



Frishberg & Partners Roundtable

“Doing Business in Ukraine in 2010”

In collaboration with U.S.-Ukraine Business Council and
The Embassy of Ukraine in Washington, D.C.

June 10, 2010

Hennadii Nadolenko: Good afternoon, my name is Hennadii Nadolenko, and I would like to welcome all of you here at the Embassy of Ukraine to our Roundtable "Doing Business in Ukraine in 2010".

This is the series of roundtables and workshops which we will be putting together with the U.S.-Ukraine Business Council and the President of U.S.-Ukraine Business Council (USUBC), Morgan Williams. Again, I welcome all of you to this



Hennadii Nadolenko, former Charge d'Affaires of the Ukrainian Embassy in Washington, D.C. (currently serving as the Ambassador to Israel)

roundtable; we have such a good group of distinguished attendees. I am confident that you will hear lots of interesting aspects about doing business in Ukraine. So, Morgan, I would like to pass the word to you.

Morgan Williams: Thank you very much, Hennadii. I am the Director, Government Affairs, Washington Office for the SigmaBleyzer Private Equity Investment Management Group. I serve as President of the U.S.-Ukraine Business Council (USUBC). SigmaBleyzer is one of the largest private equity management companies in Ukraine and manages approximately \$1 billion in assets with most of the private equity investments in Ukraine.

The U.S.-Ukraine Business Council (USUBC) appreciates the opportunity to cooperate with the Embassy of Ukraine on functions like this. Hennadii's been here for in his second tour, what we call a "re-tread", for the Embassy of Ukraine here in Washington. He is the head of the Trade and Economic Mission, and it's been a great pleasure for us to be able to work with Hennadii. It's been an excellent partnership and one that has been very productive.

As you know, right now Ukraine does not have an Ambassador to the United States. We had a nice departing party for the last Ambassador, Oleh Shamshur, recently. He's back in Kyiv, and there are rumors that the new ambassador has been chosen, but there has been no official announcement about that. The rumor is that the present Ambassador of Ukraine to Poland, I guess he's now been dismissed, so the previous Ambassador to Poland will be the new Ambassador here in Washington. I presume he's simply waiting. All of you former Ambassadors know about that process, but we expect that maybe he'll be announced before long; maybe by the end of month and the first of next month he'll be here.

Again, thank you very much for coming. We were very fortunate recently to have the Frishberg & Partners law firm become a new member of the business council. Frishberg & Partners has been active in Ukraine since 1991. Alex is one of those guys that we accuse of getting on an airplane the day after [Ukrainian] independence. He flew to Ukraine and stayed there along with a few other long-time Americans, who've been out there in Ukraine. Alex has been on the ground ever since, and he's seen-it-all so to speak. He has seen companies arrive who have done very well, and he's seen companies that came to Ukraine and made just about every mistake you can make in the book. He's had to handle all kinds of matters in Ukraine related to the development of business.

Most of us think the last 5 years have been a major bright spot in Ukraine regarding the development of business, and we think probably the next 5 years are bright spots because there are factors that will keep the business community. The more investors, the more jobs, the more income, the more wealth creation capacity that we have – that will drive Ukraine forward. And very unfortunately, we had the major set back when the economic tsunami rolled out of the United States and then rolled around the world, and hit Ukraine extremely hard. Ukraine, of course, has been expanding; people have been borrowing money and they've been going to the international markets for money. They've been taking risks and doing the kinds of things that an emerging democracy and an emerging economy should be doing, but of course they got hit hard by the tsunami and it still has severe consequences for Ukraine.

But people and businesses are adjusting and they are finding ways to survive and grow. If you've read the list of new stories that USUBC put out this morning, you'll find that at least 500 million new dollars have been invested in agribusiness in Ukraine in the last month. We expect

probably another 500 million, or maybe even a billion, will be invested in agribusiness in Ukraine over the rest of this year... [applause]. This is good, so thank you and let's have everyone give a hand for that because it is good news. [more applause].

We have Steve Johnston here from the Overseas Private Investment Corporation (OPIC), and they're open for Ukraine now. We have our friend Brian Sant Angelo who says he's going to get the US ExIm Bank open again for Ukraine this year. They have kind of forgotten about Ukraine for a couple of years, and you know how those guys are, but we're going to get them open again this year. EBRD has made probably their No. 1 commitment, besides working with the government, to support agribusiness. There is also IFC and other private equity investment companies. So USUBC takes a very broad approach and we say that our No. 1 job is to promote Ukraine as a place to do business.

The No. 2 job, of course, is to keep the US government deeply involved in Ukraine and to support business, as it is the same with the Ukrainian government, whose task is to keep all the international financial institutions there, and keep Ukraine moving forward. Ukraine's has to increase its wealth creation capacity, has to create more jobs, there has produce more income and Ukraine can't do these things by itself. To me, democracy and all the kinds of things we want for Ukraine will largely depend upon the success of the business community to keep the place open for business and to keep it growing.

Alex Frishberg met with me in Ukraine and said that he wants to continue working to help businesses grow and survive there - to do the right things and to help businesses avoid falling in the same holes/traps businesses have fallen into in the past. And Frishberg & Partners has created a new team of investment consultants, most of which is here today; and this new team was created in order to work with companies that want to go to Ukraine to invest and do business and take advantage of all of the expertise that's available so that they can hit the ground running and do it the right way.

If you know the legal system of Ukraine, the laws haven't changed very much, but business is doing much better mostly because businesses got smarter, and lawyers got smarter and figured out how to make it work out there. We got rid of all those joint ventures, and all those Americans in monogram shirts that went out there and thought that things were going to be like

it is here. They thought they could fly in from New York once a month and invest there and make a lot of money. That didn't work and the graveyard of Ukraine is full of joint ventures that didn't work. Some people made a lot of stupid mistakes out there, and a lot of them were self-inflicted - it wasn't just the environment in Ukraine. There are hundreds and thousands of companies in Ukraine doing very well and making adequate returns.

With 43 million people Ukraine is not going anywhere. Almost every apartment, as you may know, needs to be modernized, most street needs to be rebuilt, and every highway needs to be improved. The whole place is an economic development miracle waiting to happen.

So, please let me introduce the head of the law firm who, again, went out to Ukraine in the early days and now has foresight to put this new consulting team together to help attract business to Ukraine. Alex Frishberg is an attorney. He went to Washington University School of Law, and the University of Missouri in St. Louis. He has co-authored a many articles and, of course, he's had a book out about doing business in Ukraine and he's been active in Ukraine since October of 1991. He's very well-known, very experienced, and that's why we like the fact of having him as a member of USUBC. He is going to help Ukraine move forward in the future. So, Alex, I turn it over to you, and, again, thank you for recommending that we do this workshop. Thank you for being out front on saying that Ukraine is a great place to do business. Let's figure out how to do it smartly and properly. Let's move Ukraine forward, as well as make money for these private investors. Alex, it is all yours. Please give Alex a round of applause.

Alex Frishberg: Thank you very much, Morgan, and thanks to the US-Ukraine Business Council and the Ukrainian Embassy for giving us an opportunity to be here. I believe it's going to be an interesting discussion because the people sitting here, the four of us, we've been doing business in Ukraine for the last 20 years - pretty much every day, day in and day out.

I'll quickly introduce who is on the panel here, and then I'll go into a brief presentation. Everybody knows Anders Aslund – he's arguably the foremost expert in the world on the economy on Ukraine and Russia. He has written quite a lot, advised leaders of those nations, and knows everything from the inside-out, including the latest rumors. Since Anders is so knowledgeable, it will be fascinating to hear his opinion on Ukraine's economy and politics under the new Presidential administration.



Alex Frishberg delivers his presentation

We are also fortunate to have in our consulting group the first US Ambassador to Ukraine, Ambassador Roman Popadiuk, who was in Ukraine at the very inception. It just so happens that at that time Ambassador Popadiuk was also my boss – he asked me to register the American Chamber of Commerce and a few other projects.

