

ICPS newsletter[®]

The secret of renewed GDP growth: A good investment climate

Shrinking revenues from metal exports have had a negative impact on Ukraine's GDP. Since there is little reason to expect the situation on these once super-profitable markets to improve soon, efforts to renew rapid economic growth must focus on another GDP component, investment. To create a better investment climate, the Government needs to reduce the uncertainty among investors that emerged when the new Administration came to power and offer answers to key questions: re-privatization, tax breaks, customs clearance, and energy rates

Quality economic policy is #1

Over January–February 2006, Ukraine's GDP grew 1.5%. Slow economic growth underscores as never before the importance of good economic policy in order to maintain and stimulate economic growth. Poor public policy can dampen business expectations, leading to cutbacks in output and investment alike and, in the end, to a decline in GDP.

Since 2005, the value of imports has been greater than that of exports in Ukraine and, indeed, imports have been outpacing exports altogether. This situation is likely to persist, and by the end of 2006, the balance of trade will be negative. This slow growth in exports reflects the end of high prices for key Ukrainian export commodities, metals. Imports are growing at a rapid pace because of significant consumer demand for non-food products, which mainly come from abroad. Meanwhile, the Government has few instruments to turn around the foreign trade situation in the short term.

To maintain the country's economic growth when the balance of trade is deteriorating, Ukraine must do something to spur investment. The Ukrainian market is very attractive for both domestic and foreign capital. Effective policies can ensure the growth of investment even in the short run. To make this happen, policy must be predictable and not cause business expectations to decline.

What scares investors?

To establish a favorable business environment, the Government needs to offer clear answers to four key issues and establish a consistent policy in relation to them:

Re-privatization. One of the main reasons why businesses stopped investing in fixed assets in 2005 was uncertainty regarding re-privatization. Investment decisions were postponed by owners and managers, not only of the companies that appeared on lists of assets that might be subject to re-privatization, but also of many other companies that felt uncertain whether their assets, too, might not be subjected to re-privatization. Although President Yushchenko has stated several times that the issue of re-privatization was closed, Yulia Tymoshenko is sending the opposite signals. Specifically, she has taken the stance that all questionable ownership issues will be decided "in the courts." Entrepreneurs and investors see this kind of talk as a reminder that the process of confiscating assets may be beginning again. The only sensible reaction in such a situation is to withdraw capital from the danger zone.

Tax rules and tax breaks. Tax rules are a key element in the planning of business activity and investment. Although Ukrainian tax law is not perfect, for businesses it is more important that it be predictable. Sudden changes in tax rules complicate business planning and can also lead to

negative consequences for the public purse. A very important achievement of the new Government was the cancellation of tax breaks for companies working in special economic zones (SEZs) and on territories of priority development (TPDs). This created a more level playing field for all businesses in Ukraine, regardless of their location and their owners' clout. With energy prices growing, various interest groups will be lobbying in earnest to renew tax holidays and other benefits for specific companies or sectors. This makes it critical that the Government be consistent on this issue and continue to insist on the impossibility of returning to these kinds of privileges and holidays.

Custom clearance. Complicated and opaque customs clearance rules are one of the reasons that a share of imports continues to come in illegally and the share of investment goods being imported remains small. Complete simplification of cargo customs clearance procedures must become one of the new Government's priorities. This would lead to growing customs receipts and foreign investment both.

Gas and electricity rates. Most Ukrainians now understand that gas and electricity rates are going up. As with tax rules, however, for businesses the more important issue is not increases, but uncertainty. The Government should present a schedule of changes in regulated rates and prices affecting different categories of consumers that covers the next two years if at all possible. ■

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Consumer confidence remains steady

During the first two months of 2006, the Consumer Confidence Index (CCI) has essentially remained unchanged. The February CCI rose 0.6 points over December 2005, to 103.7. A CCI value above the 100-mark shows that positive expectations prevail among Ukrainian consumers

The Index of Economic Expectations (IEE) grew 2.5 points over January–February 2006, to 103.8. Expectations of personal financial standing also improved: the index x2 grew 3.1 points over this period, to 104.7, a record-high value since June 2005. The index of short-term economic expectations x3 was 100.7 in March 2006, indicating that about 50% of Ukrainian consumers aged 15–59 expect the next year to be favorable for the domestic economy.

