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A. Major Trends and Outlook

Ukraine was deeply integrated into the former Soviet economy, particularly in the agricultural and defense industries. Upon achieving independence, many analysts believed Ukraine had the best medium-term prospects for economic development of any of the former Soviet republics, including Russia. Ukraine's vast agricultural resources, port and shipbuilding facilities, machinery sector, transportation network, and skilled workforce created a favorable investment picture. Ukrainian authorities, however, did not undertake structural economic reforms. In the early 1990s, Ukraine experienced serious inflation, privatization was at a standstill, real wages plummeted, and economic output continued its steep decline.

The economic situation deteriorated throughout most of the 1990s. A brief period of stabilization ended abruptly when Ukraine was drawn into the wake of the Russian financial crisis in 1998. Ukraine recovered quickly, however, and since early 2000 the economic situation has improved remarkably. For the first time since independence, the Ukrainian economy grew in the year 2000. The GNP grew by 5.8%, industrial production by 12.5%, disposable income by 11% and consumer spending by 12%. The national currency, the hryvnia, remained stable, as did prices and interest rates. This trend accelerated during the first half of the year 2001: real economic growth was about 9% on an annual basis for the first six months of the year, industrial output surged, inflation dropped to 5.3% for the first six months of the year, and the hryvnia even appreciated slightly. The number of new business registrations, almost exclusively small and medium

improvement in business condi

the recent growth in bank deposits and bank loans, and by strong growth in consumer spending and reduced consumer saving in the first quarter of 2001.

Several factors contributed to the strong turnaround. High energy prices on the world markets facilitated Russia's rebound from the 1998 crisis, and strong growth in Russia, still Ukraine's main export market, overlapped into the

Ukrainian economy. The 1999 elections delivered a pro-Presidential, and ostentatiously pro-reform, majority in the Rada (parliament), ending temporarily the parliamentary blockade which had stalled reform for most of the 1990s. A reform-orientated government quickly improved cash collections and transparency in the notoriously corrupt energy sector. Wage and pension arrears were nearly eliminated, and the government took first, albeit incomplete steps, to improve the investment climate in general and to ease state influence on private business in particular. The budget profited from the strong economic growth and increased monetization of the economy in the year 2000: for the first time since Independence the federal budget was balanced.

In the medium to longer term, however, a continuation of this positive trend will require further and substantial reform of Ukraine's society and economy. Several examples highlight the steps Ukraine needs to take to institutionalize reform. The tax system needs overhauling to increase transparency and eliminate the numerous inconsistencies which are unfair to many types of taxpayers. High tax rates need to be reduced, and loopholes need to be closed to widen the tax base. Ukraine's tremendous agricultural potential will not be utilized until further issues affecting the private ownership of land and the development of a market for property are resolved. Ukraine's energy market, despite improved transparency, remains corrupt and energy prices are still distorted. Foreign investment is desperately needed for the Ukraine's decaying energy transportation and transmission systems, as well as its entire transportation infrastructure. Without improved transparency in the privatization process and strengthened corporate governance rules, however, such investments will not be forthcoming.

The jury remains out on Ukraine's commitment to further economic reform. In early 2001, a political scandal surrounding the still unresolved murder of a critical journalist and the publication of taped conversations purportedly made in the President's office have clouded Ukraine's international image. A new Prime Minister, and a new government nearly identical to the Yushchenko government, has reinforced the commitment to further economic reform. The new government will have to deal with a parliament divided on reform issues, however. In addition, parliamentary elections scheduled for March, 2002, may make it difficult for the

Ukraine's recent economic growth has been all the more remarkable due to the fact that the country went without significant external financial support since late 1998 until late 2000. A IMF Extended Fund Facility, established in September, 1998, was suspended several months later following irregularities involving the National Bank of Ukraine's currency transactions and Ukraine's failure to meet certain IMF requirements. These issues were resolved, and in late 2000 a first disbursement was made. However, further disbursements were suspended pending Ukraine's fulfillment of IMF requirements. As of mid 2001, the IMF and the Government of Ukraine were still involved in negotiations which may lead to a reinstatement of disbursements under the EFF program.

Following the 1998 crisis Ukraine defaulted on its sovereign debt to both public and private sector borrowers. Private sector debt was rescheduled in April 2000, and as of June, 2001, Ukraine had been servicing this rescheduled debt in a timely manner. Ukraine rescheduled its debt with the Paris Club of sovereign borrowers in July 2001. Resumption of the IMF's EFF funding is a precondition for this debt agreement to take effect. As of June, 2001, both the Overseas Private Investment Corporation (OPIC) and the Ex-Im Bank of the United States had suspended the approval of new projects in Ukraine pending the solution of outstanding investment dispute cases.

