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# *political commentary*

*#4(22), April 2005*

In this issue of *political commentary*, the International Centre for Policy Studies presents the results of government policy analysis and factors that influenced it in March 2005.

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# OVERVIEW

The first steps taken by President Yushchenko—investigating the crimes of the previous regime and expanding social programs—appeal to voters. As a result, the president enjoys a level of public support that is a record for the last 10 years. By contrast, the opposition is undergoing a crisis of faith. It has been unable so far to find a real base from which to criticize the current Administration. The odds-on favorite in the upcoming VR election is Mr. Yushchenko's party, the Nasha Ukraina National Union. He would like Premier Tymoshenko's and Speaker Lyvtyn's parties to join his bloc, which would open the door to controlling a majority in the next Verkhovna Rada (see **POLITICS**).

The first visit of Vladimir Putin to Viktor Yushchenko reduced the widespread pessimism over the likelihood that they could develop normal relations. Although Ukraine's position on a number of key issues is awkward and inconvenient for Russia, their discussions left the impression that the Kremlin is ready to accept them. President Yushchenko would like to finalize the boundary between the two countries, transform the CEA into a free trade area, and include Germany in a gas consortium to manage the Ukrainian gas transit network. Ukraine also made a grand gesture towards the EU by cancelling visa requirements for its citizens. Finally, Mr. Yushchenko's visit to the US, where he addressed a joint session of the Congress, convincingly left the chapter of chill relations between Mr. Bush and Mr. Kuchma well behind (see **FOREIGN RELATIONS**).

In keeping with his election promise, President Yushchenko shortened mandatory military service. This decision forms part of his overall plans to reform the Armed Forces, according to which Ukraine will have a professional army by 2010. Based on a Government initiative, the amended 2005 Budget now has 23% more planned revenues, and 20% more expenditures, much of which will go to pay higher wages and pensions. Import duty was reduced on tropical fruits, apparel, footwear and household appliances, and rates for rail freight were raised. In this way, the Government is hoping to improve the standard of living of Ukrainians with low incomes and to take away privileges that were enjoyed by big business under Leonid Kuchma (see **GOVERNMENT POLICY**).

The economic situation looks threatening. GDP growth is slowing down and inflation is picking up. On the other hand, household incomes are rising very rapidly (see **ECONOMIC ENVIRONMENT**).

# POLITICS

President Viktor Yushchenko and his team are making good on the slogans of their election campaign and this has the support of most of the population. Among the new government's first steps, top priorities include investigating corruption and other crimes perpetrated by people in the previous regime and expanding social programs in the Budget. The changes to the Budget initiated by the Government and voted in by the Verkhovna Rada fulfill Mr. Yushchenko's campaign promises to raise pensions, wages and assistance with newborn children. According to Government calculations, the average pension has gone up 24%, the average wage at state-run organizations by 57%, and assistance to new mothers a whopping 1,100%.

***The president is focused on uncovering the crimes of the old regime and expanding social programs***

The Prosecutor General's Office, the Interior Ministry and the SBU have launched hundreds of investigations of corruption and other abuses by people in state office. Based on information that was made public, the largest scale of crime is being investigated in the Transport Ministry, whose head, Georgiy Kirpa, apparently killed himself in December 2004. According to Interior Minister Yuriy Lutsenko, one investigation has led to the former Ministers of Defense (Oleksandr Kuzmuk), Social Policy (Mykhailo Papiyev), and Emergencies (Hryhoriy Reva).

Nearly 300 cases have been opened across Ukraine in relation to violations during the election campaign itself and during February and March nearly 20 people, mostly chairs of lower level election commissions, were sentenced to jail.

The Government also submitted a law to the Verkhovna Rada to fulfill another campaign promise of President Yushchenko's—to begin to establish a professional army by 2010. The law shortens the draft period for young men from 18 months to 12.

The new Administration has completely stopped putting pressure on the media. National channels and newspapers, which were heavily censored by the Kuchma Administration during 2002–2004, began to revive independent editorial policies.

Together, these steps are maintaining the level of optimism roused among most Ukrainians by the Orange Revolution in December. A survey carried out by the Razumkov Center in late February showed for the first time in many years that more than half the population—51%—believe that things are moving in the right direction in Ukraine. The level of trust towards government institutions has also changed dramatically. The president's actions are supported by 47% of the population, compared to only 9% during the last survey in March 2004. The Government's actions were completely supported by 36% of the population, versus 6% a year earlier, and 28% supported the Verkhovna Rada—compared to merely 4% in 2004. Mr. Yushchenko himself was given complete support by 48% of respondents, while another 23% supported some of his actions. 23% did not support him and 5% could not answer the question.

