German Advisory Group

Institute for Economic Research and Policy Consulting

Economic Reform Agenda for Ukraine

Ricardo Giucci, Robert Kirchner, Georg Zachmann,
Stephan von Cramon-Taubadel

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Institute for Economic Research and Policy Consulting (IER) is the leading Ukrainian analytical think tank focusing on economic research and policy advice. The IER was founded in October 1999 by top-ranking Ukrainian politicians and the German Advisory Group on Economic Reforms.

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Institute for Economic Research and Policy Consulting
Reytarska 8/5-A,
01030 Kyiv, Ukraine
Tel: +38 044 / 278 63 42
Fax: +38 044 / 278 63 36
institute@ier.kiev.ua
www.ier.com.ua

About the German Advisory Group

The German Advisory Group on Economic Reforms, which has been active in Ukraine since 1994, advises the Ukrainian Government and other state authorities such as the National Bank of Ukraine on a wide range of economic policy issues and on financial sector development. Our analytical work is presented and discussed during regular meetings with high-level decision makers. The group is financed by the German Federal Ministry for Economic Affairs and Energy under the TRANSFORM programme and its successor.

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59
D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de

1. Motivation

Ukraine is facing severe economic challenges. The macroeconomic situation has massively deteriorated in recent years and is now unsustainable. Harsh and unpopular measures are needed to reduce the twin deficits, i.e. the budget and the current account deficits. This already daunting task will be made more arduous by current and potential future Russian government sanctions related to trade, investment and energy. Despite these challenges, the task is manageable. A program with the IMF, in combination with additional financial support from the EU and the USA, will certainly contribute to the restoration of macroeconomic stability in the near future.

However, the Ukrainian economy is not just unstable; it is also stagnant. Economic growth was practically flat in the last two years, despite a huge potential for catching up with Western neighbors. The perspectives for this year are, as of today, not very rosy, given the prevailing uncertainty. Thus, Ukraine needs to kick start the engines of economic growth, which will ultimately lead to higher incomes and welfare of the population. The most important of these engines is the improvement of the investment climate. The country needs to tackle the issues that really matter to business, such as accounting and taxation, bureaucracy, and corruption. A more favorable investment climate would be of particular importance for the development of a competitive small and medium size enterprise (SME) sector. In this context, it is not enough to improve legislation; a serious problem in Ukraine is implementation. Thus, reforms should also aim at restoring the rule of law.

While improving the business climate is vital, sectoral policies also require urgent attention. The energy sector is crucial, since its current deficiencies are one of the main reasons for the twin deficits and for the large economic dependence on Russia. Agriculture has developed positively in recent years, but with appropriate policies investments and growth in this and related sectors could be accelerated in the very near future. The financial sector is of paramount importance for the whole economy, but it has been weakened by recent macroeconomic developments. Here too there is an urgent need for stabilization and reforms.

One might wonder whether these multiple goals can be achieved in the short- and medium term. In fact, while the current situation is very critical, it also provides a perfect opportunity for ambitious reforms. First, it has become evident to large parts of the population that the 'old style' in which the country has been managed to date no longer works. Ukraine needs a new paradigm for economic management. Second, the members of the new government have put aside personal interests and have decided to take over responsibility, at the risk of losing popularity. Thus, they are ready to change the country and create a better future for the Ukrainian people. Third, the EU and the USA are ready to support the country in this difficult situation, both technically and financially. Seen from this angle, the current situation Ukraine provides a unique opportunity for ambitious reforms. In this document, the German Advisory Group puts forward policy recommendations for macroeconomic stabilization, for improving the investment climate, and for sectoral reforms. By doing so, we hope to help Ukraine open a successful new chapter in its economic development.

2. Macroeconomic Policy Priorities

The current macroeconomic situation in Ukraine is clearly unsustainable. In 2013, the current account deficit amounted to 9% of GDP and the budget deficit to around 7-8%. An adjustment program with the IMF is essential to reduce these twin deficits to sustainable levels. The key issues in this context are exchange rate policy, fiscal policy, and trade policy.

