Quarterly Predictions

#16, July 2001

Contents

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EXECUTIVE SUMMARY

Overview

GDP growth in Ukraine in 2001–2003 will be primarily driven by increasing domestic demand. We have adjusted upwards our forecast for GDP growth in 2001, to 8%. GDP growth in Ukraine will decelerate to 5% in 2002 but pick up to 6% in 2003

Government

The most uncertain component of the budget strategy remains the tax policy. We forecast that budget revenues will account for 27% of GDP in 2001 and 2002, declining to 25% in 2003; we also anticipate the implementation of tax reform and a decline in privatisation proceeds. Over the forecast period, the budget surplus will fluctuate in the 0.2–0.5% of GDP range

Monetary

Thanks to a relatively eased monetary policy, stability in the foreign exchange market, and rapid GDP growth, increasingly more loans are being pumped into the Ukrainian private sector. Over 2001–2003, the hryvnia will depreciate by 8%

Prices

Inflation will be on a downward path, with CPI reaching 12.2% in 2001 and decreasing to 7% by 2003

External

Goods and services exports will increase by 6% in 2001, and imports by 8%. Starting in 2002, imports will continue to grow faster than exports. This dynamic will narrow the current account balance over the forecast period

Business

Reviving domestic demand will boost structural changes in the industrial sector and the rapid growth of trade. Labour costs will increase as a share of enterprise expenditures

Agriculture

Agricultural output will rise by 7% in 2001 as a result of increased demand. Over the next two years, the growth will decelerate, due to the lack of long-term investments

Privatisation/Capital markets

We adjust our forecast for privatisation proceeds in 2001 downwards, to 3 billion UAH The sale of Ukrtelekom shares to strategic investors, as well as of share packages in the remaining state-owned energy-distributing companies and four power-generating plants, will bring 7 billion UAH in 2002 and 3.5 billion UAH in 2003

Labour

Room for rapid wage increases has been created by productivity being higher than the hourly wage value. Intense demand for labour will restrain the growth of unemployment

Households

Improved consumer confidence of Ukrainian households will sustain consumption growth until the end of the year. In 2002 and 2003, the consumer market will undergo segmentation, producing an additional stimulating effect on consumption

International

World economic growth will decelerate to 2.6% in 2001, but will pick up to 3.3% in 2002 and 3.6% in 2003

MAJOR INDICATORS

	1996	1997	1998	1999	2000	2001 (forecast)	2002 (forecast)	2003 (forecast)
Economic activity								
GDP, *millions UAH*	81,519	93,365	102,593	130,442	172,952	210,329	244,575	282,207
Real GDP, *apc**	-10.0	-3.0	-1.9	-0.2	5.8	8.0	5.0	6.0
Real industrial production, *apc*	-5.1	-1.8	-1.0	4.3	12.9	15.0	8.0	8.5
Real agricultural output, *apc*	-9.5	-1.9	-9.8	-5.7	7.6	7.0	5.5	5.0
Gross investment, *% GDP*	22.7	21.5	20.7	17.4	18.6	19.0	19.4	20.3
FDI, *millions USD (1)*	526	581	747	489	594	650	1,400	1,500
Real household disposable incomes, *apc*	-12.3	5.1	-5.8	1.2	11.1	9.0	7.0	8.0
Real retail trade, *apc*	-11.1	8.2	-3.5	-4.8	7.5	7.5	6.0	6.5
Prices								
Consumer price index, *apc*	40	10	20	19	26	12	11	7
Producer price index, *apc*	17	5	35	16	21	7	9	8
Labour market								
Population, *millions*	51.1	50.5	50.1	49.7	49.3	49.1	48.9	48.7
Real wage, *average apc*	-2.5	-0.4	-2.8	-5.7	1.0	9.0	3.0	6.0
Official unemployment rate, %	1.3	2.3	3.7	4.3	4.2	4.5	5.0	5.5
Foreign economic activity								
Exports of goods&services, *apc*	19.1	0.0	-13.4	-7.9	20.3	6.0	5.5	6.0
Imports of goods&services, *apc*	17.1	-1.1	-17.0	-19.1	18.9	8.0	8.0	7.5
Current account balance, *% GDP*	-2.7	-2.7	-3.0	2.6	4.7	3.0	2.0	1.0
Budget								
Revenues (consolidated), *% GDP*	28.2	30.1	28.2	25.9	28.4	27.0	27.0	25.0
Current balance, *% GDP*	-4.9	-6.8	-2.1	-1.5	0.4	0.3	0.5	0.2
Balance by IMF methodology, *% GDP*	-3.2	-5.6	-2.7	-2.4	-1.1	-1.0	-2.3	-1.0
Monetary indicators								
Monetary base, *apc*	38	45	22	39	39	25	18	14
M3, *apc*	35	34	25	41	45	31	20	16
NBU international reserves, *millions USD*	1,972	2,359	793	1,094	1,539	1,970	2,570	3,040
Official exchange rate, average annual, *UAH/USD*	1.83	1.86	2.45	4.13	5.44	5.42	5.65	5.83
Interest rate on loans, average annual, *yearly % (2)*	77	49	55	53	41	32	28	25
International								
World GDP, *apc*	4.3	4.2	2.5	3.3	4.7	2.6	3.3	3.6
GDP of Ukraine's major trading partners (2/3 of exports), *apc*	1.4	0.8	1.3	3.0	6.0	2.9	4.0	4.0

