

# ***Quarterly Predictions***

*#13, October 2000*

## **Contents**

<i>List of tables.....</i>	<i>2</i>
<i>List of figures.....</i>	<i>2</i>
<i>List of boxes .....</i>	<i>3</i>
<i>Executive summary .....</i>	<i>4</i>
<i>Major indicators .....</i>	<i>5</i>
<i>Overview .....</i>	<i>6</i>
<i>Government.....</i>	<i>10</i>
<i>Monetary .....</i>	<i>17</i>
<i>Prices.....</i>	<i>23</i>
<i>External.....</i>	<i>26</i>
<i>Business .....</i>	<i>34</i>
<i>Agriculture.....</i>	<i>43</i>
<i>Privatisation/Capital markets .....</i>	<i>50</i>
<i>Labour.....</i>	<i>58</i>
<i>Households.....</i>	<i>62</i>
<i>International.....</i>	<i>67</i>
<i>Statistical appendix .....</i>	<i>72</i>

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## List of tables

Table 1. Changes in economic outlook for 2000–2002.....	8
Table 2. Changes in policy outlook for 2000–2002.....	9
Table 3. Consolidated budget revenues.....	10
Table 4. Foreign financing of the budget in 2000–2002.....	13
Table 5. Producer prices by industry.....	25
Table 6. Commodity exports, by group.....	30
Table 7. Commodity imports, by group.....	31
Table 8. Output of goods and services in selected economic sectors.....	35
Table 9. Industrial output.....	37
Table 10. Investment by sector.....	40
Table 11. Structure of money income in January–September 2000.....	63
Table 12. Assessing the impact of a 10% increase in world oil price on inflation and GDP.....	69

## List of figures

Figure 1. Real GDP.....	6
Figure 2. Contributions to GDP growth.....	7
Figure 3. Consolidated budget revenues.....	12
Figure 4. Composition of budget expenditures.....	15
Figure 5. Monetary aggregates.....	18
Figure 6. Hryvnia exchange rate trend.....	20
Figure 7. Commercial bank lending rates to economic entities, August 2000.....	21
Figure 8. Breakdown of consumer price index (CPI).....	23
Figure 9. Consumer and producer price indexes (CPI and PPI).....	24
Figure 10. Current account balance and trade balance.....	27
Figure 11. Commodity exports and imports.....	31
Figure 12. Industrial output.....	34
Figure 13. Output by industry in 2000.....	36
Figure 14. Structural changes in the industrial sector.....	36
Figure 15. Payments for industrial goods shipped.....	38
Figure 16. Gross investments.....	39
Figure 17. Composition of investments by sector.....	41
Figure 18. Net foreign direct investment.....	42
Figure 19. Agricultural production.....	45
Figure 20. Production of major crops.....	46
Figure 21. Changes in the number of livestock head.....	49
Figure 22. Privatisation proceeds.....	52

Figure 23. PFTS hryvnia index .....	56
Figure 24. Real wage .....	58
Figure 25. Employee breakdown by wage .....	59
Figure 26. Official unemployment rate.....	60
Figure 27. Reasons for unemployment according to results of a random survey of the labour force in 1999.....	61
Figure 28. Real disposable income .....	62
Figure 29. Real consumption.....	64
Figure 30. Real disposable income and real consumption .....	65
Figure 31. Household income, consumption, and savings.....	65
Figure 32. World economic growth in 1980–2001 .....	67
Figure 33. GDP by world region .....	70

## List of boxes

Restructuring the government debt to the NBU .....	19
Regulation of scrap metal trade will not protect domestic producers .....	29
Should the “Odesa–Brody” oil pipeline be completed? .....	33
Policy of government support of agriculture in 2001–2004: Quality and effectiveness.....	44
Chances improving for successful privatisation of the electricity sector .....	51
Evaluation as a first step towards effective management.....	54
High oil prices spur inflation.....	68

