

Quarterly Predictions

#5, October 1998

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EXECUTIVE SUMMARY

<i>International</i>	We diminish our forecast on the growth of the world economy in 1998-1999. This year the world economy will show a growth of 1.7%, which is the worst indicator since 1982. For 1999, the world growth rate will reach only 2.3%.
<i>GDP</i>	Considering the adverse affects of the external and internal crisis, we had to revise our forecast for Ukraine's economic development in 1998-1999. Thus, we forecast that real GDP will decrease by 1.7% and 1% in 1998 and 1999 respectively. However, this estimation may become a rather optimistic one if the government fails to tighten radically its budget and monetary policy.
<i>Government</i>	Due to the financial crisis, we amend our previous forecast for budget revenue downwards, lowering it to 28.5% of GDP, and expect a 2.3% budget deficit, as agreed upon with the IMF. Spending of Ukraine's consolidated budget will decrease to 30.8% of GDP in 1998, which is 6 percentage points less than in 1997.
<i>Monetary</i>	In order to ensure only moderate currency depreciation, the National Bank of Ukraine will have to conduct tight monetary policy until the end of this year and further in 1999. Weaker positions of Ukrainian banks, which worsened because of the crisis, will be another reason for limiting crediting.
<i>Prices</i>	We reviewed our forecast for the 1998 consumer price index (CPI) and increased it to 20%. As for the wholesale price index (WPI), it will grow this year up to 24%. Resumption of trust in the state monetary policy is an important pre-determinant of price stabilization. We argue that the situation will already improve in 1999, and consumer and wholesale prices will increase by only 12%.
<i>External</i>	In 1998, the current account will improve by \$200 million, equaling \$1.15 billion. The current account will continue to improve next year, due to recovery in exports and stability of imports. Thus, the current account deficit should diminish to \$400 million.
<i>Business</i>	Industrial output is expected to fall by 1.2% in 1998. In 1999, we expect production output to somewhat stabilize (showing 0.3% decrease), if the sale of ferrous metals recovers to its previous volumes in foreign markets. Gross investment will settle at 20% of GDP.
<i>Agriculture</i>	We forecast 3% overall decline in agriculture during 1998. However, we expect the situation to improve in 1999 and forecast 0.5% overall growth.
<i>Equity</i>	We expect proceeds from privatization as high as UAH 2 billion in 1999, of which UAH 1.5 billion will result from the privatization of Ukrtelecom.
<i>Labor</i>	The average real wage will decrease 0.5% due to stagnation of production and a more rapid pace of inflation. In 1999, wages will resume to increase and the expected change will be 2%. By the end of 1998 the rate of unemployment will amount to 3.5% against 2.27%. By the end of 1999 the rate of registered unemployment may exceed 5%.
<i>Households</i>	Real household income will fall 10% compared to the previous year. Though in 1999 it will grow by 2%.

MAJOR INDICATORS

	1994	1995	1996	1997	1998 (forecast)	1999 (forecast)
<i>Economic activity, UAH mln, December years</i>						
Gross domestic product	12038	54516	81519	92484	104500	118000
Real GDP, % annual change	-23,0	-12,5	-10,0	-3,2	-1,7	-1,0
Industrial output	13098	58824	73321	73481	90000	100400
Relative prices, % annual change	-27,3	-12,0	-5,1	-1,8	-1,2	-0,3
Agricultural output	3586	16974	26694	29182	34000	38000
Relative prices, % annual change	-16,5	-3,6	-9,5	-0,8	-3,0	0,5
Gross investment	4253	14547	18481	18604	20900	23500
Gross investment share in GDP, %	35,3	26,7	22,8	20,1	20	20
<i>Prices</i>						
Consumer price index %, December to December	501	282	140	110	120	112
Wholesale price index %, December to December	700	277	117	105	124	112
<i>Labor market</i>						
Population December years, mln	51,7	51,5	51,1	50,5	50,2	50,0
Average nominal monthly wage UAH	15,4	80,7	137,8	156,2	172,0	212,0
Unemployment %, December years	0,3	0,5	1,3	2,27	3,5	5,0
<i>Foreign economic activities *</i>						
Exports of goods and services \$ mln	16641	17090	20346	20355	18150	19200
Imports of goods and services \$ mln	18007	18280	21468	21891	19000	19400
Current account balance \$ mln	-1366	-1190	-1122	-1536	-850	-200
<i>Budget, % of GDP **</i>						
Consolidated budget revenue	36,0	30,4	28,2	30,4	28,5	27,9
Consolidated budget expenditure	44,9	37,0	33,1	37,1	30,8	28,5
Deficit	8,9	6,6	4,9	6,7	2,3	0,6
<i>Monetary indicators, UAH mln, December year</i>						
M3	3216	6930	9364	12541	14200	15900
Monetary base	1523	3538	4882	7058	7800	8700
Cash in circulation	793	2623	4041	6132	6800	7600
NBU net foreign reserves \$ mln	302	-411	-268	-18	-1400	...
Official exchange rate UAH/\$	1,04	1,79	1,89	1,90	3,5	3,95
* as reported by the NBU						
** excluding the Pension Fund						

OVERVIEW

In the fall of 1998, Ukraine managed to avoid financial collapse. Tactics by the government and the National Bank of Ukraine, which turned out to be efficient, allowed Ukraine to control the hryvnia devaluation and delay the risk of bankruptcy. We forecast that the government will try to abide by the terms of the IMF and ensure financial stability by not implementing real reforms. We expect a new surge of the crisis in 2000.

The main cause of the Ukrainian crisis is the government's conscious resistance to reforms...

...which are not advantageous for those dependent on budget money

The crisis was predetermined by...

... unwarranted budget policy

...unfavorable government policy regarding investors...

...and the world crisis

We have not a particle of doubt that the conscious resistance of the Ukrainian government to reforms is the main reason for the recent crisis. The existing system assists it in shadowing money flows between the budget, extra-budgetary funds and under-privatized enterprises. Given this, reforms would bring transparency to the circulation of budget funds; eliminate the practice of giving implicit subsidies to selected groups of enterprises; complete privatization and establish real ownership accompanied by the introduction of the bankruptcy mechanism; eliminate administrative barriers that may impede business operations. However, a free enterprise system and job creation is not advantageous for those entities currently dependent on budget funds.

Cooling reforms laid the groundwork for the crisis a long time ago. The main pre-determinant of the crisis has become unwarranted budget policy conducted in 1997 and through the first months of 1998, when the government was accumulating huge debts in order to finance an immoderate budget deficit. This was necessary to support under-reformed industries and an ineffective budget. Budget deficit problems were aggravated by unfavorable government policy regarding foreign strategic investors, which resulted in low competitiveness of Ukrainian goods, stagnation of exports, and lower foreign currency revenue. The currency exchange crisis, which exploded in August and September, was provoked by a sudden lack of trust by foreign investors in emerging markets, caused by the Russian crisis, and by a panic reaction among Ukrainians, resulting from the collapse of the neighboring economy. The slowing growth of the world economy worsened the situation and affected the demand for Ukrainian raw materials.

Crisis cost for Ukraine

Actual data enable us to evaluate the cost of the August-September crisis for Ukraine:

- *3% decline in the 1998-1999 real output, instead of an expected increase*
- *further reduction in real household consumption and real investment in the economy (by 1.7-3%)*
- *the hryvnia devaluation by 60%*
- *increase in domestic prices by 20%*
- *significant deterioration of living standards for the average Ukrainian*
- *40% loss of the NBU's gross reserves*

In 1999 budget policy may become more adequate...

So as to master the consequences of the financial crisis by the summer of 1999, the government will have to significantly reduce budget expenditures, in order not to disrupt the IMF program and be left with no sources of official external financing. Thus, the NBU's foreign exchange reserves will not be

sufficient to cover the debt, and the government, given little chance to attract private capital and faced with significant sums of outstanding debt to be repaid, may go bankrupt. Therefore, despite the statements regarding possible loosening of budget and monetary policy, which conflicts with the provisions of the IMF, the government will hardly implement this during the next 9 months, as it may result in economic collapse right before the elections.

However, this does not mean that the government will review its economic policy. Otherwise, it will be apt to minimize reforms, implementing only those which help carry out provisions of the IMF program. One of the likely scenarios is that in one-two months before the elections planned for the end October, the government would partially pay out social arrears. This would result in the suspension of external financing for a period of several months, which would consequently increase the risk of default, possibly leading to sharp devaluation, and winding out hyperinflation.

However, even if the pre-election period is not marked with reckless actions, 1999 will not be the year when painful reforms for the entities dependent on budget funds are accelerated. Postponing these reforms implies further stagnation of the economy and reduction in budget revenue, which may be offset by selling a large share package of the Ukrainian telecommunications company Ukrtelecom. However, the consequences of this undetermined policy will show in the new financial crisis in 2000, as it will be the year to repay the debt restructured in 1998 and the time when the world community's trust in Ukrainian government will be lost for good.

...though the government will try to minimize reforms...

...and pay out arrears before the elections

This will lead to a new crisis as early as in 2000

INTERNATIONAL

We diminish our forecast on the growth of the world economy in 1998-1999. This year the world economy will show an average growth of 1.7% (compared to the previously forecasted 2%), which is the worst indicator since 1982. For 1999, we expect the world growth rate to improve but reach only 2.3% (compared to the previously forecasted 2.5%), which may be explained by the recovery of Asian economies impeded by a slack in U.S. and Western European countries, and stabilization in other developing countries. In 1998 and further in 1999, major trading partners with Ukraine will show lower economic indicators. In particular, the GDP of Russia (which consumes 1/4 of Ukrainian exports as goods and services) will fall by 6% this year, while in 1999 it will reduce by 8%, if leftist leanings in economic policy are implemented and uncertainty continues to grow.

Global crisis

During the three months since the last issue of Quarterly Predictions was published, the economic situation in the world has significantly deteriorated. Russia's economic collapse not only destabilized the situation in the domestic market, which has significantly contracted this year, but also caused negative changes throughout the world.

Crisis in emerging markets

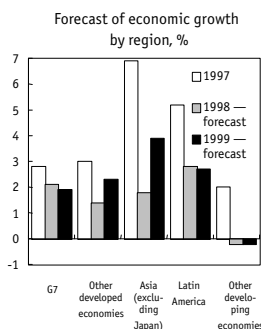
Capital outflow from Brazil, which has similar imbalances to those in Russia (large state debt and budget deficit), provoked a crisis in Latin America's largest country and world's ninth economy. Since August, Brazil has lost over \$25 billion (35%) in foreign exchange reserves. The crisis slowed down as a result of Cardoso's election for a second presidential term, the disclosure of key measures from the government package on fiscal reform immediately following the elections, and financial arrangements prepared by the IMF amounting to \$30 billion. The crisis implies a much tighter budget policy in the following year, which may lead to economic depression in the country.

To conclude, the problems in Brazil and the unstable financial situation in Argentina and Venezuela destabilize the economy of Latin America as a whole. This strengthens the crisis in emerging markets through drying out capital inflows to developing countries and lowering prices for commodities, and drives to spreading over to new countries. And if the Latin American market, which is strategically important for the U.S., continues to fall, it will negatively affect shares owned by U.S. companies and provoke a new surge in the crisis.

Besides the countries of Latin America, many other economies are apt to solve financial problems through the control of capital movements, which, in particular was done in Malaysia. Usually they may be considered efficient, for certain investors and creditors have no opportunity or intention to withdraw their capital. However, the negative consequences of such far outweigh the positive ones, as external investors and creditors hold up investments in the country, threatened by the consequent impossibility of withdrawing their capital. In general, such policy is disadvantageous for all emerging economies, as other governments may be apt to accomplish similar policy.

The economic situation in the world significantly deteriorated

Capital outflow from Brazil...



... may provoke a new surge of crises

Administrative restrictions for capital outflow are ineffective

At the same time, we do not reject the general idea of control over capital movements. It may take the form of short-term restrictions on *inflows*, contrary to *outflows*, of speculative capital in the form of economic instruments. For example, in Chile the government imposed specific taxes on certain forms of capital inflows.

Ukraine tests the new architecture for financial markets

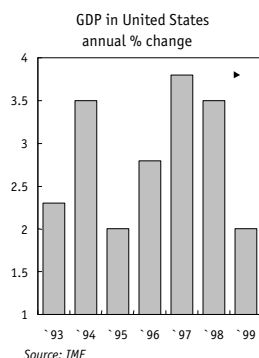
The Russian crisis forced leading economists to reevaluate the functioning mechanisms of their financial markets. The problem stems from Russia's refusal to repay its debts: they have to decide what to do with those countries, which borrowed more than they can service.

Lawrence Brainard, General Director of International Fixed Income Research in Chase Manhattan, argues that the countries of the world of securitized finance, which were previously called "too big to fail" have become "too big to save". Russia stands as the best example: one month after July 13, when the \$20 billion international bailout package was revealed, the Russian financial market broke down. Mr. Brainard characterizes the situation as a collapse of a system functioning since the 80s, when the IMF, G7 countries and the largest international banks were able to save any developing country from default and renew its credit. Today, the world has changed radically, resulting in a significant reduction in the fraction of these banks' exposure to emerging markets, mainly of those in the United States. Creditors in these markets gave way to hedge funds, which could rapidly withdraw their capital from emerging markets, having minimum responsibilities in front of the government and international financial organizations.

In this situation, the work of the International Monetary Fund became threatened. It increased several times the volume of loans to countries suffering from the crisis in order to keep investors from pulling out. Meanwhile, the main shareholders of the Fund particularly the U.S., showed their unwillingness to finance the losses of private investors with taxpayers' money. To resolve this problem, the IMF proposed a new scheme and decided to test it on the Ukrainian financial crisis.

The idea calls for persuading investors to restructure the outstanding debt: the first step is to hold tri-lateral negotiations with the IMF, investors, and the government on the conditions defined by the Fund. These in turn are to get an agreement of creditors to restructure the debt, and of the government to implement necessary reforms. Ukraine appeared the first good example to accomplish this task, as the Central Bank would have run out of its foreign exchange reserves and failed to pay its outstanding debt if the IMF and other official creditors had refused to assist. As of the end of October, the scheme agreed with all private investors who had to be repaid during the last four months of the year, envisioning a 20-25% cash repayment and 75-80% restructuring of the total stock of debt during the period of two years at 20% interest per annum. Thus, Ukraine has been granted a respite to implement reforms by 2000, at which time it will have to accept the punishment for mistakes made during 1997.

The U.S. is on the verge of a recession



U.S. economic growth significantly slowed down

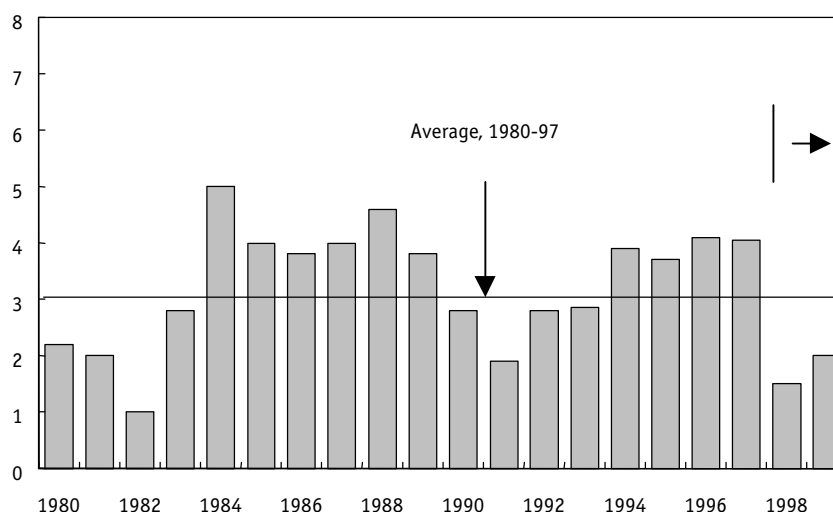
Forecasts for U.S. economic growth in 1999 range from 1-2%

After the crisis spread to new markets and Latin American countries faced the possibility of financial collapse, the world found itself under the threat of an economic recession.¹ The growth of GDP in the United States fell from 4% in the first quarter to 1.6% in the second quarter of 1998, mainly due to a deteriorated trade balance with the countries, which suffered from the crisis and benefited by currency devaluation or had to export at dumping prices. The first signs of profit decline within U.S. companies resulted in the fall of an overheated U.S. stock market: the Dow Jones index dropped sharply from 9000 to 7500 base points from the middle of July through August, and only slightly improved up to 7700 by October. This reflected in negative expectations among households regarding economic perspectives, causing a reduction in consumption in favor of savings.

U.S. indicators will further continue to deteriorate. According to the IMF forecast², while the GDP of the United States will grow by 3.5% this year against 3.7% in 1997, it will sharply drop to 2% in 1999. At that, the IMF forecast can be considered optimistic, as, according to the calculations made by Lehman Brothers³, the GDP will grow only by 1.1% in 1999, which means the U.S. will be entering a recession phase.

World economic growth 1980-99

annual % change



Source: IMF. Forecast by Quarterly Predictions

In order to avert a recession in the U.S., the Federal Reserve Board reduced the key interest rate of federal funds by 0.5 percentage points down to 5%. This step is a critical precondition for an increase in household construction and general economic upswing. It is also a positive sign for emerging economies, which testifies to the awareness of the U.S. government on the probable all-world crisis caused by global deflation pressure.

¹ Certain economists argue the possibility of a second Great Depression, giving examples of similar symptoms.

² World Economic Outlook, electronic version, as of September 30.

³ Global Weekly Economic Monitor, October 16.

Forecasts by the IMF and Lehman Brothers

% change in real GDP for 1999

	IMF	Lehman Brothers	Difference
World economy	2,5
USA	2,0	1,1	-0,9
Euroland	2,8	2,0	-0,8
Germany	2,5	2,0	-0,5
France	2,8	1,8	-1,0
Italy	2,5	1,5	-1,0
Great Britain	1,2	0,5	-0,7
Japan	0,5	-1,4	-1,9

Forecast by Lehman Brothers was published 2 weeks after that of the IMF

Source: IMF, Lehman Brothers

Euroland⁴ – the last source of growth

Western European countries, producing 20% of world GDP, will become the locomotive for world economic growth. The major industrial countries of the EU – Germany, France, and Italy – are currently at the peak of their business cycle, showing a significant pace of economic growth (2.5-3%) and reporting high domestic consumption and investment. Next year, when U.S. economic growth considerably slows down, EU countries will consume exports of countries suffering from the crisis. The IMF forecasts that the pace of economic growth will accelerate from 2.5% in 1997 to 3% this year, and lower insignificantly to 2.8% in 1999. The main reason for restrained economic growth in Euroland will be a reduction in global economic growth and lower demand from U.S., British, and Asian economies. If the two first economies enter a phase of economic recession, growth in Euroland may drop down to 2% of GDP, as forecasted by Lehman Brothers.

Western Europe will become the locomotive for world economic growth...

...which will reach 2.5-3% in 1998-1999

Mechanism for averting the crisis

This year, the Fed is expected to reduce the key interest rate by 0.25 percentage points. This time, however, unilateral steps by the U.S. may become insufficient. The majority of economists agree that the global recession can be averted only if the following steps are made:

The global recession can be averted only if...

... major G7 countries lower their interest rates...

- All G7 countries recognize and account for the upcoming activities, which implies a decrease in interest rates. For this, it is critically important to receive support for U.S. measures from Western European countries. Currently, the key countries of this region refuse to implement these changes, mainly because of converging problems related to the introduction of a common currency beginning January 1, 1999.
- Implement long-awaited reforms among the financial sector in Japan. Its weakness actually implies less bank credits available to the economy, and consequently leaves the country little chance to become a locomotive to overcome the crisis in the region. Gradually, the government recognizes

... the financial sector in Japan undergoes reforms...

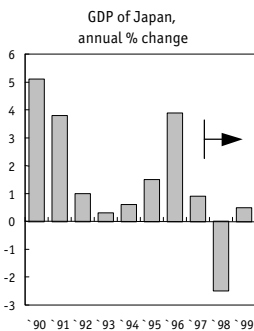
⁴ Euroland unites 11 of 15 member countries of the EU: Austria, Belgium, Ireland, Spain, Italy, Luxembourg, the Netherlands, Germany, Portugal, Finland, and France

the need to direct public funds in restructuring the banking sector. However, rapid implementation of these reforms was initiated only after the Annual meeting of the IMF and the World Bank, when Japanese government policy was rigorously criticized.

...the IMF is successfully reformed...

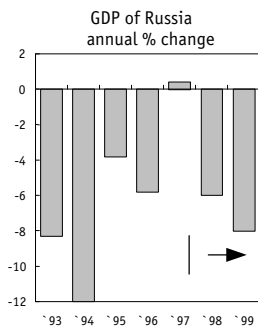
...and investors support Brazil's reforms

- IMF follows the requirements by the U.S. Congress to reform its activities, replenishing its financial resources which are currently at their lowest. This would restore the credibility of the international financial organization in the face of the world community, and consequently resume capital inflows among needy emerging markets.
- Brazil approves the budget reform package which, being high capacity, can expect full support from the IMF and investors. In a general sense, this can start reviving of trust in emerging markets, and allow them to recommence external private borrowing at the end of next year.



Source: IMF

The Russian collapse is a result of inconsistent economic policy over the last years



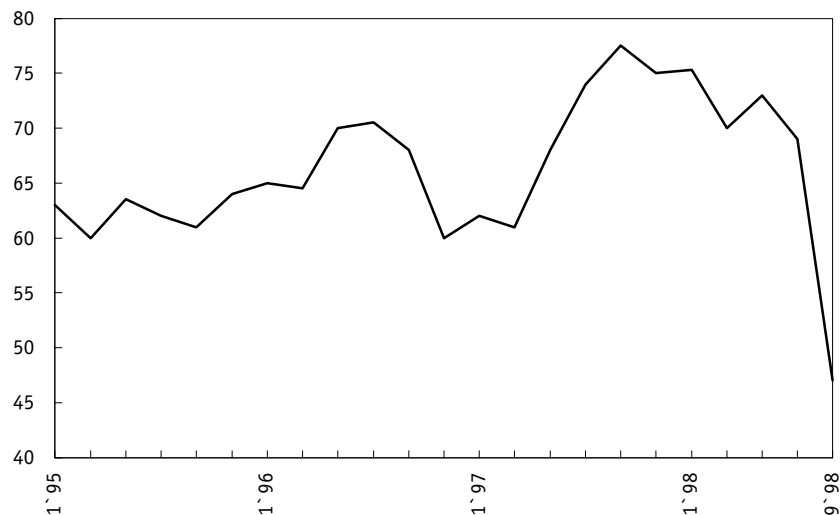
Source: IMF
Forecast by Quarterly Predictions

We argue that the two stages of the financial crisis in different parts of the world have given the international community enough evidence for the need of deliberate steps, which allows us to make optimistic forecasts. Thus, in our opinion, the slowdown of global economic growth from 4.1% in 1997 down to 1.7% this year will accelerate instead and increase to 2.3% in 1999.

Russian collapse

In August, the problems of Russian economic policy became apparent in their worst form. Low tax revenues, resulting from the amalgamation of the Russian government with major private corporations, and government refusal to enact painful reductions in excessive budget spending, which caused rapid growth of the state debt, already appeared last year. However, this year these indicators harshly deteriorated, primarily because of falling prices for key Russian exports particularly oil, and the inability to create new borrowings on the private capital market. Simultaneously, weakening political power in the Russian Federation provoked interested corporations to increase their pressure on the government.

Index of consumer sentiments in Russia



Source: Index of Consumer Sentiments in Russia Center

Who was the first to suffer from the Russian crisis?

At the beginning of September, CS First Boston examined the impact of the Russian crisis on Eastern European economies.⁵ As a result, countries were divided into three categories: (1) those which are highly vulnerable, (2) countries with medium vulnerability and (3) countries with low vulnerability. CSFB considers the following key factors: a country's exports to Russia, Ukraine, and Kazakhstan as a share of its total export and GDP, current account deficit, and the size of external debt. Based upon these factors, the bank finds the following countries to suffer from **high impact**:

- *Latvia and Lithuania.* Both countries have close trade links to the CIS, a significant current account deficit, and weak banking systems, which are undercapitalized and overloaded with bad credits.
- *Romania.* The country had a current account deficit of 6% of GDP in the first five months of 1998, the budget deficit was running above target, the IMF stand-by agreement broke down, and the economy has virtually stagnated over the past 18 months.
- *Slovakia.* Though the country has relatively low trade exposure to the CIS countries, it shows an extremely high current account deficit, which will exceed 8% this year, and keeps its currency within the band only by very high interest rates.
- *Croatia.* The economy has a overheating problem that has not been adequately addressed by policy tightening. Moreover, budget spending grows rapidly with the approach of parliamentary elections in 1999.

Medium impact will be on:

- *Estonia.* The country has less trade exposure than the other Baltic states to Russia, Ukraine and Kazakhstan, although it is substantially higher than Central European levels. Trade deficit, which was originally covered by investments, which has recently been shifting toward short-term loans. Since November 1997 the Central Bank accomplished a series of effective measures to improve the banking system.

Low impact will be on:

- *Bulgaria.* The country significantly depends on the markets of Russia, Ukraine, and Kazakhstan, and has relatively high external debts. However, neither the maturity profile of its debt nor its current account warrant concern. A successful currency board, introduced in July 1997, and the recent successful conclusion of negotiations on a 3-year EFF program, prove the low vulnerability of Bulgaria's currency
- *Poland, Hungary, and the Czech Republic.* The importance of the CIS countries for these countries has declined dramatically in recent years, as they have reoriented towards the EU market. Both current account deficit and state debt are kept at modest levels.
- *Slovenia.* This country has low trade exposure to CIS countries and very sound economic fundamentals.

Export to Russia (R), Ukraine (U), and Kazakhstan (Ě)

	R,% exp- ort	U,% exp- ort	Ě,% GDP
Bulgaria	7.9	11.6	5.0
Croatia	3.8	4.4	1.0
Czech Rep.	2.4	3.6	1.5
Estonia	6.0	13.5	7.7
Hungary	5.1	6.9	2.9
Latvia	21.0	28.7	8.7
Lithuania	8.8	30.7	10.9
Poland	4.1	10.7	1.8
Romania	3.0	4.1	1.0
Slovakia	2.7	6.0	3.0
Slovenia	3.9	4.8	2.2
Ukraine	26.7	33.2	9.5

Source: CSFB,
data for 1997

This resulted in the August 17 announcement on the default of Kirienko's Cabinet to service short-term domestic debt, a 90-day moratorium on

⁵ Impact of the Russian Crisis on Emerging Europe, September 3.

payments to non-residents, and simultaneous currency devaluation. Inadequate steps of the Russian president, who dismissed Kirienko's Cabinet (which enjoyed the confidence of external creditors) and restored Chernomyrdin as acting PM, who on the contrary was not supported by major political forces but was associated with previous economic defaults, let the Russian economy fall down. The banking sector in Russia became insolvent because of continuous bank runs and banks' inability to pay out its external liabilities. Consequent panics and a halt in economic functions were reinforced by the failure of the CB's foreign exchange policy and harsh domestic currency devaluation, which reached 200% within a month's time.

In 1998 Russia will inevitably show a harsh reduction of GDP

We consider that by the end of 1998 any measures implemented by Primakov's Cabinet will suggest a considerable reduction in Russian GDP, due to currency instability and a breakdown of the banking sector. As reported, for the first nine months of the year it already amounted to 3%. At the same time, the new Russian government has no effective economic program which would allow for the successful implementation of short-term measures. Therefore, we do not expect any slowdown in the fall of Russian GDP, which will total 6%.

Therefore, to resume economic growth, the government of Russia must accomplish the following steps:

- Balance the budget. After the crisis, real budget revenue fell by more than 50%. Given the contraction of production in enterprises oriented toward domestic demand, the government is left with the only actual possibility of receiving tax revenues from exporting enterprises, first of all, oil companies. Mass resistance by top managers of these enterprises creates another source of political instability.
- Reach agreements with international creditors, primarily with the IMF. This is a complicated task for Primakov's Cabinet, as the development, discussion, and implementation of a new economic program implies a consensus within the Cabinet. The government must regulate the problem of frozen external debt if it plans to revive relations with external creditors. At best, this problem may be resolved through a tri-lateral agreement with the government, IMF, and investors to restructure the debt, in particular, repayments on matured eurobonds.
- Restore and stabilize activities of the banking sector. This was the only successful anti-crisis measure accomplished by the new government and Geraschenko's Central Bank. Although the complex plan for reforming the banking system and protecting depositors is still under discussion, the Central Bank has already succeeded in mutual settlements on overdue payments, which allowed for resuming payments between the Moscow banks most resistant to the crisis. At the same time, given this financial situation, the government and the Central Bank should reorganize banks at the least possible cost to the budget while maintaining tight monetary policy.

We do not expect an economic catastrophe in Russia for 1999...

... though significant improvements are improbable

Current experience and political attitudes of members of Russian new Cabinet give reasons to doubt the possibility of timely and full implementation of these tasks. At the same time, we do not expect that Russian government will choose the way of hyperinflation and hope that it will be able to make realistic decisions in the nearest future. However, the critical risk factor remains Yeltsin's bad state of health, which may provoke new circuit of political instability. Based on this, we forecast that facilitation of economic depression will reach its highest of 8% for the whole 1999, which, however, will slow down at the end of the year.

GDP

Considering the adverse affects of the external and internal crisis, we had to revise our forecast for Ukraine's economic development in 1998-1999. Thus, we forecast that real GDP will decrease by 1.7% and 1% in 1998 and 1999 respectively. However, this estimation may become a rather optimistic one if the government fails to tighten radically its budget and monetary policy.

Economic situation and forecast

Current development of the economic environment

According to the reviewed assessments, we forecast that real GDP will decrease by 1.7% in 1998 (compared to the previously forecasted 0.5% decline) and will total UAH 104.5 billion in nominal terms. A substantial share of goods produced in the second half of the year will be accumulated in inventories, which implies that savings will grow up to 16.7% (compared to the previously forecasted 16%) (see **BUSINESS**).

