INDUSTRIAL RESTRUCTURING IN UKRAINE SEVEN YEARS AFTER INDEPENDENCE:

FROM SOCIALISM TO A PLANNED ECONOMY?

CHRISTIAN VON HIRSCHHAUSEN [1]

Communist Economies & Economic Transformation, Vol. 10, No. 4, 1998, pp. 451-465

The industrial policy of the government is aimed at maintaining, supporting, and developing domestic industrial producers in those branches that represent vital interests of the country, in particular its economic independence and the social and cultural standard of living of the population.

Preamble of the "State Concept for Industrial Policy in Ukraine",
decree No. 272 of the Ukrainian Cabinet of Ministers, February 29, 1996

Introduction

This paper examines the success of and obstacles to structural reform in the Ukrainian economy. While macroeconomic and monetary stability have been achieved, signs of market-oriented structural change are weak. The paper's thesis is that Ukraine needs to accelerate industrial and enterprise restructuring if it wants to reap the benefits of stabilisation and attain sustained growth. Instead of fostering market-oriented enterprise restructuring, the successive governments tried for a long time to save the un-saveable structures of value-subtracting factories and thus hampered the development of small and medium enterprises (SMEs). It seems as if Ukraine was at present embarking on a path from the non-monetary socialism to a monetary, planned economy. Socialism is definitely dead since 1992, in that the reign of the Communist Party was abandoned and a universal monetary unit of accounting introduced. But important elements of state planning - in the sense of prescribing quantitative economic plans - continue to dominate the process of industrial restructuring. The risk being that the economy may find itself in a low-level trap of GDP.

The paper is structured in the following way: section 2 provides a brief review of the history of the Ukrainian economic reform process between 1991 and 1998. Though

success was achieved in macrostablisation and privatisation, the basic conditions for structural change are still fragile. Section 3 provides case study evidence of the obstacles to structural change which are mostly due to some form of state intervention in economic affairs. This leads to a number of conclusions showing how structural reforms can be accelerated (section 4); the final section concludes.

A brief history of the Ukrainian economic reform process, 1991-1998

Point of departure (1991): an independent Ukraine facing an economic disaster

Ukraine emerged as an independent nation when the population confirmed the Parliament's (August 1991) declaration of independence in the December 1991 referendum. The new Ukraine was built on a fragile consensus of nationalists, turnaround bureaucrats, and coal miners (cf. Wittkowsky, 1996, 1997a, b). This peculiar coalition was only sustainable for one purpose, namely to assure Ukrainian independence.[2] The compromise of Ukraine's independence was also built on the false belief that the Ukrainian economy was one of the strongest of the Soviet Republics, and that it would benefit from economic independence.[3]. In fact, the Ukrainian economy faced the worst imaginable conditions for entering into economic reforms:

- Soviet production and distribution networks, in which the Ukrainian industry was tightly integrated, broke up rapidly. Transportation costs, lack of communication, judicial instability, monetary uncertainty and protectionist trade policies led to major disruptions in former network relations, in particular with Russia;[4]

- most Ukrainian natural resources turned out to be of low economic value when compared with international market criteria. Ukraine had to rely almost entirely (85%) on imported energy sources; only one third of its coal production was economically viable, oil and gas reserves were depleted (World Bank: Ukraine - The Energy Sector, 1993; Ukraine - Coal Industry Restructuring Sector Report, 1996, EU-Tacis: Business Guide to the Energy Sector of Ukraine, 1997). Metal ores (e.g. iron, copper, titanium) were of low metal content, located in remote areas, and thus difficult to get them to consumers at reasonable prices;

- the so-called agricultural “potential“ of Ukraine turned out to be low in the post-socialist context, too, as sawing and harvesting techniques were outdated, many soils eroded, and production structures inefficient, leading to specific returns of only about one sixth of international standards.[5]

1992-1994: The building of the nation and absence of economic reform

Three years of inconsistent economic policies changed a difficult situation into a disaster. The reason for this is to be found in the priority given to a peaceful institutionalisation of the new Ukrainian nation, i.e. the process of ”Ukrainisation”. Ukrainisation could only be achieved by discarding conflicting economic policies within the fragile national alliance of 1991. The government bowed to requests from all pressure groups, be they miners, Branch Ministries, regions, etc. Between the referendum in December 1991 and the autumn of 1994, almost three years passed in which the government tried to preserve an industrial structure which could not be preserved. In purely economic terms, the results of this “absence of economic policy” were disastrous. Monetary policies were loose in 1992 and 1993, based mainly upon the money printing press. Export and domestic trade restrictions remained permanently high. Retail and wholesale price controls were unpredictable (Kaufmann, 1994). Table 1 summarises key economic indicators for Ukraine between 1992 and 1997. The deterioration of main aggregates between 1992 and 1994, in particular the output slump in 1994, is evident.

Table 1: Macroeconomic indicators for Ukraine, 1992-97

about here

The economic apathy of the early years of independence can only be understood in the context of the peculiar process of the building of the nation which we called "Ukrainisation". Indeed, from a historical point of view, attempting to avoid hardship for any particular social group may have been the only way to save a national consensus that was not based on a common socio-economic program. Today, Ukraine is indeed the only European Republic of the CIS which has managed a peaceful transformation from a Soviet Republic to a democratic nation, and has the best human rights record.[6]

1994-1997: macroeconomic stabilisation and privatisation

The economic situation changed with the general realisation that continued inflation and economic isolation would lead to the loss of the country's industrial and technological base. The election of the industrialist Leonid Kuchma as President over the nationally oriented Leonid Kravchuk, in July 1994, was a sign that the population now preferred an industrial strategy over a national project, that it sought wealth rather than national symbols. The results of the October 1994 reform program are impressive: domestic prices and foreign trade were largely liberalised; administrative control of the exchange rate was abandoned, the budget deficit reduced and commercial loans from the Central bank were also reduced (Conrad and Gummich, 1995). Consequently, after the November 1994 peak, inflation stabilised rapidly. International financial institutions started to support the reform program. Figure 1 shows the development of monthly inflation rates since 1992. In 1997, the Ukrainian economy had definitely achieved stabilisation, thus joining Russia and other CEE-countries in "moderate inflation".