***Voter support for the new government is at a record-high level***

The level of support among voters for the actions of the new government put the opposition at a distinct disadvantage. Those forces that have declared themselves in opposition are forced to at least in part support their rivals. This was obvious, for instance, during the passing of the amendments to the 2005 Budget, when the Communists and the SDPU(o) unanimously supported the vote. At the moment, the opposition is having a hard time finding a position from which to criticize those in power. Only now are the traditions of competition of public policy ideas being entrenched in Ukraine. The previous opposition, which is now in power, based its criticism on the widespread abuse under President Kuchma. Since Mr. Yushchenko does not provide much ground for any accusations of abuse of power, the new opposition is without any basis to criticize. For the most part, the

challenges that are flung President Yushchenko's way by the opposition are connected to relations with Russia. They were especially critical of the new Administration's intentions of reviewing the conditions for setting up the Common Economic Area, a regional union favored by Russia.

***The opposition cannot get over its crisis of confidence***

Lack of trust among voters is a huge problem for the current opposition forces. The CPU, whose results in the last two elections have eroded substantially, needs to update its ideological position. The Party of the Regions and the SDPU(o) are mostly associated with the previous regime and various oligarchic groups and their support has been falling off. Information about the involvement of their representatives in corrupted machinations and vote-rigging is coming out of police investigations into their activities and is having an additional negative impact on their ratings. Specifically, the Interior Ministry announced that people from the Yanukovych campaign headquarters organized an attack on Yushchenko supporters by hired thugs during a rally in front of the Central Electoral Commission 23 October 2004.

According to the Razumkov Center survey, if the VR elections had taken place at the end of February 2005, the Party of the Regions would have received 17% of the vote, the Communist Party 5% and the SDPU(o) barely 1%. The level of complete support for Regions leader Viktor Yanukovych, who ostensibly got 44% of the popular vote in late December, was only 20%.

Given their plummeting ratings, the Party of the Regions and the SDPU(o) have been talking about possibly joining forces for the VR elections due in March 2006. The main force will likely be Regions, which has the best ratings and the most popular leader. A number of minor opposition forces that supported Mr. Yanukovych in the fall might also join the bloc, especially Trudova Ukraina and the Progressive Socialist Party.

The election of the new Verkhovna Rada will have a pivotal impact, insofar as the compromise reached between the old Administration and the then-opposition during the Orange Revolution means that the new legislature takes on the power to form and dismiss the Government from the president. President Yushchenko publically confirmed in March that he was reconciled with the implications of the Constitutional amendments and had no intention of challenging them.

***Mr. Yushchenko's party looks like the odds-on favorite in the next election***

At the moment, the odds-on favorite in the next elections looks to be the Nasha Ukraina National Union formed in February under the patronage of President Yushchenko and based on seven of the 10 parties that formed his Nasha Ukraina bloc. In the Razumkov Center survey, this party got 30% of the vote. Party organizers claim that hundreds of thousands of Ukrainians are keen to become members and that this party will soon become widespread.

Other powerful participants in the election—the Batkivshchyna Party of Premier Yulia Tymoshenko and the National Party of Speaker Volodymyr Lytvyn—have postponed decisions whether or not to join forces with Nasha Ukraina, which Mr. Yushchenko invited them to do in February. Whether or not such a bloc is formed will depend to a large extent on the popularity of each of the leaders by the time Autumn 2005 rolls around. If Mr. Yushchenko and his party show much better results, then Ms. Tymoshenko and Mr. Lytvyn will agree to join forces. Such a bloc would have every chance of winning a majority of seats in the new legislature. If they go separately, the trio of these parties will be each other's greatest rivals because of the closeness of their electoral bases.

Two other parties from the Yushchenko bloc—the Ukrainian National Party and Narodniy Rukh Ukrainy—have decided against joining the newly formed party. However, they will be in no position to generate real competition. Their leaders, Yuriy Kostenko and Borys Tarasiuk, are not especially popular, while their ideol-

ogy, still built largely around the concept of Ukrainian independence, seems outdated these days. Indeed, they could have a hard time crossing even the 3% threshold that would give them seats in the Verkhovna Rada.

A final powerful runner is the Socialist Party led by Oleksandr Moroz. Although its members are in the current Cabinet, the SPU is preparing to go into the election on its own. For one thing, Mr. Yushchenko did not invite it to join his bloc. For another, the SPU expects to beat out the Communists once and for all in the battle for the leftist voter, which Mr. Moroz succeeded in doing during the presidential campaign in 2004.

