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ICPS summarizes economic results for 2004

2004 was the year the Ukrainian government's policies served short-term interests: raising social benefits and curbing inflation. Following suit, the Verkhovna Rada also adopted mainly short-term resolutions. The rare long-term decisions included amendments to the Constitution and a new version of the Civil Procedural Code. ICPS expects the new government to lay the groundwork for serious transformations throughout 2005 and to launch large-scale reforms in spring 2006, after the Verkhovna Rada elections. The situation will continue to favor reforms during 2005–2006 as the economy grows, on average, 7% pa

Results for 2004 and forecast

According to preliminary data from Derzhkomstat, the state statistics committee, real GDP grew a record-high 12.1% in 2004. Such speedy growth was due to a very good grain crop (+110%), construction boom (+18.4%), and an industrial upswing (+12.5%)—in particular, in metalworking, machine-building and chemicals. Economic growth slowed down late in the year.

The election of a new president and the peaceful settlement of the country's most heated socio-political confrontation will help stabilize the political situation in 2005. However, the economic upturn will be slower than in 2004, hampered by accelerating inflation and slower growth in export prices. ICPS economists have left the forecast for real GDP growth unchanged, at 7% in 2005 and 7.5% in 2006.

Maintaining a three-way balance among social benefits, the State Budget and inflation will be the key challenge for the new government. According to ICPS analysts, it will be impossible to simultaneously fulfill all tasks that the president has set before the Government: significantly raising social benefits while preventing a Budget deficit and double-digit inflation. Most likely, the Government will carry out a good part of the social commitments made President Yushchenko during his election campaign. However, this will mean a Budget deficit around 3% of GDP, and inflation will likely reach 11%.

In H1'05, the Consumer Price Index will grow 16% pa as food prices continue to grow and the Government decides to raise regulated rates and prices, a move that was deliberately postponed throughout 2004. The most felt changes will be growing transit fares and higher rates for residential services.

During the forecast period, the value of Ukrainian imports will grow faster than exports. At the same time, the current account balance will continue to be high, which will help the National Bank to support a stable UAH/USD exchange rate and even start a slight nominal hryvnia appreciation, especially as the US dollar continues to slip worldwide.

ICPS economists base their forecast on the assumption that the new Government will not start a mass increase of social minimums and that it will first take care to fill Budget revenues, not reallocate its resources. If the new Government raises salaries, pensions and other social benefits in the amounts that were promised during the election campaign, the Budget deficit will reach UAH 27bn or about 6.5% of GDP, according to ICPS calculations. If this happens, ICPS

Table 1. Key macroeconomic indicators

Years	2003	2004	2005	2006
Indicators	(est.)		(forecast)	
GDP, mn UAH	264.2	345.9	418.5	472.4
GDP, rcc, %	9.4	12.1	7.0	7.5
Real industrial output, rcc, %	15.8	12.5	9.5	8.0
Real agricultural output, rcc, %	-9.9	19.1	2.0	2.5
Gross investment, % GDP	20.3	20.8	21.7	23.2
Real gross fixed investment, apc	15.8	11.0	10.0	12.0
Real consumption, apc	12.8	13.5	7.3	8.,3
Net FDI, mn USD	1,411	1,500	1,600	2,000
Real disposable household income, apc	7.8	16.8	8.0	10.0
Real retail trade, apc	19.4	20.0	12.0	12.0
Consumer price index, apc	8.2	12.3	11.0	6.0
Producer price index, apc	11.1	24.1	12.0	6.0
Population, mn	47.7	47.3	47.1	46.9
Real wages, aapc	15.2	23.8	18.0	15.0
Unemployment rate (ILO methodology), %	9.1	8.5	8.2	8.0
Exports of goods and services, apc	24.0	37.0	10.0	7.0
Imports of goods and services, apc	28.7	25.0	18.0	12.0
Current account balance, % GDP	5.8	10.8	7.0	4.0
Consolidated Budget balance, % GDP	-0.2	-3.4	-3.0	-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
rcc = real cumulative change

Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by Quarterly Predictions

Table 2. Impact of legislative changes on business in 2004

Business-friendly changes	Business-unfriendly changes
Involving stakeholders in the regulatory policy-making process	Adopting Civil and Commercial Codes with mutually contradictory provisions
Introducing mortgage mechanisms	Postponing the date the Civil Procedural Code comes into force
Setting up a consolidated title registration system for parcels of land and other real estate	Changing tax legislation inconsistently, failing to properly prepare technically to introduce changes long in the planning
Adopting a program to reform the residential services sector	Providing selective support to certain car makers
Compensating some of the costs for sowing spring crops and buying mineral fertilizers	Extending the ban on the sale and purchase of farmland

expects the CPI to hit at least 19% by year-end.