* *apc* = annual percentage change

Notes: (1) according to the NBU
(2) commercial bank loans, UAH

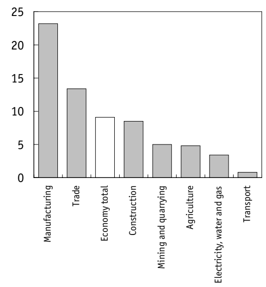
Source: State Statistics Committee, NBU, Finance Ministry; calculations and forecast by Quarterly Predictions.

OVERVIEW

We forecast that GDP growth in Ukraine in 2001–2003 will be primarily driven by increasing domestic demand. We have adjusted our forecast for GDP growth in 2001 upwards, to 8%. However, the unbalanced quality of the government's economic policy, and the lack of skilled labour or productive investments, will hold back rapid economic growth. We forecast that GDP growth in Ukraine will decelerate to 5% in 2002; in 2003, growth will pick up slightly, to 6%, following the implementation of tax reform.

In Q2'01, GDP growth accelerated again

Gross value added in H1'01, annual % change

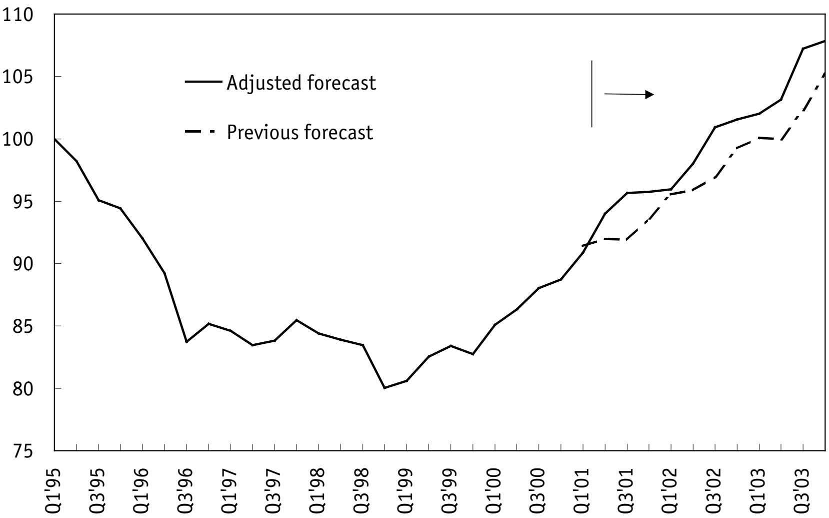


Source: State Statistics Committee.

