

2003

Investment prospects in Ukraine: Transition from a planned to market economy

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Investment prospects in Ukraine: Transition from a planned to market economy

Abstract

The Soviet economy and how it operated successfully to make it one of the world superpowers in the world under the socialist regime still is unclear to many people around the world, and especially those outside the vast territories of Soviet influence. The country of Ukraine was one of those countries, which makes it very important to understand why the country is at the position it presently finds itself in. Thus, to help us better understand the Ukrainian economy we will look into the history of the Soviet Union.

Degree Type

Open Access Senior Honors Thesis

Department

Economics

First Advisor

Dr. Michael Vogt

Keywords

Ukraine Politics and government, Ukraine Economic policy 1991, Ukraine Economic policy 1991

Subject Categories

Economics

EASTERN MICHIGAN UNIVERSITY

University Honors Program
Senior Thesis

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Investment Prospects in Ukraine:
Transition from a Planned to Market Economy.



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The Economy of the Soviet Union

The Soviet economy and how it operated successfully to make it one of the world superpowers in the world under the socialist regime still is unclear to many people around the world, and especially those outside the vast territories of Soviet influence. The country of Ukraine was one of those countries, which makes it very important to understand why the country is at the position it presently finds itself in. Thus, to help us better understand the Ukrainian economy we will look into the history of the Soviet Union.

Birth of the Soviet Economy

Following the Bolshevik revolution of 1917, Joseph Stalin introduced the concept of a having planned economy in 1928 where the state was to control the amount of output produced, mainly given by the orders of the one of the world's frightful dictators in the history of human kind and especially the history of the Soviet Union itself. The Soviet Union lacked a good system of replacing its political leaders. As a matter of fact, the Soviet economy was most fruitful during the time of Stalin. However, following his death, Stalin's predecessors were evidently much kinder to the citizens, which reflected their time of order as being more relaxed one than the chilly Stalin era. This was an important in the history of the Soviet Union played a major role in the future of the Soviet Union economy.

While the majority of economies nowadays are mixed economies that involve both state and private involvement, the Soviet one was plainly state controlled economy. It was very complicated hierarchical system that required much coordination and obligations on the part of the public. At the top of the food chain was the party power, followed by sector ministries at the intermediate level and at the lower level were the state owned enterprises. Those were mainly national industrial and agrarian organizations that took orders from their higher up political

leaders and parties. The planning and the resource allocation that the enterprises took were decided by the state itself and under the direction of the parties, or more precisely by the *Gosplan* (State Planning Commission), which sent five-year plans to the ministries. The ministries then broke down the total output required and delegated orders to various state enterprises with production quotas. The Gosbank (national bank) was kept into secret for a long time. It was responsible for the distribution of money, which it estimated based on the requirements of the economy (2). In the absence of interest rates, any capital investments in various enterprises were decided by the national bank that controlled the entire money supply. Prices were based on the cost of inputs and desired markups and taxes, as opposed to the actual demand and supply of goods and services. Therefore, the money supply played a very minor role in the economy, which will later prove to have fatal effects in the transition to a market orientated economy, which we will discuss later in the paper. Early in the 1980s, the majority of the people occupying the Soviet Union and its political leaders sensed the pressure and stagnation of the economy. According to official and non-official Soviet reports as well as CIA estimates, the GDP growth has fallen from 6-8% in 1950s to 2-4% in 1980s (14). Eventually, Gorbachov tried to revive through national reform known as the *perestroika*. While the Gorbachov's plans of opening up the economy to international trade (dramatic change from Stalin's time), the country (along with its policies) has been isolated from the world for such a long period of time that it was very difficult for it to set effective joint projects with foreign businesses. In addition, the array legislative acts that Gorbachov were usually too complicated and difficult to carry out (2).

Strengths of the Soviet Economy

One of the significant strengths of the Soviet economy was its commitment to research and development in scientific industries, which lead to many inventions and achievements. This can be best reflected by the revolutionary achievements, in the space (launch of Sputnik), military

2 Heenan, and Lamontagne. The Russia & Commonwealth of Independent States Handbook: p3-12

14 Heenan, and Lamontagne. The Russia & Commonwealth of Independent States Handbook: p28-35

(Red Scare) and industrial sectors. Furthermore, many benefits were provided to the public that included free medical care, education, good transportation system and decent national infrastructure. Furthermore, the size of population and abundant national resources played a key role in the countries gross domestic output. Nevertheless, there were many flaws in the system that would lead the economy to collapse.

Limitations of the Soviet Economy

Despite that in theory the output of the economy was planned, this was primarily true and effective for some essential consumer products. Since the government controlled the capital allocations, most of the time heavy industry projects were favored as opposed to developments in the light industry. This was later a major challenge in the transition process to market economy as most government institutions had policies and infrastructure suitable for the mass production orientated farming and heavy industrial sectors. Investments in the military sector were top priority for the Soviet Union in its military race with the United States during the Cold War. On the other hand, the availability and variety of some special consumer products was downplayed and shortages often occurred due to inadequate state orders and investments. Thus, many households accumulated cash that they could not spend for products and invest back in the economy, limiting the multiplier effect growth on the national economy.

The foreign trade (outside Soviet Union) was almost inexistent as the state currency (ruble) was not convertible to other currencies. Consequently, the leadership of the Soviet Union effectively isolated the its territory from taking advantage of foreign trade and prevented for the most of time trade with countries that had comparative or absolute advantage in the production of some products.

One of the major difficulties was giving precise production orders that were to satisfy the needs of citizens the gigantic area of the Soviet Union. Some factories were given orders that they

lacked input materials to produce while other factories in distant locations had huge surpluses of similar inputs. At the same time there was not an effective system in place to relocate and adjust shortage and surpluses of resources among enterprises. Enterprises in similar fields of production did not have good communication networks among each other. The primary demands of the state were to produce the desired output and there were not incentives or punishments for the level of quality of products. There were minimal standards that had to be met, which were regularly disregarded by top management, because of lack of supervision from the state ministries.