ICPS also bases its forecast on the assumption that there will be no sudden changes on world markets for oil, metals and chemicals.

Changes in legislation

The policy-making process did not much change in 2004: a slew of adopted laws contradicted existing legislation or had no fiscal support, while much-needed changes to legislation were not instituted. Meanwhile, the presidential election had a noticeable impact on decision-making. In addition to populist steps in the social sphere, the Government resorted to price controls and provided more support for domestic producers compared to 2003. These decisions violated the rules of competition, helping some businesses benefit at the expense of others. They also pushed up the Budget deficit, which passed the 3% mark, according to ICPS estimates.

The key challenge is to reform public administration

The policies of the new Government will be primarily affected by the need to win the VR elections in spring 2006. The election campaign, which in fact has already begun, makes it hard for the new team to launch large-scale reforms that might get mixed reviews from voters and will not yield quick positive results.

According to ICPS, it is worth using the time until the Verkhovna Rada elections to prepare for these reforms, namely: to expand public debate on the problems targeted by reforms, to adopt action plans, and to set up “reform teams.” If the preparations for “painful reforms” are public, public support for the Government will get a boost and make it easier to make sound decisions during the reform process.

Once the 2006 VR campaign is over, the Government should launch reforms in the key social sectors that have long stayed unreformed. Changes in these areas will provide a much-need impact on the quality of life, as these services are among the most important for human lives.

According to ICPS economists, the new government should be able to implement successful reforms in any area—but only if it changes the public administration system. The current system makes it impossible to develop and implement effective policies. Excessive centralization is the key drawback of the current system. As a result, central bodies function mostly in an administrative capacity, while developing strategies and government policy become, for them, secondary tasks.

Analysts at the International Centre for Policy Studies have been producing regular forecasts for Ukraine’s economic development since 1997. These are updated regularly and published in the “Quarterly Predictions” journal. If you wish to subscribe to this publication, please contact Andriy Starynskiy at telephone: (380-44) 236-5464 or e-mail: marketing@icps.kiev.ua. You may also order our publications at http://www.icps.com.ua/eng/subscribe/ or purchase them via the ICPS’s website. For additional information about ICPS economic forecasts, contact Yevhenia Akhtyrko by telephone at (380-44) 236-1292, or via e-mail at eakhtyrko@icps.kiev.ua.

UkrZaliznytsia’s rates policy gets negative marks

ICPS economists have given the Ministry of Transport and Communication’s recent announcements about rate hikes in the national railway system negative marks. The Ministry intends to raise freight rates more than double and raise ticket prices for first and second-class sleeping cars, called SV/Luxe and Coupe, by 50%. Such a sharp rise freight rates is likely to push the Producer Price Index by 3–6% over 2005. Higher rates for passenger traffic, which UkrZaliznytsia data shows is unprofitable, will mostly affect the middle class and wealthier travellers. For industrial customers, higher rates will mean a cut in the high profits of export-oriented companies in the mining, metalworking and chemical industries.

Still, the Government needs to gradually relieve UkrZaliznytsia of the need to carry out certain “social” functions on behalf of the state. Keeping passenger rates low by raising freight rates is not an efficient social security mechanism, says ICPS economist Ildar Gazizullin. “Too high a level of cross-subsidies distorts economic incentives, both for the general public and for other categories of customers. Prices and rates for all rail services need to reflect real costs as much as possible.”

According to ICPS analysts, the transport sector’s regulatory policy has been long due for serious revision. The fact that the Ministry combines the functions of running and regulating transportation is a classic conflict of interests. These functions need to be separated by setting up an independent regulatory body which could improve rate-setting and ensure better protection for the customers of a national monopoly like UkrZaliznytsia.

The national railway’s opaque management has led to distrust, among both the general public and railway customers, in its declarations about production costs and profitability for specific activities. Although everybody understands the need to modernize infrastructure and rolling stock, any moves to raise rates or attract investment will not be well received until Ukrzaliznytsia has been thoroughly audited.

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