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Changed Circumstances Review
Public Document

MEMORANDUM FOR:	David Spooner Assistant Secretary for Import Administration
THROUGH:	Joseph A. Spetrini Deputy Assistant Secretary For AD/CVD Policy and Negotiations Ronald K. Lorentzen Director, Office of Policy Albert Hsu Senior Economist
FROM:	Lawrence Norton Shauna Lee-Alaia Anthony Hill Office of Policy
DATE:	February 16, 2006
SUBJECT:	Decision Memorandum Regarding Ukraine's Status as a Non-Market Economy Country for Purposes of the Antidumping Duty Law Under a Changed Circumstances Review of the Antidumping Duty Order on Carbon and Certain Alloy Steel Wire Rod from Ukraine.

SUMMARY

On April 2, 2005, the Government of Ukraine ("GOU"), citing changes in Ukraine's economy over the last several years, requested that the Department of Commerce ("the Department") initiate a changed circumstances review of the anti-dumping duty order on carbon and certain alloy steel wire rod ("wire rod") from Ukraine, the purpose of which was to have the Department reconsider Ukraine's status as a non-market economy ("NME") country under the U.S. antidumping law. On April 26, 2005, the Department published a notice in the *Federal Register* initiating the changed circumstances review. *See Initiation of a Changed Circumstances Review of the Antidumping Duty Order on Carbon and Certain Alloy Steel Wire Rod from Ukraine*, 70 FR 21396, (April 26, 2005).

The Department's analysis of Ukraine's economic reform results to date, as performed under section 771(18)(B) of the Tariff Act of 1930, as amended ("the Act"), indicates that Ukraine has successfully made the transition to a market economy. Among other evidence in support of this finding, we note the following:

- The currency is freely convertible and wages are market-based.
- While the level of foreign direct investment ("FDI") has been low, due to Ukraine's difficult business environment and recent policy uncertainty, Ukraine is nevertheless open to foreign investment. Further, FDI levels are increasing as Ukraine develops and its investment environment improves.
- As a result of economic and institutional reforms undertaken in Ukraine since 1990, the private sector accounts for at least 65 percent of gross domestic product ("GDP") and the non-state sector about two-thirds of employment.
- While employment in the small- and medium-sized enterprise ("SME") sector is still fairly low, the number of SMEs has grown significantly in recent years.
- The collective farming system has been broken up into private farms, which has helped significantly to boost agricultural output. Private land ownership is now the norm.
- While the energy sector is still largely state-owned, collection rates for energy are over 95 percent and tariffs to industry are close to cost-recovery levels.
- Ukraine has undertaken numerous reforms in conjunction with its application to accede to the World Trade Organization ("WTO") and maintains relatively low barriers to external trade, with average effective tariff rates of seven percent.
- Ukraine has also benefitted from several years of robust economic growth. This has helped reduce enterprise arrears substantially, although bankruptcy proceedings still must be improved.

While Ukraine has made the transition to a market economy, it remains a very difficult market for both foreign-invested as well as domestic entrepreneurs due to an unnecessarily complex and burdensome regulatory environment, weak rule of law and high level of corruption. Ukraine's legal structure and conflicting laws make it very cumbersome to conduct business in full compliance with the law, providing avenues for corruption. This environment, in turn, helps sustain an "insider economy" where certain private interests can effectively lock out competition and preserve their status as powerful market actors.

Ukraine's difficult business environment does not change the underlying fact that markets, not the state, allocate resources and set prices in the economy. Rather than being a symptom of a planned economy, Ukraine's weak rule of law reflects a state that is in the process of gaining knowledge in building and strengthening market-friendly institutions. The current government, moreover, seems genuinely committed to reducing corruption and improving the business climate, as demonstrated by its more transparent style of governing and its overhaul of the bureaucracy. The process is necessarily gradual, as key market-sustaining institutions need time to fully develop. While the government still needs to complete reforms of the regulatory environment, it has made substantial progress on reducing corruption, as noted by third-party sources. On balance, the totality of Ukraine's economic reforms indicates that Ukraine's economy is now market-based. Therefore, based on the evidence of Ukrainian economic reforms to date, analyzed as required under section 771(18)(B) of the Act, we recommend that the Department revoke Ukraine's NME status, effective February 1, 2006.

Therefore, Ukrainian producers and exporters will be subject to the antidumping rules applicable to market economies with respect to the analysis of transactions occurring after February 1, 2006. Accordingly, the Department will examine prices and costs within Ukraine, utilizing them for the determination of normal value when appropriate or disregarding them when they are not. In this regard, the Department retains its authority to disregard particular prices or costs when the prices are not in the ordinary course of trade, the costs are not in accordance with generally accepted accounting principles, the costs do not reasonably reflect the costs associated with the production and sale of the merchandise, or in other situations provided for in the Act or the Department's regulations. This finding will apply to all future administrative proceedings covering periods of investigation or review that fall after February 1, 2006. Where a proceeding's period of investigation or review begins before February 1, 2006, but ends after that date, the Department will use its standard market economy methodology for the portion of the period of review that falls after February 1, 2006, if it determines that a sufficient period of time has passed so that adequate market economy data is available.

SUMMARY OF COMMENTS AND REBUTTAL COMMENTS FROM PARTIES

Parties Who Support Revoking Ukraine's NME status

In addition to the Government of Ukraine, the Department has received comments supporting a revocation of Ukraine's NME status from: the Ukrainian Association of Ferrous Metallurgy Enterprises (a Ukrainian industry association); Leman Commodities and Azovstal Iron and Steel Works (an exporter and a producer of steel products, respectively); the Western CIS fund (private equity); Harve Benard (textiles); Alticor (direct sales); the American Chamber of Commerce in Ukraine; Archer Daniels Midland (agricultural processing); AES Corporation (electricity); General Electric; Motorola; PBN (communications); Proctor and Gamble; Ukraine-United States Business Council; and United Technologies. These parties offered the following arguments in support of their view that Ukraine should be recognized as a market economy country.

1. Ukraine has assumed International Monetary Fund ("IMF") Article VIII obligations since 1996, making the currency convertible on the current account.
2. The foreign exchange market has been significantly liberalized in the past few years.
3. The 50 percent surrender requirement for foreign currency earnings was eliminated in March 2005.
4. Ukrainians have the right to strike, join trade unions and engage in collective bargaining.
5. Wages and benefits are regulated by a tripartite agreement based on talks between the government, an employer's association, and union representatives.
6. Wages in Ukraine have grown significantly over the past several years, and vary by region and skill level. Wage arrears have been declining.
7. Ukraine has a solid legal foundation for encouraging FDI and protecting foreign investors.

8. Foreign investments may not be nationalized or expropriated without compensation, and investors are free to remit profits.
9. Foreign investment levels have increased significantly in recent years.
10. The government has done an excellent job of getting value-added tax ("VAT") refunds current.
11. Numerous foreign corporations are active in Ukraine and report that the business environment is market-based.
12. The private sector has accounted for 65 percent of GDP for years.
13. The right to private property is guaranteed by the Constitution of Ukraine ("the Constitution").
14. The privatization process is advanced and often involves foreign investors.
15. Land can now be privately owned.
16. The *Commercial Code* of Ukraine, which took effect in 2004, promotes and protects entrepreneurs.
17. Ukraine has a modern banking system that is largely privately-owned.
18. Prices in Ukraine are market-based.
19. Ukraine has seen robust economic growth in recent years.
20. Ukraine has almost eliminated barter transactions.
21. The government is implementing anti-corruption initiatives, as is no more corrupt than some other market economies.
22. According to the 2006 *Index of Economic Freedom*, Ukraine is at least as economically free as other countries that have been granted market economy status, as well as those market economies that have been deemed by the Department to be "economically comparable" to Ukraine.

Parties Who Oppose Revoking Ukraine's NME status

Comments against revocation of Ukraine's NME status were submitted by Gerdau Ameristeel, Keystone Consolidated Industries, and ISG Georgetown (Petitioners in the current Carbon and Certain Alloy Steel Wire Rod case); Eramet Marietta; the Rebar Trade Action Coalition; the Ad Hoc Committee of Domestic Nitrogen Producers; the American Iron and Steel Institute; and the R&J Trading Company. The comments against revocation of NME status include:

1. Most of the reasons for the Department's rejection of Ukraine's bid for market-economy status in 1997 still exist today.
2. The currency is convertible only in Ukraine, only "authorized" banks are allowed to take part in currency transactions, and activities involving hard currency require government approval and a license.
3. The government engages in currency manipulation through sustained intervention in the currency market, maintaining a *de facto* peg at an undervalued rate.
4. Ukraine maintains a tariff schedule that assigns wages to different occupations. This schedule applies to state-owned enterprises ("SOEs") and is to be used as "guidance" for private firms, making free wage negotiation impossible.
5. The government has expressed hostility towards unions and registration of unions has been difficult.

6. Wage arrears remain a problem in certain sectors, particularly mining.
7. Pervasive corruption, cronyism, and a lack of transparency hamper foreign investment.
8. There is no faith in the legal system, and the laws affecting foreign investment are often contradictory and vague.
9. The tax system is arbitrary, increasing uncertainty for foreign investors, and foreign enterprises often face burdensome tax rates.
10. Foreign enterprises are often discriminated against, with a strong institutional bias towards supporting domestic industries. An example are delays in VAT refunds to foreign-invested firms.
11. Progress on privatization of large firms has been slow, and much privatization has been partial (90 percent of privatized enterprises retain some state ownership). Partial privatization allows the government to continue to influence the firm.
12. Privatization has been marked by corruption and a lack of transparency. The government is now "re-nationalizing" some firms that were privatized in a corrupt or illegal manner, but they may or may not be "re-privatized" at a later date.
13. The government retains substantial control over the energy sector and has taken steps to consolidate this control.
14. There is a lack of commitment to privatization in the current government.
15. Foreign investors appear to be able to buy only non-agricultural land, but conflicting laws and an uncertain framework undermine secure property rights.
16. Ukraine uses its antimonopoly law, which can apply to firms with a 35 percent market share (or even less), to regulate prices and give precedence to state orders over other production.
17. Export controls on steel scrap artificially lower the price of steel scrap in Ukraine, acting as a subsidy.
18. GOU directly regulates the prices of many goods from energy to grain and meat, and the current government appears keen on continued price controls.
19. In the original investigation on wire rod from Ukraine, respondents admitted that exports of wire rod to the U.S. were subject to a price floor and a GOU-set "indicative price," and there is no record evidence showing that this requirement has changed.
20. Ukraine is shackled by corruption, a poor rule of law, and excessive regulation.
21. Property rights protection is uncertain because of conflicts between the *Civil* and *Commercial Codes* and the lack of a joint-stock company law.
22. According to the 2006 *Index of Economic Freedom*, Ukraine lags on reform efforts sufficiently to be considered "mostly unfree".

ANALYTICAL APPROACH

In making an NME country determination under section 771(18)(A) of the Act, Section 771(18)(B) requires that the Department take into account:

1. the extent to which the currency of the foreign country is convertible into the currency of other countries;
2. the extent to which wage rates in the foreign country are determined by free bargaining between labor and management;

3. the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;
4. the extent of government ownership or control of the means of production;
5. the extent of government control over the allocation of resources and over the price and output decisions of enterprises;
6. such other factors as the administering authority considers appropriate.

