

ICPS newsletter

Political destabilisation is the main risk for economic growth

A new issue of ICPS's Quarterly Predictions journal will be published this week. We present our forecast for economic development in 2003. In our opinion, Ukraine's economy will be rapidly growing over the next few years. However, the dynamic of growth will be very sensitive to political instability on the eve of the parliamentary elections, which is likely push government policy off the long-run planning path. We forecast that GDP will grow by 5.5% y-o-y in real terms in 2001; in 2002, the growth will decelerate to 5%, picking up to 6% in 2003

In Q1'01, economic growth accelerated again. Real GDP grew by 7.7% y-o-y. Inflation bottomed out over the last three years. As a result of business growth, tax revenues of the budget increased, and so did real wages. The UAH/USD exchange rate remained stable, under conditions of rapidly increasing exports and dwindling imports.

In Q1'01, industries oriented upon domestic demand grew the most rapidly. This was primarily due to a further increase in household consumption and a rise in investment demand, which was highest in the accelerating construction and agricultural sectors.

Political crisis undermines the consistency of government policy

Political tensions are rising on the eve of the parliamentary elections, having peaked in the outpost of the reformist Cabinet. This puts the quality of the government's economic policy under threat. The Communist and vested interest centrist factions of the Verkhovna Rada have ended up in an alliance—not because they aim at the same societal targets; rather, their concerted action results from a temporary coincidence of political interests before the 2002 political elections. This alliance can neither develop

common policy nor form a Cabinet, for the parties are guided by far-from-common ideologies.

In case the alliance succeeds in creating a Cabinet, members of the government will be more concerned about pleasing the backroom forces than maximising national wealth. Being aware of the low capacity of Ukrainian democratic institutions to openly reconcile various interests, we forecast with a high degree of certainty that the policies of such a government would not be consistent. The previous Cabinet, headed by Viktor Yushchenko, set up procedures for collective decision making that allowed preventing the adoption of decisions countering government strategy. However, these procedures are not sufficiently robust to withstand the attempts of one or another party to engage in discretionary decision making, or to rescind decisions already made.

If political forces do not reach a consensus regarding the nominee for the post of Prime Minister, it is likely that the current Cabinet of Ministers will continue to work in the status of acting Cabinet until the 2002 parliamentary elections. This variant seems to be less harmful for economic development, since in this case the government policy will be more consistent and social welfare-oriented.

Political destabilisation will corrupt the strategic attitude towards state policy and create risks of reversing decisions approved in 2000. Yet, the quality of the government's economic decisions will not deteriorate too much, thanks to the following factors:

- During 2000, the transparency of the government increased. The government widely publicised its action plan, discussing the outputs and outcomes of the state policy. Some interest groups, along with the structuring of the Parliament, were transformed into official political groups and parties. As a result, Ukrainians became more aware of the impact that government decisions may have, as well as

What changed in 2000?

A specific characteristic of the political situation in H1'00, when the government implemented a number of reforms, was the ideological consensus between the President, the right-wing and centrist majority of the parliament, and the Cabinet of Ministers. We define ideological consensus as an integrity of the following strategic goals: 1) development of democracy, (2) development of a market economy, and (3) integration into the EU. Under this consensus, the government managed to approve a number of decisions, which allowed boosting entrepreneurship and optimising the use of public goods. We view the following resources as the most important:

- approval of a realistic budget for 2000 and a ban on non-cash settlements with the budget;

- privatisation of collective agricultural enterprises (KSPs) and demonopolisation of lending to the agricultural sector;
- approval of the Privatisation Program, which set the baseline for transparent and foreseeable sales of state property;
- amendments to the Law "On electricity", which significantly restricted the scale of non-payments in the electricity market, thanks to strengthened contract enforcement in the market and a stricter system of distributive accounts;
- introduction of a new mechanism for collective decision making that prevents the approval of decisions hindering entrepreneurial activity.

of the forces that lobby particular decisions. The new Cabinet of Ministers will be forced to analyse and weigh each decision carefully, for the electorate would regard deteriorating conditions as mistakes of the political forces that formed the government.

- Competition strengthened, thanks to reforms in 2000 and increased economic activity. The more competitive a market is, the more difficult it becomes to push through decisions which favour some (among the many) market agents. Therefore, we anticipate that the quality of government decisions will remain poor with respect to the least competitive markets, primarily those where the government holds a large stake. These would include the electricity sector, coal mining, oil extraction, and gas supply.