Monetary and Exchange Rate Policy

Key issues

- The previous **de facto exchange rate peg vis-à-vis** the US-Dollar is the key problem in an overall **inconsistent macroeconomic policy mix.** Rather than shielding the domestic economy from the impact of adverse external shocks, their impact was magnified, with negative consequences for the financial system and the real economy.
- **Monetary Policy** was completely subordinated to the peg and was not able to play an independent role in stabilizing the macroeconomic situation.
- As the pressure on the Hryvnia increased over the last two years, the National Bank was forced to spend more than half of its foreign exchange reserves defending the peg, leading to a serious **depletion of reserves**. At the same time, **capital controls** in various forms have been introduced, with harmful effects on business and the population.
- The **deterioration in external competitiveness** (real appreciation of the Hryvnia) caused by the peg was bad for export performance. Furthermore, the persistent pressure kept monetary conditions extremely tight. Real interest rates on bank loans in the range of 15-20% had a very negative effect on investments. As a consequence, the **real economy has stagnated** over the last two years.

Recommendations

- The allowance of greater **exchange rate flexibility**, a process which was recently started, is a step in the right direction. The National Bank of Ukraine should continue in this direction and introduce a flexible exchange rate regime. This will help to shield the economy from external shocks and support sustainable growth. This process should be accompanied by clear and transparent **communication** of all actions by the National Bank.
- While an uncontrolled and sharp depreciation of the Hryvnia should be avoided, the **capital controls** and **administrative restricting** recently introduced should be gradually phased out, as they increase transaction costs in the economy and undermine trust in the currency.
- In the medium term, the National Bank should accelerate the introduction of a new nominal anchor of monetary policy, namely **inflation targeting.** Achieving a low and stable rate of inflation will provide an important basis for macroeconomic stability, and help to de-dollarize the Ukrainian economy.
- In the period of transition to inflation targeting, the National Bank should consider intermediate exchange rate regimes such as a **currency basket system** to anchor the expectations of economic actors.

Fiscal Policy

Key issues

- Ukraine's public finances are in critical shape and require immediate attention. The **wider general government balance** (incl. Naftogaz and arrears) was in the range of 7-8% of GDP in 2013, up from 4.3% in 2011, reflecting a looser fiscal stance.
- The huge fiscal deficit has translated into severe **financing stress**, especially since Ukraine has effectively been cut off from international capital markets for quite some time now. Efforts to fund the deficit by increasing reliance on indirect monetary financing via the NBU threaten macroeconomic stability.
- The **structure of the budget** is heavily biased towards current expenditures. This leaves very little room for growth-supporting capital expenditures. The Government of Ukraine allocates less than 10% of its expenditures (3% of GDP) to capital outlays; other transition countries on average allocate almost 14% of public spending (4.4% of GDP).
- As a consequence of the significant fiscal deficits in recent years, the **public debt** surged from 12% of GDP in 2007 to 41% at the end of 2013. As a result, over 5% of total public expenditure is now used for interest payments, compared with only 1.6% in 2008. Since the majority of public debt is in foreign currency, the recent **depreciation** of the Hryvnia will put more pressure on the debt-to-GDP ratio in the short term.

Recommendations

- Under these conditions, **fiscal consolidation** is essential to stabilize the macroeconomic situation in Ukraine. Only a significant reduction in the budget deficit can stabilize public debt dynamics.
- The **state budget** 2014 should be revised as soon as possible, as it is based on very unrealistic macroeconomic assumptions (e.g. 3% real GDP growth). Both revenue- and expenditure-related measures should be used to achieve a more realistic and transparent budget.
- Measures to cut **expenditures** should include a long-overdue reduction in energy subsidies. A temporary restraint on social spending and the public wage bill is also needed. Ukraine would benefit from a law on **state aid**, as this would ensure higher efficiency of public spending, and it should streamline **public procurement**, which is often corrupt and leads to high losses for the taxpayer. The pension reform conducted in 2011 should not be reversed, as this would pose a significant threat to the stability of public finances.
- Measures to increase **revenues** include the reduction of existing tax privileges (e.g. in agriculture). No new privileges should be granted. The government should ensure fair, stable and transparent rules of taxation, as this would improve fiscal revenues in the medium term and support economic growth.
- In order to finance the deficit, more emphasis should be placed on the **local currency bond market**, which is currently underdeveloped in Ukraine compared with many other countries, and which would reduce foreign currency risks for the sovereign. Non-transparent instruments to finance the deficit (e.g. **promissory notes**) should not be used, as they have a negative economic impact and ultimately increase borrowing costs. **VAT refund arrears** need to be recognized in full and dealt with in a transparent manner that balances the interests of the state with those of private enterprises. The role of transparent **privatizations** via open tenders should be strengthened as well, as they can contribute to reduce the state debt.