Figure 1: Stabilisation of inflation in Ukraine, 1992-1998

about here

Table 2: Results of large-scale privatisation in Ukrainian industry, 1992-1997

about here

Even at times of macroeconomic decline, privatisation gained ground. Two driving forces were behind this process: workers' collectives, and private investment funds[7]. The number of private large and medium scale enterprises, whether collectively owned or leased with a private majority of ownership, increased to 74% of the total number of enterprises slated for privatisation (cf. table 2).[8] The role of private enterprises in industrial production grew significantly, too, from 17% (Q4 1992) to 64% (Q4 1997). Whether the new forms of ownership are conducive to the restructuring of enterprises remains to be seen. Today, insider control clearly dominates in the Ukrainian industry.[9] Also, access to new capital may be more difficult for collectively owned enterprises,

which have few guarantees to offer. But that privatisation has worked smoothly in a chaotic macro-environment is an established fact. It also implies that the impact of future privatisation can be only limited.

1997 onwards: the necessity for structural reforms

Since late 1997, in the wake of the Asian crisis, Ukraine, too, entered into a financial crisis that continued all through 1998. The lack of structural reforms and a deteriorating financial situation lead to decreasing confidence of international financial institutions and investors. This in turn lead to a drastic increase of interest rates (T-bills climbed up to 50% p.a.), bad international ratings, capital outflows and almost a situation of inability-to-pay of the Ukrainian Treasury. It turned out that macroeconomic stabilisation and formal privatisation can remain ineffective unless they are accompanied by substantial structural reform. This is exactly what has not happened so far in Ukraine. State intervention is still prevalent in many sectors of the economy. No enterprise closures have taken place so far, the creation of new small- and medium-sized enterprises is low. Since independence, industrial production fell by 57% (cf. figure 2). The sectors in which Ukraine was considered to have a comparative advantage, such as food processing, light industry or machine-building, suffered the most.[10]

Another indicator of the lack of market-oriented restructuring is the rise in energy intensity. In 1992, Ukraine was already among the most energy-intensive economies in the world (2 kg oil equivalent/ 1 USD of GDP, against 0.35 kg oil equivalent/ 1 USD of GDP in Great Britain). Since then, the specific energy intensity of official GDP has still increased by more than one third (cf. figure 3). Industrial enterprises are not yet subject to hard budget constraints from the energy suppliers. Several administrative procedures to reduce energy consumption through administrative controls[11] have failed. In the meantime, Ukraine's estimated medium-term energy conservation potential of about 60% remains untapped.

Figure 2: Industrial production in Ukraine, 1992-1997

about here

Figure 3: Energy consumption, official GDP and energy intensity in Ukraine, 1992-1997

about here

Why structural reform is hampered: stylised facts and evidence from case studies

Why has structural reform so far been hampered in Ukraine when it is showing signs of success in other reforming post-socialist countries? The main obstacle to structural reform is the government's continued attempt to exercise control over the economy and "plan" every step of structural reform. There has been no clear commitment that the principles of a capitalist market economy should guide the reform process. Little was done to "unleash the forces of capitalism and private ownership". Instead, it seems that Ukraine used its newly gained independence to "unleash the forces of state planning", now that the Moscow-dominated system was abolished. Indeed, an incredibly detailed and work-intensive planning activity can be observed in many spheres of economic life. This section presents stylised evidence based upon case studies.

Absence of liquidation and enterprise closures

Even seven years after the Soviet break-up, enterprise liquidation and closures have not yet begun in Ukraine. The legal framework has been formally set up, including a bankruptcy law in 1992, but so far, there is neither the political will nor the determination of creditors to enact that law (Mirskey and Coates, 1996, Saunders et al., 1998). Factories usually have three ways in which to continue operation even after entering into illiquidity: direct state subsidies, delayed tax payments and - most importantly - inter-enterprise arrears. In early 1995, the government finally agreed to carry out 20 "pilot-closures" of state enterprises which resisted restructuring. As of mid-1998, none of the closures have been carried out (ibid).

A concrete example may illustrate this point. During socialist times, the Ukrainian oil refining industry boasted a capacity of 62 mn. tonnes in six refineries, supplying all of Ukraine's consumption needs, and also consumers in other Soviet Republics. The crude oil was supplied by Russia at practically no cost. Today, oil prices have increased to international levels, domestic demand for petroleum products has decreased considerably and overcapacities abound in the neighbouring countries' refineries. In 1997, refining volumes were down to 13 mill. tonnes, i.e. a capacity utilisation of 22% only. In fact, just two large refineries would suffice to supply all of Ukraine's demand. Yet none of the state-owned refineries is compelled to reduce its capacity, let alone close down. Instead, the State Committee for Oil and Gas developed another four-year plan, including state investments of over 4 bn. USD (!) for the modernisation of all six refineries.[12]

State-planned restructuring of large-scale enterprises

The state also continues to play an important planning role in enterprise restructuring. In 1994, 6,110 state enterprises were excluded from privatisation, through a decision by Parliament, justified by the "strategic character" of these enterprises, in accordance with Art. 4(1) of the privatisation law.[13] The fact that state enterprises prevail in post-socialist countries is not a new phenomenon; but the peculiarity of the Ukrainian case is that no corporate control structures were defined for the factories concerned, nor were any incentives provided for restructuring. Having been declared as "strategic" and formally subjected to restructuring plans, the factories found themselves without a real owner, uncontrolled by Parliament and without any guidance from their respective branch ministries.

The example of a large military-industrial factory shows the dilemma of state-planned restructuring. Under the socialist regime, the factory, employing 20,000, was a large producer of satellite control equipment, receiving 90% of the electronic parts from Russia, and forwarding 80% of its products for further processing to other Soviet Union Republics. After the collapse of this network, the old military factory sought to develop new civilian products. Paid employment fell to 13,000 in 1995. The Cabinet of Ministers then decided to carry out a state-planned "pilot-restructuring". An inter-Ministerial committee was set up at government level,

composed of the owner of the factory, i.e. the Ministry for Machine Building and Conversion, the Ministry of Economy, the State Property Fund, the Antimonopoly Committee, and the management of the factory. This committee then planned each step of the restructuring, i.e. the unbundling of the former combine, the setting-up of a new, state-owned holding company, the reorientation of the product range, and the distribution of investment. But none of the departments within the former combines was given the freedom to pursue their own commercial strategy. Privatisation of individual departments is still impossible. Nor was the large industrial site (80 hectares) opened for new small and medium enterprises, seeking well-equipped industrial space. Two years after the start of "pilot restructuring", the factory had not undergone any substantial change, and no new jobs had been created on site. Paid employment has come down to 3,000-4,000.[14]

State industrial policies in so-called "strategic" branches

The state also continues to intervene in the definition and execution of plans for so-called "strategic" industrial branches. The main concept of industrial policy was that of vertical intervention, consisting mainly of subsidies to ailing industries and agriculture, price controls, and import and export restrictions. State investment programs continued for many sectors on a yearly and 5-year basis. Estimates for 1996 point to 3-5% of GDP for direct state subsidies in certain branches of industry. According to the "State Concept for Industrial Policy" (op cit.), the government's task is to maintain, develop and support these branches, to draw up investment plans and provide money to the branch, and also to watch over the corresponding employment effects of the programs.

