

ICPS newsletter[®]

Democratic and market reforms will accelerate after a Yushchenko victory

Predictions that Viktor Yushchenko would win the presidential election in Ukraine are coming true. Despite amendments to the Constitution that restrict his powers as president, he will continue to have significant influence. Mr. Yushchenko will be able to quickly form a new Verkhovna Rada majority and a Government based on that majority. ICPS experts expect market and democratic reforms to accelerate in 2005. This should improve conditions for business and investment, which will make it possible to maintain a high pace of economic growth. Economic relations with both the European Union and Russia will continue to evolve. At the same time, Moscow's influence over the political situation in Ukraine will noticeably decline and political relations with the EU will become more active

A repeat of the earlier vote-rigging was highly unlikely

Expectations of Yushchenko victory in the second run-off on 26 December 2004 are being confirmed. According to preliminary data, he was 8% ahead of Viktor Yanukovich. Mr. Yushchenko's victory was confirmed by exit-polls after the third round. The fact that the national TV channels are not significantly censored any more and have started to provide more objective information about political events has been very positive for Mr. Yushchenko.

Given that campaign conditions have changed, it was very unlikely that the vote will be rigged in favor of Mr. Yanukovich once more. First of all, he lost the support of many of the top politicians and officials who worked for him before the "Orange Revolution." Secondly, even if most members of election commissions and representatives of the administration who were implicated in vote-rigging kept their positions, many of them were not willing to risk committing a second crime. This was reinforced by the active position taken by millions of Ukrainians who demonstrated during the "Orange Revolution" that they were ready and able to defend a democratic election.

There is a risk that many voters from the east and south of Ukraine will not accept Mr. Yushchenko. After two years of biased coverage of Mr. Yushchenko on the national television channels, they are

convinced that he is an ultra nationalist manipulated by the West.

A new majority will work with Mr. Yushchenko

According to ICPS, after the election, a new majority will quickly be formed in the Rada, and it will completely or largely support the policies of President Yushchenko. This majority will likely include Nasha Ukraina, the Yulia Tymoshenko Bloc, National Agrarian Party, National-Democratic Party, and the Party of Industrialists and Entrepreneurs factions. The Socialist faction will also probably join the new majority. It is likely that a large number of deputies who were members of pro-Kuchma factions—SDPU(o), Trudova Ukraina, Yedyna Ukraina, Soyuz, and Democratic Initiatives—prior to the "Orange Revolution" will join it. The new Government will most probably be formed out of these political forces, and the premiership will go to one of them. If the new president effectively uses his powers, he will remain a key player in Ukrainian politics.

ICPS analysts also expect democratic and market reforms to pick up speed in mid-2005, once the short-term negative impact of the election is overcome. The recent Constitutional reform in effect has strengthened the powers of all elected bodies: councils of all levels, as well as the heads of cities, towns and villages. The role of independent media will grow as new investors come into the market and competition grows. This will make it

possible to dramatically reduce the level of corruption and government interference in economic processes.

President Yushchenko and the various parties in the legislature will want to demonstrate their effectiveness in the run-up to the 2006 Verkhovna Rada elections. Thus, ICPS anticipates radical reform in the policy-making process, a continuation of tax reform, the reform of the social security system, and serious efforts at reforming the regulatory and residential services systems.

Ukraine will become a center for promulgating democracy

According to ICPS analysts, the Head of State, the legislature and the Government will work to develop economic relations with both the European Union and Russia. The most likely goal will be to set up a Free Trade Area with both economic partners and attracting their investors. The Government will probably speed up the process of acceding to the WTO.

Nevertheless, foreign policy will be clearly oriented towards joining the EU. Contacts between Kyiv and Brussels will be much more pro-active and productive than contacts with Moscow, whose influence over Ukraine's domestic and foreign policy will be considerably weaker. Ukraine will either leave the CEA project with Russia, Belarus and Kazakhstan, or it will insist that it be transformed into an FTA.

The new Ukrainian administration will try to set up good political relations with the US. Mr. Yushchenko will most likely have to keep his election promise and withdraw Ukrainian troops from Iraq. Still, for Washington Kyiv's new role as a center for promulgating democratic and market concepts among CIS countries, in particular Moldova, Belarus and Russia, will be more important. ■

For additional information, contact Daria Hlushchenko by telephone at (380-44) 236-4477 or via e-mail at dgluschenko@icps.kiev.ua.