Trade Policy

Key issues

- Foreign trade is crucial for the stability and for the growth perspectives of the country. Thus, **access to foreign markets** should be improved.
- Ukraine's regional trade structure is highly diversified, with the EU accounting for 26%, Russia 24%, the CIS (excluding Russia) 11% and Asia 26% of total exports. This **diversified structure** should be maintained, since it is a positive and stabilizing factor.
- The **reputation of Ukraine as a trading partner** and in particular vis-à-vis the WTO has deteriorated; it should be improved.

Recommendations

- **Signing the DCFTA** in the near future is of crucial importance, since it will improve access to the EU market. Furthermore, by fostering the adoption of modern and internationally recognized technical and other standards, the DCFTA will also improve access to third countries.
- **Ukraine should aim to conclude further FTAs** with trade partners such as Canada, Turkey, Singapore, Vietnam and Israel.
- Strive to secure a **continuation of the existing FTA with Russia** and other members of the customs union, despite current tensions.
- Ukraine should **withdraw all protectionist measures** that is has pursued in recent years which might contradict WTO rules. These include the recycling fee on cars, safeguard measures on cars, import quotas on coke and coal, and Ukraine's request to the WTO for renegotiation of its tariff schedule. These steps would increase Ukraine's international standing and have a positive impact on bilateral and multilateral cooperation.

3. Improving the Investment Climate[1]

Business people in Ukraine, including foreign investors, do not always share the same views. However, when it comes to Ukraine's investment climate, they speak with one voice: Doing business in Ukraine is extremely difficult, troublesome, and costly. If the business climate were to improve, then much more investment would be forthcoming, since the fundamental factors such as a high level of education, natural resources and favorable geographic location clearly make Ukraine an attractive place to invest. In order to improve the investment climate, the country needs to strengthen the rule of law, reduce bureaucracy, improve the tax administration, and fight corruption. This will have an important impact on the small and medium size enterprise (SME) sector, which is currently underdeveloped mainly due to the reasons mentioned above.

Rule of Law

<u>Key issues</u>

- Generally speaking, **legislation in Ukraine** developed well over the last 10 years. There were improvements in various fields (land law, registration of companies, the tax code, and the customs code). Although there is room for improvement, Ukraine legislation does not need a major overhaul (save for the Labour Code, see below).
- However, Ukraine does need to restate the **rule of law and its implementation**. Over the last four years, civil and commercial courts became more corrupt and subject to political influence (administrative courts). Independent courts can deal much more efficiently and rapidly with any shortcomings of legislation than the legislator.
- Courts suffer from **serious underfunding**. Judges salaries have been increased over the last years, but administrative salaries in the courts have not. Judges are insufficiently supplied with office equipment, access to legal literature, and data bases on court proceedings. This can lead to a poor quality of court decisions and to additional 'funding needs' of judges.
- The work of **state offices** dealing with **compulsory enforcement** is slow and often corrupt.

<u>Recommendations</u>

- Provide **additional funding for the court system**, in order to allow competitive salaries for support staff and provide access to necessary data bases, legal literature and office equipment.
- Provide additional funding for the **compulsory enforcement service**, to make it attractive as employer, and increase access criteria for professionals working in the enforcement service. Other Eastern European countries (e.g. Bulgaria) have successfully employed private agents in clearly delineated areas of compulsory enforcement; Ukraine should consider this option as well.

[1] We would like to thank Thomas Otten from Otten Consulting, Julian Ries from Gide Loyrette Nouel, Alexander Markus from the Delegation of German Economy in Ukraine and Matthias Morgner for their input and comments to this chapter.