Examples for long-term plans come from branches, many of which are not at all considered "strategic" in a capitalist market economy. While planning in the aviation and shipbuilding sectors might be justified on military grounds, there seems to be no need to plan the automobile industry, packaging, copper and nickel mining, steel, non-ferrous metallurgy and the agro-industrial complex[15]. In agriculture, too, the state guaranteed prices and quantities to be bought from the state farms; prices continued to be fixed on a "cost-plus" basis, bearing no relation to efficient prices under competition.

The most striking effects of central planning at branch level can be observed in the Ukrainian coal industry, two thirds of which is unprofitable. Domestic production declined sharply, from 131 mn. tonnes of primary coal (1990) to about 45 mn. tonnes (1997), i.e. by 65%. Low-cost import coal plays an increasing role. Yet, instead of fostering reforms in the sector and providing competitive coal mines with new business opportunities, the government, under the pressure of the Coal Ministry, institutionalised centralised planning for coal production, trade, and prices. Cross-subsidies between efficient and inefficient mines are maintained; this prevents efficient coal mines from reaping the benefits of productivity gains, and prevents them from investing. The "plan" also requires the coal-industry to increase production back up to 130 mn. tonnes in the year 2010, i.e. to triple current production; this objective, however, seems highly unrealistic.

No clear and economic criteria for the creation of "industrial-financial groups"

Another area where state activity is intense is "industrial financial groups" (IFG, promyshlennye-finansovo-gruppy). The problems with the Ukrainian industrial-financial groups is that they are based on a logic of state-planning and not of enterprise co-operation according to market mechanisms. There is nothing to indicate that the participation of state-owned banks and Ministries in the IFGs is a necessary condition for the establishment of such corporations, neither do they guarantee their efficiency. Enterprises are glued together under political pressure, the co-operation does not correspond to a strategy of medium-term sales and profits. In that case, profitable enterprises would be forced to finance unprofitable ones, or the state would have to bear a heavy financial burden.[16]

The following case-study shows the risk of hastily creating a financial industrial group whose economic rationale becomes unviable once prices are liberalised. A large Ukrainian petroleum refinery and a Russian-Tatar oil producer, both state enterprises, were joined in 1994 to form a financial-industrial group, with 50% of the shares held by each of the two countries. The Russian oil producer has a long-term contract to supply crude oil to the Ukrainian refinery, which, in turn, delivers 79% of the processed petroleum products to Russia, keeping 21% of the crude oil as a tolling fee. A Ukrainian and a Russian import-export bank, both state-owned,

financed the start-up capital of 250,000 USD and provided some investment in the form of new infrastructure. At the time of the contract (early 1995), the market for petroleum products was still protected in Ukraine, so that domestic demand, though small, was geared mainly towards Ukrainian refineries. The situation changed drastically with the liberalisation of the Ukrainian market in 1995, the doubling of imports and the implosion of domestic prices. Today, imported petroleum products are about 15-25 USD/t cheaper than Ukrainian products. Thus, the barter deal within the industrial financial group, which was designed as a long-term project, has already lost its economic justification.

State-planned co-ordination of foreign direct investment (FDI)

At a rate of 40 USD per capita for foreign direct investment (FDI, at total of about 2 bn. USD), Ukraine trails behind all other transformation countries (except Belarus). The main reasons are the bureaucratic procedures in which potential investors have to engage and the unstable legal environment. Furthermore, the maintained multifunctionality of post-socialist factories (i.e. the mixture of productive and social functions) is not conducive to investment.[17].

In order to increase the attractiveness of Ukraine internationally, the government once again decided to proceed with state-planning. Four different foreign investment agencies exist in parallel, the goal of each being to attract further investment. Chronologically, the first was the ”State Investment Agency” (Derzhinvest), the head of which had the status of a Minister who reported to the Cabinet of Ministers. This agency was superseded by the creation, in July 1996, of the ”National Agency for Reconstruction and Development”, with the task to facilitate the access of foreign investors to Ukrainian enterprises.[18] On top of these two agencies, the Ministry of Industry created its own investment agency, the ”Commission for the participation of foreign investors”[19]. Last but not least, the Economics Ministry created a “Clearing Agency“, supposed to foster foreign direct investment through barter operations[20]. Whether four parallel state committees in the FDI-process will yield positive results is doubtful. Under no circumstances could any of the above institutions claim to be a ”one-stop shop” which foreign

investors could turn to have their administrative questions answered in a single step.

How to accelerate structural reforms?

The Ukrainian economy has achieved the first step of post-socialist economic reform, which is macroeconomic stabilisation, after a drastic slide in output that lasted until 1997. There are few indications, though, that this stabilisation is accompanied by sufficient structural change and enterprise reform to overcome the financial crisis of 1998 and to assure sustained economic growth. Five down-to-earth policy guidelines which might accelerate the reform process can be identified.

Abandon state planning and indicative prices

The "planning plague" in Ukraine can not leave economic developments unaffected. Extensive and unpredictable state planning activities have undermined the horizons for economic decisions, both in state and private enterprises. As state plans are subject to high uncertainty, business projects have to be regularly re-adjusted. This also affects the investment strategies of private enterprises that have supplier- or client relations with the state enterprises. It is time to abandon most of the state planning activity. Industry-specific Ministries (former "Branch Ministries") should be abandoned or - in the case of natural monopolies such as gas and electricity - be transformed into regulatory agencies.[21]

Deregulate non-strategic economic activities

Apart from state planning, a host of regulations still hamper the development of entrepreneurship. These regulations may concern enterprise registration (where not less than 300 enterprise categories exist), export and import licenses (e.g. four different Ministries having to sign a simple textile export) or specific pricing policies (e.g. for communal services). Attempts by the Economics Ministry to impose deregulation programs were manifold, but so far have failed owing to resistance from bureaucracies. The system of indicative prices (e.g. in metallurgy, agriculture and the energy sector)

should be abandoned. An initiative at the Cabinet of Ministers-level would be required to define a deregulation package and assure its implementation at working level.

