

New Impulses Needed to Return to Growth

by

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Introduction

The economic slow down was coming to Ukraine even before the global financial crisis spilled over developing economies.

Developers have faced troubles in finding buyers since early 2008, the deficit in trade balance reached 10 per cent of GDP in the first half of 2008, the rate of inflation peaked in May reaching 30 % in comparison to analogous period of 2007. The investment slowed down. The fast growth of economy, resulting from privatization and liberalization undertaken in late 1990s and early 2000s, was coming to an end. Naturally, the global crisis has just seriously deepened inherent defects of Ukrainian economy.

Therefore, the policy response to the crisis should be twofold. One is financial adjustment: ensuring liquidity for banks, liberalization of exchange rate, extending guaranties for depositors, supporting balance of payment and public finances through loans from international financial institutions. These measures are needed to prevent from default of the country, ensure solvency of banks, protect depositors and provide new credits to bolster effective economic activity.

But all those measures will not suffice to promptly return Ukraine to sustainable growth. Deep recession has started and may last for long. Unlocking reserves hidden in the form of unfinished institutional and structural reforms will bring new impulses, which are needed to activate underutilized resources and put Ukrainian economy back to work. We will focus on four policy areas that require bold policy approach in order to open new opportunities for development: energy, social policy, agriculture, business climate.

Rational pricing policy in energy sector

Ukraine is notorious for its inefficient consumption of energy. It uses 2.6 times more energy per unit of GDP than world average, 2 times more than the new EU members that used to be – as centrally managed economies - equally wasteful in energy consumption as Ukraine is still nowadays. In 2008 Ukraine will pay almost 10 billions USD for imported gas, which amounts to 13.5 % of the overall export earnings. And this is not the limit should Ukraine pay the market gas price. The price paid for the imported gas is not fully covered by final users and most of them pay less than half of imported gas price. For households, small enterprises and communal services using more gas is cheaper than introduction of energy saving measures: meters, thermostats, insulation, etc. The present pricing policy encourages consuming and wasting energy rather than saving it. The largest benefits from present pricing policy go to those who are using a lot of energy: users of large apartments and spacious dachas and not to the poor. Therefore, all appeals to save energy will remain futile, unless rational pricing of energy is introduced and energy saving becomes cost-efficient for millions of final users.

Besides, current policy is beneficial for external suppliers and discriminatory for domestic gas producers. Depressed domestic prices create disincentives for domestic producers to increase production of energy. Domestic producers of natural gas receive lower price for gas than foreign suppliers of gas. Assuming they are paid the same price as foreign suppliers they would have resources and motivation to re-invest in domestic natural gas production. This would finally bring to increase in gas production in Ukraine.

The rationalization of pricing in energy sector will bring to:

- substantial savings in gas consumption;
- increased domestic production of gas
- improvement in balance of payment,
- weakening substantially Ukrainian dependence on foreign supplies of gas

- a more fair approach to allocation of public support through housing subsidy provided only for the poorest (see also the next paragraph).

Targeted social policies

The crisis requires more resources to protect the most vulnerable. But at the same time the government budget revenues are shrinking. This contradiction can be reconciled through concentration of the public support on poor, unemployed, disabled persons and renouncing lavish social spending on those relatively better off.

Let us examine **pension system**. The solvency of the system is in jeopardy. Despite high rates of contributions there is not enough funds to finance all pension obligations. One of the reasons behind this is the retirement age in Ukraine that is lowest in the world: 55 for women and 60 for men. There is almost one pensioner per one working person contributing to the pension funds. The burden on a working population to finance pensions through pension fund contribution and general taxes is becoming unsustainable. The popular argument supporting policy of early retirement age goes that retirement age should stay low because life expectancy in Ukraine is low. Indeed average life expectancy at birth is relatively low in Ukraine, particularly for men - 62 years. However, when discussing arguments pro and con early retirement age, one should compare average **life expectancy at the retirement age and not at birth**. The average life expectancy for women at the retirement age in Ukraine is 25 years that is more than in the most European countries that allow women to retire only at 60, 65 or even 67. **Ukrainian women work fewer years than any women in Europe but stay in retirement longer than women in the majority of other European countries**. The average life expectancy for man at the retirement age is 14 years in Ukraine which is similar (or a bit less), to analogous indicator in developed countries. It is worth to note that when Bismarck was introducing state pension system offering full pension from the age of 70, the average life expectancy at birth was 47 years in Germany.