# EXECUTIVE SUMMARY

<b>Overview</b>	We have significantly improved our forecast: GDP will grow by 5% in 2000 and by 4.5% in both 2001 and 2002
<b>Government</b>	A more realistic budget has created conditions for decreasing the tax burden and maintaining a surplus. We forecast that these processes will persist in 2001–2002. Consolidated budget revenues in 2002 will decrease to 25.5% of GDP, but the deficit will not exceed 0.5%
<b>Monetary</b>	As a result of accelerated economic growth, real demand for money will increase, while lending rates will gradually decrease. The real hryvnia exchange rate will grow
<b>Prices</b>	As a result of a slowdown in the growth of monetary aggregates, and the absence of administrative price shocks, inflation in 2001 and 2002 will decrease to 17.5% and 13%, respectively
<b>External</b>	Economic growth in countries which are trade partners of Ukraine has resulted in substantial commodity exports in 2000. In 2001–2002, imports will increase faster than exports, which will grow slowly
<b>Business</b>	Increased domestic and stable external demand, as well as high investment activity of enterprises, will prompt growth in Ukraine's economy during the next two years. Simultaneously, dynamic structural changes will take place: thanks to privatisation and effective market regulation in basic sectors of the economy, the pace of growth in different sectors will level out
<b>Agriculture</b>	In 2001 and 2002, the country will reap the advantages of private ownership and market methods of government regulation. This will result in increased output—by 5% in 2001 and 6.5% in 2002
<b>Privatisation/ Capital markets</b>	Privatisation proceeds will total 6.25 billion UAH in 2001 and 7 billion UAH in 2002. The majority of the proceeds will come from privatisation of the oblenergos. Ukrtelekom will be sold to a strategic investor at the beginning of 2002, and electricity-distributing companies will be sold in the second half of 2002
<b>Labour</b>	In 2000–2002, wages will increase, thanks to increased demand for labour and gradual growth of productivity. Accelerated economic growth will foster the reduction of real unemployment
<b>Households</b>	Thanks to the rapid increase in real wages and expansion of social programs, growth of real disposable incomes will accelerate in 2001 and 2002 by 6.5% and 7%, respectively. Real consumption will increase annually by 6%; the share of durable goods in consumption will increase
<b>International</b>	We have improved our forecast regarding development of the world economy. GDP of Ukraine's major trade partners in 2000–2002 will increase faster than the world economy overall—by 4.7% in 2000, 4.1% in 2001, and 3.8% in 2002

# MAJOR INDICATORS

	1995	1996	1997	1998	1999	2000 (forecast)	2001 (forecast)	2002 (forecast)
<b>Economic activity</b>								
GDP, millions UAH	54,516	81,519	93,365	102,593	127,126	168,300	206,400	247,700
Real GDP, <i>apc</i> *	-12.2	-10.0	-3.0	-1.9	-0.4	5.0	4.5	4.5
Real industrial production, <i>apc</i>	-12.0	-5.1	-0.3	-1.0	4.3	10.0	8.5	7.0
Real agricultural output, <i>apc</i>	-3.6	-9.5	-1.9	-9.8	-5.7	-0.5	5.0	6.5
Gross investment, % GDP	26.7	22.7	21.5	20.7	19.8	18.6	19.1	19.9
Direct investments, millions USD (1)	257	526	581	747	489	700	1,200	1,300
Real household disposable income, <i>apc</i>	-6.3	-12.3	5.1	-5.8	1.2	6.0	6.5	7.0
Real retail turnover, <i>apc</i>	-4.3	-11.1	8.2	-3.5	-4.8	6.0	5.0	6.0
<b>Prices</b>								
Consumer price index, <i>apc</i>	182	40	10	20	19	28	18	13
Producer price index, <i>apc</i>	177	17	5	35	16	20	15	12
<b>Labour market</b>								
Population, millions	51.5	51.1	50.5	50.1	49.7	49.4	49.1	48.9
Real wage, average <i>apc</i>	9.2	-2.5	-0.4	-2.8	-5.7	1.0	2.5	3.0
Official unemployment rate, %	0.5	1.3	2.3	3.7	4.3	5.5	6.0	8.0
<b>Foreign economic activity</b>								
Exports of goods&services, <i>apc</i>	2.7	19.1	0.0	-13.4	-7.9	7.6	3.7	3.2
Imports of goods&services, <i>apc</i>	2.9	17.1	-1.1	-17.0	-19.1	7.2	4.8	5.3
Current account balance, % GDP	-3.2	-2.7	-2.7	-3.0	2.7	2.7	2.5	0.9
<b>Budget</b>								
Revenues (consolidated), % of GDP	30.3	28.2	30.1	28.2	25.9	27.5	26.0	25.5
Current balance, % GDP	-6.8	-4.9	-6.8	-2.1	-1.5	0.4	0.6	-0.5
Primary balance, % GDP (2)	-2.2	-1.9	-3.6	0.2	0.9	2.9	3.6	2.5
<b>Monetary indicators</b>								
Monetary base, <i>apc</i>	132	38	45	22	39	28	22	16
M3, <i>apc</i>	113	35	34	25	41	34	24	18
NBU international reserves, millions USD	1,069	1,972	2,359	793	1,094	1,050	1,490	1,780
Official exchange rate average annual, UAH/USD	1.47	1.83	1.86	2.45	4.13	5.50	6.38	7.00
Interest rate on loans, average annual, yearly % (3)	107	77	49	55	53	42	36	30
<b>International</b>								
World GDP, <i>apc</i>	3.8	4.3	4.2	2.5	3.3	4.5	4.2	3.9
GDP of Ukraine's major trading partners (2/3 of exports), <i>apc</i>	0.6	1.4	0.8	1.3	3.0	4.7	4.1	3.8

