EERC MASTER'S PROGRAM IN ECONOMICS*

NewsLetter

VOL.8
JUNE, 1999

"PROMOTING EXCELLENCE IN TEACHING AND RESEARCH IN THE DISCIPLINE OF ECONOMICS"

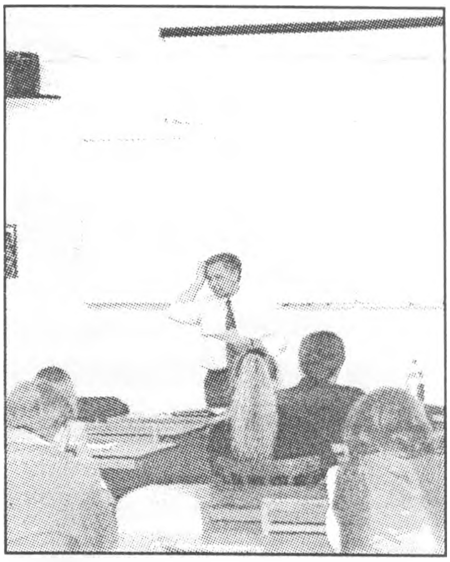
UKRAINIANS MUST UNDERSTAND WHY WE NEED REFORMS

"This country doesn't know what it is after and what it needs money for," began parliamentarian Yurii Yekhanurov in a speech to the students of EERC's Master's Program in economics on May 19, 1999. Yekhanurov believes that true economists – as he called the students of the Program – ought to be aware of and understand the current state of Ukraine in order to make a diagnosis and determine effective methods of treatment.

The structural policy of any country is a system of government actions to redistribute a country's resource potential in order to create conditions for a qualitative renewal of the base of economic development. Yurii Yekhanurov believes that countries all over the world undergo structural reconstruction. Each country has its own priorities in the structural reform process. Japan, for example, pays special attention to the development of industries directly related to the technological revolution. The U.S. focuses on strengthening its international position in the world economy. The European Union takes a five-level approach to structural policy that includes economic, industrial, technological, interregional, and international issues of development of EU member countries. As for Ukraine, Yekhanurov pointed out that the state takes all industries as foreground and because of that the lack of extreme reforms is so manifest. This is why Ukraine is enduring the deepest and longest economic decline of any post-socialist country, aside from Bulgaria. However, after ineffectual communist experiments Ukraine is decisively moving forward towards the path of economic growth.

In his speech, Yekhanurov concentrated on the structural reconstruction problems that need to be solved urgently in Ukraine. There are certain Ukrainian enterprises which occupy amazingly large territories (how many enterprises could be located there instead?) and have enormous labor resources whose effectiveness is practically zero. (As an example, in the early 1980s, a typical construction organization in Ukraine employed 450 people, in Germany - nine employees, and in the USA - seven.) The country's weak banking and monetary systems - which are the smallest in the world relative to GDP - as well as the budget deficit, shadow economy, and poor state of the agricultural sector urge the country to launch effective structural reforms.

As the former head of the State Property Fund, Yekhanurov also spoke on issues related to the state assets in Ukraine. "During my tenure at the Fund about 50 % of industrial enterprises passed into private possession," said Yekhanurov. "We did this in order to create new private owners who would prevent the Communist regime from



Yurii Yekhanurov

EDITOR'S NOTE

Yurii Yekhanurov is a parliamentarian and a member of the committee on economic policy. He is also President of the Association of Small and Medium Business of Ukraine. Previously, he has held the posts of Head of the State Property Fund of Ukraine, Minister of Economy, and Head of the State Committee for Entrepreneurship Development.

