

# ***Quarterly Predictions***

*#6, January 1999*

## ***Contents***

<i>Executive summary.....</i>	<i>2</i>
<i>Major indicators.....</i>	<i>3</i>
<i>Overview .....</i>	<i>4</i>
<i>Government.....</i>	<i>8</i>
<i>Monetary.....</i>	<i>15</i>
<i>Prices .....</i>	<i>22</i>
<i>External.....</i>	<i>26</i>
<i>Business .....</i>	<i>31</i>
<i>Agriculture .....</i>	<i>42</i>
<i>Equity .....</i>	<i>50</i>
<i>Labor.....</i>	<i>57</i>
<i>Households.....</i>	<i>64</i>
<i>International.....</i>	<i>74</i>
<i>Statistical appendix.....</i>	<i>77</i>

***International Centre  
for Policy Studies***

*8/5 Voloska St., Kyiv, 254070 Ukraine*

**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. This issue was prepared using information available up to February 1, 1999.

**QUARTERLY PREDICTIONS** is financed by the Open Society Institute.

**QUARTERLY PREDICTIONS** team: Andriy Boitsun, Serhiy Il'chuk, Dmytro Koshovy, Inna Lunina, Vitalij Nosov, Oksana Popruga (English version editor), Hlib Vyshlinsky (Publications Director), Vassyl Yurchyshyn (Project Co-ordinator).

**QUARTERLY PREDICTIONS** advisors: John Hansen, Diana Cook, Bess Lincourt, Ivanna Nevidomska, Oleksij Sekarev, Maryna Shapovalova, Oleksander Shevtsov, Yevhen Shkraban, Ihor Shumylo, John Tedstrom, Olexander Zayets, Olena Zhutayeva.

Our special thanks for assistance and advice go to Mykola Bilenky, Oleksander Kaliberda, Dmytro Konyk, Juergen Konrad, Dmytro Konyk, Kateryna Krasnova, Arvo Kuddo, Augusto Lopez-Claros, Victor Lysytsky, Michael Marrese, Serhiy Mykhailychenko, Borys Nadtochy, Oleksander Pyvovarsky, Volkhart Vincentz, Volodymyr Yatsenko, and all ICPS staff.

The above specialists are not responsible for estimates and judgement published in **QUARTERLY PREDICTIONS**.

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

Printed in Ukraine by Pekotof printers

Our address: 8/5 Voloska St., 254070 Kyiv, Ukraine

Tel. +38044 463 6337 Fax: +38044 463 5970.

E-mail: qp@icps.kiev.ua

© 1999 International Centre for Policy Studies

All quotations must be supplied with references to **QUARTERLY PREDICTIONS**.

**The International Centre for Policy Studies** is an independent, non-profit research organization with the objective of improving the Ukrainian policy development process. This is achieved by increasing the know-how of key government officials for policy choices, formulation, and debate, and the awareness of the public-at-large of the benefits of the policy. ICPS focuses on key programs of importance for the reform efforts of the government.

---

**ICPS STAFF***Executive Director*

Vira Naniivska

*Deputy Directors*

Oleksiy Nesterenko

Andrii Palianytsia

*Consultants*

Diana Cook

Bess Lincourt

Yuri Lukovenko

Joel Turkewitz

*Project managers*

Hlib Vyshlinsky

Edward Zakharchenko

Oksana Kuziakiv

Natalia Lubkovych

Serhiy Loboyko

Oksana Remyha

Vassyl Yurchyshyn

*Experts*

Andrii Boitsun

Volodymyr Hnat

Serhiy Il'chuk

Dmytro Koshovy

Inna Lunina

Dmytro Lutsenko

Oksana Masliak

Anna Melnik

Vitaliy Nosov

Oksana Pischevets

Larysa Romanenko

Yuri Yasmo

*Translators*

Tetiana Dehtiar

Oksana Popruha

*Administrative staff*

Yaroslav Nikolenko

Katerina Savchenko

Iryna Sokolova

Oksana Solodka

Victoria Spichko

---

**BOARD OF DIRECTORS***Chairman*

Bohdan Hawrylyshyn

*Board members*

Marek Dabrowski

Yaroslav Kinakh

Anders Aslund

Serhiy Tihipko

Ihor Shumylo

Victor Yushchenko

# EXECUTIVE SUMMARY

<b>Overview</b>	We present both pessimistic and optimistic scenarios of future developments. Under optimistic scenario, GDP will decline by 3% in 1999, while under pessimistic scenario it will drop by 5%.
<b>Government</b>	Under our optimistic scenario consolidated budget revenue may reach 27.4% of GDP, of which the largest share will be in cash. In this case, a 1% budget deficit as a share of GDP looks realistic. Under our pessimistic scenario, budget revenue will reach 29.6% of GDP. However, cash revenue will be too low to pay out wages, which will result in a 5.5% budget deficit as a share of GDP.
<b>Monetary</b>	Under the constraint of extremely low international reserves, the main task of monetary policy in 1999 will be to keep the hryvnia exchange rate stable and restrain inflation. The policy may turn successful only if the budget is balanced and government policy enlists the support of foreign creditors. Failure to provide these conditions will result in loss in international reserves and uncontrolled hryvnia devaluation.
<b>Prices</b>	Optimistic scenario for economic development in 1999 envisions a 20% shift in consumer and wholesale prices in 1999. At the same time, inflation may reach 40-50% if government expenditures are covered through emission and a new financial crisis explodes.
<b>External</b>	Under our optimistic scenario, we anticipate a modest current account deficit of US\$0.5 billion. Under the pessimistic scenario, Ukraine's '99 current account will be deeper in deficit — at least US\$0.6 billion expected.
<b>Business</b>	As a result of high macroeconomic risks, we deteriorate our forecast for 1999: industrial decline will amount to 3% under our optimistic scenario or 4% under pessimistic scenario. 1999 is expected to be unfavorable for investment due to higher tax pressure and more intensive consumption in the economy.
<b>Agriculture</b>	Under our optimistic scenario, which envisions restriction of government control over the agricultural sector, the decline in gross agricultural output will reach 4%. In case the government fails to implement reforms, the situation will deteriorate, resulting in 6-7% decline.
<b>Equity</b>	Proceeds from privatization to the budget in 1999 will be far less than the projected UAH 800 million, amounting to approximately UAH 350 million. The government should accelerate for-money privatization of the most attractive objects and create favorable conditions for rapid privatization of loss-making state enterprises.
<b>Labor</b>	Under optimistic scenario, the average wage will fall by only 1%, while under the pessimistic scenario real wages will reduce by 4%.
<b>Households</b>	Real disposable income will continue to decline in 1999, but the pace of contraction will depend on state economic policy. It will drop by 2% or 8% under optimistic or pessimistic scenario respectively.
<b>International</b>	In 1999 the world economic growth rate will hardly outpace the growth of the previous year amounting to 2.2%.

# MAJOR INDICATORS

	1994	1995	1996	1997	1998 (estimate)	1999 (optimistic)	1999 (pessimistic)
<b>Economic activity, UAH mln, December years</b>							
Gross domestic product	12038	54516	81519	92484	101900	121700	134000
Real GDP, % annual change	-23,0	-12,5	-10,0	-3,2	-1,7	-3,0	-5,0
Industrial output	13098	58824	73321	73481	82900	101700	111000
Relative prices, % annual change	-27,3	-12,0	-5,1	-1,8	-1,5	-3,0	-4,0
Agricultural output	3586	16974	26694	29182	32000	37000	41700
Relative prices, % annual change	-16,5	-3,6	-9,5	-0,8	-8,3	-4,0	-7,0
Gross investment	4253	14547	18481	18604	20900	22600	24100
Gross investment share in GDP, %	35,3	26,7	22,8	20,1	20	18,6	18
<b>Prices</b>							
Consumer price index %, December to December	501	282	140	110	120	120	140
Wholesale price index %, December to December	700	277	117	105	135	120	135
<b>Labor market</b>							
Population December years, mln	51,7	51,5	51,1	50,5	50,1	50,0	49,7
Average nominal monthly wage UAH	15,4	80,7	137,8	159,9	172,0	192,0	...
Unemployment %, December years	0,3	0,5	1,3	2,27	3,7	5,2	6,0
<b>Foreign economic activities*</b>							
Exports of goods and services \$ mln	16641	17090	20346	20355	17400	17100	17000
Imports of goods and services \$ mln	18007	18280	21468	21891	18300	17300	17400
Current account balance \$ mln	-1366	-1190	-1122	-1536	-900	-200	-400
<b>Budget, % of GDP **</b>							
Consolidated budget revenue	36,0	30,4	28,2	30,4	27,4	27,4	29,6
Consolidated budget expenditure	44,9	37,0	33,1	37,1	29,4	28,4	35,1
Deficit	8,9	6,6	4,9	6,7	2,0	1,0	5,5
<b>Monetary indicators, UAH mln, December year</b>							
M3	3216	6930	9364	12541	15720	18900	21700
Monetary base	1523	3538	4882	7058	8600	10300	11900
Cash in circulation	793	2623	4041	6132	7160	8600	10300
NBU net foreign reserves \$ mln	302	-411	-268	-18	-1590	...	...
Official exchange rate UAH/\$	1,04	1,79	1,89	1,90	3,43	4,25	6,00
* as reported by the NBU							
** excluding the Pension Fund							

# OVERVIEW

We have reviewed our economic forecast for the next year and present both pessimistic and optimistic scenarios of future developments. We base these scenarios on the ability of the government to provide key economic reforms that would balance the budget, restore financial stability and deliver economic growth. If implemented, these reforms will be supported by international creditors, which will prevent Ukraine from defaulting on its foreign debt payments. In this case, real GDP will decline by 3% in 1999, mainly because of numerous bankruptcies in the real sector, forced reorganization of loss-making enterprises, and sharp reduction in government spending. However, these measures would deliver long-awaited economic growth in 2000. If the government fails to implement these reforms and loses the support of international donors, it will default on the service of its foreign debt. The subsequent drop in the value of the hryvnia will be reflected in double-digit inflation rate. As a result, real GDP will drop by 5% in 1999 and the income of the Ukrainian people will continue to deteriorate for the foreseeable future.

## Reforms

*The main goal of Ukrainian reforms in 1999 is to remove the Soviet-type system of support to loss-making enterprises*

The main goal of Ukrainian economic reforms in 1999 is to remove the Soviet-type system that provides support to loss-making enterprises at the expense of (1) effective enterprises that generate real value added and profits, but are forced to pay excessive taxes, and (2) households, that suffer from the huge wage and social payment arrears of loss-making enterprises and the budget. As a result, this system:

- Large budget deficit, leading either to hyperinflation (1991-1994), accumulation of state debt (1995-1997), or to an increase in the debt of budget-supported agencies (1997-1998). This makes the domestic financial system extremely unstable, and forces banks to keep interest rates high.
- Provokes corruption: indirect subsidies to enterprises (which consist of tax non-payments, barter operations, and accumulation of debts owed to workers and suppliers) are not transparent and usually made at the discretion of government officials.
- Arrests economic growth, as operations reoriented on simply covering costs become more attractive than technological expansion and investment.

We believe the following key economic reforms are needed to change this destructive system:

1. **FIX TIGHT BUDGET CONSTRAINTS FOR ALL ENTERPRISES.** These imply: (1) liquidation of Kartoteka system, which transfers the right of paying taxes to the bank that keeps the account of the enterprise; (2) prohibition of tax allowances and (3) clearances between the budgets of all levels; (4) establishment of effective mechanisms that allow sales of an enterprise's shares if it accumulates arrears, in particular, effective bankruptcy mechanism for protection of the creditor. If these measures are implemented, enterprises, which are capable of creating profits, but prefer

to avoid paying taxes or hustle low-scale products to the budget at overstated prices, will have to give this practice up. Loss-making enterprises that destroy value will be restructured and sold to new owners, or shut down. At the same time, inter-payments between enterprises will reduce, while barter operations used to avoid taxation will cease.

2. **REDUCTION IN THE ADMINISTRATIVE REGULATION OF THE ECONOMY.** The Ukrainian government impedes economic growth by (1) limiting access to raw material markets, which are dominated by government created monopolies. The glaring examples are the agricultural and energy<sup>1</sup> sectors. These sectors are potentially competitive, but are accumulating the largest share of debt in the economy due to the extensive use of non-monetary payment mechanisms, which allow the overstatement of prices; (2) keeping a check on small and medium-sized businesses through imposing an unbearable regulatory and tax burden on them<sup>2</sup>.
3. **ADMINISTRATIVE REFORM.** Most aggressive advocates for the support of loss-making enterprises and administrative regulation of the economy are branch ministries and departments in the Cabinet of Ministers, Finance and Economic Ministries. We argue that the government should develop a strategy for returning to economic growth. This strategy should put the short costs to “prioritized” branches in the context of the actual welfare of Ukrainian people.
4. **OPTIMIZATION OF BUDGET SPENDING AND REDUCTION OF THE BUDGET DEFICIT.** One cannot help accepting the fact that Ukraine is an underdeveloped country that has not attained economic growth since Independence. Ukraine has no capacities to maintain the extensive Soviet system of social services and privileges at the expense of economic activities that suffer from excessive taxes. Besides, the government should link spending to gain its objectives and refrain from supporting ineffective budget sphere.

## Scenarios

In our opinion, economic trends in 1999 will depend on the extent of reforms stated above are implemented. The impact of these reforms would come through both direct and indirect channels:

- De-monopolization of markets and lower cost of regulation will directly revive economic activities this year (as well as positively influence entrepreneurs’ expectations) and make the investment climate more favorable.

*In our opinion,  
economic trends in  
1999 will depend on  
the extent of reforms  
are implemented*

---

<sup>1</sup> During several months of 1998, the government decision regulated activities of the most competitive enterprises through attaching them to specific energy suppliers. In 1998 and 1999 schemes of centralized input supplies to agricultural sector have been providing these supplies through government defined private firms. Most powerful elevators are owned by state firm, Khib Ukrainy. Land parcels under agricultural entities are not yet privatized, which does not allow purchasing, selling the land or using it as collateral. This eliminates a possibility of mortgage credits.

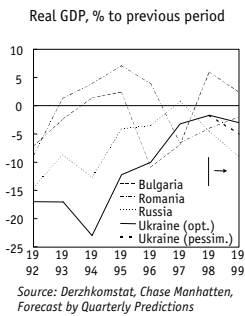
<sup>2</sup> Beginning from January 1, 1999 the Presidential Decree On Stamp Tax introduces a fixed tax on business transactions, which does not depend on the size of economic entities. The tax will increase the cost of economic activities and create further pressure on small businesses.

- Financial stability and the support of international investors will indirectly boost the economy. We consider institutional reforms extremely important, as failure to implement them will discontinue crediting of the IMF and the World Bank. The absence of external financing will lead to the default on governmental payments for foreign debt (by September 1, 1998 international reserves of Ukraine amounted to \$685 million, while payments on foreign debt due in 1999 account for \$1.9 billion). Default means that the government will lose support for its policies, the hryvnia will devalue, prices will increase and the external trade of Ukraine will be destabilized. On the contrary, if the reforms are implemented, international creditors will provide financing necessary for preventing from default in 1999. Tight budget constraints for enterprises will create sufficient budget revenue in 2000 to make payments on restructured domestic debt. Support of the IMF and the World Bank will recommence the inflow of foreign private capital into the economy

**Based on this, we developed two scenarios of our 1999 forecast**

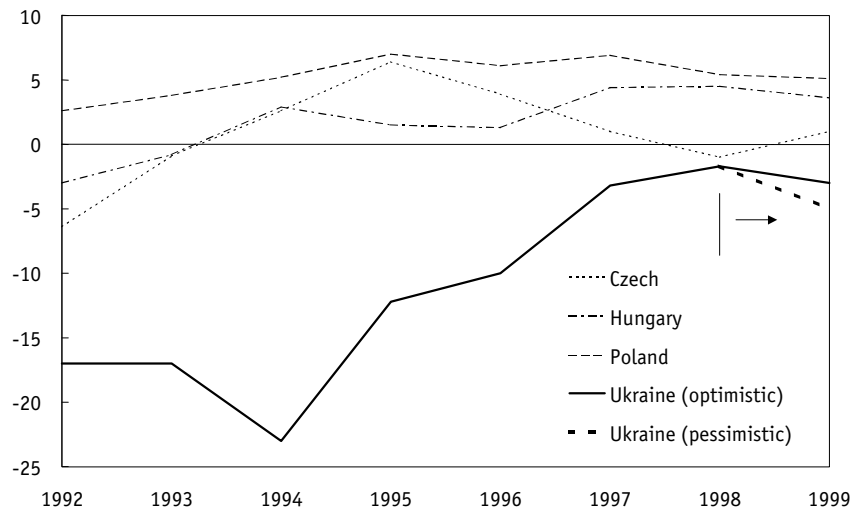
Based on this, we developed two scenarios of our 1999 forecast:

- OPTIMISTIC.** Under this scenario, the Ukrainian government will implement the measures described above and, as a result, receive support from international investors. This will prevent from the debt default and preserve financial stability. Rapid structural changes and tight budget policy will reduce real GDP in 1999 by 3%, but bring Ukraine to economic growth in 2000.



### Real economic growth

Annual % change



Source: State Statistics Committee, Chase Securities Inc. Forecast by Quarterly Predictions

- PESIMISTIC.** Under this scenario, the government fails to change the status quo. In the middle of 1999 Ukraine will run out of international reserves and discontinue its foreign debt payments. Tax arrears and netting out operations will grow rapidly as a share of budget revenue, leading to default on domestic debt and the accumulation of social arrears. Trying to restrain growing disturbances in the country on the eve of presidential elections, the government will breach financial stability, covering budget expenditures through monetary emission. As a result, the hryvnia will drop to 6UAH/\$1 by the end of 1999, inflation will shoot up to 50%, and investment will fall sharply. Unfavorable business conditions, accompanied by negative expectations for the future, will make

entrepreneurs curtail their activities leading to a 5% fall of real GDP in 1999. The loss of production and labor capacity will mean a continued deterioration in 2000.

### *Real GDP by structure*

	1998 (estimation)	1999 (optimistic)	1999 (pessimistic)
<i>Annual % change</i>			
Real GDP	-1,7	-3,0	-5,0
Real consumption	-2,6	-7,3	-3,8
Real investment	-1,7	-9,8	-14,5
Real credits to the economy	9,9	0,0	-7,4
<i>GDP by structure, %</i>			
GDP	100	100	100
Consumption	82,4	82,0	83,4
Private consumption	62,7	63,5	62,4
Public consumption	19,7	18,5	21,0
Investment	20	18,6	18,0
Private investment	19,0	18,0	17,0
Public investment	1,0	0,6	1,0
Net exports	-2,4	-0,6	-1,4
GNDI	99,3	99,1	99,3
Gross national savings	17,0	17,0	15,9

Source: State Statistics Committee, NBU, Forecast by QP

### *Ukrainian default in negative scenario*

*In 1999, Ukraine will have to redeem its debt owed to the IMF, World Bank and make payments on eurobonds amount to \$1 million. Our pessimistic scenario envisions default on these payments. Therefore, we want to explain the cost of the default and of the negative scenario as a whole. So far, there exists no example of default on eurobond payments. In this case, defaulting on eurobonds may isolate Ukraine from the world economic system. We also regard as possible the arrest of Ukrainian property abroad and of the NBU's accounts; suspension of any contacts with Ukrainian agents, which would mean in this case a 100% default risk.*

*One can screen failures to redeem debts owed to the IMF. According to the annual IMF report for 1998, Afghanistan, Iraq, Congo, Liberia, Sudan, Somali, and Yugoslavia were the countries, which held the outstanding debt to the Fund that exceeded 6 months. For this precedent, the rules of the Fund envision:*

- 1. Official consideration of this issue by the IMF Board*
- 2. Director in charge provides consultations with executive directors of the Fund and heads of international financial institutions*
- 3. Submission of an application, which deprives the debtor of the right to use resources of the Fund (applied in 1997/98 to Congo, Liberia, Sudan, and Somali)*
- 4. Application, which contains renunciation of the member state to collaborate with the Fund*
- 5. Depriving the member state of the vote (applied to Congo and Sudan)*
- 6. Compulsory exclusion of the debtor from the IMF.*

# GOVERNMENT

Budget revenue in 1998 did not exceed 28% of GDP for the first time in five consecutive years. Consolidated budget expenditures was reduced by 7 percentage points compared to 1997, falling from 37.1% to 29.4% of GDP, or by 26% in real terms. Under our optimistic scenario, which envisions radical reform in the tax and budget spheres, consolidated budget revenue may reach 27.4% of GDP, of which the largest share will be in cash. In this case, a 1% budget deficit as a share of GDP looks realistic. Under our pessimistic scenario, which envisions larger indirect subsidies to enterprises through netting out operations, budget revenue will reach 29.6% of GDP. However, cash revenue will be too low to pay out wages, which will result in a 5.5% budget deficit as a share of GDP.

## 1998 results

### *Budget revenue*

***Budget revenue in 1998 declined to the minimal level for the last five years...***

In 1998, budget revenue as a share of GDP declined to the minimal level for the last five years, 27.8% of GDP, although in 1997 it accounted for 30.4% of GDP. Consolidated budget revenue constituted 95.6% of the indicator calculated while approving the State budget of Ukraine, while state budget revenue amounted to 75.3% of that planned. Nominal revenue remained almost the same as in 1997 (about UAH 28 billion), but decreased by 16% in real terms.

Budget revenue in Ukraine mainly declined on value added tax (6.97% of GDP against 8.97% in 1997) and corporate profit tax (5.62% against 6.26% of '97 GDP). Increasing debt of wages in the economy (see **HOUSEHOLDS**) consequently caused a reduction in tax revenue from households (from 3.56% down to 3.43% of GDP).

***...which however did not result from a reduction in tax pressure on businesses***

Less extensive GDP redistribution through budget revenue did not indicate a reduction in tax pressure on enterprises. Yet, it mainly resulted from a sharp increase in outstanding debt of taxes and other mandatory payments. The increase in arrears for 11 months of 1998 accounted for 5.6% of GDP, as compared to 3.6% of GDP in 1997. Attempts to raise more budget revenue at the expense of inconsistent changes in tax legislation led to an excessive tax burden on conscientious taxpayers and an additional accumulation of arrears to the budget<sup>3</sup>.

Administrative measures to increase budget revenues were short-term, as they were not reinforced by consistent steps for restructuring delinquent enterprises and extending liability for debt on their property.

***Veksels and netting out operations amounted to 18% of consolidated budget revenues***

In 1998, the Ukrainian economy continued to suffer from non-monetary methods of clearing budget debts. The share of veksels and clearances in consolidated budget revenue amounted to 18%, while in 10 regions their weight exceeded 40%.

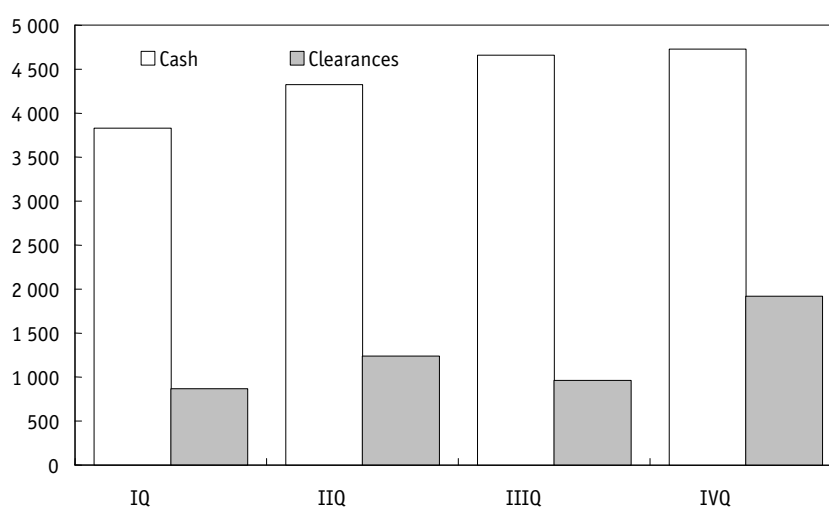
These methods of budget payments reduce cash proceeds of the latter and lead to accumulating wage arrears by budget-supported agencies. One third of the aggregate wage and social payments debt accumulated in the economy, which at present amounts to UAH 6.7 billion, is held by budget supported agencies.

---

<sup>3</sup> Arrears of loss-making enterprises on the depreciation coefficient were written off.

## Consolidated budget non-monetary and cash proceeds

UAH million



Source: Finance Ministry of Ukraine

### Budget revenue on a break-even point

Aggregate budget revenue in 1998 reached its minimum over the last five years. According to preliminary data, 1998 revenue amounted to 27.4% of GDP, while in 1994 it accounted for 35.6% of GDP.

Revenue sharply declined in the following areas:

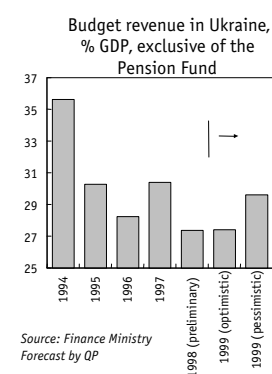
- Corporate profit tax: from 11.9% of GDP to 5.6%
- Value added tax: from 10.79% of GDP to 6.97%
- Revenues of the Chernobyl Fund: from 2.0% of GDP to 1.36%
- Rent for oil and gas extracted in Ukraine: from 0.6% of GDP down to 0.06%
- Receipts from the State Committee for Material Reserves: from 0.65% of GDP to 0.04%

The overall change in these areas accounted for -11 percentage points.

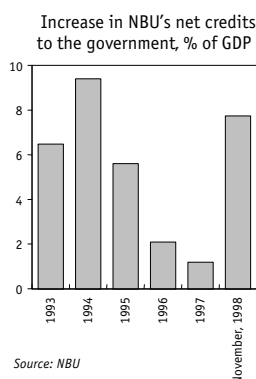
However, some revenue articles reached their maximum over the last five years (although the change on these articles hardly exceeded 1 percentage point):

- Proceeds from the privatization of state property grew from 0.21% of GDP to 0.45%
- Revenue of the Innovation Fund: from 0.08% of GDP to 0.66%
- Proceeds from taxes on international trade: from 0.74% of GDP up to 0.94%
- Proceeds from NBU net income: from 0.27% of GDP to 0.36%

Government budget activities were significantly restricted by operations of extra budgetary funds that commanded 20.5% of central budget revenue and controlled 8% of local budget revenue. Sums accumulated by extra budgetary funds gradually grew from year to year, amounting to 2.6% of GDP in 1996, 3.5% of GDP in 1997, and reaching 4.2% of GDP in 1998.



**The government was significantly restricted by activities of extrabudgetary funds**



**The real change in budget expenditure is -25.9%...**

**...as a proportional decline of expenditures in the social and cultural spheres**

**Budget spending on the economy did not improve the situation in the real sector**

The budget policy accompanied by optimistic expectations regarding high budget revenue has led to the following consequences:

- External debt grew from \$9.56 billion to \$11.4 billion, i.e. increasing by 19.2% over the first eleven months of 1998
- Outstanding t-bill liabilities increased from UAH 8.7 billion to UAH 12.6 billion, or by 44%
- NBU net credits to the government grew by UAH 7 billion for eleven months of 1998, while in 1997 the respective indicator was UAH 1 billion. The increase in these credits as a share of GDP exceeded the 1993 level and came near the 1994 mark

### *Budget expenditure*

Budget expenditure in 1998 amounted to 29.4% of GDP, while in 1997 it reached 37.1% of GDP. The real change in expenditure is -25.9%.

Although budget resolutions envisioned premium financing of the social and cultural spheres in Ukraine, budget spending on education, public healthcare, arts and sciences decreased by 25.3%.

Spending on law enforcement and public administration as a share of GDP fell to the mark of 1995-1996, amounting to 2.8% of GDP. However, lower expenditures by the central public administration were not accompanied by relevant reduction at the local level. Thus, regional spending on public administration exceeds the sum projected by the state budget by four times. We would like to emphasize the fact that local budget arrears on wages are redeemed four times slower than scheduled.

Spending on the economy decreased 24.3% in real terms, but the practice of netting out operations distorts the real picture of government subsidies provided to Ukrainian enterprises. In December 1998, one could see deplorable consequences of clearances for budget implementation, which caused a significant increase in the share of industry, energy, construction, and agricultural sectors in budget spending. Thus, compared to November, budget spending on the industry and energy sectors grew 4 times as a share of GDP, being 3 times higher on construction and 6 times higher on agriculture. Overall budget spending in December amounted to 37.5% of GDP, exceeding the annual indicator calculated for 1998 by 8%. In many cases, clearances formally arranged for financing public healthcare and social transfer payments were in fact another form of budget spending on the economy.

The main share of public investment was spent on reimbursing expenditures on social infrastructures in rural areas through the netting out mechanism. The sum of reimbursement grew by 175.6% in real terms, as compared to 1997. Thus, as in previous years, financing for these activities from the budget was predetermined by actual, usually excessive, expenditures of enterprises, which were not selected by tender. In addition, a large share of arrears to the budget (netting out mechanism switches on only in case arrears to the budget exist) indicates that significant public funds were spent to support indebted enterprises, which cannot compete in the market conditions.

The facts mentioned above eliminate the possibility of budget expenditure, which would stimulate economic growth and make the real sector more efficient, as envisioned by the budget resolution. To conclude, budget expenditure on the economy was least effective for economic recovery.