In evaluating the six factors listed above, the Department has recognized that the removal or withdrawal of state controls over the economy is not sufficient for revocation of NME status. *See Notice of Final Determinations of Sales at Less Than Fair Value: Pure Magnesium and Alloy Magnesium From the Russian Federation*, 60 FR 16440, 16443 (March 30, 1995). Rather, the Department considers whether the facts, as applied to the statutory factors, demonstrate that the economy is generally operating under market principles. To this end, Congress has provided the above-listed factors which the Department must evaluate to determine whether, in the judgment of the Department, market forces in the country are sufficiently developed to permit the use of prices and costs in that country for purposes of the Department's dumping analysis.

The reason for this analysis is that prices and costs are central to the Department's dumping analysis and calculation of normal value. Therefore, the prices and costs that the Department uses must be meaningful measures of value. NME prices are not, as a general rule, meaningful measures of value because they do not sufficiently reflect the relative scarcity of resources used in production. The problem with NMEs is not one of distorted prices, *per se*, since few, if any, market economy prices are perfect measures of value, free of all distortions (*e.g.*, taxes, subsidies, or other government regulatory measures). The problem, instead, is the price *generation* process in NMEs (*i.e.*, the absence of the independent demand and supply elements that individually and collectively make a market-based price system work).

The Department's evaluation of the statutory criteria does not require that countries be judged against a theoretical model or a perfectly competitive *laissez-faire* economy. Instead, the Department's determination is based on comparing the economic characteristics of the country in question with the operation of other known market economies, recognizing that market economies around the world have many different forms and features. Although it is not necessary that the country fully meet every statutory factor relative to other market economies, the Department must determine that the factors, taken together, indicate that reforms have reached a threshold level such that the country can be considered to have a functioning market economy.

The Department has carefully considered the facts and arguments presented by all of the parties who made submissions during this proceeding. In addition, consistent with the Department's practice in addressing prior market economy determinations, the Department has relied upon expert, third-party sources such as the World Bank, the IMF, the European Bank for Reconstruction and Development ("EBRD"), and the Organization for Economic Cooperation and Development ("OECD").

OVERVIEW OF ECONOMIC AND LEGAL REFORMS

Ukraine is a large country in eastern Europe of approximately 48 million people that features both large agricultural and industrial sectors. During the Soviet era, Ukraine played a key role in the Soviet Union's centrally planned economy, specializing in heavy industrial products such as steel and machinery. The state owned all property and prices were set and resources allocated by the government. Upon achieving independence in 1991, Ukraine began to reform its economic system, beginning with price liberalization and gradual privatization. Reforms proceeded slowly, however, amid a widespread resistance within the government and uncertainty on how to proceed with economic reforms. Reform efforts were further complicated by the steep economic decline suffered by Ukraine during most of the 1990s. Ukraine experienced the largest decline of all the transition countries in Europe not affected by war, sustaining a loss of almost 60 percent of its industrial output by 1999.

After contracting every year since independence in 1991, Ukraine's economy finally starting growing in 2000. Around this time, Ukraine began introducing new reforms. The government began to exert discipline over the budget and overhaul the government administrative apparatus, creating a more favorable climate for private investment. The government increased efforts to privatize larger enterprises and dismantled the collective agricultural system. Finally, the government took steps to eliminate barter transactions and improve oversight over the banking sector, setting the basis for monetization of the economy and increased financial intermediation. Partly as a result of these reforms, Ukraine has recently experienced some of the highest economic growth rates in Europe. Part of this growth was due to favorable external conditions such as high world market prices for key Ukrainian exports, as well as a rebound from a long economic decline.

One consequence of recent high world market prices for some of Ukraine's traditional exports is that Ukraine has been slower to diversify its economy, which is still somewhat dominated by traditional heavy industrial sectors such as metals production and chemicals. Nonetheless, high external demand for Ukraine's key exports has helped Ukraine diversify its trading partners. While Ukraine has in recent years seen rapid growth in a few new industries, such as food processing, further diversification of Ukraine's economy would make it less susceptible to external shocks. Achieving this will require an improved business environment to encourage more domestic and foreign investment. Similarly, an improved business environment would spur more job creation in the small-enterprise sector, which is still rather small compared to some other transition economies, although the number of SMEs has increased significantly in recent years.

To improve the business environment, Ukraine must continue to develop its market-enabling institutions. Ukraine inherited a Soviet-style legal structure which required significant overhauling. While the government has successfully enacted many of the requisite codes and basic laws, there has been significant debate within the central government regarding the best path forward for deepening market reforms. The legal and regulatory system is thus in a constant state of flux. The resulting regulatory environment may be perceived as a moving target, which can be daunting for investors, both domestic and foreign. If it is to sustain high levels of growth, Ukraine needs to better support the development of market-friendly institutions, such as straightforward, consistent, and transparent country-wide rules for licensing a new business. However, the lack of such a stable and mature legal framework is not necessarily indicative of a non-market economy. In the case of Ukraine, the evolving legal system is the result of a lack of institutional knowledge, not attempts by the government to control or direct the economy. While businesses may be impeded from attaining full efficiencies, the market nevertheless allocates resources and sets prices.

The following section discusses each of the six statutory factors used in determining a country's NME status and the current state of Ukraine's economy as it relates to each of those factors.

ANALYSIS OF SECTION 771(18)(B) FACTORS

Factor One. The extent to which the currency of the foreign country is convertible into the currency of other countries.

A country's integration into world markets is dependent upon the convertibility of its currency, which is a prerequisite for a market-based exchange rate. The greater the extent of currency convertibility, for both trade and investment purposes, the greater the supply and demand forces linking domestic market prices in the country to world market prices, and the greater the extent to which the exchange rate is market-based. The stronger this linkage between domestic and world prices, the more market-based domestic prices tend to be.

A. Legal framework

The 1999 *Law on the National Bank of Ukraine* establishes the independence of the Central Bank, *viz.,* National Bank of Ukraine ("NBU") and sets out the NBU's functions.[1] The NBU controls the money supply, oversees commercial bank activities, establishes the foreign exchange ("FOREX") policy, and occasionally intervenes in the FOREX market to smooth out fluctuations in the exchange rate.[2]

The *hryvnia* became Ukraine's official currency in 1996, in accordance with the *Decree On Monetary Reform in Ukraine*.[3] The *hryvnia* is the only currency that may be used for

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[1] *Ukraine: Report on the Observance of Standards and Codes - Fiscal Transparency Module* (Washington, DC: International Monetary Fund, April 2004), p10, citing to Law No. 679- XIV of Ukraine *On the National Bank of Ukraine* (1999) ("Law on the NBU"). The NBU is an economically independent central body of the state administration (See the *Law on the NBU*, Articles 2 and 4). While the NBU council does inform and consult with parliament and the president, the NBU is precluded from taking any action which would undermine the stability of the currency. Both the Law on the NBU and Article 99 of the Constitution state that the main mission of the NBU is to guarantee the stability of the *hryvnia* and the banking system.

[2] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 7.

[3] *Ukraine Law Digest: Currency* (New York and Kiev: Martindale-Hubble International Law Digest, 2005).

domestic transactions between residents, except in certain specific circumstances requiring a license from the NBU.[4] The primary legal act governing currency regulation is *Decree No. 1593 of the Cabinet of Ministers of Ukraine on the System of Currency Regulation and Currency Control* of 1993 (*"Decree On Currency Control")*, which established the regime for currency transactions in both *hryvnia* and foreign currencies and is aimed at preventing the outflow of hard currency.[5]

B. Developments in the economy

Ukraine first assumed IMF Article VIII obligations in 1996, but briefly reimposed current account controls in the wake of the 1998 financial crisis.[6] In March 1999, these restrictions were lifted, making the *hryvnia* fully convertible for current account purposes.[7] Domestic and foreign companies and individuals are free to acquire, hold and sell foreign exchange, and foreign companies are free to repatriate capital and remit profits. The NBU manages the exchange rate to preserve a *de facto* nominal peg against the U.S. dollar, which the NBU accomplishes through interventions in the foreign exchange market.[8] Nonetheless, the exchange rate is subject to market forces, as evidenced by the NBU's adjustment of the currency peg in April of 2005, when it allowed the *hryvnia* to rise against the dollar by about five percent.[9] The NBU's nominal peg of the *hryvnia* to the dollar has resulted in a gradual real appreciation of Ukraine's currency, because inflation in Ukraine, while not rampant, is much higher than in the United States.[10]

Demand for the *hryvnia* is determined by the interbank market, in which all licensed commercial banks can participate. Because banks participating in the market are bound neither in their bid/offer spreads, nor in the interbank participants from whom or to which they can buy

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[4] *Doing Business in Ukraine* (Kiev: Ernst & Young, 2005), p9.

[5] Commercial banks are free to exchange, buy, and sell foreign currency both in Ukraine and abroad, with the appropriate licenses from the NBU. General licenses, granted to virtually all banks, are issued for all currency transactions that do not require a special individual license. The transactions that require special individual licenses are delineated in an exhaustive list in the Decree. For example, individual licenses are required for remittances of foreign cash abroad, foreign investments, deposits of funds in foreign banks and settlements made in foreign currencies in Ukraine. *See Ibid*, pp 9-10.

[6] *Ukraine: 2005 Article IV Consultation– Staff Report* (Washington, DC: International Monetary Fund, November 2005), pp49-50. *See also Annual Report on Exchange Arrangements and Exchange Restrictions* (Washington, DC: International Monetary Fund, 2005), p1001.

[7] *Ukraine: 2005 Article IV Consultation–Staff Report* (Washington, DC: International Monetary Fund, November 2005), pp49-50.

[8] The IMF classifies Ukraine as maintaining a conventional pegged arrangement due to its frequent interventions in the foreign exchange market. *See Ibid,* pp49-50. *See also Annual Report on Exchange Arrangements and Exchange Restrictions* (Washington, DC: International Monetary Fund, 2005), p1001.

[9] *Strategy for Ukraine 2005-2007* (London: European Bank for Reconstruction and Development, 2005), p54.

[10] *Ukraine: 2005 Article IV Consultation–Staff Report* (Washington, DC: International Monetary Fund, November 2005), p8.

or sell, the value of the *hryvnia* in the interbank market is freely set.[11] Effective January 2004, banks are allowed to make forward transactions in so-called "NBU 1 Classifier" currencies, *i.e.,* U.S. dollars, euros, and British pounds.[12] Further, banks may also purchase foreign currencies on the interbank market, even if the purchased currency is unrelated to their clients' transactions.[13] The NBU removed the temporary two percent band around the official exchange rate in March 2005 that was imposed in October 2004 to defend the exchange rate.[14] In a further liberalization of the foreign exchange market in 2005, the NBU lifted the 50 percent surrender requirement for foreign exchange receipts.[15] In September 2005, the NBU amended its regulations to allow banks to both buy and sell foreign currencies on the same day, allowing firms to quickly react to changing market conditions, and ended a prohibition on banks conducting foreign exchange forward transactions, allowing the development of hedging instruments.[16] Although residents and non-residents may open bank accounts in either *hryvnia* or foreign currency, the use of foreign currency accounts for capital account transactions remains limited.[17]

Under the "90-Day Rule," foreign currency proceeds received into Ukraine must be credited to the Ukrainian company's local bank account not later than 90 days from the date of export of the goods.[18] Sanctions for breaches of the 90-day rule are stringent and have been criticized as being overly burdensome.[19] Several other currency controls, however, have been eased recently. In April 2005, the NBU cancelled the controversial Resolution No. 482 of October 2004, which required that foreign investment be brought into Ukraine through the investor's foreign currency accounts in a Ukrainian bank, with subsequent mandatory sale of the foreign currency in the Ukrainian interbank currency market and transfer to the investor's accounts in *hryvnia*.[20]

The convertibility of the *hryvnia* on the capital account is limited. The restrictions on capital account convertibility maintained by Ukraine, however, are due to the developing state of the Ukrainian financial sector and capital markets, and do not serve to isolate the currency from market forces. This can be inferred by the shift in the value of the *hryvnia* that the NBU allowed last year in response to changing economic conditions, and by the fact that the NBU is

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[11] *Annual Report on Exchange Arrangements and Exchange Restrictions* (Washington, DC: International Monetary Fund, 2005), pp1001, 1011.

