Strategy of Economic Reforms

December, 2014

The purpose of victory is to live in a better world than the old world; each individual citizen is more likely to concentrate upon his war effort if he feels his government will be ready in time with plans for that better world
"Beveridge Report", Great Britain, 1942

Failure to determine a strategy on the home front could be just as devastating as the military defeat
H.Hoover, 1943

AYA Capital, a Ukrainian investment banking advisory firm, has developed this presentation.

Political changes in March 2014 inspired us to release the analytical report "Economic Reforms: Aren't we missing the point?" in order to assist "new" government to develop the concept of economic reforms. Mainly those reforms that would complement the EU Association Agreement and cooperation program with the IMF in order to achieve the main goal of these reforms - fair and prosperous life of the Ukrainians.

At that point of time the Revolution of Dignity has brought us hope that our government would finally be forced to conduct comprehensive reforms, rather than imitate them to cover up for pursuing of their own corrupt interests. On the other hand, even a preliminary analysis showed that this process would not be easy, and the "new" authorities would require assistance in designing and implementing appropriate reforms.

Since March 2014, we have gained the experience of presenting our ideas to decision-makers, practical implementation of some of our ideas (under the conditions of "asymmetric" war with Russia) and the experience of convincing the civil society activists to form a proper demand for reforms.

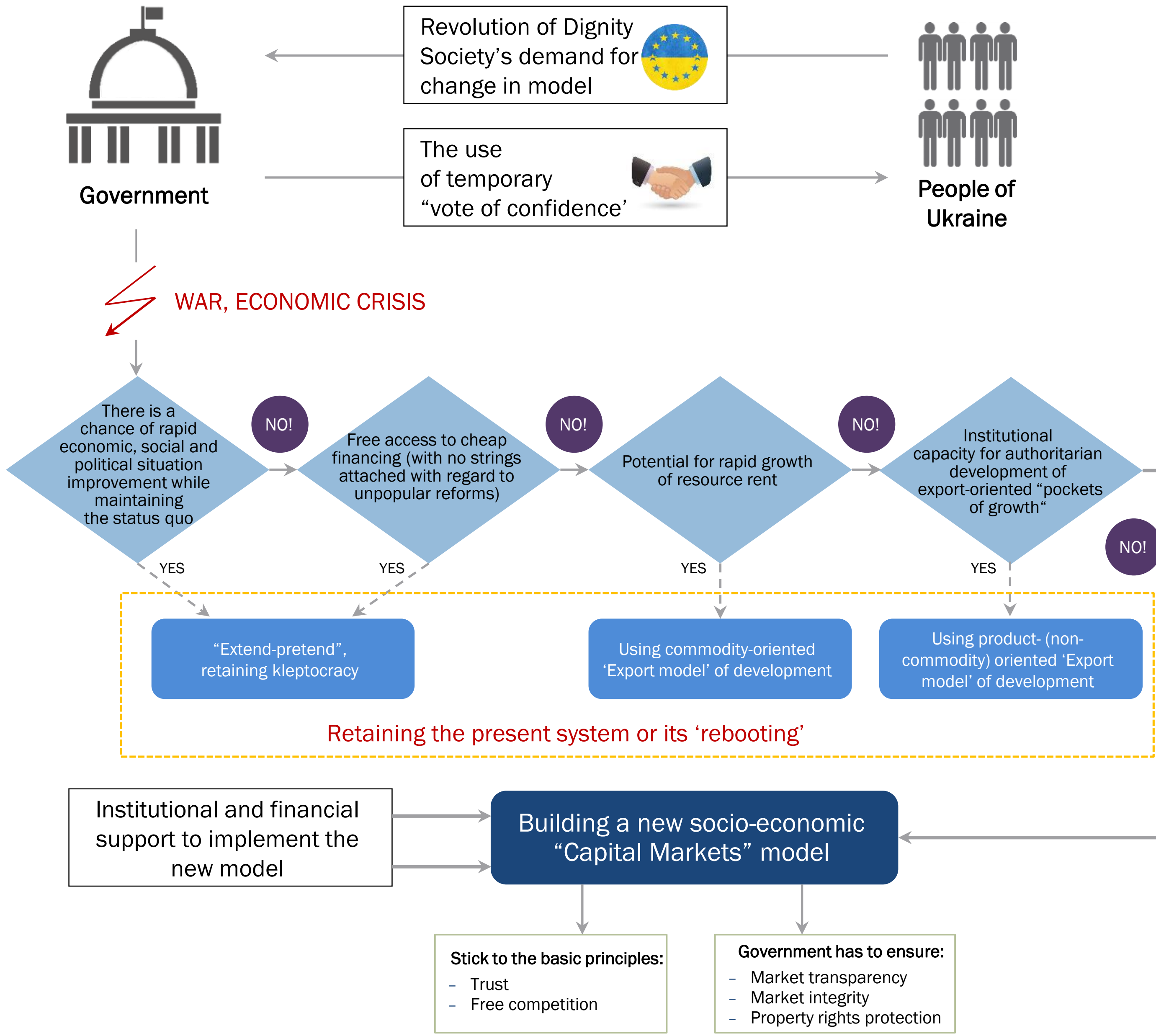
In addition, our analysis revealed that the lack of radical reforms could cause the "Third Maidan" and "returning to 90th" with lowering of living standards and massive impoverishment (even in the absence of a total war with Russia).

So now we present you the new issue of our analytical report focused on the problem of determining the strategy of economic reforms in the form of presentation. In this document we are talking about the following: the format of this strategy, choice of the basic principles of reforms and economic model we have to build in Ukraine, as well as the requirements for successful implementation of the strategy.

It should be noted that, in our opinion, the authorities now are obliged to implement reforms in combination with extremely stringent measures to modify the economic model and achieve the victory over the main external aggressor (Russia).

Executive Summary

- Keptocratic oligarchy took shape in Ukraine during the years of its independence after the Soviet Union's disintegration. As a key consequence of this model, Ukraine is the poorest one among comparable countries at the moment.
- In this presentation we demonstrate that retaining this system (or even its 'rebooting' as Export-oriented model) does not respond to the current people's demand for fairness and prosperous life. Moreover, it may lead to the loss of Ukraine's independence.
- Changing the system requires both fundamental and radical reforms. Unfortunately, 'designers' of Ukrainian reforms use outdated practices that cause the critical risk of their failure.
- We propose to consider more advanced modern approaches which may be called "The Strategy of Economic Reforms".
- We present our analysis of the key issue of this strategy: the choice of socio-economic model. Results of this analysis indicate that a key element of system transformation is the development of a model based on Capital markets (along with the creation of transparent market institutions and ensuring trust in government).
- We also present suggestions for the implementation of the proposed strategy.



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Requirements for the strategy of reforms

The evolution of approaches to strategy development

The old "classic" approach	The modern approach
Strategy is the determination of the basic long-term goals, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals. – A.Chandler	*Strategy is a general model (behavior pattern) in the course of actions or decisions. It presumes continuous learning in the process of implementation, which should not be based on a preconceived detailed plan. – G.Mintzberg*
Management focuses on monitoring the implementation of the detailed plan of strategy realization.	Management focuses on adaptation, learning, transparency and coordination between the system elements.
Centralized decision-making; creating the static strategy implementation plan for a specified period.	Decisions are made by experts; dynamic adjustment of the strategy implementation plan.
Simple hierarchical structures are preferred, determinism in organizational behavior.	Collective actions based on the common principles, multidimensional structures with the distribution of power, but clearly defined areas of responsibility.
Decision-making rests on the development of a thorough detailed road-map of actions (containing the forecast of the final impact based on assumptions).	Decision-making is possible even if the management can not fully predict the impact (although they have some expectations).
Limited capacity to respond to the external signals. No possibilities to experiment.	The strategy presumes the ability to respond to the external signals quickly, and experiment if it is impossible to assess the impact of management decisions.

Why it's necessary to change the approach

In the modern context organizations operate in difficult and rapidly changing conditions, that require quick decision-making and continuous system's adaptation to new external conditions:

- globalization, increased competition;
- new technologies;
- increased transparency and speed of information processing;
- less predictable external environment, unclear impact of some decisions on the complex systems;
- increased volatility in financial and commodity markets.

In the modern sense the STRATEGY is not a thorough schedule of actions, but the determining of the basic principles and approaches to reach the target model, chosen by organization, that adapts to the dynamic external environment.

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Requirements for the strategy of reforms

Elements of effective strategy pursuant to the modern approach

Choice

- Strategy development is always a matter of conceptual choice:
  - between comparable models, mutually exclusive strategic alternatives;
  - which is difficult to change (to restore the original state);
  - which is based on the use of scientific approach (shaping expectations about the results of choice between various strategic alternatives, considering main risks and options of possible reaction to them).

Objectives

- A strategy should contain composite qualitative long-term objectives.
- KPI (key performance indicators) should be used to analyze the interim stages of strategy implementation, rather than as targets.

Justification

- The strategy should not be based on beliefs, values, ethics, intuition or assumptions, or "visions".
- The strategy can not take the form of "wish list".
- An effective strategy should be determined based on analysis of data on the strengths and weaknesses, values and advantages of a particular organization, its available resources, etc.
- Expectations regarding the results of strategy implementation should be generated based on the analysis of data, but these expectations may change in the course of its implementation.

Learning

- An effective strategy encourages learning and rapid adaptation to changing environment.
- People who implement a strategy should focus on learning – thus they should be punished for not learning from their own mistakes (but not just for the mistake itself).

Trust

- A strategy will be successful only if the participants of the organization use the same basic principles and approaches to strategy implementation.
- Therefore, an effective strategy should be based on trust within the organization.

Format

- An effective strategy is not detailed "schedules" or "road mapswhich application for solving large-scale problems is really a reflection of outdated practices.
- An effective strategy is a formalization of the guiding principles, priorities and approaches to activities and/or changes in the organization, required to achieve its long-term goals.

An EFFECTIVE STRATEGY is a qualitatively defined and generalized model indicating the basic principles, constraints, mechanisms and resources of the organization, required to achieve its long-term goals. The choice of strategy depends on the results of data analysis on the current state of the organization and its expected state after the strategy implementation.

Requirements for the strategy of reforms

Requirements for the Strategy of economic reforms in Ukraine

Given general requirements for strategy based on the modern approach (outlined on the previous slides), we have determined the following requirements for the format of the Strategy of economic reforms in Ukraine:

1. Clear complex objectives should be identified in the Strategy. The objectives should cover both economic categories (i.e. prosperity or economic development) and social categories (i.e. sense of fairness, trust, optimism and self-confidence).

2. Strategic objectives should be stated in the principles, the parties should adhere to during strategy implementation. Principles should also reflect the real willingness of the parties to implement them.

3. In addition, it is necessary to identify the key performance indicators (KPIs) to harmonize output data and results of constant analysis of the strategy implementation results. Usage of KPIs as targets should be avoided.

4. The strategy should include the rationale for the choice of social and economic system model, as well as the analysis of its preconditions and consequences of its successful implementation.

5. It is necessary to define the appropriate social and economic “institutions”. The plan to develop these institutions should become one of the essential parts of the strategy.

6. Strategy should include the main restrictions, resources and mechanisms for its implementation.

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Executive Summary

I. Requirements for the strategy of reforms

II. Strategic alternatives: Different models of economic development

III. Requirements for the implementation of “Capital Markets” strategy

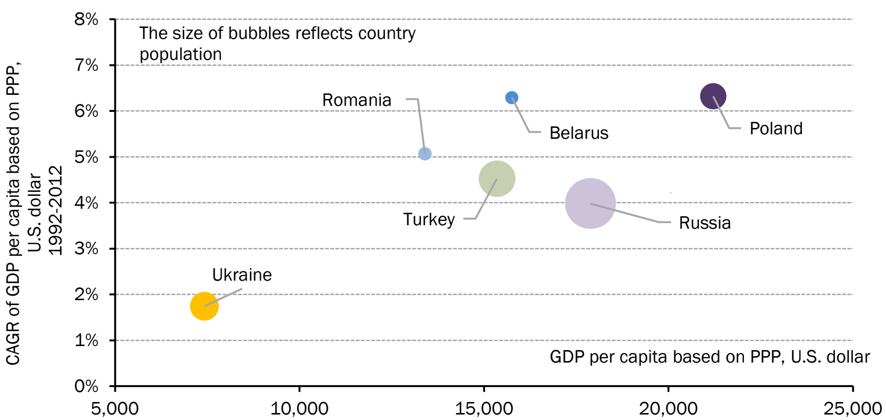
Appendices

- a. Ukraine 2014: “Growth Disaster” and the history of reforms
- b. Kleptocratic Oligarchy
- c. Export-oriented model
- d. “Capital Markets” model

Strategic alternatives: The current problem

Ukraine as an example of “Growth Disaster”

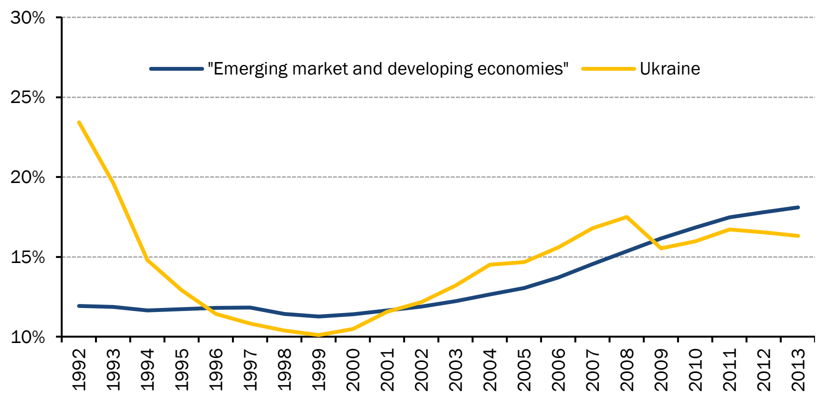
Ukraine versus selected peer countries: GDP per capita



Source: IMF, own calculations

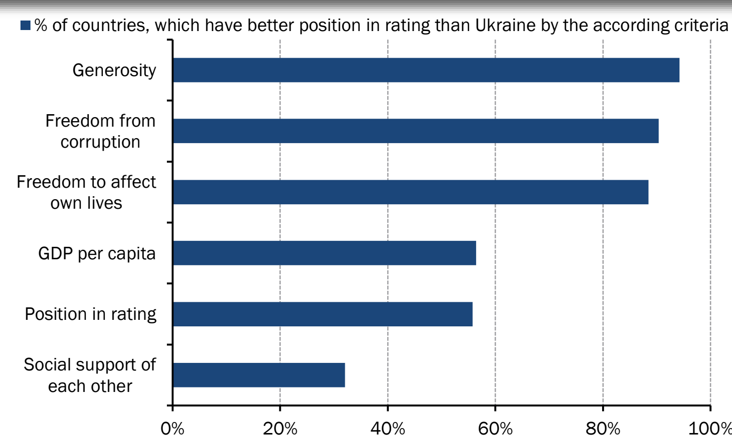
- Ukraine is the poorest one among selected peer countries. GDP per capita by purchasing power parity is only about USD 7500. It is three times lower than in Poland, and 2.5 times less than in Russia.
- Over the years of independence, the economy of Ukraine has shown one of the lowest growth rate. Ukraine is on the lowest positions in the list of developing countries by GDP per capita (its CAGR’1992-2012 is equal to 1.7% y-o-y) - 118th place out of 130 countries in the “Emerging market and developing economies“ group according to the IMF classification.
- According to more conservative estimations, the decline of GDP of Ukraine was from 0.8% to 1.4% y-o-y since the early 1990s. **In other words, Ukraine failed to demonstrate the economic growth during one of the most favorable periods in the history of world economy**.
- Poverty, frustration and loss of confidence in Ukraine are lowering the country’s rating in the list of happy countries (the 87^{t}h place out of 156 in 2013).

The ratio of GDP per capita (PPP) in the developing countries to GDP per capita (PPP) in the USA



Source: IMF, own calculations

Components of the “Happiness rating” for 2013



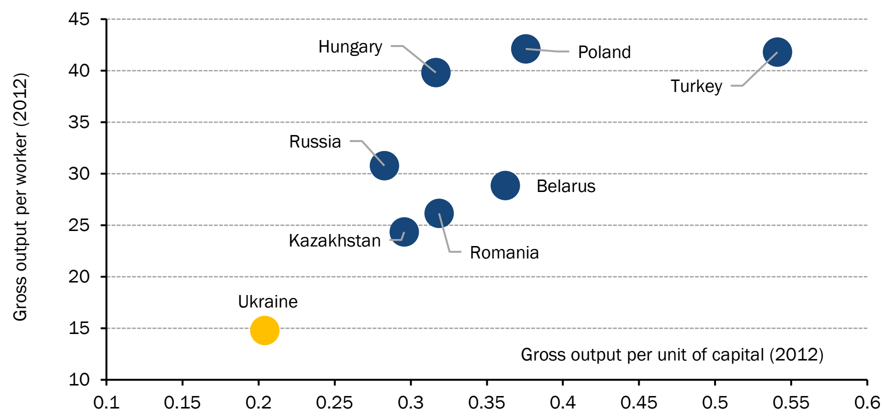
Source: World Happiness Report, 2013.

During the years of independence, Ukraine has become a ‘textbook example’ of the so-called “Growth Disaster” by demonstrating some of the lowest rates of economic growth in the world against the background of relatively positive external conditions.

Strategic alternatives: A source of problems

The issue is in institutions, not in people

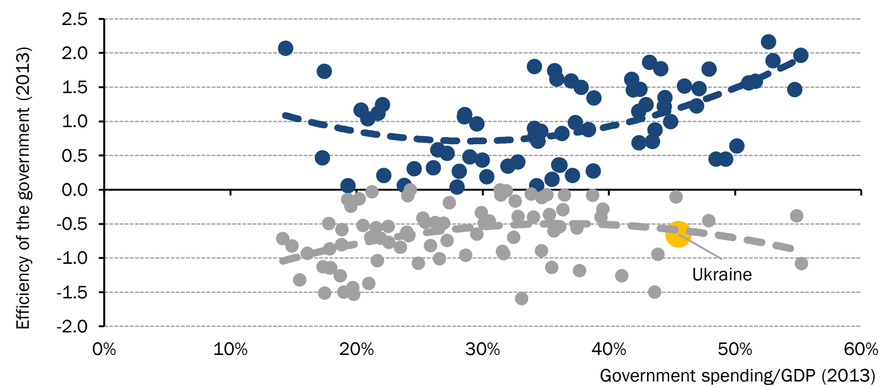
Total factor productivity (thousand U.S. dollars in const. 2005 prices)



Source: PWT 8.0

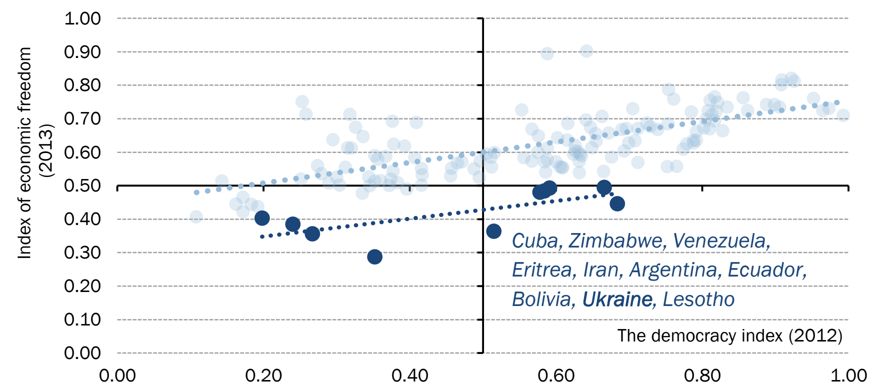
- Economic problems of Ukraine are explained by the low efficiency of the economy in the private and public sectors.
- Unsatisfactory performance level of the production factors (both labor and capital) can not be explained by the low quality of labor or capital employment ratio.
- The reason is the low quality of the institutional environment resulting from 'incompletion' of past economic reforms: high level of corruption, low efficiency of the public sector, limited economic freedoms and opportunities (slides 19-20).

The role of state in the economy and its efficiency - Ukraine vs other countries



Source: World Bank, IMF

Political and economic freedoms across the countries



Source: Economist Intelligence Unit, Heritage foundation

Economic problems of Ukraine are the consequence of a low efficiency, which in its turn is explained by the low quality of institutions.

Strategic alternatives: Status quo, ‘Rebooting’ export-oriented model, Capital markets

Selection of alternatives and its consequences

At present Ukraine stands at the parting: facing a choice of socio-economic model, drawing up new social contract between the government and society. This choice will determine whether our economy will be able to provide a fair and prosperous life of its citizens:

Strategic alternatives

Retaining “status quo”	Using export-oriented model	New economic model: changing principles, and capital markets

Expected results

Retaining the present social contract within the framework of the kleptocratic oligarchy is impossible:

- Society demands restoration of justice and reduction of corruption.
- Economic opportunities of the existing model do not allow the political elite to “buy off” society.
- Retaining the present model would lead to debt and budget crisis, resulting in default, hyperinflation and social revolt.

Slides: 30-36

Attempts to reload the present model by reducing corruption, but keeping export orientation and proactive government economic policy would not lead to the expected result:

- Deterioration of external market conditions and inability of authoritarian development of the export-oriented “pockets of growth” limit the economic potential of the model.
- ‘Reincarnation’ of the export-oriented model would not lead to the reduction of corruption and growth of economic freedoms, expected by society.
- Retaining an economic nature of the existing model eventually would lead to the recovery of corruption level and returning to the kleptocratic oligarchy.

Slides: 37-46

Inability to keep the present socio-economic contract unchanged leads to the necessity of transition to the new model, which should be based on new principles:

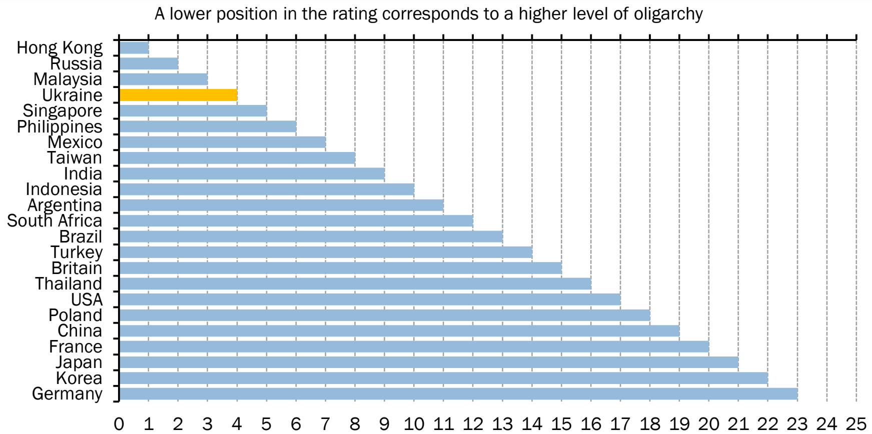
- Comprehensive restoration of trust would allow to carry out effective economic reforms and reduce macroeconomic imbalances, leading to financial stabilization.
- Increased competition and enhanced role of the market mechanisms in resource allocation would allow to improve economic efficiency in public and private sectors.
- Building a modern capital market would cause a strong economic growth in the long run.

Slides: 47-55

Strategic alternatives: Kleptocratic Oligarchy

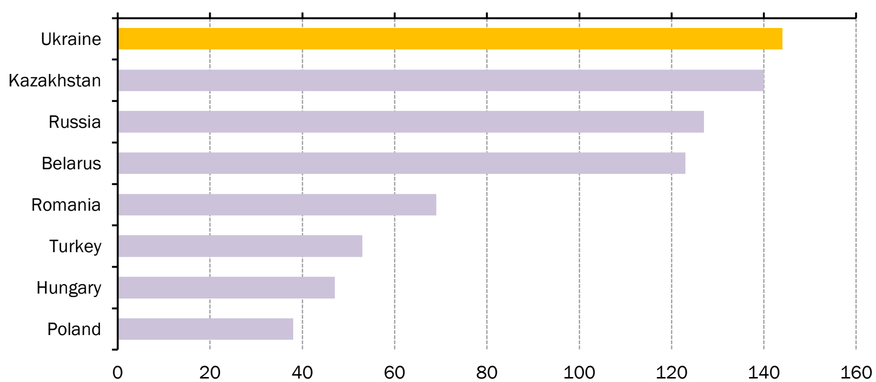
What is Kleptocratic Oligarchy?

Ranking of countries by level of oligarchy of economy



Source: The Economist (2014)

Corruption index



Source: Transparency International (data for 2013)

- With this type of economic relationships political elite primarily performs social representation functions, presenting and 'promoting' the interests of the largest owners of financial and industrial groups (often causing harm to national interests). In this case politics becomes 'commerce': since political forces are either competing for oligarchs-sponsors, or are created directly by the oligarchs.
- As a result, both oligarchs and politicians acting in their own interests become kleptocrats (derived from the word '*kleptos*' – to steal), i.e. thieves who carve up budget or get indirect and direct preferences in any form by abusing the state power.
- As a result, corruption and financial abuse of public officials, who at fact are representatives of oligarchs, become one of the main cores of society. Unfair behavior becomes the norm.
- After the Soviet Union's disintegration this model became typical for most newly formed states where there was a huge gap between the rhetoric of 'reformers' and their real actions: majority of them began to believe that the task of state is to serve the interests of a narrow circle of capitalists. Ukraine was not an exception: the core of never published "political agenda" of our kleptocrats was retaining and strengthening the system under which they would have obvious preferences compared to other economic entities, and dictate their will to state institutions.

Socio-economic system in Ukraine is both oligarchy and kleptocracy.