* THIS PROGRAM IS CARRIED OUT AT THE UNIVERSITY OF KIEV-MOHYLA ACADEMY (UKMA) UNDER THE AUSPICES OF THE ECONOMIC EDUCATION AND RESEARCH CONSORTIUM (EERC). THE PROGRAM MANAGED BY THE EURASIA FOUNDATION. THE EERC RECEIVES FINANCIAL SUPPORT FROM THE EURASIA FOUNDATION (WITH FUNDING FROM THE U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT), THE FORD FOUNDATION, THE CARNEGIE CORPORATION, THE OPEN SOCIETY INSTITUTE, THE PEW CHARITABLE TRUSTS, THE ROYAL NORWEGIAN MINISTRY OF FOREIGN AFFAIRS, THE STARR FOUNDATION, THE SWEDISH MINISTRY OF FOREIGN AFFAIRS, AND THE WORLD BANK.

returning." Yekhanurov noted that as of April 1 of this year, 64,451 Ukrainian enterprises were privatized (about 80% of which are small-scale property enterprises). Although Ukraine gained some credit in the field of privatization, Yekhanurov thinks that legal defense of proprietor's rights remains a pressing issue.

Regarding structural reform of Ukrainian industries, Yekhanurov said that the state must realize which industries are fading away. Instead of subsidizing these industries and forgiving their debts, the state must implement effective policies to reconstruct them. Clearly a structural reconstruction like this will be accompanied by a reduction in jobs and this in turn will lead to psychological and economic hardship for large groups of the population. But the most important issue, according to Yekhanurov, is that Ukrainians must understand that structural reforms, in spite of their painfulness, are indispensable for further development of the country. An effective system of social protection (which should be directed at the economic growth of Ukraine), pension reform, and favorable conditions for starting and developing new businesses are necessary to remedy Ukraine's troubles. The government of Ukraine has to offer such a way out to its people.

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EERC Master's Program Home Page:
http://www.eerc.kiev.ua

Gateway to Ukraine, the Economics of Transition , and the World of Economics:
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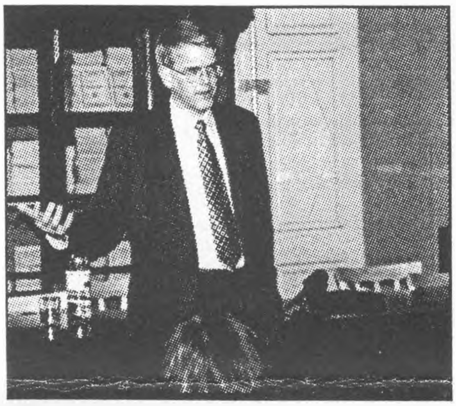
U.S. AMBASSADOR: "UKRAINE IS THE MOST DIFFICULT PLACE FOR DOING BUSINESS"



Stiven Pifer

EDITOR'S NOTE

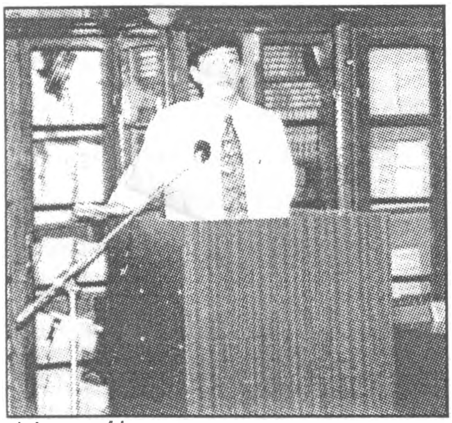
The Ambassador's Fellowship Program was created in June 1997. With a grant from the United States Information Service (USIS), the program allows EERC students to work as researchers and advisors in governmental institutions such as the Ministry of Economy, National Bank of Ukraine, State Property Fund, Antimonopoly Committee, State Statistics Committee, State Licensing Chamber, and State Committee for Entrepreneurship Development.

Where do Ukrainian-American relations stand at this moment? What are the issues of the strategic partnership between our two countries? On June 2, 1999 U.S. Ambassador to Ukraine Mr. Steven Pifer talked with EERC students about these issues.