- Units dedicated to professional analysis of government policy have emerged within the government bureaucratic structure. Thus, the work of government analysts should contribute to ensuring better quality Cabinet decisions.

In our opinion, under the present conditions of weak democratic institutions and continuing political struggle, the implementation of key reforms before the 2002 parliamentary elections appears to be unrealistic, since these reforms need to be backed by political consensus and the priority of national interests. Conversely, the decisions of the current government will concern only short-term problems. The price that the country will pay for stalled reforms will be increased cost of business in Ukraine.

We hope that the implementation of reforms will speed up in 2003, after the parliamentary elections. In our opinion, the structure of political forces will improve then, which will allow forming a uniform parliamentary majority, as well as a government supported by this majority. The higher degree of political consensus will lay the foundation for more consistent policies, and will favour the approval of key reforms.

Entrepreneurship will overcome political instability

Economic growth creates new opportunities for generating profits, thanks to increased demand, and businesses are very sensitive to these changes. If the government crisis is resolved and financial stability is maintained, business development should proceed unhindered. Competition is at the heart of this process. To outstrip competitors, firms make investments and thus raise productivity; they struggle for the market share and introduce new management and marketing strategies. Moreover, each year the Ukrainian businesses are acquiring more experience in working under market conditions, expanding their business networks, searching for and finding trustworthy clients, and discovering ways to reduce costs and increase effectiveness.

Taking into account these factors, we forecast that, despite the far less rosy prospects for changes in government policy compared to the previous quarter, the pace of economic growth will still be high. In our opinion, GDP growth will reach 5.5% in 2001, decelerating to 5% in 2002 and speeding up to 6% in 2003.

During 2001–2002, economic growth will slow down, which will primarily result from the instability of government policy and absence of a clear strategy. Industries which require long-term capital injections and foreign high-tech investments will suffer the most, since the majority of foreign companies will prefer to stay out of Ukrainian markets. The same circumstance puts the privatisation of strategic companies, including Ukrtelekom, under threat and reduces their value. Yet, we expect that economic growth will not slow down significantly, thanks to market-like behaviour of domestic firms and their rapid adjustment to ever-changing political conditions.

We forecast that economic growth will accelerate in 2003, thanks to the implementation of reforms and anticipated political consensus after the parliamentary elections. ■

Major indicators

	2000	2001	2002	2003
		(estimate)	(forecast)	(forecast)
Economic activity				
GDP, millions UAH	172,952	207,600	241,600	281,700
Real GDP, apc*	5.8	5.5	5.0	6.0
Real industrial production, apc	12.9	9.0	8.0	8.5
Real industrial output, apc	7.6	6.5	5.5	5.0
Gross investment, % GDP				
FDI, millions USD (1)	594	1,100	1,300	1,500
Real household disposable incomes, apc	11.1	8.0	7.0	7.0
Real retail trade, apc	7.5	5.0	4.0	4.0
Prices				
Consumer price index, apc	26	13	11	10
Producer price index, apc	21	13	10	8
Labour market				
Population, millions	49.3	49.1	48.9	48.7
Real wage, average apc	1.0	3.0	3.5	4.5
Official unemployment rate, %	4.2	5.0	6.5	7.5
Foreign economic activity				
Exports of goods&services, apc	20.3	5.0	5.5	6.0
Imports of goods&services, apc	18.9	7.0	8.0	8.0
Current account balance, % GDP	4.7	3.2	1.7	0.7
Budget				
Revenues (consolidated), % GDP	27.5	26.0	26.0	24.0
Current balance, % GDP	0.5	0.3	0.1	0.1
Balance by IMF methodology, % GDP	-1.2	-1.8	-2.2	-1.1
Monetary indicators				
Monetary base, apc	39	23	16	12
M3, apc	45	30	20	16
NBU international reserves, millions USD	1,539	1,980	2,500	2,760
Official exchange rate average annual, UAH/USD	5.44	5.48	5.75	5.93
Interest rate on loans, average annual, yearly % (2)	41	32	28	25
International				
World GDP, apc	4.7	2.9	3.5	3.6
GDP of Ukraine's major trading partners (2/3 of exports), apc	5.7	2.8	4.1	4.0
* apc = annual percentage change				
Notes:				
(1) according to NBU				
(2) commercial banks loans, hryvnias				
Sources: State Statistics Committee, NBU, and Finance Ministry; calculations and forecast by Quarterly Predictions.				

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