

quarterly predictions

#26, first quarter 2004

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MAJOR INDICATORS

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Indicator							(est.)	(forecast)		
Economic activity										
GDP, billions UAH	93.4	102.6	130.4	170.1	204.2	225.8	264.2	315.3	357.5	405.5
Real GDP, <i>apc</i> *	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	10.0	8.0	7.0
Real industrial output, <i>apc</i>	-0.3	-1.0	4.0	13.2	14.2	7.0	15.8	13.0	9.0	8.0
Real agricultural output, <i>apc</i>	-1.9	-9.8	-5.7	7.6	10.2	1.2	9.9	9.0	3.0	3.5
Gross investment, % GDP	21.5	20.8	17.5	19.8	21.8	20.2	20.3	21.9	22.5	23.7
Real gross fixed investment, <i>apc</i>	2.1	2.6	0.1	12.4	6.2	3.4	15.8	14.0	14.0	10.0
Real consumption, <i>apc</i>	-1.8	-0.1	-3.7	2.0	9.3	5.0	12.8	12.0	7.7	7.8
Net FDI, millions USD ⁽¹⁾	581	747	489	594	769	698	1,411	1,600	1,800	2,000
Real disposable household income, <i>apc</i> ⁽²⁾	5.1	-5.8	1.2	11.1	14.5	17.8	5.8	7.5	6.0	6.0
Real retail trade, <i>apc</i>	8.2	-3.5	-4.8	7.5	11.7	14.8	19.4	17.0	12.0	12.0
Prices										
Consumer price index, <i>apc</i>	10.1	20.0	19.2	25.8	6.1	-0.6	8.2	6.0	7.0	4.5
Producer price index, <i>apc</i>	5.0	35.3	15.7	20.8	0.9	5.7	11.1	12.0	7.0	5.0
Labor market										
Population, millions	50.5	50.1	49.7	49.3	49.0	48.0	47.7	47.3	47.1	46.9
Real wages, <i>aapc</i> **	-0.4	-2.8	-5.7	1.0	20.9	21.8	24.0	12.0	10.0	10.0
Unemployment rate, % (ILO methodology)	-	-	11.9	11.7	11.1	10.1	9.1	9.0	8.8	8.8
Foreign economic activity										
Exports of goods&services, <i>apc</i>	0.0	-13.4	-7.3	18.0	8.0	10.7	24.0	12.7	5.0	4.0
Imports of goods&services, <i>apc</i>	-2.0	-14.0	-19.1	17.8	14.1	5.0	28.7	14.5	6.0	7.0
Current account balance, % GDP	-2.7	-3.1	3.0	4.0	3.7	7.7	5.8	4.4	3.2	1.2
Budget										
Revenues, % GDP (consolidated) ⁽³⁾	30.0	27.3	24.7	26.2	25.7	27.7	28.5	27.0	27.5	27.5
Balance, % GDP ⁽³⁾	-5.6	-2.7	-2.4	-0.8	-1.5	0.7	-0.2	-1.5	-0.5	-1.0
Financial indicators										
Monetary base, <i>apc</i>	45	22	39	39	37	34	30	30	21	14
M3, <i>apc</i>	34	25	41	45	42	42	47	38	28	20
NBU gold/forex reserves, millions USD	2,359	793	1,094	1,475	3,089	4,417	6,937	9,050	11,100	12,450
Official exchange rate, UAH/USD (average annual)	1.86	2.45	4.13	5.44	5.37	5.33	5.33	5.33	5.32	5.36
Loan interest, % <i>pa</i> (average annual) ⁽⁴⁾	49	55	53	40	32	25	18	18	17	15
Global economy										
Global GDP, <i>apc</i>	4.2	2.8	3.6	4.8	2.4	3.0	3.9	4.1	3.7	2.9
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	3.1	0.9	2.7	5.7	2.4	4.0	4.5	4.7	4.1	3.4

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

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

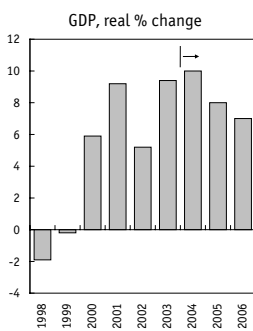
Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by Quarterly Predictions

OVERVIEW

Ukraine continues to see accelerated economic growth, with rates that have even hit 11%. Such record-high growth figures have led to a certain euphoria, which is not conducive to serious reforms—especially in the public sector. ICPS expects that the reform process will be largely on hold through 2004, and that the Government will be putting most of its efforts into the election campaign. Yet the conditions for instituting economic reforms will remain favorable: despite a slight deterioration in the situation on world commodity markets in 2005–2006, real GDP growth rates will remain high. A moderate slowdown in economic growth can be expected over 2004–2006, as the rate slips from 10% to 7%

Economic dynamics

In 2004, Ukraine's real GDP grew by a record-high 9.4%



Source: Derzhkomstat; forecast by Quarterly Predictions

The economic growth that started in 2000 in Ukraine continues to steam ahead. According to preliminary calculations from Derzhkomstat, the state statistics committee, real GDP growth jumped to a record-high 9.4% in 2003 and hit 10.8% over Q1 of 2004. In the last while, construction, processing and trade have grown the fastest. The economic boom has been accompanied by record-high growth in indicators for: (1) bank lending portfolios (61% in 2003 vs 47% in 2002); (2) net influx of FDI (US \$1.4bn in 2003 vs US \$0.7bn in 2002); (3) goods and services exports (24% vs 11%); and (4) retail turnover (19.4% vs 14.8%).

Ukraine's economy has heated up for a number of reasons:

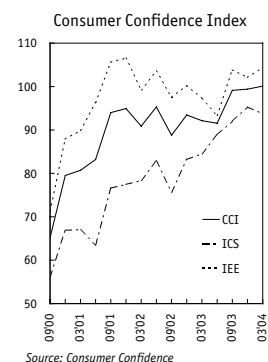
- **WIDESPREAD ACCEPTANCE OF NEW MARKET CONDITIONS.** Ukrainians are participating more and more in the market distribution of labor, which has contributed to lower unemployment rates (see **LABOR**) and growing positive expectations of economic development.¹ The financial crisis of 1998 had a strong psychological impact on average Ukrainians, further diminished their trust in state institutions² and forced people to rely on themselves, their relatives and their employers to resolve pressing economic problems in their own homes.
- **A FAVORABLE SITUATION ON WORLD COMMODITY MARKETS.** This applies first of all to the main Ukrainian export products, metals and chemicals: prices for these have gone up on average 30–50% over the past three years. Unexpected growth in oil prices (see **PRICES**) has contributed to accelerated economic growth in the Russian Federation, Ukraine's key trading partner (see **WORLD ECONOMY**), which has spurred demand for Ukrainian com-

¹ The Index of Expected Economic Conditions in the Country Over the Next Year, which is jointly calculated by ICPS and GfK-USM, rose from 79.6 in March 2001 to 101.5 in March 2004. As a result, the Index of Expected Economic Conditions in the Country Over the Next Five Years has grown from 95.4 to 104.7 over the same period.