The Commonwealth of Independent States

In December 1991, the Soviet Union was divided into the Commonwealth of Independent States (CIS) that was initially founded by Ukraine, Russia and Belarus. In a short amount of time, they were joined by nine other former Soviet states that included Armenia, Azerbaijan, Kazakhstan, Uzbekistan, Kyrgyzstan, Moldova, Turkmenistan, Tajikistan, and Georgia. The 12 states host about 300 million people and cover about 16.3% of the world's land area. Their industrial potential is about 10% of the world's total and they possess approximately 25% of all natural resources. The CIS is the world's fourth largest producer of electrical energy and the structure of intellectual property rights of the CIS is estimated to be worth US\$500 billion (14). CIS is an international institution that was created to provide a forum for the official states to work to cooperate with each other in reviving their economic and political structures towards democratic market economies. All of the countries shared many similarities inherited from the Soviet Union that included:

- A common language (Russian).
- A common currency (ruble)
- Close economic relationships among enterprises
- Almost identical public infrastructures

- Shared standards (legal, medical, and education systems)
- Similar ethnic groups (Slavic)

All of the similarities above actually made the new states extremely dependent on each other. For example, Ukraine received 56% of its gas supplies from Russia and other states such as Belarus and Moldova were totally dependent on Russia for energy resources. The CIS has not been very successful mainly due to the disagreements on common policies and imbalances of power in the organization. Russia has dominated politically and economically not only the policies of the CIS itself, but the policies of many states (14). Furthermore, the CIS states failed for the most part to include adequate investments in replacing obsolescent assets and introducing new technologies. According to the United Nations Economic Commission for Europe, the three largest CIS states (Ukraine, Russia, and Kazakhstan – generated 83% of CIS GDP), in 1997 invested less than 20% of their investment levels during 1990 (20).

Ukraine on Crossroad

Ukraine has been on a crossroad in many of its decision makings on a pathway with two diverging pathways. Many factors such as the country's location, history, long-term partnerships and shared language all contribute to a unique relationship with the Russian state. The relationship and many economic, political, and cultural similarities between Russia and Ukraine can be easily compared to the ones of the United States and Canada. For example, Nikolai Travnik of the Russian Democratic Party mentioned that "history requires that Russia's relations with Ukraine be qualitatively different from its relations with other foreign countries"(17). Moreover, surveys in 1994 found that 78% of the Russian respondents stated that Ukraine should become part of Russia. On the other hand, similar polls in Ukraine suggested that 36% agreed that there should be some kind of union between the two states. While the countries are dependent of each other they had several disputes such as the ownership of nuclear weapons that were left

14 Heenan, and Lamontagne. *The Russia & Commonwealth of Independent States*: p28-35

17 Heenan, and Lamontagne. *The Russia & Commonwealth of Independent States*: p77

20 Kaser, Michael. *Finance and Development*.

behind on Ukrainian territory, the Black Sea Fleet from the Soviet Union, the repayment of debts to Russia (27).

Today, not many people will argue that the choice has been made to take the road towards the West that is especially evident in the presidential leadership. However, survey results show that this is not necessarily true among the Ukrainian population, which seems to have diverging views that are usually reflected in regional votes. Western Ukraine is more pro-democratic while Eastern Ukraine is more aligned with the national connection with Moscow. For example, in the 1998 election results by region 15.5% of the West (composed of 8 regions according to the survey) voted for Communist parties. On the other hand, 44.4% of Eastern Ukraine (6 regions) voted in the same category and 6.7% voted for the National Democrats (26).

Political System

Before we move into the economic conditions and foreign direct investment statistics of the Ukrainian economy, it is crucial to understand the political environment that happens to play an important role in the Ukrainian economy. First of all we will cover the governmental structure developments after the country's independence, the set up of the political system and its division of power, and lastly the US diplomatic relations with Ukraine.

Post-Soviet Government System Developments

Following a number of disagreements among the interests and control of Soviet Russia over the state of Ukraine, the country reached its independence from the Soviet Union on August 24, 1991 (3). In June 28th, 1996, the Ukrainian parliament, also known as *Verkhovna Rada*, passed a new Constitution. As opposed to the values of the socialist era, the constitution itself promised and followed in its structure many of the core values exhibited in the western market economies. For example, the new Constitution provided the right to private ownership of land and

3 Central Intelligence Agency Website

26 Heenan, and Lamontagne. *The Russia & Commonwealth of Independent States*: p84: table 6.7.

27 Heenan, and Lamontagne. *The Russia & Commonwealth of Independent States*: p69-79

assets, stronger and clearer law structure and more independent judiciary system. All these factors are key government structure elements that foreign investors look for prior to any investment considerations. Despite the promising configuration of the political system, many of the principles have not been yet fully implemented by the legislative branch of government. The reasons for the lack of enforcement are mainly due to the current political dominating forces and the division of power among the branches of government in Ukraine (4).

Structure of Political System

Before, we cover the recent division of power in the political system, it is important that we explain the structure of the political system itself. The government system is composed of executive, legislative and judicial branches.

The executive branch has been headed by the chief of state, President Leonid D. Kuchma, since 1994 and the cabinet of ministers that are appointed by the President and approved by the Supreme Council. President Kuchma has been supporting a pro-market economy and a democratic orientated political system. Although his ideology has been in tact of the one of the western world, breaking developments and findings after his 2nd term presidential elections in 2000 significantly questioned and dropped his credibility among both the legislative branch and the foreign political leaders and investors. An insider of his cabinet provided audio tapes in front of the media and the public that had included his orders to murder a journalist during the presidential elections. However, the voice recorded on the tapes was not clear and evident enough to directly link the president to this murder case leaving the case in mystery still nowadays.

The legislative branch is represented by a unicameral parliament composing of 450 seats that are divided in two halves in terms of their election. The first half (225 seats) is distributed among the political parties represented on the basis of their proportion of vote earned in the national electoral vote. The other 225 seats are fulfilled by the popular vote represented by

4 Ukraine Country Commercial Guide FY 2002: Chapter 3: Political Environment, Point B

individuals of the geographic regions of Ukraine. The political parties in Ukraine are not very well developed as the majority of them tend to be focused on personal interests and represent specific group of individuals that act for the benefit of their own group. In other words, corruption is evident among many individuals of the parliament.

This has been an issue in their effectiveness to enforce Ukraine's Constitution, since they have been missing in their actions the commonwealth ideology of transforming the country to an independent market economy through democratic means of action. Therefore, the legislative system has failed to pass and implement laws that will most effectively support the guidelines of the country's novel and promising Constitution. The majority of the legislators and other political leaders agree in broad terms that in order for the country to move on in positive direction significant foreign investments are needed. Nevertheless, the legislators have had hard time so far to implement the necessarily favorable laws and business regulatory system that may attract significant number of foreign investors in the country.

The last branch of government is the judicial branch, which seems to have not been very active due to the lack of major Constitution orientated laws imposed by the legislative branch (6). Now that we have discussed the Ukrainian political system, we can move to further investigate the balance of power among and within some of the branches of government.