Perhaps no other country in the former Soviet Union (FSU) region has experienced such a large gap between economic performance and potential as Ukraine. Endowed with good natural resources, superb agricultural land, a well-educated population, ethnic peace, and a strategic location in Europe, Ukraine was positioned to be one of the most successful of the former Soviet states in attracting the foreign investment needed to restructure its economy.

Yet with an annual GDP of $645 per capita as of the year 2000, Ukraine has one of the lowest levels of income in the FSU. The U.S., with some $664 million out of total investment of $3.9 billion, is the single largest source of foreign investment in Ukraine. Growth in FDI in Ukraine has been very slow, and remains insignificantly small for a country of nearly 50 million people with the resource base and economic potential of Ukraine. In comparison, foreign direct investment in Poland since 1991 has been about $40 billion, of which more than $6 billion stems from American investors. Foreign direct investment in Hungary has been over $20 billion during the same period, despite the fact that Hungary's population is only a fifth the size of Ukraine's. Russia has been increasingly active in buying stakes in Ukrainian companies, mostly in an attempt to vertically re-integrate large scale, Soviet-era enterprises in the energy, metallurgical and chemical sectors.

The IMF, the World Bank, the United States, and other donors have consistently delivered the same message to Ukraine during the past five years: in order to establish a market economy integrated into the European and world markets Ukraine needs to reduce the role of government in the economy, increase accountability and transparency while reducing corruption, establish the rule of law in all aspects of public life, and reduce the burdens placed on private enterprise.

The fact that U.S. investors continue to top the FSI tables shows their commitment to Ukraine despite the problems they encounter doing business in the country. Their problems, both specific and general, are a regular agenda item in all high-level bilateral meetings. While the Ukrainian government has demonstrated some commitment to getting outstanding investment disputes solved, the caseload remains large. Outstanding investment problems involving U.S. investors frequently reflect Ukraine's weak corporate governance laws and lack of protection for minority shareholders, or the inability to get court decisions enforced in an effective, comprehensive and timely manner.

Trends in U.S. direct investment in Ukraine have changed over time. Investment in large production facilities involving tens of millions of U.S. dollars practically came to a standstill following the 1998 crisis. The previously mentioned problems have increased the risks of doing business in Ukraine, and have led to a perceived instability, economic and political, on the part of foreign investors, rendering large scale, long-term capital commitments unattractive in the eyes of U.S. investors. Recently, American business interests in Ukraine have reported heightened interest on the part of small U.S. firms active in the information technology and hi-tech sectors. These companies' investments are small and mobile, and are targeted at the utilization of the skills of Ukraine's highly-educated workforce in the technical and engineering sectors..

Ukraine's reputation as a difficult place to do business is shared by investors from around the world. In its most recent Corruption Perceptions survey of 91 countries, Transparency International ranked Ukraine near the bottom.

B. Principal Growth Sectors

Literally all the sectors considered good for investment - now or in the future - face the same business environment, one that is complicated by over-regulation, burdensome tax structures, inconsistent application of laws, and a lack of respect for the sanctity of the law. Sustainable macroeconomic growth will remain tied to overall structural changes such as tax reform, deregulation, privatization, budget austerity, and greater openness to trade. Nevertheless, recent economic growth is slowly strengthening Ukrainian purchasing power. Assuming that economic growth and domestic investment continues, Ukrainian based companies can be expected to import higher-quality Western capital goods to modernize and expand their production capacity. Imported durable consumer goods such as shoes, clothing, and electrical household goods will likely witness continued demand in the future, although their market share has been threatened by the higher relative cost of imported goods caused by depreciation of the local currency prior to the year 2000. However, the recent development on the foreign exchange rate is alleviating this pressure. Since early 2000, the stable nominal exchange rate and the strong inflationary differential between Ukraine and dollar-based economies has caused a significant de facto real appreciation of the hryvnia. Demand continues as well for imported non-durable goods like foodstuffs, candies, and other grocery items.

