quarterly predictions

#25, fourth quarter 2003

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MAJOR INDICATORS

Year / Indicator	1996	1997	1998	1999	2000	2001	2002	2003 (est.)	2004 (forecast)	2005 (forecast)
Economic activitv										
GDP, *billions UAH*	81.5	93.4	102.6	130.4	170.1	204.2	220.9	257.7	293.7	330.0
Real GDP, *apc**	-10.0	-3.0	-1.9	-0.2	5.9	9.2	4.8	8.0	6.5	6.0
Real industrial output, *apc*	-5.1	-0.3	-1.0	4.0	13.2	14.2	7.0	15.5	8.0	7.0
Real agricultural output, *apc*	-9.5	-1.9	-9.8	-5.7	7.6	10.2	1.2	-11.4	7.0	4.5
Gross investment, *% GDP*	22.7	21.5	20.7	17.4	19.7	21.8	19.0	21.7	22.1	22.9
Real gross fixed investment, *apc*	-25.7	2.1	2.6	0.0	12.4	6.2	4.9	20.0	8.0	10.0
Net FDI, *millions USD*(1)	526	581	747	489	594	769	698	1,100	1,000	1,200
Real disposable household income, *apc*(2)	-12.3	5.1	-5.8	1.2	11.1	14.5	17.8	6.5	6.0	6.0
Real retail trade, *apc*	-11.1	8.2	-3.5	-4.8	7.5	11.7	14.8	19.0	12.0	12.0
Prices										
Consumer price index, *apc*	39.7	10.1	20.0	19.2	25.8	6.1	-0.6	8.5	6.0	6.5
Producer price index, *apc*	17.3	5.0	35.3	15.7	20.8	0.9	5.7	10.0	5.0	6.0
Labor market										
Population, *millions*	51.1	50.5	50.1	49.7	49.3	49.0	48.0	47.6	47.3	47.0
Real wages, *aapc***	-2.5	-0.4	-2.8	-5.7	1.0	20.9	21.8	23.1	12.0	10.0
Unemployment rate (ILO methodology), %	–	–	–	11.9	11.5	11.0	10.0	9.2	9.0	8.8
Foreign economic activity										
Exports of goods&services, *apc*	19.1	0.0	-13.4	-7.3	18.0	8.0	10.7	23.0	8.0	4.0
Imports of goods&services, *apc*	17.1	-2.0	-14.0	-19.1	17.8	14.1	5.0	27.0	9.0	6.0
Current account balance, *% GDP*	-2.7	-2.7	-3.1	3.0	4.0	3.7	7.7	6.2	4.6	3.0
Budget										
Revenues (consolidated), *% GDP*(3)	28.0	30.0	27.3	24.7	26.2	25.7	27.7	28.0	27.0	27.5
Balance, *% GDP*(3)	-3.2	-5.6	-2.7	-2.4	-0.8	-1.5	0.7	0.2	-1.5	-0.5
Financial indicators										
Monetary base, *apc*	38	45	22	39	39	37	34	30	30	20
M3, *apc*	35	34	25	41	45	42	42	46	40	25
NBU gold/forex reserves, *millions USD*	1,972	2,359	793	1,094	1,475	3,089	4,417	7,000	9,000	11,000
Official exchange rate (average annual), *UAH/USD*	1.83	1.86	2.45	4.13	5.44	5.37	5.33	5.33	5.33	5.32
Loan interest (average annual), *% pa*(4)	77	49	55	53	40	32	25	18	18	16.5
Global economy										
Global GDP, *apc*	4.0	4.2	2.8	3.6	4.8	2.4	3.0	3.0	3.8	4.1
GDP of Ukraine's major trading partners (2/3 of exports), *apc*	1.2	3.1	0.9	2.7	5.7	2.4	3.8	3.9	4.0	3.9

* *apc* = annual percentage change   ** *aapc* = average annual percentage change

Notes: (1) according to the NBU; (2) starting in 2002, indicator of aggregate household disposable incomes; (3) calculated by IMF methodology; (4) commercial bank loans, UAH.

