

# *quarterly predictions*

*#27, second quarter 2004*

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# MAJOR INDICATORS

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Indicator							(est.)	(forecast)		
<b>Economic activity</b>										
GDP, billions UAH	93.4	102.6	130.4	170.1	204.2	225.8	264.2	335.8	402.6	456.7
Real GDP, <i>apc</i> *	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	13.5	9.0	7.0
Real industrial output, <i>apc</i>	-0.3	-1.0	4.0	13.2	14.2	7.0	15.8	15.0	9.5	8.0
Real agricultural output, <i>apc</i>	-1.9	-9.8	-5.7	7.6	10.2	1.2	9.9	10.0	3.5	2.5
Gross investment, % GDP	21.5	20.8	17.5	19.8	21.8	20.2	20.3	22.0	23.8	25.2
Real gross fixed investment, <i>apc</i>	2.1	2.6	0.1	12.4	6.2	3.4	15.8	16.0	14.0	10.0
Real total consumption, <i>apc</i>	-1.8	-0.1	-3.7	2.0	9.3	5.0	12.9	14.4	7.9	9.3
Net FDI, millions USD <sup>(1)</sup>	581	747	489	594	769	698	1,411	1,600	1,800	2,000
Real disposable household income, <i>apc</i> <sup>(2)</sup>	5.1	-5.8	1.2	11.1	14.5	17.8	5.8	13.0	10.0	10.0
Real retail trade, <i>apc</i>	8.2	-3.5	-4.8	7.5	11.7	14.8	19.4	20.0	15.0	12.0
<b>Prices</b>										
Consumer price index, <i>apc</i>	10.1	20.0	19.2	25.8	6.1	-0.6	8.2	6.5	8.0	5.0
Producer price index, <i>apc</i>	5.0	35.3	15.7	20.8	0.9	5.7	11.1	20.0	10.0	6.0
<b>Labor market</b>										
Population, millions	50.5	50.1	49.7	49.3	49.0	48.0	47.7	47.3	47.1	46.9
Real wages, <i>aapc</i> **	-0.4	-2.8	-5.7	1.0	20.9	21.8	24.0	24.0	18.0	15.0
Unemployment rate, % (ILO methodology)	-	-	11.9	11.7	11.1	10.1	9.1	8.5	8.2	8.0
<b>Foreign economic activity</b>										
Exports of goods&services, <i>apc</i>	0.0	-13.4	-7.3	18.0	8.0	10.7	24.0	28.0	13.0	7.0
Imports of goods&services, <i>apc</i>	-2.0	-14.0	-19.1	17.8	14.1	5.0	28.7	21.0	16.0	12.0
Current account balance, % GDP	-2.7	-3.1	3.0	4.0	3.7	7.7	5.8	8.5	7.5	3.7
<b>Budget</b>										
Revenues, % GDP (consolidated) <sup>(3)</sup>	30.0	27.3	24.7	26.2	25.7	27.7	28.5	27.0	27.5	28.0
Balance, % GDP <sup>(3)</sup>	-5.6	-2.7	-2.4	-0.8	-1.5	0.7	-0.2	-2.0	-0.5	-1.0
<b>Financial indicators</b>										
Monetary base, <i>apc</i>	45	22	39	39	37	34	30	43	30	18
M3, <i>apc</i>	34	25	41	45	42	42	47	47	35	25
NBU gold/forex reserves, millions USD	2,359	793	1,094	1,475	3,089	4,417	6,937	11,800	16,000	18,950
Official exchange rate, UAH/USD (average annual)	1.86	2.45	4.13	5.44	5.37	5.33	5.33	5.32	5.25	5.17
Loan interest, % <i>pa</i> (average annual) <sup>(4)</sup>	49	55	53	40	32	25	18	17	16	15
<b>Global economy</b>										
Global GDP, <i>apc</i>	4.2	2.8	3.6	4.8	2.4	3.0	3.9	4.1	3.7	2.9
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	3.1	0.9	2.7	5.7	2.4	4.0	4.5	5.0	4.2	3.5

\* *apc* = annual percentage change \*\* *aapc* = average annual percentage change

Notes: <sup>(1)</sup> according to the NBU; <sup>(2)</sup> starting in 2002, indicator of aggregate household disposable income; <sup>(3)</sup> calculation using IMF methodology; <sup>(4)</sup> commercial bank loans, UAH

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

# OVERVIEW

The Ukrainian economy continues to heat up: economic growth reached nearly 13%, while producer prices have grown 14% since the beginning of the year. Government policy continues to be concentrated on success in the presidential election, which means that social spending in the form of benefits to different constituencies continues to grow. Because the situation on world markets continues to be very favorable, the ICPS forecast for economic growth in 2004 has been upgraded from 10% to 13.5%. As world markets soften somewhat, the economy will also have a “soft landing,” with the pace of real GDP growth slipping to 9% in 2005 and to 7% in 2006. The main risks to this prognosis are overheating in the domestic economy and sharp fluctuations on global commodities markets

## Current economic trends

*During H1'04, Ukraine's real GDP grew a record 12.7%*

Ukraine's economic upswing is in its fifth year now. GDP is outpacing even the most optimistic expectations. Preliminary data for H1'04 indicate that the economy grew 12.7%.<sup>1</sup> The base for this economic boom remains an unprecedentedly positive external market situation, the adaptation of the population to market realities, and growing purchasing power among consumers.<sup>2</sup>

On the production (supply) side, the factors pushing strong growth have been wholesale and retail trade growing at 30.7%, construction at 30.3%, and the processing industries at 18.6%. These same sectors were behind economic growth in 2003, when the economy managed to post a record 9.4% growth despite a very poor harvest. By mid-year 2004, the pace of growth of trade had nearly doubled.<sup>3</sup>

On the demand side, consumption accelerated to 15.5% in Q1'04. Gross fixed investment grew 23.3% over the quarter, as both private and public investment grew by leaps and bounds. The former is connected to very lively commercial activity and positive expectations among businesses (see **BUSINESS**), while the latter is a reflection of growing Budget spending in the run-up to the election.

*Exports grew much faster than imports*

Throughout H1, there was a trend for exports of goods and services to grow at a noticeably faster pace than imports. This was helped by extremely favorable conditions for Ukrainian exports in a number of ways: (1) continuing escalation of prices for key commodities on export markets (see **PRICES**), (2) rapid economic growth among trading partners, especially Russia (see **WORLD ECONOMY**), and (3) the expansion of the EU in May, which led to a spike in exports to the countries that were about to join (see **FOREIGN TRADE**). As a

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<sup>1</sup> Based on the upgraded calculations of Derzhkomstat, in Q1'04 real GDP grew 12.3%. The greatest upward change was seen in wholesale and retail trade.

<sup>2</sup> For more on the factors behind economic growth, see *quarterly predictions* for Q1'04, p. 4–5.

<sup>3</sup> According to data calculated on the basis of GDP breakdown, household costs for supplies, appliances and residential upkeep rose 33.3% in Q1'04 against the same period of last year. For the whole of 2003 this indicator grew 18.3%. This indicates a shift in the structure of consumption in favor of durable goods.

result of this, Ukraine's balance of trade for the first half-year was US \$3.1bn, while the current account balance, based on preliminary data, was US \$4.2bn.

One of the results of the economic boom has been growing optimism among Ukrainians. The Consumer Confidence Index, which is calculated by ICPS jointly with GfK-USM, has passed the 100-mark for half a year now, which means that among those surveyed, optimistic outlooks prevail over pessimistic ones. The Index of the Current Situation has also reached a record high.

The accelerated growth of Ukraine's economy is doing little to close the income gap among different groups of the population. The Government has a number of measures planned for the summer and fall to ostensibly address this problem (see **HOUSEHOLDS**). Still, according to ICPS specialists, the Government has failed for the longest time to raise the poorest layers of Ukrainians to the level of the middle class and the wealthy because of the continuing development of market relations, clearly limited Budget resources, and the incomplete state of tax and pension reforms. This is one of the reasons why the country's economic success is not making such a strong impression on most people in Ukraine.

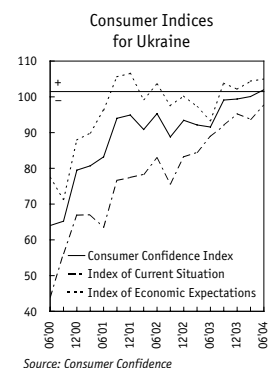
The heating up of the economy is accompanied by rapidly rising producer prices, to the tune of 14.3% during H1'04. Coke, oil products, metals and industrial electricity have grown the fastest. The last time such high growth rates were observed was in 2000, when the Government carried out a decisive battle with the barterization of the economy.

In May, a rush on the fuel market began. As a result, fuels and lubricants grew 49.2% for the first half-year. The fuel crisis made itself felt in the prices for many consumer goods. Because of the growth of prices for oil globally and in Ukraine, the usual summer-long deflation is unlikely to happen this year. The official inflation index for the last 12 months (July 2003 through June 2004) was 8%. According to ICPS, the growth of consumer prices would have been even higher if not for two factors: 1) expectations of a good harvest after last year's bad one (see **AGRICULTURE**), and 2) Government actions, mostly of an administrative nature, to control prices across the board (see **PRICES**).

During H1'04, the National Bank of Ukraine made every effort not to allow monetary pressure on prices to build and bank lending portfolios to worsen. At the same time, the NBU also tried to support the high pace of economic growth. In order to restrict the supply of money, the Bank increased reserve requirements, made conditions for refinancing more complicated, and increased the rates. As a result of these policies, the money mass grew more slowly than in 2003 (see **MONETARY POLICY**).

The share of GDP redistributed through the Budget has shrunk. In H1'04, Consolidated Budget revenues constituted 27.9% of GDP, versus 31.6% for the same period of 2003. This relative lowering of Budget revenues was the result of lower tax rates for personal incomes and corporate profits. Thus, as ICPS specialists had predicted, the lowering of tax rates did not automatically lead to a swift legalization of the shadow economy, while tax reform failed to lead to a greater correlation between economic growth and growing tax revenues. The presence of countless tax exemptions as well as the low level of public services makes it hard to achieve the goal of tax reform—to more evenly spread the tax burden throughout the society. At the same time, the Budget is being fulfilled more than 100% (see **PUBLIC FINANCE**) since, in formulating it, the Government was oriented on much poorer economic growth indicators than turned out.

### ***One effect of the boom is growing optimism among Ukrainians***



### ***The heating up economy is accompanied by rapid growth in prices***

### ***Lower tax rates did not lead to a swift legalization of the shadow economy***

### *Highlights of quarterly predictions #27:*

- *The chances of different candidates in the presidential race*
- *Shadow boxing: Can tax reform do anything to reduce the shadow economy?*
- *The impact of new VAT obligations on the farm sector*
- *The expediency of industrial regulation*
- *How to raise the effectiveness of SMEs*
- *How economic growth among Ukraine's trade partners affects its exports to those countries*
- *Lessons from the oil crisis*
- *Is Ukraine's hot property market a mere bubble?*
- *Reasons why the NBU will not peg the hryvnia to the US dollar*
- *Major changes in bank liabilities*
- *Reasons for cutting back on sugar beets*
- *Can China cool down its economy?*

## **Government policy in 2004**

***The Government's goal is to quickly raise people's incomes in an election year***

The looming election is giving Government decisions a certain populist tinge. Today, the Government's number one goal is to ensure that Ukrainians see their incomes rise in short order, rather than to work towards a general improvement in the quality of their life. This choice was inevitable with the start of the presidential race, given that one of the leading candidates is the current Premier (see **POLITICAL ENVIRONMENT**). Thus, the Government has been substantially picking up social spending<sup>4</sup>, with the idea of financing the gap by selling off the state's largest assets to its friends in big business (see **BUSINESS**) and borrowing on foreign markets.<sup>5</sup>

***The Government did not get into any serious reforms of the public sector***

The current Administration did not, after all, get into any serious reforms of the public sector. The Government also failed to make much-needed administrative reform one of its priorities. This obliviousness to the need for stabilization funds for certain commodities and the impossibility of intervening effectively led to major price fluctuations on the grain market in fall 2003 and on the oil market in spring 2004. The loss of a stable majority in the legislature meant that the ruling coalition had fewer and fewer chances of carrying out those measures the Government had declared as aimed at improving the quality of life for the average citizen—such as tax reforms and reform of the residential services sector.

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<sup>4</sup> In June, the Verkhovna Rada passed a bill prepared by the Cabinet to increase Budget expenditures by UAH 8bn and raise the Budget deficit to UAH 7.4bn or 2.2% of GDP. Among others, this will make it possible to raise the minimum wages of public sector employees from UAH 205 to 237 as of 1 September, rather than the planned 1 November.

<sup>5</sup> In February and July 2004, the Government issued sovereign eurobonds for a total sum of US \$1.1bn in order to pay off the principle on its external debt obligations—mostly earlier eurobond issues. In July, for the first time Ukraine issued eurobonds with a floating interest rate that was set at the rate of 6-month Libor+337.5bp—currently 5.4% annually—the cheapest commercial loan of the Ukrainian Government. According to ICPS, Ukraine will not turn to the commercial lending market again for the rest of 2004.

The Government has been paying ever more attention to the use of price controls, which confirms that fighting inflation is a much higher priority than effective governance—as well as the probability of a new round of price hikes the minute the election is over.

According to ICPS this passivity towards reform is the result of the lulling effect of the booming domestic economy that is driven by favorable external factors, the lack of a strategic vision of the goals and purpose of reform, and an inability to do battle with corruption.

## 2004 forecast: More fast-paced growth

The ICPS forecast for real GDP growth in 2004 has been upgraded to 13.5%. This is mostly due to the exceptionally favorable external situation (see **PRICES**), higher economic growth among trading partners (see **WORLD ECONOMY**), and higher Budget spending than had been anticipated (see **PUBLIC FINANCE**).

Among the key components of this fast growth are construction, which grew 24%, trade (22%), and industry (15%),<sup>6</sup> thanks to the high prices for Ukrainian metals and chemicals on foreign markets (see **PRICES**), high rates of private consumption (see **HOUSEHOLDS**), and a steady increase in investment into manufacturing (see **BUSINESS**). We expect public consumption to rise 18% in connection with the rise in wages, pensions and other social payments prior to the election. Budget spending will be slightly larger, at 29% of GDP, than last year.

In connection with the gradual stabilization of world prices for commodities, the pace of growth of exports and imports will taper off (see **FOREIGN TRADE**). Still, the high balance of trade, the growth of FDI, and the volume of remittances from migrant Ukrainian workers will generate a record-high current account balance of US \$5.3bn or 8.5% of GDP. The high level of foreign currency inflows will lead to rapid accumulations of gold and currency reserves and a minor nominal appreciation of the exchange rate (see **MONETARY POLICY**).

The CPI will grow 6.5%. The slightly lower pace of price rises in 2004 will be made possible by a much better harvest than the one in 2003 (see **AGRICULTURE**), as well as Government anti-inflation measures aimed at ensuring that the spike in producer prices not be felt on the consumer market. The PPI will rise 20% (see **PRICES**).

## 2005–2006 forecast: Overheating or softly landing?

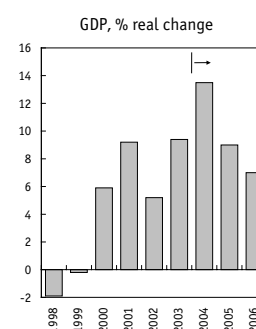
The exceptionally high pace of growth of Ukraine's economy brings with it some risk of overheating.<sup>7</sup> Although in 2004 it is still impossible to speak about an overheating economy since today's brisk growth is largely driven by the revival of capacities that were at a standstill for some time, the risk of the economy suddenly putting on the brakes is growing.

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<sup>6</sup> Admittedly, these sectors will slow down in H2'04 because of (1) the high level of growth in H2'03; (2) slow growth in actual volumes of output of manufactured goods intended for export; (3) rapid inflation in the cost of raw materials and other inputs.

<sup>7</sup> Economists understand "overheating" as excessively high economic growth, especially the kind that is driven by unfounded public spending, which risks a rapid rise in inflation and a sudden industrial slowdown, at the same time as industrial capacities are being overloaded.

*The forecast for economic growth has been raised to 13.5% for 2004*

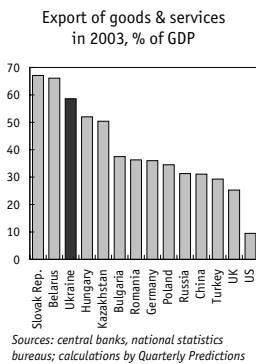


Source: Derzhkomstat; calculations by Quarterly Predictions

*The inflow of hard currency has been braking records in 2004*

*A good harvest and anti-inflationary measures will keep prices from rising too fast*

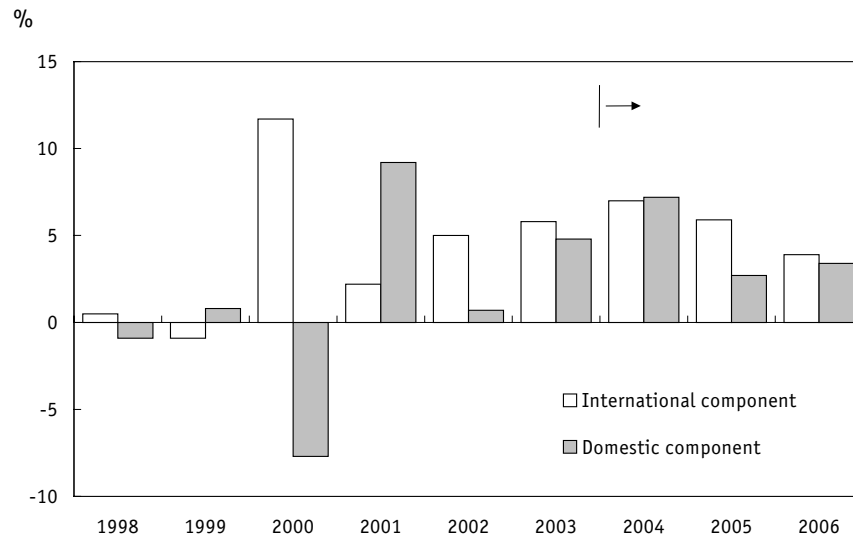
*Risk of overheating grows*



In developed countries, the domestic market is usually the “shock absorber” of any consequences of a decline. Still, the Ukrainian economy is currently mostly oriented towards exports.<sup>8</sup>

If GDP growth is divided into internal and external components (see **FIGURE 1**),<sup>9</sup> it can be seen that the contribution of the domestic market to economic growth became positive only after 2001, precisely when the influence of exports began to fall off against a temporary worsening in the global commodity situation. Only in July 2003, did the internal and external components of growth come into balance.

**Figure 1. Real GDP breakdown**



Source: Derzhkomstat; forecast by Quarterly Predictions

The main exporting sector in Ukraine is industry, whose gross value-added was 29% of GDP in 2003. In industry, the main exporting branches are mining and metallurgy, chemicals and machine-building—all of them strongly dependent on the situation on world markets.<sup>10</sup>

With the improvement of world markets for steel products and trade based on a severely depreciated hryvnia since the 1998 crisis, the share of domestic consumption of metal products has gone down sharply. And although exports are relatively diversified, the lion’s share of steel products ends up in Southeastern Asia, particularly China. Thus, should China succeed in its policy of replacing imports by domestic production or if Ukraine faces severe trade restrictions, then there will be a crisis of overproduction.<sup>11</sup>

<sup>8</sup> Exports of goods and services constituted 58.6% of Ukraine’s GDP in 2003. The results for Q1’04 were 72% of GDP.

<sup>9</sup> In the graph, the contribution of the external market is represented by the export component, while the internal market is represented by consumption and investment other than imports, to avoid counting it double.

<sup>10</sup> The proportion of exports in the output of these three branches is 78%, 73% and 61%.

<sup>11</sup> Based on their modeling, ICPS economists have determined that lowering export by 1 pp will lead to a 0.5 pp slowdown in the GDP in the first year, reaching 2 pp over five years. Calculations took total economic impact into account.

At the moment, according to ICPS, the sectors that are oriented on the domestic market make up only 40% of the economy, although they are showing clear signs of growing faster than average. Among them is relatively high-tech manufacturing, such as vehicle makers who could eventually start using domestic steel output. This would soften the negative socio-economic impact of an overheating economy should the world markets nosedive—but it would not entirely eliminate it.

Even should overheating be avoided, we expect consumer inflation to grow to 8% in 2005. The peak of this growth will likely be in the first quarter.

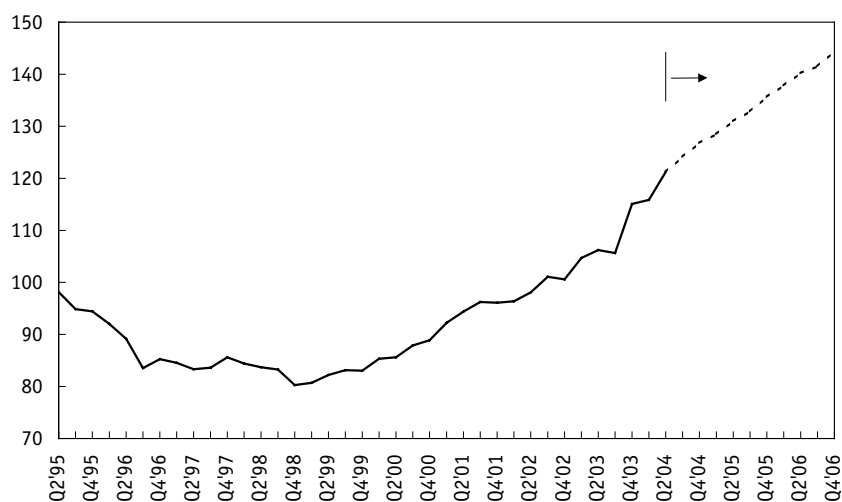
In short, ICPS specialists believe that the Government needs to begin to take steps to stimulate the development of domestic markets and sell the idea of a “soft landing,” that is, a moderate slowdown in the pace of economic growth as soon as there is any evidence that foreign demand for Ukrainian products is shrinking. Moreover, in 2005–2006, it will make little sense to continue to stimulate consumption by simply reducing taxes and rapidly increasing social spending.

***The Government needs to start stimulating the domestic market in preparation for a “soft landing”***

The Government that comes into power after a new president is elected—regardless of who becomes president, Viktor Yushchenko or Viktor Yanukovich—will understand these risks and the need to win the Verkhovna Rada elections of 2006. This means it will concentrate more on eliminating the risks of an overheating economy and thus on paying more attention to qualitative, not just quantitative improvements to public services. Then, reforms will truly result in a better quality of life, which will make it possible for confidence in the government to grow, while the economic boom will begin to be felt in all areas of the economy and all regions of the country.<sup>12</sup>

**Figure 2. Real GDP index, seasonally adjusted**

Q1'95=100



Source: Derzhkomstat; calculations by Quarterly Predictions

<sup>12</sup> According to ICPS, at this time, the only parts of the economy at risk of overheating are the export-oriented branches of industry, transport and real estate markets in major cities.

***A softening in the external situation will slow economic growth in 2005–2006***

According to ICPS, a slight softening in the external situation (see **PRICES**) and slower growth among Ukraine's main trading partners (see **WORLD ECONOMY**) will contribute to a slowdown in Ukraine's economy over 2005–2006. 2005 should see a slightly higher pace of growth (9%) than anticipated earlier, given the multiplier effect of the high level of growth in 2004. The forecast for 2006 remains unchanged at 7%.

External demand will remain the key growth factor. Private consumption will slow somewhat to 9% yearly (see **HOUSEHOLDS**) with demand for investment remaining unstable. A simultaneous worsening of the foreign market situation will lead to lower investments in export-oriented branches like metals and metal working, which will lead to a lower pace of gross fixed investment in 2006—10% (see **BUSINESS**).

As the list of major assets for selling off through privatization shrinks and global lending rates rise, the Government will have fewer options for additional financing of the Budget deficit (see **WORLD ECONOMY**) and this will require a policy of smaller deficits (see **PUBLIC FINANCE**). Instead, there is a risk that the Government will allow greater financial gaps should it get into serious reforms, or in the run-up to the parliamentary election in 2006.

A worsening of the conditions for foreign trade will gradually reduce the current account balance to US \$3.3bn in 2006 or 3.7% of GDP (see **FOREIGN TRADE**). This, in turn, will lead to a lower money supply (see **MONETARY POLICY**) and less pressure on prices (see **PRICES**), which will support the Government's anti-inflation measures.

Preparations for Ukraine's accession to the WTO and the impossibility of using revaluation to reduce pressures on the money supply through an emission of currency, in the opinion of ICPS, will force the NBU to review the current system of currency regulation. This should strengthen the nominal revaluation of the hryvnia against the dollar (see **MONETARY POLICY**).

# POLITICAL ENVIRONMENT

The ruling coalition headed by President Kuchma is unlikely to implement any of its declared reforms before the fall election and will concentrate instead on filling Budget coffers and prolonging large-scale privatization. Future policy will be formulated by the new president, be it Viktor Yushchenko or Viktor Yanukovych. If the election takes place without outrageous abuses, ICPS experts predict that economic reform will become more active in 2005. However, the risk of abuse has escalated since attempts to restrict presidential powers by amending the Constitution failed. The new president, who will continue to exercise broad powers, will be forced to seek ways to ensure the country's progress prior to the 2006 Verkhovna Rada elections, so he will likely try working with most political forces and with the West

## Current situation

### *Domestic policy*

ICPS experts have dropped their prediction that the powers of the new president will be restricted. In April, the pro-Administration coalition and leftist forces in the Verkhovna Rada failed to pass amendments to the Constitution that would have transferred a large portion of the president's powers to the legislature.<sup>13</sup> Although reformists managed to push a similar bill through first reading in the Verkhovna Rada in June, the likelihood that this draft will be adopted in the weeks before the election is very low, according to ICPS.

***Presidential powers will not be restricted***

The failure of Constitutional reform made it impossible to implement the coalition's plan of holding onto power on the basis of its majority in the Verkhovna Rada and its control over the Cabinet regardless of the outcome of the presidential election.

Given that President Kuchma has elected not to run for a third term, the composition and pecking order of the ruling elite will change whatever the election result. If Yanukovych wins the election, changes will be less significant than if Yushchenko does. A Yanukovych victory means the likelihood that his Party of the Regions will grow even stronger and the coalition's two other partners—SDPU (o) and Trudova Ukraina—will grow less significant in the government. If Yushchenko is elected president, the government will have most of its support from the Nasha Ukraina bloc.

***After the election, the structure of the ruling forces should change***

The realization that the current coalition will survive only until the election has deprived the Administration of its Verkhovna Rada majority. Since the failure of Constitutional reform, some two dozen independent deputies in the legislature's 241-deputy majority stopped supporting its position and took a neutral position, between the coalition and the opposition. Some of these deputies established a new group called Tsentr [Center]. This group currently

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<sup>13</sup> The key changes include removing from the president the right to appoint and dismiss the Government and giving this power instead to the legislature and giving the presidential power to appoint and dismiss oblast governors and heads of regional administrations to the premier. For more detail, see *quarterly predictions* for Q1'04, p. 13–14.

controls the deciding votes in the Verkhovna Rada in any confrontation between the coalition and the opposition.

***The collapse of the VR majority makes it unlikely that reforms will be implemented***

It seems most likely that, prior to the election of the new president, the Verkhovna Rada will function without a majority, although a situational majority might be cobbled together, only for specific votes.

The collapse of the VR majority reduced the chances that the Government will carry out its earlier decisions to continue tax reform, to institute reform in the residential services sector, and to declare an amnesty for shadow capital.

### ***Foreign policy***

***With EU expansion, Ukraine has a new powerful center of gravity in the West***

The enlargement of the European Union that took place in May 2004 should have an immense impact on Ukraine's fate. For the first time in many centuries, Ukraine's largest neighbor is not Russia any more, and in the West the country has a new center of gravity with a strong political force, immeasurably more developed markets, and deeper democratic traditions.

Still, the new common border between Ukraine and the EU could have a short-term negative impact. After trying to follow the path taken by EU accession countries in recent years, official Kyiv appeared disappointed over Brussels's decision to decline associate member status. This, coupled with anticipated losses of foreign trade with new EU members, has strengthened opinion among Ukraine's elite that rapid integration into the European Union is an illusion.

***Moscow continues to draw Kyiv to it***

This makes Russia's task easier. The country has successfully taken advantage of Ukraine's ruling coalition's aspirations to have its political backing and actively promoted joint projects aimed at rapprochement between Moscow and Kyiv. In May 2004, the Russian and Ukrainian legislatures simultaneously ratified an agreement to establish a regional union called the Common Economic Area (CEA) that involves coordinating trade and economic policy. Belarus and Kazakhstan are also participants in the agreement.

In July, the Ukrainian Government announced that it was revisiting its decision to use the Odesa–Brody pipeline for the westward transport of Caspian oil and agreed to transport Russian oil in the reverse direction. Lastly, President Kuchma fulfilled Russia's old dream by dropping the goal of joining NATO and the EU from its Military Doctrine.

Wanting to maintain relations with the US, Ukraine has kept its military contingent in Iraq, fifth in size among the occupation forces. President Kuchma managed to bloc a motion by the leftists in the VR to withdraw Ukraine's troops from Iraq. For the first time, Ukraine's Head of State had a proper meeting with US President George Bush, who had pretty well boycotted Leonid Kuchma during his entire term in office because of a slew of scandals. The meeting took place during NATO Summit in Istanbul.

Despite improved diplomatic relations, Ukraine–US ties have not become stronger. Negotiations for the US to grant Ukraine market economy status and consent to the country's accession to the World Trade Organization have seen little progress. Future relations will depend upon the quality and outcome of Ukraine's presidential election. If the election is openly undemocratic, this will set up new barriers between Ukraine and the West—which will only strengthen Russia's hand.

## The presidential election

A record number of candidates<sup>14</sup> were nominated for the presidency. According to sociologists, none of the candidates has any chance of gaining more than 50% of votes in the first round. The leader of the opposition center-right bloc Nasha Ukraina Viktor Yushchenko and Premier Viktor Yanukovich have the greatest chances of making it to the second round. Communist Party leader Petro Symonenko is most likely to end third in the race.<sup>15</sup>

***None of the candidates can win the election in the first round***

The two frontrunners, Yushchenko and Yanukovich, both have a chance of winning the second round.<sup>16</sup> Yushchenko has the advantage of a large base of supporters and status as an opposition leader, which is important with a population that is totally disillusioned with the results of Kuchma's decade in power. Yanukovich's trump cards are scheduled wage increases, pension hikes, and other social payments just before the election, control over the main national media—which provides slanted coverage of the presidential race—, and an opportunity to use administrative leverage. One favorable trend for Yanukovich was an obvious deterioration in relations between Yushchenko and the leftist opposition.

## Forecast for 2005–2006

Provided the election does not involve substantial abuses, say ICPS specialists, the election of either of the frontrunners will keep Ukraine on track towards a market economy and euroatlantic integration. The new president will want to demonstrate his effectiveness prior to the 2006 Verkhovna Rada elections. The new Head of State will need the support of both the legislature and the Government, who will define, approve and implement government policy, and this will oblige him to cooperate with most of the political forces currently represented in the Verkhovna Rada.

