



## IMPROVING REGULATION BY ESTABLISHING PARTNERSHIP BETWEEN GOVERNMENT AND BUSINESS



September 2017

# BRDO INTELLIGENCE

## FACTS, OPINIONS, ANALYTICS



**Oleksii Honcharuk**

Head of BRDO

### MOODY'S UPGRADES UKRAINIAN RANKING. SUDDEN IMPROVEMENT BEFORE DEATH?



Moody's credit rating agency has raised Ukraine's long-term credit rating from Caa3 to Caa2. Additionally, the rating outlook has been improved from «stable» to «positive». The reasons cited are reforms and accumulation of gold and foreign currency reserves. However, the agency's decision will not have any significant effect on the cost of loan funds for Ukraine.

First, the new rating reflects the cumulative effect of structural reforms. The most important reform initiatives include the natural gas market (raising of natural gas rates made it possible to do away with the quasi-fiscal deficit of Naftogaz), state procurement, and taxation (simplification of procedures and introduction of the automated VAT refund).

The agency monitored the cumulative effect of structural reforms in Ukraine for 21 months – the previous rating was published in November 2015. If the reforms continue, this will further improve the state's financial position. In particular, Moody's emphasised the importance of carrying out the pension reform, as it will reduce another quasi-fiscal deficit. If the appropriate initiatives are approved, within a decade the Pension Fund's deficit may be cut in half, amounting to 3% of Ukraine's GDP.

Second, a considerable improvement in the state's external position was taken into account. When the IMF lending programme began to be implemented in early 2015, the gold and foreign currency reserves were less than \$5 bn. The external vulnerability indicator (the ratio of external government debt to reserves) approached 700%. Now the reserves are three times that amount, amounting to \$15 bn, and EVI has decreased to 200-250%. Of course, it is still high, but the situation has improved.

The reserves of the National Bank have risen mostly by virtue of new IMF loans. That is, these funds will have to be repaid by the Ukrainian state at some point in the future.

The prospects for further improving the rating are limited by the fact that in 2019-2021 Ukraine will have to pay back considerable amounts of its external debt. These repayments require more external financing than official creditors like the IMF are expected to provide. The risks also include possible escalation of the conflict in the East of the country and the presidential and parliamentary elections in 2019.

However, even after the current improvement, Moody's rating is two steps behind those from Standard & Poor's and Fitch. At the same time, this higher rating is good news, as investors usually assess the risks based on the lowest of the three leading credit rating agencies' indicators. This positive outlook may also mean a further upgrade in the future, and perhaps, even by two steps. This shouldn't come as a surprise because even more drastic rating actions have been taken by Moody's in the past, in particular, towards Ukraine.

In principle, Ukraine's current situation does not allow the state to have conservative investors like pension funds among the purchasers. To enable this, Ukraine would need to be on a higher investment level (BBB- to Baa3), where it has never been before. Among the CIS countries, only Russia and Kazakhstan have achieved this level in the rating.

Therefore, the Government of Ukraine has a lot of work ahead. For a start, it would be great to get back to the level where Ukraine was in 2005-2008 — BB-/B1 (three steps higher than the current rating). Afterwards, the government should work hard to maintain this rating.

In our estimates, this positive shift in the economy (and the corresponding changes in ratings) is not a case of terminal lucidity. Rather, this is an encouraging change is just the beginning of long-lasting and stable modest growth. A more drastic scenario would require institutional changes that are only beginning to take root in Ukraine.

*More on the topic [here](#).*



**Olena Shulyak**

Construction Sector Head

### IN NEED OF CONCRETE IMPACT: AN OVERVIEW OF THE CEMENT INDUSTRY



For the purposes of policy analysis, cement is not merely a construction product but is also a tool that can be used for measuring the health of the economy. Cement consumption is known to have a significant degree of correlation with GDP and is sometimes used as an alternative economic indicator. This is particularly important for Ukraine, in which any potential and significant GDP growth would increase the interest rate on the Eurobond debt restructured in 2015, thus creating the possibility of future manipulations with statistics (but we admit, this is a rather over-optimistic scenario).

BRDO took a closer look at the Ukrainian cement industry and here is what we learned. Ukraine's raw cement reserves will allow it to cover its cement needs for 320 years. In 2016, 24 enterprises produced 9 mln tons of cement, while the country consumed 9.45 mln tons. According to the UN Economic Commission for Europe, Ukraine ranks second to last in Europe in cement consumption per capita – 222 kg. To compare statistics, in Germany this figure is 342 kg, and even higher in Poland – 489 kg.

The cement market in Ukraine is highly concentrated. Unfortunately, it is this concentration that prevents new technologies of smaller factories and lines (actively developed worldwide to develop the SME segment) from entering the Ukrainian market, especially in the country's regions.

Cement is the leading construction material in Ukraine. Therefore, the 'recuperation' of the cement industry is an extremely important step to promoting growth in construction rates. BRDO's expert analysis of the market revealed a number of problems that require urgent solutions. The main issues include low energy efficiency of operating factories, poor supervision in the market (falsification and counterfeit production), non-compliance of products with European norms, nontariff barriers to export and import, and substantial concentration of the market and low share of small and medium-sized businesses.

BRDO experts have developed several systemic measures to address these problems and have facilitated targeted policy consultations with representatives of businesses and government institutions to discuss the following solutions:

- 1 | Modernise technical regulation in Ukraine through the adoption of the Eurocodes and EU technical regulations;
- 2 | Create conditions for competitive development of small and medium-sized businesses in the cement market through providing support for regional mini-factories and to promote development of the cement market itself;
- 3 | Introduce mechanisms for supporting modernisation of the cement industry in Ukraine by way of launching energy efficiency programmes;
- 4 | Create systemic and effective mechanisms for combating counterfeit production through promoting cooperation between supervisory bodies, manufacturers and distributors;
- 5 | Introduce new technologies and programmes in construction to promote the development of the cement and concrete industry in Ukraine.

