

Quarterly Predictions

#11, April 2000

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EXECUTIVE SUMMARY

Overview	We have adjusted our forecast for real GDP growth in Ukraine upwards: it will reach 2% in 2000 and 3% in 2001.
Contract Enforcement	Poor contract enforcement is one of the most serious impediments to stable economic development. We forecast that contract enforcement in Ukraine will improve over 2000–2001, thanks to improvements in the relevant legislation.
Government	We forecast that budget revenues will amount to 26.5% of GDP this year and 26.8% of GDP in 2001. A budget surplus will be attained—0.4% of GDP this year and 0.7% of GDP in 2001.
Monetary	The hryvnia will depreciate by 21% (to 6.3 UAH/USD) in 2000 and by 14% (to 7.2 UAH/USD) in 2001. The money supply growth will decelerate to 25% in 2000, and further to 18% in 2001.
Prices	Inflation will reach 18.6% this year. In 2001, inflation in the consumer market will amount to 13.7%, thanks to abating hryvnia depreciation and a diminishing increase in money supply.
External	Over 2000–2001, foreign trade turnover will increase by 3% annually. Though still positive, the current account balance will decrease to 640 million USD in 2000 and to 470 million USD in 2001.
Business	Buoyant expectations of entrepreneurs, financial stability, and investment inflow will ensure rapid production growth in 2000–2001. Industrial output will increase by 4% in 2000 and by 5% in 2001.
Agriculture	Active reorganisation of collective farms in the midst of the spring agricultural season, given an underdeveloped land market and chaotic regulation of the agricultural commodity market, will lead to a decline in agricultural output of 5% in 2000. The first positive results of the reforms will be seen in 2001: gross agricultural output will increase by 5% over the year.
Privatisation	Over the next two years, budget revenues from privatisation, including the sale of Ukrtelekom and privatisation of electricity companies, will amount to 6.5 billion hryvnias. In 2000–2001, stock prices will increase to 85% and 50%, respectively.
Labour	Reviving economic activity and improving quality of investments will have a positive effect on labour productivity. Unemployment will continue to rise, however, since cost optimisation will force enterprises to lay off surplus labour.
Households	Real disposable household income will grow by 3% in 2000, due to the legalisation of “shadow” incomes, development of small business, and attempts of the government to make all social payments envisioned in the budget; in 2001, after an increase in real wages, the growth will accelerate to 4%.
International	World GDP growth will be 4.2% in 2000 and 3.9% in 2001.

MAJOR INDICATORS

	1994	1995	1996	1997	1998	1999	2000 (forecast)	2001 (forecast)
Economic activities								
GDP, millions UAH	12,038	54,516	81,519	93,365	102,593	127,126	159,200	185,500
Real GDP, <i>apc</i> *	-22.9	-12.2	-10.0	-3.0	-1.9	-0.4	2.0	3.0
Real industrial production, <i>apc</i>	-27.3	-12.0	-5.1	-1.8	-1.5	4.3	4.0	5.0
Real agricultural output, <i>apc</i>	-16.5	-3.6	-9.5	-1.9	-9.8	-5.7	-5.1	5.0
Gross investment, % of GDP	35.3	26.7	22.7	21.5	20.7	19.8	20.1	20.8
Foreign direct investment, millions USD (1)	151	257	526	681	747	437	700	1,100
Real household disposable income, <i>apc</i>	-33.8	-6.3	-12.3	5.1	-5.8	1.2	3.0	4.0
Real retail turnover, <i>apc</i>	-8.2	-4.3	-11.1	8.2	-3.5	-4.8	8.0	5.0
Prices								
Consumer price index, <i>apc</i>	401	182	40	10	20	19	19	13
Producer price index, <i>apc</i>	600	177	17	5	35	16	18	14
Labour market								
Population, millions	51.7	51.5	51.1	50.5	50.1	49.8	49.4	49.1
Real wage, average <i>apc</i>	10.7	9.2	-2.5	-0.4	-2.8	-5.7	1.5	2.5
Official unemployment rate, %	0.3	0.5	1.3	2.3	3.7	4.3	6.0	8.0
Foreign economic activities (1)								
Exports of goods&services, <i>apc</i>	-	2.7	19.1	0.0	-13.4	-7.9	2.6	2.6
Imports of goods&services, <i>apc</i>	-	2.9	17.1	-1.1	-17.0	-19.1	3.3	4.0
Current account balance, % of GDP	-5.0	-3.2	-2.7	-2.7	-3.0	2.7	2.3	1.7
Budget								
Revenues (consolidated), % of GDP	36.0	30.3	28.2	30.1	28.2	25.7	26.5	26.8
Current deficit, % of GDP	9.3	6.8	4.9	6.8	2.1	1.5	-0.4	-0.7
Primary deficit, % of GDP (2)	8.6	2.2	1.9	3.6	-0.2	-0.8	-3.8	-3.7
Monetary indicators								
Monetary base, <i>apc</i>	500	132	38	45	22	39	21	16
M3, <i>apc</i>	600	113	35	34	25	40	25	18
NBU international reserves, millions USD	664	1,069	1,972	2,359	793	1,094	1,240	1,740
Official exchange rate, average annual, UAH/USD	0.32	1.47	1.83	1.86	2.45	4.13	5.76	6.8
Interest rate on loans, average annual, yearly % (3)	202	107	77	49	55	53	43	35
International								
World GDP, <i>apc</i>	4.0	3.8	4.3	4.2	2.5	3.3	4.2	3.9
GDP of Ukraine's major trading partners (2/3 of exports), <i>apc</i>	-3.7	0.6	1.4	0.8	1.3	3.0	3.7	3.4