Source: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by Quarterly Predictions.

OVERVIEW

The Government of Ukraine failed to benefit from favorable conditions in 2003 to undertake serious reform of the public sector. Tax and pension reforms launched in early 2003 ran aground by H2'03. Nor are reforms likely to pick up in 2004, with government resources and attention diverted by an election campaign. In 2005, a new government should initiate economic reforms, but their positive effect will be felt somewhat later. Conditions should remain conducive to reforms throughout 2004–2005: economic growth will continue, though at a slower pace, slipping from 8% to 6%

The state of reforms

The Government failed to benefit from favorable economic conditions to deepen public sector reforms

The Government failed to benefit from favorable conditions in 2003—an economic upturn, a positive global economic situation, and rapprochement with the EU, the US and international organizations—to undertake radical reforms of the public sector. Following a flurry of tax and pension reforms in H1'03, the quality of transformations worsened:

- The switch from benefits to targeted financial assistance, reforms in the housing and public utility sector, fuel and energy complex, and other sectors dominated by the state, either went very slowly or never started at all;
- Although it is a key factor behind the shadow economy, the system of mandatory payments into social funds stayed in place;
- No mechanism was developed to resolve the failure to reimburse VAT to exporters;
- Tax breaks were cut back unsystematically and without warning;
- Corporate and property rights were not given more protection of law.

The fatal flaw in the work of the current Government is its lack of a coordinated reform plan, which results from the absence of a common strategy.

Indeed, the Government even began to back away from changes already achieved. In particular, the 2004 Budget does not include several important pension reform measures that are already in the new law on pension insurance. In addition, Government policy in 2003 often led to greater state interference, which gets in the way of the development of private initiatives. Notably, UkrZaliznytsia, the state railway corporation, and the State Customs Service actively undermined the export of oil products in an effort to stop politically sensitive price rises, while the Cabinet set up obstacles to the export of coke coal and scrap metal. Worse, the Government and local administrations took a long time to decide how to set prices for bread, rather than to pay attention to the situation at Derzhreserv, the state reserves committee, and sign timely procurement contracts for grain imports to Ukraine.

Economic growth should continue to be high

In the meantime, continuing favorable external conditions, a stable financial situation, and the willingness of top officials to continue privatizing large-sized enterprises and to complete those reforms already begun, make it likely that the economic upturn will continue apace.

*Highlights of **quarterly predictions** No. 25*

- *Three major political scenarios in Ukraine for 2004*
- *Implications of European Union enlargement and a Common Economic Area free trade zone for Ukraine's foreign trade*
- *Costs and benefits of state regulation in the grain and foodstuff markets*
- *Reasons behind unbalanced investment in certain sectors*
- *Reasons for a slowdown in the growth of personal incomes*
- *Analysis of items in the 2004 State Budget*
- *Is increasing the GDP share re-distributed via the Budget a sensible state policy goal?*
- *Tariff policy as a short-term Government solution*
- *The merits of setting up a wholesale steam coal market body*
- *Farm operations in Ukraine: problems and prospects*
- *Biodiesel production: how promising is it for Ukraine?*
- *Is it possible today to control the fall of the dollar in world markets?*

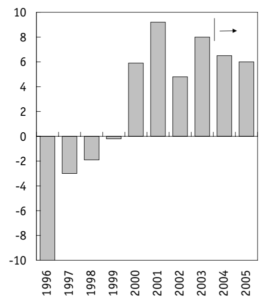
Economic trends in 2003

Expanding foreign trade and investment activity are key drivers of a dynamic economy

After slipping to 5% in mid-year because of a sharp downturn in the farm sector (see **AGRICULTURE**), the economy accelerated again towards the end of the year, resulting in a growth rate of 7.7% over January–November 2003. Growth factors remained the same: expanding foreign trade and growing domestic demand. Construction grew the fastest, rising an estimated 25% for the year, thanks to corporate capital investment. Industrial growth accelerated to 15.5%, chiefly due to growth in machine-building, food-processing, chemicals and steel. The ICPS estimate is that real GDP grew 8% over 2003.

