Quarterly Predictions

#14, January 2001

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Dear readers,

*We apologise for the late publication of this **Quarterly Predictions** issue. This delay was caused by the lack of data on Ukraine's GDP for 2000, which in accordance with the rules of State Statistics Committee should have been published on 10 February 2001. Unfortunately, by 10 March the GDP data was not published; the State Statistics Committee has still not announced when it will be published. Therefore, the 2000 GDP data presented in this issue is our preliminary estimate.*

We certainly hope that such delays are not repeated in the future.

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EXECUTIVE SUMMARY

Overview

In 2001 and 2002, the Ukrainian economy will continue to grow at a high pace. The GDP will increase by 5% and 5.5%, respectively. High increase of domestic demand and productivity of the economy will compensate somewhat deteriorated situation in external market

Reforming natural monopolies

Infrastructure sectors are of critical importance to country's economy. In Ukraine, barely touched by reforms, they are becoming the bottlenecks of the economy. Natural monopolies are present in most of these sectors. The government still lacks a clear vision on which to base its policy towards natural monopolies

Government

In 2001–2002, the budget burden on the economy of Ukraine will lessen; budget revenues will total 26% and 25.5%, respectively. Thanks to the continued deficit-free budget, the resources of the private sector will increase. Implementation of the Budget Code will be an important factor for improving the quality of budget expenditures

Monetary

The hryvnia will gradually appreciate. Interests on loans in national currency will decrease

Prices

In 2001, consumer inflation will total 17.2%. In 2002, thanks to a slowdown in the increase of monetary aggregates and the avoidance of administrative price shocks, the level of inflation will decrease to 13.6%

External

As a result of the deteriorated situation with prices, the growth of exports will slow down over 2001–2002; it will be lower than that of imports—which will increase because of real revaluation of the hryvnia and increased investments in imported equipment

Business

In 2001–2002, Ukrainian enterprises will increase their output, and their financial standing will improve. The development of infrastructure sectors will depend on the government policy with regard to their reform.

Agriculture

The pace at which reforms took place in Ukrainian agriculture during 2000 gives us reasons to expect production growth in 2001 and 2002

Privatisation/ Capital markets

In 2001–2002, revenues generated from the privatisation annually will come to 5.5–6 billion UAH. In 2001, these funds will be provided by privatisation of regional electricity distributing companies (oblenergo) and several big industrial enterprises, while selling "Ukrtelekom" will take place at the beginning of 2002

Labour

Along with increased labour productivity, real wages will grow by 2.5% in 2001 and by 3% in 2002

Households

In 2001, real income of the Ukrainian population will increase by 6.5%, primarily thanks to the development of small business and reduction of the shadow economy. In 2002, real incomes will increase by 7%, while the share of wages in the income of the population will increase, and incomes from property rights will grow

International

The growth of the global economy in 2001 will slow down to 3.4%, because of the slowed growth in the USA. In 2002, the growth rate of the world's real GDP will increase to 3.9%