After steep growth in late 2005, the Index of the Current Situation (ICS) lost 2.3 points, slipping to 103.5 in February 2006. However, this value remains the second-highest value registered by the poll since 2000. The Index of Propensity to Consume, which shows the readiness of Ukrainian consumers to purchase large household items, continues to be record high—113.5 in February 2006.

Inflationary expectations of Ukrainians also continue to be high: the Index of Inflationary Expectations (IIE) was 185.4 in February, inching up 1.1 points from the value registered in December 2005. The Index of Expected Changes in Unemployment (IECU) remained flat, at 111.6 in February 2006.

During February, positive consumer confidence prevailed in all regions except for Eastern Ukraine, where the CCI fell 11 points, to 86.3. Consumer confidence deteriorated as a result of growing pessimism over the economy and growing

Indices

Consumer Confidence Index (CCI)	103.7 (+0.6)
Index of the Current Situation (ICS)	103.5 (-2.3)
Index of Economic Expectations (IEE)	103.8 (+2.5)
Index of Expected Changes in Unemployment (IECU)	111.6 (-0.1)
Index of Inflationary Expectations (IIE)	185.4 (+1.1)

Sources: GfK Ukraine, ICPS

negative assessments of personal financial standing. Apparently, consumer confidence among residents of eastern oblasts deteriorated as industrial output shrank at the beginning of the year and negative expectations of the impact of rising gas prices increased. This rise in pessimism was also spurred by large-scale breakdowns in the region's central heating systems during heavy frosts in January 2006.

This deterioration of consumer confidence in Eastern Ukraine, where there is a concentration of densely populated urban areas, affected the CCI for large cities: it plunged 17.3 points over January–February 2006, to 96.6. Yet, Ukrainians living in large cities showed more optimistic expectations of both inflation and unemployment than residents of smaller towns and rural areas.

Since the beginning of the year, the CCI for Ukrainians with below-average incomes picked up again, reaching 92 in February 2006, fully 9.6 points above the value registered in December 2005. Consumer confidence in this group grew because of more positive economic expectations.

Positive consumer confidence prevails among middle-aged Ukrainians—those aged 31–45. Compared to December 2005, their CCI rose 2.1 points, to 101.1. The relevant IEE grew 5.3 points over this period, to 102.3. ■

consumer confidence is a joint project of the International Centre for Policy Studies and GfK Ukraine. For more information about the methods used to analyze consumer confidence, visit us online at: http://www.icps.com.ua/eng/publications/ci_calculation.html.

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New Bills to reform public administration

Two Bills that are critical to the reform of the public administration system—"On the Cabinet of Ministers of Ukraine" and "On the civil service"—were presented at public hearings called "An Action Plan for the Verkhovna Rada Coalition and the Government: Reforming the public administration system," on 14 April 2006. Participants in these hearings were Premier Yuriy Yekhanurov, Government officials, heads of central executive bodies, the authors of the bills, and representatives of NGOs and international organizations.

Justice Minister Serhiy Holovaty and Civil Service Administration Director Tymofiy Motrenko presented the two Bills. The main concept of the draft laws is to apply the principle of separating political and administrative positions, introducing the post of State Secretary to the Cabinet of Ministers to head the Government office and similar state secretary positions within each ministry. According to the authors, these Bills are needed to establish a legal foundation for setting up a modern public administration system. The Bills followed a commonly-accepted conceptual approach and are in line with the European principles of stability, professionalism and political neutrality. Participants in the hearings also adopted a resolution recommending that the Government immediately submit the Bills "On the Cabinet of Ministers" and "On the civil service" to the Verkhovna Rada and that the future VR coalition consider and adopt these bills on a priority basis.

These public hearings were organized by the International Centre for Policy Studies and the International Renaissance Foundation. The minutes of these hearings, recommendations by members of the Government and the future VR coalition, as well as the complete texts of the two Bills, can be found online on the Centre's website at: <http://www.icps.kiev.ua/project.html?pid=105> (in Ukrainian).

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