Current Political Division of Power

The parliamentary elections take place every 4 years, while the presidential elections take place every 5 years. As it can be witnessed from the graph below, in the 1998 election polls it can be seen that the Communist Party of Ukraine have earned a significant number of votes that has given it more than 2 and half times more seats (87 mandates) in the parliament compared to the next ranking party (7).

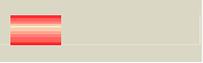
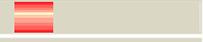
6 Ukraine Country Commercial Guide FY 2002: Chapter 3: Political Environment, Point C

7 Central Elections Commission Website: March 29, 1998

№	Party (Bloc)	Votes cast "For" in Ukraine	%	Graph	Man- dates
1	Communist Party of Ukraine	6 550 353	24.65		84
2	People's' Movement of Ukraine	2 498 262	9.40		32
3	Bloc of the Socialist Party and Peasant Party	2 273 788	8.55		29
4	The Green Party of Ukraine	1 444 264	5.43		19
5	People's-democratic Party	1 331 460	5.01		17
6	All-Ukrainian Association "Hromada"	1 242 235	4.67		16
7	Progressive Socialist Party of Ukraine	1 075 118	4.04		14
8	Social-Democratic Party of Ukraine (united)	1 066 113	4.01		14
9	Agrarian Party of Ukraine	978 330	3.68		
10	"Reforms and Order" Party	832 574	3.13		

Some of the top goals on the communist agenda include deliberate and intensified cooperation with Russia and Belarus, increase in the state involvement and control over the country's infrastructure and industry, and expansion of broad social programs for the Ukrainian citizens. The rest of the socialist based parties that had still received a significant combined number of seats (see graph above) follow some of the core values of the communist party, but have different vision of implementing the goals. However, the majority of the goals are contradictory and unattractive to many western foreign investors who are not experienced, comfortable or ready to prosper in such a political environment.

After all, there have been major changes in the balance of power from the 1998 elections compared to the most recent elections that have taken recently taken place earlier this year (2002). From the graph below, one can see that there has been shift of power from the communist party towards the newly introduced party named "Our Ukraine" as well few other new based parties that still have a lot of expectations and promises to meet of the Ukrainian people (8). It will be very important how that shift in the balance of power will be translated in legislative terms and constitutional enforcement in the near future that many foreign investors will look for.

№	Party (Bloc)	Votes cast "For" in Ukraine	%	Graph	Man- dates
1	Election bloc of Political Parties "Victor Yushchenko Bloc "Our Ukraine"	6 108 088	23.57		70
2	Communist Party of Ukraine	5 178 074	19.98		59
3	Election bloc of Political Parties "For One Ukraine!"	3 051 056	11.77		35
4	Election bloc of Political Parties "Juliya Tymoshenko election bloc"	1 882 087	7.26		22
5	Socialist Party of Ukraine	1 780 642	6.87		20
6	Social-Democratic Party of Ukraine (united)	1 626 721	6.27		19
7	Election bloc of Political Parties "Nataliya Vitrenko Bloc"	836 198	3.22		
8	"Womans for the Future" All-Ukrainian Political Union	547 916	2.11		
9	Election bloc of Political Parties "Team of Winter Generation"	525 025	2.02		
10	Communist Party of Ukraine (renew)	362 712	1.39		

Political Relations between the USA and Ukraine

After the extensive Cold War that US had against the socialist values of Soviet Union, it has been in the US interest to strongly support independent pro-democratic and capitalist orientated Ukrainian state. Therefore, the US and Ukraine began to closely cooperate between each other in 1993, after Ukraine reached independence, to strengthen their economic relationships. As matter of fact, in 1994, the US committed one of the largest American aid programs in the world at that time to Ukraine. Those funds were directed for the elimination of nuclear weapons and infrastructure as well as for building stronger and market orientated export system. Moreover, in 1996 the so called Gore-Kuchma Binational Commission was created to improve the mutual relationship and efforts of reviewing and developing the commercial, economic and military systems of Ukraine. However, President's Bush administration in 2001 decided to cancel out the commission set between the countries as it was not one of the top priorities of the US at that time. Nevertheless, both the US and Ukraine have agreed to continue dialogue and cooperate among each other in three main areas of international trade, investment and economic reform, law enforcement, and foreign policy and defense structure (5). Ukraine has

received more foreign aid from the United States than any other country except Israel and Egypt (17).

Economic Conditions

Before we move into analyzing some of the key domestic economic factors, the country's infrastructure and its levels of international trade, it is important to get familiar with some of the general facts and standards of the country itself. The general summary of the country usually explains the rationale among foreign and domestic investors for doing business in Ukraine who in turn affect the balance of trade and the economic performance of the country.

General Overview

Ukraine has approximately a population of just over 48 million people and in terms of its land it is the second largest country in Europe, after Russia. Located in Eastern Europe, Ukraine is in a strategic position often used as the crossroad between European and Asian markets. The ethnicity of Ukraine is about 73% Ukrainian, 22% Russian, 1% Jewish, and others. Ukrainian is the official language and Russian is also widely used, but very closely associated to Ukrainian as Slavic language. The other few languages used are Romanian, Polish, Hungarian and English, which is emerging among the youth population. The Ukrainian highly educated (98% literacy rate) and large population, immense natural resources, strategic position in Europe, and its emergence as a new independent democratic state from the Soviet influence has brought about high expectations and hope of economic growth among foreign investors, political leaders, and the Ukrainian citizens (3). Nevertheless, the results of those expectations will be best reflected in the country's macroeconomic record that we will closely look at in the next few sections of the paper.

3 Central Intelligence Agency Website

17 Heenan, and Lamontagne. *The Russia & Commonwealth of Independent States*: p77

Domestic Economy

The Transition Period: The 1993 Economic Crisis

The previous Soviet influence over the region of Ukraine has set strong economic bonds and interdependence between today's independent states of Russia and Ukraine. As a matter of fact, following Russia, Ukraine's domestic output is about four times the size of the next ranking country of the Commonwealth Independent States. Ukraine is known for its abundant rich agricultural industry, natural resources, and its national defense infrastructure inherited from the Soviet Union. Nevertheless, after the break up of the Soviet Union and the end of the Cold War, the country's defense system has been maintained poorly and it is in degrading condition (9).