***The new president, be it Yanukovich or Yushchenko, will want to keep Ukraine on track towards a market economy***

This forecast might be undermined by a dirty presidential election, particularly if it includes massive interference in the campaigns of key candidates, disqualifications, falsified results, and so on. The risk of this happening grew when the coalition failed to restrict the powers of the presidency. If the election is openly unfair, it will almost inevitably lead to mass demonstrations and civil unrest organized by the losing side. The domestic political situation and the functioning of government bodies could be destabilized. If this comes to pass, Ukraine is likely to become somewhat isolated from both the US and the European Union, a situation that is likely to push the winning candidate into the arms of Russia.

***The risk to this forecast is that the presidential election will involve outrageous abuses***

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<sup>14</sup> All in all, the Central Electoral Commission registered 26 candidates for the race, among them, apart from Viktor Yushchenko and Viktor Yanukovich, are leaders of the Communist and Socialist Parties Petro Symonenko and Oleksandr Moroz, Progressive Socialist Party leader Natalia Vitrenko, Party of Industrialists and Entrepreneurs leader Anatoliy Kinakh, Yabluko leader Mykhailo Brodskiy, and Kyiv Mayor Oleksandr Omelchenko.

<sup>15</sup> According to data from the Democratic Initiatives Foundation, in early July 2004 about 29% of the population were ready to vote for Yushchenko, 19% supported Yanukovich, and 8.5% favored Symonenko.

<sup>16</sup> According to data from the Democratic Initiatives Foundation, in early July 2004, 40% of the population were ready to vote for Yushchenko and 31% for Yanukovich, if the ballot included only Yushchenko and Yanukovich. Another 12% were undecided, 10% were against both, and another 6% would not bother voting.

# PUBLIC FINANCE

The reduction in income taxes that came into force 1 January 2004 did not result in a massive legitimization of shadow economy activities in the first half-year. The reason behind this low effect is the slow start on improving public services and promoting pension reform. Lowering the VAT in 2005, in our opinion, is pointless as consumer spending does not need further stimulus during this period. The growth in capital expenditures during the 2003–2004 Budget periods calls for a review of the priorities of state investment policy. The ICPS forecast is that Consolidated Budget expenditures for 2004 will grow to 29% of GDP. In 2005–2006, the deficit will be smaller

## Early results of tax reform

*Tax reform did not result in a swift shrinking of the shadow economy*

The GDP share of tax revenues shrank over the first half-year of 2004. This primarily reflected the lower tax rates<sup>17</sup> that are in effect since the beginning of the year.

*Table 1. Tax revenues*

	H1'03		H1'04	
	UAH mn	% GDP	UAH mn	% GDP
Tax revenues, including:	24,459.7	23.3	27,292.1	19.8
Personal income taxes	5,936.9	5.7	5,883.2	4.3
Corporate profit taxes	5,335.8	5.1	5,659.1	4.1

Source: Treasury; calculations by Quarterly Predictions

### *Personal income tax*

*Tax rates are not the main factor that keeps the shadow economy going*

Despite rising personal incomes (see **HOUSEHOLDS**), tax revenues from individual incomes were smaller than usual for the first half of the year. The fact that some employers switched to official payroll and tax deductions did not compensate for the loss of revenues as a result of lowered tax rates. In other words, tax rates are not the main reason why so many businesses stay in the shadow economy.

Over 2003, tax revenues grew by almost a quarter. We consider this was not so much evidence of a legitimization of incomes as greater income inequality of the population. Evidence that the shadow economy is not rapidly shifting to the official one can be seen in the fact that contributions to the Pension Fund are growing at a slower pace than personal tax deductions.<sup>18</sup> In confirmation of

<sup>17</sup> As of 1 January 2004, personal income tax was changed from a progressive 10–40% to a flat 13%, while corporate profit tax was reduced from 30% to 25%.

<sup>18</sup> Since there is no data about the level of contributions to the Pension Fund, ICPS has extrapolated these data based on the Pension Fund's expenditures out of insurance contributions during 2003 (see the Statistical Overview, Ministry of Labor and Social Policy and the Pension Fund of Ukraine in "Universal mandatory state social insurance and pension security for 2003"). During 2003, these outlays nominally grew 10.5% for 2003, while revenues from personal income tax grew 25%.

the notion that stratification by incomes is growing, the Consumer Confidence Index has been improving among those with middle and high incomes (see **HOUSEHOLDS**).

### *Corporate profit tax*

In H1'04, the GDP share of corporate profit tax revenues shrank. Rapid GDP growth (see **OVERVIEW**) and an industrial upswing (see **INDUSTRY**) did not lead to a comparable increase in tax revenues. In addition to lower tax rates, other reasons for this were growing costs for raw materials (see **PRICES**), which dampened the growth of corporate profits, and continuing tax breaks enjoyed by certain industrial sectors, Special Economic Zones (SEZs) and Territories of Priority Development (TPDs). As with personal income tax, the lowering of tax rate on corporate profits turned out not to be a powerful stimulus for the legitimization of commercial activities.

#### *How do you fight the shadow economy?*

*The Government has more than once declared its intentions of fighting the shadow economy. In June 2004, the Cabinet of Ministers issued a Resolution confirming additional measures to reduce the shadow portion of the domestic economy during 2004–2005. We have analyzed the reasons for this problem and evaluated which approaches might be the most effective in combating unofficial personal incomes.*

*The problem with tax evasion is largely the result of a low level of trust on the part of the average citizen as to how honestly and effectively the state can carry out its functions. People also see that there is a contradiction between the level of taxes paid and the quality of government services provided to the general population. Thus, the only way to change the situation is to improve the effectiveness of the public sector. Increased oversight of commercial activities and lower tax pressure appear to be fairly ineffective. On the one hand, people will always find new ways of evading controls, while on the other, the state cannot afford to reduce taxes to the point where taxpayers perceive them as adequate.*

*We consider the following set of measures the most effective:*

- *carrying out administrative reform that would have as its aim to increase the orientation of the civil service on improving the quality of services the state provides;*
- *speeding up the process of pension reform. The second phase of pension reform, setting up an accumulation fund, has to be launched as soon as possible;*
- *reviewing the current approach to legislative activity. The impact of each proposed policy decision needs to be evaluated better;*
- *continuing with tax reforms. The number of tax exemptions needs to be reduced;*
- *introducing reforms that would raise the quality of public services. This means reforming the healthcare system and speeding up the reform of residential services and the social security system.*

*This Cabinet Resolution, just like any number of previous Government programs aimed at fighting the shadow economy, will have little effect since the measures proposed in these programs fail to address the deeper roots of this problem.*

## Current trends

***During H1'04, the GDP share of Budget revenues shrank***

The portion of GDP redistributed through the Consolidated Budget shrank during H1'04, compared to the same period of 2003. In addition to lower tax rates for personal incomes and corporate profits, tax revenues also suffered because of lower collections of VAT.

The factor behind this last, according to ICPS, was higher export VAT refunds than in previous years, brought about by greater export activity (see **FOREIGN TRADE**), and the effect of VAT exemptions.<sup>19</sup>

**Table 2. Consolidated Budget revenues**

% GDP	H1'03	H1'04
Total revenues	31.6	27.9
Tax revenues, including:	23.3	19.8
Personal income tax	5.7	4.3
Corporate profit tax	5.1	4.1
Value-added tax	6.3	5.9
Excise tax	2.2	2.2
Taxes on international trade and foreign operations	1.4	1.6
Non-tax revenues, including:	7.2	7.0
Revenues of Budget-funded organizations	3.0	2.7
Revenues from capital operations	0.7	0.7
Budget balance	2.4	0.4

Source: Treasury; calculations by Quarterly Predictions

***The Government's investment priorities need to be reviewed***

Real Budget expenditures generally grew over H1'04.<sup>20</sup> This was made possible by the rapid growth of GDP as well as better sources of Budget financing than in previous years. The biggest growth in expenditures was in capital spending: in the first six months of 2004, this item grew compared to the same period of 2003 by almost a third, mostly because of increased capital transfers to businesses. According to ICPS, such increases in capital investment on the part of the state need to be subordinated to a clearly defined national investment policy. The inability of the Government to formulate and stick to such priorities<sup>21</sup> is a major risk to the efficient use of Budget monies.

<sup>19</sup> This refers to VAT exemptions on the supply of printed matter, the sale of medications, and the import of parts for the manufacture of cars, ships, ammunition and certain chemicals, as well as the zero VAT rates enjoyed by producers of meat and dairy who supply processing plants, the sale of buses, cars and spare parts at the zero VAT rate, and the special tax regime for SEZs and TPDs.

<sup>20</sup> In 2003, real Consolidated Budget expenditures grew 23.5% compared to 2002. In H1'04, real expenditures grew 23.4% compared to the same period of the previous year.

<sup>21</sup> The last state investment policy was written up in 1995 (see the 1 June 1995 Cabinet Resolution "On a Concept for regulating investment activity during transition to a market economy"). According to this document, priorities in state investment activity are the developing the fuel and energy complex and increasing the volume of consumer goods.

# Tax policy

## The VAT

In June, a bill that would reduce the VAT from 20% to 17% starting in 2005, and to 15% as of 2006,<sup>22</sup> passed first reading in the Verkhovna Rada. The purpose of reducing the VAT is to stimulate consumption and reduce the extent of the problem with refunds of export VAT. ICPS economists assessed the value of such a decision (see TABLE 3).

**Table 3. Pluses and minuses of reducing the VAT**

Pluses	Minuses
Stimulating consumption	No significant impact on the shadow economy
Beneficial to manufacturers, who will be able to sell more	Neutral impact on investment
Should lead to a slight reduction in consumer prices	Will lead to revenue losses for the Budget
Will reduce the scale of the problem with export VAT refunds by lowering the rate itself	Will complicate the problem with paying out VAT refund arrears

Source: Quarterly Predictions

According to ICPS, 2005 is not the best time to reduce the VAT because consumption will continue to grow rapidly without such a stimulus (see **HOUSEHOLDS**), while the problems with administrating the VAT are unlikely to be resolved by lowering the rate of this tax.

## Forecast for 2004–2006

### 2004

In the second half of 2004, Budget policy will be colored by the political battles for the presidential election. According to ICPS, Budget spending will outpace revenues in 2004, since the Government will make every effort to increase social spending prior to the election (see **HOUSEHOLDS**) and to reduce pressure on taxpayers. Our forecast for the Consolidated Budget deficit is being upgraded to 2% of GDP, because high levels of revenues from privatization during the first half of the year (see **BUSINESS**) will provide the financing to cover a deficit.

Budget revenues will amount to 27% GDP. There will be a decline in revenues compared to 2003 as a result of lower tax contributions. Moreover, the reduction of tax pressures on both individuals and businesses will not lead to a significant expansion of the tax base during 2004 because of the effect of tax exemptions and inadequate stimuli to draw commercial activity out of the shadows.

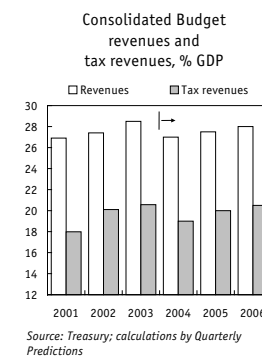
<sup>22</sup> See Bill №5258 dated 16 March 2004 introducing changes to the Law on the VAT (on the issue of taxation).

### VAT rates in different countries, %

	Reduced	Regular
<b>Russia</b>	<b>10</b>	<b>18</b>
<b>France</b>	<b>5.5</b>	<b>19.6</b>
<b>Germany</b>	<b>7</b>	<b>16</b>
<b>Poland</b>	<b>7</b>	<b>22</b>
<b>Latvia</b>	<b>9</b>	<b>18</b>
<b>Ukraine</b>	<b>0</b>	<b>20</b>

**It makes little sense to lower the VAT in 2005**

**In 2004, Budget expenditures will significantly outpace revenues**



***The political battle during the election will have a negative impact on the quality of the 2005 Budget***

## 2005

The political battle during the election campaign will make it hard to improve the quality of the Budget for 2005. The Law on the 2005 State Budget, like its predecessor, will suffer from violations of the Budget Code, interference in the tax policy process, and the prevalence of short-term priorities over long-term ones. Also, there will be little substantial progress in making state investments more effective because of the slowness of reform in the residential services, healthcare and education sectors.

The GDP share redistributed through the Budget will grow to 27.5% in 2005 as the Government puts more effort into increasing Budget revenues by reducing tax debts and eliminating exemptions once it is faced with fewer prospects for covering the deficit. Still, the increase in revenues will be counterbalanced by a reduction in the VAT compared to 2004. Spending for 2005 will not be noticeably curtailed in the run-up to the Verkhovna Rada election in spring 2006.

## 2006

***By 2006, the elimination of many tax exemptions should make it possible to fill state coffers somewhat better***

The share of GDP redistributed through the Budget will inch up to 28% and Budget revenues will be higher than in 2004 because of a gradual shrinkage of the shadow economy and actions on the part of the Government to expand the tax base (reviewing sector-based exemptions, SEZs and TPDs). The share of GDP of public spending in 2006 will be the same level as in 2004, 29%. The spring 2006 elections to the Verkhovna Rada will encourage greater spending.

## *Risks to the forecast*

- If the Government becomes more active in reducing tax debts, the share of GDP redistributed through the 2004 Budget could be 0.5–1% higher.
- Active efforts on the part of the Government to reform the pension system and other areas of the public sector would make it possible to get more financing in the form of tax revenues and will increase the Budget deficit in 2005 because of greater borrowing to carry out these reforms.
- Any further delay in resolving the problems with the VAT<sup>23</sup> could lead to significant reductions in tax revenues during 2005–2006.

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<sup>23</sup> See *quarterly predictions* for Q3'03, p. 18.

# FOREIGN TRADE

In Q1'04, the current account balance grew sharply as exports rose faster than imports. Coupled with a favorable external situation, the driver behind export growth was brisker exports to the European Union just prior to its enlargement. ICPS has upgraded its forecast for the 2004 current account balance to US \$5.3bn. In 2005–2006, imports should grow faster than exports, and this will cause the current account balance to shrink to US \$5bn and US \$3.3bn respectively

## Current trends

Starting in February 2004, exports began growing faster than imports. Moreover, in April–May 2004, export grew faster than in Q1'04, while import growth slowed.<sup>24</sup> As a result, in January–May 2004, the current account balance spiraled to a record-high US \$3.5bn,<sup>25</sup> according to NBU data. ICPS economists point to several factors behind export growth:

- growing prices on external markets for metals, chemicals and oil products (see **PRICES**);
- a final burst of exports to the European Union before its enlargement;
- accelerated growth among Ukraine's key trading partners, in particular Russia, during Q1'04 (see **WORLD ECONOMY**);
- prolonged real hryvnia depreciation (see **MONETARY POLICY**).

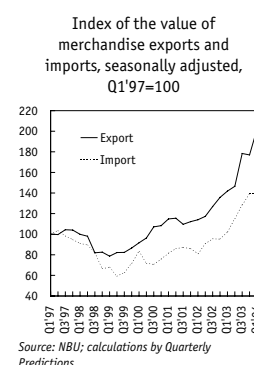
In April–May 2004, imports slowed down in all commodity groups, unlike the trend in Q1.<sup>26</sup> During April–May 2004, imports of agricultural products declined substantially, linked to considerable drop in grain imports.

## Forecast for 2004–2006

### *Current account balance*

The 2004 current account balance should reach a record-high US \$5.3bn as exports continue to grow faster than imports and the current account transfer balance remains high. ICPS expects export growth to slow down during H2'04, due to the negative impact of EU expansion and flat prices on external markets for metals, chemicals and oil products.

***The current account balance has been growing rapidly in 2004***



***ICPS substantially upgraded its forecast for the current account balance***

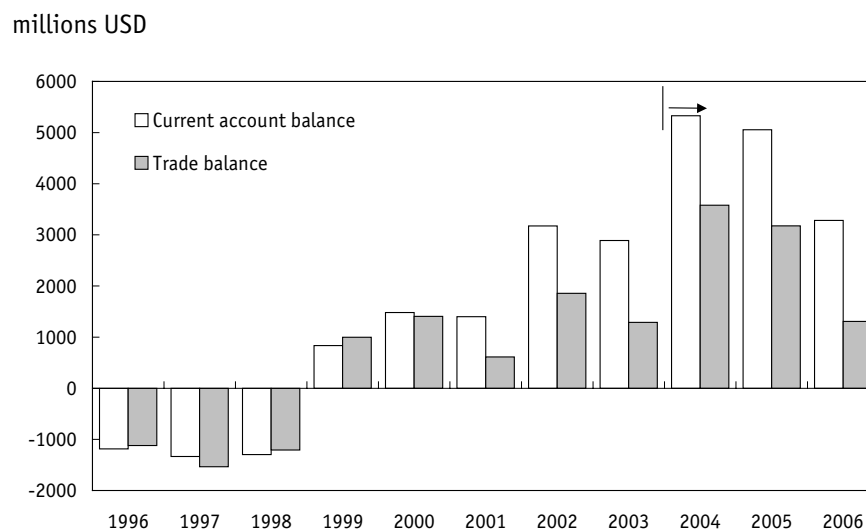
<sup>24</sup> According to Derzhkomstat, exports and imports of goods grew 45.2% and 39.2% in Q1'04, and these indicators were 51.3% and 32.5% for January–May 2004. NBU data on the balance of payments differs from Derzhkomstat because of additional amounts calculated by the National Bank. Where the text does not mention a source, QP is using Derzhkomstat data.

<sup>25</sup> In Q1'04, the current account balance reached US \$1.7bn, according to the NBU data.

<sup>26</sup> Imports grew 35.6% in 2003, 39.2% in Q1'04, and 32.5% in January–May 2004.

In 2005–2006, imports should grow faster than exports because of a slightly deteriorating external situation (see **PRICES**) and slower growth among Ukraine’s trading partners (see **WORLD ECONOMY**). As a result, the current account balance should shrink to US \$5bn in 2005 and US \$3.3bn in 2006.

**Figure 3.** *Current account and trade balances for goods and services*



Source: NBU; forecast by Quarterly Predictions

### *Exports*

**STEEL.** After a slowdown in January 2004,<sup>27</sup> steel exports accelerated during February–May. In 2004, the growth of steel exports will be distinguished by high external prices and expanding demand in Asian countries. This should compensate for reduced supplies to the enlarged EU, caused by the introduction of non-tariff restrictions.<sup>28</sup> In 2005–2006, metal exports should taper off as world prices decline (see **PRICES**).

**MINERALS.** In January–May 2004, the share of mineral products slipped over the same period last year (see **FIGURE 4**), due to lower exports of most of its inputs, especially crude oil. Instead, oil product exports escalated. Reducing oil prices in 2005–2006 (see **PRICES**) is the key reason behind the anticipated decline in exports of mineral products.

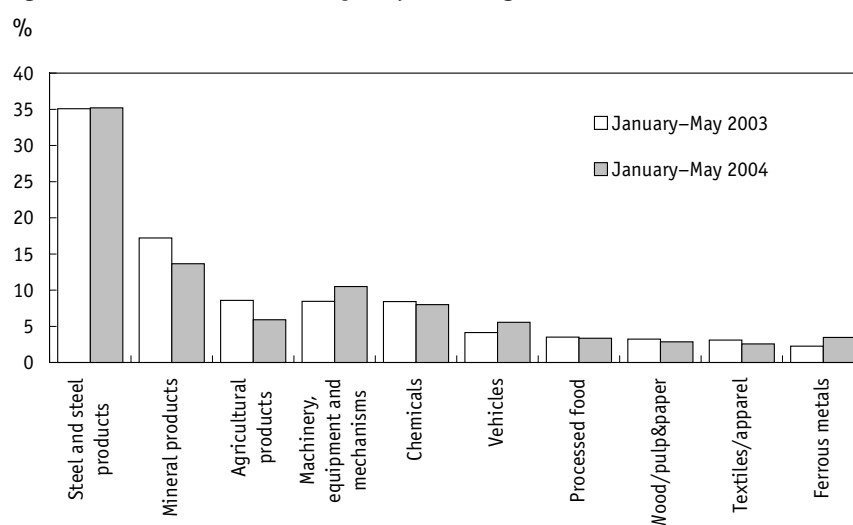
**MACHINERY AND EQUIPMENT.** In Q1’04, machinery and equipment exports skyrocketed to 70%, due to: (1) economic growth in Russia, a key trading partner for this commodity group and (2) accelerated exports of electrical equipment to Lithuania prior to the cancellation of the FTA between Ukraine

<sup>27</sup> In early 2004, the Government failed to issue export licenses for supplying certain metal products, as the 24 December 2003 Cabinet Resolution “On lists of goods requiring licenses for export and import and subject to quotas in 2004” was not amended on time.

<sup>28</sup> In 2004, a quota was set for rolled steel, but it does not take into consideration demand in the new EU members. The new EU members will also take advantage anti-dumping probes initiated by the EU-15 into Ukrainian steel cable and wire, and certain types of welded piping.

and Lithuania.<sup>29</sup> Such exports should taper off in 2005–2006, as Ukraine’s trading partners, in particular Russia and Germany, face economic slow-downs.

**Figure 4. Structure of exported goods**



Source: Derzhkomstat

**Table 4. Change in exported goods, by group**

% y-o-y	Share of 2003 exports, %	2003	2004	2005	2006
		f o r e c a s t			
<i>Total exports, including:</i>		28.5	33	14	7
Steel and steel products	33.8	31.5	27	15	5
Mineral products	15.2	60.0	20	15	5
Machinery, equipment and mechanisms	10.1	32.3	55	12	7
Chemicals	8.4	39.1	25	15	5
Agricultural products	7.9	-1.4	10	8	8
Vehicles	4.3	42.8	80	15	7
Processed food	3.9	70.0	40	20	15
Textiles/apparel	3.3	16.9	25	10	10
Wood/pulp&paper	3.1	26.4	25	20	10
Non-ferrous metals	3.0	-42.1	100	15	15

Source: Derzhkomstat, NBU; forecast by Quarterly Predictions

<sup>29</sup> In Q1'03, the share of such exports to Lithuania stood at 5% of total exports of electrical equipment, while in Q1'04, this indicator reached 40%.

**CHEMICALS.** In 2004, the volume of chemicals being exported has remained flat at about the 2003 level, but the cash value of these exports continues to climb. According to ICPS, chemical exports should ease up somewhat during the forecast period as prices fall. Still, they should remain high due to high demand among key agricultural producers.<sup>30</sup>

**TRANSPORT.** Growing demand in Russia and Kazakhstan for rail cars and rail-car equipment due to a steep increase of oil exports from these countries was the key driver behind the growth of vehicle exports during Q1'04.<sup>31</sup> In 2005–2006, vehicle exports should grow at a more sluggish pace due to market saturation.

### *Imports*

**OIL AND OIL PRODUCTS.** In 2004, the rate of growth of oil and oil product imports should be somewhat lower because of the high baseline in 2003. In 2005–2006, imports should decline because of lower prices and restricted oil extraction in Russia.

**MACHINERY AND EQUIPMENT.** Higher imports in 2004 reflect high rates of domestic investment growth (see **BUSINESS**). One particular driver behind these growing imports is repairs at atomic energy stations.<sup>32</sup> In 2005–2006, machine-building imports should fall off as investment growth slows.

**NATURAL GAS.** In 2004, the rate of gas imports should rise against the low baseline in 2003<sup>33</sup> and rapid industrial growth. Despite the downward trend in gas consumption, imports are likely to become more expensive in 2005–2006 as Russia jacks up its prices.<sup>34</sup> ICPS opinion is that these price hikes will be gradual and take place over several years.

**TRANSPORT.** Vehicle imports accelerated<sup>35</sup> slightly in Q1'04 because of increased imports of passenger cars and trucks. This is partly due to a last-minute rush by importers and consumers before the import duty for new vehicles went up in May 2004.<sup>36</sup> According to ICPS economists, the Government's

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<sup>30</sup> The key sales markets for Ukrainian chemicals include China, Hungary, Lithuania, Mexico, Poland, Russia, the US, and Turkey.

<sup>31</sup> Vehicle exports rose by 130% in Q1'04 versus 42.8% in 2003. Apart from carriages and carriage parts, exports of tractors, trucks, car parts and devices also accelerated.

<sup>32</sup> In Q1'04, machinery and equipment imports grew by 50% and imports of nuclear reactors contributed 10 pp to this growth.

<sup>33</sup> In H2'02, the registered price for gas that Ukraine received as payment for Russian transit, surged from US \$50 to US \$67 per 1,000 cu m, only to drop back to its previous level in 2003.

<sup>34</sup> Russia's energy strategy includes raising domestic gas prices from US \$27–28 per 1,000 cu m to US \$37–42 per 1,000 cu m by 2006. This would cause a matching rise in export prices. Indeed, Russian GazProm has already announced its intention to gradually raise gas prices for the Baltics.

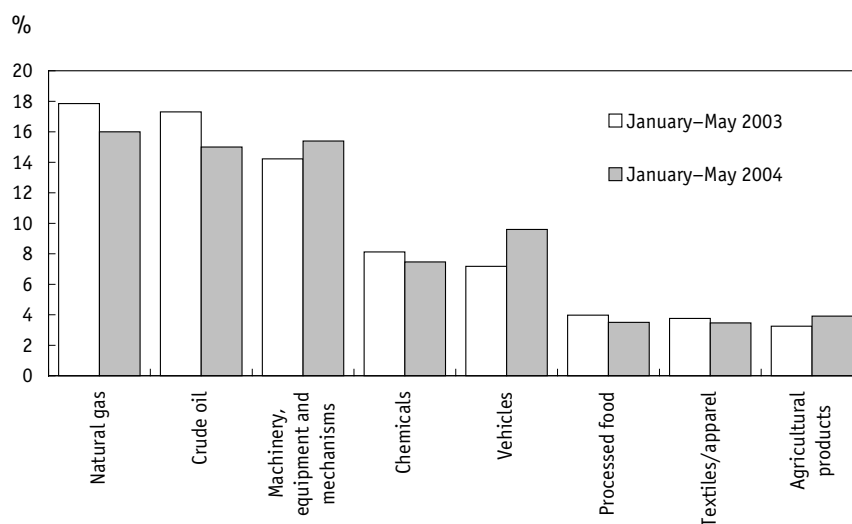
<sup>35</sup> Vehicle imports surged by 80% over 2003, and by 90% in Q1'04.

<sup>36</sup> According to the 18 March 2004 Law "On developing automobile industry in Ukraine," by the end of 2005, import duty for new automobiles with gasoline engines up to 3,000 cu cm and diesel engines up to 2,500 cu cm will be set at 15%, and at 20% for gasoline engines over 3 liters and diesel engines over 2.5 liters. Earlier, this tariff was calculated per 1 cu cm of the engine's volume and amounted to about 2–3%. The law also states that import duty for new vehicles will be reduced to 12% as of 1 January 2006.

protectionist policy towards car makers should last through the forecast period, and this will continue to restrain the growth of imports. Despite this trend, car imports will still pick up as household incomes grow (see **HOUSEHOLDS**).

**AGRICULTURAL PRODUCTS.** Food grain imports in H1'04<sup>37</sup> should come to and end in H2'04. A good harvest in 2004 (see **AGRICULTURE**) should reduce imports of agricultural products. Agricultural import growth in 2005–2006 will be driven by rising consumption.

*Figure 5. Structure of imported goods*



Source: Derzhkomstat

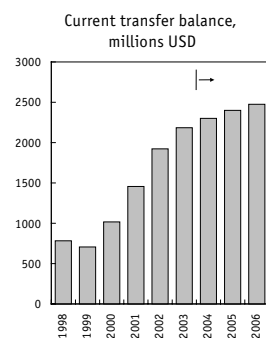
*Table 5. Change in imported goods, by group*

% y-o-y	Share of 2003 im-ports, %	forecast			
		2003	2004	2005	2006
<i>Total imports, including:</i>		35.6	24	17	13
Crude oil	16.0	50.0	10	7	5
Machinery, equipment and mechanisms	15.1	39.0	40	25	15
Natural gas	13.9	-9.4	15	10	10
Vehicles	8.1	83.5	70	25	20
Chemicals	7.7	28.8	25	22	18
Processed food	4.8	71.5	30	20	20
Agricultural products	4.7	126.2	-15	15	10
Textiles/apparel	3.7	26.6	20	15	15

Source: Derzhkomstat, NBU; forecast by Quarterly Predictions

<sup>37</sup> According to the *Interfax-Ukraine* newswire of 21 June 2004, Ukraine imported 3.5mn t of food grain between July 2003 and April 2004, including 1.5mn t in early 2004.

### **Net current transfers should grow in 2004–2006**



Source: NBU; forecast by Quarterly Predictions

### **With its latest expansion, the EU became Ukraine's largest trading partner**

## *Net current transfers*

The 2003 current transfers balance was US \$2.184bn, 76% of the current account balance.<sup>38</sup> The largest share in the incoming current transfers belongs to incoming cash.<sup>39</sup> In 2003, remittances by migrant workers and transfers through the MoneyGram and Western Union systems grew at a record-high pace of 39% and 25% respectively.<sup>40</sup>

Disbursements to ostarbeiters will end in 2005. During the final year, such disbursements will be lower than in 2004.<sup>41</sup> At the same time, incomes of Ukrainians working abroad should grow during the forecast period as they gain experience and further expand their use of official channels to transfer money to Ukraine. Since the proportion of individual money transfers is far larger than the share of disbursements to ostarbeiters, the current transfer balance should continue to grow during the forecast period.

## *Trade with neighboring countries*

**THE EUROPEAN UNION.** After expanding on 1 May 2004, the European Union became Ukraine's largest trading partner.<sup>42</sup> In Q1'04, exports to the EU-15 climbed because of steel and mechanical and electrical equipment. Exports to accession countries accelerated in Q1'04, mostly steel and steel products, electrical equipment, chemicals and grains. In May 2004, exports to the EU-10 slowed as the new EU members<sup>43</sup> applied EU-15 non-tariff restrictions.

In 2005–2006, trade with the EU will depend on agreed steel quotas and Ukraine's accession to the WTO. The European Union could become more protectionist towards its markets in view of the growing competitiveness of Ukrainian goods as the euro is revaluated (see **MONETARY POLICY**).

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<sup>38</sup> Incoming current transfers make up the largest portion of the current account balance, as the share of outgoing current transfers is insignificant.

<sup>39</sup> The share of cash transfers in the structure of incoming current transfers stands at 78%. Cash transfers include, in particular, money transfers of workers, transfers through MoneyGram and Western Union systems and disbursements to ostarbeiters.

<sup>40</sup> According to different estimates, about 3–7mn of Ukrainians work abroad. According to the Government, the average transfer was US \$190–280 during 2003.

<sup>41</sup> See also <http://www.nag-unf.kiev.ua/?do=readnews&ide=Qwc6q1E7>.