* *apc* = annual percent change

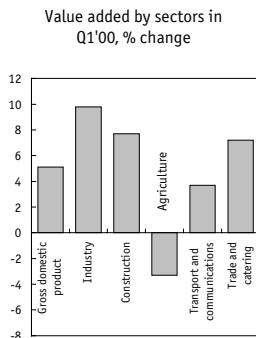
Notes: (1) according to NBU
(2) current deficit minus state debt servicing
(3) commercial bank loans, hryvnias

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

OVERVIEW

We have adjusted our forecast for GDP growth in Ukraine upwards: it will reach 2% in 2000 and 3% in 2001. Improved economic policy will lead to a rise in demand and an increase in productivity across the economy.

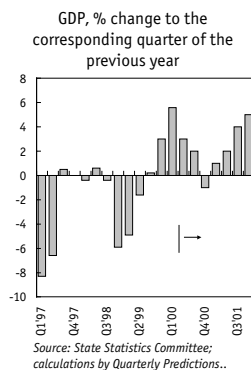
Real GDP increased by 5.6% in Q1'00



Source: State Statistics Committee

In Q1'00, real GDP grew by 5.6% y-o-y. In our opinion, the economic revival resulted from the following:

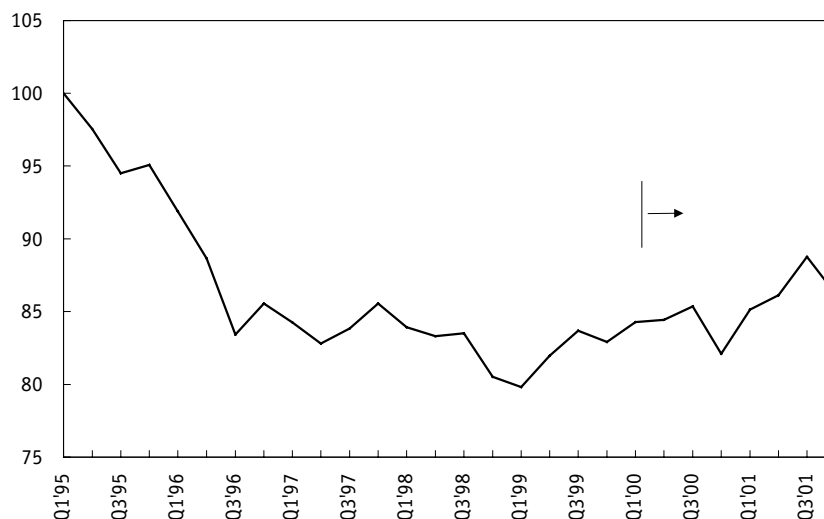
- Household consumption increased for the first time since the 1998 financial crisis. This indicates that households have positive expectations regarding their future incomes. Light industries benefited most from an increase in domestic demand, as they managed to raise profitability and improve technologies on the wave of import substitution.
- Conditions in foreign markets remained favourable. High global demand for metal products stimulated Ukrainian metalworks to increase their exports.
- National economic policy improved, due to the achievement of political consensus among the arms of government. First, the re-election of Leonid Kuchma as President, and formation of the new Cabinet of Ministers headed by Viktor Yushchenko, affirmed the irrevocability of market reforms in Ukraine. Second, the government attained macroeconomic stability in the country by means of strict budget policy and the restructuring of foreign debts to private lenders. Third, the introduction of a simplified tax system helped small businesses reduce their costs of tax accounting.



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

Figure 1. Real GDP

Index [Q1'95 = 100], seasonally adjusted



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

We have adjusted our forecast for GDP growth in Ukraine upwards in 2000 and 2001, as the rise in demand will be matched by an increase in productivity across the economy, as well as by improvements in economic policy. GDP growth will reach 2% in 2000 and 3% in 2001. We build our forecast on the following assumptions:

*Real GDP will grow by
2% in 2000 and by 3%
in 2001*

1. INCREASING PRODUCTIVITY:

- The household and business sectors have adjusted to market conditions, and have acquired a certain amount of experience. This will strengthen competition in domestic markets.
- Deepening and accelerating privatisation. Explicitly defined property rights, through the concentration of stock in private hands, will encourage entrepreneurs to invest in the long-run development of their businesses.
- Investment inflow. If the initiated reforms are implemented and the business climate is improved in the future, domestic and foreign investors will support economic recovery in Ukraine, despite the potential refusal of international financial organisations to renew their lending programs.
- Improving contract enforcement. We consider poor contract enforcement to be one of the main impediments to the effective functioning of the Ukrainian economy, since it has caused an accumulation of debts and worsened the investment climate. We forecast that contract enforcement will improve over 2000–2001, thanks to the fine-tuning of relevant legislation (see our special chapter on **CONTRACT ENFORCEMENT**).