Facilitate enterprization at local level

At enterprise level, the restructuring process is more advanced than it seems, but mainly in the negative sense: socialist industrial structures and networks collapsed as a result of the introduction of post-socialist economic reform. The task now is to create conditions conducive to establishing new enterprises within new industrial networks, based on monetary criteria such as prices, costs and profit. This process of "enterprization" (Bomsel, 1995) should be facilitated, e.g. by easing the criteria for the breaking-up of former industrial combines. The privatisation of individual departments within a combine should be made possible. Local infrastructure (e.g. heat network, energy, water, railway) should be monetised and each user be forced to pay according to his consumption. Social assets, too, can be monetised, with only the vital ones (e.g. hospital) kept under public management for some time. The industrial territories, often stretched out on hundreds of hectares, should be opened and leased to external enterprises. Unfinished buildings, the legacy of socialism, should be auctioned off. In brief, former industrial combines need to be converted into diversified industrial parks.

Implement demand-oriented infrastructure policies

Given the scarce budget resources, infrastructure policies should be streamlined, too. At present, ambitious long-term plans are set up in order to bring all transport, telecommunication, and other infrastructure on a high technical level; the costs of the transport program alone exceed 20 bn. USD. Against this supply-oriented approach we propose that a demand-oriented infrastructure policy be implemented. Bottlenecks should be identified and remedied first, rather than that entirely new infrastructures be built. Prices for infrastructure services should in general be increased to economic levels, i.e. full cost recovery. So-called "natural monopolies" are in reality often not monopolies at all and can be deregulated and partially privatised (e.g. mobile telecommunications, electricity and gas production, urban transport). If the privatisation of "strategic" infrastructure is not possible, these enterprises should at least be subjected to a hard budget constraint. Infrastructure services should be decentralised wherever possible (e.g.

railways, but also non-physical infrastructure such as education and fundamental research).

Introduce a separation between the state and the economy

Last but not least it seems important to improve the very fundamental conditions for a functioning capitalist market economy. The analysis shows that Ukraine is still characterised by a specifically "post-Soviet" phenomenon: the absence of a separation of politics and economics. In Western-type capitalist market economies, a certain separation exists - or it is at least assumed to - between state action (called politics) on the one hand, and individual, profit-oriented business activity on the other (called economics). That this is so is formally institutionalised in the Constitution and informally in the "rule of law". This separation has not yet been introduced in Ukraine; instead, one observes a peculiar unity of thought and action that we would call Ukrainian "politonomics". No institutional or ethical border separates statesmen and businessmen in Ukraine. State activity is often (mis-) used to strengthen the individual position of a politician, his industry's, or his region's financial position. Careers are made across government, enterprises, and lobbying groups[22]. Regulations are designed to maximise the personal income of the owner of a protected industry.

Separating politics from business first requires the strengthening of state institutions: Parliament, government and administration and the legal system. An improvement of their material situation (salaries, equipment) and of political independence is crucial. In turn, civil servants would have to restrain from private business activities. Whether there will be sufficient support for these measures from within Ukraine to trigger the end of "politionomics" is an open question. The support of external organisations (such as the IMF, World Bank or EU) may be required to provide the necessary impetus.

Conclusion: from a post-Soviet to a capitalist market economy?

Structural reforms in Ukraine have come to a critical cross-roads: if Ukraine wants to enjoy the benefits of macrostablisation, and avoid a further deterioration of its financial situation, a significant reorientation of structural reform is necessary. Whilst monetary policies have been reliable, one observes a substantial lack of confidence in the

mechanisms of a capitalist market economy. Instead, the country is still in search of a social consensus on a “Ukrainian” reform path, the lack of which has so far prevented the implementation of any coherent reform strategy. It is unlikely, therefore, that Ukraine emulates the growth path prescribed by truly reforming countries, such as Poland or Estonia, or even Russia.

Recourse to increased state intervention is seen as a means to better control the economy. The concrete results of state activity are little impressive, though: just like in the old, socialist days, none of the ”plans” is really being enforced, and few sanctions can be imposed on state enterprises today. However, continued state planning does hamper entrepreneurs, delays investments, and in doing so curtails economic development. The political ”window of opportunity” (Roland, 1994), which is the period immediately following the breakdown of socialism, was used in Ukraine to consolidate the new, fragile nation, to enable “Ukrainisation“. Today, the initial impetus, in which fundamental reforms are possible and can be pushed through based on a wide social consensus, is over. The heritage from the Soviet Union, that we have called the “industrial ruins from socialism”, are today easily identifiable, and the irreversible nature of structural change is beginning to be understood. But while the market infrastructure is gradually put in place (stock exchange opened in 1997, derivative trading is being prepared), the implementation of the next steps of structural reform at enterprise level will take several years. It remains to be seen whether Ukraine will gradually adopt a capitalist market economy-oriented reform path, or instead, chooses post-Soviet state planning to face the next steps of restructuring. This development also depends upon the results of the upcoming Presidential elections (spring 1999) which may provide another impetus to reform ... or just the opposite.

References

[1] Bofinger, Peter , Heiner Flassbeck, and Lutz Hoffmann, "The Economics of Orthodox Money-Based Stabilizations: the Examples of Russia, Ukraine and Kazakhstan", *Eco nomic Systems,* 1996.

[2] Bomsel, Olivier, "Enjeux industriels du post-socialisme", *Revue d´Economie Industrielle*, 1995.

[3] Brainerd, Betsy, "*The Labour Market and Policy Reform in Ukraine: An Overview",* Paris, OECD-Working Papers, vol. iii, no. 37, 1995.

[4] Conrad, Juergen, and Andreas Gummich, "Ukraine: Upswing of Reforms?", *Deutsche Bank Research Focus on Eastern Europe*, no. 138, 1995.

[5] Corbet, Michael, and Andreas Gummich, "*The Soviet Union at the Crossroads",* Frankfurt, Deutsche Bank, 1991.

[6] EBRD, "*Transition Report",* London, various issues.

[7] Estrin, Saul, and Adam Rosevar, Paul Hare, "*Company Restructuring and Privatisation in Ukaine*", Leuven Institute for Central and East European Studies, Working Paper 70/1998.

[8] Filatotchev, Igor, and Yves G. van Frausum, Mike Wright & Trevor Buck, "Privatisation and Industrial Restructuring in Ukraine", *Communist Economies & Economic Transformation*, Vol. 8, No. 2, 1996, 183-203.

[9] Frydman, Roman, Andrzej Rapaczynski, and John S. Earle, "*The Privatization Process in Russia, Ukraine, and the Baltic States*", Budapest; Central European University Press, 1996.

[10] Hirschhausen, Christian von, "*Du combinat socialiste à l'entreprise capitaliste - une analyse des réformes industrielles en Europe de l'Est,* Paris, l'Harmattan, 1996a.

[11] Hirschhausen, Christian von, " Lessons from Five Years of Industrial Reform in Post-socialist Central and Eastern Europe", *DIW-Vierteljahreshefte zur Wirtschaftsforschung- DIW Quarterly Journal of Economic Research*, Heft 1, 65. Jahrgang, 1996b pp. 45-56.