And last, but not least, we have the principal member of our group, Mr. Alexander Paskhaver. Mr. Paskhaver's name in Ukraine is like Henry Kissinger's to the rest of the world because he was an adviser to all of the Presidents – President Kravchuk, President Kuchma for both terms, and President Yushchenko. Mr. Paskhaver was always an adviser to the government, largely because of his wisdom, philosophy and knowledge of economics. In Ukraine, you'll see his picture plastered everywhere, in newspapers, magazines and on TV. To get a sense of Mr. Paskhaver's breadth of knowledge you can simply look up his last interview on the Internet.

I just flew in from Kiev a couple of days ago and I brought for you recent literature, which you will find in the back of the room. You'll see a few local magazines that you probably wouldn't find in America – like "What's On" and "Business Ukraine" - and some publications that my firm has printed. For instance, we have a brochure "Getting Started in Ukraine", which may be of interest to new investors. We also wrote this rather thick and equally boring legal reference

guide called “Doing Business in Ukraine”. This is the 5th edition, and it’s more than 650 pages. This book has everything you need to know; probably even more. As a result, it’s so boring that you could use it as a sedative, but it is equally useful. If you would like to have a copy, I brought a few extra volumes with me from Kiev.

And now, I’d like to briefly summarize what happened to me over the last 20 years. As you may remember, in August of 1991 there was a coup in the Soviet Union. At that time I used to work in DC for a big law firm called Hogan & Hartson. I saw the break-up as a unique opportunity, so I said to the firm: “Why don’t you guys open up an office in Kiev, because this is where business is going to be?” They replied, “no, we don’t think this logjam in the Soviet Union is ever going to break,” so I quit my job and bought a one-way airplane ticket. That’s how I ended up in Kiev in October of 1991.

Back then Kiev was still very much Soviet Union, dark after hours, with no restaurants, no infrastructure at all - and no corporate lawyers. For quite a long while I was the only foreign lawyer who spoke English in the entire nation of Ukraine. I don’t care what anybody else says; monopoly is a wonderful thing and, as a business owner, I really miss those early years. Unfortunately, lawyers have significant competition these days, but at that time I pretty much had a stronghold on the country for foreign clients and businesses for three or four years. Everybody had to go through my law firm simply because there was nobody else.

As a result, we became lawyers for nearly all Embassies, including American, Canadian, British, Netherlands, Austrian, Norwegian, Swedish, Swiss, Finnish, among others. At the tender age of 27 or 28, I was the lawyer for Westinghouse, Digital, KLM Royal Dutch Airlines, Alcatel CIT, Rhone Poulenc, Electricite de France, Gas de France, Philips, ING, Commertzbank – you name the company, and chances are we’ve done legal work for them. This gave me a great degree of solid legal and practical experience, because my firm had to do everything for these well-known clients from “A” to “Z”.

Naturally, we have encountered all kinds of barriers to entry on the behalf of our clients since 1991, and our job these days is the same: to overcome any barriers as quickly and efficiently as possible. To put it another way, our job is to assist businesses to enter Ukrainian market in a smooth fashion. It was not always a smooth sailing. I can still remember the early years, 1992-

1993, when racketeers started their rounds. For those of you who have never met them, racketeers are the people who would come at the end of the month and collect money, whether you had it or not. Usually they were athletes, and they would be an intimidating bunch. Actually, I had people come to kill me two times, but fortunately President Kuchma came to power and saved me, along with other businessmen. During his first and second terms Kuchma was a very strong President. He pushed through a lot of economic reforms that people forget about these days. One of the many good things he did was to remove all of the racketeers. Like many other business owners, I was very grateful...

For those of you who are interested in this topic, I can go into the history of Ukrainian crime later, but suffice it to say that Ukraine currently has no organized crime. Note that Russia still has organized crime, working parallel to the government, but Ukraine doesn't – maybe we have some street-level hooliganism at most, but all of the organized crime and thieves-in-law were either exiled or killed by the police.

In comparison to Yushenko, Kuchma ran a very strong government, where businesses depended upon the administration. As a result, to push your project through, to be successful, you needed consultants at that time. Now, consultants – I think that in DC you call them lobbyists - are people who work on your behalf when you are not there to make sure that your project comes to fruition. In 1992 I was lucky to meet Mr. Paskhaver, the gentleman sitting on my left. We immediately started to work together on various privatization projects, both small and large scale. At that time, Mr. Paskhaver co-authored much of the privatization legislation and he was also an advisor for the State Property Fund, which all investors had to deal with in cases of joint ventures with state-owned enterprises. And we have been assisting foreign clients ever since.

What, exactly, did we do? In addition to the basic legal work, like due diligence, document production, negotiations and registrations, we also had to make sure that our clients' projects remain alive. For example, one of our clients, whose name I cannot mention, went to a little town called Kakhovka to do a joint venture with a state-owned enterprise. The head of the regional State Property Fund down there said, in so many words, "get the hell out of here. We are not giving you anything". So the investor hired us, and the first thing I did was to ask Mr. Paskhaver's advice about what to do in this situation. As a result, he placed a phone call on behalf of the State Property Fund in his capacity as an advisor, and asked the regional chief one

simple question: “are you refusing foreign investment?” The chief did the smart thing and said “bring them over, we are not refusing anything, we are ready to negotiate”.

When we started our negotiations, they put up another road block. Incidentally, these road blocks happen all the time. This time, the regional State Property Fund appointed their so-called “independent property valuator,” a person who appraises state-owned property. The valuation is necessary to negotiate the parties’ percentages in the joint venture – how much each of the parties to the joint venture will contribute – and in case of in-kind contributions the valuation is performed only by licensed property valuers.

As we expected, the “independent” appraiser’s value was extremely overblown, so we forwarded the inflated valuation to Mr. Paskhaver’s organization for their review. In addition to being a first-class economist who co-authored the privatization legislation, at the time Mr. Paskhaver’s organization also granted licenses to property valuers. They looked at everything and said, “this is an inflated value that must be corrected.” Then a phone call was made to the valuator with a recommendation that he resign from this project and, in return, he will keep his license. Of course, if the valuator refused, then he knew that there was a threat of the revocation of his license. As a consequence, the valuator left because he was smart. We replaced him with our own valuator, who did everything legally, by the book.

One of the mistakes the “independent” appraiser made was valuing all the objects of social infrastructure on the factory’s premises, including the elevator shafts, balconies, the main cafeteria, roads, etc. By law, social infrastructure objects are not valued. By applying strict letter of the law, and a little lobbying, we were able to provide our client with a smooth market entry in an initially hostile business environment, plus we saved the client millions of dollars in the process. As you can see, at that time, services of experienced consultants were rather valuable.

And then came Victor Yushchenko. After the Orange Revolution in 2004, and his dioxin incident, Yushchenko ran a very schizophrenic government, where he would engage in public battles with the far more cunning and photogenic Prime Minister Yulia Tymoshenko. As a result, the government was paralyzed by inner fighting and lost all



control over business activities. In fact, one could say that there was no government at all for six years. And that's partially the reason why business prospered so much – because government was not a part of the equation. At that time, unlike the Kuchma years, consultants were not necessary. You would just go to a lawyer, who would write for you whatever documents you wanted and the deal was done.

It was a golden time, when all law firms in Kiev were busy with M&A work and real estate projects. Most acquisitions involved a Cypriot parent company, which allowed the owners to sell their off-shore company to any third party investor instead of selling the actual building or factory in Ukraine. Like everyone else, we were creating various companies, performing due diligence, negotiating and signing sale-purchase agreements and subsequently transfer the property ownership into new owners' name. It was your standard, everyday work. Then came the “perfect storm”: global economic crisis and Ukrainian Presidential elections.

The global economic crisis killed everything that investors and lawyers have come to take for granted – it killed M&A, it killed real estate transactions. And the Ukrainian Presidential elections “triple-killed” investment. Nobody wanted to invest into Ukraine without knowing who will be the new President: Yanukovich or Tymoshenko? Lo and behold, Victor Yanukovich came to power and, like many predicted, he is turning out to be a strong President in sharp

contrast to Yushenko. He has quickly rebuilt the government. In fact, there's no opposition in the government anymore. The Parliament is his, the Cabinet of Ministers is his, and Yulia Timoshenko is out. There is a concern about Yanukovich becoming too friendly with Russia, but that could also be viewed as a sign of stability.