\* *apc* = annual percentage change

Notes: (1) according to NBU  
(2) current balance plus state debt servicing  
(3) commercial banks loans, hryvnias

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

# OVERVIEW

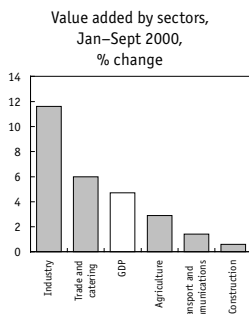
We have improved our economic forecast significantly: GDP will grow by 5% in 2000 and by 4.5% in 2001 and 2002, prompted by increased domestic demand and productivity. The major risk to our forecast is weak government capacity to make consistent policy and defend it in front of the opposition and the public.

## Business performance

**In Q3'00, economic growth accelerated**

In Q3'00, economic growth in Ukraine continued accelerating. Real GDP increased by 5% y-o-y<sup>1</sup> (in Q2'00, this indicator totalled 4.5%).

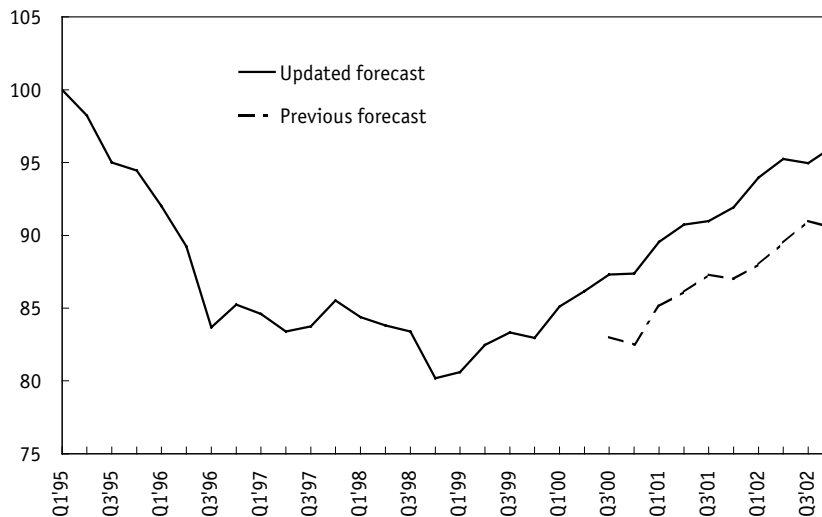
Value added increased in all sectors of the economy, without exception. The highest growth rate was observed in industry, and the lowest in construction (see **BUSINESS**). Agricultural output growth resulted from unexpectedly high yields of vegetables, oilseeds, corn, and sugar beets (see **AGRICULTURE**).



Source: State Statistics Committee.

**Figure 1. Real GDP**

Index, Q1'95=100, seasonally adjusted



Source: State Statistics Committee; forecast by Quarterly Predictions.

**According to our forecast, GDP will grow by 5% in 2000**

According to our forecast, GDP in 2000 will increase by 5%. More specifically, industrial growth will total 10% (see **BUSINESS**) and agricultural output will decrease by 0.5%, due to the decline in grain crops and livestock (see **AGRICULTURE**).