[12] Hoffmann, Lutz, und Axel Siedenberg "*Aufbruch in die Marktwirtschaft - Reformen in der Ukraine von innen betrachtet*", Frankfurt am Main, New York, Campus, 1997.

[13] Ishaq, Mohammed, "The Ukrainian Economy and the Process of Reform", *Communist Economies & Economic Transformation*, Vol. 9, No. 4, 1997, 501-517.

[14] Kaufmann, Daniel, "Diminishing Returns to Administrative Controls and Emergence of the Unofficial Economy: a Framework of Analysis and Applications to Ukraine", *Economic Policy*, vol. 19, December, 1994.

[15] Mirsky, Arelene, and Richard D. Coates, "*Restructuring and Bankruptcy in Ukraine",* Washington; Deloitte Touche Tohmatsue and USAID, 1996.

[16] Saunders, Charles, and Alex Belozyorov, Konstantin Povstyanoy, "*A Survey of the Ukrainian Equity Market: Teetering on the Brink*", Kyjiv, MFK Renaissance.

[17] Selm, Gijbertius van, "*The Economics of Soviet Union Break-up",* Rotterdam, 1995.

[18] Standing, Guy, "*Labour Market Dynamics in Ukrainian Industry in 1992-94",* Budapest, International Labour Organization (ILO), Central and Eastern European Team, 1994.

[19] Sundakov, Alex, Machinery of Government and Economic Policy, in: Cornelius, Peter K., and Patrick Lenain: *Ukraine - Acceleration the Transition to Market*, Washington, International Monetary Fund, 1997.

[20] Wittkowsky, Andras, "Politische Eliten der Ukraine im Umbruch", *Osteuropa*, 46. Jahrgang, Heft 4 (April), 1996.

[21] Wittkowsky, Andreas, "*Ukrainian Simulations during the Transitional Period",* University of Bremen, mimeo, 1997a.

[22] Wittkowsky, Andreas, "*Historischer Kompromiß Ukraine - Politische Ökonomie der Nationalstaatsbildung (1991-1996)",* Doctoral Dissertation; University of Bremen, 1997b.

[23] World Bank, "*World Development Report 1996 - From Plan to the Market*", Washington, D.C, 1996.

Endnotes

---

1 Dr. Christian von Hirschhausen, DIW German Institute for Economic Research, 14191 Berlin (Germany) and member of the German Team of Economic Advisors to the Government of Ukraine, 252024 Kyiv (Ukraine). This paper has benefited from the participation in an advisory project for the Ukrainian Economics Ministry and the Presidential Administration, financed by the German Economics Ministry through the Kreditanstalt für Wiederaufbau (KfW). The author thanks the management and workers of the 50 enterprises visited all over the country for open and controversial discussion; furthermore Andreas Wittkowsky, Wolfram Schrettl, Eirik Svindland, Ulrich Thießen, Maria Kopylenko, Jürgen Bitzer, Katharina Dittmann and Gritt Hannemann for comments. Technical assistance: Wolfgang Härle, Michael Jahn and Andrew Partington. The usual disclaimer applies; in particular, the opinions expressed in this article do not engage the responsibility of any of the above-mentioned institutions.

[2] Beyond that common goal, each of the parties pursued very diverging interests: for the nationalist movement, independence was a goal in itself and economic reform a necessity to stabilise the newly acquired independence. For the turnaround bureaucrats, independence was a way to hang on to the newly gained (Ukrainian) power, where old (Soviet) power had inevitably vanished. For the coal miners, the country's largest industrial lobbying group, independence was the only way to assure a strong position for the coal mining industry in a weak Ukraine (instead of having to play a weak role in the strong Soviet coal industry).

[3] This overestimation of Ukraine's potential was further strengthened by the international evaluation of the country as a base for natural resources and agricultural products, the so-called "export potential" (i.e. ores, coal, oil and gas, agricultural products). A study carried out by Deutsche Bank Economic Research in 1991 had even placed Ukraine on top of the Soviet Republics, mainly due to the so-called "export potential" (i.e. ores, coal, oil and gas, agricultural products), cf. Corbet and Gummich, 1991. The only source that could have avoided this misinterpretation, by warning against overestimating Ukraine's economic potential, was Goskomstat´s (the Soviet Planning Agency) confidential calculation: if valued at world market prices, Ukraine would have been the third largest net receiver of external aid within the Union (and not, as it was thought, the second largest net payer; cf. Selm, 1995, pp. 74-78), due to considerable imports of natural gas and oil from Russia and Turkmenistan.

[4] Further, it turned out that the Ukrainian industry had provided the low-tech end of the production networks in the Soviet Union, whereas the high-tech activities had been reserved for Russian producers (e.g. in the military-industrial complex, electronics, nuclear energy).

[5] For the first time since the war, Ukraine had to import cereals. The share of agriculture in total exports fell from 18% in the 1980s to 11% in 1994; the absolute volume of exports declined by 50%, production by 33% on average (World Bank: Agriculture Report Ukraine, 1994).

[6] This is confirmed, e.g., by the speaker of the U.S. House of Representatives Committee for Foreign Affairs, Robert Torricelli (Intelnews, August 22, 1996, p. 2).

[7] For workers’ collectives, the redemption of ”their” state enterprises, mostly leased beforehand, was a cheap way of becoming the real owners of the entity they had already managed for quite some time. Over 3,000 ”lease enterprises” were privatised in this way between 1992 and 1995. Mass privatisation, which had been planned for a long time, started in January 1995. For the newly created private investment funds, the privatisation of medium and large enterprises through auctions was an efficient way of quickly accumulating capital. For this, the funds used predominantly external resources, i.e. privatisation vouchers entrusted to them by individuals. The branches in which investment funds were most active were food processing, cement and construction materials, metal trading, furniture and infrastructure (mainly ports).

[8] Due to some unbundling, the number of medium and large enterprises increased between 1992 and 1997; three important areas excluded from privatisation are the energy complex, the agro-industrial complex, and some enterprises in the "strategic" military-industrial complex.

[9] An in-depth analysis of post-privatisation and corporate governance in 100 Ukrainian enterprises was carried out by Filatotchev et al. (1996), who conclude that “in terms of active corporate governance, there is clearly very little role for monitoring by outsiders, while employees appear to have a relatively important influence“ (p. 200).

[10] In contrast, sectors in which the energy-poor Ukraine was advised not to engage in, gained ground: metallurgy, chemistry/petrochemistry, energy. In other words, structural change on the sectoral level proceeded precisely in the opposite way to that expected.