² According to a poll by Taylor-Nelson-Sofres Ukraine and the Democratic Initiatives Fund, in March 2004, all government institutions had negative trust indicators: the Verkhovna Rada was at -46, the president at -41, the Cabinet of Ministers at -39, the police at -33, the judiciary at -26, prosecutor's offices at -25, the SBU at -7, and the Armed Forces at -2. The balance of trust/distrust is calculated as the difference between total trust and total distrust.

modities from Russian enterprises, especially for machinery (see **FOREIGN TRADE**). In addition, Ukrainian oil refineries increased their output of petroleum products (see **INDUSTRY**) to augment exports to Europe.

- **ENLIVENED PRIVATIZATION.** For the first time in recent years, the State Property Fund fulfilled the State Budget plan for privatization revenues, raising UAH 2.15bn in 2003. The interests of big business, which wants to maximize benefits from its support to the ruling coalition, and the Government, which is keen to increase the social benefits in the run-up to the presidential election (see **POLITICAL ENVIRONMENT**), made it possible, through the mechanism of privatization, to stimulate both domestic investment (see **BUSINESS**) and consumption (see **HOUSEHOLDS**).³
- **RISING HOUSEHOLD INCOMES.** Despite moderate growth rates for real household incomes (see **HOUSEHOLDS**), the Consumer Confidence Index and Index of Propensity to Consume have steadily improved.⁴
- **FINANCIAL STABILITY.** The UAH/USD exchange rate has remained unusually stable over the last two years. This means that the competitiveness of exports has been steadily rising as the real effective exchange rate has long been depreciating (see **MONETARY POLICY**). Regardless of the unstable situation on some markets, the Consumer Price Index has not passed the 10% mark in the past three years (see **PRICES**). Finally, since 2000, the Government has not allowed the Budget deficit to exceed 1% of GDP (see **PUBLIC FINANCE**).



Highlights of quarterly predictions #26

In this issue, you can read about:

- The factors behind record-high economic growth
- Who has the best chance in the 2004 presidential election?
- How Constitutional amendments will change the balance of power
- The Customs Code: Advantages and shortcomings
- What benefits will market economy status bring?
- How to overcome cost inflation
- Is capital still fleeing Ukraine?
- How to make temporary "free money" in Government accounts work
- Tax policy: Can changes be expected?
- Will industry's "resource pinch" get worse?
- How sensible is further concentration in the energy sector?
- How much land costs in Ukraine
- Regulatory changes on the housing market and their impact
- What is spurring faster FDI growth?
- Why household income rates have slowed despite record wage growth?
- Reform of privileges: Urgently needed
- World experience with stabilization funds

³ In 2003, the consumption rate grew from 5% to a record-high 12.8%, while gross fixed assets leapt from 3.4% up to 15.8%.

⁴ According to the results of a public opinion poll, the number of consumers who expressed an optimistic outlook has grown equal to the number of pessimists as of March 2004. For details, see the April 2004 **consumer confidence** report.

Euphoria versus reforms

Record-high growth rates have led to euphoria

Record-high growth rates have allowed Premier Yanukovich to rapidly improve his ratings in the presidential race (see **POLITICAL ENVIRONMENT**) and have led government officials to wax euphoric over “their” economic accomplishments.

Most of the priorities set by the Government make it possible to improve the economic situation in the short term

The Government’s economic policy has been primarily aimed at: (1) activating the privatization of state-owned enterprises; (2) renewing tax reforms, particularly reforms in personal income tax and the VAT; (3) initiating pension reform; (4) removing Ukraine from the FATF blacklist and improving relations with IFIs; (5) gaining market economy status; (6) maintaining a stable exchange rate and stable prices. The majority of these priorities make it possible to improve the economic situation in the short term.

The Government has not been given to profound reforms in the public sector

The Government has clearly not been inclined to get into profound reforms in the public sector and it has not made administrative reform a priority. In our opinion, the current Administration continues to interpret administrative reform as a cosmetic fix of the state apparatus, and not as a fundamental change in the decision-making system.⁵

The far more lively privatization process (see **BUSINESS**) is most likely oriented, not towards maximizing Budget revenues and investment commitments, but towards maintaining the balance of power among domestic financial-industrial groups and certain foreign investors.

The most radical changes have been seen in the personal income tax regime—in particular, the introduction of a flat 13% rate to replace the existing progressive tax system. This decision was not resisted by any stakeholder, since it simplified the tax mechanism and reduced tax pressure—especially on individuals with high incomes. Meanwhile, unless the issue of creating incentives for payments into the social funds, especially the Pension Fund, is resolved somehow, bringing personal incomes out of shadows will not pick up steam.

Pension reform has so far amounted to little more than a mechanistic raise in state pensions and this has revealed just how few resources the Fund has to substantially increase pension levels,⁶ or to reduce inequalities in the social security system across different groups of the population.

Despite considerable effort on the part of the Government, it was unable to secure the maximum openness in trade with either the US and the EU, or with CIS countries. Thus, none of the exceptions to the FTA among CIS countries were eliminated, while the Common Economic Area proved an ineffective mechanism for introducing a free trade area among its participants any time soon.

Despite progress in relations with the European Union, the US and the IFIs—particularly the removal of Ukraine from the FATF blacklist, the signing of a bilateral agreement on access to goods and services markets with the EU, the

⁵ For more detail see Janus Gonciarz and Natalia Hnydiuk “Administrative reform: unfulfilled dreams and lost opportunities. How to find a constructive way to implement the key components of administrative reform?” – Kyiv: Millennium, 2002.

⁶ After being recalculated at the beginning of the year, pensions actually rose only 4.2% on average. At the same time, the number of applications to the Pension Fund requesting a review of pensions computed in accordance with the new law grew so high that it led to the need for a repeat re-calculation of all pensions.

renewal of World Bank financing under the Programmatic Adjustment Loan, and the adoption by the IMF of an annual program of precautionary stand-by credit for Ukraine worth a total of US \$605mn⁷—neither Washington nor Brussels acknowledged Ukraine as a market economy country. We consider the delay in granting market economy status related primarily to the issues of democracy and human rights, that is: reforming the judicial and investigative systems, combating corruption, ensuring freedom of speech, and protecting intellectual property rights.

Since the Government did not pay attention to establishing stabilization funds for specific goods and did not prepare state agencies to intervene, the country saw significant price fluctuations on grain markets in fall 2003 and on the petroleum products market in spring 2004.

As before, the Government failed to pay attention to sector reforms, especially to the energy and residential services sectors. The slow advance of land reform increases the likelihood that the current moratorium on the sale of farmland will be extended—most likely to 2010 (see **AGRICULTURE**).