[12] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 7.

[13] *Ukrainian Odyssey: Economy 2004 and Investment Climate* (Kiev: SigmaBleyzer, 2004), p12.

[14] *Strategy for Ukraine 2005-2007* (London: European Bank for Reconstruction and Development, 2005), pp54-55.

[15] *Id*.

[16] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), p75.

[17] *Doing Business in Ukraine* (Kiev: Ernst & Young, 2005), p11.

[18] *Id.*

[19] *Barriers to Investment in Ukraine* (Kiev: European Business Association, 2005), pp31-33.

[20] *Ukraine Macroeconomic Situation* (Kiev: Sigmableyzer, May 2005), pp1-2.

independent. The NBU is one of the most respected institutions in Ukraine, after having smoothly introduced Ukraine's new currency in the 1990s. The NBU has preserved its independence and core mission despite changes in government and other large policy shifts over the past several years.[21] Furthermore, restrictions on certain capital account transactions are common to many developing market economies that are concerned about capital flight and currency stability.

<u>Assessment of Factor</u>

The *hryvnia* is fully convertible into foreign currencies for trade purposes. There are significant restrictions remaining on capital account transactions, but these are in place to reduce the volatility of the currency and do not isolate the currency from market forces. While the NBU has maintained a nominal peg of the *hryvnia* to the dollar, it adjusts this peg to adapt the currency to changing market conditions. The NBU is also an independent entity, suggesting that remaining capital account restrictions are indeed intended to shield domestic capital markets from excess volatility and not to isolate the currency from market forces. While capital account controls and the NBU's interventions in the foreign exchange market may affect the supply or demand for foreign exchange, the underlying convertibility of the *hryvnia* and the fact that the value of the currency is freely set in the interbank market by independent actors ensures that the exchange rate is fundamentally market-based.

Factor Two. The extent to which wage rates in the foreign country are determined by free bargaining between labor and management.

This factor focuses on the manner in which wages are set because they are an important component of a producer's costs and prices and, in turn, are an important indicator of a country's overall approach to setting prices and costs in the economy. The reference to "free bargaining between labor and management" reflects concerns about the extent to which wages are market-based, *i.e.*, about the existence of a market for labor in which workers and employers are free to bargain over the terms and conditions of employment.

A. Legal framework

Ukraine has a legal framework which establishes the rights and obligations of workers and employers, forming both the basis for free bargaining over wages and other terms and conditions of employment. Labor rights are protected by, *inter alia,* the Constitution, under which every citizen has the freedom to choose freely a profession and place of work, freedom from compulsory work (excepting conscription), and the freedom to strike and belong to unions and employee federations.[22]

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[21] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Macroeconomic Risk,* January 20, 2006.

[22] For example, Article 43 of the Constitution guarantees the right to freely choose employment, be employed and earn not less than minimum wages. Article 44 of the Constitution guarantees citizens the right to strike.

The main principles of Ukrainian labor law are set out in the Labor Code, which governs nearly all aspects of relations between employers and employees, including contracts.[23] Employers must follow statutory requirements regarding work time (limited to 40 hours a week), overtime, and vacation. Employees can choose to terminate their employment at any time subject to two-weeks notice. Employers, however, may terminate only under conditions expressly stated in the Labor Code, *e.g.*, employer liquidation or the employee's absenteeism, and with a notice period of two months.[24]

The 1995 *Law on Remuneration* is the basic law concerning wage development and establishes the right to a minimum wage, as determined by the GOU.[25] Under this law, wages in non-state entities are set through negotiations between the employer and an individual employee via an employment contract or through the employer and a union via collective bargaining.[26] Such wages must equal or exceed the monthly minimum wage. This wage is established annually in the *Law On the State Budget of Ukraine* and must be paid in *hryvnia*.[27] Given that there is a single minimum wage, rather than a set of minimum wages varying by sector and position, the minimum wage does not affect relative wages and so does not distort the relative wage structure in the economy. Technically, non-state sector wages may be subject to indexation according to a tariff rate system, *i.e.,* jobs and associated wages are graded according to complexity and required qualifications. The government sets the wage tariff schedules for SOEs, typically after negotiations between representatives of management, employees, and government.[28]

The *Law of Ukraine On Trade Unions, Their Rights and Guarantees for Activity* (*Trade Unions Law*), passed in 1999, provides for individual rights to join or form unions. The law

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[23] *International Labor and Employment Laws, Volume II Ukraine* (Washington, DC: International Labor Law Committee, American Bar Association, 2001), p5. The Labor code is implemented together with other labor laws and regulations, including: the 1993 Law on Collective Contracts and Agreements and the 1995 Law on Wages. See *Ukraine Law Digest: Labor Relations* (New York and Kiev: Martindale-Hubble International Law Digest, 2005).

[24] *Doing Business and Investing in Ukraine* (Kiev: PriceWaterhouseCoopers, 2005), p43. See also *International Labor and Employment Laws, Volume II Ukraine* (Washington, DC: International Labor Law Committee, American Bar Association, 2001), pp14, 20-21, 18.

[25] Law No. 108/95 of *On Remuneration* (1995), as amended. Article 8 of the Law *On Remuneration* requires that the state fix minimum wages for all enterprises, regardless of ownership.

[26] Under the *Labor Code*, all employers should conclude collective agreements via negotiations. See *Conducting Business in Ukraine* (Kiev: Baker & McKenzie, 2005), p54. Under Article 15 of the *Law On Remuneration*, enterprises can determine individually forms and systems of labor remuneration, labor norms, tariffs, job rates, scale of position wages, and terms of payment "in compliance with the Ukrainian legislation, general and regional agreements."

[27] *A Chronicle of Recent Developments in Ukrainian Legislation* (Kiev and Washington, DC: Russian-Ukrainian Legal Group, P.A., March 2005), referring to Law No. 2505-IV *On Incorporating Amendments into the Law On the State Budget of Ukraine in 2005,* (2005).

[28] For example, article 8 of Law No. 108/95 of *On Remuneration* (1995), as amended, states that the state shall establish wages for workers in "establishments and organizations financed from the budget as well as executive officers of state-owned enterprises."

defines unions as "legally independent associations with the right to fully represent the interests of their members," and governs the establishment, suspension, and termination of trade unions.[29]

Under the former *propyska* system, each citizen was required to maintain an internal passport with a stamp from the local authorities, certifying that person's right to live and work in a given region and reside in a given domicile. This acted as a constraint on freedom of movement as well as on the supply dynamics of the labor market. Until November 2001, individuals were still required to register at their workplace and place of residence in order to be eligible for social benefits. Access to certain benefits was limited to the place where one was registered. The *Law on Freedom of Movement* was passed in December 2003 and introduced a new registration system permitting every citizen to live, work and receive services anywhere in the country.[30]

B. Developments in the economy

Public sector wages, including at SOEs, are ultimately set by the government, which is also common in market economies. Moreover, the government sets these wages only after tripartite negotiations consultations among government, unions, and employers, indicating that supply and demand forces play a role in public sector wage formation.[31] As discussed above, there are laws that still allow for indexation of private sector wages to that of comparable public sector employment, but in practice, private sector wages are determined on the basis of individual or collective bargaining between labor and management, with commentators noting that Ukrainian labor legislation "provides significant discretion (to the private parties) with regards to compensation levels," so that the relative wage structure is a function of supply and demand.[32]

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[29] *International Labor and Employment Laws, Volume II Ukraine* (Washington, DC: International Labor Law Committee, American Bar Association, 2001), p25; citing to Law No. 1045-XIV of Ukraine *On Trade Union, Their Rights and Guarantee of Activities*, (1999). The Constitution provides for the right of most workers to join trade unions and no government permission is required to establish a trade union. These rights were generally respected in practice. Changes adopted in 2003 to the Trade Unions Law granted unions the status of "legal entities," requiring only that they supply a "notification of registration" as opposed to requiring approval from the Ministry of Justice ("MOJ") to be established. The MOJ could not deny any applications. However, the new 2004 *Civil Code* reinstates the requirement that all legal entities, including trade unions, must register. The MOJ may deny registration if the union does not meet the requirements. See *2004 Country Report on Human Rights Practices*: *Ukraine* (Washington, DC: Department of State, 2005), section 6a. However, the report does not describe systematic abuse of the right to deny registration to unions. The report notes, however, that: "Interference with freedom of association increased significantly in the campaign period before the October 31 presidential election and the November 21 runoff." The example provided in the report points to the problem of corruption discussed in Factor 6, rather than being indicative of the government's intention to interfere with the development of market-based wages.

[30] *2004 Country Report on Human Rights Practices*: *Ukraine* (Washington, DC: Department of State, 2005), section 2d.

[31] See Law No. 108/95 of *On Remuneration* (1995), articles 5, 8, and 13.

[32] *Doing Business in Ukraine* (Kiev: Ernst & Young, 2005), p37. See also *Investment in Ukraine* (Kiev: KPMG, 2005), p35, stating that "[s]alaries of employees are determined in accordance with the employment contract."

The private sector makes up the bulk of all employment in Ukraine, accounting for 67.3 percent of employment in 2004.[33] As described above, workers are free to choose their employment. Because of this freedom, along with the fact that public sector wages are formed after tripartite bargaining, wages in the public sector are also subject to market forces. If wages in the public sector were not competitive with the market-based wages prevailing in the private sector, making due allowance for the terms and conditions of employment and workers' relative skill and age, employment would be shifting into the private sector.

Like many countries in the former Soviet Union, Ukraine's labor market is heavily regulated, with the labor code providing strict employment protection, imposing rigidities on the labor market, at least for those firms that completely follow the law.[34] These regulations, however, are not strictly enforced.[35] As a result, serious labor law abuses may go undetected while scrupulous employers find it difficult to adhere to the law. Alternatively, firms may operate informally, outside the law altogether. A large percentage of Ukraine's workforce is employed in the informal sector, with estimates placing informal sector employment at over 40 percent of total employment in the late 1990s.[36] The result of the combination of rigid labor laws and weak enforcement is an inefficient labor market, but one that still follows market principles.

While the mere fact that wages are rising does not necessarily indicate that wages have become market-based, it does suggest that wages are sensitive to external conditions, and wages in Ukraine have increased markedly over the past several years in line with Ukraine's impressive economic growth.[37] While wages still remain low overall compared to regional averages, they do vary across sectors, skill levels, geographic region, and company type (*e.g.*, foreign-invested enterprises versus domestic), indicating that supply and demand forces are at work in the labor market.[38] Wage variations to a large extent reflect the relative bargaining power of various groups of workers (*e.g.*, skilled vs. unskilled, workers living near economic growth centers vs. those living in more remote locations). Despite government involvement in wage-setting in the state-owned sector, average wages in sectors with substantial state ownership (*e.g.,* extractive industries, such as coal mining) are neither high nor have they been rising faster than in sectors dominated by the private sector, such as finance. While foreign investors may meet resistance

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[33] *Ukraine: Statistical Appendix* (Washington, DC: International Monetary Fund, November 2005), p14. Note that a recent World Bank report estimate the private sector share of employment to be only around 40 percent. *See Report No. 32721-UA Ukraine Jobs Study: Fostering Productivity and Job Creation* (Washington, DC: World Bank, 2005), pp6-7. The explanation for this discrepancy appears to be that two studies define the term "private sector" differently. In particular, the IMF *Statistical Appendix* now includes "collective and cooperative sector" employment as being part of the private sector, whereas the World Bank focuses on *de novo* private firms.