Real GDP will decrease by 1.7% in 1998

GDP Dynamics

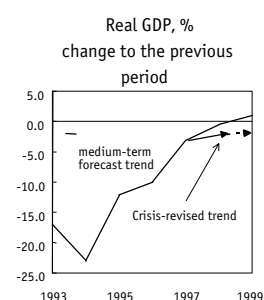
	1997	1998 (previous forecast)	1998 (revised)
GDP, UAH bln	92,5	101,6	104,5
Real GDP, % annual change	-3,2	-0,5	-1,7
Gross national saving share in GDP, %	17,4	16,0	16,7

Source: State Statistics Committee, IMF.

Calculations and forecast by Quarterly Predictions.

Ukraine's stabilization episode was over before it set in

Economics predetermines a two-year stabilization period for countries in transition. A distinctive feature of this period is when a country suffering from hyperinflation moves to a relatively stable economic environment, which is primarily characterized by a low inflation rate and stable exchange rate. This period is defined as a stabilization episode. After this period the country may shift to the category of developing countries with a stable and attractive economic environment. An alternative to this is a recurring crisis inflation spiral, such as the one in Ukraine during 1993-1994. In 1996-1998, Ukraine demonstrated stable national currency and domestic prices, which were critical factors for economic recovery and future development of the country. However, the absence of actual budget policy reforms and real economic sector did not allow the country's economic capacities to develop. Currently, while on the verge of its stabilization episode, Ukraine has to decide whether to focus on market economic reforms, which are accompanied both by unavoidable losses and prospects for a relatively quick recovery followed by entrance into the European community, or to join Russia and Belarus in their stagnation circuit.

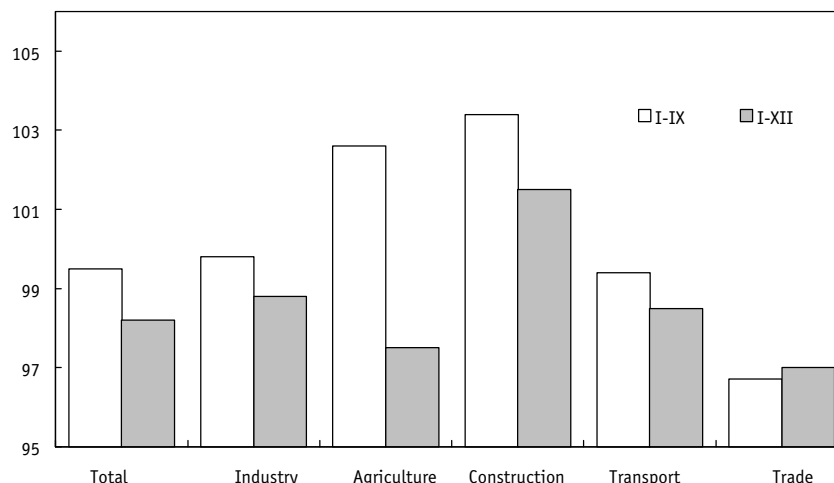


Source: State Statistics Committee
Calculations by Quarterly Predictions

All sectors except construction will show a decline

In 1998, all sectors except construction will show a decline, which is expected to be the most severe in the agriculture, transport and trade sectors. This forsakes the positive trend towards growth, set up in the first half of 1998.

Index of gross value added by economic sectors during January-September and January-December (forecast), 1998



Source: State Statistics Committee.

Calculations and forecast by Quarterly Predictions

1% fall of GDP in 1999 is an optimistic forecast...

Resuming stabilization may be predetermined in 1998 by forced improvements in public finances and a search for internal sources to finance social expenditures. The economic crisis may even facilitate positive changes in Ukraine, resulting from the pressing need to use all existing anti-crisis resources. International research centers give different estimations of the change in real GDP ranging from -2 to +2 percentage points. Still, all researchers unanimously emphasize the need to fulfill provisions of the program agreed with the IMF in order to avoid economic collapse and service significant sums of outstanding internal and external debt, which will mature next year. We also optimistically believe that the fall in GDP will not exceed 1%, if one assumes that the state authorities continue to adhere to strict monetary and fiscal policies.

Major macroeconomic indicators, end of 1998

	QP (previous)	QP (revised)	Chase Securities Inc.	IMF	CSFB
Real GDP, % change	-0,5	-1,7	-1,5	0,0	-0,2
CPI, % change	10,6	20,0	27,6	29	41,8
Budget deficit, % of GDP	2,9	2,8	2,9	2,8	3,0
Current account, % of GDP	-3,9	-3,3	-1,4	-2,8	2,7
NBU gross reserves, \$bln	1,8	1,3	0,8	1,2	...
Exchange rate, UAH/\$, as of end period	2,25	3,5	3,49	...	3,5

Sources: Chase Securities, Credit Suisse First Boston (CSFB), IMF (September 1998). Calculations and forecast by Quarterly Predictions

Currently, a series of measures are considered to be critical for economic stabilization and control of the crisis:

- Maintain the budget deficit at the low level, agreed with the IMF, by significantly reducing government consumption. Consequently, lower budget spending will obviously lead to a decline in GDP during the nearest months. However, in this case the shift may be considered insignificant compared to a collapse that may occur if no wide-scale strict financial policy is accomplished by the government. The policy should primarily focus on regulating government spending (see **GOVERNMENT**). All other ways will most likely lead to untwisting the new crisis spiral.
- Stabilize the national currency. We argue that a slight devaluation may be appropriate in the current situation, as it can help ensure consistent currency policy and prevent losses in currency reserves (see **MONETARY**).

...for this, it is necessary...

... to keep the budget deficit low...

...and attain stabilization of the hryvnia

GDP and GNDI structure

GDP structure by spending

In 1998, the share of government and household consumption will decline as compared to 1997 due to a considerable reduction in government consumption and social transfers.

The share of consumption will decline in 1998...

<i>GDP structure by spending, % of GDP</i>			
	1997	1998 (previous)	1998 (revised)
GDP	100	100	100
Consumption	83,1	83,4	82,4
Private consumption	61,1	64,8	62,7
Government consumption	22	18,6	19,7
Investment	20	20	20
Private investment	18,2	18,5	19
Government investment	1,8	1,5	1,0
Net exports	-3,1	-3,3	-2,4

Source: State Statistics Committee, IMF.

Calculations and forecast: Quarterly Predictions

At the same time, the share of investment will also see no growth, as 1998 turned out to be unfavorable for improvements in the investment climate. Suspended privatization processes, stagnation in the production sector, deteriorating financial situation in Ukraine's industrial sector, and a decrease in foreign investor interest, accompanied by the collapse of the Ukrainian stock market, leave little hope that investments will grow.

...accompanied by a decline in investments...

On the other hand, lower consumption and stagnation in investments will be offset by positive changes in the trade balance. By now, Ukraine can no longer maintain a high trade balance deficit, as it is one of the critical factors creating devaluation pressure on the hryvnia. A considerable improvement in trade balance will be attained mainly due to the following factors:

...which will be offset by improvements in foreign trade balance

- Reducing the demand for imports, due to a considerable currency devaluation

- Decrease overall volumes of imports, due to a contraction of production and fall of GDP

Foreign investments were crucial for growth in Hungary

From the very beginning of its economic reforms, Hungary placed emphasis on widely attracting foreign capital in the form of direct investments and made efforts to create a favorable investment climate. During 1989-1996, foreign direct investment in Hungary amounted to \$13.2 billion, which is much greater than in the Czech Republic and Poland (\$7.1 billion and \$5.4 billion respectively). Thus, per capita foreign direct investment in Hungary was equal to \$1,300 (compared to Ukraine, which ended up with \$50 per capita foreign direct investment in 1998). Besides financing a relatively large budget deficit, such policy allowed Hungary to stimulate economic development and ensured further stable growth of real GDP.

	1994	1995	1996	1997
<i>Real GDP, % change to the previous year</i>	2,1	0,3	2,8	6,0
<i>Consolidated budget balance, % of GDP</i>	-8,3	-7,1	-3,1	-4,6
<i>Foreign direct investment, \$ bln</i>	1,2	4,5	1,8	1,7

Therefore, the foreign trade balance will significantly improve (see **EXTERNAL**). The positive side of the currency devaluation is that it launches a so-called “switch-on mechanism”, or reorientation of the internal market towards domestic products. This implies crowding out imports and facilitating of positive economic changes.

GNDI structure

Gross national disposable income (GDP + net factor income + net transfers, see **EXTERNAL**) defines gross country income more precisely, as it also includes the current account balance.

Gross national disposable income structure

UAH bln

	1997	1998 (previous)	1998 (revised)
Gross national disposable income	92,9	101	103,6
Gross Domestic Product	92,5	101,6	104,5
Net factor income	-1,11	-2,31	-3,0
Transfers	1,57	1,68	2,1
Absorbtion (C+I)	95,3	105,0	107,1
Consumption (C)	76,8	84,7	86,2
Investments (I)	18,5	20,3	20,9
Net exports of goods & services	-2,8	-3,4	-2,5
Current account balance, % GDP	-2,6	-3,9	-3,3
GNI/GDP, %	100,5	99,4	99,1
Direct foreign investment, \$ bln	0,6	0,8	0,7

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

In 1997, the volume of net transfers offset the negative factor income in Ukraine for the first time in the last 5 years. Therefore, GNDI exceeded GDP by 0.5%. However, even though in 1998 the share of transfers in the structure of GNDI will be greater than that in 1997, much higher interest payments on non-resident revenue will nullify the surplus in net exports of goods and services. GNDI dynamics strengthens the economic meaning of 1997, which may have become a year of positive economic changes for Ukraine. Unfortunately, the stabilization episode, unaccompanied by expected reforms, has never changed into stable growth.

GOVERNMENT

Due to the financial crisis, we amend our previous forecast for budget revenue downwards, lowering it to 28.5% of GDP, and expect a 2.3% budget deficit, as agreed upon with the IMF. Spending of Ukraine's consolidated budget will decrease to 30.8% of GDP in 1998, which is 6 percentage points less than in 1997. Still, one cannot expect radical changes in the structure of budget spending. To overcome the current financial crisis, the Ukrainian government has to develop economic policy oriented towards creating budget constraints for enterprises and the state as a whole. We see the main change, which would lead to higher budget revenue and lower budget spending, in the reduction of the volume of implicit and explicit subsidies to enterprises.

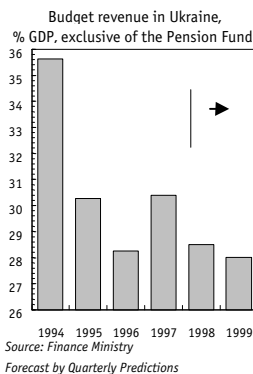
Budget revenue

The Financial crisis will negatively effect the financial position of enterprises (see **BUSINESS**) and reduce household income (see **HOUSEHOLDS**). This will consequently result in the decline of budget revenue on corporate profit tax from 6.3% in 1997 to 5.6% of GDP in 1998, and on value added tax, which will go down from 8.9% in 1997 to 6.9% of GDP this year. From October 1, the change in the terms of VAT reimbursement, according to Presidential Decree 857 of 07.08.98, will only keep the situation from further deterioration.

With this, we predict that real budget revenue on corporate profit tax will fall by over 20% in 1998, on value added tax by 30%, and on excise duties by 12%, as compared to the previous year. This breach will be partially offset by higher revenue collected by extra-budgetary funds and an increase in revenues on local taxes and duties. We expect lower revenues on income tax (however, compared to 1996, this means a higher real tax burden, which has grown 10% for this period).

Due to a significant reduction in collections by the majority of budget items, we lower our forecast for the consolidated budget revenue of Ukraine from 29.4% down to 28.5% of GDP, and the overall decrease in real budget revenue in 1998 will amount to 11%. Thus, revenues collected for the state budget will decline by 20%, while revenues of the local budgets will increase 3-4% in real terms. In 1999, we expect further reduction in the budget revenue, down to 28% of GDP.

Currently, budget revenue suffers from continuously increasing tax, mandatory payments arrears accumulated by businesses, and the practice of writing them off. Furthermore, while current tax legislation allows for budgetary collections at 60% of GDP (see **QUARTERLY PREDICTIONS, #4**), the actual level of budget revenues during 1995-1998 did not exceed 30.2% of GDP.⁶



Consolidated budget revenue will decrease to 28.5% of GDP in 1998

Decrease in the real budget revenue in 1998 will amount to 11%

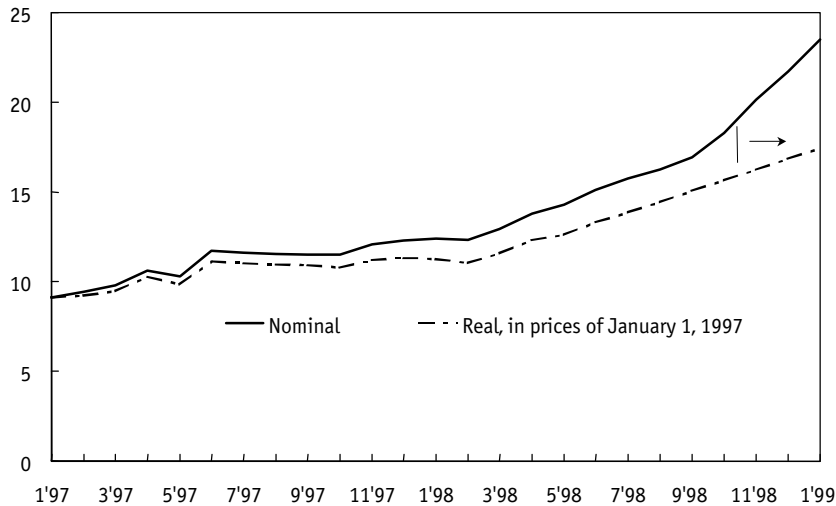
⁶ Compared to 1989, when Ukraine's budget revenues (including assessments to the budget of USSR) amounted to 40% of GDP.

Arrears on taxes and mandatory payments grew from UAH 9.1 million to UAH 16.2 billion for the period from January 1, 1997 to August 1, 1998, which is about 60% in real terms. The average monthly increase in 1998 accounted for over 7% of GDP.

Enterprises' outstanding debt to the budget increased by 60% over a year and a half

Arrears on taxes, mandatory payments and social insurance contributions

UAH billion



Source: State Statistics Committee. Calculations by Quarterly Predictions

The practice of writing off tax arrears has become permanent. In 1997, the sum tax restructured and written-off by enterprises totaled UAH 5.4 billion, or 5.8% of GDP. Although the relevant Law stipulated this as a one-off measure, the absence of drastic government measures concerning delinquent tax-payers during previous years left enterprises hopeful of new writings off. In particular, in 1998 the sum of written off arrears for agro-industrial enterprises will be UAH 3.4 billion. Meanwhile, government authorities are discussing the possibility of writing off arrears accumulated in the coal-mining sector. What is important to emphasize is that such procedures are never accompanied by a clear strategy development for business sector recovery and enterprise restructuring.

The practice of writing off tax arrears has become permanent

The state, looking past the accumulation of tax and mandatory payment arrears and permitting recurrent debt restructuring and write-offs, implicitly supports loss-making enterprises. The cost of this support is extremely high and is one of the most important factors that provoked the financial crisis.

Often debt accumulation and consequent financial instability are caused by expectations of mutual settlements. In 1998, they ranged from 10.3% to 22.1% of the consolidated budget revenue, which is 2.5% –6.8% of GDP. The share of mutual settlements is particularly high in revenues for local budgets, and in particular, in March 1998 it reached 26%.

The share of mutual payments in consolidated budget revenues ranges from 10% to 22%

The base for budget revenue (both at the central and local levels) grows more unstable because of the existing system of revenue distribution among various budget levels. For example, in 1997, value added tax revenues were collected for the central budget, while corporate profit tax revenues were assigned to

Instability of the budget revenue base grows because of the existing system of revenue distribution

local budgets.⁷ Due to these changes, the share of value added tax in state budget revenues amounts to 70%, while the main sources of local budget revenues are corporate profit tax, income tax and land tax, which make up about 90% of their total tax revenues.

***Budget tax revenues in Ukraine
(for 6 months of 1998)***

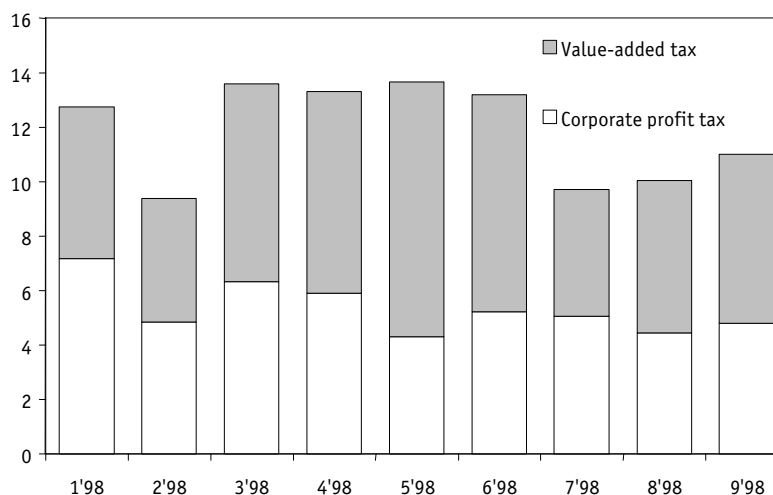
	State budget UAH million	Local budgets UAH million	State budget, %	Local budgets, %
Total tax revenue	4289.8	4960.5	100	100
Income tax		1615.4		32.57
Corporate profit tax	68.9	2351.2	1.61	47.40
Vehicle owner tax		122.3		2.47
Land tax		457.2		9.22
Value added tax	3072.3		71.62	
Trade licence for specific entrepreneurial activities		117.9		2.38
Tax on international sales and overseas operations	435.0		10.14	
Local taxes and duties		176.2		3.55

Source: Finance Ministry. Calculations by Quarterly Predictions

While budget revenues from value added tax and corporate profit tax are subject to abrupt monthly changes, per capita corporate profit tax revenues also vary depending on the region.

Budget revenue on VAT and corporate profit tax

% of GDP



Source: Finance Ministry of Ukraine Calculations by Quarterly Predictions

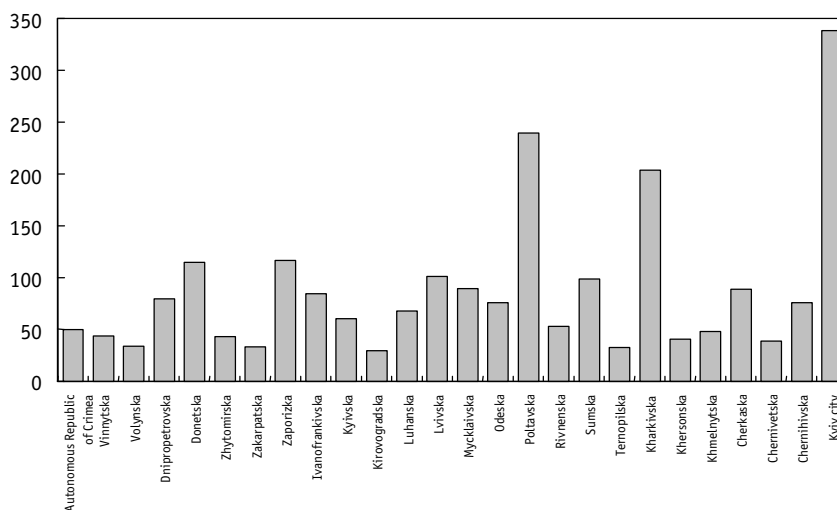
The shown dynamics of these taxes being counted separately into state and local budgets aggravates the problem of financing expenditures from the

⁷ Beginning from the second quarter of 1998, the lowering of the depreciation coefficient from 0.7 to 0.6 directed an insignificant share of corporate profit tax revenues into the central budget

central budget, which include interest payments on state debt and other protected articles. Moreover, it worsens the situation in financially weak regions, as they largely depend on subsidies from the state budget.

Local budget revenue per resident

Six months of 1998, in % to average revenue in Ukraine



Source: Finance Ministry of Ukraine Calculations by Quarterly Predictions

Currently, the situation in Ukraine may be called paradoxical since revenues collected to local budgets are substantially decentralized, while responsibilities for their allocation are not precisely defined and state authorities are highly empowered. We argue that consolidating value added tax and corporate tax revenues at the central level would reduce the problems with budget revenues and improve controlling procedures for the allocation of public costs.

Consolidation of VAT and corporate tax revenues at the central level would reduce problems with budget revenues

Western Europe stands for common taxes

In Germany, only low-yield taxes are separately paid into Federal, regional and community budgets. As for taxes yielding higher revenues, they are distributed between the various budgets of different levels. Thus, about 80% of tax revenues are held by common taxes (profit tax, corporation tax and value added tax).

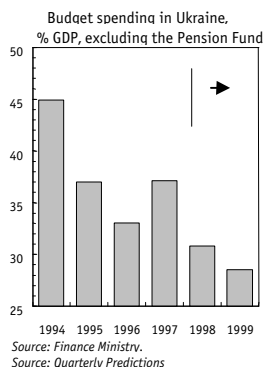
The more authority granted to the central government, the greater is the share of federal tax revenues. For example, the central government in Austria is more powerful than that of Germany. Thus, the share of federal taxes in overall tax revenue amounts to 27%. In Switzerland, where public governance is decentralized, the share of common taxes does not exceed 20% of total tax revenues, while regional and community taxes constitute about 55% of total tax revenues.

Distribution of tax revenues among budgets of different levels, 1992, %

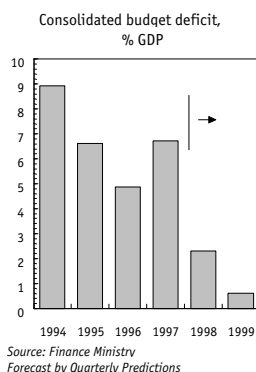
	Ger- many	Aust- ria	Switz- erland
Common taxes	73,1	66,1	19,5
Federal taxes	14,5	26,9	24,6
Regional taxes	4,6	2,4	32,8
Municipal taxes	7,8	4,6	23,1

Source: E.Nowotny. Der Öffentliche Sektor.

Real reduction in budget spending accounts for 20% compared to 1997



The deficit will decrease to 2.3% of GDP in 1998, and to 0.6% of GDP in 1999



The problem of budget spending cannot be resolved without a revision of governmental functions

As before, the government considers itself responsible for everything...

Budget spending

We forecast that budget spending will reduce in 1998 to 30.8% of GDP, which is 6.3 percentage point less than in 1997, primarily due to lower budget deficit planned at 2.3% of GDP. In real terms, this decrease accounts for 20%.

With that, spending on science will be reduced by 55%, education and public healthcare – by 30% and 25% respectively. We expect that a reduction in defense expenditure will be offset more than by 1/3, as in 1997, by an increase in payables in this sector. The lowest will be reduced expenditures on law enforcement and economic activities – by 17% and 15%, respectively. For 1999, we forecast further decline in budget spending, down to 28.5% of GDP, resulting from a decrease in budget revenue and budget deficit, down to 28% and 0.6% of GDP respectively.

Even given the financial crisis, we do not expect radical changes in the structure of budget spending in 1998, which primarily implies a reduction in law enforcement allocations and more consistent and efficient spending in the social sphere. This only emphasizes the lack of understanding that high budget spending and its invalid structure were a primary cause of the financial crisis in Ukraine.

Structure of budget spending in Ukraine, 1997-1998

% expenditures

	1997	1998 (forecast)
Social spending (excluding state price controls)	11,28	12,66
Education	14,67	13,31
Healthcare	11,53	11,04
Science	1,70	0,97
Defense	5,07	4,22
Administration, law enforcement	8,67	9,09
Foreign affairs	0,50	0,65
Expenditure on the economy (including state price controls)	22,33	24,03
Effects of the Chernobyl nuclear accident	5,09	4,55

Source: Finance Ministry. Calculations and forecast by Quarterly Predictions

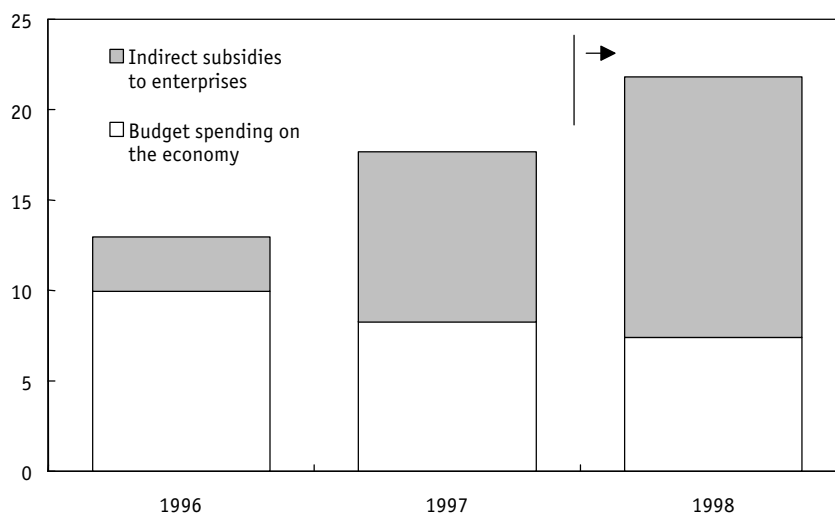
The problem of cutting back budget spending in Ukraine cannot be resolved without a revision of government functions. Thus, the main function of a socialist state is to command economic activities. For this, the national income is distributed through the budget system and directed into strategic industries. For example, in 1989 about 50% of budget spending in Ukraine was directed towards economic activities.

In market economies, state authorities do not usually regulate activities of the competitive enterprises. The government focuses its funds and efforts on the maximization of public benefits, problems of revenue redistribution, and macroeconomic stabilization.

In Ukraine, the transition to a market economy was not accompanied by a determined decision by the government not to intervene in economic activities. Still, the government considers itself responsible for all economic processes, in particular for subsidizing domestic producers. The changes made concerned only the form: direct budget financing of enterprises and

industries was substituted by indirect subsidies in the form of non-payments, write-offs and restructuring of outstanding debts, and tax privileges.

Direct and indirect subsidies to enterprises in Ukraine 1996-1998, % GDP

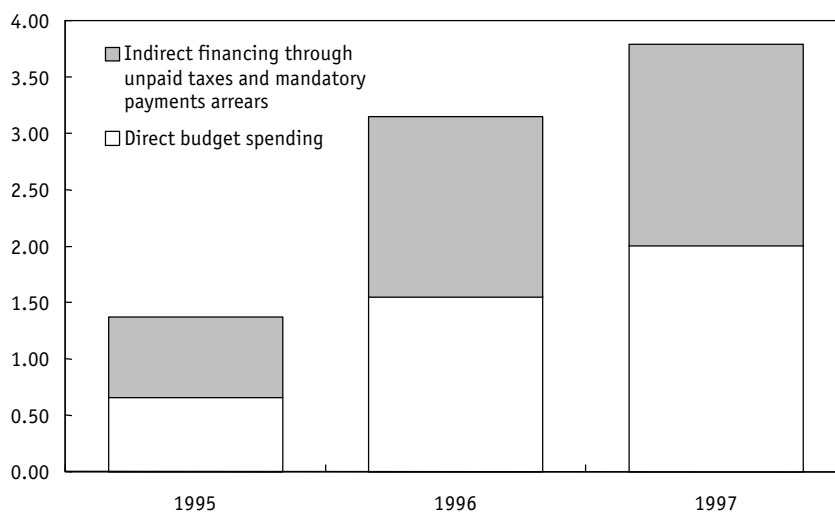


Indirect subsidies include tax arrears, restructured and written-off debt
Source: State Statistics Committee, Finance Ministry Calculations and forecast by Quarterly Predictions

In this context, Ukraine's coal-mining industry serves as a good example. In 1995, due to an increase in coal prices, budget financing of the sector was reduced fivefold as a share of GDP (down from 3% to 0.6% of GDP). The assumption was that the leveling of prices for coal with its actual cost (including sufficient profit) would allow coal-mining enterprises to cover their actual inputs into extracting and concentrating coal. Today, the price for coal in Ukraine exceeds coal prices in Poland and Russia (including transportation costs). However, coal enterprises continue to request more budget financing.

...and continues to support ineffective enterprises

Government financing of the coal-mining industry, % GDP



Source: Ministries of Statistics and Finance. Calculations by QP

In 1996, direct budget expenditure on coal-mining industry grew up to 1.6% of GDP. Furthermore, in 1997 they exceeded the value added by the industry, and amounted to 2% of GDP.

In 1997, total government support of the coal-mining industry amounted to 4%

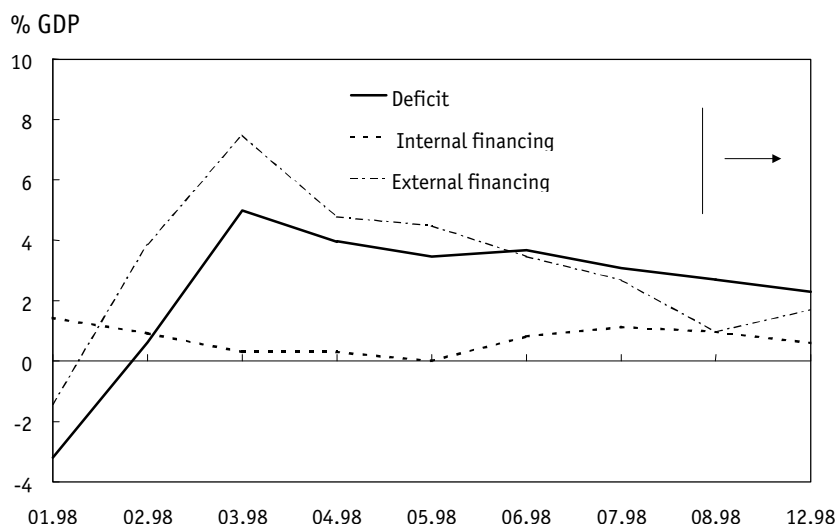
Besides direct budget subsidies, the industry received additional financing almost equal in size through a de facto postponement in tax and mandatory payments. Thus, the volume of coal-mining industry financing totaled 4% of GDP in 1997, which, however, was not accompanied by improvements in the industry. To conclude, redistribution of budget revenues received from profitable enterprises in favor of inefficient enterprises implies further increase in budget spending and deterioration of the overall financial and economic situation in Ukraine.