Despite the fact that the revenue side of the Consolidated Budget was over-fulfilled by 3%, spending was not 100% (see **PUBLIC FINANCE**), and real household incomes grew only 5.8% (see **HOUSEHOLDS**), which is lower than the general economy picked up. This basically means that the additional Budget revenues yielded by economic growth are not being spent to finance reforms and reduce the income stratification evident in Ukrainian society.⁸

According to ICPS, the factors behind such passive implementation of reforms are the lulling effect of economic growth in the wake of a favorable world market situation, the Government's lack of a strategic vision of the goals and the purposes of reform, and its inability to combat corruption.

As a result, the share of wages in the GDP has stayed flat over the last five years, at about 45%: in OECD countries, this indicator exceeds 60%. Meanwhile, low household incomes are not able to make the domestic market dominate and domestic demand remains substantially weaker than external demand. As a consequence, during 2003 and early 2004, Ukraine became even more dependent on foreign markets and the ratio of exports to GDP has reached nearly 60%.

In our opinion, the dependence of the Ukrainian economy on foreign markets is becoming the key risk threatening sustainable development. The domestic market must be developed in order to reduce this particular risk. The experience of Eastern European and CIS⁹ countries proves that there are two models of development: import substitution and global technological integration.

Additional Budget revenues are not being spent to reform financing and reduce poverty

Steep economic growth and the absence of a strategic vision are key factors behind sluggish reforms

Dependence on foreign markets has become the key risk for sustainable development

⁷ A singular feature of this credit program is that if the country requires a loan, it can borrow from the IMF within the credit limit. Ukraine is unlikely to make use of this line of credit in 2004, since a positive balance of payments means it will not need to replenish its gold and hard currency reserves.

⁸ The gap in the Consumer Confidence Index among various income groups is growing wider and wider. The negative mood that dominates among low-income consumers is primarily related to high expectations of inflation and unemployment.

⁹ For details, see the research of the Center for Macroeconomic Analysis and Short-Term Forecasting at: http://www.forecast.ru/_ARCHIVE/Analytics/AltDenKred/MonPol-2007.pdf.

Government programs: Nothing much new here

In March 2004, the Cabinet of Ministers summed up its first year's performance and reported to the Verkhovna Rada on how it had completed the Government Program.¹⁰ The Verkhovna Rada has deemed the Government's performance satisfactory, thanks to the favorable background against which the decision came—high economic growth in 2003.

Given the traditional abstraction of Government Program tasks, which rarely define clear and specific actions for the Cabinet, it is quite difficult to evaluate whether the Cabinet has fully implemented any Program. Among the few specific measures stipulated in the 2003 Program, the Government managed to: raise the minimum wage, push the law on pension insurance through the Verkhovna Rada, service debt liabilities on time, and transfer local budgets to the State Treasury for servicing. The Cabinet, however, did not succeed in completing negotiations on Ukraine's accession to the WTO, implementing all the tasks for developing the fuel and energy complex, or getting laws on the land market and land assessment adopted.

The Yanukovich Government's new Program is almost a carbon copy of its old Program. Among the new items in the Program are: a separate section on government policy goals; a Government plan for special VAT accounts; and a number of measures in agricultural policy. According to ICPS, the new Program replicates most of the shortcomings inherent to Programs of previous Governments:

- *declarations of intent not supported by concrete measures that might assist in reaching the desired goals;*
- *overly general policy measures;*
- *no impact analysis of measures;*
- *sources and amounts of financing for measures not defined;*
- *no criteria for assessing successful completion of Program tasks.*

The Program that was adopted does not fulfill its function: it does not define clear public policy priorities and does not include well-grounded measures for its implementation. On the contrary, the Program effectively functions in a strictly declarative capacity.

We think the Cabinet of Ministers needs to concentrate efforts on reforming the public services sector during 2004–2005. Speedy economic growth has created conditions that are favorable for implementing “expensive” reforms specifically during this very period. Better quality public services would, in turn, improve conditions for doing business in the country and raise public confidence in the government. Among the sectors requiring reforms are residential services, healthcare, social welfare, the pension system, and the defense sector. Effective reforms in any of these problematic areas would turn into a real accomplishment for the Government.

¹⁰ The Cabinet's Program was developed for 2003–2004 and the Government has provided a mid-term report on the progress of the Program. Since a new Program was approved by the Verkhovna Rada in March, it cannot now dismiss the current Government for the next 12 months.

THE IMPORT SUBSTITUTION MODEL is based on the primacy of domestic innovation and technological resources and the attraction of foreign (western) technologies as an alternative to the import of ready-made products. The key elements of this model are:

- increasing productivity to enable stable expansion of domestic demand;
- strengthening the competitive positions of domestic producers first of all on domestic markets;
- selectively protecting domestic markets, restricting the flow of capital;
- allowing the domination of large corporations—domestic FIGs;
- providing investments, not into export sectors that manufacture commodities with low value-added, but into manufacturing oriented towards the final consumer;
- facilitating equal access to resources for enterprises of all sectors.

THE GLOBAL TECHNOLOGICAL INTEGRATION MODEL means involving the domestic chain of production in the operational structures of international corporations. The key elements of this model are:

- a massive influx of foreign investment into processing and other enterprises that have become linked to multinational corporations;
- supporting lower prices for the components of production: resources and labor;
- instituting maximum openness of goods and capital markets;
- preventing large FIGs from dominating the economy.

Ukraine's economic policy, like the policy in the majority of CIS countries—and unlike the policy of candidates for European Union membership—aims at implementing import substitution.¹¹ Ukraine's position outside the European Union leaves little alternative to this model of domestic market development. We think that the Government needs to pay attention to increasing productivity in order to improve domestic market development—and to ensure equal access to raw materials, energy and other resources for all enterprises. In particular, the Government needs to avoid “price scissors.”

Ukraine's economic policy tends towards the import substitution model

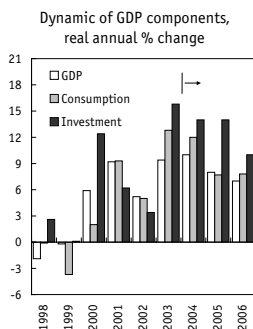
Forecast for 2004

Although prospects for active reform seem pessimistic, ICPS is upgrading its forecast for economic growth in 2004 to 10%. The continuing favorable situation on international commodity markets will spur growth in sectors directly related to exports: industry (13%) and transport (12%). High industrial activity will also contribute to keeping growth rates very high in construction (20%). As private consumption continues to grow at 12%, trade will grow at about 15%.

The economy will grow at 10% in 2004 as reforms go slow

¹¹ According to Derzhkomstat, 92.5% of food products and 60.5% of non-food products consumed by Ukrainian citizens are manufactured within the country. Five years back, these indicators stood at 85.3% and 46.9% respectively.

Real GDP will grow at a slower pace in the medium-term



Source: Derzhkomstat; forecast by Quarterly Predictions

Strong economic trends and the economy's need for capital injections because of severely depreciated capital assets will help maintain a high level of investment activity. Thus, ICPS is revising its forecast for the growth rate of gross fixed assets upward, to 14% (see **BUSINESS**).