Ineffective Post-Soviet Economic Reform

After 1991, analytical studies of experts predicted that Ukraine will be the fastest growing economy of all the new independent states after Soviet's break-up (11). Despite that 90% of those voting in 1991 supported the country's independence; the country was to be faced with much more political and economic obstacles in the near future. The Ukrainian republic has disappointed the expectations of many people for a long period of time following its independence. The trust of Ukrainian citizenry in the political leaders was demolishing while ties with the Russian government still remained strong. The new government officials were incompetent to operate in the new uncertain government and economic framework that the country's independence has given to its new emerging political leaders. Despite that the Ukrainian government set its new born agenda to follow market economy orientated leadership, it failed to set attractive and strong legal framework in the privatization of its state assets.

Hyperinflation

The inflation was most evident in the transition period of the country. In the early 1990s, the Ukrainian privatization was very weak, if existent, and the use of its capital infrastructure led

9 Ukraine Country Commercial Guide FY 2002, Chapter 2: Economic Trends and Outlook

11 Yastreba, Andriy. Personal Interview

to a steep decline in domestic output. The output in 1999 had collapsed to less than 40% of its level in 1991. On the other hand, Ukraine's dependence on Russia for energy supplies and the significant hike in the energy price directed the country to a forceful deficit in its balance of trade, since the value of imports increased following the increase in prices of imports. The political parties' indecisiveness and lack of clear economic reform agenda left the government with a loose monetary policy that was later reflected in a significant hyperinflation in 1993. For example, the government printed without much limits more money and used them to provide numerous loans to revive the old state enterprises. In addition, not until 1996, the government formed its own currency, the Ukrainian hryvna. Therefore, during the transition period it used the Russian ruble that did not isolated the country from inflationary effects transferred from countries in the region. All those led to a significant increase in the money supply that was followed by a hyperinflation. In 1992, consumer prices in Russia raised sixteen fold and producer prices raised twenty fold. Consequently in 1993, consumer prices in CIS increased by 875% in Russia and record setting 4,735% in Ukraine (20). The inflation ruined the bank accounts of the consumers and later led to vast bankruptcies among the banks, because they were not able to repay the money demanded by the terrified consumers who stormed into banks to demand the worthless Ukrainian currency that they had been saving (9).

Lifestyle during the Transition Period

The inflation had tremendous negative effects on the lifestyle of many Ukrainian citizens. Real wages in May 1997 were worth only 26% of the wages during their 1991 levels. This illustrates the magnitude of erosion of the purchasing power of the consumer. Furthermore, during many times the government institutions had several shortages of their budgets delaying the salary payments to the workers. Below are two quotes of Ukrainian teachers who participated in a teacher training forum organized by the National Council on Economic Education. The

9 Ukraine Country Commercial Guide FY 2002, Chapter 2: Economic Trends and Outlook

19 Lopus, Jane. *The Social Studies*.

20 Kaser, Michael. *Finance and Development*.

statements below truly exemplify the difficulties that the average state worker had to struggle with during inflationary period (19).

Natalia T., from Lviv, Ukraine: The elderly people are in a critical condition. The savings of my parents and their friends have devalued. [In Soviet times], my parents deposited 6,000 rubles into a savings bank, which would have bought a car or furniture at that time. My mom trusted the government. Today this money has gone to the wind. It will buy nothing. It doesn't exist.

Galina V., from Odessa, Ukraine: I live with skyrocketing inflation. My real standard of living is low. The buying power of my salary has decreased considerably since independence. To survive, I am forced to combine several jobs. I have very little spare time. Before independence, the rent for my apartment was very low, and now it is very high. Now I have to pay a large percentage of my salary for rent, food, transportation - everyday things. I can't afford long-term purchases like a TV or a refrigerator.

Iren Bozilov who was a college student in Kharkiv revealed that during the economic crisis public universities gave coupons instead of cash to college students that worked on campus. Those were used to buy various essential food products from store, because otherwise in a matter of no time their earnings would have evaporated (1). Nevertheless, things were to be changed for better after a new pro-reform administration was elected following the 1993 economic catastrophe. There were a significant number of new freedoms that many people received that were not evident during other. Below are two excerpts commenting on the positive civil liberties gained during the transition period (19).

Olexander B., from Lutsk, Ukraine: What I appreciate most in this period of transition is an access to information. When we lived behind the Iron Curtain, it was next to impossible to get access to the authors who were needed to me as a teacher. . . and to read about what was happening outside the former Soviet Union. I'm very happy that now, finally, I can read what I want to read, I can talk to the people I want to talk to, I can see what I want to see, and I can go wherever I want to go.

1 Bozilov, Iren. Personal Interview.

19 Lopus, Jane. Life in the transition economies. *The Social Studies*.

Yuri V., from Lviv, Ukraine: The possibilities of making choices have expanded. I can choose my sphere of work and my place in society. This was inconceivable under the planned economy.

Public Dissatisfaction and Mistrust

The majority of the Ukrainian public did not have much trust its legislature and political system as a whole during the transition period. For the period of 1994-1997, the public trust in astrologers was higher than the legislature and the some main political parties (The Rukh, Communists, and Nationalists). In 1993, 12% of public respondents in Central and Eastern Euro barometer surveys reported satisfaction with the overall performance of the country. In 1996, the response rate in the same category has slightly improved to 17.4%. Moreover, in 1993, only 14.85 of the public reported satisfaction with democracy and 11% expressed hope in the future. Only 4.4% reported improvement in the family household finances (21). All of the statistics above clearly show the strong dissatisfaction and turmoil of the average Ukrainian citizen during the communist times.

Recent Economic Developments

It has taken the country a number of years since the economic collapse, equivalent to almost two presidential mandates, until the republic was to establish a more effective pro-reform administration. The table on the next page exhibits some of the key economic factors that illustrate the economic direction of the country since 1998. Nevertheless, other resources and organizations tend to have some higher positive fluctuations in the economic variables compared to the ones listed in the table on the next page. For safety reasons, statistical reports according to the Business Information Systems of the Newly Independent States (BISNIS) were chosen that show one of the more conservative statistical in the table on the next page (10).

10 Vorobyov, Andriy. BISNIS Representative in Ukraine

21 Heenan and Lamontagne. The Russia & Commonwealth of Independent States: p82-3: table 6.2, 6.4

Economy	1998	1999	2000	2001	2002 (est.)
A. GDP (\$ billion)	30.55	30.67	32.56	37.61	39.15
B. GDP Growth Rate	-1.9%	-0.4%	5.8%	9.1%	4.1%
C. GDP Per Capita (\$)	604.1	612.4	656.0	720.6	808.6
D. Inflation	20%	22.0%	25.8%	6.1%	5.5%
E. Unemployment (official)*	3.7%	4.3%	4.2%	3.75%	3.8%
F. International Reserves (\$ billion)	0.680	1.16	1.539	3.095	3.405
G. Average Exchange Rate (1 USD)	2.45	4.13	5.44	5.37	5.38
H. Gross External Debt (\$ billion)	11.45	10.33	8.12	7.98	7.80
I. Industrial Output (% change)	-1.0	4.0	12.4	18.8	6.00

The country has been slowly pulling itself out from the huge deficit that peaked in 1994. Furthermore, after the 1998 financial crisis in Russia, Ukrainian officials became even more conscious of their responsibility and need for a change in the face of a new more effective reform. The political and promising administration increased to a degree the confidence among foreign and local investors. Those are some of the main factors that increased the value of exports and domestic consumer spending through the multiplier effect.