[11] Cf. the July 1994 ”Law on Energy Conservation”, the ”State Energy Conservation Committee” set up on July 1995, and the creation of a body supposed to control electricity consumption, the “State Inspection for Control over Electricity and Thermal Consumption“ (August 1996).

[12] This plan is in fact a follow-up of the governments ”State program for Oil and Gas”, signed in 1993 by the then Prime Minister L. Kuchma: Resolution No. 774/93 of the Council of Ministers, dated 21 September 1993.

[13] This number came down to 4,100 in early 1998, which represent mainly the former military-industrial complex, but also metalworking, mechanical engineering, vehicle construction, energy sector and electronics.

[14] In late 1996, the government made *state-planned restructuring* the dominant mechanism for 208 large-scale factories (as listed in the Decree of the Cabinet of Ministers Nr. 684, 27 July 1996 “On carrying out the privatisation according to individual plans”).

[15] See, for example, the decision of the Cabinet of Ministers No. 774/93, the development program "Packaging 2000", the Energy program drawn up by the Ministry of Economy (1995), Decree by the Cabinet Of Ministers “On the Creation of the State Stock Company Ukrainskie Polimetally” (18 March 1998).

[16] In 1996, the government published a list of 32 Ukrainian transnational industrial-financial groups, that it wanted to create. The first six industrial financial groups now being introduced are: titanium and titanium products; gas pipes; chemical fibres; combines; alumina and aluminium. Ukrainian industrial-financial groups differ from Russian financial-industrial groups (FIGs) in that the driving force in Ukraine is industry,

not the financial sector; see also the the special issue in Communist Economies & Economic Transformation, vol. 7, No. 1 (March 1995) and Malle, Silvana, "Russian Entrepreneurship and Business in Transition: Towards the Re-Building of State Conglomerates", Economic Systems, vol. 20, 1996, pp. 37-64.

[17] The few successful cases of large foreign investments in Ukraine show that a compromise on social functions is a necessary condition for establishing co-operation: when Kraft-Jakobs-Suchard took over the Karl-Marx Chocolate factory and invested 26 mn. USD, the first large foreign direct investment, it was obliged to keep the multifunctional factory including flats, holiday resorts, spas, kindergartens, and other social services; the number of employees was fixed for five years (cf. also Filatotchev et al., 1996).

[18] Cf Intelnews of 6 July 1996, and Ukaz of the President Nr. 493/96 of 2 July 1996.

[19] In the first instance, the Commission advertised four state enterprises to foreign investors: Automotive works SAS Zaporozhe, steel producer Dneprodserzhinsk, electronic and TV-producer Elektron Lvov, alumina producer Nikolaev. In the case of Avto SAS, the peculiar strategy seems to have worked: in March 1998, the Korean group Daewoo pledged 1.5 bn. USD in investment for a majority stake; in return, the Ukrainian government provided massive protection against imported cars.

[20] See Ukaz of the President of February 1997 "On the State Committee for Investment and Clearing Issues".

[21] A more general analysis on the (mis-)functioning of government is provided by Sundakov (1997) who concludes that the machinery of government in Ukraine has changed little since Soviet socialist times; see also World Bank (1996, p. 85 "Decision-making in Ukraine is bogged down by overlapping responsibilities"). Ishaq (1997, p. 516) also asserts that "policy making is still unpredictable, highly complex and bureaucratic, and confused so that any advances made are reversible.".

[22] Prominent examples of "politeconomy" careers in Ukraine are i) President Kuchma, former general director of one of the Soviet Union's largest military combines, and former President of the Association of Ukrainian Industrialists; ii) former Prime Minister Pavel Lazarenko, allegedly co-owner of Ukraine's largest gas wholesaler "United Energy Systems", whose regional monopoly provides the company with substantial monopoly rents (cf. allegations in The Economist, 14 December 1996, p. 32, IntelNews Business Journal, December 23 1996, VWD-GUS, 11. December 1996); iii) former Vice Prime Minister for Industry Anatoly Kinach, now President of the Association of Ukrainian Industrialists and a potential candidate for Presidency in 1999. In the March 1998 elections, about 125 candidates with no Party affiliation were elected, who mainly represent the regional business elites. Wittkowsky (1997b) even contends that one can identify the industrial affiliation of each Ukrainian Prime Minister since independence by the specific regulations put in place by him. Indeed the "Who is Who in Ukrainian Politics" (Kyiv, 1996) reads like the Gotha of state industry and agriculture.

Table 1:

Macroeconomic indicators for Ukraine, 1992-97

	1992	1993	1994	1995	1996	1997
	Macroeconomic development					
GDP (market prices, % change year on year (yoy)	-16.8	-14.2	-23.0	-11.8	-10.0	-3.2
Gross industrial output (% change, yoy)	-6.4	-7.6	-27.2	-11.5	-5.1	-2.0
Agricultural output (% change, yoy)	-8.3	1.5	-17.0	-3.9	-9.0	-2.0
Capital investment (% change, yoy)	-36.9	-10.3	-25.0	-35.0	-22.0	..
Inflation rate (CPI, Dec./Dec.)	2,100%	10,255%	401%	182%	40%	10%
	Sector shares (in % of GDP)					
Industry	44.6	27.6	35.0	34.4	43.2	..
Construction	7.5	7.2	7.4	9.3	8.1	..
Agriculture	20.6	18.4	14.3	13.2	17.3	..
Trade	6.5	10.1	7.3	6.6	6.9	..
Services and other	20.8	36.7	36.0	36.5	24.5 #	..
	Foreign Trade					
Exports of goods and services (bn. USD)	11.3	8.6	10.2	12.7	15.5	15.4
Imports of goods and services (bn. USD)	11.9	11.1	12.7	15.3	19.8	19.6
of which: energy imports (as a % of total imports)	n.a.	49%	44%	45%	48%	..
BOP deficit (bn. USD)	0,62	0,85	1,40	1,40	1,45	..
Foreign debt (bn. USD)	3.5	4.2	7.2	8.1	9.2	9.5

Sources: MinStat Ukraine, MinEcon Ukraine, World Bank, EU-TACIS, RFK Renaissance

Table 2:

Results of large-scale privatization in Ukrainian industry, 1992-1997

	Number of large and medium scale industrial enterprises	
1992	6,850	
1994	7,963	
1994	8,826	
1995	8,931	
1996	9,051	
1997	9,710	
	of which: * state ownership	*** private ownership**
1992	5,159	1,686
1994	5,421	2,525
1994	4,763	4,045
1995	3,882	5,030
1996	2,715	6,386
1997	2,516	7,194
	Share of industrial enterprises in private property: number of enterprises	**volume of production**
1992	25%	17%
1994	32%	29%
1994	46%	38%
1995	57%	48%
1996	70%	58%
1997	74%	64%