MAJOR INDICATORS

	1995	1996	1997	1998	1999	2000 (estimate)	2001 (forecast)	2002 (forecast)
Economic activity								
GDP, *millions UAH*	54,516	81,519	93,365	102,593	130,038	175,900	212,400	254,300
Real GDP, *apc**	-12.2	-10.0	-3.0	-1.9	-0.3	6.0	5.0	5.5
Real industrial production, *apc*	-12.0	-5.1	-0.3	-1.0	4.3	12.9	8.0	8.0
Real agricultural output, *apc*	-3.6	-9.5	-1.9	-9.8	-6.9	7.6	4.2	5.8
Gross investment, *% GDP*	26.7	22.7	21.5	20.7	19.8	18.8	19.6	20.7
Direct investments, *millions USD (1)*	257	526	581	747	489	580	1,200	1,300
Real household disposable income, *apc*	-6.3	-12.3	5.1	-5.8	1.2	11.1	6.5	7.0
Real retail turnover, *apc*	-4.3	-11.1	8.2	-3.5	-4.8	7.5	6.0	5.0
Prices								
Consumer price index, *apc*	182	40	10	20	19	26	17	14
Producer price index, *apc*	177	17	5	35	16	21	16	12
Labour market								
Population, *millions*	51.5	51.1	50.5	50.1	49.7	49.3	49.1	48.9
Real wage, *average apc*	9.2	-2.5	-0.4	-2.9	-6.0	1.0	2.5	3.0
Official unemployment rate, %	0.5	1.3	2.3	3.7	4.3	4.2	5.5	7.0
Foreign economic activity								
Exports of goods&services, *apc*	2.7	19.1	0.0	-13.4	-7.9	15.0	4.0	5.0
Imports of goods&services, *apc*	2.9	17.1	-1.1	-17.0	-19.1	12.0	7.0	6.5
Current account balance, *% GDP*	-3.2	-2.7	-2.7	-3.0	2.7	0.8	0.5	0.3
Budget								
Revenues (consolidated), *% of GDP*	30.3	28.2	30.1	28.2	25.3	27.5	26.0	25.5
Current balance, *% GDP*	-6.8	-4.9	-6.8	-2.1	-1.5	0.5	0.1	0.1
Balance by IMF methodology, *% GDP*	—	-3.2	-5.6	-2.7	-2.4	-1.2	-2.6	-2.2
Monetary indicators								
Monetary base, *apc*	132	38	45	22	39	39	22	19
M3, *apc*	113	35	34	25	41	45	30	22
NBU international reserves, *millions USD*	1,069	1,972	2,359	793	1,094	1,539	2,100	2,730
Official exchange rate average annual, *UAH/USD*	1.47	1.83	1.86	2.45	4.13	5.44	5.63	5.86
Interest rate on loans, average annual, *yearly % (2)*	107	77	49	55	53	41	33	29
International								
World GDP, *apc*	3.8	4.3	4.2	2.5	3.3	4.7	3.4	3.9
GDP of Ukraine's major trading partners (2/3 of exports), *apc*	0.6	1.4	0.8	1.3	3.0	5.8	3.8	4.3

* *apc* = annual percentage change

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

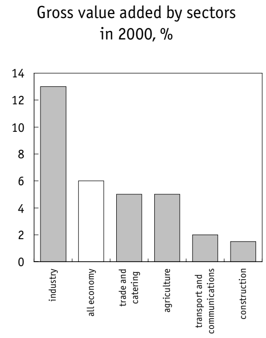
Sources: State Statistics Committee, NBU, and Ministry of Finance; calculations and forecast by Quarterly Predictions.

OVERVIEW

According to our forecast, Ukraine's economy will maintain its high growth rate in 2001 and 2002. In these years, the GDP will increase by 5% and 5.5%, respectively. Quickly rising domestic demand and increased productivity will make up for the downward trend in foreign markets. The key issues for investors will be effective economic policy, political consensus, and inflation control.

There was a continued improvement in economic growth in Q4'00

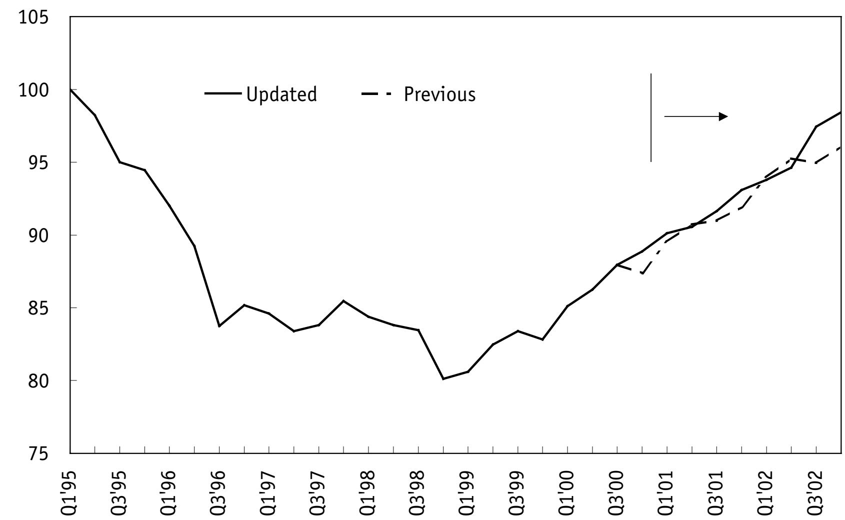
In Q4'00, economic growth in Ukraine continued accelerating. According to our estimate, real GDP in Q4'00 increased by 6.5%[1] compared with the same period in 1999. The increase was mainly due to industrial growth (see **BUSINESS**) and a farming boom (see **AGRICULTURE**).



Calculations by Quarterly Predictions.

Figure 1. Real GDP

Index, seasonally adjusted, Q1'95=100



Source: State Statistics Committee; calculations and forecast by Quarterly Predictions.