A strong government, at least to me, doesn't just mean stability. In practical terms, it also means that there will be a need for consultants once again. That's why we decided to put together an investment consulting group, which would open doors for investors who might have problems otherwise getting in. And our law firm would ensure that all agreements and registrations are in place. This is basically where we are right now.

With reference to the state of Ukraine's economy, I would keep in mind that there is the official economy, and then there's the real economy, known as the "shadow economy," which in my estimate is between 60-70% of the total economy. Judging Ukraine purely by its official macro-economic indicators would give anyone an erroneous conclusion about its state of economy. Anders will tell you much more, and so will the rest of the panel, but in my opinion the Ukrainian economy is bottoming out. And slowly but surely it's going to go back up. This is happening now, and in six months it will be better. In two more years, Ukrainian business environment will be even better. Unfortunately foreign investors don't see that just yet because, for some reason, they concentrate on the politics and the role of Russia in Ukraine's welfare. Actually, business in Ukraine is ongoing and some stay that it's still pretty good.

One of the businesses going brilliantly is agriculture, which is not surprising in light of Ukraine's status as "the breadbasket of Europe." Despite the existence of a moratorium on farm land sales, there are different ways of getting into agriculture. You can rent fields from farmers, combine them into huge tracks of land and then either run it yourself or sell it off to the next investor. In many cases the consultants now are doing this. Some are going to run the farming operations themselves and not sell it off. That is why they are actively investing into the infrastructure on the land, too. They are buying buildings and everything possible so that their competitors will never want to come onto their territory. Other companies are in it for the short haul. They basically lease land, lease the silos, lease the tractors, collect the grain, sell it off, but these investors are in the business just to sell their operations to somebody else, they are not actually

investing lots of money themselves. Still, 500 million dollars in a short term is actually a pretty good indication of how business is going on.

To conclude, right now is great time for foreigners to invest in Ukraine. Everything is a distress sale. Ukraine does not have many new investors coming in and, therefore, everything is half-off. That means 40% to 50% off buildings, factories and things like that. So if anybody was to come in within the next year, that would be a great time to enter the market. However, this information simply does not reach the West because Ukraine somehow always manages to get bad press.

With all this in mind, I wanted to conclude by saying that in addition to being one of the oldest foreign-owned law firms in Ukraine, we have also put together a consulting group that specializes in market entry services. It will be very useful for foreigner investors to know that our group exists, especially when a strong government came to power. Thank you for your attention, and at this stage I'll turn over the floor to Mr. Anders Aslund, who will talk about Ukrainian economics, politics, and business environment.

Morgan Williams: Alex, thank you very much. About two months ago I ran into Anders Aslund in Kyiv and he told me they were going to have a big presentation and press conference. I'm just a farm boy from a small village out in Kansas. When I was growing up in Kansas they asked if I needed some language skills and I said that English was enough for me. Why would I want any language skills? Anders told me that they were going to announce this big study about what Ukraine could do. Alexander Paskhaver was there as well. I went to this presentation where Alexander only speaks Ukrainian, but Anders speaks in a mixture of Russian and Swedish! I thought to myself – what is this small kid from Kansas doing here? I didn't understand what was going on, so I just clapped when everyone else clapped.

Anders has been working on Ukrainian economics since 1991. He's also written books and writes a many very provocative articles. It is always very interesting to hear him. Anders, since everyone knows you and we are glad that you are still staying involved in Ukraine and you are still writing articles, please talk to us about doing business in Ukraine in 2010 and, specifically, the environment in which we do business in Ukraine.



Anders Aslund: I was last in Kiev two weeks ago. What we have seen, since Yanukovich took over, is a sharp difference. What has been established, as Alex pointed out, is about consolidation of power. Previously, the problem was political gridlock. What we are seeing now is rather political steamrolling. I'll leave the political aspect aside and see what this means for the economy.

I think that what we have seen to begin with has been quite an extraordinary fast action. Yanokovich, soon after his inauguration, appointed a new government – everyone was very quickly appointed. Also, the mid-level people have been appointed at an extraordinary speed. The first big deal was to get gas or a base deal with Russia, essentially capping the gas price enough to make it possible to get a decent budget. Only a few days after this the budget was adopted. We officially have a budget deficit of 5.3% of GDP. The IMF basically demands 6% maximum budget deficit.

On June 2nd President Yanukovich presented a substantial reform program. It is a bit over 80 pages and it is still quite similar to the Commission on Ukrainian Economic Reform that

Alexander Paskhaver and I co-chaired. Some of the proposals of that Commission are there, but some are not. This can be expected, but it is clearly a step forward. But, what has gone wrong?

There have essentially been no IMF negotiations. The IMF cooperation was interrupted last autumn for essentially one reason: the opposition in Parliament, which managed to mobilize a majority, adopted a law on social standards. This meant that the minimum wages and various social expenditures connected therewith would increase substantially, which would cost 2.5% of GDP. As long as the government was unable to block this, the IMF was not prepared to prolong cooperation. Obviously, the government could not pass through a decent budget last year because it did not have a vote for it. Therefore, the government preferred not to adopt a budget. So, this budget law that was passed is for this year.

The problem now is that there have not been any concrete IMF negotiations, and all of the members of the government have said so. Therefore, last week, President Yanukovich called the managing director of the IMF, Dominique Strauss-Kahn, and asked for him to send out an IMF mission for talks. They had talks yesterday, and today it was announced that there will be a mission to Ukraine on June 11. This only means that sound conversation can start. Before that there was nothing to discuss from the IMF's point of view, but this does not mean that an agreement is around the corner as some people seem to suggest.

What are the problems as far as the IMF is concerned? The first problem is that the budget deficit is not acceptable to the IMF. There are essentially two problems here. One is that the law on social standards, which Yanukovich pushed through in Parliament last year, was adopted from the beginning of January of this year. This added 2.5% of GDP to the budget deficit. The other is that no energy prices are as yet clearly set, and no energy reform is clearly on the way. Therefore, the IMF sets the budget deficit at 9% of GDP. Some people argue that it is even higher. Energy reform has been essential for the IMF and the European Union and, for that matter, for the World Bank. The Ukrainian government basically needs to come to terms on these two issues in order to go forward with the IMF. **[Note: Since this workshop, the IMF and Ukraine have agreed to a \$14.9 billion dollar loan arrangement].**

Instead, the government is trying to do quite a few other things. It has talked a lot about a law on state procurement, which is necessary. Ukraine currently has no law on state procurement.

Their old law was bad and it was subsequently cancelled. So, there is no law on state procurement, which is completely unacceptable. The World Bank has worked with the government on this issue and there is a good draft law. The question is if it will be adopted soon.

Something that the new government has talked about is to adopt a new tax code within a month or so. There is a draft tax code that is considered decent, but I don't know all of the details. I think this is something sensible that should be done. Another issue is that the government is trying to adopt a package of laws on de-regulation. This also makes perfect sense and should be done.

Privatization is, of course, of interest because this is a government buy-in launch of big eastern businessmen, and they want privatization. The question is how it will be carried out.

A positive surprise has been that the government is talking about legalizing private sales of agricultural land. This is vital for the development of Ukrainian agriculture, which Morgan is so rightly interested in. With privatization of agricultural land you can have mortgages. Otherwise, you can't have effective foreclosure if you can't transfer agricultural land. So, there is something at least on the table. The question is how much will this actually be done because this is what is being talked about. This is what we really should look forward to.

In my view, I think that an agreement with the IMF is vital because Ukraine does not have funding for budget deficit of 9% of GDP. Right now treasury bills are being sold on the domestic market at interest rates of 11-13% per annum, which is far too expensive. An IMF loan, by comparison, is slightly over 3% per annum. So, not to try and get an IMF agreement is, in this situation, expensive wastage.

Instead, it was today announced, typically coming out via "Ukraininskaya Pravda" on the web, that Ukraine has got a 2 billion dollar loan from the Russian bank "VTB" for half a year at an interest rate of 6.7% per annum, which is quite good for Ukraine – it is about half the market interest rate for treasury bonds. According to "Ukraininskaya Pravda" the conditions for this loan have, until recently, been secret. This, of course, raises certain questions. Thank you.



