

BY ULRICH ERNST

## Orange Economics

Ukraine's "orange revolution," which overturned a fraudulent presidential election and ensured the election of Viktor Yushchenko, was largely a social and cultural phenomenon. Yet the express commitment to the "European Choice" also implied an economic choice. While it may not have been foremost in the minds of demonstrators trying to stay warm in the tent city on Khreshatyk Boulevard, the orange revolution meant the choice of a modern, competitive market system over a state-run economy dominated by oligarchs. Pride in the ability of Ukraine's economy to compete in an open market dovetailed with belief in the nation's democratic future.

What are the prospects for Ukraine's economy in the increasingly competitive environment that comes with accession to the WTO and rapid engagement with the European Union (EU)? The U.S. Agency for International Development commissioned an assessment of the competitiveness of Ukraine's economy and selected clusters, under the auspices of the Support to Micro, Small, and Medium Enterprise Development (BIZPRO) project. BIZPRO's Ukrainian experts and 16 expatriate policy and sector specialists contributed to the resulting report, *Ukraine: Competing in the Global Economy*, summarized below.

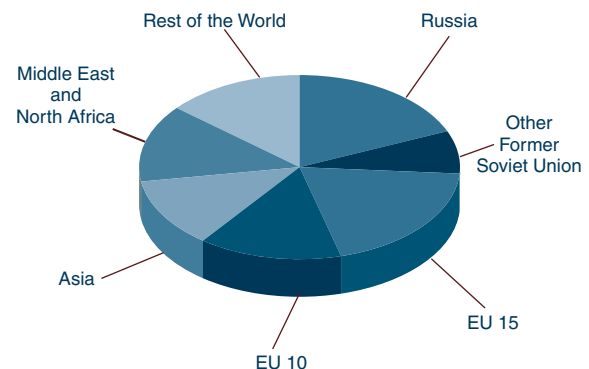
### Competitiveness Concerns The Entire Economy

After almost a decade of economic contraction, Ukraine's turnaround in 2000 under then-Prime Minister Yushchenko has led to extraordinary growth, putting Ukraine in the upper tier of fast-growing economies worldwide by 2004. Soaring demand for Ukraine's traditional exports (principally iron and steel) accounts for much of that growth, and domestic demand responded as well. To prosper in a market environment, however, Ukraine must channel this momentum into other sectors of the economy.

Recent studies of economic growth—at the level both of entire economies and of particular interventions to spur enterprise development—yield a clear lesson: success requires full mobilization across all segments of the economy, from reforming policy to building market institutions, nurturing linkages, and promoting innovation at the firm level. Concerted action across the economic spectrum produces major productivity gains—the essence of sustainable economic growth.

Such action demands full participation by all economic actors. Markets, private enterprises, and the state have roles in this process. The interplay between markets and the state influences the ability to design and implement trade policies, develop new structures for translating Ukraine's edge in science and technology into innovation, create robust support structures in information and communications technology (ICT) and finance, or build the institutions that make markets prosper. Ukraine needs complementary strategies to meet the competitiveness challenge and move the economy beyond its traditional range of products.

### UKRAINIAN EXPORTS BY DESTINATION



## A Frail Market Framework

To date, weaknesses at all levels—from firm-level innovation to policy, market structures, and supporting institutions—have held back productivity growth. Three factors stand out:

- *Policy design and implementation* have raised the risk of investing and producing. Administration of state functions needlessly inflates the cost of doing business, and the poor investment climate—inimical to rapid modernization of the economy—deters the foreign direct investment (FDI) needed to promote innovation and integrate the economy into global value chains.
- *Market institutions* are feeble and oriented to yesterday's economy. Weaknesses in the quality infrastructure and market channels put the Ukrainian producer at a disadvantage long before the product reaches the consumer. Disruption of the traditional links between research and production has impaired innovative capacity.
- *Key supporting industries*, in particular the financial sector and ICT, have failed to provide the intermediation and support needed to promote innovation and investment.

## Strategic Priorities

Both domestic investors and international analysts have pinpointed strategic priorities for improving the country's investment climate. Each year, the World Economic Forum conducts an Executive Opinion Survey in Ukraine—and 103 other countries—as the basis for its *Global Competitiveness Report*. Against the benchmark of average scores for new EU members from Central and Eastern Europe, Ukraine's most striking shortfall appears in the quality of its public institutions. The next-lowest relative score is for the macroeconomic environment, which is dragged down by poor appraisals of the financial sector—including criteria such as access to loans—and extraordinary dissatisfaction with customs procedures. The highest score relates to “cluster development,” where Ukrainian investors actually see their economy as *more* advanced than the average new EU member. An independent ranking by the Economist Intelligence Unit highlights major gaps (again relative to new EU members) in the areas of finance and policies toward private enterprise, competition, and FDI.