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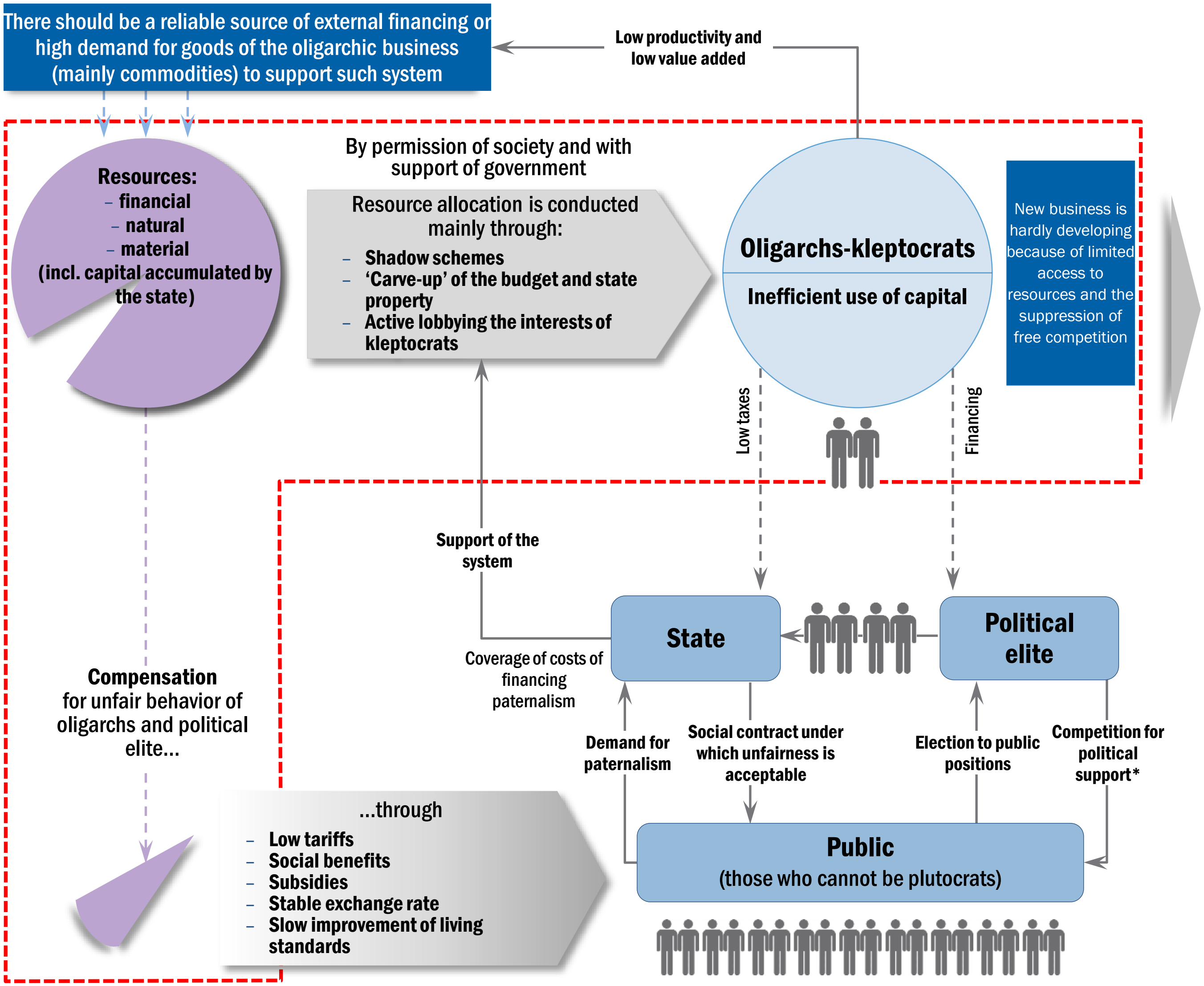
Strategic alternatives: Kleptocratic Oligarchy

How does this model work?



* – *mainly due to populist slogans*

Result

1. Slow economic growth.
2. Macroeconomic instability.
3. High cost and limited access to financial resources.
4. No large investments in efficiency improvement.
5. Loss of competitiveness in the long run.
6. Unlimited influence of oligarchs on government's decision-making.
7. Strong dependence on external financing and conjuncture of commodity markets.
8. Weak state (due to the accumulation of debt and underfunding of basic state functions).

- In the case of cut-off in access to cheap sources of funding or reduced demand for commodities there is very high probability of system collapse.
- Lack of resources to support the system would result in rapid changes of power – some populists will be replacing other populists.
- Oligarchs gradually would become weaker, and electorate would become less infantile.
- There would not only be an economic downturn, but also a high rate of UAH devaluation, hyperinflation and impoverishment of the population, compared to the mid-90s.
- High probability of social revolts.

Kleptocratic Oligarchy can not currently satisfy the society. Indeed, in case of retaining this model, it may even lead to the loss of Ukraine's independence. 'Rebooting' of the old system in the absence of significant resource rent would lead to a change of political elite (probably not in a peaceful way).

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Strategic alternatives: Kleptocratic Oligarchy

Inability of maintaining the status quo

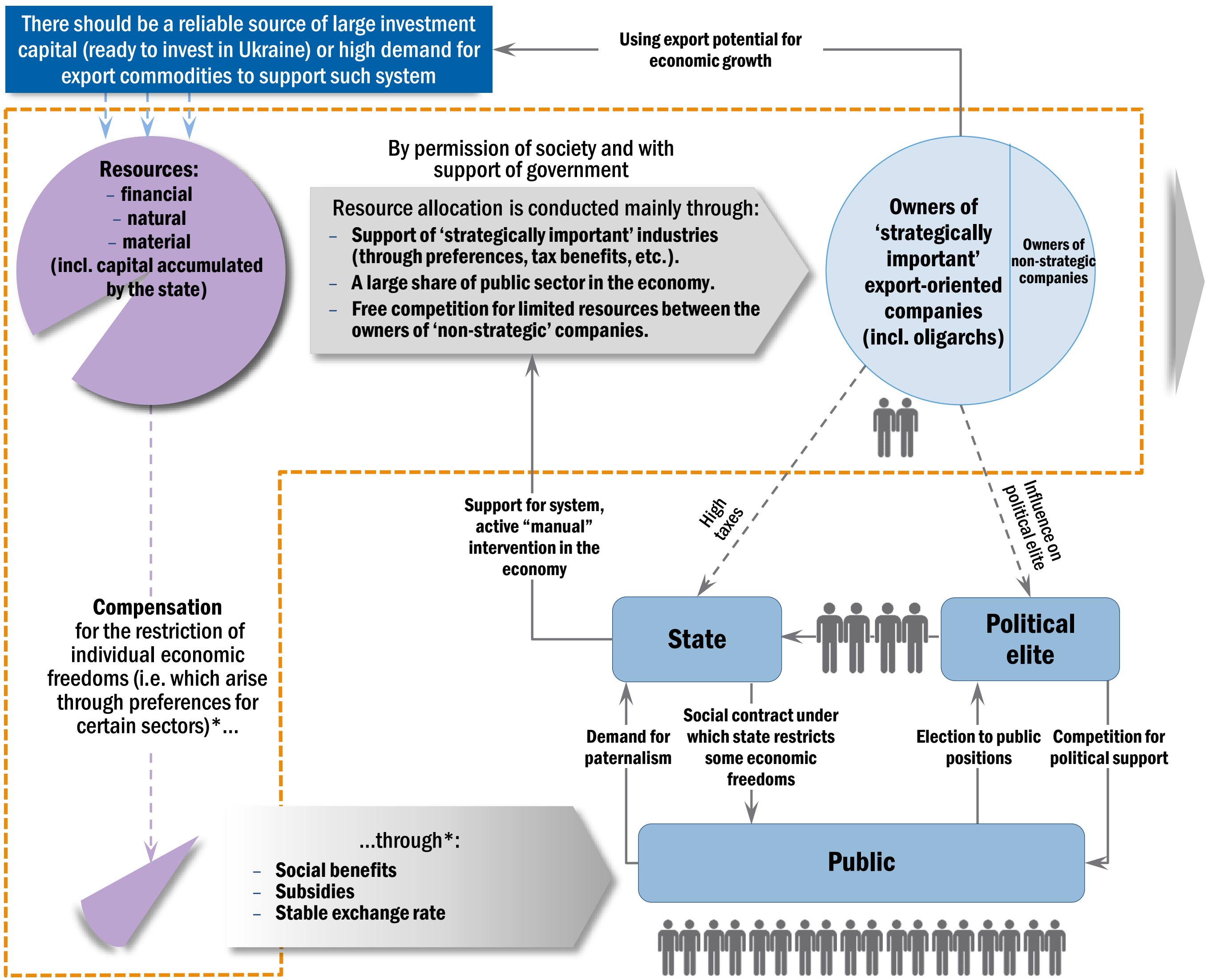
The effects of maintaining the status quo:

1. Rebalancing of Chinese economy (which was the main driver of global demand and prices for basic commodities in recent years) impairs growth prospects of Ukraine by reducing demand for traditional Ukrainian exports. Providing rapid economic growth without changing the structure of exports is impossible.
2. Ukraine should not rely on the influx of "hot" investment money by example of 2005-2007. International investors are much more selective after the 2008 crisis: it is necessary to compete with developed countries for investments.
3. Too high (and growing) level of social commitment together with weak economic growth prospects and a significant level of accumulated debt would inevitably lead to budget and debt crisis.

Inability to save socioeconomic contract based on the rule "Corruption, unfairness and restrictions on political and economic freedoms in exchange for social benefits" would lead to further increase of social tension and violent changes of power.

Strategic alternatives: Export-oriented model

How does this model work?



* – the level of this "compensation" is lower than under the kleptocratic model

Result

1. Strong dependence on external financing for large investments in efficiency improvement in export-oriented industries.
2. Economic growth would depend more on export market conditions.
3. High probability of maintaining the oligarchic system (i.e. the risk of retaining a large influence of oligarchs on government's decision making).
4. Limited access to financial resources for companies from "non-strategic" industries.
5. High probability of maintaining the weak state (through the accumulation of debt and related underfunding of its basic functions).

The Export-oriented model can allow keeping the present oligarchic system in Ukraine unchanged (only by restricting the level of kleptocracy), but its implementation faces the problem of worse global commodities market conjuncture compared to the early 2000s, the need of high-quality bureaucratic apparatus and the availability of effective institutions.

Strategic alternatives: Export-oriented model

The effects of implementation of the export-oriented model

The effects of export-oriented model implementation:

1. Fast refocusing on new markets along with minor changes in the export structure (increase in the share of agricultural products) would not bring the expected results because of reduced global demand (mostly due to the slowing Chinese economy).

2. Building export-oriented economic model following the example of successful "Asian tigers" is not possible in Ukraine due to lack of the necessary preconditions for success: Ukraine is characterized by a high level of industrialization, low quality of public governance, relatively higher standard of living, etc.

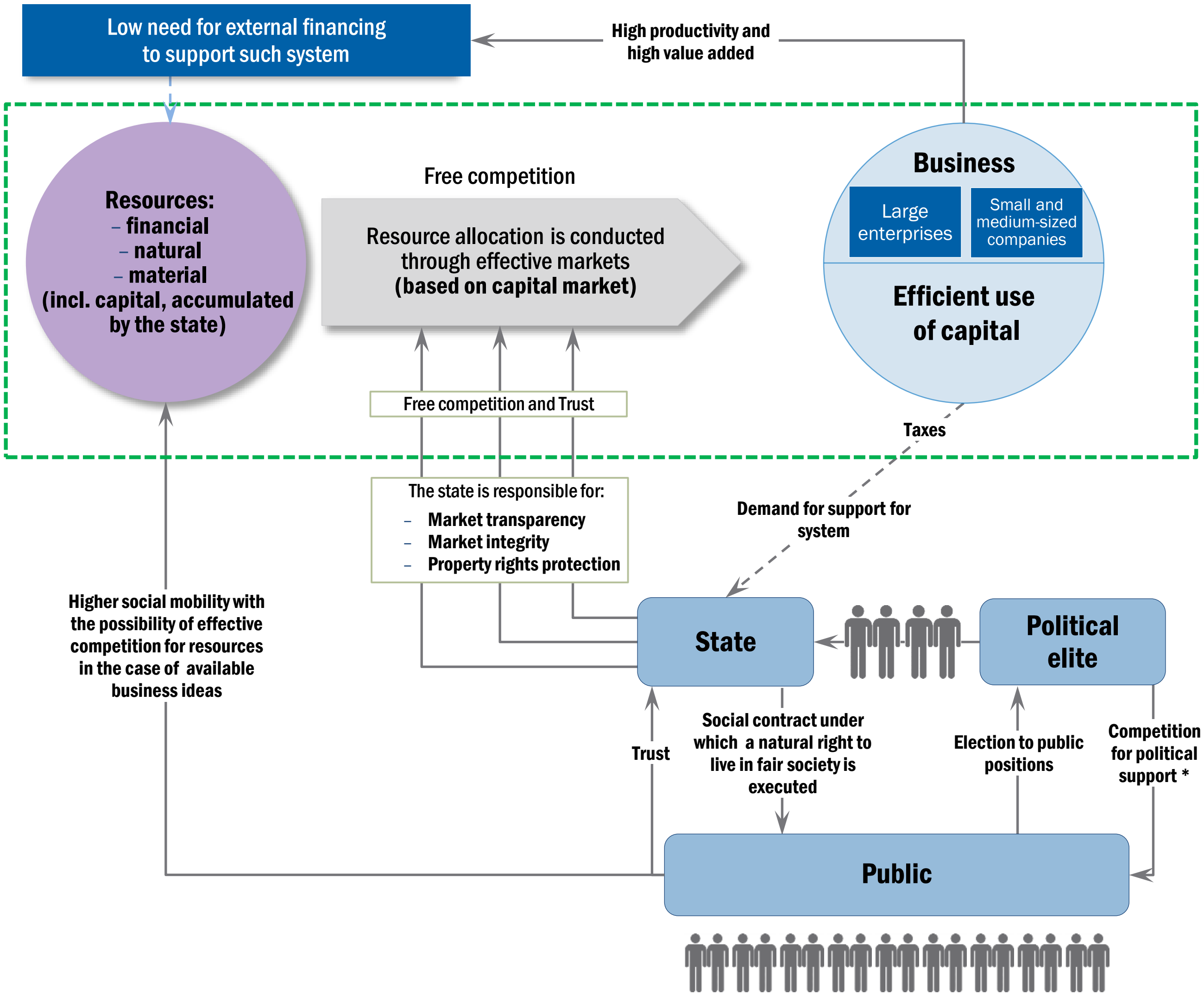
3. Increase of the level of state intervention in the economy (so-called 'pockets of growth') and implementation of proactive "policy of re-industrialization" would have a questionable economic effect. It could lead to maintaining the level of corruption and gradual loss of trust to the government and these 'pockets of growth'.

4. Retention of economic preferences for the selected sectors and companies would prevent (a) the growth in the level of trust, and (b) execution of a 'public order' to restore social fairness. This will restrict the potential for 'unpopular' reforms.

The demand for more active role of the state in the economy from some social groups is based on the false copying the experience of other countries. Economic results of an export-oriented model implementation are questionable. On the one hand it would not allow to compensate the demand for reduction of corruption and restoration of fairness for society, on the other - it would result in a return of economic and political elites to 'parasitism' and restoration of the foundations of the kleptocratic and oligarchic model.

Strategic alternatives: "Capital markets" model

What is an economic model "Capital markets"?



* – mainly due to proposals on better realization of the system (i.e. by promising to ensure more efficient markets)

Result

1. Sustainable high rates of economic growth.
2. Correcting of macroeconomic imbalances.
3. Reducing the cost and improving the access to financial resources.
4. Investments in efficiency improvement.
5. Improving the competitiveness of Ukrainian business.
6. Overcoming economic inequalities in the society.
7. 'Eradication' of paternalism.
8. Low influence of oligarchs on government's decision-making.
9. Strong state (through the effective use of funds and expected organic increases in tax proceeds).

- The only sustainable option to ensure fairness and prosperous life in the country is the transition to an economic model based on efficient capital markets.
- Capital markets would effectively pool the resources of economic agents, allow for their effective use and fair distribution of results.
- This would lead to increased productivity, 'natural' improvement of competitiveness of Ukrainian economy due to the market incentives.
- Sustainable high rates of economic growth would allow to achieve the main objective – ensuring a prosperous living for Ukrainians.

A key element of the new system should be effective Capital markets.
Their development will serve as an impulse for the development of the whole economy.

Strategic alternatives: "Capital markets" model

Changing principles and the role of the state in economy

- During transition to the new model the government should allow the market to decide how to use available resources in the best way.
- Instead of 'good intentions' to make public investment into 'strategically important' projects in order to stimulate some 'innovative' projects or 'prevent negative economic consequences', the state should only have one single role:

THE STATE SHOULD ONLY HAVE ONE SINGLE ROLE IN THE ECONOMY – ENSURING 'MARKET EFFICIENCY'

- This function is narrowed down to the three main tasks, represented in the diagram below. Their realization would provide fulfillment of the two basic principles of the new economic system – Trust and Free competition.
- Ensuring effective functioning of the market does not mean minimizing the role of government. In contrast, efficient market cannot be spontaneous, and so the role of the state here is very important and challenging. This distinguishes it from free or so-called 'wild market', which is characterized by the absence of state regulation and relying fully on the power of 'invisible hand' of markets in achieving a public wealth.

Fairness + Prosperous Living

Efficient Market

Key element: Capital market

Trust | **Free Competition**

Ensuring transparency

Information should be:
- Complete, timely and reliable/proven
- Presented in a user-friendly format with advantage given to substance over form
- Symmetrical for both parties to the market agreement

Ensuring market integrity

- Liquidity
- Infrastructure
- Integration between foreign exchange, stock and commodity markets
- Preventing manipulations

Protection of Property Rights

- From expropriation or 'surprise' taxes
- From raiding, extortion and fraud
- From banditism or war

The state should focus on a difficult function of assuring markets' efficiency, which at its core appears as implementation of the three mentioned objectives. At the moment Ukrainian state is unable to realize these functions.

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The effects of implementation of the “Capital markets” model:

1. Execution of a ‘public order’ for the changes would increase the possibility of implementation and effectiveness of the so-called ‘unpopular reforms’, leading to avoiding budget and debt crisis.

2. Increased role of market mechanism in the allocation of resources would lead to increased competition and elimination of the main problem of the Ukrainian economy: low efficiency in both private and public sectors.

3. Increased role of the market in resource allocation would allow to ‘naturally’ determine sectors that have the biggest economic potential without a parallel increase in corruption (in case when officials are trying to address this question). That is, development of export-oriented sectors is probable just as it might be in the framework of the export-oriented model, but this would be determined by the market itself.

4. Development of effective capital market would solve the problem of complex and unequal access to funding, thus ensuring achievement of economic fairness and providing a source for long-term growth.

Implementation of “Capital markets” model would allow achieving sustainable high rates of economic growth, correction of macroeconomic imbalances, improving access to financial resources and overcoming economic inequalities in the society.

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Requirements for the implementation of “Capital Markets“ strategy

Elements required for successful implementation of “Capital Markets“ strategy

1 Compliance with the principles of trust, transparency, free competition

Ensuring competition of ideas, objectivity and justification of administrative decisions, initiative and transparent teamwork of government, assigning people with experience and spotless reputation as public officials and focusing on professional development would facilitate the formation of both reasonable and informed decisions. This will also increase the level of trust in government.

2 Application of scientific approach and focus on learning

Effective implementation of strategy and solving the issue of personnel restrictions is not possible without focusing on learning in the process of implementation of economy reforms. Such focusing means that decisions are based not on beliefs, values, ethics, intuition or assumptions, but on the hypotheses that are confirmed by data (*see next slide*).

3 Improving quality level of personnel

Inadequate staffing is one of the key problems on the way of implementing the chosen strategy of economic reforms in Ukraine. Improving quality level of personnel will depend on improving competition (both in business and in politics) refusal to ‘nepotism’ in assignments. People should not be punished for their mistakes, but for the fact that they do not learn from these mistakes.

4 Usage of KPIs (key performance indicators)

KPIs should be used to analyze the interim stages of strategy implementation rather than as main objectives of the strategy.
KPIs should also allow reasonable level of deviations: not only to encourage performers to achieve these indicators, but also to motivate them to learn from their mistakes.

5 Institutional support of the West

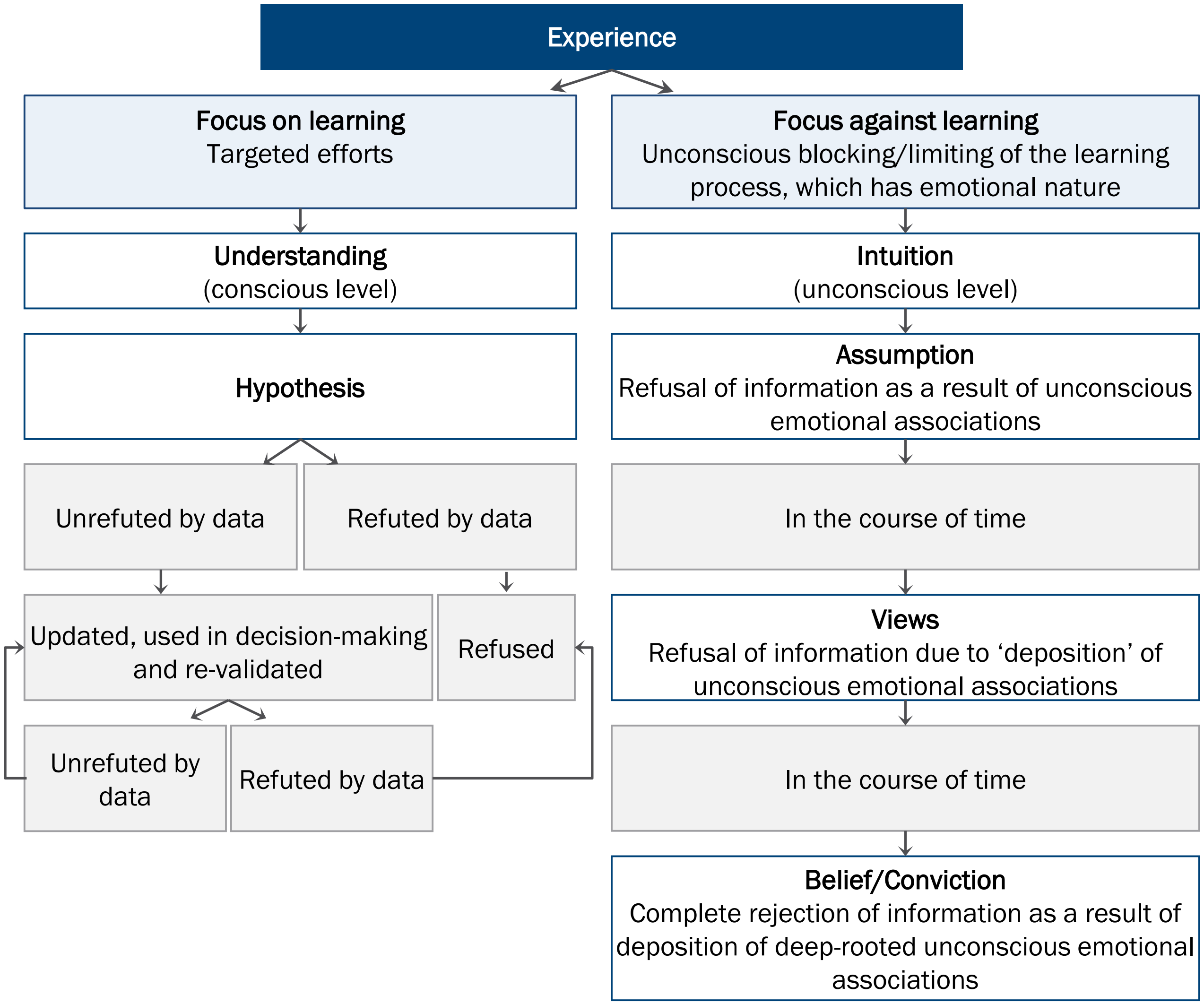
Ukraine needs an analogue of ‘Marshall Plan’, which should be aimed at making Ukraine a part of modern civilization by developing effective capital market. An important tool of the aid from the West is the elimination of trade and regulatory barriers for Ukrainian companies, technical assistance, training Ukrainian specialists in foreign companies, creating the panel of the Western governmental, business and labor leaders, each of which should be an advisor for implementation of certain reforms.

6 Financial support of the West

‘Marshall Plan’ for Ukraine should stipulate a sufficient amount of funding by the West - in the context of focus areas and tools. The main focus areas of funding should be in modernization of technologies and business practices, infrastructure development, crucial supplies of fuel/military equipment. Tools of such funding should play the role of some ‘critical margin’ to attract other investments. For example, these instruments include investment funds, incl. those created for loan/leasing to private business, export agencies, etc.
A special clause of the Plan should cover mechanisms for providing and administration of funds.

Requirements for the implementation of “Capital Markets” strategy

Focus on learning



- Focus on learning requires constant reviewing of the hypotheses and life-long learning. In this approach, the main task is primarily to shape appropriate expectations and only then draw conclusions.
- The use of such an approach in the process of strategy implementation will lead to the establishment of an effective decision-making mechanism.
- The problem with the choice of focusing on learning is the lack of understanding of the problem by those who actually target ‘against learning’. Many managers believe that higher education, especially a university degree, diploma or even an MBA from a western business school is a key to focusing on learning. However, such beliefs are false, because focusing on learning is not a matter of available knowledge, but rather of the process of “updating” the knowledge.

Economic reform is a process that consists of trials and errors. And successful reforms differ from unsuccessful ones primarily because they were supported by timely conclusions, what is a focus on learning.