In Q2'01, GDP growth accelerated again. Over January–June, GDP increased by 9.1% y-o-y. The growth leaders were the manufacturing industries and trade sector, largely because of a boost in domestic demand—meaning primarily private consumption, which increased by 12.1% y-o-y in H1'01. Among the main contributors to the accelerated growth in trade (13.5% y-o-y in H1'01) were the simplified taxation system adopted for small enterprises and increased productivity.

Figure 1. Real GDP

Index [Q1'95=100], seasonally adjusted



Source: State Statistics Committee; forecast by Quarterly Predictions.

GDP will grow by 8% in 2001

We anticipate that output will stabilise in H2'01, but taking into consideration the high growth pace in H1'01, we reconsidered our forecast for 2001 and ended up increasing it. Thus, GDP in Ukraine will grow by 8% in 2001.

On the one hand, gradually recovering private farms (following the 2000 reforms) have sparked a productivity rise in the agricultural sector; therefore, farmers can promptly respond to increased domestic demand. Also, higher attractiveness of the sector in terms of bank lending has helped farmers to obtain short-term loans for the purchase of fuels, seeds, fertilisers, and spare parts (see **AGRICULTURE**). As a result, we expect that the value-added in the sector for 2001 overall will grow by 6.5% (4.8% y-o-y in H1'01).

On the other hand, exports grew significantly over H1'01, on the back of a larger than expected drop in imports. In H2'01, however, we expect that the tendency will switch, with export growth decelerating while import growth picks up. In our opinion, Ukrainian producers will curb exports due to worsened conditions in external markets, while real appreciation of the hryvnia (UAH) will promote imports (see **EXTERNAL**).

Gradual worsening of economic policy poses a threat to economic growth

Gradual worsening of Ukraine's economic policy poses a threat to further economic growth. In our opinion, the following actions are symptoms of this process:

- The present government is reconsidering the resolutions, approved in 2000,[1] on reducing non-payments in the electricity sector (see **BUSINESS**).[2]

- The new cabinet has postponed the privatisation of large industrial enterprises and imposed a moratorium on the privatisation of energy-distributing companies[3] (see **PRIVATISATION/CAPITAL MARKETS**).

Economic growth will decelerate to 5% in 2002…

The approaching parliamentary elections lessen the possibility of maintaining a balanced budget in H1'02, which may easily result in price increases (see **PRICES**) and a higher exchange rate (see **MONETARY**). Due to the worsened expectations of economic agents in response to political instability, and the likely fragility of financial indicators, we forecast that economic growth will decelerate to 5% in 2002.

…picking up to 6% in 2003

We expect that tax reform will be implemented in Ukraine beginning in 2003, thus prompting GDP growth to accelerate by 6% that year.

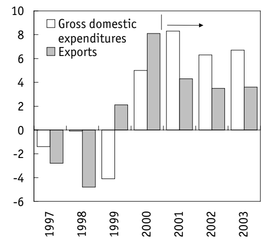
Domestic demand is the engine of growth

In our opinion, rapid GDP growth will be maintained over the forecast period, largely because of increased domestic demand. According to our forecast, the contribution of domestic demand to GDP growth will be greater than that of external demand.[4] This tendency is completely opposite to the tendency of 1999–2000, when exports made the biggest contribution to GDP growth.

In our opinion, the following determinants will lead to growth in domestic demand in Ukraine:

- Higher consumer confidence. According to the consumer survey conducted by ICPS and GfK-USM, the consumer confidence index increased by 3.7 percentage points in H1'01, primarily due to buoyed expectations for economic development over the next year and over 5 years.

Contributions of the domestic and external demand into growth



Calculations and forecast by Quarterly Predictions

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[1] See *Quarterly Predictions,* No. 15 (April 2001), p. 9.

[2] On 5 July 2001, the parliament approved the Law "On the electricity wholesale market" which eliminated the system of centralised distribution accounts used to enforce payments for electricity. The president vetoed the law on 31 July 2001.

[3] The president vetoed the Law "On imposing a moratorium on coercive sales of assets" approved by the parliament on 5 July 2001.

