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ICPS newsletter

Economic growth will slow down in 2002–2004

This week, a new issue of ICPS's Quarterly Predictions journal is to be published. Ukraine's economic trends in 2001 saw the highest GDP growth and the lowest inflation rate since independence. In 2002, growth will decelerate to 4.5%, due to the worsened situation of trade partners. In 2003, thanks to economic acceleration in Ukraine's trade partners, and improved government policy at home, GDP will increase by 5.5%. In this issue, we look into the 2004 forecast for the first time. GDP growth will drop to 5%, primarily because of structural problems and rising political tension

Increasing constraints to growth

In 2001, the GDP growth rate surged to 9%, which was a new record high for Ukraine (in 2000, GDP increased by 5.9%). The major development factor was increased domestic demand. All through the year, consumer confidence was picking up, and by the yearly results, household spending increased by 12.5% in real terms. Having optimistic expectations, enterprises planned production expansion, and hence, invested actively in order to enhance their own competitiveness. By the yearly outcome, the volume of investments into capital assets augmented by 17.2%.

At the same time, in 2001, further growth came to be impeded by state-of-the-market factors, which will have an effect in the short run, as well as structural factors, which will be affecting the economic situation for a longer period. We believe that the following restrictions are holding sway over the market situation:

• worsened current dynamics of the global economy and uncertainty over its future progress; therefore, we forecast that export growth will decline sharply in 2002;

• slowed dynamics of domestic demand, in view of stabilised consumer confidence; in our opinion, this change will be short-lived. In the structure of the consumer confidence index, short-term expectations regarding economic development dropped, though expectations regarding long-run development remained optimistic.

According to our forecast, in 2002, economic growth will slow down to 4.5% under the sway of these factors. In 2003–2004, the impact of unfavourable market-situation factors will be gradually mitigated, as the situation of Ukraine's trade partners picks up and the behavioural pattern of Ukrainian consumers also alters (thanks to an increase in their incomes). At the same time, economic development will be increasingly more affected by structural restrictions curbing growth—outdated equipment, shortage of skilled personnel, and immature infrastructure. In 2003, GDP growth will speed up to 5.5%; in 2004, it will slow down to 5%, primarily due to increased political tension (around the presidential election).

A survey recently conducted by the Scientific Research Institute of Statistics, in Ukraine show that increasingly more enterprise managers consider outdated equipment and a lack of skilled workers to be the main obstacles to further economic progress. The primary issue for transport enterprises is obsolete equipment, while for construction enterprises it is the lack of qualified workers. At the same time, enterprise managers in all sectors except for construction sector are encountering with a more fierce competition in the domestic market. Therefore, competition will stimulate entrepreneurs to overcome barriers to economic growth by (1) investing in new equipment, and (2) raising wages in order to attract skilled workers.

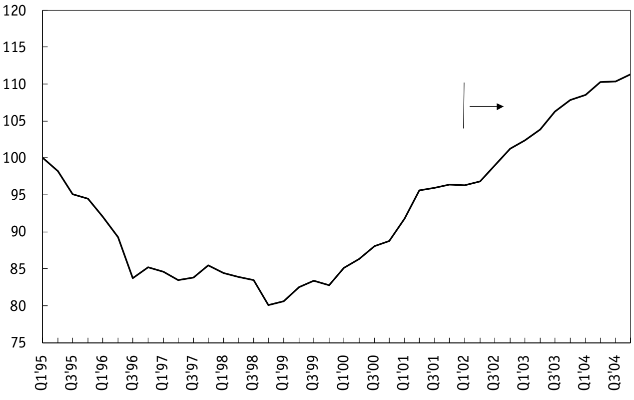
The lack of a developed infrastructure imposes additional non-production losses upon entrepreneurs, and the uncertainty interferes with their planning. We cite as an example theimmense inefficient transport expenditures and limited possibilities of export for agricultural produce, due to the lack of a proper logistics system. In our opinion, in infrastructure sectors there are possibilities of obtaining profits that are not fully employed in Ukraine. Economic growth leads to an increased demand for high-quality and modern services in the infrastructure sector, but today's antiquated system is not capable of satisfying this demand. In order to smooth out this discrepancy, a policy of government regulation of natural monopolies must be worked out, and mechanisms to attract private capital should also be established.

Financial stability

During 2001, the renewal of business activity in Ukraine should largely be accredited to financial stability. The positive trade balance and more optimistic outlook of economic agents pushed up the hryvnia exchange rate by 2.5%, and doubled international foreign currency and gold reserves. The rapid expansion of the monetary base spurred by the currency influx did not trigger

Real GDP

Index, seasonally adjusted, Q1'95=100



Source: State Statistics Committee;
calculations and forecast by Quarterly Predictions.

surging inflation, because of the increased real demand for money. The inflation rate in the consumer market dropped to a record low value—6.1%. At the same time, real lending to the private sector by commercial banks increased by a record 37%.

