 December 2007. This Agreement is

²⁷ Enhanced Free Trade between Ukraine and the EU: Metal Industry. Analytical Report, International Centre for Policy Studies, Kyiv 2006

automatically renewed year by year provided that neither party gives the other party written notice of denunciation of the Agreement at least six months before it expires. With each early renewal, quantities in every product group shall be increased by 2.5%. In the event that Ukraine enters the World Trade Organization (WTO) before the expiration of this Agreement, the Agreement shall be terminated and the quantitative limits shall be abolished as of the date of accession. This agreement provides for a quota of 1 320 000 tons in 2007²⁸.

In 2006, Ukraine's total trade with the 27 countries of the EU amounted to about 28 billion Euros (it represents 1.1% of total EU trade), a figure, which has been growing steadily since the economic crisis in 1998. However, Ukraine's manufacturing and trade structures are unbalanced. Iron and steel, mineral products and chemicals accounted for 64% of the Ukrainian exports to the EU, whilst machinery and equipment, and chemicals appear prominently in EU exports to Ukraine (66%)²⁹. EU-Ukraine trade in services is still very limited in value terms (1.5 billion Euros in 2003³⁰), but it is also growing. According to the Statistics Committee of Ukraine, the EU25-Ukraine trade in services amounted to 2.4 billions Euros in 2005 and 3.2 billions Euros in 2006.

Besides realizing the European integration, Ukraine implements projects in order to benefit from its geographical location and cooperation with regional partners. Therefore different frameworks of regional integration for achieving economic growth of the area are pursued. GUAM (Georgia, Ukraine, Azerbaijan, Moldova) is one of the most dynamic regional projects implemented in order to establish mutual cooperation in trade, energy, transportation, education and culture. Countries located in the Black Sea and Caspian regions aspire to synthesize their potential in order to ensure mutual sustainable growth and security. Based on the Free Trade Area Agreement mutual trade between the GUAM Member States developed dynamically: during 2001-2006 their turnover increased more than 3 times and reached the benchmark of 2 billions USD, and the first 9 months' tendency shows that in 2007 it will hit the ceiling of 3 billions. These are only initial results of the GUAM FTA established at the Kyiv Summit in May 2006. During 2006-2007, GUAM internal trade increased annually more than 40%, thus the target of \$10 billions in the year 2012 seemed realistic³¹.

²⁸ Source: Delegation of European Commission in Ukraine

²⁹ Source: Delegation of European Commission in Ukraine

³⁰ Source: EUROSTAT <http://epp.eurostat.ec.europa.eu>

³¹ Source: GUAM <http://www.guam.org.ua>

Accession to the WTO, establishment of the Free Trade Area with the European Union and further development of cooperation within GUAM will intensify Ukraine's trade flows, improve competitiveness of national producers, provide investments, offer wider opportunities to the domestic consumers, diversify the internal market, increase the labour capacity, enable more flexible movement of people, improve financial mechanisms, and accelerate modernization. Deepening of economic ties between the countries will also contribute to global and regional security.

The summary of current Ukraine's integration aspirations allows to assume that the country is inevitably boarding the fast going globalization train where economic interconnectedness, access to mutual markets, harmonized procedures and single values guide towards dynamic growth.

5. Energy Sector in Ukraine

Energy plays a significant role in Ukraine's domestic and foreign policy. Moreover the Ukraine's energy aspect is one of key factors for economic and security situation on the European and Asian continents. Global oil and natural gas consumption is constantly growing as production is increasingly restricted by exhausted reserves and environmental regulations. On one hand, Ukraine's economy is extensively sensible to any oil and gas trends, and on the other – any minor shift in Ukraine's energy system immediately causes effect on the rest of the continent. The recent gas dispute that occurred between Ukraine and Russia in 2006 fueled immense anxiety across Europe and the world. It was gas and oil price hike that directly and indirectly reversed a positive trend in Ukraine's economy in 2005-2005 lowering the GDP growth indicator from 13% in 2004 to 3% and 8% in 2005 and 2006 respectively.

Extracting 18 billions cubic meters (Bsm) of natural gas and 4.1 millions tons (29 millions barrels) of crude oil on its territory, Ukraine is estimated to be 60% dependant on the external supply. National oil resources fill only 15-20% of the national demand, while the share of oil in the energy balance of Ukraine is approximately 10%. Although Ukraine has made efforts at exploration, particularly in its region of the Sea of Azov, oil production has remained relatively flat since independence. The largest importer of oil into the country is Russia that by itself is the second largest extractor of oil in the world.

The year 2007 has been marked by unprecedented rise of oil rates when the price per barrel has exceeded 100 USD. According to the Ministry of Economics

of Ukraine, the petrol prices averagely increased by 35.6%, which was due to the global trend as well as to the 40% reduction the Ukrainian oil production. In 2008 the further increase of oil price at 25% is expected.

