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ICPS newsletter

ICPS forecasts sustainable economic growth in 2003-2005

While in early H2'03 Ukraine's economy showed decreased GDP growth, ICPS has upgraded its forecast for economic growth in 2003 to 6%. ICPS forecasts as regards the dynamic of Ukraine's economy in 2003–2005 are unveiled in the next issue of the Quarterly Predictions journal, which went to print last week

The first downturn in agriculture in the past four years has led to a slowdown in overall economic growth in Ukraine. However, in view of a continuing favourable external economic situation, intensified domestic competition in the most developed sectors of the economy, and rapidly rising personal incomes, we upgrade our forecast for economic growth in 2003 to 6%. The effect of these factors is expected to continue throughout the forecast period. In 2004, real GDP growth should accelerate to 6.5%, thanks to rising consumption, while in 2005 the economy should continue to grow at this year's pace, with a focus on greater investment. The chief risk to the forecast will remain political instability on the eve of the 2004 presidential election.

Current trends

In early H2'03, the growth of the Ukrainian economy began to slow down. While H1'03 results showed real growth of the national economy of 8.6%, the results for January–August 2003 showed a marked slowdown of real GDP growth, to 5.3%, approaching the 2002 rate. The slower pace of growth reflects the downturn in agriculture, while the chief factor spurring economic growth remained foreign trade (over H1'03, exports of goods & services picked up by 24% y-o-y).

A favourable foreign trade situation has been spurring industrial production, which amounted to 14.6% over January-August 2003, compared to 10.7% over Q1'03. This record high growth rate was the result of high prices for Ukrainian exports, primarily metals and chemical products. In addition, expanded demand for investment among metallurgical enterprises and rising consumer demand thanks to improved wealth of the population, speeded up growth in manufacturing.

Rapidly growing exports drove up imports, in particular, of machinery and equipment. This allowed enterprises to upgrade their fixed assets.

Macrofinancial stability, despite a slight increase in prices, continues. A record-high current account balance has attracted more hard currency to the country, ensuring a stable exchange rate, given the reluctance of the National Bank of Ukraine to revaluate the hryvnia-dollar nominal exchange rate. Nevertheless, there continues to be strong downward pressure on the hryvnia in relation to the currencies of its 12 key trading partners, which has increased the competitiveness of Ukrainian exports.

According to the results for January-July 2003, the Consolidated Budget surplus expanded to 2 billion UAH, 1.6% of GDP. Throughout 2003, there has been a continuous improvement in the execution of the revenue side of the budget, with the share of GDP re-distributed via the budget picked up compared to the same period of 2002. At the same time, the financing of budget expenditures, despite improvements, fell short once more. This partial financing of expenditures can be explained by the accumulation of funds in government accounts in anticipation of the next spike of foreign debt payments due in September, and anticipated increases in social benefit payments in late 2003-early 2004.

Based on the results of the summer months, the State Statistics Committee reported deflation of 1.7%. This took place despite a food crisis that was at its worst in late June, sending prices for certain foodstuffs (flour, pasta, cereals) soaring. It is probable that this deflationary indicator is actually underestimated, largely because of the State Statistics Committee's methodology for calculating this indicator.

Central and local government agencies continued their strategy of active intervention in price setting for basic necessities. Even though this resulted in a 0.5% decline in prices for bread and baked goods in August, this is most likely a temporary phenomenon. The absence of a long-term strategy for stabilisation, as well as the failure to support subsidies with the necessary budget funds will sooner or later result in a hike in bread prices—even skyrocketing prices, if decisions about grain imports are postponed through inconsistent government policy.

The incumbent Prime Minister Viktor Yanukovych has become the most popular among pro-government politicians, largely thanks to a continuing high economic

Read in the new issue of Quarterly Predictions:

- Who benefits from the proposed reform of the state system?
- How will changes in tax and pension legislation affect personal incomes and corporate profits?
- Causes and effects of the food crisis of 2003
- Is there a need for early debt re-payment to the IMF?
- What are the reasons behind the sudden increase in investments in Ukraine?
- How to tackle the problem of energy-generating capacities?
- Why are targeted subsidies better than tax breaks for agricultural producers?
- Development prospects for foreign trade in the Western regions
- New and old Europe: Cooperation or conflict?

growth rate in H1'03. At the same time, the approach to reform in Ukraine gives cause for concern. Tax reforms clearly lack a consolidated strategy, and cancelling tax holidays has proved more of a challenge than slashing the tax rate has been. The government has not yet managed to substantially expand the tax base and ensure a direct relationship between tax rates and social security, in reacting to the food market crisis that caused prices to skyrocket in late June, the government promptly resorted to "administrative" measures, the privatisation continues to be guided not by the principle of finding the most effective owner and maximising budget revenues but by the desire to preserve the status quo among influential financial and industrial groups.