Requirements for the implementation of “Capital Markets” strategy

An example of implementation: recommendations for basic principles of the new government when building a new economic system

	Basic principles	Priority areas of changes
Principles which should guide new authorities	▪ Ensuring trust ▪ Increasing transparency ▪ Free competition in the broad sense	▪ Realizing that legitimacy is a voluntary recognition of the government’s rights, being a category of confidence, rather than a norm or procedure. ▪ Declaration and readiness of the authorities to refuse returning to Kleptocratic oligarchy model. ▪ Lustration should not turn into a hypocrisy, honesty should be the cornerstone of the public governance. ▪ Carrying out preliminary explanatory campaign concerning the necessity of fast and radical reforms.
The role of the state in economy	▪ Ensuring market efficiency	▪ Refusal of ‘fatal conceit’ concerning ‘manual’ intervention in the economy. ▪ Declaration and readiness to ensuring market transparency and integrity, protection of property rights. ▪ Building of efficient capital market as the basis of the new system.
The approach to implementation of reforms	▪ Radical reforms ▪ Focus on learning, reforms as a process of trials and errors	▪ Readiness to take responsibility for unpopular difficult decisions. ▪ Complex decisions should not be based on beliefs (values, convictions or assumptions) – implementation of reforms should be focused on learning (testing of the hypotheses based on data). ▪ Improving quality level of personnel depends on improving competition.
Team selection	▪ “Technocratic government” is required ▪ Ensuring trust to all team members	▪ Prime Minister should be ready for radical reforms (without populism). ▪ Instead of focusing on a wide consensus it is necessary to ensure trust to all the team members of new Government. The government should constantly strive for voluntarily recognition and people’s trust in the government and public institutions.
Relationship with the West	▪ Upholding equal partnership, overcoming civilizational gap	▪ Gaining more active support from the West and the IFIs, including through rapid implementation of the Association Agreement between Ukraine and the EU (AA) and the fundamental requirements of the Memorandum with the IMF, developing the analog of ‘Marshall Plan’ for Ukraine.

Developing new economic model primarily requires changing the basic principles of interaction between economic agents. As far as it requires radical reforms, the best option is to create a ‘technical government’, the members of which are willing to defer political ambitions and radically change the socio-economic model of Ukraine.

Appendix A. Ukraine 2014: «Growth Disaster» and the history of reforms

The source of problems: capital, people or productivity?

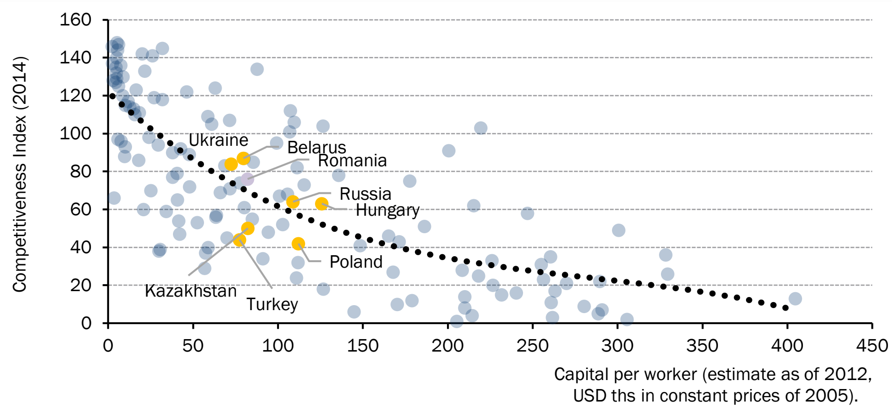
Human capital index and its components: problem is not in people, but in institutions

	Human capital index	Education	Health	Enabling environment
Russia	51	41	62	63
Poland	49	42	47	57
Hungary	54	33	73	62
Romania	69	57	61	83
Turkey	60	77	51	45
Kazakhstan	45	43	69	51
average	55	49	61	60
Ukraine	63	45	55	96
Ukraine is better / (worse) than average	-13%	9%	10%	-37%

Source: World Economic Forum (2013)

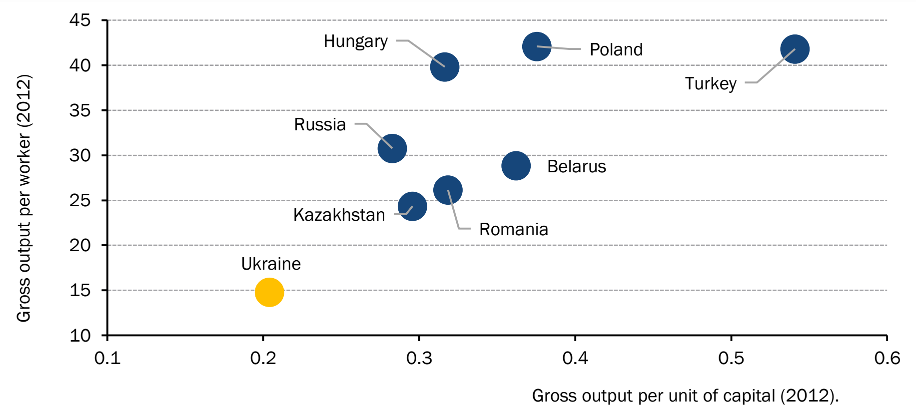
- Economic growth is a result of interaction mechanism of the basic production factors: capital, human capital, labor and productivity (both labor and capital).
- Assessment of human capital quality shows that the problem of economic growth in Ukraine - is not people, but institutions - game rules which restrain the realization of human potential.
- Capital stock per worker (K/L) in Ukraine is slightly below than in comparable countries, but this difference is not critical. Kazakhstan and Turkey have much higher level of economic competitiveness at the same level of K/L ratio.
- Ukraine hugely underperforms comparable countries (and most of the World) in terms of capital and labor productivity.

Capital/labor ratio and competitiveness



Source: PWT 8.0, World Economic Forum

Factor productivity (USD thousand in constant prices of 2005)



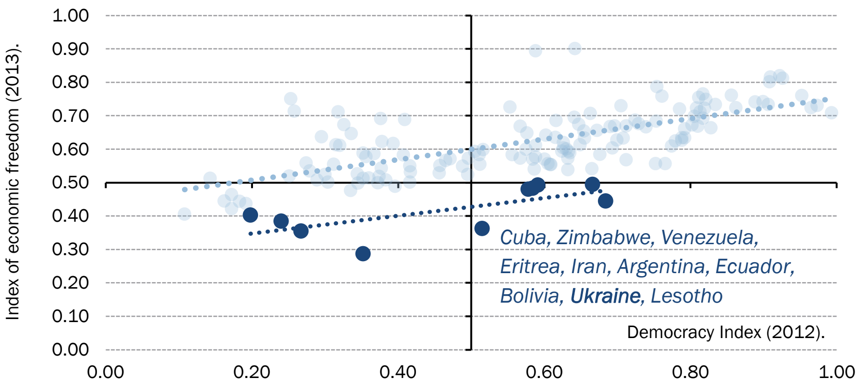
Source: PWT 8.0

Ukraine's economic problems are the result of low efficiency, which is due to the low quality of institutions.

Appendix A. Ukraine 2014: «Growth Disaster» and the history of reforms

The source of problems: economic institutions and effectiveness of the state

Political and economic freedom



Source: Economist Intelligence Unit, Heritage foundation

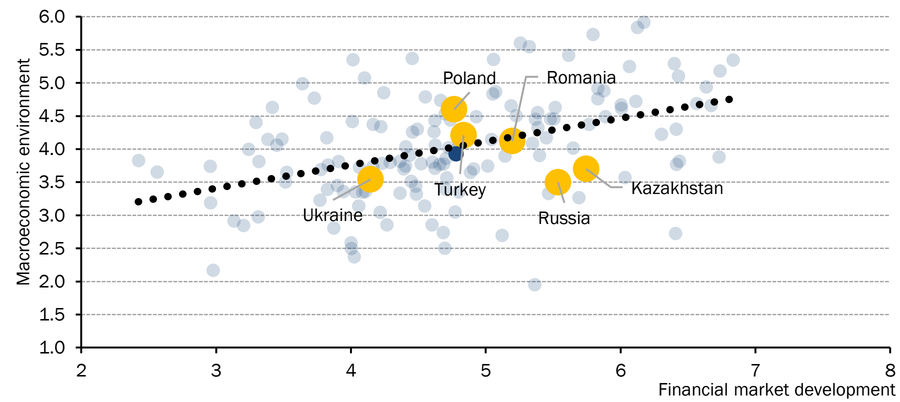
- Socio-economic system of Ukraine is characterized by a relatively high level of political freedoms, but nevertheless a very low level of economic freedom. Ukraine belongs to a special group of countries (selected for the same interrelation of these parameters): Cuba, Zimbabwe, Venezuela, Eritrea, Iran, Argentina, Ecuador, Bolivia and Lesotho.
- Likewise, Ukraine is characterized by a significantly low quality of governance and a relatively low level of financial market institutional development. The latter may be regarded as a major cause of the unfavorable macroeconomic environment (which fuels a chronic macroeconomic instability).

Public governance Indicators

	Rule of law	Control of Corruption	Regulatory Quality	Government Effectiveness
Belarus	20	37	14	17
Hungary	67	65	78	70
Kazakhstan	31	20	37	35
Poland	73	71	81	71
Romania	56	53	69	53
Russia	25	17	37	43
Turkey	56	62	65	66
average	47	46	54	51
Ukraine	23	12	29	30
Ukraine is better / (worse) than average	-51%	-74%	-47%	-41%

Source: The World Bank (2013)

Development of economic institutions



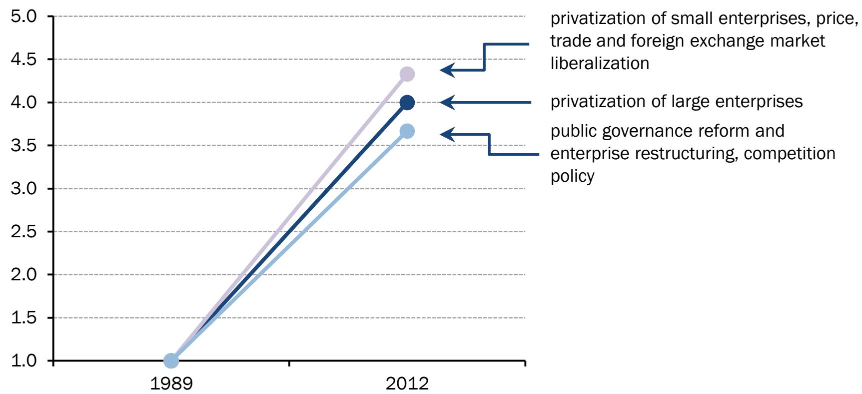
Source: World Economic Forum (2014)

Ukraine is characterized by a significantly low quality of governance and a relatively low level of financial market institutional development.

Appendix A. Ukraine 2014: «Growth Disaster» and the history of reforms

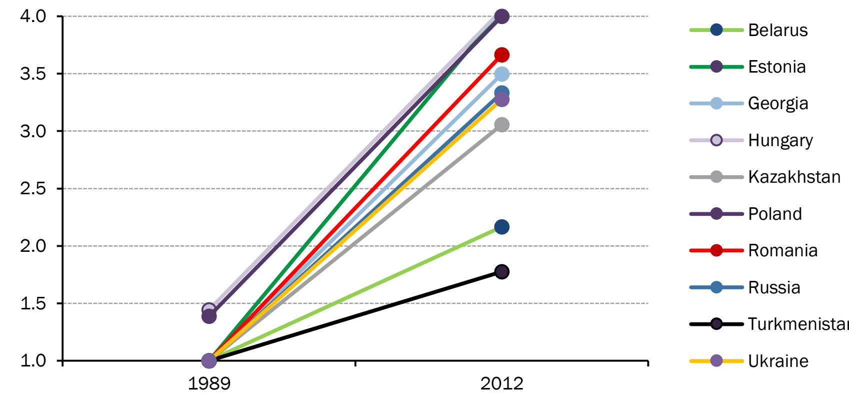
Ukraine has not completed the transition from a planned to a market economy

Index of reforms: the way of Estonia



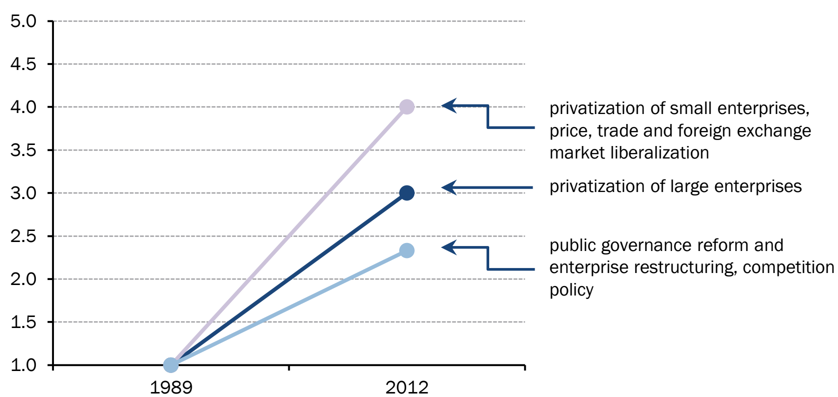
Source: EBRD, own calculations

Index of reforms: transition countries



Source: EBRD, own calculations

Index of reforms: the way of Ukraine



Source: EBRD, own calculations

- In the early 1990s, a the whole group of post-Soviet countries faced the necessity of economic transformation, which included a standard set of market-oriented reforms (liberalization, privatization, public governance reform, etc.).
- Relevant indexes, calculated by EBRD, allow us to monitor progress of implementation of these key reforms by each country. Corresponding data on Ukraine show that we have started, yet still not completed the process transition.

Ukraine has not belonged to the explicit outsiders of market reforms implementation for years of Independence, but it is obvious that the country has not completed the transition from a planned to a market-oriented economy.

Appendix A. Ukraine 2014: "Growth Disaster" and the history of reforms

Approach to reforms: implementation and results

Sweeping "shock reforms"
- Estonia
- Latvia
- Lithuania
- Czech Republic
- Poland
- Slovakia

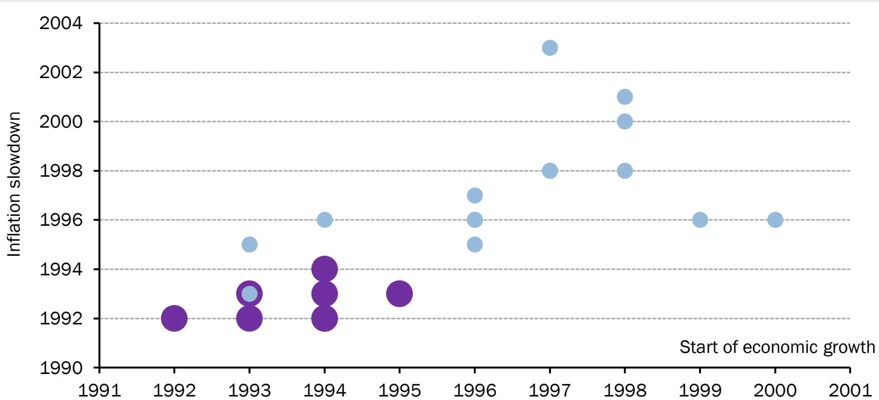
High base, gradual progress
- Croatia
- Hungary
- Slovenia

Interrupted "shock reforms"
- Albania
- Bulgaria
- Macedonia
- Kazakhstan
- Russia

Gradual changes
- Azerbaijan
- Armenia
- Georgia
- Kazakhstan
- Ukraine
- Tajikistan
- Romania

Restricted reforms
- Belarus
- Uzbekistan
- Turkmenistan

End of initial economic turbulence for various transition countries



Source: IMF

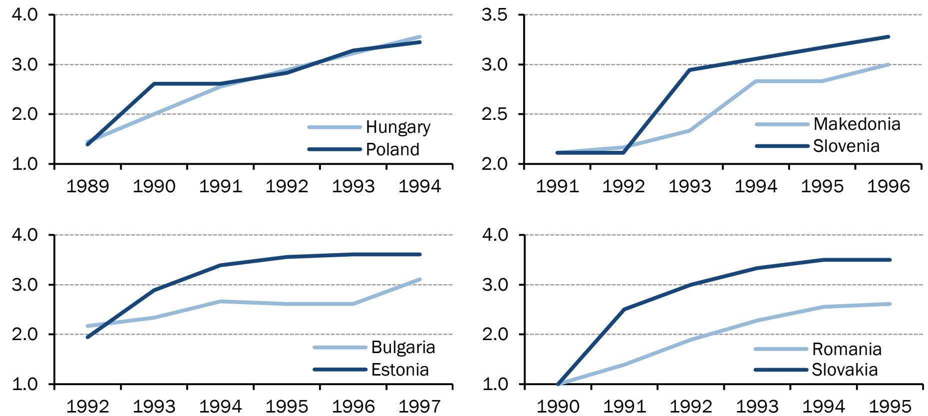
- The analysis shows that countries which had chosen the strategy of radical reforms in the early 1990s, achieved macroeconomic stabilization much sooner than "gradual reformers".

Radical economic reforms in the early 1990s in Eastern Europe brought better results than implementation of gradual changes approach.

Appendix A. Ukraine 2014: "Growth Disaster" and the history of reforms

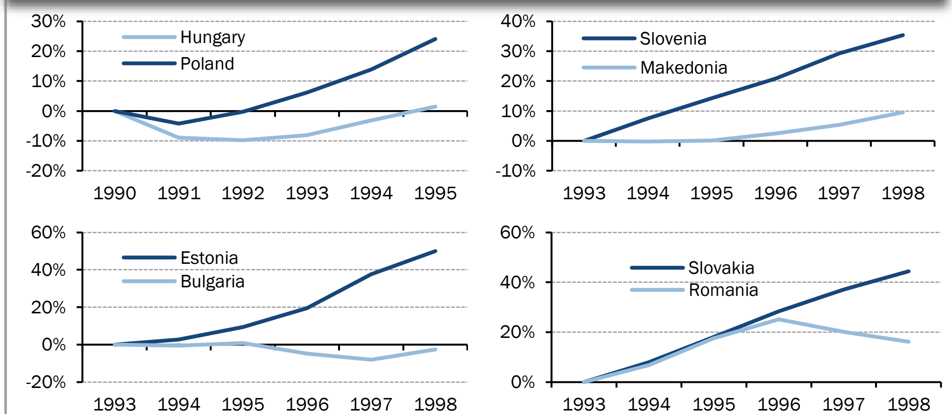
The pace of reforms implementation – comparison of countries which were on an equal footing

Index of reforms: examples of gradual and radical approach to reforming



Source: EBRD

The effects of the difference in pace of reforms: the dynamics of GDP per capita in PPP terms *



Source: IMF

Notes: * – GDP growth rate of indicated year compared to GDP at the beginning of radical reforms

- In certain transition countries (Poland, Czech Republic, Estonia) supporters of radical reforms as the best way of ensuring the conditions for a rapid economy recovery (so called "shock therapy") succeeded to implement this approach, especially at the beginning of the transition period, despite its negative impact in short term (cutbacks in output and unemployment). This was possible due to the wide support of population and a willingness to radically put an end to the past. The government took advantage of the political and social consent to apply drastic measures which term would reduce the standard of living in the short term with the promise of a fast recovery.
- In other countries (Romania, Bulgaria) implementation of necessary reforms was more difficult because of the strong position of oligarchic groups, political instability and complex social problems.
- History shows that countries which had carried out reform faster (privatization, liberalization, public governance reform, competition policy) subsequently demonstrated significantly higher rates of economic growth.

Radical economic reforms of the early 1990s in Eastern Europe yielded better results than implementation of gradual changes approach.

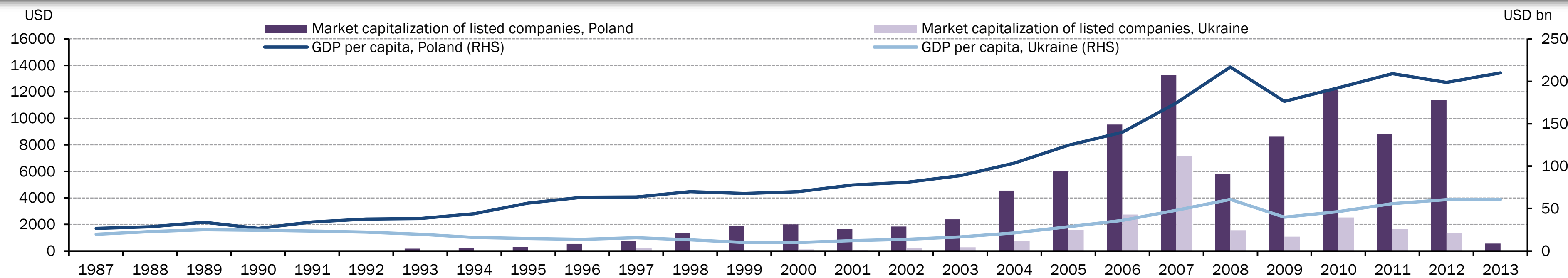
AYA Capital

AA : BC : CL : DB : EE

Appendix A. Ukraine 2014: "Growth Disaster" and the history of reforms

Sweeping reforms: the experience of Poland

The influence of radical reforms on the economic development of Poland



1989 – the Sejm passed 10 acts according to the Balcerowicz Plan ("Shock Therapy"):

- allowance for state-owned businesses to declare bankruptcy ;
- elimination of price controls;
- forbidding financing the state budget deficit by the national central bank and the issue of new currency;
- foreign trade liberalization;
- abolishing the preferential laws on loans for state-owned companies and interest rates tied to inflation;
- elimination of state control over income level and reducing the role of state enterprises;
- introducing common taxation for all companies and abolishing special taxes that could have been applied to private companies previously;
- allowing foreign companies and individuals to invest in Poland and export their profits abroad;
- abolishing the state monopoly in international trade;
- creating a uniform customs rate for all companies.

1990-1991

- Most prices liberalized
- Most foreign trade controls removed
- Small-scale privatization begins
- Privatization law adopted
- T-bills market initiated
- Crawling peg exchange rate regime introduced
- Competition law adopted
- **Stock exchange begins trading**
- Banking law enacted

1992-1993

- Corporate and personal income taxes reformed
- EU Association Agreement
- Mass privatization program begins
- VAT introduced
- Financial restructuring law adopted
- First bank privatized

1994-1995

- Major external debt restructuring
- National Investment Funds (NIFs) established
- Wage restrictions redefined
- Agricultural import restrictions changed
- First sovereign Eurobond
- Full current account convertibility introduced
- WTO membership
- IAS introduced

1996-1997

- New privatization law adopted
- OECD membership
- NIF shares listed on WSE
- First corporate Eurobond
- Energy law, Electricity law adopted, Securities law amended

1998-1999

- Independent Monetary Policy Council established
- New foreign exchange law enacted
- Independent banking regulator established
- Investment funds law enacted
- Telecommunications privatization begins
- Substantive negotiations for EU accession started
- Pension reforms implemented
- Health care system reformed

Source: World Development Indicators, EBRD

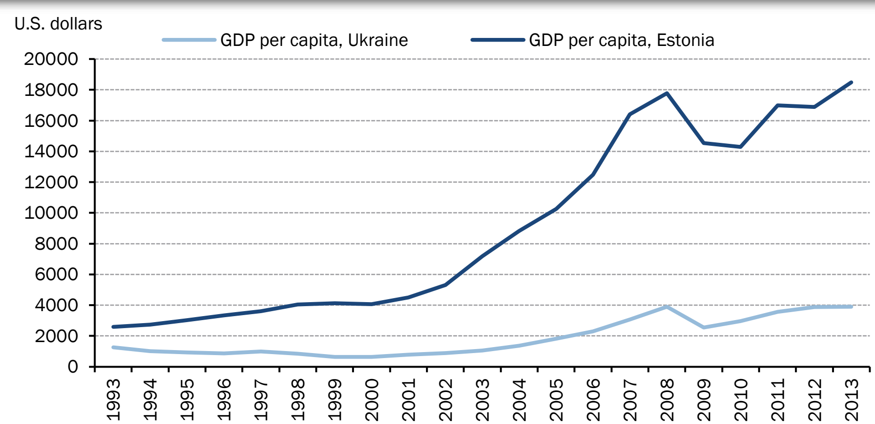
Although the "shock therapy" caused a short-term decline of standard of living in the 1989-90, radical reforms gave a crucial impetus to the economic development of Poland. Rapid liberalization and development of the capital market are the reasons of striking difference between living standards of Ukraine and Poland.

Sweeping reforms: the experience of Estonia

Estonia has began to carry out serious economic reforms immediately after the restoration of its independence in 1991. From the very beginning of reforms the Estonian government has operated in close cooperation with the IMF. The liberal economic policy excluded protectionism from the outset. Under these conditions, the market mechanism has become the main impetus for restructuring the Estonian economy.

- According to the ideas of the then leading Estonian economists (S. Kallas, R. Otsason and others) the sequence of economic reforms in Estonia was based on package approach and included the following measures:
  - Liberalization of prices due to slashing subsidies and the abolishment of fixed prices with a domestic trade liberalization
  - Establishing a balanced government budget both by raising taxes and reducing the government spending
  - Restrictive monetary policy reflected in increasing the interest rate of the Bank of Estonia to restore a positive real interest rate
  - The taxation policy, aimed at stopping an inflationary spiral
- Liberalization of foreign trade through growth of export and import licensing as well as foreign economic activity (FEA) license provided for all entities, tariff cut aimed to demonstrate the state commitment to trade liberalization, internal convertibility of local currency on current accounts.