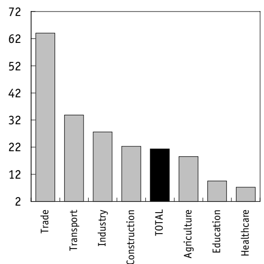
[4] We calculate the contribution of a component to GDP growth as the share of this component in the GDP multiplied by its growth rate. Domestic demand is considered as gross expenditures, including consumption, investments, and change in inventories. External demand is considered as exports.

- Increased real household incomes (see **HOUSEHOLDS**), thanks to rising wages (see **LABOUR**) and decelerating inflation (see **PRICES**). Another factor that will amplify household incomes will be a cut of the personal income tax rate in 2003 (see **GOVERNMENT**).

Rapid GDP growth will be maintained largely due to higher domestic demand

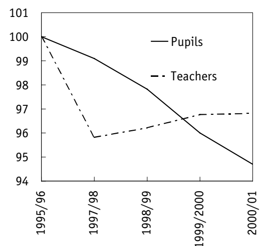
- Rising investment demand in the business sector (see **BUSINESS**). The lack of productive capital will force firms to rapidly replace obsolete equipment. As a result, volumes of loans extended by banks should grow (see **MONETARY**).

Labour productivity in 2000, hryvnias per hour



Source: State Statistics Committee; calculations by Quarterly Predictions.

Index of teachers and pupils, beginning of the academic year, 1995/96=100



Source: State Statistics Committee.

Labour productivity has been increasing in trade and industry but declining in healthcare

Productivity growth is a major determinant of the Ukrainian economy's robust growth. To test our hypothesis regarding productivity growth, we calculated labour productivity, which is the most widely used measure of productivity.[5] Our calculations revealed that during 1996–2000 labour productivity rose at the highest rate in trade and industry. Increased productivity allowed producers to react promptly to the increased domestic demand for consumer and investment goods. Higher efficiency entails raising output at the least cost, thus providing for more flexible pricing strategies, investments in broadening the product range, and hiring more skilled workers.

Meanwhile, labour productivity in education has increased very slowly in Ukraine, while in healthcare it has even fallen. This creates a serious threat to the quality of human capital in the future and to the long-term improvement of Ukrainian households' welfare. In our opinion, the reason for low productivity in these sectors is inefficient allocation of resources, an as-yet unreformed practice inherited from the Soviet times. This inefficiency is revealed by the following characteristics:

- *The number of teachers per pupil and doctors per 1,000 residents is far higher in Ukraine than in other countries.[6]*
- *High fixed costs of running the infrastructure put in place during Soviet times (e.g., electricity bills, current and capital repairs).*
- *Narrow specialisation of employees in these sectors. In developed countries, a schoolteacher usually runs several courses. Conversely, Ukrainian teacher usually specialises in only one area; as a result, the number of teachers remains unchanged while the number of pupils is diminishing.*

In our opinion, there is enormous potential for increasing productivity in education and healthcare. How fast this gap is filled will determine the quality and long-term robustness of economic growth in Ukraine. In the nearest years, the most important factor that would raise productivity in education and healthcare will be systematic (programmatic) planning of budget expenditures (see ***Government****).*

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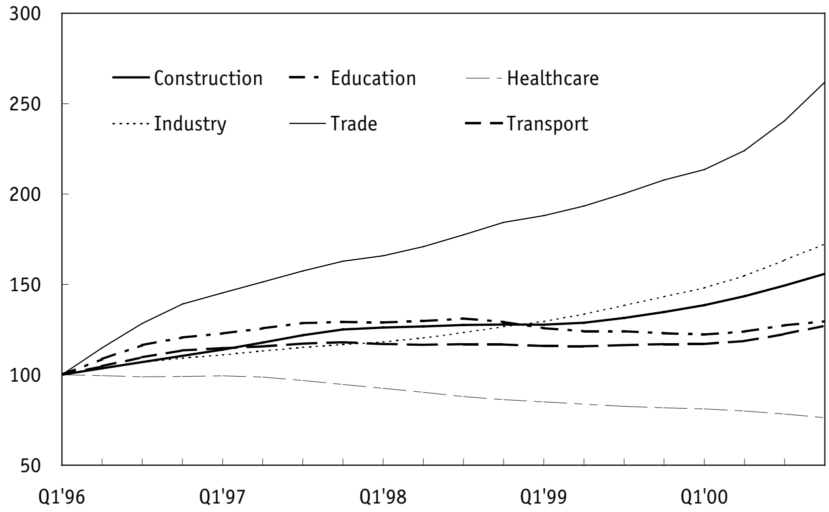
[5] Relying on data reported by the State Statistics Committee, we calculated real labour productivity by dividing the real gross value-added by the number of hours worked. In our analysis, we left out the agricultural sector, because new rules for calculating the number of people employed in agriculture, adopted in early 2000, complicate the analysis of labour productivity dynamic in this sector.