# FOREIGN RELATIONS

## *Russia*

***The Kyiv meeting of Presidents Yushchenko and Putin eased pessimism over possible relations between them***

Vladimir Putin's first visit to Viktor Yushchenko relieved some of the pessimism about possible relations between the two. Mr. Putin's open support of Mr. Yushchenko's rival, Viktor Yanukovich, during the election and the obvious differences in the views of the two leaders—one of whom would like to restore the Russian empire, and the other who has declared his desire to see Ukraine integrated into the EU—created fertile ground for tense relations between the Ukrainian and Russian presidents. But the Kyiv visit shows that another scenario is also possible: establishing new relations, in which Ukraine wants to and is able to stand up for its own interests.

***Ukraine has formulated new positions on key issues...***

In contrast to the January meeting in Moscow, Msrs. Yushchenko and Putin attempted to negotiate openly and to look for solutions to key issues in their relations. Among them are the fate of the Common Economic Area, the gas transport consortium, and interstate boundaries. During their talks, the Ukrainian president formulated a new position on each point, and the Russian president listened to it.

Ukraine would like to make a priority of an important issue—settling the boundary between the two countries, which still has not been fixed in the Azov and Black Seas. The most touchy point is the boundary running through the Azov Sea, which put the two countries on the edge of armed conflict in 2003, over Tuzla Island. After these talks, Mr. Yushchenko announced that the task for 2005 would be to delimit the marine portion of the international border. Ukraine's interest lies in recognizing the border in the Kerch Strait based on the border that had been drawn between the two republics under the USSR. This effectively leaves Ukraine in control of the strait. Russia would like to revise the old Soviet map. The two sides have announced the start of intensive consultations at the level of negotiations.

Ukraine has also formulated a new view of the consortium to manage and operate the country's gas transport network, which was tabled by Msrs. Kuchma and Putin back in 2001. Ukraine insists that Germany participate in the consortium. Kyiv has also proposed simultaneously setting up a consortium to transport Turkmen gas with Kazakhstan, Russia and Turkmenistan. In this way, Ukraine would like to strengthen its role in the transit of gas to Europe and to reduce its energy dependence on Russia.

Serhiy Teriokhin, designated Ukraine's representative to the High-level Group that is involved in formulating the CEA, expressed Ukraine's new position in no uncertain terms. Kyiv is ready to very quickly form a Free Trade Area within this organization, but will not take part in setting up an inter-state form of government. This position on the part of Ukraine effectively destroys the basic concept of the CEA as Russia intended it. Under the slogan of economic integration with Astana, Kyiv and Minsk. Moscow would like to create a regional union that would tie key regional countries to it.

Creating a new topic for negotiations that will have an impact on Russia's position, Ukraine has touched on the topic of future conditions for the placement of Russia's Black Sea Fleet in Sevastopol. This topic is on the agenda for discussion by Ukraine's National Security Council. At one time, it was important for the Ukrainian side to establish that the Russian fleet would be harbored on the basis of a long-term lease, which confirmed Ukraine's sovereignty over the strategic harbor. Now Ukraine is looking at reviewing the value of the lease. In this way, Kyiv can put some pressure on Moscow.

Ukraine's new position on a number of key issues is both awkward and inconvenient for Russia, which has for a long time been trading its support for the Kuchma Administration in exchange for real influence over Ukrainian politics. With President Yushchenko, who has the support of the West, this is impossible. On the other hand, the Kyiv talks left the impression that the Kremlin is willing to tolerate the position of the new Ukrainian regime.

***...which are awkward and inconvenient for Russia, but Moscow listened Kyiv out***

One result of the visit was the formation of the Yushchenko–Putin Commission to replace the intergovernmental cooperation commission. In fact, earlier decisions were made at the level of the presidencies, but the new approach allows Ukraine to formalize relations between the two leaders and eliminate the traditional “let’s dine at the dacha” approach, where the interests of Kyiv invariably lost out. Within the context of an official commission, relations between the presidents should become more transparent, which should open the path to greater equality.

***The Yushchenko–Putin Commission will replace a back-room approach that did little for Kyiv***

The kind of pragmatism that Ukraine is looking for in its relations with Russia can also be seen in Mr. Yushchenko’s effort to establish a dialog with Russia’s biggest businesses. The president invited them to establish direct relations and offered guarantees of their interests, hinting that they might find conditions for doing business more liberal than in Russia.

Ukraine has also put out a bid for regional leadership. Formally, it can do so within GUUAM, a regional association that includes Georgia, Uzbekistan, Azerbaijan and Moldova; informally, with those CIS countries that have held democratic elections and have begun to develop as democracies. This ambition was evident in a joint statement issued by Georgia and Ukraine with regard to events in Kyrgyz Republic. Ukraine could possibly play the same role for other post-soviet countries that is similar role to that of Poland within the EU in relation to Ukraine, that is, as an advocate and a point of exchange of the eurointegration experience. In this way, Ukraine has taken over Russia’s mission to democratize the post-soviet sphere. Having been given this role by the West after the break-up of the Soviet Union, Russia failed to live up to the challenge and is currently itself under pressure from the West because of perceived problems with democratization. A second trend is that the sphere of Russian influence over former USSR territory is shrinking.