Forecast for 2003

The government's focus on reforms and its relatively effective cooperation with the legislature should lead to better-quality draft laws submitted during the fall session. Given the current favourable external situation and expanded domestic demand, the prospects for the economy are better. Thus, we upgraded our 2003 forecast for real GDP growth from 4% to 6%.

The downturn in agriculture will slow to 9%, given the later harvesting. The industrial growth rate will slow down somewhat and end up around 12.5% for the year, owing to stabilised external prices for metal products and a minor rise in enterprise expenditures on inputs resources and materials. A halt in the soaring prices for Ukraine's basic exports will put downward pressure on turnover in goods & services, to 12% by late 2003.

The budget will have a moderate deficit of 0.5% of GDP. Some complications will arise over the preparation of the 2004 budget, because of a possible revision of indicators if the President approves the law, which will slash the VAT rate to 17% starting 1 January 2004, although this is, in fact, prohibited by the Law on the Budget.

We downgraded our inflation forecast to 6.5%, based on a deeper deflation than expected this past summer. Nevertheless, increased production costs and sharply rising inflationary expectations will prevent the government from raising rates for housing services and utilities.

The National Bank's increased volumes of currency purchases will push up the broad money base, which will likely rise nearly 50% this year. However, the impact of soft monetary policy on prices will be moderate. The average exchange rate will stay at 5.33 UAH/USD, although real depreciation will continue to stimulate exports.

Forecasts for 2004–2005

The forecast for an economic upturn for 2004 and 2005 has been upgraded, given the multiplying effect of 2003 changes; higher revenues in the thriving sectors will attract more investment and improve the wages of workers employed in these sectors.

Government activities in 2004 will likely focus on stimulating consumer demand and bringing already-initiated reforms to conclusion, rather than on attracting investments and starting new reforms that might jeopardise political ratings in an election year. In the short run, this will facilitate speedier GDP growth in 2004, when the economy will move ahead at 6.5%.

The government is likely to try to keep budget spending at 2003 levels, that is, 28.5% of GDP, in order to carry out its social obligations to the fullest. A high inflow of hard currency into the country and low lending rates on international markets will allow the country not only to refinance its foreign debt payments, but also increase its budget deficit, to 1.5% of GDP. This, in turn, will be financed by restructured foreign debts and privatisation.

However, no sectoral reforms will be undertaken prior to the election, because of an underestimation of their importance and pressure from influential business groups on the government. Such reforms might be initiated by a new President in 2005, although their pace and quality will depend largely on the character of the new head of state.

The orientation towards macrofinancial stability will continue. Large foreign debt payments and the risk of escalated inflation will inhibit NBU liberalisation in the financial sector, which is a key requirement of the World Trade Organisation. The National Bank of Ukraine will likely reduce many restrictions just prior to Ukraine's accession to the WTO, which is expected to take place in 2005. As market liberalisation unfolds, the exchange rate will be increasingly subject to fluctuations on the forex market. Maintaining a high current account balance under such conditions will drive the hryvnia exchange rate up to 5.25 UAH/USD.

Forecast risks

The failure to maintain a single, clearly set course of economic development, the unsatisfactory capitalisation of the economy, low mobility in the workforce, the overly sluggish process of de-monopolisation, and the weakness of many state institutions keep Ukraine vulnerable. The chief risks to the above forecast are:

- Destabilised political situation prior to the 2004 election, resulting from constitutional amendments and exacerbated political struggles in the run-up to the election;
- Rapid integration of Ukraine into the Common Economic Area which will result the delay of Ukraine's accession to the WTO, the preservation of the economy's current ineffective industrial structure, the absence of incentives to enhance the quality of public policy, and the loss of the possibility of following an independent trade—and, ultimately, economic—policy through a supranational body formed largely by Russians;
- Unlikelihood of good harvests in the mid-term, as a result of worsening seed stocks and numerous bankruptcies among agricultural producers, because of the collapse of prices in 2002 and the crop failures of 2003;
- An abrupt deterioration of the external market situation, due to the world price slump for Ukrainian exports and weakened economic situation of Ukraine's major trade partners;
- A jump in domestic prices, which could occur if the government refuses to allow modest increases in prices for a number of state-regulated goods, and postpones decisions regarding imports and price liberalisation;
- Lower tax revenues than expected in 2004, which would result in a bigger gap in the 2004 budget than forecast.■

Experts of the International Centre for Policy Studies have been producing regular forecasts for Ukraine's economic development since 1997. These forecasts are updated quarterly and published in the Quarterly Predictions journal. If you wish to subscribe to this publication, please contact Maksym Korepanov at tel.: +380-44-236-5464 or e-mail: marketing@icps.kiev.ua. You may also order our publications via the ICPS website: www.icps.com.ua or purchase them in the Internet shop at www.icps.com.ua/store/.

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To be included in the distribution list, please contact the ICPS publications department at marketing@icps.kiev.ua
icps newsletter editor Yevhen Shulha (shulha@icps.kiev.ua). Phone: +380-44-236-4477.
English text editor D. (Ksenia) Ovcharenko.