ICPS expects Budget expenditures to remain largely unaltered, at 28.5% of GDP. For the second year running, high growth in public consumption (12%) in the run-up to the presidential election will lead to higher spending in education (+6%) and healthcare (+5%).

Lower tax pressure will push Budget revenues down to 27% of GDP (see **PUBLIC FINANCE**). At the moment, the Budget deficit can be relatively easily covered through international borrowings¹² and privatization revenues (see **BUSINESS**).

Imports will now grow somewhat faster than exports, which should cause a further reduction in the trade balance (see **FOREIGN TRADE**). Meanwhile, substantial capital inflows in the form of FDI and money transfers from Ukrainians working abroad should allow the National Bank of Ukraine to steadily replenish its gold and hard currency reserves and maintain a stable exchange rate (see **MONETARY POLICY**).

The 2004 Consumer Price Index should rise 6%. This year, a far better grain harvest compared to 2003 (see **AGRICULTURE**) and the Government's efforts to curb inflation by preventing increased industrial production costs from being passed along to the consumer (see **PRICES**) should result in moderate price growth.

Forecast for 2005–2006

A slight deterioration in world markets (see **PRICES**) and a slowdown in the pace of growth of Ukraine's major trading partners (see **WORLD ECONOMY**) will dampen economic growth in Ukraine during 2005–2006 and stimulate the Government to take measures to develop domestic markets. This will be most apparent as reforms kick in the residential and public services sectors. We expect economic growth rates to drop to 8% in 2005 and 7% in 2006.

Investment demand will remain unstable. In our opinion, the expansion of the domestic market will lead to high rates of investment in the light and food industries. At the same time, a worsening in the global situation will lead to reduced investments in export-oriented sectors, such as metals and metal products. This should also slightly slow the pace of gross fixed assets growth to 10% in 2006.

The key factor behind Ukraine's economic growth will be domestic demand. The growth of real private consumption, though declining slightly, will still be 9% for the year (see **HOUSEHOLDS**).

Deteriorating conditions for foreign trade will reduce the current account balance to US \$0.9bn in 2006 (see **FOREIGN TRADE**). This will lead to lower money

The main driver behind economic growth will be domestic demand

¹² In February 2004, Ukraine issued eurobonds worth a total of US \$600mn to ensure a timely pay-out of the principal on the country's foreign debt in March. The yields on Ukraine's 2004 eurobonds have dropped again, to 6.875% pa. According to ICPS, in 2004 Ukraine will take advantage of relatively low interest rates on world markets and will be able to attract foreign credits worth a total of US \$1.35bn with repayment on the principal debt at US \$1.1bn.

supply levels (see **MONETARY POLICY**) and less pressure on prices, which should help the Government's anti-inflationary policy. At the same time, fewer price controls in 2005 should allow the level of inflation to rise slightly, to 7% by year-end (see **PRICES**).

Preparations for Ukraine's accession to the WTO will force the NBU to revise its current scheme of currency regulation. Given the country's declining current account balance, greater fluctuations in the UAH/USD exchange rate can be anticipated. In 2006, ICPS expects a renewal of moderate nominal depreciation of the hryvnia (see **MONETARY POLICY**).

Forecast risks

Today, the key risk to the ICPS forecast for economic development during 2004–2006 is the possibility of a sudden change in the world market situation, specifically on markets for steel and chemical products. Unexpected fluctuations could be due to both increasing and declining prices over the period.

The key forecast risk is a sudden change in world markets

Other risks to the forecast are:¹³

- a radicalized political situation on the eves of the presidential (2004) and VR (2006) elections;
- higher-than-expected reductions in 2004 Budget revenues if individuals fail to leave the informal economy as anticipated after reduced tax pressures;
- high inflationary expectations related to prices controls for some goods, especially bread and energy resources;
- worsening liquidity among banks due to a steep rise bad loans;
- the establishment of an FTA within the Common Economic Area;
- an underassessment of the impacts of EU enlargement;
- the failure of Ukraine to accede to the WTO in 2005.

¹³ For more details, see *quarterly predictions* for Q4'03, p. 8–9.

POLITICAL ENVIRONMENT

The pro-Administration coalition should remain in control until the 2004 presidential election. If the election of the new president takes place without massive abuse, economic reforms should go in high gear in 2005. The new president—be it Viktor Yushchenko or Viktor Yanukovich—will be forced to seek ways to ensure the country's progress until the 2006 Verkhovna Rada elections, and so will try to work with the majority of political forces

Current situation

Domestic policy

The pro-Administration coalition is focused on restricting the next president

Most of the attention of the pro-Administration coalition of centrist forces headed by the lame-duck incumbent, Leonid Kuchma, is focused on restricting the powers of the next Head of State before the presidential election slated for October 2004. The coalition is trying to shift the center of influence and decision-making to the Verkhovna Rada, where it has a majority of supporters, and to the Government, which is made up of its representatives. In December 2003, the coalition, with the support of the Communist Party, managed to get preliminary approval of Constitutional amendments in the Verkhovna Rada. These amendments:

- remove the power to appoint and dismiss the Government from the president and transfer these powers to the Verkhovna Rada;
- transfer to the premier the presidential right to appoint and dismiss oblast governors and heads of regional administrations.

Under pressure from opposition forces—as well as the US and the EU,¹⁴ who supported the opposition on this issue—, the coalition rejected the two amendments that fueled the most controversy: (1) replacing direct presidential elections by having the Verkhovna Rada elect the country's top official instead; (2) applying this new approach to the upcoming election. These amendments substantially restricted the chances of the opposition candidate to become the new president. Dropping these amendments meant that the new president would be elected as scheduled,¹⁵ by the voting population, and hold office for the entire five-year term, as stated in the Constitution.

The coalition won over two of the four opposition forces for its Constitutional reforms

Having sacrificed these amendments and agreed to introduce proportional elections to the legislature and local councils starting in 2006, the coalition gained the support of two of the four opposition forces: the Communist and the Socialist Parties both backed the move to subordinate the Government to the Verkhovna Rada instead of the president. The situational alliance of the coalition and leftist forces made it likely that the Constitution would be

¹⁴ In January 2004, the US, the European Union and the Council of Europe stated they were concerned about the context and timeframe for implementing Constitutional reform. They condemned the way the amendments passed first reading and called for an open debate of all alternative initiatives.

¹⁵ On 18 March 2004, the Verkhovna Rada scheduled the presidential election for 31 October 2004.

changed when the amendments went into final reading. Although first ballot on 8 April 2004 had only 294 votes instead of the Constitutional 300, the coalition should be able to collect the necessary two-thirds during its next attempt. In other words, it is still quite likely that the new president will have fewer powers, than the incumbent, though he will retain many levers of influence over public policy. The main risk to this forecast is the continuing squabbles and splinters within the majority, which votes without party discipline even on key issues.