<sup>42</sup> Results for January–May 2004 show that the share of commodity exports to the EU-25 was 33.6%, while the share of exports to the CIS was only 24.4%.

<sup>43</sup> Ukraine and the EU signed an agreement on metal products trade in 2004, envisaging a quota of 606,000 t, provided the quota is extended to about 1mn t in 2005. Given the EU-10 demand for about 800,000 t of metal products per annum, deliveries to this region should slip sharply in 2004. The new EU members will also apply anti-dumping probes into Ukrainian steel and steel products, and chemicals, initiated by the EU-15. According to a European Commission decision, half of these anti-dumping probes will have a transitional period from six to twelve months, which reduces their negative impact on Ukraine's trade in 2004, while the rest of the measures will be applied in full.

**RUSSIA.** Imports from Russia shrank as oil imports went down<sup>44</sup> in Q1'04 versus the same period in 2003. Although exports picked up pace,<sup>45</sup> they were still below average. Actual volumes of metal exports to Russia are unlikely to change much<sup>46</sup> in 2004 compared to 2003 but their price component will grow. According to ICPS, Russia's share in Ukrainian exports should shrink during the forecast period as Ukraine gradually re-orientes towards EU markets. However, if the EU increases the protection of its markets—especially for steel and chemicals—, Russia's share will also not change much, as these products form a large portion in Ukraine's exports to Russia. In this case, Ukraine will likely expand sales to Asian and African countries.

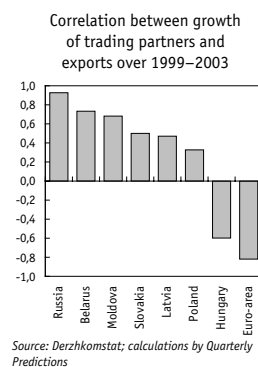
**MOLDOVA.** In Q1'04, exports to Moldova grew faster than average, continuing the 2003 trend.<sup>47</sup> Compared to Q1'03, imports from Moldova steamed ahead,<sup>48</sup> consisting mostly of seeds and oil-bearing and other crops, steel, electrical machinery and equipment. Still, the share of imports from Moldova in overall imports into Ukraine remains insignificant. Exports should grow as Moldova's economy picks up pace compared to Ukraine's other trading partners. The risk to this forecast is a worsening of the conflict between Moldova and Transdnistria.

**BELARUS.** In Q1'04, exports to Belarus accelerated<sup>49</sup> largely because of brisker exports of steel, transport vehicles, railway equipment, and grains. Imports climbed faster due to larger imports of cars, semi cabs and other land-based transport, and electrical machinery and equipment. Over the next few years, exports to Belarus should grow faster than average, continuing the upward trend in trade with this country.<sup>50</sup>

According to ICPS calculations, the correlation<sup>51</sup> between the economic growth of trading partners and Ukraine's exports to these partners over 1999–2003 was the highest for Russia, Belarus and Moldova. This can be explained by the relatively low economic development of these countries, whose economic growth is inevitably accompanied by revival in trade. A lower correla-

**Export/import shares,  
January–May 2004, %**

	<b>Export</b>	<b>Import</b>
<b>EU-15</b>	<b>19.9</b>	<b>23.3</b>
<b>EU-10</b>	<b>13.7</b>	<b>8.0</b>
<b>Russia</b>	<b>16.8</b>	<b>39.0</b>
<b>Moldova</b>	<b>1.8</b>	<b>0.3</b>
<b>Belarus</b>	<b>1.5</b>	<b>1.6</b>



<sup>44</sup> In Q1'04, Russia's imports to Ukraine slipped to 37.6% versus 39.9% in Q1'03.

<sup>45</sup> Ukraine's exports to Russia rose 41.3% in Q1'04. Exports accelerated because of steel, electrical machinery and equipment, transport vehicles and railway equipment.

<sup>46</sup> According to the 24 December 2003 Cabinet Resolution "On lists of goods requiring licenses for export and import and subject to quotas in 2004," Ukraine agreed upon a 715,000 t piping quota to Russia in 2004. In 2003, the quota was 740,000 t and was 99.5% fulfilled.

<sup>47</sup> Exports to Moldova leapt by 60% in 2003, and by 50% in Q1'04. Energy supplies and steel had the largest share of Ukraine's exports to Moldova.

<sup>48</sup> Imports inched up by 1% in 2003, and surged by 70% in Q1'04.

<sup>49</sup> In Q1'04, exports to Belarus climbed 60%, after growing 30% in 2003.

<sup>50</sup> Exports to Belarus fell in 2000–2001, grew 6.9% in 2002, and surged 30.3% in 2003.

<sup>51</sup> The correlation coefficient is a relative connection between two factors. The coefficient's value ranges from -1 to +1. A positive value means there is a direct relation between the variables, while a negative value indicates an inverse relation. When the coefficient's value approaches 1, it means there is a strong relation; when the ratio approaches 0—there is no relation. The drawback is that this ratio measures only linear interdependence and does not reflect more complicated relations between a country's GDP growth and trade activity.

tion between economic growth and trade development can be seen with Slovakia, Latvia and Poland, and this correlation is actually negative in Hungary and Euro-area countries, which implies that the role of foreign trade declines for countries with higher economic development. The lower correlation for European countries is also in part due to greater protection of national industries.

### *WTO accession*

***The risk is growing that WTO accession will be postponed***

ICPS specialists have not altered their forecast that Ukraine will accede to the WTO in late 2005, although the risks that the accession date will be postponed are growing for several reasons:

- Russia might accede to the WTO before Ukraine, given Moscow's substantial progress in negotiations lately, in particular its reaching agreement with both the EU and China. If this were to happen, Ukraine could well be hampered by additional demands from Russia as to the terms of its accession to the WTO.
- The US, one of the key members in the Working Group whose decisions influence the decisions of other countries, has postponed signing its memorandum.<sup>52</sup> In the opinion of ICPS specialists, the US will not sign until after the presidential elections in both Ukraine and the US are over. Moreover, this decision will depend on how democratic the election process in Ukraine is (see **POLITICAL ENVIRONMENT**).

***The likelihood of changes in WTO accession rules is going down***

At the same time, the likelihood that Ukraine will have to negotiate additional issues because of changes in WTO accession rules has lessened. The Doha round, which could result in changes to accession procedures, has been postponed again and is unlikely to end before Ukraine joins.<sup>53</sup>

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<sup>52</sup> As of 1 July 2004, Ukraine had signed 24 bilateral agreements with members of the Working Group on its accession to the WTO. It is continuing talks with 21 more countries.

<sup>53</sup> This round of negotiations was expected to end not later than 1 January 2005. Although it began in 2001, the first edition of the WTO General Council decision on the Doha talks—a framework document including a number of issues scheduled for consideration during this round—was promulgated only in July 2004. EU Trade Commissioner Pascal Lamy says negotiations could finish by 2006.

# PRICES

During the first half of 2004, oil prices in Ukraine began to move, and the cost of producing food remained high. Still, consumer inflation was moderate, mainly due to tight Government policy in regulating these markets. Meanwhile, industrial inflation picked up steam as export prices grew and production costs increased. The current policy of holding inflation in check will be maintained until November 2004, so the Consumer Price Index will likely have risen only 6.5% over the year. In 2005, the liberalization of consumer prices should push the CPI another 8%. The growth in industrial prices will taper off as the situation on key global commodity markets deteriorates

## Consumer prices

During the first half of 2004, inflationary processes moved at a moderate pace, despite price hikes on oil markets and cost-pushed inflation in agriculture. This dynamic was driven by expectations of expanding supplies of agricultural products and by the Government's policy of stabilization.

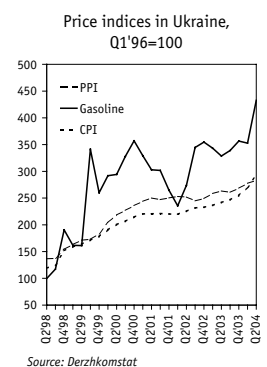
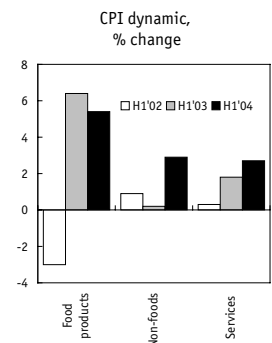
In H1'04, price growth reached the same level as in 2003,<sup>54</sup> as the Government managed to curb key price pressures. Results for Q2'04 show stronger inflationary trends, although expectations of a good harvest and the beginning of expanded food supplies made it possible to contain price fluctuations. By the end of June, food prices, in particular flour and milk prices, began to shrink. However, disturbances on the petroleum products market caused prices for non-comestible goods to start rising. In response to gasoline price hikes, these prices also spiked, 49.2% versus a 7.7% drop in H1'03.

ICPS has upgraded its forecast for consumer price growth from 6% to 6.5% in 2004. Stronger inflationary pressures will come from: (1) higher household incomes prior to the presidential election (see **HOUSEHOLDS**); (2) shrinking supplies of some food products, such as meat (see **AGRICULTURE**); (3) higher fuel prices for farmers and, with some types of fuel, for the general population.

Higher inflation rates may be avoided through:

- A big crop and steady supplies over H2'04 (see **AGRICULTURE**);
- Government measures to stabilize prices—regulating the oil products market, DerzhReserv interventions, stable rates for residential services;
- Moderate growth in consumer demand during most of 2004 until the election;

**During H1'04,  
the Government limited  
CPI growth to 4.4%**



<sup>54</sup> Over H1'04, consumer prices climbed 4.4% versus 4.6% during the same period in 2003. The highest price growth was in meat (23.6% versus a 5.8% decline in 2003) and sugar (11.8%, down from 19.7% in 2003). A steep decline was evident in egg prices (-29.7% versus -32.1%). Prices for other commodities changed in accordance with traditional seasonal trends.

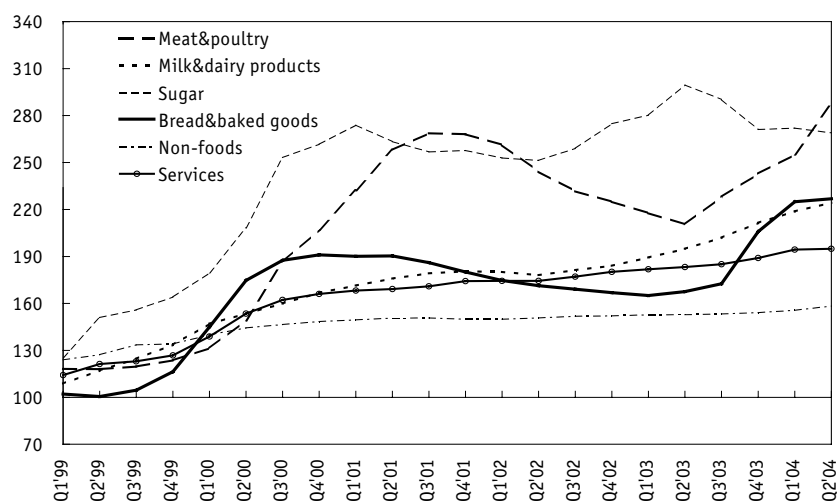
- Lower inflationary expectations,<sup>55</sup> despite the emergence of uneven price growth across sectors.

#### CPI, 2001–2006

2001	6.1%
2002	-0.6%
2003	8.2%
2004	6.5%
2005	8.0%
2006	5.0%

**Figure 6. Consumer Price Index components**

index of average quarterly change, seasonally adjusted, Q4'97=100



Source: Derzhkomstat; calculations by Quarterly Predictions

The 2005–2006 inflationary dynamics will be driven by:

- growing consumer demand after the 2004 election;
- growing negative inflationary expectations caused by price liberalization;
- cost-pushed inflation.

Still, prices will be held in check by:

- Government measures to regulate markets;
- a small deficit (see **PUBLIC FINANCE**) and tight monetary policy (see **MONETARY POLICY**);
- growing competition on retail markets, spurred by the arrival of multinationals and the gradual liberalization of foreign trade, especially after Ukraine accedes to the WTO;
- slower growth in demand due to the multiplier effect of a slowdown in the export sector.

***In 2005, consumer prices will be liberalized and inflation will hit 8%***

As a result, according to the new ICPS forecast, CPI growth should accelerate to 8% in 2005, and fall back to 5% in 2006. In this forecast, we included the considerable likelihood that the Government will have to “transfer” to 2005, the inflation that was “frozen” before the election, in order to restore market equilibrium. There is also a possibility, however, that price controls could continue to be very rigid.

<sup>55</sup> During H1'04, inflationary expectations subsided: polls revealed that the relevant consumer index slipped from 186.1 in December 2003 to 169.5 in June 2004. For more information see **consumer confidence** for July 2004.

The risk to this forecast is the growing influence of monopolists in the market, should regulation be weak and speculation rise despite government efforts to stabilize market imbalances.

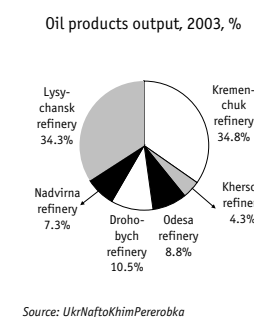
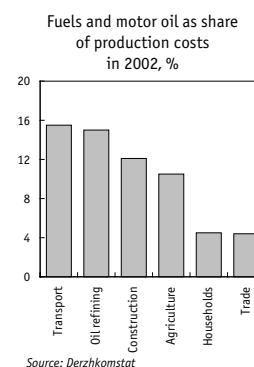
**The risk to the ICPS forecast is instability on oil markets**

*Lessons from the oil crisis*

*Once again, the Government proved unprepared to forestall a rush on the oil products market and lost out.<sup>56</sup> In our opinion, the key reasons behind this sudden destabilization were:*

- *expectations of a shortage of oil products as a result of the shutting down of the Lysychansk and Kherson oil refineries for repairs almost at the same time. Between them, the two plants refine about 40% of Ukraine's oil;*
- *a seasonal spike in demand, particularly among growers;<sup>57</sup>*
- *growing oil product exports due to a favorable situation on world oil markets;<sup>58</sup>*
- *lack of transparency on the wholesale oil market<sup>59</sup> and lack of opportunities for interventions by government agencies;*
- *speculative activity by intermediaries, who jumped at the opportunity while supplies were low on the domestic market.<sup>60</sup>*

*The result of actions by producers and intermediaries and the Government's belated response was a jump in consumer inflation<sup>61</sup> and rising producer costs,<sup>62</sup> which had a multiplier effect on prices. Lower consumer purchasing power and higher expenses, based on ICPS modeling, could lead to GDP growth being lower by 0.5 percentage points.*



<sup>56</sup> During May–June 2004 alone, retail petroleum products became 40.6% more expensive. In early June 2004, wholesale prices for gasoline and diesel were more than 50% higher than April prices.

<sup>57</sup> The minimum requirement for the agricultural sector is 350,000–450,000 tonnes of oil products in spring and to about 600,000–800,000 t in autumn.

<sup>58</sup> According to Customs data, over January–May 2004, oil product exports rose 23% over the same period of 2003.

<sup>59</sup> Oil refineries can supply oil products several ways: (1) directly to jobber filling stations; (2) through affiliated intermediaries; (3) through companies operating on a tolling basis. There is no system of open futures or commodity exchange trading.

<sup>60</sup> In May 2004, oil refineries reduced oil-refining outputs by 6.8% over May 2003.

<sup>61</sup> In particular, about half of CPI growth in May 2004 (0.32 of 0.7pp) is the direct impact of higher oil product prices.

<sup>62</sup> According to the 2002 inter-sector balance sheet, the largest customers for fuels and motor oil, other than the technical needs of oil refining, are transport, where refined oil products constitute 15.5% of production costs, construction with 12%, and agriculture with 10.5%. However, for sectors often declared as “the most affected”—food industry and trade—fuels and motor oil actually make up only 1.3% and 4.4% of production costs.

*The Government's administrative approach<sup>63</sup> to crisis management succeeded in stabilizing the situation, but it failed to provide radical and systemic improvement in the regulation of this market. Oil refineries simply agreed to cut prices by 10% and introduce tighter price controls at jobber stations. In future, prices will be determined according to a formula, using a procedural approach: fuel prices will be tied to prices for crude oil. Generally, this idea can prove useful, but it will not protect the market from external shocks.*

*To establish a long-term balance and minimize welfare losses, it is necessary to:*

- **DEVELOP MARKET INFRASTRUCTURE, INTRODUCE GREATER TRANSPARENCY AND MONITORING, IMPROVE ANTI-MONOPOLY POLICY.** *These methods can help the Government institute a policy that will counter cycles and contribute to long-term relations among market participants that are aimed at market stabilization.*
- **SET UP RESERVES AGAINST NEGATIVE MARKET CONDITIONS.**<sup>64</sup> *The cost of setting up the missing infrastructure for such reserves is a key hurdle that is practically impossible to overcome in the short-term.<sup>65</sup> Given the fact that, after its energy crisis, the US spent nearly five years setting up its reserves, Ukraine should not put off forming strategic reserves any longer.*
- **DIVERSIFY SUPPLY SOURCES.** *For example, to use Caspian and Black Sea supplies. However, it is not very likely that such steps will bring tangible price improvements, as the current ratio of extraction and anticipated demand for Caspian oil diminishes the advantage of this option.*
- **REDUCE ENERGY CONSUMPTION.** *This is the most long-term approach as well as the most effective one.*<sup>66</sup>

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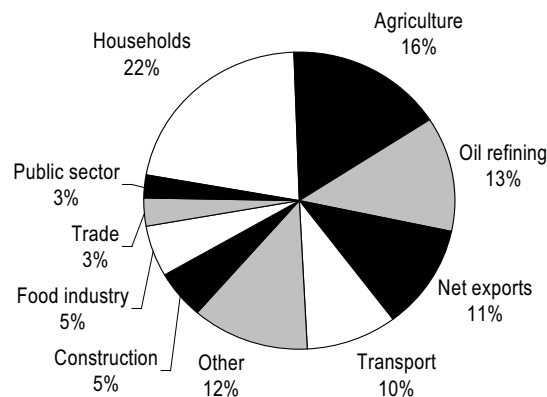
<sup>63</sup> This mostly meant price controls and export restrictions by way of licensing introduced 28 May 2004 in Cabinet resolutions, and massive tax raids.

<sup>64</sup> For example, after the oil crises of 1973 and 1978, the US set up reserves of oil and oil products for three to six months of consumption. Europe had launched such a practice back in 1968. As of July 2004, EU countries had reserves worth 100 days of imports.

<sup>65</sup> The cost of setting up such reserves includes the fixed costs of the actual infrastructure and the oil purchases, and the variable costs of oil storage. For example, the cost of storing one barrel of oil in the US Strategic Oil Reserve is about US \$1.50 and about US \$3 more to cover operating costs. The US has achieved such low cost levels by using salt mines as storage tanks, as using artificial reservoirs would require investing about US \$15–20 per barrel. Even assuming that Ukraine's cost for oil storage will be lower, setting up 6-week oil reserves (about 2–4mn tonnes) could cost up to US \$150–200mn in infrastructure, another US \$600mn in oil, and US \$20–40mn a year in storage costs.

<sup>66</sup> Since the 1973 world oil crisis, the US has been cutting down energy consumption and by 2002 the country had reduced energy consumption almost by half (from 8% to 4% of GDP in constant prices). This was not only due to rising world energy prices, but also to higher taxes on oil consumption. Excise duty was almost doubled, which provided additional incentive for lowering demand for oil products and contributed to growing productivity.

Figure 7. Oil product consumption in 2003



Source: Derzhkomstat; calculations by Quarterly Predictions

## Producer prices

During the first half of 2004, rising exports and export-oriented production were responsible for strong price pressure, first of all on resource markets—in particular, on iron-ore, coke and gas. Producer inflation reached 14.3% over H1'04 due to rapidly rising prices on external metal and chemical markets and, consequently, higher costs for raw materials and energy.

Over H1'04, this price growth was led by oil refining and coke production (53.5%), metal and metal products (22.1%), and fuel extraction (20%). Escalating gas prices caused a 9.5% price growth in the utilities sector (power, gas and water generation and distribution).

**The PPI saw record-high growth over the last four years**

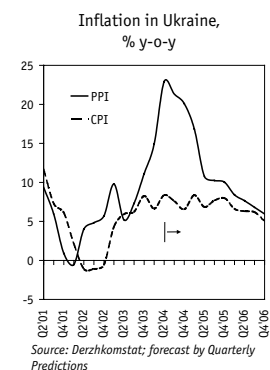
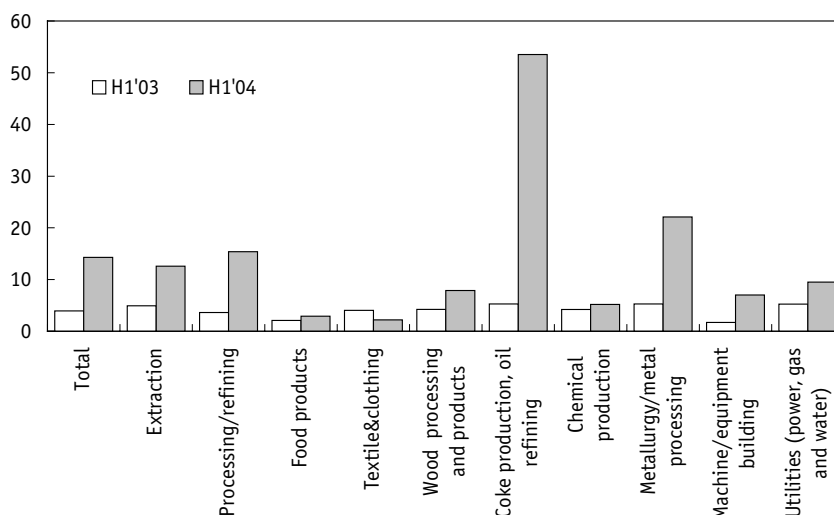


Figure 8. Producer Price Index breakdown

% annual



Source: Derzhkomstat

The Government tried to freeze prices for raw materials and finished goods on the domestic market, but these efforts were only somewhat successful. The policy for simultaneously lowering prices for both finished products and in-

puts was sabotaged<sup>67</sup> and the impact of Government measures weakened.<sup>68</sup> Although the benefit to the society of lowering cost-pushed inflation<sup>69</sup> is evident, sectoral distortions can increase unproductive costs and therefore undercut Government efforts.

#### ***PPI in 2001–2006***

<b>2001</b>	<b>0.9%</b>
<b>2002</b>	<b>5.7%</b>
<b>2003</b>	<b>11.1%</b>
<b>2004</b>	<b>20.0%</b>
<b>2005</b>	<b>10.0%</b>
<b>2006</b>	<b>6.0%</b>

By year-end, price growth should slow down due to:

- a slowdown in the growth of world prices for metals, chemicals and grains;
- partial success on the part of the Government in controlling raw material markets (see **INDUSTRY**);
- a seasonal decline in food prices coupled with growing supplies of farm products (see **AGRICULTURE**);
- stabilized prices on the oil products market.

However, producer inflation will reach the unheard of 20%, mainly because of unpredictable export growth (see **FOREIGN TRADE**) and the impact of higher input costs.

#### ***In 2005–2006, export prices should stabilize***

During 2005–2006, producer price growth should slow as the situation deteriorates on external markets. Above all, prices should stabilize in export-oriented sectors.

However, the liberalization of energy prices by partner-countries and the need to invest will make it difficult for cost-pushed inflation to completely abate by 2006.

There are several risks to this forecast:

- continuing high oil prices in the world and in Russia;
- the overheating of the domestic economy and the multiplier effect of cost-pushed inflation across sectors;
- disproportions and internal shortages on specific markets in response to the Government's failed efforts;
- abuse of monopolistic positions in a situation where regulation is weak.

## **Commodity prices**

Destabilization emerged in the world oil market in autumn 2003, when it became clear that the anti-Iraq coalition headed by the US would not be able to stabilize the situation in Iraq. The global economic upswing (see **WORLD**

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<sup>67</sup> In particular, some ore and metal market participants refused to supply raw materials to the domestic market (see the *Interfax-Ukraine* newswire of 3 June 2004). Large corporations like UkrZaliznytsia, the state railway, were forced to look for non-domestic metal suppliers in order to fight higher costs (see the *Interfax-Ukraine* newswire of 23 June 2004).

<sup>68</sup> For more information about sectoral agreements with the Government, see *quarterly prediction* for Q1'04, p. 45.

<sup>69</sup> See *quarterly predictions* for Q1'04, p. 29–30.

**ECONOMY**) stimulated uneven growth in oil demand, especially in China.<sup>70</sup> The threat of global terrorism, a growing Euro and OPEC's attempts to make use the favorable situation to advantage were also responsible for an upward trend on the global oil market. In June, quotes on North Sea Brent crude reached US \$37 per barrel and light Texas crude hit US \$42 per bbl. A moderate increase in quotas by OPEC countries in Q2'04 did not change the market situation, which is generally a balance of demand and supply—about 82mn barrels a day.

In line with the ICPS forecast, by the end of 2004, prices for oil will fall no lower than US \$30 per bbl (OPEC basket). ICPS economists expect oil prices to slip to US \$25–28 per bbl in 2005–2006 for several reasons:

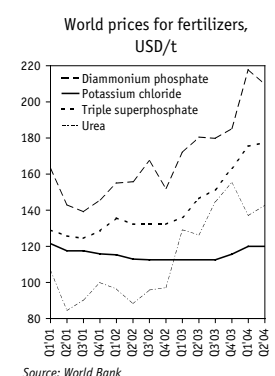
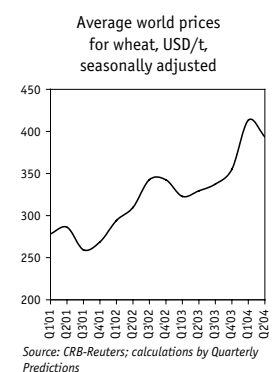
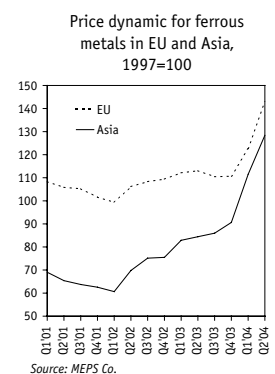
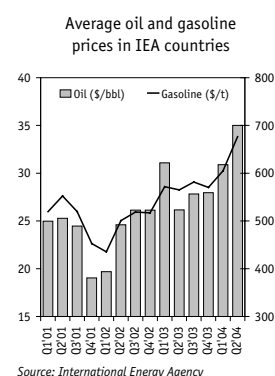
- a recession in Asia (see **WORLD ECONOMY**);
- a softening of OPEC's position;<sup>71</sup>
- the strengthening position of independent suppliers, who have recently been expanding their presence on the market.

On the whole, the oil market has a “natural” stabilizer that will not allow constant price growth in the long run: high prices restrain demand and stimulate supply. The risk to this forecast is further overheating in the Chinese and South-Asian economies, as well as escalating conflicts in the Middle East.

Metal prices picked up sharply in early 2004, and then slowed in Q2'04. Increased car purchases, investments, and housing construction in China and spin-off demand in neighboring countries were responsible for a global metal and metal products shortage. Oversaturation on European markets left little grounds for a matching growth in Asian prices. A high level of protectionism in the US has prevented price drops. By year-end, prices should stabilize in response to efforts by the Chinese Government to cool its economy (see **WORLD ECONOMY**). In 2005–2006, as new Asian capacities go on line, the metal shortage should abate, leading to lower prices.

Grain price growth evident during Q1'04 changed into a downward trend in Q2'04 due to lower trade volumes and expectations of a good harvest in the EU-25 and the CIS. Meanwhile, the grain shortage that emerged as a bad crop in China and the expansion of livestock breeding in the EU led to growing demand has continued. Still, key regions are fully stocked with grain, and the global grain trade will reach a ten-year low in 2004. Low stocks and a gradual growth in world consumption should keep pressure on grain prices during the upcoming season.

Prices for chemicals continue to rise as a result of unsatisfied demand in Asia for fertilizers and basic chemicals. ICPS expects prices to stabilize in EU countries and to drop in the US due to overproduction. The new EU members, China and developing countries should have additional capacities in the medium term due to the prospects of their own markets and low environmental requirements. Expanding supplies should contribute to lower prices in 2005–2006, although traditional suppliers will oppose to such a course of events.



<sup>70</sup> China became the second largest consumer of oil in the world, which caused brisk growth in demand. In Q1'04, growth rates stood at about 13% in China, 10% in Asia, and about 4% in Europe and the US.

<sup>71</sup> In June 2004, OPEC agreed to raise quotas to 2.5mn barrels a day in two stages, and to expand production when necessary in the future.

# MONETARY POLICY

The National Bank has been pursuing a policy of restricting the money supply to prevent inflation from building up and bank lending portfolios from worsening. However, the ICPS forecast for money supply growth in 2004–2006 has been upgraded because of foreign currency inflows that are beyond precedent in Ukraine. The growing cost of bank liabilities will not affect a trend to gradually lower lending rates. The forecast is for the NBU to tolerate moderate hryvnia appreciation against the US dollar even in 2004

## The money market

### *Current trends*

***The NBU continues to limit the money supply***

In trying to prevent the kind of strong monetary pressure on prices that tend to accompany economic acceleration (see **OVERVIEW**), the National Bank has continued to pursue a policy of limiting money supply, as can be seen in a number of ways:

- despite economic acceleration (see **OVERVIEW**) and rising foreign currency inflows<sup>72</sup> compared to 2003, the money mass has grown more slowly;<sup>73</sup>
- more money was sterilized than the volumes of refinancing;<sup>74</sup>
- bank lending portfolios grew more slowly<sup>75</sup> despite the expansion of conditions offered for term deposits.<sup>76</sup>

At the moment, we see the NBU as trying to accomplish two key tasks: (1) restricting money supply and (2) lowering risk in the banking system. The latter means improving bank portfolios, reducing the proportion of interbank loans among bank liabilities, and improving capitalization and other indicators of bank system quality. These degenerated because of worsening liquidity in 2003 and growing risk that the economy might suddenly cool off. In order to achieve these goals, the NBU has enacted a range of measures:

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<sup>72</sup> The foreign exchange market expanded by US \$12.5bn to US \$35.3bn over H1'04. At the same time, net purchases of foreign currency by the NBU grew from US \$1.359bn in H1'03 to US \$2.877bn in H1'04.

<sup>73</sup> The money mass grew 19.9% in H1'04, compared to 21.8% in H1'03.

<sup>74</sup> According to NBU data, in H1'04 it granted UAH 1.135bn in refinancing and it mobilized some UAH 1.196bn from domestic banks. The refinancing interest rate at auctions grew 2 pp to 10.66% pa in H1'04.

<sup>75</sup> Lending volumes grew 19.4% in H1'04 vs 25.3% a year earlier, while personal deposits grew 25.8% vs 27.3%.

<sup>76</sup> Banks are more frequently offering the option of withdrawing deposits from accounts before term without penalty, as well as monthly or one-time interest payments on the opening of a deposit account.