## *Reduced budget expenditure accounted for 15% of GDP in the last five years*

*In the last five years, budget spending in Ukraine, exclusive of the Pension Fund, decreased from 44.9% of GDP in 1994 to 29.36% of GDP in 1998. Expenditures changed on the following articles:*

- *The economy (from 21.8% of GDP to 6.87%), in particular financing price regulation: from 3.69% of GDP to 1.01%*
- *Defense: from 1.65% of GDP to 1.3%*
- *Education: from 5.33% of GDP to 4.31%*
- *Healthcare: 4.75% of GDP to 3.43%*
- *Science: from 0.5% of GDP to 0.31%*

*Having reduced these expenses, the government increased its expenditures on servicing foreign and domestic debt (from 1.09% of GDP to 2.33%); social insurance and social welfare (from 1.09% of GDP to 3.96%); administration and law enforcement (from 2.73% of GDP to 2.81%)*

According to the 1999 budget resolution, budget policy will guarantee full payments on social programs composed on the basis of current legislation, at the expense of a consequent increase in budget deficit. According to materials by the Budget Committee of the Ukrainian Parliament, overall annual financing of the social sphere amounts to UAH 180 billion, which exceeds the '99 GDP forecast by 45%. The financial need for the healthcare sector, privileges and compensations is calculated at UAH 25 billion, or 140% of total state budget spending in 1998.

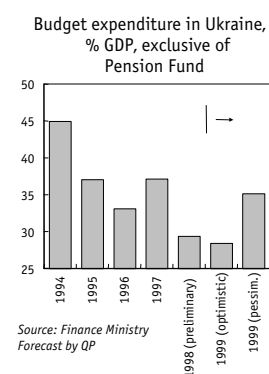
During the last five years, Ukrainians experienced all consequences (excluding default) of the budget deficit in a stagnating economy. Financing the deficit through emission in 1993-1994 resulted in severe hyperinflation, which harshly hurt low-income households. Rapid growth of domestic debt from restricted financial resources and the absence of trust in economic government policy transferred government securities from the left to the right side of the budget. Meanwhile, payments on foreign debt cause a loss in NBU international reserves and increase budget expenditures on the debt service as a result of the currency devaluation. Under the negative scenario, these sums will exceed overall state budget expenditures on defense and education in 1999.

As a result, economic growth may be achieved only if public activities are limited, according to the Budget Committee report advocating legislative termination of burdensome social privileges.

The budget resolution for 1999 does not clearly define spending priorities and contains no real evaluation of expenditures. Almost all expenditures are considered top-priority. Both the budget approved for 1999 (distribution of revenue and spending), and some articles of the Law on the Budget contain inconsistent claims. Thus we forecast deterioration in the budget sphere in Ukraine.

## **1999 Budget**

According to the budget approved for 1999, consolidated budget revenue almost equals the final indicators for 1998, amounting to 27.6% of GDP. At this, central budget revenue increases by 4%, from 14.8% of GDP in 1998 up to 18.96%, while local budget revenue (exclusive of subsidies) decreases from 12.6% of GDP to 8.7%.



***The 1999 budget resolution contains unreal parameters for expenditures...***

***...causing a threat of uncontrolled deficit***

***'99 budget revenue will equal the respective final indicators of 1998...***

*...with 1% deficit as a share of GDP...*

*...which looks quite realistic under our optimistic assumptions*

It is also envisioned that the central budget will receive additional proceeds from corporate profit tax, amounting to 26.7% of the total sum, and almost 30% of total income tax revenue, while in 1998 proceeds from these taxes were included in local budget revenues. Additionally, the revenue from transit fees for gas will increase to 1.3% of GDP. Considering the 1% budget deficit as a share of GDP envisioned for the next year, budget spending in Ukraine will amount to 28.6% of GDP.

We agree that these indicators may be achieved only according to our *optimistic* scenario, i.e. if the following measures are implemented:

- Prohibition of netting out practices between budgets of all levels
- Termination of tax allowances by the government
- Establishment of hard budget constraints for enterprises that have debts to the budget and other creditors, being liable for these debts with their property

If these tasks are accomplished, consolidated budget revenue, according to our evaluation, will amount to 27.4% of GDP; expenditures and the deficit will be 28.4% and 1% of GDP respectively.

Obvious risk factors for budget implementation are the following:

1. **AFTER THE 1999 BUDGET WAS APPROVED, A NUMBER OF NEW LEGISLATIVE ACTS FOR CHANGING TERMS OF TAXATION AND BUDGET EXPENDITURE WERE ADOPTED.** These acts envision lower tax proceeds (decision by the Ukrainian Parliament for reducing excise duties on fuel products) and higher budget spending (Presidential Decree on increased wages for servicemen and all ranks of duty men at law enforcement agencies; Presidential Decree 'On measures for improving work conditions in rural healthcare agencies').
2. **THE 1999 BUDGET APPROVED BY THE PARLIAMENT OF UKRAINE LACKS CERTAIN ARTICLES ON EXPENDITURE.** Article 43 of the Law On the 1999 Budget envisions clearance operations with economic agents on tax and mandatory payments, which will be written down for the Ministry of Interior, Ministry of Defense, SBU, and other military structures for consumed goods and services. According to data by the Defense Ministry of Ukraine, the minimal financing need for the Ukrainian armed forces amounts to UAH 3.1 bn, while the budget envisions only UAH 1.7 bn. Thus, expenditures on defense may grow by UAH 1.4 bn in 1999.
3. **A SHARE OF STATE BUDGET REVENUE WILL BE TRANSFERRED TO EXTRA BUDGETARY FUNDS, ALTHOUGH THEIR SHARE WILL DECREASE FROM 20.5% TO 8.3% AS A SHARE OF STATE BUDGET REVENUE.** However, to retain spending of the Chernobyl Fund at previous levels, the deficit will be compensated by proceeds from value added tax (not less than 17% of envisioned VAT proceeds of the budget). Therefore, approximately 15% of state budget revenue will be transferred to extra budgetary funds.
4. **A NUMBER OF DECISIONS EXTEND THE OFFSET PRACTICE IN 1999.** Under special conditions, offsets may involve liabilities irrespective of their term,

even if they are not yet overdue within the bounds of the expenditures envisioned by the corresponding article of the State Budget<sup>4</sup>.

### *Collapse scenario for Ukraine's financial system*

*Overstated budget revenue is a common occurrence of the budget process in Ukraine. Overstatement of the 1999 draft budget proposed by the Budget Committee of the Ukrainian Parliament reached the level of 1994.*

#### *Budget revenue in Ukraine, % GDP*

<i>Year</i>	<i>Projected by Verkhovna Rada</i>	<i>Actual</i>
<i>1993</i> .....	<i>51,3</i> .....	<i>33,4</i>
<i>1994</i> .....	<i>74,3</i> .....	<i>35,6</i>
<i>1995</i> .....	<i>35,6</i> .....	<i>30,3</i>
<i>1996</i> .....	<i>36,3</i> .....	<i>28,2</i>
<i>1997</i> .....	<i>30,3</i> .....	<i>30,4</i>
<i>1998</i> .....	<i>29,4</i> .....	<i>27,4</i>
<i>1999 (projected by Verkhovna Rada)</i> .....	<i>27,6</i>	
<i>1999 (projected by Budget Committee)</i> .....	<i>42,2</i>	

*Higher budget revenues accompanied by the emission of energy veksels (as proposed by the Budget Committee) would have fatal consequences for the domestic financial system, causing both an unplanned increase in budget spending and uncontrolled money circulation in the country. Proposed emission of energy veksels (on the sum of UAH 5.7 billion), which would exceed the primary emission by the NBU (UAH 1.5 million), would mean that the right to issue a large share of money equivalents will transfer from the NBU to economic agents.*

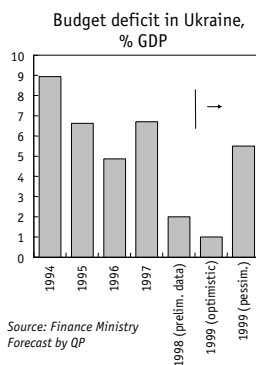
*Experience in utilizing energy veksels and other money substitutes (barter, offsets, etc.), proves that the issuer of veksels determines the quantity and price of veksels needed to pay out debts. This procedure envisions redeeming veksels at a discount or fixing higher prices either on services of energy companies or products that are involved in the veksels scheme. Non-transparency of veksels schemes creates opportunities for corruption and overstated prices (especially in cases of natural monopolies). Therefore, energy veksels would only lead to higher budget expenditure.*

*It was also proposed to finance over 25% of local budget expenditure in 22 regions through energy veksels. Spending in over 14 Oblasts are 20% dependent on subsidies from the state budget, which would be deprived of sure tax revenues in 1999. Therefore, more than 80% of local budget social programs would be tied with veksels schemes.*

*As a result, the alternative budget would produce an illusion of high revenue, which would lead to an overestimation of budget expenditure, set it out of control and raise huge sums of accounts payable by budget-supported agencies.*

<sup>4</sup> See Decision of the CMU "On the order of payment for construction materials and goods supplied for rebuilding housing after the disaster in the Zakarpatska Oblast".

**Some articles of the Law on the 1999 Budget threaten state budget revenues**



A number of articles from the Law “On the 1999 State Budget of Ukraine” create serious danger for state budget revenues and threaten control over local budget spending. Article 47 demands local governments to “provide full subsidizing of payments for energy, heat, and gas consumed by budget agencies”. Article 45 envisions additional subventions to local budgets for paying out energy arrears, which total UAH 5.2 billion. Thus, energy vekselns proposed by the Budget Committee were replaced by energy offsets. If implemented, these measures could lead to additional spending of local budgets and lower cash proceeds of the state budget, which would mean actual implementation of key ideas of the Budget Committee.

**Revenue decentralization + responsibility centralization = ?**

*In 1999, extensive decentralization of the tax base by vague responsibilities for spending budget funds will set it out of control at the local level. Again, local budget expenditure will not be oriented toward strategic priorities – overfulfilling various expenditure articles will lead to an increase in accounts payable accumulated by budget-supported agencies. The problem is that the methods of local budget formation which are being currently employed lack the following:*

- *Local administration has no responsibility for efficient spending*
- *Projected local budget spending does not match actual revenues; this results in a total loss of control over expenditures*
- *Neither economically strong nor weak regions received stimuli for increasing revenues. Strong regions refuse raising more revenue, as the surplus may be extracted by the state budget by lowering the share of state tax revenue envisioned for the region. Meanwhile, a positive effect in weak regions might be achieved rather through improving and developing its economic capacities than by means of simple subsidies redistributed by the state budget from stronger regions.*

*To conclude, the current practice of subsidizing local budgets impedes structural reforms. Continuous subsidies to local budgets planned for eliminating urgent budget problems is ineffective for the prospects of future growth.*

**Under a pessimistic scenario, budget revenues may increase as a result of growing offsets shares...**

**...while limited cash flow will cause a budget deficit amounting to 5.5% of GDP**

Government inability to stop these risk factors, extension of offset practice and reduction in cash proceeds from the budget system (where the state budget will be hurt the most) are the components that characterize our *pessimistic* scenario. According to this, Ukraine’ consolidated budget revenue in 1999 will account for 29.6% of GDP, or 2.2 percentage points more than under our optimistic scenario. However, more than 25% of this sum will be received in money substitutes, while cash inflow will be insufficient for paying out wages and social transfer payments. Additional pressure on cash proceeds will be a sharp contraction of economic activities after the government announces a default on external payments. To prevent social upheaval, the government will have to finance the budget deficit of 5.5% of GDP through emission. In this case, consolidated budget expenditure will rise to 35.1% of GDP.

# MONETARY

Under the constraint of extremely low international reserves, the main task of monetary policy in 1999 will be to keep the hryvnia exchange rate stable and restrain inflation. The policy may turn successful only if the budget is balanced and government policy enlists the support of foreign creditors. Failure to provide these conditions will result in covering the budget deficit through emission, loss in international reserves, and uncontrolled hryvnia devaluation.

## Exchange rate and international reserves

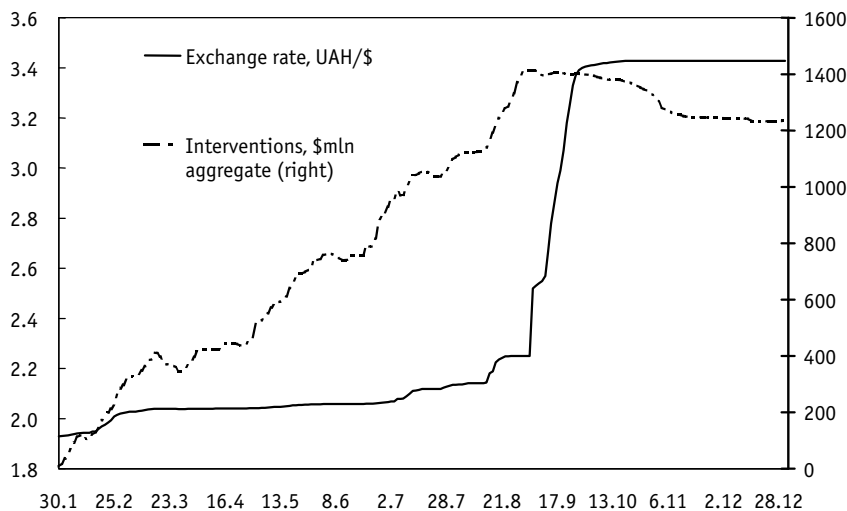
The most troublesome component of monetary policy in 1999 will be the hryvnia exchange rate. During 1997-98 Ukraine's currency market was largely liberalized and led to extensive interventions by the NBU at the beginning of 1998 to keep the national currency in the pre-determined currency band. However, these interventions must be viewed as a forced measure to level the state budget imbalance that occurred in 1997-98. In particular, the NBU had to redeem short-term, high-yield government debt owed to non-residents through losses in its international reserves.

*The most troublesome issue of monetary policy in 1999 is the hryvnia exchange rate*

---

### *NBU interventions and exchange rate dynamics*

January 1998-January 1999



Source: NBU, Calculations by Quarterly Predictions<sup>5</sup>

The failure to provide reforms meant to win back the confidence of investors was too costly for the Ukrainian economy. In 1998, Ukraine received credits from private investors amounting to \$1.1 billion, while the government had to pay back approximately \$2 billion to those investors who were ultimately discouraged by unfavorable business conditions in Ukraine and started withdrawing their capital.

*Ukraine's total capital outflow amounted to \$1 billion in 1998...*

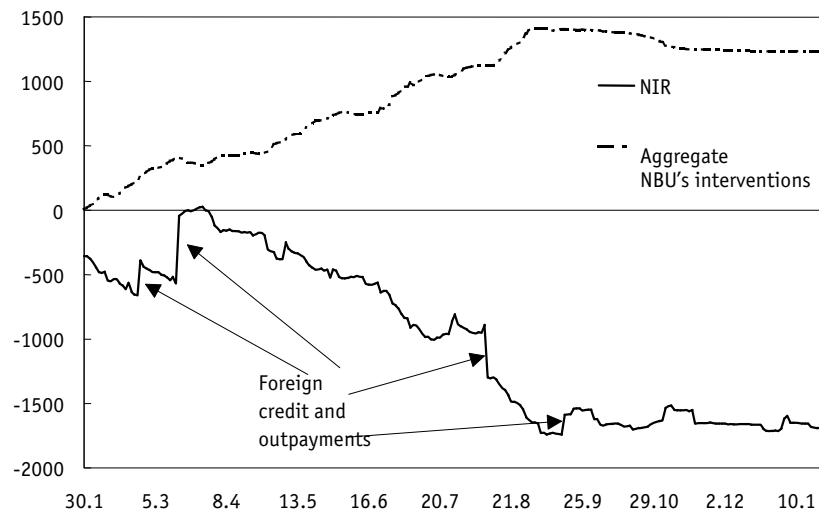
---

<sup>5</sup> Data for interventions and monetary aggregate are provisional, and therefore may differ from those in later official publications

---

## Dynamics of aggregate intervention and NBU net international reserves (NIR)

\$mln, January 1998 – January 1999



Source: Ukrainian News, Business. Calculations by Quarterly Predictions

---

**...though this trend will not develop in 1999, due to a lack of reserves...**

Obviously, this pattern cannot be followed in 1999, as (1) extremely low international reserves leave little chance for the NBU to continue intervening (at the end of 1998, gross international reserves were as low as \$950million, compared to \$2.34billion in January 1998), and (2) non-existent reforms and default risks ruin the expectation of inflows of private foreign capital in the local market.

**...that will not grow even in an optimistic scenario...**

Even in the optimistic scenario (which envisions support by the IMF and a balanced budget), we do not expect an increase in gross reserves for 1999. Rapid improvement in the trade balance will be offset by huge payments for servicing the external debt (approximately \$1.9billion). As a result, the volume of gross reserves will not exceed 3 weeks of imports and will make monetary policy extremely sensitive to external shocks.

**...implying high currency risks throughout 1999**

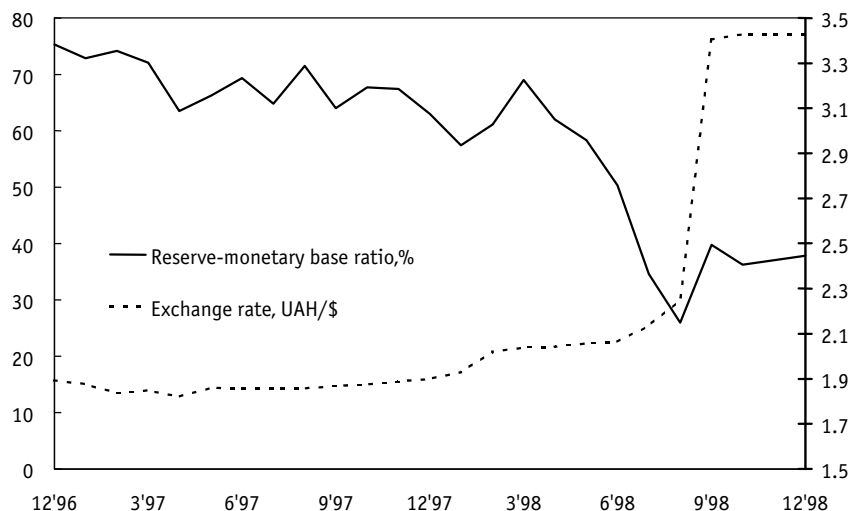
The currency risk will be high throughout 1999, as the absence of foreign capital injections will not improve the international reserves-monetary base ratio, which will not exceed a 40% level<sup>6</sup>. Ukraine can expect capital inflows and higher volumes of reserves only if it implements the measures envisioned by programs agreed with the IMF and the EBRD.

---

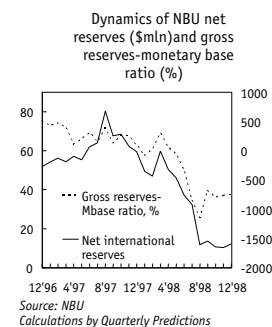
<sup>6</sup> According to the *currency crises curve* developed by the Moscow Institute for Economic Analysis for countries that underwent currency crises or speculative attacks in the recent years, the pace of expected devaluation of the national currency is directly related to the international reserves-monetary base ratio (see Illarionov A. Economic issues, #12, 1998). In countries with high ratios (approximately 100%), the pace of devaluation did not exceed 15-25%, while 70%-ratio countries suffered from a 45-85% devaluation.

## Dynamics of gross international reserves - monetary base ratio and exchange rate, %

1997-98



Source: NBU, Calculations by Quarterly Predictions



Source: NBU  
Calculations by Quarterly Predictions

In our opinion, administrative restraints on the foreign exchange market will not be eliminated totally in 1999, since given low international reserves, the NBU will not be able to beat back speculative attacks successfully<sup>7</sup>. The exchange rate will also be regulated by instruments proper for a floating exchange rate (in particular, management of reserve requirements and interest rates), while the NBU intervention will not be practiced widely.

In the optimistic scenario, the hryvnia-to-dollar exchange rate will remain predictable and the devaluation expected before elections will not exceed UAH 4.25/\$1 at the end of the year.

In the pessimistic scenario (Ukraine refuses to collaborate with the IMF, infringing provisions of the concluded agreements), external financing of the national economy will be discontinued and will result in huge losses in international reserves which therefore will drop to 1-1.5 weeks of imports by the end of 1999.

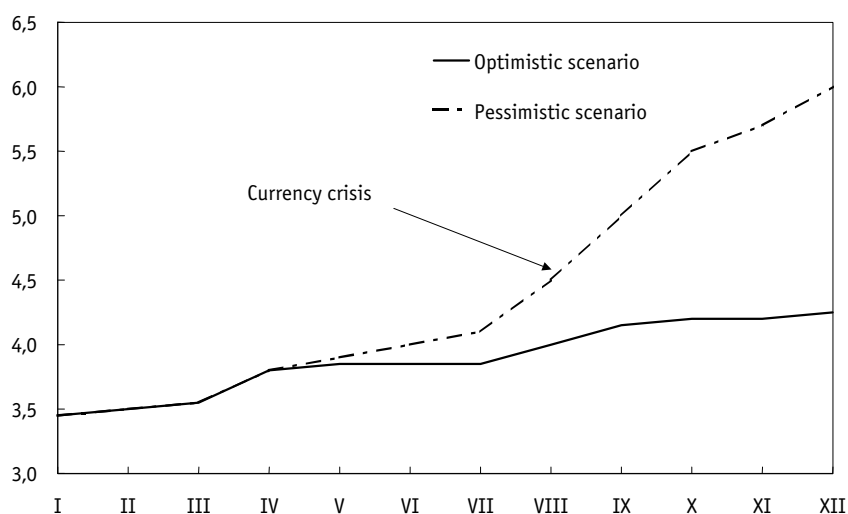
In the first quarter of the current year, dynamics in the exchange rate will hardly depend on the IMF's decision to lend further support to Ukraine, as the government, while accumulating debts, will still be able to service the external debt and suppress budget deficit. Failure to redeem the external debt and a pressing need to clear off budget liabilities before the presidential elections will immediately result in looser monetary policy, leading to a devaluation shock later in August-September 1999. By this scenario, the exchange rate will reach at least UAH 6/\$1 by January 2000.

***In the optimistic scenario, the exchange rate will be UAH 4.25/\$1  
A pessimistic scenario brings total losses in international reserves...***

***...and shock devaluation at the end of the current year***

<sup>7</sup> At the same time, any administrative regulations of the financial market disturb the equilibrium and diminish the effectiveness of allocated resources. For this, as soon as government economic policy gains confidence and the foreign exchange market has less pressure, the system of currency regulation must be liberalized (the first step must reveal activities on the OTC Inter-Bank Forex Market).

## Hryvnia/U.S.D. exchange rate



Source: Quarterly Predictions

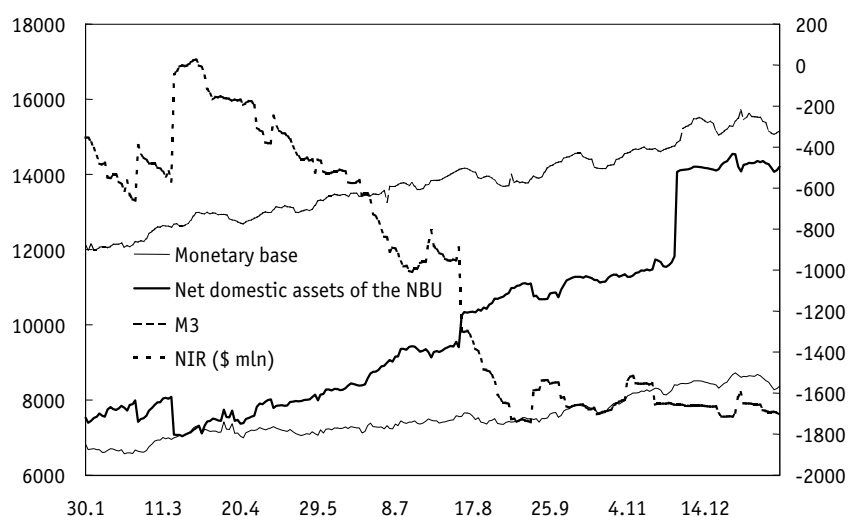
## Money supply

**In 1998 the NBU regulated and gradually enlarged real money supply**

In 1998, the NBU implemented tight monetary policy, which resulted in only 2% growth of the real monetary base and 5% increase in the real broad money supply. In an absence of real sources to finance budget deficit, the government must turn to the NBU credits. As a result, the NBU raised its net domestic assets more rapidly than other monetary aggregates, which increased by almost 80% in real terms over the last year.

## Dynamics of major monetary aggregates (UAH million) and NBU Net International Reserves (NIR, right axis)

1998



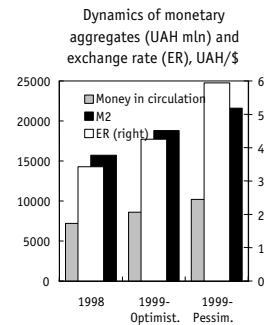
Source: NBU, calculations by Quarterly Predictions

In an optimistic scenario, the NBU will maintain tight monetary policy aimed toward holding the exchange rate within the planned band. This will be reinforced by stable real money supply over 1999, which we view as a critical anti-inflation measure (see **PRICES**). Main monetary aggregates will grow by 20% in nominal terms. Thus, by the end of 1999 the broad money supply will reach UAH 18.9 billion (compared to the respective indicator of UAH 15.7 billion at the end of 1998), the monetary base will be UAH 10.3 billion (UAH 8.6 billion in 1998), and the currency in circulation will grow up to UAH 8.6 billion (UAH 7.16 billion in 1998). Therefore, the multiplier will remain at the level of 1998, which is 1.83, while the money velocity will slow down from 7.4 in 1998 to 7.0 in 1999.

The National Bank will continue its policy of “pulsating” money supply – 1-2 month periods of tightening will be followed by monetary expansion at the end of each quarter, which comes from the need to reduce accumulated arrears<sup>8</sup>.

On the other hand, in a pessimistic scenario, monetary policy will exhaust resources and fail to prevent destabilization. Broad money supply will reach UAH 21.3 billion, which though implies contraction in real terms and reduction of real credits available to the economy if inflation exceeds 40%.

### **An optimistic scenario envisions tight anti-inflation policy**



Forecast by Quarterly Predictions  
**In a pessimistic scenario, monetary policy will not prevent destabilization**

## **Interest rates and credits to the economy**

### *Interest rate policy*

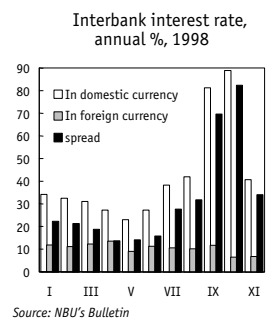
Considering sharp contraction of the secondary T-bill market, inter-bank interest rates remain trustworthy indicators of the interest rate policy<sup>9</sup>. These rates intensively concentrate the risk of the economic environment (including devaluation pressure and the risk of destabilizing the banking system).

Based on the dynamics observed last year, we argue that a 40-45% interbank interest rate will be accompanied by rapid currency devaluation. Devaluation expectations prompt higher interest rates that contain continuously increasing risk premiums, and growing rates are often evidence of tightening monetary policy to restrict devaluation pressure.

Another indicator of the devaluation pressure on the hryvnia is commercial bank interest rates of credits nominated in hryvnias and hard currencies. Both the rates and the spread between them tend to diminish in the stabilization period. If the spread starts growing, devaluation risk increases and, according to our estimations, the critical point it reached in 1998 was 30 percentage points.

The current goal of interest rate policy is to stop crediting the government and orient released funds on refinancing commercial banks. As a result, the refinance and lombard rates could become effective monetary instruments.

### **Growing interest rates reflect devaluation risk**



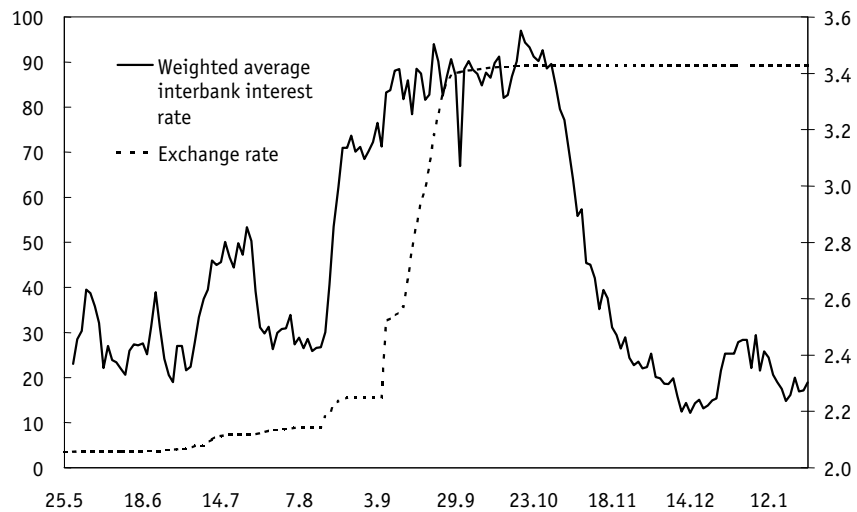
Source: NBU's Bulletin

<sup>8</sup> This tendency continued in January as well: starting from January 1, the monetary base was reduced from UAH 8.6 billion down to 8.4 billion, while the volume of currency in circulation dropped from UAH 7 billion to 6.6 billion.

<sup>9</sup> As we stated in our previous publications (see **QUARTERLY PREDICTIONS, APRIL, JULY 1998**), the NBU continues to regulate its refinance and lombard rates administratively. As a result, they cannot be viewed as trustworthy indicators that reflect economic processes in Ukraine.