Table 1. How the balance of power will change if amendments to the Constitution are passed by the Verkhovna Rada

Loses power	Gains power	No change in power
The president (executive)		
To appoint a premier approved by the Verkhovna Rada	To dissolve the VR, if it fails to establish a majority or a Cabinet (Government)	To represent Ukraine in international relations
To appoint a Cabinet nominated by the premier	To nominate the premier for VR approval	To dissolve the Verkhovna Rada if it fails to sit within 30 days of the start of a session
To dismiss the Government	To nominate the Ministers of Defense and Foreign Affairs for VR approval	To appoint and dismiss ambassadors
To recommend to the VR to dismiss the premier and the Cabinet	To nominate head of the SBU for VR approval	To call for a referendum
To dismiss the prosecutor general without VR consent	To suspend a Government decision while appealing to the Constitutional Court	To appoint the prosecutor general with the approval of the VR
To appoint and dismiss the head of the SBU	To appoint one half instead of one third of the Constitutional Court	To recommend to the VR to appoint or dismiss the Governor of the NBU
To appoint heads of local administrations		To recommend to the VR to appoint or dismiss the Central Electoral Commission
To appoint one half of the NBU Council		To appoint one half of the National Radio and Television Council
To appoint and dismiss heads of the State Property Fund, the Anti-Monopoly Committee and the State Information Committee		To void decisions of the Crimean Council of Ministers
To establish, reorganize and eliminate central executive bodies at the request of the premier		The status of Commander-in-Chief and head of the National Security Council
To cancel Government decisions		To appoint and dismiss the top commanding officers of the Armed Forces
		To recommend declaration of war to the VR
		To deploy the Armed Forces in the case of aggression against Ukraine
		To mobilize and announce a state of emergency
		To veto laws adopted by the VR

Loses power	Gains power	No change in power
The Verkhovna Rada (legislature)		
<p>To work without a majority. Such majority must to be set up within 30 days of the first sitting</p> <p>To dismiss the Government during the last session before a VR election</p>	<p>The right to hold office for 5 years instead of 4</p> <p>The right of national deputies to be members of the Government</p> <p>To nominate and appoint the premier</p> <p>To appoint the Cabinet at the request of the president and premier</p> <p>To appoint and dismiss head of the SBU at the president's request</p> <p>To appoint and dismiss heads of the State Property Fund, the Anti-Monopoly Committee and the State Information Committee</p> <p>To approve the president's dismissal of the prosecutor general</p> <p>To appoint one half instead of one third of the Constitutional Court</p>	<p>To adopt laws</p> <p>To determine guidelines for domestic and foreign policy</p> <p>To declare wars and make peace at the president's request</p> <p>To impeach the president</p> <p>To dismiss the Government</p> <p>To appoint and dismiss members of the Accounting Chamber</p> <p>To appoint and dismiss the human rights commissioner (ombudsman)</p> <p>To appoint and dismiss the NBU Governor at the president's request</p> <p>To appoint and dismiss one half of the NBU Council and the National Radio and Television Council</p> <p>To appoint and dismiss members of the Central Electoral Commission at the president's request</p> <p>To elect judges</p> <p>To dissolve the Crimean legislature</p> <p>To ratify international agreements</p>
The premier (Government)		
<p>To nominate candidates for Minister of Defense and Minister of Foreign Affairs</p> <p>Must resign after the election of a new Verkhovna Rada</p>	<p>Need not resign after the election of a new president</p> <p>To nominate local administration heads for appointment and dismissal</p>	<p>The status of Head of the Government</p> <p>To nominate members of the Government, except for the Ministers of Defense and Foreign Affairs</p>
The Cabinet of Ministers (Government)		
<p>Must resign after the election of a new Verkhovna Rada</p>	<p>Need not resign after the election of a new president</p> <p>To establish, reorganize and eliminate executive bodies</p> <p>To appoint and dismiss heads of local administrations at premier's request</p>	<p>To implement public policy</p> <p>To elaborate the State Budget</p>
Sources: Bill amending the Constitution (Bill No.4105), the Constitution of Ukraine (adopted 28 June 1996)		

The growing likelihood that the powers of the next president will be curtailed has pulled together the coalition, for whom the greatest threat is defeat in the presidential election. A working majority in the Verkhovna Rada, which stands to gain additional powers after amending the Constitution, and control over the Government—which may no longer have to resign upon the election of a new president—serve as guarantees of security for coalition members. This means the coalition is likely to survive without any substantial changes, at least until the election. After the election, its fate will largely depend on the new president, who may be its enemy and try to change its configuration, or its ally and try to preserve it until the 2006 Verkhovna Rada elections.

A majority in the legislature and control over the Government guarantee security for coalition members

The coalition's Achilles' heel remains the fact that it lacks an effective plan of action, something it has failed to develop due to continuous internal squabbles, since it is based, not on commonly-held views of public policy, but on the opportunities and privileges of being in office.

The coalition's Achilles' heel remains its lack of an effective plan of action

Together with the looming presidential election, this restricts the Government's capacities to institute consistent and decisive policy. Its sectoral policy is more aimed at increasing state influence, than on much-needed reform.

Foreign policy

Radical political conflicts within the country complicate Ukraine's relations with the US and the European Union. Ukraine's two main western partners are concerned about the use of dishonest means to hang onto power. This hampers achievement of Kyiv's current goals in relations with Washington. Negotiations on granting Ukraine the status of a market economy country and US consent for Ukraine's accession to the World Trade Organization are not seeing much progress. The government's persistent violations of democratic rules, particularly pressure on media, impede Ukraine's negotiations with the EU in terms of a new joint plan of action for the next few years.

Radical internal political conflicts complicate Ukraine's relations with the West

Unlike the West, Russia is not putting much emphasis on the issue of Ukraine's democratic development and is focusing on large-scale joint projects that are likely to result in Kyiv's rapprochement with Moscow: setting up an integrational union under the Common Economic Area and a joint consortium to run Ukraine's gas transport system. Both countries have quickly patched up the crisis in their relations that emerged in October 2003, when Russia made territorial claims on Ukraine in the Kerch Strait. Presidents Kuchma and Putin signed an agreement that satisfied Moscow's wish to recognize the sea as "common internal waters." In exchange, Ukraine obtained a promise to establish the border on the sea surface and the sea shelf, which Russia has not wanted to yield for quite a long time.

Russia is concentrating its efforts on large-scale joint projects

Although cozy relations with the pro-Administration coalition have been providing Russia with certain advantages in pushing its interests in Ukraine, it still has not succeeded to lobbying the use of the Odesa-Brody oil pipeline in the southeastern direction to transport Russian oil. After many months of debate, in February the Government adopted the decision to run the pipeline in the northwestern direction to transport Caspian oil. If the Government consolidates this decision by signing contracts with oil-extracting companies, Odesa-Brody will become an important mechanism for expanding Ukraine's cooperation with the West, which welcomed the decision.