Source: based upon Ukrainian Economic Trends

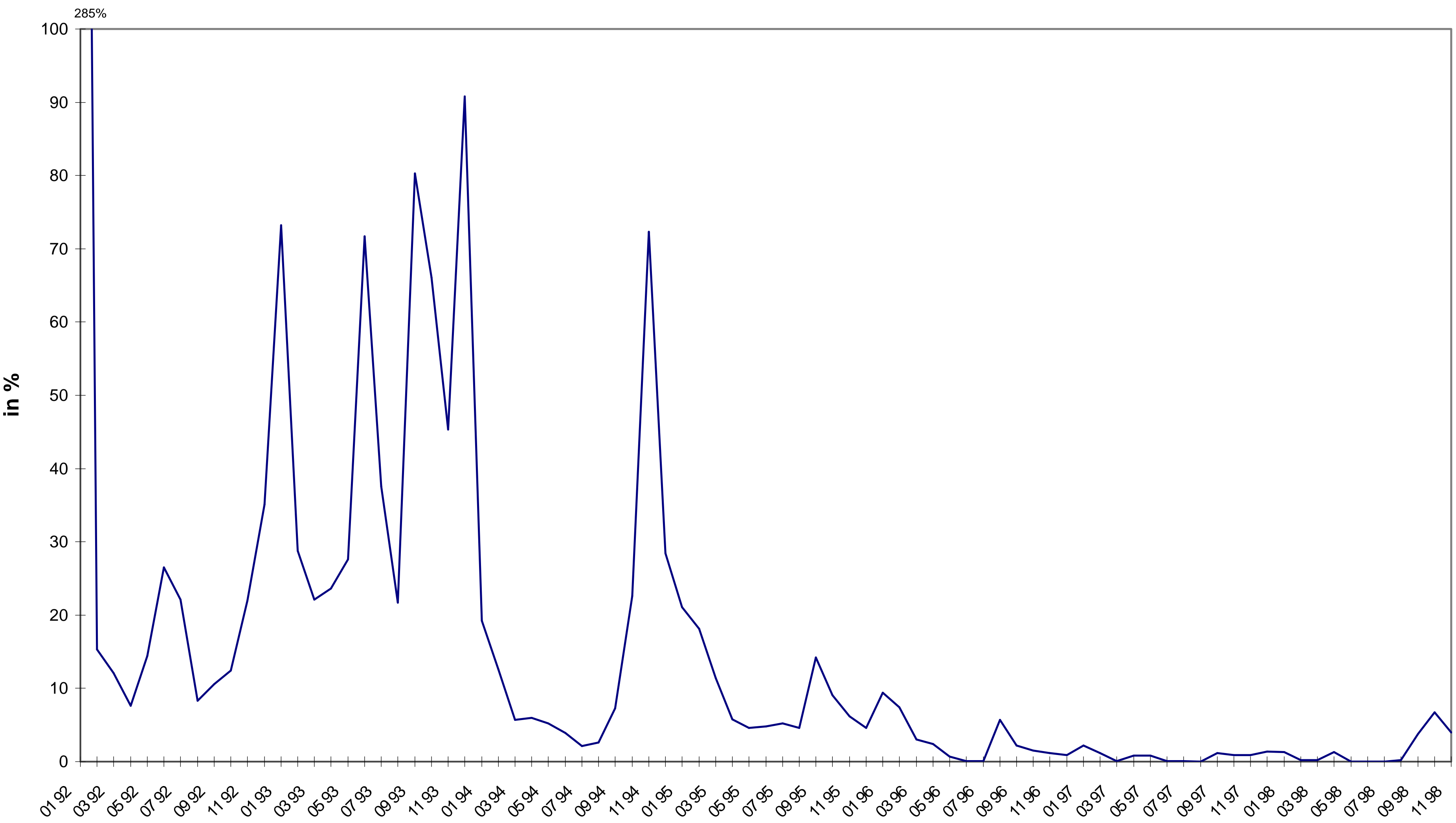
Figure 1: Monthly Inflation in Ukraine, 1992-98
285%
in %
100
90
80
70
60
50
40
30
20
10
0
01 92
03 92
05 92
07 92
09 92
11 92
01 93
03 93
05 93
07 93
09 93
11 93
01 94
03 94
05 94
07 94
09 94
11 94
01 95
03 95
05 95
07 95
09 95
11 95
01 96
03 96
05 96
07 96
09 96
11 96
01 97
03 97
05 97
07 97
09 97
11 97
01 98
03 98
05 98
07 98
09 98
11 98