## Weighted average interbank interest rate (yearly %) and exchange rate dynamics (right axis)

May'98 – January'99



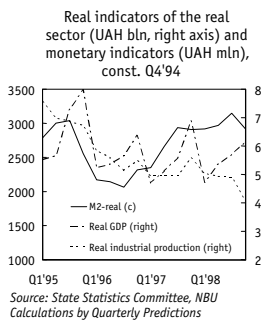
Source: Ukrainian News, Business

## Crediting

From the third quarter of 1996, real monetary supply has steadily increased, while industrial production has declined. The need to finance government consumption and support large unprofitable enterprises drained funds which could have been invested in the real sector. If in 1999 the planned level of deficit is not breached, the real sector can receive UAH 2 billion out of UAH 3 billion, which is the expected amount of broad money expansion. However, a significant share of this sum may fall into the hands of red directors of large loss-making enterprises that have become shift in advocating their interests.

Let us remember that a widening monetary supply may have a positive effect only if it is accompanied by structural reforms in the real sector and supported by enterprises' readiness to invest (and as a result, the demand for real money increases). Therefore, the emission, which is not upheld by structural reforms and stimuli for creating profits, leads to hyperinflation and total collapse of the real sector.

In 1998, commercial banks kept crediting the economy at a steady level, mainly relying upon credible clients. As before, small and medium businesses have little access to credits, which is mainly restricted by high interest rates and banks' unwillingness to accumulate risky loans in their credit portfolios. Although credits available to the economy have grown in nominal terms, in fact this results from the recalculation of loans nominated in foreign currencies. On the other hand, the share of long-term credits to the economy started growing in 1998. Thus, in previous years, the share of long-term credits to the economy was only 10%, while in 1998 it increased and amounted to 16-18%. By our optimistic scenario which predicts a more favorable business climate in Ukraine, the mentioned trend will stimulate further development of the credit market and growth of the Ukrainian economy as a whole.



**Credits to the economy will not be reduced if the budget is balanced in 1999**

## Banking sector after the crisis

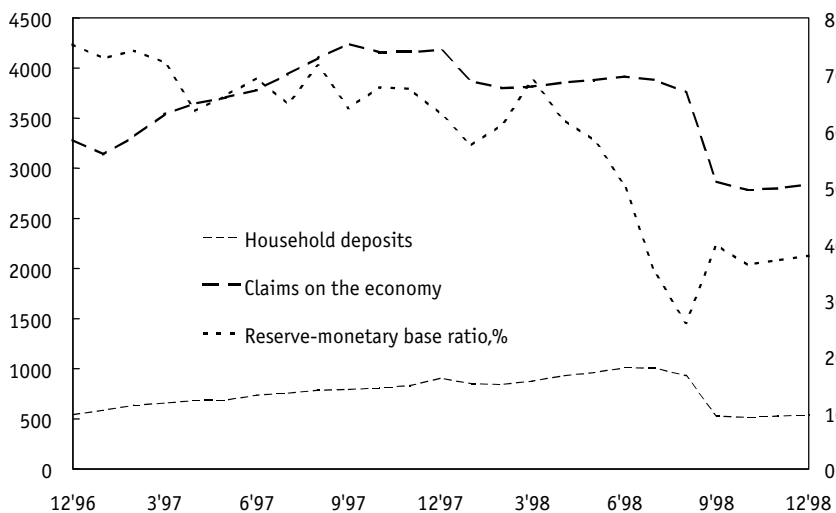
The National Bank will carefully cross-examine paying capacities of the banking sector, which extensively worsened during the currency crisis. Only the liquidity of solvent banks will be supported by the NBU, and, as an exemption, "system<sup>10</sup> banks" that temporarily turn insolvent. This policy will not imply a significant default risk and will prevent from an exaggerated liquidity crisis in the banking sector, even if some banks were merged or shut down during the year.

In 1999, the NBU's important task will be to restructure the banking sector in order to prevent insolvency. This also includes the following issues: (1) banks that should be closed and (2) those that must undergo sanitation; (3) define policy for bank consolidation, (4) choose instruments for sanitation, and (5) schedule a sanitation program. It is also important to attract new foreign banks to Ukraine. We argue that such a program must have a positive effect, as it will assist in improving positions of the banking sector, which will gain trust from business and household sectors.

### Household deposits

Devaluation and inflation tendencies at the end of 1998 led to a significant contraction of the deposit system that harshly reduced resources of the banking sector which were available for the economy. Household deposits were damaged most harshly: in spite of high devaluation, households continued withdrawing money from banks and tried to transfer it to dollars.

### Bank credits to the economy and household deposits (\$mn), gross reserves-monetary base ratio (%), right axis

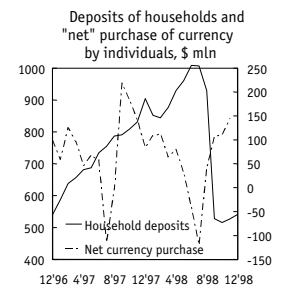


Source: NBU Calculations by Quarterly Predictions

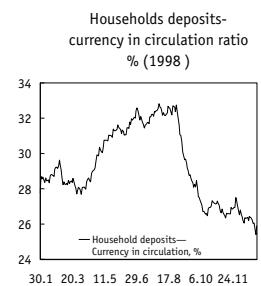
Household distrust in the banking system is evident by the sharp reduction in deposits and the share of currency in circulation. Individuals prefer maintaining savings in U.S. dollars even though they lose part of their money while purchasing foreign currency at the black market exchange rate. The system of insurance, which has been developing since 1998, has to be improved and extended in order to receive additional cash inflows to the banking sector.

<sup>10</sup> System banks are major banks that are largely involved in the budget process.

### Devaluation and inflation led to a significant reduction in deposits



Source: NBU Calculations by Quarterly Predictions



Source: Ukrainian News, NBU Calculations by Quarterly Predictions

# PRICES

The major pre-determinants of inflation dynamics in 1999 will be the size of the budget deficit, money supply, and pace of national currency devaluation. The traditional slow-down of inflation in the middle of the year will not become a long-term tendency as long as key reforms for balancing the budget are implemented. Only these reforms can provide an optimistic scenario for economic development in 1999, which envisions a 20% shift in consumer and wholesale prices. At the same time, inflation may reach 40-50% if government expenditures are covered through emission and a new financial crisis explodes.

## Consumer prices

***Inflation in 1999 will mostly depend on the scenario***

In 1999, the rate of inflation will mostly depend on the scenario of economic development. Thus, according to our negative scenario, unbalanced budget and devaluation will hardly be avoided, but inevitably result in higher inflation pressure.

***According to our optimistic expectations, consumer prices will increase 20%...***

According to our optimistic expectations, the government will be able to service its external debt and check devaluation; as a result, the increase in consumer prices will be 20% during 1999.

Shock destabilization in autumn 1998 and the phased currency devaluation will support high inflation expectations in the first months of 1999. If this scenario develops, price dynamics on the consumer market in 1999 will mimic the respective dynamics of the previous year, which was displayed the highest inflation at the beginning and end of the year. The only difference will be that prices will grow faster in the first half of the year, due to the inert nature of last year's currency crisis. Furthermore, reforms needed for this scenario envision a rise in prices for electricity, gas and utilities for the household sector.<sup>11</sup> This will liquidate price disparities and reduce budget expenditures. Traditional autumn growth of consumer prices next year will be underpinned by uncertainty caused by the presidential elections, which will produce additional pressure on the rate of inflation. We expect consumer prices to increase by: 6% in the 1<sup>st</sup> quarter of 1999; 2% in the 2<sup>nd</sup>; 3% in the 3<sup>rd</sup>; and 7% in the 4<sup>th</sup> quarter.

***...or 50% in a negative scenario***

By our pessimistic scenario, should the IMF discontinue the EFF program, the local currency further devalue and thus deepen social strain, the only alternative to cover budget expenditures and transfer payments shall be through emissions (expected monthly volumes are UAH 200-250 million). Hastening devaluation will cinch prices up to their dollar equivalent, despite administrative price restraints. The result will be a drastic soar prices, reflected in a 50% rate of inflation. Let us keep in mind that a yearly inflation rate of 30-40% sharply reduces the potential pace of economic growth in developing countries and increases the risk of economic recession.

---

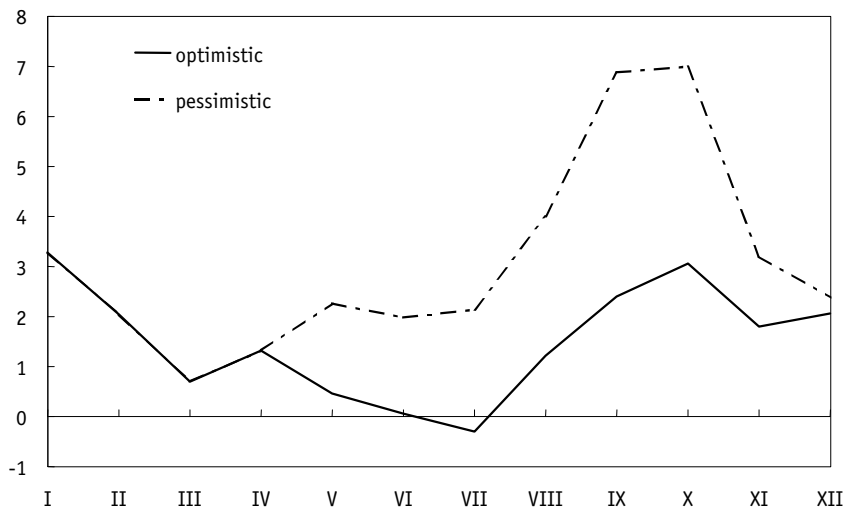
<sup>11</sup> Starting from October 1, 1998 the Law of Ukraine on the moratorium to increase tariffs on utilities and public transportation fares prohibits the government to raise respective duties before it redeems its transfer payments.

In the negative scenario, the most probable measures of a newly elected president, whom we see to be a leftist (due to deterioration in the overall standard of living), will be to administratively fix prices on basic consumer goods. This will create a deficit of these goods in the official sector or lead to an increase in subsidies to enterprises and, as a consequence, to a higher budget deficit provoking wide-scale financial destabilization, following the pattern of 1993-1994.

**Administrative price restraints will cause further destabilization**

### Consumer price inflation by optimistic and pessimistic scenarios

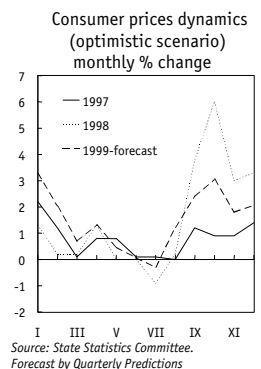
Monthly % change



Forecast by Quarterly Predictions

Beyond any of the two scenarios, the growth in prices will be formulated by the following factors:

**1. MONETARY POLICY OF THE NATIONAL BANK OF UKRAINE.** Over the past several years, inflation dynamics in the consumer market were predetermined by the exchange rate and money supply<sup>12</sup>. The NBU successfully employed stabilization instruments for reducing money supply when the inflation rate started dropping (this, in turn, was provoked by exchange rate shocks, administrative price regulation for utilities, etc.), or implementing stimulating monetary policy during periods when prices and exchange rates stabilized.

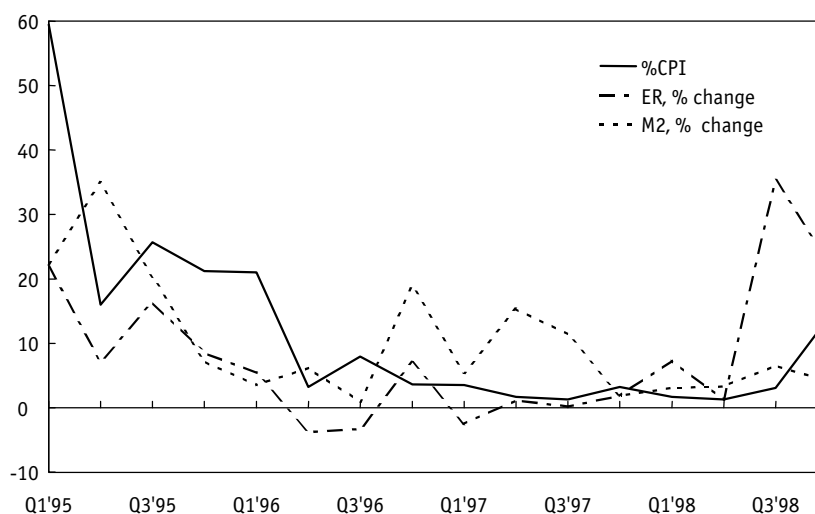


<sup>12</sup> As we stated in our previous publication, dynamics of inflation  $\pi$  in 1996-98 could be described by the following equation:  $\pi = 0.231M2_{-1} + 0.31\pi_{-1} + \dots$ , where  $M2_{-1}$ ,  $\pi_{-1}$  are respectively aggregate M2 and inflation rate for the previous month, while  $l$  stands for logarithm. Being practically fixed during this period, the exchange rate showed only insignificant dynamics. However, in the period of high inflation in 1994-1995, inflation almost traced the trend of the exchange rate:  $\pi = 1.11 ER + \dots$ , where ER is the nominal exchange rate of the hryvnia (karbovanets') to the dollar. Today we can observe a short-term weighted relation between inflation, exchange rate and monetary supply. We assume that inflation would remain in the determined (average weighted) limits if the exchange rate and monetary supply did not undergo shock changes.

---

## Consumer prices, money base and exchange rate

Quarterly % change, 1995-98



Source: State Statistics Committee, NBU

Calculations and forecast by Quarterly Predictions

---

Generally, we envision that the NBU will continue acting independently and provide sensible monetary policy. Thus, if future developments follow our benign scenario for the balanced budget and financial stability, the National Bank will be capable of tighter monetary policy oriented upon further price stabilization. In case negative tendencies prevail, the NBU will be left with enlarging the monetary supply in order to finance a growing budget deficit, having no chance to prevent price destabilization.

**2. LOW AGGREGATE HOUSEHOLD DEMAND.** Unwinding the inflation spiral will not be expeditious, restrained by reducing real income of households both in 1998 and 1999 (see **HOUSEHOLDS**).

## Producer prices

**Wholesale prices will be most dependent on exchange rate dynamics**

Considering dependence of Ukraine's real economy on imported energy, producer prices will be determined by exchange rate dynamics. Therefore, a 20% increase in wholesale prices and considerable devaluation (matching inflation in the consumer market) is realistic for 1999 only under the optimistic scenario.

The growth of wholesale prices that already started in 1998 in the fuel and energy sector will inevitably lead to higher prices in other sectors of the economy in early 1999. This tendency, however, will not receive large-scale development over the next few months because of restrained demand by end-consumers. As a result of the latter, an increase in wholesale prices at the end of 1998 outstripped the consumer price index and the growth of broad money supply, giving way only to the exchange rate.

On the other hand, the UAH 6/\$ exchange rate, which may occur at the end of the year according to our pessimistic scenario (see **MONETARY**), will lead to about 100% increase in imported energy wholesale prices. As a result, the overall increase in producer prices will not be lower than 35-40%, being most significant at the end of the year.

### *Wholesale price change in industry, index (end year)*

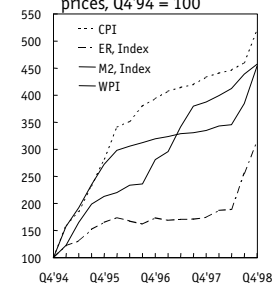
Industry	1998	1999-opt.	1999-pes.
Energy	166,4	130	160
Fuel industry	135,3	120	135
Ferrous metals	150,7	125	130
Chemicals and oil-refining	130	120	120
Machine-building	123,5	115	115
Light industry	126,5	115	115
Food industry	114,8	110	120
Construction materials	126,1	120	140
Total	135,3	120	135

Source: State Statistics Committee

Forecast: Quarterly Predictions

We must emphasize the sensitivity of Ukrainian producers to financial destabilization, which transfers in higher prices on their output. According to the results of Business Opinion Survey in the 3<sup>rd</sup> quarter of 1998, conducted by the International Centre for Policy Studies, 30.3% of the surveyed managers of Ukrainian enterprises called higher prices on their output a means of adjusting to the financial crisis. Only 3.8% of those surveyed considered lower prices a reasonable instrument.

Indexes of the exchange rate, M2, consumer and wholesale prices, Q4'94 = 100



Source: Derzhkomstat, NBU

**Producer prices are very sensitive to financial destabilization**

# EXTERNAL

For 1998 we keep unchanged our previous estimate of the current account deficit — around US\$1.15 billion (or 3% of GDP). Generally successful debt restructuring efforts, coupled with institutionalized capital immobility, prevented massive capital outflow. On the bottom line, the financing gap in the balance-of-payments absorbed about US\$1.3 billion of foreign exchange reserves reducing them to little more than 3 weeks of import cover by early 1999. Our outlook for 1999 is mixed. Under our optimistic scenario, we anticipate a modest current account deficit of US\$0.5 billion (leaving almost unchanged our previous forecast). Under the pessimistic scenario (i.e. lack of austerity), Ukraine's '99 current account will be deeper in deficit — at least US\$0.6 billion expected. However, even under our optimistic scenario, gross international reserves are not forecast to recover — still only 3 weeks of import cover expected as of late 1999.

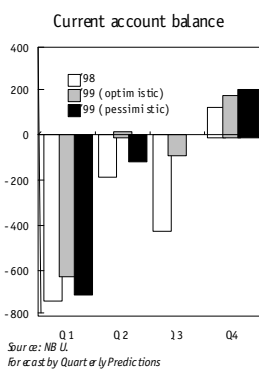
## Current account

**14% improvement in '98 C/A expected...**

For 1998 we reiterate our previous estimate of current account deficit at US\$1.15 billion (or 3% of GDP), a 14% improvement over 1997 on the back of rebalancing in merchandise trade. Exports are estimated to have shrunk by 15%, while imports have been curtailed by 19% translating into a 36% improvement in the trade balance. The latter more than offsets deterioration in the balance of service trade and in the income and transfer balance.

**...still drastic improvement ahead**

In 1999, we forecast a rather drastic improvement in the current account under both of our scenarios. Under our reform scenario, that improvement will result from deliberate austerity policy (i.e. curtailment of public consumption). In this case, we assume real exchange rate of UAH to be stable throughout 1999, as we believe its adjustment was adequate in 1998. In the collapse case, rebalancing will be forced by default, mainly due to significant real devaluation of the hryvnia in case of credibility crisis (see **MONETARY**).



Under our optimistic scenario, we anticipate a modest current account deficit of US\$0.5 billion (leaving almost unchanged our previous forecast). Under the pessimistic scenario (i.e. lack of austerity), Ukraine's '99 current account will be deeper in deficit — at least US\$0.6 billion expected.

We also assume the following across both scenarios:

- depressed state of Ukraine's major export markets (Russia/CIS), slowdown in the OECD, no major upturn in Asia (see **INTERNATIONAL**);
- though some recovery in energy prices is expected in 1999, we do not perceive possible deterioration of terms of trade as significant to factor it in;
- deteriorating trade regime for Ukrainian exporters due to their dumping practices, as well as a retaliation for domestic protectionist policy.

**Further contraction of trade in '99**

Under these assumptions, our benign case should see '99 exports falling by 2%, with imports being slashed by 5%. Our doom case has still lower exports (by 3%) as a result of poor competitiveness of Ukrainian enterprises, which charge dumping prices for their products, and consequently face limitations in

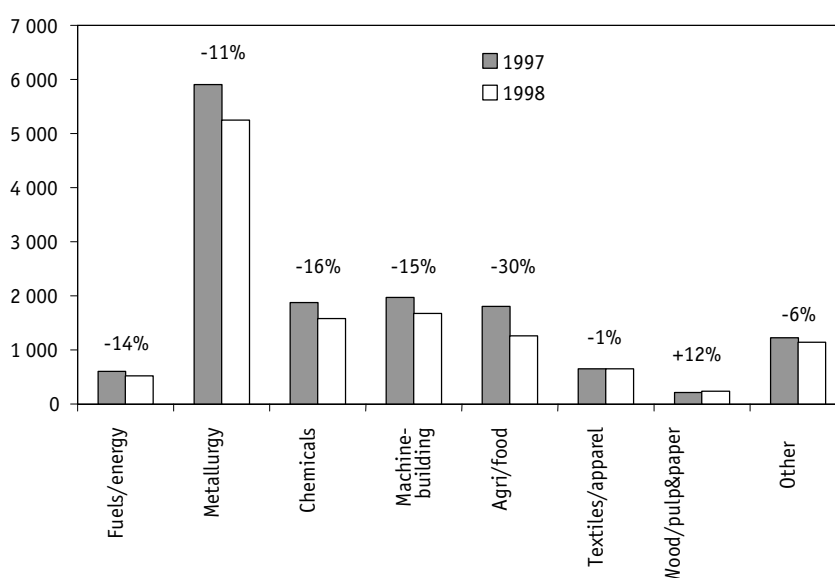
accessing world markets. At the same time, higher imports reflect excessive public consumption and softer budget constraints of public enterprises in the first half of 1999, which will be completely offset by the results of default during the next six months of the year.

Drastic devaluation of local currency in September 98 has been expected to boost competitiveness of Ukraine's labor intensive industries like textiles/apparel and probably agriculture/food. So far, this has not occurred either due to an adjustment lag or trade regime constraints (or a mix of the two). As for agri/food exports, we attribute its quite rapid curtailment in 1998 to the collapse of the Russian market, its major export destination. Since Europe is not yet an alternative market (due to CAP and similar restrictions), Ukrainian food/agri exports would follow CIS demand trends (which are downward directed).

**No positive effects of currency devaluation on exports**

### Patterns in merchandise exports

US\$ millions



Source: State Statistics Committee, estimates by Quarterly Predictions

For 1999, we anticipate stronger export sales from textiles/apparel, as well as recovery in agri/food export volumes, products of which are more competitive in world markets, while energy, metals and chemicals should be falling. Export sales of Ukrainian mechanical engineering is going to stay flat (or perhaps even rise if large-scale contracts awarded).

**Stronger export sales from textiles/apparel and agri/food anticipated**

What remains in the black box is whether Ukrainian enterprises embark on restructuring and cost optimization to enhance their competitiveness. Typically weakness in sales markets drives a profit-maximizing firm to do just that. Our belief is that this is not to happen for virtualized Ukrainian enterprises — they will seek to expand their sales in volume (to compensate cash losses from lower prices) provoking antidumping suits<sup>13</sup>. Weak Ukrainian

**breakthrough in cost-optimization desired**

<sup>13</sup> According to Clifford G. Gaddy and Barry W. Ickes, for participants in post-Soviet economies the goal of exporting is not profit, but cash, as they want to offset the value they ruin in the domestic market through barter or by overpricing their products (see Policy Studies, #1, 1999, "Beyond a bailout: time to face reality about Russia").

government would be supportive in granting exemptions and privileges to relax their budget constraints (see **BUDGET**). This already conventional way is to be more pronounced under our pessimistic scenario but has little room in the reform case.

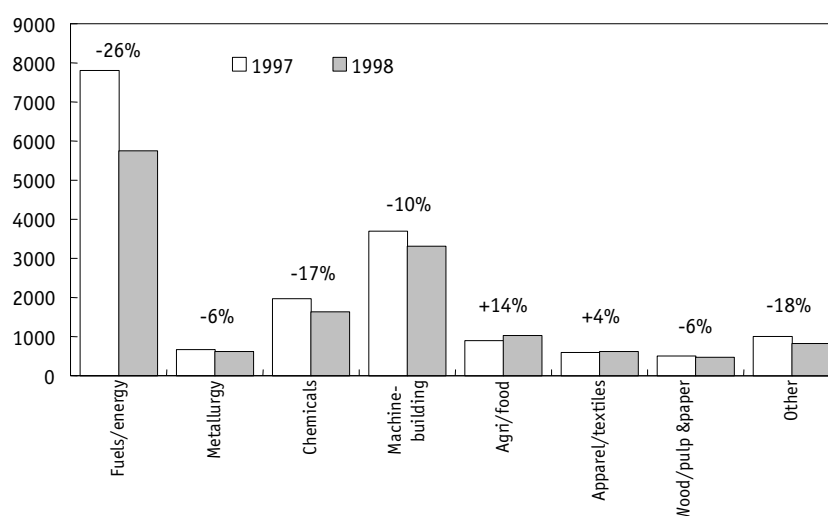
***In 1998, energy/fuel imports lost the most...***

***...while agri/food imports increased***

In 1998, energy/fuel is estimated to have lost the most in its weight in Ukraine's import mix. This results from a decline in gas prices, accompanied by lower transit fee for Russian gas. A rise in agri/food imports, given the background of shrinking imports and devalued hryvna, looks surprising, but may be partially explained by sugar beats and sunflower oil imports in the first half of 1998 (see **QUARTERLY PREDICTIONS**, issues 4 and 5). We expect this development to reverse in 1999 as the domestic market is going to be smaller, while Ukrainian producers will be better positioned.

### *Patterns in merchandise imports*

US\$ millions



Source: State Statistics Committee, estimates by Quarterly Predictions

***Further contraction of service exports in '99***

In services, 1998 exports are estimated to decline by 15% on the back of lower pipeline transit revenues. We also anticipate smaller '98 revenues for most services with an exception of travel. For 1999, we forecast further 1% decline in service exports mainly due to lower transit volumes.

***Growth in service imports is to reverse...***

On the import side, payments for foreign services are estimated to have risen by 9% with growth observed across the board. However, in 1999 this import expansion is to subside and reverse by 7% (now falls are expected across the board) since local demand is to be weaker, while no significant real appreciation of hryvna is expected.

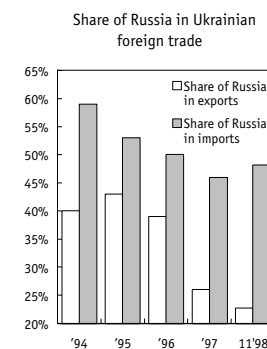
We anticipate improvement in income balance for 1999, especially under our negative assumptions when Ukrainian authorities give up the debt service. The transfer balance is going to be less generous and almost collapses in the default scenario.

### *Has Russian crisis triggered reorientation in Ukraine's trade patterns?*

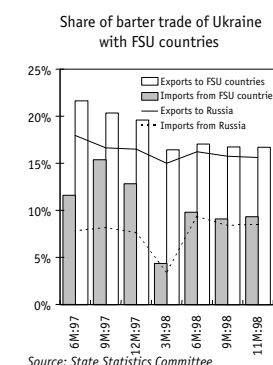
*Not quite. As we hypothesized previously, abrupt rouble devaluation disrupted Ukrainian export sales to Russia, which fell from 26% to below 23% of total merchandise exports. Though matching hryvna devaluation is likely to bring some recovery to Ukrainian export sales, depressed Russian demand will result in a falling share of Ukrainian exports going to Russia. On the import side, later and gradual adjustment of hryvna's exchange rate vs. rouble induced more imports from Russia (hence, a rise in Russia's weight in Ukrainian merchandise imports). We believe this is a short-lived development and owes to adjustment lag.*

*As for 1999, we would expect lightening of Russia's weight in Ukraine's merchandise trade at the expense of barter sales, which are frequently arranged with governmental involvement (to keep national enterprises busy). Due to dubious economic expediency of such arrangements, we believe they should be crowded out from current 9-17% to less than 5% (as in settlements with other regions. Yet, under the pessimistic scenario, the persistence of those barter arrangements may keep Russian exposure high (e.g. food-for-debt swap with RAO Gazprom).*

### **Better income balance but worse transfer balance in '99**



Source: State Statistics Committee



Source: State Statistics Committee

## Capital/financial account

In 1998, Ukraine's capital and financial account will exhibit a net inflow of over US\$0.4 billion owing to capital controls, illiquid markets and successful rollover of debt inhibiting quick outflow. Yet, the negative amount of errors and omissions (sometimes treated as a proxy for capital flight) more than offsets this capital account surplus. Anecdotal evidence seems to be supportive to hypothesis of overall net capital outflow from Ukraine in 1998.

For 1999, our bullish and bearish scenarios keep the account in the black (with higher net inflow under the former), though in the latter case on a much lower scale of capital flows. However, even for our optimistic scenario, we cut anticipated 1999 FDI inflow from US\$0.7 billion estimated for 1998 to US\$0.6 billion as there is going to be more uncertainty over Ukraine's fundamentals due to forthcoming Presidential elections. On balance, we keep portfolio investments zero as weak investment sentiment will keep inflows minimal, while outflows will be also low as most of foreign short-term capital has already left the country. Debt amortization will be matched by new borrowings – either in full scale (under the reform scenario) or only partially (under default case). Since room for more rollovers is limited, support from the IMF is crucial in defining which way Ukraine goes.

**A net capital outflow in '98 when errors & omissions included...**

**...while for '99 capital account surplus anticipated**

**IMF's stance is crucial in deciding where/how Ukraine goes**

## Reserves vs. Financing Gap

*US\$1.3 bn loss of reserves in '98*

In 1998, the resulted financing gap absorbed about US\$1.3 billion from NBU's reserve coffers reducing the gross foreign exchange reserves to around 3 weeks of import cover by the start of 1999 (vs. almost 7 weeks as of early 1998) (see **MONETARY**). Given the low reserves, the current currency band arrangement (or any new one) will face a credibility problem without strict capital controls. In other words, liberalization of forex market seems inconsistent with a currency band arrangement.

*In '99, either a minor drop or...*

For 1999, under our sanguine assumptions, the resulting financing gap of US\$0.1 billion will be covered from already thin reserves.

*a heavy loss of reserves*

If developments follow our bearish scenario, Ukraine will face a heavy loss of reserves — over US\$.6 billion (leaving about 1 week of import cover), a critical blow to credibility of any currency band arrangement.