Changes in GDP per capita in Estonia



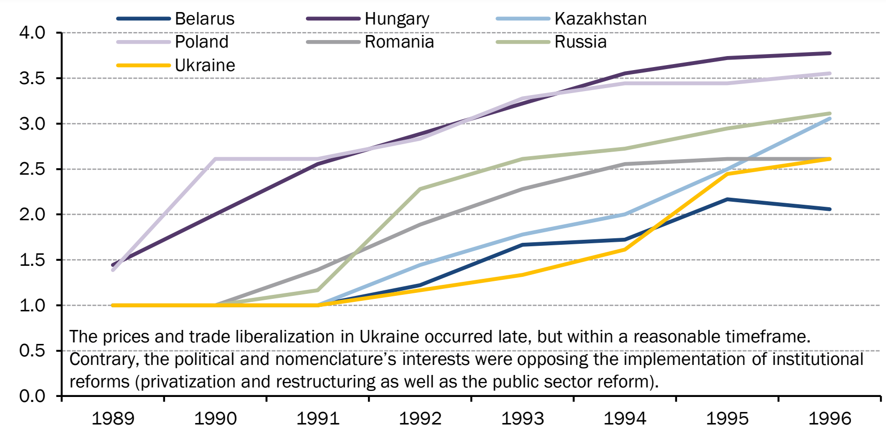
Source: World Development Indicators

- The economic stabilization program became an essential part of the reforms strategy. Curbing an inflation, stabilizing public finances and improving an external trade balance were the key purposes of the program.
- At the start of the stabilization program the different forecasts about further development of Estonia were made. Expected results were as follows: that inflation would decline after the simultaneous and general sharp rise in prices because of the termination of subsidies; that the budget deficit would be reduced and the balance of payments would be improved.
- The successful implementation of market reforms led to the fact that Republic of Estonia was the first post-Soviet state to become an associate member of the European Union.

Appendix A. Ukraine 2014: “Growth Disaster” and the history of reforms

1991-1994: lack of important reforms and economic policy mistakes = economic tragedy

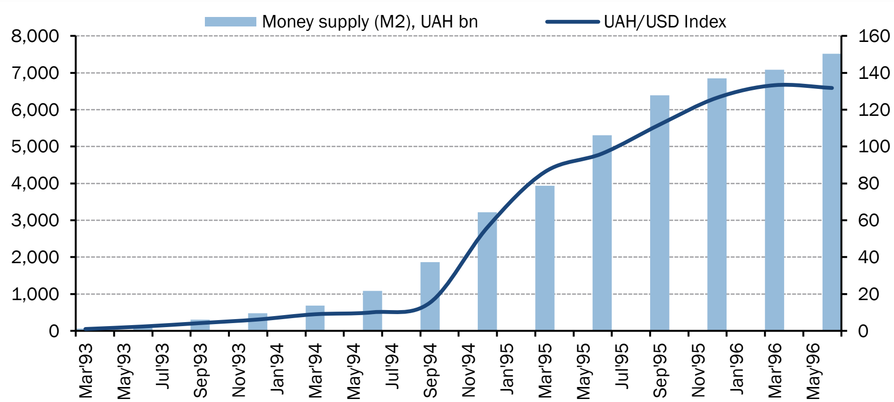
EBRD index of reform: the weakness of Ukraine in 1991-1994



Source: EBRD

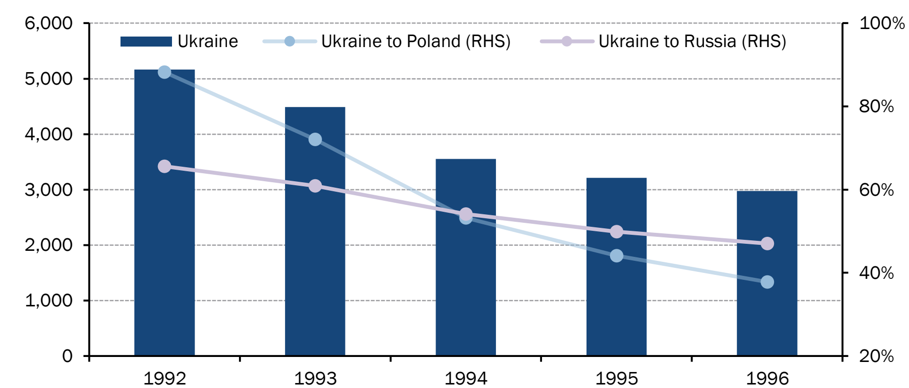
- The first years of independence for Ukraine were associated with a relatively slow reforms: the late privatization, liberalization of prices and market and, particularly, government spending.
- Overall, the reforms were implemented not proactively and systematically, but only partly in response to the inability of the state to keep the political and social status quo. Therefore, we can not say that the “shock reforms” were implemented in Ukraine, rather Ukrainian economy suffered “a lack of reforms shock”.
- The efforts made to preserve the Soviet system of public spending with the inherited high level of social transfers amid the fallen revenues led to the extremely high budget deficit (~10% of GDP).
- Financing the deficit was effected on the account of NBU (according to the CASE estimations about 90% of NBU emission was directed to financing the deficit in 1993). The hyper-inflation (10,000% in 1993) and hyper-devaluation had become a result of such economic policy.

Source of financial instability: financing the budget deficit



Source: CASE (Research, 1999)

GDP per capita based on PPP, U.S. dollar



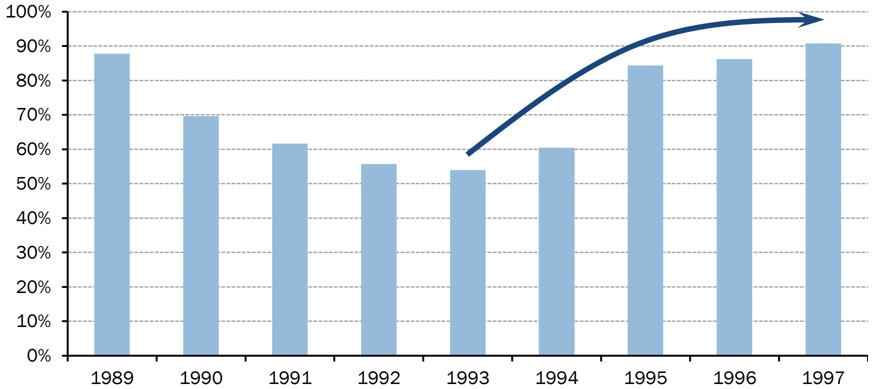
Source: IMF, own calculations

The economic tragedy of the early 1990s was caused at most by the slow implementation of reforms and economic policy mistakes

Appendix A. Ukraine 2014: "Growth Disaster" and the history of reforms

1996-1998: lack of reform of public finances (spending) = blow to the private sector as the result of the global crisis in 1998

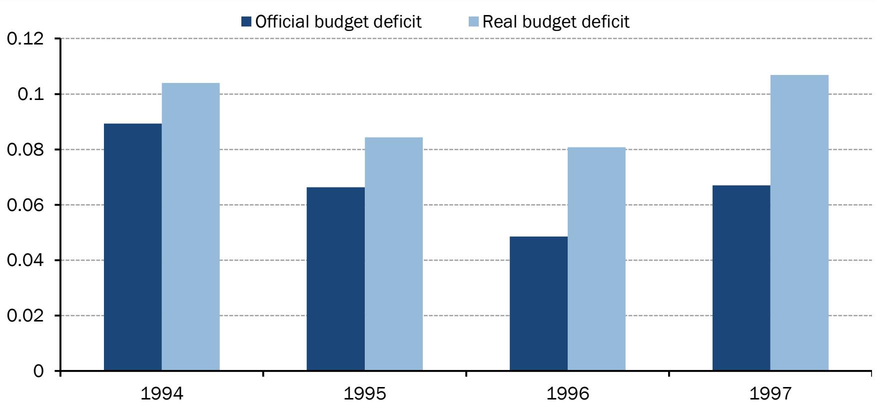
Reforms Index: Ukraine to the average to compared countries



Source: EBRD, own calculations

- Since 1994, the economic reforms had gained momentum: in 1994-1996 Ukraine managed to catch up with some post-Soviet countries according to the EBRD index of reform.
- Reforms, gradual adaptation to the shock caused by the disruption of production chains and stabilizing macroeconomic policy had allowed the state to reduce the annual rate of inflation to 10% in 1997, while the rate of real GDP declined to 3%.
- The development of domestic debt market became an important stabilizing factor, which helped to reduce the role of NBU in financing the budget deficit. However, at the same time the availability of resources allowed the Government to use 1996-1997 not for public spending reform, but for preserving the existing inefficiencies. As a result, the budget deficit reached the critical levels again.
- The global financial crisis of 1998 only deepened the budget crisis in Ukraine, that caused a new wave of devaluation. Financial and private sectors experienced the greatest challenge.

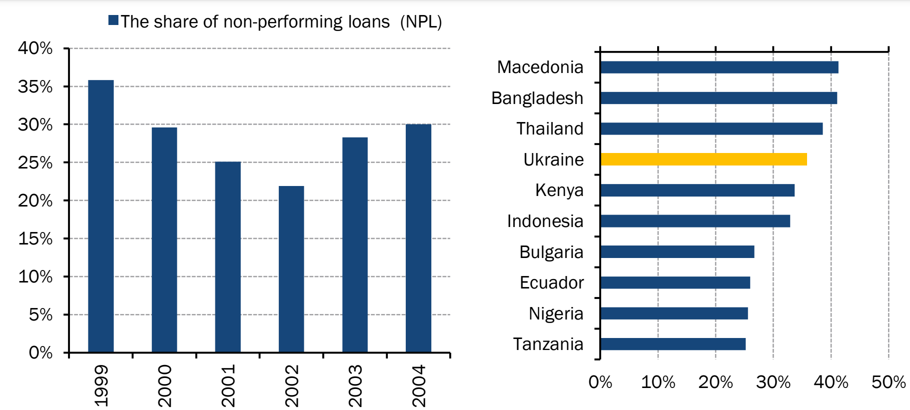
Budget deficit, % of GDP



Source: CASE

Notes: the real deficit - taking into account the costs that had to be accounted in prior periods.

The impacts of the crisis of 1998: decline in the quality of banks loan portfolios



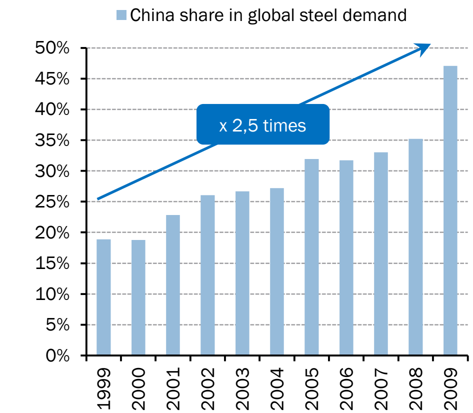
Source: World Bank

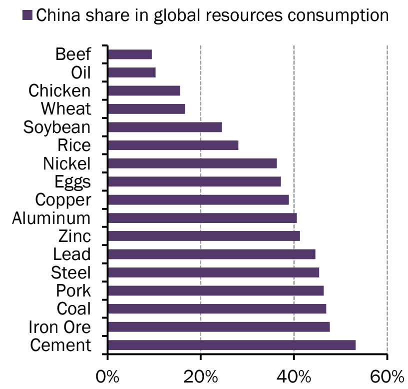
Pause in reforms, particularly in the reform of public spending caused the critical budget deficit, fiscal and debt crisis and excessively painful response to the crisis of 1998.

Appendix A. Ukraine 2014: "Growth Disaster" and the history of reforms

1999-2008: economic growth by chance (and without reforms) that will not occur again= accumulation of problems for the future

China as the root cause of the commodities boom

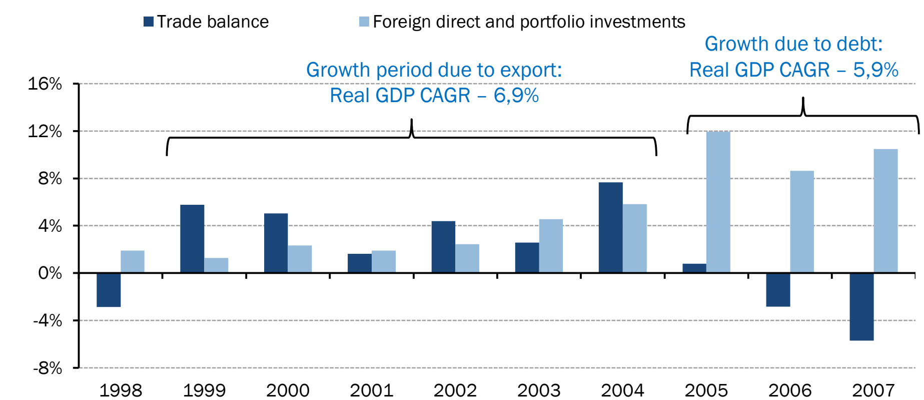




Source: World steel association, GMO

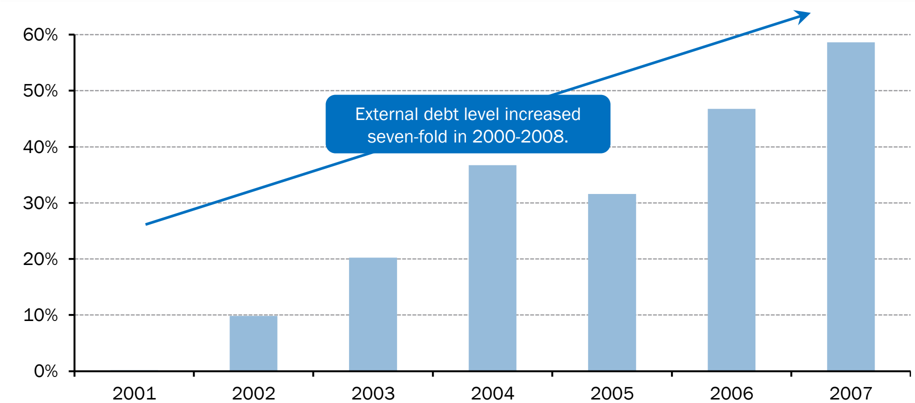
- The rapid growth in demand for raw materials caused by China in the first half of the 2000s had resulted in a significant improvement of terms of trade for Ukraine. A number of factors (rising prices for goods in export basket of Ukraine, low gas prices) **allowed Ukraine to use commodity boom to jump-start its economy without implementation of any important reform.**
- Besides the economic growth "not thanks to but in spite of", low efficiency of the economy and lack of reforms in the mid-2000s, Ukraine made a number of economic policy mistakes (significant increase in social transfers and subsidies, fixing the exchange rate), which led to overheating of the economy and accumulating the macroeconomic imbalances.
- As a result, as it was 10 years before, the global financial crisis in 2008 inflicted a significant blow to the economy and particularly to the financial system of Ukraine, leveling the achievements of the economic growth period.

External Sector Indicators % of GDP



Source: NBU, State Statistics Committee

The growth rate of public and private external debt in Ukraine *



Source: NBU

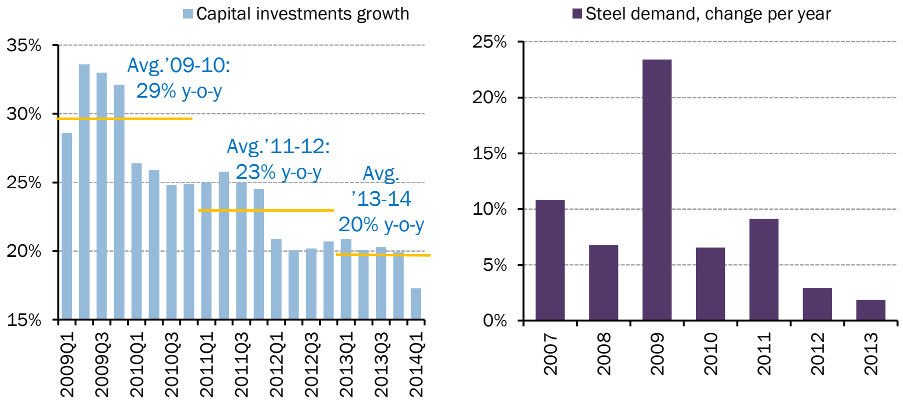
Notes* – excluding trade credits

Efforts to maintain the social and economic status quo led to the accumulation of economic problems that erupted during crisis of 2008, crossing out the years of economic growth and laying the foundations for financial problems in Ukraine in the following period.

Appendix A. Ukraine 2014: "Growth Disaster" and the history of reforms

2009-2014: efforts to save something that can not be saved = economic and financial crisis and lowered economic potential

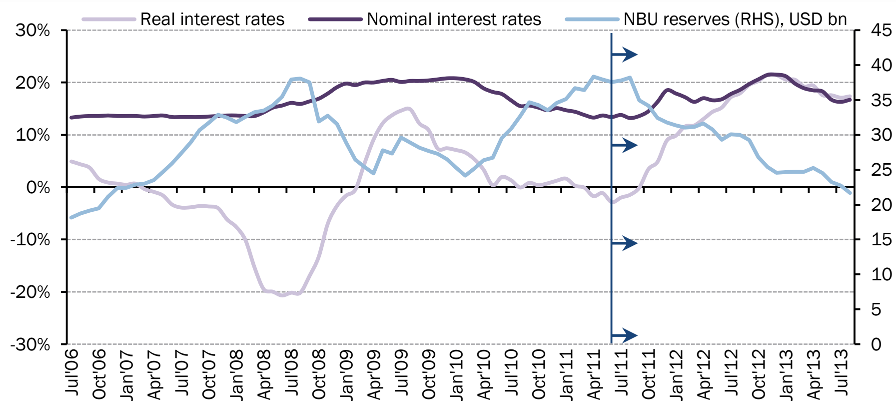
The start of economic slowdown in China has reduced demand for steel



Source: Bloomberg, World steel association

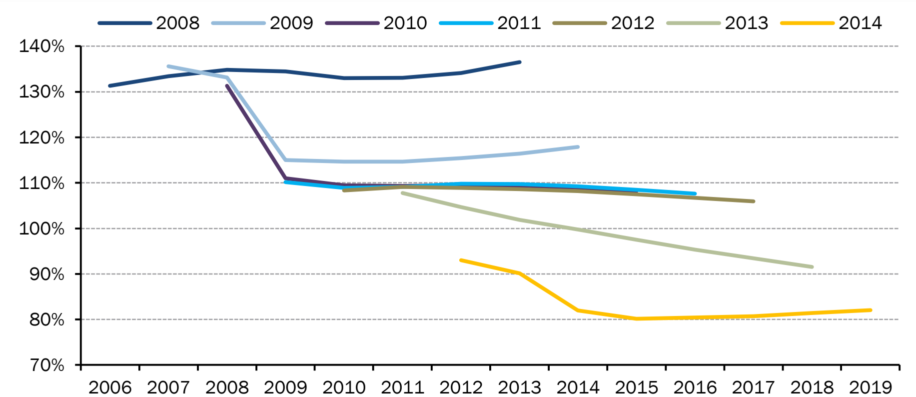
- China's stimulus package and calming of financial markets by the decisive actions of the US Federal Reserve caused the rapid global economic recovery after the crisis of 2008-2009. This allowed Ukraine to restore its economy partially without reforms and elimination of preconditions for macroeconomic imbalances.
- Starting to slow in 2011, the Chinese economy caused deteriorating situation in the Ukrainian export sector. That led to increasing pressure on the UAH exchange rate since autumn 2011, to which NBU responded by implementing a tight monetary policy. The result: besides the declining business activity in the external sector, industries oriented to the domestic market faced rapid rise of real interest rates. Latter was the main factor driving Ukraine's economy to the state of recession since 2012.
- Result: the end of the period of favorable external business environment, lack of reforms and economic policy mistakes have led to the decrease of Ukrainian economic potential.

The impact of regulatory policy on deteriorating the external business environment: the growth of real interest rates in local currency in 2011-2013.



Source: State Statistics Committee, own calculations

Evolution of the GDP per capita (PPP) forecast by IMF: the expected level of GDP in Ukraine to the average expected level across the Emerging Markets



Source: IMF

Efforts to maintain the status quo (including supporting fixed exchange rate and lack of structural reforms) instead of adapting the economy to new realities of global economy caused the accumulation of macroeconomic imbalances.

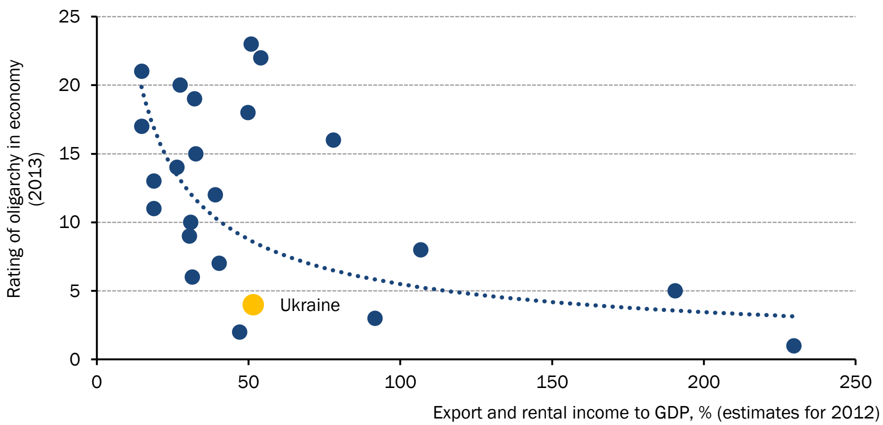
AYA Capital

AA : BC : CL : DB : EE

Appendix B. Kleptocratic oligarchy

Is this model a result of “natural factors”?

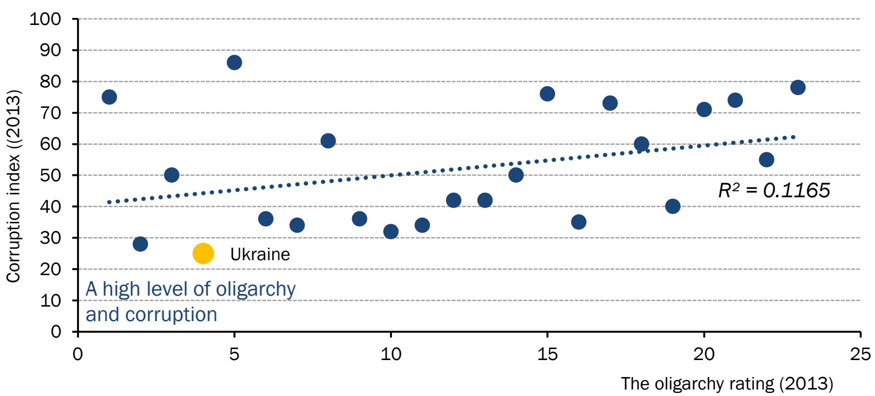
The conditions for the development of oligarchic economy: exports and natural resources



Source: IMF, World Bank, The Economist

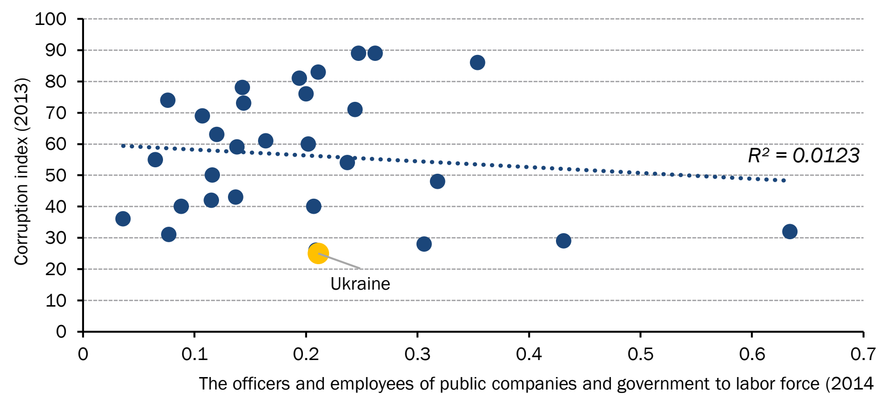
- Level of oligarchy in Ukrainian economy can be partly explained by “natural conditions”: Ukraine has a large share of exports in the economy and the economy consists of a large share of industries, which benefit from the economies of scale. Together these lead to a high concentration of production and create favorable conditions for the growing influence of oligarchs.
- However, the high level of corruption in Ukraine does not have any “natural” explanation. Neither the influence of the oligarchs nor the state significant influence on society and the economy do not guarantee the growth of corruption to such high level, as we can see in Ukraine.

Weak correlation between corruption and oligarchy



Source: The Economist, Transparency International

Weak correlation between the size of the public sector and corruption



Source: Transparency International, OECD, IMF

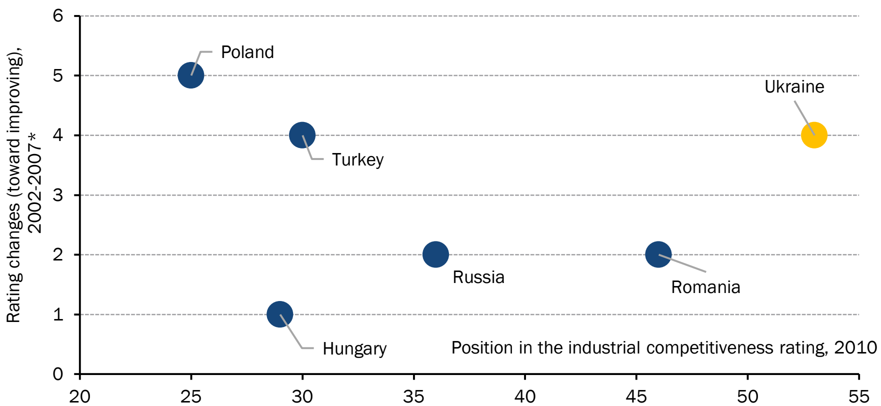
AYA Capital

High levels of corruption and oligarchy are two parallel phenomena mutually reinforcing, but their coexistence does not stipulate a necessity.