2004 presidential election

Viktor Yushchenko and Viktor Yanukovych have the highest political ratings

Among possible candidates for the presidency, the highest-rated politicians remain the leader of the oppositional right-centrist Nasha Ukraina bloc, Viktor Yushchenko, Premier Viktor Yanukovych, and the leader of the oppositional Communist Party, Petro Symonenko.¹⁶ Other politicians will have a hard time to break past the three frontrunners to the presidency.

The consent of the Communist and the Socialist parties to support amendments to the Constitution has only aggravated conflicts within the opposition camp. This has diminished Mr. Yushchenko's chances of involving the SPU, headed by Oleksandr Moroz, in his presidential race. Their support is very important for the Nasha Ukraina leader to gain votes in central and eastern Ukraine. Meanwhile, relations between Mr. Yushchenko and Mr. Symonenko deteriorated even further. The latter has leveled even harsher criticism at the Nasha Ukraina leader, which largely forms the basis for his own campaign. This will surely play into the hands of the coalition candidate, who is very interested in the opposition's internal conflicts and a stand-off between Viktor Yushchenko's Ukrainian-speaking electorate and Petro Symonenko's largely Russian-speaking supporters.

Mr. Yanukovych's chances of becoming the single Administration candidate are growing

The chances of Viktor Yanukovych to become this candidate grow as the election approaches although, unlike Mr. Yushchenko or Mr. Symonenko, who can depend on their own forces during the race, he will have to negotiate support with other coalition members. None of his possible contenders in the race for the presidency—NBU Governor Serhiy Tihipko, Transport Minister Georgiy Kyrpa, Defense Minister Yevhen Marchuk, or ex-Premier Anatoliy Kinakh—can count on more than 4%¹⁷ of the electorate. An important argument in favor of Viktor Yanukovych is that he is accepted by voters in the densely populated eastern oblasts, where he shows the most support. This is also the main problem for Viktor Yushchenko and, unless he can do something about it, he will not be able to turn his lead in the polls into victory in the election.

Forecast for 2005–2006

Viktor Yanukovych's chances of winning the presidency grow as Viktor Yushchenko continues to have difficult relations with other opposition leaders and the east-west polarization of the country's electorate, which affects the chances of the Nasha Ukraina leader the most.

The new president will go for effective performance before the 2006 VR election

According to ICPS, provided the election does not involve outrageous abuses of power, the election of either of these politicians will keep Ukraine on track towards a market economy and Euro-Atlantic integration. The new president will want to demonstrate effective performance before the 2006 Verkhovna Rada election. Since he will need the support of both the legislature and the Government, who will define, approve and implement public policy, the Head of State will have to cooperate with most of the political forces currently represented in the legislature.

¹⁶ According to data from the Democratic Initiatives Fund, in early March about 24% of the population were ready to vote for Viktor Yushchenko, 12% supported Viktor Yanukovych, and 11% favored Petro Symonenko.

¹⁷ According to DIF data.

This forecast might be undermined by a presidential election that takes place with substantial abuse of power, particularly large-scale interference in the campaigns of key candidates, their disqualification, falsified results, and so on. The risk of this will grow if the coalition fails to restrict the powers of the presidency. If the election is openly unfair, it will almost inevitably lead to mass demonstrations and civil unrest organized by the losing side. The internal political situation and functioning of government bodies could be destabilized. If this scenario comes to pass, Ukraine is likely to become somewhat isolated by the US and the EU, which will force the winning candidate to seek support in Russia.

The risk is that the presidential election will involve substantial abuse of power

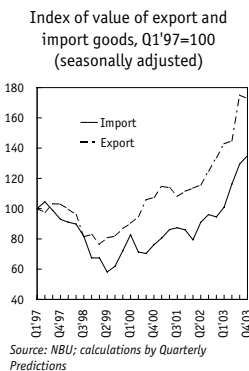
FOREIGN TRADE

An extremely favorable situation on world markets ensured record-high exports growth throughout 2003, while rising consumption and investment led to the growth of imports. The 2003 current account balance deteriorated slightly, largely due to accelerated imports during Q4'03. In 2004, persistent high external prices and growing investments will lead to a significant surge in foreign trade turnover. During 2005–2006, a slight deterioration in the external situation will be the main reason for slower growth in foreign trade

2003 Results

Goods

During 2003, imports grew faster than exports



The growth of imported goods surpassed export growth throughout 2003.¹⁸ In Q4'03, imports accelerated further,¹⁹ leading to a deterioration of the current account balance.²⁰

In Q4'03, exports repeated the trends recurring throughout the year:²¹ in addition to growth in traditional export commodities such as steel, minerals, chemicals and foodstuffs caused mostly by a favorable external situation, exports of machinery, equipment and transport vehicles surged at a record-high pace.

During 2003, the share of agricultural products and non-ferrous metals²² of the overall export volumes declined. Agricultural exports shrank due to poor grain crops, while non-ferrous metals dropped because of limitations on exports introduced in order to supply domestic producers²³ with raw material. The mechanism for restricting non-ferrous metal exports proved ineffective, due to steep price rises on foreign markets in 2003. As a result, in early 2004, the

¹⁸ According to data from Derzhkomstat, exports and imports grew 28.5% and 35.6% during 2003. NBU data on the balance of payments differs from Derzhkomstat because of additional amounts computed by the Bank. Where the text does not mention a source, QP is using Derzhkomstat data.

¹⁹ Q4'03 saw accelerated growth in imported farm and chemical products, machinery and equipment.

²⁰ The 2003 current account balance stood at US \$2.891bn, compared to US \$3.173bn in 2002.

²¹ For more information on the factors behind 2003 commodity export growth, see *quarterly predictions* for Q3'03, p. 48.

²² The share of non-ferrous metals in the breakdown of Ukraine's exports shrank from 6.7% to 3%, while the share of agricultural products slipped from 10.3% to 7.9%.

²³ The 25 December 2002 Law amending the Law on scrap metal listed commodities not subject to export and changed requirements regarding enterprises having ISO conformity certificates, so that only industrial enterprises could export non-ferrous metals as their own products.

Government completely halted customs clearance of exports of non-ferrous metals.²⁴

In 2003, imports of goods grew thanks to rising consumer and investment demand for goods. The fastest growth was registered in imports of transport vehicles (80%), processed food (70%), crude oil (50%), and machinery and equipment (39%).

After a temporary surge in 2002,²⁵ registered prices for gas slipped during 2003. As a result, the value of gas import volumes dropped 9.4% in 2003, though actual volumes rose almost 5%.

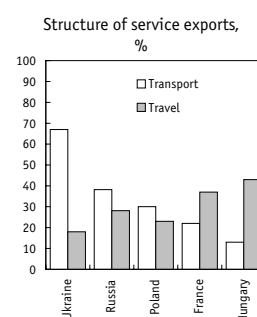
Services

According to NBU data, the services balance of trade improved during 2003 as service exports grew faster than imports—11.45% vs 3.5%. Service exports rose primarily in the “Travel” and “Other services” areas. NBU data also shows that transport service exports grew a mere 4%, due to reduced exports of pipeline services as tariffs for Russian transit gas²⁶ were lowered. Imported services rose mainly under the item “Travel” and due to growing imports of transport, insurance, royalty and licensing services. The low growth of imported services is partly due to NBU policy aimed at combating capital flight that is concealed as insurance services and royalties paid abroad (see **MONETARY POLICY**).