# BUSINESS

Industrial output fell by 1.5% in 1998, a minor overshoot vs. our previous estimate of a 1.2% drop. The Russian/East Asian contagion revealed the unsustainability of growth in Ukraine's unstructured industry. Since the macroeconomic environment continued to be weak, while there is little ground for major restructuring effort to succeed, for 1999 we adopted a pretty gloomy outlook — our forecast of '99 industrial growth has been revised from -0.3% to -3%. We identify food and textiles/apparel as the first candidates to stay buoyant. Other sectors (especially energy) are trapped in virtuality of non-cash settlements and governmental manipulations. 1998 was the first year, when investment in fixed capital grew, increasing by 1% of GDP. 1999 is expected to be unfavorable for investment due to higher tax pressure and more intensive consumption in the economy. Under reform scenario, investment in fixed capital will reduce by 1% of GDP, while the default scenario envisions a 2.3% reduction in this indicator as a share of GDP.

## Industrial output

### *Production*

Ukrainian statistics reported an industrial decline of 1.5% in 1998, a minor recovery from -1.8% in 1997, as well as from -1.6% reported for the first 11 months of 1998. Major losers of 1998 turned out to be ferrous metals, mechanical engineering and fuel, while nonferrous metals, apparel/textiles, wood/pulp & paper and building materials gained the most in terms of production growth. These developments appear to be in accordance with desired restructuring patterns (i.e. higher weight of the consumer-oriented sectors at the expense of heavy industry). However, we are not yet persuaded on the robustness of that shift. The latter can be entrenched only within the framework of our reform scenario.

For 1999, we *optimistically* expect local industry to contract by about 3% in real terms, which will be attained by rigorous restructuring effort (i.e. give-up of bailout of fundamentally insolvent enterprises with state hands). Yet, this case lays at least the ground for robust recovery in 2000.

According to our pessimistic assumptions for 1999, the fall in industry will be deeper reaching 4%. In this case, there is no hope for Ukraine to switch to sustainable growth path.

Our grim outlook is quite in accord with evaluation index of macro environment for business<sup>14</sup>. According to the results of Business Opinion Survey, which is based on the answers of enterprises' management, only wood and textiles/apparel do not expect significant deterioration of environment for their operations. At the same time chemicals, metals and construction materials are almost unanimous in expecting worse environment for their activity in the 4<sup>th</sup> quarter of 1998 through the 1<sup>st</sup> quarter of 1999.

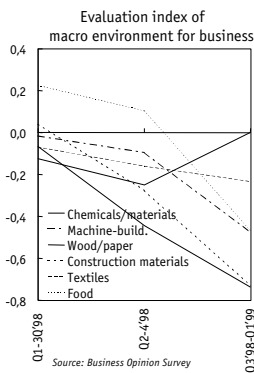
***1.5% industrial decline in 1998***

***Under optimistic scenario for 1999, contraction of local industry will be 3%...***

***...or 4%, according to pessimistic assumptions`***

---

<sup>14</sup> BUSINESS OPINION SURVEY, #3, January 1999



## Industrial output

Annual % change (real terms)



Source: State Statistics Committee. Forecast by Quarterly Predictions

**Food and textiles/apparel to stay buoyant in '98...**

**...while unstructured heavy industry is a burden for sound sectors**

We regard food and textiles/apparel as the most buoyant performers owing to their consumer orientation, generally inexpensive restructuring programs and high cash collection<sup>15</sup>. Both are expected to exhibit about 2% production growth rates even on the background of declining GDP. Fundamentally, wood/pulp & paper and construction materials also look robust, yet their growth prospects are put into question by the high weight of barter settlements. Nevertheless, our growth forecast for those sectors looks sluggish as we regard unstructured heavy industry to be a burden for the rest of the economy.

## Sectoral production

Annual % change (real terms)

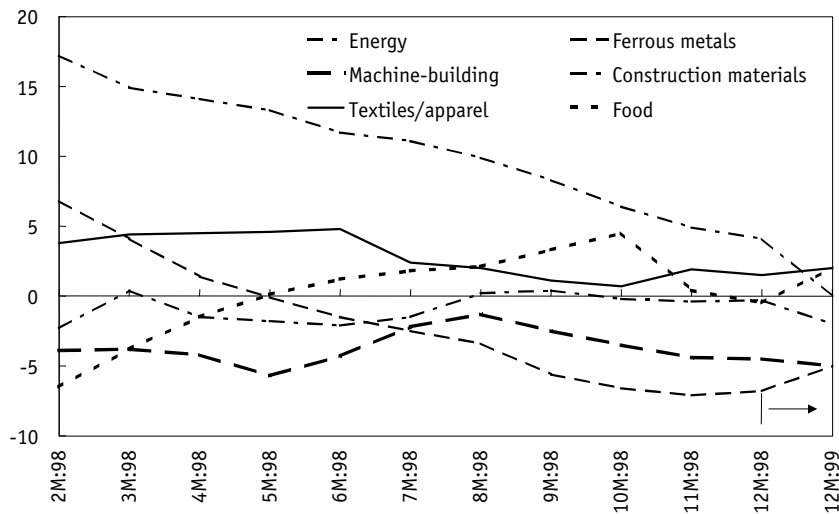
	1997	1998	1999	
			optimistic	pessimistic
Industry total	-1,8	-1,5	-3	-4
Electricity	-2,6	-0,3	-2	-4
Fuel	4,5	-0,7	-3	-5
Ferrous metals	7,7	-6,8	-5	-5
Non-ferrous metals	2,7	12,4	0	1
Chemicals	-0,6	0,9	-2	-3
Mechanical engineering	-3,6	-4,5	-5	-6
Wood/pulp & paper	-5,1	10,4	1	0
Construction materials	-7,9	4,1	0	-4
Textiles/Apparel	-5,2	1,5	2	1
Food	-14,6	-0,5	2	1

Source: State Statistics Committee. Forecast by Quarterly Predictions

<sup>15</sup> In other words, it does not take much money to turn a food-processing or an apparel producing enterprise into a profitable business as they produce fundamentally right products (people has regular need in food and apparel). Typically their restructuring requires change in design, packaging, marketing efforts which are relatively low-cost to implement.

## Output dynamics by industry

Annual % change, optimistic forecast



Source: State Statistics Committee. Forecast by Quarterly Predictions

## Financial results

Ukrainian financial statements are poor guides to sectoral performance. If one assumes local financial data to be reliable, then he/she is going to face counterintuitive implications. For instance, according to Ukrainian official statistics, since 1997 (regarded as a favorable year) local industries improved (!) their financial performance in crisis-hit 1998 (notice higher profit margin for the first 9 months of 1998). A better profit margin in ferrous metals in 1998 looks absurd given the background of depressed export prices and slim cost-cutting effort. Another evidence of inadequacy of Ukrainian financial reporting is electricity, which is reported to be a top profit generator, yet faces considerable working capital gaps (e.g. not enough cash to pay wages and taxes). Alternatively, one should accept the notion that local enterprises are not profit maximizers and local financial data is irrelevant.

Besides discrepancies of Ukrainian Accounting Standards (UAS) vs. International Accounting Standards (IAS), one major distortion of financial results lies in prevalence of non-cash settlements (i.e. barter, offsets, promissory notes). We believe that the ultimate reason for their widespread use is reluctance (or weak and inconsistent effort) on behalf of the Ukrainian government to impose hard budget constraints<sup>16</sup> on enterprises.

We think of the government policy to be the critical factor causing expansion of non-monetary payment methods, which reduce both budget revenue and household income. Moreover, in many ways the government is itself an arranger/initiator of barter/offset schemes under the slogan of 'support to national producer'.

**Reported financial results are irrelevant for performance evaluation**

**Nonmonetary settlements add to nontransparency**

<sup>16</sup> See for details Policy Studies, #1, January 1999.

## Sectoral operating profit margins (UAS)

	1H:97	1997	1H:98	9M:98
Industry total	4.3%	5.4%	5.7%	6.3%
Electricity	9.8%	11.0%	14.3%	16.6%
Fuel	7.7%	11.4%	14.1%	14.3%
Ferrous metals	-5%	.1%	.3%	.7%
Non-ferrous metals	1.5%	3.2%	-1.5%	-5%
Chemicals/Petrochem.	-7%	-1.2%	-4.1%	-3.8%
Mechanical engineering	4.2%	4.7%	1.6%	2.0%
Wood/pulp & paper	1.7%	3.3%	.8%	.5%
Construction materials	-1.6%	1.3%	-3.9%	-2.8%
Textiles/Apparel	-5.8%	-4.5%	-11.4%	-9.6%
Food	8.0%	6.9%	7.1%	7.6%

Source: State Statistics Committee

**...and signal restructuring problems**

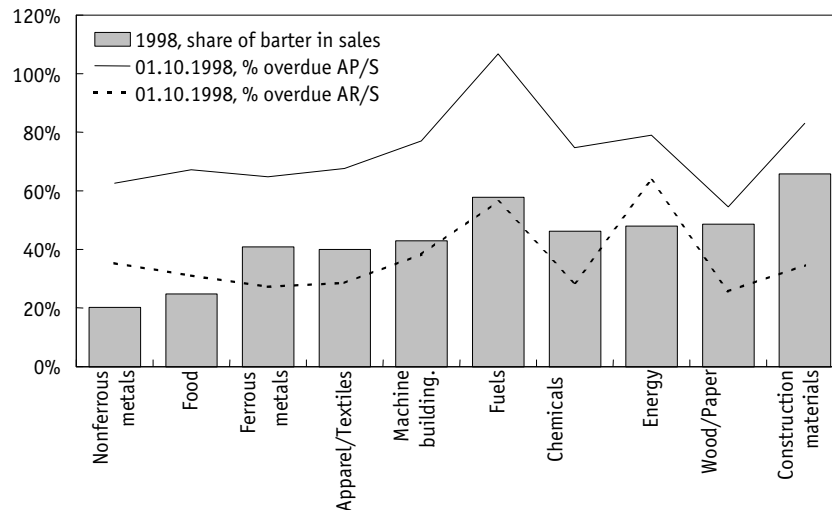
**Food & textiles/apparel look sounder...**

**...while energy is trapped in non-cash settlements**

Having said that, we intend to cover regularly the weight of barter settlements across industries (as reported by Derzhcomstat). We will treat its dynamics as a proxy for soundness and restructuring of Ukraine's industry. With this interpretation in mind, food, nonferrous metals and textiles/apparel appear to be relatively sound sectors in Ukraine. The latter two owe much for their high cash collections to their export exposure<sup>17</sup>. In contrast, construction materials, fuel, wood/pulp & paper as well as electricity are trapped in barter. For electricity and fuel sectors, the problem turns out to be even more acute if one adds vekselns and frequent, as well as large-scale, offsets.

## Weight of barter across industries

% of sales



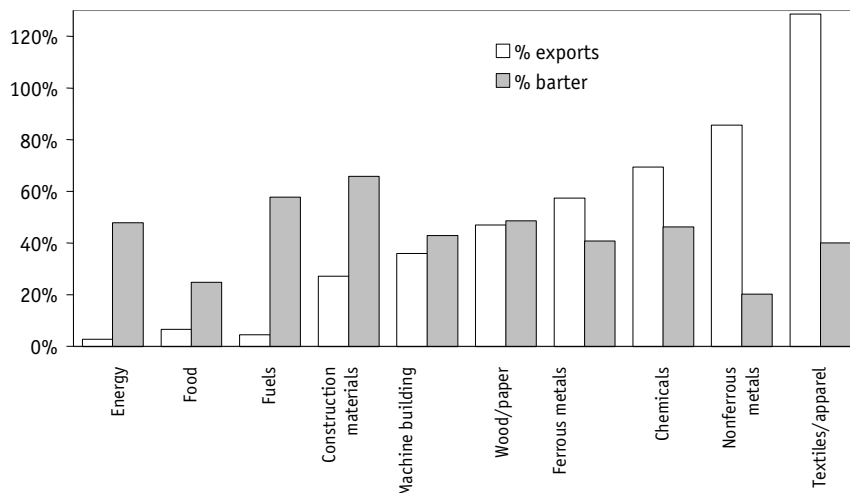
Source: State Statistics Committee

<sup>17</sup> In official statistics, Ukraine's textiles/apparel sector is reported to have exports more than their total sales revenue. The explanation of this counterintuitive phenomena lies in dominance of tolling operations amongst local manufacturers (i.e. an enterprise generates its revenue from fees paid for their processing/manufacturing services, while export volumes are reported at goods sale price).

For food and construction materials, which currently have very modest export sales, we foresee the greatest potential in export expansion (owing to potential cost advantages from low labor and raw material costs). The latter should be part of the restructuring efforts at enterprises of those two sectors.

### *Weight of export across industries*

% of Sales



Source: State Statistics Committee, QP estimates

### *Ukraine's electricity as a mirror of its unrestructured economy?*

*In a well-functioning economy, the reliability and availability of power supply is taken as granted. Yet in a number of transition economies (Ukraine included) pervasive non-payments for power supplied threaten the service reliability of electric utilities (e.g. disruptive customer cut-offs across the board to maintain adequate frequency). Being a backbone of any sophisticated economy, the electricity sector turns out to be a reflection of the whole economy (see table below). The data suggest that low cash collections in power sector are inconsistent with economic recovery and solid growth. Therefore, by the same virtue of its backbone status, the electricity sector should become a starting point in attacking non-payments/barter.*

#### *Non-payments of power bills*

<i>as % of Sales</i>	<i>Total Collections</i>	<i>Cash Collection</i>	<i>Barter</i>
<i>Bulgaria ('97)</i>	<i>91</i>	<i>100</i>	<i>0</i>
<i>Georgia ('97)</i>	<i>68</i>	<i>36</i>	<i>n/a</i>
<i>Lithuania ('97)</i>	<i>96</i>	<i>100</i>	<i>0</i>
<i>Russia (8M:98)</i>	<i>84</i>	<i>15</i>	<i>58</i>
<i>Ukraine ('98)</i>	<i>78</i>	<i>16</i>	<i>48</i>

*Source: World Bank, Minenergo, Derzhcomstat, QP.*

## Investment

According to our estimations for 1998, gross investment (gross fixed capital investment and inventory investment) fell by 1.7% in real terms. They equaled gross investment in 1997 and constituted approximately 20% of GDP in 1998.

*In 1998 gross investment fell...*

*...although investment in fixed capital grew*

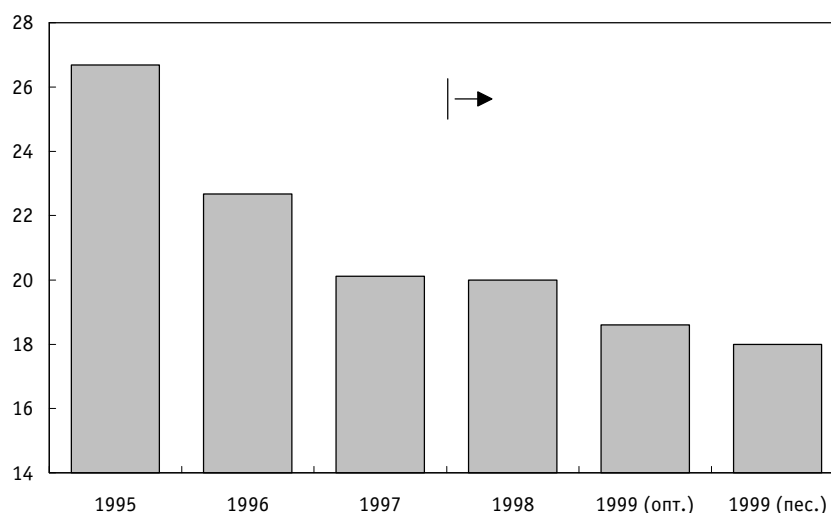
According to 1998 results, investment in fixed capital improved by 1% in real terms. While during the first six months of 1998 the pace of investment was even higher, the second half of the year turned to be unfavorable. The main reason for the deterioration in investments is the downtrend of business and resulting lower volumes of investment in production.

According to results received by the Business Opinion Survey project<sup>18</sup>, entrepreneurs' expectations grew regarding lower domestic demand in the third quarter of 1998, which made them reduce investment in fixed capital. The additional negative impact on investment produced a sharp growth of interest rates in the fall, as well as a reduction of working capital and profits for enterprises. In spite of this, a significant increase during the first half of 1998 predetermined the growth of gross investment in fixed capital from 18.3% of GDP in 1997 to 18.8% of GDP in 1998.

---

### Gross investment

% GDP



Source: State Statistics Committee, Forecast by Quarterly Predictions

---

The financial crisis in the fall of 1998 led to a more rapid accumulation of finished goods. Negative inventory investment in the first half of 1998 (UAH - 410 million, or -0.92% of GDP) turned positive in the third quarter (increasing by UAH 754 million), which resulted in UAH 344 million, or 0.47% of GDP, of inventory investment for the first nine months of 1998. A further reduction in sales during the fourth quarter caused further accumulation of finished products. Even though inventories in materials slightly decreased due to the economic recession, the increase in aggregate inventories amounted to UAH 1.3 billion, or 1.2% of GDP, in 1998.

---

<sup>18</sup> Business Opinion Survey, #3, January 1999.

The current year will not be favorable for investment activities due to an increase in the tax burden and re-orientation of economic resources upon consumption before presidential elections.

***1999 will be unfavorable for investment...***

Enterprises will also have fewer funds available for investment, due to further stagnation in the real sector. Even if one considers the increase in credits promised by the NBU to commercial banks up to UAH 1 billion (see **MONETARY**), this will hardly result in more active investment in fixed capital. Commercial banks will continue to hold credit interest rates high as a result of low confidence in government economic policy, which means that investment will not be of a long-term character.

According to our optimistic scenario, which envisions financial stability and positive expectations by entrepreneurs, gross investment will decrease this year by 10%, amounting to 18.6% of GDP.

***... which will drop 10% in an optimistic scenario...***

By a pessimistic scenario, which envisions a default of Ukraine, investment activities will be even worse. First, we expect foreign investment to decrease two times compared to the reform scenario. Increasing inflation will not favor private investment as well (see **PRICES**). In case development follows this pattern, gross investment will fall by 15% and account for 18% of GDP. In addition, the structure of investment will deteriorate as the share of inventory investment grows.

***...or 15% in a pessimistic scenario***

### ***Business investment***<sup>19</sup>

According to our estimations, gross fixed capital investment grew in 1998 for the first time in recent years, and the calculated increase was 1% in real terms. Capital investment (as the largest share of gross investment, which is fast reported) rose by 4.8% during the last year. In the second half of the year, the pace of growth continuously slowed down, from 8.5% in the first six months of the year to 6% for nine months, and ended up with an annual 4.8% increase.

***Investment in fixed capital increased by 1% in 1998***

In 1999, investment in fixed capital will decrease as the government tries to increase budget revenues to pay out social arrears. This will cause further reduction in working capital of enterprises, in particular, after the introduction of a stamp tax and 10% tax on depreciation expenses. Again, as usual, the main burden will be imposed on efficient enterprises which are capable of investing, while loss-making enterprises will not be hurt at all.

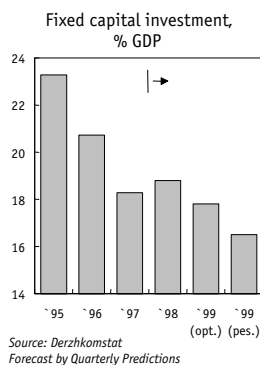
***In 1999, investment in fixed capital will decrease...***

For example, the 1999 budget envisions UAH 1.1 billion in revenue from 10% tax on depreciation funds, which will be transferred to the state budget by enterprises of all forms of ownership. However, one ought to keep in mind that 60% of fixed capital is owned by enterprises that report losses continuously, do not pay corporate profit tax and remain in Kartoteka 2 for years.

***...due to administrative pressure on effective enterprises***

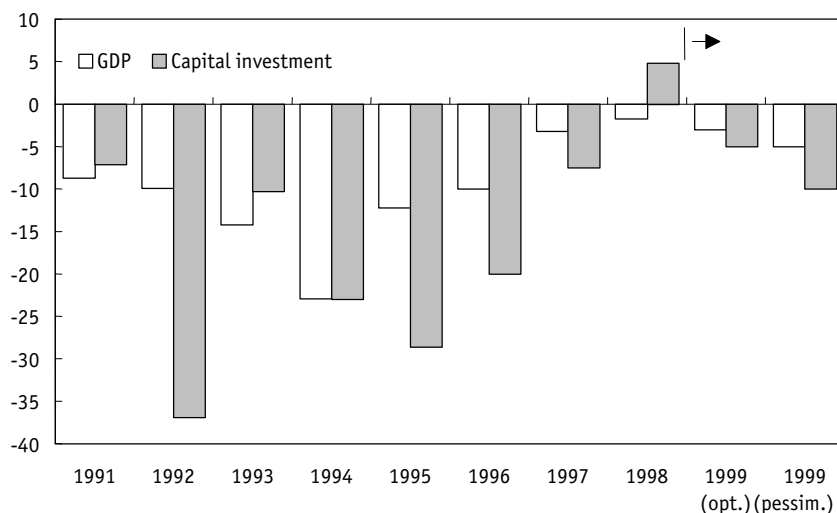
---

<sup>19</sup> Business investment is gross fixed capital investment, including capital investment and capital repairs. Therefore, capital investment is lower than business investment, though it retains its largest share. The calculation of fixed capital investment performed by the State Statistics Committee takes into account a wider selection of enterprises than when capital investment is calculated.



## GDP and capital investment

Annual % change, real numbers



Source: State Statistics Committee

Introduction of the stamp tax is further confirmation of the fact that the Ukrainian government is going to support loss-making enterprises. Charges on depreciation funds will be assessed to the Leasing Fund and used for producing agricultural machinery. So far, however, agricultural enterprises cannot afford to pay for this equipment (see **AGRICULTURE**), being restrained by state policy in the agricultural sector. Establishment of the Leasing Fund indicates that the government will not refuse its administrative methods of regulating the agro-industrial sector.

Beyond any of the two scenarios, lower domestic demand in 1999 will result in lower investment. But the scale of decrease will mainly depend on government policy.

***In the optimistic scenario, investment in fixed capital will decrease by 1% of GDP...***

If the government abandons its administrative methods of regulating economic activities, receives financing from the IMF program, and keeps inflation below 20%, private investment will drop to 18% of GDP and public investment will be 0.6% of GDP. The main share of aggregate investment will be made in fixed capital, amounting to 17.8% of GDP, while inventory will be 0.8% of GDP respectively.

***...or by 2.3% -in a pessimistic scenario***

In case the government continues to support loss-making enterprises at the expense of effective firms and does not fail in its administrative measures to regulate economic activities, the IMF is very likely to discontinue its financing in Ukraine, which will face default and accelerating inflation. In addition, fewer domestic and foreign agents will invest in fixed capital. At this, private investment will amount to 17% of GDP and public investment 1% of GDP. Larger volumes of public investment in the negative scenario will be totally offset by its low efficiency, as investment will be made in production rather than in infrastructure. We expect the share of gross investment in fixed capital to be 16.5%, while inventory investment reaches 1.5% of GDP.

## *Inventory investment<sup>20</sup>*

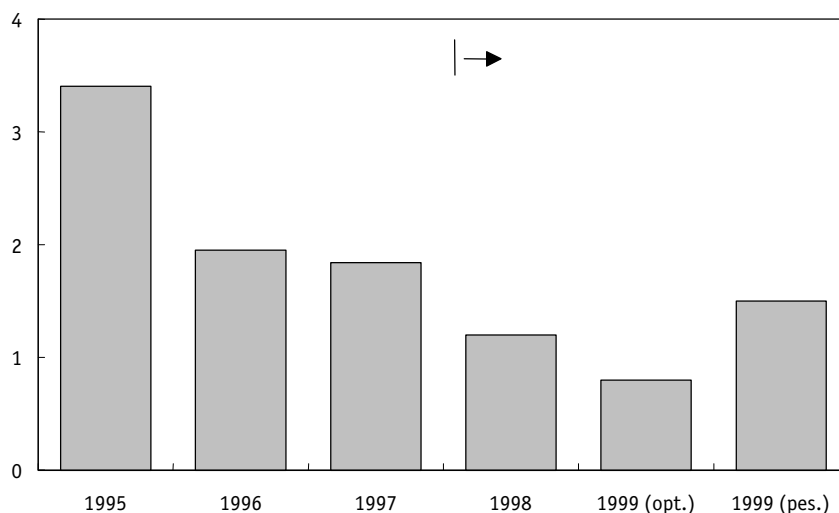
According to our estimations, inventory investment amounted to 1.2% of GDP in 1998, as compared to 1.84% of GDP in 1997. Although inventory investment fell during the first six months of 1998, it substantially grew in the second half of the year as a result of an increase in inventories of finished goods. This arose from a reduction in sales after the crisis and operations of firms that continue to accumulate products in warehouses.

***Inventory investment amounted to 1.2% of GDP in 1998...***

---

## *Inventory investment*

% GDP



Source: State Statistics Committee. Forecast by Quarterly Predictions

---

In the current year, inventory investment will amount to 0.8% of GDP. If bankruptcies of loss-making enterprises are initiated, accumulation of illiquid finished goods will gradually move to zero. On the other hand, if no reforms are provided, inventory investment will grow as a result of low-quality goods production. In addition, high inflation will suppress sales, which, in the negative scenario, will lead to inventory investment, amount to 1.5% of GDP.

***...which will increase in 1999 by 0.8% of GDP in the reform scenario...***

***...and by 1.5% of GDP in the crisis scenario***

## *Foreign direct investment*

Foreign capital inflow in 1998 amounted to \$922 million, which is 21% more than in 1997. The Korean Company DAEWOO that invested \$180 million in Ukrainian Avto-ZAZ in the second half of 1998 produced this rapid increase in direct foreign investment (FDI). Capital outflow equaled \$179.6 million, and therefore the net surplus in non-resident capital amounted to \$742.8 million.

***The net surplus in non-resident capital amounted to over \$700 million in 1998***

---

<sup>20</sup> The term "inventory investment" refers to an increase or decrease in inventory. Inventory investment includes two components: a change in material turnover funds, and acquisition of assets minus dispossession.

***In an optimistic scenario, growth of FDI will lower to \$800 million in 1999...***

***...and down to \$50 million in pessimistic expectations***

Two scenarios of economic development define the forecast for FDI inflow this year. The reform scenario estimates foreign capital inflow at \$800 million and foreign capital outflow at \$200 million, which will result in net foreign capital surplus amounting to \$600 million. If the government fails to implement reforms and the IMF ceases collaboration with Ukraine, the increase in FDI will go down to \$500 million, while capital outflow will grow to \$250 million, resulting in a \$250 million net surplus.

### *Protection and allowances do not work out*

*In 1998, FDI inflow was the largest in Ukrainian history, due to investments by Korean DAEWOO, amounting to \$180 million, which was made by a special preferential regime. In addition, FDI significantly grew as a share of GDP, accounting for 2.2% of GDP at the end of the year, when the hryvnia devaluated (as compared to 1.5% of GDP in 1997). However, this success is insufficient for effective transformation against FDI inflows in other transition economies, which constitute 5-10% of GDP.*

*One may assume that Ukraine is an attractive market for investment, due to its size, 50 million people, and rather skilled labor. But the absence of internal reforms discourages foreign companies that do not believe in stable development of their business. As a result, Ukraine receives only moderate inflows.*

*In one piece of research, Lehman Brothers<sup>21</sup> presents four major factors that predetermine FDI. These are (1) the size of the market and its maturity, (2) trade and exchange rate regime, (3) regulatory climate, and (4) cost factors.*

*Consequently, the policy for integrating in the EU must encourage FDI inflow, as Ukraine has a chance to join a huge market. However, short-term steps must provide changes in the regulatory climate, which is the major impediment to increasing FDI. Ukrainian powers should also implement wide-scale administrative reforms, develop consistent tax legislation and protect it from changes, as well as meet its commitments in front of investors.*

*Tariff and non-tariff instruments that were usually considered favorable for FDI produced just the opposite effect in many countries. They led to changes in the real foreign exchange, which limits export and investment opportunities for a firm. Tax allowances also stir up investment evaluations and provoke the organization of interest groups that support the existing protective system. On the contrary, open policies for exchange rates and trade provided in Asian countries proved to be effective. Enterprises that received investment exported more than half of their output.*

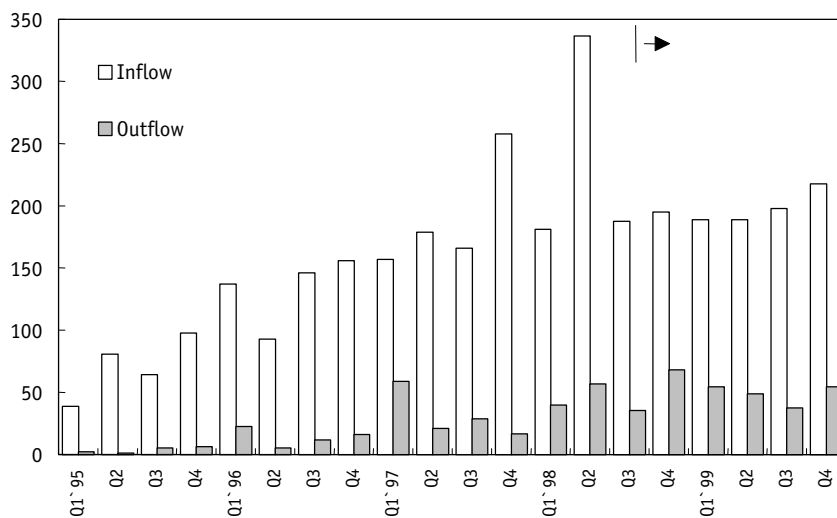
*Political stability also plays an important role in defining the investment climate, efficient and rapid reforms in the labor market, and labor force mobility, which is critical for effectively utilizing a skilled local labor force.*

---

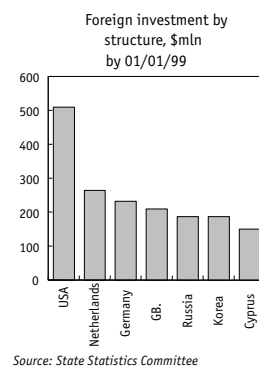
<sup>21</sup> Augusto Lopez-Claros "The Determinants of FDI in Transition Economies", Global Weekly Economic Monitor, Lehman Brothers, 22 January 1999.