First time in five years the State Committee of Statistics reported 2% drop in production of fossil fuel in Ukraine, including 3% decrease in extraction of bituminous and lignite coal and coke.

5.1 Oil

According to the *Oil and Gas Journal*, Ukraine has 395 million barrels of proven oil reserves in 2007, the majority of which are located in the eastern Dnieper-Donetsk basin and Carpathian mountains. Ukraine has six crude oil refineries, with a combined throughput capacity of approximately 880 000 barrels per day (bbl/d) or 43.821 million tons per year³². However, with domestic demand at just over 30 percent of the country's refining capacity, Ukraine's refineries are operating below their potential. In 2007 only two national refineries, Lysychanskyi and Kremenchuzkyi, worked at the full capacity. First time in five years the State Committee of Statistics reported 2% drop in production of fossil fuel in Ukraine, including 3% decrease in extraction of bituminous and lignite coal and coke. Until recently, Ukraine's refineries did not even receive enough crude oil supplies to supply the country's domestic petroleum product demand.

Ukraine improved its situation in securing sufficient crude oil supplies for its refineries by offering oil exporters in Russia and Kazakhstan a stake in the country's refineries. Ukraine's recent success in privatizing its refineries has allowed the country to acquire additional oil supplies to meet domestic demand, as well as to accumulate funds for necessary modernizing the industry and to boost utilization rates at its refineries.

In November 2006, in order to minimize the dependence in oil imports the Cabinet of Ministers of Ukraine adopted a Program for Diversificating Oil Imports by 2015. This program foresees continuation of oil reforms launched by the "Energy Strategy of Ukraine" effective until 2030. According to this program the Ministry of Energy and Fuel of Ukraine intends to attach Ukraine to the Caspian Pipeline Consortium that stretches from Kazakhstan to Novorossiysk. In this framework Ukraine plans to launch negotiations on participation in construction of

³² Energy information Association
<http://www.eia.doe.gov/emeu/cabs/Ukraine/Background.html>

two pipelines to provide the Western gateway from the Ukrainian oil transportation system through Slovakia, Austria, Czech Republic and Germany.

5.2 Oil Transit

Ukraine largely benefits from its geographical location by being an ideal transit for oil and natural gas flows from Russia and the Caspian Sea region to European markets. According to the Ukrainian Ministry of Energy and Fuel, Ukraine increased oil transportation through its pipeline system by 13.3% or 119.664 thousand bbs/d (5958.9 thousand tons per year) and amounted to 1.02 millions barrels (50 904 thousand tons). The transit to the Western Europe (through Slovakia, Hungary, Czech Republic) in 2007 increased by 131.4 thousand bbs/d (6545.3 thousand tons per year) or by 19.7% comparing to 2006. The exports flow via the Druzhba and the Pridnieper pipelines to Slovakia, Hungary the Czech Republic, and the Black Sea.

The capacity of 1.6 million bbl/d (79.57 million tons per year) could be exported through Ukraine after a 15-year intergovernmental oil transit improvement signed in 2003. Most of the oil transited via Ukraine is Russian oil, sent through the 1.2-million-bbl/d (59.86 million tons per year) capacity Druzhba pipeline. The southern fork of the pipeline runs through Ukraine. Also, the Prydniprovski Main Pipeline operates nine interconnected pipelines throughout Ukraine with a total length of 1,500 miles and a capacity of 2.1 million bbl/d (104.76 million tons per year). The Pridnieper pipeline transports crude to refineries in southern Ukraine as well as around 200,000 bbl/d (9959390.00 tons per year) of Russian and Kazakh crude through Odesa on the Black Sea³³.

Still the issue of completing Odesa-Brody pipeline initially built to transport 300,000 bbl/d (14939085.00 tons per year) of Caspian oil from the newly completed Pivdennyi Black Sea marine terminal, and carry it northward through the Ukrainian system to Europe. There are multiple reasons why the extension may not be currently feasible. The primary hurdle is securing commercial guarantees of Caspian oil, especially in light of recent developments with Kazakhstan agreeing to send oil via the Bourgas-Alexandroupolis pipeline and BTC routes. Azerbaijan will be sending most of its oil through the BTC pipeline. Also, the European Bank for Reconstruction and Development (EBRD) has stated it may make more economic sense to construct the extension further to Wilhelmsaven, Germany,

³³ Energy information Association <http://www.eia.doe.gov/emeu/cabs/Ukraine/Background.html>

where it would avoid the crowded straits off the Danish and Swedish coast. Additionally, industry players have publicly stated that Caspian crude oil will be unlikely to displace cheaper Urals blend crude oil from Russia at central European refineries. Finally, the refinery at Plotsk would have to be upgraded to accommodate the lighter quality Caspian crude.

