Quarterly Predictions

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Contents

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EXECUTIVE SUMMARY

Overview

GDP will grow by 5.5% y-o-y in real terms in 2001; in 2002, the growth will decelerate to 5%, picking up to 6% in 2003.

Public debt policy

The government should borrow within the framework of a long-term public debt strategy. In our opinion, the government needs to accomplish the following tasks: formulate its policy regarding debt, set up a system of debt management, and develop the domestic capital market.

Government

We forecast that in 2001–2002, budget revenues will stabilise at 26% of GDP. In 2003, after the introduction of the new Tax Code and a decline in privatisation proceeds, revenues will drop to 24% of GDP. In 2002, budget expenditures will be allocated to programs.

Monetary

A non-deficit budget has eased the implementation of monetary policy. The real exchange rate will continue growing, due to the higher supply of foreign exchange. Interest rates on hryvnia-nominated loans will be adjusted downwards.

Prices

In 2001, the consumer price index (CPI) will grow by 12.9%. In 2002–2003, inflation will decelerate further, with the dynamic smoothing out.

External

In 2001–2003, the current account will see a diminishing surplus.

Business

In 2001–2003, the domestic market will be more attractive compared to foreign markets, since households will be increasing consumption and firms will be raising investments.

Agriculture

In 2000, agricultural producers had incentives to increase output. Accordingly, the sector has become attractive for investors and creditors.

Privatisation/Capital markets

Privatisation proceeds will reach 4.4 billion UAH in 2001. Sales of share packages in Ukrtelekom, a handful of power-distributing companies and 4 power-generating companies will bring to the budget 5.8 billion UAH in 2002 and 3 billion UAH in 2003.

Labour

Thanks to continued economic growth, conditions in the labour market have been improving. In 2001, real wages will grow by 3%, picking up by 3.5% in 2002 and by a further 4.5% in 2003. Due to structural adjustments, the official unemployment rate will gradually swell to 7.5% in 2003.

Households

Households will reveal a higher propensity to consume in 2001; consumption will grow by 8.5% this year. It will grow by 7% annually in 2002–2003.

International

World economic growth is expected to decrease to 2.9% in 2001, as a result of the slowdown in the economies of the USA, Japan, and emerging markets. At the same time, growth in the global GDP will pick up in 2002 and 2003 and is expected to reach 3.5% and 3.6%, respectively.

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	207,600	241,600	281,700
Real GDP, *apc**	-10.0	-3.0	-1.9	-0.2	5.8	5.5	5.0	6.0
Real industrial production, *apc*	-5.1	-1.8	-1.0	4.3	12.9	9.0	8.0	8.5
Real industrial output, *apc*	-9.5	-1.9	-9.8	-5.7	7.6	6.5	5.5	5.0
Gross investment, *% GDP*	22.7	21.5	20.7					
FDI, *millions USD (1)*	526	581	747	489	594	1,100	1,300	1,500
Real household disposable incomes, *apc*	-12.3	5.1	-5.8	1.2	11.1	8.0	7.0	7.0
Real retail trade, *apc*	-11.1	8.2	-3.5	-4.8	7.5	5.0	4.0	4.0
Prices								
Consumer price index, *apc*	40	10	20	19	26	13	11	10
Producer price index, *apc*	17	5	35	16	21	13	10	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	3.0	3.5	4.5
Official unemployment rate, *%*	1.3	2.3	3.7	4.3	4.2	5.0	6.5	7.5
Foreign economic activity								
Exports of goods&services, *apc*	19.1	0.0	-13.4	-7.9	20.3	5.0	5.5	6.0
Imports of goods&services, *apc*	17.1	-1.1	-17.0	-19.1	18.9	7.0	8.0	8.0
Current account balance, *% GDP*	-2.7	-2.7	-3.0	2.6	4.7	3.2	1.7	0.7
Budget								
Revenues (consolidated), *% GDP*	28.2	30.1	28.2	25.9	27.5	26.0	26.0	24.0
Current balance, *% GDP*	-4.9	-6.8	-2.1	-1.5	0.5	0.3	0.1	0.1
Balance by IMF methodology, *% GDP*	-3.2	-5.6	-2.7	-2.4	-1.2	-1.8	-2.2	-1.1
Monetary indicators								
Monetary base, *apc*	38	45	22	39	39	23	16	12
M3, *apc*	35	34	25	41	45	30	20	16
NBU international reserves, *millions USD*	1,972	2,359	793	1,094	1,539	1,980	2,500	2,760
Official exchange rate average annual, *UAH/USD*	1.83	1.86	2.45	4.13	5.44	5.48	5.75	5.93
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	2.9	3.5	3.6
GDP of Ukraine's major trading partners (2/3 of exports), *apc*	1.4	0.8	1.3	3.0	5.7	2.8	4.1	4.0