Morgan Williams: Anders knows that one of the first major microeconomic issues which we took on with the Ukrainian government was about VAT refund. Ukraine takes 20% VAT on all products exported. About a year and a half ago they started keeping all of this money without refunding VAT to exporters. It got to be a major crisis by the time this new government took over. The VAT system in Ukraine has been broken for a long time. They use it as a way to subsidize agriculture, so Cargill pays farmers for grain, which includes a 20% VAT payment that the farmer doesn't have to pay it all back to the government because it is part of the subsidy. So every time there is a bushel of grain

sold for export the government owes a debt. It is a terrible system which needs to be fixed. If you double the production, then the debt doubles. In most countries, if you double the production, then the subsidies don't double. So, there is a legislative problem and the system is badly broken. This VAT system goes up and down, but now it is estimated that the Ukrainian government owes exporters 3 billion US dollars.

When you owe Cargill and other such companies over 100 million dollars the problem gets up to the CEO, the CEO flies into Washington. USUBC member grain companies are owed between 400 and 500 million dollars in VAT. One of our newest members is the largest steel company in the world, ArcelorMittal, and they are now owed 300 million dollars from the Ukrainian government in back VAT refunds. They export 80% of their product and they pay 25 million dollars into this black hole every month and are not getting anything back. They'd like to reinvest most of those funds and they need that money for working capital, so we have engaged in some significant discussions with the new government and told them this was a critical factor in Ukraine moving forward.

Ukraine just announced a new economic plan last week that aims on getting Ukraine within 5 to 10 years into the top 25-30 economies of the world. We don't disagree with that, so I went in to

see the Minister of Finance a couple of weeks ago and he indicated he wanted to be around for 10 years and wanted to get Ukraine into the top 25. I said, “Fine, but you need to start paying the world’s top companies, who have hundreds of millions they can invest in Ukraine, the VAT refunds owed to such companies. This would be a good way to start.”

The Ukrainian government needs to take a long-term view, but, unfortunately, the Minister of Finance and the other related institutions are mostly number crunchers, working on critical issues today, and they came up with this VAT bond system. They say that they will pay of these VAT refunds in bonds and, with no discussions with the private sector, he said they will issue 5-year bonds. But, no one really wants Ukrainian 5-year bonds, and they said the interest rate would be 5.5%. Anders just told us that people aren’t buying Ukraine bonds at 5.5%. So, this program was announced and it is locked-in. They basically said “take it or leave it – you only have one choice – take these bonds”. We know that the VAT bonds will sell at a discount, and the discount will probably be 20-25%. So, if you are owed 100 million, you are going to turn around and sell the bonds on the market for cash and take a really big hit.

So, the second part of the question is what they will do in the future. Will they put in a normal cycle, fix the legislation, and start paying VAT back? The pain of taking a 20-25% hit on your VAT refunds could be reduced if they say in the future that if you do a normal turnaround you will be paid cash - cash in - cash out. The government says this privately, but publicly they have not said that this is actually what they are going to do – that they will allocate the money to fix the system. This is a big impediment to the present structure. That’s one issue we have been working on. At least 5.5% bonds are better than nothing, but it still leaves a bad taste for some of the largest investors in the world. And, again, they haven’t said outright that they will fix the problem in the future and do it right.

We’ve been talking with the IMF and trying to put pressure on the government to admit that they have made major mistakes in the past and that they will fix it up in the future. This would go a long way in meeting some of the goals that the government just announced.

Anders Aslund: Let me add a bit more, please. This is obviously an issue that the IMF is deeply upset about and not in the least because of the U.S.-Ukraine Business Council’s persistent criticism on this point. Of course, you are right in what you are saying.

But there is an additional aspect. If these VAT bonds would come out, there would be so many domestic Ukrainian bonds that it will kill the treasury bond market, and it would become impossible to finance anything more domestically.

Morgan Williams: The people at the Ministry of Economy state that they are not worried about these bonds paying 15 or 20%. The question is how are they going to do that. They think that they could issue such bonds, for example, to Cargill and Cargill can sell them for a 30% discount, and the next guy will buy them and make 20% on them on the secondary market. Isn't that great? It is strange how they think.

The IMF is concerned about this issue and they don't normally get involved with individual companies – they usually deal with sector issues. But, this is a budget issue – you can't maintain a sustainable and realistic budget if you are funding a large portion of the budget by not returning VAT. So, it is actually the EBRD, IMF, World Bank and the IFC, all together, that have told Ukraine that it needs to fix its VAT refund system.



Morgan Williams introduces Ambassador Popadiuk

We will now move on to Ambassador Roman Popadiuk. Roman was the first ambassador of the United States to Ukraine. With his Ukrainian heritage, he has stayed very much involved and now he is in charge of someone's presidential library down in Texas. You will know who this President is because he was in office when Ukraine first became independent [George Herbert Walker Bush]. We appreciate the fact that Roman has stayed involved in Ukrainian issues and business issues. He is a part of this new team and we are very happy to have him here. Mr. Ambassador, the floor is yours.

Roman Popadiuk: Good afternoon, everyone. Morgan, thank you very much for that kind introduction. I would like to thank the Embassy of Ukraine as well as recognize Alex and Morgan for their hospitality and kindness in getting this forum together.



Morgan mentioned that I worked for President George Bush, number 41, during 1989-1993. During that time Ukraine became an independent nation, so I had an opportunity to witness the debates, the policy formulations as well as the discussions leading to Ukrainian independence.

As the first US Ambassador to Ukraine, I had the unique opportunity of seeing that nation get on its feet and start moving forward toward the future.

I'm very optimistic about Ukraine – probably a lot more optimistic than a lot of the news analysis over the last few weeks and months, particularly in the wake of the election of President Yanukovich.

As a colonial country under the rule of the Soviet communist system, Ukraine was used to following orders and not doing things on its own. It has been very difficult to break that mindset and get Ukraine into a position where it, as an independent country, can move forward. So, basically, what I'm trying to emphasize here is that Ukraine is not experiencing something abnormal. It is not off the radar as a country that is uniquely corrupt or unorganized. It is strong in some points, but weak in others. It is a country that is going through the normal birth pangs of trying to establish its own identity, culture and bureaucratic infrastructure.

Having experienced a lot of discussions with the early leadership of Ukraine, I witnessed the up and down, choppy-waters syndrome that Ukraine is still going through. Having seen that I'm a little more optimistic about Ukraine.

I'd like to turn my comments now to the current administration in Ukraine, the Yanukovich administration. We've heard a lot of talk that President Yanukovich is taking Ukraine back to Russia and that this is the end of Ukrainian democracy and possibly the end of Ukraine. However, there are two things when it comes to business: business risk and political risk. The businessmen in the audience fully understand business risk. If you sell widgets and you establish a company and nobody buys your widgets, you can accept that – it is tough luck. In comparison to your competitors, you may have produced a bad widget or you didn't market it properly.

But, if you manufacture widgets and you show up in country "X" and get nationalized or taxed to death or pressured politically, that is unacceptable. Businessmen can live with business risk, but they cannot live with political risk. They always want the political risk outlined for them. I think that one of the biggest factors that Ukraine has, in addition to the monetary issues that Anders so aptly summarized, is the need to stabilize. That is the need to stabilize politically and take the political risk out of the equation for foreign business opportunities as well as for Ukrainian domestic business.

The political risk needs to be taken out on two levels – on the international level and on the domestic level. I will outline briefly what I mean by this. On the international level I'm obviously talking about the Ukrainian-Russian relationship. President Yanukovich has received a lot of criticism and continues to do so regarding his moving Ukraine too close to Russia. I'm not taking sides on whether he is moving too close to Russia or not close enough to Russia – I'm looking at it in terms of the political risk for the stabilization of Ukraine. I think that Yanukovich fully realizes that you must have a stable relationship with Russia in order to attract foreign investment for Ukraine to grow its economy.

There were three major international issues which Ukraine faced when Yanukovich took office and of which there has been heavy press coverage in the West. One was NATO; the other one is energy; and third one was the Black Sea fleet. I will examine each of them very briefly.