In 2003, Ukraine's real GDP grew 8%

GDP, real % change



Source: Derzhkomstat; forecast by Quarterly Predictions.

The NBU reports that, over the first nine months of 2003, exported goods jumped 26% y-o-y, and imported goods 30%. Over this period, the export of services increased by almost 13%, although imports remained flat. This trend retained to the end of the year.

Foreign trade volumes grew rapidly, not only because of a rise in the export of raw materials and partly processed products, but also because of high growth in the export of equipment and machinery (according to ICPS estimates, 35% over 2003), especially vehicles (55%). Imports grew not only in response to growing industrial energy needs, but also due to a growing influx of goods to supply investment (see **FOREIGN TRADE**).

Lively exports fostered greater openness in the Ukrainian economy: the export/GDP ratio reached 60%. In other words, the national economy is becoming increasingly sensitive to external market conditions. This is evident in two trends: (1) heightened risk of a weaker economic dynamic if major export markets begin to deteriorate; and (2) intensified development of the domestic market.

A key factor in accelerating economic growth from 4.8% last year to 8% was a sharp increase in investment. The ICPS estimate is that investments rose to a record-high 20% in 2003. The impulse behind rising investments seems to be an improved current account situation at enterprises and optimistic expectations of economic growth in the next few years. Traditionally, enterprises have largely used their own capital as an investment source. As a result, the increase in corporate profits observed in 2003 (see **BUSINESS**) dramatically expanded investment opportunities for domestic business. Still, sectoral analysis of investments shows both unbalanced and inconsistent investment activity. Thus, positive trends in revived production capacity remain unstable and are not expanding to the rest of the economy.

In 2003, consumer demand grew by 10%, due to several key factors: (1) increased personal incomes; (2) better economic expectations than the previous year; and (3) more active use of accumulated savings (see **HOUSEHOLDS**).

Despite growing inflation, macrofinancial indicators remain stable

Continuing financial stability has also helped keep economic trends strong. A high balance of payments (over US $3 billion annually) has stimulated hard currency inflows into the country (see **FOREIGN TRADE**). This kept the hryvnia exchange rate stable, which the National Bank has virtually pegged at 5.33 to the US dollar (see **MONETARY POLICY**). Meanwhile, in the light of a weakening dollar worldwide (see **WORLD ECONOMY**), as well as growing inflation in Ukraine's main trading partner, Russia, the hryvnia is perceptibly depreciating[1] in real terms, which mostly boosts the competitiveness of Ukrainian exports.

Price and exchange rate stability has been helped by 100% fulfillment of Budget revenues (see **PUBLIC FINANCE**). This should have made it possible for the Government to fully finance Consolidated Budget spending, but because local budgets switched to having their expenditures serviced by the Treasury, it has not happened. Both local budgets and the special State Budget fund have been underfinanced, while expenditures in the general fund have been covered nearly 100%.

A high budget surplus led to a liquidity crunch on the interbank market

Over the year, the Budget surplus hit 2% of GDP, becoming one of the causes behind a liquidity crunch on the interbank market that peaked in mid-November (see **MONETARY POLICY**). Better administration of Budget revenues coupled with industrial output and import growth rates higher than GDP pushed the share of GDP re-distribution through the budget to 28%. Better fulfillment of the revenues part than the expenditures portion reflected the accumulation of large sums of money in the Treasury. As a result, the 2003 Consolidated Budget should show a 0.2% GDP surplus.

Inflation grew at year-end

In autumn 2003, prices began to climb sharply. This burst of inflation was largely due to increased production costs for flour, bread and meat because of the higher cost of imported grains, as well as to partial price liberalization for flour and baked goods during October–November[2] (see **PRICES**). Price rises were also triggered by an overheating economy. According to preliminary estimates, consumer prices will have increased 8.5% by YE'03.

In a bid to curb inflation and demand for hard currency, the National Bank resorted to even tighter monetary policy (see **MONETARY POLICY**). This led to a leveling-out of demand and supply on the interbank forex market, and dampened the rate of lending volumes. According to ICPS estimates, bank deposits and credit portfolios grew roughly equally at 60% in 2003.