* *apc* = annual percentage change

Notes: (1) according to NBU
(2) commercial banks loans, hryvnias

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

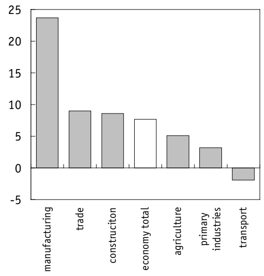
OVERVIEW

In this issue we present our forecast for economic development in 2003. In our opinion, Ukraine's economy will be rapidly growing over the next few years. However, the dynamic of growth will be very sensitive to political instability on the eve of the parliamentary elections, which is likely push government policy off the long-run planning path. We forecast that GDP will grow by 5.5% y-o-y in real terms in 2001; in 2002, the growth will decelerate to 5%, picking up to 6% in 2003.

In Q1'01, economic growth accelerated again

In Q1'01, economic growth in Ukraine accelerated again, with real GDP growing by 7.7% y-o-y. Inflation bottomed out over the last three years (see **PRICES**). As a result of business growth, tax revenues of the budget increased (see **GOVERNMENT**), and so did real wages (see **LABOUR**). The UAH/USD exchange rate remained stable, under conditions of rapidly increasing exports and dwindling imports (see **MONETARY**).

Gross value added in Q1'01, annual % change



Source: State Statistics Committee.

In Q1'01, industries oriented upon domestic demand grew the most rapidly. This was primarily due to a further increase in household consumption and a rise in investment demand, which was highest in the accelerating construction and agricultural sectors.

Political crisis undermines the consistency of government policy

Political tensions are rising on the eve of parliamentary elections

Political tensions are rising on the eve of the March 2002 parliamentary elections, having peaked with the dismissal of the reformist Cabinet.[1] This puts the quality of the government's economic policy under threat. The Communist and vested interest centrist factions of the Verkhovna Rada have ended up in an alliance—not because they aim at the same societal targets; rather, their concerted action results from a temporary coincidence of political interests before the elections. This alliance can neither develop common policy nor form a Cabinet, for the parties are guided by far-from-common ideologies.

In case the alliance succeeds in creating a Cabinet, members of the government will be more concerned about pleasing the backroom forces than maximising national wealth. Being aware of the low capacity of Ukrainian democratic institutions to openly reconcile various interests, we forecast with a high degree of certainty that the policies of such a government would not be consistent. The previous Cabinet, headed by Viktor Yuschenko, set up procedures for collective decision making that allowed preventing the adoption of decisions countering government strategy. However, these procedures are not sufficiently robust to withstand the attempts of one or another party to engage in discretionary decision making, or to rescind decisions already made.

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[1] Before the elections to the Ukrainian Parliament (*Verkhovna Rada*), all political forces will be seeking to get a maximum number of seats in the new Cabinet, in order to get access to public resources and siphon them off into election campaigns, as well as to use these positions as a mouthpiece and capture votes.

If political forces do not reach a consensus regarding the nominee for the post of Prime Minister, it is likely that the current Cabinet of Ministers will continue to work in the status of acting Cabinet until the 2002 parliamentary elections. This variant seems to be less harmful for economic development, since in this case the government policy will be more consistent and social welfare-oriented.

What changed in 2000?

A specific characteristic of the political situation in H1'00, when the Yuschenko government succeeded in implementing a number of reforms, was the ideological consensus between the President, the right-wing and centrist majority in the parliament, and the Cabinet of Ministers. The ideological consensus integrated the following strategic goals: (1) to develop democracy, (2) develop a market economy, and (3) promote integration into the EU. Under this consensus, the government managed to approve a number of decisions, which allowed boosting entrepreneurship and optimising the use of public money. We view the following decisions as the most important:[2]

- *approval of a realistic budget for 2000 and a ban on non-cash settlements with the budget;*
- *privatisation of collective agricultural enterprises and demonopolisation of lending to the agricultural sector;*
- *approval of the Privatisation Program, which set the baseline for transparent and foreseeable sales of state property;*
- *amendments to the Law "On electricity", which significantly restricted the scale of non-payments in the electricity market, thanks to strengthened contract enforcement in the market and a stricter system of distributive accounts;*
- *introduction of a new mechanism for collective decision making that prevents the approval of decisions which hinder business activity.*

Political destabilisation would corrupt the strategic approach towards state policy…

Political destabilisation would corrupt the strategic approach towards state policy and create risks of reversing decisions approved in 2000. Yet, the quality of the government's economic decisions will not deteriorate too much, thanks to the following factors:

yet the quality of economic decisions will not deteriorate too much, thanks to …

- During 2000, the transparency of the government increased. The government widely publicised its action plan, discussing the outputs and outcomes of the state policy. Some interest groups, along with the structuring of the Parliament, were transformed into official political groups and parties. As a result, Ukrainians became more aware of the impact that government decisions may have, as well as of the forces that lobby particular decisions. The new Cabinet of Ministers will be forced to analyse and weigh each decision carefully, for the electorate would regard deteriorating conditions as mistakes of the political forces that formed the government.