NATO was a big issue under the Yuschenko government. The United States was pro-NATO for Ukraine and we support NATO membership for Ukraine. The Yuschenko government was very ardent in seeking NATO membership for Ukraine. You all know the history of the Bucharest summit and the other meetings of NATO, so there is no need to go over that. Suffice it is to say that there was a large division in the Ukrainian community about NATO membership. A lot of Ukrainian citizens did not understand what NATO is about and did not support NATO membership. At the same time, there were a lot of stumbling blocks for Ukraine to face in terms of NATO membership. These came mostly from Western European countries, such as Germany and France, who did not feel that Ukraine was at a point that it could pass the threshold for NATO membership. So, there was a lot of political opposition in the West as well as a lot of indecision on the part of the Ukrainian polity in terms of what NATO membership would mean or whether Ukraine should proceed with NATO membership. Of course, Russia always opposed Ukraine's NATO membership and there was always pressure from the Russians for the Ukrainians to not opt for NATO membership.

By taking the issue of NATO membership for the foreseeable future off the table, Yanukovich removed a big irritant out of the relationship between Ukraine and Russia. It helped stabilize that relationship a little, but it does not mean that Ukraine will never be a member of NATO nor does it mean that Ukraine is giving up its hopes on NATO membership. It also does not mean that Ukraine will come under the dominance of Russia. It just means that Ukraine is being

realistic about its chances for NATO membership. So, why keep this irritant in the relationship with Russia, which just doesn't help matters.

The second and third issues are energy and the Black Sea fleet. They are actually connected. With respect to the Black Sea fleet issue, the original agreement between the two countries was supposed to expire in 2017. Yanukovich went ahead and extended the agreement for 25 years within days after his administration came into office. The fleet in itself, is not a threat to Ukrainian independence. As a matter of fact, I think that the idea of forcing it out was probably more of a threat to Ukraine because it gave a pretext for the Russians to keep pressuring Ukraine. The extension of the fleet agreement takes another irritant out of the relationship with Russia because the Russians will have no pretext for pressuring Ukraine. I think this was probably a good move on the part of Yanukovich, as there was not going to be a threat to Ukrainian independence, but it could have been an irritant in the relationship between the two countries. The only issue I have with Yanukovich is that he probably did this a little too quickly - doing it right after his election was probably not a good public relations move for both the Ukrainian polity and the West.

As regards energy, energy is extremely important for Ukraine and Ukraine is very dependent on Russia for its energy needs. Gas in particular – I think Ukraine imports about 80% of its gas, mainly from Russia because Russia is both a source and a transit route, and of course, it is subsidized gas. Ukraine has to maintain a good relationship with Russia in order to keep that pipeline going. The Black Sea fleet agreement was, basically, an exchange for the energy. We can debate whether this was a good move or a bad move or whether the prices will go up or go down – that's open for discussion. The main point is that I see this as an attempt to stabilize the relationship between Ukraine and Russia, and also to stabilize the gas market in Ukraine for the short-term.

In the long term, Ukraine will need to tackle the energy challenge. For example, Ukraine is probably one of the most energy inefficient countries in the world. Ukraine needs to become more energy efficient, and so there are things it can do to become less dependent on Russia. Ukraine also needs to increase its access to technology in terms of exploiting its oil and gas reserves in its own country.

I have outlined the international aspects of the political risk equation. Internally, Ukraine will have to take out a lot of the political risk in doing business in Ukraine. I can name three things off the top of my head – number one is the legal structure. Ukraine has plenty of laws, but the problem is that the laws are not enforced.

It is one thing to have the legal mechanism on the books and to talk about legal rules and procedures, but it is another thing to enforce them. It is open to question to see how much the new Yanukovich regime will be able to enforce the legal mechanisms in order to stabilize the political environment for doing business in Ukraine.

A second thing is that there is a bureaucracy in Ukraine. The bureaucracy is still peppered, to a great extent, with a lot of people, who are of the old mentality – initiative is not rewarded and decision-making is taken at your own risk. As a result, you have a situation where it takes a very long time for a decision to be made. This is not conducive to doing business.

It takes a very long time when dealing with the bureaucracy, especially when there is a regime change. The Soviet mentality, the fear of taking initiative, and fear of retribution amongst bureaucrats – all lead to a “go slow” and “don’t take a risk” approach.

The third thing that the Yanukovich administration will need to tackle is something that everyone has been tackling since day one, and that is corruption. I don’t think that I need to elaborate on that. There is a lot of corruption in Ukraine. This is something that has been a detriment to doing business in Ukraine.

These are the three things that Yanukovich will need to do to undertake stabilization of the domestic environment for doing business. Am I optimistic? Yes, I’m optimistic for a number of reasons. Number one – I think a generational change is taking place in Ukraine. You look around in terms of the new people coming forward – and, yes, I know there are a lot of holdovers; the more the government has changed the more the same people are on the top – but, slowly but surely those changes are going to take place on a generational basis. The young people have a different outlook from the people that have been in authority since the early 90s.

A key point is the oligarchs themselves. The oligarchs are probably more pro-West than a lot of people realize. At the same time, they are more favorable towards having a functioning legal

structure. To put it bluntly, the oligarchs have made their money and now they want a legal system that protects them. They, therefore, are in favor of rules and procedures that will work. At the same time, the oligarchs' interests are not to go under the Russian fold. Their interests are to maintain ties towards the West and to also maintain a strong economic base in Ukraine because that is where their wealth and their future will be. They fully realize that if they get melded into a Russian-type of economic system, then that wealth will be threatened by the superiority of the Russian holdings. The oligarchs are very, very careful, and I think that the oligarchs, to a great extent, will be looking westward. This will be one of the things that will be interesting to observe as Yanukovich moves forward.

Having said all that, I'd just like to go back to my days as Ambassador in the early 90s. One of the rumors going around was that Ukraine was a country that was going to last 5 years. Skeptics viewed Ukrainian independence as just a fantasy play on the Ukrainian's part and that it would come back under the Russian fold much as it did after the Bolshevik Revolution. Twenty years later – Ukraine is still an independent country. This goes back to my earlier comment – it is choppy waters, but Ukraine will survive and it will stabilize.

I'd like to emphasize something that Alex said in his opening comment – Ukraine will grow economically. I'm not an economist, and Anders can correct me on this, but I think that while we may have not hit bottom in Ukraine, that we are close to the bottom. Therefore, the only way to go is up at this stage of the game. Foreign support and foreign investment is going to be extremely important for Ukraine. The problem is that Ukraine hasn't been able to attract much of that foreign investment for the two political reasons I mentioned – international political stability and the domestic political stability of the environment for doing business in Ukraine. The United States is very key to this – I'd love to see the United States give more support to Ukraine, politically as well as economically, and support Ukraine in its relationship with Russia. This is a whole different question.

My feeling is that Ukraine, as a country of 46 million people and a country that is rich in resources, both human and natural resources, is in a good position, if it could stabilize itself politically and grow its economy, to be a regional power. Ukraine is big enough and borders seven countries, which is a strategic location, and borders the Black Sea. Ukraine can be the balance between East and West. I can see Ukraine, twenty or thirty years from now, not needing

NATO and not needing an eastern bloc. Ukraine can be an actor in its own right. I think it is big enough and strong enough that it can move in this direction and accomplish this over the next decade or two. Everything will obviously depend on how the government approaches the problems that I just mentioned to you. It will also depend on whether Ukraine is able to attract foreign investment.

At this stage of the game, I think Ukraine may be on the right road and hopefully will continue on that road. At the same time it is important not to sacrifice anything in terms of democratic rights or personal freedoms. These are also things that need to be strengthened in order for Ukraine to grow and develop into a viable state in the future. Thank you.



Morgan Williams introduces the founding partner of Paskhaver Group, Mr. Alexander Paskhaver

Morgan Williams: Thank you very much, Ambassador. Those were very interesting, very provocative and very insightful remarks from the Ambassador.

Let's move on now to Alexander Paskhaver, and then we will open up the forum to questions, dialogue, debates and discussion.

Alexander thank you very much for coming. We appreciate you taking Mr. Aslund under your wing and teaching him everything he knows. We also appreciate you keeping him on the straight and narrow. Anders claims that everything he knows you taught to him. We're glad to have Anders's teacher here, and welcome to the program.

Anders Aslund [in Russian]: But he didn't teach me Swedish!



