

Executive Summary

1. This country impact review covers IFC's assistance to Ukraine in fiscal year (FY) 1993–2006. During that time, the International Finance Corporation's (IFC's) Ukraine strategy was largely shaped and constrained by the country's challenging business climate. Given the length and depth of Ukraine's recession in the 1990s and inconsistent political momentum for reform, the country remained relatively unattractive to private investors for much of the period. To improve the business environment, IFC engaged in an extensive program of advisory operations as the first component and continuing mainstay of its involvement. As Ukraine's urgent transition priorities were being addressed, the focus of IFC's advisory operations shifted from privatization to a host of tasks designed to improve the enabling environment.

2. In the 14 years of its engagement in Ukraine, IFC mobilized \$55 million in donor funding for 45 advisory operations.¹ Ukraine accounted for 36 percent of total advisory funding for the Private Enterprise Partnership for Eastern Europe and Central Asia (PEP-ECA) in FY 1993–2005; this was second only to the Russian Federation with 42 percent. By leveraging donor-funding for advisory operations, IFC gained an early foothold in Ukraine and maintained visibility throughout the period.

3. IFC's strategic focus on advisory operations was appropriate given the country conditions. At the same time, significant efforts were also made to promote IFC investment in FY 1994–97; however, the increase in investment activity that was expected to follow IFC's advisory efforts did not materialize until conditions had sufficiently improved in FY 2004–05. Recent investment climate improvements call for a more targeted and long-term strategy, especially for investment operations.

4. Ratings for IFC advisory operations and IFC investment operations in Ukraine are better than aggregate evaluated advisory and investment operation ratings in other ECA countries and, for investment operations, better than the aggregate for the rest of IFC. For advisory operations, IFC achieved strong and sustainable results in the majority of the projects implemented. This is especially true for larger and longer advisory assignments using the comprehensive framework eventually adopted by the PEP facility, although firm-level projects had mixed results. Evaluated investment projects performed slightly better than those in the rest of the ECA region as well as than other IFC projects, although the findings are not statistically significant. Meanwhile, an analysis of the risk profiles of recent investment commitments yields encouraging indications of likely future performance for these projects.

Background

5. Ukraine's transition was complicated by a lack of political consensus and entrenched opposition to reform. Although Ukrainian authorities reiterated their support for market liberalization and private enterprise throughout the period, their actual commitment to reform, privatization, and transparency wavered. Compared with the rest of ECA, particularly Central and Eastern European countries, Ukraine was slow to start its privatization and reach a significant proportion of private sector ownership, largely due to political pressures. For the same reasons, privatization of large-scale enterprises and most utilities is not yet complete. Legal and regulatory deficiencies and other issues related to regulatory enforcement, such as the high cost of doing business and perceived high degree of corruption, further contributed to an overall unfavorable investor perception of Ukraine.

6. Inconsistent commitment to instituting the legal and regulatory underpinnings of economic reform and the delayed privatization process were among the main reasons why Ukraine lagged behind its ECA and Commonwealth of Independent States (CIS) peers in terms of the length and extent of the economic recession in the mid-1990s.² Most CIS countries experienced a contraction of gross domestic product (GDP) at the time, but Ukraine was particularly affected, both in the degree of contraction—its 1999 GDP was 42 percent below its 1993 level in constant dollar terms, which was the biggest drop in ECA—and in the low extent of recovery. At present, Ukraine is the only ECA country besides Moldova whose 2005 GDP is below its 1993 level in constant dollar terms: down 11 percent compared with a regional average, excluding Ukraine, of up 70 percent and a CIS average, excluding Ukraine, of up 50 percent. The business environment deficiencies and associated negative perceptions, coupled with economic contraction, translated into very low foreign direct investment (FDI) inflows throughout 1993–2004. Ukraine’s average 1993–2004 FDI/GDP ratio stood at 1.5 percent, compared with an ECA average, excluding Ukraine, of 4.0 percent, whereas its average annual 1993–2004 FDI per capita equaled \$14, compared with an ECA annual average, excluding Ukraine, of \$126.

IFC Strategy

7. IFC’s Ukraine strategy set out to focus on advisory operations intended to (a) establish Ukraine’s private sector within a transition from a centralized planned economy dominated by public enterprises, (b) alleviate business climate constraints through legal and regulatory reform, and (c) foster investment opportunities. Large-scale privatization projects were initially to help accomplish this by creating a critical mass of small and medium enterprises (SMEs) that could serve as the engine of private sector growth and become attractive investment targets for private sponsors (defined by IFC as local investors). Meanwhile, it was expected that IFC would follow its advisory work with investment operations as opportunities arose, a recurring expectation that proved unrealistic throughout much of the period. Although the latter expectation regarding investment activity was optimistic, IFC’s overall Ukraine strategy was appropriate given country conditions.

8. In the past few years, Ukraine’s business climate has undergone notable improvements, including greater macroeconomic stability and a more cohesive legal and regulatory framework. The effect of structural and regulatory reforms, starting from 1998, became evident after 2000 with the resumption of GDP growth, which has since been sustained. Some of the improvements are at least partly attributable to the impact of IFC advisory operations. For example, the SME Survey and Policy Development Project facilitated simplified taxation for SMEs and registration reform; whereas International Bank for Reconstruction and Development (IBRD) operations enabled others (notably, sound macroeconomic policies). In addition to business climate improvement, positive international perception of the 2004–05 “Orange Revolution” was an important driver behind the increase from \$1.7 billion to an estimated \$7.8 billion in FDI inflows in 2005, compared with 2004.

