

ICPS newsletter

Adverse implications of delays on economic reforms. ICPS's new economic forecast

The International Centre for Policy Studies is preparing a new issue of the Quarterly Predictions journal, where it retains its pessimistic forecast of Ukraine's economic development during 2003–2004. We believe that in 2003 growth will slow down to 3.5%, while the year 2004 will see it accelerating only to 4%. The chief factor holding back growth will be the postponement of reforms. In its first forecast for 2005, ICPS predicts that GDP growth will accelerate to 4.5%, mostly thanks to increased investments. The launch of economic reforms in that year would lay the foundations for more rapid economic development subsequently. Over the forecast period, a moderate economic dynamic and a positive current account balance will contribute to price and exchange rate stability

GDP grew at a slower pace in 2002

According to the year-end results, during 2002 the growth rate of the Ukrainian economy plunged from 9.2% to 4.6%.

The main factor slowing down the growth was the poor quality of economic policy:

- delays on economic reforms, especially reforms in infrastructure sectors and tax reforms (see Table 1);
- poorer quality of the budget policy—in particular, rejection of the formal procedure to proportionately curtail expenditures again forced the "manual" management of spending. In 2002, the only budget articles that were 100% executed were the ones stipulating cash payments to the population. Meanwhile, there were substantial reductions in state investments, as well as accumulation of debts to services providers (especially infrastructure enterprises).

Investment growth decelerated to 5% in 2002, against 8% in 2001, prompted by: 1) accumulated debts of the State Budget and budget-funded organisations towards infrastructure enterprises (electricity, gas, and water production and supply; transport and communications); and 2) fallen investments across sectors which are financed from the state and local budgets (extracting industry, education, healthcare, public administration). Investments decelerated

despite sharp cuts in loan interest. In 2002, the share of bank loans in enterprise investments doubled, to 5%, yet it is still low. Therefore, own enterprise money will continue to be the main source of investment.

In 2002, consumption growth slid to 6% despite an accelerated increase in household incomes. We believe that the reason behind this dynamic was the worsened consumer expectations regarding Ukraine's economic development¹, which prompted increased saving.

Forecast for 2003–2004

We believe that the economic dynamic over 2003–2004 will be influenced by the presidential elections, which are to be held in autumn 2004. In such conditions, state policy will not be shaped by any long-term vision of national development, instead it will be dominated by short-lived political interests.

In 2003, GDP growth will fall to 3.5%, largely due to diminished consumption following the slowed growth in household incomes and worsened consumer confidence. Investment growth will stay at the 2002 level of 5%—due, in our opinion, to the following obstacles:

¹ According to the consumer survey conducted by ICPS and the GfK-USM company, consumer confidence in Q4'02 sank by 1.5 points y-o-y.

In this issue of Quarterly Predictions:

- Analysis of budget policy alternatives;
- Financing sources for the public debt during 2003–2005;
- Causes of an accelerated inflation in Ukraine in 2003;
- Causes of a record-high positive current account balance in 2002;
- Implications of the two-stage raise in the minimum wages in 2003;
- Impact of the military operation against Iraq upon global oil prices.

(1) reduced own investment funds of enterprises because of higher expenditures on wages; and (2) slowdown in lending.

According to our forecast, in 2004 the economy will grow faster, at 4%, thanks to accelerated consumption given the following factors: (1) income growth will accelerate, spurred by an increased number of social benefits paid out prior to the presidential election; and (2) decreased personal income tax rates.

Meanwhile, investment growth in 2004 will drop to 4%, due to escalating investment risks associated with the presidential elections. We expect the capital outflows in this year to rise, while investment decisions will be put off till 2005.

Because of the small investment volumes, enterprises will be unable to upgrade production in order to satisfy household demand, particularly for non-foods. Therefore, increased household consumption will push up imports instead of domestic production. Higher growth in Ukraine's major trading partners will allow Ukraine to expand export production; however, the production will mostly be dominated by goods with a low degree of processing. This fact aggravates the risks

for the Ukrainian economy related to any threats to the global economy.

We forecast that financial stability will persist during 2003–2004. The current account balance, despite continuing to shrink, will be high enough to ensure a steady inflow of foreign currency to Ukraine and a moderate nominal depreciation of the hryvnia to the US dollar. In 2003, the inflation will escalate to 6%, largely due to: (1) deteriorated inflationary expectations on the part of households, in particular owing to a raise in the minimum wage; and (2) higher tariffs on housing and public utilities. Nevertheless, in 2004 the growth of consumer prices will fall back to 3.1%, as a result of the absence of price shocks, and of administrative pressure aimed at achieving price stability across Ukraine's regions.

In 2005 economic reforms will commence

We believe that in 2005 economic reforms will commence that will lay the foundations for future acceleration in economic growth (see Table 1). We predict that GDP growth in 2005 will be 4.5%, primarily thanks to an acceleration of investment growth.

in 2005 we expect consumption to accelerate to 6.5%, in view of higher income growth and changes in the consumer behaviour of Ukrainians. Namely, they will spend a larger portion of their incomes on non-foods, as well as durables, which in turn will foster the consumer credit market. An increase in the volumes of the lending market will drive down the cost of hryvnia loans by YE'05, which may equal the cost of USD or euro credits.

At the same time, the year 2005 carries risks of macrofinancial imbalances, prompted by the easing of fiscal and monetary policy in 2004 and the impossibility of locating sufficient refinancing to offset the 2005 foreign debt payments. In 2005, we expect an accelerated nominal hryvnia depreciation, and consumer market inflation (to 5.5%). We explain the considerably accelerated growth of producer prices in 2005 (by 6%) with the raise in tariffs on housing and public

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Table 1. Reform priorities

Priorities (Year of expected reform)	Substance of the reform	Expected results
Tax reform (2004)	reduction of the personal income tax introduction of taxation on deposit interest reduction of the corporate profit tax rate from 30% to 25% increased depreciation norms	partial legalisation of personal incomes stimulated domestic consumption and accelerated economic growth increased enterprise investments
Replacement of benefits with targeted subsidies (2005)	taking stock of the benefits identifying groups of people in real need of state support	improved quality of services budget spending optimisation increased volumes of aid to those who need it most
Reform infrastructure sectors (2005)	corporatisation of enterprises in infrastructure sectors (transport, communications, housing and public utilities, etc.) separation of commercial and social functions, and partial privatisation of such enterprises	increased sectoral investment improved quality of services budget spending optimisation tariff optimisation at infrastructure enterprises, and increased profitability
Accession to the World Trade Organisation (WTO) (2005)	signing bilateral agreements on access to the goods and services market harmonisation of legislation, investment and foreign trade policy to WTO requirements	increased competition strengthened confidence of foreign partners in Ukraine, increased foreign direct investments the possibility to apply WTO mechanisms in settling trade conflicts will allow to cut the number of discriminatory anti-dumping measures against Ukrainian goods
Improved investment climate (2005)	boosted effectiveness of the judicial arm of government improvement of Ukraine's image abroad through PR measures	sustainable economic growth, which will allow to ensure higher living standards of the population increased foreign direct investments will foster competition

Source: International Centre for Policy Studies.

utilities, which will be the first step in reforming the sector. ■

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