Appendix B. Kleptocratic oligarchy

Implications: low economic efficiency

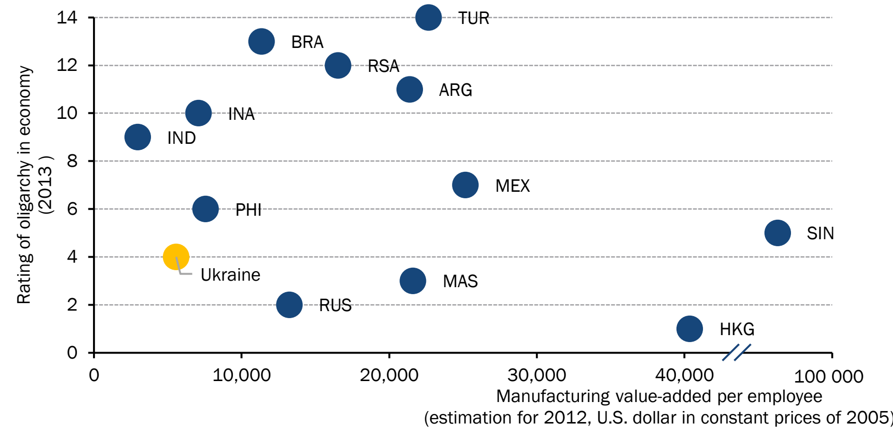
Global industrial competitiveness rating



Source: UN

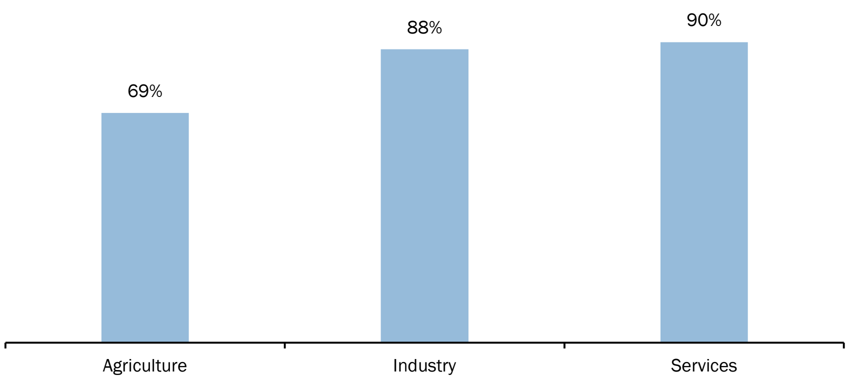
Notes: * - change of the rating for 2002-2007 shows some improvement in the position of Ukraine, but after 2008 it became even worse (in 2007 Ukraine took 52-nd and in 2010 - 53-th place in rating)

Ukrainian oligarchs are less effective than others



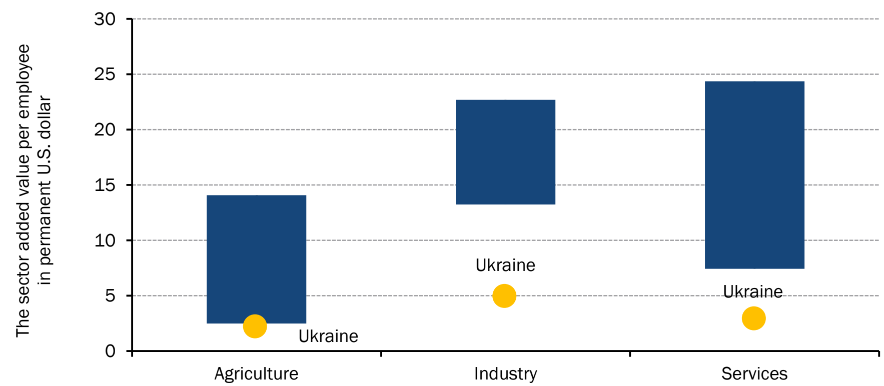
Source: The Economist, World Bank, own calculations and estimations

The share of countries (of its total number), where the productive efficiency of represented sectors is higher than in Ukraine (data for 2012)



Source: World Bank, own calculations

Added value per employee in Ukraine compared to other countries (the difference between the minimum and maximum values among comparable countries (2012)



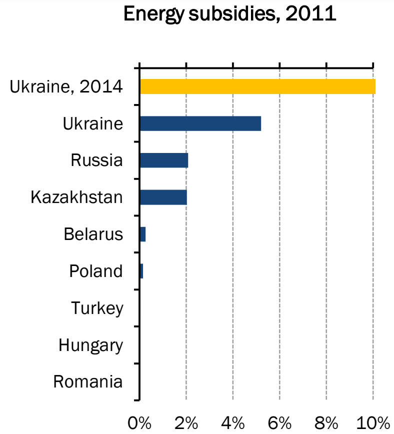
Source: World bank, own calculations and estimations

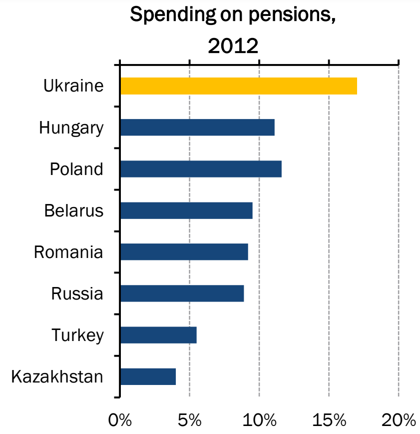
Ukraine is far behind the nearest competitors on the parameters of economic efficiency in all sectors.

Appendix B. Kleptocratic oligarchy

Implications: populism and public debt

Subsidies and pensions (% of GDP)

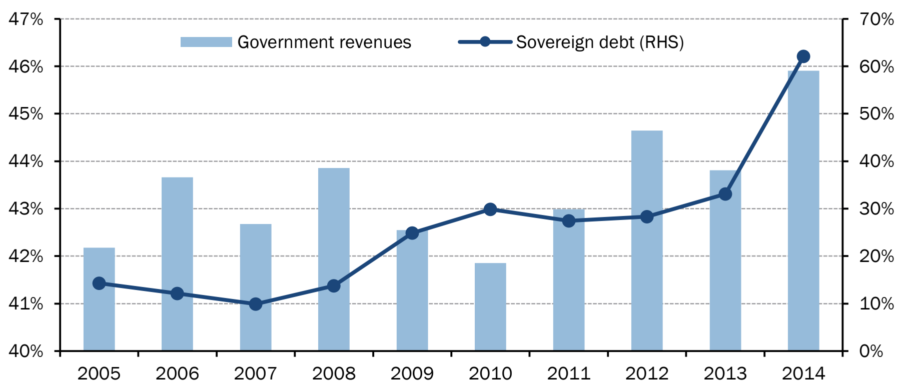




Source: World Bank, IMF, data for 2014 – own calculations and estimations

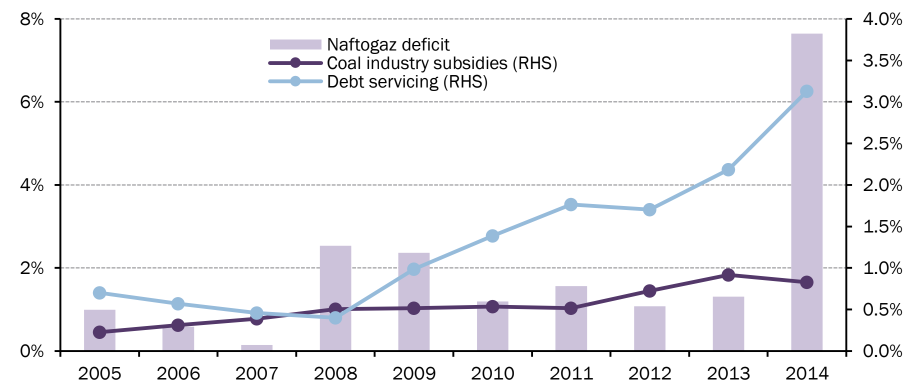
- In the field of populism Ukraine shows multiple records at once: almost the highest spending on pensions in the world, as well as the record high level of energy subsidies (among the countries - net importers of energy).
- Public revenues (which are almost entirely made up of taxes) constitute almost the half of GDP. With the exception of resource-rich countries this is the level of the Republic of Congo, Bosnia and Herzegovina, Iran, Argentina, Belarus, Serbia and Bolivia.
- Slow economic growth, periods of financial instability and bloated social transfers caused the estimate public debt at 70% of GDP in 2015, what is considered as threatening level for developing countries.

Public revenues and debt of GDP



Source: Ministry of Finance, data for 2014 – own calculations and estimations

Price of paternalism: the growth of the expenditures (% of GDP)



Source: Ministry of Finance, data for 2014. – own calculations and estimations

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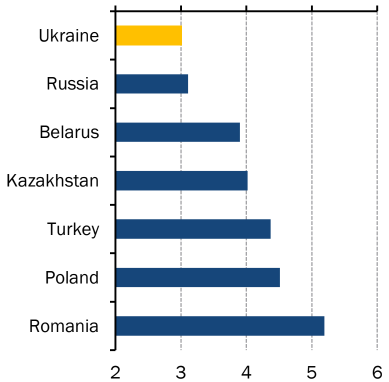
Economic and social populism has already led to the growth of public debt to a dangerous level.

Appendix B. Kleptocratic oligarchy

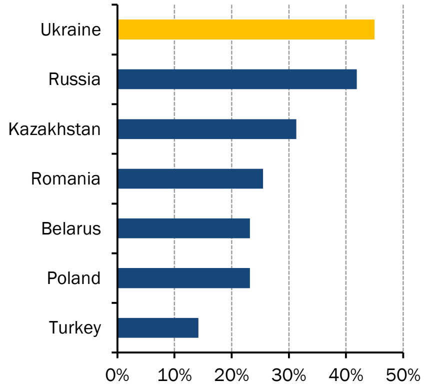
Implications: paternalism and frustration

Ukrainians prone to paternalism

The propensity to paternalism (lower index level corresponds to higher level of paternalism)



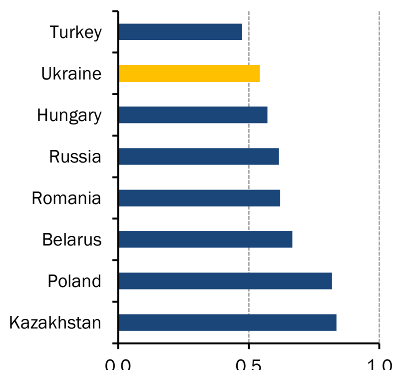
% of affirmative answers the question "Should the government support citizens more?"



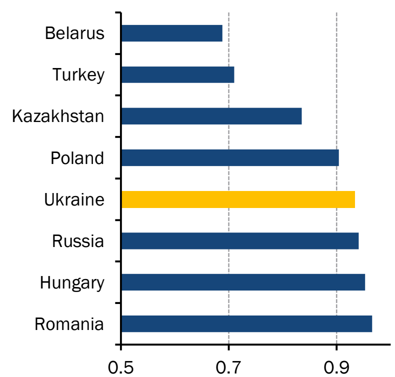
Source: World Values Survey Wave 6: 2010-2014

Self-distrust

Freedom of influence on their own lives (lower index level corresponds to lower freedom level)



Freedom from corruption (lower index level corresponds to lower corruption level)



Source: World happiness report (2013p.)

- As a result of formation of the kleptocratic oligarchy (which implies the exchange of "freedom for social transfers"), the Ukrainian citizens have become paternalists.
- Similarly, restrictions on political and economic freedoms, and also the formation of a sense of social injustice led to increasing of self-distrust among the citizens.
- Both these factors create serious barriers to the realization of human capital in Ukraine.

Kleptocratic oligarchy restricts the human potential development.

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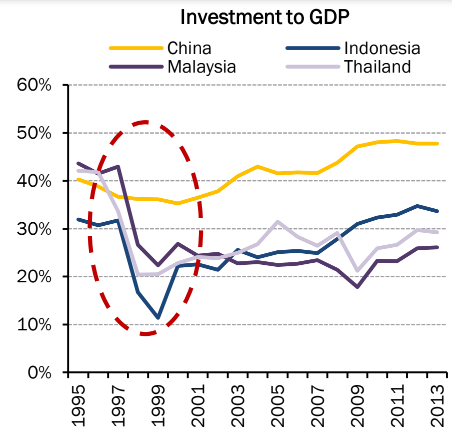
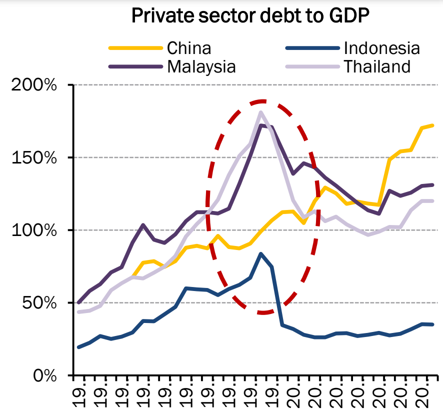
Appendix B. Kleptocratic oligarchy

Rebalancing the of China's economy worsens the prospects for Ukraine's economic growth

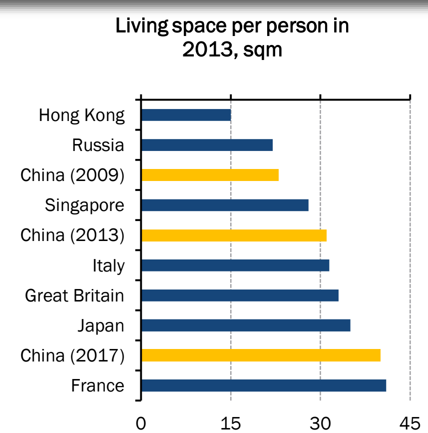
Rebalancing the economy within the "Asian model"





Source: IMF, Bank for International Settlements

The scale of the investment boom the real estate market in China



Джерело: Morgan Stanley

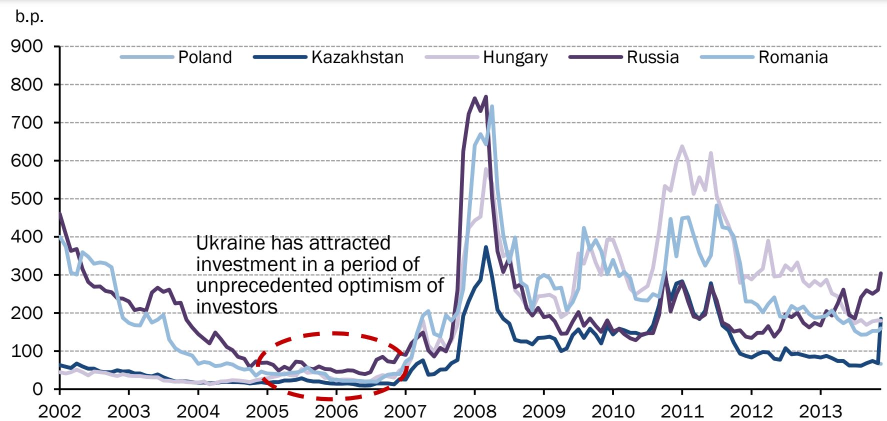
- China's economy is developing according to the pattern of so-called "Asian economic model", which is based on the high contribution of investments to GDP. Stimulating investment finally leads to over-investing and to the need to rebalance the economy - from investment to consumption with shifting the development emphasis from the external to the internal demand.
- The other countries from the cohort of "Asian model" that has already gone through this process before (such as Malaysia, Indonesia, Thailand) may set an example of rebalancing process.
- Rebalancing the economy, which has been done historically by a sharp decline of investment share of GDP from about 40% to 20-30%, and most commonly expressed by deleveraging of private sector, accompanied by the financial crisis. The financial crisis is not necessary or inevitable condition for the rebalancing process, but the decline of investments contribution to GDP is.
- Over 45% of China's investments are accounted for the investments in real estate construction and infrastructure - the sectors forming the greatest demand for raw materials (see. the graph "China as the root cause of the raw materials boom" on the slide No.28). Consequently, disinvestment in construction and infrastructure will cause the decline of demand for raw materials.
- Drop in demand (particularly for steel) will form the negative foreign economic conjuncture for Ukraine (lower prices, higher competition with other manufacturers).
- It is important to note, that China's economic slowdown because of rebalancing is not an isolated process. According to the IMF forecast the nominal GDP growth of the top 10 Emerging Markets (excluding China) will decelerate from 20% y-o-y in 2010 to 6% y-o-y in 2015-2019.

Ukraine can not count any longer on a favorable foreign economic conjuncture.

Appendix B. Kleptocratic oligarchy

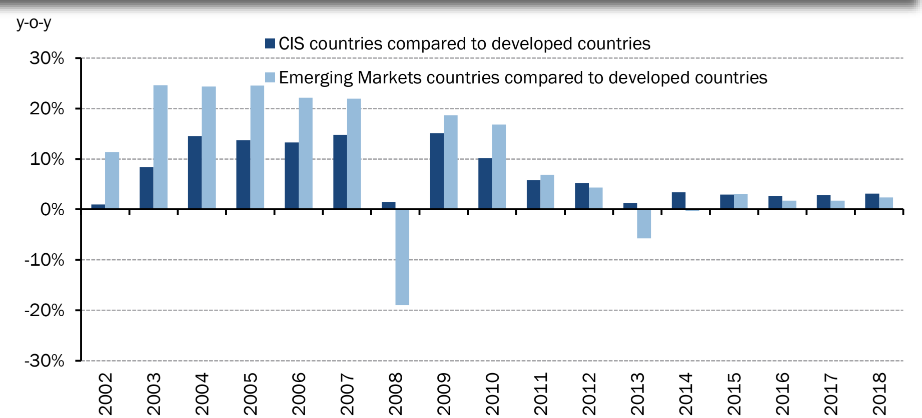
Attracting investment would be much more difficult than it was prior to 2008

Sovereign risk in different countries



Source: Bloomberg (the sovereign 5-year CDS level in U.S. dollars as of 10/17/14).

The absolute difference in the growth rate of nominal GDP in U.S. dollars, the IMF forecast



Source: IMF

- Besides worsening the prospects for economic growth within the export-oriented model, Ukraine faces an additional challenge on the other side of the balance of payments: there is no point to expect the inflow of investment, even though a so-called excess liquidity is in the financial markets in the context of maintaining the Ukraine's existent socioeconomic status quo.
- On the first hand, after the crisis of 2008 the global investors have become more scrupulous. An assessment of sovereign risks to a greater extent depends on the profile and specifics of a certain country. Instead of investing in emerging markets as in a single asset class (as it was prior to 2008), investors to a greater extent are focusing on a balance of the specific risks and potential profits (which is often determined by estimating the expected economic growth in nominal U.S. dollars).
- On the second hand, emerging markets will experience more growing competition for global investment from the developed countries. Differential of economic growth has already become several times lower and according to the IMF forecasts it will not return to a prior levels observed before the 2008 crisis.

Even lower macroeconomic risks (without reforms of institutional environment) does not guarantee the inflow of investments.

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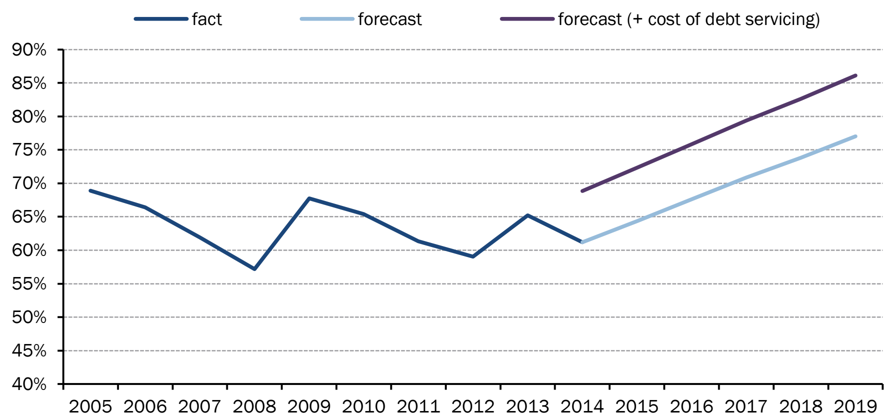
Appendix B. Kleptocratic oligarchy

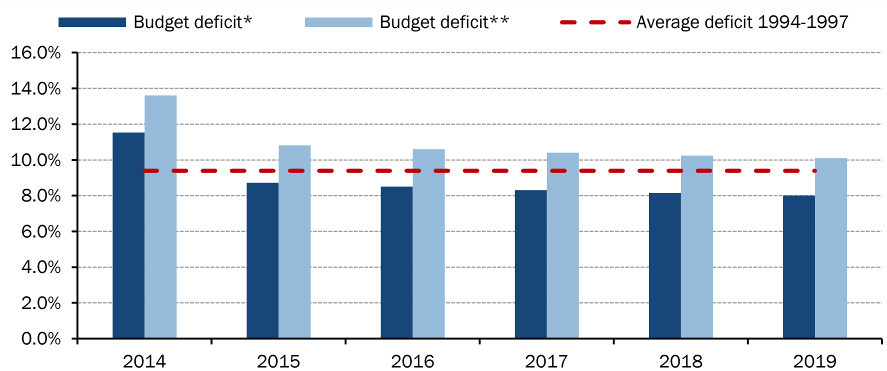
Budget spending threatens to reach a crisis level

Expenditure on pensions and salaries as a percentage of public revenue



Source: fact - the Ministry of Finance, IMF forecast - calculation and estimations of AYA Capital

The expected state budget deficit in case of maintaining the status quo



Source: calculation and estimations of AYA Capital

* – In case of retention the existing level of gas tariffs.

** – -in case of retention the gas tariffs at the existing levels and primary budget deficit at the average level for 2005-2007 and 2010-2013.

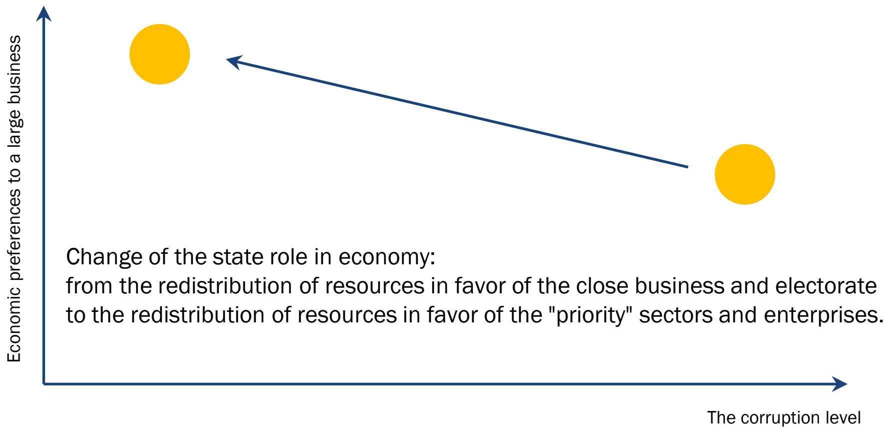
- In the context of maintaining the export economy model (which will be able to demonstrate the economic growth by gradual achievement of 4.5% per year according to the IMF forecasts), as well as in the context of maintaining the increase in social spending (primarily pensions and public sector wages), the share of such spending in public revenue (budget and pension fund) will rise over 75% (15 percentage points above the current level).
- According to the IMF forecasts the budget deficit dynamic in Ukraine looks optimistically: declining from almost 6% in 2014 to only about 1% in 2019. However, such a forecast does not include the deficit of Naftogaz (which will be retained in case of preserving the status quo). Farther, it is based on the assumption that the primary deficit (excluding debt service costs) will turn from a deficit into a surplus of 3.1% of GDP in 2019 (note: in the history of Ukraine a primary budget surplus was observed only twice – 7.5% of GDP in 1999 and 0.1% of GDP in 2003).
- Such rapid cuts in public expenditure involves the implementation of an unpopular fiscal reforms, which automatically assumes the destruction of the existing status quo.
- If these reforms are not carried out, the actual budget deficit (including deficit of Naftogaz) will reach 8-10% of GDP on a constant basis. Retaining such a deficit for several years will imply a return in 1990s: either the fiscal and debt crisis for a partial example of 1998 and with a high probability of sovereign default or hyper-inflation of 1994-1995.

The efforts to maintain the status quo will lead either to hyper-inflation, or to default, or to hyper-inflation and default simultaneously.

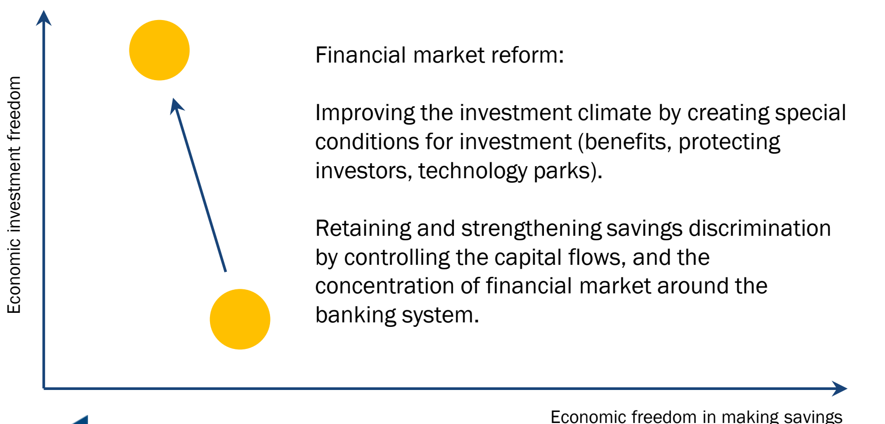
Appendix C. Export-oriented model

What does the "export model“ mean?

The policy of "economic nationalism" - what changes do its apologists expect?



The policy of the "investment support" - what changes do expect its apologists?