Ambassador Pifer has stated that from 1992-93 there was a major evolution in U.S.-Ukrainian relations and significant progress in the strategic partnership between our two countries. In 1992-93 there were only a few issues on the agenda for this partnership. The main issue was, of course, nuclear weapons after the Soviet Union's collapse. Now the agenda is constantly growing and includes political, economic, cultural, and security issues.

In the Ambassador Pifer's opinion, the U.S. is looking to expand relations with Ukraine. But an improvement of the relations between the two countries directly depends on economic stability in Ukraine. Transformation of Ukraine into a European democratic country with a stable market economy is incredibly important both for Ukraine's development and for the continued presence of American institutions (including the U.S. Embassy) on Ukrainian territory. Ukraine's course of development influences American investors, who represent an important constituency for Ukraine. As the largest foreign investor in Ukraine, the U.S.'s cumulative total of investment now comes to about 450 million dollars; total foreign direct investment in Ukraine is around 2.4 billion dollars. But in the Ambassador's opinion that is a paltry sum for a country of Ukraine's size and potential. Ukraine needs investment, which means new capital, new jobs, new technology, modern management practices, and new tax revenues. Unfortunately, the Ambassador believes that Ukraine's current tax system, regulatory environment, and high level of corruption make Ukraine the most difficult place in the world for doing business, which naturally discourages commercial partnerships between the two countries.

TRANSITION PROCESS: WHERE IS UKRAINE?



Johannes Linn

EDITOR'S NOTE

Johannes Linn studied law at the Free University in Berlin, Germany. He received his training as an economist at Oxford University in England (BA, 1968), and at Cornell University in the U.S. (PhD, 1972). Mr. Linn joined the World Bank in 1973. In 1987/88, Mr. Linn was Staff Director of World Development Report 1988, which dealt principally with issues of public finance in development. In 1991, Mr. Linn was appointed the World Bank's Vice President for Financial Policy and Resource Mobilization. Since January 1996, Mr. Linn has held the position of the Bank's Vice President for Europe and Central Asia (ECA).

The World Bank's Vice-President for Europe and Central Asia, Johannes F. Linn, spoke to EERC master's students on June 7, 1999. The topic was "The World Bank and Transition Economies of the Former Soviet Union Countries." As a specialist to Europe and the Central Asia region, Mr.Linn tried to summarize the transition process in the countries of the former Soviet Union, especially during the 1997-98 financial crisis. In his opinion the lesson learned over the last few years is that those countries that have strong fundamentals, especially fiscal balance, good banking supervision, strong market reforms, and a cohesive government with reasonable political support can withstand the financial turmoil. The countries of Central Europe and the Baltic region are a good example. During the last three years all of these countries have enjoyed macroeconomic stability, as shown by the fact that they were not significantly affected by the financial crisis in East Asia and Russia in 1997-98. GDP growth in these countries averaged 5.3 percent from 1995 to 1997 and inflation is down from 150 percent in 1992 to about 10 percent in 1998. There is major progress in structural reforms and a significant level of foreign direct investment. As a result, all these countries are ready for integration into the European Union. In Linn's opinion, the transition process there is almost complete.

Countries with difficulties in economic and social development, poor economic management, and unattractive conditions for private investors, on the other hand, were affected by the financial crisis substantially. Unfortunately, Linn places Russia and Ukraine in this "unhappy" group with limited prospects, where economic and social development is complicated in comparison to other NIS countries. Linn paid special attention to issues the World Bank considers to be similar for Russia and Ukraine and crucial for both countries' development. Among these are:

- macroeconomic instability;
- major difficulties in structural reforms (especially in agriculture);
- problems in financial and enterprise sector;
- insufficient regulatory framework;
- social sector issues (lack of pension and educational reforms); and
- weak public administration on the national and oblast levels.

Despite these negative points, Linn personally feels that Russia and Ukraine have significant economic potential. In his opinion the main question is determining the political framework in which economic reforms can take place in these countries. The future of these reforms, Linn believes, basically depends on the political will and desire to implement these reforms.