5.3 Natural Gas

The case of natural gas is even more sensible, as Ukraine is estimated to be 73% dependant on imports and the gas share in the national consumption equals to 41%. According to the *Oil and Gas Journal* Ukraine has roughly 18 trillion cubic meters (Tcm) of natural gas reserves, from which roughly 19 billions cubit meters (Bcm) was produced in 2005. In 2006, Ukraine produced 18 bcm and consumed 87 billions cubic meters of natural gas, making it the former Soviet Union's largest natural gas net importer³⁴. In its recent report the US Energy Information Association characterized Ukraine as one of the European largest energy consumer, and it consumes over twice as much energy per unit of GDP than Germany. In 2005, almost half of Ukraine's energy consumption came from natural gas, and over 75 percent of this natural gas came from Russia. Ukraine holds 31 Bcm of natural gas in storage, and in January 2006 the former Prime Minister Yekhanurov announced a plan to increase the capacity at Ukraine's 13 existing storage facilities to 33 Bcm by 2009. The six major facilities, most of which are depleted gas fields, are located in the regions of Lviv, Kyiv, and Chernihiv. Ukrainian storage is held by Naftogaz Ukrainy, RosUkrEnergo and Ukgazenergo, with a few small contracts with other companies³⁵.

As to the agreement signed in October 2006, Gazprom through its mediator RosUkrEnergo supplied to Ukraine at least 55 billion cubic meters (bcm) of Central Asian gas in 2007 at 130 USD per thousand cubic meters (tcm). The intermediary process is widely blamed for being not transparent. Gazprom buys gas from Turkmenistan at 100 USD per thousand cubic meters and sells it to RosUkrEnergo, which then sells it to Ukraine. Russia pays Ukraine natural gas transit fees of 7.3 cents per thousand cubic feet per 100 miles, a 47% price increase

³⁴ International Monetary Fund, Ukraine: Selected Issues,
<http://www.imf.org/external/pubs/cat/longres.cfm?sk=20408.0>

³⁵ Energy information Association
<http://www.eia.doe.gov/emeu/cabs/Ukraine/Background.html>

from 2005. The contract was subject to renegotiation in October 2007 and will be such each year afterward.

Although the gas issue was always a sticking point in Ukraine-Russia relations, the beginning of 2008 saw this problem elevated to even a higher status. In 2008 according to the agreement between Gazprom and RosUkrEnergo, Ukraine shall be getting 58 bcm of gas. However, the 2008 gas procurement already gets jeopardized in the beginning of the year due to Gazprom's claims on 1.5 billions USD of outstanding balance owed by Ukrainian Naftogaz. Sharp allegations aroused straight after statements of the new government committing to establish direct relations between Naftogaz and Gasprom excluding RosUkrEnergo from the deal. Coincidentally or not, the new gas dispute appeared after the new Ukrainian political composition that followed the elections 2007, WTO accession and messages on Ukraine's NATO aspirations articulated both by Ukrainian and Western elites thus regenerating Ukraine's Euro-Atlantic policy. If RosUkrEnergo is ousted, Gasprom laments, Ukraine will be required to purchase Russian not Central Asian gas and will be charge the full amount of 315 USD per tcm.

Gasprom had constantly claimed to raise the price for the future supply of natural gas in order to adjust it to the market price. The Ukrainian government aware of the future price hike up to 179.5 USD per thousand cubic meters, that puts a scary burden on the economy and on some industries particularly, nevertheless, is hardly capable to comprehend an effect that may be caused by 315 USD per tcm. The 179 USD price has been envisioned as a shock for the most energy consuming industries such as chemical, metal and textile production. However, the new price of 179 USD is already aligned in the State Budget 2008 though affecting many growth indicators.

In return to the Russian discourse, Ukraine intensified its search for ways to ease the dependency and to diversify the gas procurement. Alongside existing diversification policies Yulia Tymoshenko announced intention of her government to increase charges for gas transportation via Ukrainian territory. Moreover, the Ukrainian Prime-Minister during her recent visit to Brussels and meeting at the European Commission drew an immense attention to her initiative to provide the EU with the new gas pipeline "White Stream". The White Stream is announced to become a new link for the Central Asian gas (Azerbaijan on the first stage and Turkmenistan through Azeri territory on the second) through Georgia, Black Sea, Ukraine to the EU at the Romanian frontier.

Initially the White Stream project was outlined by the London-based GUEU (Georgia, Ukraine, European Union) White Stream Pipeline Company, with

Georgian participation presented last July at an energy conference in Tbilisi and again last October at the Energy Security Conference of heads of state and governments in Vilnius³⁶.