Nevertheless, preserving financial stability this year will be a thorny task. According to our forecast, deterioration of the foreign trade balance will set the pace of trends in the currency market (the heretofore stabilised exchange rate will undergo a moderate depreciation), while difficulties with budget execution and higher tariffs for the services of natural monopolies will lead to accelerated inflation.

We believe that government will manage to forestall negative financial expectations. The NBU will adhere to its policy of preserving a stable real exchange rate, ensuring that any depreciation will be smooth. At the same time, the Ministry of Finance will not allow any increases in the budget deficit.

Improved government policy

In our opinion, during 2001 the main idea behind the government's economic policy was maintaining the *status quo*. Most final decisions requiring approval, were broached either back in 2000 or under the pressure of external forces. Thus, the executive "missed the boat" of the economic upturn and did not accomplish any reforms. The adverse consequences of such inertia revealed themselves already by the end of 2001, when the budget deficit swelled as a result of the decelerated economic dynamics.

Further on, when the economic growth will plateaus, and structural limitations will become more conspicuous, the *status quo* strategy will be increasingly hazardous. We consider it quite likely that in the newly elected parliament a majority will form that will demand new initiatives from the government and will undertake the responsibility for approving the required decisions. According to our predictions, they will focus first of all on the following directions of government policy:

• **Tax policy.** The unreformed tax system impedes economic progress. The non-transparent administration system leads to inefficient expenditures of enterprises and heightens the risks of business activity. The overly cumbersome tax burden heaped upon employers and employees forces enterprises to shift to the shadow sector and hampers the creation of new jobs. Due to the inconsistency of many budget items and the threat of an imbalance, the tax reform has been put on the back burner. Thus, we adjust our assumption regarding the enactment of the Tax Code; it will come into effect only at the outset of 2004. The reason for this change lies in the urgent need to coordinate the tax policy and its legal formalisation in the new redaction of the Tax Code. We believe that full responsibility for this scope of work should be undertaken by the Minister of Finance, who needs to develop the required capacities in order to accomplish it, however, that will require some time;

• **Government regulation of natural monopolies.** Because of abuses of monopoly positions and inefficient spending, the Ukrainian society sustains losses all the time. International experience offers a series of regulations to minimise these losses. However, the lack of such regulations will reduce the role of privatisation to that of merely transforming the state monopoly into a private one, and will not assist in attaining public goals. Since there is a need to regulate relationships in the Ukrainian telecoms market (otherwise, the privatisation of the Ukrtelekom OJSC will not bear positive results), we venture the assumption that the sale of Ukrtelekom shares to a strategic investor will take place not in 2002, as it is set forth in the budget plan, but in 2003.

In our opinion, the anticipated creation of a parliamentary majority and achievement of a political consensus will enhance the quality of government policy in 2003. However, in 2004 the political struggle prior to the presidential elections will spawn an atmosphere of uncertainty and risk among business circles.■

Major indicators

	2001	2002	2003	2004
	(estimate)		(forecast)	
Economic activity				
GDP, *billions UAH*	204.1	228.2	260.0	289.4
Real GDP, *apc**	9.0	4.5	5.5	5.0
Real industrial production, *apc*	14.2	6.0	9.0	8.0
Real agricultural output, *apc*	10.0	7.0	6.8	5.8
FDI, *millions USD* (1)	700	700	1100	900
Real household disposable income, *apc*	14.5	7.0	7.0	8.0
Real retail trade, *apc*	11.7	6.0	6.5	6.0
Prices				
Consumer price index, *apc*	6	9	6	6
Producer price index, *apc*	0.9	4.5	5.5	4.5
Labour market				
Population, *millions*	49.1	48.9	48.7	48.4
Real wages, *average apc*	20.9	4.6	5.7	7.0
Official unemployment rate, %	3.7	5.0	5.5	5.0
Foreign economic activity				
Exports of goods&services, *apc*	10.0	5.5	8.0	7.0
Imports of goods&services, *apc*	14.0	12.0	10.0	8.0
Current account balance, *% GDP*	3.2	0.3	0.9	1.3
Budget				
Revenues (consolidated), *% GDP* (2)	25.5	24.5	24.5	24.0
Balance (IMF methodology), *% GDP*	1.2	0.8	1.5	0.2
Monetary indicators				
Monetary base, *apc*	37	19	14	11
M3, *apc*	42	22	23	13
NBU international reserves, *millions USD*	3095	3340	3900	4100
Official exchange rate (average annual), *UAH/USD*	5.37	5.52	5.78	5.95
Loan interest (average annual), *yearly %* (3)	32	28	25	22
International				
World GDP, *apc*	1.3	1.3	3.2	3.5
GDP of Ukraine's major trading partners (2/3 of exports), *apc*	2.6	2.8	3.7	3.9

** apc = annual percentage change*

Notes:

(1) according to NBU;
(2) calculated by IMF methodology since 2001;
(3) commercial banks loans, UAH

Sources: State Statistics Committee, NBU, and Finance Ministry; calculations and forecast by Quarterly Predictions.

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