[34] *Enhancing Job Opportunities* (Washington, DC: World Bank, 2005), pp51, 215.

[35] *Ibid*, p215.

[36] *Ibid*, p94.

[37] *Ukraine: Statistical Appendix* (Washington, DC: International Monetary Fund, November 2005), pp17-18.

[38] *Id. See also Enhancing Job Opportunities* (Washington, DC: World Bank, 2005), p149. *See also the Economist Intelligence Unit, Risk Briefing, Ukraine: Labour Market Risk*, January 20, 2006.

when reducing employment to an efficient level, absolute demands to maintain employment are fading.[39]

Ukraine has ratified all eight International Labor Organization ("ILO") core labor conventions.[40] Freedom of movement is guaranteed by law. As in many transition economies, labor mobility is limited, not because of government policy (see the discussion in the legal section above), but because of transport, housing, and infrastructure constraints.

A substantial portion of the workforce is unionized, but these workers are at present mostly in the public sector, where strikes are frequent.[41] Unions have been active in eliminating wage arrears, which were common in the 1990s but have been greatly reduced.[42]

Assessment of Factor

Wage rates are market-based. Workers are free to choose their place of employment, labor mobility is not limited by law, and workers may form unions that are independent of the government. Wages in the private sector are formed as the result of individual or collective bargaining, and most employment in Ukraine is now in the private sector. Private sector employers are free to choose the size and composition of their labor forces. Public sector wages are formed after negotiations among labor, management, and the government. Both private and public sector employment wage formation reflects bargaining between workers who are free to choose their place and type of employment. Furthermore, the variation of wages across sectors and the high mobility of the highly skilled suggest that wages are market-based. Wage arrears have been a significant problem in the past, but were largely a phenomenon of the crisis period of the 1990s and today are largely confined to a few money-losing state sectors.

Factor Three. The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country.

Opening an economy to FDI tends to expose domestic industry to competition from profit-maximizing market-based suppliers, and to the management, production and sales practices that they bring. It also tends to limit the scope and extent of government control over business operations, since foreign investors, as a general rule, demand a certain degree of autonomous control over their investments.

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[39] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

[40] *Strategy for Ukraine 2005-2007* (London: European Bank for Reconstruction and Development, 2005), p15.

[41] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Labour Market Risk,* January 20, 2006. *See also Enhancing Job Opportunities* (Washington, DC: World Bank, 2005), p197.

[42] *President Orders Ukrainian Coal Industry Reform, Aims for Privatization* (London: World Markets Research Center, August 26, 2005). *See also Ukraine: Statistical Appendix* (Washington, DC: International Monetary Fund, November 2005), p22.

A. Legal framework

Following the repeal of the Soviet-era *Economic* and *Civil Codes*, all business activity in Ukraine, whether based on foreign or domestic investment, is now governed by the new *Civil Code* and the *Commercial Code*, both of which took effect January 2004.[43]

The 1996 *Law on the Regime of Foreign Investment* (the *Foreign Investment Law)* establishes the specific rules for treatment of foreign economic interests in Ukraine. The law treats foreign investment in the vast majority of sectors equally, and it provides guarantees on stability of the legal regime, non-expropriation, freedom to utilize profits made in Ukraine, and currency convertibility.[44] The law also provides for access to international arbitration and protection against unlawful acts of government agencies and officials. Foreign and private domestic entities have the same right to establish and own business enterprises in Ukraine and to engage in all forms of remunerative activity. Private individuals can freely buy and sell interests in business enterprises. Foreign investors may choose any type of business, including joint venture and wholly-owned. Foreign investment is allowed in any activity not prohibited by law (discussed below) and in line with the company's articles of association. Foreign investors are guaranteed the right of "unhindered transfer" of profits, revenues, and other proceeds in foreign currency after taxes.[45] There are no performance requirements imposed on foreign investors other than those clearly spelled out in privatizations conducted via open tender.[46] The *Foreign Investment Law* also provides for protection against changes in legislation. However, commentators have noted that this protection has been narrowly interpreted to provide such protections only in regards to nationalization and expropriation.[47] By law, foreign investment is restricted to minority shares in certain industrial sectors, including telecommunications, publishing, insurance, broadcasting, alcohol, and armaments.[48]

Foreign investments must be registered with the appropriate state authorities, following procedures established by the 1996 resolution of the Cabinet of Ministers *On the Procedure for the State Registration of Foreign Investment*. Registration can be refused only if documentation is incomplete or if the investment conflicts with existing legislation, such as environmental

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[43] These Codes are described in Factor 5 below in the sub-section on entrepreneurship.

[44] *Conducting Business in Ukraine* (Kiev: Baker & McKenzie, 2005), pp14-15.

[45] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 6. Note that NBU Resolution 482 has been repealed. See FN20 *supra*.

[46] *Id*.

[47] *Conducting Business in Ukraine* (Kiev: Baker & McKenzie, 2002), p14.

[48] *Doing Business in Ukraine* (Kiev: Ernst & Young, 2005), p16. *See Also The Economist Intelligence Unit, Risk Briefing, Ukraine: Legal and Regulatory Risk,* January 20, 2005.

standards. The authorities, therefore, do not have the legal discretion to issue unjustified non-transparent registration refusals, and denials may be challenged in court.[49]

Licenses and permits are required for all business activities in certain sectors, whether foreign- or domestically-invested. The Law *On Licensing for Determined Business Activities* applies to all economic entities and specifies the types of economic activity subject to licensing requirements.[50] This includes general licenses in sectors, which are often subject to government regulation in market economies in the interest of consumer protection. However, commentators have noted that the legal system in Ukraine, including the procedures for registration or obtaining licenses and permits, is opaque and overly complicated.[51]

Although complex registration and licensing procedures, together with generally weak of rule of law, are significant weaknesses in Ukraine's legal framework for FDI, licensing and registration procedures exist to some degree in all economies. Burdensome and complex licensing procedures act to increase transaction costs, however. For example, the *Law On Licensing of Certain Kinds of Business Activity* lists the myriad of government agencies involved in the licencing process, dependent on the area of business.[52] Complex licensing procedures also increases opportunity for administrative corruption, leading more businesses into the shadow economy. For foreign investors, these high transaction costs could act as a barrier to market entry.

The GOU is taking action to streamline licensing and registration procedures for both foreign and domestic market actors. For example, the July 2004 *Law On State Registration of Legal Entities and Natural Persons Engaged in Entrepreneurial Activity* replaces the business registration procedures with a new "one-stop-shop" government registration procedure. Commentators have noted that full implementation has been impeded by a lack of institutional capacity.[53] However, a network of bilateral investment protection treaties helps to remedy

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[49] *Conducting Business in Ukraine* (Kiev: Baker & McKenzie, 2005), p16, citing to the Resolution of Ukraine *On the Regulation on the Procedure for the State Registration of Foreign Investment* (1996).

[50] *Ukraine: Report on the Observance of Standards and Codes - Fiscal Transparency Model* (Washington, DC: International Monetary Fund, April 2004), pp9-10, citing to Law No. 1775-III of Ukraine (2000). *Ukraine Law Digest: Licenses, Business and Professional* (Kiev: MartindaleHubble International Law Digest, 2005). This includes general licenses in sectors such as mining, pharmaceuticals, transportation and provision of securities and banknotes; NBU licenses for banking activity, as described above in factor one; licensing of certain financial services activity such as insurance and the provision of securities and banknotes; permits for retail trade, foreign currency exchange and gambling enterprises; licenses for import and export of goods, work and services; licenses for enterprises in the power and nuclear energy sector; licenses for protection of intellectual property; specific licenses for activities in the field of education; licensing of manufacturing of and trade in alcohol and tobacco; and licenses for the use of broadcasting channels.

[51] For example, see *Doing Business in Ukraine* (Kiev: Ernst &Young, 2005), p16.

[52] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 3.

[53] *Barriers to Investment in Ukraine* (Kiev: European Business Association, 2005), p7, which notes, "...in practice the procedure of 'one window registration' does not work at the moment due to lack of organizational and technical capabilities of the bodies performing such registration. Moreover, practical implementation of the registration procedure created additional difficulties and inconveniences for the companies/individuals seeking registration. Nevertheless, we hope that the current

limitations in the rule of law that might otherwise lead foreign investors to shy away from Ukraine.[54]

B. Developments in the economy

Ukraine is open to FDI in virtually all sectors of the economy, except that foreign ownership is limited to a minority stake in alcohol, armaments, insurance, publishing, telecommunications, and broadcasting.[55] Nevertheless, because of Ukraine's difficult and high-risk business environment, foreign investors in Ukraine have concentrated on areas that offer a quick return on their investment, such as food processing and retail.[56] This has been changing in recent years, however. In 2005, Austria's Raiffeisen Bank completed its acquisition of Aval, Ukraine's second largest bank, and another sale of a large Ukrainian bank is pending.[57] In October 2005, the Kryvorizhstal steel company was sold to foreign investors.[58]

While Ukraine is open to FDI in most sectors, Ukraine's difficult business environment has resulted in per capita FDI levels that are still low, but increasing. The biggest obstacle to increased FDI has been Ukraine's weak rule of law, which can partially undermine the guarantees afforded to foreign investors under law. This rule of law problem is compounded by Ukraine's costly and burdensome regulatory regime and a large number of taxes, as has been documented by the World Bank.[59] The sheer number of procedures, licenses, and taxes that must be paid to establish and run a business in Ukraine dissuades investment, offers many opportunities for corruption, and affords locals with insider knowledge an upper hand.

Despite the difficulties of the business environment, FDI inflows are growing. Ukraine has several advantages that are attractive to foreign investors. Wages are low, education levels are high, the domestic market is large, and the country is positioned just outside the enlarged European Union. Ukraine has recently seen increases in FDI and is set to expand on these gains further. FDI inflows into Ukraine increased from 2 percent of GDP in 2001 to 2.8 percent of

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situation with regard to registration will take a favorable turn in the near future (this issue is in the area of implementation of the law)."

[54] Such treaties have been entered into with over 40 countries, including the United Stated. *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2004), Chapter 6.

[55] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Legal and Regulatory Risk*, January 20, 2006.

[56] *Ukraine Odyssey: Economy 2004 and Investment Climate* (Kiev: SigmaBleyzer, 2004), p17.

[57] Wagstyl, Steven, *Rush of Deals Dispels Worries* (London: Financial Times, November 8, 2005), p30.

[58] *The Economist Intelligence Unit, Business Eastern Europe: Mittal Europa*, October 31, 2005.

[59] *Doing Business in 2006* (Washington, DC: The World Bank and International Finance Corporation, 2006) pp11, 157.