We argue that in order to increase control over budget spending, the transparency of budget operations should be ensured, and extra-budgetary funds are to be included in the budget. Specific accounts, opened for ministries and agencies (in order to reckon budget credits or settle payments for resources received from state reserves), is another means to protect expenditure, directed on enterprises financing.

State budget debt

Conversion of T-bill outstanding debt, maturing in 1998, allowed postponing their redemption until 2000. This facilitates the budget situation of the current year, which gives us hope that the budget deficit will be decreased to 2.3% in 1998. Thus we expect that the debt financing will consist of two sources: external (about 0.6% of GDP), and internal (1.7% of GDP), through NBU credits (see **MONETARY**).

State debt deficit and its financing in 1998



Notes: Budget deficit consists of the sum of external and internal financing, and government deposits

Source: Finance Ministry, Ministry of Economy Calculations and forecast by Quarterly Predictions

The high level of actual government spending and of the budget deficit being maintained by the government during the last two years, accompanied by a rapid increase in the stock of debt under conditions of a breakneck drop in production, discredited the government in the opinion of investors. This resulted in high interest rates and further worsening of the budget situation.

Expenditure on the domestic debt service increased from 0.6% of GDP in 1996 to 2.1% of GDP for nine months of 1998.

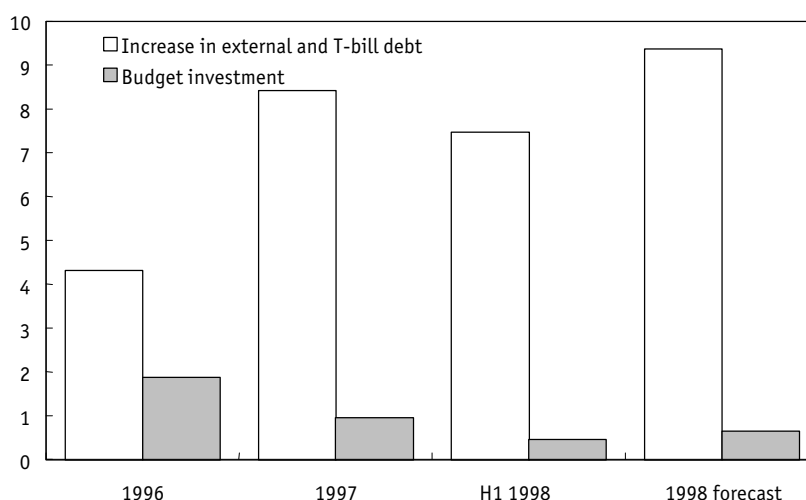
We forecast that expenditures on servicing the domestic debt for all of 1998 will reduce to 1.8% of GDP. At the same time, in 1999 expenditure on the external debt service will grow significantly due to currency devaluation, up to 2.5% of GDP. Thus, according to our estimations, the overall spending on external and internal debt service in 1999 will be as high as 4% of GDP, compared to 2.8% in 1998.

In 1999, overall spending on the external and internal debt service will be as high as 4% of GDP

The government's debt may be justified only if it leads to a further increase in budget revenue or a reduction in government spending, i.e. if it has a positive profit level which allows the government to redeem the capital amount of debt and repay interest on it. Such justified government spending includes investment, and in the case of transition economies, expenditures on structural reforms and the formation of a pension insurance system. During the last few years, the yearly increase in the external and domestic public debt of Ukraine was several times higher than the volume of budget investment. Therefore, the spending financed through government borrowing was merely consumed, and resulted in new government expenditures on the debt service, instead of an increase in economic output and revenues.

Increase in state debt of Ukraine and budget investment during 1996 and 1998

%GDP



Source: Ministries of Finance and Economy. Calculations and forecast by Quarterly Predictions

Still, most politicians (and economists) do not recognize the cost of inconsistent harmful structural reforms to the real economy and public finances.

The absence of actual structural reforms in the real sector leads to straight losses

From January 1, 1997 through July 1, 1998, the increase in the foreign and T-bill debt (in UAH, by the official exchange rate) amounted to UAH 11 billion. For the same period, the increase in enterprises' arrears on tax and mandatory payments amounted UAH 6.6 billion, while an extra UAH 5.4 billion of arrears on these payments were restructured or written off, which in total gives UAH 12 billion. Therefore, even if this sum is adjusted by the amount of collected fines, the additional revenue to the budget and the Pension Fund might have accounted for UAH 11 billion. This means that

Ukraine could have avoided borrowing and escaped from the financial crisis. For this, the government failed to implement strict and consistent measures regarding loss-making enterprises, accompanied by measures for encouraging effective ownership. This may be the main cause of the expected budget crisis at the end of 1999, which will worsen in 2000, when the government has to redeem the debts that were restructured in 1998.

MONETARY

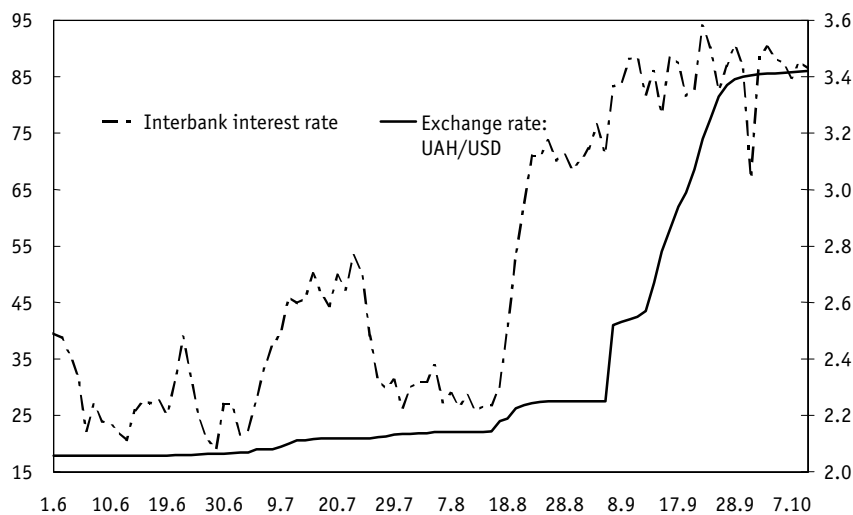
Monetary policy will be primarily determined by the exchange rate and dynamics of international reserves. In order to ensure only moderate currency depreciation, the National Bank of Ukraine will have to conduct tight monetary policy until the end of this year and further in 1999.

Interest rates and exchange rate

The high level of budget deficit, inefficient debt policy, and the need to support national currency kept interest rates at extremely high levels over the course of 1998 – the real interest rate was maintained at 35-40% even during the pre-crisis period. Still, even these high rates, implied by growing risks, could not prevent capital outflow from Ukrainian financial markets and restrain currency devaluation, which was mainly caused by a wide scale of the recent crisis.

Interbank interest rates (yearly %), and hryvnia exchange rate against the U.S. dollar

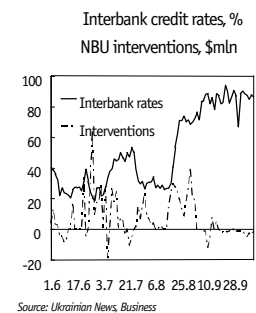
June '98-September '98



Source: Ukrainian news, Business Calculations by Quarterly Predictions

During January-August the NBU carried out wide-scale interventions to support the hryvnia. However, this measure must be considered a forced one, resulting from the public finance imbalance during 1997-1998. Currently, the NBU has to repay highly expensive short-term government debt, through the loss in its reserves.

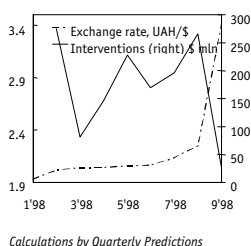
Budget imbalance kept interest rates high during all of 1998



Source: Ukrainian News, Business

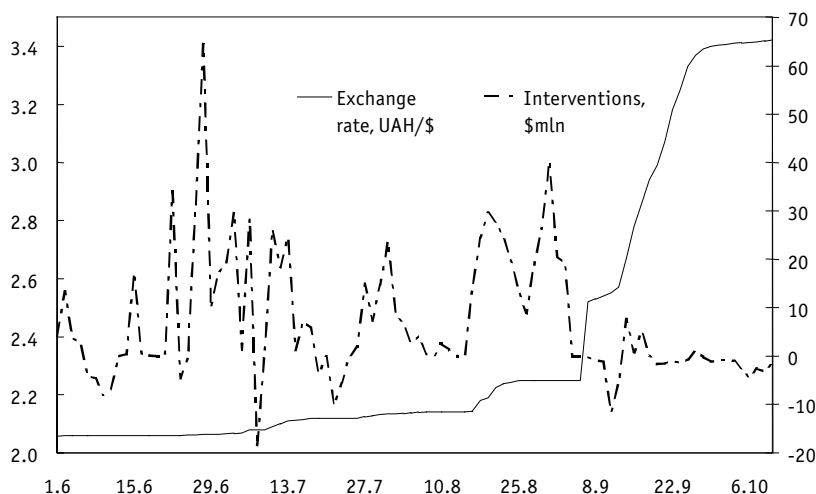
In January-August, the NBU wide-scale interventions strengthened the hryvnia

Dynamics of exchange rate and NBU's monthly interventions



NBU interventions (\$ million) and exchange rate dynamics

June '98 – September '98



Source: Ukrainian News, Business. Calculations by Quarterly Predictions

Data for interventions are provisional, and therefore may differ from those in later official publications

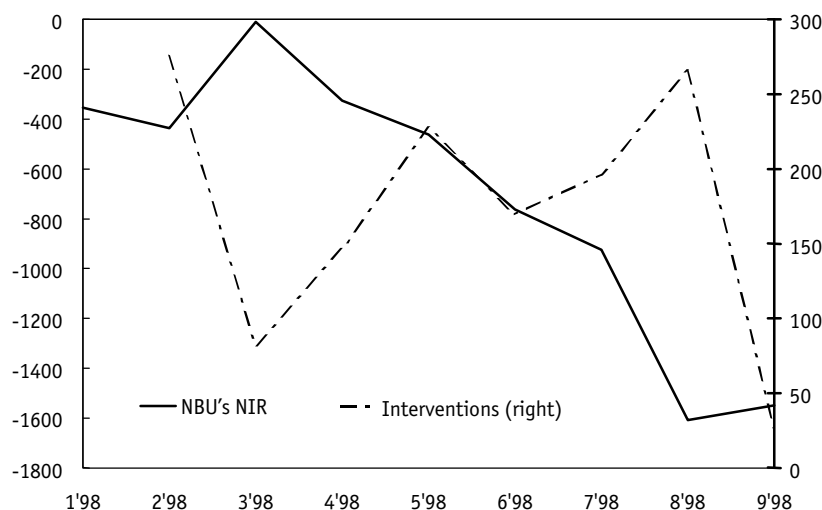
Release of the IMF credit tranche was not followed by currency stabilization...

...moreover, it was devaluated by 47%

Expectations regarding stabilization of the exchange rate after the first EFF credit tranche, released in early September, remained unsupported. Moreover, the new currency band provoked a sharp increase in the demand for dollars, which resulted in steep devaluation of the exchange rate. In September, it dropped from UAH2.25/\$1 to UAH3.3/\$1, which amounts to 47% growth.

Monthly interventions and NBU's net international reserves

\$ mln



Source: Ukrainian News, Business. Calculations by Quarterly Predictions

The sharp devaluation in Ukraine should restore the parity of real exchange rates (if it has been disturbed) and stimulate Ukrainian exports, which would

consequently improve the current account balance and limit devaluation pressure. However, the effect of devaluation on the balance of payments will not be stimulating in the short-term⁸ (see EXTERNAL).

Today, the NBU's economic and administrative measures for restricting the devaluation pressure and demand for foreign currency (increase in banking reserves, constriction of interbank foreign exchange market to the size of UICE, recommencement of compulsory foreign currency sales for exporters, and introduction of new restrictions on purchasing dollars) are the subject to fierce criticism. However, we view such policy as the only way to avert harsh devaluation and consequent financial collapse.

**NBU's administrative
regulation of the
exchange market gave
positive results**

New exchange rate regime needed?

Following further development of the crisis, the issue of a new exchange rate regime became a question of present interest. Currently, two bipolar alternatives are under discussion: (a) implement a freely floating regime or (b) introduce a strictly fixed regime through the system of currency board. Proponents as panacea view both alternatives, but in our opinion neither of the two can be carried out.

We argue that introducing a freely floating regime in the current unstable economic and financial situation will harshly raise the demand for dollars, which will cause devaluation and lead to an imbalance in the financial and banking sectors. Moderate managed devaluation has positive implications on the competitiveness of domestic products in foreign markets and carries out a necessary stabilization function.

The currency board regime may be valid only if two conditions are fulfilled:

- *Monetary base is totally covered by the CB's international reserves*
- *Low-deficit budget and/or zero increase in the Central bank's net domestic assets (implies strict monetary and fiscal policy)*

The current situation is that Ukraine's foreign exchange reserves are insufficient for the immediate implementation of strict fiscal policy, which demands a significant time frame to be efficiently developed.

In our opinion, both alternatives cannot be applied to Ukraine in the short-term. Certainly, the NBU will have to ease exchange restrictions, which, however, will not lead to absolute liberalization. Thus, if the foreign exchange market begins to worsen again, we stand for a slightly devaluated currency band. At that, the need of currency devaluation would be admitted, and the NBU should announce its objectives in advance for the public to become aware of. According to our evaluations, upper bounds of the currency band may become the following: end of 1998 – 3.8 UAH/\$1 (12% growth in the fourth quarter), March 1999 – 4.05 UAH/\$1 (7% quarterly growth), June 1999 – 4.25 UAH/\$1 (5% increase). However, the NBU must not be left face to face with the crisis — only privatization and investment processes stipulate for capital inflow and normalization of the exchange rate policy.

We forecast that during the next months the NBU will perform strict monetary policy which will support the hryvnia at a rate lower than the 3.5

⁸ A classic model of the impact of devaluation on trade balance is the J-curve. In the aftermath of devaluation, the trade balance (1) initially worsens, due to the perverse valuation effect, (2) gradually improves over time as the elasticities rise, and (3) surpasses its starting point when the Marshall-Lerner condition is satisfied.

Monetary authorities will try to maintain a 3.5UAH/\$1 exchange rate in 1998

In spite of unpredictable political factors...

...we expect that the exchange rate will not exceed 4 UAH/\$1 by the end of 1999

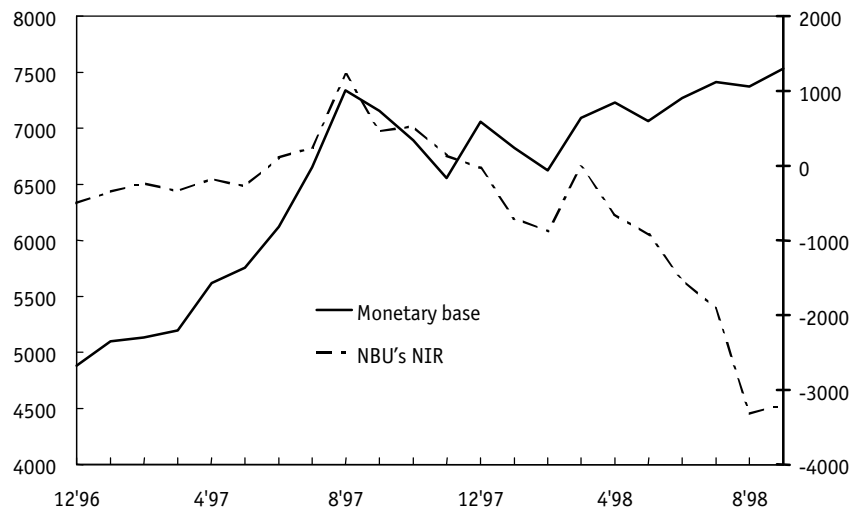
UAH /\$1 upper band. This will reflect in high interest rates on hryvnia assets and measures (including administrative ones) to restrict the demand for dollars in UICE. At the end of 1998, access to dollar operations may be expanded if the mechanism for compulsory sales of the exporters' receipts works fine and a boom demand for dollars is restricted.

Tight monetary policy, expected to continue through 1999, implies an increase in the dollar exchange rate, which will be only a little higher than the inflation rate. This will result in a slight real devaluation needed to support Ukrainian exports. However, beginning from August 1999, on the eve of presidential elections, the devaluation pressure on the hryvnia will begin to grow. Another source of this pressure will be the outstanding external state debt, postponed until 2000. Therefore, we estimate devaluation in autumn and winter of 1999 to grow by 8-10%, and the exchange rate to reach 3.95 UAH/\$1 by the end of the year (while the average rate in 1999 will be 3.7).

Foreign reserves

The last quarter of 1998 and beginning of 1999 will become the period for identifying new sources of foreign exchange reserves. Since 1998, the total reduction in the NBU's reserves caused by the interventions, accounted for \$1.6 billion.⁹ Gross reserves somewhat stabilized at slightly higher than \$1 billion, level in September, after the NBU stopped its interventions and introduced obligatory currency sales. We estimate the gross reserves to increase up to \$1.3 billion, considering receipts from the IMF, the World Bank, and the EU.

Monetary base (left axis), NBU's net international reserves

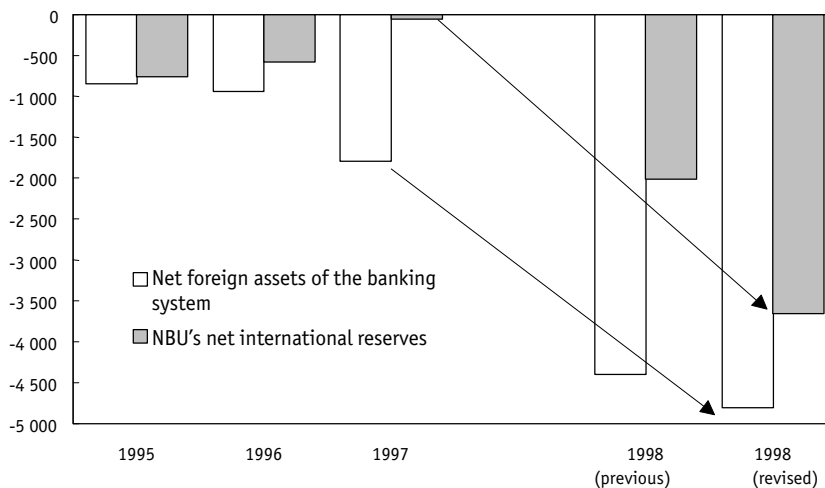


Source: NBU

At the end of August, the gross reserves of the NBU reduced to \$880 million (or 2.4 weeks of imports, which is the lowest amount since 1994), making it doubtful that Ukraine is capable of repaying its debts. To prevent default, we want to stress the need of structural economic reforms. And Ukraine must enter international markets with competitive production.

⁹ The main loss resulted from the withdrawal of funds by non-residents which were invested in Ukrainian T-bills in 1997 as to cover the budget deficit.

Banking system's net foreign assets and NBU's net international reserves¹⁰, UAH mln

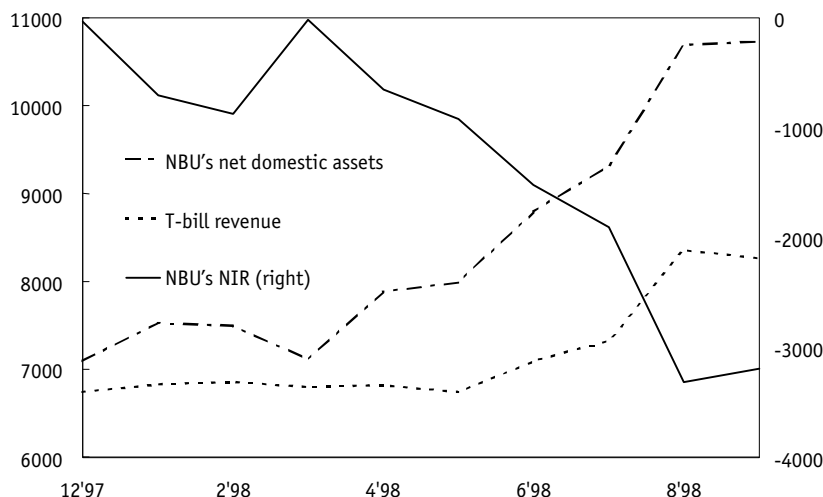


Source: IMF, NBU. Calculations and forecast by Quarterly Predictions

Collapse of the T-bill market

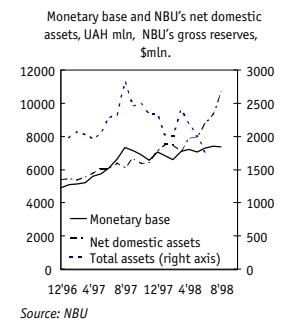
Unfortunately, in early 1998 it became clear that the scheme for repaying high yield T-bills, which are reaching their maturity date, contains numerous mistakes. In 1998, non-residents' withdrawal from the market (who mainly created the demand for T-bills in the primary market since 1997) was not offset by the demand from domestic investors. Thus, by the middle of 1998, the NBU became the only purchaser of T-bills, which mature after 1998.

NBU's net domestic assets and net international reserves, Finance Ministry's income from T-bill sales, UAH mln



Source: NBU, Ukrainian News, Business

By the end of August, domestic debt accounted for UAH 11.9 billion, of which UAH 1.87 billion was in T-bills held by non-residents (including mid-



Source: NBU

Ukrainian investors did not offset non-residents' withdrawal from the T-bill market...

...and the NBU became the only purchaser of T-bills

In 8 months, non-resident shares fell from 40% to 15%

¹⁰ The NBU's Continuous interventions resulted in more rapid decline in the NBU's net foreign reserves than in net foreign assets of the whole banking system.

term T-bills (SOVDP) hedged by Merrill Lynch). For the period of 8 months, non-resident shares in domestic debt fell from 40% to 15%.

In September, the debt on non-resident holdings in T-bills was successfully restructured...

In September, during the voluntary restructuring of the state debt, existing T-bills were changed into new ones, maturing after 2000. Non-residents were proposed to exchange their T-bills and SOVDP maturing in 1998-1999 for T-bills with a 45% yield, nominated in hryvnias and hedged at 22% in dollar terms, or eurobonds with a 20% yield. Restructuring that covered almost the whole debt to be redeemed at the end of 1998, was crucial for the situation in the financial market, as it eliminated the risk of further currency outflow, resulting from further non-residents' withdrawal from the T-bill market. We argue that non-residents were well aware of the risks in the Ukrainian market, as 50% yields mean a high probability for financial losses.

...though restructuring was not that successful with Ukrainian banks

Part of the debt on T-bills held by Ukrainian banks was also subject to voluntary restructuring. However, only 50% of T-bills were converted, as banks-residents were proposed less advantageous conditions of restructuring. First, newly converted T-bills will mature in 2001-2004. Second, proposed yield is too low, if one considers potential dynamics of the exchange and inflation rates. Nevertheless, yielding to pressure from the government and the Finance Ministry, that has no actual resources to service the existing domestic debt, a number of Ukrainian banks had to convert their T-bills. Obviously, this has negative consequences for banks' liquidity, as the share of T-bill holdings in their portfolios are much higher than that of non-residents.

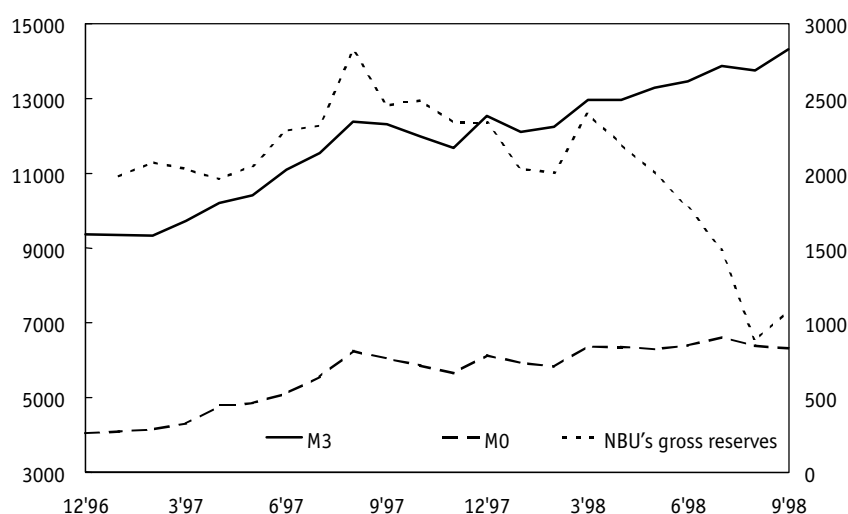
Money supply

Tight monetary policy in 1998 was a forced measure for fighting the crisis

The 1998 tight monetary policy which restrained the growth of the monetary base to 3% during the period from August 1997-September 1998, was a forced measure for limiting crisis effects in the foreign exchange market. The NBU's growing credits to the government, oriented on financing its excessive expenditures through T-bill purchases, was the main source of the increase in broad money supply. However, it resulted in the continuous loss of foreign exchange reserves. At the same time, inflation and household demands for dollars were checked through the contraction of money in circulation. We forecast that broad money supply (M3) will increase by 12% for all of 1998, while money in circulation will increase by 11%, which, adjusted by a 20% inflation, implies a substantial reduction in the real money supply.

This year money aggregates will grow gradually

Money supply (UAH mln, left) and NBU's reserves (\$ mln)



Source: NBU

In our opinion, the government will be successful at implementing the monetary program agreed with the IMF. However, we admit the possibility of a slightly higher ceiling in the NBU's net domestic assets, set during the nearest review of the major economic indicators, in relation to the significant inflation expected at the end of the year.

In the nearest 9 months the monetary program agreed with the IMF will be successfully implemented

<i>Guidelines for monetary policy in 1998</i>				
	QP (previous)	QP (revised)	Chase Securities Inc .	IMF program
Monetary base, % change	12	11	14,9	6
Broad money, % change	15	12	14,2	10
Net foreign assets of the banking system, UAH billion	-4,4	-4,8	...	-4,7
Net domestic assets, UAH billion	18,8	18,9	...	18,5
Velocity M2	7,5	8,1	~ 10	10,4
Interest rate (3-month),%	40-45	45-50	50	...

Source: NBU, IMF, Chase Securities Inc. (data from the middle of Sept.)
Calculations and forecast by Quarterly Predictions

In our opinion, tight monetary and fiscal policy in 1998 was a forced measure, necessary to prevent the spread of the crisis. This policy is extremely painful for the government, being the cost of ineffective public management, which would be even higher if no radical economic reforms are implemented. At the same time, on the eve of presidential elections, tight monetary policy may be immolated to earning the electorate's confidence, and thus, the NBU will be impelled to expand significantly domestic crediting.

Tight monetary policy is at stake

Emission is hazardous for Ukraine

Currently, a great number of top officials believe that the economy lacks money. Among other arguments are growing payment arrears between enterprises, caused by the absence of so-called working capital. The assumption is that if money injections were made, enterprises would overcome the crisis and the GDP would start growing.

However, different economic schools make clearly similar conclusions:

- *The main cause of inflation in any country is an excessive monetary base, given a certain level of production*
- *Inflation pressure is maintained if the monetary base continues to grow and/or production constantly declines*

Another statement is that expansionary monetary policy is appropriate only if accompanied by structural reforms which favor real production, while enterprises make decisions to invest (which results in the growing demand for real money). On the contrary, if the creation of money is not supported by structural reforms, it leads to an increase in inflation expectations and is more hazardous than not being implemented at all.

In spite of the existing risks, we argue that the mentioned external and internal risks will predetermine the tight monetary policy in 1999. A 10-12% increase in money supply will be consistent with the inflation rate.

In 1999 the increase in money supply will be consistent with the inflation rate

Banking system

Credits

Strict monetary policy limits economy credits

Strict monetary policy substantially limits the volume of loans available for businesses. An additional constraint is excessive government spending, which was rapidly growing in the first six months of 1998, as it results in a substantial drain of resources in the form of credits to the government.

At the end of 1998, the National Bank will hardly increase the rate of refinancing, due to the need to restrict the pressure on the hryvnia. In the first half of 1998, the main channels of commercial banks' resources were refinance auctions, lombard credits, and REPO operations, totaling UAH 800-830million. Thus, today's total volume of refinancing will not exceed UAH 600-650 million by the end of 1998.

Crisis pressure on commercial banks

Before the crisis exploded, Ukrainian banks were not widely involved in the international financial system, which, on one hand, limited their access to money resources, while on the other, impeded rapid capital outflow from weak markets.

At that, the majority of weak Ukrainian banks, which, before the crisis, had an unbalanced assets portfolio, were severely dependent on the T-bill market, and because they were considered undercapitalized, will probably not survive. Besides direct losses, bad credits, and the disappearance of main revenue sources, the hryvnia devaluation pulled statute funds of 23 banks below the ECU1 million margin. Approximately the same number of banks shrank below ECU3 million. According to Ukrainian legislation, the first group of banks may go into liquidation, while the second group may be deprived of the license for exchange transactions. Unfortunately, even if calculated by the "conditional" exchange rate (2.25 UAH/\$1), instead of the present (3.4 UAH/\$), the situation with statute funds cannot be redeemed, as the actual position of these banks remains weak, and a revaluation of assets is expected.