The World Bank representative Mr. Gregory Jedrzejczak participates in the EERC Speaker's Series

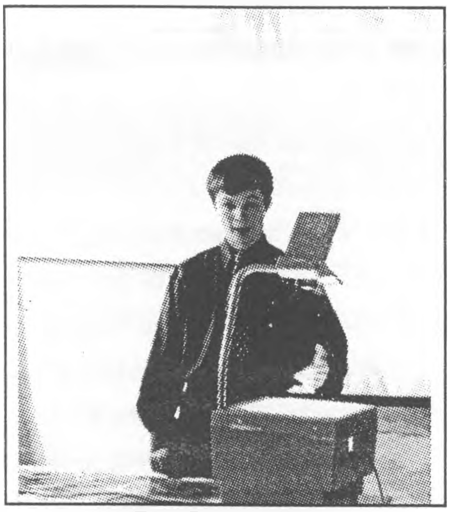
SHOULD THE UKRAINIAN STOCK MARKET EXIST?

The belief that the Ukrainian stock market should exist only because there are stock markets in developed countries, in the opinion of Tymofiy Mylovanov, is wrong. There should be an incentive for a market to emerge. The main reason for stock market existence is reallocation of resources and channeling funds from savers to businesses that have profitable opportunities for investment. Because the causality is that the primary market where securities are issued and investments are made creates a secondary market where liabilities are traded, the necessary condition for market development is the presence of profitable investment opportunities (taking into account risk premium) and savers who would like to invest in securities. A sufficient condition, however, is developed market institutions.

This is particularly true for Ukraine. The crisis of the Ukrainian stock market in 1997 was not caused by the overall crisis of emerging markets or specific crises in Asia or Russia, but, in Mylovanov's opinion, solely by its internal inconsistency. In fact, it is not a market for stock, but rather a market for speculation in "privatized" pieces of paper ("liabilities" which are not enforced and which, except for a few cases, do not create cash dividend flows), where capital gains are the only source of profit.

In Ukraine, investment is risky and uncertain, enforcement is weak, and transaction costs are high, while the economy is shrinking. But key differences between the Ukrainian and developed stock markets are that privatization does not provide profitable investment opportunities and speculators are poor substitutes for developed domestic investor base.

Thus, it is not surprising that in 1997 the Ukrainian stock market grew about 170% from January to August, was approximately stable until October and then plummeted. In January 1998 it was 50% less than its value in August 1997. Since then the market has essentially been considered dead.



Tymofiy Mylovanov

EDITOR'S NOTE

Tymofiy Mylovanov, 1999 graduate of the EERC master's program in economics. From April to November 1997, Mylovanov worked for Alfa Capital Ukraine as Head of the Depository Division and then in the position of Head of Back Office until October 1998. This year he was admitted to a Ph.D. program at the University of Wisconsin-Madison.

Tymofiy Mylovanov thinks that the main reasons for the Ukrainian stock market crisis are the following:

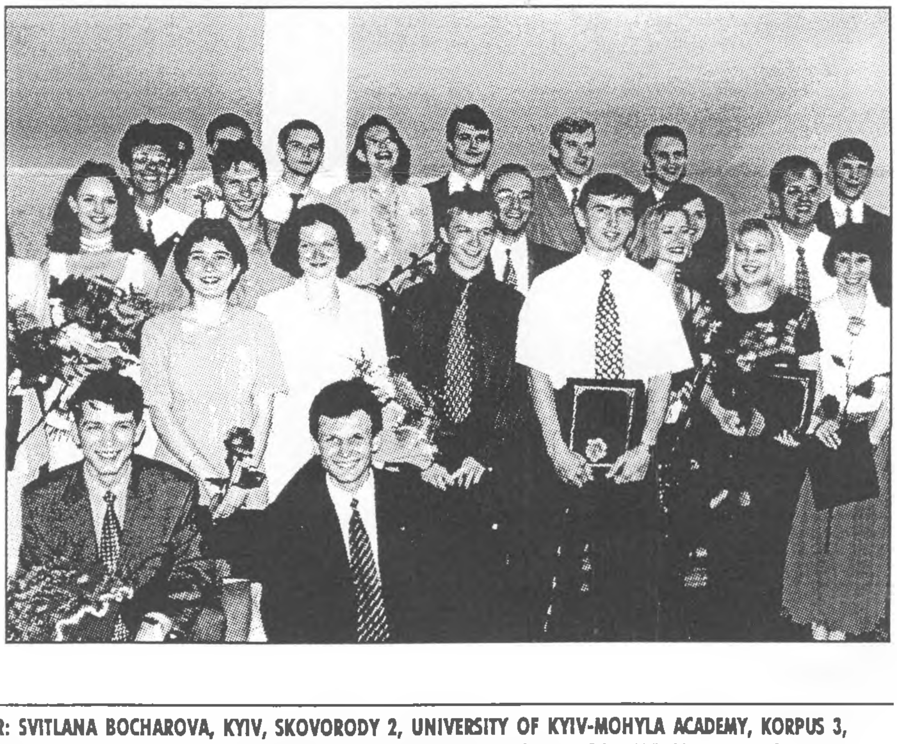
- The absence of profitable investment opportunities, the constantly worsening economic situations in Ukraine, and high economic and political risks.
- The failure of the Ukrainian stock market to perform the main economic functions of any financial market
  - in fact, the stock market does not perform transfer of funds from savings to investment. There are no underwriting operations. The market does not encourage corporate control, does not ensure liquidity of financial instruments and does not determine the value of investment projects;
  - there is no long-term fundamental (savings) demand for securities.
- The Ukrainian stock market is highly speculative
  - most of the market participants were oriented on short-term or even instant profit;
  - there have been strongly reinforced expectations about the price movements;
  - return on securities consists only of capital gain or loss;
  - dividends in most cases are not paid.
- Market friction
  - non-transparency. Absence of information about trades, volumes, prices;
  - high transaction costs;
  - information asymmetry and its incredibility;
  - weak institutional infrastructure, in particular settlement procedures;
  - weak enforcement. Inadequate bankruptcy framework.

Hence, in Mylovanov's opinion, it is obvious that in order to develop the Ukrainian stock market government should concentrate on two main issues. First, a domestic investor base should be created. This requires creation and promotion of mutual funds, investment and insurance companies, and other institutional investors. Additionally, the incentive environment must be set so that individuals are motivated to invest in stock rather than keep money in cash or another currency or in a foreign financial system. However, it is necessary to remember that administrative methods will not work. Second, supply in the market needs to be enhanced. Businesses should have incentives to obtain financing through financial markets - in particular, by issuance of new securities, rather than through lobbying and administrative instruments. Government must not intervene in the decision-making processes of financial market participants, because it creates distortions and crowds out market-based mechanism of resource allocation. On the other hand, all profitable enterprises should be privatized. It is a well-known and very relevant argument that government is less efficient than the market. This means that no "strategic status" of enterprise can justify its government ownership. And finally, it is worth remembering that excessive government borrowing through the bond market leads to crowding out of private investment. Hence, supply development of the market should not be driven by issuance of government bonds.

The third point is that considerable attention must be paid to the institutional structure of the market. It is necessary to ensure transparency and an acceptable level of liquidity. To alleviate impact of information asymmetry, disclosure procedures and distribution of information among market participants should be improved. The other goal is to decrease transaction costs. This can be done through development of the operational infrastructure of the market, promotion of competition and standardization of investment instruments and procedures.

In summary, Mylovanov said that the Ukrainian stock market is undeveloped and therefore highly vulnerable to financial crises. Moreover, it does not perform its main economic function and, hence, has no significant positive impact on economic development. Hopefully, the situation might be changed if considerable effort is devoted to the development of demand and supply aspects of the market along with creation of adequate institutions.

1999 EERC Graduates



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