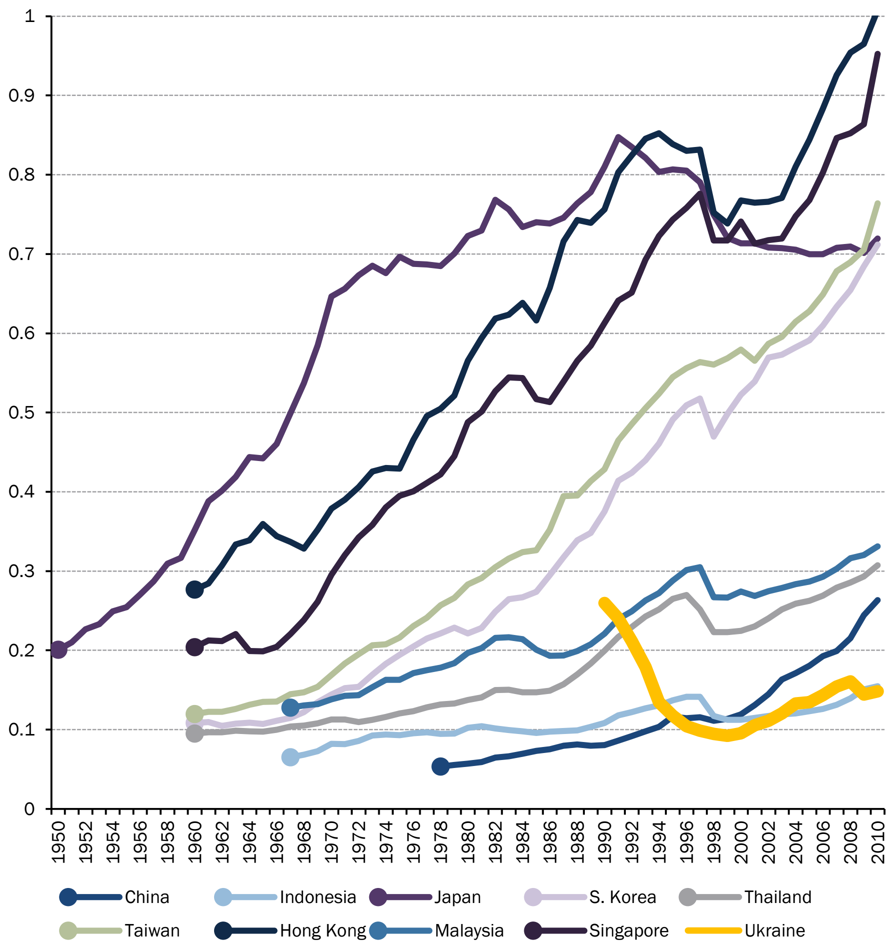
- Choosing the "Export-oriented economic model" at its core is an effort to restart the existing "oligarchic and kleptocratic" model, making two key corrections:
  - reducing the "kleptocratic" model component by combating corruption;
  - increasing the role of state economic policy within the process of attracting investment and developing the priority sectors (policy of "economic nationalism").
- However, strengthening the role of state in the resources allocation and identifying new recipients of tax and other benefits will cause the following:
  - high probability of only marginal reduction of the level of corruption, because the incentives and conditions, allowing the corrupt relationships to flourish, will be maintained (benefits, allocation);
  - reducing the level of economic freedom because it is necessary to form a closed alternative finance market to finance specific sectors and enterprises on favorable terms (as an example the two finance markets of China and other countries following the export model).

Choosing the "Export-oriented" economic model at its core is an effort to restart the existing "oligarchic and kleptocratic" model without solving the issue of justice and by violating the principle of free competition.

Appendix C: Export-oriented model

Source of inspiration: success of "Asian model" and "Reindustrialization" policy

Successes of "Asian tigers": the ratio of GDP per capita in developing countries to GDP per capita in the US (international USD)

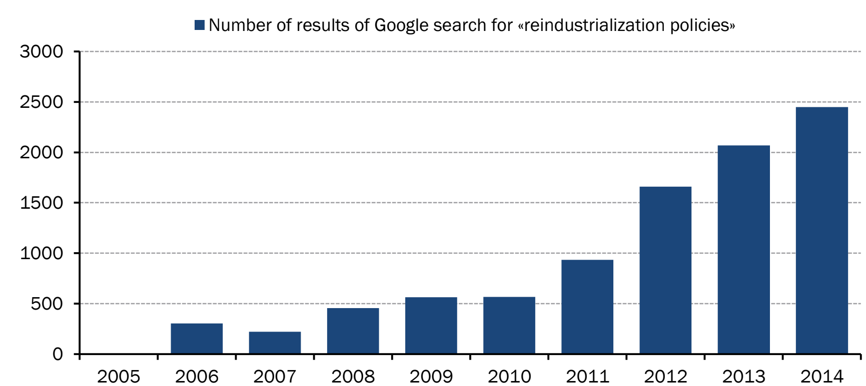


Source: Angus Maddison Database

Supporters of the needs of reloading present economic models (those who propose to bet on "export-oriented" model with active government involvement in decision-making about allocation of available resources) find inspiration in two areas:

- Historical success of so-called "Asian model" of economic growth on examples of "Asian tigers". Some experts and policy makers believe that the experience of implementation of this model may be applied in Ukraine.
- In modern popularity (especially in Eastern European countries, which experienced a slowdown in economic growth due to a lack of structural reforms implementation - such as Serbia) of the thesis about need to apply state industrial policy (second name – "re-industrialization policy").

Popularity of thesis on the necessity re-industrialization



Source: Google, own estimates

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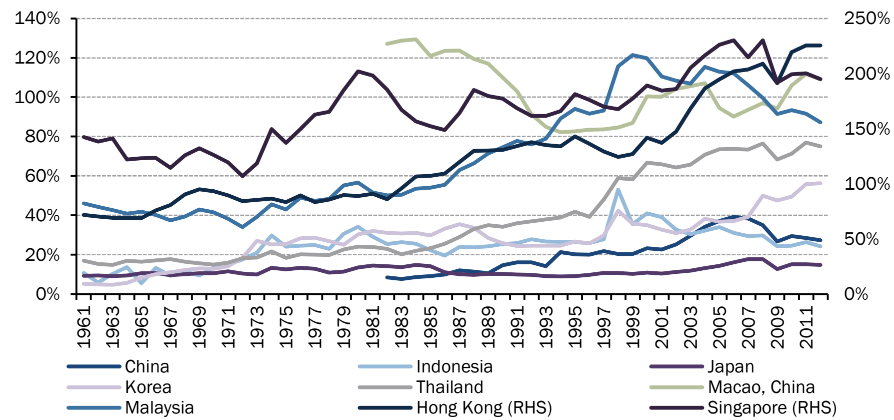
Appendix C: Export-oriented model

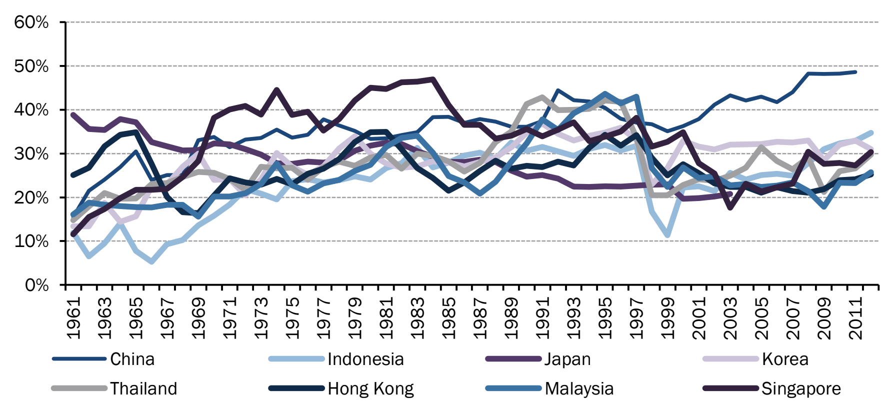
"Asian model": how does it work?

Exports to GDP



Source: World Bank, own estimates and calculations

Investments to GDP



Source: World Bank, own estimates and calculations

“Asian economic model” of the second half of the XX century: **fast industrialization forced by state with production oriented to foreign markets, with the financing conducted by financial repression mechanism** - creation of artificial barriers to alternative use of savings (in order to provide industrial sector with cheap capital investment). It is the last that provides a high level of investment and savings to GDP and a low level of consumption.

Factors of model success:

- Availability of **actively growing foreign market of products sales**. For the “Asian tigers” of the early period developed countries served as such market, in the last period it was China.
- **Weak initial conditions** (low capital-labour ratio), positive demographic situation, poverty and technological backwardness.
- **Conditions for efficiency of financial repression:** there should be a negative correlation between the level of interest rates and the level of savings (which contradicts economic logic in normal circumstances). Operation of this mechanism in the “Asian tigers” countries was explained by the lack of social security system. Accordingly, when the government artificially restricts savings yields, population is forced to keep most of the income to cover future expenses.
- **The economy must be characterized by a high level of competitiveness** in order that subsidizing investment through financial repression would be sufficient to capture foreign markets.
- **High quality of public governance.**
- High **public trust in institutions of public governance, or autocratic restrictions of political rights** especially in the early stages of industrialization.

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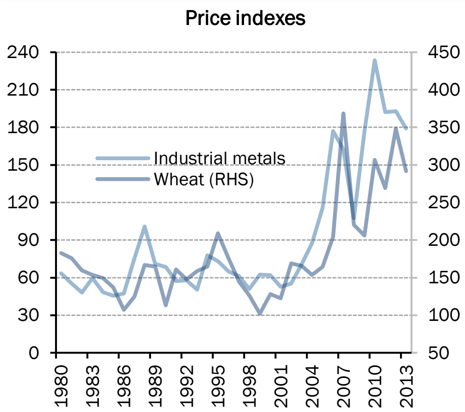
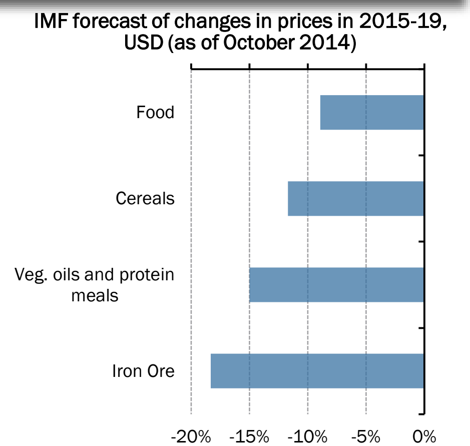
Appendix C: Export-oriented model

Focusing on foreign markets might not bring the expected results

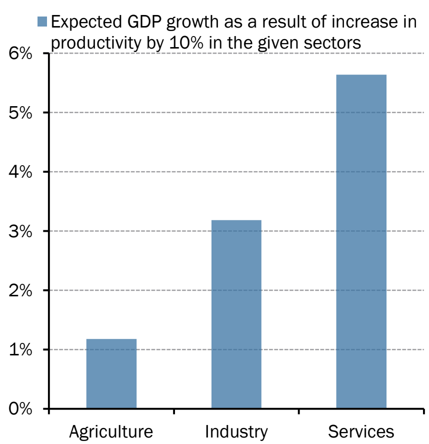
Agricultural products prices are correlated with other commodities prices

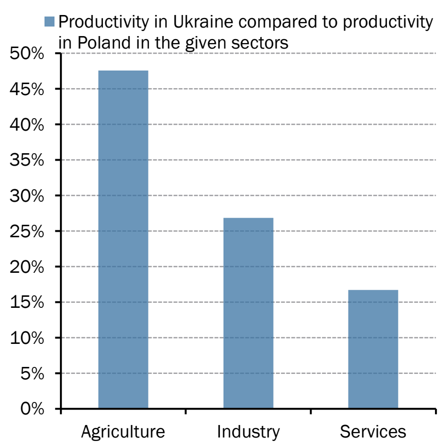




Source: IMF

The effect of increased productivity





Source: World Bank, own estimates and calculations

The popularity of "export-oriented model" as a strategic option for Ukraine is based on the latest experience of economic boom of the first half of the 2000s, in particular the success of economic policy of supporting export-oriented industries.

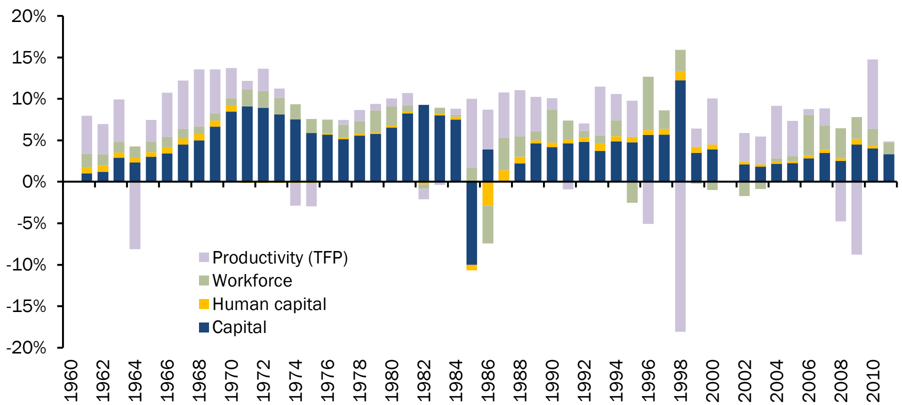
- However, as we mentioned above, the rebalancing of China's economy and the completion of industrialization of South Asia (through decline in investment) leads to a decrease in demand for Ukrainian exports.
- Reorientation of exports (from steel to agricultural products) would unlikely achieve its intended result: price prospects for agribusiness sector are not the better than for industrial metals. According to our optimistic expectations, the magnitude of agriculture export increase will be close to 20 USD by 2020, that is equivalent to the loss of Naftogaz due to difference in prices for natural gas for the same period (while maintaining the existing disparity in prices).
- Possibility of the existence of an effective government policy for stimulating exports is not obvious. For example, the success of export industries in the first half of the 2000s has no relation to government policy, and it is the result of pure coincidence. So-called terms of trade had improved by 50% since 2001 till 2008, while it had remained unchanged for the most of Eastern European countries. Similarly, prices for Ukrainian exports had increased on average by 34% during this period (for other transition countries they had increased by 15% only).
- Finally, increased productivity in service sectors would have the greatest economic effect.

Export orientation and focus on imaginary "points of growth" is unlikely to bring the desired economic effect.

Appendix C: Export-oriented model

Alternatives: "Asian model"

Share of GDP growth of Singapore, which is accounted for the change of:

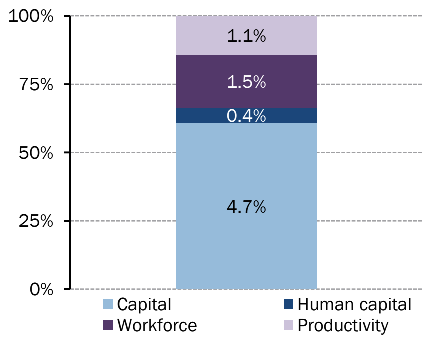


Source: PWT 8.0 (2012), own calculations

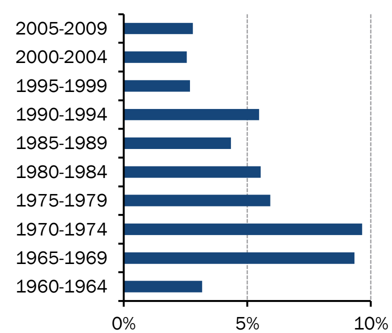
- It is believed that principles of so-called "Asian model of economic growth" might be used in Ukraine. But popularity of this thesis is based on usually wrong ideas concerning the mechanism of its operation.
- The above example of Singapore demonstrates "Asian model" functioning: the main factor of economic growth is an increase of capital stock starting from a low base.
- The greatest economic growth rate are observed in the early stages of economic growth, that is in the early stages of industrialization ("there was no plant, we built one", and as a result economic growth rates of the region are exorbitant).
- An important growth factor for the most of the "Asian tigers" was urbanization, which resulted in increased productivity, "the transition from shovel to industrial machine" (even of low quality).

Singapore: change in GDP per capita on PPP basis

The contribution factors in annual growth rate, 1960-2012

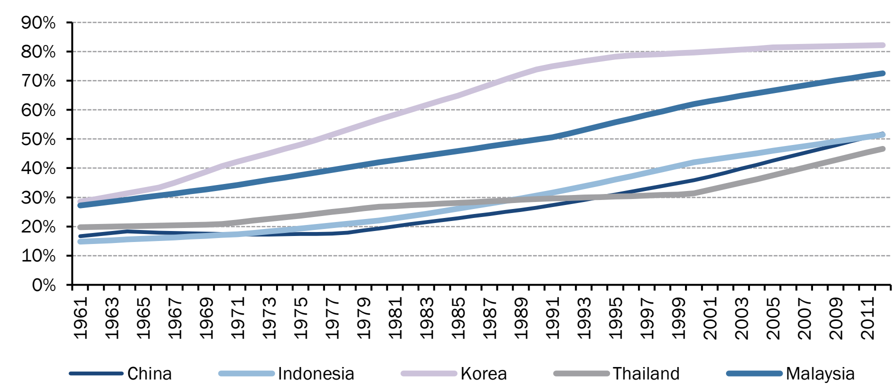


Average annual growth of five years



Source: PWT 8.0 (2012), own calculations

Level of urbanization



Source: World Bank

"Asian model of economic growth" is not just an export-oriented autocratic economic policy, but a complex set of components, one of which is the use of financial repression.

Appendix C: Export-oriented model

Comparison of initial conditions of "Asian model" and current Ukraine

Comparison of initial conditions of "Asian model" and current Ukraine

	Initial conditions					Results		Contribution to GDP growth			
	Year	GDP per capita*	C/L	GDP to Capital	HC	GDP growth	GDP growth per year	Capital (C)	Human capital (HC)	Labor (L)	Productivity (TFP)
China	1978	978	4 971	0,25	1,79	2146%	9,9%	45%	6%	9%	35%
Indonesia	1967	934	4 598	0,47	1,39	1128%	5,9%	62%	7%	19%	10%
Japan	1950	1 921	11 306	0,46	2,28	1959%	5,1%	48%	7%	10%	33%
South Korea	1960	1 226	9 289	0,63	1,77	3583%	7,3%	42%	11%	23%	17%
Thailand	1960	1 078	4 648	0,32	1,74	2672%	6,7%	57%	4%	14%	21%
Taiwan	1960	1 353	6 711	0,99	1,89	3499%	7,3%	56%	8%	17%	16%
Hong Kong	1960	3 134	68 239	0,32	1,87	2249%	6,4%	51%	7%	26%	14%
Malaysia	1967	1 830	15 300	0,43	1,64	1605%	6,7%	40%	13%	30%	9%
Singapore	1960	2 310	38 931	0,27	1,63	4230%	7,7%	60%	5%	19%	14%
Sri Lanka	1960	1 295	72 019	0,33	1,87	2249%	6,4%	51%	7%	26%	14%
average		**1 606**	**23 601**	**0,45**	**1,79**	2532%	6,9%				
Ukraine	**2011**	**4 524**	**72 443**	**0,20**	**3,16**						

Source: PWT 8.0 (2012), calculations and evaluation of AYA Capital

** – Source: Angus Maddison Database*

- The main prerequisite of success of the "Asian model of economic growth" in Ukraine should be conformity with initial conditions, among which the most important are the following :
  - GDP per capita;
  - capital-labour ratio (physical capital stock per worker, K/L);
  - capital productivity (GDP per capital)
  - development of human capital.
- According to these parameters Ukraine compared to the "Asian tigers" at the moment of start of the model implementation is:
  - richer;
  - has a three times larger capital stock;
  - is characterized by twice less productive capital;
  - is characterized by almost twice higher level of human capital.
- Thus, Ukraine does not correspond to the initial conditions of "Asian model". Similarly, the prerequisites of the model success (growing demand for exports, efficiency of economy and governance, and organization of the financial system - inability of applying financial repression while avoiding negative macroeconomic consequences) for Ukraine are not validated.

There is no ability to apply "Asian model" in Ukraine due to the differences in initial conditions and discrepancy of success preconditions - particularly because of the low level of public governance and organization of the financial system.

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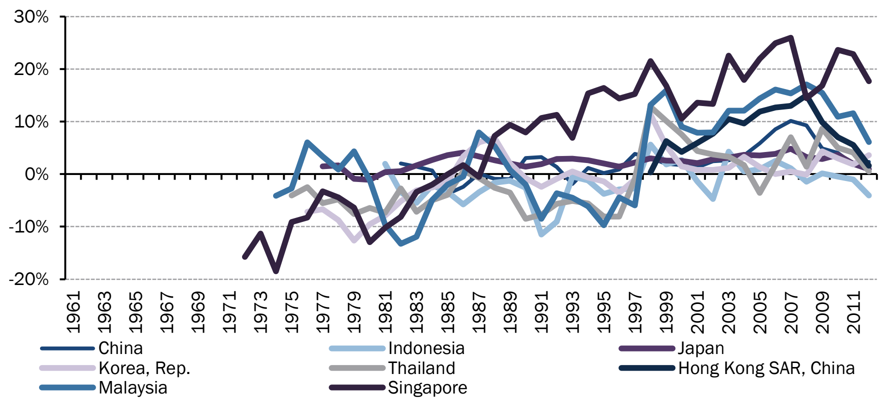
Appendix C: Export-oriented model

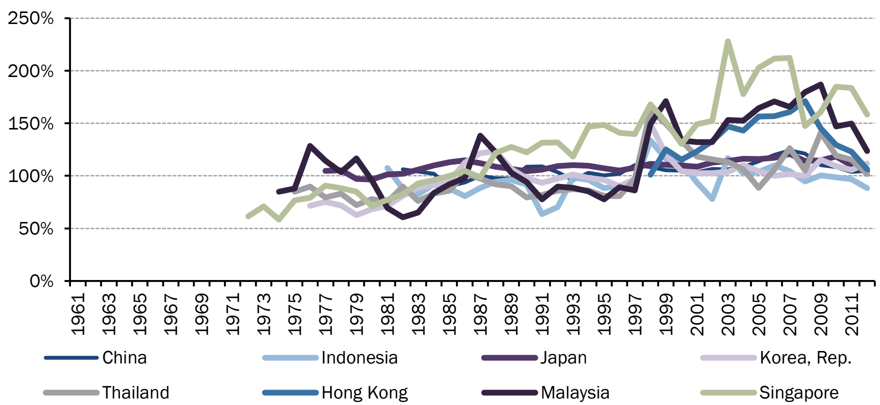
"Asian model" requires financing from domestic sources

Investments minus domestic savings (% of GDP)



Source: World Bank, own calculations

Share of domestic savings in investments



Source: World Bank, own calculations

- "Asian economic model" presumes systematic excess of aggregate supply over domestic demand (produce more than consume), and several specific features in the functioning of financial sector.
- During active growth phase the economies of "Asian model" are characterized by the high level of investments to GDP - often more than 30% (e.g., in Ukraine this metric is less than 20%). Investments are financed by raising both foreign and domestic (household savings) funds.
- Share of domestic savings in investments is dominant: in the worst case, 5% to 10% of GDP were designated for foreign investments (e.g., foreign direct investments in Ukraine in 2010-2011 reached about 4% of GDP).
- The countries, which are trying to use this type of model should find a way to maintain the high level of savings (more than 25-30% of GDP) and to transfer these savings to the financial system on discriminatory terms (which is possible in the countries, that do not have full-fledged social security system).

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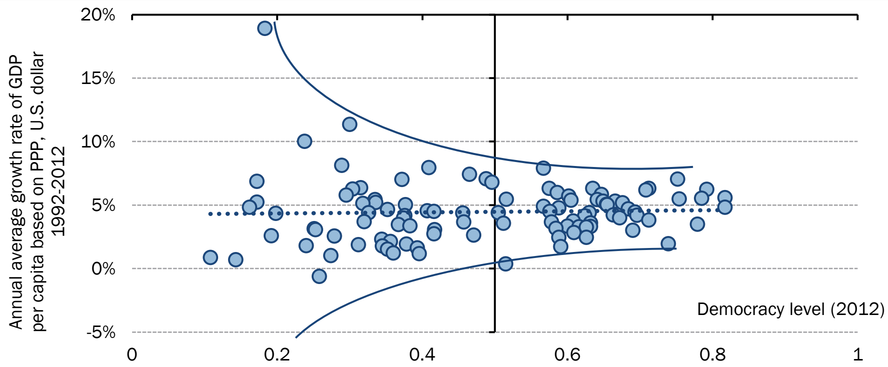
"Export-oriented" model presumes reliance on domestic financial market.

Appendix C: Export-oriented model

Autocracy does not favor economic growth

Autocracies do not ensure economic growth



Source: The Economist Intelligence Unit, IMF

The views of government officials are biased

	Business associations	Government officials	Consulting companies
Business environment is favorable	30%	61%	18%
Expectations of changes and improvement of the investment environment in 2014	48%	63%	14%
Sufficient steps of authorities to improve investment climate	37%	79%	25%
The engine of economic environment improvement is equally business and authorities	44%	79%	39%
The success of authorities to attract investors	41%	79%	43%
The high efficiency of the investment programs implementation	26%	57%	15%
Attracting business to solving social and economic problems on a voluntary basis	31%	75%	13%
The authorities are paying enough attention to small investors	48%	82%	24%
The low level of social tension	26%	61%	25%
Prevalence of property expropriation: unavailable	44%	71%	39%

- Another problem of searching for alternatives to "Capital Markets" model is a misconception about favorable role played by autocratic approach to economic reforms implementation (many people in Ukraine consider Lee Kuan Yew as perfect example).
- However, thesis about a positive role of the autocracy of political regime in achieving sustainable high economic growth rates is not supported by the facts. Research shows that autocratic approach to economic policy does not have advantages over democracy and market-oriented economic policy.
- Autocracy of economic policy results only in greater variance of results. In other words, history shows that autocratic economic policy may be compared with a kind of lottery, that can bring results of both Singapore, and Zimbabwe *.
- A divergence of views of government officials and representatives of business, which is shown in the table “The views of government officials are biased” may serve as an example of the problem of autocratic approach application to economic policy in case of Ukraine.

