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Ukraine's economic growth: Key factors, and caveats for the future

Ukraine is stepping onto the path of economic growth. In 2000, the country's GDP increased by 6% for the first time since independence. In 2001, the growth rate, accompanied by a two-digit growth in investment and single-digit inflation, is expected to be even higher. ICPS economists Ruslan Piontkivsky and Tetiana Sytnyk comment on the reasons for this economic growth and evaluate its sustainability potential

The underlying reason for the growth in Ukraine is the learning process within both the government and the private sector on how to operate in a market economy. Government policies have become more predictable and have learned how to make profits, by reacting swiftly to changing demand and enhancing competition.

The impetus for the growth was given by the hryvnia's devaluation resulting from the financial crisis in 1998. Devaluation stimulated growing exports and import substitution. The enormous increase in external demand, caused by fast growth in the world economy, contributed to the boom of Ukraine's exports in 2000. Although a slowdown in the world economy has become more tangible in 2001, Ukraine's economy continues to grow with strong recovery in domestic demand compensating for the slowdown in external demand.

Public policy

The Ukrainian government's policies still remain inconsistent. However, the range of these fluctuation in quality has been reduced. The following policy commitments have spurred persistent growth:

• strict budget policy — First, in 2000 the government banned non-cash payments to the budget. Second, cash execution of the budget allowed repaying wage arrears in the government sector as well as pension arrears thus improving the consumer confidence of the poorer population groups. Third, the budget surplus has limited inflation and promoted financial stability;

• privatisation — This has allowed new owners to gain control over their enterprises. As a result, they have become interested in investing in the enterprises, instead of simply stripping assets. In coming years, government plans to sell its stakes in the machine-building, energy, and telecommunication sectors;

• agricultural reform — In 2000, the property of former collective farms was transferred to private owners. The government also demonopolised the market of inputs for the agricultural sector and promoted bank loans to the sector by subsidising interest from the budget. Economists forecast further progress in reform after the adoption of a new Land Code that will allow the purchase and sale of land, as well as its mortgage;

• simplified taxation (single tax) for small businesses — The presidential decree passed in 1999 has allowed small enterprises to pay a flat tax and substantially reduced reporting requirements for small businesses. As a result, many shadow activities have been legalised;

• decreased taxation burden — Particularly, the biggest changes included the abolishment of contributions to Chornobyl Fund (10% of payroll) and State Innovation Fund (1% of enterprise turnover). Further reductions of the tax burden are envisioned in the draft Tax Code, which is currently being reviewed by parliament.

Evolution of business behaviour

Adapting business behaviour to market conditions has helped to increase the productivity of Ukrainian enterprises. While increased competition was the main push towards a greater productivity, privatisation was the main pull. When private owners received control over enterprises, they demanded higher profit performance from management. In 1998–1999, managers responded with reduced costs, particularly, labour costs. The unemployment rate, calculated by ILO methodology, increased from 8.9% in 1997 to 11.9% in 1999. In 2000–2001, managers strove to capture rising demand and to outstrip competitors. Enterprises increased investments and introduced new products. As business confidence grows, businesses are becoming more oriented towards long-run planning.

Businesses are investing actively in Ukraine. Gross investment rose by 12% in 2000, and it is estimated to reach 16% in 2001. Investments are heavily needed to replace obsolete equipment and to capture new markets. Currently, most investments are financed from enterprise profits, but financial stability will eventually stimulate commercial banks to increase their stake through long-term lending.

Evolution of consumer behaviour

Recovery of consumer demand is driving economic growth. Consumer confidence has been increasing in response to financial stability, greater predictability of government policies, and improving economic prospects. In

June 2000, ICPS, in cooperation with the marketing research company GfK-USM, launched a consumer confidence survey. From June 2000 through September 2001, the Consumer Confidence Index increased by 30 points[1]. Throughout 2000, most of the increase in consumer confidence was due to the growing optimism of Ukraine's low-income citizens. In 2000, the revenues of this group increased as a result of redemption wage and pension arrears. After a long period of deprivation, poorer people responded to the increase in their revenues primarily by increasing consumption.

Constraints to growth

Private entrepreneurship in Ukraine is gradually getting stronger and more capable of overcoming the poor quality of government policies. Managers are learning how to influence policies in an open democratic manner. However, as economic growth persists, entrepreneurs will face such obstacles to expansion as the lack of skilled labour and the lack of capital.