GDP in 2003 to a projected 4.7 percent of GDP in 2005.[60] In dollar terms, these inflows were about $770 million in 2001, $1,412 million in 2003, and a projected $3,867 million in 2005, which reflects, in part, the sale of Kryvorizhstal to foreign investors. Prior to the Kryvorizhstal sale, foreign investment had been concentrated in the trade, food processing, and financial sectors.[61] This sale of Kryvorizhstal to foreign investors for an unexpectedly large price, along with the foreign acquisition of the second-largest bank in Ukraine, signals improved confidence in Ukraine's investment environment.[62] The fact that investment into Ukraine is now diversifying also shows that more market integration is occurring, *i.e.*, that more sectors in Ukraine will reap the efficiency gains of greater competition, international practices, and foreign technical expertise.

<u>Assessment of Factor</u>

Ukraine permits all forms of foreign investment, *e.g.*, joint ventures and wholly-owned companies, in most sectors of the economy. Foreign investors are free to repatriate profits and capital and are protected from nationalization or expropriation. Serious problems persist with burdensome regulations. However, this is more indicative of transitional problems than any effort by the government to direct or control investment. Despite these ongoing problems, foreign investors are growing more confident in the economic prospects in Ukraine, as demonstrated by the increasing FDI inflows into Ukraine in recent years.

Factor Four. The extent of government ownership or control of the means of production.

The right to own property is fundamental to the operation of a market economy, and the scope and extent of private sector involvement in the economy often is an indicator of the extent to which the economy is market-driven. The two main areas of concern under this factor are the extent of enterprise privatization and of land ownership.

1. The extent and pace of privatization of enterprises

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60 *Staff Report for the 2005 Article IV Consultation: Supplementary Information*, (Washington, DC: International Monetary Fund, November 4, 2005), p4.

61 *The Economist Intelligence Unit, Risk Briefing, Ukraine: Foreign Trade and Payments Risk*, January 20, 2006.

62 *Staff Report for the 2005 Article IV Consultation: Supplementary Information* (Washington, DC: International Monetary Fund, November 4, 2005), p2. *See also* Wagstyl, Steven, *Rush of Deals Dispels Worries* (London: Financial Times, November 8, 2005), p30.

A. Legal framework

The 1992 *Law On the Privatization of State Property* provides for the privatization of large enterprises through the use of, *e.g.*, buy-outs, vouchers, auctions.[63] Privatization of small enterprises is governed by the 1992 *Law on Privatization of Small State-Owned Enterprises*, which allows for sale of the entire enterprise to one buyer.[64]

Under the *Law On the Privatization of State Property*, SOEs of "national importance" will not be privatized, which is defined as "essential for the maintenance of Ukraine's sovereignty and the performance of basic State functions, defense and national security, health and the environment, public utilities, or objects considered important for the social development of Ukraine." "National importance" therefore is not defined so broadly as to explicitly include industrial policy objectives.[65]

B. Developments in the economy

Ukraine had a late start on large-scale privatization compared with many other countries. In the 1990s, the government never fully committed to a complete reorientation of the economy, preferring to pursue mostly small-scale privatization and the sales of minority stakes in larger enterprises to preserve state control.[66] Over the past several years, however, privatization efforts in Ukraine have intensified, even if sales of larger assets were not always conducted in a transparent manner.[67] Accordingly, privatization progressed to the point where the private sector accounted for at least 65 percent of GDP in 2004.[68] After much delay, the telecommunications market is to be opened through the partial privatization of Ukrtelecom, which is set for 2006.[69]

The State Property Fund ("SPF") has guided privatization efforts in Ukraine since 1992 and initially attempted mass privatization through widespread distribution of "privatization property certificates," ("PPCs"), although progress on privatization had been fairly slow until recent years.[70] In response to a governmental desire to raise more revenue and shift towards

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[63] *Ukraine Law Digest: Privatization* (New York and Kiev: Martindale-Hubble International Law Digest, 2005). See also *Investment in Ukraine* (Kiev: KPMG, 2005), p17.

[64] *Ukraine Law Digest: Privatization* (New York and Kiev: Martindale-Hubble International Law Digest, 2005).

[65] *Investment in Ukraine* (Kiev: KPMG, 2005), p17.

[66] *The Economist Intelligence Unit, Country Profile 2005: Ukraine* (London: Economist Intelligence Unit, 2005), pp31, 33.

[67] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Macroeconomic Risk*, January 20, 2006.

[68] *Transition Report 2005, Economic Transition in Central and Eastern Europe and the CIS* (London: European Bank for Reconstruction and Development, 2005), p196.

[69] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Infrastructure Risk,* January 20, 2006.

[70] *Doing Business and Investing in Ukraine* (Kiev: PriceWaterhouseCoopers, 2005), p10.

case-by-case privatization, the SPF developed the *Law On Privatisation Program for 2000-2002,* which ended mass privatization via PPCs and laid out a plan for privatizing large industrial enterprises during that time period.[71] Further privatization over the past few years has continued under this legislative framework.[72]

The pace of privatization has increased dramatically in recent years, as the largest state-owned firms, most recently Kryvorizhstal, have been sold off.[73] In 2002, privatization proceeds amounted to only 0.5 percent of GDP, but exceeded 1 percent of GDP in 2003, 3 percent of GDP in 2004, and 5 percent of GDP in 2005, an especially large increase given the rapid growth in GDP over the past several years.[74] By early 2005, the state had given up majority ownership in 90 percent of the industrial enterprises it owned in 1991, although in some cases the state still has the capacity to exert influence through minority stakes.[75] Several more large SOEs are scheduled for privatization in 2006.[76]

In the past, some firms were privatized in a non-transparent manner. In a controversial move, the government, led by former Prime Minister Tymoshenko, acted to nullify several recent privatizations, after determining that these sales were conducted illegally, notably that of the Kryvorizhstal steel mill. This firm, which was originally sold to domestic Ukrainian investors for $800 million in 2004, was re-sold to international investors in October 2005 for $4.8 billion.[77] This "re-privatization" was conducted transparently, and the previous owners were refunded the money with which they had purchased the firm a year earlier.

One of the major complaints of both foreign and domestic investors in 2005 concerned the uncertainty about the extent to which past privatizations would be revisited for potential "re-privatization." This uncertainty about property rights contributed to a general slowdown of foreign and domestic investment in the first half of 2005, as businesses waited to see how the new government would handle this controversial issue. Encouragingly, in September, the government pledged to limit the process of "re-privatization" to two firms, Kryvorizhstal and one other firm, Nikopol Ferroalloys.[78]

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[71] *Id.*

[72] *Id.*

[73] Note that Kryvorizhstal was originally privatized in 2004, but was briefly returned to state control in 2004 in advance of a repeat privatization in October 2005.

[74] *Staff Report for the 2005 Article IV Consultation: Supplementary Information* (Washington, DC: International Monetary Fund, November 4, 2005), p4.

[75] *Doing Business and Investing in Ukraine* (Kiev: PriceWaterhouseCoopers, 2005), p11.

[76] *Ukraine Macroeconomic Situation* (Kiev: Sigmableyzer, November 2005), p2.

[77] *The Economist Intelligence Unit, Business Eastern Europe: Mittal Europa*, October 31, 2005.

[78] *The Economist Intelligence Unit, Country Briefing: Ukraine Economy: Calling a Halt to Re-Privatization*, September 30, 2005.

2. Land Ownership

A. Legal framework

Article 41 of the Constitution guarantees the right to private ownership, including the right to own land. The 1991 *Law on Ownership* also recognizes the right to own private property, and permits the use of (including the right to realize revenues from) real and other property for commercial purposes.[79] The *Law on Ownership* was followed by the 1992 *Land Code*. However, under the 1992 Land Code, land could not be purchased for commercial purposes and legal entities were only allowed to use land, not own it.[80] Both laws failed to establish a comprehensive regime for the transfer and pledging of property.[81] Ukraine's parliament, the Rada, adopted a new *Land Code* on October 25, 2001, which entered into force on January 1, 2005. The 2001 *Land Code* gives a detailed description of real property rights and obligations, including a definition of land as a commodity which may be sold, purchased, exchanged, donated or pledged.[82]

The 2001 *Land Code* grants foreign citizens and foreign legal entities the right to buy and sell certain non-agricultural land, but explicitly prohibits them from owning agricultural land. The GOU has also promulgated laws in an attempt to ensure an equitable and orderly transition from collective to private land ownership. For example, under the 2001 *Land Code*, the sale and gifts of agricultural land were prohibited until 2005 and individual and enterprises cannot acquire rights to more than 100 hectares of agricultural land until 2010. The *Law On the Amendment of the Land Code of Ukraine, No.* 2059-IV, adopted on November 18, 2004, extended these deadlines to 2007 and 2015, respectively.[83]

The *Law On Mortgages* was adopted in June 2003 and came into effect in 2004, although implementation may take several years and mortgage lending remains rare.[84] Currently, only non-agricultural land may be used as collateral. Agricultural land may be used as collateral when the moratorium on alienation of agricultural land sales described above is lifted.[85]

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[79] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

[80] *Ukraine Law Digest: Land (*Kiev: Martindale-Hubble International Law Digest, 2005).

[81] *Conducting Business in Ukraine (*Kiev: Baker & McKenzie, 2005), p38.

[82] *Ukraine Law Digest: Land* (Kiev: Martindale-Hubble International Law Digest, 2005).

[83] *Legal Alert: Real Estate & Construction* (Kiev: Baker & McKenzie, December 2004), www.bakernet.com.

[84] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 6. *See also Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005), p56, stating that mortgage lending comprises only 6 percent of bank assets, with 75 percent of such loans concentrated in Kiev.

[85] *The Economist Intelligence Unit, Country Profile 2005: Ukraine* (London: Economist Intelligence Unit, 2005), p40.

B. Developments in the economy

Most agricultural land was still tied up in collective farms until 2000, when they were finally broken up into private farms. This helped to substantially increase grain harvests in subsequent years.[86] This demonstrated a fundamental commitment on the part of Ukraine to private ownership of land. Nevertheless, while this reform allowed for the emergence of a market for leased agricultural land, the moratorium on the sale of agricultural land (discussed above) means that it is still not possible to use land as collateral for loans. In addition, while Ukraine's land ownership reforms successfully placed most land in private hands, foreigners are explicitly forbidden from owning agricultural land (*see* above). Such a restriction is not unknown in market economies, however. They are sometimes temporary in nature and reflect restitution concerns in a transition period and can also be motivated by longer-standing concerns about sovereignty and national security.

In addition, while this reform successfully placed most land in Ukraine in private hands, the distribution of official titles to the land is not complete, as only about half of all landowners have received title to their property.[87] Land titling appears to have progressed further for agricultural land, with two-thirds of titles having been distributed as of 2004, but the benefit of secure title is partially undermined by the moratorium on the sale of agricultural land.[88]

Despite the adoption of recent legislation, the legal framework for registration of ownership rights in land is incomplete, unclear and cumbersome.[89] For example, one continuing issue with land titling is the existence of multiple land registration databases.[90] The GOU has identified titling as a necessary component of an efficient land market and is working with international partners to continue to improve its registration systems.[91] Commentators have also noted that the adoption of a *Law on the Land Market* and the cancellation of land transfer moratoriums referred to above are necessary preconditions for a functioning land-transfer mechanism in Ukraine.[92]

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[86] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Macroeconomic Risk,* January 20, 2006.

[87] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 6.

[88] *Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005), p56.

[89] *Barriers to Investment in Ukraine* (Kiev: European Business Association, 2005), pp10-11.

[90] *Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005), p56.

[91] Examples include the Rural Land Titling and Cadastre Development project sponsored by the World Bank and the Ukraine Land Titling Initiative (ULTI) Project sponsored by the US Agency for International Development. *See*, *e.g.*, *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 6. *See also Strategy for Ukraine 2005-2007* (London: European Bank for Reconstruction and Development, 2005), p 45.