Agribusiness and the food processing and packaging sectors have been among the more rapidly growing sectors of the economy, and remain areas of potential growth in the future. The sector's potential will dependent on the government's commitment to transparent privatization and land-reform policies in agriculture, particularly through passage of a land code that was pending in the parliament in June of 2001. Many farm producers remain heavily indebted to the government for past deliveries of agricultural inputs, limiting ability to sustain growth in the agricultural sector.

The **energy sector** is another major area for potential investment. Ukraine's decaying electricity grid, as well as needed investment in power generating facilities and the country's energy extraction and transit systems, could potentially attract substantial sums of foreign investment. The successful privatizations of six regional electricity distribution companies (oblenergos) in April 2001 was a first, and significant step towards improving Ukraine's energy industry and towards increasing transparency and reducing corruption in the sector. This action was also the first truly large-scale privatization performed in Ukraine according to internationally accepted standards of transparency and fairness. A further 12

companies are scheduled to be privatized in 2002. In a encouraging development, recent attempts to circumvent the transparent privatization process by stripping energy sector companies targeted for privatization of their most valuable assets have been stopped by the Ukrainian government.

Telecommunications and information technology are important growth sectors as well. The privatization of Ukrtelekom, the national telecommunications monopoly, is scheduled for 2002. The potential of Ukraine's highly qualified technical workforce has been increasingly recognized by foreign investors as well.

The **construction** industry experienced a boom in early 2000 after years of stagnation. Construction spending grew by 9% in the first quarter of 2001 on a year-to-year basis. U.S. companies can position themselves for this surge in demand by identifying qualified distributors in Ukraine or establishing an on-the-ground market presence.

C. Government Role in the Economy

Privatization in Ukraine has proceeded unevenly thus far, with relatively rapid results in small-scale privatization and a slower pace for large-scale privatization. While the reasons for delays are complex, factors include: an underdeveloped legislative base without clear, easily understood procedures for selling state property; the absence of political will to overcome strong resistance from local authorities and enterprise directors; parliamentary resistance; and a lack of clear incentives in the complicated privatization scheme. Privatization, for Ukrainian citizens as well as foreign investors, will remain a key variable that will shape Ukraine's success or failure in implementing market reforms.

Mass privatization of small- and medium scale enterprises was essentially completed in 1999. These enterprises, now in private hands, have contributed significantly to the economic growth of the recent past. In absolute numbers, Ukraine has now privatized the majority of formerly state-owned companies. In terms of employed workers and value of output, however, more than half of the country's productive assets still remain in state hands. Early in the year 2000 the government started implementation of a program aimed at privatizing those large scale enterprises still in government hands. The implementation of this program has been patchy, however. The April, 2001, privatization of six electricity distribution companies, which included two purchases by a U.S. investor, was to date the first, and only, large-scale privatization according to internationally accepted standards. This privatization was only made possible through consistent and high-level engagement and support on the part of the international donor community. A second test of Ukraine's ability and willingness to conduct transparent privatization will come with the scheduled sale of another 12 oblenergos in late 2001, and the planned sale of energy generating companies and the national telecom monopoly in 2002.

Other large-scale privatizations conducted since early 2000 have been marked by unclear, intransparent and changing regulations, and heavy political influence from all government players in the privatization process: the State Property Fund, the Presidential Administration, the Cabinet of Ministers and the Rada. Part of Ukraine's problems surrounding large-scale privatization are caused by the fact that the rules for privatization are still weak and poorly institutionalized, giving competing political interests -- and the lobbies that use them -- undue influence on the privatization process. Often management and workers resist the prospects of surrendering government ownership to investors interested in an adequate return on capital. Local and regional governments, who view large state-controlled enterprises within their jurisdictions as an important tool for political influence and patronage, resist surrendering the control that privatization implies. Ukrainian, and increasingly Russian, business interests have been known to use the weak institutional setting and wide-spread environment of corruption to circumvent privatization rules and procedures to their own advantage.

The attractiveness of many large-scale enterprises has been diminished by the fact that Ukraine has taken the strategic decision not to restructure enterprises before privatization, leaving this task to the investors acquiring the companies. While in theory this policy allows the new owners themselves to make the decisions affecting the long-term prospects of the company, in practice it forces investors to face the most difficult -- and in the end result only politically solvable -- questions surrounding the restructuring of Ukraine's Soviet-era industrial infrastructure, especially those involved downsizing productive capacity and the workforces of the purchased companies.