- increasing minimum statutory capital requirements;<sup>77</sup>
- tightening requirements for regulatory capital, in particular a mechanism for lowering the amount of regulatory capital by the amount that liquidity norms are exceeded plus insider transactions<sup>78</sup> plus the amount by which the value of fixed assets is exceeded;<sup>79</sup>
- raising the capital adequacy norm (ratio of capital to risk-weighted assets) from 8% to 10% as of 1 March 2004;
- introducing a requirement, as of 1 April 2004, for banks to establish reserves for securities that remain in their portfolios for more than 15 days. Such reserves are to be formed according to the fair value of those stocks—average weighted value according to the results of the previous five days of market trading—and any decrease in their utility, such as a worsening of issuer’s financial standing or a change in market yield;
- tightening reserve requirements by: (1) lowering the share of cash that is allowed to be accounted in mandatory reserves,<sup>80</sup> and (2) introducing, as of 1 July 2004, a daily reserve of no less than 60% of mandatory reserves formed in the previous reporting period;<sup>81</sup>
- making access to refinancing more difficult by: (1) as of 1 March 2004, making refinancing possible only when any interbank lending does not exceed 20% of all liabilities and interbank borrowings do not exceed 15% of all liabilities; (2) as of 10 April 2004, tightening requirements for blanket overnight credits;<sup>82</sup> (3) as of 14 June 2004, raising discount rates for a range of securities that can be used as collateral for refinancing;
- tightening borrowing requirements with banks. As of 17 June 2004, the NBU can draw money from a bank only when the total amount of demand deposits is not more than 45% of total bank borrowings.

***The NBU has taken steps to improve bank indicators...***

***... and restrict the money supply***

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<sup>77</sup> As of 1 January 2004, the minimum statutory capital for national banks and regional banks rose by €0.5mn, to €5.5mn and €3.5mn. For local banks, it rose €0.15mn to €1.15mn.

<sup>78</sup> For more details, see NBU Resolution №192 of 29 April 2004.

<sup>79</sup> For more details, see NBU Resolution №267 of 17 June 2004.

<sup>80</sup> As of 10 March 2004, that share was lowered from 40% to 25% for the hryvnia drawer and from 25% to 10% for the foreign currency drawer. As of 10 July 2004, cash cannot be included in mandatory reserves.

<sup>81</sup> According to NBU Resolution №172 of 21 April 2004, the NBU Board is empowered to set the daily basis for mandatory reserves, to adjust the amount of reserves (20–80% of the previous period) and the range of assets that can be used to form mandatory reserves—no more than 40% of assets. Prior to this, banks formed their reserves on a monthly basis.

<sup>82</sup> Blanket overnight refinancing loans can be granted to banks in an amount worth no more than 10% of mandatory monthly reserves calculated and formed by the borrowing bank. For more details, see the NBU Resolution of 24 December 2003 “On approving the Regulations on NBU regulation of bank liquidity through refinancing, deposits and other operations.”

As a result of these decisions:

- the liquidity of the banking system has grown—mainly due to mandatory reserves augmentation—as well as its capitalization;<sup>83</sup>
- it is possible for the central bank to respond more flexibly to the Government's intensive spending in the run-up to the fall election.<sup>84</sup>

Meanwhile, the value of bank liabilities grew considerably over Q2'04. The average rate on hryvnia deposits grew from 8.5% pa at the end of March to 9.9% pa by the end of June. We consider this was caused by increased NBU transaction rates<sup>85</sup> and by stronger restrictions on refinancing.

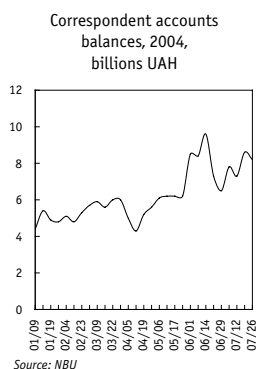
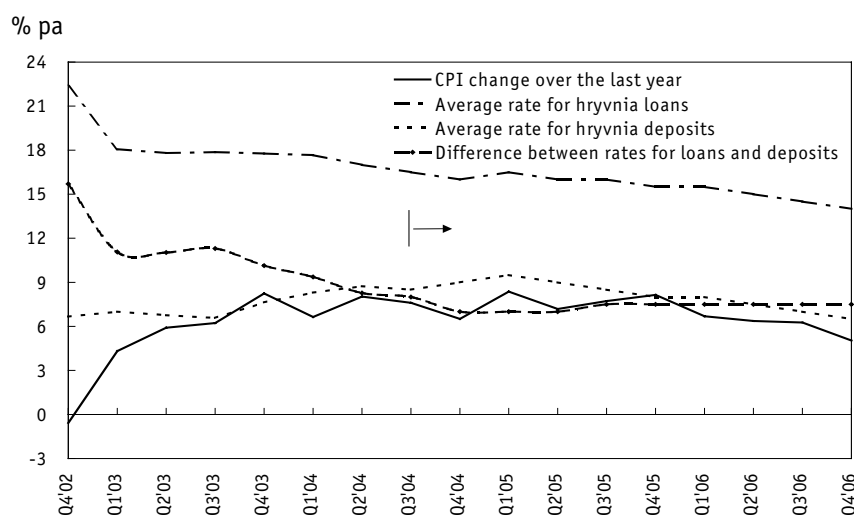


Figure 9. Opportunity cost of money



Sources: NBU, Derzhkomstat; forecast by Quarterly Predictions

**Despite the rising cost of deposits, lending rates fell**

Despite the rise in the cost of deposits, interest rates on loans continue to shrink. Average annual interest on bank loans in hryvnia fell from 17.2% at the end of March to 16.6% at the end of June. Cheaper credit has been made possible by:

- a large surplus of bank liquidity;
- gradual lowering of credit risk;<sup>86</sup>
- lower inflationary expectations, compared to 2003 (see **PRICES**).

<sup>83</sup> According to NBU data, the growth of regulatory capital (20.2%) matched net assets (19.3%) and loan portfolios (20.6%) in H1'04. The short-term liquidity norm (H6) grew from 33.7 at the beginning of 2004 to 39.42 at the end of June.

<sup>84</sup> As the *Interfax-Ukraine* news agency reported 22 July 2004, the money on government accounts in both the national and foreign currencies amounted about UAH 15bn on 19 July, representing growth of nearly 150%.

<sup>85</sup> The NBU raised its rates for blanket overnight loans to 11% pa from 8.7%, and rates for loans secured by government bonds went up to 9.5% pa from 9%. The discount rate was also raised in June 2004, by 0.5 pp to 7.5% pa.

<sup>86</sup> This refers, for example, to the establishment of a mortgage register by the Ministry of Justice and the implementation of the Law dated 18 November 2003 "On guaranteeing creditor claims and registering liens," which allow banks to reduce the costs of making a claim against the property of a borrower who is in default.

Despite a considerable decrease in the margin between average hryvnia lending and deposit rates (see **FIGURE 9**), domestic banks have managed to increase profits<sup>87</sup> by expanding volumes and broadening the scope of bank services.

### *The structure of bank liabilities*

Considerable changes emerged in the structure of the sources of bank liabilities over the last year. The share of personal deposit, which stood at 38.5% on 1 July 2004, became greater than that of the commercial deposits, which were 33.2%. According to ICPS, this increased confidence in the banking system among individual depositors has been in response to macroeconomic stabilization over the last few years.

Typically, individuals are ready to lend their money to banks for longer periods than businesses who, during an economic boom try to invest all the available resources in production and distribution. The rapid growth of personal deposits has been caused by a sustained growth in real personal incomes (see **HOUSEHOLDS**) and the underdeveloped market of financial services.<sup>88</sup> Still, we think in a few years' time, the share of personal deposits will be half of all bank liabilities, the way it is, for instance, in Central and Eastern European countries.

The role of the interbank market has shrunk to 10.8% of bank liabilities on 1 July 2004. According to ICPS, this has been caused by expectations that daily mandatory reserve requirements will be introduced and that the banks who are very active on the interbank market will no longer be able to get refinancing.

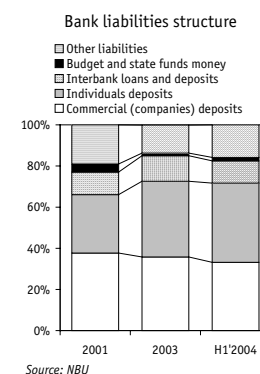
The growth of other kinds of liabilities is connected, in particular, with more active demand among domestic banks for international loans as a source of cheaper and longer-term financing compared to domestic loans. Still, the spread between sovereign and corporate bond yields remains high. Ukrainian 7-year eurobonds were issued with a 6.875% pa yield in March 2004, while PrivatBank's 3-year certificates yielded 10.875% in December 2003 and UkrSib-Bank's inaugural issue of eurobonds yielded 10.5% in March 2004. UkrSots-Bank, which was planning to enter the eurobonds market in May, has abandoned the idea because of the high cost of such financing for Ukrainian banks.

### *Forecast for 2004*

The ICPS forecast for the growth of the money mass in 2004 has been upgraded from 38% to 47%, based on the substantial increase in forecasts for: (1) economic growth (see **OVERVIEW**) and, therefore, demand for money and (2) the current account balance (see **FOREIGN TRADE**).

In our opinion, the National Bank to continue to pursue a policy of limiting the supply of money, in order to maintain a balance between high rates of lending and the risk of economic overheating. Currency exchange will be one channel for increasing the money mass, as well as the outflow of money accumulated on Government accounts. In the fall, the NBU will introduce sterilization measures in the face of intensifying social spending as the election looms (see **HOUSEHOLDS**). Deposit certificates issued by the NBU and transactions with government bonds will be the main instruments for absorbing money mass.

### **Personal deposits form the biggest part of bank liabilities**



**Money supply will grow in 2004 at the same rate as last year—47%...**

<sup>87</sup> According to the NBU, H1'04 profits for commercial banks were up 2.2 times over H1'03 profits.

<sup>88</sup> Individuals bank deposits in hryvnia and foreign currency are only 14% of GDP.

We anticipate higher cash growth rates<sup>89</sup> in H2'04 due to the rise in payouts to citizens prior to the election. The M0 aggregate growth forecast remains unchanged at 30%.

There should be a minor reduction of average loan rates to 16% pa at the end of 2004. Further rate decline will be prevented by the risk associated with the election and by NBU anti-inflationary policy aimed, specifically, at containing the growth of lending volumes. According to ICPS, lending portfolios will grow by 50% this year, compared to 61% in 2003.

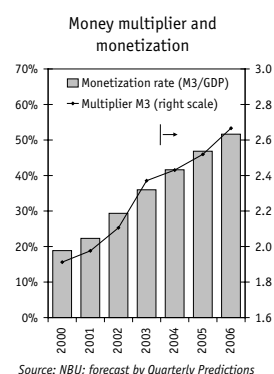
Return on deposits will remain at the current fairly high level. The main reason for that is the need to maintain a positive real interest rate on deposits.

### Forecast for 2005–2006

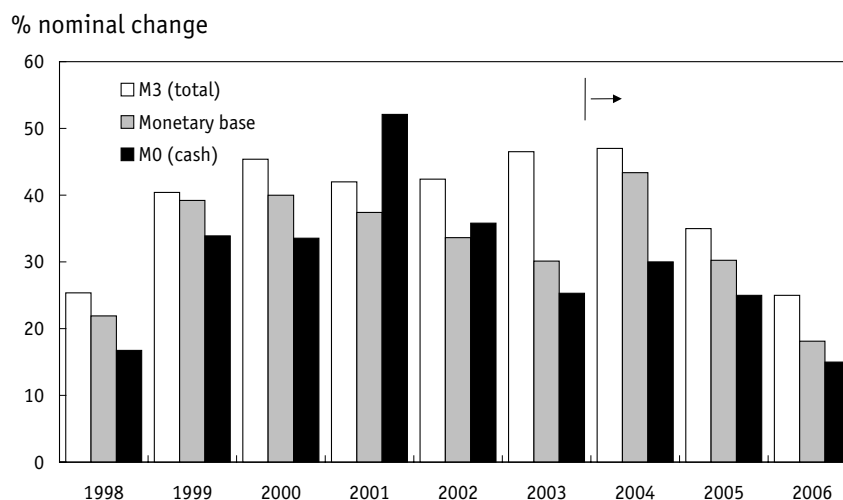
The ICPS forecast for money mass growth in 2005 and 2006 has been upgraded to 35% and 25%, based on higher forecasts for foreign currency inflows from exports and transfers (see **FOREIGN TRADE**). In response to the activation of the inflationary cycle after the presidential election (see **PRICES**), the National Bank is likely to introduce strong measures to sterilize the monetary mass at the beginning of 2005. Lower foreign currency inflows, sterilization by the NBU and nominal hryvnia appreciation against the US dollar will lead to lower emission rates than in 2004.

With money mass growth outstripping the growth rate of the economy as a whole, further remonetization can be expected. The ICPS forecast is for the monetization rate to rise from its current 34% to 52% by the end of 2006, the average level of CEE countries.

**... falling to 35% in 2005, and 25% in 2006**



**Figure 10. Money aggregates**



**Interest rates will fall substantially only in 2006**

ICPS economists expect interest rates to begin to fall substantially only in 2006, when inflation shows a serious slowing down (see **PRICES**). The average hryvnia deposit and lending rates should fall to 6.5% and 14% by the end of 2006.

The main risk to this forecast is the possible overheating of the economy and a concomitant worsening of bank liquidity as the level of bad debt rises.

<sup>89</sup> Cash in circulation grew by 11.4% in H1'04.

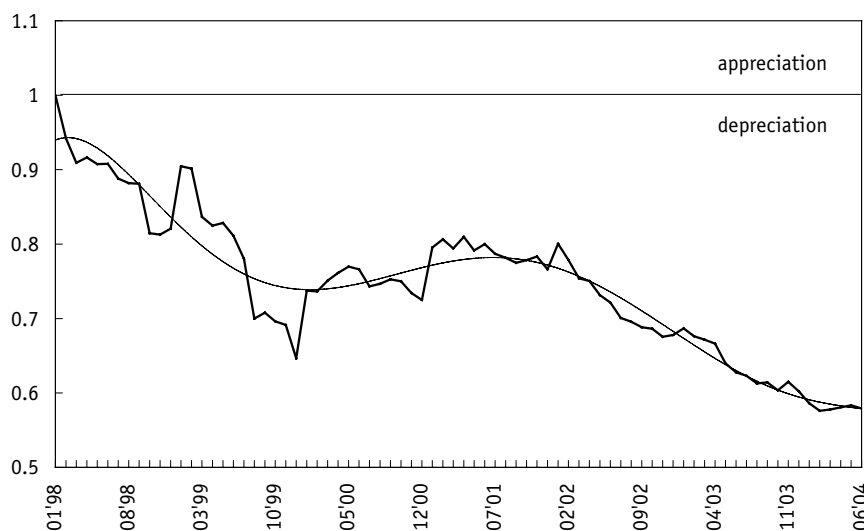
## Foreign exchange market

### Exchange rate

USD/UAH nominal exchange rate has been rising insignificantly, reaching 5.32:1 by the end of June 2004. At the same time, the euro exchange rate has stabilized on world markets, which has slowed real hryvnia depreciation. According to ICPS calculations, the REER<sup>90</sup> fell 3.9% over January–June 2004, compared to a fall of 8% in the corresponding period of 2003.<sup>91</sup>

**Figure 11. Real effective hryvnia exchange rate**

January 1998=1



Sources: NBU, IMF, national statistics offices; calculations by Quarterly Predictions

According to ICPS, the National Bank will abandon its policy of strictly pegging the hryvnia to the US dollar<sup>92</sup> in response to: 1) record-high foreign currency inflows; and 2) criticism of the current policy by the Head of the NBU Council.<sup>93</sup> Ukraine's central bank will likely use the difference in the exchange rate more actively as a tool to lessen the impact of the foreign currency emission channel.

***The NBU will abandon pegging the hryvnia to the US dollar***

According to ICPS, appreciation will continue throughout the forecast period. It will be insignificant in 2004, with the US dollar rate reaching 5.3 UAH/1 USD by year-end.

<sup>90</sup> ICPS calculates the real effective hryvnia exchange rate (REER) across Ukraine's 12 biggest trade partners, who account for two-thirds of the foreign trade balance.

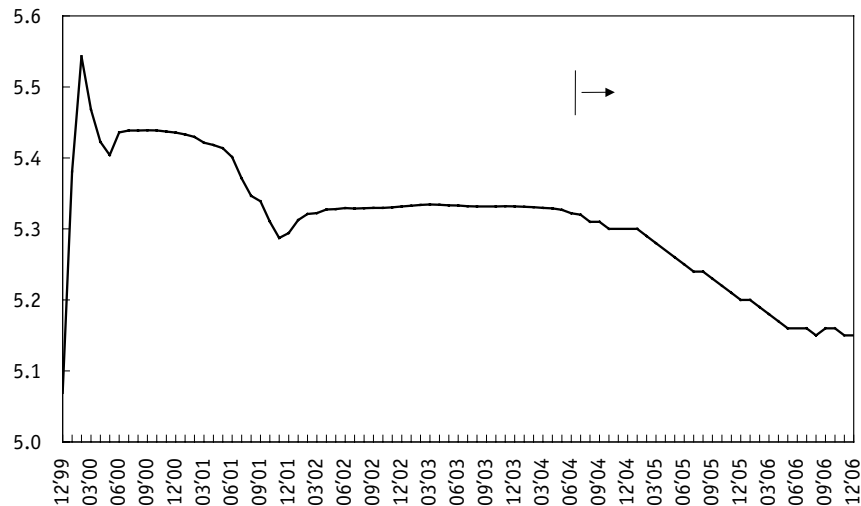
<sup>91</sup> According to revised ICPS data, real hryvnia depreciation in 2003 amounted to 12.6%.

<sup>92</sup> The NBU officially regards the current currency market regime as a controlled floating exchange rate but, in fact, the hryvnia exchange rate has been stable at 5.3 UAH/1 USD for two and a half years. All other currency rates are set daily or monthly based on cross rates at the international exchange.

<sup>93</sup> See the *Interfax-Ukraine* newswire of 22 May 2004.

The ICPS forecast is for significant changes in currency regulation in 2005, in connection with financial market liberalization prior to accession to the WTO,<sup>94</sup> and with pressure from influential banks wanting to broaden their scope for making profits. The NBU will likely introduce a controlled floating exchange rate as early as 2005. ICPS economists expect the appreciation rate to increase, albeit moderately, under pressure from huge foreign currency inflows. The US dollar rate will fall to 5.2 UAH/1 USD in 2005, and to 5.15 UAH/1 USD in 2006.

**Figure 12. Nominal hryvnia exchange rate**  
UAH/USD



Source: NBU; forecast by Quarterly Predictions

**Nominal hryvnia appreciation will slow down the fall of the REER**

Nominal appreciation will slow down the fall of real effective exchange rate of the hryvnia. Lower inflation in Russia and a halt in the growth of the euro on international markets after 2005<sup>95</sup> should also contribute this slowdown.

One risk to this forecast is Ukraine's failure to accede to the WTO at the end of 2005.

### Capital flows

**Capital flight has shrunk somewhat...**

In early 2004, the improvement of the current account balance (see FOREIGN TRADE) was accompanied by shrinking capital flight.<sup>96</sup> Portfolio investment, which was the major instrument of capital flight from Ukraine until now, actually grew slightly in Q1'04 by US \$60mn.

<sup>94</sup> For more details on financial sector liberalization, see *quarterly predictions* for Q2'03, p. 20–21.

<sup>95</sup> ICPS expects the weak US dollar policy, aimed at cutting the US debt and resulting from the country's double deficit, to continue throughout 2004–2005. The euro exchange rate will average 1.35 USD/1 EUR in 2005 and 1.25 USD/1 EUR in 2006.

<sup>96</sup> The negative balance of "portfolio investment," "other investment" and "net errors/omissions" items slid from US \$1,138mn in Q1'03 to US \$956mn in Q1'04.

ICPS specialists link the lower capital flight volumes with more active privatization (see **BUSINESS**), accelerated economic growth (see **OVERVIEW**) and increasing profitability.<sup>97</sup>

Nevertheless, new import schemes have appeared that involve consistent overpayment for actual import volumes. This has forced the NBU to start tracking balance sheets for volumes of unrepatriated export earnings and payments for undelivered imports under “Other short-term assets.” For Q1’04, this amounted to US \$1,365mn.

*... but remains high, with ever more sophisticated schemes*

Because of continuing strong capital flight, over H1’04 the NBU introduced mandatory price reviews by the State Analytical Center for Monitoring External Commodity Markets. This is designed to check the correlation between work, services and intellectual property contract prices and general market conditions, if the total amount of money transferred abroad is more than €50,000.<sup>98</sup>

According to the NBU, in 2004 the two main schemes for capital flight have been:

- acquiring imported goods that have not passed Customs: the 90-day currency monitoring on foreign contracts is closed by a document on the submission/receipt of goods at a bonded warehouse outside the customs territory of Ukraine;
- transactions between individual residents and non-residents involving collateral promissory notes.

We think the high level of capital outflow will continue over the next few years for three main reasons: (1) high political risks connected to the fall election, especially property redistribution; (2) desire on the part of businesses to hide real revenues from taxes; (3) more active investment by Ukrainian businesses in foreign assets, especially among the new EU members.

*Capital flight will continue at a high pace*

In 2004, the balance of portfolio investments and private loans should stay positive because of the high rate of international borrowings by both the Government (see **OVERVIEW**) and the private sector.<sup>99</sup>

### *International reserves*

Over H1’04, the rate of growth of NBU gold and foreign exchange reserves peaked at 50%. As of 1 July 2004, international reserves stood at US \$10.4bn, or 3.7 months’ worth of goods and services imported over the next period. According to ICPS economists, the record-high growth rates of international

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<sup>97</sup> According to Derzhkomstat, the financial results of businesses and organizations—other than small, agricultural and Budget organizations—for January–May 2004 was almost as high as for the whole of 2003, UAH 17.8bn. The share of profitable enterprises inched up from 62.8% to 63.2%.

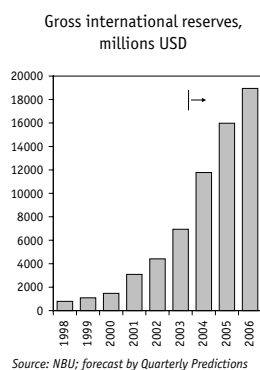
<sup>98</sup> See the 30 December 2003 NBU Resolution on national and foreign currency transfers for non-residents on certain transactions.

<sup>99</sup> More active corporate borrowing is explained by the low cost of money on international financial markets and strong demand among Ukrainian businesses for investment during this period of high economic growth. According to the NBU, over January–May 2004, Ukrainian corporations attracted external unsecured loans in the amount of US \$1.2bn, which is almost double the figure for the same period of 2003.

reserves are the result of an unprecedentedly high CAB (see **FOREIGN TRADE**), and larger amounts of net FDI inflow (see **BUSINESS**).

The ICPS forecast is that the accumulation of gold and foreign exchange reserves will continue to grow swiftly. It will likely increase to US \$11.8bn (3.7 months of imports) by the end of 2004, and to US \$18.9bn (4.7 months of imports) by the end of 2006.

The key risks to this ICPS forecast are: (1) the playing out of radical scenarios in the 2004 presidential and 2006 Verkhovna Rada races, increasing business risk in Ukraine and spurring capital flight; and (2) sudden changes in the world market situation.



# INDUSTRY

A continuing favorable situation on external markets and expanding domestic demand accelerated industrial growth to 15.9% in the first half of 2004. At the same time, Q2'04 registered a slowdown in the processing industries primarily due to stabilizing world prices. The ICPS forecast is for high global prices to stay in place throughout 2004, and for domestic industry to grow 15% by year-end. In 2005 and 2006, ICPS economists expect a slowdown of industrial growth rates to 9.5% and 8% due to a slight deterioration in the external situation

## General trends

In April 2004, industrial output began to taper off. Stabilization in world prices and EU expansion (see **FOREIGN TRADE**) in Q2'04 caused a slowdown in the processing industries, in particular in metals, metal products and machine-building. Meanwhile, extracting industries have been able to maintain high growth rates, as utilities gradually shrink. Results for H1'04, show that industrial growth was a healthy 15.9%.<sup>100</sup>

ICPS has revised its 2004 forecast upward to 15%, as there is no reason to expect a sudden decline in production during 2004: world prices keep growing (see **PRICES**) and consumer confidence across the country continues to build (see **OVERVIEW**). In particular, domestic consumption rates for some products such as metals and metal products are now outpacing export rates.

The forecast for slower industrial growth in 2005–2006 remains in place, however. An upgrade in the ICPS forecast for 2005 from 9% to 9.5% is based on improved expectations of growth in the processing industries. In 2006, industry should grow 8%.

Deterioration in the situation on external markets remains the key risk for industrial development, as raw materials continue to make up the bulk—two thirds, according to Derzhkomstat calculations—of outputs in extraction and processing. At the same time, there is a positive trend towards a growing share of raw materials with higher value-added (metal products) and recovery in the machine-building sector.<sup>101</sup>

In the opinion of ICPS specialists, the likelihood of government interference on the domestic market—specifically the application of regulatory instruments that was a real threat in Q1'04 (see **PRICES**)—will now subside thanks to:

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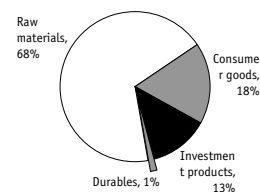
<sup>100</sup> Since January 2004, Derzhkomstat, the state statistics committee, calculates industrial growth indicators using a new Industrial Product Nomenclature. Given this fact, the content of some positions was significantly altered, while indicators for different years can be incompatible regarding these positions. Apart from that, Derzhkomstat now uses the “sale (turnover) volumes of industrial products in selling prices” indicator to replace the “volumes of manufactured products in wholesale prices” indicator. Although the method for calculating the industrial output index (in wholesale prices) has not been changed, the index is computed discounting distribution of thermal energy, gas and water.

<sup>101</sup> The share of machine-building in the country's industrial output rose from 12.2% in 2001 to 13.6% in 2003.

**Q2'04 saw industrial growth slow down somewhat...**

**... although no steep decline in output is expected over 2004**

Distribution of extraction and processing products sold, January–May 2004



Source: Derzhkomstat

### Industrial growth

2001	14.2%
2002	7.0%
2003	15.8%
2004	15.0%
2005	9.5%
2006	8.0%

### Extraction growth

2001	3.3%
2002	2.3%
2003	5.5%
2004	8.5%
2005	5.0%
2006	4.0%

- accession to the WTO in late 2005;
- gradual price hikes for Russian energy supplies, which will lead to a reduction in price distortions for domestic consumers.

## Extraction

In H1'04, extraction steamed ahead at 8.5%. Expanding iron ore extraction resulted in stable supplies of iron products to domestic metalworks and a decline in raw material imports.<sup>102</sup> The country even saw instances where reserved capacities were reactivated, as new market prices made them profitable again.<sup>103</sup> Q1'04 also saw the domestic market saturated with steam coal, largely due to cutbacks in power generation by thermo-electric stations (TESS), and this also contributed to growing steam coal exports.

ICPS has upgraded its forecast for 2004 to 8.5%. According to ICPS economists, expanded extraction in all key resources—oil, gas, coal and iron ore—will continue throughout the year as high prices for resources continue on both domestic and external markets.

According to ICPS, the sector should grow 5% and 4% in 2005 and 2006. However, the increase in the share of exploratory digs with difficult conditions for extraction and subsidizing investments in the extraction industry point to the likelihood of lower extraction outputs during the forecast period.<sup>104</sup>

Thus, despite the concentration of resources in the oil and gas sector, plans for the further expansion of extraction<sup>105</sup> are likely to remain strictly declarative. Even if domestic gas prices were to grow and gas payments to improve, the availability of barely-accessible gas and oil deposits that involve small exploration works means involving foreign investors. At the same time, the sector's highly criminalized<sup>106</sup> state and an ill-defined regulatory environment—especially conditions for obtaining licenses—greatly reduces its investment appeal.

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<sup>102</sup> According to UkrRudProm data, imports of iron products from Russia plunged by 52.6% over H1'04.

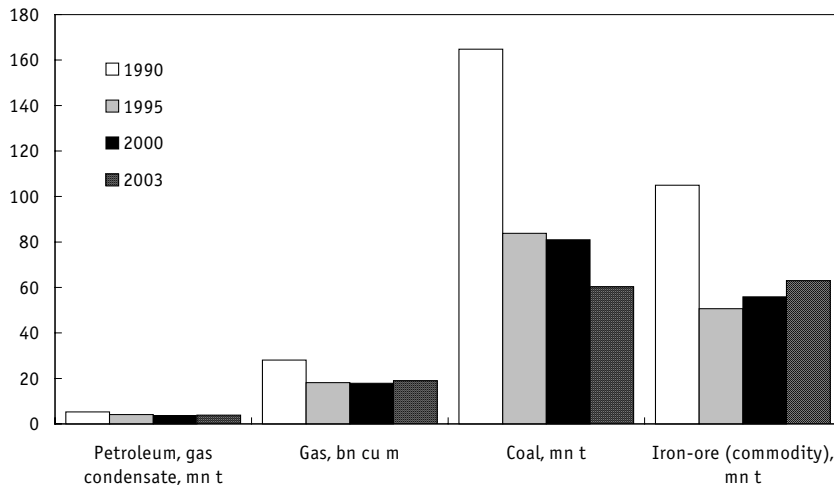
<sup>103</sup> For example, in May 2004, VAT Central Mining, an ore enriching plant, revived the extraction of magnetite quartzite at the Ordzhonikidze mine, which had been shut down since 2001.

<sup>104</sup> Lately, the capital investment rate in extraction was lower than average for the industry, at 14.7% and 6.7% in 2002 and 2003.

<sup>105</sup> During Q1'04, NAK NaftoGaz Ukrainy invested UAH 1.647bn. By 2007, the company plans to meet approximately half of the domestic demand for gas by expanding gas extraction and encouraging greater efficiency nationwide.

<sup>106</sup> According to a report by the Steering Committee for Fighting Corruption and Organized Crime set up by the President's Office, the sector has many cases of unauthorized gas and oil extraction and refining, a lack of government tracking of wells, in particular, caused by a short-sighted policy in exploration.