[92] *Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005), p56.

<u>Assessment of factor</u>

Despite its slow start and recent turmoil over some of the privatization practices of the previous government, Ukraine's privatization program has advanced rapidly over the past several years. The GOU does maintain ownership in certain sectors, such as the coal industry, energy distribution, and the defense sector, but these sectors are either generally unprofitable and thus unattractive candidates for privatization or are in sectors that many market economy countries are likewise reluctant to privatize. Land privatization is largely complete, although the titling system is underdeveloped.

Factor Five. The extent of government control over the allocation of resources and over the price and output decisions of enterprises.

Decentralized economic decision-making is a hallmark of market economies, where the independent investment, input-sourcing, output and pricing actions of individuals and firms in pursuit of private gain collectively ensure that economic resources are allocated to their best (most efficient) use. Prices in such economies tend to reflect both demand conditions and the relative scarcity of the resources used in production.

An important measure of government control over production decisions and the allocation of resources is the degree to which the government is involved in the allocation of capital. Given that banks are important allocators of capital, the degree to which the state exercises control over the commercial banking sector is an important consideration.

For purposes of this factor, the four main issues are: (1) the extent of price liberalization, (2) arrears, (3) the status of commercial banking reform, and (4) the degree to which individuals and businesses can engage in entrepreneurial activities.

1. The extent of price liberalization

A. Legal framework

The 1991 *Law on Prices and Pricing* liberalized essentially all prices, limiting price controls to certain consumer goods and services (mainly food staples and other necessities).[93] Prices and tariffs for products and services which are still subject to state regulation include certain food stuffs such as sugar and grain and services or products of natural monopolies (tariffs for public utilities and electric energy for individual consumption; prices for fuel and energy resources for individual consumption; tariffs for transportation).[94] Such limited price controls are not uncommon in market economies to achieve social welfare objectives. The 2004 *Commercial Code*, discussed below, states that products shall be sold at prices determined on a market basis on a per-sale or a contractual basis; price controls will only be applied in cases specified by legislative acts.[95]

B. Developments in the economy

The great majority of prices in Ukraine have been liberalized except for basic food staples, and there are no price controls on goods produced by foreign-invested enterprises.[96] The present government briefly introduced additional price caps on fuel early in 2005 to combat alleged price collusion, but they were soon repealed.[97] Overall, observers at the EBRD classify Ukraine as having achieved comprehensive price liberalization and as having largely phased out state procurement at non-market prices.[98]

The energy sector has been successful in raising its prices towards cost-recovery levels and in improving its collection rate. Cash payment collections in the gas and electricity sectors rose from 49.2 percent and 58.1 percent in 2000 to 95.2 percent and 94.6 percent in 2004,

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[93] Law No. 507-XII of Ukraine *On Prices and Pricing* (1991).

[94] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2005), Chapter 3.

[95] Law No. 436-IV of Ukraine, 16 January 2003. For example, see Article 44 which states that entrepreneurship shall be conducted on the basis of: ...independent development by the entrepreneur ...fixing of prices for products and services in compliance with the law. See also Article 107 (2), stating that "the production cooperative shall sell its products, provide services for prices and tariffs, determined by the cooperative independently or on the contractual basis, and in cases envisaged by the law – for state-fixed prices and tariffs." Article 192 (1), Legislation on Prices and Pricing, states that Pricing policy, procedures for price setting and application, powers of state authorities and local governments with regard to pricing and price regulation, as well as price control, shall be established by the law on prices and pricing and other legislative acts.

[96] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Legal and Regulatory Risk,* January 20, 2006. *See also Transition Report 2005, Economic Transition in Central and Eastern Europe and the CIS* (London: European Bank for Reconstruction and Development, 2005), p196.

[97] *The Economist Intelligence Unit, Country Report July 2005: Ukraine* (London: Economist Intelligence Unit, 2005) p19.

[98] *Transition Report 2005, Economic Transition in Central and Eastern Europe and the CIS* (London: European Bank for Reconstruction and Development, 2005), p196.

respectively, the latest year for which definitive, expert third-party sources are available.[99] This markedly improved payment discipline has occurred during a time of rising gas and electricity prices, which reached about $51/tcm for gas and 3.3 cents per kWh for electricity in 2004.[100] The 3.3 cent per kWh average price in 2004 compares with a World Bank estimate of an electricity price of 3.9 cents per kWh that would cover both short-term costs and long-run investment. For natural gas, the $51/tcm in 2004 is an estimate of average domestic Ukrainian gas prices. This compares with the $50-$54/tcm price under which Russian and Turkmenistan agreed to supply Ukraine with natural gas.[101] Particularly given that there are additional costs in downstream energy distribution, the average prices charged in Ukraine for energy in 2004 do not appear to have reached a full long-term cost recovery level. However, the average price figures conceal differences between the low regulated prices charged to households and the higher prices charged to industry. Taking into account the higher prices charged to industrial consumers, the subsidy aspect of low average energy prices in Ukraine appears to only benefit households, which is an understandable (if economically inefficient) response to social welfare concerns. For industrial consumers, which as wholesale consumers tend to be cheaper to supply, energy prices appear to be close to cost recovery levels. In a further sign that the energy prices to industry are sensitive to market conditions, Ukraine is expected to pass on to its industrial consumers the full cost of the recent doubling of the price of its gas supplies.[102]

2. The level of arrears in the economy

A. Legal Framework

Systemic business arrears are a concern because they distort the allocation of resources, ensuring that loss-making firms stay in business and absorb resources that would otherwise go to more productive uses. They also distort the price system by weakening the budget constraints that firms face. Hence, effective insolvency provisions are important to the functioning of a market economy by imposing hard budget constraints on enterprises.

The 1992 *Law on Bankruptcy* helped lead to the creation of a widespread non-payments culture, in which arrears rapidly accumulated. The GOU sought to rectify the deficiencies in the 1992 law by implementing a new bankruptcy law in 2000, which among other things, permits debtors to initiate bankruptcy and reorganization procedures.[103] While the new *Law On Restoring Debtor's Solvency & Declaring a Debtor Bankrupt* does speed up the process of

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[99] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, January 2005), p6.

[100] *Id.*

[101] *Ibid,* p7.

[102] *The Economist Intelligence Unit, Risk Briefing, Alert - Companies may struggle to meet raised gas bill,* January 25, 2006.

[103] *Ukrainian Odyssey: Economy 2004 and Investment Climate* (Kiev: SigmaBleyzer, 2004), p29. *Barriers to Investment in Ukraine* (Kiev: European Business Association, 2005), p13.

declaring bankruptcy, commentators have also noted that it is quite weak and provides "virtually no measurable reorganization provisions."[104] The Rada passed amendments to the 2000 law in March 2002 that increased protections of creditors' rights but commentators still point to weaknesses in the overall framework for insolvency.[105] Nonetheless, Ukraine's continuing weaknesses in the legal framework for insolvency are shared to some extent by other market economies.[106]

B. Developments in the Economy

Inter-enterprise arrears in Ukraine were once pervasive throughout the economy but have been reduced dramatically in recent years, and are now largely limited (as a much smaller share of the economy) to unpaid debts to the energy sector.[107] Despite the continued absence of the threat of liquidation that an effective bankruptcy law provides, but aided by a strong economic recovery, the total stock of arrears declined as a percentage of GDP from 51.4 percent in 2002 to 39.6 percent in 2003 to 25.2 percent in 2004.[108] While still high, the fact that the stock of arrears has been reduced so quickly suggests that the previous widespread accumulation of arrears throughout the economy was a symptom of Ukraine's economic crises in the 1990s and that the culture of non-payment has been largely eliminated. Wage arrears were also once a serious problem in Ukraine, but they, too, have been largely eliminated.[109]

3. The status of commercial banking reform

A. Legal framework

An important measure of government control over resource allocations is the degree to which the government allocates capital/credit. Since banks typically are the primary allocators of capital, particularly in a country like Ukraine where the capital markets are underdeveloped, it is important to look at the extent to which the government controls the banks or directs bank lending.

Under the *Law on the National Bank of Ukraine*, Ukraine operates a standard two-tier banking sector: an independent central bank (the NBU), and commercial banks.[110] The NBU

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[104] *Strategy for Ukraine 2005-2007* (London: European Bank for Reconstruction and Development, 2005), pp61-62.

[105] *Barriers to Investment in Ukraine* (Kiev: European Business Association, 2005), pp13-15.

[106] Law in Transition 2005: Courts and Judges (London: European Bank for Reconstruction and Development, 2005), pp5-14.

[107] *Ukraine: Statistical Appendix* (Washington, DC: International Monetary Fund, November 2005), p22.

[108] *Ibid,* p22.

[109] *Ibid,* p22.

[110] Law No. 679- XIV of Ukraine *On the National Bank of Ukraine* (1999).

licenses and regulates banking activities.[111] Commercial banks are governed by the 2001 *Law on Banks and Banking Activities*, which improved on the 1991 law of the same name by establishing more stringent accounting rules for banks and banking activities.[112]

B. Developments in the economy

While Ukraine has had a largely privately owned banking system since the 1990s, Ukraine's protracted economic contraction in the 1990s and the 1998 financial crisis impeded development of the sector until recently. Unlike in many transition economies, the state was quick to privatize the banking sector, and by 1997 the state owned only 13.5 percent of total sector assets, which fell to eight percent in 2004.[113] There are 162 banks operating in Ukraine, which is a large number for a country of Ukraine's size and development. Most are quite small, with about 125 banks holding assets of less than US$150 million.[114] These "pocket banks" serve primarily to fund their enterprise owners.[115] The top 30 banks in Ukraine account for three-quarters of the sector's assets, indicating that the "pocket banks" are a marginal phenomenon and that the larger banks are the primary agents of financial intermediation in Ukraine.[116]

Historically, foreign banks have not been as active in Ukraine as in other transition economies, owing to burdensome licensing requirements and the difficult business environment. Early in 2005, there were 22 foreign-invested banks operating in Ukraine, but they accounted for only about 20 percent of total banking sector assets.[117] This is changing, however, as indicated by two recent foreign buyouts of domestic Ukrainian banks. In the autumn of 2005, Austria's Raiffeisen Bank completed its acquisition of Aval, Ukraine's second largest bank.[118] This US$1 billion purchase made Raiffeisen the largest bank in Ukraine. In December 2005, BNP Paribas agreed to acquire a majority stake in Ukrsibbank, Ukraine's fourth-largest bank.[119] Parliament and the National Bank of Ukraine have also recently lifted restrictions on foreign banks opening

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[111] *Doing Business in Ukraine* (Kiev: Ernst & Young, 2005) p8. See also *Conducting Business in Ukraine* (Kiev: Baker & McKenzie, 2005), p46.

[112] *Ukraine: Development Topics: Financial Sector Reform* (Washington, DC: World Bank, July 2004), http://web.worldbank.org. *Conducting Business in Ukraine* (Kiev: Baker & McKenzie, 2005), p46. See also *Ukrainian Odyssey: Economy 2004 and Investment Climate* (Kiev: SigmaBleyzer, 2004), p39.

[113] *Transition Report 2003, Economic Transition in Central and Eastern Europe and the CIS*, (London: European Bank for Reconstruction and Development, 2003), p210. *See also Transition Report 2005, Economic Transition in Central and Eastern Europe and the CIS*, (London: European Bank for Reconstruction and Development, 2005), p196.

[114] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), p70.

[115] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Financial Risk,* January 20, 2006.

[116] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), pp70-71.