[2] We presented a detailed analysis of these measures in *Quarterly Predictions* nos. 10, 11, and 12 (January, April, and July 2000).

... increased transparency of the government, strengthened competition, and higher professionalism of the civil service

- Competition strengthened, thanks to reforms in 2000 and increased economic activity. The more competitive a market is, the more difficult it becomes to push through decisions which favour some (among the many) market agents. Therefore, we anticipate that the quality of government decisions will remain poor with respect to the least competitive markets, primarily those where the government holds a large stake. These would include the electricity sector, coal mining, oil extraction, and gas supply.

- Units dedicated to professional analysis of government policy have emerged within the government bureaucratic structure. Thus, the work of government analysts should contribute to ensuring better-quality Cabinet decisions.

In our opinion, under the present conditions of weak democratic institutions and continuing political struggle, the implementation of key reforms before the 2002 parliamentary elections appears to be unrealistic, since these reforms need to be backed by political consensus and the priority of national interests. Conversely, the decisions of the current government will concern only short-term problems. The price that the country will pay for stalled reforms will be increased cost of doing business in Ukraine.

We hope that reforms will speed up in 2003

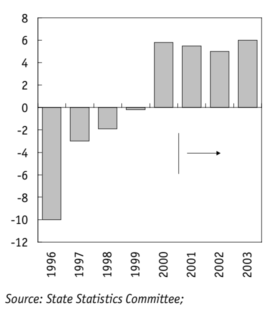
We hope that the implementation of reforms will speed up in 2003, after the parliamentary elections. In our opinion, the structure of political forces will improve then, which will allow forming a uniform parliamentary majority, as well as a government supported by this majority. The higher degree of political consensus will lay the foundation for more consistent policies, and will favour the approval of key reforms.

Entrepreneurship will overcome political instability

Business development should proceed unhindered

Economic growth creates new opportunities for generating profits, thanks to increased demand, and businesses are very sensitive to these changes. If the government crisis is resolved and financial stability is maintained, business development in Ukraine should proceed unhindered. Competition is at the heart of this process. To outstrip competitors, firms make investments and thus raise productivity; they struggle for market share and introduce new management and marketing strategies. Moreover, each year Ukrainian businesses are acquiring more experience in working under market conditions, expanding their business networks, searching for and finding trustworthy clients, and discovering ways to reduce costs and increase effectiveness.

Real GDP, annual % change



Source: State Statistics Committee; forecast by Quarterly Predictions.

Taking into account these factors, we forecast that despite the far less rosy prospects for changes in government policy compared to the previous quarter, the pace of economic growth will still be high. In our opinion, GDP growth will reach 5.5% in 2001, decelerating to 5% in 2002 and speeding up to 6% in 2003.

During 2001–2002, economic growth will slow down, which will primarily result from the instability of government policy and absence of a clear strategy. Industries which require long-term capital injections and foreign high-tech investments will suffer the most, since the majority of foreign companies will prefer to stay out of Ukrainian markets. The same circumstance puts the privatisation of strategic companies, including Ukrtelekom, under threat (see **PRIVATISATION/CAPITAL MARKETS**) and reduces their value. Still, we expect that economic growth will not slow down significantly, thanks to the market-like behaviour of domestic firms and their rapid adjustment to ever-changing political conditions.

Table 1. Risk of rescindment of decisions approved in 2000

Decision	Potential for rescindment	Consequences of rescindment
A ban on non-cash payments to the budget and among state-owned enterprises (SOEs)	Difficult at the budget level, as the law must be amended accordingly; easy at the level of SOEs. The public, however, has become aware of the negative consequences of non-cash payments	Failure to fulfil the budget, worsening competition conditions, and skewed allocation of resources in the economy
Privatisation of collective agricultural enterprises	Very difficult	—
Demonopolisation of lending to agricultural enterprises	Possible to reverse; however, strong competitive interests have already formed	Restrictions on entrepreneurship, reduced investment in agriculture
Transparent privatisation	On the one hand, difficult to reverse, because the Privatisation Program has the force of law; on the other hand, easy to reverse in each particular case	Foreign investors will stay out of the market, resulting in slack development of businesses and failure to fulfil the budget
Reduction of payment arrears in the electricity sector	Amendments to the law "On electricity" require the majority vote of the Parliament. Breaching this law might become easier if the government passes the necessary decisions	Threat of an energy crisis
Collective decision making by the Cabinet	This mechanism has been introduced by the Cabinet of Ministers, a decision which can be rescinded since a Law "On the Cabinet of Ministers" does not exist	Inconsistent government decisions and poor conformity to government goals. This increases the riskiness of investment in Ukraine

Source: Quarterly Predictions.