The political crisis will not turn into an economic one: 2005-2006 forecast

The presidential election has increased the drag on economic growth in Ukraine. Nevertheless, 2004 was another year of record-high economic growth, which ICPS expects to settle at 12%. Losses from the political crisis are expected to be worth no more than 0.5% of GDP. High inflation and a slight deterioration in world commodity markets in 2005 should dampen real GDP growth to 7% for the year. In 2006, the economy is likely to pick up again due to lower inflation and lively investment

Despite numerous statements by politicians, the deepening political crisis after the run-off of the presidential election did not turn into an economic one. The consumer market did not see any shortages, prices grew less in November than in October, and the hryvnia saw no devaluation in the official exchange rate. According to ICPS estimates, the economic impact of a radical political struggle, threats of separatism and ineffective action on the part of the government administration will be no more than 0.5% of annual GDP. At the same time, the economic slow-down that accompanied the political crisis has actually eased the risk of overheating that began to grow over the summer.

ICPS economists have downgraded their forecast for economic growth in 2004 from 13.5% to 12% in real terms, because inflation has grown to 12% and because of the radicalized political confrontation. Economic growth has been driven by rising exported goods and services (34%), which surpassed growth in imports (22%) as well as growth in gross consumption (12.6%). Significantly higher exports than imports will make it possible for Ukraine to post a record-high current account balance, above 10% of GDP according to ICPS estimates.

In 2005, the economy should continue to slow down, with real GDP growth dropping to 7%. At the same time, investment is likely to grow faster than GDP, which could spur the economy to post 7.5% growth in 2006, even in the face of a slight but persistent trend towards deteriorating global commodity markets.

Macro-financial situation should gradually improve. ICPS expects a gradual shrinking of the Budget deficit, from 3% of GDP in 2004 to 1% of GDP in 2006.

Budget expenditures should stabilize at 29% of GDP during the forecast period. Budget revenues are likely to grow due to the removal of tax breaks and moderate movement out of the shadow economy into the formal one. Any fiscal gap should not lead to new arrears in social payments, thanks to the availability of financial resources. Once more, privatization and international borrowings will be the key sources for financing the deficit.

Inflation should inch down to 11% in 2005 and drop to 6% in 2006. At the same time, ICPS expects high consumer inflation (up to 15–16% year-on-year) in H1'05 due to a continuing trend of growing food prices, seasonal hikes in petroleum product prices, and the likelihood that the Government will raise regulated rates, a decision that was

postponed in 2004 as political poison. Transit fares and utility rates are likely to grow the most.

In 2005–2006, imports are expected to grow faster than exports, although current account and trade balances will remain rather high. Maintaining these trends will allow for considerable forex inflows once the election is over, and for gold and forex reserves to be replenished. Thus, NBU will be able to continue to support a stable UAH/USD exchange rate and even to start moderate nominal revaluation in light of continuing dollar depreciation around the world. ■

ICPS has published its quarterly forecasts for economic development in Ukraine since 1997 in the *Quarterly Predictions journal*. To subscribe, contact Andriy Starynskiy by phone at (380-44) 236-4477 or via e-mail at marketing@icps.kiev.ua. You can also order the publication on-line at <http://www.icps.kiev.ua/eng/subscribe/>.

For additional information, contact Andriy Blinov by telephone at (380-44) 236-4477 or via e-mail at ablinov@icps.kiev.ua.

Table 1. Key indicators

Year	2003	2004	2005	2006
Indicator	(f o r e c a s t)			
GDP, billions UAH	264.2	346.2	418.5	472.4
Real GDP, apc*	9.4	12.0	7.0	7.5
Real industrial output, apc	15.8	13.0	9.5	8.0
Real agricultural output, apc	9.9	17.0	2.0	2.5
Real gross fixed investment, apc	15.8	11.0	10.0	12.0
Real consumption, apc	12.8	12.6	7.7	9.3
Consumer price index, apc	8.2	12.0	11.0	6.0
Real wages, aapc**	24.0	23.0	18.0	15.0
Unemployment rate (ILO methodology), %	9.1	8.5	8.2	8.0
Exports of goods&services, apc	24.0	34.0	10.0	7.0
Imports of goods&services, apc	28.7	22.0	16.0	13.0
Current account balance, % GDP	5.8	10.4	7.1	3.9
Consolidated Budget balance, % GDP	-0.2	-3.0	-2.5	-1.0
Official exchange rate (average annual), UAH/USD	5.33	5.32	5.29	5.22

* apc = annual percentage change ** aapc = average annual percentage change
Source: Derzhkomstat, National Bank of Ukraine, Ministry of Finance; calculations and forecast by Quarterly Predictions.

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icps newsletter editor: Yevhen Shulha (shulha@icps.kiev.ua)
Phone: (380-44) 236-4477. Fax: (380-44) 236-4668
English text editor: L.A. Wolanskyj
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Address: vul. Pymonenka 13A, Kyiv, Ukraine 04050
Web-site: <http://www.icps.com.ua/eng/>