[117] *Id.*

[118] Wagstyl, Steven, *Rush of Deals Dispels Worries* (London: Financial Times, November 8, 2005), p30.

[119] Warner, Tom, *BNP to buy Stake in Ukrainian Bank* (London: Financial Times, December 2, 2005), p26.

subsidiaries in Ukraine and on foreign banks opening local branches.[120] Increasing foreign involvement will undoubtedly inject new competition into the banking sector and bring the benefits of new products and services, technical expertise, and modern business and accounting practices.

Albeit from an extremely low base, due to Ukraine's protracted economic depression in the 1990s, the banking sector and financial intermediation have grown markedly over the past several years. In mid-2005, total bank assets stood at 46 percent of GDP, which is comparable to transition economies with more established financial systems.[121] The amount of credit extended by commercial banks grew on average 45.9 percent per annum from 2000 through mid-2004, with the ratio of credit to GDP more than doubling over that period to almost 30 percent of GDP.[122] While most loans still go to enterprises, consumer loans have been increasing as well.[123] There are concerns that this credit boom could be unsustainable, in part because of what appears to be high levels of non-performing loans ("NPLs"), with the IMF reporting in June the percentage of NPLs to total loans to be 23.1 percent.[124] However, Ukraine has extremely strict standards for defining NPLs. Excluding substandard loans that are nonetheless being timely serviced, the NPL figure falls to 6.6%.[125] This suggests that no crisis is imminent, but that the financial sector in Ukraine needs to develop its capacity for risk assessment, and that many of the "pocket banks" lend within their enterprise groups without regard to risk. An economic downturn could cause a banking crisis if a large number of borrowers default on their loans, but the cumulative stock of commercial banks' reserves have gone up along with this increased lending, from about 4 billion *hryvnia* in 2000 to over 14 billion *hryvnia* in 2004.[126] To help prevent a non-payments crisis, the NBU in 2004 raised reserve requirements to ten percent.[127] While Ukraine's recent credit boom could still jeopardize the stability of the banking sector, Ukraine's credit-to-GDP ratio is still much lower than in most countries that have experienced banking sector crises.[128]

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[120] *The Economist Intelligence Unit, Industry Briefing, Ukraine: Financial Services Background,* November 10, 2005. *See also The Economist Intelligence Unit, Industry Briefing, Ukraine finance: Central Bank Relaxes Foreign Bank Rules,* January 6, 2006.

[121] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), p69.

[122] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, January 2005), p15.

[123] *Ukraine: Statistical Appendix* (Washington, DC: International Monetary Fund, November 2005), p38.

[124] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), pp71-72.

[125] *Id.*

[126] *Ukraine: Statistical Appendix* (Washington, DC: International Monetary Fund, November 2005), p34.

[127] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, January 2005), p14.

[128] *Ibid*, p21.

While it is unlikely that credit will continue to expand at the pace that it has over the past several years, this growth in credit has resulted in greatly improved financial intermediation that benefits Ukrainian business, which has historically largely depended on retained earnings for financing purposes.

4. The degree to which individuals and businesses can engage in entrepreneurial activities

A. Legal framework

Prior to 2004, the Soviet-style *Civil* and *Economic Codes* were the primary laws governing commercial activity. After years of *ad hoc* reforms resulting in a patchwork of regulations based on these codes, the GOU passed the 2004 *Civil* and *Commercial Codes* which completely supplanted the old codes. All business activity in Ukraine, whether based on foreign or domestic investment, is now governed by the new *Civil Code* and the *Commercial Code.* These codes provide for the right to conduct commercial activity, establish businesses, invest in commercial enterprises, and delineate the rights and obligations of commercial actors. *The Civil Code* is broader than the *Commercial Code* and regulates all activities, not just business related, between natural and legal persons.

Unfortunately, there are many inconsistencies between the two codes, with conflicting legal definitions, obligations and rights. Commentators have noted that the 2004 Civil Code is a marked improvement over earlier legislation and aims to support a market economy, including freedom of contract, fair competition and protection of business rights. The *Commercial Code*, however, takes a different approach, and in some areas "seems to be imposing a planned economy on the nation."[129] Given these serious concerns, the Rada Committee on Legal Policy is receiving technical assistance from international partners such as the OECD to identify and address these problems.[130]

It should be noted that alongside the 2004 Codes, the GOU has also implemented a series of legal reforms, discussed above in factor three, designed to encourage private entrepreneurship, reduce "red tape" and fight corruption. Additionally, the law *On Investment Activity* sets forth the basic legal and economic conditions of carrying out investment activity within Ukraine, irrespective of the nationality of the investor.[131] Businesses may establish themselves under one

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[129] *Legal Issues with Regard to Business Operations and Investment in Ukraine* (Paris: Organization for Economic Cooperation and Development, 2004), p18. Under the *Commercial Code*, for example, the State can grant SOEs benefits above and beyond what is available to private entities. The *Commercial Code* also authorizes the state to hire and fire SOE managements and direct the actions of SOEs. See *Ibid*, pp22-23.

[130] See, for example, the report *Legal Issues with Regard to Business Operations and Investment in Ukraine* (Paris: Organization for Economic Cooperation and Development, 2004) and the *Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005).

[131] *Conducting Business in Ukraine* (Kiev: Baker & McKenzie, 2005), p14.

of several forms, *i.e.,* joint stock companies, limited liability companies, additional liability companies, and full and limited partnerships.[132]

Corporate governance in many enterprises remains loosely regulated and minority shareholder rights, in particular, are not sufficiently protected. Corporate governance regulations and shareholder rights protections provide an important foundation for promoting the incentives to invest, which in turn encourages entrepreneurship. The State Securities Commission, in cooperation with the International Finance Corporation, has drafted a set of voluntary governance principles in order to enhance self-regulation in the absence of regulatory oversight, but few corporations have adopted them.[133] A draft Law *On Joint Stock Companies* is being prepared in the Rada to address many of the issues raised in a 2002 presidential decree recommending reforms that would implement international best practices with regards to corporate governance.[134] Implementing such a law has been identified as a pressing reform by many third-party commentators.[135]

B. Developments in the economy

Entrepreneurship is flourishing in Ukraine. Aided by sound macroeconomic policies, a weak currency, and buoyant external demand, cumulative growth in 2000-2004 fell just short of 50 percent.[136] Some of Ukraine's core industries, particularly metals and chemicals, have proven to be very competitive in the world market and have been very profitable.[137] These firms have been quite successful in accessing new markets, particularly in the European Union.[138] Although slowing external demand for these products have recently reduced growth in these industries, other sectors, particularly food processing and retail trade, are still seeing rapid growth, demonstrating that Ukraine is diversifying its production base, albeit relatively slowly, and is allocating resources to productive use.[139]

The government has recently been addressing one long-standing problem with the business environment, that of VAT arrears. While the stock of overdue VAT refunds is still

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[132] *Doing Business in Ukraine* (Kiev: Ernst & Young, 2005), p18.

[133] *Strategy for Ukraine 2005-2007* (London: European Bank for Reconstruction and Development, 2005), p21.

[134] *Ukrainian Odyssey: Economy 2004 and Investment Climate* (Kiev: Sigma Bleyzer, 2004), p33.

[135] *Ibid*, p33. *See also Strategy for Ukraine 2005-2007* (London: European Bank for Reconstruction and Development, 2005), p16; *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2004), Chapter 6; *Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005), p55.

[136] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Macroeconomic Risk,* January 20, 2006.

[137] *Id.*

[138] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), p30.

[139] *Ukraine Macroeconomic Situation* (Kiev: Ukraine: SigmaBleyzer, December 2005), p1.

high, it declined by more than half in 2005.[140] Delays or even outright refusals to issue VAT refunds have been a significant impediment to Ukraine's business environment, particularly for exporters that rely on VAT refunds.[141]

While a substantial portion of Ukraine's economy remains informal and thus is not registered with the authorities, by some measures the informal share of the economy is decreasing.[142] This growing willingness of firms to operate formally is one indication that the business environment in Ukraine is improving. Another measure of the business environment is the size of the SME sector. In Ukraine, the number of SMEs registered and actively conducting business has also increased significantly over the past several years from 396,000 in 2000 to 520,000 in 2003, although SMEs represent a fairly small portion of the economy.[143]

Nevertheless, entrepreneurs face a very difficult environment in Ukraine. Difficulties begin with Ukraine's complex and burdensome registration and licensing requirements, compliance with which is excessively time-consuming.[144] For example, according a World Bank study, there are 18 procedures that must be done to collect all the required licenses to conduct business in Ukraine, and completing these procedures takes an average of 265 days and costs more than twice Ukraine's annual income per capita.[145] There have been efforts to simplify procedures for setting up a business, but they have not yet been fully implemented.[146]

Once a business is registered, it must operate under an unpredictable and burdensome regulatory and taxation regime. For example, there are 84 taxes in effect in Ukraine, and complying with them all takes an average of 2,185 hours per year.[147] Further, the government has made many changes to the taxation system over the past several years, rendering the taxation system unpredictable, which detracts from firms' ability to develop long-term business plans. For example, in 2003 alone, there were 43 amendments to the tax laws, and almost 75 percent of firms responded in a recent International Finance Corporation ("IFC") survey that the tax laws

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[140] *The Economist Intelligence Unit, Country Report January 2006: Ukraine* (London: Economist Intelligence Unit, 2006) pp19-20.

[141] *Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005), p48.

[142] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), p20.

[143] *Business Environment in Ukraine* (Washington, DC: International Finance Corporation, 2004), p14.

[144] *Doing Business in 2006* (Washington, DC: The World Bank and International Finance Corporation, 2006), pp11,157.

[145] *Id.*

[146] *Barriers to Investment in Ukraine* (Kiev: European Business Association, 2005), p7.

[147] *Doing Business in 2006* (Washington, DC: The World Bank and International Finance Corporation, 2006), p157.

(particularly the frequent changes thereof) were a serious impediment to business.[148] Redress in the courts is difficult, as documented in the same IFC survey; only 14 percent of company managers believe that the justice system can protect their interests in business disputes, and that the vast majority of firms resort to "unofficial payments" to solve problems.[149] Foreign firms often find the business environment particularly difficult.[150]

Similar to the issues of corruption and weak rule of law discussed below, Ukraine's difficult business environment is best seen as a developmental and transitional problem associated with inexperience in building market-friendly institutions, rather than something that calls into question the essential "marketness" of the country itself.[151]

Assessment of Factor

______The government still sets some prices, but these are for the goods that are heavily regulated in many market economies, such as energy and basic consumer goods. Even the energy sector, a source of serious price distortions in the past, has seen significant price increases and dramatic improvements in cash payments. The result has been a much-improved situation regarding inter-enterprise arrears. Some of Ukraine's traditional industries such as steel have seen a resurgence over the past several years, due to favorable world-market conditions. As these industries are largely privately-held, their growth has not been due to government direction. This suggests that investments are flowing to the areas that offer the highest-return, and that resources are being allocated primarily by market forces. While Ukraine has been slower to expand into new industries than many transition economies due to its difficult business environment, there are encouraging trends, particularly in areas such as services and food processing, which have seen rapid growth. Other traditional industries, such as coal, are still consistent loss-makers but shielded from restructuring, due to social welfare and stability concerns.

Individual privately-owned banks, not the government, are the primary allocators of capital in the economy. The banks are rapidly growing in their role as financial intermediaries, and although the level of financial intermediation remains low, many firms and individuals are receiving access to credit for the first time. Thus, a market-based capital allocation system exists, albeit a rudimentary and inefficient one.