Moscow’s integrational ambitions are being stopped at the social level. The idea of gathering all the presidents of former soviet republics for the 9 May celebration was not supported by the Ukrainian president. Mr. Yushchenko will remain in Kyiv for the celebration and will only show up in the Russian capital 8 May for the summit of CIS leaders. Moreover, the president of Georgia will also be absent, as he is expecting US President George Bush to visit Tbilisi 9 May.

### *The EU*

Ukraine has made a grand gesture towards the EU by temporarily cancelling visa requirements for EU citizens. From 1 May to 1 September 2005, travellers from the EU and Switzerland will be able to enter Ukraine without a visa. A similar step will shortly be made for US citizens.

***Ukraine has dropped visa requirements for EU citizens***

Prior to this, Ukraine had already made a series of changes to visa procedures that have put it in an asymmetrical position vis-a-vis other countries. When Poland was preparing to join the EU and visas became a mandatory condition of accession, Polish citizens were relieved of the need to have a visa in return for free visas for Ukrainian citizens. The “Polish approach” was borrowed by Lithuania and Slovakia and proposed to Bulgaria and Romania, which are preparing to accede in 2007. However, this approach will not work once these countries do accede to the Schengen zone.

A country's visa requirements are a reflection of political trust, and in this instance, Ukraine is opening itself up to the rest of Europe. The new president has been emphasizing Ukraine's openness to the world ever since his inaugural speech in late January. Thus, the Ukrainian government is indicating its trust in citizens of other countries and sees in it further incentive to European integration and more personal contacts. Indirectly, this will also make it easier to promote Ukraine in the rest of the world. Given that visa regimes are being dropped for politically stable countries with a high level of security, the risk of illegal migrants or criminals is insignificant for Ukraine.

***Kyiv is hoping  
for market economy  
status in June***

In return, Ukraine is hoping that the EU will ease up its visa restrictions somewhat for certain categories of Ukrainians, such as students, scientists, artists, journalists, and entrepreneurs. The European Commission has expressed the belief that it is possible to start preparing for talks on liberalizing the visa regime. This will be raised at a meeting between the two sides in April.

Ukraine is hoping to get market economy status from the EU by June, when the Committee on Ukraine–EU Cooperation meets next. The EU has not made its position clear on this issue yet. It has, however, emphasized the need for decisive internal reforms in Ukraine in order for relations to progress. The EU laid out this stance towards internal tasks at a Ukraine–EU3 meeting in Kyiv. The accomplishments of the Orange Revolution have been acknowledged as the Ukrainian contribution to democratization in the world and this, in turn, has made it possible to raise dialog to a new level with western partners, compared to the previous regime. Still, the Europeans are underscoring the need right now to fulfill the Action Plan.

A survey carried out by Taylor-Nelson-Sofres in 6 EU countries show that most Europeans are ready consider Ukraine a member of the EU once it applies and complies with the requirements of accession. Indeed, respondents argued that Ukraine is a part of Europe and that accession would further its democracy even more. This is a fairly new position in terms of perceptions of Ukraine among EU countries. In fact, public opinion in the EU has acknowledged Ukraine's European identity, something that Ukraine had been claiming for years.

***The US***

***Mr. Yushchenko's visit  
to the US ended the  
era of chilly relations  
between Mssrs. Bush  
and Kuchma***

When its status was raised from "working" to "official," Viktor Yushchenko's first visit as president of Ukraine to the US became a major event. Both countries had great expectations of the visit and on its conclusion announced a new era in Ukraine–US relations. The official wrap-up of the visit between George Bush and Viktor Yushchenko was capped off by a joint declaration that confirmed the strategic partnership between the two countries. Ukraine once had this kind of relationship with the US, but it was scuppered by a slew of scandals that swirled around Leonid Kuchma throughout his second term in office and contact was almost entirely cut off. In the joint statement this time, Mr. Bush even declared US support for Ukraine's bid to join NATO.

In addition to its official side, the Ukrainian president's tour had a huge public relations component that included events with American business, communities and the Ukrainian diaspora. Without doubt, there was also a strong emotional component that appealed to the American political soul. For instance, the Ukrainian delegation included two former US citizens: the president's wife, Kateryna Chumachenko-Yushchenko, and his justice minister, Roman Zvarych.