Transport services traditionally dominate exported services,²⁷ because Ukraine takes advantage of its favorable geographic location and the availability of transport infrastructure. In the structure of exported services of European countries, as in Ukraine, transport services and the item “Travel” dominate, although transport services have a smaller share and “Travel” a larger share in structure of exported services in Europe than in Ukraine. The item “Other business services,”²⁸ which is also important in the exported services structure of European countries, has a small share of Ukraine’s service exports. On the one hand, Ukraine is not yet able to compete on world markets in such areas as financial services. On the other hand, the country has potential in the export of computer and information services, R&D, and construction services.

The unbalanced structure of services poses a long-term risk, because, if Russia diversifies its transit routes, Ukraine’s service exports will drop significantly.

In 2003, the services balance of trade improved



Source: Bank of France, National Bank of Poland, National Bank of Hungary, NBU, Central Bank of the Russian Federation

²⁴ The 17 February 2004 Cabinet Instruction temporarily stopped customs clearance of exported nickel, copper and aluminum products.

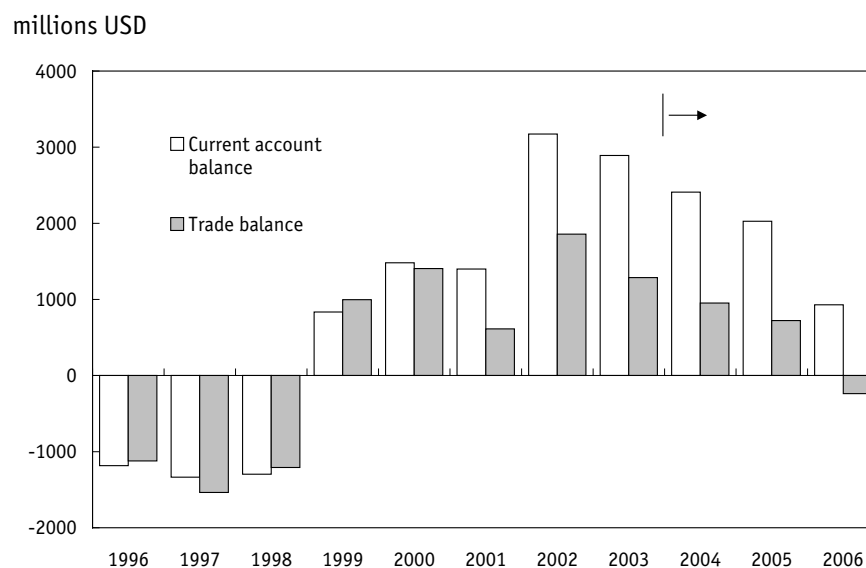
²⁵ In H2'02, the registered price for gas, which Ukraine receives as payment for Russian gas transit, surged from US \$50 to US \$67 per 1,000 cu m, while in 2003 the price fell back to its previous level.

²⁶ In 2003, the rate for Russian gas transit slid to US \$1.09/1,000 cu m/100 km, after a temporary increase in H2'02, when it stood at US \$1.46/1,000 cu m/100 km.

²⁷ According to the NBU, transport made up 67% of all exported services in 2003.

²⁸ The “Other business services” category includes merchanting, operational leasing services, other trade-related services, and various business services.

Figure 1. Current account and trade balance for goods and services



Source: NBU; forecast by Quarterly Predictions

Forecast for 2004–2006

Goods

ICPS upgraded its forecast for 2004

ICPS has adjusted its forecast for commodity exports in 2004 upward, in view of a stronger-than-expected growth of prices for ferrous metals, chemical products, oil and oil products on world markets (see **PRICES**). The key factor behind this improved forecast for imports in 2004 is an improved forecast for investment (see **BUSINESS**) and consumption (see **HOUSEHOLDS**).

A slight deterioration of the external situation will slow the growth of foreign trade in 2005

In 2005, Ukraine will face a slight deterioration of the external situation, which will be the key reason for slower growth in foreign trade. ICPS economists predict that Ukraine will accede to the WTO in 2005, which will not cause any major changes in trade during the year due to a certain inertia in external economic processes. Moreover, WTO accession includes a transition period to soften the impact of liberalizing trade for the most vulnerable domestic producers and to prevent a boom in import growth during the first years of WTO membership. According to ICPS, imported goods will grow slightly faster during 2006, due to Ukraine's accession. At the same time, export growth rates should slow down for two reasons:

WTO accession will affect exports and imports as of 2006

- It is safe to assume that Ukraine will be unable to defend its interests in terms of lowering restrictions on Ukrainian exports once it accedes to the WTO, since it does not carry much weight in trade disputes.
- Markets in China and other Asian countries will be start shrinking as they expand their own production capacities. In turn, China's expanding production will put an end to the growth of global prices, which will have a negative impact on Ukraine's export volumes.

Import growth in the forecast period will surpass commodity export growth. As a result, the current account balance will shrink in the forecast period.

Risks to the forecast are:

- the closure of expanded EU markets as euro revaluation makes Ukrainian goods highly competitive;
- rapid and effective integration into the CEA;²⁹
- Ukraine does not accede to the WTO in 2005 and accession is postponed for an indefinite period of time. This will have a negative impact on foreign trade figures and slow the economic transformations that would be taking place after WTO accession. In particular, competition on the domestic market will not grow, and consumers will have a limited choice.

Commodity trade growth

	Ex-ports	Im-ports
2001	12%	13%
2002	10%	8%
2003	29%	36%
2004	14%	16%
2005	5%	6%
2006	4%	7%

Table 2. Change in exported goods, by group

% y-o-y	share of 2003 exports, %	2003	2004	2005	2006
		(forecast)			
<i>Total exports, including:</i>		28.5	14	5	4
Steel/steel products	33.8	31.5	15	5	3
Mineral products	15.2	60.0	15	4	3
Machinery, equipment and mechanisms	10.1	32.3	17	5	5
Chemicals	8.4	39.1	12	5	3
Agricultural products	7.9	-1.4	8	10	8
Vehicles	4.3	42.8	10	5	5
Processed food	3.9	70.0	10	4	3
Textiles/apparel	3.3	16.9	15	7	6
Wood/pulp&paper	3.1	26.3	15	4	3
Non-ferrous metals	3.0	-42.1	15	10	10

Sources: Derzhkomstat, NBU; forecast by Quarterly Predictions

Table 3. Change in imported goods, by group

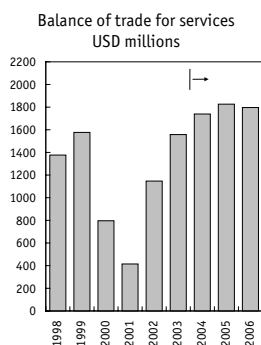
% y-o-y	share of 2003 imports, %	2003	2004	2005	2006
		(forecast)			
<i>Total imports, including:</i>		35.6	16	6	7
Crude oil	16.0	50.0	15	5	3
Machinery, equipment and mechanisms	15.1	39.0	20	12	12
Natural gas	13.9	-9.4	3	2	2
Vehicles	8.1	83.5	25	7	10
Chemicals	7.7	28.8	7	7	4
Processed foods	4.8	71.5	10	5	7
Agricultural products	4.7	126.2	10	-20	5
Textiles/apparel	3.7	26.6	20	15	15

Sources: Derzhkomstat, NBU; forecast by Quarterly Predictions

²⁹ For more detail on the implications of setting up a CEA-based free trade area, see *quarterly predictions* for Q4'03, p. 34–36. For more information about analysis of benefits and costs at different stages of economic integration, see *quarterly predictions* for Q2'03, p. 26–28.