*However, the situation will not become critical if several banks undergo liquidation or consolidation. We base this assumption on the following: first, the share of bank credits and deposits in the GDP structure is insignificant (for example, financial depth does not exceed 4%, see **QUARTERLY PREDICTIONS, APRIL 1998**), which means weak direct impact on the real sector. Second, bankruptcy of weak banks, which have a limited number of clients, will increase transparency and improve control over the whole banking system.*

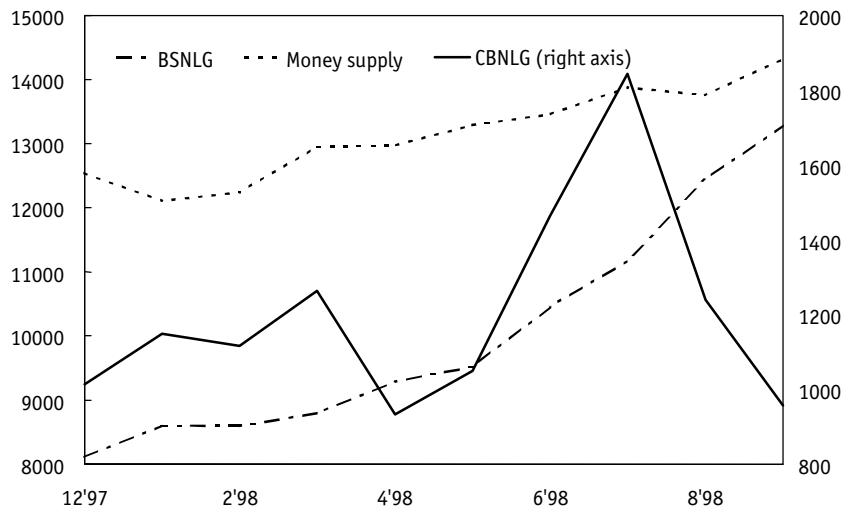
Ideally, loans to the economy may increase...

...though the banking sector is too weak

Today, after the collapse of the T-bill market and introduction of administrative restrictions imposed on exchange speculations, banks are left with inter-bank credit activities and crediting of the economy. Ideally, loans to the economy will increase (accompanied by lower interest rates) and assist in the development of the real sector. In practice, however, high risks and instability of the Ukrainian business environment will be deterrent for this type of credit activity. Another factor that restrains development of the banking sector is low liquidity of Ukrainian banks, resulting mainly from the loss of liquid assets during the conversion of T-bills into long-term securities.

Banking system (BSNLG) and commercial banks' (CBNLG) net loans to government, and money supply in 1998

UAH million

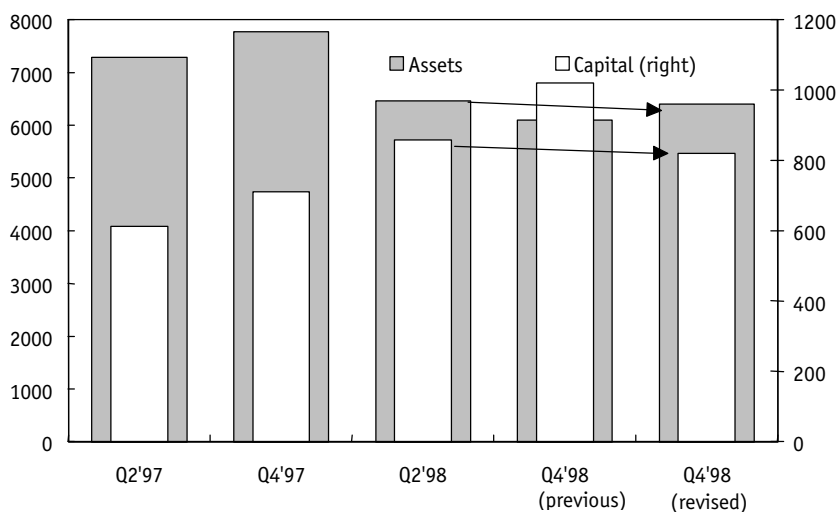


Source: NBU, Business, Ukrainian News

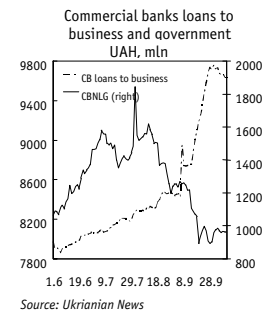
Bank capital expansion, which has been observed during recent years, will not be maintained. The volume of assets will not decline, which results from the appreciation of assets in foreign currency, exchanged in the national currency at the current rate. This will cause variance from bank norms and evaluation ratios and indexes applied to the bank system (such as maximum value of credit to one debtor as a share of credit portfolio, capital as a share of liabilities etc.). The situation even worsens, if the evaluation of bank capital and assets is made in the dollar equivalent. To conclude, every Ukrainian bank is faced with difficulties, which will lead to a broad restructuring of their portfolios and more precise selection of clients.

Assets and capital of 7 major commercial banks

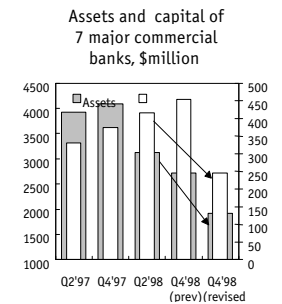
UAH million



Source: Financial Risks. Calculations and forecast by Quarterly Predictions



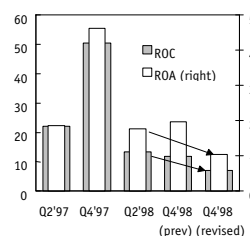
Source: Ukrainian News



Source: Financial Risks

Calculations and forecast: Quarterly Predictions

Return on assets (ROA) and return on capital (ROC) of 7



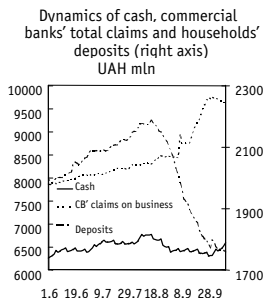
Source: Financial Risks

Calculations and forecast by Quarterly Predictions

Deposits

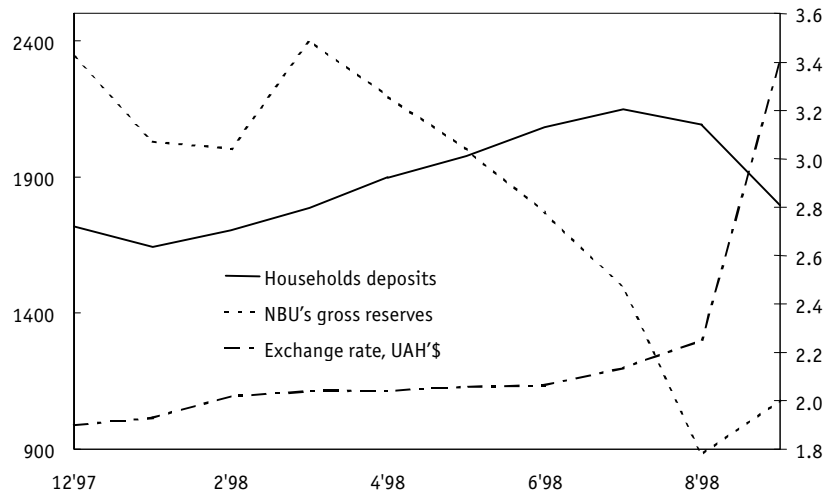
Gradual growth of household deposits since 1997 accelerated in the first half of this year, and may be considered increasing confidence in the banking system. Rapid devaluation and inflation caused a significant contraction of the depositary system, which means a weakening banking system. One could have expected an increase in foreign currency deposits, though households preferred to hold their savings in dollars aside the banking system. Therefore, though aggregate deposits started growing at the end of September, it was merely a result of the revaluation of foreign currency deposit residuals.

We forecast that the general scenario for the nearest months will be the accretion of deposits during the periods of relative stability and a significant decrease in their volume during periods of uncertainty. Considering extremely high sensitivity of households and businesses to exchange rate dynamics, we view the stability of the hryvnia exchange rate as a key factor for the accumulation of deposits.



Dynamics of household deposits (UAH mln), NBU gross reserves (\$mln), and exchange rate (right axis)

1998



Source: NBU

PRICES

The financial crisis in August-September 1998 provoked a price shock in the consumer market. We reviewed our forecast for the 1998 consumer price index (CPI) and increased it to 20%. As for the wholesale price index (WPI), it will grow up to 24%. The only factor that helped restrain inflation was low aggregate demand. In addition, we consider resumption of trust in the state monetary policy an important pre-determinant of a successful price stabilization policy. We argue that the situation will already improve in 1999, and consumer and wholesale prices will increase by only 12%.

Consumer prices

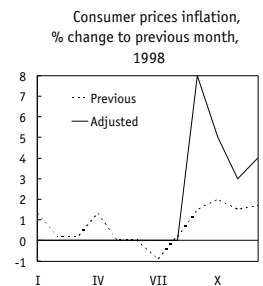
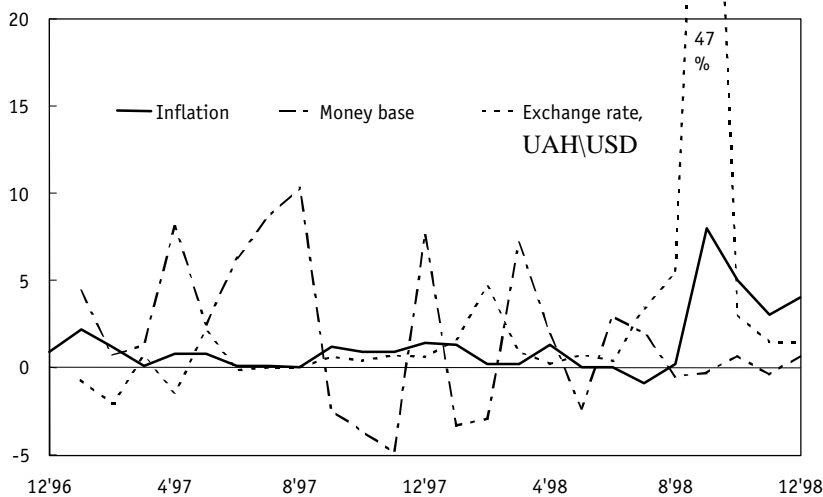
The rapid pace of the financial and currency crisis in August-September 1998 caused extremely high inflation pressure on all types of goods in the consumer market, as compared to two years of stabilization. This pressure could have been even more severe if aggregate household demand had not been rather moderate (see **HOUSEHOLDS**), due to mostly unchanged wage rates and significant wage arrears. Sharp devaluation of the national currency led to a proportional rise in prices for imported goods, which still take a large share in the structure of consumption¹¹.

The financial crisis implied a price shock...

...which was restrained by low demand

Consumer prices, money base and exchange rate

Monthly % change



Source: State Statistics Committee. Calculations by Quarterly Predictions

Source: State Statistics Committee, NBU.

Forecast by Quarterly Predictions

¹¹ The minimal consumer basket usually fixes a limited range of essential goods, which are partially subsidized at the local level. It is usually calculated according to the poorest population of the country.

Tight monetary policy will allow a 20% withhold of inflation in 1998

As government monetary policy maintains the principal role in restricting inflation, it is evident that limited money supply (see **MONETARY**) will continue to keep the inflation rate at a low level. The September devaluation shock will most likely become apparent during October and November, due to a price increase in energy and other products of energy-consuming industries. We estimate the general increase in consumer prices (December to December) to equal 20% (while the monetary base and exchange rate will grow by 5% and 85% respectively)¹².

The structure of the consumer basket will change

Further deterioration of living standards will lead to an extraction of non-food products from the minimal consumer basket. Therefore, inflation in the consumer market will be determined by the price dynamics in food products. Imported foodstuffs will be crowded out by domestically produced foods, due to an increase in the prices for foreign products, and the hryvnia devaluation.

Emission = Inflation

The Inflation rate p depends on various factors, which may change in time. During 1994-1996, p dynamics were determined by the exchange rate, while in 1997-98 the most influential (in the short-term) were monetary aggregates. Among other factors, we highlight the dynamics of inflation during previous periods (with consistent negative expectations), and social arrears (which is an anti-inflation measure but implies a high social cost). Our statistical research allowed us to define the following relationship (medium-term period of 1996-98):

$$p = 0.23LM2_{-1} + 0.31p_{-1} - 0.24lWArr_{-1} + 0.01lER,$$

where $M2_{-1}$, p_{-1} , $WArr_{-1}$ are respectively aggregate M2, inflation rate and wage arrears for the previous month, while ER and l stand for exchange rate and logarithm respectively. As we expected, wage arrears as a restraining factor have a negative coefficient. Besides, almost equal values of coefficients by $M2$ and $WArr_{-1}$ highlight the fact that wage arrears, being considered a political instrument, were to offset emission. We were surprised by the low coefficient of the exchange rate (statistical significance of the coefficient is equal to 1.6, while the desired is not lower than 2).

This equation shows that a rapid increase in money supply (for Ukraine it is possible only through emission) has a direct relation to an untwisting inflation spiral, which would consequently lead to a reduction in real GDP, deterioration in living standards, and decrease in real investments. This implies further stagnation of the economy.

Risk factors

Sharp hryvnia devaluation is the most dangerous factor...

Currently, continuous sharp hryvnia devaluation can become the most dangerous factor for untwisting the inflation spiral. A policy for gradual hryvnia devaluation, which had been implemented until August, resulted in a significant loss of international reserves by the NBU (see **MONETARY**). However, it turned out to be a crucial factor for prompt price stabilization.

At the same time, even if the devaluation policy (moderate and controlled) is maintained, tight monetary policy would restrain the inflation spiral. If the

¹² Official statistics report 3.8% inflation in September. They explained it by the fact that the consumer basket consists of goods produced at the local level, which were not affected by the currency devaluation. This inflation rate is clearly underestimated and cannot be considered accurate. In fact, this understatement comes from the failure to index wages in November (see **HOUSEHOLDS**).

government decides to pay out all its domestic debts to index wages, etc. inflation may rise out of control and turn into hyperinflation.

The negative impact of Russian turmoil on the Ukrainian environment will affect people's expectations. Traditional links will implicitly carry over Russian events into Ukraine (see **INTERNATIONAL**). Therefore, devaluation and inflationary expectations in Ukraine will be formed by the political and economic situation in Russia.

Another inflation factor is the government's intention to cover household expenses on communal services 100%. However, due to expert estimations, tariffs for utilities were covering all expenses of communal services long before the crisis exploded. Still, while full payment is lacking, non-payments of insolvent debtors are being rewritten on those clients who pay by overcharged tariffs. A rise in prices for imported energy will provoke a consequent increase in prices for utilities. Thus, considering the absolutely inelastic demand for them, the population, being the major consumer in this sector, will cover all additional expenses.

Those local authorities that promised to restrain prices and tariffs for transport and municipal services till the end of 1998 did not find any actual solution to the problem and only postponed it until 1999. Therefore, the increase will take place January-February 1999, and constitute 25-35% for these categories.

Producer prices

Our expectations on the stabilization of wholesale prices were absolutely ruined by the currency devaluation. Regarding the economy's strong dependence on imported energy and raw materials, which are usually priced in U.S. dollars, we estimate inflation of wholesale prices for September-December 1998 to be even higher than the inflation on consumer prices, and total 24% in 1998.

... though inflation pressure from gradual hryvnia devaluation may be offset by tight monetary policy

A rise in energy prices will cause 24% inflation of wholesale prices in 1998

Wholesale price change in industry

%

Industry	January-August	September
Energy	110,7	120.4
Fuel industry	104,9	111.6
Ferrous metals	106,8	113.9
Chemicals and oil refining	102,6	109.8
Machine building	103,8	103.9
Light industry	101,4	102.3
Food industry	102,9	102.8
Construction materials	101,9	102.3
Total	103,4	109.4

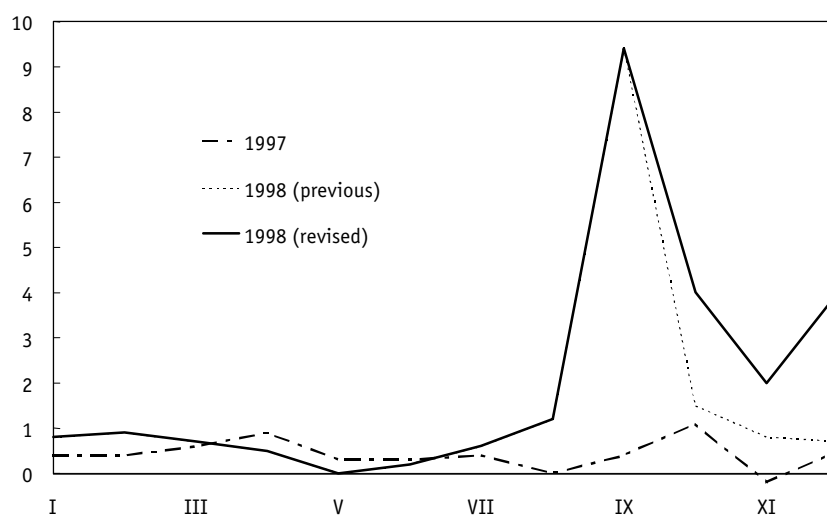
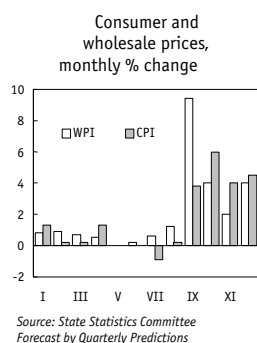
Source: State Statistics Committee

During the pre-crisis period (spring and summer 1998) one could have observed inflation tendencies from rising energy prices. However, while this rise immediately influenced only basic industries which are highly energy-consuming (such as the fuel industry, ferrous metals and machine building), it is still implicit for industries producing goods for final consumers, mainly due to restricted demand. Unfortunately, the price imbalance that occurred

this fall will lead to higher inflation pressure on the wholesales market and later on the consumer market.

Wholesale prices

monthly % change



Source: State Statistics Committee. Forecast by Quarterly Predictions

Devaluation will have inflation pressure on all industries

A significant increase in energy prices will simultaneously cause subsequent inflationary pressure on all industries. Thus, in September 1998 the overall increase in production prices was 9.4%. Applied administrative methods for regulating fuel prices in September primarily resulted in a deficit of goods. Moreover, the oligopoly of the market suggests a price shock after restrictions are abolished.

Inflation in 1999

Tight monetary and fiscal policy in the first half of 1999...

We argue that the inflationary potential developed by the fall 1998 currency crisis will not be fully released. The main restraining factors will be tight monetary and fiscal policies agreed upon with the World Bank and IMF. By summer 1999, the need to restrict the money supply and keep the budget deficit at a low level will preserve a poor aggregate demand. Thus, this policy suggests stable prices and exchange rate. In the second half of 1999, before the presidential elections, monetary authorities will slightly ease the monetary policy, which will not result in a price shock (following the pattern before the parliamentary elections in spring, 1998, see **QUARTERLY PREDICTIONS, APRIL 1998**).

... will allow for a reduction in inflation down to 12%

For 1999, we forecast a 12% increase in consumer and wholesale prices as compared to the previous year.

EXTERNAL

In 1998, the current account balance will improve by \$200 million, equaling -\$1.15 billion. This will result mainly from a shrinking trade deficit, which will be partially offset by a fall in exported services and transfer payments. Another source of improvement in the current account is a successful restructuring of outstanding foreign debt. The current account will continue to improve next year, due to the renewal of export operations and stability of imported goods. Thus, the current account deficit should diminish to \$400 million.

Merchandise trade

General trends

The key factors affecting Ukraine's foreign trade in the 4th quarter of 1998 are the following:

- Sharp reduction in trade with the Russian Federation due to the Russian financial crisis.
- Continual deterioration of the world market of steel products, which is the principal component of Ukrainian exports.
- Shrinkage of imports that reached 14% since the beginning of 1998, mainly due to lower volumes of fuel imports from Russia. The decrease is likely to deepen because of the liquidity crunch in Ukraine, with imports suffering from it for the rest of 1998.

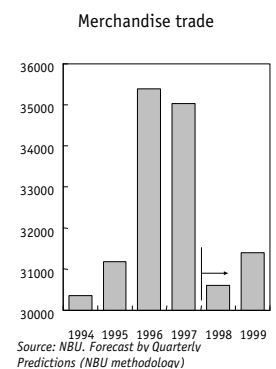
In evaluating the impact of these factors, we forecast general improvements in the 1998 trade balance, as imports will be falling faster than exports. In 1999 we expect further improvement. A successful devaluation policy by the NBU (see **MONETARY**) will support exports, while keeping in check imports in the first half of next year.

Exports

For 1998, exports are expected to fall to \$13 billion (Statistics Committee methodology), almost 9% decline compared to 1997. The NBU estimates it to reach \$14.2 billion. For 1999, assuming the stabilization of Ukraine's financial markets, enhanced competitiveness owing to considerable real devaluation of the hryvnia, and export promoting policy of the government, we expect exports to recover up to \$15 billion (by the NBU's methodology).

A major threat for Ukrainian exports is a deteriorating trade regime with the Russian Federation. For the first 8 months of 1998, deliveries to Russia amounted to 24.8% of the Ukrainian overall export of goods, or 7% of GDP. We expect the export of goods to this country to be reduced by \$1.5 billion (or by 40% of 1997 exports destined to Russia).

This summer we highlighted the following reasons for the contraction of export sales to Russia: persistence of VAT on Ukrainian imports, stagnating Russian demand, switch by Russian consumers to foreign substitutes. Today, we have also to recognize an additional and crucial factor which will have strong repercussions, namely the full-blown financial crisis. However, Russia is expected to improve its trade regime because of the sharp devaluation of its



Balance of trade will improve in 1998...

... and this trend will become stronger in 1999

In 1998, exports will decline by 9%...

...though in 1999 we expect it to grow

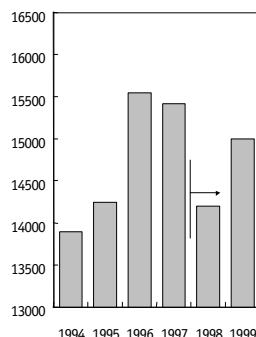
Major factor for the reduction in exports is lower sales to Russia

currency: it eliminated 3% import tax introduced on all goods in early summer, and decreased VAT on food products to 10%.

Major factors contributing to the significant reduction in exports to Russia during the nearest 18 months will be:

- Ruble devaluation, which undermines the competitiveness of Ukrainian exports in the Russian market.
- Collapse of the banking sector in the Russian Federation, which inhibited ruble and foreign currency transfers. Even if banks resume their normal operations, Russian importers will have problems finding additional funds to cover their costs related to inflation.
- Fall in production and consumption in Russia (see INTERNATIONAL).

Exports of goods from Ukraine
\$ mln



Source: NBU Balance of Payments
Forecast by Quarterly Predictions

Machine-building is the first to suffer from the Russian contagion

Ukraine's machine-building appears to have the highest Russian exposure. A number of Ukrainian enterprises in this industry receive up to 90% of their orders from Russian customers. Therefore, this sector is going to face the strongest pressure to reorient its sales, to be accompanied by significant losses. Though being modestly oriented to the Russian market, ferrous metals and chemicals are going to confront with severe rivalry from Russian competitors, as their markets shrink. Agricultural and food sectors with high reliance on the domestic market are generally expected to be buoyant, though there is high variability in the Russian exposure among their sub-sectors.

	% of RF in sectoral export	% of RF in sectoral revenue
<i>Ferrous metals</i>	16	11
<i>Machine-building</i>	48	18
<i>Agri/Food</i>	43	7
<i>Chemicals</i>	15	11

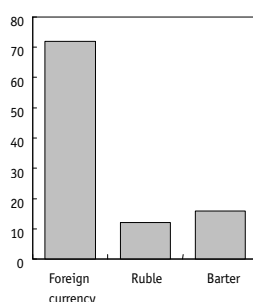
Ukrainian exports to Russia will follow the general trend of the Russian recession

By October 1998, the depth of real devaluation of Ukrainian currency has matched that experienced by the Russian ruble. Therefore, we expect that Ukrainian exports will recover competitiveness vs. Russian substitutes by the end of this year. However, the drastic devaluation and consequent economic crisis provoked a sharp fall in Russian aggregate demand. Therefore, we expect that, owing to the adequate devaluation of the hryvnia, Ukrainian exports to Russia will follow the general trend of the Russian recession in 1999, while losses in 1998 will be excessive because of the adjustment lag.

The Russian crisis has already affected Ukrainian exporters, whose contracts were realized during the peak of the crisis:

- The sharp fall of ruble exchange rate to the U.S. dollar caused the real price of ruble contracts to fall 2.5 times.
- Some Ukrainian exporters were locked in with their ruble proceeds as ruble operations (allowing to convert rubles into hard currency or hryvnias) have been suspended at the local currency exchange (UICE) since August 26. These two impacts are not negligible as, according to the NBU's data, settlements in rubles for shipments to Russia accounts for 12% of the export proceeds.

Structure of export payments



Source: State Customs Committee, Ministry of Economy MFFRT

The Russian crisis will also have a direct impact on other economies of the CIS, first of all Kazakhstan, Belarus, and Moldova, where the weight of trade turnover with Russia is about 50%. Considering the fact that these countries are major Ukrainian trading partners in the CIS (following the Russian Federation), we may expect a reduction in Ukrainian exports to these countries.

In this setting, we can only expect that the volume of barter trade will be buoyant, though it will not compensate for the loss in cash trade.

Though foreign markets significantly deteriorated recently, government economic policy still provides poor assistance to exporters. Thus, we do not see that the government understands the need of timely VAT reimbursement to exporters, which now proves the Presidential Decree that extends the period of VAT reimbursement for exports to three months. Extremely thin foreign exchange reserves and the persisting threat of devaluation should prompt the government to boost export revenue. Still, there are some positive measures implemented by the President and the government. These are: abolishment of the Presidential Decree on the collection of deposits from sunflower exports, and the Decision of the Cabinet of Ministers of Ukraine On the approval of anti-crisis measures for financial stabilization, which envisions the following steps:

- Temporary suspension of the Decision of the CMU on the register of goods, which are prohibited for barter operations concerning exports to CIS countries. As a result, we expect, an increase in the export of foodstuffs to Russia, who will probably fail to pay for the import of these products in hard currency.
- Introduction of lower indicative prices for certain goods exported from Ukraine. At the moment, indicative prices are abolished for cast iron and titanium jaw through the suspension of anti-dumping procedures against these goods.
- Simplification of the procedure for registering foreign trade contracts and reduction of terms for the relevant paper work.

We do not believe that Ukraine should sustain initiatives proposed by CIS countries for overcoming the financial crisis. These include establishing a clearing chamber that would be responsible for payment settlements between economic entities in CIS countries. On the contrary, the regional crisis again proved the need to further diversify business relations, which has already had positive results.

Compared to the previous year, Ukraine will not be able to cover the shift in exports to Russia, which will occur this year, by the adequate surplus in exports to foreign countries. The reported data show a 5.6% decrease in exports for the first nine months of 1998, with respect to the corresponding period of the previous year.

A critical factor in the reduction of exports is continuous deterioration of conditions on commodities markets, in particular that of non-precious metals and their derived products, which make up one third of Ukrainian exports. Thus, the export of goods to China, one of the key consumers of Ukrainian raw materials, decreased by 25% in the first half of 1998.

Nevertheless, the next year is much more promising, as some markets, for example Asian ones, have nearly stabilized by now. Besides, devaluation prompts returning to the markets, were Ukrainian metal production could not

Government policy still poorly supports exporters

The regional crisis proved the need to further diversify trade

A continuous deterioration of conditions on commodities markets causes lower export of steel products

The major problem of Ukrainian export competitiveness is high production cost

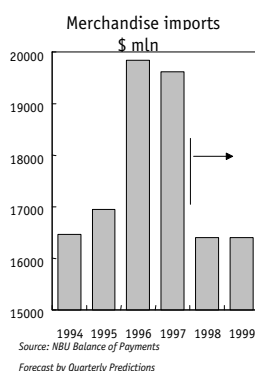
compete because of the price factor. As reported by enterprise trustees, the markets of Eastern Europe and Northern Africa will begin to stir.

Still, the main problem of Ukrainian export competitiveness, particularly that of the agro-industrial sector, remains the high cost of domestic production. Thus, compared to 1995, the cost price of 1 centner of sunflower grew 2.7 times in 1997. Moreover, inputs per 1 unit of export outputs are growing constantly. For example, cast-iron smelting, the production of which has been reduced 2.7 times in the last ten years, increased its electro-capacity 1.6 times per ton for the same period, and consumes today more than 8.6% of fuel and 25% of thermal energy. In metal-rolling production, having been reduced 2.4 times for the last ten years, the consumption of electric power has grown by 37%, fuel by 11.4%, and thermal energy has increased 1.6 times per ton melted. These numbers again stress the need for more operative efforts to implement structural reforms and attract foreign direct investment in production.

Imports

In 1998 imports will fall by 16%

We forecast that imports will be approximately \$14.4 billion (National Bank – \$16.4 billion), which constitutes a 16% reduction compared to 1997. The major factors are the following:



- Reduction in physical volumes of imported energy resources. For seven months of this year the volumes of gas imports from Russia were reduced 1.5 times compared to the corresponding period of the previous year. At that, the share of imports from Russia constitutes 50% of total imports, and the share of energy in Russian imports makes up 80%.
- Worsening financial situation in Ukrainian enterprises and administrative restrictions on purchasing foreign currency, which impede normal payments with foreign suppliers.
- Hryvnia devaluation (which totaled 80% since January 1998, and constituted 50% after the introduction of a new currency band), which implies more expensive imports and results in re-orienting domestic consumers to products manufactured in Ukraine.

In 1999 imports will remain at the same level as 1998

For 1999, considering our pessimistic forecast for the GDP (see **GDP**) we expect imports to remain at the same level as 1998. Improvements in the financial positions of importers and liberalization of the currency regime will be offset by the hryvnia devaluation (see **MONETARY**) and stagnation in major industries (see **BUSINESS**).

According to the data reported for the first three quarters of 1998, the volume of imports to Ukraine was reduced by 14.6%, or almost \$2 billion compared to the corresponding period of the previous year. In the fourth quarter this tendency will accelerate, but stand still at a certain point, as the share of raw materials for Ukrainian producers is the largest in the structure of Ukrainian imports.

Other urgent measures are of a long-term character, and need more time to be implemented. Therefore, positive results from them are to be expected only next year. They include:

- Regulation of Ukrainian customs tariffs in accordance with the Memorandum of Economic Policies agreed with the IMF (reduce tariffs on a number of commodity positions, convert the existing non-

transparent mixed specific/ad valorem tariffs to specific tariffs, and regulate the frequency of changes made to customs tariffs).

- Expected adoption of the draft Antidumping Code of Ukraine by the Verkhovna Rada.