The orange revolution has set a new tone for policy toward private enterprise and FDI. With respect to the financial sector, reform should include legislative and regulatory changes to facilitate consolidation in the sector and raise capital adequacy ratios. Ukraine's reformers must also work with banks to improve systems for risk management and

introduce new instruments that meet the needs of the target clusters. Two further deficiencies must be addressed:

- To build on the country's legacy in science and technology and transform this potential more systematically into commercially viable innovation, linkages between the country's innovation infrastructure and its cluster-specific needs must be strengthened. The emphasis should be on demand pull in the innovation process.
- To streamline market channels and reduce transaction costs, Ukraine must take measures such as full implementation of the concessions law to improve the physical infrastructure for transportation and logistics.

## Beyond Traditional Exports

Foreign trade has been the main driver of Ukraine's economic recovery. Although the former Soviet Union remains Ukraine's main source of imports—much of it oil and gas—it has been displaced by the expanded EU as the principal target for exports. However, Ukraine's economy remains fairly well integrated with its traditional trading partners, while integration vis-à-vis the EU is one-third of the average level of an OECD economy. In other words, trade with the EU still lacks the structures needed for sustainable growth.

With its expansion in May 2004, the EU and Ukraine have become direct neighbors. In theory, trade with the EU 15 should have accounted for roughly 40 percent of the country's trade, but even with the addition of the new members, the EU accounts for less than 35 percent of total exports. To promote nontraditional exports into EU and global markets, one area that deserves greater attention is quality infrastructure (norms, standards, testing, and certification). Ukraine must upgrade its quality infrastructure to compete better in Western markets and stay ahead of former Soviet Union countries upgrading their standards. Ukraine also must devise new programs to help industries graduate from Gosstandart of Russia (GOST) to international standards.

## Highlights from the Cluster Assessments

Improving standards, strengthening market institutions, and improving cooperation between public and private competitiveness initiatives are critical first steps, but they must be complemented by cluster-specific efforts to improve productivity and gain market share, as outlined below. BIZPRO's competitiveness assessment for Ukraine focused on prospects and problems for Ukraine's *nontraditional* exports. The selection of clusters for analysis was based on both the performance of various commodities in export markets and an independent assessment of key markets. Several of these clusters are receiving assistance from BIZPRO.

**ICT.** Ukraine is fast becoming a major player in the global ICT industry. It ranks fourth worldwide in the number of programmers graduating, after the United States, India, and Russia. The current focus is on outsourcing, with increasing emphasis on quality. Ukraine's ICT cluster is establishing itself as an R&D laboratory and has emerged as a strong advocate for intellectual property rights. Like the financial sector, ICT has the potential to facilitate productivity-raising innovation across the economy. The current penetration rate of ICT is low, but as investment picks up in key sectors, ICT diffusion will increase.

**Textiles and Apparel.** This cluster combines elements of the old economy (generally operating well below capacity) with new small and medium-sized enterprises. Ukraine's competitive advantage lies in flexibility and time to market, although weak logistics and slow customs procedures have undermined that advantage. The January 2005 removal of textile quotas might affect Ukraine's apparel cluster only tangentially, as long as linkages to markets are strengthened. Relevant assistance would include identifying buyers and building linkages to enterprises, and organizing market preference workshops to attune firms to specific market trends, nuances, and expectations. Local designers should be included in these workshops to understand market preferences and network with manufacturers. Finally, the flax and linen component of the cluster deserves further investigation to identify products and strengthen production and design.

**Furniture.** Ukraine imports far more furniture than it exports, although its exports have been capturing share in growing markets. Limited in their knowledge of the expecta-

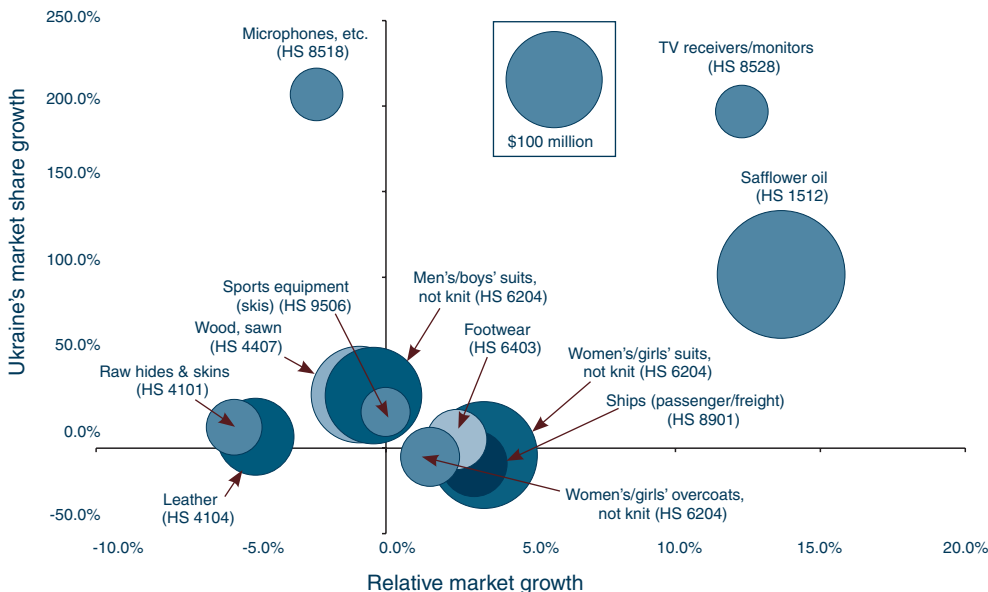
tions of target markets, Ukrainian companies do not know how to market themselves, and even if they see the potential of upgrading production processes, limited access to capital holds them back. Domestically, the gray market remains significant. For the furniture cluster—as for home furnishings—assistance must emphasize developing design skills in tune with target markets.