These government actions successfully brought the economy to a growth in its GDP for the first time in the year of 2000 (5.8 % +) since its independence. Nevertheless, the official growth rate of the GDP is expected to slow down in 2002 to 4.1% and consequently industrial output to 6.0% increase compared to 18.8% in 2001 (10). This slowdown is mostly due to the Bush's Administration embargo on the imports of steel. The embargo will significantly hurt Ukraine's level of exports as the USA used to be Ukraine's main export destination partner of the country's popular steel industry (11).

As seen in the table on the previous page, the country's international reserves have been steadily increasing since 1998 and are expected to peak in 2002 at \$3.405 billion. In 2001,

10 Vorobyov, Andriy. BISNIS Representative in Ukraine

11 Yastreba, Andriy. Personal Interview

inflation rates have reached their lowest rate in seven years at 6.1% compared to the country's double digit inflation rates in the few years before. In 2002, inflation rates are estimated to further decrease to 5.5% (10) I believe that one of the reasons for maintaining the low rates of inflation is due to the effective monetary policy that the government has currently exercised that will be discussed further in detail in section under Monetary Policy.

The average exchange rate has been stabilized as well in the range of 5.37-5.44 hryvnya for 1USD since 2000. The stabilization of the exchange rate in the past few years has been reflected with greater industrial output most likely due to the increase of demand among foreign businesses to import from Ukraine (i.e. higher Ukrainian exports) (10).

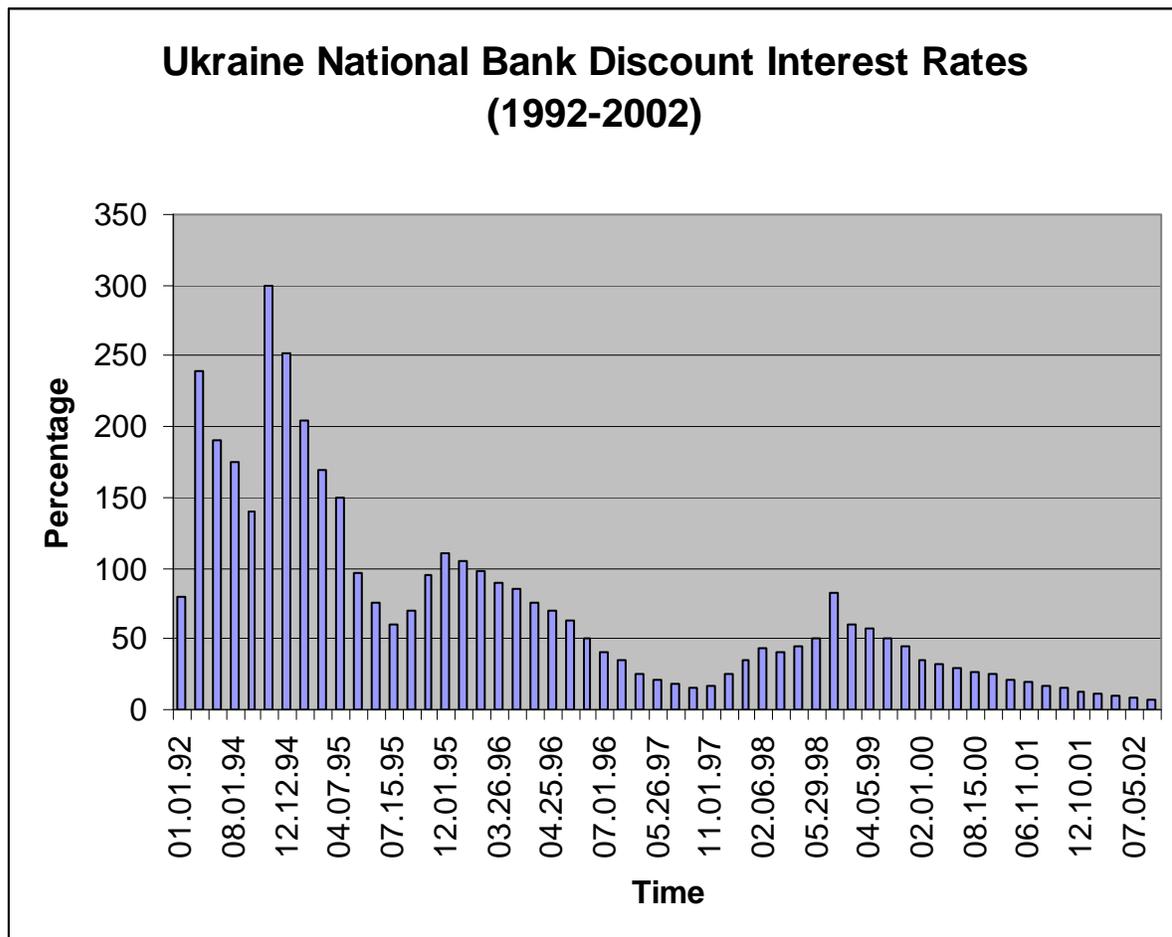
The table on the previous pages also shows that the unemployment rates have been stable and low since 1998 in the range of 3.7% to 4.3% (10%). However, it is important to point out that those are the official unemployment levels. In general, the majority of unemployed people do not necessarily report to the government that they are unemployed, since they do not have any significant benefits to do so or fines, if they do not (11).

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Monetary Policy

Below are the discount interest rates of Ukraine for the period of 1992-2002. The introduction of the Ukrainian constitution in 1996 stabilized the interest rates and correspondingly the money supply. The national bank's activity in its monetary policy was considerable. It intervened 56 times for the 10 year period to adjust the country's interest rates. During the hyperinflation period, interest rates peaked 300% on November 25, 1994 (28).