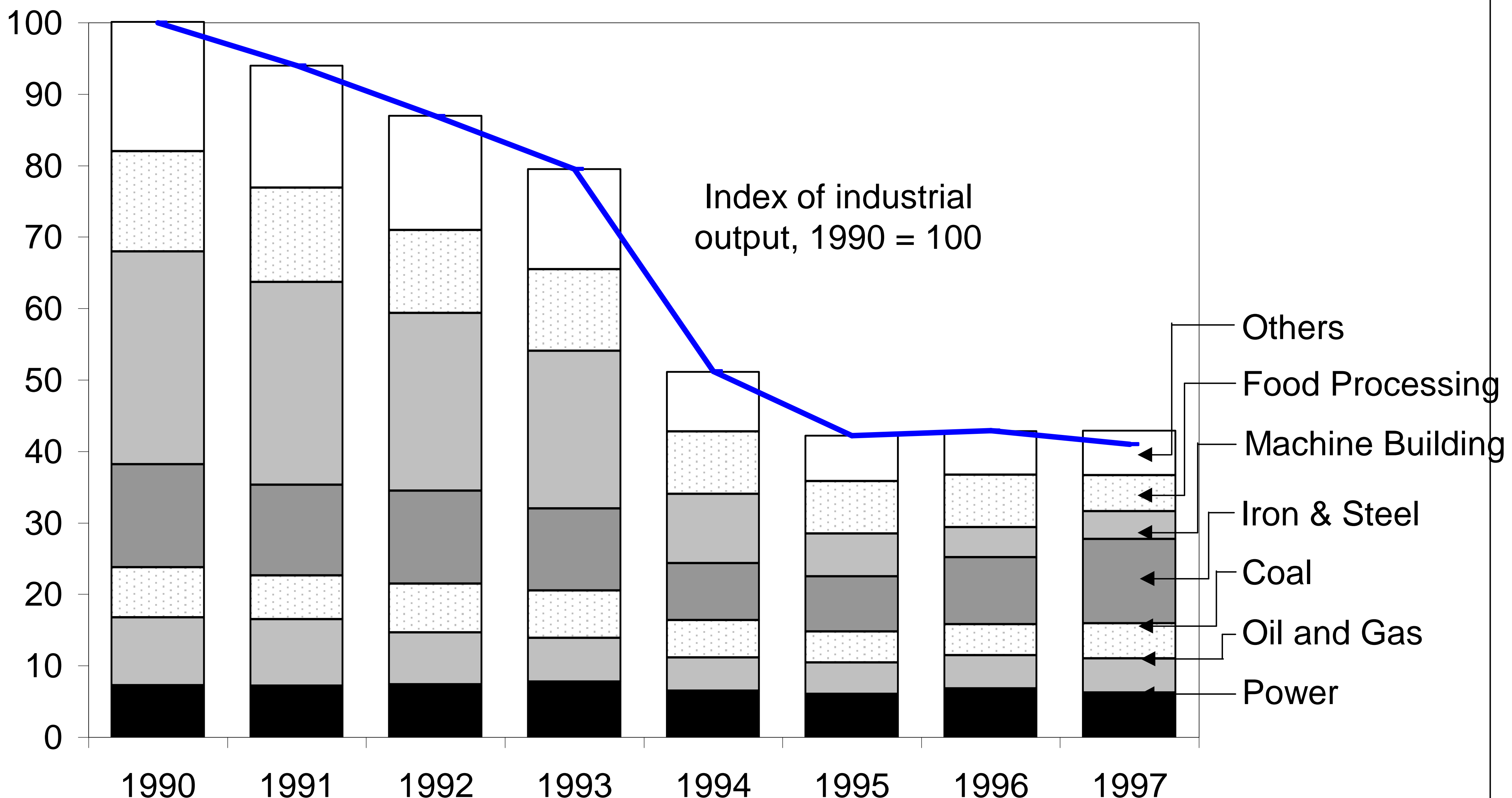
Figure 2: Industrial production in Ukraine, 1990 - 1997
100
90
80
70
60
50
40
30
20
10
0
Index of industrial output, 1990 = 100
Others
Food Processing
Machine Building
Iron & Steel
Coal
Oil and Gas
Power
1990
1991
1992
1993
1994
1995
1996
1997
Source: Ukrainian Economic Trends

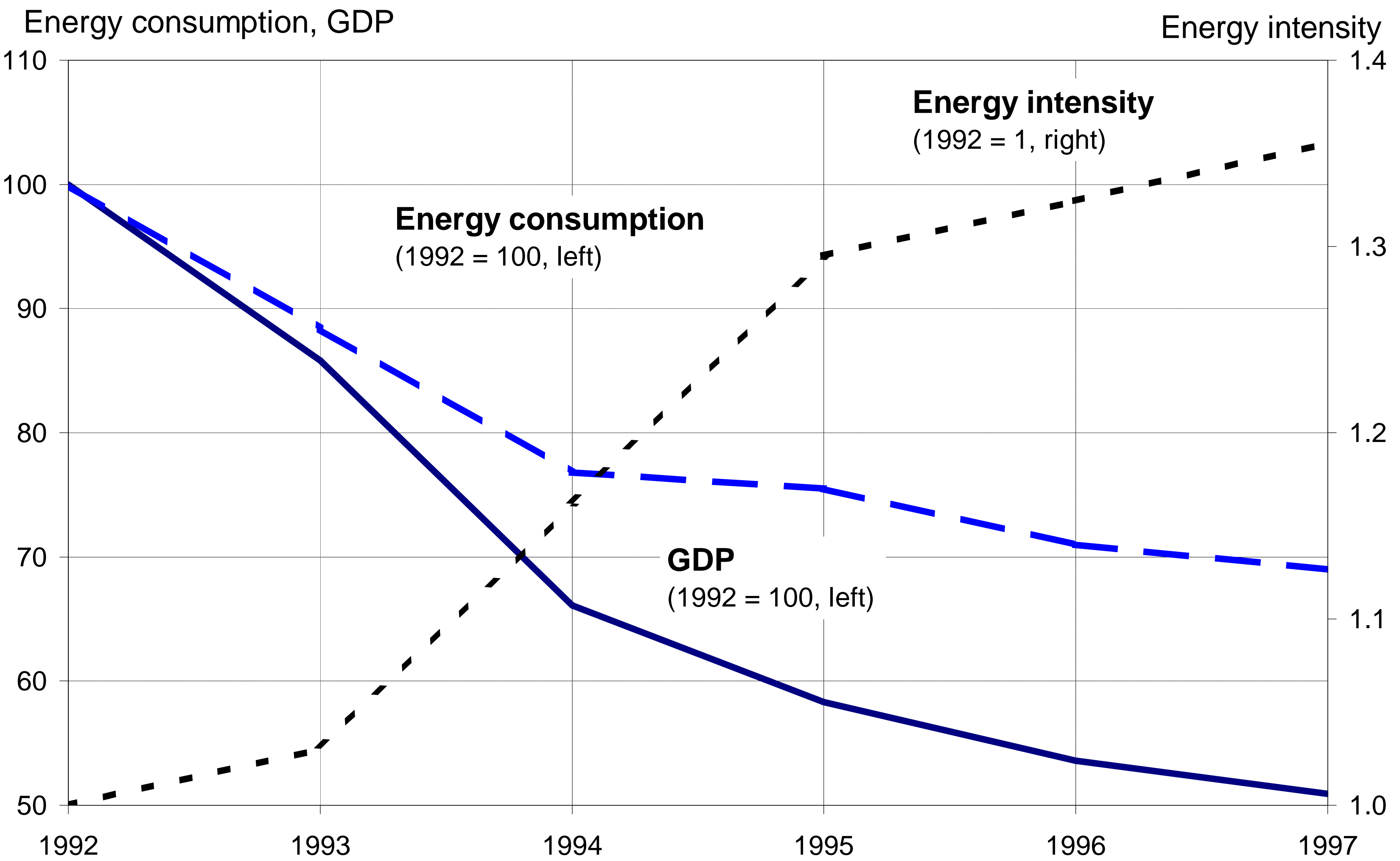
Figure 3: Energy consumption, official GDP and energy intensity in Ukraine, 1992 - 1997
Energy consumption, GDP
Energy intensity
110
100
90
80
70
60
50
1.4
1.3
1.2
1.1
1.0
1992
1993
1994
1995
1996
1997
Energy intensity
(1992 = 1, right)
Energy consumption
(1992 = 100, left)
GDP
(1992 = 100, left)