9. Despite Ukraine’s continuing political uncertainty, more proactive strategies for both investment and advisory operations would be advantageous. IFC’s early strategies were somewhat reflexive, because the difficult conditions made upcoming developments and investment opportunities hard to anticipate. Going forward, a longer-term and more targeted approach than before may be required to identify investment opportunities systematically in areas of high impact, country competitive advantage, and unmet demand.

The Scale of IFC Operations

10. Contrary to early strategy expectations and as discussed in subsequent country assistance strategies (CASs), IFC investment commitment volumes were negligible in FY 1994–98. These volumes only increased significantly starting in FY 2004, closely following the improvement in Ukraine’s business climate and in parallel with the decrease in intensity of advisory operations. In part, this was

determined by IFC's initially cautious approach to investment operations, due to the difficulty of finding reputable private sector sponsors. The constraints were countered later by IFC's increased promotion efforts and by political developments in 2004–05. At the same time, IFC contributed to the increase in private sector business opportunities by helping improve the investment climate through its advisory assignments.

11. Due to the rapid growth of recent commitments, Ukraine currently accounts for 5 percent (\$571 million) of IFC's total ECA commitments for FY 1994–2006 and, as of the end of FY 2006, Ukraine comprised IFC's ninth largest country portfolio worldwide. On balance, even though IFC's involvement in the country throughout the period could have been more substantial, the Corporation was operating in an environment that was crowded with suppliers. The scale of its investment and advisory operations, significant relative to IFC's activity in the region, was relatively small, compared with the activities of the European Bank for Reconstruction and Development (EBRD) and various other donors in Ukraine.

Performance of Evaluated Operations

12. The results of Ukraine advisory operations are strong under all performance indicators; thus, overall development effectiveness received a rating of satisfactory or better in 68 percent of projects, and overall IFC work quality a rating of satisfactory or better in 76 percent of projects. The sound performance of PEP and pre-PEP programmatic projects drove aggregate results, despite the poorer performance of smaller assignments related to individual investment transactions. In particular, PEP and programmatic pre-PEP advisory projects in Ukraine outperformed evaluated peers in other ECA countries; 79 percent of such projects received ratings of satisfactory or better for development effectiveness, compared with 59 percent for evaluated PEP operations in the rest of ECA. In dollar terms, however, the weaker strategic relevance, impact, and efficiency of a single large project lowered these results. The outcomes and impacts of most programmatic privatization assignments, such as small-scale and mass privatization, are significant on a country-wide scale. At the same time, smaller assignments were only viable when they addressed a specific need and/or request of an otherwise committed and proactive client, and the majority failed to generate sustainable outcomes and impacts: only 43 percent of advisory operations related to specific transactions received ratings of satisfactory or better for development effectiveness.

13. The main success factors for evaluated advisory operations were project strategic relevance and timeliness, a comprehensive multidirectional project framework coupled with large funding volumes and longer duration, and adherence to a multigenerational project approach. Conversely, among the main performance limitations are lack of government/client commitment, strategic fit, and donor cohesion and coordination. For recent projects, staff recruitment and retention have emerged as recurring hurdles in project design.

14. Development and investment outcome success rates for evaluated Ukraine operations are better than, but broadly similar to, those for the rest of ECA and IFC. Because only a small number of operations in Ukraine have attained operating maturity, which enables full evaluation, extensive analysis of evaluation ratings within the Ukraine portfolio is impossible and findings from comparisons with the rest of ECA and IFC are not statistically significant. That said, the aggregate development and investment outcome success rates of the evaluated Ukraine operations indicate performance trends in line with the performance of evaluated projects in the rest of the ECA region and the rest of IFC approved in FY 1994–2001. The relatively poorer performance of financial markets projects is partly due to timing and instrument mix, but leaves room for improvement in executing IFC's investment project appraisal and structuring work and maximizing IFC's special contribution in that sector. Although the majority of projects in IFC's Ukraine portfolio have not reached operating maturity, risk profile analysis yields a positive indication of likely future performance.

IFC-IBRD Cooperation

15. IFC coordinated a number of activities in Ukraine (predominantly advisory) with IBRD, but the extent of the cooperation was relatively limited. Going forward, stronger cooperation between the two institutions is advisable for addressing Ukraine's remaining privatization challenges. A continued need exists for investments in Ukrainian infrastructure and municipal utilities, both still dominated by public-sector enterprises, where joint IBRD-IFC work may deliver the best results. Progress in the sector can be made through IBRD and IFC coordination between IBRD and IFC to ensure the support of privatization at the policy level (while avoiding conflict of interest) to be followed by post-privatization IFC investments with sponsors committed to good governance. Other possibilities may include the promotion of public-private partnerships and finance of municipal utility projects in Ukraine using loans and/or partial credit guarantees. The joint IBRD-IFC Subnational Finance Department may be of valuable assistance in the latter effort, pending endorsement of IFC local currency financing mechanisms by the National Bank of Ukraine.

Recommendations

16. Based on study findings, the Independent Evaluation Group (IEG) recommends that IFC do the following:

- Focus its strategies on medium-term (a three- to five-year horizon) priorities and follow a more systematic approach to identifying investment opportunities.
- Coordinate with IBRD to ensure that both institutions work sequentially and/or in parallel (as circumstances may require) to address remaining privatization challenges among larger companies, as well as in infrastructure and municipal utilities.
- Replicate the strong design of its successful large advisory projects, promote greater donor coordination and cohesion in its areas of engagement, and exploit synergy models between programmatic advisory and investment operations.