2. CONSISTENT ECONOMIC POLICY:

- Consensus of the legislative and executive branches of power regarding reforms. Consistent economic policy can now be implemented, thanks to the support of the President and approval of the Government Action Program by the Verkhovna Rada. General agreement on the strategy and collaboration of the two branches will allow creating an integral legal framework for business development. We anticipate that the Verkhovna Rada will approve the Tax Code and the new Civil Code during 2000–2001.
- New procedures for the development and approval of government decisions. These procedures must create conditions for the effective and open discussion of state policy by all interested parties.

The risks to our forecast are the following:

- Reforms may lose public support if routine decisions discord with the Government Action Program. Reforms will not bring positive results if the government makes ill-considered decisions and fails to conform to formal procedures.
- Inconsistent government policy for contract enforcement in the power sector. The ongoing energy crisis threatens economic growth and social stability.

How to improve the decision-making process in the government

Inconsistent economic policy is the key factor that restrains economic growth. Consistency may be attained only by the creation of decision-making procedures that would harmonise the government's daily decisions with the long-term strategy. The existing procedures do not allow the government to focus on priorities, properly manage the agenda, or establish an effective and transparent process for reconciling various interests.

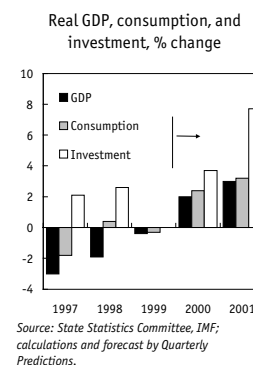
The most important condition for the improvement of the decision-making process is to prevent decisions being made outside properly constituted Cabinet of Ministers' meetings. During the last several years, many government decisions and resolutions have been approved without being discussed at a Cabinet of Ministers' meeting.¹ Instead, draft normative acts were simply signed by members of the Cabinet of Ministers and the Prime Minister. Informal consultations and hasty counter-signing of multiple drafts cannot be called careful and well controlled government work. The Cabinet of Ministers should change its working procedures, and it should process other types of documents.

The new Cabinet headed by Viktor Yuschenko started changing decision-making procedures, and the Resolution "On government committees" was issued on February 17, 2000. According to this document, four profile committees have been created within the Cabinet of Ministers. The resolution also envisions that "draft normative acts and other documents can be submitted to the Cabinet of Ministers for consideration only if these documents have been approved by the respective government committee". The new government is trying to develop decision making as a collective process, with obligatory preliminary discussions in committees and Cabinet of Ministers' meetings. However, the Cabinet of Ministers' regulations have not been approved yet, and no formal procedures have been set for it.

Besides, instead of considering draft normative acts, the Cabinet of Ministers should work with analytical documents which pose a problem and contain an analysis of alternative solutions to it. Political leaders should not be expected to be specialists in their field or responsibility, and certainly should not be expected to be good lawyers, able to assess normative acts. The job of political leaders is to consider professional advice offered to them and to make decisions about policy options available to the government; implementation of these decisions through normative acts and administrative measures should be left to the Secretariat of the Cabinet of Ministers and the respective ministries.

¹ The only document that regulates the Cabinet of Ministers' work is the Resolution "On the organisation of the Cabinet of Ministers' work" dated July 8, 1993, but it does not regulate the Cabinet's decision-making process. The Law "On the Cabinet of Ministers" addressed the issue only partially. Article 52 of the draft law determined that "the Cabinet of Ministers approves decisions and resolutions through voting at Cabinet of Ministers' meetings". The law, however, has not become effective, as the President vetoed it.

- Failure to complete reforms in the agricultural sector. There is no guarantee that the reorganisation of collective agricultural enterprises will help to increase productivity in the sector, under conditions of an underdeveloped land market infrastructure and chaotic regulation of the agricultural produce market.
- The absence of external support of reforms. If the IMF Extended Fund Facility program and projects of the World Bank are not renewed, Ukraine will face significant difficulties in repaying its foreign debts. Under these conditions, macroeconomic stability will be threatened, as international reserves shrink, the hryvnia exchange rate becomes even more volatile, and expectations of economic agents worsen.
- Ukraine may see worsening conditions in world markets. Since Ukraine's foreign trade turnover exceeds GDP, fluctuations in world markets can affect the financial situation of domestic enterprises significantly.



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