Figure 13. Mineral extraction



Source: Derzhkomstat

## Processing

After a high growth rate of 22.8% in Q1'04, the processing industry started slowing down, dropping to 18.6% by the end of June. In particular, metals and metal processing registered lower growth rates, as did machine-building. According to ICPS, this is the result of three key factors:

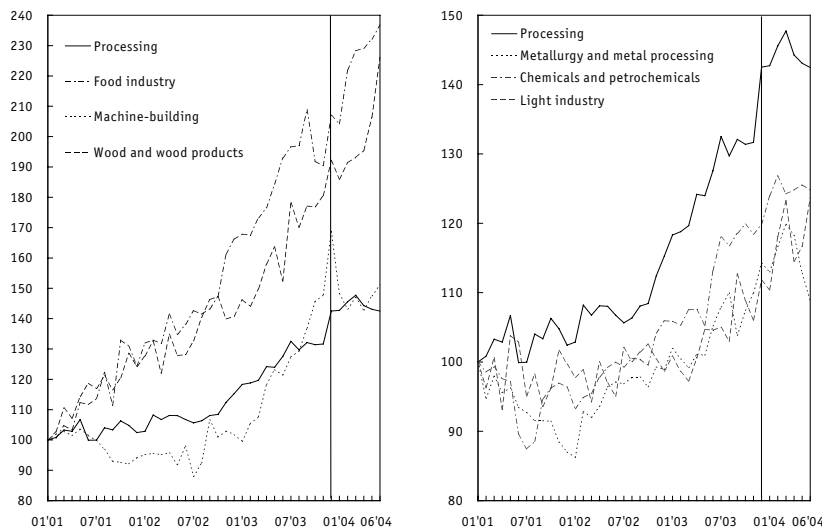
- in Q2'04, world metal markets stabilized (see **PRICES**), while the problem of periodic shortages of resources like iron-ore and coke became more pressing in Ukraine;
- in Q2'04, machine-building exports slowed down as key trade partners acceded to the EU (see **FOREIGN TRADE**);
- cost-pushed inflation could have a negative impact on domestic demand for investment products and thus slow down sales in machinery.

### Processing growth

2001	17.2%
2002	8.9%
2003	18.2%
2004	18.0%
2005	11.0%
2006	9.0%

Figure 14. Extraction dynamics

index, 2001=100, seasonally adjusted



Source: Derzhkomstat

Although the influx of investment into capital-intensive sectors steamed ahead over Q1'04,<sup>107</sup> the overloaded and worn-out state of fixed assets in these industries means that further expansions of output or reductions in production costs—even if privatization is accelerated—seem highly unlikely.

Our forecast for 2004 has been upgraded to 18% based on positive expectations that external commodity markets in Q3'04 will continue the favorable situation evident throughout Q1'04.

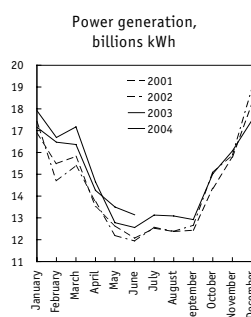
ICPS forecasts for a slowdown in growth rates to 11% and 9% in 2005 and 2006 are based on the anticipation that prices at world commodity markets will decline. According to ICPS economists, there will be no structural changes during the forecast period: metals, metal products, machine-building and food will continue to contribute the lion's share to the country's industrial growth.

## Utilities (power, gas and water)

This sector is seeing a decline in output as growth rates gradually slip: in Q1'04 the sector expanded by 4.3%, while over all of H1'04 growth was only 2.9%. The main reason behind this shrinkage is a reduction in line losses during power distribution;<sup>108</sup> real power consumption actually rose 3.8%. Meanwhile, water and thermal energy consumption is shrinking among both industrial and residential consumers. The drop in power generation cut the share of thermal energy generation.<sup>109</sup>

ICPS maintains its forecast for 2004 that the industry will grow 3%. Both power consumption and exports should escalate.

The main factor behind the sector's growth to 5% and 4% during 2005 and 2006 will likely be exports of electricity.<sup>110</sup> Meanwhile, domestic power consumption will start going down as industrial production stabilizes and reforms in the residential services sector kick in.



Source: Derzhkamstat

### Utility growth

<b>2001</b>	<b>2.6%</b>
<b>2002</b>	<b>1.1%</b>
<b>2003</b>	<b>4.7%</b>
<b>2004</b>	<b>3.0%</b>
<b>2005</b>	<b>5.0%</b>
<b>2006</b>	<b>4.0%</b>

<sup>107</sup> Along with growing capital investment into sectors offering a quick return on investment, Q1'04 also saw high investment growth rates in capital-intensive industries: 78.8% in metals and metal processing, 67.5% in machine-building, and 47.5% chemicals and petrochemicals.

<sup>108</sup> In January–May 2004, power losses dropped 19% over the same period in 2003, to 13bn kWh.

<sup>109</sup> Results for H1'04 show that the share of TESs in power generation shrank 9.3%, while the share of atomic energy stations (AES), thermo-electric plants (TEP) and hydroelectric stations (HES) grew 0.2%, 8.3% and 48.3%. To mitigate the negative impact of lower TES workloads and improve settlements for coal purchased by TESs, ORE, the wholesale electricity market operator, imposed a restriction on atomic power generation in March 2004. The high growth rates of HESs are linked to their lower baseline in 2003, while TEPs have improved settlements with ORE.

<sup>110</sup> In anticipation of the scheduled launch of two new reactors at the Khmelnytsk and Rivne AESs, Ukraine has negotiated possible electricity exports worth 500mn kWh per month to Russia. To enable expanding technical capacity of electricity exports to the West, the country's high-voltage power grids are being upgraded.

Ukraine obtained international support in developing the nuclear energy sector. A US \$125mn tranche from the EBRD and Euroatom is intended to ensure safety at the two new reactors. Until now, construction has mainly been financed by internal resources: Ukraine introduced a targeted additional charge on wholesale electricity rates and issued bonds for EnergoAtom.<sup>111</sup>

## Industrial regulation

### *Consolidation in the energy sector*

In June 2004, the process of setting up NAK Energy Company of Ukraine (ECU) was completed.<sup>112</sup> Firstly, this step could complicate the reform of the wholesale electricity market that is already underway. Secondly, it is likely to decrease transparency in the energy sector.

***The Energy Company of Ukraine has been established***

The awaited merger of coal assets will also result, say ICPS analysts, in opaqueness and lack of competitiveness during the eventual privatization of assets owned by the newly-established Vuhillia Ukrainy company.<sup>113</sup> This decision differs little from previous attempts at reforming the sector by merging companies. Given the high financial and social costs entailed, plans to shut down unprofitable coal sector enterprises by 1 July 2006 might not be fulfilled.

Previous Government attempt to improve the state of the domestic coal industry by setting up OREV, a wholesale steam coal market, could prove a failure. As ICPS predicted earlier, higher coal prices have aggravated the problem of re-distributing profits in the fuel and energy complex. Thus, in Q2'04, the Government announced its decision to cap coal prices. Given this move, the rules at OREV, which began operations in February 2004, could well change again. By March 2004, more than 60% of Ukraine's coal was being sold through OREV, that is, some companies continued to purchase coal through direct contacts with mines. The higher coal prices at OREV are the result of higher transport rates and the high-cost companies operating on the market. Despite the declared voluntary participation of enterprises in the market, the probability that companies will be pressured to participate is growing.

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<sup>111</sup> The 2004 State Budget Law of 27 November 2003 included a targeted additional charge on thermal energy and electricity rates in order to finance a number of projects in the energy sector, in particular the completion of atomic reactors and hydro generation blocks at power stations. The government planned to spend UAH 600mn on these measures. Apart from that, in January–May 2004, subsidiary EnergoRynok, the wholesale electricity market (ORE) operator, placed bonds for the total of UAH 430mn. The company also expects to pay off bonds by raising tariffs.

<sup>112</sup> NAK ECU will be a conglomeration companies that generate, distribute, supply and export power. The company will not include NEK UkrEnergo, which transports power, or a slew of TEPs. For an analysis of setting up ECU see *quarterly predictions* for Q1'04, p. 48–49.

<sup>113</sup> The 6 July 2004 Presidential Decree “On measures for raising the effectiveness of management in the coal sector and its development” announced the establishment of NAK Vuhillia Ukrainy, into whose statutory funds the assets of coal sector enterprises will be transferred.

## *Regulation of mining and metalworking*

The combination of market and command economy elements means surfaced again in Ukraine when the Government attempted to protect the domestic market against steep industrial price hikes during H1'04.<sup>114</sup> According to ICPS, direct price and resource distribution controls in the mining and metals sector are not effective, since there are no natural monopolies in this area.<sup>115</sup> Through the Anti-Monopoly Committee, it may be possible to make such regulation more effective and also work towards agreement between business and the Government about domestic price growth for key mining and metal products and their sales volumes.

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<sup>114</sup> The Government: (1) made a decision to sell 2.429mn tonnes of domestic metal products on the internal market at prices set in December 2003, and (2) set up the licensing of exports of coke, black and coking coal, iron ore and iron-ore concentrate. The Government set up an interdepartmental working group, whose specific task was to examine whether it was useful to change prices on the output of mining enterprises and metalwork's of any form of ownership. It is expected that all the new restrictions will be dropped by early 2005. In fact, the Government already cancelled the licensing of coke exports in July 2004.

<sup>115</sup> According to ICPS experts, the regulatory methods applied by the Ministries of Industrial Policy and Economy and European Integration do not match the functions entrusted to these executive bodies. Such regulatory methods can be used on the electricity or communication markets, where special regulatory agencies have been established.

# AGRICULTURE

In 2004, a good grain crop should ensure that the farm sector grows 10%. Starting in 2005, improved supplies of fodder will contribute to growing headcounts and livestock output. On the other hand, a new VAT regime in agriculture starting in 2005 will likely impede growth in the short term, although in the long run it will help push less competitive producers to leave the market. In 2005–2006, growth in agriculture will be sluggish as the sector takes its time upgrading technologies

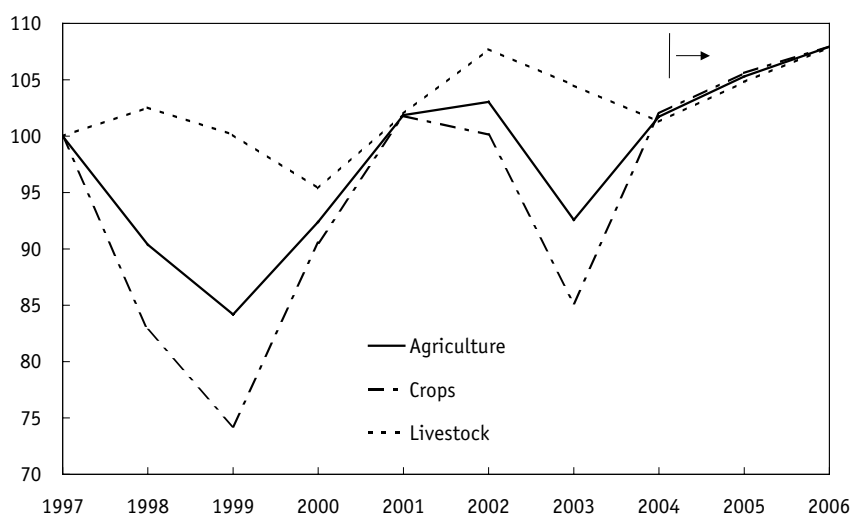
## Forecast

During H1'04, agricultural output slipped by 2.3% year-on-year because of cutbacks in livestock. At the same time, winter crops grew well, with only 5.6% wasted. While areas under winter crops shrank 15.3% in 2003, according to preliminary data, areas under spring crops expanded 23.5%. The introduction of a partial subsidy on the cost of mineral fertilizers<sup>116</sup> encouraged greater use of fertilizers.<sup>117</sup> As a result, the expected grain yields are rather high. Given this fact, ICPS upgraded its forecast for agricultural growth in 2004 from 9% to 10%.

**The agricultural growth forecast for 2004 has been revised upward, to 10%**

**Figure 15. Agricultural output**

index, 1997=100



Source: Derzhkomstat; forecast by Quarterly Predictions

<sup>116</sup> The 14 January 2004 Cabinet Resolution set the rates for subsidies to growers for buying fertilizers: for ammonium nitrate it was UAH 100/t; for carbamide UAH 130/t; for *nitroamofoska* (NPK), a branded mixture of ammonium nitrophosphate with potassium, UAH 270/t; and for superphosphate UAH 130/t.

<sup>117</sup> According to the *Interfax-Ukraine* newswire of 14 June 2004, growers purchased 1.7 times more ammonium nitrate, three times more carbamide and *nitroamofoska*, and twice as much superphosphate as the previous season.

***In 2005–2006, agriculture will grow at a sluggish pace***

In 2004, higher agricultural spending should make the sector more attractive for growers, which will manifest itself in expanded planting under winter crops come autumn and improved technologies and consequently better crops. Apart from that, sufficient supplies of fodder should give meat production a boost in 2005, while overall agricultural output should climb by 3.5%. Still, the new VAT regime for farmers will likely hamper growth. A slight increase in productivity in the sector should finally lead to 2.5% growth in 2006.

The risk to the ICPS forecast is that the Government will fail to undertake measures to support growers in 2004 and the grain price will collapse.

## **The new VAT regime**

***Starting in 2005, a new VAT regime will affect the agricultural sector***

The Verkhovna Rada adopted a law,<sup>118</sup> according to which the farm sector will be under a new VAT regime as of 2005. Farmers have a choice between a general and special VAT regime. Under the special regime, the VAT rate will be 10%, falling to 9% in 2007, while the general regime will be a 17% rate, falling to 15% in 2006 (see **PUBLIC FINANCE**). If a company chooses the special regime,<sup>119</sup> it will not pay VAT to the Budget, but will keep the VAT taken from buyers to cover VAT owed when it purchase supplies and machinery. If the difference between these two is negative, the company will not receive any refunds from the Budget and this difference will not go on the company's balance. The only exception is exclusively export operations: such growers who chose the special regime will have the right to VAT refunds.

*Table 6. VAT options in agriculture*

	Current regime	General regime as of 2005	Special regime as of 2005
Tax rate	20%; 0% on animal products for processing	17%; 15% as of 2006	10%; 9% as of 2007
VAT payment	Remains with producer	Paid to the Budget by producer	Remains with producer
Budget refund on domestic deals	Yes	Yes	No
Budget refund for exports	Yes	Yes	Yes

***The new VAT regime means less support to farmers...***

The results of ICPS modeling show that the introduction of the new VAT regime in agriculture will have a number of consequences:

- a four-to five-fold reduction of support to growers, which was given in the form of VAT exemptions;
- the special VAT regime will be attractive only to those enterprises who can cover VAT with the cost of supplies and machinery and still have a certain

<sup>118</sup> The 24 June 2004 Law amending certain laws on taxing agricultural enterprises and social assistance for their workers.

<sup>119</sup> An farm business cannot register under the special taxation regime if it performed taxable operations with non-farm goods or services exceeding 3,600 untaxed minimum wages—a total of UAH 61,200—during the previous 12 calendar months.

surplus in the VAT owed for their own products. This gain is likely only for those enterprises with a high value-added share in their output. But companies whose share of production costs is over 52% at a 9% VAT rate and 58% at a 10% VAT rate, will suffer losses because they will not be able to cover the VAT they owe when they buy supplies and machinery;

- competition will lead to price leveling for both groups of producers, regardless of the regime they choose. As a consequence, producers operating under the special regime will have an extra gain at the consumer's expense.

Overall, despite agricultural losses in the short term, this change in taxation should contribute to higher efficiency in the long term by forcing less competitive growers to leave the market.

*... but should lead to greater efficiency in the sector*

## Field crops

### Grain

ICPS economists have upgraded their forecast for grain output in 2004 to 35.4mn t, in anticipation of good crops and high yields. The forecast for 2005 and 2006 has also been upgraded to 37mn t and 38mn t as farm technologies are gradually updated and world grain prices grow (see **PRICES**).

*ICPS has upgraded its forecast for grain output in 2004–2006*

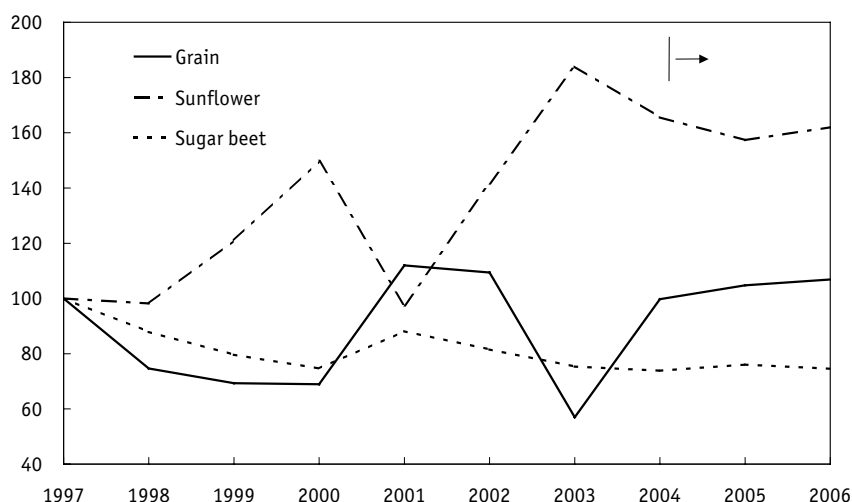
In 2004, the Government plans to undertake a number of measures to eliminate the grain surplus as soon as it is harvested:

*The Government's planned grain pledges and interventions...*

- purchasing 1mn t of food wheat for Derzhreserv, the state reserve, at a minimum price of UAH 800/t;
- DAK Khib Ukrainy making grain pledges of 0.5mn t. The declared price—UAH 780/t for third grade wheat—is quite attractive for growers. The Government also approved a price for storing pledged grain of a minimum UAH 5/t per month, but not more than 1.5% of the grain's value;
- forming regional reserves of 1.681mn t.

**Figure 16. Crop output**

index, 1997=100



Source: Derzhkomstat; forecast by Quarterly Predictions

*... will result in a smaller price drop compared to 2001–2002*

These planned measures should remove more than 3mn t of grain from the market just as the supply of grain is at its peak. According to ICPS economists, the Government will manage to implement these measures in 2004 to a larger extent than in previous years because of higher Budget allocations.<sup>120</sup> This should lead to a slighter fall in the price of grain compared to 2001–2002, when pledge purchases and purchases for DerzhReserv were insignificant. The risk to the ICPS forecast is failure to implement these measures within the established time limits.

## Sugar market regulation

Producing beet sugar is more costly than producing cane sugar, making this sugar uncompetitive on world markets. That is why the state subsidizes domestic beet sugar production. In all, there are several goals behind this regulation:

- to supply domestic demand for sugar: sugar is considered a strategic commodity as a slew of other industries depend on it;
- to maintain jobs: in some areas, the sugar refinery is virtually the only local employer;
- to ensure the profitability of sugar beet and sugar production.

*The Government is using different mechanisms to regulate the sugar market...*

To control the sugar market, the Government has undertaken a number of measures:

- **SETTING QUOTAS FOR SUGAR DELIVERIES TO BOTH INTERNAL AND EXTERNAL MARKETS.**<sup>121</sup> The Government sets the A quota for the maximum amount of beet sugar that can be supplied to the domestic market in a given year, the B quota for the sugar volumes that may be exported under international contracts and to replenish the A quota, and the C quota for the amount of sugar produced over and above the A and B quotas, which can only be exported.
- **SETTING MINIMUM PRICES FOR SUGAR BEET AND SUGAR.** The Cabinet of Ministers sets prices annually. The minimum price has stayed unchanged at UAH 165/t for sugar beet and UAH 2,370/t for sugar since 1 September 2001. Selling sugar at prices lower this minimum is liable to a fine worth double the value of product sold illegally.
- **RESTRICTING SUGAR IMPORTS.** The Verkhovna Rada sets a quota for raw cane sugar imports at a discounted rate (the full import duty rate for raw cane sugar is €0.30/kg) every year. In addition, there are restrictions on sugar imports within the CIS free trade area: mutual restrictions on refined sugar with Russia, the exclusion of sugar from free trade with Uzbekistan, and the exclusion of sugar and sugar syrups from the free trade regime among Belarus, Georgia, Moldova and Russia.

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<sup>120</sup> In particular, the amendment of the 2004 Budget Law in June 2004 increased funds for pledge and intervention operations from UAH 55mn to UAH 255mn.

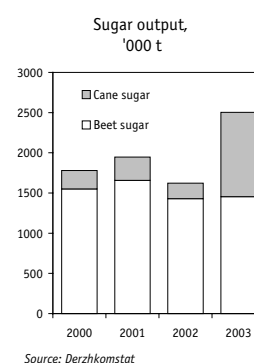
<sup>121</sup> See the 17 June 1999 Law “On regulating sugar production and sugar sales.”

Still, Government efforts to regulate the sugar market are not effective for a number of reasons:

**... but they aren't working**

- Market prices fall below the set minimums because the market is overstocked or because demand shrinks at year-end just as sugar refining peaks and, thus, supply. As a result, producers are forced to sell sugar at lower prices, which puts them at risk of being fined. This testifies to the ineffectiveness of the minimum price approach.
- Raw cane sugar import quotas do not always take into account domestic production volumes, as a result of which the market becomes oversaturated and sugar prices fall across the board.
- Import quotas and rate restrictions lead to creative schemes of sugar delivery to get around these—including importing raw cane sugar on tolling schemes, re-exporting within “free” trade areas, which are continually limited by excluding sugar from the free trade regime, and smuggling. Since products manufactured on a tolling basis largely remained in Ukraine,<sup>122</sup> these operations were prohibited.<sup>123</sup>

As a result of this kind of flawed regulation, domestic production of sugar beet and beet sugar has been shrinking. Moreover, sugar beet production is suffering higher losses because sugar refineries find it more profitable to refine cane sugar. In the opinion of ICPS, sugar beet and beet sugar production will continue shrinking in the long run. One of the factors behind this decline will be Ukraine’s accession to the WTO and subsequent increases in quotas for cane deliveries.



The ICPS forecast is for sugar beet output to slip by 2% in 2004, down to 13mn t as areas sown under sugar beet shrink 2.5%. According to ICPS, the impact of banning sugar imports on a tolling basis and excluding sugar and sugar syrups from the free trade regime with Georgia and Russia<sup>124</sup> will be felt only in 2005, when producers decide to expand planting under sugar beet. This will lead to a 3% growth in sugar beet output. In 2006, after Ukraine accedes to the WTO in late 2005 (see **FOREIGN TRADE**), this should shrink 2% once more as import quotas for sugar cane are increased.

The total output of sugar in Ukraine will reflect the dynamic of sugar beet production, although sugar content, which depends on the growing environment—weather conditions, use of fertilizers, treatment with pesticides—will lead to an adjustment in volumes.

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<sup>122</sup> According to estimates by ProAgro, a Ukrainian company, Ukraine received more than 1mn t of raw sugar under tolling schemes during the 2002–2003 marketing year. Although this entire volume should have been exported, up to one third of it stayed on the domestic market.

<sup>123</sup> See the 14 April 2004 Cabinet Resolution “On prohibiting sugar and sugar syrup imports on the customs territory of Ukraine on a tolling basis.”

<sup>124</sup> See the 14 April 2004 Cabinet Resolution “On temporarily excluding sugar and sugar syrups from the free trade regime with the Republic of Georgia and the Russian Federation.”

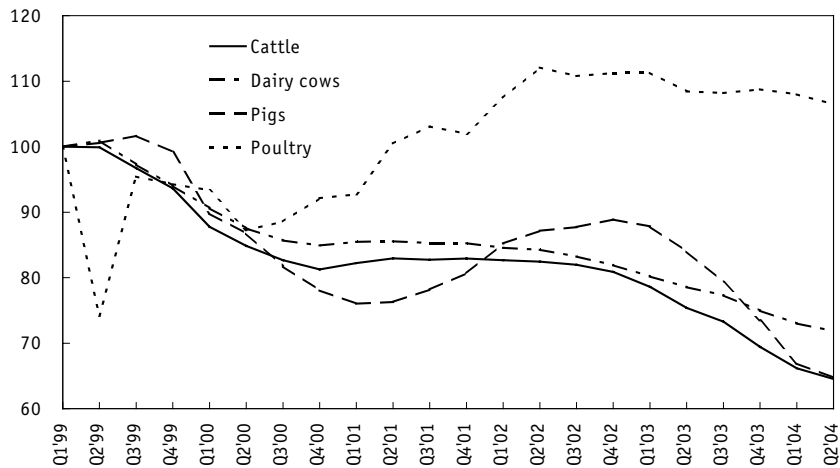
# Livestock

## Livestock output shrank in H1'04

In the first half of 2004, livestock output slid 2.3% year-on-year, as milk and meat output declined and herds of all types of livestock and poultry headcounts shrank. After some stabilization in cattle and dairy herds in 2001 and H1'02 the downward trend resumed. Headcounts are rapidly decreasing at agricultural enterprises. More expensive feed and higher export demand have been responsible for a steady downward trend in swine herds since mid-2003. During H1'04, headcounts shrank a further 22.9% over H1'03. Poultry counts were on the rise until 2000 and stabilized after some cutback during H1'03.

**Figure 17. Livestock and poultry headcounts**

index, seasonally adjusted, Q1'99=100

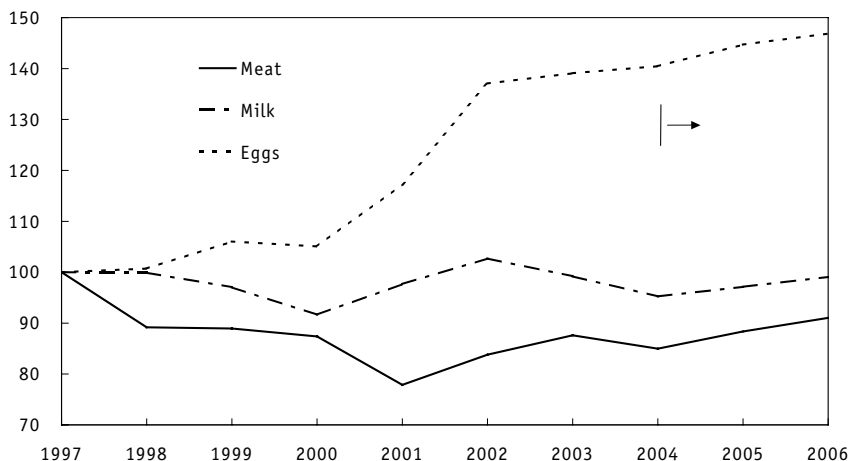


Source: Derzhkomstat; calculations by Quarterly Predictions

In H2'04, ICPS expects headcounts to start improving due to better feed. Poultry headcounts should grow the fastest due to major investments in the sector.<sup>125</sup>

**Figure 18. Livestock output**

index, 1997=100



Source: Derzhkomstat; forecast by Quarterly Predictions

<sup>125</sup> See S. Rybak, "Transformations in poultry breeding" in *Agroperspectiva* #1, 2004, pp. 30–32 and "Market illusions" in *Agroperspectiva* #2, 2004, pp. 22–24.

ICPS has adjusted its forecast for livestock output by 0.8 pp in 2004, down to -3% in light of faster-than-expected decline in headcounts and milk output. In line with this forecast, improved fodder supplies in H2'04 should establish the necessary conditions for the sector to post growth at 3.5% in 2005 and 3% in 2006.

**ICPS downgraded the forecast for livestock development in 2004 to -3%**

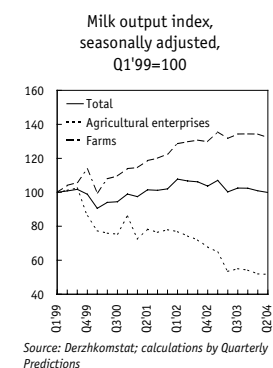
## Dairy

**SUPPLY.** Milk output has been declining for two consecutive years. Compared to H1'03, milk output shrank 2.2% during H2'04—at agricultural enterprises this figure was 10.1% due to a more rapid decline in headcounts as dairy cows were slaughtered. The rising role of private farms in milk output continues: in H1'04, they accounted for 80.4%, compared to 78.6% in H1'03. At the same time, milk yields of dairy cows<sup>126</sup> started improving at agricultural enterprises, which means that less productive cows are being slaughtered, and more productive dairy cows retained.

**DEMAND.** Despite a shrinkage of 2.2% in the milk supply, volumes submitted for processing grew 24% in H1'04 and dairy output jumped 23.2%. The share of pasteurized milk rose from 28% in H1'03 to 36% in H1'04. Higher milk volumes delivered for processing testifies to the fact that dairy farmers are sell less milk on markets<sup>127</sup> and consuming less milk. Key reason for this is rising domestic and external demand for Ukrainian dairy products. In particular, milk and dairy exports jumped by 89%<sup>128</sup> in cash equivalent in H1'04, mostly due to trading with Russia.<sup>129</sup>

**FORECAST.** ICPS has downgraded its forecast for milk output growth in 2004 from -2% to -4% in light of faster-than-anticipated shrinking of dairy herds. But in 2005–2006, ICPS expects milk output to grow 2% per year. This seems likely in view of: (1) higher dairy demand among the population due to continuing income growth (see **HOUSEHOLDS**), which will allow dairy plants to offer higher prices to dairy farmers; (2) a gradual increase of milk yields at agricultural enterprises as less productive cows are culled. At the same time, ICPS economists predict that during the forecast period the upward trend in the role of private farms in milk output will persist. Price incentives will not be enough for them to invest in more productive herds and new technologies for animal breeding at commercial farms.

**Despite lower milk supplies, volumes for processing have been growing**



## Meat

**CURRENT TRENDS.** Since early 2004, meat production has been shrinking, declining 5.2% over H1'04 compared to 2003. Average prices for cattle and poultry sold by agricultural enterprises leapt 44.9%.

Like milk output, meat production is largely concentrated in private farms. Over this period their share in meat output stood at 68.9%.

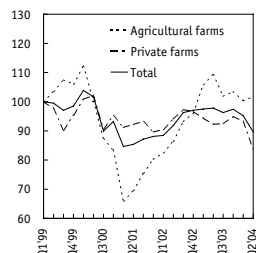
<sup>126</sup> In H1'04, milk yields grew 12.8% compared to H1'03.

<sup>127</sup> During H1'04, fresh milk sales at city markets shrank 8.5%.

<sup>128</sup> ICPS has calculated export indicators using data from Dezhmysluzhba, the state customs service.

<sup>129</sup> Russia's share in dairy exports amounted to 74% in January–May 2004.

Meat output index,  
seasonally adjusted,  
Q1'99=100



Source: Derzhkomstat; calculations by Quarterly Predictions

Despite a drop of 20% in volumes of meat submitted for processing during H1'04, meat outputs grew 24%. This is due to higher pork and poultry imports, including under tolling schemes.<sup>130</sup> Lower headcounts and yields and higher prices have caused exports of both live animals and meat to go down.<sup>131</sup>

**FORECAST.** In line with the ICPS forecast, meat output should shrink by 3% in 2004, mostly due to the decline in herds. In H2'04, livestock numbers should stabilize due to improved fodder supplies, but this will contribute to higher meat output starting from 2005 only. According to the ICPS forecast, this should rise 5% in 2005 and 3% in 2006. The key drivers of growth will be adequate feed and demand for meat, both domestic and external—especially Russia.<sup>132</sup>

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<sup>130</sup> Over H1'04, meat and food by-product imports quadrupled.

<sup>131</sup> Over H1'04, compared to H1'03, exports of live animals declined 60% because of cattle exports, while meat and food by-product exports shrank 19% due to higher pork and frozen beef exports.

<sup>132</sup> The Russian share of meat exports reached almost 100% in H1'04.