[6] Ukraine has 4.5 doctors per 1,000 people, compared with 2 in Germany, 1.6 in Sweden, and 1.3 in Poland. See: *Ukraine: Restoring Growth with Equity: A Participatory Country Economic Memorandum*. World Bank, 1999 (p. 66). In addition, the average Ukrainian teacher has 12 pupils (at the start of the 2000/01 academic year), while a Danish teacher has 25 pupils.

Figure 2. Productivity trends, by economic sector in 1996–2000

Index [Q1'96=100]



Source: State Statistics Committee; calculations by Quarterly Predictions.

Rapid growth of domestic demand will push through further structural changes in the industrial sector. We anticipate that the weights of the food and machine-building industries in industrial output will grow (see **BUSINESS**). Meanwhile, contributions of the ferrous metals and metal products industries will gradually decline over 2001–2003.

The structure of exports will follow a similar pattern with the rapidly growing food and machine-building industries increasing their sales to foreign customers.

What are the constraints to growth?

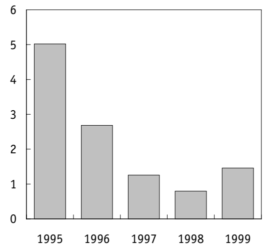
We believe that a more efficient allocation of available resources was important in promoting the GDP growth since mid-1999. In particular, competition forced entrepreneurs cut their costs by releasing surplus labour. Thanks to the releases, labour productivity increased in the industrial and trade sectors.

The lack of skilled labour and quality capital slows down economic growth

This strategy, however, has been losing its value, since the increasing demand prompts firms to employ more labour and capital of a higher quality. Trying to expand their activities, entrepreneurs are likely to face the following challenges:

- Lack of skilled labour. The still-unreformed educational system cannot satisfy the demand of enterprises for a modern labour force. In the Soviet Union, the vocational schools, colleges, and universities prepared workers trained to perform narrow tasks in particular economic sectors. Over the last ten years, the economic structure of Ukraine underwent radical transformation, while educational methods have changed negligibly. As a result, recent graduates are not competitive in the labour market.[7]

Net capital investments, % of GDP



Source: State Statistics Committee.

- Lack of quality capital. A tiny share of the net capital investments[8] in GDP indicates that installed capacities have been rapidly wearing out but are being slowly displaced by new equipment. Low profits and limited external financing opportunities put harsh constraints on the implementation of long-term investment projects. Although FDI inflows will be growing over the forecast period, the main bulk of these investments will arrive as payments for stakes purchased through privatisation tenders; these will flow directly into the budget (see **GOVERNMENT**).

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[7] According to the survey of the labour force in Ukraine conducted according to the methodology of the International Labour Organisation, graduates of secondary, vocational, and post-secondary schools made up 18% of the total unemployed in March 2001.

[8] Net capital investments are calculated as gross capital investments less capital consumption. Capital consumption is determined as a decrease of the current value of fixed capital due to its physical or moral depreciation or accidental loss.

The **Quarterly Predictions** group was established in September 1997 by the International Centre for Policy Studies in cooperation with the New Zealand Institute of Economic Research.

The **Quarterly Predictions** journal presents our forecast of Ukraine's economic performance based on comprehensive research of all its sectors. This issue was prepared using information available up to July 31, 2001.

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