Increasing retirement age is particularly important for Ukraine for two reasons. The first is demographic. Population trends will make present pension system to collapse. The proportion of pensioners to working population, that is already alarming, is deteriorating every year. The second one is an immediate contribution to the stabilization of public finances during the crises. In the first year in which we start increasing retirement age, the number of new pensioners could be cut by half, if we apply gradual approach, or even by 100 per cent, if we apply radical approach, that I do not recommend.

More profound pension system reform, that would replace present pay as you go system with individual account pension system, will bring other benefits including stimulus to quit shadow economy and to operate legally and contribute regularly to her/his own individual account. This will have a positive effect on present macroeconomic balances too.

Monetization of social benefits could be recommended as another way to rationalize social spending. There are still a lot of privileges granted to various categories of citizens. Cheap energy and other housing services, free transport, etc. Monetization of these benefits will allow beneficiaries to choose whether to make use of the offered service or spend money for other purposes. Providers of services will thus have rational calculations based on supply and demand, and real prices. Targeted, means tested forms of support, including housing subsidy for poorest to help them face energy and housing services price growth, should be developed instead.

Opening opportunities for agricultural sector

According to the World Bank and FAO estimates Ukraine can produce 2-2.5 times more food than it produces now. But there are two most important conditions to boost agricultural

production, ensure large scale inflow of new capital to agriculture and food processing industries and create new jobs. They are the following:

a) Lifting moratorium on agricultural land sale. Lack of genuine market for agricultural land hampers effective allocation of land and long term investment in land and agriculture in general. Besides, it deprives titular owners, former 'kolgospnyky' and 'radgospnyky', quite many of them being now aged people, to draw adequate benefits from formally obtained ownership. Excessive limits for foreign companies in their access to agricultural land prevent inflow of large foreign capital to agricultural sector. Only 2 per cent of foreign investment goes to agricultural sector. Additionally, lifting moratorium will allow for using land as collateral to get loans from banks and therefore provide more financing for investment in agriculture and/or in non agricultural jobs in countryside.

b) Free trade area (FTA) agreement with European Union including agricultural goods. Ukraine, that used to be called granary of Europe, has limited access to European Union food market. In all free trade agreements that EU has concluded so far there were some restrictions on access to the EU agricultural and food market. Fortunately enough, FTA with Ukraine is to be treated as a special case. The recommendations of the European Parliament call on all parties "to include agricultural products as far as possible" into the FTA agreement. So far, negotiators of EU-Ukraine free trade agreement adopted a working assumption that only 95 per cent of trade will be liberalized, whereas remaining 5 per cent, in particular agro products will remain subject to restrictions.

It is argued sometimes that non-member countries owing to their exclusion from the Common Agricultural Policy (CAP) cannot get full access to EU agricultural market. However this argument seems misleading. Firstly, the ongoing CAP reform envisages more room for market forces to operate. New form of support - payments according to acreage (so called direct payments) substituting for price support - allow for fair competition for non-EU actors. Secondly, it is worth to note that the EU newcomers have participated fully (and very successfully) in EU agricultural market from the day of their accession despite the fact that formally their full access to EU agricultural subsidies has been stretched over for 7 years.

Thus, there are no serious economic obstacles to fully open EU and Ukrainian markets under FTA. With the free trade in agricultural products the new value added will appear. On the one side, Ukrainian agro-sector, as net exporter of food products and having enormous unused potential, will benefit a great deal from the access to the EU market. Establishing FTA between the EU and Ukraine, which eliminates all restrictions on trade in agricultural goods, other than required food safety standards, would attract large foreign and domestic capital to agricultural and food processing industries in Ukraine. On the other side, EU consumers will get a chance to obtain much wider choice of food products in terms of price and quality. There are only vested interest groups on both sides interested in keeping restrictions in food trade between EU and Ukraine. Keeping restrictions in agricultural trade between the two counterparts would be clearly against the interest of consumers and most effective producers both in Ukraine and the EU.

Encouraging foreign investors

The crisis in real sector is evidenced by substantial drop in investments. Until recently metallurgy contributed 40 % of Ukraine's foreign earnings, but the country can not rely on continuous world demand for these precuts, current crisis shows. Ukraine needs a more diversified economic structure, which can be achieved through attraction of foreign investors. To attract them and also retain domestic investment coherent comprehensive strategy should be developed and implemented. Let me only enumerate some steps:

- systematic approach and high profile in the approximation with EU legislation
- abolishing double standardization and certification

- identifying and approaching concrete FDIs with well prepared and presented proposals
- continuation of privatization program.

To sum up, to overcome the present economic crises Ukraine needs not only well managed financial policies but also substantial new impulses on supply side.