The White Stream is planned to use the existing Baku-Tbilisi-Erzurum gas pipeline, then to stretch over 100 of the Georgian territory from the west of Borjomi down to Supsa and further onto the seabed of the Black Sea. Then the gas route calls at the Crimean town of Feodosiya and after can either run through the Ukrainian gas transporting system or continue the flow through the Black Sea to Romania. The list of the project's participants points to efforts of loosening dependency on the Russian supplies and, meanwhile, actively engaging GUAM framework. GUAM that states the cooperation in energy transportation as one of its key goals will face an explicit inner loyalty test if the White Stream becomes feasible, as it will require commitments from three of its members: Azerbaijan, Georgia and Ukraine.

Facing setbacks in completing the Nabucco project, the European Union fails in diversifying its energy supplies as enshrined in the EU's New Energy Policy, established to combat climate change and boost the EU's energy security and competitiveness. The Nabucco project was planned to provide Europe with Caspian oil and gas linking through Turkey avoiding the Russian territory. It is the EU's fifth project that aims at lowering gas dependency on Russia. The pipeline should stretch over 3 300 kilometres from the Middle East (Iran) through Azerbaijan and Turkmenistan, then via Turkey, Bulgaria, Romania, Hungary terminating in the Austrian town of Baumgarten. With a maximum annual capacity of 31 billion cubic meters of natural gas, supplies from the region could account for between 10% and 15% of the EU's natural gas consumption in 2025. The construction works have been expected to open in 2008 to be completed by 2011. Companies from five countries would be involved in construction: Austrian OMV, Hungarian MOL, Romanian Transgaz, Bulgarian Bulgargaz and Turkish BOTAS. Also, among other interested in participating in the project are French Gaz de France and Total as well as German EON Ruhrgas and RWE³⁷.

From the beginning the Nabucco pipeline was deemed to compete with the Gasprom project South Stream that will stretch through the Black Sea

³⁶ Source: Vladimir Socor, "TRANS-BLACK SEA PIPELINE: ANOTHER CHANCE FOR GEORGIA AND EUROPE", *Eurasia Daily Monitor*, The Jamestown Foundation, February 1, 2008 – Volume 5, Issue 20

³⁷ Source: Press Articles, Ministerial Conference, June 2006, <http://www.nabucco-pipeline.com/>

overlapping with Nabucco's route. The Russian project considered various routes reaching Italy, Greece, Bulgaria, Romania, Hungary and Austria. Although the Nabucco should be built a year earlier than the South Stream, the recent Russian deal with Serbia on its participation in the project literary buried Nabucco. Moreover, the current international position, especially the US and Israel's, strictly opposes a mere possibility of cooperation with Iran that should yield gas for the Nabucco.

In the light of recent drawbacks in succeeding with the Nabucco project, Tymoshenko is eager to offer an alternative to the EU and find a solution to Ukraine's gas issue. Moreover, the White Stream perspective could boost gas production in Azerbaijan if transportation opportunities would be provided. Nonetheless, the perspective of an access to Turkmen gas that is wholly contracted by Russia is rather vague at this point. Until now Turkmenistan has failed to be exposed to direct cooperation with Ukraine exclusively selling its gas to Russia.

5.4 Coal

Ukraine's proven reserves of coal equal to 37.6 billion short tons, 17.9 billion tons of which is anthracite and bituminous coal³⁸. Ukraine's resources accounted for about 15% of the former Soviet Union's total coal reserves.

Most of Ukraine's coal is mined in the Donetsk/Luhansk region of Donbas basin. The country's coal industry, which counts slightly less than 200 mines and employs about 500,000 people, is managed by the state organizations and suffers from numerous problems including labor strikes, hazardous working conditions, inefficiency and low productivity. Ukraine has the world's second-highest mining fatality rate, with an average of 317 deaths a year since 1990. Only in China is the fatality rate higher. This years shocking accident in Zasyadko mine took over 100 human lives.

In 2007 the decline of cole production has been observed due to severe geological and technological equipment. Only 58.8 million tons of coal has been produced that is 2.9 million tons less then in 2006.

³⁸ Source: Ministry of Energy and Fuel of Ukraine

5.5 Diversification scenarios

Diversification of natural gas sources is a prerequisite for diminishing Ukraine's energy dependence. The most probable diversification scenarios imply supplying gas from Iran and Turkmenistan through the Transcaspian corridor, which complies with Tymoshenko's hypothetical initiative on the White Stream pipeline.