Reducing bureaucracy

Key issues

- Ukrainian **accounting standards** create much unnecessary bureaucracy for companies and the public administration. This concerns small and medium size enterprises (SMEs) in particular, as they do not have the same means to deal with such problems as bigger companies, and thus puts them at a competitive disadvantage. To confirm one business operation a company has to issue up to 4 different documents: invoice, act/delivery note, waybill (goods delivery), and VAT special document. To confirm a VAT credit, the received VAT special document must be even registered in the state register of VAT documents. If documents have even minor formal mismatches they may be declined by tax authorities, resulting in the loss of VAT credits and tax expenses, because the principle 'form over substance' is common practice.
- **Labour law** remains a special and highly inflexible area of administrative law that is in need of major overhaul. Companies face enormous administrative burdens; for example, a proper vacation procedure requires a vacation plan, a hand-written application for vacation signed by the employee and the employer, and a 'prikaz' ('order') from the employer that actually grants the vacation, again signed by the employer and the employee. In addition, vacation pay is calculated in a very complicated manner.
- The **application procedures for work and residency permits** for foreign employees are also intricate and burdensome, and receipt of a work permit does not automatically entail approval of residency. Permits are usually granted for no more than 1 year, although longer periods are possible by law. This is a significant impediment for foreign investment in Ukraine.
- Ukrainian **Antimonopoly Law** applies a very low threshold for transaction volumes that require prior antimonopoly clearance. The clearance procedure is very complex and costly since a large number of documents have to be prepared. In case the purchaser or the target have affiliated companies in other countries, the documents often have to be notarised/legalised in the foreign country and translated into Ukrainian, thus generating additional costs.

Recommendations

- To **reduce bureaucracy in the sphere of accounting** a single document for confirmation of business operations (similar to the EU Invoice) should be introduced. This document should combine and replace the invoice, the act/delivery note, the waybill, and the VAT special document. It should not require countersigning by the parties and/or registered in any state registers.[2] The document should also contain bank details to be used as basis for payment. The precise form of this document should be adopted by September 2014, and the use of the document should become mandatory as of January 1, 2015, so that all taxpayers have time to update their accounting software accordingly.
- **A new Labour Code**, based on the concept of the free will of the parties, should be adopted. In particular, termination procedures should be simplified, in a way that balances the employee's and the employer's interests. The administrative burden can

[2] Amendments that cancel the VAT special document and its obligatory registration in the state register should be made to the Tax Code. The Law on Accounting 16.07.1999 № 996-XIV should be amended to specify the obligatory details of the new primary document, so that this document can be used for VAT accounting as well (VAT rate, number of VAT payer etc.).

be significantly reduced by abolishing the labour book and the various 'prikazes' for all kinds of interaction between employers and employees.

- The procedure for **granting employment permits and residency permits** must be greatly **simplified**. An employment permit should automatically grant residency rights, so that it is not necessary to apply for both separately. An employment permits should be granted for the entire duration of the employment agreement on which it is based. The requirement of the health certificate should be abolished and the procedures for establishing proof of higher education simplified.
- **Adjust the antimonopoly clearance thresholds** to a level that is comparable to Western European standards. The requirements for submission of documents that describe the impact of a transaction on the Ukrainian market should be greatly reduced.

Tax administration

Key issues

- For companies with a yearly turnover above UAH 10 m, Corporate Profit Tax (CPT) **advance payments** were introduced in 2013. However, companies with CPT **overpayments** in 2012 faced serious problems when they attempted to offset such overpayments against CPT advance payments in 2013, even though no restrictions are foreseen in the Tax Code[3].
- Companies, especially exporters, continue to experience problems with **VAT reimbursement** from the state, with negative implications for business and the economy. Automated VAT reimbursement is foreseen for companies that fulfill certain requirements of the Tax Code, but the tax authorities often fabricate formal reasons for refusing a reimbursement or to prove that a company doesn't fulfill all necessary criteria. Even after the amount of a VAT refund has been confirmed by audit, the tax authorities will often postpone the actual payment pending a check of the entire supply chain leading to the transaction in question. If any supplier in this chain has not declared and paid its VAT obligations, the tax payer at the end of the chain will not receive a VAT refund.