**Money supply
1991-2001**

UAH million, end of period

Period	M0	Growth rate in %	M1	Growth rate in %	M2	Growth rate in %	M3**	Growth rate in %
1991*	0.3	-	1.7	-	2.4	-	-	-
1992	5	1667	21	1221	25	1050	-	-
1993	128	2560	334	1629	482	1928	-	-
1994	793	620	1860	544	3216	667	-	-
1995	2623	331	4682	252	6846	213	6930	-
1996	4041	154	6315	135	9023	132	9364	135
1997	6132	152	9050	143	12448	138	12541	134
1998	7158	117	10331	114	15432	124	15705	125
1999	9583	134	14094	136	21714	141	22070	141
2000	12799	134	20732	147	31387	145	32084	145
2001	19465	152	29773	144	44997	143	43619	142

Growth rates are estimated up to the previous period, %.

Composition of monetary aggregates:

M0 - currency outside banks;

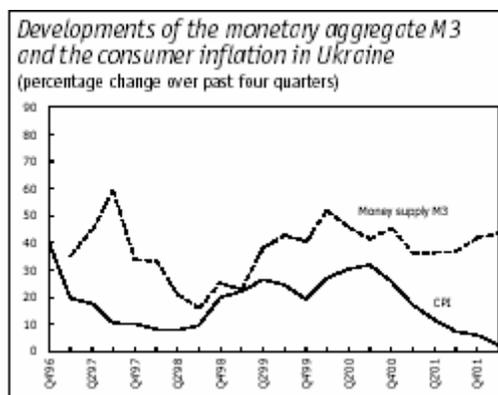
M1 = M0 + funds in current accounts in domestic currency;

M2 = M1 + time deposits in domestic currency, currency funds.

M3 = M2 + clients' funds on trust bank transactions and securities of own liabilities.

While the growth of the M3 is considerably high (42% in 2001), the consumer price levels (inflation of 6.1% in 2001) and growth in output (GDP growth of 9.1%) have been much lower.

The graph on the next page also exhibits the differential in inflation levels and money supply for the period of 1997-2001 (30).



The reason for the trend exhibited in the graph above is mainly due to re-monetization of the currency as well as probable understatement of some of the officially reported inflation and GDP growth levels. Maintaining the official inflation and GDP growth levels at low level compared to the substantially high levels in the money supply can be explained by the following factors:

- Administrative regulation of prices for specific services (especially utility services) have kept inflation levels low while maintaining stable levels of demand
- International prices of basic goods such as fuel have gone down in 2001-2002 period that have slowed down the increase in consumer products in the country
- The stable exchange levels have led to a lower demand of foreign currency and many people have exchanged their foreign money deposits (accumulated during the hyperinflation) into the national currency (i.e. high money supply). There is an evident trend of de-dollarisation of bank credits and deposits. For example during 2001-2, the Ukrainian population sold 188.5 million more US dollars than it purchased (30).
- Official GDP growth levels are understated since many transactions take place in the black market

Developments in the year 2002 are promising as well. Annual discount interest rates have been going down in the year 2002 from 12.5% in January, 2002 to 10.1% in September, 2002. This can be seen in the table on the next page (23).

National Bank of Ukraine 2002 (annual %)

Period	Discount rate established by NBU
January	12.5
February	12.5
March	11.8
from 11.03	11.5
1 quarter	12.3
2nd quarter	10.0
3rd quarter	8.1
9 months	10.1

**The discount rate established by the NBU is calculated as average weighted in case of its changes during a month, the discount rate of the NBU is given for reference.*

Correspondingly to the changes in the discount rates, the total interest rates that private banks charge to borrowers have decreased from 23.0% in January, 2002 to 20.0% in September, 2002 (-3.0%), as seen in the table below. However, interestingly enough the decrease of the interest rates for credits in the domestic currency is far greater than the total credits decrease (6.2% decrease compared to 3.0%). This is mostly due to the increase (+1.1%) of interest for credits in foreign currency that has slowed down the actual total decrease in interest rates (23). Also, in the table on the next page, it can be seen that there is huge spread between the credit and deposit rates of domestic currency compared to the spread of foreign currency (i.e. USD) (24). This shows the divergence of confidence between the Ukrainian currency (UAH) and the stronger and stable US dollar among the general public and investors.

23 National Bank of Ukraine: Interest rates of refunding banks by the NBU 2002

24 National Bank of Ukraine: Interest rates of banks on credits and deposits 2002

Also, the significant spread reflects the lower amount of risk for the banks of borrowing and/or lending foreign currency as compared to the local currency (24).

**Interest rates of Ukrainian banks on credits and deposits
2002 (annual %)**

Period	Total		In domestic currency		In foreign currency	
	Credits	Deposits	Credits	Deposits	Credits	Deposits
January	23.0	9.5	29.7	10.1	10.8	7.4
February	24.3	8.7	29.4	9.2	11.9	6.5
March	22.4	8.2	27.6	8.6	11.9	6.7
April	22.0	7.6	27.1	8.1	12.3	6.1
May	22.1	7.5	26.1	7.8	12.8	6.2
June	21.6	7.8	25.0	8.2	12.9	6.4
July	20.2	7.3	24.9	7.9	11.8	5.8
August	20.5	7.1	24.0	7.6	12.0	5.7
September	20.0	7.0	23.5	7.6	11.9	5.5

Moreover, the decrease in interest rates of Ukrainian banks has lead to a greater demand among borrowers to borrow money from the banks. Therefore, the increase in lending has lead to an increase in the majority of dimensions of money supply (i.e. MO, M1, M2, and M3) through the multiplier effect that can be witnessed in the table on the next page (25).

24 National Bank of Ukraine: Interest rates of banks on credits and deposits 2002

25 National Bank of Ukraine: Money Supply 2002

Money Supply 2002

UAH million, end of period

Period	M0	Growth rates in %	M1	Growth rates %	M2	Growth rates %	M3	Growth rates %
January	18101	(93)	27586	(93)	43070	(96)	43619	(96)
February	18666	103	28416	103	44507	103	45032	103
March	19646	105	30287	107	46793	105	47345	105
April	20980	107	30672	101	47844	102	48389	102
May	20394	(97)	30670	100	48344	101	48813	101
June	21441	105	32494	106	50772	105	51195	105
July	22561	105	34037	105	53393	105	53913	105
August	23568	104	35367	104	55824	105	56294	104
September	23655	100	36504	103	57283	103	57729	103

Growth rates are estimated up to the previous period, %.

Composition of monetary aggregates:

M0 - currency outside banks;

M1 = M0 + funds in current accounts in domestic currency;

M2 = M1 + time deposits in domestic currency and currency savings;

M3 = M2 + client trust funds from banks fiduciary transactions and securities of own liabilities.