In April 2007, the European Commission announced its Black Sea Synergy initiative, a new regional segment of the European Neighbourhood Policy in the Black Sea region. It includes cooperation in energy issues between the EU and the Black Sea countries alongside with Azerbaijan, Armenia and Moldova. If implemented, it could become the next EU project in strategic European seas (third after the Northern dimension and Mediterranean Euromed, Barcelona process), thus facilitating diversification goals of the European Commission. Ukraine, in this context, should be regarded as a reliable EU's ally to participate in EU's diversification scenarios.

In future, most natural gas resources from Norway, Netherlands and Algeria will be depleting in the EU states. Gas routes into Ukraine can only be realized if further stretched to Europe. Scenario of Iranian gas origin can be jeopardized by the US policy of Iran's isolation, Russia's contraction by imposing a total control over gas imports from Kazakhstan, Uzbekistan and Turkmenistan, political instability in countries of the Caspian and Caucasian region.

If the Energy Strategy of 2030 and the Program for Diversification of Oil Imports by 2015 implemented successfully, Ukraine can reach essential decline of oil and gas consumption thus lower its import dependency. Programs for energy efficiency and energy saving if realized will lighten an economic burden of costs for energy resources.

6. The Current State Budget

The early elections 2007 called after the parliament has been dissolved, changed the political situation in the country. The new political composition and appointment of the new government consequently led to changes in the budget sphere. The changes initiated by the new team mainly pertained to revision of the previous budget draft and adoption of the new document. The first budget draft was prepared and submitted to the Parliament by the previous Cabinet of Ministers of PM Victor Yanukovich. The Yanukovich's version implied a "conservative"

scenario of economic policy and stated the following macroeconomic indicators for 2008: 810.1 billion UAH of GDP (160.4 billions USD), 6.8 percent of CPI inflation. Governmental revenue and expenditures amounted to 192.96 billions UAH (38.21 billions USD) and 211.9 billions UAH (41.9 billions USD) respectively. The budget deficit was planned to amount to 18.94 billions UAH (3.75 billions USD). The GDP growth rate was set at 7.2 percent minimum if the marginal rate of natural gas price will not exceed 10 percent. Another necessary conditions for the economic growth rate foreseen by the first draft were sustaining high growth of the world economy (4-9%) and price stability on the metals market.

Appointment of Yulia Tymoshenko as the Prime Minister of Ukraine on 18 December 2007 rearranged foreign and domestic political situation thus initiated revision of the budget 2008 conception. Increase in natural gas prices and overlooked growth rates for the world economy required to be reflected in the new budget. The revised budget draft presented changes pertaining to the revenue and expenditure structure, volumes and revenues from export and import, monetary policy and changes on the labour market. The state's capacity to fulfill its commitments to maintain the level of social standards and social security were a subject to careful examination.

Therefore the newly elected parliament and the appointed government faced a challenge to reconsider key figures and indicators in the Budget 2008 draft due to the forecasted changes in the shortest-term possible. If the government failed to pass the new budget by the end of 2007 it would automatically enforce a regulation that implies allocation of 1/12 of the previous annual budget a month. In this case the government would not be able to fulfill its obligation to increase social programs as well as to issue compensation for former Soviet Oshchanbank account holders that required allocation of additional 6 billions UAH. Also, monthly expenditures of the early 2007 are not adjusted to the increased inflation rate and gas prices in 2008 therefore not sufficient to maintain the current economy. If the budget is not passed in time the revenues from rent for oil and gas exploration as well as other payments for natural resources would be stopped. Also a number of social programs including the abovementioned Oshchadbank compensations and other initiatives activated by the Constitutional Court decision pertaining to legislation on the social benefits would not be implemented. And finally, if all the abovestated wasn't considered and the Budget 2008 not passed in time, Ukraine would face the budget deficit of 12% of GDP.

The Law of Ukraine "On the State Budget 2008" was passed on 28 December 2008. More or less the document drafted in a very limited time framework

included adjustments on the new gas price and rent charges for natural resources. The government also underlined several principals aimed to enhance transparency of auction regulations pertaining to sale, rent or lease of land. In comparence to the budget of Yanukovych's government, revenues in the budget 2008 increased by 24 billiions UAH thus reaching a total figure of 216.93 billions UAH (42.96 billions USD). The expenditures also increased becoming 235.75 billions UAH (46.68 billions USD). The budget deficit, however, remained almost the same – 18.82 billiions UAH (3.72 billions USD) shrinking only by 120 millions UAH (23 millions USD). The decrease in the budget deficit was achieved by reconsideration of macroeconomic indicators towards their growth. For instance, the nominal GDP forecast in 2008 is expected to reach 889.4 billions UAH (176.11 billions USD) and the CPI inflation is fixed at 9.6%.