At the same time, the effects produced by the currency devaluation will be much stronger. Thus, for the first time imports to Ukraine would be restricted by a sheer market mechanism, compared to previously introduced administrative restrictions which were severely criticized by foreign partners and international institutions. Besides, conditions are favorable for introducing a more flexible tariff policy, which may have a positive effect on negotiations for entering the World Trade Organization. If the government makes use of these conditions, Ukraine may become a member of the WTO by 2000, when it is planned to initiate a new round of multi-lateral trade negotiations for a large-scale decrease in tariffs.

Balance

In 1998, the trade deficit for goods will improve twofold compared to the previous year, totaling \$1.4 billion (National Bank \$2.2 billion). In 1999, we expect further improvements in the trade balance of goods as a consequence of export renewals, which show -\$1.4 billion by the National Bank methodology.

Services

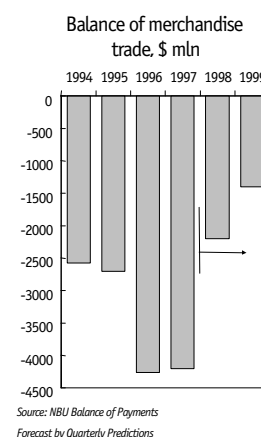
For 1998, the balance of trade in services will show a usual surplus, totaling \$2.4 billion (National Bank — \$1.35 billion). We have slightly improved our previous forecast as a consequence of an expected decrease in import growth. In case of financial stabilization in 1999, services will show equal growth in both exports and imports, and surplus will constitute \$2.3 billion (NBU — \$1.2 billion).

For 1998, we retain our previous forecast for service exports to be reduced by approximately 20%, down to \$3.95 billion, due to a decrease in the rate charged for Russian gas transit. Service exports which show a stable trend of gradual increase described in our previous publication will slightly grow up to \$4.2 billion.

We forecast that in 1998 service imports will grow by not more than 15%, totaling \$1.6 billion (National Bank — \$2.6 billion). This number is somewhat lower than for several previous years, when the average increase equaled 20% from year to year. We argue that this is directly related to the current financial crisis. For 1999, we expect that service imports will resume to grow up \$1.9 billion (National Bank — \$3 billion).

Balance of goods and services

This year, the balance of foreign trade will improve approximately 2 times and show a surplus of \$1 billion according to State Statistics Committee methodology (National Bank — deficit of \$850 billion), due to a more rapid decrease in imports than exports. In 1999, the balance of goods and services will continue to improve and total -\$200 million by the National Bank methodology.



In 1998, balance of foreign trade will improve approximately 2 times...

... and will continue to improve in 1999

Income and transfers

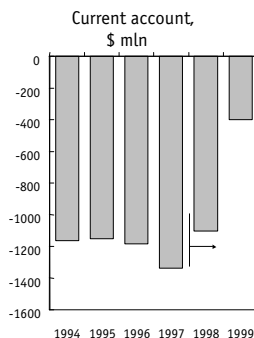
We improve our forecast for the balance of income article in 1998, and expect it to decrease to -\$1 billion, mainly due to the restructured outstanding debt to non-residents. According to updated evaluations, it will decrease to -\$800 million in 1999.

Receipts by the transfers article will constitute \$700 million in 1998, which is \$150 million less than last year. The sum received in the first half of the year was only \$340 million, and may continue to deteriorate further due to the financial crisis and unstable situation with payments. In 1999, transfer receipts may additionally fall to \$600 million.

Current account

During 1998-1999, the current account deficit will improve by \$1 billion

For 1998, we expect the current account deficit to improve and constitute \$1.150 billion against \$1.335 billion in 1997. The main change will concern the trade balance of goods (the deficit will be reduced by \$2 billion), but its positive effect will be lessened by a lower surplus in the trade of services (by \$1.3 billion), a slight deterioration of the income balance deficit, and lower transfers. We argue that current accounts will continue to improve through 1999, and its deficit will total \$400 million.



Source: NBU Balance of Payments
Forecast by Quarterly Predictions

Capital account

According to 1998 results, the capital accounts deficit will constitute \$350 million. The outflow of short-term capital (\$ 1.150 billion) and payments on medium- and long-term loans (\$1.450 billion) will be partially offset by:

- New loans, amounting to \$1.550 billion, including a \$400 million loan from the World Bank, and a \$50 million loan received from the European Union in 1998.
- Surplus in foreign direct investment, equal to \$700 million (see **BUSINESS**).

Considering the need to cover the deficit in current and capital accounts by \$1.5 billion, official reserves will be reduced by \$1.05 billion. \$450 million extracted from the International Monetary Fund will offset the rest of the deficit.

In 1999, the major factors will be an increase in official reserves (\$150-200 million) and the absence of short-term private capital, while the main sources of foreign capital will remain the World Bank, IMF, and other official lenders.

BUSINESS

Industrial output is expected to fall by 1.2% in 1998. This is a primary result of the global (and especially Russian) crises, which led to inaccess to external markets, price increases, and limited access to credit. However, the hryvnia devaluation will be advantageous for certain industries. In 1999, we expect production output to somewhat stabilize (showing 0.3% decrease), if the sale of ferrous metals recovers to its previous volumes in foreign markets. In our opinion, gross investment will settle at 20% of GDP in 1998-1999, though the structure of investments will deteriorate as the share of fixed capital investment decreases, being crowded out by inventory investment. However, in 1999 the situation may change for the better if strategic foreign investors are encouraged to participate in the privatization process.

Industrial output and sales

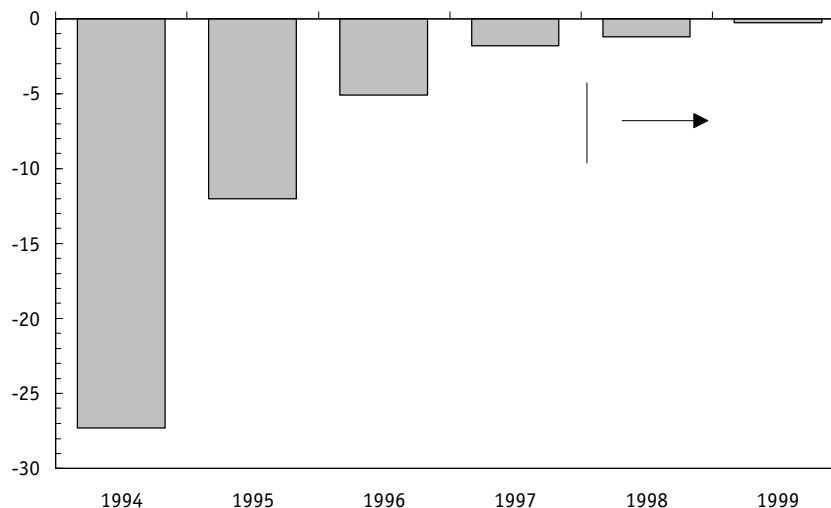
Global and domestic economic crises will predetermine the fall of industrial output and sales during the next eighteen months. The global crisis and Russian economic collapse will affect all industries, particularly metallurgy. The domestic crisis will have a heterogeneous effect on different branches as some of them experience a sharp currency devaluation and currency deficit. Nevertheless, we downgrade our forecast for industrial growth from zero to – 1.2%.

Key factors in 1998:
global and domestic
economic crises...

... make us forecast a
1.2% fall in industrial
output

Industrial output

% change



Source: State Statistics Committee. Forecast by Quarterly Predictions

Restraining factors for industrial output, predetermined by the crisis, will be the following:

- Unstable exchange rate and currency regime (see **MONETARY**), which would have a paramount impact on importers of raw materials.
- Weakening banking sector, implying higher prices of credit resources and restricted access to them.

- Temporary loss of the Russian market and decrease in global economic growth (see **EXTERNAL**).
- Lower real household income (see **HOUSEHOLDS**).
- Extension of the term for VAT reimbursement to exporters up to 3 months, beginning from the end of 1998¹³.

Stimulating factors for growth in particular industries will be:

- Lower domestic demand for competitive import goods and substitutes due to a significant increase in the dollar exchange rate.
- Return to markets where Ukrainian exports were non-competitive because of the price factor (for example, to Central Europe, where economies show stable growth).

Changes in output

%, to the corresponding period of the previous year

	1997	1-9' 1998	1998 (forecast)	1999 (forecast)
Industrial sector, total	-1,8	-0,3	-1,2	-0,3
Electricity	-2,6	0,4	0,0	-1,0
Fuel industry	4,5	0,1	0,0	-2,0
Ferrous metallurgy	7,7	-5,6	-7,0	1,0
Non-ferrous metallurgy	2,7	15,7	10,0	0,0
Chemicals	-0,6	3,9	3,0	-2,0
Machine-building	-3,6	-2,5	-4,0	-5,0
Wood processing	-5,1	13,2	8,0	1,0
Construction materials	-7,9	8,3	5,0	0,0
Light industry	-5,2	1,1	2,0	3,0
Food industry	-14,6	3,3	3,0	5,0

Source: State Statistics Committee.

Forecast by Quarterly Predictions

Sales have decreased sharply during the third quarter

Deterioration in sales during the third quarter of 1998 is another explanation for a possible production fall. Sales, as a share of output production, reached only 85.8% compared to 94.6% and 91.7% in the second and first quarters respectively. To some extent, this reduction may be explained by the general disappearance of economic activities in summer, which is too large to be considered a mere seasonal factor. In our opinion, an increase in inventories resulted from the restricted external and domestic demand during the crisis, as well as overproduction on the eve of the crisis. We forecast a gradual reanimation in sales due to lower volumes of production, caused by tight resource constraints, and a gradual revival of economic activities next year.

We expect the share of sales by barter to grow

We also expect growth in the share of industrial sales by barter, regardless of the standstill at 41.4%-41.7% in the third quarter. The reasons for a larger share of barter in sales are the following:

- Inter-state barter schemes are extended after restrictions are abolished

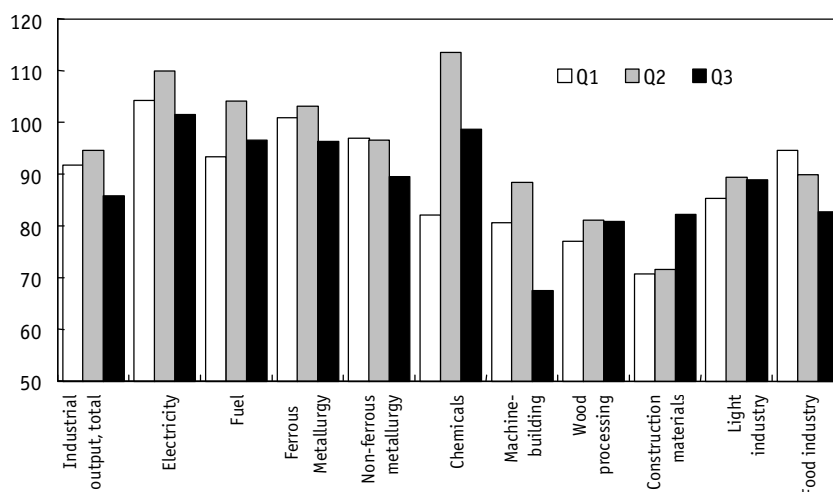
¹³ According to the Presidential Decree On Particular Changes in Taxation dated August 7, 1998, approved in this part by the Verkhovna Rada

on the export of particular goods for barter to the CIS countries (see **EXTERNAL**).

- The government is disinclined to eliminate the whole range of barter settlements with the central, and especially local, budgets (see **GOVERNMENT**).
- As a result of the crisis and tight monetary policy, access to credit sources became limited.

Sales by industry in 1998¹⁴

% of industrial output for the period



Source: State Statistics Committee.

Calculations by Quarterly Predictions

The factor that could regulate the system of payments in the country, accompanied by the elimination of the 'kartoteka' system, may be the Presidential Decree approved by the Verkhovna Rada, dated October 1, 1998, on paying VAT at the time of shipment, not at the time of payment. Still, the Decree contains remaining VAT exemptions on electricity, coal and gas that will remain in effect until the end of 1999. Aggregate sales in these industries amount to 25% of the total industrial sales, which would again become a source of non-payments in the economy. But the most important fact is that the 'kartoteka' system is still maintained, and a change in VAT calculations would lead to enterprises accumulating a large amount of debt to the budget.

Sources of growth and decline

Growth and improvement in financial standing will be observed with those export goods which contain an insignificant share of imported inputs, and those products that had to compete with imports in the domestic market. Simultaneously, a sharp fall in the production volumes will occur in those industries dependent upon imported raw materials and those oriented on Russian market.

¹⁴ Sales statistics in certain industries are distorted. The constant, excessive 100% margin in electricity and extremely low sales of construction materials prove a significant proportion of shadow activities in these industries.

Who wins from devaluation?

Our evaluation on the impact of movements in the exchange rate on sectoral performance is based on the following parameters:

- Weight of sales for hard currency (i.e. exports)- higher weight implies more benefit from devaluation.
- Weight of operating costs fixed in hard currency — lower weight implies less harm.
- Weight of debt nominated in hard currency — lower weight again implies less harm.
- Share of capital expenditures fixed in hard currency – benefits from devaluation, if insignificant.
- Net debtor or creditor position in domestic currency – benefits from devaluation, if the amount paid exceeds the amount received.

Under our assumptions about inflation and nominal exchange rates, we expect real devaluation of the hryvnia to reach 51% in 1998. Such depth of devaluation is more than sufficient for Ukrainian goods to regain their competitiveness in Eastern Asian and Russian markets. Therefore, industries with considerable export weight would benefit (specifically ferrous metals and chemicals).¹⁵ Besides, the Ukrainian economy's minimal exposure to foreign debt financing turned out to be advantageous during the crisis.

Energy-intensive industries like fertilizers, power generation, as well as inefficient steel mills, would be hurt as energy prices are usually fixed in hard currency terms. However, such enterprises have significant outstanding tax and wage arrears. Devaluation would reduce the real value of those liabilities and effectively reward (in the short-term) their inefficiency.

Some infrastructural industries, such as electricity, will not suffer much from devaluation, as tariffs are fixed in dollar terms. Major losses from devaluation will be born by those power distributors, which have a large share of households in their customer base, as this customer group pays tariffs nominated in hryvnias, which are not to be adjusted by the end of the year.

H:1998/ % of revenue	Gains...		Losses...	
	Hard currency sales/expo rts	Hryvnia liabilities	Hard currency operating costs	Hard currency debt
Ferrous Metals	54	15	40	3
Chemicals	63	9	50	0
Electricity	81	15	82	1

The impact of the crisis on metallurgy will be dissimilar...

Output of ferrous metallurgy, Ukraine's main industry, will be affected by various factors. In general, metallurgy will benefit from devaluation, though the effects on different products will be dissimilar. Due to a much sharper devaluation of the Russian ruble, these effects will be least significant for

¹⁵ Increases in export volumes are not considered

those Ukrainian items that have highly competitive Russian substitutes. They will also be rather moderate for those producers which have lost access to markets not as a result of their competitiveness in low prices, but due to economic crisis in the consuming country.

At the same time we expect positive effects from devaluation to appear only in the last quarter of 1998, after producers adjust to new market conditions. This may only happen if the hryvnia stabilizes and administrative restrictions for purchasing currency are abolished.¹⁶ Otherwise, immediately following the crisis, the output of ferrous metallurgy will be reduced from general financial instability as well as from suspension of exports to Russia, which is a major importer of Ukrainian metal production. We forecast that output in ferrous metallurgy will decrease by 7% in 1998 and slightly recover by 1% in 1999.

The chemical industry, which accelerated the growth of Ukrainian exports during 1995-1996, will undergo substantial structural changes. The production of commodities imported outside FSU countries, such as ammonia, will grow, while the tire sub-industry (20% of chemical production) may contract, since its exports are mainly oriented toward Russian enterprises.¹⁷

Though ferrous metallurgy is expected to stabilize next year, we envision a fall in the electricity and fuel industries. The energy industry will suffer from ineffective privatization, which allowed speculators instead of strategic investors to receive large share packages of distributing companies. The situation will also deteriorate because of the existing government policy favoring barter operations in the sector. The coal industry will witness reduced budget purchases of fuel compared to 1998.¹⁸

The crisis will have a heterogeneous impact on industries oriented toward the domestic market, which has shown steady growth for the first six months of 1998.

The situation in the food industry will remain little changed, as the demand for most of its products is inelastic. It can easily increase its volume of sales, crowding out much more expensive imports. At the same time, enterprises, which utilize imports (i.e. confectioneries) or which are based in the Russian market (i.e. canning) will endure difficulties. However, we expect that these problems will be overcome and the food industry will report the highest growth, equal to 5%. The crisis will hardly have an impact on the light industry, and may become rather advantageous as the industry competes in the domestic market with imports and produces export goods by tolling.

The production of construction materials and the wood processing industry will decline dramatically compared to the most rapid growth reported at the beginning of 1998. Given the crisis conditions, private enterprises and especially the budget will be forced to restrict investment. However, the growth of production in these industries slowed down before the crisis exploded, though the construction season was still in progress. We expect the output of construction materials and wood processing to stabilize at the current level in 1999.

... but after a substantial fall this year the situation will improve in 1999

Perspectives for Ukraine's fuel and energy sector are pessimistic

The impact of the crisis on the food industry may be zero

Industries dependent on investment dynamics will suffer...

¹⁶ In other instance, exporters would accumulate currency abroad and avoid investing it in Ukrainian production.

¹⁷ 86.6% of tire products are sold through barter operations.

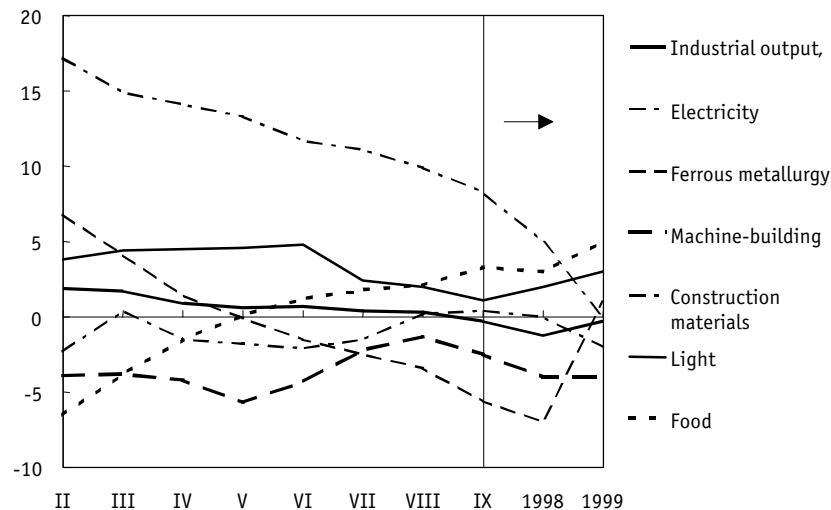
¹⁸ This year, this was done through a pre-paid purchase of fuels to the State Reserve, which provides tied credit of the energy industry.

Finally, the worst scenario is forecasted for the machine-building industry. The DAEWOO-AvtoZAZ project ended up merely with component assembly of DAEWOO automobiles with the minimal value-added created. Enterprises oriented toward sizable industrial complexes in Russia, especially the gas and fuel industry, may face certain difficulties while trying to sell their products. Ukrainian clients, given tight budget constraints, will not be able to create sufficient demand either. Therefore, we forecast that this year's 4% fall will continue, and rise up to 5% in 1999.

...while machine-building will show the worst reduction

Output dynamics by industry

% change, 1998 against the respective period in 1997



Source: State Statistics Committee.

Forecast by Quarterly Predictions

Investment

In 1998 gross investment will decline...

Gross investment (gross fixed capital investment and inventory investment) will slightly decline in 1998 compared to the previous year. They will constitute 20% of GDP, compared to 20.12% in 1997.

Investment in fixed capital grew rapidly during the first six months of 1998. On the contrary, the second half of 1998 will be detrimental for investment activities, as the financial crisis reduced current assets and profits of enterprises and limited the number of bank credits. This will lead to lower business investment in the second half of 1998. In general, gross investment in fixed capital will increase from 18.3% of GDP in 1997 to 18.5% of GDP in 1998.

While investment in fixed capital will decline due to the financial crisis in the fall of 1998, the accumulation of inventory investment will accelerate, which consequentially deteriorates the structure of gross investment in Ukraine. On the other hand, as compared to last year, inventory investment will be a bit lower from the actual decrease in inventories in the first half of the year, and will amount to 1.5% of GDP (compared to 1.84% of GDP in 1997).

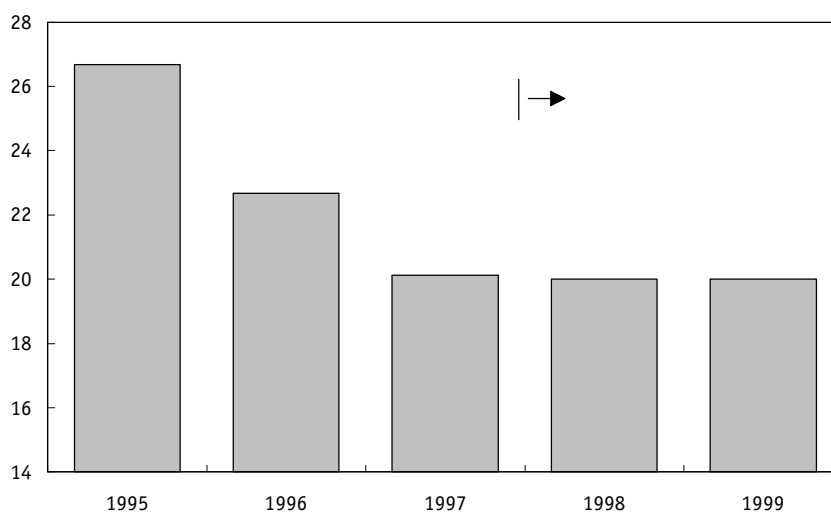
... while the structure of the same volume will improve in 1999.

If the pace of privatization is steady, the financial crisis restrained, and a realistic budget approved, we expect investment in fixed capital to increase during 1999 and the structure of gross investment to improve. While inventory investment will fall to 1% of GDP, gross fixed capital investment will increase

up to 19.5% of GDP. This increase mainly results from foreign investment in private and joint stock companies and higher investment in fixed capital made by Ukrainian producers.

Gross investment

% GDP



Source: State Statistics Committee. Forecast by Quarterly Predictions

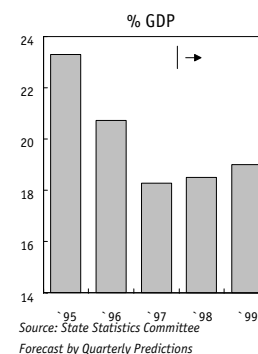
Business investment¹⁹

In 1998, the share of gross fixed capital investment will be 18.5% of GDP calculated for this period. We have lessened our previous forecast due to a decline in investment activities during the second half of the year. However, even this number shows an improvement compared to last year's indicator.

The main cause for deterioration in investments during the second half of the year is a reduction of working capital and lower volumes of available bank credits. Though capital investment (as the largest share of gross investment in fixed capital) amounted to 8.5% for the first six months of 1998, this number significantly declined during the third quarter. Due to operative data reported for 9 months, the increase in capital investment was as low as 6%, and we expect it to be even lower in the fourth quarter.

Steadily high interest rates in the financial market and low credit activity in the Ukrainian banking system, resulting from the NBU's tight monetary policy to restrict currency devaluation, practically blocked the already limited access to bank credits. In 1997, the total sum of bank loans to enterprises was UAH 7.295 billion, or 7.9% of GDP (in Poland, the corresponding indicator was 25% of GDP). This mainly results from the unnaturally high share of in-kind payments in the Ukrainian economy and insufficient regulations guaranteeing the rights of the creditor. Structural impediments to crediting are considered to be the critical factor that discourages the investment activities of Ukrainian producers.

Investment in fixed capital will increase slightly in 1998



¹⁹ Business investment is gross fixed capital investment that includes capital investment and capital repairs. Therefore, capital investment is lower than business investment, though retaining 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.

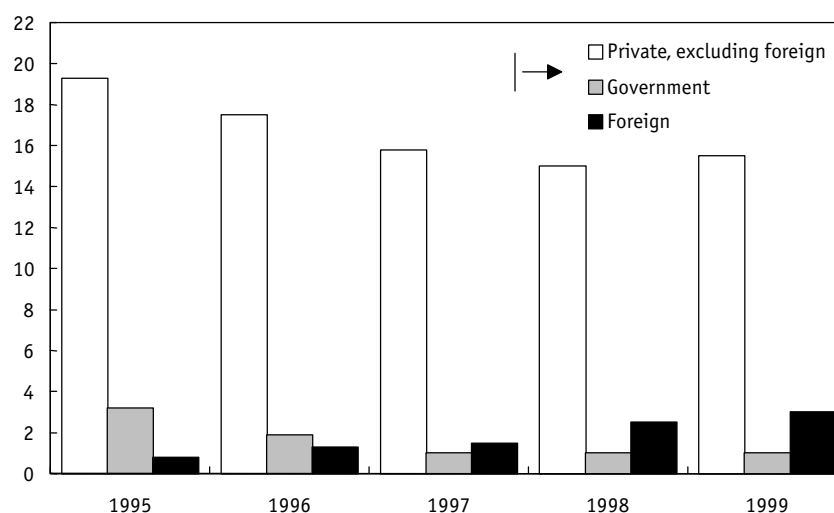
Ukraine is left with no sources of domestic investment

Another barrier to an increase in working capital and higher investments is the depreciation coefficient, allowing the government to drain funds from the real economy to the budget, which by definition should be allocated for its re-equipment. In the long-term, the depreciation of deductions to the budget used to finance government consumption, encourage anti-investment attitudes among consumers.

This will consequently lower domestic investment from 15.8% of GDP last year to 15% of GDP in 1998. Budget-financed investment at the central and local levels will remain roughly unchanged, amounting to 1% of GDP. Due to significant devaluation of the hryvnia, foreign investment shares will increase to 2.5% of GDP, compared to 1.5% of the previous year. The increase in FDI in the nearest future will help Ukraine achieve stable economic growth. However, international experience proves that FDI cannot grow in the long run unless domestic private and government investments in the infrastructure are made.

Domestic and foreign investment in fixed capital

% GDP



Source: State Statistics Committee. Forecast by Quarterly Predictions

In 1999, we expect gross investment in fixed capital to grow up to 19%, due to an increase in foreign investment and resulting from a rapid sell out of Ukrainian enterprises to strategic investors.

Inventory investment²⁰

The growth of inventory investment was negative in the first half of the year, and amounted to -0.9% of GDP (for the corresponding period in 1997, it accounted for 1% of GDP). In other words, inventory investment was reduced by UAH 410 million during the first six months of 1998.

Business surveys conducted in the second quarter indicated a reduction in inventories, both in materials and finished goods. Expectations for the third quarter also witnessed a slight reduction. However, the financial crisis in the fall of 1998 badly hurt partners (domestic and especially Russian) with Ukrainian businesses, which means a further accumulation of finished goods.

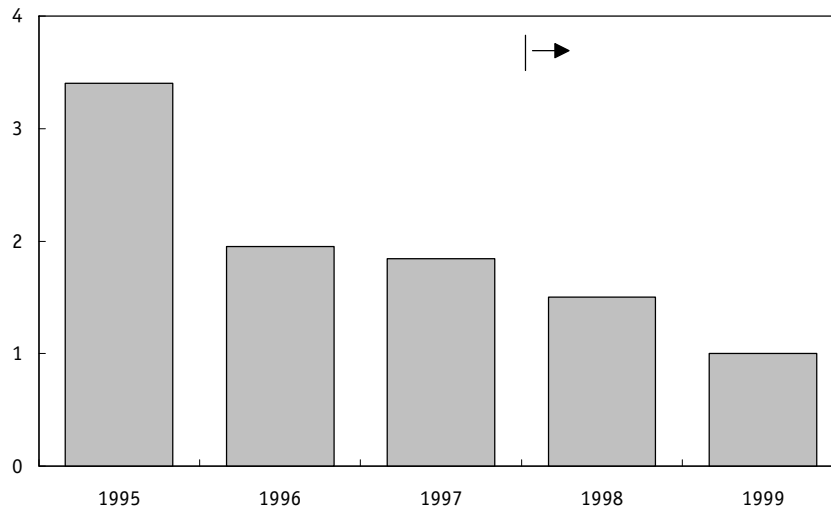
²⁰ The term "inventory investment" refers to an increase or decrease in inventory. Inventory investment includes two components: a change in material turnover funds, and acquisitions of assets minus disposessions.

Therefore, this year the share of inventory investment will decline insignificantly, to 1.5% of GDP, while in 1997 it accounted for 1.84%.

... while in 1998 inventory will decline to 1.5% of GDP

Inventory

% GDP



Source: State Statistics Committee, Forecast by Quarterly Predictions

Having mastered the after-effects of the financial crisis, economic activities in the business sector will pick up again, leading to an increase in sales and consequent reduction in inventory investment. The latter will also be due to in-kind payments of wages and pensions, which is becoming a widespread practice in Ukraine. Additionally, an increase in retail turnover and growing sales of domestic products will lower the share of inventory to 1% of GDP.

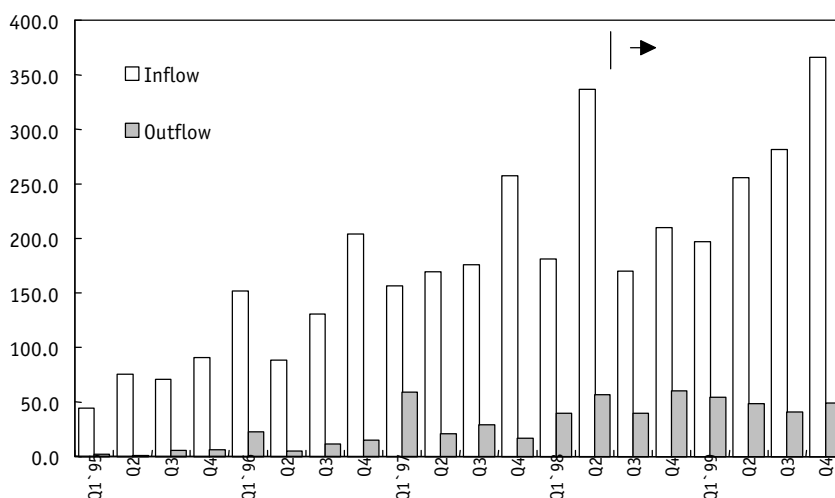
In 1999, an increase in inventory will account for 1% of GDP

Foreign direct investment

DFI will not be as harshly affected by the financial crisis as portfolio investment. Direct foreign investment is made in the real economy for a long-term period of at least 5 years.