## Foreign direct investment

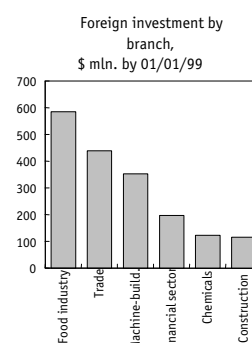
\$ million



Source: State Statistics Committee. Calculations by Quarterly Predictions



Source: State Statistics Committee



Source: State Statistics Committee

# AGRICULTURE

We deteriorate our forecast for agriculture in 1999. Under our optimistic scenario, which envisions restriction of government control over the agricultural sector, the decline in gross agricultural output will reach 4%. In case the government fails to implement reforms, the situation will deteriorate, resulting in 6-7% decline. According to the former scenario, grain production will remain at the same level as 1998, while livestock production will drop 6% due to worse provision of feed stock last year. Under the latter scenario, output in the private sector will decline as a cause of the worsening economic environment, and grain production and livestock output will decrease by 4% and 9% respectively.

## Overview

***Overall decline in agriculture totaled 8.3% in 1998...***

***...and will range from 4% to 7% depending on the extent of reform implementation in agriculture***

Overall decline in agriculture totaled 8.3% in 1998, compared to a 1.9% reduction in 1997. Last year became the third consecutive year of losses in the agricultural sector, amounting to UAH 2.8 billion against UAH 3.5 billion in 1997. We expect this trend to develop through the next year. Under our optimistic scenario, which envisions efficient reforms for the sector during recent months (providing de-monopolization and reducing government control over the sector), the decline will be 4%. Under the pessimistic scenario, the government will refuse to reform the sector, and it will deteriorate 6-7%. Beyond these scenarios, the reduction of output by sector will be less significant than expected, due to the introduction of two-year tax holidays for agricultural producers beginning from January 1, 1999<sup>22</sup>.

During 1998 agricultural enterprises accumulated UAH 2.7 billion in accounts payable. By the beginning of 1999, the total amount of accumulated accounts payable in the agricultural sector was UAH 13.3 billion, which exceeds the sum of accounts due (UAH 3.3 billion) by 4 times. We consider this fact an impediment to the short-term stabilization of the sector.

Domestic agriculture is a huge economic sector, which employs one half of Ukrainian labor. Thus, the government cannot afford to subsidize agricultural activities, which must start creating profits. With this in mind, we see the following reforms as efficient:

- Agricultural land privatization, introduction of mortgage credits
- Development of market mechanisms in the agricultural sector: (1) termination of government subsidies to loss-making farms, (2) refusal of input supplies by the government, (3) de-monopolization of input supply scheme and sales of agricultural output, (4) privatization of grain handling and grain storing enterprises (in particular, grain elevators)
- Creation of favorable economic conditions for crediting and investment activities (by reducing interest rates and lessening the tax burden, which is exceptionally high in the processing sector)

---

<sup>22</sup> Agricultural producers received remission of value added tax for a 5-year term, and are excused from paying fixed agricultural tax for a 2-year period. The latter remission, however, was terminated regarding payments of obligatory pension insurance.

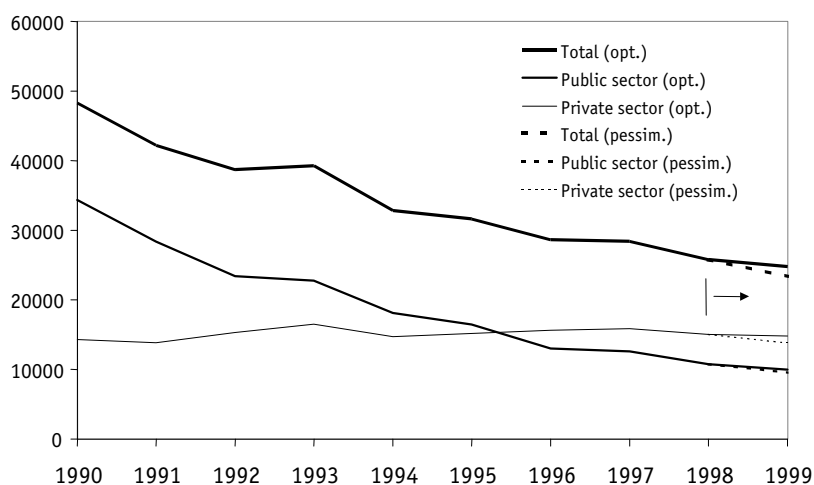
- Administrative reform, which will eliminate opportunities for the government to intervene in the sector's activities

At the same time, the probability that these measures will be implemented this year is still very low. New program for reforming the local agro-industrial complex during 1999-2010, which was developed by Minagroprom, is based on socialist methods of managing agricultural activities, which envision a gradual increase in public spending on the sector, provision with 30% of necessary input supplies, and guaranteed state purchase of agricultural output. This government policy will cause further deterioration in agriculture and impede development of the private sector.

**Probability of rapid reform is very low...**

### *Gross agricultural output in real prices*

Base=1996, UAH mln.



Source: State Statistics Committee, Calculations by Quarterly Predictions

Decline in grain production will be 4% in 1999 due to a worse regime of field work (than 1998) as well as a shortage of seeds, fertilizers, and plant protection products. Actual outcome may improve only if farms avoid losses from the draught and heavy rains that occurred last summer. As to livestock production, we expect a more rapid decline (6% or 9% under optimistic and pessimistic scenarios respectively). This results from a lack of positive changes in the structure of ownership.

**Decline in 1999 results from downturn in livestock production**

The key reason for pronounced deterioration in agriculture is the absence of private land ownership. Although the right to own land is guaranteed by the Constitution of Ukraine, there exist no mechanisms for acquiring this right. Yet, the President of Ukraine enacted the first step in this sphere, issuing Decree "On the sale of non-agricultural land parcels", which was not vetoed by Parliament.

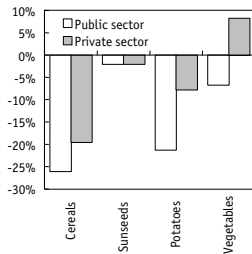
Obviously, the Presidential Decree should have covered agricultural land parcels. However, the President spoke against agricultural land privatization, which is more evidence of inconsistency in state agrarian policy.

Further development of the agricultural sector is predetermined by legalization mechanisms for using land as collateral. However, state monopolist mortgage banks will nullify any efforts in this sphere, as farms cannot use their land as real collateral. This will immediately result in corruption and crediting loss-making farms, causing further accumulation of accounts payable in the sector.

## Plant growing

### Plant growing decreased by 15% in 1998

Plant growing in private and public sectors in 1998, annual % change



Source: State Statistics Committee  
Calculations by QP

### State input supplies negatively affect the sector

### Output in this subsector sharply reduced by 25.4%

Plant growing in 1998 was reduced by 14.9%. At this, private production was contracted less significantly than in the public sector. Yet, this did not change the proportions of these sectors. Thus, the share of grain production in the private sector was 10.2% in 1998 against 9.5% in 1997; in potato production it was 97.4% against 97.0%, and in vegetable production it was 84.1% against 82.0% for the respective period. As for sunflower seed production, the share of private sector remained unchanged since 1997, amounting to 5.1%.

In general, the share of plant growing in the private sector increased by 0.6-0.7%. Meanwhile, the production of key plants (grain, sugar beets, flax, and sunflower seeds) is performed by the public sector. These proportions seem to be natural, as private farms own only an insignificant share of land. Private producers that concentrate their activities in backyards prefer to grow low cost plants, which require less area and manual labor.

In 1999, the government continues to support the agricultural sector with input supplies and arranged centralized yield sales. The share of state supplies in overall input volumes will be 30% (in particular, 500,000 tons of fuel products will be delivered for spring work), which is 2% more than in 1997. The agricultural sector receives input supplies from the government at higher than market prices, which results from the monopolist scheme of state supply and non-monetary methods of payment. In fact, the market infrastructure in this sector consists of Minagroprom and state input suppliers (fuel from the State Reserve is distributed through regional branches of Ukragrotekhservis and representatives of DAK 'Khib Ukrainy'; deliveries of fertilizers and pesticides are made by Agrokhimtsentr, while machinery is supplied by the Leasing Fund).

## Cereals

According to tentative data by the State Statistics Committee, gross cereal production in 1998 amounted to 26.5 million tons, of which food grain takes 16.7 million tons, or 63%, and fodder grain accounts for 9.8 million tons (37%). Output in this subsector reduced by 25.4% against the results of 1997.

Summer heat and excessive government intervention in the sector's activities caused a sharp reduction in production in the sector<sup>23</sup>. Consequently, research conducted in agricultural enterprises shows that managers of these entities are trapped in a virtual command economy, as they do not consider agrotechnology, issues of management and labor skills key factors that predetermine the effectiveness of production<sup>24</sup>. As a result, the land gets more exhausted, while yield declines all across the board.

In 1998, fall fieldwork matched the volume of 1996 (7.5 million hectares for winter crops, among which 6.8 million hectares was for cereal). 85% of planting is considered satisfactory. At the same time, planned volumes of work were not fulfilled, while reseeded is planned on an area of 1 million hectares, which slightly exceeds last year's indicator (937,000 hectares).

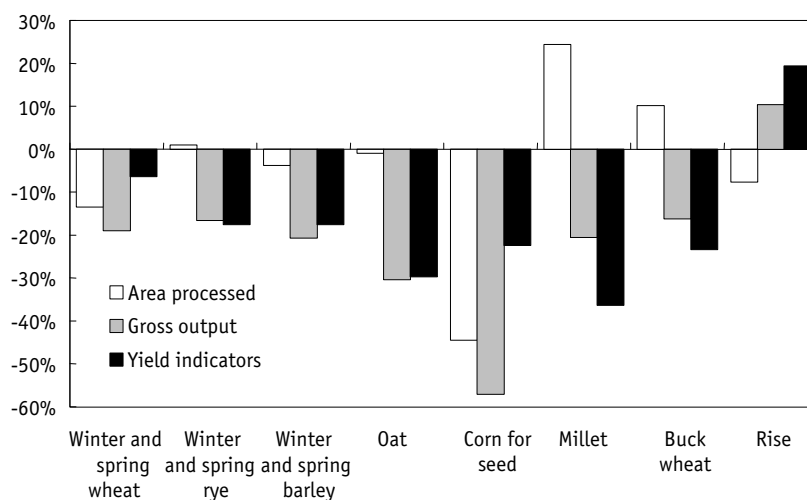
<sup>23</sup> This year, however, the Ministry of Justice prepared its conclusions regarding the responsibility of state agencies and executives for infringing the rights of entrepreneurs and interrupting their activities. The Ministry disseminated this document among Chairmen of regional state administrations, accompanied by a cover letter from Deputy Prime Minister Serhiy Tyhipko.

<sup>24</sup> BUSINESS OPINION REVIEW, January 1999.

---

## Grain production dynamics

1998 against 1997



Source: State Statistics Committee. Calculations by Quarterly Predictions

---

Minagroprom forecasts that gross cereal production will grow by 25% in 1999, rising up to 34.7 million tons, in particular, wheat up to 17.9 million tons (which is 20% more than in 1998). However, we consider these indicators overestimated.

Gross output is the land under crops multiplied by the average yield. Land under crops is not extended and there exists no program for extending them. This means that the increase in the gross output forecast by Minagroprom will result from a 25% growth in yield. However, we still do not have any information regarding a plan for improving agricultural technology, while agricultural machinery available for the spring field works remains at the level of the previous year (68% by February 1, 1999). Besides, access to organic and mineral fertilizers is limited for the majority of agricultural producers, which suffer from a lack of funds.

These problems are reinforced by deficits in seeds (the need for seed grain is estimated as 1.8 million tons, while stock amounts to 1.6 million tons). With this in mind, one can expect an increase in yield, if losses that occurred last year as a result of unfavorable weather conditions will not appear again in 1999. These losses amounted to approximately 14% of land under crops. The consequent need to plow additional land (about 10 million hectares, which is the largest increase in recent last years) will protract all field work scheduled for spring, and barely lead to a 25% increase in yield. According to our estimations, growth in cereal production will not exceed a 5-6% margin, while gross output will be hardly more than 28 million tons<sup>25</sup>.

***We consider  
Minagroprom indicators  
for 1999  
overestimated...***

***...increase in cereal  
production will not  
exceed 5-6%***

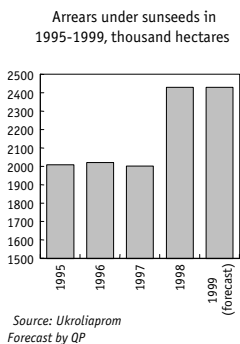
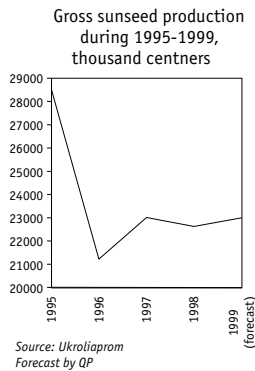
---

<sup>25</sup> Our forecasts given below often differ from official ones, as the latter are consciously overstated, due to the need to report improvements in the sector on the eve of presidential elections.

## Sunflower

**Sunflower seed production fell by 2% in 1998...**

**...and will remain unchanged in 1999**



Gross sunflower seed production, occupying over 8% of areas in crops, amounted to 2,262,000 tons<sup>26</sup> last year, which is 2% less than in 1997. The decline was caused by a sharp reduction in yield indicators (by 19.1%) because of draughts (9.3 centners per hectare against 11.5 centners per hectare in 1997). As a consequence, even a 21.3% increase in areas in sunflower, which totaled 2,429,000 hectares, did not offset the decline in the sunflower seed output.

We expect that sunflower seed production and the areas for sunflower seed will not diminish in 1999, remaining at the 1998 level, due to favorable market conditions (gradually strengthening demand and prices)<sup>27</sup>. The yield may grow to 10 - 10.5 centners per hectare only if weather conditions are favorable. Production will also depend on government regulations on export-import operations in the oil and fat complex. We think that significant restrictions imposed on sunflower seed exports will reduce output as a result of unpredictable government policy.

We expect that farmers will start changing the structure of areas for crops, extending the amount of land for rape seed. This has not yet become a common plant in Ukrainian agricultural practice, implying significant improvements in respective technology. The advantage of rape seed is that it causes less exhaustion to the soil, which allows increasing aggregate volumes of oil-yielding crops without killing the land, as is the case with sunflower<sup>28</sup>.

We expect 1.7 million tons of the actual weight of sunflower seed to be distributed between the local sunflower seed processing industry (850,000-900,000 tons) and exports (800,000-850,000 tons). The reader should keep in mind that these indicators depend on the yield of oil crops in Argentina. If this country produces its planned 7 million tons, which is 27% more than in 1998, Ukrainian sunflower seeds will be sold to the domestic processing industry. If Argentina's yield suffers from draught, Ukrainian traders will export sunflower seeds.

We explain a larger share of exports in the structure of sunflower seed sales (50% against 45% in 1997) by higher export price at the end of 1998, which grew to \$215-220 at the end of last year from \$180-200 in 1997. This new price resulted from the growing demand for oil-yielding crops in the world, as consumers are using more vegetable oils.

<sup>26</sup> Due to the use of low-yielding varieties of seeds, the actual weight of harvested sunflower seed was only 1,700,000 tons.

<sup>27</sup> According to official data, farms plan to plant about 2.1 million hectares of sunflower, which is 13.5% less than last year. Minagroproprom will try to force farms to reduce this area to 1.6 million hectares, but will probably fail in its attempt.

<sup>28</sup> In world practice, vegetable oil is not usually distinguished between the oil-yielding seeds from which it is produced. As a result, rape seeds and rape oil easily compete with sunflower products in the world market. Sometimes, vegetable oil is delivered to consumers without any indication of the crop it is produced from, being labeled simply 'vegetable oil'.

## *Reforms in the oil and fat industries must put traders and manufacturers on equal terms*

*Sunflower production has become the most dynamic subsector of Ukrainian agriculture, as a result of receiving credits from traders. This subsector is highly market oriented, which allows it to achieve comparatively higher results. At the same time, conditions of sunflower production have worsened steadily from year to year. The government's preventive measures were not successful, as hasty policy for dealing with problems could not improve the situation in the long-term. Thus, government decisions were mainly predetermined by pressure from traders or manufacturers, which are involved in a tense struggle. We find the following reasons for this:*

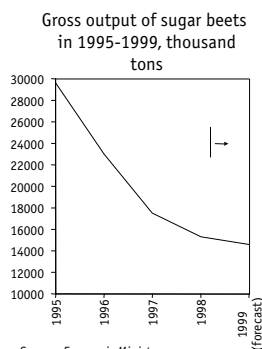
- domestic manufacturers suffer from a lack of funds, having restricted access to expensive credits*
- unfavorable environment for investing in the industry (investors have more attractive alternatives either in other countries or other branches)*
- import tariffs on products from the oil and fat industry (oil, mayonnaise etc.) in the countries' potential importers and zero import tariffs on oil-yielding seeds*
- the need to load capacities of oil extracting plants in Europe*

*Improvements may come only as a result of putting traders and manufacturers in equal conditions. Theoretically, we see two ways of dealing with this problem: (1) reduce sunflower seed export revenues through imposing export tax, and (2) increase revenues from sunflower seed sales to domestic producers, providing higher prices on sunflower seeds. In our opinion, these measures should come one at a time.*

*The first measure envisions export tax on oil-yielding seeds, which would be gradually reduced. We see 5-7% export tax as optimal, which would eliminate the advantages of exporting seeds. It is also necessary to consider the expectations of market agents regarding government regulations, and impose tariffs only during off-season.*

*Development of the domestic processing industry implies more complicated measures. The credit problem should be solved at the macroeconomic level, through refusing the practice of heavy borrowing for the budget deficit financing. To stimulate investment activities by traders, the government should create favorable conditions for building enterprises that would process oil-yielding seeds. Definite advantages would be a favorable regulatory environment and reduction of tax pressure. It is also necessary to terminate import tariffs on oil materials (oil-yielding seed grain and crude oil) and subsidiary materials that are not produced in Ukraine.*

**Sugar production declined by 6.4% in 1998...**



Source: Economic Ministry  
Forecast by Quarterly Predictions

**...and in 1999 the pace of decline will be preserved**

**Last year livestock production increased by 2.3%**

**The structure of the sector changes in favor of activities with a short production cycle**

## Sugar

During the 1998 season, sugar production diminished to 1,875,000 tons, as compared to 2,003,000 tons in 1997, totaling in a 6.4% decline. As to sugar beet production, all indicators worsened last year: gross output diminished by 13.2%, resulting from a reduction in the area for sugar beets by 11.3% and a 2.2% decrease in the yield.

Our forecast for 1999 is that the pace of decline will be the same as last year. In spite of the officially forecast growth in the sector (areas for sugar beets are planned to increase from 1.05 million hectares to 1.2 million hectares; gross sugar beet output will grow from 15.3 million tons to 20 million tons, while sugar production will rise from 1.9 million to 2.3 million tons), the area of deep planting was reduced as compared to last year. We think that areas for sugar beets will contract by 10% in 1999. Even if weather conditions are better than last year<sup>29</sup> and yield indicators remain unchanged compared to last year, both the gross output of sugar beets and sugar production will fall by 6%.

The financial standing of sugar refineries remains catastrophic. We argue that loss-making refineries must be shut down or re-oriented toward the production of other food products. This may be achieved if the government stops supplying inputs to sugar refineries. Unfortunately, we do not expect the measures for the mass shutting down in the subsector, which will result in a further accumulation of arrears. This year, centralized supplies of mazut are planned to be launched at the end of February – long before the season starts – which proves the government's intention to continue supporting loss-making sugar production.

## Livestock

Gross livestock production grew by 2.3% in 1998. This improvement, compared to the deterioration in plant growing, may be explained by the following factors:

- the sector is less dependent on weather conditions
- strengthening demand on the side of processing industries as a result of a reduction of dollar prices on local products, which resulted from the hryvnia devaluation
- remission of value added tax for producers of meat and dairy products in 1998
- larger share of the private sector involved in livestock production

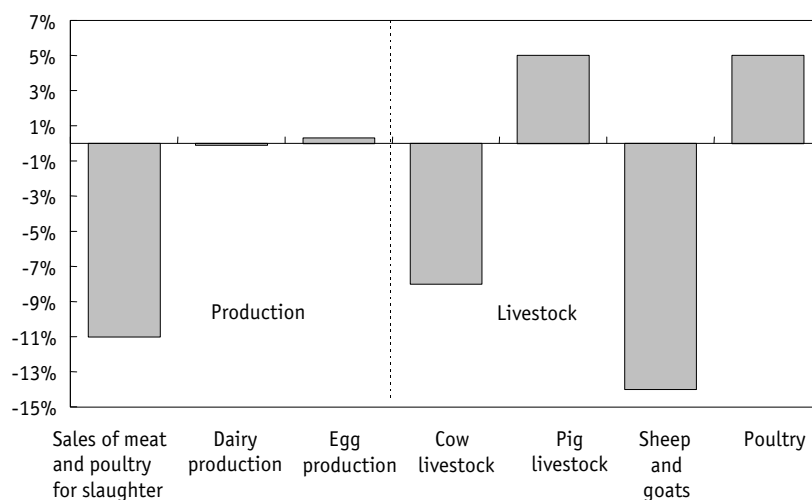
The structure of livestock production changes in favor of those activities that are characterized by a shorter production cycle: by January 1, 1999 cattle livestock was reduced by 8%, as compared to January 1, 1998, while poultry and pig livestock grew by 5%.

According to official data, meat production decreased, which looks strange compared to growing poultry and pig production and a much less significant decline in cattle livestock. We explain this phenomenon by extensive unofficial sales of meat by meat-processing enterprises and farmers, which accumulate significant arrears and avoid bank operations.

<sup>29</sup> In 1998, weather conditions were worse than average.

## Livestock production

1998 against 1997



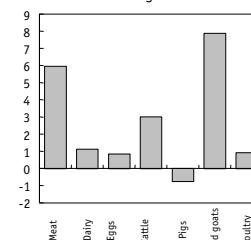
Source: State Statistics Committee

However, this trend is not maintained in dairy production, due to better financial positions by dairy factories. As a result of lower real income received by households during recent years (see **HOUSEHOLDS**), they had to refuse consuming more expensive meat products or transfer to relatively cheaper imported substitutes (chicken legs etc.). Thus, milk production fell in 1998 only by 0.1%.

We forecast a sharp reduction of livestock production in 1999. The decline will amount to 6% or 9% under optimistic or pessimistic scenarios respectively. The main reason is harsh contraction of fodder procurement (by 30%) resulting from unfavorable weather conditions last year. In December 1998 fodder procurement amounted to 65% of the norm, compared to 77% in December 1997. Meanwhile, private sector provision was 20% higher than that of the public.

Gradual decrease in the cattle livestock and growth of poultry and pig livestock will continue through 1999. This may be testified by the fact that increase in pig livestock was 37% in 1998, compared to a 4.5% increase in cattle livestock over the same period. In 1998, the share of private sector in livestock production grew by 2.5%. In particular, it rose by 6% in meat production and 1.1% in dairy production. The heads of cattle livestock bred by the private sector grew by 3%. Decline in the private sector concerned only the pig livestock, which dropped by 0.8%. It is also worth mentioning that increases in the share of private sector slowed down in the second half of 1998. We consider this tendency as negative, which will restrain further growth of livestock production, taking into account high effectiveness of private production<sup>30</sup>.

The share of private sector in livestock production, 1998 against 1997



Source: State Statistics Committee

**In 1999 the decline in livestock production will be 9% under pessimistic scenario...**

**...or 6% - under optimistic assumptions**

<sup>30</sup> According our calculations, effectiveness of agricultural lands' utilization by the public and private sectors is the following: collective firms receive 13 kilos of meat and 81 liters of milk per hectare, while annual outcome of the private sector is 83 kilos of meat and 124 liters of milk per hectare.

# EQUITY

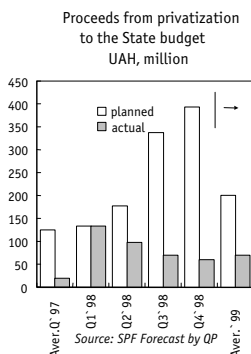
Continued financial instability, insufficient reform efforts by the executive branch, as well as confrontation between the parliament and the government, are all factors which will arrest effective privatization and worsen the situation in the stock market of Ukraine. We envision proceeds from privatization to the budget to be far less than the projected UAH 800 million, amounting to approximately UAH 350 million. Given the crisis of public finances and faced with the need to pay out a huge state debt, the government should accelerate for-money privatization of the most attractive objects and create favorable conditions for rapid privatization of loss-making state enterprises. For the securities market, we forecast a slight drop in stock prices. Direct investors will remain the main agent of the market. As a result, the government should concentrate on the legislative protection of corporate rights.

## Privatization

### *For-money privatization*

***During 1998 the effectiveness of for-money privatization was reduced***

Although the State Property Fund (SPF) transferred UAH 360.2<sup>31</sup> million to the government budget (compared to UAH 76 million in 1997), the effectiveness of for-money privatization was steadily declining. Instead of the projected increase in privatization revenue, it was constantly decreasing: down from UAH 133 million in the first quarter to UAH 58.5 million in the fourth quarter.



One can explain the growing volumes of for-money privatization by the initiation of for-money sales of stocks energy companies. The proceeds received by the SPF from privatization in the energy sector amounted to UAH 300 million in 1998. Sales of energy objects allowed them to receive over half of the privatization revenue both through tenders (UAH 192 million out of UAH 304 million) and exchange auctions (UAH 98.6 million out of UAH 161 million). The decision to suspend the privatization of energy companies considerably reduced revenue in the second half of last year.

We argue that under these conditions, UAH 800 million projected for privatization revenue in 1999 is overstated.

***Projected privatization revenue for 1999 is overstated...***

***...due to reduced revenue through PFTS and exchange sales***

First, we shall discuss revenue from the sale of share packages in stock exchanges and PFTS. Hryvnia prices of stock fell 4-5 times over 1998 and will probably drop by 20-30% in 1999. During November and December, when stock prices and the currency exchange rate settled down, the SPF's monthly proceeds from the sale of stock in exchange auctions was as low as UAH 4-6 million, while the number of share packages proposed for sale amounted to 330-430. By terminating exchange sales of the stock of energy companies, which constituted 60% of the exchange sales revenue in 1998, executives only reinforced this negative trend.

<sup>31</sup> Actual revenue was UAH 120 million more, but the term of payment was deferred until 1999, resulting from a hitch by the Antimonopoly Committee in purchasing the stock. Calculations in the next paragraph include this sum.

Second, proceeds from tender sales will also decrease. During the last two years, the SPF did not succeed in selling any sizable object through tender, while one could remember numerous examples of blunders in tender privatization. In 1998, regional offices of the Fund initiated 215 tenders, which resulted in 26 purchase and sales agreements. The central SPF office proposed 86 share packages of sizable enterprises for tender sales, but succeeded in selling only 24 of them.

*...diminished proceeds  
from tender sales...*

In addition, the campaign for selling the right to manage state-owned share packages, which was begun in the second half of last year, reduced interest in privatization tenders, as these two mechanisms allow for receiving similar results.

Besides, the Verkhovna Rada of Ukraine is holding close to its right to intervene in the privatization of some enterprises: thus, it suspended the sale of Nikopol and Zaporizhia ferroalloy mills; Mykolaiv alumnum factory; energy companies, etc. We expect this tendency to strengthen on the eve of presidential elections.

Third, the government, being eye to eye with the parliament, will not receive proceeds from the privatization of Ukrtelekom in 1999. We argue that forced acceleration of the sale is dangerous, as the risk that share prices will be undervalued on the eve of presidential elections is too high.

*... and suspension of  
Ukrtelekom  
privatization*

Thus, the financial crisis should focus efforts by the government and SPF on increasing cash proceeds from privatization, which imply the following measures:

- Provide several tenders per month for selling controlling blocks of stock of attractive enterprises (forming these packages eliminates transfer of the right to manage these enterprises to executive agencies or commercial structures). To make tenders more efficient, it is important to involve financial experts, which would receive a certain percent from the sale of the share package.
- Refuse preliminary exchange sale of shares of sizable enterprises, which constitute 5% of authorized capital as envisioned by the Privatization Program approved by Presidential Decree. We do not expect portfolio investment inflow in Ukraine this year, which eliminates the need to fix the indicative price - the reason for preliminary exchange sales.
- Sell shares of medium-sized enterprises in sizable packages through exchange auctions. This results from ineffective regional tenders.
- Provide pilot secured sales for several attractive enterprises. By January 1, 1999 there already existed nine programs for the issuance of ADR by the S rule for Ukrainian stock. These enterprises should become the first to begin with (on the contrary, the SPF will have to spend far more).
- Adopt Privatization Program '99, which would legalize the proposals given above.