In recent years, in order to ensure a balance of the budget certain regulations pertaining to improving social programs for different citizens' categories have been rolled back during the drafting process. The budget of 2008 became the first one that implied efforts not to discontinue enforcement of the previous legislation aimed at improvement of social expenditures but to restrict it to those groups of the citizens that truly need it.

The Budget 2008 essentially increased a minimal living cost level, amount of minimal wage, pension, particularly by cancelling the mechanism of equalizing in pensions and benefits. The budget's expenditure part also consists of widened healthcare pyments and the whole range of other social programs. Still, the minimal wage is not sufficient to offset the cost of the minimal basket of goods and services. (Table 10)

Table 10. Minimal wage and minimal basket of goods and services in 2008

	1 st Quarter	2 nd Quarter	3 rd Quarter	4 th Quarter
Minimal Wage, UAH	515	525	545	605
Minimal Basket of Goods and Services, UAH	592	605	607	626

The gap between the wage and goods's basket indicators is expected to be partially compensated by the social programs. Among the new initiatives of Tymoshenko's budget, the special emphasis should be paid to the program of compensations for depreciated savings to holders of accounts in the former Soviet

Oshchadbank (Sberbank, *Russian*). This program directly or indirectly covers 7 percent of general expenditures of the budget 2008. First of all this program has been enforced as a result of political commitments of the democratic coalition in the newly elected parliament.

As to a link between the central (State) and regional budgets, the budget 2008 foresees larger amount of funds allocated for the regional development. Prior to all, the regional dimension of the Budget 2008 implies allocation of additional funds to local budgets in order to support subsidiary programs for electricity, heating, natural gas, solid fuel, water supply, waterfiltering, utility, etc. Also the Budget foresees the whole range of programs aimed at stimulation of local administrations to accumulate funds and increase their revenues.

Overall, the key incentives of the budget 2008 are increasing of expenditures into a social sector, discontinuation of unreasonable benefits and implementation of political commitments of the new government.

7. Changes in Ukraine's Tax System

The main tax related tasks assigned to the new Cabinet of Ministers are reflected in the governmental program "Ukrainian Breakthrough: Not for Politicians but for People" approved on 16 January 2008. Although the program's incentives are not revolutionary, they imply elimination of tax benefits and unification of tax legislation. The government defined the following tax reforms to be implemented in the short-term perspective:

- Approval of Tax Reform Strategy,
- Gradual reduction of tax burden level and its even distribution,
- Widening tax operation principles,
- Minimization of tax benefits,
- Unification of taxation norms,
- Ensuring equitable relations between tax payers and fiscal authorities,
- Improvement of administering Value Added Tax (VAT) and decriminalization of the VAT reimbursement process,
- Learning possibilities to replace the VAT by the consumption tax (sale tax) in order to raise fiscal efficiency,

- Establishment of steady and sufficient funding of the regional governance administrations by introducing improvements to the local taxation system,
- Introduction of the real estate tax,
- Harmonisation of Ukrainian tax legislation in accordance to the EU regulation,
- Introduction of general single social payment for the Labour Pay Fund,
- Completion of Ukraine's Tax Code draft.

Besides the short-term perspective the newly appointed government has worked towards improvement of tax norms in order to assess further tax policy decisions. This pertains to amending a number of tax regulations simultaneously with adoption of the State Budget 2008. These amendments will cause direct or indirect effect taxation mechanism, substantiate revenues of the central and regional budgets. Classification of the abovementioned amendments breaks them into the following series: land issues, excise-duty policy, business profit tax, income of citizens. taxes on goods and services.

7.1 Land Issues

Amendments to the legislation on land issue aim to improve land pricing and sale procedures. In particular, improvement of the Land Code of Ukraine pertains to land sale and monetary assessment of land districts, clarified land sale procedure and appointment of officers responsible for the operations.

Amendments to the Law of Ukraine on Land Fee foresee increased land tax rates without defining monetary equivalent until the current rate will reflect the real land value. The principal monetary land estimate is to be introduced in order to compute tax amount for the land district purchased according to the civil law agreements (the land price can not be less than the fee stated in the agreement.) The above stated norms will enable to adjust tax to the prices on a land market thus increasing revenues of local budgets.

The Law of Ukraine on Privatization of State Property is amplified with a number of regulations on purchase of state-owned land that is attached to the privatized estate.

These changes and supplements foresee certain procedures aimed to avoid depreciated land rates (pertains to defining land details, technical documentation,

expertise of the land district, purchases on land auctions.) Legal adoption of those issues will facilitate additional revenues to the State Budget.

In order to secure revenues to the regional budget amendment to the Law on Land Lease have been passed. It foresees a mechanism of optimal lease rates for a land that belongs to the state or to the community and implies a fixed rate defined from the normative estimated price.