GDP increased by 6% in 2000

In 2000, overall GDP growth in Ukraine totalled 6%. Financial stability and a predictable government policy prompted an increase in household consumption (see **HOUSEHOLDS**) and business investment (see **BUSINESS**). The particularly favourable conditions in foreign markets promoted increased exports (see **EXTERNAL**).

Ukraine's high economic growth will be maintained in 2001 and 2002

In our opinion, the high 2000 growth rate increased the confidence of Ukrainian businesspeople. They will aim to achieve even greater profits in upcoming years. The active investment needed to accomplish that will promote increased productivity.

Based on these factors, we forecast that the high growth rate in the Ukrainian economy will stay in 2001 and 2002. The GDP will increase by 5% in 2001 and by 5.5% in 2002. The slower pace in 2001 and the quicker one in 2002 will reflect the trend in the global economy (see **INTERNATIONAL**).

[1] According to the refined State Statistics Committee data, GDP was 5.7% higher in Q3'00 than in Q3'99.

Economic policy in Ukraine, while pursuing the same goals as that in other CEE countries, is not as swift in achieving them

It was not until 2000 that Ukraine had its first year of economic growth. Meanwhile, most Central and Eastern European (CEE) countries achieved growth as early as 1994, with Poland's economy growing steadily since 1992. These accomplishments show that efficient economic policy is crucial for achieving economic growth.

In our opinion, the economic priorities set by the Ukrainian government in 2000 are similar to those pursued by CEE countries. They include:

- *improving public administration;*
- *achieving macroeconomic stability;*
- *improving the budget process and ensuring financial stability;*
- *restructuring and privatising public enterprises and regulating infrastructure sectors;*
- *implementing land reform;*
- *promoting private ownership and enterprise by means of appropriate legislation.*

CEE countries, however, have been more successful than Ukraine in achieving these priorities. They owe this success to adjusting their economic policy towards the goal of European Union membership. With EU support, and under EU pressure, they have reformed their governments and introduced EU legislation. In Ukraine, these processes are still in their infancy.

Table 1. Economic growth in EU candidate countries

% real GDP change

	1996	1997	1998	1999	2000 (estimated)
Countries with over 5 years of growth					
Poland	6.0	6.8	4.8	4.1	5.0
Slovakia	6.2	6.2	4.1	1.9	2.0
Slovenia	3.5	4.6	3.8	4.9	4.5
Hungary	1.3	4.6	4.9	4.5	5.5
Countries with 3–5 years of growth					
Estonia	3.9	10.6	4.7	-1.1	6.0
Latvia	3.3	8.6	3.9	0.1	4.0
Lithuania	4.7	7.3	5.1	-4.2	2.0
Romania	3.9	-6.1	-5.4	-3.2	1.5
Czech Republic	4.8	-1.0	-2.2	-0.2	2.5
Countries with over 1–2 years of growth					
Bulgaria	-10.1	-7.0	3.5	2.4	5.0

Source: Business Central Europe.

Below we will examine new problems and risks that have changed our view of the economic environment in 2001 and 2002 over the last three months.

Quality of government policy

Government decisions became more consistent…

Ukrainian government decisions became more consistent in 2000. The government began to use new procedures in its work. The obvious result was 31% fewer Cabinet resolutions and decisions in 2000, including 57% fewer orders.

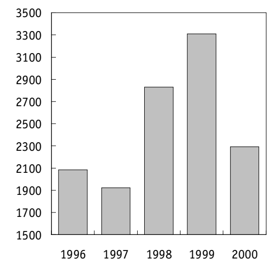
Government committees flushed out inconsistent drafts. Approving decisions only at Cabinet meetings ensured that decisions were in line with the government's declared priorities.

Will there be a further improvement in government efficiency in Ukraine thanks to better enforcement? There are some reasons why the answer is not wholly positive:

…but enforcement is not sufficient

- Considering practicable policy alternatives has yet to become a mandatory procedure at Cabinet decision-making meetings.
- Decisions approved do not usually have an enforcement plan that could foresee the reaction of the various stakeholders, and how the government should respond.
- The government lacks procedures for monitoring implementation and assessing effectiveness.

Number of resolutions and orders by the Cabinet of Ministers of Ukraine



Source: Liha: Law.