# BUSINESS

Business activity continues to liven at a brisk pace. In July 2004, the system for registering a business was simplified, which should have a positive impact on business development. Investments are likely to grow 16% in 2004, in light of favorable investment expectations in an economic boom and accelerated privatization of strategic objects on the eve of the presidential election. The outlook for 2005–2006 is for a gradual slowdown in investment growth as industrial growth begins to inch down. At the same time, accelerated growth in construction signals the heating up of the real estate market

## The business environment

In the first half of 2004, business activity was influenced by two main factors:

- negative: accelerating cost-pushed inflation (see **PRICES**). The favorable export situation (see **FOREIGN TRADE**) is countering this impact;
- positive: higher-than-expected economic growth (see **OVERVIEW**), which is stimulating the expansion of domestic demand<sup>133</sup> anticipated in business circles.

Overall, the mood of Ukrainian business is optimistic. Among other factors, lower regulatory hurdles to launching commercial activity are contributing to this. The impact of a new simplified system for registering businesses that was launched in July 2004<sup>134</sup> has several features:

- **IMPACT GROUP:** all business sectors, although the changes are more important for small and medium-scale enterprises (SMEs). Compared to SMEs, big businesses have both more resources and more pull to cut through the red tape of registration.
- **NATURE OF IMPACT:** the “one-stop-shop” principle will cut the entrepreneur’s time and costs related to launching a new business.

*Businesses plan to increase output in 2004*

*One-stop registration of businesses should have a positive impact*

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<sup>133</sup> According to results of quarterly business polls carried out by the Institute of Economic Research and Political Consultations, in Q2’04, only 12.2% of the polled businesses planned to cut output, while 54.4% planned to increase it. Business expectations for domestic demand in Q2’04 are also optimistic, which matches industrial expectations.

<sup>134</sup> The 15 May 2003 Law “On the state registration of legal entities and private entrepreneurs” came into force on 1 July 2004. According to the new system, the State Registrar shall submit the relevant data from registration applications to the statistics authorities, the State Tax Administration, the Pension Fund and other social insurance funds. Thus, potential business owners need only submit papers for state registration once and not have to visit all the different bureaucracies, as was the case until now.

- **RISKS AND LIMITATIONS:** the new registration system is not easy to introduce.<sup>135</sup> The law does not make clear whether only a state registrar and not a business entity should handle a registration. Lack of a regulatory mechanism to oversee the activities of state registrars increases the risk of more illegal payments, since the decision to register a company now depends on a single entity, the registrar.

## Investments

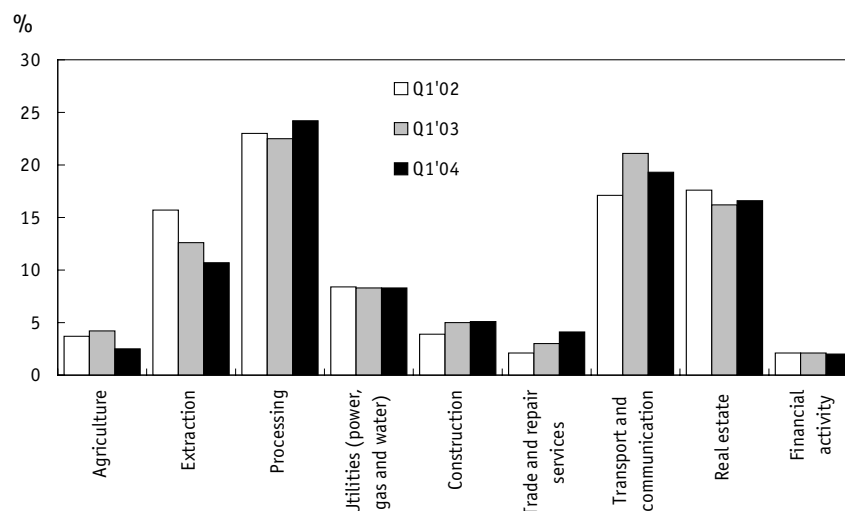
**Fixed investment moved at a record-high pace**

In Q1'04, the growing inflows of investment surpassed the record-high rate of 2003. Gross fixed investment rose by 23.3%, with fixed investment skyrocketing 52.1%.

Investment volumes have been keeping pace with industrial growth. A special factor in 2004 has been high government investment into industry.<sup>136</sup>

In Q1'04, fixed investment grew the most in the processing industry,<sup>137</sup> transport and real estate operations. Despite a slight slowdown in processing growth during H1'04 (see **INDUSTRY**), total investments into processing have not slipped during the year in the face of positive expectations for sectors oriented towards domestic demand (see **OVERVIEW**). High investments into transport continue as trade revives significantly and foreign trade turnover grows (see **FOREIGN TRADE**). Real estate investments were stimulated by further price growth on real estate market.

**Figure 19. Investment in fixed assets, by sector**



Source: Derzhkomstat

<sup>135</sup> On average, companies spend about 34 days on registration procedures in Ukraine, from the moment that they submit an application for state registration until they open a current account and received their official stamp. Source: World Bank "Doing Business" Indicators, see [rru.worldbank.org/DoingBusiness/TopicReports](http://rru.worldbank.org/DoingBusiness/TopicReports). Since July 2004, all the necessary steps should require half this much time. By mid-July 2004, the "one-stop shop" registration system had not been introduced across Ukraine yet.

<sup>136</sup> In Q1'04, government investments in fixed assets in extraction grew to 47.8%, while all investments grew 27.7%; its investments in processing grew 108.3% vs 65.7% for all investments; and its investments in utilities grew 81.4% vs 53%.

<sup>137</sup> Investments grew the fastest in pulp and paper, wood and wood products.

The share of fixed investment in extraction shrank in recent years (see **FIGURE 19**) due to lower investments in iron-ore extraction. However, ICPS economists expect a gradual increase in financing in light of the activated privatization process in this sector and favorable prices for metals and metal products (see **PRICES**). The share of fixed investments in utilities remains stable, as investment activity in this sector is subject to government regulation. Trade continues to attract high fixed investments, stimulated by reviving activity among industrial intermediaries and expanding chains of shopping malls.

We have upgraded the forecast for gross fixed investment rate of growth in 2004 to 16%. The key growth driver is positive investor expectations in view of higher-than-anticipated economic growth (see **OVERVIEW**).

We leave our forecast for 2005 and 2006 unaltered and expect a slowdown in growth rates, down to 14% and 10%, as industrial growth rates slip (see **INDUSTRY**), export gains shrink (see **FOREIGN TRADE**) and business investment opportunities shrink.

### Foreign direct investments

Net foreign direct investments continued upwards in Q1'04, reaching US \$310mn. Chemicals and petrochemicals boasted the highest rates of FDI growth, contributing 26% to total FDI growth. Foreign investment growth was predominantly the result of a 89.5% stake in the Crimean Soda Plant being sold to a German company for US \$66mn through the PFTS, a stock trading system.

Investment growth slowed down in sectors that offer a quick return on investments, the ones that traditionally appeal to foreign investors. At the same time, foreign investors are showing interest in new areas:

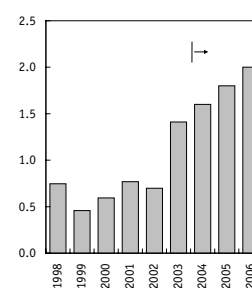
- real estate transactions, because of accelerated growth in construction and escalating prices on the real estate market;
- the financial sector, which has seen a new investor<sup>138</sup> in the banking services sector, as well as a revival in the financial services market.

ICPS leaves its forecast for FDI growth in 2004 unchanged at US \$1.6bn. We think the impact of high economic growth is stronger than pre-election jitters, and the influx of FDI is unlikely to slow down. The forecast for 2005 and 2006 thus also remains unchanged at US \$1.8bn and US \$2bn respectively.

## Inventory

In 2000–2003, a tendency towards increased inventories developed in Ukraine. This situation is typical for transition economies, where underdeveloped infrastructure and logistics and the lack of clear-cut economic cycles result in growing inventory when the economy accelerates.

Net FDI, billions USD



Source: NBU; forecast by Quarterly Predictions

**Foreign investors are showing interest in real estate and financial services**

**In recent years, the trend has been towards growing inventories**

<sup>138</sup> A new bank with foreign capital, Fokas, was registered in Ukraine. Aspra Finanz, a Swiss company, owns a 48% stake in Fokas.

**In 2004, inventories should inch up by 0.7% of GDP**

In 2003, stocks inched up by 0.5% of GDP. According to ICPS estimates,<sup>139</sup> a poor crop was responsible for substantially reducing the grain inventory that had accumulated over the previous year, although the Government's counter-cycle policy, which requires DerzhReserv, the state reserves committee, to form grain and flour reserves, caused a positive change in inventory by the end of the year. Meanwhile, as industrial growth accelerated, inventories of metals, metal products and machinery shrank.

In 2004, ICPS expects inventories to rise to 0.7% of GDP as a good harvest and active policy in support of the farm sector<sup>140</sup> (see **AGRICULTURE**) have their effect. Apart from that, growing extraction of fuels, primarily coal (see **INDUSTRY**), and problems with sales on the domestic market should push up inventories in this sector as well. Favorable external demand should help shrink inventories in metals, metal products and machinery.

The cyclic nature of changes in inventory and the lack of strong incentives to change will lead to slight fluctuations in inventory stock during 2005–2006. In 2004, agricultural indicators are expected to be high, so the country is likely to soon see seasonal inventory rotations, which should not lead to any substantial annual changes under normal circumstances. Slowing demand should reduce the extent of fluctuations in metal and metal products and extraction.

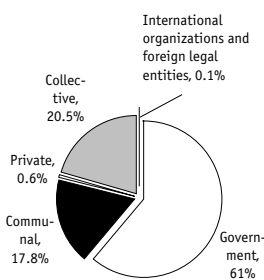
## Construction and services

### Construction

Construction growth rates continue upwards, having already reached 29.8% in Q1'04, mainly because of expanding industrial output and developing infrastructure.<sup>141</sup> The main investors in construction are, once again, state-owned companies.

Housing prices grew at a more sluggish pace in Q1'04, as prices for land picked up.<sup>142</sup> Evidence that the real estate market is heating up are being signaled by:

Fixed investment in construction in 2003, by ownership forms, %



Source: Derzhkomstat

<sup>139</sup> Detailed information about changes in inventories is available for 2002 when inventories grew by 1% of GDP due to a good harvest and mainly because of the agricultural sector, whose growth was 0.5% of GDP, and the food industry, whose growth was 3.5%. Meanwhile, in metal and metal products inventories fell 0.5% and machine-building fell 0.7% due to rising domestic and external demand for these products.

<sup>140</sup> DAK Khib Ukrainy plans to make grain pledges of 0.5mn t, Derzhreserv 1mn t, and regional companies more than 1.5mn t. Part of the crop will stay with farmers until it is sold on domestic and foreign markets—which should also cause inventory growth.

<sup>141</sup> The largest construction projects are in the energy sector (Ukryttia [Shelter] at the Chernobyl AES, two reactors at the Rivne and Khmelnytsky AESs, and the Dnister Hydroaccumulative Electrical Station), transport (the Southern-Trans-European Highway and the L'viv–Krakivets, Kyiv–Kharkiv–Dovzhanskiy, L'viv–Brody, Kyiv–Odesa highways), the reconstruction of gas transport system, and the upgrading and modernization of metalworks and coke plants. Investments are actively being pumped into constructing bridges and other municipal infrastructure.

<sup>142</sup> Apartment prices have slowed their growth to 10% in Kyiv. At the same time, prices for land for development purposes in suburban areas rose 4–12 times during the last three years, depending on the location.

- high economic growth: demand for real estate follows the same cycle as economic growth;
- the rapid turnover of small apartments;
- growing demand for land parcels and construction materials, and the ensuing higher production costs in construction.

Analysis of the real estate market uses a number of indices:<sup>143</sup>

- 1) a correlation between average apartment prices and average household incomes<sup>144</sup> indicating: how many years people need to work to buy an apartment;
- 2) a correlation between the average price for housing and potential rental income from owning real estate.<sup>145</sup> If this index grows, it means that, in purchasing real estate, investors are mostly counting on further growth in housing prices;
- 3) a correlation between the average price for 1 sq m of housing and its production cost.

*Table 7. Real estate market indices*

City	Housing price / Income	Housing price / Potential rental income	Housing price / Production cost
Kyiv	20.0	2.3	3.2
Odesa	28.4	2.5	2.2
L'viv	22.0	1.2	2.2
Sevastopol	19.7	—	1.8
Donetsk	17.7	1.1	1.3
Dnipropetrovsk	16.3	—	1.3
Zhytomyr	16.3	—	1.3
Zaporizhzhia	14.5	—	1.2
Kharkiv	13.0	1.0	1.1
Cherkasy	11.7	—	1.0

Calculations by Quarterly Predictions

<sup>143</sup> ICPS economists analyzed the housing market in cities, where apartment prices grew perceptibly during 2003. Indices have been calculated for two-room apartments. The analysis focused on the secondary market, as the primary market is largely regulated.

<sup>144</sup> Derzhkomstat's data on household commercial activity can be understated as compared to real earned incomes. However, they remain comparable with each other.

<sup>145</sup> Potential rental income is calculated over a 50-year period with a 15% discount rate, the current average rate for long-term bank deposits in hryvnia, which is an alternative to investing money in housing.

***Despite the overheated real estate market, prices are not likely to fall soon***

According to ICPS, despite the heating up of the real estate market, prices are not expected to fall soon, because:

- price growth is mostly driven by legislative amendments that came into force in early 2004:<sup>146</sup> (1) VAT is now payable on sales of new housing, which automatically raises prices, while (2) mandatory requirements to get construction financing exclusively through financial institutions has temporarily dampened construction sales;
- the cartel-like construction market will make it possible for builders to keep housing prices high, despite an expanding supply from individual developers;
- unsatisfied demand driven mostly by the desire of the average citizen to improve living conditions.<sup>147</sup> Demand for the most desirable apartments close to transportation and the downtowns of large cities forms the largest part of investment. Thus, if the market overheats, prices will first fall in these areas, which should ease pressure on other segments of the housing market.

***Construction should grow 24% in 2004...***

We have upgraded the forecast for construction growth to 24% in 2004, based on: (1) positive industrial expectations that should encourage the expansion of production capacities; (2) an upswing in business activity that should contribute to expanded commercial construction.

***... and slow down in 2005–2006***

In 2005 and 2006, construction growth should go down to 16% and 10% due to shifting priorities in industrial investments. Capital will be channeled primarily into upgrading and repairing equipment. Due to gradual market saturation, by 2006, ICPS expects demand for retail space to shrink.

### *Transport*

In Q1'04, transport growth reached 11%. The ICPS forecast for 2004 remains unchanged at 12%. Demand among industrialists, especially exporters, for transport services continues to expand, leading to higher rates<sup>148</sup> and a growing shortage of rolling stock. In 2005 and 2006, growth should taper off to 10% and 6% as foreign trade turnover growth slows down (see **FOREIGN TRADE**) and the overall economic revival levels off (see **OVERVIEW**).

### *Retail trade*

We have upgraded the forecast for gross value-added growth in retail trade and the restaurant business over 2004 to 22%. This growth will be spurred by expanding business activity and accelerating household income growth (see **HOUSEHOLDS**). In 2005 and 2006, this sector's growth rates will slow down to 15% and 12% due to a gradual decline in foreign trade and dampened consumption.

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<sup>146</sup> For more information see *quarterly predictions* for Q1'04, p. 61.

<sup>147</sup> According to Derzhkomstat, Ukraine saw only 65.5% of planned housing completions in 2003. Average housing amounts to 20 sq m per capita, whereas in Europe this indicator is at least twice as high.

<sup>148</sup> The 13 July 2004 Cabinet Instruction #455-r raised rates for rail freight. The rise amounts to 12–96%, depending on the type of cargo. In April, rates for rail transport of scrap metal exports were jacked up 70%.

## Property reforms

Large-scale privatization has reached unheard-of levels.<sup>149</sup> This is being pushed by a coincidence between the Government's interest in increasing Budget revenues and the interests of big businesses that support the ruling coalition (see **POLITICAL ENVIRONMENT**). These are hoping to grab as many state assets as possible before the election of a new president. Thus, privatization in 2004 is noticeably favoring Ukrainian investors.

***The Government and big business are keen on rapid privatization***

The sale of a 93% stake in KryvorizhStal, Ukraine's largest steel works, became the largest privatization transaction ever in the history of modern Ukraine and raised several issues:

- **WAS THIS THE RIGHT TIME TO SELL?** Given the favorable situation on steel markets, the plant's profitable performance and investment programs that had been launched, a company like this could have been sold for top dollar. Instead, a speedy sale before an election means that the privatization revenues would go mostly to increasing social outlays rather than to investing.
- **DID THE STRATEGIC VALUE OF THE ASSET JUSTIFY OPAQUENESS?** The conditions of the tender largely pre-determined the winner,<sup>150</sup> which is why foreign participants complained about them as being clearly unfair. This kind of treatment undoubtedly affects Ukraine's investment image. World practice considers it acceptable to announce a particular asset of strategic importance and to sell it to a domestic investor, but not to formally announce an open tender that blatantly favors particular bidders.

*Table 8. The advantages and disadvantages for KryvorizhStal of a domestic vs a foreign owner*

	Domestic investor	Foreign investor
Advantages	Experience in the local business environment, established business relations with KryvorizhStal	Broader sales markets Higher sale price for the asset
Disadvantages	A possible re-distribution of control within the Investytsiyniy Metalurgiyiny Soyuz <sup>151</sup> Re-sale to another investor, canceling investment commitments	Using the company to manufacture products with low added value

<sup>149</sup> In H1'04, several major national assets were privatized: KryvorizhStal (UAH 4.26bn), PavlohradVuhillia (UAH 1.4bn), and the Dzerzhynskiy Metal Works (UAH 0.71bn). By early July, the Budget had received more than UAH 7bn in privatization revenues.

<sup>150</sup> The key restriction that limited the participation of foreign investors was an add-on condition about coking, namely that the buyer had to have profitably produced and sold not less than 1mn t of Ukrainian-made coke per year for the previous three years. KryvorizhStal uses about 4mn t of coke per year. As a vertically integrated company, KryvorizhStal already provides 2.8mn t of its own coke. For technological reasons, its ninth blast furnace uses Russian coke.

<sup>151</sup> The winner of the tender was Investytsiyniy Metalurgiyiny Soyuz [Steel Investment Union], an industrial and financial consortium that includes the Interpipe Corporation (Viktor Pinchuk) and the affiliated Nyzhniodniprovsk Piping, Bipe, a Ukrainian-Cypriot company, Kredyt-Dnipro Bank, and Aura, an insurance company; ZAT Ukr-Invest, a shareholder in UkrSibBank; and AzovStal, a Mariupol-based steel works, Avdiyivka Coking Plant, MarkoKhim Coking Facility—all controlled by ZAT System Capital Management (Donetsk-based Rynat Akhmetov).

**ICPS has upgraded its forecast for privatization revenues in 2004 to UAH 9bn**

We have upgraded the forecast for privatization revenues in 2004 to UAH 9bn or 2.7% GDP. During 2004, most of the assets of UkrRudProm,<sup>152</sup> an ore conglomerate, will be privatized, a process that has already begun. Affordable share packages have been offered for sale to different domestic financial and industrial groups. The idea seems to be to keep a balance of power among them all.

The ICPS forecast for privatization revenues in 2005 remains unaltered at UAH 1.6bn but the one for 2006 has been reduced to UAH 1.5bn for several reasons: (1) after the huge purchases of 2004, potential investors will be busy accumulating capital again for new acquisitions; (2) after the “fire sale” privatizations of 2004, the State Property Fund will need time to prepare new large objects for sale;<sup>153</sup> (3) the Government formed by the country’s new president (see **POLITICAL ENVIRONMENT**) will be busy analyzing the results of the hyper-active privatizations of 2004.

The risk to the forecast is that UkrTelecom<sup>154</sup> will actually be sold during the forecast period, since, according to ICPS specialists, this corporation has not yet been properly prepared for privatization. Notably, this is one of the few state assets that could be sold to a foreign investor.

### *How to make small and medium business more effective in Ukraine?*

*Analysis of the position of SMEs reveals that, although some of Ukraine’s quantitative indicators are already near European levels, the role of these companies in the domestic economy is still low. This is evident from a number of indicators:*

- **Number of entrepreneurs per 1,000 of population.** In 2003, 41 small businesses were registered per 1,000. This indicator is comparable to European figures, which average 45 per 1,000. However, in terms of structure, SMEs actually make up only 16% of this indicator. The remaining 84% are private entrepreneurs, mostly individuals engaged in trade or unofficial employees registered as flat tax payers to minimize payroll costs.
- **GDP share of SMEs.** In 2003, the GDP share generated by SMEs reached 10%.<sup>155</sup> According to polls, only 20% of those entrepreneurs

<sup>152</sup> The 27 May 2004 Cabinet Instruction #348-r offered for sale a 25.1% stake in VAT Sukha Balka, 25.78% of VAT Pivdennyi Ore Mining and Enrichment, 50% + 1 share of VAT Pivnichniy Ore Mining and Enrichment, 50% + 1 share of VAT Central Ore Mining and Enrichment, and 37.6% of VAT Inhulets Ore Mining and Enrichment. It also offered 100% of Kryviy Rih Steelworks, Dokuchayev Fused Metal Works, Novotroitsk Ore Management Plant, Gorky Ore Management Plant (Balaklava), and Kryvbas Explosives, an industrial plant.

<sup>153</sup> ICPS analysts assume that all large assets prepared for privatization by the State Property Fund will be sold in 2004, except for the Odesa Port Plant, the chemical enterprise, and UkrTelecom, the national telecoms provider.

<sup>154</sup> According to the State Property Fund Head Mykhailo Chechetov, one possible option could be to sell 42.86% of VAT UkrTelecom in 2004 and to take in the Budget revenues in 2005.

<sup>155</sup> An explanatory note to the Bill “On amending some laws regulating business activity” is available at [www.parliament.org.ua](http://www.parliament.org.ua). For comparison, according to a study by the International Finance Corporation in September 2003, the share of GDP produced by SMEs is 50–52% in Germany, 49% in Poland, 46% in the UK, and 34% in the Czech Republic.

engaged in the retail trade (about 80% of SMEs) who started their activity five-six years ago have managed to accumulate up to US \$15,000–20,000,<sup>156</sup> while the financial balance of pre-tax activities in SME sector was negative.<sup>157</sup>

- **Share of workers at SMEs.** In Ukraine, SMEs employ only 19% of the population, which is far lower than in European countries.<sup>158</sup>

ICPS economists are convinced that government policy needs to contribute to improving the business environment in which SMEs operate, and they see the priority tasks as:

- ensuring a transparent and consistent regulatory environment by implementing the Law on regulatory policy and expanding the scope of the “conflict of interest” principle;<sup>159</sup>
- achieving a balance in the tax and social payment system by reviewing and reducing tax breaks and consolidating all social funds into a single one;
- setting up an effective system for government administration by providing open information about the Government;
- providing guarantees of the protection of ownership rights by improving legislation in this area and establishing out-of-court mechanisms for protecting these rights.

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<sup>156</sup> Materials of the Academia think-tank are at [www.academia.org.ua](http://www.academia.org.ua).

<sup>157</sup> According to Derzhkomstat, in 2003, 62.9% of SMEs were profitable and took in a total of UAH 4.2bn in revenues. The remaining 37.1% were unprofitable and sustained losses of UAH 5.4bn.

<sup>158</sup> According to the same IFC study, the share of employment in SMEs is 44% in the Czech Republic, 46% in Germany, 49% in the UK, and 61% in Poland.

<sup>159</sup> Ukrainian legislation contains a non-standard concept of “conflict of interests” only in Art. 4 of the 21 December 2000 Law “On the procedure for repaying tax liabilities to Budgets and Special Budget Funds.” The concept is applied only to tax payments: “In case the norms of a law or other normative and legislative act issued on the basis of a law, or the norms of various laws or various normative and legislative acts allow for ambiguous or multiple interpretations of the rights and obligations of taxpayers or regulatory bodies and there is a choice of deciding in favor of the taxpayer or the administrative body, the decision shall be made in favor of the taxpayer.”

# LABOR

Ukraine's wages continue to grow at a high pace since early 2004. Brisk economic growth, further increases in productivity and a higher minimum wage mean that real wages should surge some 24% in 2004, about 18% in 2005 and by 15% in 2006. The unemployment rate averaged 9% in Q1'04. Thanks to continuing and growing demand for labor, unemployment will shrink to 8% during the forecast period, a level that is much lower than it is now in most Central and Eastern European countries

## Wages and productivity

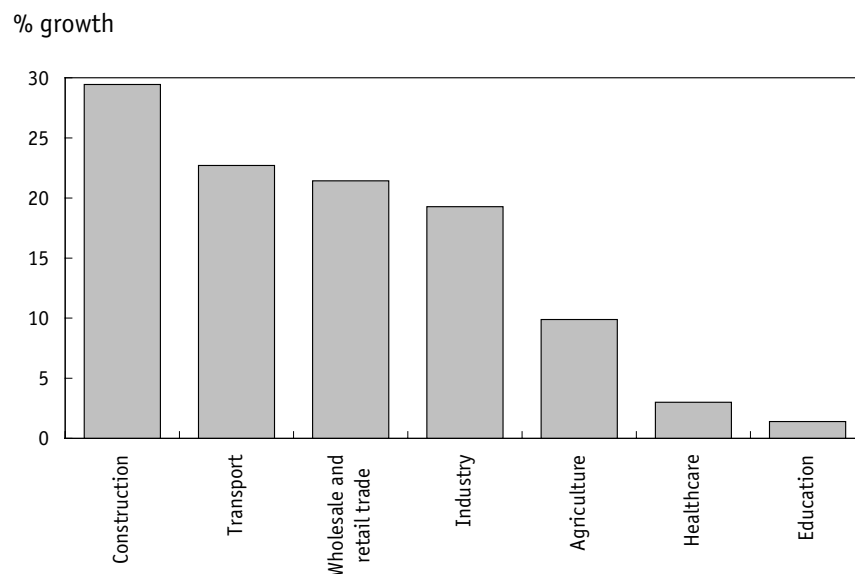
### Current trends

**In January–May 2004, real wages rose 26.7%**

In January–May 2004, real wages climbed 26.7% year-on-year.<sup>160</sup> During this period, the key drivers behind wage growth were:

- record-high economic growth rates (see **OVERVIEW**), in particular in industry (see **INDUSTRY**). This contributed to expanding working capital, which allowed employers raise wages;
- relatively good Budget revenues (see **PUBLIC FINANCE**), which contributed to increasing wages at Budget-funded enterprises and in the public sector;
- growing productivity.

**Figure 20. Labor productivity in 2003**



Source: Derzhkomstat; calculations by Quarterly Predictions

<sup>160</sup> Starting in January 2004, Derzhkomstat switched to a new system of calculating wage statistics that is in line with international practice and the System of National Accounts standards.

Just as in 2002, labor productivity has been growing rapidly in Ukraine, rising the most in construction, transport, trade and industry. The high growth of productivity in industry and transport is related to substantial inflows of investment to these sectors (see **BUSINESS**). Productivity in trade perked up as economies of scale kicked in, due to consolidation and clustering in the sector over the last years.<sup>161</sup> Productivity growth in construction is clearly linked to new technologies and methods in the sector.

***In 2003, productivity grew the most in construction and transport ...***

Relatively low productivity in agriculture was the result of the sector's overall low technological development and low level of investments. Productivity growth in medicine and education is restricted because the possibility of increasing work hours in these sectors is limited by the volumes of Budget funding allocated to these sectors.

***... and the least in education and healthcare***

### ***Wage arrears: Where does Government influence end?***

*Since early 2004, the Government has repeatedly declared that it was trying to greatly reduce, and even completely pay out wage arrears by year-end. Such statements at this particular time can be dismissed as simply efforts to gain popularity in the run-up to the presidential election, rather than a step in the right direction by a Government in a modern market economy.*

*Wage arrears have been going down for several years in a row. However, this issue has lost its urgency more recently,<sup>162</sup> compared to the late 90s, when arrears were burgeoning in both the Budget-financed and the private sectors.*

*As of 1 January 2004, Derzhkomstat's calculations of total wage arrears do not include data from businesses that ceased activity in 2001–2003—including those in bankruptcy court—where legal successors have not been assigned. This change in methodology eliminated arrears worth UAH 407mn.*

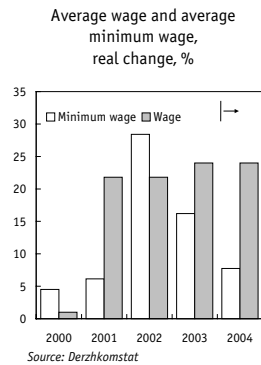
*In January–May 2004, wage arrears shrank by UAH 95mn to UAH 1,702mn. Regardless of changes in the calculating methods, the actual distribution of total arrears by form of ownership and activity type has changed little. As of 1 June 2004, 57.8% of total wage arrears are owed by non-state enterprises (in particular communal enterprises), 43% of these open joint stock companies (VATs), debtors whom the Government cannot directly influence: by law, all issues pertaining to paying out this part of the country's arrears are to be settled between the employer and the employee. The only thing the Government can do is take measures to prevent debt accumulation, such as regulating contractual relations between employers and employees, promoting the development of effective trade unions and strengthening their impact on how wage arrears are settled, and so on.*

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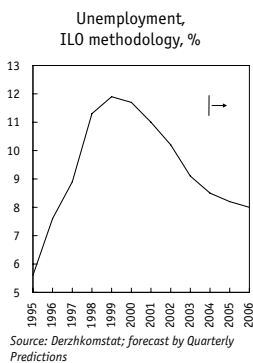
<sup>161</sup> See *quarterly predictions* for Q4'03, p. 66.

<sup>162</sup> From 1 January through 1 December 2003, wage arrears were reduced by UAH 189.9mn, down to UAH 2,123.6mn.

**In 2004–2006, wages should grow as productivity increases**



**In 2004, unemployment should shrink to 8.5%, and to 8% in 2006**



## Forecast

ICPS expects wage growth rates to continue at a high pace during the forecast period. The economic upturn and investment growth will contribute to improving the efficiency of company performance, leaving more money to be spent on payroll. High investment growth should improve productivity that is wages should go up. On the other hand, greater investments into production mean that skilled workers will be needed and this, in turn, means higher wages.

Based on the ICPS forecast for 2004, wages will grow 24% in real terms. This forecast has been revised upward in light of higher-than-expected overall economic growth (see **OVERVIEW**). The minimum wage will also be raised to UAH 237<sup>163</sup> as of 1 September 2004, instead of 1 November as originally planned by the Government. In 2005, real wages growth are likely to slow down to 18% due to slower overall economic growth (see **OVERVIEW**) and higher inflation (see **PRICES**). In 2006, wages should rise by 15% in real terms.