Recommendations

- The key to improving the offsetting/repayment of CPT is to strictly **apply existing legislation**, i.e. establish the rule of law. CPT payers must be sure that the articles of the Tax Code which guarantee their rights to tax offsetting/repayment are executed impartially and rapidly. This will have a positive impact on the investment climate in Ukraine by increasing trust in Ukrainian tax authorities. In the longer term, the introduction of personal responsibility (financial, criminal and administrative) for Tax Code violation and corruption has to be implemented for all tax authorities, including the Head of State Tax Service. Appropriate changes should be made to the relevant codes of Ukraine (Tax, Criminal, Civil etc.).
- A functioning **VAT reimbursement mechanism** is an important signal of a stable investment climate in Ukraine. The practice that VAT refunds are cancelled if any one supplier in the supply chain has not paid VAT should be dropped; one tax payer cannot be held responsible for the actions of all others in the chain. For companies that are owed VAT refunds by the state (confirmed by tax audits, the so-called 'stock

[3] Letter N 4420/6/15-14-15-13 issued by State Tax Service declares that offsetting of CPT overpayment and advance CPT payments is possible. However, in practice any offsetting over a certain level (UAH 100,000 in 2013 and UAH 50,000 in 2014) must be approved by the State Tax Service.

problem'), a solution that balances the interests of Ukrainian taxpayers, the international donor community, and the companies concerned must be found. A gradual repayment of such debts in cash, or the issuance of VAT bonds might be considered. It must be stressed that whatever solution is found is a final, once-off response to an inherited problem.

Fighting corruption

Key issues

- **High levels of endemic corruption**, which affect all sectors of the Ukrainian economy, are unanimously quoted as one of the major reasons for the current economic and financial crisis. Corruption has also been a wellspring for the civil protests and unrest that have resulted in the current political situation. **Ukraine is ranked 144 (out of 177 countries)** in the latest Transparency International '**Corruption Perceptions Index'**.
- Corruption results in loss of public money and/or poor public service delivery. It is one of the major causes of insufficient activities of **domestic business**, in particular of small business, which has less means than well-connected big business to defend itself from improper behaviour by public officials. Furthermore, corruption is a key reason for low engagement of **foreign business** and for low levels of FDI. Corruption **undermines the credibility of the political system** and results in a **lack of trust in public institutions** such as the judiciary, law enforcement, and public service providers in education, public health and utilities.

Recommendations

- **Implementation of the concept of illicit enrichment** (UN Anti-Corruption Convention, Article 20) by introducing criminal liability in cases where the living standards and increase in assets of an official cannot be reasonably explained by his/her official income.
- **Temporary introduction of an 'Anti-corruption Watchdog'**, since the state prosecution authority itself is corrupt.
- **Transparency regarding the wealth of the family members of state and government officials** (the constitutional court currently protects family members' 'right to privacy').
- Shifting the **main focus** of anti-corruption enforcement from low level officers and employees to the **high ranking civil servants** at the top of the corruption 'pyramid'.

4. Sectoral Issues

While macroeconomic stabilization and the improvement of the investment climate will bring immense overall benefits to the Ukrainian economy, policymakers should also address existing weaknesses in key sectors. We concentrate in the following on energy, agriculture and the financial sector.

Energy Sector

Key issues

- Natural gas is the most important energy carrier in Ukraine. In 2012 36% of total energy supply came from natural gas. More than half of this gas is imported from Russia and the **cost of imports of natural gas** correspond to about 8% of Ukrainian GDP in 2012 (compared with roughly 1% in the EU). The reason for this high share is that gas import prices have quadrupled from about USD 100 per thousand cubic meters in 2007 to about USD 400 in 2013. At the same time, gas consumption has not reacted to increasing prices as subsidised internal gas prices and the general economic situation did not encourage investments in energy efficiency. Energy intensity in Ukraine as almost four times higher than in the EU.
- In addition to the high cost of gas imports, Ukraine's unidirectional sourcing strategy poses a **supply security** risk. Currently, Ukraine imports about 50% of its gas and 100% of its nuclear fuel needs from Russia. A disruption of Russian supplies would cause serious difficulties, at least in the short and medium term.
- Ukraine's energy sector will require **investments** of up to USD 200 bn until 2030 according to the International Energy Agency. Currently there is no framework that ensures investors the necessary cash-flows over the long lifetimes of the corresponding projects.
- Transit through the Ukrainian **gas transport system** has contributed revenues of up to USD 3 bn per year. But transit volumes have been declining and there is a clear risk that Russia might in the future be able to circumvent transit through Ukraine. This would put additional pressure on transit volumes and/or margins.