Source: Rating of investment attractiveness of Ukrainian regions, 2014

* – more details regarding influence of such economic policy on economic growth could be found in *William Easterly «Benevolent Autocrats», 2011.*

The conventional opinion about the superiority of the autocracies over free market in the implementation of reforms and achieving sustained economic growth is not supported by the facts.

Appendix C: Export-oriented model

Logical errors and government policy of “re-industrialization”: what is really going on

“De-industrialization” is a negative phenomenon, which is possible to be stopped

If we assume “de-industrialization” as a decrease in the share of manufacturing sector in the country’s GDP, as well as a decrease in the share of employed in this sector, such a phenomenon has several reasons, most of which are symptoms of a healthy economic growth :

- Increased labor productivity leads to reduction of the employment.
- Decline of manufacturing share of GDP is the result of a structural shift in favor of new industries (IT, new elements of service sector).

“Re-industrialization” is a result of state policy implementation

The period of "de-industrialization" (withdrawal of manufacturing facilities from developed countries to countries with transition economies) and current period of "re-industrialization" (returning some facilities back to developed countries) in no a direct result of state economic policy. This process is determined by two factors:

- Dynamics of difference in wages and other expenditures (as well as the relative dynamics of FX rates).
- Change of technologies which requires using more skilled labor, and/or simultaneously reducing the share of labor costs.

“The policy of re-industrialization” is a special type of economic policy

- Recommendations which form a base for so-called "policy of re-industrialization" are nothing but general recommendations for economic competitiveness improvement.
- It is assumed that the conditions of competitiveness in a particular sector may be improved without solving the problem at the general level.
- This is a misconception, because it is impossible to achieve a macrofinancial stability in an isolated sector of economy or ensure absence of corruption and protection of property rights for a particular group of investors, etc.

Concept of the State "re-industrialization" policy is a set of logical errors.

Appendix C: Export-oriented model

In search of alternatives beyond "Asian model"

Comparison of initial conditions of economically successful countries (growth countries) and current Ukraine

	Initial conditions					Results		Contribution to GDP growth			
	Year	GDP per capita*	C/L	GDP to Capital	HC	GDP growth	GDP growth per year	Capital (C)	Human capital (HC)	Labor (L)	Productivity (TFP)
Chile	1984	5 011	45 941	36%	2.46	318%	5.4%	59%	6%	25%	8%
Dominican Rep.	1970	1 561	16 238	59%	1.63	696%	5.2%	59%	9%	29%	0%
India	1980	938	5 906	46%	1.37	565%	6.3%	36%	12%	24%	22%
Kazakhstan	**1999**	**5 035**	**77 307**	**16%**	**2.87**	**161%**	**8.3%**	**20%**	**2%**	**14%**	**63%**
Peru	1993	3 030	51 133	22%	2.46	157%	5.4%	54%	4%	11%	30%
Poland	**1991**	**4 738**	**65 776**	**28%**	**2.67**	**138%**	**4.4%**	**27%**	**6%**	**3%**	**63%**
Romania	1991	3 065	25 235	43%	2.80	53%	2.2%	65%	10%	-72%	78%
Turkey	1980	4 022	22 484	71%	1.61	278%	4.4%	79%	10%	9%	4%
Egypt	1975	1 421	38 931	27%	1.63	4230%	7.7%	60%	5%	19%	14%
Poland & Kazakhstan		**4 887**	**71 542**	**22.2%**	**2.77**						
Ukraine	**2011**	**4 524**	**72 443**	**20.4%**	**3.16**						

Source: PWT 8.0 (2012 p.), AYA Capital calculations and estimates

* – Angus Madison database

- Search of suitable models should start with sampling. Our methodology included Emerging markets countries with 2013 GDP of more than USD 30 bn, which during 1980-2012 or 1992-2012 excelled above average annual growth rate of GDP per capita for the group. Then we excluded countries that belong to the "Asian tigers" and OPEC countries, and Azerbaijan, which is rich in natural resources. Also, we excluded countries for which there is no corresponding data for analysis (Angola, Bangladesh, Belarus, Sudan, Uzbekistan, Vietnam and Pakistan).

- In the above sample the initial conditions of Ukraine (relatively high capital-labor ratio and the only possible way to economic growth through increased productivity) correspond to Kazakhstan and Poland only.

- Given the fact that Ukrainian economy is much more similar to Polish than to the Kazakhstan (because of significant role of natural resources in the latter), Polish experience, which is an example of "Capital Markets" model, should be used as an template for implementation in Ukraine.

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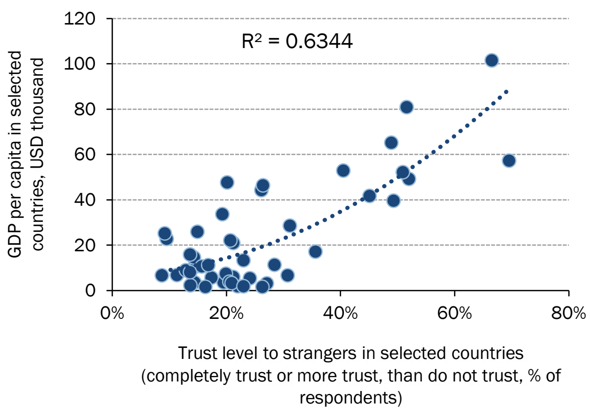
The experience of Poland, which is an example of "Capital Markets" model, should be used as an template for implementation in Ukraine.

Appendix D: "Capital Markets" model

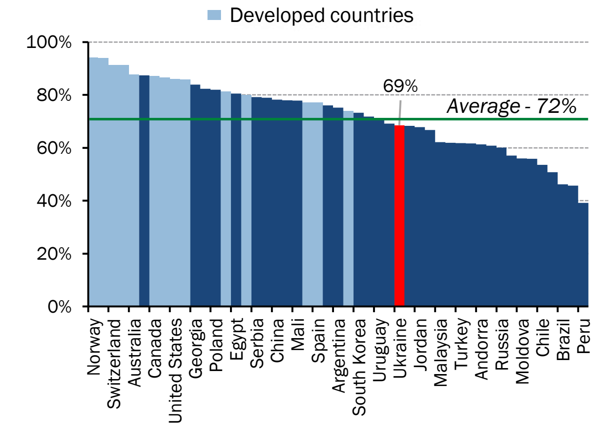
Trust is one of the two basic principles of the new economic system

Increase of trust level favorably influences economic growth



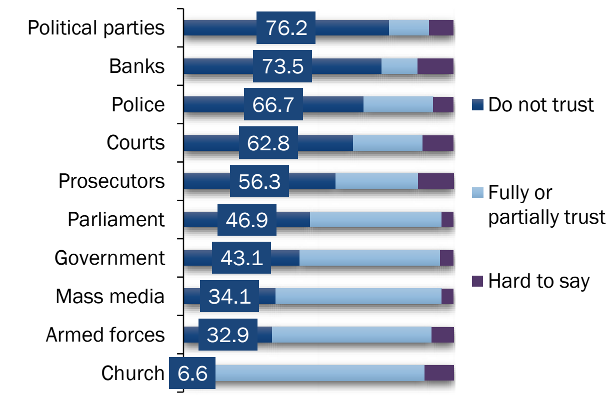
Source: Values Surveys Databank (data regarding trust level from 2007 poll), World Bank (2013 GDP data)

Trust level to strangers in Ukraine is lower than the level of developed countries indicator as well as global average



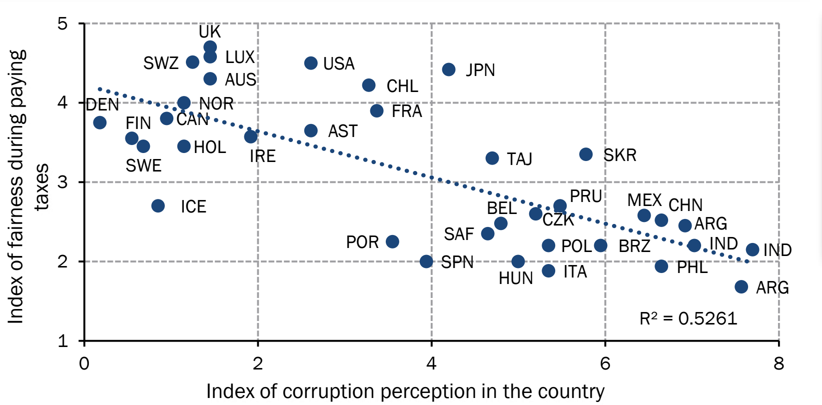
Source: Values Surveys Databank (data from 2007 poll)

How many Ukrainians trust social and political institutions (April 2014 poll)



Source: Razumkov Centre (% of respondents)

We can not expect lowering the scale of "shadow economy" without high trust level to the authorities



Source: A.Winnicki, A.Damm «How tax morale and tax ethics affect tax compliance rates in EU?» (2014)

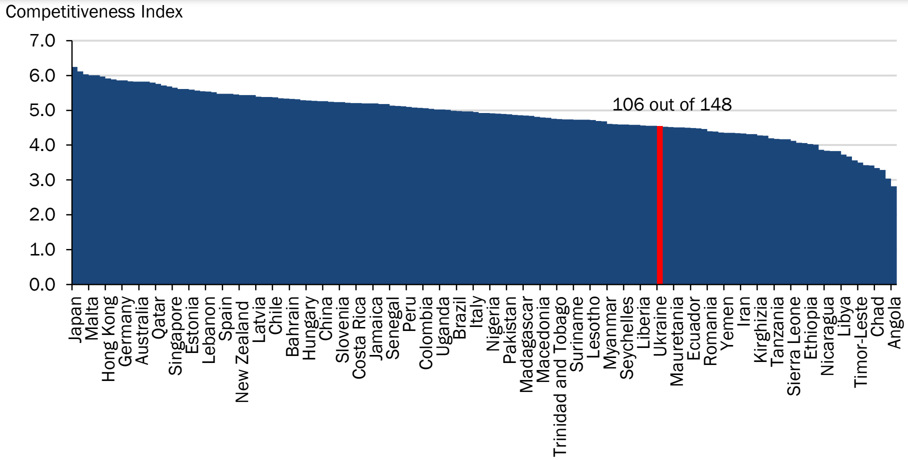
- The level of trust to strangers in Ukraine is lower than developed countries' and the global average.
- Trust (including one to the state) makes possible cooperation, which in turn stimulates economic growth through effective market exchange.
- An efficient capital market provides confidence among market participants and the state in order to market participants pooled their money and they were not afraid to invest. However, we observed low trust in public institutions and authorities: the results of the survey in April 2014 showed that nearly 50% of respondents were of the view that the new government primarily protects its own interests.
- Also, the level of trust is important to address the public finances. Studies indicate that the scope of tax evasion practice is largely dependent on the level of trust among economic agents as well as between economic agents and the state. Without increasing the level of trust of business to the state, the economy will not be de-shadowing.

It is impossible to build the new system on the old principles: political elite should change their principles, primarily supporting the development of trust between market participants.

Appendix D: "Capital Markets" model

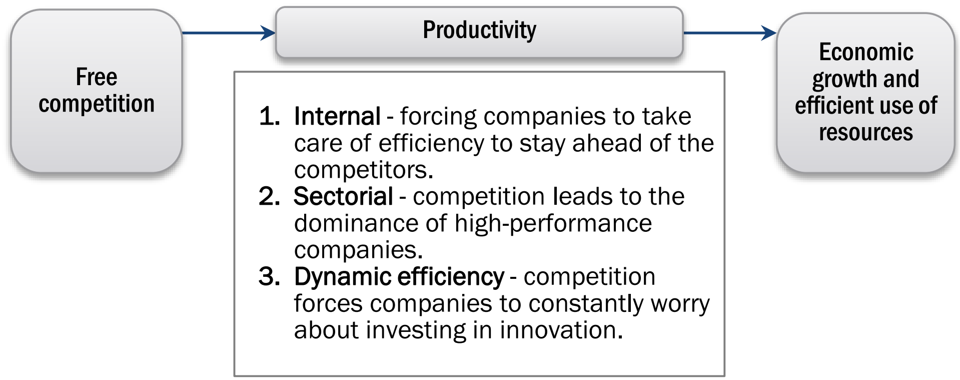
Free competition - the second basic principle of the new economic system

Ukrainian rating by the level of competition in local markets in 2013

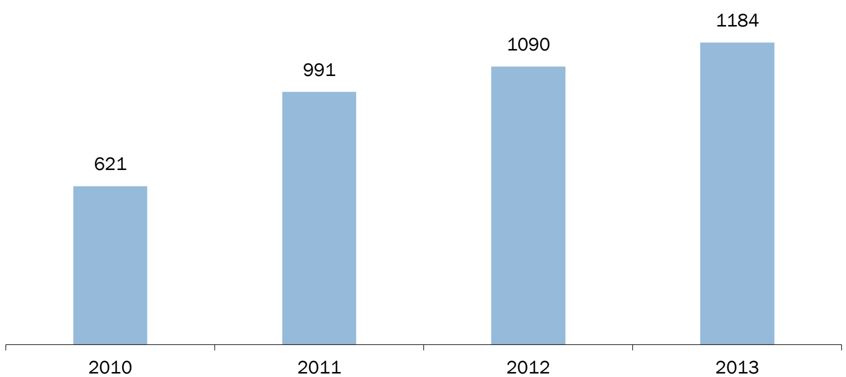


Source: WEF, Global Competitiveness Report 2013-2014

Free competition promotes economic growth



The number of cases considered by Anti-Monopoly Committee of Ukraine during 2010-2013



Source: AMCU annual reports 2010-2013

- In addition to the fact that the level of competition in local markets in Ukraine is one of the lowest in Europe, in recent years there has been suppression of competing economic entities by people close to the authorities - that was most characteristic of the times of Yanukovych "ruling".
- In the new economic system the efficient capital markets, as well as any other effective market involves free competition - both for capital and for assets of its investment.
- Competition in the capital market leads to the elimination of "excess profits". Thus, the investor receives only a fair rate of return on invested capital, and therefore there is an efficient reallocation of resources, resulting in developing the most efficient sectors.
- Improving the quality of personnel is largely dependent on increased competition - both in business and in politics.

Reducing the possibility of restricting free competition leads to the most efficient sectors development, even without the "manual" state intervention. This brings economic benefits not only to the owners of capital, but also to consumers.

Appendix D: "Capital Markets" model

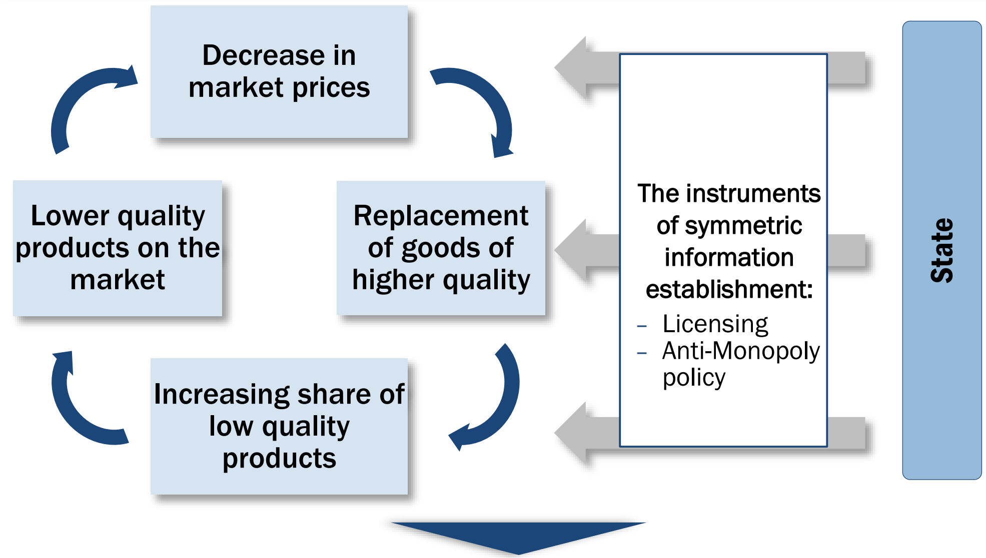
Ensuring markets transparency

Indices related to transparency in the economy

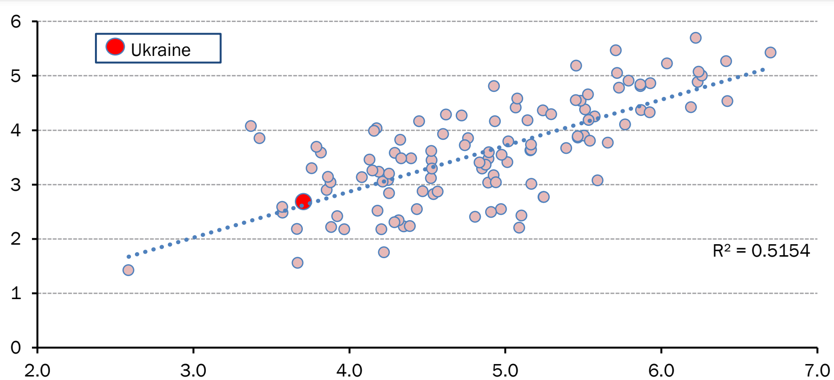
	Transparency of government policy	Standards of quality of reporting and information disclosure
Slovakia	3,9	5,2
Hungary	3,4	5,2
Kazakhstan	4,5	4,5
Poland	3,6	4,9
Romania	3,8	4,3
Russia	4,0	4,1
Turkey	4,4	4,8
Average	3,9	4,7
Ukraine	3,6	3,7
Ukraine better / (worse) than average	-9%	-22%

Source: Global Competitiveness Report 2014 – 2015

Influence of asymmetry of information on commodity market



Development of financing through local equity market, depending on the quality of auditing and accounting standards

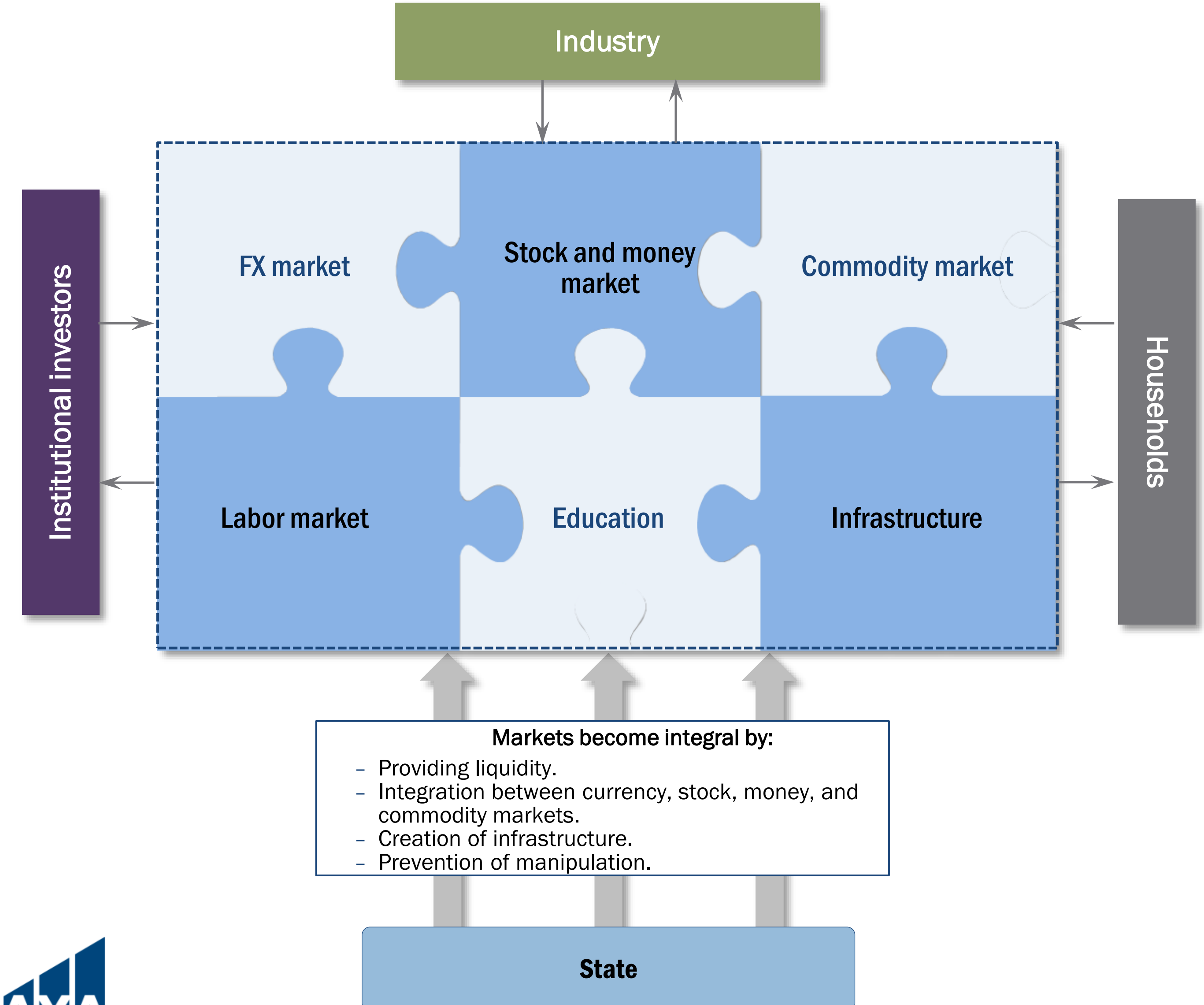


Source: Global Competitiveness Report 2014 – 2015

- Market participants should expect that they have the same (symmetric) information on the "goods" (object of agreement).
- Otherwise the lemons market appears - a market model, the operation of which is violated due to asymmetric information problems between "buyer" and "seller".
- In these markets the sellers have stimulus to put on sale products of low quality because creating high quality reputation is not in favor of specific merchant, but all the vendors in the market to which this statistic applies. The result is a tendency to decrease both the average quality of goods and market size. The current state of the capital market in Ukraine is consistent with this model.
- Therefore, to ensure market efficiency, the state should set standards of disclosure and, in turn, make transparent public policy.

Appendix D: "Capital Markets" model

Ensuring the integrity of markets



- Modern markets - are infrastructural, technological and regulatory interrelated complex “ecosystems”:
  - Capital markets include stock exchange, quotation system, clearing, depository, etc.
  - Energy market includes gas-pipelines and storage, electricity and heat generation and distribution, etc.
  - Capital markets are interrelated with foreign exchange and commodity markets.
- Violations of functioning of system of selected components would lead to a breach of the smooth functioning of the market economy.
- Therefore, the state should create a regulation to ensure the smooth operation of all components of this complex system and to minimize the possibility of restricting free competition in these markets (due to monopolization, conspiracy, fraud, etc.).

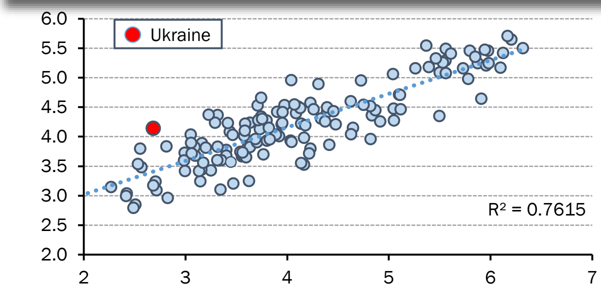
Appendix D: "Capital Markets" model

Securing property rights protection

- Market participants must have confidence that no one on the market will “rob” them:
  - **domestic entities** - by raiding, extortion, unexpected and excessive taxation etc.;
  - **external actors** - by direct attack or other forms of military aggression from outside.
- Only in case of their interests protection, market participants are ready to start new businesses, and investors - to invest. And the capital market will start to work effectively.

In terms of property rights protection Ukraine takes 135 place out of 144, and 139 by the level of minority shareholders protection

The dependence of the overall index of competitiveness of the country's level of property rights protection



Source: Global Competitiveness Report 2014 – 2015

Ukraine	Comparison of armed forces potential of Ukraine and Russia	Russia
21	Global rating position	2
160 000		766 000
4 112		9 150
400		9 150
0		250
0		1
1		69
USD 5 bn		USD 126 bn

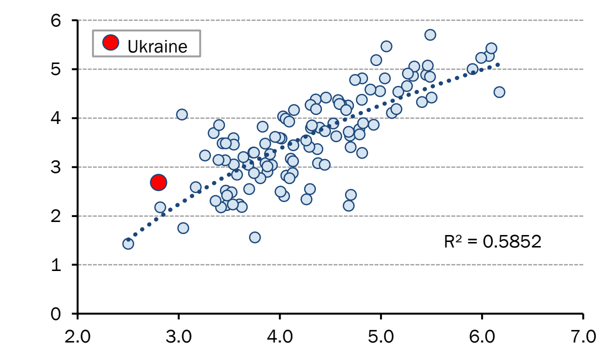
Source: Global Firepower Index 2014

Total number of military conflicts during 1946-2014	245
Of those, conflicts in which a market economy opposed non-market economy	73

	Wins, %	Number of wins	Number of losses
Wins of countries with “more market” economy	77%	56	17
Wins of countries with “less market” economy	23%	17	56

Source: Center of Systemic Peace, AYA Capital estimates and calculations

Dependence of local equity market financing development on the level of protection of minority shareholders



Source: Global Competitiveness Report 2014 – 2015

- In fact, Ukraine currently has to exist in a situation similar to Israel – “sitting on a gunpowder keg”, as soon as possible building the effective system of protection against the constant threat of invasion from Russia.
- Since Russia has a great resource and military potential, we need to build a system that would effectively allocate limited resources of our country - including military purposes. This does not imply a return to central planning, as the history of conflicts in XX-XXI century shows that **the most effective army in the world exists in countries with effective market economy.**
- Analysis of the armed conflicts during 1946-2014 shows that the probability of winning is larger in the case of a market economy in the country and more democratic society. States that meet these conditions, won 77% of the sample conflicts. These countries will benefit because they are able to attract more resources, to create more powerful alliances, soldiers are better trained and equipped, and more motivated. These results are confirmed by research data*.