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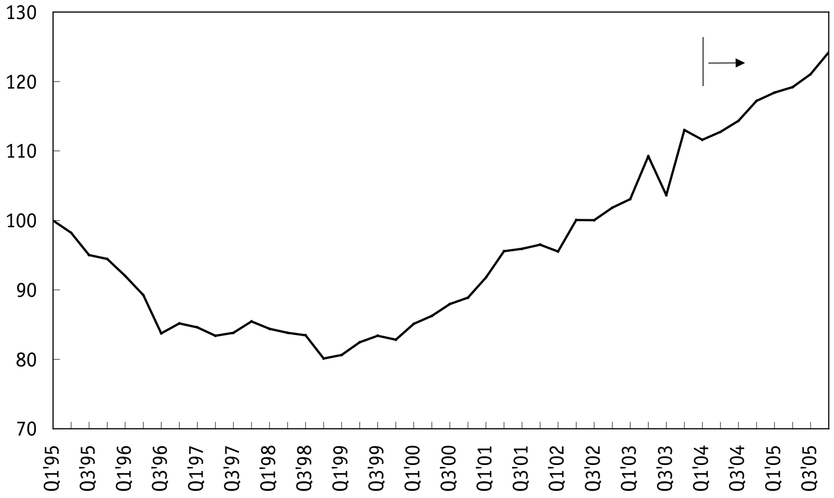
[1] According to ICPS calculations, the effective hryvnia exchange rate declined 15% over January–September 2003.

[2] At YE'03, the majority of oblasts canceled the price limits on basic grains set during the summer, leaving price controls only on "social" grades, that is, the most important basic bread-making grades (which, according to ICPS estimates, account for less than half the output of baked goods), and restricted the profit margins of bakeries to 5%. Over 2003, prices for flour and breads grew by 75% and 36%, respectively.

Figure 1. Real GDP index, seasonally adjusted

Q1'95=100



Source: Derzhkomstat; calculations and forecast by Quarterly Predictions.

Forecast for 2004

The pro-Administration coalition will control the legislature and executive till October 2004

Prospects for reform initiatives are fairly pessimistic. According to ICPS assumptions, the pro-Administration coalition will retain control of the Verkhovna Rada and the Government till October 2004 (see **POLITICAL ENVIRONMENT**). Moreover, the composition of the coalition and their majority in the Cabinet will remain unchanged, although individual ministers may well be reshuffled.The quality and effectiveness of policy pursued by the ruling coalition will remain lacking, and urgent reforms will be shelved until the election. On the one hand, this Government simply does not understand their importance; on the other, there is no effective planning and pressure from influential business groups. Such reforms are likely to be started up only in 2005, though their pace and quality will depend on who is the new Head of State.

The forecast for economic growth in 2004 remains unchanged at 6.5%

As predicted earlier, in 2004 Government activity will likely be aimed at stimulating consumption and completing those reforms already launched, not at investment or new, unpopular reforms. This will help to keep GDP growth high, although it will no longer be supported by the same improving external economic situation as in 2003 (see **FOREIGN TRADE**). Therefore, ICPS leaves its forecast for real GDP growth of 6.5% in 2004 unaltered.

A slower growth rate of real personal incomes at the end of 2003 will cause the growth of consumption to slip next year from 10% to 9% (see **HOUSEHOLDS**). Investment growth will go into a downspin, plunging from 20% to 8% (see **BUSINESS**), which can be attributed to: (1) the presidential election; (2) a downturn in export growth; and (3) a slowdown in commercial lending.

Prior to the election, the Government is likely to stimulate consumption and increase Budget expenditures, up to 28.5% of GDP, in order to fulfill social commitments. Cuts in the corporate profit and personal income tax rates will put downward pressure on Budget revenues, which will slip from 28% to 27% of GDP in 2004 (see **PUBLIC FINANCE**). The Government will manage to finance a Budget deficit of 1.5% of GDP mostly at the expense of external borrowings and through privatization. However, rising interest rates in top world economies (see **WORLD ECONOMY**) and shrinking inflation in Ukraine (see **PRICES**) will spur the Government to revive the moribund domestic T-bill market.