Additional proceeds from privatization can be received from land sales. In the second half of January, the President signed the Decree "On the sale of non-agricultural land parcels", which determines the privatization order of parcels under privatized enterprises and property. The document defines land parcels that may be purchased and sold, as well as the order of their evaluation. The Decree also says that the seller of land parcels owned by the municipality is

*Additional proceeds  
may be received from  
selling land*

local committees, while state administrations are authorized to sell state-owned land parcels.

### *Privatization program '99 as background for privatization-2000*

*Ukraine met the new year 1999 lacking the Privatization Program '99 approved by the Verkhovna Rada. Members of the parliament did not pass the document twice, as the latter could not even hold 100 votes, let alone the 226 envisioned for approval. An attempt to approve the program as part of the Presidential Decree also failed: MPs rejected it after the third hearing. We assume that a compromise settlement will be approved in March 1999, which will terminate the Program for 1998.*

*An advantageous point of the compromise Program is to leave only 25% or 50% (plus one share) of authorized capital of strategic objects in state property, while the rest is proposed for sale in large share packages (mainly controlling share blocks). Unfortunately, the program does not contain a proposal to terminate the right to manage the state share, if there were no preliminary efforts to privatize it.*

*One of the most important innovations in the Program is the article about pre-sale restructuring of mega-enterprises. The idea is to liquidate enterprise debts before it is privatized. Implementation of this task envisions the following measures: transferring the social infrastructure into the ownership of local communities; restructuring and divesting those departments that can operate independently; and deactivating useless capacities. However, this process is long-term, if one considers the absence of a legislative and tax framework for bankruptcy and restructuring, accompanied by the opposition of influential creditors, which are interested in debt accumulation by firms. At the same time, this is a real positive turn in government policy. To enhance effectiveness, it is necessary to focus on several projects for restructuring, involving independent experts and consultants.*

*Investors will benefit from the measures listed in the document that protects the rights of shareholders during the privatization and post-privatization periods. They clearly define that share companies and state privatization authorities are prohibited to alienate the property of the share company, amounting to more than 25% of the company's assets, and restructure it through merging, affiliation, split-offs, and reorganization, unless the plan for share or 75% of authorized capital placement is fulfilled.*

*The program envisions that in the case of a new emission of shares, company shareholders have the privilege to buy the quantity proportionate to the part they hold in the authorized fund on the date of the decision to issue. This is the first precedent in Ukrainian legislation for protecting the rights of minority shares: if a shareholder did not participate in a meeting where a decision was made to change the authorized fund, or he put his vote against this decision, the issuer must propose to this share holder to redeem his shares at a price not lower than the par value.*

Following unsuccessful efforts to legalize land privatization, this document sets out to compromise the case. If the Verkhovna Rada approves the Decree, this will be a decisive step which assists in attracting foreign investors and creating a base for mortgage crediting.

The document includes experience from 15 cities of Ukraine, which transferred approximately 260 land parcels in private ownership. The average price of one hectare equaled UAH 120,000 (in Kyiv-city, from UAH 200,000 to 500,000). Total proceeds to local budgets from land sales amounted to UAH 8 million.

Land market capacities in Ukraine are significant due to the following:

- According to official calculations, the gross area of non-agricultural land parcels amounts to 500,000 hectares, which is a little more than 0.5% of the total land in Ukraine.
- Lacking regulations of land ownership issue in Ukraine, 50,000 objects were privatized.

Our forecast is that these capacities will not be employed in 1999, due to a high risk of nationalization (earlier we emphasized the need to adopt a law that would define respective conditions). Consolidated budget revenue on this article will reach UAH 20 million in 1999.

### *Privatization certificate*

Beginning from 1999, the SPF will turn to for-money privatization. This change in policy will significantly slow down the pace of privatization, as numerous objects are not attractive. The SPF will not sell these objects at low prices due to political considerations (in 1998 the SPF imposed limitations on lower prices during the tender sales of stock from large enterprises). As a result, the absence of privatization certificates will leave loss-making firms among state property.

***The transfer to for-money privatization slows down the pace of privatization***

Fine confirmation of the above are the results of privatization in 1998: the annual share sales of joint stock companies amounted to UAH 1.385 billion, of which the cash share constituted 37%. At that, stock market prices (in % to par value) were the following: 49% in tenders, 29% in exchange auctions and PFTS, and 4% in specialized for-money auctions.

The SPF made a stake on payments for share packages of privatized enterprises, which would be made in restructured T-bills maturing in 2001-2004 (banks received these T-bills during the OVDP rollover). However, executive authorities turned down the transparent variant of using restructured T-bills, which allowed paying for them at 20-40% of the share package price. Instead of this, the proposed mechanism envisions holding specific privatization auctions. Fortunately, the Verkhovna Rada did not approve this variant. However, the initial idea of using rollover T-bills in the privatization process does not look attractive any longer and it will not be employed in 1999.

Therefore, it is very important to preserve the norm on the opportunity to sell stock at a price lower than the par value and limit the possibilities for fixing the lower price. Privatization objects must be priced in consideration with the demand and supply conditions at the time of sale.

If the SPF does not agree to sell objects for 1 hryvnia, the need for rapid privatization and real compensation of household savings in the Oschadbank will turn the government to use compensation certificates, which would cover a share of stock.

## State property management

In October 1998, the Cabinet of Ministers of Ukraine approved a Concept for assigning responsibilities for state property management to the central and local governments. The SPF transferred its function to manage state corporate rights to the National Agency for the Management of State Corporate Securities, which focuses also on providing tenders for trustees that would manage the property.

However, this scheme has two exceptions:

- The Cabinet of Ministers reserved its right to transfer the right to manage share packages without any tender. In the second half of 1998, over 10 share packages were treated this way. The Agency provided no justification of this step to the government.
- Transfer of the right to manage state property and responsibilities for the results of management significantly differ for executive authorities and juridical persons. Therefore, the competitive environment for state property management is substantially distorted.

***The scheme for transferring the right to state property management is not transparent, which enhances corruption***

These points nullify the already approved scheme of transferring the right to state property management, make the process less transparent and stimulate corruption. As a result, juridical persons receive greater benefit from managing state corporate rights through a specific person working in a government agency.

A valuable outcome of the Agency's work is the analysis of state corporate rights management in Ukraine and compilation of the state shares kept in various companies in a single register. It became obvious that state property management was ineffective since the beginning of privatization:

- The state share register contains 5,292 corporations, among which only 1,126 have trustees assigned by the SPF
- The state share in 3,723 share companies is below 25%, i.e. the government does not possess even a blocking minority stake and may only earn dividends which are too doubtful to occur under crisis. At the same time, a government trustee is able to use state share for the support of some shareholders, creating favorable conditions for corruption. Thus, such packages must be immediately sold.

The agency also provided an analysis of proposals regarding the management of state corporate rights that were submitted during the last several months of 1998. State Oblast administrations submitted 1,724 applications for the right to management, 1,580 by ministries and other agencies of central government, while juridical persons submitted only 19 applications<sup>32</sup>. The conclusion is that the commercial sector does not see any sense in state property management on conditions that are rather strict (the reader should remember that the Cabinet of Ministers does not disclose the terms of agreement while transferring the right to manage the state share package). The Agency received only 17 applications that contained the objective of management, its justification, and goals of state corporate management. These applications indicate the potential quality of this management.

---

<sup>32</sup> Another 2,611 enterprises (about 50%) did not receive any application at all.

These facts prove that transfer to the right to state property management is a poor alternative to privatization. A slightly better variant envisions transferring the right to manage state property to trustees selected by tender. These candidates are much more interested in better performance by their enterprises. Another alternative is to transfer the right to manage state share packages to managers of the enterprise. The latter might improve their work if they are allowed to increase wages or receive a share of government dividends.

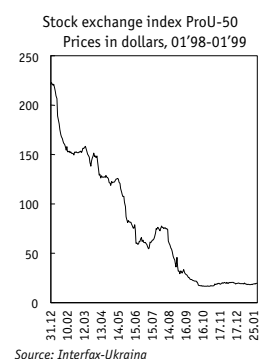
***Transfer to the right to state property management is a poor alternative to privatization***

## Corporate securities

The continuous decline in stock prices that accelerated during the financial crisis, slowed down in October 1998, constituting 1/5 of the hryvnia price at the beginning of the year, and 1/11 of the respective price in U.S. dollars. The sale volumes on PFTS (biggest formal trading venue in Ukraine) were reduced from UAH 30 million in August to UAH 7 million in October. The liquidity of the market reached its minimum: bid prices are several times lower than ask prices, the volume of bids in PFTS is 40 times lower than the volume of offers.

***Current stock prices in Ukraine constitute 1/11 of their dollar price at the beginning of 1998***

During the third quarter of 1998, stock prices increased by 10-20%. However, the increase slowed down in November-December, and prices started to hover around the achieved level, lacking a robust trend for future development.



We do not expect the stock market to grow in 1999. High foreign exchange risk; recession of production; lower investment and savings; presidential elections; a wide range of enterprises proposed for privatization; and crisis in Brazil are all these factors that pre-determine decline, and can be opposed only to one growth factor, which is the lowest stock price in dollars. The most optimistic forecast envisions an insignificant reduction (20-30%) of dollar stock prices over the year.

***We do not expect the stock market to grow in 1999...***

A temporal increase in stock prices will concern only several large enterprises, which are in demand by strategic domestic investors. In the second half of 1998, only a single financial and industrial group bought stock from large enterprises (in particular, energy distributing companies and ferroalloy mills) in order to accumulate controlling share blocks.

***...while stock prices will fall 20-30%***

At the same time, a drop in stock prices and collapse of the T-bill market created favorable conditions for strategic investors and produced domestic capital inflows in the market. Strategic investors, focusing their activities in the processing sector, construction and food production, are the main agents of the corporate securities market in Ukraine. Therefore, the Ukrainian securities market should rather be viewed as a means to transfer the right of ownership than as an instrument of speculation. Respectively, the State Securities and Stock Market Commission, together with other executive bodies, should create favorable conditions for forming large share packages and guaranteeing the protection of shareholders' rights.

***Major agents of the market are strategic investors***

Unfortunately, hasty changes in the legislative base provoke 90% of stock market agents to infringe legislative norms. This particularly concerns those issuers that could not afford to hire qualified lawyers and, as a result, did not keep up with the new rules. Another worrisome fact is that operations became more expensive as a result of increased market regulations by the government.

The situation may improve only if the following measures are implemented:

- Review the current legislation, making it easy to adhere to norms. Suspend requirements that could hardly be accomplished in time (in particular, the obligatory submission of annual accounting report '99 in accordance with the IAS).

- Approve the common law on share companies that would contain the general regulations of share companies' activities in Ukraine. It must be easily understood by investors, issuers, and intermediaries.
- Review tax norms for the corporate securities market, which are especially discriminative regarding joint stock investments and the issuance of bonds. These activities turn out to be unprofitable, as corporate profit tax is imposed on them. As a result, enterprises did not issue bonds during 1998, while investment funds gave up attracting household savings.

# LABOR

The recession in major sectors of the Ukrainian economy and a new spur of inflation in the second half of 1998 led to a 2.8% annual contraction in real wages. In 1999, further contraction of production will also predetermine the deterioration in real wages. If the government restricts administrative regulations on the economy and provides strict budget and monetary policies, the average wage would fall by only 1%. Another path is increasing instability, growing prices and collapse in the production sector, which will reduce real wages by 4%. By the former scenario for 1999, the number of employed will be reduced by 600,000 people. At the same time, partial employment will be cut down and wage arrears shortened. By the end of the year, the unemployment rate will amount to 5.2% of the able-bodied population at the productive age. By the latter scenario, administrative regulations will hinder creating new working places and restrict individual entrepreneurial activities. Therefore, the number of officially registered unemployed will reach 6%.

## Wages

Last year, the average real wage declined by 2.8%, which mainly resulted from a bad slump in GDP in the second half of 1998. The fall financial crisis hampered Ukrainian production and sales, which produced partial employment and reduced the volume of accrued wages in the real sector. For the last six months of 1998, the average wage fell by 7%.

*In 1998, the average real wage declined by 2.8%*

The average wage will continue to decline as its growth is restrained by the very factors that affected it last year:

- Stagnation in the real sector (see **BUSINESS**)
- Partial employment
- Low labor productivity: enterprises do not employ their workers on a full-time basis, who, as a result, lose their level of qualification, as well as firms continue to utilize outdated technologies
- Wage arrears

This year, changes in the average wage rate depend on the efficiency of government policy to deal with the mentioned above problems. Improvements in wages would arise mainly from recovery of the real sector, which may be achieved only if the government stops supporting loss-making enterprises, reduces tax pressure, and liberalizes economic activities. Prolonged restructuring in medium and large enterprises, as well as adherence to the tactics of “soft budget constraints” fortify the impact of major impediments to the increase in the average wage, which are low labor productivity and a surplus labor force. If the government introduces an efficient law on bankruptcy and implements other measures for restricting administrative regulations on economic activities, we expect a 1% decrease in the average wage.

*Improvements in the wage may arise only if stagnation in the real sector comes to the end*

**Decline in the real wage will continue in 1999...**

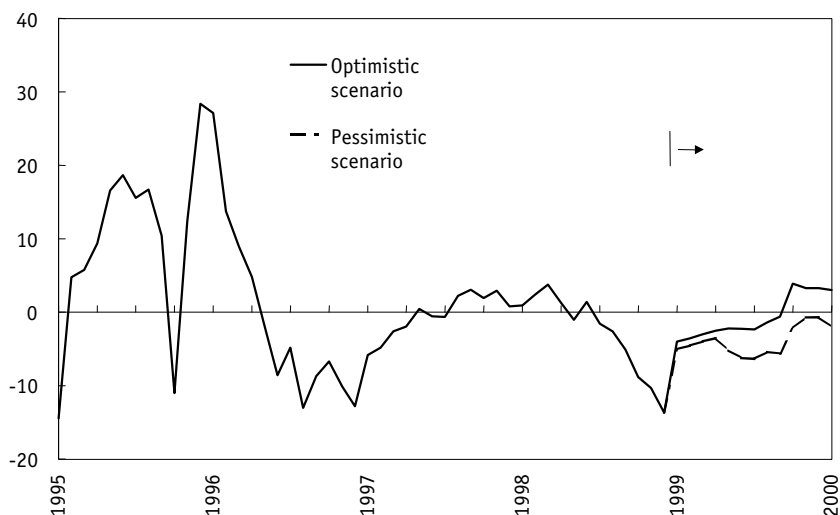
**... amounting to 1% or 4% according to the respective reform and collapse scenarios**

The alternative to the above is that the government will receive less revenue from taxes (see **BUDGET**) and force the NBU to loosen monetary policy in order to redeem social transfer payment arrears and wage debts to budget-supported agencies (see **MONETARY**). These unreasoned steps will worsen instability, lead to inflation, and cause further recession in the real sector. By this scenario, we expect the average wage to drop 4% in 1999. At the same time, enterprises will fail to pay out a greater part of the accrued wages and forcedly transfer their workers on partial employment.

---

### *Real wage*<sup>33</sup>

Annual % change to the respective month of the previous year



Source: State Statistics Committee, calculations and forecast by QP

---

We argue that rapid liberalization of the labor market and settlement of fair conditions for all enterprises would allow the labor force to become more mobile and productive in 1999, which also results from a lower number of inefficient vacancies.

Thus, given a reduction in tax pressure, the unemployed would be able to occupy newly created work places where wages are paid without delays. These flows of labor would not significantly worsen the unemployment rate and would not result in a cycle of unemployment.

So far, movements in Ukraine's labor force have not been successful: the majority of workers search for jobs in a narrow circle of available vacancies that has hardly been widened. At present, the supply of newly created work places remains limited, which nullifies all efforts to improve the employment situation.

---

<sup>33</sup> Data does not include cooperatives, small enterprises, and collective farms. Real wage is adjusted by the consumer price index.

### *Mobility of labor in Ukraine is not optimal*

According to official statistics, mobility of labor in Ukraine is low. Thus in 1997, according to the State Statistics Committee, labor turnover<sup>34</sup> in the real sector was 33%, and 39% in the industrial sector. For example, in the US and Canada, where labor force mobility is traditionally high, the respective indicators were 126.4% and 92.6%. In countries with low labor mobility – Japan and the Netherlands – the labor turnover was 39.1% and 22% respectively. In Russia's transition economy this number was 46.2%, while in Poland it equaled 42%<sup>35</sup>. But Ukraine, as well as Russia, has its own specifics. These countries undergo deep recessions in the real sector, while Polish economy has been steadily growing.

Labor force turnover predetermines the flow of jobs and labor motion within the framework of already created work places. The former concerns taking on workers for new jobs and dismissing those whose positions will be liquidated, while the latter considers labor flows with respect to work places that have been provided earlier. The proportions of these two factors may be defined with the help of an additional labor turnover coefficient<sup>36</sup>. This varies from 0 to 1: the closer it is to 1, the greater is churning<sup>37</sup> – labor motion that deviates from the optimal real employment rate. In 1997, the additional labor turnover coefficient for the economy in general equaled 0.83, while for the industrial sector it was calculated as 0.77. It is also worth mentioning that the additional labor turnover estimates the upper value of churning, which is in fact a bit lower. Besides, this indicator does not take into account the need to redistribute work between newly created work places.

The largest share of layoffs occurs by an employee's initiative (which means labor drain), and the share of dismissals by the firm's administration. Thus in 1997, the share of employees laid off by their own initiative ("drain" coefficient) equaled 68%, while the share of administrative dismissals was only 14% of the total number of redundant workers. However, a larger share of those who quit their jobs by own initiative is a common tendency for OECD countries<sup>38</sup>. The labor

---

<sup>34</sup> Labor turnover is the sum of labor hire and layoff per year. Often this number is calculated as a ratio to the average employment during that very year.

<sup>35</sup> Vladimir Gimpelson and Douglas Lippoldt. "Labor turnover in Russian economy", *Labor market dynamics in the Russian Federation*, OECD, Paris, 1997. Data for Russia and Poland is for 1993. In Ukraine, labor turnover was equal to 40% in 1993.

<sup>36</sup> Additional labor turnover is the ratio of the difference between turnover and net change in the number of employed (those dismissed and hired) to the turnover.

<sup>37</sup> Vladimir Gimpelson and Douglas Lippoldt. "Labor turnover in Russian economy", *Labor market dynamics in the Russian Federation*, OECD, Paris, 1997.

<sup>38</sup> Labor drain in the USSR was considered abnormal, and, therefore, authorities tried to prevent it. In the '70s, the share of labor drain reached 20%, while in the 80's it decreased to 12%.

<sup>39</sup> New owners of the large Russian enterprise *Norilsknikel* have already introduced this strategy (see *Komsomolskaya Pravda*, of January 29, 1999)

*drain in these countries calms down during the recession periods, when employment opportunities decrease. Meanwhile, Ukraine, undergoing an economic crisis has a rather high drain of labor.*

*Experts regard intensive labor mobility as more favorable for the economy. Mobile labor force makes the enterprises' adjustments to economic shocks less painful and facilitates economic recovery in a crisis. Intensive labor turnover confirms the adjustment capacities of labor. Higher labor mobility over a certain time period indicates a larger number of available vacancies, which simplifies job searches. This factor helps reduce chronic unemployment, in particular among low-skilled workers.*

*High mobility of the Ukrainian labor force among established work places (churning) creates a free-rider problem which comes from employers' desire to prune away costs of improving staff qualifications. A plentiful supply of qualified workers gives a great opportunity to replace the needed worker. Enjoying a comparatively low cost of hire and layoff procedures, employers often use this method of churning. As a result, the employer has no need to spend money on educating his employees and raising their level of skills, as he can hire a qualified job hunter at an even lower wage.*

*Surplus labor is often seen as a result of legislative guarantees for employment and a high cost of layoffs, but this assumption is true only partially. In 1997, the share of layoffs in the economy was 19% of the average headcount, while the level of recruitment equaled 13.6%. We consider this coefficient of recruitment unusually high, given the economic recession and surplus labor force. To restrain employment, enterprises can check the inflow of new specialists and treat the staff with more respect<sup>29</sup>. In practice, managers prefer to dismiss the staff and recruit new workers instead. Therefore, the problem of surplus labor cannot be solved by simply transferring compensation layoff payment to the State Employment Fund. This will only increase Fund expenses on its passive policy and reduce its spending on active policy.*

## Employment

***In 1998 the number of employed decreased by 600,000 people***

According to our calculations, the number of people employed in Ukraine was reduced by 600,000 last year, and amounted to 22 million people by December 1998.

Major factors that produced this reduction are the following:

- output decline in major economic branches
- gradually revealed surplus labor force from enterprises
- reduction in the number of people employed in the budget sphere
- poor supply of new vacancies and low number of self-employed

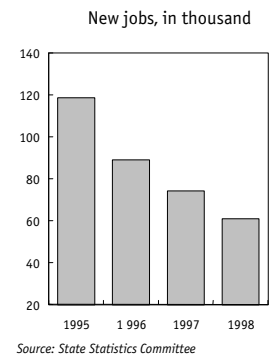
Failure to breach the status quo, based on state support of loss-making enterprises at the expense of effectively operating companies, should also be considered as a factor that reduces the number of new employment opportunities and increases the social cost of inconsistent government steps. The number of new working places created in 1998 was almost two times less than in 1995 and amounted only to 60,900. An unbearable tax burden that is to service excessive budget spending as well as extremely high payroll tax hardly favor the creation of new jobs.

In 1999, the number of employed people will continue to fall due to a revealed surplus labor force from enterprises, progressing recession in the real sector, and layoffs in the budget sphere (so far, the government program envisions a 30% reduction).

If Parliament adopts efficient laws on bankruptcy, while ineffective enterprises are shut down or restructured and a substantial share of workers employed in the budget sphere is laid off, the number of employed will be reduced by 600,000 people this year. A simultaneous reduction in tax pressure will favor the creation of new jobs and make it easier to become employed. This will favor transferring labor from large enterprises to small- and medium-sized firms.

Suspending fundamental reforms in the labor market and other sectors of the economy means less active reduction in the number of employed, which will decrease only by 400,000 people. In this case, the accumulation of wage arrears will accelerate (see **HOUSEHOLDS**). Less frequent layoffs, while the production sector undergoes stagnation, will immediately result in the growth of hidden unemployment, as the number of those on compulsory administrative vacations or working on a part-time basis will increase.

By this scenario, sharp inflation and a more pronounced decline in real wages will suppress domestic aggregate demand. Accompanied by higher tax pressure on efficient enterprises, these factors will restrict creating new jobs, which, in turn, will not allow the labor market to develop either this or next year.



***By the reform scenario, the number of employed will decrease by 600,000 people...***

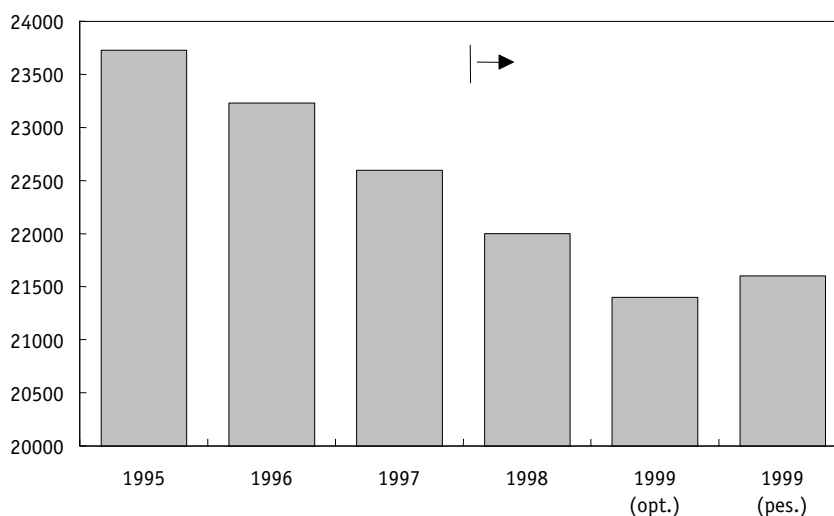
***...though the unemployed will have job opportunities***

***If reforms are suspended, only 400,000 people will lose their jobs...***

***...but partial employment and wage arrears will grow***

## *Employment in the Ukrainian economy*

Thousand people



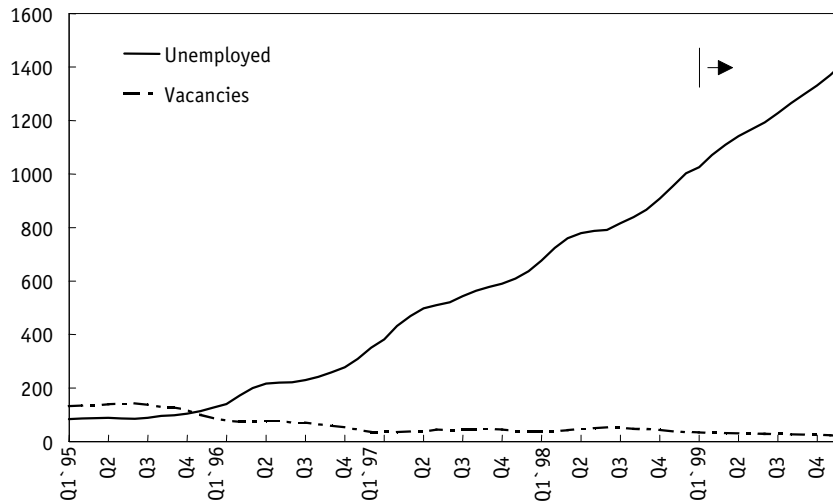
Source: State Statistics Committee, forecast by Quarterly Predictions

During the first nine months of 1998, the number of workers on compulsory administrative vacations amounted to 2.5 million people, or 20% of those

employed in the real sector (for 740,000 people, these vacancies lasted more than one month). The number of those who worked short hours or weeks amounted to 2 million people, or 16% of employed. This situation will not change until the government agrees to replace owners in these enterprises and facilitate privatization.

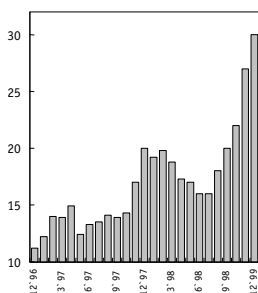
### Number of unemployed and vacancies

Thousand people



Source: State Statistics Committee, forecast by Quarterly Predictions

Competition per vacancy



Source: State Statistics Committee

The number of officially registered unemployed grew sharply at the end of 1998 and amounted to 1 million people, or 3.7% of the able-bodied population in production age, by January 1, 1999. During the fall of 1998, a significant reduction in vacancies will increase competition per vacancy, which was equal to 30 unemployed per vacancy.

The number of officially registered unemployed grew by 366,000 people during 1998. The State Employment Fund spent over 68% of its budget on paying out unemployment compensation, while expenditures on active policy amounted to only 10%<sup>40</sup>. In general, Fund expenditures totaled 0.2% of GDP, which is an extremely poor indicator, as compared to other countries<sup>41</sup>.

Over the course of 1998, chronic unemployment significantly grew. Thus, while in the 1<sup>st</sup> half of 1997 the average term of unemployment was 7.3 months, in the 1<sup>st</sup> half of 1998 it grew to 9.4 months.

<sup>40</sup> Expenditures on active policy include expenses on education, public works, organization of career fairs, and support of small businesses. Spending on passive policy consists of unemployment compensation, transfer payments to families of unemployed, etc.

<sup>41</sup> In 1996, respective spending in Hungary was 1.2%; in Slovakia 1.3%; and in Poland 2.2% of GDP (see *Biznes*, #4 (315), of January 25, 1999).

Unemployment will continue growing in 1999, which will concern both real and registered unemployment. By the reform scenario, the number of registered unemployed will increase by 400,000 people and amount to 5.2% of the able-bodied population in productive age. By the pessimistic scenario, the government will fail to refuse administrative regulations, which will further restrict creating new working places and impede individual employment. This means that the majority of unemployed will register at the State Employment Center. We assume that these negative developments will worsen the rate of unemployment by 6%.

***By the reform scenario for 1999, the rate of unemployment will amount to 5.2%...***

***...or 6% if the government continues administrative regulation of the economy***

# HOUSEHOLDS

In 1998, real disposable income fell by 5.8% compared to the previous year. Real consumption of goods and services fell by 4.5%, while savings dropped by 14.5%. Real disposable income will continue to decline in 1999, but the pace of contraction will depend on state economic policy. If the government follows the provisions of the IMF program, which envisions a balanced budget and removal of barriers to economic activities, real household income may fall only by 2%. Consumption and savings will reduce by 1% and 10% respectively. Failure to collaborate with the IMF will imply higher prices and a consequent reduction in real disposable income. In this case, we expect an 8% contraction in real disposable income, while consumption and savings will fall by 6% and 25% respectively.

## Income

*In 1998, real household income decreased by 2.6%...*

Over the course of 1998, nominal monetary household income increased less rapidly than prices. As a result, real purchasing power of wages, pensions and other household income sources decreased by 2.6%. The most significant contraction concerned income from wages, which accounted for 14% in real terms.

### *Household income in 1997-98*

UAH mln in nominal terms,

	1997	annual real % change	1998	annual real % change
Monetary household income	44579	7,9	48165	-2,6
Wages	27340	-1	26129	-13,5
Pensions and benefits <sup>42</sup>	10072	—	13248	18,9
Proceeds from sales of agricultural products	1493	32,4	1934	3
Stipends	138	—	138	—
Transfers from outside	113	—	98	—
Other income <sup>43</sup>	5423	73,8	6618	8
Taxes and mandatory payments	6233	29,7	8068	16,9
... of which income tax	3295	10,3	3576	-2
Disposable monetary income	38346	5,1	40097	-5,8

Source: State Statistics Committee. Calculations by Quarterly Predictions

<sup>42</sup> Pensions and benefits that are paid from the Pension Fund of Ukraine. Pensions financed by the state budget are also included (according to data of the Treasury of Ukraine).