Alexander Paskhaver: I would like to follow up on the presentation that Mr. Ambassador just made. Ukraine is developing like any other developing country, and we are putting in place a new government. However, countries develop in different ways. They have different historical backgrounds, which cause them to develop in different ways. I also had the pleasure in the last twenty years of working with all levels of power in the Ukrainian government, including all of the Ukrainian presidents. I have observed the entire dynamics of the process as the country has developed.

There was research done back in 1995 about different freedoms within different nations around the world. In essence this is a characteristic of the economic investment climate. Given the parameters of the research, I would say that Ukraine is worse off than all of its neighbors which, just like Ukraine, began their lives as independent governments twenty years ago. It is worse than Belarus; worse than Russia; worse than Kazakhstan; and worse than Moldova. This should make us very cautious.

There are certain constants that have shown us over the last twenty years why Ukraine is going the way it is going. We don't have government elite and we don't have experience in having government elite. Many say that our government is corrupt. But it is not just our government that is corrupt it is our entire society that is corrupt; The average Ukrainian looks at corruption as a forgivable sin which you can live with. It is traditional for Ukrainians to disrespect the law as well as private ownership rights. This is not a negative characteristic; this is a consequence of living for 300 years in foreign states. Finally, and this directly relates to foreign investors, the government leaders in the upper levels are actually business owners – they are businessmen who have ended up in high level government jobs. Their politics may be briefly characterized with a popular saying in our language: “We need investment, but we do not need investors”. What was said earlier today illustrates precisely that point.

If you look at concrete manifestations and different variations of the investment climate during the tenure of different presidents, then you will not see wide variations against the background of constants of a bad investment climate. I honestly can't say that the investment climate has gotten better over the past twenty years. If one takes the indicator of economic freedoms about which I previously stated, I can say that during the 10-year term of President Kuchma that indicator continuously improved. This is the result of Mr. Kuchma presidency, and whatever was said in the past, right now in Ukraine no one talks about this positive aspect of Mr. Kuchma's presidency.

The next five years belonged to the presidency of Mr. Yuschenko. We observed a paradox, an external paradox: we witnessed a time when political freedoms improved, but against that background the investment climate worsened. This is quite difficult to explain because the government was run in a highly unqualified manner under the rules of bureaucracy. Moreover, the vertical power chain of the state, which was created by President Kuchma, was destroyed

under Mr. Yushenko, and the corruption burden in this connection increased along with the corruption risks.

Currently, of course, we do not have enough data to predict how everything will be under President Yanukovich. I would like to say, in agreement with what was said earlier, that, undoubtedly, he was able to create a new vertical power chain with a lightning speed. However, we should not forget that this vertical power chain does not completely mean effective governance because this vertical power chain was created within a corrupt society.

Is it possible to change the above constants that I spoke about? We know that it is possible. This is not a question that we can pose today to the newly-created government in spite of the fact that we hear from this government about the many good things they have already done. We do have the experience of the President of the Republic of Georgia who, according to the same indicator of economic freedom, was able over several years to develop his country and quickly improve economic freedom. This led to an investment boom in Georgia.

In order to understand whether Mr. Yanukovich can do the same thing, one needs to analyze what his administration is doing. I am participating a bit in this process which was announced by Mr. Yanukovich – the process of preparing important reforms. In fact, I should say that extensive reforms were carried out in Ukraine already between 1995 and 2000. However, after this period the government became very silent as to reform.

President Yanukovich is currently stating that he will continue this process. I really hope that this is the case. If so, then we will be able to talk about some other characteristics of the investment climate. But based on my experience, I can say that reforms of such degree can't take place in a bureaucratic regime. In other words, it won't work if the President orders the Prime Minister to undertake reforms, and the Prime Minister instructs the Minister of the ministry, subject to reform, and the Minister passes on such orders and instructions down the line to finally reach a government bureaucrat, who is completely disinterested in the reforms.

There are a few simple signs as to whether reforms may be carried out or not. I can list them. Special financing is necessary. If there is no special financing and the reforms are attempted under a general procedure, then such reforms will not be successful. There needs to be a special structure which is not dependent upon the Ministries that will be reformed. If this structure is not

in place, then there will be no reform. Finally, there needs to be personal liability of some political figure. If not, there will be no reform.

I have yet to see these signs within our power structure. I hope to see them in the future, but as of now they are non-existent. I say that I very much hope to see these signs because it is obvious that our government simply cannot withstand the situation that it is in right now. The government doesn't have enough money to support the present level of social protection, the present level of pension protection or the present level of socially low prices. Therefore, the facts which I just listed to you do not yet confirm any optimistic expectations.

Finally, I would like to touch upon the issue of stability. Stability is absolutely necessary, and this is quite obvious. The government officials, which were in power during the presidency of Mr. Yuschenko, did not reach stability – and this is also obvious. There is a stability factor in the fact that Mr. Yanukovich was able to quickly create a strong vertical chain of administration.

However, there are two “buts”. If we compare the vertical chain of power during the Kuchma era and during the Yanukovich era, then we see that there was no conflict between Western and Eastern Ukraine during the Kuchma era. The policy of President Kuchma resulted in the situation where actual and fundamental mentality conflicts between the western and eastern parts of Ukraine were insignificant for our society.

The sociological surveys, which were conducted during the Kuchma era and recorded, for example, reveal that such conflicts as the language conflict were insignificant during the Kuchma era. The public placed such conflicts very low on the totem pole in terms of priority problems to be resolved. This was Kuchma's policy, but it is not the policy of President Yanukovich. Therefore, I have some doubts as to how stable the situation is right now.

As to the second “but”, it is connected with the securing stability by way of strengthening ties with Russia. Any country, like Ukraine, which is the weak party, must have some strong ally – some power toward which it may become closer. In this regard, it is undoubtedly important that there are no conflicts between Ukraine and Russia. However, the policy of Russia, which it keeps completely out in the open and is set forth in strategic documents, is to transfer the most strategic assets of the former countries of the Soviet Union into its ownership.

What does this mean in terms of stability? From the point of view of the foreign investor, very little will change and this honestly may result in stability. At that time, when a foreign investor becomes interested in some object or asset in Ukraine, such foreign investor will simply need to coordinate its activity not only with Kiev, but also with Moscow.

However, from the point of view of a Ukrainian citizen or even the Ukrainian government, some level of independence will be lost. Therefore, we must look at this issue not only from the point of view of the foreign investor, but from the point of view of the existence of a country like Ukraine. I don't believe that the Yanukovich administration will take this avenue "to the very end". Since President Yanukovich is the representative of a few large groups of Ukrainian business owners, he therefore cannot go further than the interests of such business owners. In this regard, the interests of an independent Ukraine and the interests of such prominent business owners significantly coincide.

In conclusion, I can say that there are very, very interesting times ahead. From my part, I am observing the current situation by, for example, working with the State Property Fund, and I can see increased interest of foreign investors towards strategic objects. I can say that Ukraine will soon resume privatization efforts. As you may recall, Ukraine undertook privatization during the tenure of President Kuchma. The connection is simple – if there is a vertical chain of power, then there will be privatization. If a vertical chain of power is absent, then privatization will not occur. In this regard, I believe that the government of Yanukovich will provide a new opportunity for foreign investment regardless of those political aspects about which we have spoken earlier today. Thank you.



Question and answer session begins

Morgan Williams: We are pleased to open up the forum for questions. I'd like to hear some dialogue, discussion and debate. We have Ambassador Keith Smith with us, who is a regional energy expert for Eastern Europe and Eurasia. What questions would be of interest to you?

Ambassador Keith Smith: Well, I didn't expect you to ask me, but I was a little bit surprised that the most optimistic people on Ukraine and the Yanukovich government happen to be the foreigners. The most skeptical happen to be the Ukrainians. I found this very interesting and I have some questions about the Yanukovich government. Yes, they can form a government very quickly because they basically put the same people there who were there a few years ago. These are the same people who squeezed out the foreign investors in the energy sector. Messrs. Azarov and Boyko passed Decree No. 33, which in fact made it almost impossible for some of the countries to operate. I don't see any real change in the energy sector – in fact I think it will become a more difficult market.

Yes, the oligarchs don't want Russia to come in and take all of their assets. I also think a lot of the oligarchs want to look to the West, but they don't want competition inside Ukraine by Western investors.