## Unemployment

In Q1'04, the average unemployment rate was 9%.<sup>164</sup> Since the beginning of the year, consumer expectations of unemployment have improved substantially. By June, the Index of Expected Changes in Unemployment (IECU) had slipped to 112.6, 7.4 points lower than in June 2003.<sup>165</sup>

According to ICPS, unemployment will continue its downward trend during the forecast period. In 2004, unemployment should inch down to 8.5%. This forecast has been upgraded in view of higher-than-expected overall economic growth (see **OVERVIEW**), which will further increase demand for labor, and steadily lower expectations of unemployment. The unemployment rate should continue shrinking, but more slowly: to 8.2% in 2005 and 8% in 2006. During this forecast period, Ukraine will have one of the lowest unemployment rates among CEE countries.<sup>166</sup> We think the relatively low unemployment is due to several factors:

- low unemployment benefits<sup>167</sup> and relatively strict conditions for receiving these benefits;
- a significant rise in the role of small holdings in rural areas as the main source of employment for their members;
- losses of savings by a large part of the population because of high inflation in early 90s that, in combination with low incomes, means that most Ukrainians can hardly afford to stay unemployed, even temporarily, and thus readily agree to poorly-paid work.

<sup>163</sup> On 1 December 2003, the minimum wage stood at UAH 205.

<sup>164</sup> Average unemployment was 9.1% over 2003.

<sup>165</sup> The Index is calculated for the quarterly joint Consumer Confidence report by the ICPS and GfK-USM. This index can vary from 0 to 200, 200 meaning that all respondents expect the number of unemployed to increase within the next 12 months. The index is 100 when the shares of positive and negative assessments are equal.

<sup>166</sup> In 2003, unemployment in Central and Eastern European countries ranged from 20% in Poland to 5.5% in Hungary.

<sup>167</sup> In 2003, average monthly unemployment benefits amounted to UAH 112.40 per head, which is 30.8% of the UAH 365 minimum subsistence level for the able-bodied.

# HOUSEHOLDS

Over January–May 2004, real disposable household incomes grew 15%. Record-high economic revival has made possible high growth in all key income components of Ukrainian households. Thanks to this, real disposable household incomes and consumption will both grow 13% by year-end. In 2005–2006, household incomes will likely rise 10% yearly, while consumption will grow 9% annually. In 2004, retail turnover will steam ahead, reaching a record-breaking 20%. The share of imported goods in Ukraine’s retail networks will likely escalate during the forecast period. In 2005, retail turnover will grow 15%, slipping to 12% in 2006

## Incomes

### *Current situation*

Since early 2004, growth rates for real disposable household incomes have vastly accelerated, growing 15%<sup>168</sup> over January–May 2004. According to ICPS economists, household income growth was driven by several factors during this period:

- further rapid wage growth (see **LABOR**);
- speedy growth of household incomes from entrepreneurial activity<sup>169</sup> due to accelerated economic revival (see **OVERVIEW**);
- slower inflation (see **PRICES**);
- higher growth in the “Social benefits and other current transfers” category, a result of pension rises due to pension reform<sup>170</sup> and Government moves to raise social benefits to the general population.<sup>171</sup>

Since the beginning of 2004, the structure of individual incomes has changed substantially. In particular, the share of the “Profits and mixed income” category fell from 16.3% in December 2003 to 10.8% in May 2004 for a number of reasons:

***Over January–May, real disposable household incomes rose 15%***

***The profits of private entrepreneurs form a smaller share of incomes***

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<sup>168</sup> In 2003, real disposable household incomes rose 7.8%.

<sup>169</sup> The relevant category “Profits and mixed income” surged by 16.8% in real terms over January–May 2004.

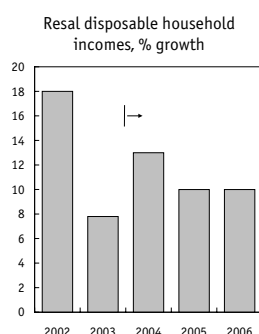
<sup>170</sup> Since 1 April 2004, pensions are being paid out with a 12% rise. According to a statement by Borys Zaichuk, chair of the Pension Fund Supervisory Board, in April 2004, the average Ukrainian pension was UAH 185, while the average for 2003 was UAH 135 (see the *Interfax-Ukraine* newswire of 13 April 2004).

<sup>171</sup> According to a 17 December 2003 Cabinet Resolution amending the procedure for assigning and paying out government assistance to families with children and the procedure for assigning and paying out social benefits to low-income families, as of 2004, the amount of the one-time cash bonus for the birth of a child is double the minimum subsistence level. This same Resolution also raised the minimum subsistence level by 20% for children having one or both parents who are Group I or Group II invalids.

- stabilized growth in the number of private entrepreneurs,<sup>172</sup> partly because uncertainty about the simplified taxation system in late 2003 led to some individuals ceasing their commercial activity;
- a shift in some portion of entrepreneurs to the status of employees because of the lowering of personal income tax (see **PUBLIC FINANCE**), which helped cut payroll costs.

### Forecast

According to ICPS, household incomes will continue upwards at a high pace in 2004, reaching 13% in real terms by year-end. We have revised the forecast upward in light of the improved outlook for the country's economy (see **OVERVIEW**). Higher economic growth rates will help maintain high growth in both wages (see **LABOR**) and private entrepreneur incomes. In addition, ICPS expects further growth in social benefits as the Government takes steps to augment this household income category.



Source: Derzhkomstat; forecast by Quarterly Predictions

**Table 9. Key government plans to increase social benefits before the election**

Aim of decision	Regulatory act(s)
To pay monthly targeted cash benefits of UAH 50 to war veterans and up to UAH 50 to low-income invalids in Group II and Group III (as of 1 May 2004)	The 16 March 2004 Law "On improving the financial standing of war veterans"
To raise the minimum rate of a standard (regular) academic stipend to 20–30% of the minimum subsistence level, individual (personal) scholarship to 30–42% of the minimum subsistence level (as of 1 July 2004)	The 12 July 2004 Cabinet Resolution "On providing stipends"
To raise military pensions to 40% of the relevant salary scale, military or other rank, plus a percentage bonus for long-term service (as of 1 September 2004)	The 13 July 2004 Cabinet Resolution "Improving pension security for military personnel, officers and rank-and-file of internal affairs bodies and certain other individuals"
To raise the minimum Chernobyl pension by 12% (as of 1 September 2004)	The 13 July 2004 Cabinet Resolution "Raising pensions assigned according to Sec. 4 of Art. 54 of the Law "On the status and social protection of individuals suffering from the Chernobyl disaster"
To raise the minimum wage by 16%, to UAH 237 (as of 1 September 2004)	The 17 June 2004 Law "Amending the 2004 State Budget Law (Art. 89)"

Source: Liga-Inform

<sup>172</sup> See *quarterly predictions* for Q4'03, p. 64.

We forecast that real disposable household incomes will grow at a high pace, in 2005–2006, but lower than in 2004. This slower growth will be caused primarily by: (1) a slower rate of economic growth (see **OVERVIEW**); (2) higher inflation in 2005 (see **PRICES**); (3) fewer Government decisions to improve the social welfare once the presidential election is over. Based on the ICPS forecast, real growth of disposable household incomes will reach 10% in 2005–2006.

## Consumption

### Current trends

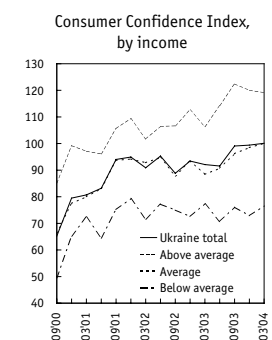
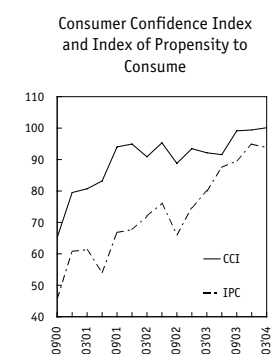
Direct consumer spending has grown at a record-high pace in Ukrainian households since early 2004, rising 15.5% over Q1'04. High consumption rates reflect accelerated income growth and record-high consumer confidence.

The Consumer Confidence survey<sup>173</sup> shows that the inclination to make major household purchases continues upward: in March 2004, the relevant Index of Propensity to Consume reached 93.8, surpassing the March 2003 indicator by 13.8 points. A growing propensity to make major household purchases was also reflected in the dynamics of household spending on different groups of goods. Among household spending on consumer goods during Q1'04, expenses on household goods, home appliances and current maintenance grew the highest at 33.3%. Household spending on food and non-alcoholic beverages remains the largest item in Ukrainian household expenses, constituting 38% of the direct spending on consumption. Still, such spending rose only 5.6% during Q1'04.

Substantial increases in household spending on non-food items are apparently the result of improved consumer confidence among average-income consumers. Average-income households became the decisive group in determining national consumer confidence, as the overall national Consumer Confidence Index (CCI) coincides with the CCI for average-income households over Q4'03 and Q1'04. According to ICPS, significantly higher non-food consumption is the result of growing incomes and greater propensity to consume among those in this income group. Apart from escalating incomes and propensity to purchase durable goods, another important driver behind this spending spree was the growing supply of durables at mid-range prices.

Unlike high- and average-income citizens, consumer confidence among low-income Ukrainians has not improved much over the last year: the relevant CCI fluctuated from poll to poll and has not shown overall upward movement. This trend in consumer opinion reflects the fact that neither economic revival nor Government social policy have so far been able to provide the necessary impulse to bring the level of wellbeing and expectations of poor people to a qualitatively new level and, thus, to somewhat narrow the gap between the mood of this and the other two income groups.

**In Q1'04, household consumption rose 15.5%**



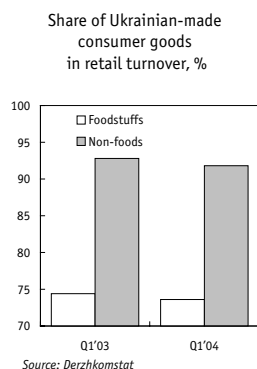
Source: Consumer Confidence

<sup>173</sup> See *consumer confidence* for April 2004.

**In 2004, consumption will jump 13%...**

**... and by 9% yearly during 2005–2006**

**During Q1'04, retail turnover leapt 21%**



## Forecast

According to ICPS, consumption will grow at a pace similar to income growth rates in 2004, increasing 13% by year-end. Consumption will grow at a high pace due to accelerated income growth, positive consumer confidence, and a relatively high propensity to consume.<sup>174</sup>

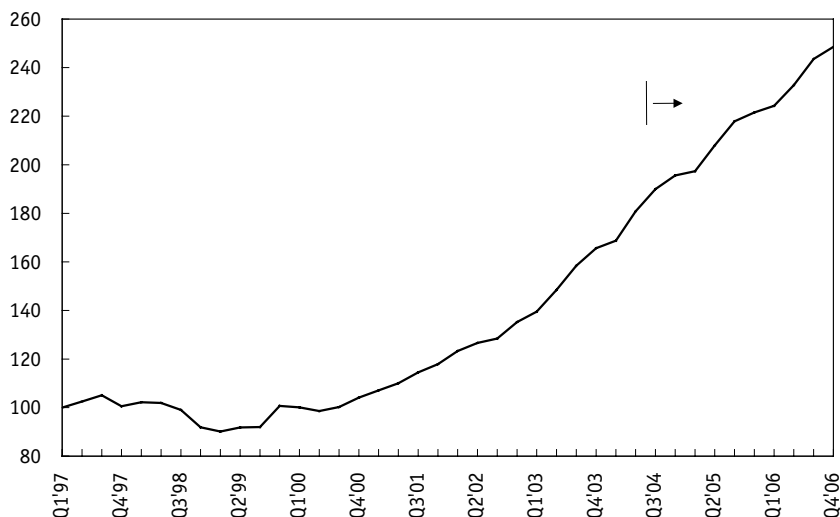
ICPS economists expect consumption to grow slower in 2005–2006, as consumption among middle-income households, which increased in 2002–2003 and largely drove this indicator, grows at a more sluggish pace. This will continue to be the key group shaping the country's consumer confidence. At the same time, the purchasing power of low-income households will remain insufficient to give a new push to accelerate consumption. According to the ICPS forecast, in 2005–2006, consumption will grow 9% per year.

## Retail trade

Since early 2004, retail turnover has moved at a record-high pace. In Q1'04, it grew by 21.4% in real terms, compared to the same period last year. Accelerated growth in consumption will lead to high retail turnover rates.

The share of Ukrainian-made goods sold through retail networks slipped from 74.4% in Q1'03 to 73.6% in Q1'04. This share shrank among both food and non-food products. The share of imported food products rose mostly because of relatively expensive products such as fruit and vegetable preserves and confectionery. Thus, demand for imported food products grew mainly among prosperous consumers. The largest share of imported non-foods went to clothing, footwear, dishes and home appliances.

**Figure 21. Real retail turnover index, seasonally adjusted, Q1'97=100**



Source: Derzhkomstat; forecast by Quarterly Predictions

<sup>174</sup> According to results of the June consumer confidence survey, the Consumer Confidence Index stood at 102 points and the Index of Propensity to Consume reached the 96.4-mark, a rise of 1.9 and 2.6 points over the second quarter.

The ICPS forecast for 2004 is that retail turnover will continue at a record-high pace, rising 20% in real terms by year-end. Moreover, growth rates will remain high, although somewhat less high than currently. Based on the ICPS forecast, they will grow 15% in 2005 and 12% in 2006.

***During the forecast period, retail trade growth will gradually slow down***

# WORLD ECONOMY

Central and Eastern European economies steamed ahead during Q1'04, partly related to export opportunities on the European market as Euro-area economies also accelerated, and to an investment bubble just before these countries joined the EU. ICPS has revised its 2004 forecasts upward somewhat, in particular for Central and Eastern European countries, and this resulted in an upgrade to the aggregate forecast growth of Ukraine's trading partners by 0.3 pp, to 5%. ICPS economists continue to expect slower economic growth among these trading partners over 2005–2006

## General trends

***In Q1'04, Ukraine's trading partners saw faster-than-expected growth***

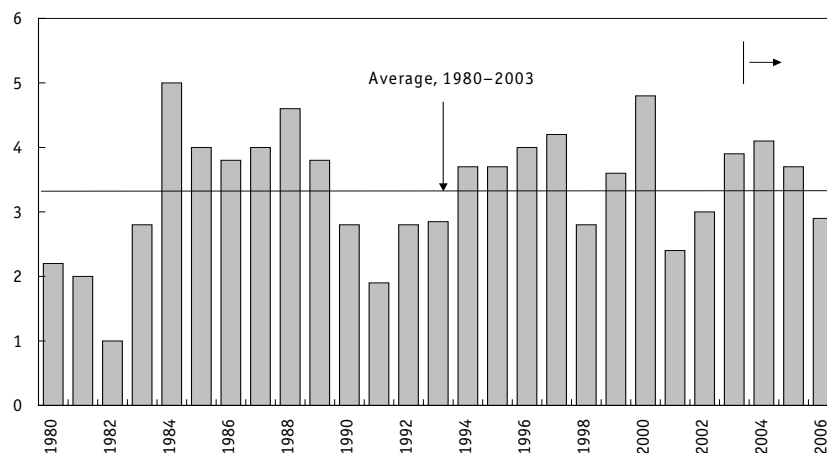
In Q1'04, China and the US continued growing at a high pace. However, both countries faced difficulties. China has shown clear signs of overheating, and its Government has been trying to cool off the economy to avoid any crisis.

The US economy has been signaling a slowdown for some time. Currently, its Government is trying to maintain growth rates at least until the presidential election in November. High Budget and trade deficits in the US<sup>175</sup> will maintain downward pressure on the US dollar. Evidence of such behavior is in the US Federal Reserve System delay of a decision to raise interest rates.<sup>176</sup> Escalating prices for fixed assets, in particular for real estate, threaten the eventual bursting of bubbles that could lead to new crises.

The general world trend is towards raising interest rates. Most likely the European Central Bank will refuse to curtail interest rates, which might stimulate Euro-area economies.

**Figure 22. World economic growth**

real annual change, %



Source: IMF; forecast by Quarterly Predictions

<sup>175</sup> This fiscal year, the US expects a deficit of 4.7% of GDP. The current account deficit climbed from 4.6% of GDP to 5.1% of GDP in Q1'04.

<sup>176</sup> On 30 June, the Federal Reserve System raised interest rates on federal funds by 0.25 pp to 1.25%. ICPS expects further steps in this direction.

## The US

In Q1'04, US GDP rose by 4.8%. The key growth driver was retail sales, which rose 4%, and a 0.7% accumulation of inventories. In particular, high prices for real estate helped Americans finance consumer spending by way of investment and windfall profits from residential real estate transactions. Higher labor productivity<sup>177</sup> also played an important role: in Q1'04, it was 6.4% higher than the same period of 2003.

In June 2004, the US economic slowdown began to emerge: indicators for industrial growth and retail trade proved far lower than anticipated.<sup>178</sup> This slowdown correlates with ICPS expectations, but the forecast for 2004 economic growth in the US has nevertheless been upgraded by 0.3 pp to 4.3% because of higher-than-expected results for Q1'04.

The cooling off of the American economy immediately showed itself in slower inflation, which the US economists had viewed lately as the key threat: in June, the core CPI (excluding food and energy) inched up by a mere 0.1% and cumulative growth of the core CPI stood at 1.9%<sup>179</sup> over the last 12 months.

ICPS is also upgrading its US forecast for 2005 to 3.4% in view of a lower likelihood that real estate prices will collapse as monetary policy tightens.

The ICPS forecast for 2006 remains unchanged at 2%. The reasons behind this slower economic growth in the US during this year will be the need to eliminate the large Budget deficit, which is a threat to macroeconomic stability. This should lead to a tighter Budget policy that will inevitably affect economic growth rates. Tighter monetary policy will result in limited investment resources.

## Euro-area countries

In Q1'04, Euro-area economies grew 1.3%. The German and French economies yielded higher growth rates of 1.5% and 1.7%. However, higher results in the first months of the year reflected a favorable foreign economic situation.<sup>180</sup> ICPS continues to forecast a 1.8% economic upturn in the Euro-area over 2004.

In 2005–2006, economic results will depend upon the policies of European supranational and national institutions alike. Within policy aimed at stimulating economic development, there are four directions of action:

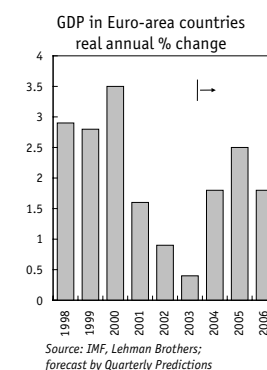
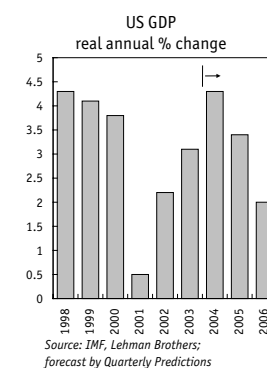
<sup>177</sup> Excluding the financial sector.

<sup>178</sup> At the same time, Consumer Confidence Indices calculated by two independent US pollsters in June showed significant improvement. This might indicate that lower retail sales in June are not a trend and this indicator can be expected to grow in July. Industrial growth continues to stand at 5.6% year-on-year and retail sales were up 6.3% over June 2003.

<sup>179</sup> However, rising fuel prices are beginning to make themselves felt: the overall CPI, which includes food and energy, climbed 3.3%.

<sup>180</sup> Particularly, the expected cooling of Chinese economy will lead to reduced export opportunities for European companies.

**A powerful domestic market and growing productivity are keeping growth rates high**

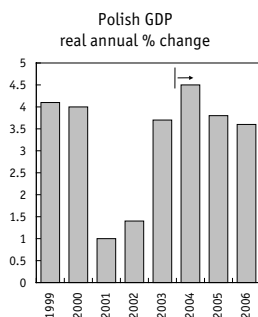


**The Euro-area accelerated substantially...**

**... but will not continue without decisive economic policies**

**Government plans for reform face resistance from powerful interest groups**

**The zloty depreciated, which stimulated exports**



Source: IMF, the Central Statistics Office of Poland; forecast by Quarterly Predictions

- MOVING ECONOMIC POLICY TOWARDS LISBON AGENDA PRINCIPLES.** This action program includes coordinating the actions of European Governments to increase flexibility and competitiveness of their economy. Within the framework of this general economic process, it is important for EU countries to overcome the in-fighting among different centers of interest: old members vs new ones, small countries vs large ones and so on.
- EASING LABOR MARKET RESTRICTIONS.** The socially oriented economies in most Euro-area countries provide too many benefits to employees (such as a 35-hour work week, minimum wages, and so on) that in the final analysis make them less competitive. Under this program, governments will have to stand up to powerful trade unions.<sup>181</sup>
- OPTIMIZING PUBLIC SPENDING.** Large Budget items burden the European economy. Just as in the case of labor regulations, these Budget expenditures have a negative impact on economic incentives and are ultimately ineffective. The necessary resources need to be released to set up conditions for economic growth, as large Budget deficits prevent the majority of Euro-area countries from attracting additional resources without cutting government spending. Spending can be cut first and foremost by revising the social welfare and public services systems. Another key to improvement is maximally limiting state support of individual large corporations.
- MAKING EUROPEAN CENTRAL BANK (ECB) MONETARY POLICY MORE ACTIVE.** The ECB has consistently shown little reaction to changes in the economic environment. One of the reasons is the traditional convolutedness—and thus low flexibility—of European mechanisms of government. The ECB needs to become more oriented towards supporting economic development goals.

ICPS expect these much-needed reforms to end up implemented in an inadequate, half-hearted fashion. As a result, the forecast for 2005 and 2006 remains unaltered: growth will be 2.5% and 1.8%. The latest attempts at reforms (pension reforms, changes in labor laws, the rejection—at least declaratively—of the practice of state support to large companies, etc.) testify that European Governments are set on reforms, although this is not always enough to overcome the resistance of power interest groups and fears of losing the next election.

## Central Europe

Central European countries continue to grow at a high pace. In early 2004, their growth accelerated mainly as additional opportunities opened with the accession to the EU.

### Poland

In Q1'04, Poland's real GDP grew 6.9%, making Poland the most rapidly growing new EU member, except for the tiny Baltic countries. The key behind this acceleration was the depreciation of the zloty, which provided additional export opportunities for Polish companies. ICPS has upgraded its forecast for Poland's economic upswing in 2004 by 0.5 pp, to 4.5%, in view of its positive results in the first quarter.

<sup>181</sup> For example, in July 2004, employees of the French energy and gas giants EDF and GDF organized long-lasting demonstrations with thousands of participants to protest the privatization of these companies.

However, the Polish economy continues to face two risks:

- an aggravated political crisis;
- the inability to institute structural reforms.<sup>182</sup>

In 2005–2006, the Polish Government will be forced to stop the current practice of supporting economic growth, as its 2004 Budget deficit is likely to surpass 7% of GDP. ICPS leaves its forecast for Polish economic growth in 2005 and 2006 unchanged at 3.8% and 3.6%.

## Slovak Republic

In early 2004, the Slovak economy moved ahead at a strong pace. In Q1, economic growth was 5.5%, thanks to powerful domestic demand. The launching of tax reforms produced positive results. The Budget deficit began shrinking substantially, going from 3.5% of GDP in 2003 to 2% of GDP based on Q1'04 results, although Slovakia's 2004 Budget allows for a deficit of 4% of GDP. Given these high indicators in Q1, ICPS has upgraded its forecast for the country's economic upturn in 2004 by 0.5 pp, to 4.5%.

In 2005, growth should hit 5%. ICPS has slightly upgraded its forecast for 2006, by 0.2% pp to 5.5%. During this year, Slovakia should start seeing large returns on recent investments, which the country is actively using to increase exports.

## Hungary

Accelerated economic growth in Western Europe led to an economic upswing in Hungary in Q1'04 of 4.2%. An important growth driver was investment: during this period, capital investments surged 18.9%.<sup>183</sup>

However, domestic demand lags far behind external GDP factors: in Q1'04 it rose by a mere 2.8%. The Government still faces a Budget deficit that needs curtailing. It was 5.6% of GDP in 2003 and is expected to hit 5.8% in 2004. This will result in low growth in domestic demand.

The ICPS 2004–2006 forecast for Hungary remains unchanged, so economic growth should reach 3.5% in 2004. In 2005, the real GDP dynamic will accelerate to 3.8% due to an economic upturn in Euro-area countries, while in 2006 Hungary can expect a slowdown to 3.2%.

## Russia

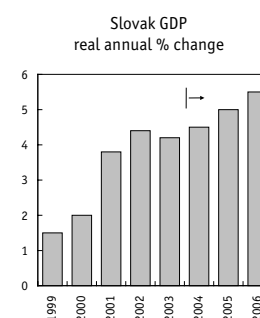
High oil prices (see **PRICES**) are stimulating high growth in the Russian economy. In H1'04, real GDP climbed 7.4%. The oil-oriented economy and marginal expansion in domestic demand for oil—only about 5% per year—are responsible for intensive export growth. In January–May 2004 exports rose 26.1%.<sup>184</sup>

<sup>182</sup> According to OECD research, Poland's labor market is the worst of the countries represented in this organization. In particular, Poland has the lowest employment rate, high taxes coupled with limits on minimum wages and conditions for firing, and a flawed social welfare system.

<sup>183</sup> Import growth stood at 16.1%, mostly due to import of investment goods.

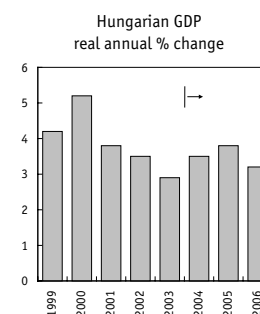
<sup>184</sup> Actual volumes of oil exports to non-CIS countries surged 23%. The average price for Russian oil was 13.3% higher than in 2003.

### Earlier reforms ensured Slovakia growth based on domestic demand



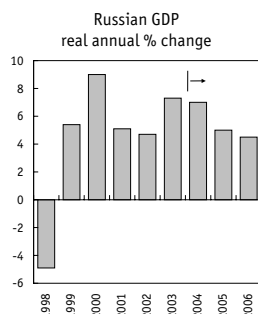
Source: IMF, Statistics Office of the Slovak Republic; forecast by Quarterly Predictions

### Hungary is in the rearguard in Central Europe



Source: IMF, the Central Statistics Office of Hungary; forecast by Quarterly Predictions

**The world oil situation should provide Russia with 7% growth in 2004**



Source: IMF, State Statistics Committee of the Russian Federation; forecast by Quarterly Predictions

**Two main trends in the Russian economy are expanding export of raw material and import substitution**

**The Chinese economy is obviously overheating**

**Beijing is doing what it can—administratively—to cool off the economy**

Import growth lags behind slightly—in January–May 2004 imports grew 23.3%—and the domestic market continues its trend towards import substitution. Growth in other sectors such as machine-building is linked primarily to satisfying the needs of the extraction industry.

Most of the Government's initiatives so far are strictly declarative, or are being implemented without effect. For this reason, ICPS is not predicting any additional major macroeconomic improvements from structural reform during the forecast period. The economic forecast for Russia's economic growth stands at 7% for 2004.

A surge of bankruptcies in the banking sector during Q2'04 has not reached the critical mass that might have led to a crisis on the financial market. In the event, state-owned banks strengthened their positions: VneshTorgBank bought an 86% stake in GUTA-Bank—the largest among the crisis victims, but technically still not bankrupt. SberBank, the state savings giant whose deposits are secured by state guarantees, also benefited from the crisis. Coupled with events around YUKOS, it seems clear that in Russia, the new trend is towards nationalizing big business—mostly by force.

ICPS economists continue to expect slower economic growth rates in 2005–2006 due to a drop in oil prices (see **PRICES**). Thus, Russia's economic growth should reach 5% in 2005, and 4.5% in 2006.

## China

In Q1'04, the Chinese economy continued to grow at a very high pace, 9.8%, which raised concerns about its overheating. Almost all indicators surged ahead: investments sprang upward 43%, retail sales jumped 11%, exports grew a solid 34% and imports an even more impressive 42%. A low baseline due the peak of the SARS epidemic in Q2'03 makes the high growth rates in H1'04 so much more impressive.

A substantial problem—and one of the factors for behind the overheating of the Chinese economy—is excessive cash reserves. During the many years of economic growth, the 4 largest state-owned banks allocated loans to national companies not for commercial reasons, but for political motives, which has resulted in the accumulation of an enormous amount of bad loans<sup>185</sup> in the economy.

The Government has already started taking measures to cool off its economy:

- accumulating inventory;
- cutting Budget expenditures;
- stopping public investment;
- increasing the waiting period for issuing permits for construction and for implementing investment projects;

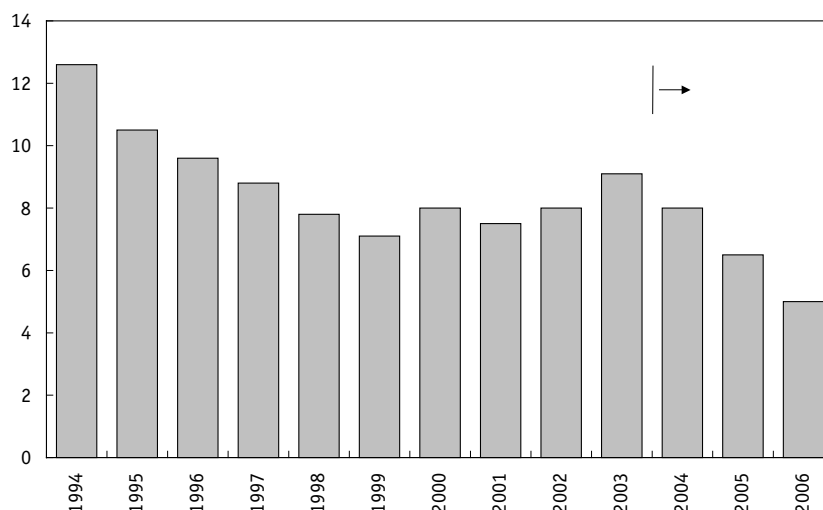
<sup>185</sup> According to official data, bad debt amounts to 30% of Chinese GDP. About half of all these bad loans are in the portfolios of the four largest state-owned banks.

- tightening monetary policy.<sup>186</sup> Banks are being asked to limit loans to companies from overheated sectors.

These mainly administrative measures have already resulted in slower economic growth. Real GDP growth in Q2'04 decreased to 9.6%. In June, industrial growth slipped to 16.2% in annual terms, compared to 19.1% in April. In May, investments in fixed assets rose by 18.3% over the same period in 2003, while in April, this indicator had been 34.7%.

**Figure 23. China's GDP dynamic**

real annual change, %



Source: National Bureau of Statistics of China; forecast by Quarterly Predictions

We expect the Chinese economy to grow 8% in 2004. Still, China is more likely to be able to set up a “soft landing.”<sup>187</sup> Despite gradual liberalization, its economy continues to be effectively regulated by centralized command levers in situations where business activity needs to be restricted. In addition, the Chinese economy does not show any signs of bubbles on the real estate or stock markets. We base our forecast for 2005–2006 upon the “soft landing” scenario. Accordingly, China’s economy will grow 6.5% and 5% during these years.