7.2 Excise-Duty Policy

By the initiative of the government the following amendments and amplifications have been passed for the following legislation:

- on excise-duty on alcohol and tobacco,
- on excise-duty on ethyl alcohol.

Changes to the above stated legislation increase excise-duty rates on alcohol and tobacco, thus restricting the use of unhealthy products, preventing from tax fraud, boosting budget revenues and applying globally unified tax standards as realization of Ukraine's WTO commitments.

7.3 Business Profit Tax. Tax on Income of Citizens. Tax on Goods and Services

The tax legislation on Value Added Tax, on taxation of profit from business, and on income of the citizens have been amended on the following:

- **VAT** – restrictions on bills of exchange for imports, technical clarifications, that pertain to reimbursement procedure.
- **Business profit tax** – amendments to the Law on Taxation of Business Profits improved definition of a “typical price”, adopted norm for tax procedure that enables payment of provisional tax at the annual rates.
- **Tax on income of citizens** – in order to sustain the local budgets revenues amendments to the Law on Tax on Income of Citizens in the part of stake emitted by the Ministry of Finance.
- **Other amendments** – improvement of the procedure of charging a rent for oil, natural gas and gas condensate extracted in Ukraine, rent charges for crude oil and oil products transportation through the

Ukrainian territory, rent charges for transit of natural gas and ammonia through the territory of Ukraine (Law on Oil and Gas.)

Therefore, the amendments passed with the Law on the State Budget 2008 in general do not rearrange the tax regulations they rather serve as a guidance to assess policies of the current government in future.

The adopted amendments and amplifications didn't not imply changes to the execution system, except several technical improvements in accordance with the WTO norms.

The taxes, as regarded for further perspective, can be a confusing subject therefore can provoke conflicts between the state and citizens. On the other hand, after Ukraine's accession to the WTO the tax regulation will be harmonized according to commitments to change of tariff and non-tariff norms as well as taxation procedure. In the meantime, the issue of compensation loses in revenues to certain budgets and inter-budget relations should be considered.

And in conclusion, drafting and approval of the Tax Code of Ukraine is a key task that will improve the tax system and offset possible inconveniences occurring after Ukraine's WTO accession.

8. Recommendations

Welcoming the recent Ukrainian WTO accession, the Ukrainian civil society is still overwhelmingly anxious over the recent patterns in economic and energy sectors. The *GDP growth rate* that has decreased over last 3 years and is forecasted at 5.5% by the World Bank in 2008 as well as unprecedented *inflation rate* that accelerated to 16.6% in 2007 and hit the records at 3% in January 2008 – all continue to raise concerns. In order to reverse the dangerous trend of GDP growth at a decreasing rate and acceleration of inflation, the Ukrainian government should provide a system of short-term and long-term measures ranging within monetary, energy, fiscal and institutional policies. Inflation is one of the functions that inversely explain the economic growth although it is not directly included in the formula. Thus restraining the current inflation rate becomes a prerequisite of maximizing further growth in Ukraine. Other key prerequisites for sustaining growth are maximizing the production and quality output through modernizing technologies and applying energy consuming reforms especially in its largest industries such as metal/steel, machinery, chemical and food production. The

inflation rate of 3% reported in January 2008 raised concerns both domestically and abroad. The negative trend inhibited from the last periods is reckoned to be graven due to large-scale social expenditures, which also included the program on issuing compensations for former holders of saving accounts in the Soviet Oshchadbank. The increasing amount of cash provided to consumers has immediately got reflected on inflation figures. In this case the rapid increase of government expenditures and private consumption should be backed by the increasing growth in the output as well as by extra *revenues* to the budget. The government should currently take care of extra cash flow to the budget, presumably from *privatization*, as announced. However, the planned privatization foreseen in the budget must allocated 8 billions UAH and additional 12 billions UAH that are expected from the so-called unforeseen privatization. Being informed on the list of enterprises called for the forthcoming “planned” privatization that include tycoons Ukrtelecom and Odesa Port Plant, the Ukrainian public so far is not aware of the next “package” that aims to allocate additional 12 billions UAH. Transparency and fairness are claimed by PM Tymoshenko to be maintained as key principles of privatization process not to remind of “bribarization” from the nineties and beginning of the new millennium. Large number of the Ukrainian state-owned companies will become eligible for privatization in 2008 in order to allocate revenues, attract investments, diversify the supply and modernize technologies. Still, the government should engage public to an open dialogue on assessing privatization in those economic sectors that are subjects to ensuring national security such as energy supply, energy production, transportation, extraction of precious materials etc. In a longer perspective the government and the public should engage into a dialogue on accepting private domestic or international capital into the state-owned medical, educational and other social services, thus relieving from a burden of budget expenditures and developing financial instruments of insurance and loans for administering these sectors.