Educational reform is lagging behind the development of a market economy. Consequently, the education system is still not reacting properly to changing demands in the labour market. Enterprises are having problems in finding labour with relevant skills. Moreover, lacking external financing, enterprises do not have sufficient resources to displace obsolete equipment. The constraints can be removed with the expansion of the banking system and FDI inflows.

The lack of sufficient capital in the energy, transportation, and communications sectors threatens the development of the whole economy. Establishing clear regulations for these markets and successful privatisation are the way to attract investments to these sectors. In Ukraine they are just starting to comprehend the importance of this issue, otherwise infrastructure sectors will become bottlenecks of the Ukrainian economy.

Financial stability

During the last 3 years, the financial environment in Ukraine has improved noticeably. In 2001, inflation will not exceed than 10%. The exchange rate has been stable for nearly two years, and he monetary reserves of the NBU have reached their highest level — $3 billions.

In our opinion, two major factors have helped to restore macroeconomic stability:

• The real devaluation in 1998–99 fostered improvement of the trade balance. Domestic producers benefited from price competitiveness on import substitutes, while export-oriented industries used the advantage of less expensive domestic labour and supplies to expand into international markets. As a result, the current account changed from a deficit of 3% of GDP in 1998 to a surplus of 2.6% GDP in 1999, and further to 4.7% of GDP in 2000.

• Fiscal policy became much more tight. Unavailability of financing from private sources, strict conditions of international financial institutions (the IMF and World Bank), and tough lessons learned from previous experience made the authorities cut excessive expenditures. The government deficit diminished from 2.4–2.7% of GDP in 1998–99 to a mere 1.1% GDP in 2000. Starting 2000, when privatisation revenues exceeded the deficit, the government began to cut the public debt.

The combination of tight fiscal policy and forex inflows from the current account surplus resulted in more expansive monetary conditions for private agents. Two positive processes characterise the current macroeconomic outlook:

• Expanding financial intermediation. Bank lending has been growing since the time when the first indications of economic recovery appeared. From Q3'99 to Q3'01, bank lending increased in real terms by 88%. Moreover, it has been accompanied by a visible improvement in the quality of loan portfolios, with the share of bad loans dropping from 35% to 17%;

• Trust in the national currency has increased due to a more responsible fiscal stance, a modified regime of the exchange rate, and better tracking of inflation. Tightening of the fiscal policy was accommodated by a growth in money demand, fuelled by production growth and a declining share of non-cash transactions.

However, these positive developments should not be overestimated. Continued stability of the macroeconomic environment will rest on the ability to overcome the following obstacles:

• real interest rates on loans remain high;

• non-bank financial intermediation is undeveloped;

• foreign direct investment inflows (those not related to privatisation) are low;

• the government's t-bill market credibility is restoring very slowly, as many market players do not trust policy changes to be irreversible;

• the persistence of wide currency substitution (dollarisation) makes the exchange rate and money demand potentially more volatile, and a financial crisis — thus more likely.

External risks

The decrease of growth in developed countries presents a significant risk for Ukrainian economy. It is important to correctly estimate the possible scale of this decrease, as well as to forecast the moment of its cessation. ■

The updated forecast will be published in the November issue of "Quarterly Predictions".

For more information, please contact Ruslan Piontkivsky, ICPS Senior Economist, e-mail: rpiontkivsky@icps.kiev.ua; or Tetiana Sytnyk, ICPS Chief Economist, e-mail: tsytnyk@icps.kiev.ua; tel.: (38044) 463-5966.

ICPS regular economic research is posted at www.icps.kiev.ua/ukr/economic_policy.html.

[1] The Consumer Confidence Index increased from 64 in June 2000 to 94 in September 2001. This means that in September 2001 almost half of respondents expected the improvement in their welfare.

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ICPS Newsletter editor Maria Melnyk (mmelnyk@icps.kiev.ua)
English text editor D. (Ksenia) Ovcharenko.

The International Centre for Policy Studies is an independent non-profit research organisation whose mandate is to promote the introduction of public policy concepts and practices in Ukraine.
Address: 8/5 Voloska Street, Kyiv 04070, Ukraine
Phone (380-44) 462-4937/38/48.
Fax (380-44) 463-5970
Web-site: http://www.icps.kiev.ua