**Home Furnishings.** Ukraine's home furnishings cluster includes target commodities such as glassware, wrought iron, Christmas ornaments, porcelain, and ceramics. For some of these commodities, exporters have discovered significant market niches and have been expanding production. However, further expansion is hampered by the lack of inter-firm cooperation—collaboration essential to establish brand or origin recognition. Compounded by inadequate sales and marketing expertise, this lack of coordination perpetuates the lack of access to (potential) target markets. The home furnishings business is largely dependent on intermediation by agents, few and far between in Ukraine. Expansion is also hampered by a lack of basic business skills: BIZPRO's analysis confirmed a widespread inability to forecast input costs and set stable prices. Finally, as in all sectors, inadequate access to capital is hampering the transformation necessary to produce at a larger scale with consistent quality.

**Leather and Footwear.** In working with this cluster—already making inroads into EU markets—a useful point of leverage is the National Union of Leather and Footwear Manufacturers, which can play an important role in identifying relevant companies and act as a clearinghouse for industry information. The union could facilitate initiatives that may include

joint marketing, possibly culminating in a “Made in Ukraine” mark that would indicate quality.

#### SELECTED EXPORTS FROM UKRAINE TO THE EU, 1998–2003



**Construction Materials.** Construction in Ukraine is booming, and increasing household incomes will fuel further demand. The domestic construction materials cluster draws on a rich endowment across the spectrum of natural resources and has the potential to compete effectively with imports and expand export markets. Yet outside a few “islands of excellence,” product quality is not competitive. Both performance and design of construction materials are outmoded, and technology must be upgraded. From raw material to finished products, deficiencies in distribution channels add cost

and undermine competitiveness, market development is lagging—especially with respect to cluster cooperation vis-à-vis foreign competitors—and there is little domestic brand recognition.

**Horticulture.** While it has seen market successes (juices), this cluster is still in a transition from “home” production to a competitive industry. Half of fresh fruits and vegetables are produced in small “dacha” plots, wholesale trade remains inefficient and fragmented, and modern storage facilities are lacking. Poor equipment (sorting, packaging, coolers, refrigerators, and term trucks), limited skills (language, customs procedures), and scant experience in exporting exclude potentially competitive producers from export markets. Moreover, a risky agrarian regulatory environment creates uncertainty about tax incentives and imposes restrictions on land sales that hamper cluster development.

**Meat.** Meat is a major export, especially to Ukraine’s partners to the east. On the production side, problems include the lack of animals bred specifically for meat, poor rearing conditions, and the quality and quantity of feedstuffs. Outdated processing technology makes it difficult to reach Western quality and sanitary standards for sausages and processed meats. Finally, the value chain lacks a true margin discovery mechanism because subsidies distort the true market status of the industry, and “gray channels” compromise the integrity of the sector and undermine consumer confidence in products.

**High-Technology Manufacturing.** Ukraine’s high-tech sector has a sophisticated base in the country’s military-industrial complex, but its potential is far from being realized. Needed interventions—in addition to improving the investment climate, which is limiting badly needed FDI—include strengthening enterprise linkages with universities and research institutes, and focusing on contract manufacturing, strategic alliances, and investment partners. “Smart privatization” and post-privatization restructuring are essential to the cluster’s policy agenda. New high-tech venture startups are a somewhat lower priority.

**Tourism.** The Crimea and the Carpathian Mountains offer significant tourism potential, but market knowledge is limited. Technical assistance to industry associations could help the cluster make the most of better market research, build on improved understanding of competitive trends, and better use key channels, particularly the Internet. Strategic priorities include strengthening linkages in the value chain, branding the Ukrainian tourism experience, repositioning toward specialty travel, and improving staff quality.

### **“Ukraine Competes!”**

Ukraine has the potential to sustain growth by diversifying its exports. Its entrepreneurs and managers need guidance and support to face the challenges of global competition, but the ingredients are there. What is needed now is an “orange revolution” in the way many parts of the economy operate to take advantage of a changing policy environment and generate growth that benefits all Ukrainians. “Ukraine Competes!” will be the battle cry for a new campaign heralding that economic revolution, and should become a mantra for the economy as a whole.

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*[http://www.dai.com/pdf/Ukraine\\_Competitiveness\\_Report\\_Highlights\\_-\\_Jan\\_05.pdf](http://www.dai.com/pdf/Ukraine_Competitiveness_Report_Highlights_-_Jan_05.pdf)*

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