The crisis will insignificantly effect FDIs

Foreign direct investment (\$ mln)



Source: State Statistics Committee. Forecast by Quarterly Predictions

Privatization did not help the energy industry find strategic investors

In September 1998, Minister of Energy Oleksij Sheberstov presented a letter to the President of Ukraine containing an analysis of ten tenders, held by the State Property Fund (the SPF) for the sale of share packages of oblast energy supply companies. In the Minister's opinion, the main goals for privatization are not met: the energy sector does not receive funds for its development, strategic foreign investors are not involved in the process, and their experience and up-to-date technologies are not utilized. Mr. Sheberstov also emphasized that privatizing the energy sector according to existing procedures (regulations) takes the national energy system out of government control.

Thus, eight large share packages for energy supply companies, being re-sold by the official winners of the privatization tenders, are owned by three offshore companies which are registered at the same address. These companies were also buying energy shares during preferential subscription which allowed them accumulate controlling blocks of shares for several energy companies. Hence, the eight energy companies leave the Ministry's control, and each of them are monopolists of energy supplies in their oblasts. The Ministry also expects a lower share of cash in the companies' receipts, which will further deteriorate the situation in the energy sector. At that, investments in these enterprises, envisioned by tender provisions, will be made in the form of mutual settlements, interest payments, and credit penalties etc.

The second example is even more glaring. In May 1998 the SPF announced a commercial tender, where 35% of DAEK Odesaoblenergo's share package was proposed for sale. The tender envisioned granting the winner the right to manage 25% of state-owned shares. For the first time, strategic investors were among the participants of the tender, including Electricite de France energy company. Other applicants included two offshore companies – FS Trading and Vostion Group. They were chosen by the SPF as participants in the tender, as no clear criteria existed for defining work experience in the branch. Over the course of the tender, strategic investors pooled their efforts and proposed to invest over \$410 million in Odesaoblenergo, while the other two participants agreed to invest UAH 49 million, as fixed in the tender provisions. Further, FS Trading proposed to pay UAH 3 million more than envisioned by the consortium. The tender commission, yielding to pressure by the Ministry of Energy and Cabinet of Ministers of Ukraine, violated the regulation clause for the commercial tender, which states that the winner should be selected based upon the criteria of the price bid for the stake, not the amount of investment commitments. It identified that strategic investors as winners of the tender because according to the existing legislation, members of the tender commission are not responsible for their decisions. Later, however, the Arbitration Court declared the winner of the tender FS Trading. The group that owns FS Trading proposed strategic investors — participants of the tender — to redeem FS Trading. The latter refused this proposal and announced a phasedown of their work in Ukraine.

Top officials of the Fund agree that tenders are the most advantageous for mobile intermediaries, and not for large and inert strategic companies, while the privatization of the most attractive in enterprises should be controlled by the Presidential Administration and the CMU.

Therefore, they are less sensitive to changing market conditions, and even under conditions such as the financial crisis, would not drain in panic from the Ukrainian market, especially those projects that had already been approved. Here we can emphasize the positive effect of the hryvnia devaluation, as the value of investments in foreign currency increases and gives additional opportunities for foreign investors during this year and in 1999.

On the other hand, it takes much time to divest direct investment. The financial crisis substantially reduces the number of holders willing to purchase a large package of shares. Capital invested in personal property and real estate becomes almost illiquid, which implies a significant time frame to sell it and release the funds. Therefore, we expect that outflows of non-resident capital will not exceed \$200 million this year (during the first six months of 1998, capital invested by non-residents decreased by \$96.5 million) and mainly will concern dividend payments.

During the first two quarters, investments grew rapidly, mainly because of investments made by the Korean company DAEWOO into Ukrainian AvtoZAZ. For the same period, direct foreign investment increased by \$5.177 billion, which is 50% more than for the respective period of 1997.

Even though FDI will gradually decline during the second half of 1998, we expect the volume of direct investment to grow by 20% compared to 1997. The total volume of FDI in the Ukrainian economy is expected to amount to \$900 million, against \$759 million received in 1997. Excluding \$200 million of divested capital, the net increase in non-resident investments will be \$700 million.

Further inflow of foreign capital may become a critical factor for Ukraine's economic growth in 1999. We forecast that foreign direct investment will increase by \$1.1 billion next year, which is about 3% of GDP. The key pre-determinant of the FDI volume in 1999 will be the effectiveness of involving strategic non-resident investors in the process of privatizing the largest Ukrainian enterprises. At this time, there exists no example of a successful and transparent sale of a large-sized object to a trustworthy foreign investor. The failure to attract strategic investments to key industries may be from not fully employing Ukraine's capacity, thus losing the opportunity for future growth.

In 1999, foreign direct investment inflow will reach \$900 million...

...while in 1999 it will reach \$1.1 billion

AGRICULTURE

We forecast 3% overall decline in agriculture during 1998. This season saw a considerable decrease in grain production, namely 17%. Sunflower seed production will be much lower than expected, equaling 2.2 million tons. At the same time, growth in sunflower exports and a resulting corresponding decline in Ukraine's sunflower oil production from a lack of seeds are probable. Sugar production will also be significantly lower than last year at 1.7 million tons. Livestock production is expected to see a 2% decline. However, as there are a few positive tendencies in some of the sub-sectors, particularly due to the growing private sector (especially in livestock production), we expect the situation to improve in 1999 and forecast 0.5% overall growth.

Outlook

Overall decline in the sector will be 3%

We forecast 3% overall decline in agriculture for 1998. The decline will be caused by lower sunflower seed and grain production and a decreasing number of livestock.

However, we expect better agricultural performance in 1999

However, the decline in agriculture has slowed in the past few years, and we expect some minor growth in the next year, or about 0.5%. The growth will result from an insignificant improvement in plant growing, resulting from more productive autumn field work this year, as well as positive changes in animal husbandry stemming from a growing private sector.

The harvest of crops was negatively influenced by this summer's heat. In addition, agricultural equipment is in poor condition, which firstly made farmers start harvesting sugar beets earlier this year, and secondly resorted to manual labor in some cases.

Agriculture remains the least reformed, and as a result, the largest loss-bearing sector of the Ukrainian economy. This becomes obvious from the analysis of the financial results of agricultural activities. Last year, when the balance sheet profit of the economy fell (from UAH 14.4 billion in 1996 to UAH 10.8 billion in 1997), the greatest share of losses was fixed in the agricultural sector: they grew from UAH 1.3 billion in 1996 up to UAH 3.4 billion in 1997. Our conclusion is that current economic conditions make agricultural activities non-remunerative, irrespective of the form of an enterprise's ownership.

One of the reasons for the absence of considerable changes in the sector is the lack of real private land ownership. The continual failure to deal with this question harshly impedes development of the agricultural sector, creating barriers to attract funds for production growth. That is, without collateral, banks do not give mortgage credits, which makes investors turn to other sectors of the economy. The absence of a land market should also be kept in mind.²¹

²¹ Land privatization may also be considered a source of budget revenue, which is particularly important, for a significant budget deficit lacks sources of financing.

According to the Constitution of Ukraine “The land, its mineral wealth... are objects of the right to property of the Ukrainian people (Article 13). The right of property to land is guaranteed. This right is acquired and realized by citizens, legal persons and the State, exclusively in accordance with the law (Article 14)”. This Law is the working Land Code, which defines state, collective, and private land ownership. The right of collective land ownership is not envisioned by the Constitution. Therefore, there is a pressing need to make the Land Code consistent with basic Ukrainian law. The former, enacted in 1992, conflicts with the relations emerging in the agricultural sector.

Although in the last few years the process of denationalization has almost been completed, land has been divided into shares, and while approximately 6 million Ukrainian people received certificates of the right to a land parcel (share), the outcome remains rather poor, which may be explained by reform being implemented only half way. In order to assure the actual right for private land ownership, it is necessary to:

- Extend the number of entities, which may be eligible for the right to private land ownership (today, it is limited to the members of collective agricultural enterprises).
- Give legal entities the right to private land ownership.
- Broaden the list of land categories which may become items of private ownership.
- Give foreign legal entities and nationals the right to private ownership.
- Introduce a form of the State Act for the right to land ownership, as land must be an item of sale and purchase operations.
- Complete allotment of land and property in-kind; create a National real estate title registration system.
- Legally allow land to be used as collateral.

How Kyrgyzstan dealt with the issue of private land ownership

The issue of private land ownership in Ukraine is completely politically based, and decisions regarding these issues depend on the distribution of forces in the Verkhovna Rada. In this light, it would be useful to resort to the recent experience of Kyrgyzstan, where this question was put on the referendum, held on October 17, 1998. The one who initiated the referendum for enacting certain amendments to the Constitution (in particular, introducing private land ownership), was Askar Akaev, the President of Kyrgyzstan. Of the 96% of electorates, which participated in the referendum, 91% answered yes to the question.

Considering the insularity of Kyrgyzstan's experience, we should primarily focus on the mechanisms for dealing with questions, which the parliament fails to resolve. Thus, according to the Ukrainian Constitution, the President of Ukraine may initiate a referendum if 3 million signatures are gathered in support of this initiative. In our opinion, the issue of a free transfer of the right to land may be put on a referendum by a relevant information campaign.

Plant growing

Cereals

Gross cereal production is 21% lower than in 1997

Gross cereal production amounted to about 28 million tons (including 5 million tons gathered by private farms), which is 21% less than that of corresponding period in 1997. This reduction mainly results from a 9.3% contraction of areas under crops and a 13% decrease in yield. The latter was caused by unfavorable weather and poor capabilities of grain harvesting machines. However, even given favorable weather conditions, farms would not be able to improve yield indicators next season, because the land has been exhausted. The only source of improvement is the application of modern technologies for grain cultivation.²²

As of the end of October 1998, the volume of field works insignificantly exceeded the corresponding volume of the previous year. If this regime of field works is maintained, we forecast that cereal production in 1999 will remain at approximately the same level as 1998.

Government intervention resulted in forced redistribution in the grain market

The grain market is the object of direct government intervention in the activities of market operators, especially input suppliers. This year the government, having a 30% share in overall input supply, issued Act 1146, which set the seniority for repayments of grain debts. The Cabinet of Ministers' Act 1461 in October abolished this seniority. Meanwhile, the two-month period that this Act was enforced allowed the companies that supplied fuels through the state monopoly DAK 'Khib Ukrainy' to improve their positions.

The other sphere of government intervention in the grain market is regional order. Although the system of state order has been abolished, oblast administrations continue to regulate producers' activities, which results in the limitations imposed on shipments of agricultural products.

Sunflower

Sunflower seed production was only 2.2 million tons, which is significantly less than that forecasted by official authorities

In 1998, sunflower seed production was lower than forecasted by the state authorities, declining to 2.2 million tons as compared to 1997. Therefore, the forecast for production growth made at the beginning of the season did not come true. A 16% expansion of area under crops was offset by approximately a 17% decrease in yield indicators. A certain share of output was lost because of drought, and yield indicators diminished mainly due to the use of low-yielding varieties of seeds. Additionally, the quality of 1998 output was very low, and the actual weight of harvested sunflower seed will only be 1.7 million tons, due to a considerable share of empty seeds in the output.

Since 1990, sunflower seed exports have tended to grow more rapidly than oil exports. Thus, during this period, sunflower seed exports have grown 11 times.²³ Preferences for exports of sunflower seeds are more apparent than oil exports, mainly due to the following reasons:

- Import tariffs on oil usually ranges 5-7%, while the tariff on sunflower seed equals zero.

²² These include: timely autumn field work, moderate application of high-quality fertilizers, utilization of plant protection products and modern machinery.

²³ However, sunflower seed production profitability also decreased 11 times.

- Immediate sales of sunflower seeds allow to bring in cash revenue much quicker than if seeds are processed for oil.
- Consumers in developed countries are using more vegetable oils, including sunflower oil. Thus, countries are buying more sunflower seeds from Ukraine to produce their own oil. This enforces the first two factors.

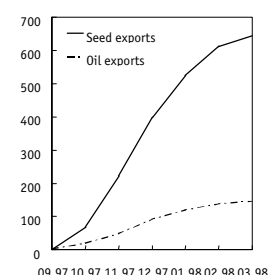
Oil and fat production is contracting

During recent years, the situation has been continuously deteriorating. The major negative tendencies are the following:

- *Profitability of the sector reduced from 221.7% in 1995 to 17.2% in 1997. During the same period, the production cost of sunflower seeds grew approximately three times, which lowered general effectiveness of oils and fats. As a result, profitability of the industry was reduced 5 times.*
- *Growing weight of delivered tolling supplies and decreasing share of payments in cash.*
- *Equipment for all oil and fat industries is not used to its full capacity (this ranges from -4% in margarine production to -29% in oil extraction).*

Sunflower seed production is increasing solely due to the use of larger areas of land. If maintained, this trend may lead to the full breakdown of the processing industry in Ukraine, leaving a large share of agricultural land exhausted, diminishing yield indicators, and worsening the quality of sunflower seeds. As a result, the breakdown of agricultural land must be substantially improved. In particular, the seeds used for producing oils and fats are not grown in Western regions of Ukraine, which has favorable conditions for planting soybeans and rape seeds.

Sunflower oil and seed exports 1997-1998, thousand tons



Source: Ukroliaprom

Sunflower is one of the most marketable crops in Ukraine's agricultural sector. We expect sunflower seed exports to grow this season and equal not less than 50% of the gross output (1.1 million tons, or about 0.9 million tons of actual weight), unless the government implements measures for leveling conditions of sunflower seed exports and sales to domestic producers.²⁴

Sugar

This season, sugar production will diminish by 15% compared to the previous year, yielding 1.7 million tons. This mainly results from a lower yield of sugar beets, which appeared as low as 16 million tons (compared to the officially forecasted 18.3 million). Lower actual yield comes deteriorating equipment, which was worse than last year.

Sugar beet production loses its priority for domestic producers as the general standing of the sugar industry deteriorates, debts increase, and the processing of imported raw sugar becomes more attractive. Besides, domestic conditions for planting sugar are more difficult (for example, the technique of deep planting is employed), which only stimulates the cultivation of other plants.

Sunflower seed exports are growing...

... which impedes the development of oil and fat complex

Sugar production will amount to 1.7 million tons, which is 15% less than last year

²⁴ Presidential Decree 755 dated July 8, 1998, which imposed deposits on sunflower seed exports, was abolished by Decree 974 dated September 3, 1997.

Sugar sales are carried out on the basis of barter future contracts (the supply of inputs – seeds and fuels – is made in advance, as to be exchanged for sugar in the future). The share of cash money in payments for sugar inputs amounts to only 10%. This allows gas, mazut, and other input suppliers to dictate their prices for the sugar they already paid for.

Sugar exports will possibly grow

At the same time, the hryvnia devaluation caused dollar prices for sugar to fall two times, which creates favorable conditions for sugar exports and stimulates the growth of sugar production in 1999. On the other hand, the government, scared by possible difficulties with supplies in the domestic market as a result of increased exports of sugar production, issued Resolution 1680 dated October 22, 1998 ‘On raw cane sugar imports into Ukraine’, which diminished the relevant import tariff. The previous ad-valorem tariff was equal to 15% of the sugar imported by the 1998 quota, which envisions 300,000 tons of sugar imports. By this quota, Ukraine imported 110,000 tons of raw sugar. According to the Resolution, the volume of raw cane sugar envisioned by the quota shall be imported with a 1% tariff.

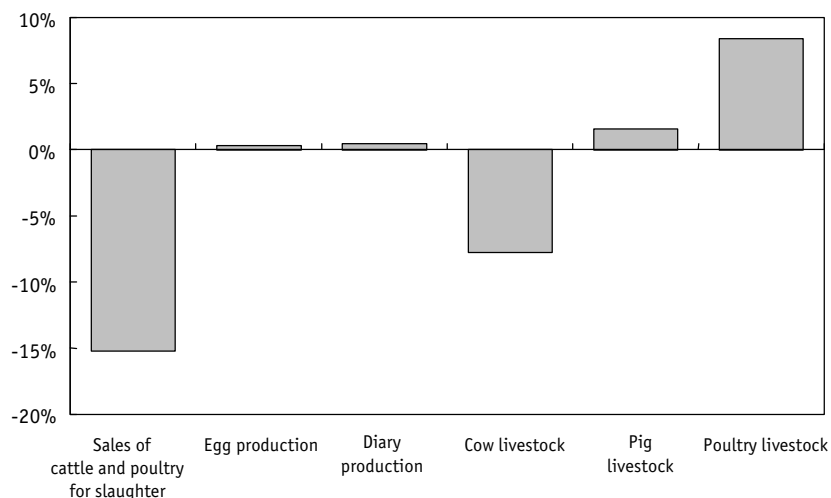
Livestock

Livestock production will decrease by 2%

Livestock production will decrease by 2% in 1998. Recently, the volume of cattle and poultry sales was reduced significantly (by 14% against the corresponding period of 1997), as well as the number of cattle livestock breed (by 9%). However, poultry production indicators increased, reflecting in a 10% increase of poultry livestock. In general, we expect the production of meat to diminish by 8-10%.

We forecast that in 1999 livestock production will slightly grow, due to a higher demand from domestic processing enterprises, which will become more competitive after the currency devaluation. Poultry production will grow the most rapidly, while the increase in pig production will be a bit lower. At the same time, the decline in cattle production will slow down. These dynamics reflect the speed of circulation of funds in cattle and poultry breeding, which is, on average, 2 years in cattle production, 8 months in swine production, and 1.5 months in poultry production.

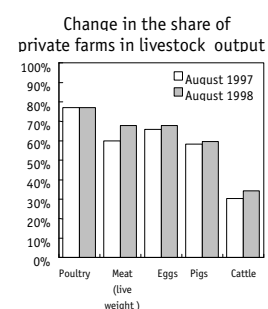
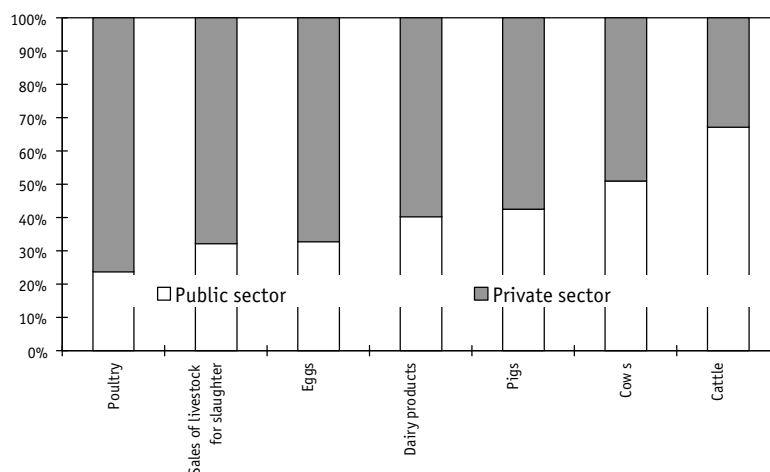
Livestock production in January-August 1998 against the corresponding period in 1997



Source: State Statistics Committee

At the same time, analysis of the ownership of farms shows that the decline results mainly from indicators showed by collective specialized farms, while the private sector reports a slight improvement. Respectively, the weight of livestock production in the private sector grows by all indicators. However, this could not offset the contraction in output by collective farms.

Livestock output by private and public farms in August 1998



Source: State Statistics Committee. Calculations by Quarterly Predictions

Source: State Statistics Committee. Calculations by Quarterly Predictions

The diminishing weight of output in livestock production by the public sector reflects 14%²⁵ reduction in cattle against a respective 2.4% reduction showed by the private sector, and in meat sales, which reduced in these sectors by 31% and 2.7% respectively.

In 1998, we expect a slight increase (0.5%) in dairy production, again coming from production growth in the private sector, which will exceed the reduction reported by collective farmers.

²⁵ January-August 1998 to the corresponding period of 1997

EQUITY

The financial crisis worsened privatization problems in Ukraine. Therefore, we update and lower our forecast for real proceeds from privatization in 1998 from UAH 700 million down to UAH 500 million. State authorities decided to use the crisis period for a review of state policies on the administration of state property, privatization, and securities markets. However, certain measures for the implementation of planned changes suggest the absence of a consistent action plan, which can only worsen the situation. The opposition also took advantage of weakened authorities, which aims at discouraging further privatization. This trend is especially dangerous, given the crisis in the sphere of public finance. The privatization process, which secures property rights of investors and guarantees a transparent stock market, is the government's last hope for maintaining economic stability. Under favorable conditions we expect proceeds from privatization as high as UAH 2 billion in 1999, of which UAH 1.5 billion will result from the privatization of Ukrtelecom.

Privatization

By the fourth quarter of 1998 the State Property Fund (SPF) transferred approximately UAH133 million to the government budget. Instead of the planned increase in privatization revenue, they were constantly decreasing: down from UAH 133 million in the first quarter to UAH 85 million in the second quarter and further to UAH 70 million in the third quarter.

The main reason for lower privatization revenues is the deteriorating situation in the financial and stock markets in Ukraine and neighboring countries. The hope for stabilizing and improving share prices, which emerged in July, disappeared as soon as August-September immediately after the collapse of the Russian market. Therefore, since January 1998, prices for marketable shares have fallen 4-10 times and reached their lowest rates.

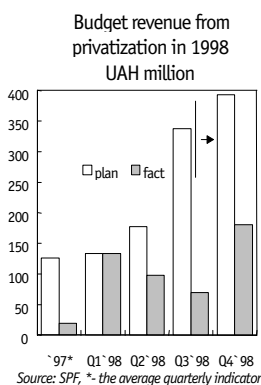
Exchange sales

Given these critical conditions, the fastest and most transparent method of privatization for money is exchange auctions. They provide the SPF with 50% of its total revenue as lower share sales in these auctions pre-determine the default on the plan of privatization for money.

We argue that during the financial crisis it would be necessary to sell sizable share packages (15-30%) of medium-sized enterprises designed for strategic and local investors (for example, shares of grain depots). However, the SPF would be unable to hold tenders for all these objects and effectively manage state-owned packages of shares. Therefore, the government will be better off if it accomplishes fast and cheap (meaning the organizational cost) sales of its shares.

At the same time, the sale of sizable packages of shares through an exchange (5-10% of statutory capital) of large-sized enterprises are undesirable because if not demanded by portfolio investors, they will be sold at too low a rate. The efforts should be primarily focused on holding commercial and non-commercial tenders, and on transferring to winners those packages of shares which were drawn from exchange auctions, as:

The financial crisis diminished proceeds from privatization



It is reasonable to sell share packages of small-sized enterprises at stock exchange auctions...

...but undesirable to sell sizable share packages of large enterprises...

- Through the tender, an investor pays a higher price, motivated by receiving additional packages of shares.
- The state would receive a fee for in trust management of share packages.
- After investments are made and the financial market is stabilized, prices for shares will grow.

The change in tactics is also reasonable for facilitating the sale of share packages for the smallest enterprises, which ought to be sold through specialized money auctions so as not to discredit exchange auctions by selling non-marketable objects through them. Stock-exchange auctions proved that they could carry into effect the following functions:

...and shares of small-sized enterprises

- Provide sales for residual share packages and maintain a rapid pace of privatization after certificate auctions are over.
- Finance the Ukrainian Center for Certificate Auctions (revenue from the second and third auctions amounted to UAH 543,000 and 627,000 respectively, while collections from the first auction, where attractive objects were proposed, exceeded UAH 3.5 million).

Tender sales

The financial crisis and severe budget constraints suggest focusing efforts on holding commercial and non-commercial tenders for selling large packages of enterprises (over 25% of statutory fund) attractive for investments. Thus, only strategic investors may resolve the problem of insufficient state budget revenue as well as improve the financial situation and production capacities of the largest Ukrainian enterprises.

In the first half of 1998 the SPF enacted a number of important changes into the order of holding tenders: it proposed to sell the right to manage state-owned share packages to winners of tenders, and placed the experience of operating in the branch as a requirement to claimants.²⁶ Even given these changes, the general normative base remains inconsistent and cannot attract the needed strategic investors, which keeps consistently low levels of privatization revenues, loss of trust among investors to tenders, and growing resistance to privatization from the branch lobby.²⁷

The SPF cannot attract strategic investors, as it has no efficient normative base and political power.

Privatization in 1999

The SPF developed the Privatization Program in 1999, which envisions a number of important changes.

The plan for 1999 is...

First, the Program proposes to carry out only for-money privatization. However, we argue that the SPF will continue to hold certificate auctions, as households still keep on hand significant number of certificates, equaling approximately 8 million.

...to carry out only for-money privatization...

²⁶ Though not having developed criteria for identifying this experience

²⁷ Top managers of the energy, petroleum and gas sectors submitted to the President their proposal to suspend the privatization of enterprises within their branches .

... change tender conditions...

Second, the SPF developed draft changes to the conditions of holding tenders, which concern the issue of selling Ukrainian largest enterprises according to the law on small privatization. The Fund also plans to grant responsibilities to the members of tender commission, make tender procedures more transparent and simultaneously reduce the risk of violating confidentiality of tender proposals.

However, the variant proposed by the SPF – to hold competitions of business plans and evaluate them according to ten criteria – has much to do with corruption issues given Ukrainian conditions and will probably discourage investors. Simplified criteria for choosing the winner – to invest the sum or the price paid for the share package – will also make the process more transparent.

Third, the SPF tries to introduce new schemes for privatization: secured sales (an intermediary who initially purchases a share package at a low fixed price is obliged to sell them at the highest price possible) and the purchase of shares through depositary receipts.

...introduce secured sales...

A mechanism for secure sales must be worked out during the purchase of share packages for the energy-generation companies Donbasenergo and Tsentrenergo, which is planned with Creditanstalt Austria IB and Swiss UBS for the end of this year. This step can be considered perspective, though the process for receiving the end result is time-consuming.

Applying this mechanism to the purchase procedure will allow for receiving substantial monetary revenues from the privatization of Ukrtelecom in 1999 – a fixed sum for the share package, which equals 25% of the company's statutory fund (or \$400 million, which can ease financing the budget deficit), may be placed by an authorized person as early as before the presidential elections. Thus, the final sale will take place after the elections, increasing the price of the shares.

... and privatization through ADR sales...

The issuance of ADR is simple and transparent: the organizational price will be equal to zero in case of previously registered programs of depositary receipts. However, the effect from this issuance will not reach its maximum as the prices for Ukrainian shares fell significantly, and will be maintained at low levels by the end of 1999. Therefore, we argue that next year the SPF should not go beyond 2-3 pilot projects for ADR issuance.

... and initiate land privatization

The final important innovation is land privatization (see AGRICULTURE). We expect that the Verkhovna Rada will not pass this proposal as last year. Given this, the executive branch will have to compromise and propose the sales of land occupied by privatized objects, which will significantly increase their price.

Highly important, but not included in the SPF Program, is the task of developing a draft law on re-privatization, which would identify the terms of re-privatization and lessen investors' fears about the possibility of nationalization. This fall, when investors started to pull out of the market, the SPF initiated the process of re-privatizing 46 sizable share packages, which is a positive sign. Investment commitments are not met, mainly due to a lack of state control. According to concluded agreements, enterprises should have received UAH 1.5 billion and \$681 million, while the actual sum was UAH 235 million and \$215 million. However, inconsistent declarations made by the government regarding the need of re-privatization discourage investors and discredit this sensible measure.

Chances to adopt the reformatory Privatization Program for 1999 have diminished of late. This has resulted from the fact that the Verkhovna Rada became aware of the government and President's weakness in overcoming the financial crisis and began to prepare for the forthcoming presidential elections. However, responsibility for a confrontation between the parliament and the executive branch should be placed on the government and the President. They were the first to initiate an extremely risky transfer of state-owned share packages of 93 attractive Ukrainian enterprises for sale to the authorized Finprom and Derzhinvest companies (see **QUARTERLY PREDICTIONS**, #4). The Verkhovna Rada had the full right to cancel this procedure, though these steps by the government provoked fraction of the parliament by communists to start developing a decision to suspend privatization. Thus, they hardly understand the need to approve the law on privatizing Ukrtelekom, which could be nearly the single source of budget deficit financing (see **GOVERNMENT**).

However, the Verkhovna Rada can impede these reforms

Under favorable conditions we expect proceeds from privatization to be as high as UAH 2 billion in 1999, of which UAH 1.5 billion will come from the privatization of Ukrtelecom.

We expect the proceeds from privatization to be as high as UAH 2 billion in 1999

State property management

The privatization strategy, which has been little changed since 1993 when it was introduced, did not pay much attention to the issues of state property management and control over trustees' activities in the process of privatization. The main function performed by the SPF was to sell state property, while unskilled trustees of the SPF, Ministries, and chief managers of enterprises responsible for state-owned shares were not interested in their work. As a result, such enterprises were left without an owner for a period of several years, which caused the fall of production, deterioration of financial indicators, and lower sales prices.

The government decided to separate the functions of state property management and privatization...

The financial crisis slowed down the pace of privatization and made the problem of state property management the first to resolve. The government decided to revert to the idea rejected in 1993, which envisions assigning state property management and state property sales to two different agencies: the newly-established National Agency for Management of State Corporate Securities and the SPF.

The SPF will be assigned the three following functions: it will (a) sell, (b) let for rent, and (c) register state property. All the other functions, including development of privatization plans, management of state-owned share packages, and negotiations over terms of privatization will be transferred to the Agency. It is planned that the Agency's employees will independently manage corporate rights, and will focus on the preparation and transfer of management to trustees.

Among other approved responsibilities of the Agency is the alienation of state property, or simply privatization. The *extra-budgetary* fund by the Agency would collect all dividends on state corporate rights, which resembles the formation of a pre-election fund.