While Ukraine still has a deficient bankruptcy law, arrears as a percentage of GDP have been swiftly declining. Moreover, arrears are concentrated in those state-owned industries that have little prospect of profitability because the industries arose during the state-planning period

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[148] *Business Environment in Ukraine* (Washington, DC: International Finance Corporation, 2004), pp54-55.

[149] *Ibid*, p7.

[150] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Legal and Regulatory Risk,* January 20, 2006.

[151] The World Bank documents that many market economy countries impose burdensome procedures on business. *See Doing Business in 2006* (Washington, DC: The World Bank and International Finance Corporation, 2006). The phenomenon of "unofficial payments" is discussed in Factor 6 below.

and now exist primarily to provide employment in economically depressed regions of the country.

The legal environment for commercial activity is still in transition, with significant "red tape" and contradictory regulations. This has been identified as an area for concern for the GOU and many significant reforms have been undertaken to remedy the problem. The complex web of business regulations is not necessarily indicative of policies intended to control the market, but rather a lack of experience in creating market-friendly institutions. Entrepreneurial activity is nevertheless prospering.

Factor Six. Such other factors as the administering authority considers appropriate.

Under this factor, the Department can address any additional issues relevant to its consideration of market economy status. These issues include trade liberalization, rule of law and corruption.

Corruption

Corruption is a phenomenon in all economies, to some extent, and in many ways is best seen as a developmental issue, rather than something that calls into question the essential "marketness" of the country itself. Nevertheless, while corruption always constitutes an efficiency drag on the economy (by distorting market signals and increasing uncertainty), taken to an extreme, corruption fundamentally undermines the reliability of domestic prices and costs in the economy because the actual costs of a given transaction are not accurately conveyed in the price. Because domestic prices and costs are crucial to the Department's standard anti-dumping methodology, the extent of corruption is a relevant part of the analysis. The standard under this factor is not whether corruption is present (as it is in many market economies), but rather whether it so distorts price signals as to render prices and costs unreliable measures of value.

Corruption in Ukraine is a serious impediment to business. In one recent survey conducted by the IFC, 82 percent of firms made "unofficial payments" to navigate the bureaucracy of Ukraine and spent between 1-10 percent of their annual revenues on these payments.[152] This high level of corruption appears to stem from an institutional weakness in Ukraine.[153] Observers define "institutions" in this context as a set of informal and formal constraints that govern economic behavior and shape an individual's ability to act productively and cooperatively. Countries with strong institutions tend to have clear laws, secure property rights, enforcable contracts, and even-handed and transparent government.[154] There is a large

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[152] *Business Environment in Ukraine* (Washington, DC: International Finance Corporation, 2004), p24.

[153] *Ukraine: 2005 Article IV Consultation–Ex Post Assessment of Longer-Term Program Engagement* (Washington, DC: International Monetary Fund, November 2005), pp17-18.

[154] *Ukraine: Selected Issues* (Washington, DC: International Monetary Fund, November 2005), p7.

body of empirical evidence demonstrating the importance of strong institutions to economic growth.[155]

The institutions that lead to non-corrupt practices are difficult to legislate (as informal norms and *de facto* procedures are as important as the laws themselves), so in addition to looking at the legal framework, an assessment of this factor must include surveys of perceptions of corruption and broader economic developments to help determine the extent to which corruption distorts the economy.

Ukraine has had a short history as an independent state and so had to construct its key state essential institutions from scratch, and the resultant uncertainty and instability have provided many avenues for corruption. The 1995 law *On Combating Corruption* is the basic legal framework for combating corruption. However, it is not stringently enforced.[156] Nonetheless, in recent years the past several governments have taken the issue of corruption seriously and have undertaken measures to combat it. An advisory committee for combating corruption and organized crime includes the State Security Service, Justice Ministry, Ministry of Internal Affairs, and State Customs Service. According to Ukrainian sources, approximately 18,000 civil servants have been dismissed and the Customs Administration has been reformed in an effort to reduce corruption in public administration.[157] Further, together with the World Bank, the government will implement a project aimed at increasing transparency of government activity and introducing mechanisms for public consultations. The February 2004 Resolution *On Measures to Eliminate Conditions Favoring Corruption* aims to return shadow funds from foreign bank accounts and streamline VAT refund procedures.[158]

As explained above, corruption cannot be uprooted through legislation alone, and it takes time to change the informal norms that help lead to corrupt behavior. Ukraine is still considered a very corrupt country by most observers, including Transparency International, which assigns it a score of 2.6 and a rank of 107 (out of 158) in the most recent *Corruption Perceptions Index*.[159] As serious a problem of corruption as this score indicates, it still represents an improvement over previous years; for example, in 2004 Ukraine received a score of 2.2 and in 2003 Ukraine received a score of 2.3.[160] Its corruption perceptions ranking in 2005, moreover, while serious, is comparable to some other market economies.

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[155] *Ibid*, pp7-8.

[156] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2004), Chapter 6.

[157] *Transition Report 2005, Economic Transition in Central and Eastern Europe and the CIS* (London: European Bank for Reconstruction and Development, 2005), p194.

[158] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2004), Chapter 6.

[159] *Corruption Perceptions Index 2005* (Transparency International, 2005), www.transparency.org.

[160] *Corruption Perceptions Index 2004* (Transparency International, 2004) and *Corruption Perceptions Index 2003* (Transparency International, 2003), www.transparency.org.

The various economic developments discussed elsewhere in this memorandum indicate that prices and costs are still functioning as effective market signals. Resources are being allocated to productive use, as evidenced by the economic growth in new sectors. Financial intermediation and banking sector assets are growing, suggesting both an increasing trust in the banking sector and in the ability of lenders to be repaid. Finally, the increasing participation of foreign firms in the economy indicates that foreign investors are displaying an increasing confidence that they will not lose their property or profits to corrupt practices. Taken together, these facts indicate that while corruption is still a serious problem in Ukraine, it represents a transition problem of lost efficiency, rather than one that fundamentally undermines the validity of price signals.

Weak rule of law

As discussed in several of the preceding sections, the rule of law is very weak in Ukraine. A weak rule of law is closely related to a high level of corruption and weak market-sustaining institutions. For this analysis, "rule of law" refers to the process of introducing new laws and regulations (and the transparency thereof), the extent to which laws are applied uniformly, and the competence and impartiality of the judiciary. Ukraine has had serious problems on all of these fronts. Its lawmaking process has been opaque and often driven by insider interests, laws and regulations are often unclear and conflicting, laws are often applied unevenly or rarely at all, and the judiciary is often inexperienced and subject to political pressure.[161]

Reasons underlying the weak judiciary include inadequate structure, overworking of judges, low pay, inexperience, and a lack of transparency. These problems can be characterized as structural and transitional that may be overcome with time, resources and experience. Corruption, discussed above in the broader context, may also play a role. There is a common perception that judges may be susceptible to bribery and recruitment of judges is opaque and subject to abuse.[162] The judicial system is subject to pressure from special interests, and the judicial process is slow and inefficient.[163]

Strengthening the rule of law will be crucial to Ukraine's future economic development. To secure continued growth, Ukraine will need to identify, in consultation with the public, the laws and regulations that needlessly burden enterprises and work to eliminate them. Ukraine must ensure that future law-making takes all parties' interests into account. Ukraine will also need to improve its public service to better ensure that state officials know the law and can apply it even-handedly, and continue to develop the judiciary as a check on abuse.

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[161] *Country Commercial Guide: Ukraine* (Washington, DC: U.S. Department of State, 2004), Chapter 6. *See also The Economist Intelligence Unit, Risk Briefing, Ukraine: Legal and Regulatory Risk*, January 20, 2006.

[162] *Blue Ribbon Commission for Ukraine, Proposals for the President, A New Wave of Reform* (New York: United Nations Development Program, 2005), p30-32.

[163] *The Economist Intelligence Unit, Risk Briefing, Ukraine: Legal and Regulatory Risk*, January 20, 2006.

The problem in developing the rule of law, as serious as it is, is not unique to Ukraine. Many transition economies and market economies have faced challenges in developing the institutions necessary for an efficient market economy. The key question is to determine whether or not the rule of law is so weak that it has prevented market forces from taking root in the economy. As discussed throughout this memo, Ukraine's economy may be inefficient due to these institutional constraints, but the market is nevertheless the driving force in setting prices and allocating resources. In Ukraine's market environment, weak rule of law is not rooted in state planning or control. Rather than a symptom of being a planned economy, Ukraine's weak rule of law reflects a state that is in the process of gaining institutional knowledge and experience.

Trade Relations

GOU is currently in the process of negotiating accession to the WTO. Ukraine has also concluded bilateral trade and economic agreements establishing most-favored nation treatment with 54 countries, including the United States.[164] Ukraine had also concluded a Partnership and Co-operation Agreement with the European Union, which provided for the application of MFN treatment between the parties to the Agreement, except for advantages granted in the context of the creation of a customs union or a free-trade area, advantages granted to developing countries, and advantages accorded to adjacent countries in order to facilitate frontier traffic.

ANALYSIS AND ASSESSMENT

Although section 771(18)(B) of the Act enumerates six factors that the Department must consider in determining whether a country operates on market principles, the statute provides no direction or guidance with respect to the relative weight that should be placed on each factor in assessing the overall state of the economy. As discussed above in the "Analytical Approach" section, the Department considers whether the facts, as applied to the statutory factors, demonstrate that the economy is generally operating under market principles.

In the case of Ukraine, there are many positive developments that support the conclusion that Ukraine has a market economy. The exchange rate is market-based, due to the convertibility of the currency and a functioning interbank market. Although currency controls are in place to limit capital flight and volatility, and the NBU actively intervenes in the FOREX market to smooth the exchange rate, this is something that many central banks do around the world. Wages are market-based and reflect the relative bargaining power of labor and management, which vary with local market conditions and the industry sector in question. Ukraine is open to foreign investment, and although FDI inflows have been very low, the government is taking action to

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[164] These countries are Algeria, Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, China, Croatia, Cuba, the Czech Republic, Denmark, Egypt, Estonia, Finland, the Former Yugoslav Republic of Macedonia, France, Germany, Great Britain, Guinea, Greece, Hungary, India, Indonesia, Iran, Ireland, Israel, Italy, Japan, the Republic of Korea, the Democratic Republic of Korea, the Kyrgyz Republic, Lebanon, Libya, Luxembourg, Montenegro, Moldova, Mongolia, the Netherlands, Norway, Poland, Portugal, Romania, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Tunisia, Turkey, the United Arab Emirates, the United States, and Viet Nam.

improve the business environment, with positive results. The government no longer controls the vast majority of prices, and markets now allocate resources and determine output in Ukraine. The vast majority of SOEs have already been privatized. Ukraine's banking sector is still developing, but is overwhelmingly privately-owned. Ukraine is open to trade, has low effective tariff rates, and is in negotiations to join the WTO. Both Ukraine's imports and exports have been growing rapidly. Thus, market forces within Ukraine have developed sufficiently enough that, in general, the Department may use prices and costs within Ukraine for purposes of its antidumping analysis.

RECOMMENDATION

Based on the preponderance of evidence related to economic reforms in Ukraine to date, analyzed as required under section 771(18)(B) of the Tariff Act of 1930, as amended (the Act), we recommend that the Department treat Ukraine as a market economy for the purposes of antidumping proceedings, effective February 1, 2006.

Agree________ Disagree________

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Joseph A. Spetrini
Acting Assistant Secretary
for Import Administration

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Date