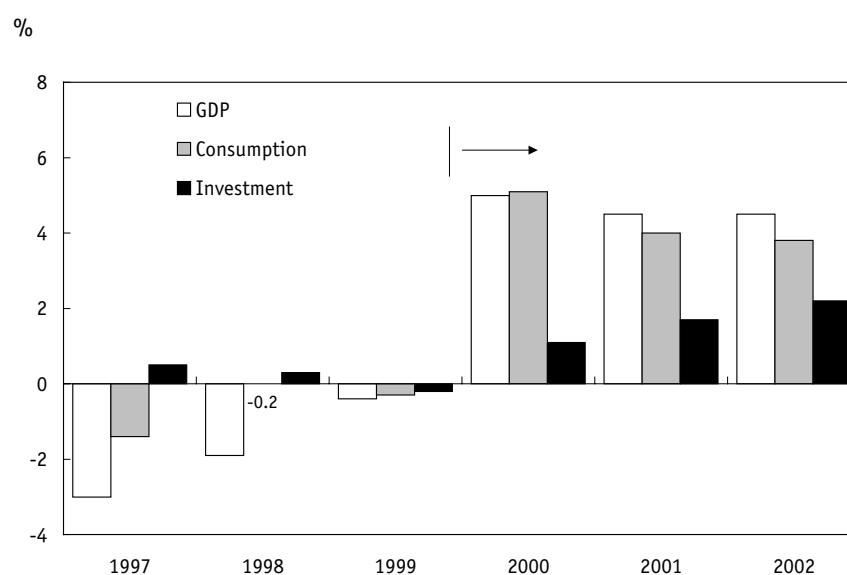
We explain the outstanding revival of business activity in 2000 by the following reasons:

- expansion in domestic demand. As a result of increased real wages, small business development, and repayment of budget debts on social welfare, household incomes grew by 11.8% during the first 9 months of 2000 (see **HOUSEHOLDS**);

<sup>1</sup> During the first 9 months of 2000, overall GDP growth totalled 5%.

- increase in investment resources at enterprises as a result of stable tax and budget policy. Firstly, the tax burden has decreased in 2000 thanks to cancellation of the “highway levy,” the reduction of the number of excisable commodities, and progress in VAT refunds from the budget. Secondly, this year’s strict budget policy (compared to last year’s) enabled a decrease in loan interest rates (see **GOVERNMENT**);
- financial stability. The exchange rate was predictable, while monetary policy was more consistent, and monetary expansion had a stimulating effect (see **MONETARY**);
- favourable conditions in foreign markets (see **INTERNATIONAL**). Despite the increase in world oil prices, the global economy continued to grow (see **INTERNATIONAL**).

*Figure 2. Contributions to GDP growth*



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

Thanks to the influence of these factors, enterprises have been adapting to market conditions more easily. Reacting to increased demand, managers of enterprises have invested in new equipment (see **BUSINESS**) and hired more skilled employees (see **LABOUR**).

We forecast that the economic growth factors will persist in 2001–2002. External market conditions will deteriorate slightly, but will still be favourable. At the same time, domestic demand will grow, both on the part of households and on the part of businesses. The tax burden will decrease and budget policy will remain strict (see **BUDGET**). The growth of domestic demand will result in increased imports (see **EXTERNAL**). GDP will increase by 4.5% in 2001 and again by 4.5% in 2002.

***Within the next two years, GDP will grow by 9%***

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*Table 1. Changes in economic outlook for 2000–2002*

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Variable	Revised forecast
GDP	Will increase faster, because of high domestic and stable external demand, and thanks to productivity growth
Private consumption	Will grow faster, thanks to increased income from entrepreneurial activity and improved expectations
Public consumption	Will increase in 2000 as a result of budget revenue growth; forecast for 2001–2002 remains unchanged
Investment	Will increase faster, due to higher profits and higher volume of FDI in 2001–2002
Export	The forecast for 2000–2001 is adjusted upward, since foreign markets will continue to be favourable. No change for the 2002 forecast
Import	Will increase faster in 2000–2001, because of increased growth in domestic demand. No change for the 2002 forecast
Inflation	Will be higher, as a result of sluggish expectations and demand pressure
Exchange rate	The rate will drop, since foreign currency inflow will increase
Unemployment (according to the labour force survey)	Slightly increased, as a result of higher mobility of employees
Wages	No change
Budget balance	No change
GDP of trading partners	The forecast is adjusted upward, mainly because of accelerated growth in the Russian economy

Source: Quarterly Predictions.

