

ICPS newsletter[®]

Ukraine's Economy: Ten years after

The latest issue of "Quarterly Predictions" has hit the stands, celebrating 10 years of uninterrupted macroeconomic forecasting by ICPS. Over this last decade, Ukraine's economy has undergone radical changes. To note this milestone, ICPS provides a brief review of Ukraine's economic achievements during this period and an assessment of the opportunities that Ukraine can make use of in the future

Ukraine's economy in 1997

Ten years ago, Ukraine's economy was very different. The process of privatization was just going into full swing, barter was the standard form of commercial transaction in many sectors—for instance, only 18% of electricity was being paid for in cash—, there was a serious default crisis in the fuel and energy sector, and the official average wage was US \$80.

In 1997, the economy felt the negative impact of the transformations that began with the fall of the Soviet Union and the destruction of the centrally administrated economy. Economic collapse had not ended and real wages were stagnating.

The public finance system was operating in a state of chronic shortfalls of funds. The Budget deficit was more than 5% of GDP and the Government continuously resorted to large-scale borrowing. This soft Budget policy was to become one of the factors behind the financial crisis of 1998.

Still, 1997 was a clear turning point for Ukraine from the macroeconomic point-of-view. Inflation had fallen to 10% from the astronomic heights registered in the mid-90s and the currency rate had stabilized.

That year, Ukraine was preparing the final stage of its certificate-based privatization and formed an impressive list of large assets to be sold at tenders, primarily in the power industry and the agro-industrial complex. The list of assets subject to privatization was significantly expanded to include new groups of companies whose privatization was formerly impossible.

Tangible progress

Since 1997, Ukraine's economy has grown 74% in real terms and its dollar value has grown 2.5 times. ICPS analysts expect foreign direct investment (FDI) in 2007 to be more than 10 times what it was in 1997.

In the meantime, the role of investment in the country's economic growth

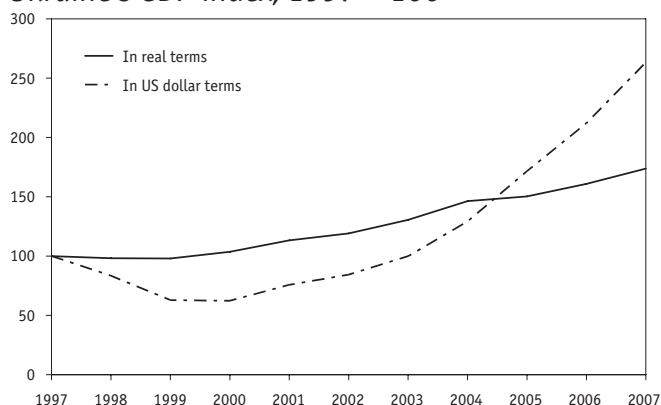
has grown significantly. The ratio of investment to GDP was 21.4% in 1997. According to ICPS economists, investment will be 28.3% of GDP in 2007. Moreover, the role of private consumption—the most significant GDP component—has remained nearly unchanged over this decade.

Because imports have been growing faster than exports in recent years, Ukraine's negative balance of trade has grown worse than 10 years ago. According to the ICPS forecast, the current account deficit will be 4% of GDP in 2007, whereas it was 2.7% of GDP in 1997. Still, the country has a significant (more than 3%) current account surplus over 1999–2005, the result of a significant depreciation of the hryvnia over 1998–1999.

Thanks to the active inflows of capital and macro-financial stability in recent years, the opportunities for the central bank to regulate the foreign exchange market have changed radically. NBU had reserves equal to 5.5 weeks of imports in 1997; by 2007, this was up to 22 weeks.

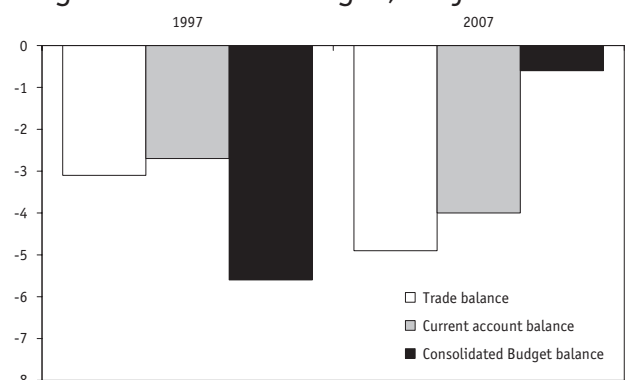
Stabilized inflation, greater competition in the banking sector and broader access among domestic banks to foreign capital have pushed interest rates down dramatically. In 1997, commercial banks were giving out hryvnia loans at 45–50%

Ukraine's GDP index, 1997 = 100



Source: Derzhkomstat; calculations and 2007 forecast by *quarterly predictions*

Foreign trade and the Budget, % of GDP



Sources: NBU, Treasury; calculations and 2007 forecast by *quarterly predictions*

interest per annum. By 2007, hryvnia loan interest rates were down to 14–15%.