The table above shows stable overall growth rates ranging between 1% and 7% of the money supply for the first 9 months of the year 2002 among the various aggregates of interpreting money supply. Only during January and May there was a temporary decrease in the money supply in the range of -%1 to 7% considering all of the monetary aggregates (25).

Considering all of the monetary policy factors discussed so far, it can be said that for the past 9 months the Ukrainian government has effectively managed to control the money supply and keep stable growth rates of its money supply. Therefore, recently the Ukrainian monetary policy has been in an excellent condition.

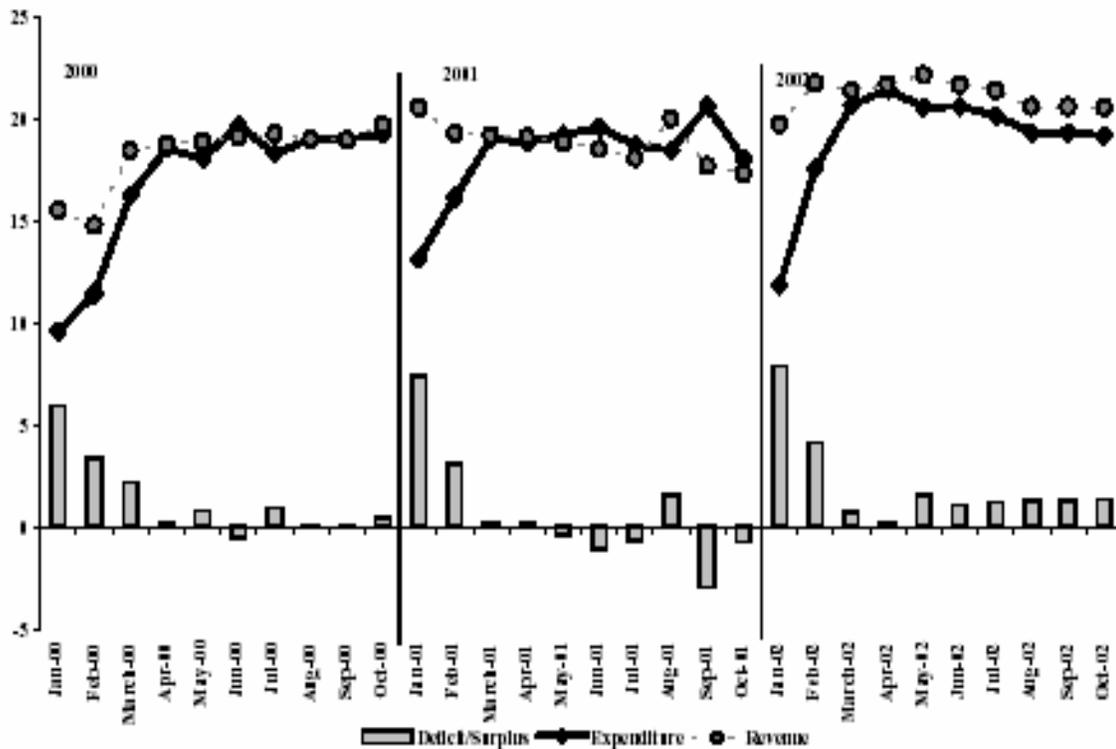
Fiscal Policy

The performance of the fiscal policy for the period between January and October 2002, as shown on the graph below, is in good shape compared to the previous two years (graphs). In 2002, there is a surplus in the state budget as share of the GDP as revenues exceed state expenditures in every single month of that year up until October 2002. This is illustrated by the bars in the third graph below that are all in positive (surplus) direction as well as the revenue dotted line that is above the expenditures solid line in every single month (22). Therefore, the government should have enough excess resources to fund money for any statewide emergency needs of the Ukrainian citizens and the country's infrastructure.

January-October 2002 Budget Execution Report

KEY HIGHLIGHTS OF THE FISCAL SITUATION

Figure 1. Revenues, Expenditures, and Surplus of the State Budget as a Share of GDP (in Percent)



<i>Fiscal Analysis Office Verkhovna Rada Budget Committee</i>		<i>January-October 2002 Report Budget and Fiscal Review November 2002</i>			
Table 7. State Budget Revenues in January-October 2002 and 2001 (in Millions of Hryvnia or Percent)					
	Actual		Change		
	Jan-Oct 2002	Jan-Oct 2001	nominal	nominal percentage	real percentage
Tax revenues	36,434	30,129	6,305	20.9	21.6
VAT	11,083	8,509	2,574	30.3	31.0
Personal income tax	8,595	6,940	1,655	23.8	24.6
Enterprise profit tax	7,256	7,001	255	3.6	4.2
Excise taxes	3,318	2,208	1,110	50.3	51.1
Resource-based taxes	1,987	1,832	154	8.4	9.0
Import duty	1,722	1,429	293	20.5	21.2
Local taxes and fees	451	431	20	4.6	5.2
Non-tax revenues	10,849	9,852	997	10.1	10.7
State Targeted Funds	403	1,015	-612	-60.3	-60.1
Other	1,089	756	333	44.0	44.9
Total revenues	48,774	41,751	7,023	16.8	17.5

Source: State Treasury of Ukraine

The state's budgetary surplus in the previous graph is further supported by the real percentage changes (including inflation) in the breakdown of the total revenues in the table above. There was considerable increase in total revenues (+17.5% - real percentage) between Jan-Oct 2002 and Jan-Oct 2001 mainly contributed to higher tax revenues of value added tax (+31.0%), personal income(+24.6%), and excise taxes (+51.1%) listed in the table above. Furthermore, there was a real 21.2% increase in import duty revenues (22). The increase in import duty revenues is likely to be mainly contributed due to the 28.4% estimated increase (\$15,775m to \$22,046) in the value of total imports in 2002 compared to the year 2001 (see table under Trade Balances) (10).

Several reforms were introduced to lower taxes for opening up and operating new entrepreneurship ventures (11). That can be partially explained by the insignificant increase of real 4.2% in the enterprise profit tax revenues, compared to relevant significant increases of the other tax revenues (22).

Despite of all the above, many Ukrainian economists speculate that the real GDP is in shadow as much as 40 to 50%, meaning that the actual GDP of the country is about 40% to 50%

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higher than the official GDP reported on the economic factors table on the previous pages (11). This is a very significant fluctuation, if the speculation is true. The variance between the official and unofficial GDP is because of the past faulty structure of the fiscal policy that has complicated and ineffective tax system laws that are further explored by Pandi Kondi in the second part of this paper. Simply, many businesses hide their cash revenues by producing undervalued billings to other business partners and customers to lower the taxes that they pay to the Ukrainian government. This tends to under value the official GDP levels that are likely to be in much higher levels than reported, if all business were to report the full amount of their taxable incomes (11).