<sup>43</sup> These include social transfer payments, reported by the Treasury of Ukraine, as well as payments received by households from the financial system (for example, insurance payments by *Orania* state insurance company), prize money, and other payments.

Stagnation in production adds to the number of unemployed and explains the reduction in the share of wages in household income. In addition, the income of those who continue to work on a forced part-time basis cannot grow (see LABOR), and the problem of wage arrears remains untouched because of hidden unemployment.

*... which was a result of lower income from wages*

### *Statistics of household income in Ukraine*

*Official statistics consider revenue from currency sales a source of household income, though only a small share of all those employed receive their pay in foreign currencies. Usually enterprises and organizations hide payments in foreign currencies from taxation and do not report them to the State Statistics Committee. Instead, the SSC processes data on currency sales received from currency exchange kiosks, however this generally show only a transfer of household savings from foreign currencies into hryvnias. Therefore, we do not assume the volume of currency sales as household income, as these, being added to other sources of household revenue, distort the real picture. The purchase and sale of foreign currencies depend rather on the population's expectations on devaluation. This factor significantly influences the trends of official statistics during periods when the exchange rate policy is unstable or changing. Thus, according to SSC reports, household income grew by 2.5% in September 1998 compared to August 1998, though the actual increase in the income was 13.5% in nominal terms. After the holiday season and a rise in salaries anchored to the dollar, household income from wages increased. At the same time, the income from pensions and other transfer payments grew, which significantly added to the aggregate household income in September 1998, as compared to August. Meanwhile, official statistics pitched the estimate too low, due to decreased currency sales by households due to the September devaluation of the hryvnia.*

The only factor that restrained shrinking household incomes in 1998 was an increase in revenues from pensions. Beginning March 1998, pensions were increased by 10-30% for more than 6 million pensioners, which constitutes over 40% of all retired people.

*In 1998 a limited reduction in household income resulted from higher income from pensions...*

Then the government failed to finance the increase on this issue. Accumulated pension arrears were large, accounting for UAH 1.44billion by January 1998, which constituted 14.3% of household income from pensions and other transfer payments in the previous year. Pension payments were increased only by means of barter<sup>44</sup>, which also proved unsuccessful: by the end of the first half of 1998, pension arrears were as high as UAH 1.71 billion.

*...while pension arrears continued to grow*

Beginning from the 4<sup>th</sup> quarter, the Pension Fund has benefited from new taxes, which increased cash inflows. All the above mentioned measures allowed for paying out higher pensions during the year.

Therefore, the real increase in revenues from pensions and other transfer payments amounted to 18%<sup>45</sup> in 1998. This positive tendency was

<sup>44</sup> This included the inter-payment mechanism that envisioned covering payments for utilities, heating and gas from pension arrears. The Pension Fund also received its charges in goods and was selling them to pensioners during 1998.

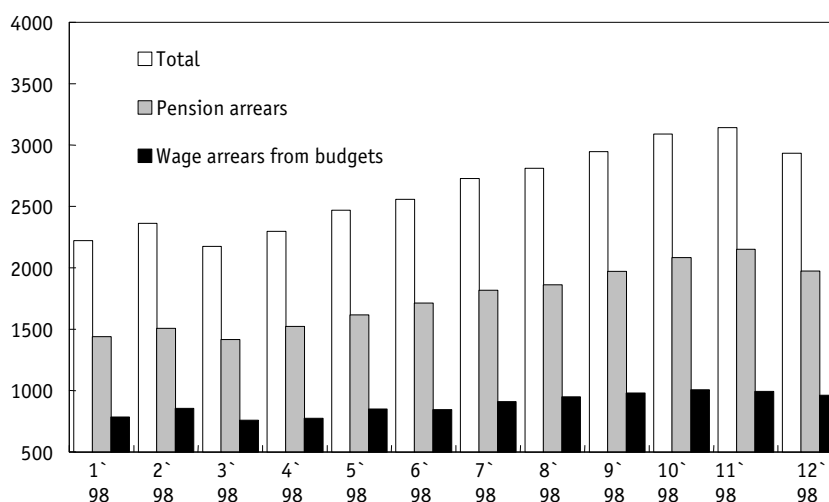
<sup>45</sup> We consider this estimate overrated, as it also includes barter payments. Prices of barter goods are usually higher than respective market prices, and, in fact, pensioners can buy fewer goods than their income allows.

accompanied by further accumulation of arrears that grew to UAH 1.97 billion by the end of 1998. That year, the increase in the debt of pensions was UAH 694 million, or 48%.

This negative trend only fortifies our assumptions that the increase in the household income from pensions is temporal, as the tax base (wages that were actually paid out) has not grown respectively, while tax rates continue to grow. On the contrary, the tax base contracts from year to year, which forces the government to invent new taxes and various means to receive them in order to provide pension payments.

### *Budget wage and pension arrears*

UAH mln, as of end period



Source: State Statistics Committee

***In 1998, the real volume of paid taxes grew by 17%...***

In 1998, the volume of taxes and mandatory payments paid by households increased due to a larger size and growing number of mandatory payments, as well as improved individual taxation. In 1998, the real volume of paid taxes grew by 17% and rose from 16% to 20% as a share of household income.

***...therefore, real disposable household income fell by 5.8%***

Thus, disposable income, which is available for consumption or savings, fell significantly and the decline accounted for 5.8% in real terms. Wage arrears (that could have been added to income) grew by 35% in the real sector and amounted to UAH 5.717 billion, while in the budget sector they increased by 33% and were as high as UAH 1.028 billion. For 1998, we estimate wages paid out in the form of barter (barter goods are usually overpriced) as UAH 3.213 billion, which is 6.7% of the total household income from wages.

***In 1999, income from wages will continue to decline...***

In 1999, the contraction of production in main industries will support the negative trend of decline in household income from wages. The failure to discontinue the support of loss-making enterprises, unwillingness to shut them down or restructure them, implies preservation of non-reimbursable working places. The debt of wages will continue to grow this year as well as in 2000, unless the effective mechanism which envisions responsibility for the accumulated arrears is introduced.

***...while wage debts will continue to grow***

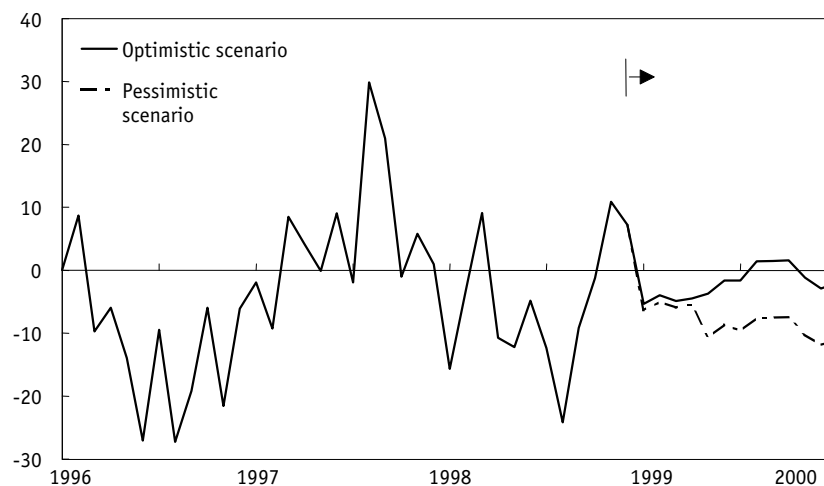
## *Wage arrears as a consequence of state policy for the support of loss-making enterprises*

*In Ukraine, loss-making enterprises maintain exorbitant wages and increase wage rates even if they have respective debts. Managers of such enterprises use these methods in order not to lose qualified workers and create a semblance of social equity, claiming that workers will not understand the reduction in their wages. Other reasons that explain why wage rates are extremely inflexible in the Ukrainian economy are legislative guarantees that fix wages and prohibit their reduction. This is particularly dangerous for the economy in recession. Debt accumulation is also catalyzed by administrative regulations that restrict dismissals (for example, employees cannot be laid off if their enterprise has begun the process of privatization). Many large enterprises that were built to meet the needs of the Soviet economy have technological problems that make temporary suspension almost impossible. As a result, these enterprises must keep up their output at the usual level even if the demand for them goes down. As a result, they fail to pay out wages to their workers.*

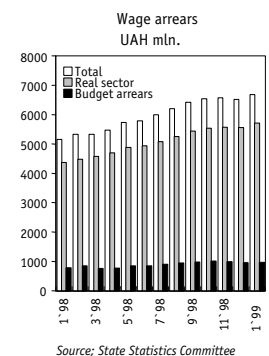
*The main pre-determinant of the accumulation of wage arrears is that the government does not allow the transfer of debtor's ownership to its creditors implicitly supporting directors and intermediary firms in their enrichment. At the same time, support to loss-making enterprises provided by the government impedes development of the private sector, which would create new work places. Higher tax pressure that is usually created in the state which is unable to redeem its debt will directly hurt Ukrainian effective and financially sound enterprises, while loss-making enterprises will be the last to suffer.*

### *Real income*<sup>46</sup>

Annual % change to the respective month of the previous year



Source: State Statistics Committee. Forecast and calculations by QP



Source: State Statistics Committee

<sup>46</sup> Real income is calculated by subtracting foreign currency sales, obligatory payments, and voluntary contributions from household money income figures reported by the Derzhkomstat, and then deflating the number by the consumer price index.

**By the pessimistic inflation scenario, real disposable income will decrease by 8%...**

**...while the optimistic reform scenario envisions a 2% shift**

**In 1998 real household consumption decreased by 4.5%...**

**...with the most significant consumption in the 4<sup>th</sup> quarter**

**In 1999 consumption will contract less significantly than aggregate household income**

In 1999, the government will accumulate new arrears for wages, pensions and social transfer payments. In case it fails to implement real reforms and ceases collaboration with the IMF, there is a high probability that these debts will be covered through emission on the eve of presidential elections. Harsh inflation will immediately hurt the poor<sup>47</sup>, and real disposable income will shrink by 8%. In case economic policy is changed and the threat of default is averted, real monetary household income will be reduced only by 2% in 1999.

## Spending

### Private consumption

In 1998 real household consumption (purchase of goods and services) was reduced by 4.5%, compared to 1997. Although the share of consumption in disposable household income grew, this reduction results from lower household income.

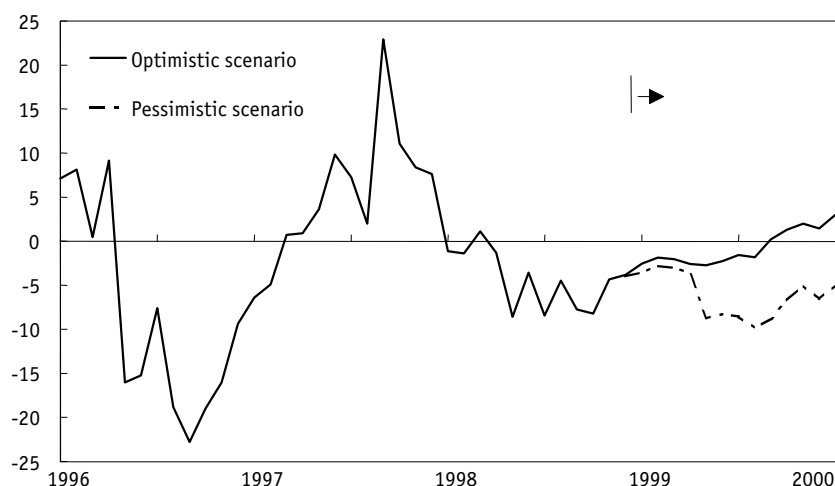
During January-September 1998, the contraction in household income outran consumption decreases, but in the 4<sup>th</sup> quarter household consumption decreased harshly while savings grew. These resulted from the price drop and ensuing pessimistic expectations by households regarding future lay-offs and loss of revenues from wages.

We think of this trend as of a short-term occurrence and expect that this year households will retain the level of consumption at the expense of savings. As a result, the contraction in consumption will be less significant than in aggregate household income.

---

### Real consumption

Annual % change to the respective month of the previous year



Source: State Statistics Committee. Forecast and calculations by QP

---

<sup>47</sup> Wage indexing, which would temporarily restrain the decline in real income from wages and have fatal consequences for the economy in the long-run because of progressing inflation, were minimized by government decision of December 21, 1998. Thus, the size of income subject to indexing was reduced three times (from UAH 221 to UAH 73.7), while the rate of indexing is equal to the CPI-5%. As a result, we expect only an insignificant increase in household income from indexing.

### *Estimation of the real poverty level in Ukraine*

*Public speeches of Ukrainian officials devoted to poverty in Ukraine are based on data by the State Statistics Committee, which covers the number of people that received a per capita income lower than the lower income margin. Thus, in the 1<sup>st</sup> quarter of 1998 this estimate accounted for 52.8% of Ukrainians, as their per capita income was smaller than UAH 73.7. Beginning from January 1, 1999 it was fixed at UAH 90.7, which automatically adds to the mentioned share. However, it would be absurd to consider 2/3 of the population poor, which makes it impossible to fight against poverty at the national level.*

*In our opinion, the estimate publicized by the State Statistics Committee is overrated due to the inconsistent methodology of receiving the data. To compare, research by PADKO company, which was based on data regarding Ukrainian households' monetary income submitted for receiving utility payment subsidies, showed that the share of Ukrainian households that have incomes lower than UAH 73.3 is only 16.2%.*

*Another problem is that the lower-income margin does not coincide with the poverty line. Ukrainian legislation does not define the concept of poverty. The question is how it should be determined in transition economies. Thus, typical for the transition are unstable real revenues, which cause frequent changes in the structure of consumption. This important factor is not regarded while fixing the absolute poverty line, though the impact of the changing consumption structure may be reduced if the government fixes a relative poverty line. This is defined as a 35-50% share of the per capita income in the country. Often the average per capita income is substituted by the average per capita consumption, which is calculated more accurately.*

*Experts from the Kyiv Sociology Institute conducted research for the World Bank, the main assumption of which was that households were poor if their average per capita income or real consumption was less than 40% of the average estimate. According to the results of the research, the poor, calculated on the basis of real income, constituted 28% among the Ukrainian population, and amounted to 18% if the experts based their analysis on real consumption.*

*It is also worth mentioning that Ukrainians have their own subjective evaluation of their welfare. This indicator deteriorates from year to year, reaching its highest in 1998 when 68% of those surveyed considered themselves poor, as compared to 1994 when the respective number was 47%.*

*Besides, Ukrainian statistical authorities must develop proper correction factors for households. These would consider minimal needs in food, which depend on the activities of different household members, their constitution, their genotype and state of health. It is also important to take into account the cost of living that varies from region to region.*

**Household consumption will be stimulated by restricted government consumption**

**By an optimistic scenario consumption will drop by 1%, while by a pessimistic scenario it will contract by 6%**

**Real retail turnover fell by 5.4% in 1998...**

Lower consumption is the very factor which restrains aggregate demand, while a decline in savings affects the volume of credits which are available for the real sector, and investment. This year especially depressed consumption and investment will harshly hurt the economy. Extensive consumption is a core factor for growth in the industrial sector oriented at the domestic market (see **BUSINESS**). Among stimuli to household consumption is a reduction in tax rates, which consequently implies lower budget expenditures. Preservation of the existing mechanism for allocation of budget revenue indicates an extremely large share of people that enjoy privileges. We argue that it is impossible to deal with the poverty problem by supporting certain groups of society through the system of indirect subsidies. The efficient program for allocating social transfers should be far more personified than it is today.

Our optimistic reform scenario envisions a 1% decrease in consumption in 1999. By the negative scenario, the drop in income will be significant and the growth of prices on durable goods will reduce the demand for them, which will consequently suppress household consumption by 6%. As a result, the aggregate demand will fall, causing further deterioration in the real sector.

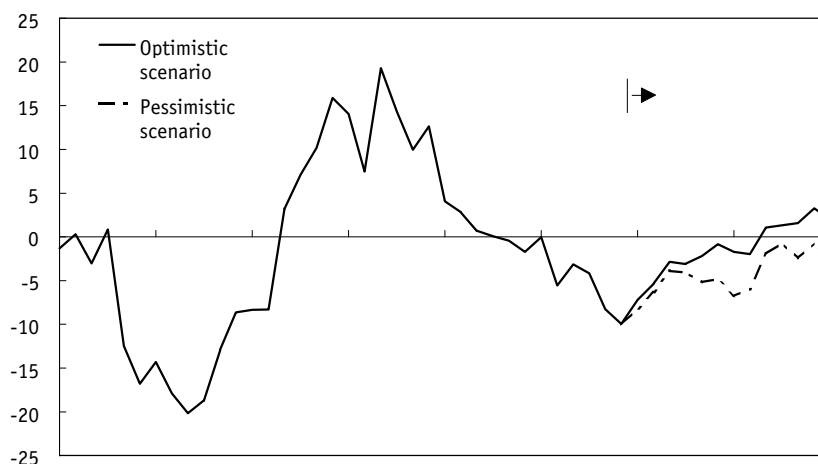
## Retail sales

Retail turnover, including public catering, amounted to UAH 19.1billion in 1998. According to the State Statistics Committee, the real decline amounted to 5.4% (in 1997 the rise equaled 5.9%).

---

### Retail sales<sup>48</sup>

Annual % change to the respective month of the previous year



Source: State Statistics Committee. Calculations and forecast by Quarterly Predictions

---

<sup>48</sup> Retail sales means sales in shop networks, including the network of public catering. Sales in official food and slopshop markets and other unofficial markets are not included.

Further contraction of retail turnover mainly results from the reduction in consumption. If household income reduces insignificantly while consumption remains roughly unchanged, the volume of retail sales will go down only by 1% in 1999. If our negative expectations come true, the contraction will reach 4%.

**...and will continue to decline during this year**

### Residential investment<sup>49</sup>

As a result of lower income and higher interest rates, spending on private construction in 1998 fell compared to 1997. Last year, 3152.2 thousand square meters were placed in operation, which constitutes 93% of the 1997 indicator.

#### Residential construction

UAH mln	1995	1996	1997	1998 <sup>50</sup>
Residential construction, UAH mln	815	874	905	956
...as a share of capital investment in all forms of ownership, %	8,7	7	7,3	8,3
...as a share of gross investment, %	5,6	4,7	4,9	—
...as a share of GDP	1,5	1,07	0,98	—

Notes: Data for 1998 are preliminary

Source: State Statistics Committee

Spending on house building will continue to decline during the current year. The main reasons for this decline are low household income, limited credits, and a high interest rate for credit resources.

## Savings

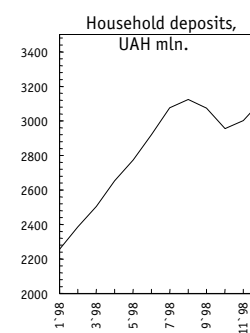
Household savings dropped 14.5% in real terms in 1998, as compared to 1997. In 1997, the decline in real savings amounted to 3.8%.

Two main reasons for the fall of savings are the reduction in household income, which implies 100% consumption of income by the poor, and constant expansion of consumption resulting from the growing number of new goods and services available in the domestic market.

After the financial crisis, mean- and high-income households sharply reduced their consumption. As a result, savings dropped only 14.5% in real terms in 1998, which is two times less than we previously envisioned.

Last year, appreciable currency devaluation changed the structure of household savings, which were mainly made in foreign currencies. High real interest rates and growing confidence in the banking system that worked steadily during September-December 1998 favored an increase in the number

**Household savings dropped 14.5% in 1998**



Source: NBU

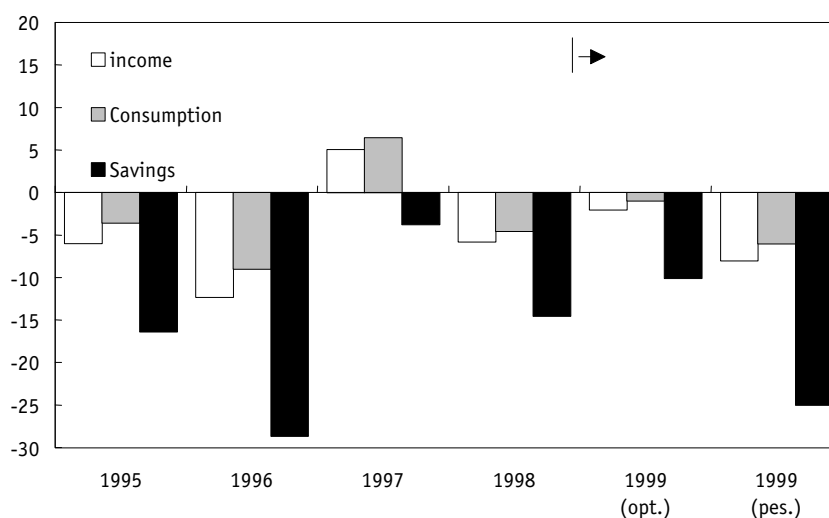
<sup>49</sup> Household spending on house building, which is usually viewed as investment, is rather attributed to capital investment than to household consumption. State Statistics Committee data includes expenditures on individual house building, while the purchase of apartments and expenses on country cottage construction are not regarded.

<sup>50</sup> Increase in individual house building as a share of capital investment accompanied by reduction of the actual floor space let in operation may be explained by the preliminary character of data regarding capital investment that is significantly underrated.

of savings deposits in the banking system last year. At the same time, savings in local currency fell significantly.

### *Household income, consumption and savings in Ukraine*

Annual % change



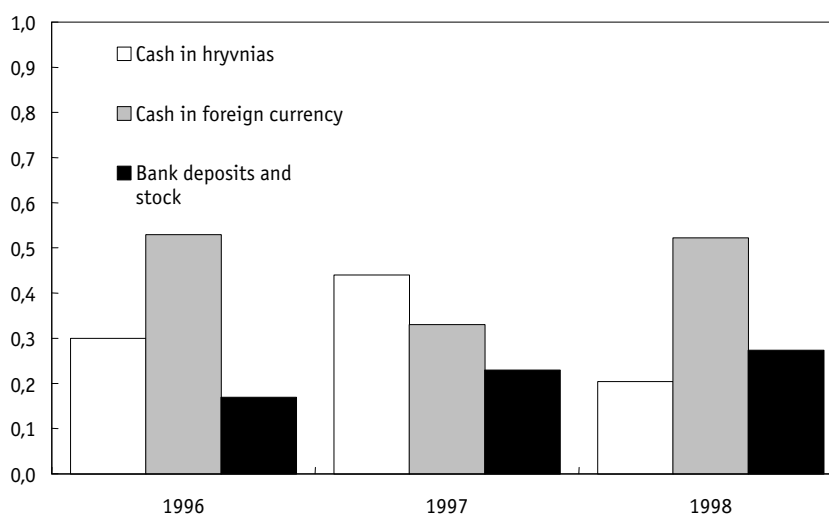
Source: State Statistics Committee. Calculations and forecast by Quarterly Predictions

We forecast that substantial devaluation risk in 1999 will predetermine more extensive savings of households in foreign currency. By our pessimistic scenario, savings in domestic currency will fall dramatically.

While savings in the banking system will increase, savings that have been kept out of the system will decrease. The main pre-determinants of this positive trend will be stable operation of the Ukrainian banking sector, determined position of the NBU, and high real interest rates on savings deposits.

### *Structure of household savings in Ukraine*

share



Source: State Statistics Committee. Calculations and forecast by QP

Beyond the two scenarios, the total volume of savings in 1999 will fall. By the optimistic variant, the reduction in real income will not be significant. For this year, we expect households will mainly spend their income on consumption to retain it at previous levels, which will consequently reduce real savings by 10%, as compared to 1998. Our pessimistic scenario envisions a significant drop in real income, which means household spending on consumption will be more extensive. As a result, savings will fall by 25% in real terms.

***By an optimistic scenario, savings will decrease by 10% in 1999, while a pessimistic scenario envisions a 25% drop***

# INTERNATIONAL

Results of world economic performance were better than expected. Growth is estimated at 2.2%, which is 0.5% higher than our previous forecast. In 1999 the world economic growth rate will hardly outpace the growth of the previous year, however regional tendencies will be different. The pace of growth in developed countries will slow down, Asian economies will recover and resume growing, while countries of Latin America and other transition economies will have a tough time overcoming the crisis.

**1998 world economic growth was 2%**

The last quarter of 1998 turned to be more favorable for the world economy than expected. According to preliminary evaluations by the IMF, the annual world growth rate amounted to 2.2% in 1998, as compared to their fall forecast of 2%, and the previous QP forecast of 1.7%. At the same time, the pace of economic growth was twice as slow compared to 1997.

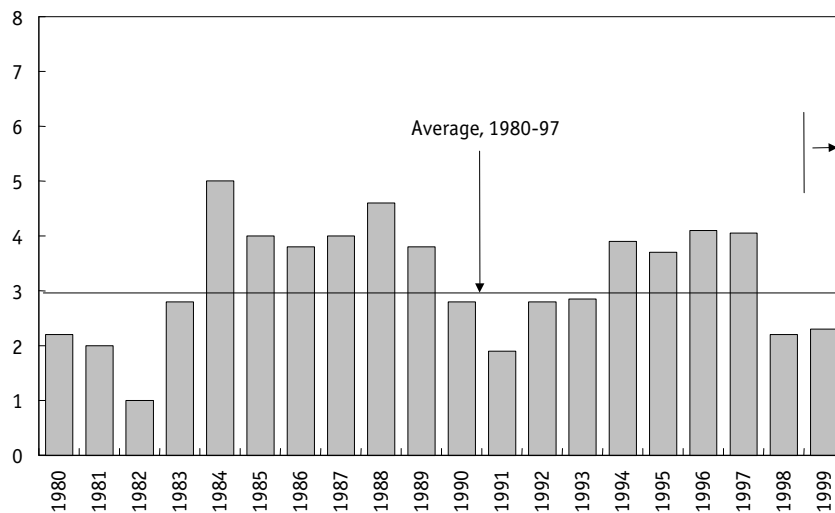
**Interest rates lowered by developed economies gave positive results**

The Federal Reserve System and European Central Bank agreed upon a decrease in interest rates amounting to 75 base points, which made more credits available in developed economies and released tension in the U.S. stock market. Steps taken by these big countries in the world market strengthened the credibility of economic agents regarding stability of the world economy in general. Owing to this policy, the U.S. economy showed 3.8% annual growth, compared to 3.9% in 1997, while economies in the Euro zone reached 2.8%, compared to a 2.5% surplus performed last year.

---

## World economic growth, 1980-1999

Annual % change



Source: IMF, Forecast by Quarterly Predictions

---

**1999 world economic growth will be 2-2.5%**

For 1999, we anticipate economic growth to stabilize within the bounds of 2-2.5%. Growth by region will be significantly different from that of last year.

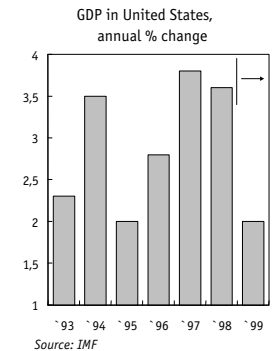
Most topical remains the expectation for U.S. economic growth by 2 percentage points, down to 1.8-2.3%. Indicators attained in the last quarter of 1998, which appeared better than expected, do not predict significant deterioration thus far. However, American economists argue that a lower rate of economic growth is unavoidable. They name the main reason as a reduction of net exports, resulting from depressed demand by the rest of the world (in particular, Latin American countries). Among others, the following factors will be the most important:

- Reduction of domestic consumption, due to more cautious behavior by households and expected stagnation in the stock market
- Contraction of investment activities as a result of more expensive credits; increased surplus capacities; lower profits; and deteriorating expectations by entrepreneurs

In Euro zone, which consists of the countries that introduced the common European currency on January 1, 1999, growth will also slow down. Major factors are expected to reduce foreign demand and already existing inventories of finished goods will tend to grow.

Meanwhile, Asian countries will rapidly recover and improve their positions. Growth will accelerate two times as compared to 1998, amounting to 4.5%. Member countries of the ASEAN-4 (Indonesia, Malaysia, Thailand, and the Philippines) will almost cease their domestic recession, which exceeded 10% last year. By the third quarter of 1998, negative changes in the real GDP of Indonesia and Malaysia, which suffered the most from the crisis, approximated zero. South Korea reported an increase in its real GDP, while economic activities in China and the Philippines started up as well. In this region, the major pre-determinant of growth is domestic supply, which is expected to grow by 4% in 1999.