Notes: * - see, e.g., analysis of wars during 1818-1992 by Reiter and Stam, 2002.

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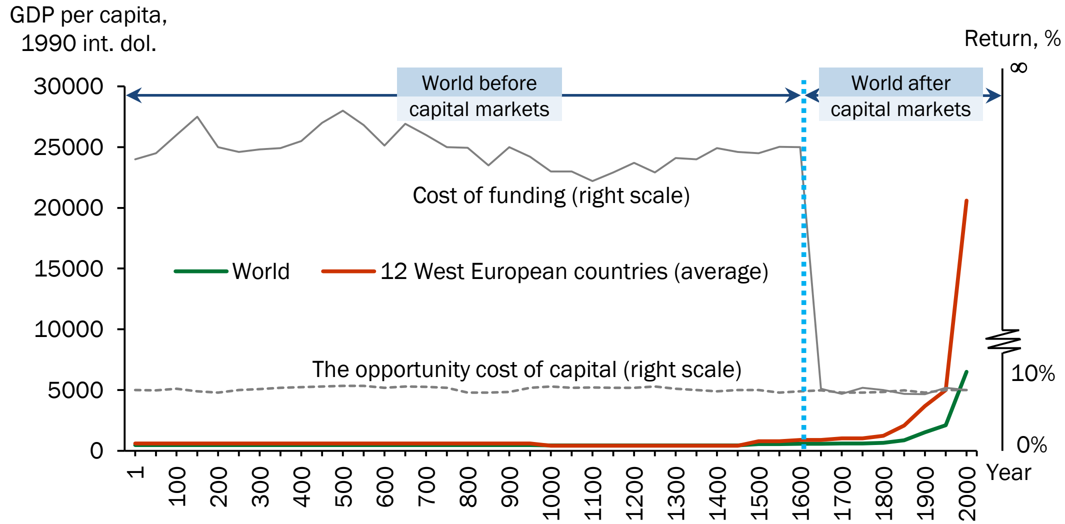
Appendix D: “Capital Markets” model

The economic model of "Capital Markets" – what does the history prove?



Source: Angus Moddison, 2007. Contours of the World Economy, 1-2030 AD; Kevin Kalser, 2013. What is Value?

- For millennia, people's living standards (measured as GDP per capita) were more or less at a similar level.
- In the early 17th century there was an event that changed the course of economic history – the first joint-stock company was established in the Netherlands. For the first time, a sufficient number of ordinary citizens brought together their modest capital to invest it in something they considered beneficial. Their example was so successful that joint stock companies started popping up all over Europe. These companies have begun to invest in trade, manufacture of machinery and equipment.
- The spread of shareholding companies in Europe was accompanied by the emergence of stock exchanges, which can be considered the beginning of a «new era» in the world economic history – the «Era of Capital Markets».
- Unlike the previous era, the «Era of Capital Markets» is characterized by sustainable economic growth, as shown in the graph above..
- This is no paradox. Capital markets are based on the law of nature - the «survival of the fittest». The driving force of evolution and economic growth has the same nature!

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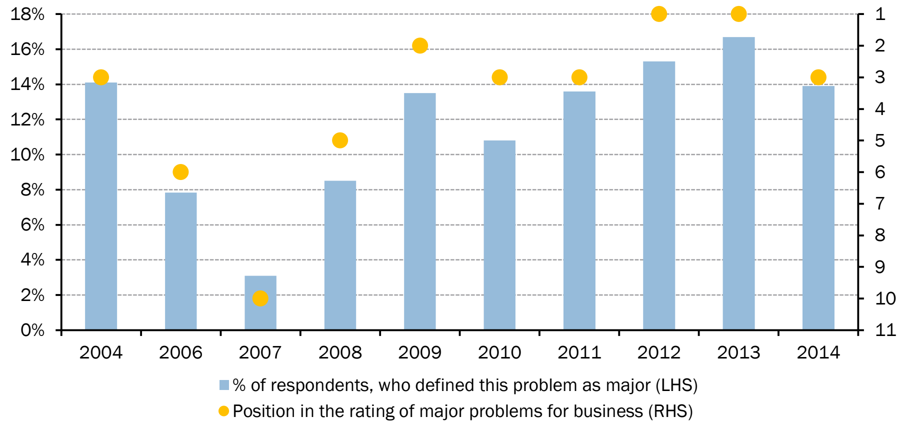
International experience shows that the only system that can provide sustainable economic growth model is based on efficient capital market.

Appendix D: "Capital Markets" model

The need for capital market development: solving the problem of access to financing

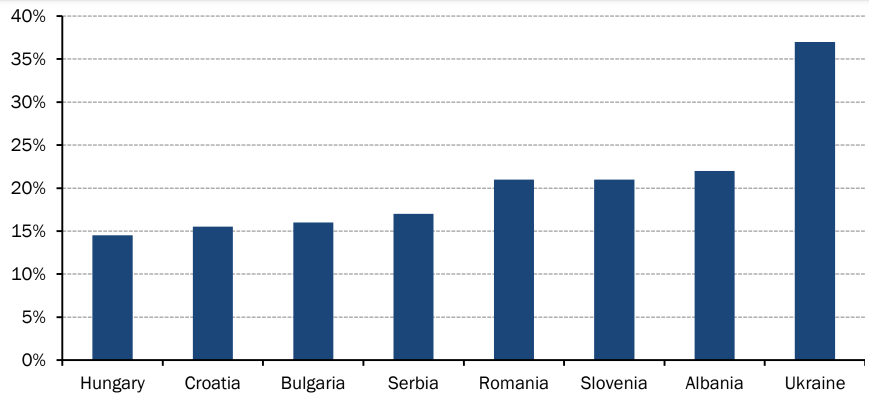
Problems of business: access to financing



Source: WEF

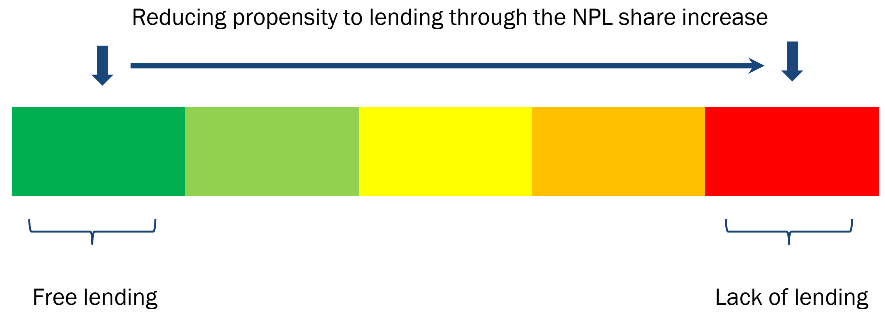
- According to regular polls of Ukrainian business, one of its most pressing problems is access to financing.
- Banking sector has been and remains a traditional channel of financing of investment needs of business in Ukraine. However, periods of financial instability have led to an increase in the proportion of bad loans of the banking system to a critical level.
- The high proportion of bad loans in the assets of the banking system, in turn, is an obstacle to active lending to business.
- Considering that the most effective source of economic growth in Ukraine is productivity increase, businesses have no choice but to seek alternative channels of financing their investment needs. Equity investments could serve as this alternative channel. This, in turn, can only take place through the development of efficient capital markets.

The share of “bad loans” in the loan portfolio



Source: Raiffeisen Research (May 2014)

Dependence of lending from NPL share

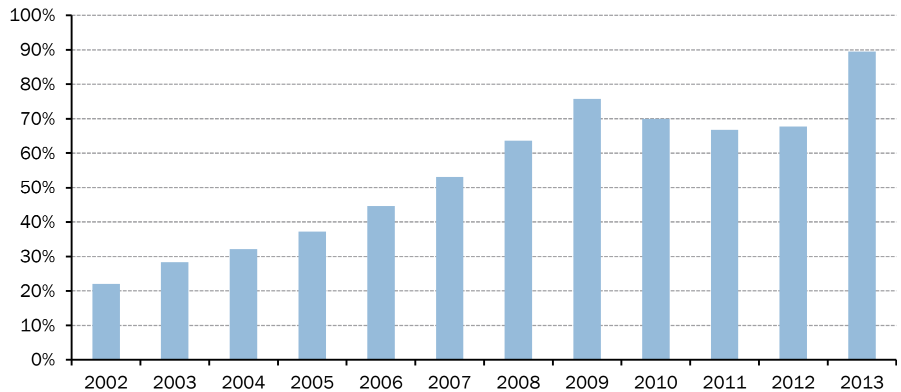


Capital markets development is a prerequisite for improving the efficiency of the economy of Ukraine.

Appendix D: "Capital Markets" model

The need for capital market development: solving the problem of high debt burden

Debt of corporate non-financial sector* to GDP

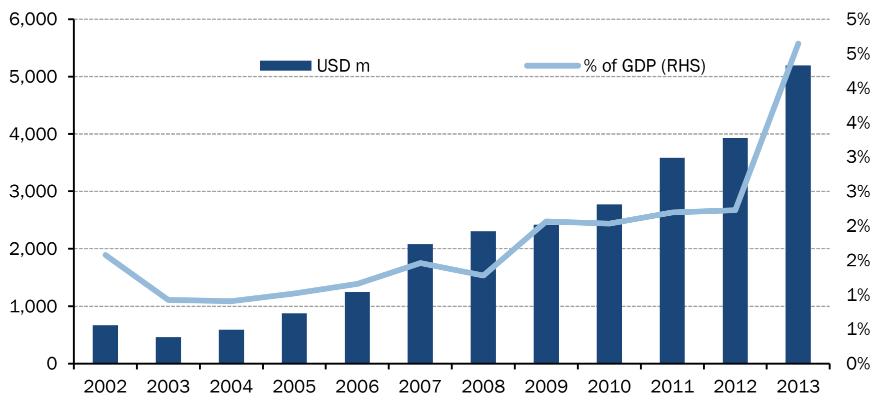


Source: NBU, own estimates and calculations

Notes: * - consists of loans in local currency, funds raised through placement of Eurobonds and foreign loans (excluding trade credits)

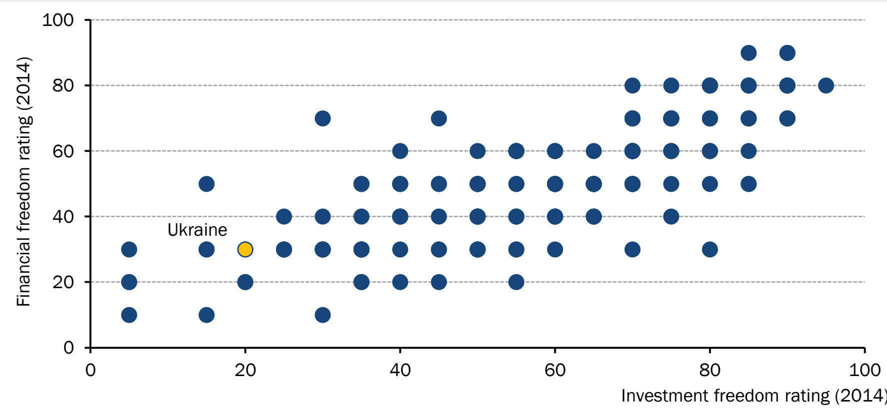
- The debt burden of non-financial corporate sector has reached a relatively high level (90% of GDP). Accordingly, further debt financing is problematic.
- In such circumstances, the only alternative is to attract investments in equity of companies.
- To fulfill this task, Ukraine imperative is to increase the level of investment freedom, which includes the development of the capital market institutions.

Overseas portfolio investments of corporate non-financial sector



Source: NBU, own calculations

Ukraine is Investment freedom rating outsider



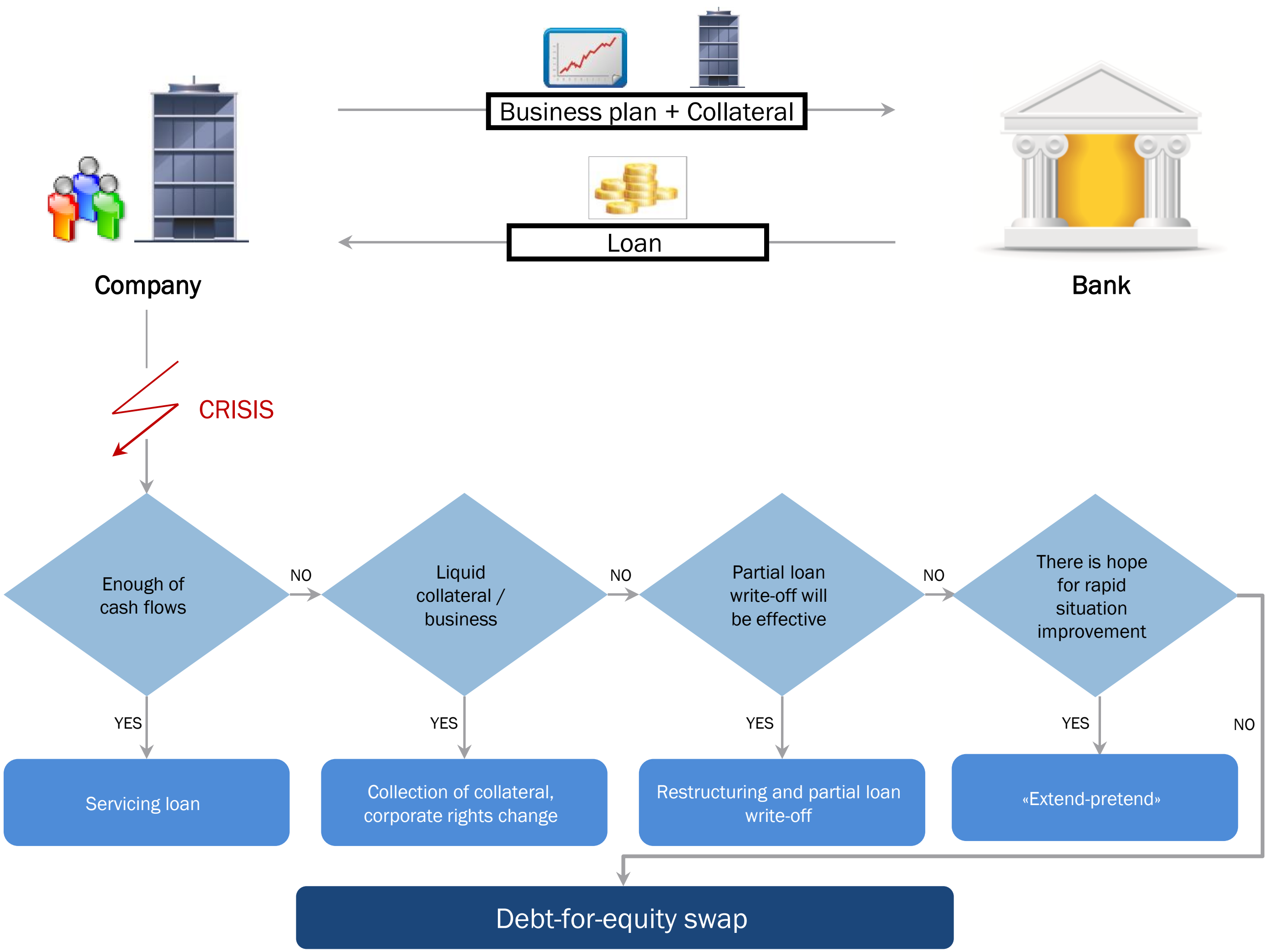
Source: Heritage Foundation

Given the high debt burden of business, the only way to finance investment is to attract financing through equity capital market instruments.

Appendix D: "Capital Markets" model

The need for capital market development, solving the problem of non-performing loans of the banking system

- Currently there is an extremely urgent problem of loans that can not be serviced even by “bona fide” borrowers.
- The problem is caused by the fact that many borrowers before the crisis received loans basing on business plans that assume the continuation of rapid growth. From 2008-09 business volumes and margins fell, and cash flows do not allow to service the loans.
- On the other hand, lenders were slow to take advantage of the right to sell the collateral and declare the company bankrupt (which is “costly” in Ukrainian legal realities).
- The banks were in no hurry to write-off the loans.
- Majority of banks used “extend-pretend” approach – prolong maturity and increase the amount of principal in the amount of unpaid interest without recognition of default on the loan.
- Such an approach would help if the rapid growth began after a brief crisis. Unfortunately, for many reasons this did not happen, and there is little expectation that this will happen soon. So now we can state the fact that these loans are problematic.
- **One of the ways to solve this problem - the exchange of loan part for the equity of the borrower.**



Capital markets development can partly solve the problem of the high proportion of “bad” loans in the banking system assets through securitization.

1 "Gradual changes" Option

Some changes help the country to find a balance, but priority of quick results significantly slows down fundamental transformation of the economic system and society

- Our experience in reforms implementation in Ukraine shows that all parties adequately understand the interconnectedness of the key components of the reform process (some reforms can not be effectively carried out while the others are not completed). On the other hand, almost all parties currently lean towards "Gradual changes" option - from a desire to avoid significant risks, lack of time to analyze "difficult" decisions, "bureaucratic inertia", and many other reasons.
- However, our analysis shows that **this option is unlikely to lead to positive results and have a high chance of failure due to the emergence of "reactionary movement".** This option is characterized by the priority of short-term gains over long-term outcome and leveling of gains by inefficient system (high expenditures). At the same time, business, society and government will likely not be able to overcome the "mental normality" of corruption.

Feeling an urgent need for change may cause harmful support of "strategic" sectors → High probability of "manual" pumping of investments in selected sectors (agriculture, IT, etc.) → High probability of macroeconomic instability, dependence on external financing → Significant deterioration of public finances and the rapid loss of economic competitiveness

2 "Radical reforms" Option

Fundamental rapid transformation based on a new social contract and the development of efficient capital markets create fiscal space to support the modernization of the economy and launch a common recovery mechanism

- An alternative to "Gradual change" is "Radical reforms" option, in which the fast implementation of changes, aimed at developing efficient markets and concentration of state functions to ensure their effectiveness, is presumed.
- This option has several advantages compared to gradual changes:

  (1) speed of reforms prevents opposition mobilization and reforms blocking;

  (2) much shorter period of uncertainty;

  (3) rapid reforms do not require the state to engage in "fine tuning" (implementation of economic policies in strict accordance with the nature of fluctuations in economic conditions);

  (4) rapid recovery of transformed economy after a possible short-term shock.

A new social contract between society, business and government: the state as a provider of services and "security" of market efficiency → The deep and systemic reforms. Transparency, trust and a new view on the state service → Significant rapid improvement of public finance → Creating effective capital market ensures companies in need of financing, improves their performance

The experience of the past 8 months - a tendency to “gradual changes”

- Given the importance of many urgent reforms to Ukraine, our experience in their implementation shows that all parties adequately understand the interconnectedness of the key components of the reform process (some reforms can not be effectively carried out while the others are not completed).
- On the other hand, according to our experience, almost all parties currently lean towards “gradual changes“ option – due to a desire to avoid significant risks, lack of time to analyze “difficult” decisions, “bureaucratic inertia”, and many other reasons.
- Moreover, currently some reformers with “inspiration worthy of better application” started working on the development of “vision” and strategies, as well as looking for hard-to-find “leaders” and “tested people” for their further implementation (where to invest, which industries should be developed, what products to produce) - this corresponds to “Autocratic gradual change“ scenario described on slide 38.
- Meanwhile, the government should give the opportunity to the market to decide how to use available resources in the best way. And the state should only perform one role in the economy - ensure market efficiency. Efforts to expand the role of government in the economy will only demonstrate “fatal conceit” and unlikely to be successful due to limited resources, including staff.
- A striking example of the inefficiency of government regulation and “fatal conceit” over the last 6 years has become the currency market, where the National Bank fought not with manipulation (i.e. with the restriction of free competition, breach of trust, etc.) and used administrative pressure against the speculators (whose role in market is very important - without them any market would not be liquid).
- Another example of the ineffectiveness of government regulation of markets during the war conflict with Russia are the precedents about:
  - purchase of equipment and medicines by volunteers for ATO abroad - as was inability of fast delivery in Ukraine due to significant over-regulation of import procedures (i.e., due to limited access to obtain the Certificate of end users), and the volunteers were forced to buy these products from smugglers;
  - slow conduct of state tenders for the procurement of military weapons during confrontations with terrorists and urgent need in the equipment.

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Appendix D: "Capital Markets" model

An example of how capital markets can help during war

- Formation of capital markets is not only non-contrary to the interests of today's "war time", but could become one of the main factors that will help us to win the war with Russia. Government should systematically hold IPOs of large state enterprises-monopolists. Previously they need to be re-organized and made attractive to investors. But in any case, this is the question of political will.
- Let's consider the state company "Ukrgazvydobuvannya". The company needs to attract the capital required to develop the domestic production of hydrocarbons, which is essential to ensure the country's energy security during military conflicts (especially when enemy country is the main supplier of energy resources in Ukraine).
- What could be done:
    1. The state should abandon hidden subsidies on gas and allow the company to sell it on the wholesale market.
    2. Rent can be calculated as the difference between the market price and the total economic cost of production.
    3. Corporate governance standards, developed by Organisation for Economic Cooperation and Development (OECD) must be applied for state-owned companies.
- With the help of only these three steps, we get a company with expected market value of USD 10-12 bn, which is attractive both for international investors (which have to be invited as "anchor investors") and for Ukrainian investment companies. This can be implemented in a relatively short time - about six months. And then the company could attract the necessary capital, and the state - improve energy security and increase tax revenues from the company.
- Now it is impossible to attract foreign investors in Ukraine, and everybody understands - there is a "hidden war" despite the cease of fire. But we also have domestic market, where the government may offer the shares of such companies to be sold. The population in any case has UAH and FX resources that has to be invested in something. The state has a good experience in selling Ukrainian domestic 'war bonds' – citizens for patriotic reasons have bought these securities, the proceeds of which go to the needs of the armed forces.
- The state should 'transfer' this experience to the equity capital markets and increase the rate of capitalization of patriotism, which can be very useful both for state enterprises, and for the population. For instance, the state actively places military orders, including on state-controlled enterprises. Demand on the products of military factories has increased recently. But some companies just do not have enough financial resources to produce more. Sale of minority stakes of such plants to private investors could be very useful measure for the economy.

Capital markets development will help to accumulate the necessary capital during the war. The emergence of "anchor" IPOs and "anchor" investors in the equity capital market will create a primary impulse for the further development of local capital markets - which in turn will push for economic growth.

Appendix D: "Capital Markets" model

Analysis of major scenarios and risks of implementation of “Capital Markets” strategy

	Total war against Russia	“Fragile peace” Scenario*		
		Gradual changes		Radical reforms
		«Autocratic»	«Market-based»	
Scenario description	Intrusion of much larger part of the regular Russian army on the territory of Ukraine, opening fronts in the southern (Crimea) and the western (PMR) directions.	Manual control of economy - temporary support of “strategic” industries with gradual structural reforms (with the expected transition to the “Capital Markets” model in the long run).	Slow implementation of reforms aimed at developing efficient markets and eliminating structural imbalances without “manual” selection of “pockets of growth”.	Rapid implementation of reforms aimed at developing efficient markets and concentration of the state functions to ensure their effectiveness.
Necessary conditions for successful scenario implementation	• Using the strategy of “asymmetric war”, capitalization of patriotism. • In case of conflict localization - fast development of economic system based on efficient markets. • Support (including financial) of Western countries, tougher sanctions against Russia.	• Strong external demand for Ukrainian exports or access to very cheap financing. • Luck in selecting “priority” industries. • Readiness of people for limiting the general economic freedoms (by preferences for certain sectors).	• Political stability, the absence of active opposition, which uses populist slogans. • The presence of significant external funding sources.	• Appointment of a technocratic government, ready to take risk by implementing unpopular reforms. • Changing of principles, approach to reform. • Conducting preliminary explanatory campaign on the need for reform. • Getting more active support from the Western countries and IFIs.
Paternalism	✘	✔	✔ in 2015 ✘ in 2020	✘
Postponing difficult decisions	✘	✔	✔	✘
‘Manual’ control over the economy	✔ (level of intervention depends on the scale of the conflict)	✔ in 2015 ✘ in 2020	✔ in 2015 ✘ in 2020	✘
Trust in government	✔	Depends on the success in selecting industries that should be “pockets of growth”.	✘	✔ In the mid-term period ✘ In the short-term period
Macroeconomic effect	Strengthening of the recession in the short term, causing a significant need for financing the budget deficit (likely due to monetization) and increasing pressure on the balance of payments.	High probability of preservation of external financing need. Even in case of definition of successful industries this option requires considerable time for the whole economy to feel the positive effects of such a model.	Macroeconomic instability. High probability of “returning to wild 1990-th” via some possible changes of power by populists. This would be accompanied by decreasing living standards, hyperinflation, banditism, etc.	Sustained high rates of economic growth, "adjustment" of macroeconomic imbalances, improving access to financial resources, overcoming economic inequalities in society.
Scenario probability	Depends on the decision by Russia on attack on Ukraine.	Low probability of high external demand, successful selection of industries that should be “pockets of growth” for the economy, and the readiness of the population to limit their economic freedoms after Maidan.	High probability of reforms implementation failure (accumulation of social tensions through stretching over time), leading to kleptocratic system’s “rebooting” and then - “returning to wild 1990-th”.	High in the case of the government's “sacrifice” of its political rating in the short term because of unpopular reforms.

Note: * - cease of fire during which Russia will continue efforts to establish control over Ukraine by hidden "subversive" ways of limiting our right to free choice of the European way of development

In the case of "fragile peace" with Russia radical reforms scenario is the only one of the options available, which will rapidly achieve the transition to a new economic system ensuring macroeconomic stability and sustainable high economic growth.

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