The fact that the Orange Revolution had had a great deal of US media coverage did much to give Mr. Yushchenko's visit a very positive aura, as it brought Ukraine to the awareness of ordinary Americans for the first time. What's more, it showed just them a new Ukraine, one that was clearly a worthy partner.

The Ukrainian president's address to the joint session of the two American chambers was an event of great symbolic value, acknowledging his political accomplishments, alongside other historical figures such as Lech Walesa, Nelson Mandela, Vaclav Havel and Boris Yeltsin. Moreover, it was a triumphant moment. Not only was President Yushchenko warmly received by US Congressmen and Senators as the leader of a democratic revolution, but he was able to clearly state what steps Ukraine needs from the Americans in order for relations to progress.

***The Ukrainian president's address before American lawmakers had great symbolic value***

Actually, the US had made a similar gesture to Ukraine previously, when two senators nominated Viktor Yushchenko for the Nobel Peace Prize. What is important now is to turn this political capital into real gains in terms of external relations with the US.

President Yushchenko took advantage of the opportunity to present to US lawmakers key issues that Ukraine needs the US to address: dropping the Jackson–Vanik amendment, WTO accession, market economy status, and support with accession to the EU and NATO.

Among the points addressed by Mr. Yushchenko, three were particularly significant for the US: Ukraine's willingness to continue to help the government of Iraq in terms of economic and security issues; confirmation of Ukraine's position in the battle against international terrorism; and the country's determination to promote freedom in the region.

The war against terrorism and the mission to promote freedom in the region are two signals of cooperation with the US that underscore the commonality of the two countries' political positions. Ukraine could, in fact, be given the mission by the West to promote democratic values through out the post-soviet region. This is an important task that earlier the West had given to Russia.

# GOVERNMENT POLICY

***The military draft has been shortened, and the size of the Armed Forces***

The Verkhovna Rada has cut back the term of mandatory military service and approved the continuing reduction of Ukraine's Armed Forces. All factions and groups in the legislature voted in favor, including the opposition. The military draft has been shortened from 18 months to 12. This decision, a very popular one among the general population, is retroactive, to include young men who were drafted into the Army in the fall of 2004. The overall number of the Armed Forces can now be reduced a further 40,000, down to 245,000 servicemen by the end of 2005.

These two decisions were among the campaign promises made by President Yushchenko and were drafted as bills by the Government. They were part of his election platform's plank regarding reform of the Armed Forces, according to which Ukraine will drop the universal draft altogether and switch to an entirely professional military by 2010. The transition to an army of soldiers who are working under contract requires that the forces be cut back at the same time. Ukraine does not have the money to maintain an army the size of the one it has today. Moreover, a military of this scale is no longer necessary from the point of view of running a modern war.

Ukraine's military has been gradually reduced since 1991. Over this period, the size of the Armed Forces has gone down from a peak of 1 million to 285,000 today. According to the Defense Ministry, by 2010, it will be cut back a further 85,000.

***The 2005 Budget revenues have been expanded by 23%...***

At the end of March, the Verkhovna Rada approved changes to the Law on the 2005 State Budget. This bill was supported by all fractions in the legislature except for the Party of the Regions and the Party of Industrialists and Entrepreneurs. Compared to the December edition, the revised Budget anticipates 22.7% more revenues and 19.5% more spending. The main source of additional revenues is expected to be higher tax receipts, including the VAT and corporate profit tax. In the new edition of the Budget, capital investments and maintenance of the government apparatus have been cut back, while social benefits to the general population have been increased substantially.

Along with changes to the Budget itself, amendments were made to most laws that determine taxation rules. The most significant among these was the removal of tax holidays and other preferential treatment for Special Economic Zones (SEZs) and Territories of Priority Development (TPDs) and the narrowing down of the types of businesses who have the right to reduced rates on the VAT and the land tax. Import duty for cars was changed and excise tax on tobacco and alcohol products was increased. According to ICPS, the dropping of most tax preferences is an appropriate move. A more level playing field for businesses should encourage the legitimization of shadow operations and make Ukraine more attractive to potential investors than any number of arbitrary tax holidays for selected companies.

The net result of these changes will be increased tax pressure in the economy. This will be partly the result of the cancellation of specific sector-based tax breaks and the closing up of loopholes that made tax evasion possible. ICPS economists say that this move will indeed increase Budget revenues in 2005 and the next few years. At the same time, the price for this policy will be a temporary slowdown in commercial activity among those businesses who have lost their privileged tax status or have found opportunities to use cheap tax evasion schemes cut off.

***...and expenditures by 20%***

The expenditures side of the Budget has also been changed. Some spending, including capital investment and maintenance for the state apparatus, has been cut back, while financing for social programs has been increased. In this way, it is very clear that the new Government's policy priority is raising the level of social secu-

city among the population of Ukraine. The price for choosing to make this a priority will be a certain amount of hand management of the country's social insurance funds. This will largely nullify the reforms of the Pension Fund that have been achieved so far, and will postpone the prospects for reforming the other social funds. Another consequence of raising social benefits across the board is accelerated inflation on consumer goods.