On the energy side, one of the biggest financial backers in the new government is a guy that deals very closely with most non-transparent side of Russian energy companies. Quite frankly, I think that having this man in a very powerful position in the energy sector and in the government makes me more pessimistic about a foreigner's chance in the energy sector. Maybe agriculture is doing well, but I certainly would not recommend an investor to go to Ukraine and invest in the energy sector.

Answer – Ambassador Popadiuk: I do agree with everything you said, but with one caveat. In terms of the oligarchs, you said that they don't want competition and the energy sector is a good example of that. However, I would caution you about one thing. In order for Ukraine to achieve energy independence and in order to attenuate the controls of Russia, Ukraine will need to develop the energy sector. That energy sector is going to need foreign investment - both for infrastructure and advanced technology – in order to make use of the existing gas and oil fields and get maximum output from those areas and to do new exploration.

There is a potentially large energy pool in the Black Sea and Ukraine knows it has to explore that pool. Ukraine is not able to develop that by itself because it does not have the technology. Ukraine will need a foreign investor – and the foreign investor in this case will not be Russia, it will be either an American or other Western investor. Thus, the reality of these challenges are going to have to be faced by the oligarchs. The reality of the situation is that both energy needs and the infrastructure needs will force the Ukrainian government to reach some kind of compromise to lessen oligarchic control. It can be a joint venture or some other kind of mechanism, but they will be forced to open up the energy sector.

So, I agree with everything you said, but I disagree a bit in terms of the future for the energy sector in Ukraine.

Anders Aslund: Well, I would basically agree with Keith and, as I've said, we don't see anything positive on the energy side apart from feed the GazProm from Russia. This is, of course, what the EU and the IMF will check very closely upon. So far, there has been no start in

the energy sector – there is no sign of energy reform. I think that there must be reform of the gas transit system and there must be an adjustment of energy prices. The latter might be coming, as there is some movement in that direction. There also needs to be more transparent and appropriate governance in the energy sector; otherwise, it will be quite difficult for any foreign investors to enter the market. Of course, Ambassador Popadiuk is also right that it will happen, but the question is: when?

Alexander Paskhaver: I'm very glad that Mr. Ambassador articulated an opinion that is very close to mine. I can also share my concern about how this will work, whether it be Ukrainian, Russian or foreign. Right now they are forming a union of atomic energy – the ownership percentage of Russia in such entity will be greater than that of Ukraine. This is obvious because Russia has a larger volume of atomic energy. Whose interests do you think will be considered when they plan this in the future? This is what worries me.

Question: I would firstly like to thank the panel for such a comprehensive discussion. My question is: How does the Ukrainian government look at the risk of the customs union among Russia, Belarus and Kazakhstan? Is it prospective and lucrative path among these countries and Ukraine? My second question pertains to management in the government. What do you think is necessary to run the country and conduct reforms in a successful manner? Maybe a younger team of professionals?



Anders Aslund: I will agree with what Mr. Paskhaver said earlier. In doing his trip to Moscow, President Yanukovich stated that Ukraine does not have an interest in the customs union. One of the reasons is that the European Union has said that there can't be a European Association Agreement and a customs union. Yanukovich has been crystal clear on this point and there can be no discussion.

Ambassador Popadiuk: I don't have much to add to what Anders has said. Obviously, a customs union would run contrary to the EU and Ukraine's joining of the EU.

In terms of your second question, it is a very interesting question. I think that one of the key things you need in terms of governance is compromise. When you are in a political campaign, the objective is victory, so there is really no room for compromise. You have to win - and if you bring this mentality into the government and run it from top to bottom on this principle, there is no room for compromise. This makes for a very difficult government. If you include compromise in that mentality, then you need to compromise in Parliament, you need to compromise with foreign governments, and you need to compromise within your own bureaucracy in order to keep things moving. There are many more aspects of governance, but compromise is a key.

Alexander Paskhaver: With reference to the "young team of professionals," I will just give an example. As a general principle, we all hope that the new generation will be better than the old generation. But we have a good experiment – the current mayor of Kiev once was an owner of a very large bank. When Chernovetsky became a mayor, he brought with him into office a very young team of highly professional people from the bank that he was used to working with. Never before have we witnessed such a level of thievery and corruption that he and his young team of professionals brought into that office.



Question: I was curious about the degree of influence that China has had in the economic and political fabric of Ukrainian society. In China you have an authoritarian government, but there is a great deal of economic freedom which has generated a great deal of prosperity amongst the people. Another issue which Anders Aslund mentioned is the Ukrainian tax code. Will there be opportunities for companies to have corporate tax waives for a period of time? Or will there be depreciation of equipment or tax holidays as a way of encouraging investment from the US to Ukraine?

Ambassador Popadiuk: I can address the first issue. I can only speak about the earlier part of Ukrainian independence. There was talk about the Chinese model in the Ukrainian government to a great extent at that time. The Chinese model is seen as the “third way” – the other two ways being the US and Western model, where you have an open, democratic society with a free market economy, and the Soviet system or communist model, where you have neither a democratic government nor a free market economy. The Chinese model is kind of a hybrid where you have an authoritarian or semi-authoritarian government which keeps political and social stability but at the same time opens up the economy as much as possible under a system of free trade. Ukrainians were very favorable towards the Chinese model during the time when I was Ambassador and for even a few years afterwards. I don’t know if it is prevalent today, but up until Kuchma it was talked about a great deal.

Anders Aslund: It remains to be seen what will come out of the new Ukrainian government. I do think it is interesting to see the role that China is playing on the financial crisis in the region. China has given loans of 3 billion dollars to Belarus and 1 billion dollars to Moldova. China has not given anything so far to Ukraine, but there was a proposal from Ukraine under the former government of 5 billion dollars from China which never materialized. This is something that I believe one should keep an open eye for because it may be forthcoming. We are seeing China popping out financially in many places. So far the most surprising thing is how absent China has been with respect to Ukraine.

Alexander Paskhaver: You need to separate the interests of Ukraine towards Chinese money and trade and the Chinese model of development. I know, for instance, that the Ukrainian government is preparing to undertake certain steps to increase its relationship with China. With respect to the Chinese model, it was very widely discussed in Ukraine. As I understand, we all

came to a certain consensus that the Chinese model maybe would have worked very well for us, but it could not be implemented due to the mentality of the average Ukrainian.

From the viewpoint of managing the government, the Ukrainian government is simply not comparable to the Chinese government. Thus, a standard, popular answer as to why Ukraine did not choose the Chinese model of development is quite well-known – we simply have too few Chinese people in the country.

Morgan Williams: Will the IMF and Ukraine get together and find an agreement? If so, how much will the package be?

Anders Aslund: It is as yet too unclear. There is an IMF mission going out for preliminary discussions on June 11th. Clearly the deal must be re-done. If there will be an IMF agreement, then that will mean serious legislative work. I think it is extremely unlikely that we will see any IMF agreement before such work. Ukraine still needs the IMF loan, but there is an alternative in Russian and Chinese money. However, that would be a very bad situation for foreign investors. Foreign investors are interested in an IMF agreement in order to receive certain safeguards for reform. So, this is really an open crossroads – I wrote about this in an article in Kyiv Post and Moscow Times. Yanukovich absolutely needs to make a choice: IMF financing with reforms or much less reforms and Russian financing.



Question: In accordance with international marketing strategies, what must investors focus on to invest in countries that are politically unstable? Most countries that are not politically stable and have corruption are dependent on other countries and neighboring countries. I wonder how Ukraine is logistically depending on its neighboring countries. I also wonder what Ukraine is implementing in order to satisfy the wants of international investors.

Alexander Paskhaver: We were just talking about how it is usually the opposite in Ukraine. Ukraine says that it needs the foreign investors, but the business owners together with the bureaucracy are resisting this foreign investment in order to retain control. When it comes to a bureaucratic infrastructure, Ukraine has everything. We even have special departments which are responsible, in principle, so that all foreign investors would receive the services they need. But, in the majority of cases, we see the exact opposite effect – we see more resistance, not assistance.

Morgan Williams: Anders, will Mr. Tigipko still be in the government on December 31, 2010? And, what will his role in fact be if he is still in the government? Will he still be deputy Prime Minister on December 31, 2010?