Despite these obstacles, Ukraine garnered 2.1 billion hryvnia ($390 m) in privatization revues in the year 2000, a sum more than equal to the revenues earned from privatization in all previous years since independence, combined. Ukraine forecast 5.9 billion hryvnia in revenues in the year 2001, a figure which will not be met due to the decision to extend the overly optimistic timeline for privatization of the national telecom carrier. In the future, improvement of the general investment climate and fair and transparent rules for privatization could lead to significant revenue growth for the state, and increased investment in and modernization of the Ukrainian economy.

D. Balance of Payments Situation

third of their level in the previous year – despite very heavy international borrowing to prop up the reserves position. Reserves recovered somewhat in 1999 thanks in large measure to a major exchange rate adjustment that made Ukrainian products more competitive in both domestic and export markets. Since July 2000, reserves have increased sharply, from $900 million to $1.8 billion in June of 2001. As of this date, reserves were back at the levels known prior to the 1998 crisis. The growth is all the more remarkable due to the almost complete absence of external funding since 1998, and foreign investors increased tendency to shy away from the Ukrainian economy. Trade surpluses following the 1998 devaluation of the hryvnia were the main factor behind the growth in reserves. At the same time, however, reserve growth has been facilitated by the fact that Ukraine defaulted on its sovereign debt following the 1998 crisis.

The balance of payments situation improved substantially following the devaluation of the hryvnia in the wake of the 1998 financial crisis. Exports grew by 26% and imports by 15% in 2000. Exports grew another 20% in the first quarter of 2001, while imports fell by 5.8%. The current account balance, which was minus $1.2 billion in 1998, grew to $800 million in 1999 and leaped to $1.4 billion in the year 2000. Russia remains Ukraine's major trading partner.

In mid-2001, Ukraine's balance of payments situation is far better than the situation experienced prior to the 1998 crisis. Short term portfolio capital flight is no longer a danger, and the valuation levels of the national currency are adequate. Ukraine's external balance of payments situation in the near to mid-term will be heavily influenced by its trade -- and its trade and debt policies -- with Russia. Russia remains Ukraine's top export market. A slowdown in the Russian economy will have an effect on Ukrainian growth. In addition, Ukraine's current account surplus depends heavily on the fact that in-kind Russian gas payments for use of the transit pipeline are monetized as service exports. Any diversification of Russia's gas shipments to Western Europe will therefore affect Ukraine's balance of payments situation. In addition, Ukraine still owns $1.4 billion to Russia for unpaid energy bills. It is still unclear how, and when, this debt will be serviced.

Key Ukrainian exports in the metallurgical and chemical sectors are the object of various anti-dumping investigations around the world. In fact, Ukraine experienced its strongest growth in exports in the year 2000 in those sectors that are faced with anti-dumping activities.

E. Infrastructure

A large part of Ukraine's national infrastructure dates back to the post-World War II period. Economic decline, investment cutbacks, and insufficient service-charges have led to the deterioration of this infrastructure. The tenuous state of Ukraine's telecommunications, energy systems, transportation, and road/highway infrastructure will require upwards of $40 billion in investment over several decades. As part of international efforts to assist Ukraine in its transformation to a market economy, the World Bank, the European Bank for Reconstruction and Development, and other institutions have several infrastructure projects underway. Special emphasis will be given to energy conversion, projects that promote private-sector initiative in infrastructure development and improvement, and projects that promote improved nuclear safety.

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Industry/title: ___________

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__Recommended by another firm
__Recommended by Commerce staff
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__Other (specify): ______________________________

3. Please indicate the extent to which your objectives were satisfied:
1-Very satisfied
2-Satisfied
3-Neither satisfied nor dissatisfied
4-Dissatisfied
5-Very dissatisfied
6-Not applicable

__Overall objectives
__Accuracy of information
__Completeness of information
__Clarity of information
__Relevance of information
__Follow-up by Commerce representative

4. In your opinion, did using the CCG service facilitate any of the following?
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__Corroborated market data from other sources
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5. How likely would you be to use the CCG service again?
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__Probably would
__Unsure
__Probably would not
__Definitely would not

6. Comments:

____

* * * About Your Firm * * *

1. Number of employees: __1-99 __100-249 __250-499
__500-999 __1,000+

2. Location (abbreviation of your state only):______

3. Business activity (check one):
__Manufacturing
__Service
__Agent, broker, manufacturer's representative
__Export management or trading company
__Other (specify):_________________________

4. Value of export shipments over the past 12 months:

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__$101K-$500K
__$501K-$999K
__$$1M-$5M
__Over $5M

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