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## Economic environment

In our forecast, we specially note to the growth of productivity. The high level of domestic demand, along with long-term growth, will result from improved ability of the economy to produce goods and services in a more efficient way.

*Since the end of 1999, the productivity of Ukraine's economy has been increasing*

In our opinion, the trend of continued productivity growth began in Q4'99. Since that time, GDP in Ukraine has been growing faster than the number of hours worked at enterprises. The efficiency of the economy has increased, thanks to improvements in management and new owners, as well as investment growth (see **BUSINESS**).

**Table 2. Changes in policy outlook for 2000–2002**

Variable	Forecast
Political stability	Agreement on the 2001 budget will be evidence of a framework consensus regarding reforms reached by all arms of government. Opposition criticism will increase as the 2002 parliamentary elections approach. The poor ability of the government to deal with this criticism can pose a risk to political stability
Consistency of legislative framework	Civil and Customs Codes will be adopted in 2001. Uncertainty will persist until the Tax and Land Codes are passed in 2002
Business development	More consistent regulations will foster adaptation of economic entities to market conditions. However, new government capacity to develop “rules of the game” will be slow to appear
Privatisation	For the first time, the government will privatise natural monopolies. Electricity-distributing companies will be sold in 2001, and Ukrtelekom in 2002. Preparations will start for transferring gas-transport pipelines to investors
Integration in the world economy	The government will gradually reduce protectionist measures while preparing the country to join the WTO
Debt burden	Realistic budget policy will allow decreasing the debt burden. IMF will renew EFF program; this will allow the government to restructure its debt to the Paris Club

Source: Quarterly Predictions.

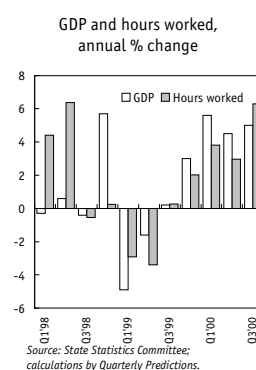
Government policy will be an important factor for the further growth of productivity. Firstly, in pursuing a strict budget policy and gradually decreasing the tax burden, the government will prompt further investment growth. Secondly, by introducing WTO and EU standards, Ukraine will spur domestic competition, as well as shape Ukraine’s competitive advantage necessary for successful integration into the world economy (see **INTERNATIONAL**). In this situation, productivity growth will be the most effective way to ensure the competitiveness of Ukrainian enterprises.

In 2001–2002, effective privatisation of natural monopolies will be a criterion for evaluating the success of economic policy. Natural monopolies belong to the infrastructure sector and their development, therefore, will determine the sustainability of economic growth. Ukraine will fully benefit from privatisation of natural monopolies only if effective regulations protecting public interests and stimulating efficient use of resources are introduced in these sectors.

The major risk to our forecast is the government’s poor capacity to develop consistent policy and defend its policy in front of the opposition and the public.<sup>2</sup> The threat of this risk will be increasing as the 2002 parliamentary elections approach. The lack of government capacity to deal with these problems can increase uncertainty in the business environment. This uncertainty, in turn, will restrain consumption and investment. Furthermore, Ukraine will continue to lose the confidence of international investors and will not be able to combat deteriorated conditions in the international market.

<sup>2</sup> See *Policy Studies*, November 1999.

**Further productivity growth will depend on effectiveness of economic policy**



**The major risk to our forecast is poor government ability to develop and defend policy**

**QUARTERLY PREDICTIONS** was established by the International Centre for Policy Studies in cooperation with the New Zealand Institute of Economic Research in September 1997.

**QUARTERLY PREDICTIONS** provides our forecast of Ukraine's economy based on comprehensive research of all its sectors. The forecast is an assessment, based on the information available on a specified date. This issue was prepared using information available up to October 31, 2000.

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