We forecast that economic growth will accelerate in 2003, thanks to the implementation of reforms and anticipated political consensus after the parliamentary elections.

Strong monetary and budget policies will ensure political stability

Monetary authorities are more oriented towards targeting the inflation rate...

Irreversible growth will largely depend on financial stability, which in turn depends on monetary and budget policies. Monetary policy is becoming more oriented towards targeting the inflation rate (see **MONETARY**), while budget policy is aiming to strengthen control and improve the quality of budget expenditures (see **GOVERNMENT**). Preserving these tendencies is a safeguard of ongoing economic growth.

...while budget policy aims to strengthen control and improve the quality of budget expenditures

Monetary policy must become more independent of the financial appetites of the government. Consequently, there is an increasing need to develop long-term strategy regarding the state debt. A common interest of the National Bank and the Ukrainian government in this sphere is the development of the domestic government securities market. In our special chapter on **PUBLIC DEBT POLICY** we analyse the problems and prospects for the development of the domestic government securities market.

Table 2. Forecast indicators for economic development in 2001–2002

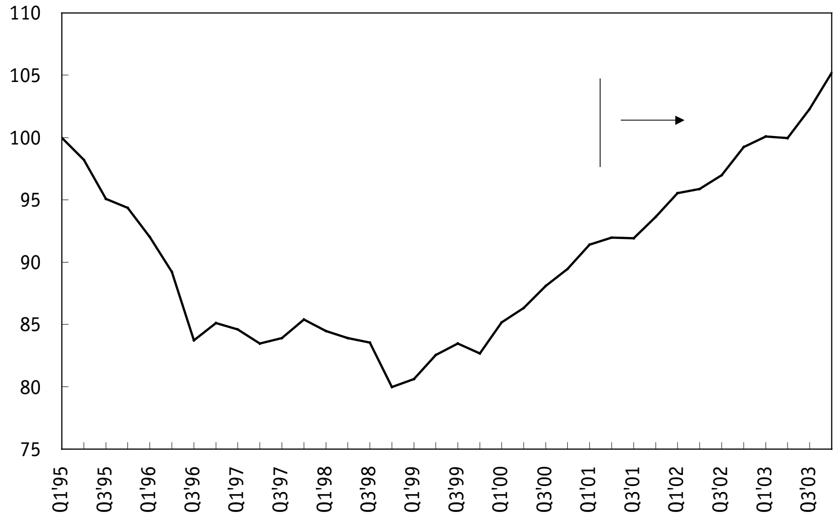
Forecast indicator	Change
GDP	As growth in Q1’01 was high, we adjusted our forecast for 2001 upwards, but lowered it for 2002, due to political instability
Private consumption	Thanks to high marginal propensity to consume, growth will accelerate; accordingly, savings will increase more slowly
Investments	No change
Exports	Slightly upward for 2001–2002, thanks to greater access of Ukrainian exporters to foreign markets
Imports	Upward for 2001–2002, due to higher real appreciation of the hryvnia
Inflation	Downward: stabilisation of the exchange rate and growth of the agricultural sector
Exchange rate	Downward: monetary authority transformed into targeting a low inflation rate and exchange rate stability
Loan interest	Downward: lower inflation and a cut in the reserve requirement
Real wage	Slightly upward due to the lower pace of inflation
Unemployment (according to ILO methodology)	Slightly upward due to a higher forecast for the real wage
Budget balance	Upward adjustment of the budget surplus forecast for 2001, due to a decline in the forecast volumes of foreign borrowings
GDP of Ukraine’s major trading partners	Downward: growth slowdown in the US and EU, as well as the crisis in Turkey

Source: Quarterly Predictions.

The risk to our scenario for economic development in 2001—2003 is the return to granting tax privileges and allowing non-cash settlements with the budget. Under these conditions, a budget deficit would be unavoidable, which would again unwind the inflation spiral and utterly undermine the confidence of private investors in the Ukrainian government's policies.

Figure 1. Real GDP

Index, seasonally adjusted, Q1'95=100



Source: State Statistics Committee; forecast by Quarterly Predictions.

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