**U.S. economic growth will be twice as slow...**

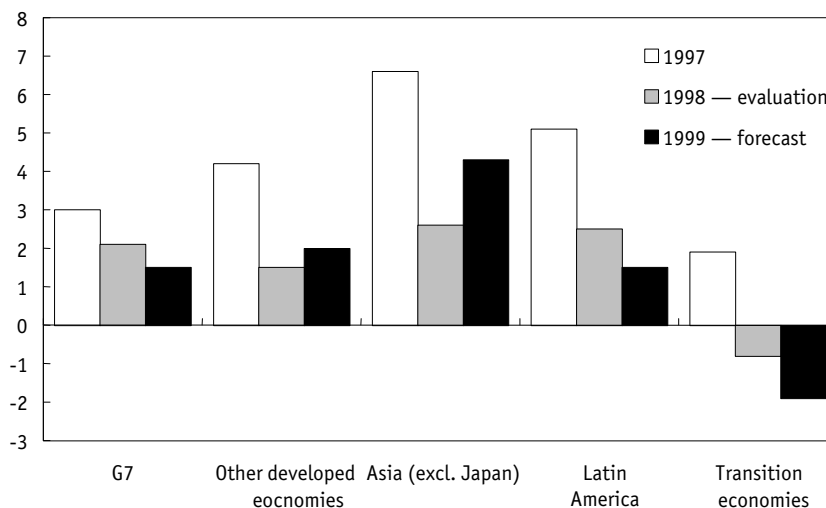


**...while downward tendencies will be less pronounced in the Euro zone ...**

**...and Asia will recover from its recession**

**Forecast of economic growth by region**

Real GDP, annual % change



Source: IMF

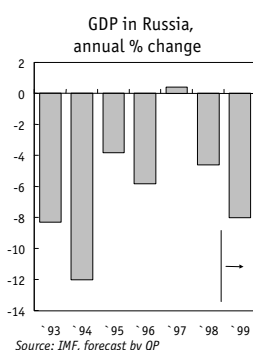
**Worsening economic indicators in Latin America and FSU countries...**

**...as a result of the failure to overcome the crisis in Brazil...**

Among developing economies, the most troublesome are regions of Latin America and transition economies. Leaders of these regions, namely Brazil and Russia, have not proved yet that they are capable of overcoming the economic crisis. External factors will also turn unfavorable for these regions: (1) prices on fuel products are expected to drop 8-10%, (2) capital markets will not recover yet, for the fall crisis made investors see emerging markets as extremely risky, and, as a result, caused massive capital outflows and shutting down of numerous hedge funds.

Rapid growth during the previous periods will turn into a recession in Latin American countries, and the average increase in real GDP will be 1.5%. In Brazil, the largest Latin-American country, real GDP will fall by 1%. Optimistic expectations of a rapid recovery from the debt crisis were deceived after disclosing key measures from the government package on fiscal reform, which were to be supported by a huge credit line from the IMF and IBRD. The politically weak government failed to adopt a package on deliberate fiscal reform. Even now, official and private creditors remain uncertain about the situation. Given this, the only instrument for achieving financial stability is high interest rates. In general, Brazilian economic growth will be restricted this year, due to forced monetary and budget policy tightening on the back of political uncertainty.

**...and Russia**



Economies in transition will be the only ones to undergo a sizeable recession in 1999. According to IMF forecasts, the expected decline in the region will be 1.9% (in 1998, the reduction in real GDP amounted to 0.8%). The margin passes along the border of FSU countries. However, CEE countries will report 3.2% growth (excluding Romania, which has undergone a recession for three consecutive years while Russia, Ukraine, and Kazakhstan are expected for a downturn).

The most severe recession is forecast for Russia. In 1998, Russia's real GDP was reduced by 4.6%, while industrial output fell by 5.2%. Since the previous issue of **QUARTERLY PREDICTIONS**, the Russian government has not implemented any drastic measures that could influence our forecast for Russian economic trends this year. Thus, Russia has not concluded any financial agreements with the IMF. Being on the verge of sovereign default, the country (namely private debtor Oneksimbank) became the first in the list of defaulters on Eurobond payments. As a result, our forecast will remain unchanged for Russian GDP dynamics, and an 8% decline is expected for 1999.

### 1. Gross domestic product and gross national disposable income, 1995-1999

	1995	1996	1997	1998	1999	
	(evaluation)				(optim.)	(pessim.)
<i>GNDI, UAH mln</i>				103861	120539	
	54 063	81 406	92 948			133133
Gross domestic product	54 516	81 519	92 484	104549	121694	134083
Net factor income	-747	-1 045	-1 110	-2475	-3080	-1525
Transfers	294	931	1 573	1788	1925	475
Absorption	56 290	83 572	95 346	107024	122464	135983
Consumption	41 651	65 119	76 846	86114	99829	111848
Private consumption	26 663	46 848	56 478	65518	77316	83691
Public consumption	14 988	18 272	20 368	20596	22513	28158
Investment	14 640	18 453	18 500	20910	22635	24135
Private investment	13 257	17 395	17 575	19864	21905	22794
Public investment	1 383	1 058	925	1045	730	1341
Net exports of goods and services	-1 774	-2 053	-2 862	-2475	-770	-1900
Composition of GDP, % GDP				100,0		
Consumption	76,4	79,9	83,1	82,4	82,0	83,4
Private consumption	48,9	57,5	61,1	62,7	63,5	62,4
Public consumption	27,5	22,4	22,0	19,7	18,5	21,0
Investment	26,9	22,6	20,0	20,0	18,6	18,0
Private investment	24,3	21,3	19,0	19,0	18,0	17,0
Public investment	2,5	1,3	1,0	1,0	0,6	1,0
Net exports of goods and services	-3,3	-2,6	-3,1	-2,4	-0,6	-1,4
Gross national savings	22,8	20,0	17,4	17,0	17,0	15,9
Gross national disposable income		99,9	100,5	99,3	99,1	99,3
<i>Annual % change in real GDP</i>						
GDP	-12,2	-10,0	-3,2	-1,7	-3,0	-5,0
Consumption	7,0	-14,7	1,7	-2,6	-7,3	-3,8
Investment	-37,5	-22,9	-14,3	-1,7	-9,8	-14,5

Source: State Statistics Committee, IMF. Calculations and forecast by Quarterly Predictions

## 2. Budget revenue in 1995-1999

% GDP	1995			1996			1997			1998 (preliminary data),			1999		
	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	(opt.) Conso- lidated	1999 Conso- lidated (pes.)
Corporate profit tax	8,92	2,42	6,50	6,74	1,78	4,97	6,26	0,00	6,26	5,62	0,21	5,41	5,00	5,00	3,80
The Chornobyl Fund	1,88	1,88		1,83	1,83		1,84	1,84		1,36	1,36		0,30	0,30	0,30
Income tax	2,93	1,35	1,58	3,18	1,52	1,66	3,56			3,43		3,43	3,50	3,50	3,10
The Pension Fund	7,68	7,68		8,83	8,83										
The VAT	8,31	2,80	5,51	7,66	3,39	4,27	8,91	8,91	0,00	6,97	6,97	0,00	7,20	7,20	6,30
Excise tax	0,75	0,56	0,19	0,79	0,67	0,13	1,31	0,80	0,51	1,20	1,19	0,01	1,30	1,30	1,20
Foreign economic operations	0,79	0,76	0,03	0,55	0,52	0,02	0,77	0,76	0,01	0,94	0,94	0,00	1,10	1,10	0,60
Privatization of state property	0,14	0,01	0,13	0,25	0,00	0,25	0,14	0,00	0,14	0,45	0,35	0,11	0,30	0,30	0,30
Local taxes and levies	0,23		0,23	0,35		0,35	0,39		0,39	0,38		0,38	0,38	0,38	0,40
Other revenue	6,33	4,65	1,69	6,88	5,09	1,79	7,22	4,97	2,25	7,03	3,79	3,23	8,32	8,32	13,60
Total revenue	37,95	22,10	15,85	37,07	23,63	13,44	30,40	17,27	13,12	27,37	14,81	12,56	27,40	27,40	29,60
Total revenue excluding the Pension Fund	30,27	14,41	15,85	28,24	14,81	13,44	30,40	17,27	13,12	27,37	14,81	12,56	27,40	27,40	29,60

Source: Finance Ministry. Forecast by Quarterly Predictions

### 3. Budget expenditure in Ukraine, 1995-1999

% GDP	1995			1996			1997			1998 (preliminary data)			1999 (opt.)		1999 Conso- lidated
	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	State	Local
Social spending*	1,92	1,00	0,92	2,32	0,97	1,35	4,18	1,63	2,55	3,96	1,57	2,38	3,50	3,50	3,50
Education	5,38	1,38	4,00	4,92	1,36	3,56	5,44	1,34	4,11	4,31	1,05	3,26	3,80	3,80	5,30
Public healthcare	4,65	0,38	4,28	3,88	0,33	3,56	4,28	0,42	3,86	3,43	0,33	3,10	3,20	3,20	4,20
Science	0,44	0,44	0,00	0,60	0,60	0,00	0,63	0,63	0,00	0,31	0,30	0,00	0,35	0,35	0,30
Defense	1,66	1,65	0,00	1,50	1,50	0,00	1,88	1,88	0,00	1,29	1,28	0,01	1,40	1,40	1,80
Public administration	2,80	2,07	0,74	2,80	2,05	0,74	3,22	2,68	0,54	2,81	2,28	0,53	2,50	2,50	2,80
Foreign policy	0,23	0,23	0,00	0,22	0,22	0,00	0,18	0,18	0,00	0,23	0,23	0,00	0,30	0,30	0,30
Economy**	11,96	5,35	6,62	10,26	5,81	4,45	8,50	5,63	2,87	6,87	3,25	3,62	4,30	4,30	8,50
Chornobyl disaster consequences	1,74	1,74	0,00	1,87	1,87	0,00	1,89	1,89	0,00	1,37	1,37	0,00	1,40	1,40	1,40
The Pension Fund spending	7,56	7,56	0,00	8,87	8,87	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00
Foreign debt servicing	0,43	0,43	0,00	0,55	0,55	0,00	1,01	1,01	0,00	1,60	1,60	0,00	1,20	1,20	0,20
Domestic debt servicing	4,21	4,21	0,00	2,50	2,50	0,00	2,23	2,23	0,00	0,73	0,73	0,00	1,70	1,70	1,40
Other spending	1,59	0,64	0,96	1,64	0,87	0,77	3,66	2,78	0,87	2,45	1,36	1,09	4,75	4,75	5,40
Total spending	44,57	27,06	17,51	41,93	27,51	14,43	37,10	22,30	14,80	29,36	15,37	13,99	28,40	28,40	35,10
Spending excluding the Pension Fund	37,02	19,51	17,51	33,06	18,63	14,43	37,10	22,30	14,80	29,36	15,37	13,99	28,40	28,40	35,10
Deficit	6,62	6,80	-0,18	4,86	4,88	-0,01	6,70	6,82	-0,10	1,99	1,94	0,05	1,00	1,00	5,50
Financing sources															
domestic loans	0,00	5,40	0,00	1,93	1,93	0,00	5,35	5,35	0,00	1,29	1,29	0,00	0,60	0,60	0,50
foreign sources	1,46	1,46	0,00	1,52	1,52	0,00	1,62	1,62	0,00	0,79	0,79	0,00	0,40	0,40	0,40
NBU credits	5,40	0,00	0,00	1,65	1,65	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	0,00	5,00

\* excluding state price regulation \*\* including state price regulation  
Source: Finance Ministry. Forecast by Quarterly Predictions"

#### 4. Indicators of the monetary policy, 1996-1998

UAH million, as end of period, if not specified

	Monetary base	NBU's net international reserves	NBU's net domestic assets	Broad money M3	Currency in circulation	Household deposits	NBU's interventions in the UICE, \$mln.	Exchange rate, UAH/\$	NBU's gross reserves, \$ mln	International reserves, monetary base ratio, %	Funds from T-bill sales	Government bill debt, including interest	Banks' claims on the government	Commercial banks' claims on the economy
12'96	4882	-499	-270	9364	4041	1022	...	1,8930	1941	75	...	...	...	6213
3'97	5199	-344	-191	9725	4306	1212	...	1,8480	2028	72	...	...	...	6541
6'97	6121	110	61	11102	5102	1365	...	1,8570	2285	69	...	...	...	7019
9'97	7155	461	256	12320	6040	1477	...	1,8680	2452	64	...	...	...	7924
12'97	7058	-33	-18	12541	6132	1717	...	1,8990	2340	63	6737	8762	9249	7939
1'98	6823	-706	-353	12108	5925	1645	...	1,9297	2030	57	6830	8915	9764	7473
2'98	6621	-874	-437	12240	5826	1704	276	2,0199	2004	61	6857	9042	10105	7671
3'98	7095	-17	-9	12960	6365	1787	82	2,0385	2400	69	6799	9080	10379	7776
4'98	7231	-651	-326	12971	6355	1898	146	2,0425	2196	62	6820	9163	10618	7873
5'98	7061	-924	-462	13295	6295	1975	228	2,0573	2001	58	6737	9160	10878	7981
6'98	7269	-1524	-762	13458	6390	2082	170	2,0647	1771	50	7091	9723	11648	8083
7'98	7411	-1909	-925	13880	6599	2148	196	2,1349	1200	35	7327	10258	12484	8282
8'98	7372	-3318	-1608	13757	6384	2091	266	2,2500	850	26	8358	12089	13640	8460
9'98	7534	-3197	-1549	14327	6311	1797	26	3,4050	880	40	8260	13297	15235	9759
10'98	7887	-3389	-1642	14417	6511	1768	-74	3,4275	833	36	8260	12268	15159	9538
11'98	8386	-5682	-1657	14847	6566	1806	-79	3,4270	906	37	8260	11983	14978	9587
12'98	8604	-5471	-1595	15720	7158	1853	-11	3,4270	685	38	8260	12634	15317	9736

Source: NBU

### 5. Consumer and wholesale prices, 1996-1998

% change to the previous period

		Consumer prices, % change			Consumer prices, index 12/1995=100			Wholesale prices, % change			Wholesale prices, index 12/1995=100		
	Monthly	Annual/Quarterly	Monthly	Annual/Quarterly	Monthly	Annual/Quarterly	Monthly	Annual/Quarterly	Monthly	Annual/Quarterly	Monthly	Annual/Quarterly	
		End period		End period		End period		End period		End period		End period	
1995		181,7%		100,0		177,0%		100		117,7		112,1	
1996		39,7%	27,4%	139,7	127,4	17,3%	12,1%	117,3		118,2		118,3	
1997	January	2,2%		142,8		0,4%			117,7				
	February	1,2%		144,5		0,4%			118,2				
Q1	March	0,1%	4,1%	144,7	144,0	0,6%	1,9%	118,9	118,9				
	April	0,8%		145,8		0,9%		120,0	120,0				
	May	0,8%		147,0		0,3%		120,3	120,3				
Q2	June	0,1%	1,8%	147,1	146,6	0,4%	1,8%	120,8	120,8			120,4	
	July	0,1%		147,3		0,4%		121,3	121,3				
	August	0,0%		147		0,0%		121,3	121,3				
Q3	September	1,2%	0,8%	149,0	147,9	0,1%	0,8%	121,4	121,4			121,4	
	October	0,9%		150,4		1,1%		122,8	122,8				
	November	0,9%		151,7		-0,2%		122,5	122,5				
Q4	December	1,4%	2,8%	153,9	152,0	0,5%	1,2%	123,1	123,1			122,8	
	1997	10,1%	15,9%	153,9	147,6	5,0%	7,7%	123,1	123,1			120,7	
1998	January	1,3%		155,9		0,8%		124,1	124,1				
	February	0,2%		156,2		0,9%		125,2	125,2				
Q1	March	0,2%	2,7%	156,5	156,2	0,7%	1,9%	126,1	126,1			125,2	
	April	1,3%		158,5		0,5%		126,7	126,7				
	May	0,0%		158,5		0,0%		126,7	126,7				
Q2	June	0,0%	1,5%	158,5	158,5	0,2%	1,3%	127,0	127,0			126,8	
	July	-0,9%		157,1		0,6%		127,8	127,8				
	August	0,2%		157,4		1,2%		129,3	129,3				
Q3	September	3,8%	0,5%	163,4	159,3	9,4%	4,7%	141,4	141,4			132,8	
	October	6,2%		173,5		10,7%		156,6	156,6				
	November	3,0%		178,7		3,5%		162,1	162,1				
Q4	December	3,3%	12,3%	184,6	179,0	2,9%	2,8%	166,8	166,8			161,8	
	1998	20,0%	10,6%	184,6	163,2	35,4%	13,2%	166,8	166,8			136,7	

Source: State Statistics Committee

## 6 Current account balance

\$ mln

	Trade in goods		Trade in services		Income	Transfers	Current account	
	Export	Import	Export	Import			Balance	% GDP
1994	13984	16469	2747	1538	-344	547	-1163	-10
1995	14244	16946	2846	1334	-434	472	-1152	-3.7
1996	15547	19843	4799	1625	-572	509	-1185	-2.7
1997	15418	19623	4973	2268	-644	845	-1335	-2.7
1998 (estimation)	13200	15800	4200	2500	-900	650	-1150	-3.0
1999 (optimistic)	12900	15000	4200	2300	-800	500	-500	-1.6
(pessimistic)	12800	15100	4200	2300	-300	100	-600	-2.1

Table by the NBU methodology. Forecasts and evaluations should be considered as indicative. Data may be shown in round numbers and therefore may not give the accurate sum

Source: NBU. Forecast by Quarterly Predictions

## 7. Output by industry, annual % change

	1994	1995	1996	1997	1998	1999 (optimistic)	1999 (pessimistic)
Total industrial output	-27,3	-12,0	-5,1	-1,8	-1,5	-3	-4
Energy	-12,5	-6,0	-6,9	-2,6	-0,3	-2	-4
Fuel industry	-17,2	-9,7	-6,7	4,5	-0,7	-3	-5
Ferrous metals	-28,8	-4,6	11,9	7,7	-6,8	-5	-5
Non-ferrous metals	-26,3	-3,5	8,0	2,7	12,4	0	1
Chemicals and oil refining	-25,5	-9,1	-3,4	-0,6	0,9	-2	-3
Machine building and metal processing	-38,3	-23,9	-26,1	-3,6	-4,5	-5	-6
Wood/pulp&paper	-32,8	-17,4	-18,6	-5,1	10,4	1	0
Construction materials	-37,0	-28,0	-34,2	-7,9	4,1	0	-4
Textiles/apparel	-46,8	-32,6	-24,6	-5,2	1,5	2	1
Food industry	-18,4	-12,6	-7,2	-14,6	-0,5	2	1

Source: State Statistics Committee

## 8. Investment by components

UAH million

	1993	1994	1995	1996	1997	1998 (estimation)	1999 (optimistic forecast)
Gross fixed capital investment	360	2833	12692	16891	16902	19660	21550
of those, capital investment	293	2299	9378	10489	12753	11543	—
Gross fixed capital investment, % GDP	24,3	23,5	23,3	20,7	18,3	18,8	17,8
Change in inventory	178	1420	1855	1590	1702	1250	970
change in material turnover funds	175	1395	1787	1467	1572	—	—
acquisitions of assets minus disposessions	3	25	68	123	130	—	—
Change in inventory, % GDP	12	11,8	3,4	1,95	1,84	1,2	0,8
Gross investment	538	4253	14547	18481	18604	20910	22520
Gross investment, % GDP	36,3	35,3	26,7	22,65	20,14	20	18,6
Consumption of capital	297	2287	9955	14702	15936	—	—
Net investment	241	1967	4591	3779	2668	—	—
Net investment, % GDP	16,3	16,3	8,4	4,6	2,9	—	—

Source: State Statistics Committee. Forecast by Quarterly Predictions

### 9. Gross agricultural output

in prices of 1996, UAH million

	Total	Public sector	Private sector	Private sector, % share
1990	48269,4	34342,0	14287,4	29,4
1991	42210,3	28366,5	13843,8	32,8
1992	38706,8	23402,4	15304,4	39,5
1993	39287,4	22770,5	16516,9	42,0
1994	32805,0	18079,8	14725,2	44,9
1995	31634,0	16452,6	15181,4	48,0
1996	28642,7	13015,6	15627,1	54,6
1997	28420,8	12582,7	15838,1	55,7
1998	25774,6	10751,0	15023,6	58,3
1999 (optimistic)	24743,6	9949,8	14793,8	59,8
1999 (pessimistic)	23011,6	9253,3	13758,2	59,8

Source: State Statistics Committee. Calculations and forecast by Quarterly Predictions

## 10. Gross output of major agricultural crops

	Area under crops, thousand hectares				Gross output				Yield, centner per hectare							
	1997		1998		1997		1998		1997		1998		1997		1998	
	1997	1998	change +/-	%change	1997	1998	change +/-	%change	1997	1998	change +/-	%change	1997	1998	change +/-	%change
Total crops, of those:	14502,3	12749,3	-1753,0	-12,1	35 471,72	26 461,90	-9 009,82	-25,4	24,5	20,8	-3,7	-15,1	24,5	20,8	-3,7	-15,1
Winter and spring wheat	6508,4	5637,5	-870,9	-13,4	18 403,90	14 918,50	-3 485,40	-18,9	28,3	26,5	-1,8	-6,4	28,3	26,5	-1,8	-6,4
Winter and spring rye	695,7	702,1	6,4	0,9	1 348,12	1 125,78	-222,34	-16,5	19,4	16,0	-3,4	-17,5	19,4	16,0	-3,4	-17,5
Winter and spring barley	3704,0	3566,8	-137,2	-3,7	7 407,35	5 879,20	-1 528,15	-20,6	20,0	16,5	-3,5	-17,5	20,0	16,5	-3,5	-17,5
Oat	553,6	548,6	-5,0	-0,9	1 062,28	740,57	-321,71	-30,3	19,2	13,5	-5,7	-29,7	19,2	13,5	-5,7	-29,7
Corn for seed	1636,5	909,6	-726,9	-44,4	5 339,51	2 297,52	-3 041,99	-57,0	32,6	25,3	-7,3	-22,4	32,6	25,3	-7,3	-22,4
Millet	213,6	265,7	52,1	24,4	312,14	248,01	-64,13	-20,5	14,6	9,3	-5,3	-36,3	14,6	9,3	-5,3	-36,3
Buck wheat	447,7	493,0	45,3	10,1	405,08	339,58	-65,50	-16,2	9,0	6,9	-2,1	-23,3	9,0	6,9	-2,1	-23,3
Rice	22,5	20,8	-1,7	-7,6	65,01	71,76	6,75	10,4	28,9	34,5	5,6	19,4	28,9	34,5	5,6	19,4
Sugar beets (factory)	1004,67	891,29	-113,38	-11,3	17 662,80	15 333,18	-2 329,62	-13,2	175,8	172,0	-3,8	-2,2	175,8	172,0	-3,8	-2,2
Sunflower for seed	2001,48	2428,79	427,31	21,3	2 308,36	2 261,89	-46,47	-2,0	11,5	9,3	-2,2	-19,1	11,5	9,3	-2,2	-19,1
Potatoes	1577,41	1513,11	-64,30	-4,1	16700,81	15335,61	-1365,20	-8,2	105,9	101,4	-4,5	-4,2	105,9	101,4	-4,5	-4,2
Vegetables	451,60	443,26	-8,34	-1,8	5168,10	5456,33	288,23	5,6	114,4	123,1	8,7	7,6	114,4	123,1	8,7	7,6

Source: State Statistics Committee

## 11. Livestock production

	Total				Public sector				Private sector							
	1997		1998		1997		1998		1997		1998		1997		1998	
	1997	1998	change +/-	% change	1997	1998	change +/-	% change	1997	1998	change +/-	% change	1997	1998	change +/-	% change
Cattle and poultry for slaughter, thousand tons (live weight)	2 961,0	2 635,3	-325,7	-11,0	1 047,2	774,9	-272,3	-26,0	1 913,8	1 860,4	-53,4	-2,8	1 913,8	1 860,4	-53,4	-2,8
Dairy production, thousand tons	13 752,5	13 738,7	-13,8	-0,1	5 282,8	5 124,3	-158,5	-3,0	8 469,7	8 614,4	144,7	1,7	8 469,7	8 614,4	144,7	1,7
Eggs, million	8 244,8	8 269,5	24,7	0,3	3 009,0	2 948,8	-60,2	-2,0	5 235,8	5 320,7	84,9	1,6	5 235,8	5 320,7	84,9	1,6
Cattle production, thousand heads	12 713,6	11 696,5	-1 017,1	-8,0	8 761,1	7 709,8	-1 051,3	-12,0	3 952,5	3 986,7	34,2	0,9	3 952,5	3 986,7	34,2	0,9
of those cows, thousand heads	6 238,4	5 864,1	-374,3	-6,0	3 278,0	2 851,9	-426,1	-13,0	2 960,4	3 012,2	51,8	1,8	2 960,4	3 012,2	51,8	1,8
Pigs, thousand heads	9 437,0	9 908,8	471,8	5,0	3 719,1	3 979,4	260,3	7,0	5 717,9	5 929,4	211,5	3,7	5 717,9	5 929,4	211,5	3,7
Sheep and goats, thousand heads	2 344,7	2 016,4	-328,3	-14,0	932,6	643,5	-289,1	-31,0	1 412,0	1 372,9	-39,1	-2,8	1 412,0	1 372,9	-39,1	-2,8
Poultry, thousand heads	122 707,2	128 842,6	6 135,4	5,0	28 868,2	29 128,0	259,8	0,9	93 839,1	99 714,6	5 875,5	6,3	93 839,1	99 714,6	5 875,5	6,3

Source: State Statistics Committee

## 12. Labor market

Thousand people, as of year end

	1992	1993	1994	1995	1996	1997	1998 (estimation)	1999 (optimistic)
Total population	—	—	51700	51500	51100	50500	50210	49950
Population growth rate (annual % change)	—	—	—	-0,39	-0,78	-1,17	-0,57	-0,52
Labor force components								
labor resources	29524	29743	29448	30146	29950	29805	29750	29700
able-bodied population of working age	27989	28015	27851	27612	27392	27208	27150	27100
Changes in employment and unemployment								
Total employment	23343	23945	22039	23726	23232	22598	22000	21400
Employed in real economy	23269	23427	21193	21962	20868	19835	19000	17400
Individual entrepreneurship	74	518	846	1764	2364	2763	3000	4000
Unemployment	71	84	82	127	351	637	1003	1417
Change in unemployment	—	13	-2	45	224	286	366	414
Unemployment rate (% in able-bodied population of working age)	0,3	0,3	0,3	0,46	1,27	2,27	3,7	5,2
Unemployment rate (% in able-bodied population of working age according to ILO)	—	—	—	5,6	7,6	8,9	—	—

Source: State Statistics Committee. Forecast and calculations by Quarterly Predictions

### 13. Wages

	Average wage <sup>1</sup> UAH.	Quarterly change <sup>2</sup> , %	Annual change <sup>3</sup> , %	Annual average change <sup>4</sup> , %
1994				
March	8,6	-10,0	-28,2	-44,0
June	10,7	3,7	-20,0	-40,5
September	13,2	11,6	-21,4	-38,7
December	28,9	6,3	10,7	-16,1
1995				
March	45,6	-20,0	-1,6	-9,6
June	68,9	21,2	15,0	-1,2
September	90,4	10,8	14,2	9,8
December	116,7	0,8	8,3	9,2
1996				
March	121,6	-14,3	16,1	13,2
June	133,1	2,0	-2,4	8,7
September	144,3	3,4	-8,9	2,4
December	152,2	-0,5	-10,0	-2,5
1997				
March	142,0	-8,9	-4,4	-6,6
June	152,8	6,0	-0,7	-6,2
September	162,8	5,6	1,5	-3,6
December	167,2	-0,1	1,8	-0,4
1998				
March	157,2	-8,4	2,4	1,3
June	166,1	4,1	0,5	1,6
September	169,9	1,8	-3,1	0,4
December	176,6	-8,3	-11,0	-3,0
1999				
March	186,7	-0,7	-3,5	-4,3
(opti- June	200,1	5,3	-2,3	-5,1
mistic September	208,2	2,7	-1,5	-4,7
forec December	207,1	-3,7	3,5	-1,0
ast)				

Source: State Statistics Committee. Forecast by Quarterly Predictions

<sup>1</sup> An average value of monthly nominal wages of a quarter. Data excluding co-operatives, small enterprises and collective farms.

<sup>2</sup> The ratio of an average real quarterly wage to that of the previous quarter.

<sup>3</sup> The ratio of an average real quarterly wage to that of the corresponding period in the previous year.

<sup>4</sup> An average value of monthly nominal wages of a quarter.

### 14. Household income and spending, UAH mln

	1992	1993	1994	1995	1996	1997	1998 (estimation)	1999 (optimistic)
Money household income	24	628	5389	25693	37618	43885	48165	59670
Wages	17	356	3377	15641	23723	25600	26129	—
Pensions	3	137	1042	5064	9782	12374	13248	—
Proceeds from sales of agricultural products	1,1	32	152	671	1081	1493	1934	—
Stipends	0,2	3	26	99	111	144	138	—
Other income	2,7	100	792	4218	2921	4274	6716	—
Obligatory payments and voluntary contributions	2	30	376,0	2156	3918	5223	8068	10826
Disposable income	22	598	5013	23537	33700	38662	40097	48844
Real disposable income, annual % change <sup>5</sup>	—	-22,1	-33,8	-6,3	-12,3	5,1	-5,8	-2
Consumption	15	441	4025	20249	27679	32368	35391	43568
Purchase of goods	14	372	3469	16353	19555	21276	24248	—
Payment for services	1	69	556	3788	7895	10601	10340	—
Other expenditures	—	—	—	108	229	491	803	—
Annual change, %	—	-18	-26,4	-3,6	-9	6,5	-4,5	-1
Savings	6	142	833	3289	6021	6294	4706	5276
Increase in savings in the form of deposits and stock	1	27	198	383	2436	2585	1289	—
Increase in savings in hryvnias	5	115	635	1714	1350	2136	960	—
Increase in savings in foreign currency	—	—	—	1192	2235	1573	2457	—
Annual change, %	—	-31,5	-53,9	-16,3	-28,6	-3,8	-14,5	-10
Savings as a share of disposable income marginal propensity to save	27,3%	23,7%	16,6%	14,0%	17,9%	16,3%	11,7%	10,8%

Source: State Statistics Committee. Forecast by Quarterly Predictions