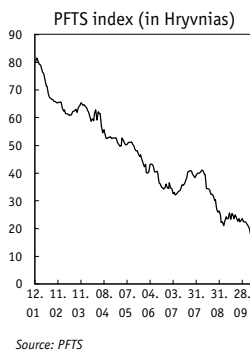
... but the whole idea may be discredited by inter-agency confrontation

The crisis in Russia destroyed every hope of market growth before the presidential elections

We argue that the Agency granted such responsibilities discredit to the whole idea and may make inter-agency confrontation between the Agency, the SPF, and ministries even more tensed. We view real priorities of the Agency as restructuring management of enterprises²⁸, selection of persons to be authorized, and development of a mechanism for making trustees an interested party.

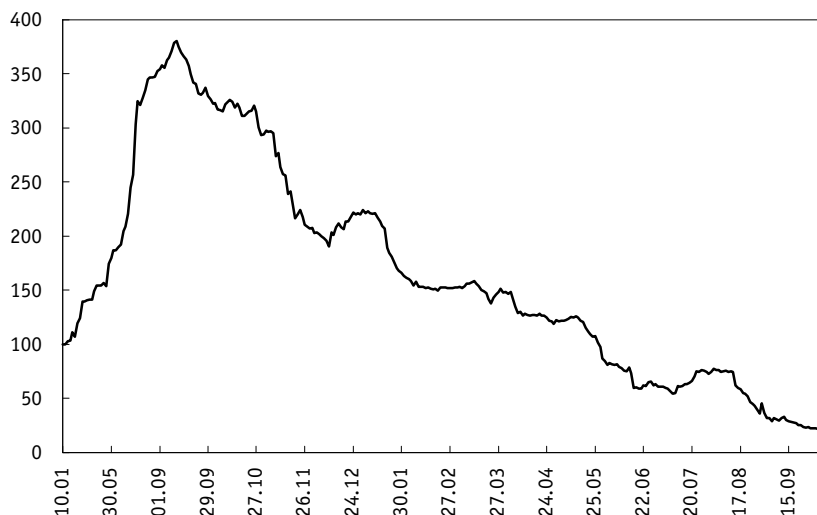
Corporate securities

The revival of the securities market in July, resulting from the temporary improvements in Russia, was of a short-term character. It changed into a long-term crisis after the Russian market collapsed and the situation in the domestic market deteriorated. During this period, the value of the PFTS (OTC electronic trading system) stock market index²⁹, calculated in hryvnias, went down from 40 to 16.5 (which is not adjusted for 60% hryvnia devaluation!). Monthly volumes of selling in the system fell from UAH 30-50 million last year to UAH 5 million in September 1999. The liquidity of the market significantly decreased – bids are several times lower than selling quotations, the volume of bids in PFTS is 40 times lower than the volume of offers.



Stock exchange index Pro U-50

Prices in dollars



Values are weekly before August 20, 98, and daily after the date

Source: Interfax-Ukraine

Currently, the capitalization of 15 companies, which are traded more frequently than others, is lower than \$500 million, while at the beginning of the year it was as high as \$3 billion. The market is experiencing payroll cuts and most representative offices of foreign brokerages were liquidated.

²⁸ If the amount of outstanding liabilities is several times higher than the statutory fund, one should not expect that the sales prices for shares will be high in the process of privatization.

²⁹ Biggest formal trading venue in Ukraine

The main reason for the fall is that the share of non-residents in the blue chips market was 90%. No positive changes in the economy and improvements in legislation regulating stock and investment activities encouraged new investors to come. The crisis of public finance, privatization scandals, infringements in shareholders' rights, and the national currency devaluation made non-residents leave the market, which was facilitated by Asian and Russian turmoil. Therefore, Ukraine, on the contrary to its neighbors – Poland, the Czech Republic, and Hungary, where domestic capital takes a considerable share of the market, underwent severe droplet.

Given this, we have to update our forecast and confirm the fact that no portfolio investments will be made in Ukrainian corporate securities till the end of 1999.

National capital is on its way to the stock market

The collapse allowed the national capital to redirect towards the stock market. The domestic investor was not able to enter the stock market, as he was noncompetitive compared to western investors, which kept the general prices for shares rather high. Ukrainian traders geared their activities to receiving bids for the stock purchase from non-residents. Besides, the stock market could not compete with the T-bill market in the sense of its profitability and security of the latter.

Falling prices for shares renewed the interest of domestic investors in the stock market

Thus, every region has attractive enterprises, and domestic investors, willing to efficiently allocate their capital. Compared to the situation in 1995-1997, securities traders can propose the whole range of services related to purchasing an attractive enterprise's controlling block of stock by the investor. Since then, both the regulations for stock operations and the system for accounting property rights of shareholders have improved. Lawyers and courts have accomplished appropriate skills.

Objects which are most attractive for domestic investors are enterprises of the light and food industries, construction, and agricultural sectors: these require a fractional amount of capital with a high rate of return. These enterprises imply insignificant political risk for the process of re-privatization, oriented upon the domestic consumer, which implies little sensitivity to the hryvnia devaluation and external crisis.

The crisis made traders improve management of their securities portfolios. Currently, when there is little sense to sell 20-30% of enterprises' shares, one should directly go and see the enterprise, proposing his services in optimizing financial flows, searching for strategic investors, and developing a sales network. To conclude, most perspective market challenges are strategic investment, corporate and financial management, while brokerage and analytical activities have moved backward.

The crisis made traders improve management of their securities portfolios

The development of the debt market has facilitated as well. This includes promissory notes, mutual settlements, and barter schemes, as the goods market operates in any conditions. We forecast that the market of financial service for goods flows will be highly competitive for banks and securities traders.

Finally, we should highlight the fact that portfolio investments unequivocally collapsed. If the government manages to maintain a stable environment and improve regulations for stock activities, then extremely low prices of Ukrainian enterprises, which constitute 10% of 1997-year prices, will again become attractive for foreign investors. The most risky of them will contrive to enter the market before the presidential elections.

Besides, the market infrastructure improved during the recent years, securities traders improved their professional skills, and several enterprises enacted steps towards entering external capital markets. Thus when the crisis began, Ukrrichflot global depository receipts, traded on the Vienna Stock Exchange since August 11, fell insignificantly from 48 to 45 Austrian shillings. As an aside, the price of Ukrrichflot's share in the domestic market ranges UAH 4-5, which is 2.5 times less than on the Vienna Stock Exchange.

More transparent but over-regulated market

Since January 1, 1999 the stock market of Ukraine will employ a new scheme of work: according to decisions by the State Securities and Stock Market Commission (SSSMC), shares of the first thousand attractive enterprises will be traded only in formal markets, which will be exclusively serviced by the depository system.

Orientation of SSSMC upon making the stock market more transparent will be accompanied by its over-regulation

In other words, in order to sell the shares of an attractive enterprise one should open an account with a custodian and deposit his/her shares.³⁰ The one who purchases these shares should also open an account with the same custodian. Stock exchanges and PFTS should conclude corresponding agreements with depository companies, where custody accounts are kept. Only with these conditions fulfilled a contract on purchase-sale of equities considered authoritative. Thus, this procedure allows SSSMC to track the course of every concluded contract.

Still, this scheme is too expensive and inconvenient for small share packages. Besides, there exists only one depository, which services only 70 issues of stock. This gives us reasons to forecast that the turnover of shares will shrink in 1999 and will be strictly controlled by the executive branch.

³⁰ Custodian trustee must be registered by a nominal shareholder in the register of enterprise stakeholders.

LABOR

The average real wage will decline 0.5%, due to stagnation of production and a more rapid pace of inflation. In 1999, wages will resume to increase and the expected change will be 2%. This will primarily result from higher labor productivity in major industries, a consequent revival of economic activities and a continuous release of surplus labor in the area of production. In 1998, the crisis and reduction in the surplus labor force will predetermine the decrease in the number of employed by 600,000 people. In 1999, the main reason for a further reduction in the number of employed by 700,000 people will be accelerated layoffs in both budgetary and production spheres of the economy. Unemployment registration may grow in the second half of 1998 as the population will be interested in receiving subsidies on utility payments. By the end of 1998 the rate of unemployment will amount to 3.5% against 2.27% at the end of 1997. We argue that by the end of 1999 the rate of registered unemployment may exceed 5%.

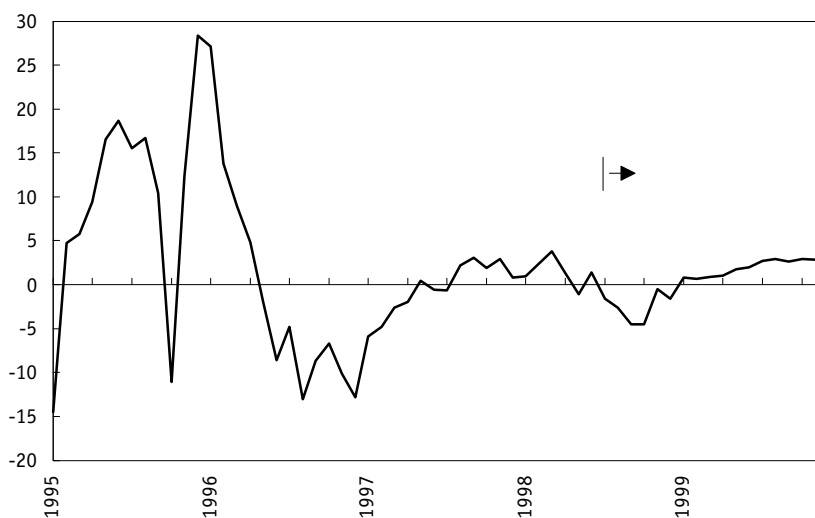
Wages

The growth of real wages observed at the beginning of the year will cease in the second half of 1998 due to growing inflation and contraction of industrial production, as well as to a more restricted increase in construction (see **GDP, BUSINESS**). We forecast that real wages will drop by 2.6% for the last six months. This will result in 0.5% decline of the average real wage in 1998, which is almost equal to the decrease reported for 1997.

In 1998 real wages will decrease by 0.5%

*Real wage*³¹

Annual % change to the respective period of the previous year



Source: State Statistics Committee Calculations and forecast by Quarterly Predictions

³¹ Data does not include cooperatives, small enterprises, and collective farms. Real wage is adjusted by the consumer price index.

Expected higher labor productivity...

Dynamics of the average wage depends on labor productivity, as there exists a direct relation between them: the higher the labor productivity, the greater the wage. Attaining new production technologies and ridding enterprises of the surplus labor force, as well as transferring workers to other economic sectors (particularly service), are all factors that increase labor productiveness.

... will increase real wages by 2% in 1999

We forecast that increased direct foreign investments, western technologies, and cutbacks on the surplus labor force in 1999 will lead to higher labor productiveness. Real wages may grow by 2% if economic activity is revived after the crisis is over.

Employment

Employment will decrease to 22 million people in 1998

Employment in Ukraine will be reduced by 600,000 people in 1998 and by the end of the year will decrease to 22 million people. The main reason for the reduction in employment will be a decrease in economic activity and initiation of reform on budget spending through a reduction in the number of people employed in the budget sphere. However, the pace of this reform remains rather slow, which gives us a reason to argue that the agreement with the IMF to reduce the number of employed by 300,000 people in 1998 and 400,000 people in 1999 will be fulfilled only partially, due to the presidential elections in October 1999.

Even if the of people employed in small businesses grows...

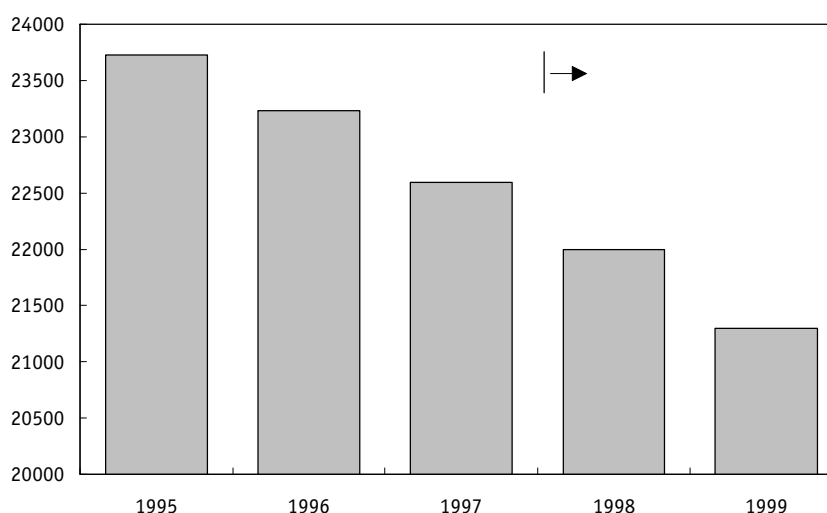
Employment among people working in private enterprises and individuals acting as private entrepreneurs will accelerate, due to a simplified system of taxation for small business entities, beginning January 1999, with the major changes in lump sum tax. Employment among these categories will grow from 2.8 million people to 3 million people in 1998. For 1999, we forecast this indicator to reach up to 4 million people.

... total employment will decrease to 21.3 million people in 1999

However, given an increase in the number of employed in small-sized enterprises, stagnation in production among other sectors of the economy will lower the total employment to 21.3 million people in 1999.

Employment in the Ukrainian economy

million people



Source: State Statistics Committee. Forecast by Quarterly Predictions

Barriers in the labor market as an impediment to growth³²

Ukraine has tremendous implicit labor capacities. While official statistics reported a 54% decline of GDP during 1991 and 1997, the decrease in employment was fixed at 10% for the same period. Slow restructuring of the labor market mainly resulted from the expectations of government workers regarding a sharp increase in the number of unemployed and non-developed policy for employment promotion.

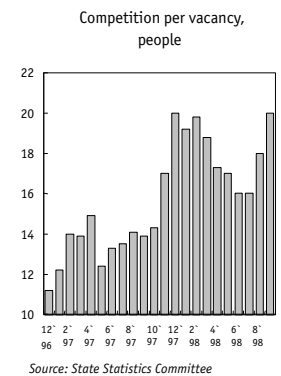
The fact that only 27% of all unemployed persons are registered with state employment centers simply proves the fact that Ukrainians do not consider the state as a guarantor of social security. However, even given this low registration rate, the State Employment Fund orients over 2/3 of its spending on lay-off compensation payments, which was UAH 40 on average in September. Additionally, the government financed only an insignificant part of the operative measures for seeking employment. However, one should keep in mind that the actual reduction in unemployment may be achieved by the following operative measures of active labor market policy:

- Loans for initiating private business
- Employment search assistance through consultations and publicizing information
- Professional training
- Public work
- Employment subsidies paid to employers or/and employees

The critical pre-determinant for effective employment of the labor force is an increase in its mobility through eliminating existing barriers in the labor market, which are extremely high in Ukraine. The major are:

- Underdeveloped legislative base for asserting employee rights: written contracts are not wide-spread in Ukraine, and the basic labor law, enacted in 1972, remains in force, little changed and inconsistent with current economic development. It is necessary to develop and adopt a new basic labor law or a series of specific labor laws. We consider the latter variant simpler to accomplish, and propose the Law "On Individual Labor Contract" to become the first among them.
- There exists no independent state-controlled agency ensuring adherence to labor laws. Today, three different inspections operating in the labor market are financed from oblast budgets and therefore are dependent in their decisions on local authorities. Fines for breach of the law are insignificant and amount to 5-9 minimum wages (or UAH 275-495).

Collective labor contracts fail to guarantee employee rights. Trade unions overlook the wide-spread practice of compulsory administrative vacations without preserved wages³³, while collective labor contracts contain numerous discrepant articles which impede economic growth, including tariffs on communal services, housing subsidies, energy, etc.



³² The article contains working materials by Arvo Kuddo, World Bank expert on labor market issues

³³ Officially, the administration of an enterprise must pay to workers on compulsory administrative vacations 70% of their wages, however this is never practiced. According to law, wages may not be preserved only if agreed upon with the trade union.

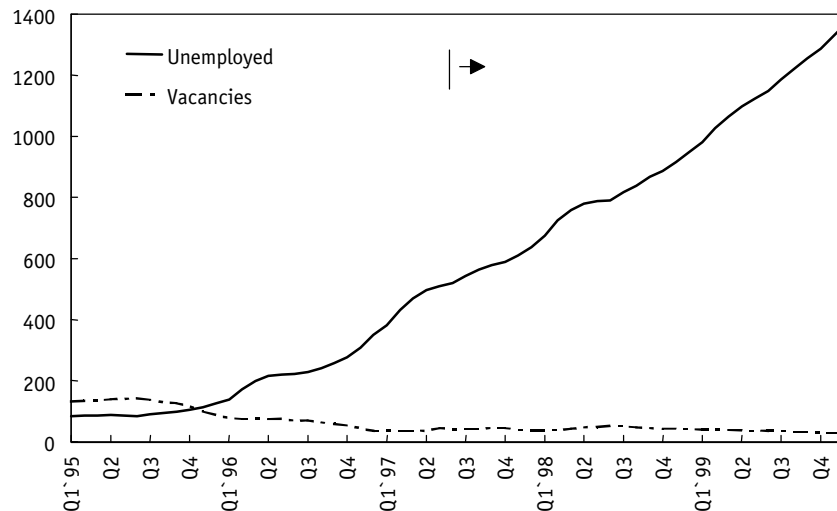
During 1998 unemployment will increase from 2.3% to 3.5%...

...and at the end of 1999 it will exceed 5%

The tendency of growth in registered employment will be pronounced during 1998 and 1999. Registered unemployment will increase from 2.3% to 3.5% as from the end of 1997 through 1998³⁴. Moreover, we expect it to exceed 5% by the end of 1999. The pre-determinant of this tendency will be an economic recession and increase in the number of people laid off, as well as higher tariffs for utilities: so as to be assigned a housing subsidy, all family members must submit certificates containing information about their income. However, this becomes impossible if unemployed members of a family are not registered. Furthermore, a significant number of Ukrainians have worked in Russia. We expect many of them return to Ukraine, due to numerous layoffs in Russia caused by the current crisis (see **INTERNATIONAL**). This will only increase the domestic rate of unemployment.

Number of unemployed and vacancies

thousand people



Source: State Statistics Committee. Forecast by Quarterly Predictions

The situation in the labor market is worsening mainly as a result of the financial crisis. This has caused numerous layoffs in banks, investment companies, and enterprises specialized in trade and transport services. Also having suffered are producers of those goods oriented on the Russian market. This will consequently lead to higher demand on the services of employment centers. While private employment centers will be better off in this situation and improve their effectiveness due to an increased number of candidatures, state employment centers will suffer from the increased number of registered unemployed. With state employment centers being extremely overloaded with the work and given little funds to provide better services for job-seekers, the government will be unable to implement efficient policy in the labor market.

The government will fail to implement active policy for employment searches

Next year state employment centers will have to make more payments for lay-off compensations. Additionally, from January 1999 the responsibility of paying out two months worth of unemployment compensation to dismissed workers will be transferred from enterprises to the State Employment Center. Considering this, state policy for employment searches will have no financing. As a result, the state will limit its efforts in this sphere by passive labor policy, namely lay-off compensation.

³⁴ By September 1, 1998 the official unemployment registration number was 867,000 people, or 3.2% of the able-bodied, working age population.

HOUSEHOLDS

In 1998, real household income will fall 10% compared to the previous year due to lower wages, a larger share of taxes in revenue structure, and an increase in inflation toward the end of the year. Additionally, we expect a gradual decrease in household income from pensions during the second half of the year, which is mainly a consequence of the increased outstanding debt of the Pension Fund. This will inevitably lead to a significant contraction in household consumption and savings, which will decline by the end of the year by 5% and 45% respectively. However, we expect the situation to improve in 1999 which will witness an end to the crisis and an upswing of domestic activities. More open fiscal and monetary policy on the eve of presidential elections will temporarily increase household income. We expect that it will grow by 2% during 1999. This will produce an increase in consumption and savings by 1% and 15% respectively.

Income

Beginning from January 1998, real household income declined significantly as compared to the previous year. Thus, while income declined by 6% in the first half of 1998, the reduction for eight months of the year totaled 9.7%. There exist two main reasons for this – a reduction in income from wages, and a growing share of taxes and other mandatory payments collected through more efficient tax inspections from households. Thus, while real household income from wages dropped 12.7% during January and August, taxes rose by 16.7% in real terms.

The only source of growth in household income was an increase in pension payments. Starting from March 1, 1998, when maximum pension rates were raised, household income from pensions increased by 17.9% for the period from January through August. However, we consider this process a temporary one, as no proportional growth in revenues collected by the Pension Fund was noticed. While the average monthly revenue collected by the Pension Fund is UAH 664 million, the relevant amount spent by the Fund equals UAH 850 million, which results in the Pension Fund's monthly deficit of UAH 150 million.³⁵

In order to increase the Pension Fund revenue, the government raised tax rates and mandatory payments. The relevant Presidential Decree imposed the following taxes and payments:

- Additional 1% fee on the employed: the share of payroll tax assigned to the Pension Fund shall increase from 1% to 2% (additional monthly revenues will constitute UAH 28.5 million).
- Tax on exchange transactions by individuals shall be UAH 0.01 per UAH 1 exchanged (monthly revenues will constitute UAH 13.3 mln).
- Purchase and sales operations with automobiles: contribution to the PF shall be fixed at UAH 100 (monthly revenues will total UAH 2 mln).

Real household income is rapidly declining...

...as income from wages decreases, while taxes tend to grow

Household income from pensions is growing...

...which is a temporary effect, as the Pension Fund still shows a deficit

³⁵ According to Boris Zaichuk, Chairman of the Pension Fund

- Assessment from the purchase of jewelry to the Pension Fund shall be fixed at 5% of the cost (additional monthly revenues will total UAH 0.3 million)³⁶.

Even considering all of these changes, the monthly deficit of the Pension Fund will be reduced by only UAH 142 million, which will not resolve the pension problems. Therefore, an increase in pension charges will be accompanied by the accumulation of the relevant debt. We forecast that by the end of the year, the increase in income from pensions will slow down in real terms.

Real income of households will harshly suffer from the price rise

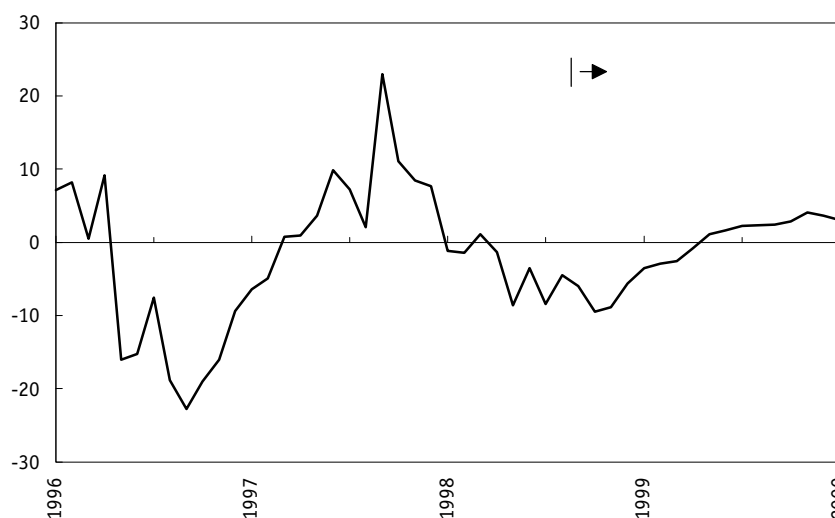
Real household income will be the first to suffer from the rising prices in the autumn of 1998. The most sensitive to this rise is income not anchored to foreign currencies, which prevail in the economy. Even if indexed after breaching the 5% inflation barrier (which may happen in November), real household income will fall sharply³⁷ because the sum that is subject to indexing is limited by the first UAH 220 received by an individual as wages and/or pension. From these UAH 220, only the first poverty line (UAH 73.3) will be indexed in accordance with inflation by 100%, while the next two lines will receive 80% and 70% of indexing respectively.

Stagnation in production will lower household income by the end of 1998

Stagnation in production and a consequent decrease in major industries (see **GDP, BUSINESS**) leaves few reasons to hope that household income from wages will grow in the second half of the year. We forecast that real household monetary income will decline by 10% in 1998.

*Real income*³⁸

annual % change



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

³⁶ Additional revenues are calculated by Pension Fund experts

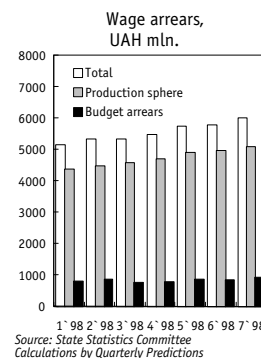
³⁷ According to the Law of Ukraine "On indexing household monetary income" and the Resolution of the Cabinet of Ministers of Ukraine "On approval of the order for Indexing the money income of households" dated May 7, 1998. The number of money incomes to be indexed by 106.19 percentage points in November equals 663.

³⁸ Real income is calculated by subtracting foreign currency sales, obligatory payments, and voluntary contributions, from household money income figures reported by the State Statistics Committee, and then deflating the number by the consumer price index.

Wage arrears tend to grow both in the areas of production and budget, and we see no real reasons for their reduction. Moreover, wage arrears may become even larger if the government tries to keep the budget deficit within the boundaries defined by the IMF. Besides, budget revenue declined when the financial crisis began to develop, mainly because of the contraction of business activities. This made the situation with payment of wages even more complicated in the budget and social spheres (see **GOVERNMENT**).

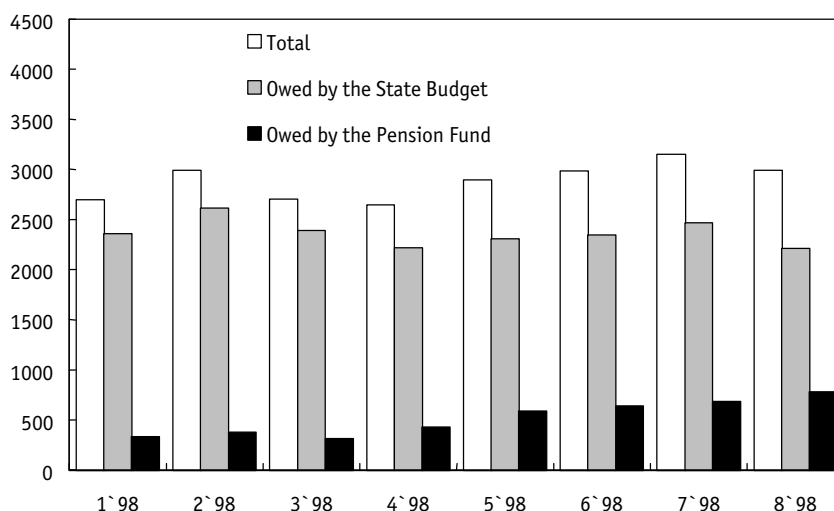
Budget arrears of wages will continue to grow

The budget deficit will continue to grow if no budget reforms are implemented, in particular, if the number of budget-supported workers is not reduced (see **LABOR MARKET**). The presidential elections in October 1999 will also thwart progress. However, the general pace of budget reforms will largely depend on the IMF, as the schedule for repaying the budget debt, agreed with the IMF, envisions a reduction in the number of budget-supported employees. As a result, if the Fund holds to the terms of this agreement, the government will have to accelerate budget reforms.



Social arrears³⁹

UAH mln, as of end period



Source: Ukrainian News

Pension arrears grow even more rapidly than wage arrears in the budget sphere. If the pension system remains unchanged, the outstanding debt of the Pension Fund will continue to grow. In 1999, the risk factor for higher household income will be lower monetary income from wages resulting from a growing number of unemployed. If the government does not implement any measures for reducing fiscal pressure and encouraging investment activities vulnerable to the recovery of the real sector, as well as if consequences of the crisis are not mastered, monetary household income from wages may decrease in 1999⁴⁰.

**Pension arrears grow even more rapidly
Monetary household income from wages may decrease in 1999...**

³⁹ Does not include arrears owed by local budgets. Pension Fund arrears also include pension arrears financed directly by the Fund. Arrears of Chernobyl pensions and pensions to military servants as well as other payments which are to be repaid directly by the Fund and have no other source of financing, are included in the budget arrears on social benefits.

⁴⁰ Labor earnings as a share of GDP remain understated in Ukraine. While in the United States labor earnings account for about 75% of GDP, the relevant indicator

Pension Reform is in the air

Pensioners' welfare depends largely upon the amount and timely receipt of their pensions. Current pension rates in Ukraine are very low – on March 1, 1998 the average pension was UAH 54. Pension arrears are huge – on March 1 the total stock of debt was equal to UAH 1.5 billion. Although Verkhovna Rada officially attempts to increase the pension rates and reduce outstanding government debt, the situation definitely needs much more cardinal changes.

The heart of the problem is the organization of Ukraine's pension system. The existing solidary system of pension insurance envisions distributing pension allocations charged from the employed among actual pensioners. A low pension size results from low revenues of the Pension Fund and an enormous number of people eligible to receive financial aid. The reasons for low revenue of the Pension Fund are the following:

- *Low payroll figures, 33% of which are allocated to the Pension Fund (beginning from June 1, 1998 it was increased by 1% and currently is 34%). This was caused by an economic downturn and decline in employment, as well as the concealment of wage payments by enterprises and organizations.*
- *Hard financial situation and increasing number of tax evaders (in 1997, only 48% of all registered taxpayers allocated their mandatory payments to the Pension Fund and only 85.4% of payments due were actually paid out).*
- *Enterprises' arrears to the Pension Fund, which is a result of payments made in-kind or avoiding the banking system (through the till, on the date of receiving cash from the sale of goods or services).*
- *Wage arrears: if repaid, the Pension Fund receives its share of payroll tax only on the date when payments are made.*
- *No internal payments from the state budget for pensions to military servants and other categories of retired people.*

Another specific feature is the large share of retired people among the population of Ukraine, which may be explained by the following factors:

- *Demographic situation: an increase in the number of elderly people, which is observed in many other developed countries.*
- *Low retirement age compared to other countries. In Ukraine, the official retirement age is 60 years for men and 55 years for women, while in Germany, Spain, and Belgium it is fixed at 65 years for both men and women. In Great Britain the retirement age is 65 years for men and 60 years for women. For example, in Denmark and France the common retirement age is 67 and 60 years respectively. However, a gradual increase in the retirement age is observed in countries with a relatively low age, which, in particular, concerns France and Italy⁴¹.*

in Ukraine was equal to 47%. The main reason for such a gap is concealed labor income of households, which is the result of a burdensome payroll tax.