However, this year's (2002) total increase in tax revenues of real 17.5% may be accounted to a better fiscal policy and collection of taxes from citizens and businesses. Thus, this will downsize the shadow economy (uncollected taxes and lower GDP) of the country that in the past has been speculated to be very high (40-50%) (22).

Trade Balances

TRADE	1998	1999	2000	2001	2002(est.)
A. Total Exports (\$ million)	12,637	11,581	14,572	16,265	22,322
B. Total Imports (\$ million)	14,675	11,846	13,956	15,775	22,046
C. Trade Balance (Ukr) (\$ million)	-2,038	-265	616	490	276
D. U.S. Exports (\$ million)	368	204	725.3	569.2	N/A
E. U.S. Imports (\$ million)	531	518	360.3	457.7	N/A
F. Trade Balance (US) (\$ million)	-163	-314	365	111.5	N/A

Previously reported increase in the domestic output and foreign investor confidence level after 1999 led to a significant increase in exports in 2000 (\$14,572 million) and total surplus of \$616 million in the same year, as seen on the table above. However, there has been a slowdown in the 2001 surplus due to a significant decrease of about 21.5% (down to \$569.2m from \$725.3m in 2000) of Ukrainians exports to the US. Also, Ukraine's imports from the US hiked by 27%

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(\$360.3m to \$457.7m in 2001) further contributing to the decrease of the surplus (10). This was mainly due to an increase in the export duties in the agricultural industry that discouraged the export levels of Ukraine (13).

Foreign Direct Investments

As discussed in the economic conditions analysis section above, foreign direct investments prove to be an essential driving force in determining the economic developments of the country. The Ukrainian State Statistics Committee reported that for the period of 1992 to April 1, 2002 the total value of foreign direct investments into Ukraine is approximately \$4.532 billion. Disbursed over the years, we can see from the table below that the high investments levels in the last several years have made sound contributions to their total value of \$4.532 billion. Also, it can be seen that the investment levels have been increasing since 1999 and are expected to peak at the \$700m level in 2002. Those levels of investments were contributed by a total of 7,794 state and private business organizations.

Total Foreign Direct Investment	1998	1999	2000	2001	2002 (est.)
	\$747m	\$471m	\$ 593m	\$531m	\$700m

The capital city, Kyiv, has been the most attractive international investor's destination with a total of \$1, 209.1m and accordingly the Kyiv region (\$340.8m) and the Donetsk region (\$305.3m) (10). The Donetsk region was the first experimental free economic zone introduced in Ukraine to attract foreign investors that later resulted in its significant foreign investments in that region. Moreover, the foreign direct investment market has responded positively to Ukraine following favorable changes in the country's Law of Investment Activity of 1992 and Foreign Investment Law of 1996. The changes in the fiscal policy eliminated several tax breaks previously assigned to foreign investors as well as tried to balance out more effectively the tax

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load between foreign and domestic investors, increasing the foreign investors market competition with domestic investors.

The U.S.-Ukraine Trade Agreement (1992) reproduced an agreement between the two countries as the Most Favored Nations Status. Consequently, reports of April 1, 2002 show that the US is the leading US source of foreign direct investment in Ukraine with \$763.3m (16.8%); followed by Cyprus \$485m (10.7%); Great Britain \$426.3m (9.4%); Netherlands, \$383.8m (8.5%); and Russia, \$317.7m (7.0%) (10). Ironically enough, many Ukrainian economists speculate that the considerable foreign direct investments of the midget economy of Cyprus are primarily fueled by money laundering of the elite of the Ukraine's government officials who accumulated huge earnings in the chaos of the 1993 Ukrainian economic crisis. Nowadays, those considerable illegal earnings are believed to be added back into the Ukrainian economy through 'foreign' direct investments from some the Ukrainian individuals' funds that for example were deposited in Cyprus banks and/or invested in businesses their at one point of time (11).

As of the April 2002 statistics, the top four sectors for foreign investments are the food industry, \$806.7m (17.8%); domestic wholesale/retail trade, \$675.3m (14.9%); financial services, \$376.2m (8.3%), and machine building, \$344.4m (7.6%).

Some of the major foreign investors in Ukraine that can be potential competitors to MASCO in the construction industry include American Industrial Development Corporation (AIDCO), Best International (USA), Interwindows (USA), OTIS (USA), Western NIS Enterprise Fund, Knauff (Germany), Henkel Bautechnik (Germany), and JOBI (Austria) (10). The internationally competitive business marketplace in the construction and building materials industry is analyzed in further detail in the second part of the paper.

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Conclusions

The country has gone through a very difficult period of transition shifting from a bitter traditional state controlled system to a new fragile market system. The Ukrainian involvement in the CIS has further postponed the disintegration of the Soviet economy, but it was crucial into transforming the dependent planned economies into less dependent market economies. One of the tests that the country had to undergo was the hyperinflation that ruined the purchasing power of the people leaving many into disparity.

It is obvious to me personally that there are still various considerable weaknesses in the political systems that prevented the economy of advancing in the expected rate following Ukrainian's independence. Some of those include the Socialist mindset of the majority of legislators, high corruption levels, and a number of political figures that undermine the market economy orientated goals of President Kuchma. In addition, President's Kuchma murder accusation scandal has added more unrest and weakening of the presidential legislative support and confidence among foreign investors. Nevertheless, there has been considerable involvement between the US and Ukraine in efforts of providing greater opportunities and better economic environment for foreign investors. Also, the shift in the balance of power in the parliament in 2002 might be just enough to create a better cooperation among the executive and legislative branches or lead to another fiasco in the political system that has been going for some time now.

Following a lengthily depression of the Ukrainian economy up until 1998, recent recovery following 1998 has exceeded many of the economists' expectations, putting back the economy back on the road towards growth. Even that foreign direct investment have been increasing over the last couple of years, the growth rate has been far short from the potential and size of the Ukrainian economy. As a result, generally speaking foreign direct investment levels and confidence still remain unstable due to still existing unfavorable gaps in the tax system,

political corruption, and weak corporate legal framework. Despite all the obstacles above, US investors have continued their commitment to Ukraine, which is evident by highest share of foreign direct investment in Ukraine that the US currently maintains compared to other countries. The involvement of the US and other foreign investors in Ukraine has helped them to learn how to operate in the most beneficial economic means in distinctive and currently deficient political and economic systems for international trade.

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