What kind of economy will Ukraine have in another 10 years?

ICPS economists see two possibilities for the way Ukraine's economy will develop in the long-term.

Scenario 1: Status quo—continuing the way things are, without taking advantage of development opportunities. In this case, Ukraine's economy will continue to grow 4–6% per annum in the medium term. It will be oriented mainly towards exports of goods with low added value and imports will be poorly diversified. The economy will depend strongly on external factors.

This development option leads to a deadlock, as:

- Reserves for economic growth based on soviet industrial capacities are nearly exhausted.
- Ukraine will gradually lose external markets, in particular the CIS market, once it accedes to the WTO and competition grows stronger.
- Ukraine's economy is one of the most energy intensive in the world. Growing prices for energy, in particular for natural gas, will make most sectors uncompetitive on global markets.
- Current demographic trends could soon cause Ukraine to lose its competitive edge as regards skilled and inexpensive labor.
- In principle, the current structure of the economy, where raw material

production dominates, cannot ensure strong economic growth over a number of years.

Scenario 2: Development taking advantage of potential opportunities.

If the country switches to this development model over the next two–three years, in another six to eight years it will be ensured 6–10% annual GDP growth. The structure of the economy will shift towards an increase in the share of services and high technologies.

Potential development opportunities for Ukraine's economy include:

- **Technological innovation.** Ukraine's high scientific and technological potential could ensure successful development in the fields of energy, materials science, information and communication technologies (ICT), patents, hi-tech and services.
- **The search by developed economies for opportunities to outsource services of acceptable quality.** Since the very beginning, outsourcing services were commissioned on Asian markets because of the cheap labor force. Currently, there is a growing understanding that differences in culture, time zones and high transport costs make Central and Eastern European countries an appealing alternative. Still, growing costs among Central and Eastern European veterans in this business are forcing investors to seek opportunities outside the EU.
- **Participation in "Europe–Asia" transit corridors.** Europe is the largest consumer in the world, while Asia is the largest manufacturer and a potential consumer that is growing

at a rapid pace. Lying along a straight line between these two centers of the global economy, Ukraine could readily become a key transport link along this corridor. The development of modern transportation routes will give a major push to the development of related businesses: roadside infrastructure and services for connecting routes.

- **Innovative development of agriculture.** As the world population grows and incomes rise—that is, consumption patterns change—the appeal of agricultural business continues to be strong. Growing demand for organic products, as an alternative to the growing and breeding technologies of the modern industrial era, and for "green tourism" services in Europe, and growing population numbers and incomes in Asia ensure broad opportunities for innovative development in this sector. ■

ICPS economists have been providing regular forecasts for Ukraine's economic development since 1997. These forecasts are updated every three months and published in quarterly predictions.

If you are interested in receiving this publication on a regular basis, contact Andriy Starynskiy at (380-44) 484-4410 or at marketing@icps.kiev.ua.

ICPS analysts present their views on the potential of Ukraine's long-term economic development in a publication called "The Future of Ukraine's Economy" that you can download from <http://www.icps.com.ua/doc/FutureEconomyUkraine%20U.pdf> (in Ukrainian).

"EU–Ukraine FTA: Analytical, methodological and informational support for negotiations" project kicks off

The International Centre for Policy Studies is continuing its work in formulating the Ukrainian position in talks between Ukraine and the European Union regarding a new, deeper agreement. This month, ICPS launched a project called "EU–Ukraine FTA: Analytical, methodological and informational support for negotiations" with funding from the Swedish International Development Agency (SIDA). The Centre's partners in this project are Ukraine's Ministry of the Economy, Ministry of Foreign Affairs and the Secretariat of the Cabinet of Ministers.

The purpose of the project is to facilitate the process of Ukraine's economic and trade integration into the European Union by providing analytical, methodological and informational support to central and local government bodies, business and the press.

During the course of the project, ICPS experts and government officials will analyze the impact of a FTA at the macro level. They will also analyze the opportunities and consequences of Ukraine's participation in the Union's agencies and programs. The main focus of the project will be on consultations over an FTA with the EU in seven regional centers: Dnipropetrovsk, Donetsk, Kharkiv, L'viv, Odesa, Poltava, and Uzhhorod. These events will involve representatives of local business and government and independent experts. Discussions will be based on a report called "Free Trade between Ukraine and the EU: An impact assessment" produced by ICPS over 2006–2007 after extensive consultations with stakeholders.

For additional information, contact Project Manager Olha Shumylo by phone at (380-44) 484-4400 or by e-mail at oshumylo@icps.kiev.ua.

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