Recommendations

- **Removing final energy price distortions** is crucial. Given the size of the distortions, an immediate adjustment would be politically unfeasible and ineffective (due to potential non-payment). Consequently, a multi-year roadmap to reduce the distortions in the heat and gas market should be developed. A significant first step would be to ensure that prices for district heating cover all the cost of district heating companies. This should be done immediately as it will be far more difficult when the next heating season approaches. In parallel gas prices for households should be gradually increased to 100% cost recovery over five years.
- To achieve this, the **energy regulator** has to be granted real independence from the Government. This will help to avoid politically motivated energy pricing decisions in the future. Reduced public expenditures on subsidies could save almost USD 5 bn per year – the equivalent of 2.5% of GDP in 2014. Energy price reform should be buffered by a reform that improves the targeting of social payments to needy households.
- A 'best practice' **energy efficiency program** should be adopted as a tool to help final energy consumers cope with rising energy prices and to reduce Ukraine's dependence on Russian gas supplies.

- A solution must be found that shields the **gas transit system** from domestic political influence. This would ensure that domestic gas producers who want to export and foreign exporters who want to transit gas can rely on the pipeline system. To achieve this, the new government should do two things: (1) commit to fully and quickly implement the Energy Community provisions; (2) privatise the gas transport system to an investor. A European public bank might facilitate such a transaction by acting as a temporary investor ('pre-privatisation') that buys part of the shares, engages in the restructuring of the company and then sells it together with the remaining state shares as soon as the necessary regulatory reforms are conducted.
- To improve security of supply Ukraine should immediately start to develop a binding emergency plan to minimise the cost of supply disruptions. In addition, the **regulations for the usage of the pipeline and the storage system** should be brought in line with European rules. If European companies were enabled to sell gas to Ukrainian consumers directly, security enhancing reverse flows might become more widely used. Finally, cooperation with alternative suppliers for nuclear fuel should be fostered.

Agriculture

Key issues

- Agriculture plays an important role in the Ukrainian economy. Including input supply and food processing it accounts for over 20% of Ukrainian GDP. However, **international productivity comparisons** reveal that Ukrainian agriculture is performing far below its potential. Given an appropriate policy environment that encourages investments in efficient production, agriculture could be an engine of economic growth in Ukraine.
- Overall, Ukraine has pursued a liberal trade regime. However, agricultural trade has been a notable exception. In particular, Ukrainian policy makers have repeatedly implemented **export restrictions** in recent years. These restrictions were justified in public by the need to protect Ukrainian consumers, but behind the scenes they were largely driven by rent seeking and corruption.
- Infrastructure and marketing systems link world market prices at Ukraine's borders to the prices that producers receive for their products. Despite good preconditions for efficient grain and oilseed marketing in Ukraine, **marketing costs for agricultural commodities** - including transportation, storage and certification - are highly inflated. Grain producers in Ukraine receive a much smaller share of the world market price for their crops than their competitors in other exporting countries.
- The main elements of **agricultural taxation** are the fixed agricultural tax (FAT) and the special value added tax (VAT) regime for agriculture and agricultural exports. The FAT, at roughly 0.5 EUR/ha is essentially irrelevant in quantitative terms, and it is not equitable, because the more profit an enterprise makes, the lower its relative burden. In the past, recurring irregularities with the reimbursement of VAT for grain and oilseed exporters have fuelled corruption and depressed farm gate prices for export commodities, while frequent changes to the special VAT regime created uncertainty.
- An efficient agricultural finance sector is a necessary condition for boosting agricultural productivity and competitiveness. However, the **provision of loans to agriculture** in Ukraine is low compared with several benchmark countries, despite the very lucrative investment opportunities that are available.
- Modern agriculture is capital intensive, and especially human capital plays a vital role in determining productivity and competitiveness. However, Ukraine's **agricultural education and research system** is producing neither the trained individuals at all levels from apprentices to PhDs, nor the innovations that Ukrainian agriculture needs to improve its international competitiveness.