These weak points show themselves clearly in the Tax Code situation (see **GOVERNMENT**). In early 2000, the government's draft tax code envisaged drastic tax cuts. But no practicability analysis was made at the time, and as a result, the code, which had been approved in the first reading, must now be revised to prevent significant budget losses. Such inconsistency can make tax policy a risk factor for companies taking business decisions.

In addition, weak enforcement of economic policy undermines investors' confidence in Ukrainian reforms.

Political consensus

Political instability has been another reason for the lack of investor confidence in Ukraine. Firstly, it jeopardises the consensus between the executive and the legislature on reforms achieved in 2000. Secondly, it results in delaying the passage of key legislation (in particular, a new reading of the Civil Code) through the Verkhovna Rada.

Political discussion can stimulate positive changes

At the same time, present political discussion in Ukraine may promote some positive changes:

- creating conditions for implementing the basics of public policy: public balancing of policy goals and strategies of various political groups;
- increasing transparency of interaction between government bodies;
- stricter accountability of government agencies, such as the new procedure to put the State Tax Administration and customs under the Ministry of Finance's supervision.[2]

[2] For arguments in favour of this measure, see *Quarterly Predictions*, July 2000 (p.22).

Bottlenecks of Ukrainian economy

The weakness of Ukraine's infrastructure sectors (power engineering, transport, communications, gas and water supply) can become a drag on the growth of the rest of the economy. A common problem for all the above sectors is the lack of investment, which undermines their ability to provide services to other sectors. Dealing with this problem involves changing the infrastructure sectors' ownership, management and regulation. These changes would attract more investment into these sectors.

Another feature, common for all infrastructure sectors is natural monopoly, which creates or a unified approach to these sectors. There is abundant international experience of government policy and policy in natural monopolies. We examine this experience and how it could be used in Ukraine in ***REFORMING NATURAL MONOPOLIES****.*

Financial stability

Can inflation be reduced substantially in 2001 and 2002?

Accumulation of NBU monetary reserves will make impossible a quick reduction in inflation…

Reducing inflation and replenishing NBU monetary reserves were set as Ukraine's medium-term economic goals in the letter of intent to the IMF. But these are largely mutually exclusive goals. In our opinion, in 2001 and 2002 the NBU will focus on replenishing its reserves, which means extensive purchase of exchange (see **MONETARY**). This will make impossible any quick reduction of inflation (see **PRICES**).

Raising productivity will be another key factor in decreasing inflation. For example, a productivity increase in agriculture would cut price shock risks stemming from the deficit of farm produce.

…and will keep the hryvnia losing its nominal value at a reasonable rate

NBU's purchase of currency will keep the hryvnia losing its nominal value at a reasonable rate. We do not foresee any material fluctuations of the exchange rate during the forecast period. The high inflow of exchange will make a fall of the hryvnia unlikely. There will be a certain risk of revaluation at the moments of peak proceeds from privatisation.

Market conditions

A higher domestic demand in 2001 will make up for the somewhat worse conditions in foreign markets

According to our forecast, a much higher domestic demand in 2001 will make up for the somewhat worse conditions in foreign markets. A December 2000 consumer poll gives proof to this prediction. It showed that consumers had much better expectations for 2001, as a large part of the high hopes comes from the less-well-to-do Ukrainians.[3] This means that there will be a higher demand for domestic products.

For export-oriented sectors, demand will be smaller in 2001 than in 2000. We nevertheless predict that the new owners of these sectors' privatised enterprises will insist on investing in order to ensure long-term competitive ability on export markets. If they do, the increased volume of Ukrainian exports will make up for the losses caused by its lower prices (see **EXTERNAL**). The risk of this forecast is worse-then-predicted conditions in foreign

[3] See *Consumer Confidence*, January 2001.

markets, which could be caused, in particular, by U.S. economy's crash landing or Russia's recession.

Export growth will accelerate again in 2002

According to our forecast, the global economy's growth will accelerate again in 2002. The ability of Ukrainian enterprises to adapt quickly to changing external demand will reflect in the quality of investments made in 2000 and 2001. Exports will grow, but import growth will outpace it, bringing the trade balance down.

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 January 31, 2001.

Quarterly Predictions activities are financed by the Open Society Institute.

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The above specialists and members of the ICPS Board of Directors are not responsible for the forecasts and conclusions published in **Quarterly Predictions.**

Information for **Quarterly Predictions** is provided by the State Statistics Committee of Ukraine, the National Bank of Ukraine, Infobank, Ukrainian News, and Reuters.

Printed in Ukraine by Pekotoff-print

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