These changes to the Budget reflect the short-term nature of the Government's current objectives: raising social security among the general population and combating corruption in commerce. Longterm goals, such as investing in innovative economic development or rebuilding the very system of social security in Ukraine were not visible in the amended Budget. ICPS analysts consider the decision to cut back on capital investment for 2005 a realistic move, given that the allocations set by the previous Government often bore no relationship to new state priorities and, as a result, were not an effective way to spend public money. According to ICPS, money spent on development has to be justified in great detail, which could realistically be done in the plan for the 2006 State Budget.

In March, the legislature also amended the Customs Code. Import duty on tropical fruit, apparel, footwear and household appliances was reduced. The changes level out duty rates generally to the level of the reduced duty.<sup>1</sup> This reduction in import duties is generally a good thing, according to ICPS economists. Firstly, the anticipated reduction of duties to the level of preferential rates should reduce "grey" imports. In other words, the quantity of imports on the Ukrainian market is unlikely to change much, but it will be legitimized. Secondly, lowering import duty rates is part of the requirements for accession to the WTO, which Ukraine is hoping to do by the end of 2005 or beginning of 2006. Thirdly, lowering import duties is unlikely to have much of an impact on Budget revenues, in that the legalization of grey imports will compensate any losses due to the lower duty rate.

***Import duty on apparel, fruit and appliances has been reduced***

The Ministry of Transport and Communications decided to raise rates for freight traffic an average of 50%, while tickets for luxury and first-class sleepers have gone up 50%. Such a steep rise in rates could cause producer price inflation to speed up 3–6 pp over 2005. Raising passenger fares, which UkrZaliznytsia, the state rail monopoly, claims are below cost, will make itself felt most on the middle class. For industrial customers in the export-oriented metals and chemicals sectors, higher freight charges will cut into their high profits somewhat.

***Railway rates have gone up***

Basically, the Government needs to gradually remove from UkrZaliznytsia the burden of carrying out a "social" function for the state. Keeping prices low on passenger fares by charging more for freight is not an efficient way to provide social security for the general population. Too-high a level of cross-subsidization distorts economic incentives both for the average person and for other groups of consumers. Prices and rates for all railway services should as much as possible reflect real costs.

The current regulatory policy in the transport sector needs revamping. Combining the functions of corporate management and regulation within a single ministry sets up a serious conflict of interests. By separating these functions from a monopolist like UkrZaliznytsia and setting up an independent regulatory body, rate-setting procedures can be improved and the protection of customer interests ensured. The opacity of UkrZaliznytsia's operations stirs scepticism among the general population towards company statements about the profitability and cost of certain of its services. And although everyone agrees that it's high time to modernize both the infrastructure and rolling stock of the national railway, until UkrZaliznytsia undergoes an audit, any moves to raise rates or attract investment will be unsuccessful.

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<sup>1</sup> According to the Customs Code, imported goods are subject to a three-tiered customs duty: preferential, reduced and full.

# ECONOMIC ENVIRONMENT

## ***GDP growth is slowing down***

At the beginning of 2005, the economy grew more slowly than at the start of 2004. Preliminary data indicate that in January–March GDP grew 5.4%, compared to 10.8% in the same period of 2004. This slowdown in economic growth is the result of a slowdown in industry.

Industrial output grew 7.1% over January–March 2005, compared to 19.5% over the same period of 2004. Machine-building, metal and chemical industries are growing more slowly than last year, and coke and oil product output have dropped by 2.9%. Overall, industry is growing more slowly than at the beginning of 2004 because of expensive raw materials and slower growth in prices for Ukrainian exports.