*More on the topic [here](#).*



**Oleksii Orzhel**

Energy Sector Head

### THREE STRIKES TO ADDRESS THE ENERGY PARADOX



Many consumers are not willing to make energy-efficient investments even when those investments appear to pay off in the relatively short-term - a problem known well in behavioural economics as the «Energy Paradox» or the «Energy-Efficiency Gap». To address this issue, Ukraine decided to impose new regulatory requirements and provide additional sources of finance. To this end, the Parliament recently adopted three laws aimed at closing the mentioned gap:

«On the Energy Efficiency Fund»

«On Energy Efficiency of Buildings»

«On Commercial Accounting of Heat and Water Supply»

From the outset, BRDO has been a strong supporter of state involvement in the energy efficiency area. But we have mixed feelings regarding the above laws.

To illustrate, establishing an Energy Efficiency Fund is necessary because of the long payback period of energy efficiency projects and the need for cheap investments. With this in mind, the Law of Ukraine «On the Energy Efficiency Fund» was intended to ensure financing of measures aimed at improving energy efficiency. Unfortunately, the Law does not envisage any type of financing for non-residential energy efficiency measures (e.g. SME financing).

The draft law «On Energy Efficiency of Buildings» will help increase the number of buildings with more efficient energy consumption. It is based on EU requirements and thus reflects leading international practices. However, the devil is in details, and we expect a difficult implementation process due to Ukraine's non-transparent and burdensome permit procedures.

Finally, the Law On Commercial Accounting for Thermal Energy and Water Supply also has both positive and negative consequences. On the bright side: the volume of unaccounted consumption of water and heat will be reduced, the accounting market (a market for servicing accounting units and meters) is going to develop actively, consumers will be able to feel the consequences of consumption reduction and they will no longer pay for housing and communal services. But those results will come at a price: the Law contradicts the provisions of the Law on Metrology currently in force and Ukraine's international obligations. Due to a lack of funding, it is likely that meters will first be installed in apartment buildings, and then in stand-alone residences. A time delay is expected - accounting will be implemented gradually, based on the financial capabilities of consumers. Consumers will be financially burdened - without the consumer's financial input proper accounting will not be established.

In any case, in terms of energy efficiency, there is a strong sentiment that we're on the right track. Moving step by step, Ukraine will achieve an entirely new level of energy efficiency.



**Igor Lavrynenko**

Analysis Head

### PUBLIC PRIVATE DIALOGUE. WHO CARES?



It goes without saying that public dialogue is important for any more or less important policy decision. But does this statement reflect the reality? Is there any benefit from meeting stakeholders? Some meetings have no effect at all, because presentations supply no new information. Sometimes presenters speak in vague and general terms and for that reason offer nothing new. Sometimes presenters offer arguments that are significant but that are already well known within the government, because officials have raised the arguments on their own. ... such meetings do not have any impact on actual decisions. Do you think this quote is about Ukraine? If so, you are wrong; this is Cass Sunstein's quote on the US. Do you think the situation is similar in Ukraine? If so, you are wrong again. Ukraine hardly attempts any sort of public policy consultations and so the results are inconclusive.

Only 47% of the Ukrainian ministries and agencies are capable of organizing and maintaining a public dialogue on policy initiatives.

BRDO has recently presented the «Capacity for Dialogue» ranking of Ukrainian ministries and agencies. The ranking system analysed how central government bodies comply with the requirements on openness and accessibility of information in their regulatory activities. The study concluded that, on average, these requirements are fulfilled by only 47% of state institutions.

According to the «Capacity for Dialogue» study, the Ministry of Regional Development, Building and Housing leads the ranking with a score of 55 out of a maximum 58, and the State Audit Service follows with a score of 49. The State Space Agency of Ukraine (23), the Ministry of Youth and Sport (24), and the Ministry of Justice (26) rank the lowest.

Many agencies approach complying with the openness and accessibility of information requirements in a regular way. Ministries rarely inform the general public about their plans and amend regulatory acts retrospectively. Some institutions simply do not regard their regulatory acts as regulatory. The situation is complicated by the lack of interaction between policy-making bodies and bodies charged with implementing policy decision.

Stakeholders from among the business and the general public are often provided with contacts to which they can send their policy-related proposals and suggestions, they rarely communicate amongst themselves, and they are often unaware of the reasons for the rejection of their proposals.

The openness of ministries was assessed using four markers:

- Are the actions of a government institution predictable? In other words, is the institutions capable of planning its regulatory activities in advance and informing society about the rules that it seeks to change?
- Is a government institution capable of attracting and taking into account stakeholder proposals during the development and approval of regulatory acts?
- Is a government institution capable of informing society about its regulatory activities?
- Is a government institution capable of assessing the effectiveness of existing regulation?

*More on the topic [here](#).*

# IMPROVING REGULATION IN UKRAINE

BRDO is an independent think tank. Our mission is to promote effective regulation and economic freedoms in Ukraine with a focus on small and medium sized enterprises as important drivers of growth.

BRDO is supported by a growing number of partners and donors, including the European Union's EU4Business Program (FORBIZ project) implemented by GFA Consulting Group, GIZ International Services, and Berlin Economics GmbH, the Embassy of the Kingdom of the Netherlands (MATRA program), EDGE - Expert Deployment for Governance & Growth Project (Agriteam Consulting/Global Affairs Canada), and the World Bank.