⁴¹ Social Protection publication, issue 8'98

⁴² Two consecutive years before retirement or any five years of employment

- Numerous privileges to specific occupations associated with early retirement. By March 1, 1998 such retired people accounted for 28.33% of all retirees.

As a result, several complaints were made about the pension system:

- The pension system is not joined, and therefore makes no correlation between the total time worked and the amount of pension to be paid. The latter is defined only by the amount of wages earned over a short period of time.⁴² Additionally, the maximum pension payment is checked in relation with the Pension Fund deficit. This negatively affects households' expectations about the direct relation between wages and future pensions, which results in a large amount of wages paid out unofficially.
- It provides no work stimulus. In Ukraine, the minimum standing for receiving a pension is 25 and 20 years for men and women respectively, while the potential standing (if a person were to work from age 20 till the official retirement age) would be 40 and 35 years respectively. Even with 15 working years lost, a person will be assigned a retirement pension.

Besides the need to reform the existing system, it is critical to introduce an individual account system controlled by state and private pension funds. If this system, envisioning an additional source of pension payments in the form of savings on individual accounts, is not established, the existing solidary system will not provide the revenue sufficient to maintain worthy living standards among the elderly.

As international experience proves, only individual pension accounts may resolve the problems of the solidary pension system. However, the individual account system may be efficient only if the inflation rate is low, and the economy maintains growth and sustainability. If hyperinflation occurs, all savings are nullified. It is also critical to acquire a highly capitalized stock market, as pension savings are immense accumulated funds which need to be effectively allocated. Given the inefficient and low-capitalized stock market, Ukraine is faced with the absence of assets in which pension funds may be invested.

Thus, reform of the pension system is highly time-consuming, as the solidary system will have remained the basis of the pension insurance system for the next 30-40 years. That is the main reason for the acceleration of pension reform, the main objective of which should be identified as encouragement of individual responsibility for the provision of his old age. For this, we propose the following steps:

- Reduce preferential pensions.
- Gradually raise the pension age, which would reduce the burden imposed on the labor force and increase revenues of the Pension Fund.
- Increase the minimum number of work years necessary to receive a pension, and extend the term when the wage determines the pension size.
- Initiate the introduction of pension accounts and assist in developing non-state and professional pension funds.
- Lower the aggregate payroll tax and increase payments to the Pension Fund made by employees instead of employers. It is critical that both categories do not consider these payments as tax payments.

Lower income from wages may provoke a decrease in payments to the Pension Fund by enterprises and organizations, which will consequently decrease the income from wages.

...however, more open monetary and fiscal policy before the presidential elections will increase household income

However, more open monetary and fiscal policy on the eve of presidential elections will increase household income in the short-term. Partial payment of outstanding pensions and social arrears may become the actual factor that covers the shift in wage income. We expect real household monetary income to grow 2% in 1999.

Spending

Household consumption

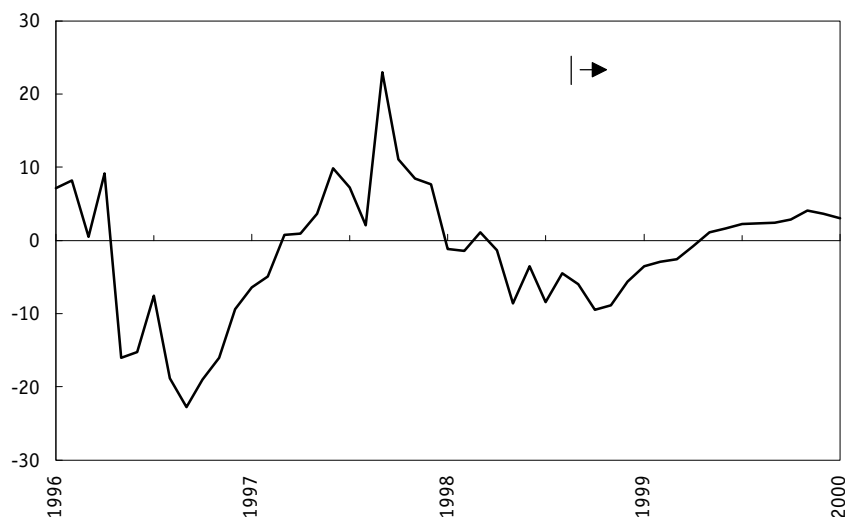
Real household consumption will witness a 5% decline in 1998

Real household consumption (purchase of goods and services) in 1998 will decline 5%, compared to 1997. The decline will be primarily due to lower household income.

During January and August household consumption saw a decline of 3.7% due to lower household income, and is expected to decrease even more by the end of the year. However, household consumption will decline less rapidly than household income because of a more rapid reduction in household savings — households will attempt to lessen the influence of reduced income on their consumption. Additionally, difficulties connected with exchanging hryvnias into foreign currency prompt households to store up on foodstuffs and non-food goods, which is a form of saving.

Real consumption

annual % change



Source: State Statistics Committee.

Calculations and forecast by Quarterly Predictions

During January and August the share of goods and services in the structure of consumption was 70% and 30% respectively. Even though household debt on utility payments is large (the utility portion in the structure of services is considerable and equals 1/4), services as a share of household consumption

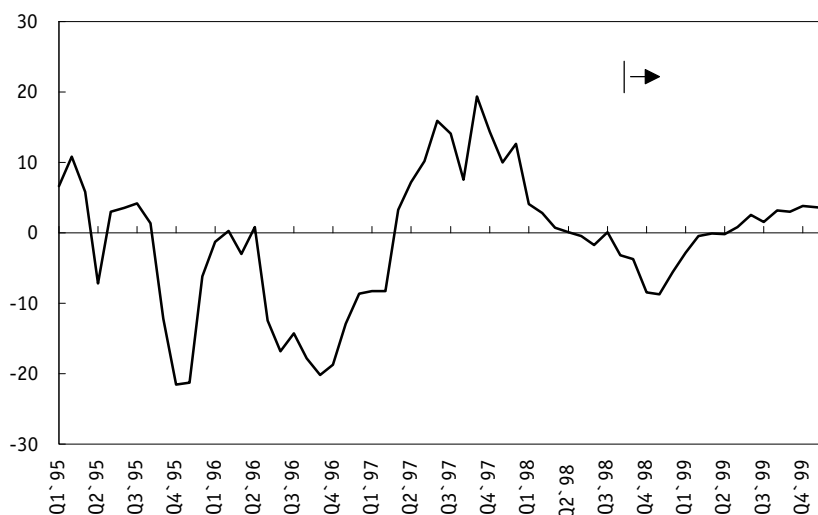
continue to grow. Currently, household arrears on utility payments are equal to UAH 3.173 billion, and the term of this debt is almost 10 months.⁴³

Retail sales

Real retail turnover increased 0.8% during the first half of 1998. However, this indicator deteriorated by 2.4% in the third quarter of 1998 compared to the respective period of 1997, mainly as a result of significant reduction in household income. In general, the retail turnover reduced by 0.6% during the first nine months of 1998.

Retail sales⁴⁴

annual % change to the respective month of the previous year



Source: State Statistics Committee.

Calculations and forecast by Quarterly Predictions

With regards to our expectations that household income will fall by the end of the year – which inevitably leads to a reduction in consumption – we forecast a 2% decline in retail turnover in 1998. However, a moderate rise of household income in 1999 means that households will be “back to shops”, which will increase retail sales by 1%.

Retail sales will decline in 1998, but in 1999 they will begin to grow again

Savings

Household savings will drop 45% in real terms in 1998, as compared to 1997. In 1997, the decline in real savings amounted to 3.8%. This reduction in savings is caused by a significant decline in household income. Therefore, households have to turn to savings of previous periods so as to smooth their consumption.

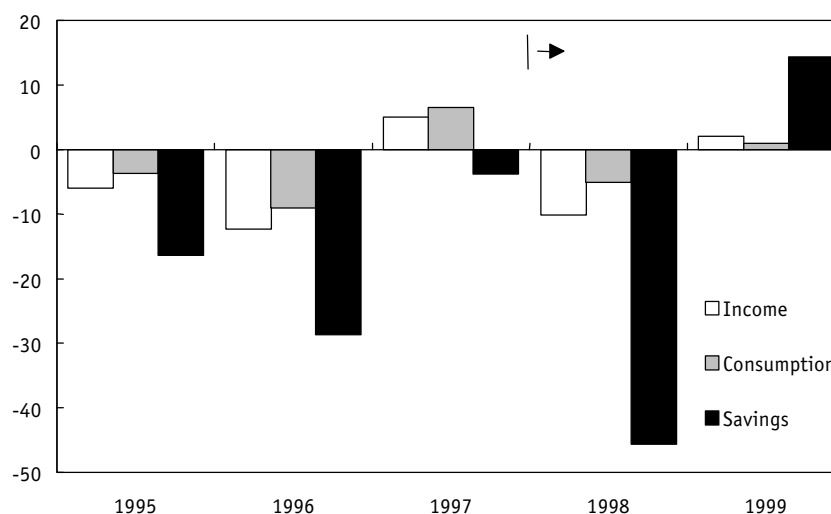
Savings will drop 45% in 1998

⁴³ Both household arrears on utility payments and budgetary subsidies to tariffs that are lower than should be considered as household income. Obviously, lower monetary household income will induce an increase in arrears on utilities. Therefore, a decrease in actual household income will be less than that in monetary income. Unfortunately, statistics cannot cover the income received by households in-kind from private land holdings, which usually grows during a period of recession.

⁴⁴ Retail sales means sales in shop networks, including the network of public catering. Sales in official food and sloshop markets and other unofficial markets are not included.

Household income, consumption and savings⁴⁵ in Ukraine

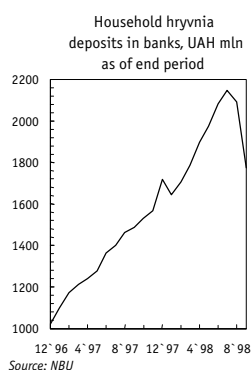
annual % change



Source: State Statistics Committee.

Calculations and forecast by Quarterly Predictions

Additionally, a significant devaluation of the hryvnia and frozen savings accounts in Russia led to a reduction in the share of household savings in the form of bank deposits. The growth in the share of savings in the form of time deposits dropped from 25%, reported for the period from January through September, to 3.3% for the period from January through September. Household savings in national currency fell by UAH 400 million during the last week of August and in September, and totaled UAH 1.773 billion by September 30.



⁴⁵ Savings are calculated as income (which was defined at the beginning of the chapter) minus consumption. Data reported by the State Statistics Committee allows for determining the three components: increase in cash hryvnias in hands; increase in foreign cash in hands; and increase in bank deposits and stock held by households

STATISTICAL APPENDIX

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1. Gross domestic product and gross national disposable income, 1995-1998

UAH, million	1995	1996	1 997	1998 (forecast)	
				previous	revised
Gross national disposable income	54 063	81 406	92 948	100 962	103 649
Gross domestic product	54 516	81 519	92 484	101 592	104 549
Net factor income	-747	-1 045	-1 110	-2 310	-3 000
Transfers	294	931	1 573	1 680	2 100
Absorption	56 290	83 572	95 346	104 998	107 099
Consumption	41 651	65 119	76 846	84 728	86 199
Private consumption	26 663	46 848	56 478	65 832	65 599
Public consumption	14 988	18 272	20 368	18 896	20 600
Investment	14 640	18 453	18 500	20 270	20 900
Private investment	13 257	17 395	17 575	18 746	19 855
Public investment	1 383	1 058	925	1 524	1 045
Net exports of goods and services	-1 774	-2 053	-2 862	-3 360	-2 550
Composition of GDP, % GDP				100.0	100.0
Consumption	76.4	79.9	83.1	83.4	82.4
Private consumption	48.9	57.5	61.1	64.8	62.7
Public consumption	27.5	22.4	22.0	18.6	19.7
Investment	26.9	22.6	20.0	20.0	20.0
Private investment	24.3	21.3	19.0	18.5	19.0
Public investment	2.5	1.3	1.0	1.5	1.0
Net exports of goods and services	-3.3	-2.6	-3.1	-3.3	-2.4
Gross national savings	22.8	20.0	17.4	16.0	16.7
Gross national disposable income		99.9	100.5	99.4	99.1

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

2. Budget revenue

% GDP

	1995			1996			1997			1998 (forecast),	1999 (government project of 23.10.98)		
	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	Conso- lidated	State	Local
Corporate profit tax	8.92	2.42	6.50	6.74	1.78	4.97	6.26	0.00	6.26	5.20	3.24	0.93	2.31
The Chernobyl Fund	1.88	1.88		1.83	1.83		1.84	1.84		1.10	0.55	0.55	
Income tax	2.93	1.35	1.58	3.18	1.52	1.66	3.56		3.56	3.60	3.37	1.00	2.37
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	6.70	7.85	7.85	0.00
Excise tax	0.75	0.56	0.19	0.79	0.67	0.13	1.31	0.80	0.51	1.20	2.65	2.00	0.65
Foreign economic operations	0.79	0.76	0.03	0.55	0.52	0.02	0.77	0.76	0.01	1.00	1.18	1.18	0.00
Privatization of state property	0.14	0.01	0.13	0.25	0.00	0.25	0.14	0.00	0.14	0.50	0.55	0.51	0.03
Local taxes and levies	0.23		0.23	0.35		0.35	0.39		0.39	0.40	0.44		0.44
Other revenue	6.33	4.65	1.69	6.88	5.09	1.79	7.22	4.97	2.25	8.80	8.11	5.17	2.94
Total revenue	37.95	22.10	15.85	37.07	23.63	13.44	30.40	17.27	13.12	28.50	27.94	19.20	8.74
Total revenue excluding the Pension Fund	30.27	14.41	15.85	28.24	14.81	13.44	30.40	17.27	13.12	28.50	27.94	19.20	8.74

Source: Finance Ministry. Forecast by Quarterly Predictions

3. Budget spending

% GDP

	1995			1996			1997			1998 (forecast)	1999 (government project of 23.10.98)		
	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	State	Local	Conso- lidated	Conso- lidated	State	Local
Social spending*	1.92	1.00	0.92	2.32	0.97	1.35	4.18	1.63	2.55	3.90	3.63	1.85	1.78
Education	5.38	1.38	4.00	4.92	1.36	3.56	5.44	1.34	4.11	4.10	3.56	1.13	2.43
Public healthcare	4.65	0.38	4.28	3.88	0.33	3.56	4.28	0.42	3.86	3.40	3.31	0.45	2.86
Science	0.44	0.44	0.00	0.60	0.60	0.00	0.63	0.63	0.00	0.30	0.44	0.44	0.00
Defense	1.66	1.65	0.00	1.50	1.50	0.00	1.88	1.88	0.00	1.30	1.44	1.43	0.00
Public administration	2.80	2.07	0.74	2.80	2.05	0.74	3.22	2.68	0.54	2.80	2.52	2.38	0.14
Foreign policy	0.23	0.23		0.22	0.22		0.18	0.18		0.20	0.45	0.45	
Economy**	11.71	5.09	6.62	9.96	5.51	4.45	8.28	5.41	2.87	7.40	3.98	3.62	0.36
Chornobyl disaster consequences	1.74	1.74		1.87	1.87		1.89	1.89		1.40	1.49	1.49	
The Pension Fund spending	7.56	7.56		8.87	8.87								
Foreign debt servicing	0.43	0.43	0.00	0.55	0.55	0.00	1.01	1.01	0.00	1.75	1.34	1.34	0.00
Domestic debt servicing	4.21	4.21	0.00	2.50	2.50	0.00	2.23	2.23	0.00	0.85	2.07	2.07	0.00
Other spending	1.85	0.89	0.96	1.94	1.17	0.77	3.87	3.00	0.87	3.40	4.29	2.88	1.41
Total spending	44.57	27.06	17.51	41.93	27.51	14.43	37.10	22.30	14.80	30.80	28.50	19.53	8.97
Spending excluding the Pension Fund	37.02	19.51	17.51	33.06	18.63	14.43	37.10	22.30	14.80	30.80	28.50	19.53	8.97
Deficit	6.62	6.80	-0.18	4.86	4.88	-0.01	6.70	6.82	-0.10	2.30	0.56	0.58	0.66
Financing sources													
domestic loans	0.00	5.40		1.93	1.93		5.35	5.35		1.70			
foreign sources	1.46	1.46		1.52	1.52		1.62	1.62		0.60			
NBU credits	5.40	0.00		1.65	1.65		0.00	0.00					

* excluding state price regulation ** including state price regulation

Source: Finance Ministry. Forecast by Quarterly Predictions

4. Indicators of the monetary policy, 1998

UAH million, as end of period, if not specified

	Monetary base	NBU's net international reserves		NBU's net domestic assets	Broad money	Currency in circulation	Household deposits	Commercial banks' claims on the economy	NBU's interventions in the UICE, \$ mln	Exchange rate, UAH/\$	NBU's gross reserves, \$	Government T-bill debt, (including interest)
		UAH mln	\$ mln									
12'97	7058.4	-33.19	-17.87	7091.6	12540.7	6132.5	1716.7	7938.5	...	1.899	2340	8761.6
1'98	6822.8	-706.40	-353.20	7529.2	12108.4	5924.8	1644.7	7472.6	...	1.930	2030	8914.9
2'98	6621.4	-874.34	-437.17	7495.8	12239.9	5825.6	1704.5	7670.5	275.50	2.0199	2004	9042.2
3'98	7095.1	-17.32	-8.66	7112.4	12959.9	6364.7	1787.0	7775.6	81.59	2.0385	2400	9079.8
4'98	7231.2	-651.24	-325.62	7882.4	12971.1	6355.2	1897.7	7872.8	146.44	2.0425	2196	9162.6
5'98	7060.9	-923.64	-461.82	7984.6	13294.7	6295.0	1975.5	7981.5	227.65	2.0573	2001	9159.7
6'98	7269.4	-1524.36	-762.18	8793.7	13457.7	6390.1	2081.8	8082.8	169.64	2.0647	1771	9722.5
7'98	7410.5	-1908.70	-924.98	9316.2	13879.8	6598.7	2148.3	8282.3	196.24	2.1349	1490	10258.3
8'98	7372.3	-3318.31	-1608.10	10690.6	13756.7	6383.7	2090.8	8460.4	265.61	2.2500	880	12088.8
9'98	7534.5	-3196.88	-1549.25	10731.4	14327.0	6310.9	1796.8	9758.9	26.49	3.4050	1080	13297.5
12'98 fore- cast	7800	-3000	-1400	10800	14200	6800	1800	3.5	1300	...

Source: NBU, Ukrainian News agency. Forecast by Quarterly Predictions

5. Consumer and wholesale prices, quarterly data, 1995-1998

% change to the previous period

	Consumer prices	foodstuffs	non-food products	services	Wholesale prices
Q1'95	50.7	—	—	—	49.9
Q2'95	15.2	—	—	—	20.8
Q3'95	24.0	—	—	—	20.7
Q4'95	19.9	—	—	—	15.2
Q1'96	19.7	13.5	8.6	39.5	9.2
Q2'96	3.2	0.2	2.7	8.2	2.7
Q3'96	7.8	-1.8	2.0	26.7	2.0
Q4'96	3.6	4.6	2.5	2.7	2.2
Q1'97	3.5	4.8	1.2	2.8	1.4
Q2'97	1.7	2.2	0.4	1.6	1.5
Q3'97	1.3	-0.5	0.7	1.7	0.8
Q4'97	3.2	4.7	0.9	1.9	1.4
Q1'98	1.7	2.5	0.1	1.2	2.4
Q2'98	1.3	2.8	0.1	5.3	0.7
Q3'98	3.1	3.8	2.6	4.1	11.0
Q4'98	14	12	4	18	10.0
1999	12	—	—	—	12.0

Source: State Statistics Committee. Forecast by Quarterly Predictions

6. Consumer and wholesale prices, monthly data, 1996-1998

% change to the previous period

	Consumer Price index			Wholesale Price Index		
	1996	1997	1998, forecast since October	1996	1997	1998, forecast since October
I	9.4	2.2	1.3	3.4	0.4	0.8
II	7.4	1.2	0.2	2.9	0.4	0.9
III	2.9	0.1	0.2	2.9	0.6	0.7
IV	2.4	0.8	1.3	1.5	0.9	0.5
V	0.7	0.8	0	0.8	0.3	0
VI	0.1	0.1	0	0.4	0.3	0.2
VII	0.1	0.1	-0.9	0.6	0.4	0.6
VIII	5.7	0	0.2	0.4	0	1.2
IX	2	1.2	3.8	1	0.4	9.4
X	1.5	0.9	6	0.1	1.1	4
XI	1.2	0.9	3.5	1.2	-0.2	2
XII	0.9	1.4	4.5	0.9	0.5	4

Source: State Statistics Committee. Forecast by Quarterly Predictions

7. Current account balance

\$ mln

	Trade in goods			Trade in services			Income	Transfers	Current account	
	Exports	Imports	Balance	Exports	Imports	Balance			Balance	% GDP
1994	13984	16469	-2575	2747	1538	1209	-344	547	-1163	-10
1995	14244	16946	-2702	2846	1334	1512	-434	472	-1152	-3.7
1996	15547	19843	-4296	4799	1625	3174	-572	509	-1185	-2.7
1997	15418	19623	-4205	4973	2268	2669	-644	845	-1335	-2.7
1998 (forecast)	14200	16400	-2200	3950	2600	1350	-1000	700	-1150	-3.3
1999 (forecast)	15000	16400	-1400	4200	3000	1200	-800	600	-400	-1.3

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

8. Output by industry

	1994	1995	1996	1997	1998 (forecast)	1999 (forecast)
Total industrial output	-27.3	-12.0	-5.1	-1.8	-1.2	-0.3
Energy	-12.5	-6.0	-6.9	-2.6	0.0	-1.0
Fuel industry	-17.2	-9.7	-6.7	4.5	0.0	-2.0
Ferrous metals	-28.8	-4.6	11.9	7.7	-7.0	1.0
Non-ferrous metals	-26.3	-3.5	8.0	2.7	10.0	0.0
Chemicals and oil refining	-25.5	-9.1	-3.4	-0.6	3.0	-2.0
Machine building and metal processing	-38.3	-23.9	-26.1	-3.6	-4.0	-5.0
Wood processing	-32.8	-17.4	-18.6	-5.1	8.0	1.0
Construction materials	-37.0	-28.0	-34.2	-7.9	5.0	0.0
Light industry	-46.8	-32.6	-24.6	-5.2	2.0	3.0
Food industry	-18.4	-12.6	-7.2	-14.6	3.0	5.0

Source: State Statistics Committee. Forecast by Quarterly Predictions

9. Investment by components

UAH million

	1993	1994	1995	1996	1997	1998 (forecast)	1999 (forecast)
Gross fixed capital investment	360	2833	12692	16891	16902	19300	21840
of those, capital investment	293	2299	9378	10489	12753	14600	16480
Gross fixed capital investment, % GDP	24.3	23.5	23.3	20.7	18.3	18.5	19
Change in inventory	178	1420	1855	1590	1702	1600	1200
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	1.5	1
Gross investment	538	4253	14547	18481	18604	20900	23600
Gross investment, % GDP	36.3	35.3	26.7	22.65	20.14	20	20
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

10. Animal husbandry production

January - July 1998 against January - July 1997

	Total			Collective farms			Private farms		
	January - July 1997	January - July 1998	change, %	January - July 1997	January - July 1998	change, %	January - July 1997	January - July 1998	change, %
Cattle and poultry for slaughter, thousand tonnes (live weight)	1641.5	1392.0	-15.2	661.9	448.4	-32.3	979.6	943.6	-3.7
Egg production, thousand	5587.4	5604.1	0.3	1924.5	1841.7	-4.3	3662.9	3762.4	2.7
Cattle production, thousand heads	14708.7	13264.7	-9.8	10451.9	8918.4	-14.7	4256.8	4346.3	2.1
Cow production, thousand heads	6753.8	6229.4	-7.8	3728.7	3178.8	-14.7	3025.1	3050.6	0.8
Swine production, thousand heads	10258.5	10421.4	1.6	4562.5	4430.2	-2.9	5696.0	5991.2	5.2
Poultry production, thousand heads	154885.4	167867.2	8.4	35958.2	39923.9	11.0	118927.2	127943.3	7.6
Diary production, thousand tonnes	8225.1	8262.4	0.5	3383.7	3332.7	-1.5	4841.4	4929.7	1.8

Source: State Statistics Committee

11. Share of private farms in animal husbandry

January - July 1998 against January - July 1997

	January - July 1997				January - July 1998				change, %
	Total	Collective	Private	Share	Total	Collective	Private	Share	
Cattle and poultry for slaughter, thousand tonnes (live weight)	1641.5	661.9	979.6	60	1392.0	448.4	943.6	68	8
Egg production, thousand	5587.4	1924.5	3662.9	66	5604.1	1841.7	3762.4	67	2
Cattle production, thousand heads	14708.7	10451.9	4256.8	29	13264.7	8918.4	4346.3	33	4
Cow production, thousand heads	6753.8	3728.7	3025.1	45	6229.4	3178.8	3050.6	49	4
Swine production, thousand heads	10258.5	4562.5	5696.0	56	10421.4	4430.2	5991.2	57	2
Poultry production, thousand heads	154885.4	35958.2	118927.2	77	167867.2	39923.9	127943.3	76	-1
Diary production, thousand tonnes	8225.1	3383.7	4841.4	59	8262.4	3332.7	4929.7	60	1

Source: State Statistics Committee

12. Labor market

Thousand people, as of year end

	1992	1993	1994	1995	1996	1997	1998 (forecast)	1999 (forecast)
Population components								
Total population	—	—	51700	51500	51100	50500	50200	50000
Population growth rate (annual % change)	—	—	—	-0.39	-0.78	-1.17	-0.59	-0.40
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	21300
Employed in sectors of the economy	23269	23427	21193	21962	20868	19835	19000	17300
Individual entrepreneurship	74	518	846	1764	2364	2763	3000	4000
Unemployment	71	84	82	127	351	637	950	1350
Change in unemployment	—	13	-2	45	224	286	313	400
Unemployment rate (% in able-bodied population of working age)	0.3	0.3	0.3	0.46	1.27	2.27	3.5	5
Unemployment rate (% in able-bodied population of working age)	—	—	—	5.62	7.6	8.9	—	—

Source: State Statistics Committee. Forecast by Quarterly Predictions

13. Wages

		Average wage, ¹ UAH	Quarterly change, ² %	Annual change, ³ %	Annual average change, ⁴ %
1993	March	0.2	-51.4	-16.1	-15.1
	June	0.4	-7.0	-42.4	-42.2
	September	1.5	13.6	-33.2	-33.8
	December	4.9	-24.5	-61.2	-61.3
1994	March	8.6	-10.0	-28.2	-28.2
	June	10.7	3.7	-20.0	-19.9
	September	13.2	11.6	-21.4	-18.1
	December	28.9	6.3	10.7	14.5
1995	March	45.6	-20.0	-1.6	-1.3
	June	68.9	21.2	15.0	14.9
	September	90.4	10.8	14.2	14.2
	December	116.7	0.8	8.3	9.9
1996	March	121.6	-14.3	16.1	16.6
	June	133.1	2.0	-2.4	-1.9
	September	144.3	3.4	-8.9	-8.8
	December	152.2	-0.5	-10.0	-9.9
1997	March	142.0	-8.9	-4.4	-4.4
	June	152.8	6.0	-0.7	-0.7
	September	162.8	5.6	1.5	1.5
	December	167.2	-0.1	1.8	1.9
1998	March	157.2	-8.4	2.4	2.4
	June	166.1	4.1	0.5	0.5
	September	170.2	2.0	-2.9	-2.9
	December	194.4	0.6	-2.2	-2.2
1999	March	195.1	-5.6	0.8	0.8
	June	208.1	4.9	1.6	1.6
	September	217.5	3.2	2.8	2.8
	December	226.1	0.6	2.7	2.8

Source: State Statistics Committee. Forecast by Quarterly Predictions

¹ An average value of monthly nominal wages of a quarter.

² The ratio of an average real quarterly wage to that of the previous quarter.

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

⁴ An average value of monthly annual nominal wages of a quarter.

14. Household income and spending

UAH mln

	1992	1993	1994	1995	1996	1997	1998 (forecast)	1999 (forecast)
Money household income	22.9	638	5175	22891	37618	44579	45847	57424
Wages	16.5	364	3310	15776	23723	27340	—	—
Pensions	—	—	—	—	—	10072	—	—
Proceeds from sales of agricultural products	1.1	32	152	668	1081	1493	—	—
Scholarships	—	—	—	—	111	138	—	—
Other income	5.3	243	1713	6447	12703	5536	—	—
Obligatory payments and voluntary contributions	2.4	69	602.6	2292	3918	6233	7626	10350
Disposable income	20.5	569	4573	20599	33700	38346	38221	47074
Annual change, % ⁵	—	-22.1	-33.8	-6.3	-12.3	5.1	-10	2
Consumption	14.4	431	3724	17234	27679	33558	35284	43064
Purchase of goods	13.3	390	3197	13739	19555	23561	—	—
Payment for services	1.1	41	527	3428	7895	9506	—	—
Other expenditures	—	—	—	67	229	491	—	—
Annual change, %	—	-18	-26.4	-3.6	-9	6.5	-5	1
Savings	6	138	809	3364	6021	4788	2937	4010
Increase in savings in the form of deposits and stock	1.2	23	157	408	2436	1115	—	—
Increase in savings in hryvnias	4.8	116	651	1764	1350	2100	—	—
Increase in savings in foreign currency	—	—	—	1192.0	2235	1573	—	—
Annual change, %	—	-31.5	-53.9	-16.3	-28.6	-3.8	-45	15
Savings as a share of disposable income marginal propensity to save	29.2%	24.3%	17.7%	16.3%	17.9%	12.5%	7.7%	8.5%

Source: State Statistics Committee. Forecast by Quarterly Predictions

⁵ Annual change, % — change in real indicators during the year to the previous year. Real indicators are adjusted by Consumer Price Index.

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