Recommendations

- The liberal stance of Ukraine's trade policy should be extended to cover agriculture. Agricultural prices on world markets are high and projected to remain strong. Since Ukraine is a net exporter of food products, high agricultural prices are on balance good for the country. Ukraine should send a clear signal to producers, traders, customers and international partners that it is committed to being a reliable source of agricultural exports and will **completely refrain from interfering with grain and oilseed exports**.
- To ensure that farmers receive a competitive share of the international value of their products, policy makers should address the institutional causes of excessive marketing costs. In particular, **certification requirements along the marketing chain should be simplified** and unnecessary procedures should be eliminated immediately.
- The FAT should be abandoned by the beginning of 2015 and replaced by the **implementation of the Corporate Profit Tax** (CPT) in agriculture. Exemptions from the CPT should be granted only for profits that are re-invested into farm operations or used to repay loans received for investments. Profits that are paid as dividends to shareholders should not benefit from any exemptions.
- A reform for the **special VAT regime for agriculture** is an important medium term goal. However, due to the complexity of the system and its implications, we recommend against putting this issue at the top of the new government's reform agenda.
- A clear government commitment not to interfere with grain and oilseed exports would greatly **improve the creditworthiness of agricultural enterprises** in Ukraine. The introduction of the CPT for agriculture would have the same effect, by obliging agricultural enterprises to implement professional bookkeeping. When providing loans to grain and oilseed producers, **banks should be freed from the strict NBU provisioning regulations** regarding foreign exchange lending, since the prices for grain and oilseeds are determined on world markets and thus denominated in foreign exchange (i.e. there is no currency mismatch in economic terms).
- The entire **agriculture education and research system** in Ukraine should be overhauled. We recommend the establishment of a new Ukrainian University of Agriculture with the guidance of a consortium of leading international agricultural universities. In addition, Ukraine should seek to expand existing exchange programs that allow Ukrainian students to train as apprentices on farms and attend technical colleges and universities abroad. It should establish a competitive scholarship system for participation in such exchange programs.

Financial Sector

Key issues

- The current situation in the **banking sector** is fragile, as significant **deposit withdrawals** have been recorded in recent weeks. These withdrawals have put pressure on banks' liquidity positions. A clear link between these developments and the situation on the foreign exchange market can be drawn.
- This comes at a time where the banking sector has not yet fully recovered from the impact of the 2008/09 global financial crisis, as **high amounts of non-performing loans** continue to burden the balance sheets of banks and prevent them from actively **lending to the real economy**. The previous **inconsistent macroeconomic policy mix** that kept financial conditions overly tight further contributed to the disappointing lending performance.

- The **problematic financial intermediation** is aggravated by the fact that Ukraine's financial sector is not diversified, and consists mainly of banks. **Capital markets** for issuing and trading stocks and bonds are still under-developed and do not contribute significantly to financial intermediation. Due to this underdevelopment, many Ukrainian companies are forced to **raise debt and equity** on foreign markets in order to finance their **investments**.

Recommendations

- Priority must be given to the **stabilisation of the banking sector**, as any major disruption here would pose severe threats to the entire Ukrainian economy. The **transparent refinancing** of illiquid, but solvent banks through the provision of emergency liquidity will play a major role in this regard.
- Where **systemic banks** are in danger of becoming insolvent, the authorities should intervene and provide public funds for recapitalization.
- **A stress test** following best international practice should be implemented to provide a comprehensive and transparent picture of financial conditions in the banking system.
- After the short-term stabilization has been achieved, the main objective must be to **re-start lending**. The problem of **non-performing loans** should be dealt with in a swift and decisive manner, **consolidation efforts** in Ukraine's still fragmented banking sector should be supported, and the activities of **credit bureaus** should be strengthened.
- Deep capital markets are an integral part of the financial sector in developed countries. In Ukraine, the development of the local bond market should be a top priority. By issuing more local bonds, the sovereign can set a benchmark that will support private companies to raise debt. The local stock exchanges should be also developed in order to offer an alternative to raising equity on foreign markets.