2004 will see a stable hryvnia and less inflation

The emphasis on macrofinancial stability will persist. In anticipation of a better harvest in 2004, price growth should drop to 6% y-o-y. The National Bank will continue to support a stable UAH/USD exchange rate.

EU enlargement is the main external challenge of the near future

The major challenge for Ukraine's foreign economic policy in 2004 will be the expansion of the European Union. Ten more countries will soon adopt the EU's common foreign economic policy, which will dramatically affect Ukrainian exports to these countries. The positive effects of liberalized customs duties will be outweighed by non-tariff restrictions—which, according to ICPS calculations, will annually cost Ukraine US $320–340 million in exports to accession countries during 2004–2005 (see **FOREIGN TRADE**).

Forecast for 2005

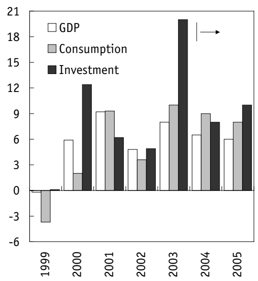
Real GDP growth in 2005 should be 6%

The impact of foreign trade on the economic upturn will fade

The ICPS forecast for real GDP growth in 2005 remains unchanged at 6%. The main factor behind the slowdown will be a deteriorating situation in markets for Ukrainian exports, primarily Asian countries. This, in turn, will cause foreign trade growth to shrink (see **FOREIGN TRADE**) and industrial trends to fall off (see **INDUSTRY**).

The major factor behind the growth will remain domestic consumer demand. The growth rate of real consumption will remain unchanged at 8%, thanks to growing personal incomes (see **HOUSEHOLDS**).

Dynamic of GDP components, real % change



Source: Derzhkomstat; forecast by Quarterly Predictions.

Demand for investment will remain unstable. The expansion of domestic markets is likely to bring about a high investment rate in light industry and food processing. At the same time, a worsening external situation will likely stall investment in export-oriented sectors such as metallurgy and metal processing. A end to the election effect should spur renewed investment growth, whose rate could reach 10% in real terms in 2005 (see **BUSINESS**). Net foreign direct investment should rise to US $1.2 billion, driven chiefly by further economic liberalization.

Monetary pressure on prices is not likely to increase, given a drop in the balance of payments' current account to US $1.8 billion. Softened price regulation will stimulate inflation to grow slightly—to 6.5% at year-end (see **PRICES**). Lowered restrictions on currency operations prior to Ukraine's accession to the WTO should trigger greater fluctuations on the forex market (see **MONETARY POLICY**). In light of a continuing relatively high balance of payments, there could be a minor upward adjustment in the nominal value of the hryvnia, although real depreciation will continue to stimulate exports.

Forecast risks

The closer the presidential election, the higher the risks for doing business in Ukraine

As the presidential election approaches, the first round of which is scheduled for 31 October 2004, doing business in Ukraine becomes riskier. An intense struggle for the top office could prompt the Administration to attack the businesses of its rivals during the election campaign, which will increase the risk of a forced redistribution of property. This, in turn, will cause businesses to postpone investment decisions until 2005. The need for populist pre-election social outlays will make it impossible for the country to pursue a reasonable monetary policy in H2'04. It is safe to assume that the ruling coalition will resort to illegal tactics to hold onto power (see **POLITICAL ENVIRONMENT**), which could radicalize the domestic political situation and isolate Ukraine from the West.

STATISTICAL APPENDIX

The ***quarterly predictions*** group was established in September 1997 by the International Centre for Policy Studies, in cooperation with the New Zealand Institute of Economic Research.

The ***quarterly predictions*** journal presents our forecast of Ukraine's economic performance, based on comprehensive research of all its sectors. These forecasts are estimations based on the information available up to the stipulated date. This issue was prepared using information available as of 15 December 2003.

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