Anders Aslund: I have no idea.

Alexander Paskhaver: As far as I understood, your question is whether Mr. Tigipko's influence will get stronger? I don't like to make these types of forecasts, but since I am not formally connected with this administration, I can give you my purely subjective opinion. We need to divide this question into formal power and informal influence. He sits in a very high post right now. I think he will remain there for as long as he wishes because he is very convenient for the current administration. In terms of



Alexander Paskhaver responds to a question about Mr. Tigipko's influence

whether he carries any influence, it is not that large and it is doubtful that it will increase. Anders knows everything that I know, but he is politically correct!

Question: You all mentioned the concept of government pushing things down – pushing policy and laws on business. Some of you mentioned eliminating political risks. To what degree do you see the government pushing out the private sector and to what degree do you see the business community solidifying in a united voice to address these concerns.

Ambassador Popadiuk: I think that is a very valid question – we are looking at the government acting from the top-down, but what about from the bottom-up? Looking at business, Ukraine will not be able to survive unless it has a strong private sector. But, you need to start with the top – the government must provide the atmosphere in which the private sector can operate. Ukraine needs to have the government provide the infrastructure, the environment and the support structure for the private sector to operate.

This goes back to some of the points I mentioned earlier, such as the legal structure, cutting back on bureaucracy, making the laws more conducive to business, opening the playing field more to foreign investment and attracting foreign investment. All of this would have a multiplying factor in solidifying and making the private sector grow. I'm not an economist, but I would still go with the notion that the government must provide the atmosphere for economic development.

Morgan Williams: From the point of view of the business councils, particularly the European Business Association, the AmCham and us, know that we must be very well organized and together on many of these issues. We've issued joint position papers about the VAT issue. One thing I will say about the new government is that we've had access to them and when you see these people you will see that they are decision-makers, and if you can influence them, then they will do something. In the previous government, we would time and again meet with government officials, but they were all talk and no action. No one had any capacity to make decisions. We've had access to the Minister of Finance, Mr. Tigipko and others, and we expect such access to continue. It is very heartening to know that you are talking to people who, if they decide to move and make a decision, will be able to implement something. The business community has so far been pretty satisfied with the access we've had to the new government.

Anders Aslund: Thank you for your question. This is a government of the businessman, so they are defending their own interests. There are at least five major oligarchic groups behind the government. You might subdivide them again into ten. We can see perfectly how they function because this was the same with the Yanukovich government when he was Prime Minister from 2002-2004. The point is that some ministers, who essentially pushed for good reform legislation (for example, the introduction of the flat income tax), also pushed for their own business interests. There was no policy coordination - Yanukovich delegated the issues to his very powerful ministers and they would fight it out amongst themselves. It is not a consensus of getting a policy consensus it is rather a question of the strongest wins. There are no checks and balances between these businessmen. And, since the businessmen are strong, they have no interest in organization.

You join organization when you are weak – the Russian oligarchs joined the Russian Union of Industrialists and Entrepreneurs when Putin had come to power and threatened them. The Ukrainian oligarchs are still strong, so they have not joined the Ukrainian Union of Industrialists and Entrepreneurs. The same is true of the Ukrainian



Association of Banks, which is *Anders Aslund responds to the question from the audience* not a very strong organization.

Therefore, as Morgan stated, the US-Ukraine Council and the EBA are strong and the Ukrainian government gives them more access because they are more representative than the Ukrainian organizations. If the government wants to talk to the Ukrainian businessmen, they will talk with individuals rather than organizations because these individuals are actually more representative of Ukrainian business.

Morgan Williams: We are also interested in access as to whether there is going to be competition available in certain parts of the Ukrainian economy, including consumer goods, IT, etc. There is still a lot of room in the Ukrainian economy for businesses. For example, the company I work for, SigmaBleyzer – would not even think about investing into the energy business in Ukraine. We feel that there are so many opportunities out there for our business, especially in the providing services and goods to consumers, that we don't need to knock heads with guys that don't want you in their business area. If you are smart and have a good attorney and learn from the past and get into areas that are still very wide open in U Ukraine, you will have a good chance for success.

Alex and I agreed earlier that if you want to be successful in Ukraine, then you have to be out there full time on the ground. You need to hire sharp, young, capable Ukrainians – there is a great talent pool out there. You need to be committed to the long-run and you of course need adequate financing. You need to be very street smart and, again, have a good attorney and make sure you are organized legally in a way that you can avoid as many problems as possible. If you've picked the right field, there are still a lot of opportunities out there.



Question: Ambassador Popadiuk mentioned problems in gas and energy efficiency. Those who grew up in Ukraine or live in Ukraine know that this is a very serious problem. We can still see people heating their houses or apartments with gas stoves. Usually a gas efficient society is praying for delivery, utilities and central heating. There is a need for the new administration to improve the infrastructure and modernize the gas sector.

Secondly, Ukraine recently became a member of the WTO. Russia is still working on accession to WTO. Once Russia becomes a member of the WTO how will relations between Russia and Ukraine vis-à-vis WTO work out?

Ambassador Popadiuk: That is a very good question about energy use in Ukraine. You correctly pointed out that Ukraine is probably the most or one of the most energy inefficient countries in the world. Ukraine actually provides subsidies and, as a result, there is no incentive to maximize the use of energy. There have been many plans and thoughts throughout the various administrations to undertake



improvement of energy efficiency. I'm not aware of anything that the Yanukovich government has done at this time. Unfortunately, there is a lot of lip service in the energy sector, but there is not a lot of actual activity. This is a key ingredient for the Ukrainians – they have to maximize energy efficiency in order to survive into the future in terms of consumption and payments. Ambassador Smith has the Yanukovich government made any movement in this area?

Ambassador Smith: The World Bank has an energy efficiency program that is worth over 500 million dollars and the EU has just approved a 1.3 billion Euro program for energy efficiency for Ukraine. So there are some things being done on the energy efficiency side, but no statement so far from Yanukovich's side.

Anders Aslund: On the first question, I think that the signs we are seeing are rather going in a negative direction. This is, of course, a major point of adjustment. Also, Ukraine has increased the gas volume from Russia – this has not been necessary. This suggests that there are no plans to undertake serious energy reforms.

With respect to the second question, yes, it would be good for Ukraine if Russia joins the WTO because Russia has a habit of prohibiting Ukrainian exports to Russia if they become too large. Ukraine usually produces approximately the same products as Russia. There is an enormous amount of trade disputes between Russia and Ukraine. Now, Russia simply prohibits a product and that's it. There is no arbitration court to which Ukraine can appeal. If Russia becomes a member of WTO, Ukraine can appeal to the wonderful arbitration court called the World Trade Organization and there can be penalties imposed on Russia. Thus, Russia would not be able to continue prohibiting pork and dairy imports from Ukraine. This would also be true of such wonderful products as vodka, steel, pipes, etc. So, it would be of major importance if Russia were to become a member of the WTO.

Ukraine could demand that Russia establish a bilateral protocol with Ukraine to clean up all of the trade disputes before Russia is allowed to enter the WTO. For reasons that are not entirely clear to me, Ukraine has not yet done so; neither under the former nor under the current government. However, one may argue that in such case Russia wouldn't join the WTO and Ukraine will not get the relevant benefits.

Morgan Williams: Mr. Frishberg, since you got this all started, can we have some final comments from you?

Alex Frishberg: Sure, I'll make this quick. First and foremost, thank you for coming, and special thanks to the Ukrainian Embassy in Washington D.C. and U.S.-Ukraine Business Council for their hospitality. Considering that Ukraine has a new government, I thought that it might be useful for you to meet the gentlemen seated at this table. Without a doubt, today's speakers are world-level experts in Ukrainian business, economy and politics, so I'm very glad that you had a chance to hear their honest opinions about the current state of affairs in Ukraine. And if you have any questions about legal or business issues, please contact us at office@frishberg.com.ua

or office@paskhavergroup.com. Now, I'd like to invite you to a reception, where you may ask us any questions that we couldn't answer in public. Thank you again for coming!



The end of Frishberg & Partners' Round Table on "Doing Business in Ukraine in 2010"