***The “soft landing” scenario means economic growth of 8% in 2004 and 6.5% and 5% in 2005–2006***

The risk to this forecast is a “hard landing”—steep economic decline. In other words, a crisis. This could come about due to external factors such as regional crises, changes in the mood of investors and so on. Dependence on these has risen significantly since the time when China’s economy was closed.

<sup>186</sup> On 25 April 2004, the mandatory reserve rate was raised from 7% to 7.5%. This was the third time this rate was raised since autumn 2003.

<sup>187</sup> The June 2004 Damocles Index, an index calculated by Lehman Brothers, an investment bank, to show the level of threat of a potential crisis, stood at 24 for China and 34 for Russia. The index’s maximum value is 100, which means that there is a 50% likelihood of a crisis within the next 12 months. 75 points mean there is a 33% likelihood of a crisis.

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*Table A1. GDP and gross national disposable income, 1998–2006, millions UAH, unless specified otherwise*

	1998	1999	2000	2001	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
Gross domestic product	102,593	130,442	170,070	204,190	225,810	264,165	335,800	402,600	456,700
Consumption	83,569	100,481	128,901	156,344	170,325	203,696	242,800	289,600	335,100
Private consumption	61,449	74,615	96,315	116,277	128,786	149,709	176,700	213,000	246,100
Public consumption	22,120	25,866	32,348	40,067	41,539	53,987	66,200	76,600	89,000
Gross investment	21,357	22,746	33,531	44,525	45,594	53,600	73,800	95,800	114,900
Net export of goods and services	-2,333	7,215	8,557	3,321	9,898	6,865	19,200	17,100	6,700
Export of goods and services	42,974	70,884	106,200	113,245	124,461	154,319	198,200	226,600	236,100
Import of goods and services	-45,307	-63,669	-98,562	-109,924	-114,563	-147,454	-179,100	-209,500	-229,400
Consumption, % GDP	81.5	77.0	75.2	76.6	75.4	77.1	72.3	71.9	73.4
Private consumption, % GDP	59.9	57.2	56.6	57.0	57.0	56.7	52.6	52.9	53.9
Public consumption, % GDP	21.6	19.8	18.6	19.6	18.4	20.4	19.7	19.0	19.5
Gross investment, % GDP	20.8	17.5	19.8	21.8	20.2	20.3	22.0	23.8	25.2
including change in inventory, % GDP	1.1	-1.9	0.0	2.1	1.0	0.5	0.7	0.3	0.1
Net export of goods and services, % GDP	-2.3	5.5	5.0	1.6	4.4	2.6	5.7	4.3	1.5
Export of goods and services, % GDP	41.9	54.3	62.4	55.4	55.1	58.6	59.0	56.3	51.7
Import of goods and services, % GDP	-44.2	-48.8	-58.0	-53.8	-50.7	-56.0	53.3	52.0	50.2
Annual real change in GDP, %	-1.9	-0.2	5.9	9.2	5.2	9.4	13.5	9.0	7.0
GDP deflator, <sup>188</sup> %	12.0	27.3	23.1	9.9	5.1	6.9	12.0	10.0	6.0

*Table A2. Gross domestic product by income source, 1998–2006, millions UAH, unless specified otherwise*

	1998	1999	2000	2001	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
Gross domestic product	102,593	130,442	170,070	204,190	225,810	264,165	335,800	402,600	456,700
Wages	49,307	57,838	71,930	86,440	103,117	119,591	157,800	193,200	219,200
Taxes net of subsidies	19,758	22,975	28,523	27,264	27,639	31,884	38,600	52,300	63,900
Operating surplus	33,528	49,629	69,617	90,486	95,054	112,690	139,400	157,000	173,500
<i>Structure of GDP, %</i>									
Wages	48.1	44.3	42.3	42.3	45.7	45.3	47.0	48.0	48.0
Taxes net of subsidies	19.3	17.6	16.8	13.4	12.2	12.1	11.5	13.0	14.0
Operating surplus	32.7	38.1	40.9	44.3	42.1	42.6	41.5	39.0	38.0

Source: Derzhkomstat; calculations and forecast by Quarterly Predictions

<sup>188</sup> The GDP deflator is the weighted sum of the deflators of its components.

*Table A3. Breakdown of real GDP change factors, 1998–2006,<sup>189</sup> %*

	1998	1999	2000	2001	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
GDP change	-1.9	-0.2	5.9	9.2	5.2	9.4	13.5	9.0	7.0
GDP change by expenditure groups	-0.4	-0.1	4.0	11.4	6.4	10.6	14.2	8.6	7.3
Gross national spending <sup>190</sup>	0.0	-6.6	3.9	12.7	3.4	13.3	15.0	9.1	9.0
Total consumption	-0.1	-3.0	1.5	11.0	3.8	9.6	11.0	5.7	6.6
Private consumption	0.7	-1.3	1.3	9.1	5.1	6.9	7.4	4.7	4.7
Public consumption	-0.8	-1.7	0.2	1.9	-1.3	2.7	3.7	1.0	1.9
Gross fixed investment	0.5	0.0	2.4	1.2	0.7	3.2	3.2	3.1	2.3
Change in inventories	-0.4	-3.6	0.0	0.4	-1.2	0.5	0.7	0.3	0.1
Export of goods and services	0.5	-0.9	11.7	2.2	5.0	5.8	7.0	5.9	3.9
Import of goods and services	-0.9	7.4	-11.6	-3.5	-2.0	-8.5	-7.8	-6.4	-5.6
Statistical discrepancies	-1.5	-0.1	1.9	-2.2	-1.2	-1.2	-0.7	0.4	-0.3
<i>Annual real change</i>									
Total consumption	-0.1	-3.7	2.0	9.3	5.0	12.8	14.4	7.9	9.3
Private consumption	1.3	-2.2	2.3	9.0	9.0	12.1	13.0	9.0	9.0
Public consumption	-3.5	-7.9	1.0	10.4	-6.7	14.8	18.0	5.0	10.0
Gross fixed investment	2.6	0.1	12.4	6.2	3.4	15.8	16.0	14.0	10.0
Change in inventories	-27.3	...	0.0	2.1	1.0	0.5	0.7	0.3	0.1
Export of goods and services	1.2	-2.2	21.5	3.5	7.4	10.3	12.0	10.0	7.0
Import of goods and services	2.0	-16.7	23.8	6.0	3.3	16.4	14.0	12.0	11.0

Source: Derzhkomstat; calculations and forecast by Quarterly Predictions

<sup>189</sup> Items contributing to GDP change are given as the real annual change of the item, multiplied by its proportion. Numbers may not add up due to rounding off.

<sup>190</sup> Comprises consumption, investment and change in inventories.

*Table A4. Gross value-added by sector, 2001–2006, real % change*

	2001	2002	2003 (est.)	2004 (forecast)	2005 (forecast)	2006 (forecast)	% of gross value-added in 2003
Agriculture, hunting and forestry	10.2	2.0	-9.9	10.0	3.5	2.5	11.9
Extraction	10.8	2.4	5.5	8.5	5.0	4.0	4.8
Processing industry	14.0	9.5	18.1	18.0	11.0	9.0	21.2
Utilities (power, gas and water)	3.8	1.7	4.7	3.0	5.0	4.0	5.2
Construction	7.8	-2.6	23.1	24.0	16.0	10.0	4.1
Wholesale/retail trade, trade in motor vehicles, repair services	43.0	7.8	19.6	22.0	15.0	12.0	12.8
Transport	19.0	7.4	12.4	12.0	10.0	6.0	13.3
Education	5.1	-0.5	1.9	8.0	5.0	5.0	5.3
Healthcare and social security	5.1	4.6	2.8	8.0	4.0	6.0	3.5
Other types of economic activity	0.8	...	8.3	8.0	7.0	6.0	17.9
Net tax on products	-16.1	0.5	10.9	13.0	9.0	9.0	
GDP	9.2	5.2	9.4	13.5	9.0	7.0	

*Table A5. Industrial output, 2001–2006*

	2001		2002		2003		2004 2005 2006 f o r e c a s t		
	millions UAH	arc, %	millions UAH	arc, %	millions UAH	arc, %	arc, %	arc, %	arc, %
arc = annual real change									
Total industrial output	155,891.1	14.2	171,206.7	7.0	220,605.1	15.8	15.0	9.5	8.0
Extraction	19,116.0	3.3	19,822.0	2.3	21,900.4	5.5	8.5	5.0	4.0
Fuel extraction	12,652.7	4.8	13,026.5	-0.8	13,778.7	3.6	5.0	3.0	3.0
Non-fuel extraction	6,463.3	0.2	6,795.5	7.7	8,121.7	9.1	14.0	8.0	5.0
Processing industry	112,397.9	17.2	126,186.0	8.9	171,592.6	18.2	18.0	11.0	9.0
Food industry and processing of farm output	27,795.2	18.2	30,883.6	8.4	38,409.0	20.0	14.0	10.0	8.0
Textiles/apparel	2,403.4	13.8	2,216.9	0.4	2,498.1	4.0	11.5	6.0	4.5
Timber production and wood products	837.3	28.0	1,002.4	23.4	1,499.4	23.6	22.0	20.0	20.0
Pulp&paper, printing, and publishing	2,900.5	18.2	3,327.6	8.4	4,294.7	25.7	30.0	20.0	18.0
Coke production and petroleum refining	6,068.3	54.3	9,837.3	25.5	16,896.9	8.7	9.0	4.0	4.0
Chemicals and petrochemicals	10,592.1	10.6	10,789.4	6.5	14,523.1	16.8	15.5	8.0	5.0
Other non-metal mineral products	5,061.1	11.4	5,378.7	5.3	6,797.3	17.9	25.0	15.0	15.0
Metallurgy and metal processing	35,270.4	4.9	39,031.0	3.9	53,650.9	14.3	12.0	6.0	4.0
Machine building	18,975.3	18.8	21,309.4	11.3	30,091.4	35.8	36.0	18.0	16.0
Utilities (electricity, gas and water)	24,377.2	2.6	25,198.7	1.1	27,112.1	4.7	3.0	5.0	4.0

Source: Derzhkomstat; calculations by Quarterly Predictions

*Table A6. Budget revenues, expenditures, deficit, state debt, 2002–2006, % GDP*

	2002			2003 (estimate)			2004	2005	2006
	Consolidated	State	Local	Consolidated	State	Local	Consolidated (forecast)		
Total revenues	27.1	20.4	12.6	28.5	20.8	13.0	27.0	27.5	28.0
Tax revenues	20.1	23.8	7.2	20.6	13.5	7.0	19.5	20.6	21.1
Personal income tax	4.9	0.0	4.9	5.1	0.0	5.1	4.0	4.5	4.8
Corporate profit tax	4.1	3.6	0.6	5.0	5.0	0.1	4.0	4.8	5.0
VAT	6.0	6.0	0.0	4.8	4.8	0.0	5.3	5.5	5.8
Excise	1.8	1.7	0.1	2.0	1.9	0.0	2.0	2.0	2.0
Tax on foreign trade	1.1	1.1	0.0	1.4	1.4	0.0	1.5	1.5	1.2
Land excise fees	0.8	0.0	0.8	0.8	0.0	0.8	1.0	1.1	1.1
Local taxes and levies	0.2	0.0	0.2	0.2	0.0	0.2	0.2	0.2	0.2
Non-tax revenues	6.5	5.6	0.9	6.9	6.0	0.9	6.0	6.0	6.0
Own receipts of budget organizations	3.4	2.7	0.7	2.9	2.2	0.7	2.5	2.4	2.4
Revenues from capital operations	0.5	0.2	0.3	0.7	0.3	0.4	0.6	0.6	0.6
State targeted funds	0.2	0.1	0.1	0.3	0.1	0.2	0.3	0.3	0.3
Official transfers	—	1.1	0.1	—	0.9	4.4	—	—	—
Total spending	26.4	19.7	12.2	28.7	21.2	12.8	29.0	28.0	29.0
Welfare	3.7	2.9	0.7	3.8	3.0	0.8	4.1	4.1	4.1
Education	1.0	1.1	0.0	0.9	0.9	0.0	1.2	1.3	1.3
Healthcare	0.3	0.3	0.0	0.1	0.1	0.0	0.3	0.4	0.4
Science	1.6	1.6	0.0	2.0	2.0	0.0	2.1	1.9	2.0
Defence	2.1	2.1	0.2	2.2	2.2	0.1	2.2	2.3	2.3
Public administration and law enforcement	3.0	2.5	0.7	4.6	3.5	1.1	3.4	3.4	3.4
Housing and public utilities	0.3	0.2	0.1	0.3	0.3	0.1	0.3	0.2	0.2
Economy	5.6	3.1	2.3	4.9	2.6	2.3	6.0	5.5	6.0
Chernobyl disaster	5.4	2.2	3.2	5.7	2.2	6.5	2.9	5.7	5.9
Foreign debt servicing	3.3	0.7	2.6	3.7	0.9	2.8	3.9	3.6	3.9
Domestic debt servicing	0.6	0.0	0.6	0.7	0.0	0.7	0.6	0.6	0.6
Other expenditures	0.6	4.0	1.7	0.8	0.2	0.5	0.7	0.7	0.7
Budget balance (IMF methodology)	0.7	0.6	0.1	-0.2	-0.4	0.2	-2.0	-0.5	-1.0
Privatization proceeds	0.3	0.3	—	0.8	0.8	—	1.8	0.4	0.3
Total debt	—	33.5	—	—	29.4	—	25.1	21.9	20.6
Foreign debt	—	24.1	—	—	21.6	—	17.3	14.9	13.5
Domestic debt	—	9.5	—	—	7.8	—	7.8	7.0	7.2

Sources: Treasury, Ministry of Finance; calculations and forecast by Quarterly Predictions

Table A7. Major indicators of monetary policy, 1998–2006, millions UAH, at end of period<sup>191</sup>

	Monetary base	%	Broad money M3	%	Cash in circulation	%	Exchange rate, UAH/USD	NBU gross reserves, millions USD	Reserve/monetary base ratio, %	Commercial bank interest rates on loans, % pa	Lending from commercial banks	Deposits at commercial banks
12'98	8,625	22	15,705	25	7,158	17	3.4270	793	29	60.4	8,873	8,278
3'99	8,562	—	15,923	—	6,717	—	3.9264	703	32	68.0	9,571	8,914
6'99	10,334	—	18,579	—	7,916	—	3.9489	975	37	47.4	9,618	10,353
9'99	11,069	—	20,468	—	9,008	—	4.4697	1,377	55	50.9	11,080	11,037
12'99	11,988	39	22,070	41	9,583	34	5.2163	1,094	50	51.9	11,787	12,156
3'00	12,580	—	24,211	—	9,465	—	5.4276	1,074	46	42.5	13,849	13,870
6'00	14,124	—	27,098	—	10,783	—	5.4382	940	36	39.7	15,266	16,315
9'00	14,888	—	28,975	—	11,541	—	5.4397	986	36	39.7	16,828	16,576
12'00	16,780	39	32,252	45	12,799	34	5.4345	1,476	50	37.3	19,574	18,738
3'01	16,742	—	33,029	—	12,736	—	5.4192	1,516	49	33.8	21,547	20,022
6'01	18,998	—	36,956	—	14,487	—	5.3828	1,860	53	32.1	24,466	21,907
9'01	20,434	—	39,643	—	16,208	—	5.3311	2,723	71	30.6	25,947	22,852
12'01	23,055	37	45,755	42	19,465	52	5.2985	3,090	72	29.6	28,373	25,674
3'02	25,076	—	47,345	—	19,646	—	5.3220	3,112	66	27.6	29,669	27,101
6'02	26,227	—	51,195	—	21,441	—	5.3288	3,405	69	25.0	32,653	29,296
9'02	29,158	—	57,729	—	23,655	—	5.3295	4,019	73	23.5	36,400	33,533
12'02	30,808	34	64,870	42	26,434	36	5.3316	4,417	76	21.8	42,035	37,715
3'03	31,191	—	70,114	—	26,002	—	5.3345	4,615	79	18.0	46,021	43,503
6'03	35,178	—	79,034	—	29,375	—	5.3328	6,172	94	17.2	52,656	49,017
9'03	38,021	—	86,495	—	30,862	—	5.3315	6,682	94	17.2	60,491	54,946
12'03	40,089	30	95,043	47	33,119	25	5.3315	6,937	92	17.7	67,835	61,365
3'04	41,438	—	101,151	—	33,580	—	5.3293	7,923	102	17.2	73,430	66,964
6'04	47,200	—	114,000	—	36,900	—	5.3207	10,400	117	16.6	81,000	76,800
12'04 (f.)	57,450	43	139,700	47	43,050	30	5.3000	11,800	109	16.0		
12'05 (f.)	74,850	30	188,600	35	53,800	25	5.2000	16,000	112	15.5		
12'06 (f.)	88,400	18	235,750	25	61,900	15	5.1500	18,950	111	14.0		

Source: NBU; forecast by Quarterly Predictions

<sup>191</sup> Starting 2000, monetary indicators include accrued interest.

*Table A8. Consumer and producer prices, 1998–2006*

Year	Quarter	Consumer prices			Producer prices				
		Quarterly change	End of period	Average	Index, 12'95 = 100	Quarterly change	End of period	Average	Index, 12'95 = 100
1998			20.0%	10.6%	184.6		35.4%	13.2%	166.7
1999			19.2%	22.8%	220.2		15.7%	32.0%	192.6
2000			25.8%	28.2%	276.8		20.9%	20.9%	232.6
2001			6.1%	12.2%	293.7		0.9%	8.9%	234.7
2002			-0.6%	0.8%	292.0		5.7%	3.0%	248.1
2003			8.2%	5.2%	316.1		11.1%	7.7%	275.7
2004 (f.)			6.5%	7.2%	336.7		20.0%	19.3%	331.0
2005 (f.)			8.0%	7.7%	363.6		10.0%	12.8%	364.2
2006 (f.)			5.0%	6.3%	381.9		6.0%	7.5%	385.9
2002	I	-1.1%			290.4	-0.5%			233.5
	II	-0.7%			288.3	5.0%			245.1
	III	-1.5%			284.0	0.9%			247.3
	IV	2.8%			292.0	0.3%			248.1
2003	I	3.7%			303.0	3.3%			256.4
	II	0.8%			305.4	0.6%			257.9
	III	-1.2%			301.7	2.9%			265.5
	IV	4.8%			316.1	3.9%			275.7
2004	I	2.4%			323.7	6.8%			294.5
	II	2.1%			329.9	7.6%			316.9
	III (f.)	-1.6%			324.7	1.5%			321.9
	IV (f.)	3.7%			336.7	2.8%			331.0
2005 (f.)	I	4.0%			349.9	4.0%			344.1
	II	1.0%			353.5	2.0%			351.0
	III	-1.1%			349.4	1.0%			354.9
	IV	4.1%			363.6	2.6%			364.2
2006 (f.)	I	2.6%			373.1	2.4%			373.0
	II	0.7%			375.7	1.3%			377.9
	III	-1.2%			371.0	0.3%			379.0
	IV	2.9%			381.9	1.8%			385.9

Source: Derzhkomstat; forecast by Quarterly Predictions

*Table A9. Balance of payments, 1998–2006,<sup>192</sup> millions USD*

	1998	1999	2000	2001	2002	2003	2004 (forecast)	2005 (forecast)	2006 (forecast)
Current account balance	-1,296	1,658	1,481	1,402	3,173	2,891	5,300	5,000	3,300
Trade balance in goods and services	-1,207	1,821	1,575	613	1,857	1,288	3,580	3,200	1,300
Merchandise trade balance	-2,584	244	779	198	710	-269	1,800	1,160	-850
Exports of goods	13,699	13,189	15,722	17,091	18,669	23,739	31,600	36,000	38,500
Imports of goods	-16,283	-12,945	-14,943	-16,893	-17,959	-24,008	-29,800	-34,800	-39,400
Balance of services	1,377	1,577	796	415	1,147	1,557	1,780	2,010	2,150
Exports of services	3,922	3,869	3,800	3,995	4,682	5,214	5,600	5,970	6,270
Imports of services	-2,545	-2,292	-3,004	-3,580	-3,535	-3,657	-3,800	-4,000	-4,100
Income	-871	-869	-942	-667	-606	-581	-550	-520	-500
Transfers	782	706	848	1,456	1,922	2,184	2,300	2,400	2,750
Capital account (excluding changes in reserves)	782	-421	-925	435	-1,243	107	-450	-800	-350
Direct investments <sup>193</sup>	747	489	594	769	698	1,411	1,600	1,800	2,000
Portfolio investments	47	-86	-201	-866	-1,716	-922	0	-200	-200
Other investments	-9	-814	-1,318	529	-240	-365	-2,050	-2,400	-2,150
Net change in NBU reserves	1,324	-283	-398	-1,606	-1,045	-2,045	-4,850	-4,200	-2,950
Errors/omissions	-820	-954	-150	-231	-885	-953	0	0	0

Source: NBU; forecast by Quarterly Predictions

<sup>192</sup> Table is constructed using NBU methodology. Numbers may not add up due to rounding off.

<sup>193</sup> Calculated as net foreign investments in Ukraine minus net investments of Ukrainian residents abroad.

*Table A10. Gross agricultural output, 1996–2006*

	Total, millions UAH	Annual real change, <sup>194</sup> %	Crop production, millions UAH	Annual real change, %	Livestock production, millions UAH	Annual real change, %
1996	26,694.4	-9.5	15,271.8	-8.9	11,422.6	-10.4
1997	30,032.0	-1.8	18,550.1	6.1	11,481.9	-12.3
1998	32,758.0	-9.6	18,562.3	-17.3	14,237.7	2.5
1999	37,683.0	-6.9	20,314.0	-10.3	16,926.0	-2.4
2000	54,259.0	9.8	31,242.1	22.0	20,857.9	-4.8
2001	69,536.0	10.2	42,889.4	12.4	26,646.6	7.0
2002	64,380.0	1.2	38,344.4	-1.6	26,035.7	5.1
2003 (estimate)	64,473.0	-9.9	36,548.8	-14.9	27,924.2	-3.0
2004 (forecast)	74,519.0	10.0	46,050.8	20.0	28,468.1	-3.0
2005 (forecast)	83,297.1	3.5	51,479.2	3.5	31,817.9	3.5
2006 (forecast)	89,652.5	2.5	55,263.3	2.0	34,389.3	3.0

*Table A11. Major agricultural commodities, 1993–2006*

	Grain, '000 t	Annual change, %	Sunseeds, '000 t	Annual change, %	Sugar beets, '000 t	Annual change, %	Meat, '000 t (live-weight)	Annual change, %	Milk, millions t	Annual change, %	Eggs, millions	Annual change, %
1993	45,623	18.4	2,075	-2.4	33,717	17.1	4,312	-16.3	18.4	-4.0	11,794	-12.6
1994	35,497	-22.2	1,569	-24.4	28,138	-16.5	4,115	-4.6	18.1	-1.3	10,154	-13.9
1995	33,930	-4.4	2,860	82.3	29,650	5.4	3,581	-13.0	17.3	-4.8	9,404	-7.4
1996	24,571	-27.6	2,123	-25.8	23,009	-22.4	3,351	-6.4	15.8	-8.4	8,763	-6.8
1997	35,472	44.4	2,308	8.7	17,663	-23.2	2,976	-11.2	13.8	-13.0	8,242	-5.9
1998	26,471	-25.4	2,266	-2.0	15,523	-13.2	2,653	-10.8	13.8	-0.1	8,301	0.7
1999	24,581	-7.1	2,794	23.3	14,064	-9.4	2,647	-0.3	13.4	-2.8	8,740	5.3
2000	24,439	-0.6	3,460	23.8	13,185	-6.2	2,600	-1.8	12.6	-5.6	8,659	-0.9
2001	39,706	62.5	2,251	-35.0	15,489	17.5	2,317	-5.0	13.4	6.0	9,652	8.0
2002	38,792	-2.3	2,970	32.0	14,400	-7.5	2,509	7.6	14.1	5.2	11,297	16.8
2003 (estimate)	20,221	-47.9	4,248	29.9	13,339	-7.4	2,607	3.5	13.7	-3.4	11,464	1.5
2004 (forecast)	35,386	75.0	3,823	-10.0	13,043	-2.0	2,528	-3.0	13.1	-4.0	11,579	1.0
2005 (forecast)	37,156	5.0	3,632	-5.0	13,434	3.0	2,630	4.0	13.4	2.0	11,926	3.0
2006 (forecast)	37,899	2.0	3,741	3.0	13,165	-2.0	2,709	3.0	13.6	2.0	12,105	1.5

Source: Derzhkomstat; calculations and forecast by Quarterly Predictions

<sup>194</sup> The ratio of gross output of the current year (in 2000 prices) to the same indicator of the previous year.

<i>Table A12. Wages, 2001–2006</i>						<i>Table A13. Retail turnover and housing starts, 2001–2006</i>			
	Quarter	Nominal monthly wage, UAH	Real % change, quarter-on-quarter	Real % change, year-on-year	Annual average, % change <sup>195</sup>	Retail turnover, quarterly, millions UAH	Year-on-year quarterly % change, real terms <sup>196</sup>	Private housing starts, quarterly, millions UAH	Year-on-year quarterly % change, real terms
2001	Q1	266.03	-3.8	15.3	4.6	7,262	7.2	253.0	-1.5
	Q2	303.23	11.2	24.7	11.0	8,149	11.4	257.2	8.3
	Q3	327.67	9.7	24.2	16.9	8,971	13.7	297.9	29.9
	Q4	349.55	4.3	22.4	21.8	9,369	13.7	549.3	14.8
2002	Q1	334.76	-3.2	23.2	23.6	8,207	15.2	284.4	14.2
	Q2	364.02	9.5	21.3	22.7	9,313	14.9	292.0	11.1
	Q3	393.10	9.6	21.2	22.0	10,313	11.9	341.3	11.9
	Q4	412.02	4.8	21.8	21.8	11,359	15.0	653.1	12.5
2003	Q1	402.43	-2.4	22.8	21.8	9,895	13.2	278.3	-11.8
	Q2	446.00	10.8	24.3	22.6	11,314	17.2	359.5	15.0
	Q3	488.98	9.6	24.3	23.4	13,129	23.3	383.1	2.1
	Q4	512.94	4.8	24.4	24.0	17,654	22.5	801.4	10.4
2004	Q1	517.48	—	—	15.7	12,599	21.0	519.4	62.4
	<sup>197</sup> Q2	568.10	—	—	26.0	15,305	21.7	574.2	30.0
	Q3 (f.)	—	—	—	—	17,321	19.9	580.6	25.0
	Q4 (f.)	—	—	—	24.0	18,838	18.1	1,154.5	20.0
2005	Q1 (f.)	—	—	—	—	16,727	17.0	697.8	15.0
	Q2	—	—	—	—	19,509	15.0	731.4	15.0
	Q3	—	—	—	—	21,370	14.7	768.2	20.0
	Q4	—	—	—	18.0	23,055	13.3	1,460.8	15.0
2006	Q1 (f.)	—	—	—	—	20,352	13.6	832.1	10.0
	Q2	—	—	—	—	23,218	11.9	866.2	10.0
	Q3	—	—	—	—	25,385	11.8	902.4	10.0
	Q4	—	—	—	15.0	27,256	12.2	1,702.7	10.0

Source: Derzhkomstat; forecast by Quarterly Predictions

Source: Derzhkomstat; forecast by Quarterly Predictions

<sup>195</sup> The ratio of the average real wage during the four latest quarters to the real average wage during the previous four quarters.

<sup>196</sup> The retail price index is used to calculate real monthly retail turnover. Beginning in 2001, retail turnover has been calculated in accordance with the Classification of Types of Economic Activity (KVED in Ukrainian).

<sup>197</sup> In January 2004, Derzhkomstat changed its methodology for calculating wage statistics. The new methodology takes into account international recommendations and the standards of the System of National Accounts. Data for 2004 and the following years is not comparable with previous periods.

*Table A14. Household income and spending, 2002–2006, millions UAH, unless specified otherwise*

	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
Household income <sup>198</sup>	186,073	211,922	—	—	—
Wages	79,026	90,491	—	—	—
Operating surplus	33,498	34,543	—	—	—
Property incomes	5,182	5,086	—	—	—
Social assistance and other current transfers	31,647	36,663	—	—	—
Disposable income	141,618	157,288	—	—	—
Real disposable income after taxes, annual % change	18.0	5.8	13.0	10.0	10.0
Expenditures	168,015	199,908	—	—	—
Real consumption, <sup>199</sup> annual % change	5.6	12.2	13.0	9.0	9.0
Savings	17,058	12,014	—	—	—

Source: Derzhkomstat; forecast by Quarterly Predictions

<sup>198</sup> Overall household income, less income from the sale of foreign currency.

<sup>199</sup> In accordance with the System of National Accounts (SNA), excluding non-profit organizations delivering services to households.

*Table A15. Real GDP among major trading partners, 1996–2006, % change*

	1996	1997	1998	1999	2000	2001	2002	2003 (est.)	2004 (forecast)	2005 (forecast)	2006 (forecast)	% in Ukraine's exports (2003)	% in world output (2003)
Russia	-3.4	0.9	-4.9	5.4	9.0	5.1	4.7	7.3	7.0	5.0	4.5	18.7	2.6
Euro area	1.4	2.3	2.9	2.8	3.5	1.6	0.9	0.4	1.8	2.5	1.8	18.2	15.9
China	9.6	8.8	7.8	7.1	8.0	7.5	8.0	9.1	8.0	6.5	5.0	4.3	12.6
Turkey	6.9	7.6	3.1	-4.7	7.4	-7.5	7.8	4.5	6.5	5.0	3.5	3.9	—
Hungary	1.3	4.6	4.9	4.2	5.2	3.8	3.5	2.9	3.5	3.8	3.2	3.7	—
Poland	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.7	4.5	3.8	3.6	3.3	—
US	3.6	4.4	4.3	4.1	3.8	0.5	2.2	3.1	4.3	3.4	2.0	3.1	21.1
Romania	3.9	-6.1	-4.8	-1.2	2.1	5.7	5.0	4.9	5.3	5.0	5.0	2.2	—
Moldova	-5.9	1.6	-6.5	-3.4	2.1	6.1	7.8	6.3	7.5	6.0	4.0	2.1	—
Belarus	2.8	11.4	8.3	3.4	5.8	4.7	5.0	6.8	8.5	5.0	4.5	1.5	—
Bulgaria	-8.0	-5.6	4.0	2.3	5.4	4.1	4.8	4.3	5.0	4.8	4.0	1.4	—
Slovakia	5.8	5.6	4.0	1.5	2.0	3.8	4.4	4.2	4.5	5.0	5.5	1.3	—
UK	2.6	3.4	2.9	2.4	3.1	2.1	1.7	2.3	2.6	2.4	1.5	1.3	3.2
Latvia	3.3	8.6	3.9	1.1	6.8	7.9	6.1	6.7	7.0	5.5	5.0	1.2	—
Total	1.2	3.1	0.9	2.7	5.7	2.4	4.0	4.5	5.0	4.2	3.5	66.1	—

Source: IMF; forecast by Quarterly Predictions