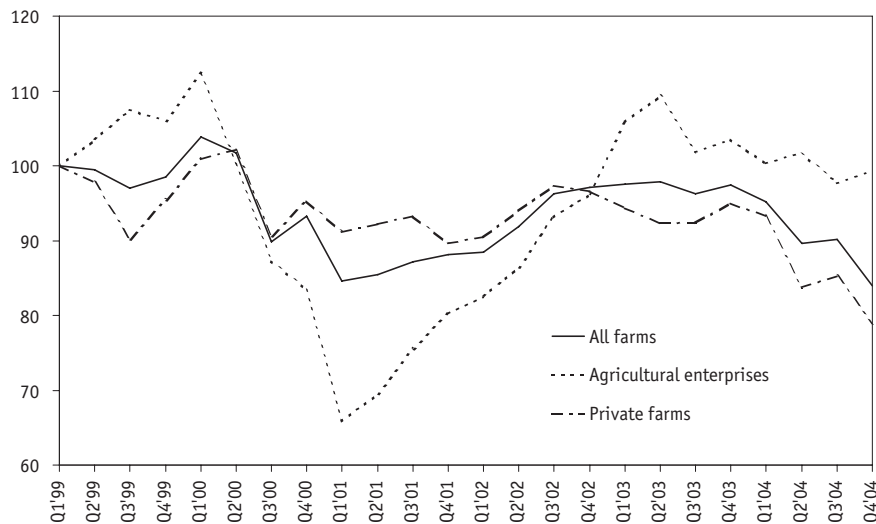
## ***Inflation is high***

Consumer prices grew 4.4% over January–March. Food prices rose the fastest: meat and poultry, milk and dairy products, potatoes, vegetables, and fruit. Among non-food items, medications grew noticeably more costly, while among services, local and highway transport did. A rapid climb in prices for consumer goods remains the biggest risk to the new Government’s economic policy in 2005. Increasing expectations of inflation and the further growth of disposable incomes are likely to push prices up quickly in 2005. A sharp and large-scale increase in social benefits could accelerate inflation still further.

Among the items in the consumer basket, meat grew the most in price. This is largely because of a steady decline in supplies since 2003.

**Figure 1. Sales of cattle and poultry for slaughter (liveweight)**

Index, seasonally adjusted, Q1'99 = 100



Source: Derzhkomstat; calculations by Political Commentary

Manufacturer prices for industrial goods grew 4.9% over January–March 2005. This is lower than the growth registered in the same period of 2004, 6.8%. ICPS analysts connect this to a stabilization in world prices for metals. In 2005, the main factor pushing inflation in producer prices will remain rising prices for Ukrainian export commodities and growing costs of fuels—gas and gasoline—for industrial producers.

In January, revenues to the Consolidated Budget were 28.5% of GDP, compared to 26.2% in 2004. This occurred because of growing receipts from corporate profit taxes and import duties. Revenues from personal income taxes, VAT and excise tax were lower in January 2005 than in the previous year.

Expenditures in the Consolidated Budget for January 2005 were 22.2% of GDP, which was lower than in 2004. 97.5% of this went on current expenditures. The largest single item was pensions and social assistance—44% of all payments, versus 19% in January 2004. In this way, the shortfall in the Pension Fund, which ICPS economists estimate at a possible UAH 10bn, was covered by Budget monies in January.

In January–February 2005, real disposable household incomes grew 25.1% over the same period of 2004. This indicator grew because of a sharp rise in social benefits, up to 80% in nominal terms, against a low baseline in the first few months of 2004.

***Disposable private incomes grew 25% over January–February***

In March, the Government paid out coupons on the principal against bonds worth US \$168.2mn and EUR 122.6mn. Altogether, there are Ukrainian government euro-bonds issued in 2000 worth EUR 1,167.67mn and US \$1,587.55mn in foreign circulation. In March, the Government was able to cover 62.665% of the principal on this debt. Overall, state and secured debt amounted to nearly 24.7% of GDP in 2004. According to the 2005 State Budget, the Government will be borrowing UAH 9.5bn on the domestic market and UAH 3.2bn on foreign markets.

Thus, at the beginning of March, the Government borrowed nearly UAH 0.2bn on the domestic market. In contrast to earlier borrowings in January and February, annual interest on these bonds was reduced from 9.8% to 6.7%. Most likely the buyers of these bonds were foreign investors, for whom this level of income is acceptable as long as the hryvnia-dollar rate remains as stable as it is. Altogether, internal borrowings have added up to UAH 2.389bn since the beginning of the year.

Such huge borrowings at the start of the fiscal year are tied into the enormous social commitments that the Government has taken on without being able to ensure the necessary revenues to cover them.

In February, personal deposit grew again, to a level higher than prior to the winter political crisis. The share of hard currency deposits shrank somewhat, but remained higher than it had been at the start of 2004. This trend confirms a renewed trust among average Ukrainians in the domestic banking system, on one hand, and increased inflationary expectations on the other. Domestic demand for hard currency among private individuals dropped down to nearly June 2004 levels. For the first time since September 2004, the general populace sold more hard currency to banks than it purchased.

ICPS economists anticipate that the economy will grow 8% in 2005. Factors stimulating this growth will be high external demand for export commodities, as well as higher consumer demand for goods and services.

Consumer prices will rise 16% by the end of 2005, compared to December 2004. The CPI growth is likely to peak in Q1'06. Throughout 2005, consumer goods are likely to grow the fastest, along with regulated rates and prices—increases that had been postponed throughout 2004. The most felt rises will be for transport and residential services.