Distribution of income in Ukraine and its structure by sources (part 1.2) plots that salaries provide the biggest share of income, whereas benefits from businesses, financial operations and property ownership are relatively low. This drives to two possible conclusions:

- First, that the Ukrainian citizens suffer certain formal and informal restrictions in business activities (registration, licensing, fiscal regulations, tax burden)

- Second, that the large share of the Ukrainian business remains in the shade economy.

In both cases, the state must ensure favorable conditions for the domestic entrepreneurship in order to observe its development outside of the shade economy.

Although Ukraine is a market economy standing on the doorstep of the WTO, endemic corruption is continuing to create significant obstacles to its economic development. Corruption is widespread throughout both executive and judicial bodies. Corruption pervades all levels of social and governmental activities and all sectors of the economy. Although all political promises include efforts to fight corruption, the fight is yet to begin in earnest.

The civil society supports Ukraine's current economic integration processes that are aimed at opening the economy to free trade, multilateral economic cooperation and diversification of supplies to the domestic market (particularly energy supplies). The recommendations address completion of the WTO membership by ratifying the accession protocol at the Parliament in the nearest future and activating all tariff and non-tariff conditions foreseen by the accession agreement. The WTO accession is fulfillment of one of key criteria for establishing the Free Trade Area with the European Union. The talks on the FTA within the framework of the EU-Ukraine new enhanced agreement must be launched in the nearest perspective.

The Ukrainian authorities must acknowledge that the WTO accession, Ukraine-EU FTA and further development of cooperation within GUAM will intensify Ukraine's trade flows, improve competitiveness of national producers, provide investments, offer wider opportunities to the domestic consumers, diversify the internal market, increase the labour capacity, enable more flexible movement of people, improve financial mechanisms, and accelerate modernization. Deepening of economic ties between the countries will also contribute to global and regional security. The summary of current Ukraine's integration aspirations allows to assume that the country is inevitably boarding the fast going globalization train where economic interconnectedness, access to mutual markets, harmonized procedures and single values guide towards dynamic growth. The government must in this regard ensure successful implementation of the integration policies and fulfillment of membership commitments.

As mentioned above, it should be strongly emphasized that one of the pillars to sustain the economic growth is realization of energy consuming reforms and diversification of energy supplies. Programs for energy efficiency and energy saving alongside with the Energy Strategy 2030 if realized will lighten an economic burden

of costs for energy resources. Diversification of natural gas sources is a prerequisite for diminishing Ukraine's energy dependence. The most probable diversification scenarios imply supplying gas from Iran and Turkmenistan through the Transcaspian corridor, which complies with PM Tymoshenko's initiative on the White Stream gas pipeline. In the search for diversification scenarios, Ukraine should fully benefit from its geographical location and the existing gas transportation system. It should be noted that in April 2007, the European Commission announced its Black Sea Synergy initiative, a new regional segment of the European Neighbourhood Policy in the Black Sea region. It includes cooperation in energy issues between the EU and the Black Sea countries alongside with Azerbaijan, Armenia and Moldova. If implemented, it could become the next EU project in strategic European seas (third after the Northern dimension and Mediterranean Euromed, Barcelona process), thus facilitating diversification goals of the European Commission. Ukraine, in this context, should be regarded as a reliable EU's ally to participate in EU's diversification scenarios.

Following the key incentives of the budget 2008 that imply increasing of expenditures into a social sector, discontinuation of unreasonable benefits and fulfilment of political commitments of the new government, the government must employ measures in order to avoid depreciation of its increased expenditures on social programs. Although the Budget 2008 essentially increased a minimal living cost level, amount of minimal wage, pension, particularly by cancelling the mechanism of equalizing in pensions and benefits, still minimal wage indicators are not sufficient to offset the cost of the minimal basket of goods and services (Part 1.3). The government that intends to impose *a social justice* must also elaborate a systematic approach tackling the problem of remaining citizens living behind the poverty line. Once again, while increasing the social spendings, the match between the government expenditures, private consumption and government revenues must be cautiously watched in order to hold inflation.

The tax reform initiated in 2008 alongside intention to outline the Tax Code of Ukraine should be carried out towards improvement of tax norms, ensuring equitable relations between tax payers and fiscal authorities, establishment of steady and sufficient funding of the regional governance administrations through introduction of improvements to the local taxation system, harmonisation of Ukrainian tax legislation in accordance to the EU regulation, as well as in order to assess further tax policy decisions. But more importantly, the tax reforms should introduce principles of transparency and accountability to the fiscal system, prevent from abusing the range of benefits, restrict corruption mechanisms and to facilitate development of private entrepreneurship.