The State Budget deficit for 2005 will be 4% of GDP. According to ICPS, Budget revenues will be lower and expenditures higher than planned. The Budget share of

GDP will rise to 28%. Factors driving this increase will be the elimination of a number of tax holidays and a reduction in loopholes that allowed tax evasion. The Budget deficit will be partly financed by privatization revenues and partly through borrowings. About half of this borrowing, in the estimation of ICPS specialists, will be on the domestic market.

Although Ukrainian imports will grow faster than exports in 2005, the current account and trade balances will remain high. This, in turn, will enable the NBU to maintain a stable hryvnia/dollar exchange rate and even to consider a slight revaluation in light of the continuing slide of the dollar against world currencies. ICPS analysts do not expect the National Bank to seriously revalue the hryvnia against the dollar and predict that the exchange rate will remain at the level of UAH 5.25/1 USD.

**Table 1. Key macroeconomic indicators**

Indicators	2001	2002	2003	2004	2005		ICPS forecast for 2005
					1	1-2	
GDP, <i>rcc</i> , <sup>2</sup> %	9.2	5.2	9.6	12.1	6.5	5.5	8.0
GDP, <i>mn UAH</i>	204,190	225,810	264,165	345,943	24,278	50,064	418,800
Gross fixed investment, <i>rcc</i> , %	6.2	3.4	15.8	10.2	—	—	7.0
Private consumption, <i>rcc</i> , %	9.0	9.0	12.1	15.8	—	—	16.0
Public consumption, <i>rcc</i> , %	10.4	-6.7	14.8	4.7	—	—	3.0
Industrial output, <i>rcc</i> , %	14.2	7.0	15.8	12.5	8.4	7.3	9.5
Agricultural output, <i>rcc</i> , %	10.2	1.2	-9.9	19.1	3.7	3.5	0.5
Retail sales, <i>rcc</i> , %	13.7	15.0	21.0	20.0	21.2	20.3	17.0
Exports, FOB, cumulative change, %	11.6	10.4	28.5	41.6	16.0	...	17.0
Imports, CIF, cumulative change, %	13.0	7.6	35.6	26.0	4.0	...	22.0
Current account balance, <i>mn USD</i>	1,402	3,173	2,891	6,804	—	—	6,400
Net FDI, <sup>3</sup> <i>mn USD</i>	769	688	1,411	1,711	—	—	1,800
Disposable household income, <i>rcc</i> , %	14.5	18.0	7.8	18.2	26.6	25.1	15.5
Consumer Confidence Index <sup>4</sup>	94.9	93.4	99.4	100.1	—	—	—
Average pre-tax wages, <i>UAH</i>	311.6	376.4	462.3	589.6	640.9	653.1	—
Average pre-tax wages, annual real average change, <i>y-o-y</i> , %	19.3	18.2	15.2	23.8	13.5	14.3	10.5
Unemployment, ILO methodology, %	11.1	10.1	9.1	...	—	—	7.5
Consolidated Budget revenues, % <i>GDP</i>	26.9	27.4	28.5	26.2	28.5	...	28.0
Consolidated Budget expenditures, % <i>GDP</i>	27.2	26.7	28.7	29.6	22.2	...	32.0
Balance (deficit (-), surplus (+)), % <i>GDP</i>	-0.3	0.7	-0.2	-3.4	6.3	...	-4.0
Consumer Price Index, %	6.1	-0.6	8.2	12.3	1.7	2.7	16.0
Index of Inflationary Expectations <sup>5</sup>	169.6	178.7	186.1	180.0	—	—	—
Broad money M3, change since start of year, %	41.9	41.8	46.5	32.4	-0.1	4.1	42.0
Average official exchange rate, <i>UAH/USD</i> <sup>6</sup>	5.372	5.332	5.333	5.319	5.305	5.300	5.250

Sources: Derzhkomstat, Treasury, NBU, ICPS

<sup>2</sup> *rcc* = real cumulative change.

<sup>3</sup> Net FDI = foreign direct investment in Ukraine, less direct investment abroad by citizens of Ukraine.

<sup>4</sup> The aggregate Consumer Confidence Index is calculated as an average of separate indices; values can range between 0 and 200. The index is equal to 200 when all the population is positive about the economic situation. It is equal to 100 when the shares of positive and negative expectations are equal. It is less than 100 when negative expectations prevail.

<sup>5</sup> This index ranges from 0 to 200. It is equal to 200 when all the population expects inflation to rise. It is equal to 100 when the shares of the population expecting inflation to rise or fall are equal. This index is more than 100 when expectations of rising inflation prevail.

<sup>6</sup> The indicator for the current year is calculated as the average for the last month of the indicated period.