Services trade dynamics

	Ex-ports	Im-ports
2001	5%	19%
2002	17%	-1%
2003	11%	4%
2004	7%	5%
2005	5%	5%
2006	5%	8%



Granting market economy status is an instrument for influencing transition economy countries

Services

During the forecast period, the current structure of exported services will not shift: transport services and “Travel” will be the key growth items. Exports of pipeline services will pick up with the brisker growth of new EU members and the shutting down of their atomic energy stations. The growth of export goods, and the development of the tourism and hotel business will stimulate higher exports of transport services during the forecast period. The growth of tourism and hotel businesses will also be key to perking up service export growth in the “Travel” category. Growth of exported services should reach 7% in 2004, slowing down to 5% in 2005–2006 due to lower commodity export growth.

The key factors behind brisker imported services will be higher consumer incomes and business activity (see **BUSINESS**). During 2004–2005, service imports should grow at 5%. In 2006, imported services should accelerate to 8% as financial and insurance services markets are liberalized in the run-up to WTO accession.

Market economy status

Market economy status, granted by the EU and the US,³⁰ should at least declaratively strengthen Ukraine’s position in trade disputes and raise the country’s investment appeal. To a large extent, granting this status is a political issue, since even developed economies often do not meet official criteria for a market economy. Thus, granting market economy status can be used as an instrument for influencing transitional economies.

Gaining market economy status will have a positive impact on Ukrainian exports of steel products and chemicals, which are the subjects of a majority of anti-dumping suits and special probes. This status is important primarily in trade with the EU and the US, the two leaders when it comes to initiating anti-dumping suits and special probes against Ukrainian commodities. At the same time, granting Ukraine market economy status could actually complicate the country’s accession to the WTO somewhat.³¹

Russia’s experience shows that, after a country gets market economy status, trade disputes continue—although it does become more complicated to initiate them.

³⁰ EU criteria for granting market economy status include freeing prices on all markets; using international standards in accounting and auditing; eliminating mutual offsets and tolling schemes; having legislation that guarantees clear rights and stability for business operations; and having unhampered conversion of currency. US criteria include: the convertibility of the national currency; the extent to which wages are determined through negotiations between labor and management; the extent of state control and use of the means of production; the extent to which foreign investment and joint ventures are allowed; and the extent of price controls.

³¹ In particular, according to Art. 29 of the Agreement on Subsidies and Countervailing Measures, which is included in the Marrakech Agreement establishing the World Trade Organization, a country going through the transition from planned to market economy may, unlike market economies, make use of a slew of subsidies.

The new Customs Code: Pluses and minuses

On 1 January 2004, the new Customs Code³² came into force. In particular, the Code attempts to simplify customs procedures for subjects of foreign economic activity (FEA). The Code somewhat changes the current procedures and introduces a number of new ones.³³ The document includes many articles that do not act directly, which means: (1) to make the Code work, the country needs to also adopt a number of regulatory acts; (2) customs offices will be able to alter procedures, which could have a negative impact on FEA subjects.

Among the positive aspects of the new Customs Code, ICPS specialists see several worth mentioning:

- *the Code unifies a number of legislative acts into a single document;*
- *the Code simplifies some current customs procedures;³⁴*
- *the Code shortens the period for customs offices to review an application for the customs declaration of commodities;*
- *the Code introduces a bulk of alternative measures for guaranteeing delivery of goods during their transit on Ukrainian territory.*

Still, the Code also has some aspects influencing FEA ambiguously:

- *the determination of customs value is to be done according to international agreements. However, the methods for calculating customs value are not clearly described;*
- *the Customs Code needs to be based on international customs conventions, but the document contains references only to some of them;³⁵*
- *customs control has been reinforced,³⁶ in particular, over tolling operations and the list of customs violations has been extended. On one hand, the Code helps combat smuggling; on the other, it complicates the commercial activity of FEA subjects who are actually following the law.*

³² The Verkhovna Rada adopted the new Customs Code on 11 July 2002.

³³ New terms, concepts and definitions change a number of customs procedures. These include: “customs regulations,” “customs procedures,” “carrier,” “vehicles,” “customs carrier,” “customs privileges,” and “customs preferences.”

³⁴ For example, the Code introduced new types of customs declarations. In particular, a periodical declaration valid for a specific period of time is anticipated for importers who regularly import the same commodity.

³⁵ The Code uses provisions of the GATT, the Customs Convention in the International Transport of Goods under Cover of TIR Carnets (TIR Convention) and the International Convention on Harmonized Commodity Description and Coding System. However, Ukraine has not yet joined the basic international conventions: Kyoto, Istanbul, etc.

³⁶ During customs control, customs offices now independently determine the form and extent of the customs control. The Code has also extended the right of customs officials to access business territory or premises for the purpose of carrying out a customs inspection.

Unlike the US, the EU may grant Ukraine market economy status

Negotiations to grant Ukraine market economy status

Ukraine's accomplishments in getting market economy status from the EU amount to obtaining market status for specific enterprises, such as Stirol and VAT Cherkasy Azot. The European Union has announced that it has no additional issues with Ukraine in this area, so the Ukrainian Government is waiting for the EU's final decision.

The US acknowledges Ukraine's accomplishments on the way to market economy status. At the same time, according to ICPS experts, there is a high probability that it will postpone granting this status to Ukraine because American steel makers want to protect their interests, while market economy status would strengthen the competitive advantages of Ukraine's steel makers on the US market. Moreover, the US has connected the granting of this status directly to the issue of intellectual property rights. Despite some positive steps in this area, Ukraine still has to introduce substantial amendments to its legislation and ensure effective enforcement.

Obviously, this is the very reason why Ukraine still has not submitted a repeated official application³⁷ to be recognized as a market economy country by the US. It has to be mentioned that American companies operating in Ukraine can assist in granting this status³⁸ to Ukraine. However, to make it happen, the business environment needs to satisfy US companies operating on this market.

³⁷ Ukraine submitted an application in 2001, but it was rejected.

³⁸ US companies can submit a letter to the US Department of Commerce with a request to grant Ukraine market economy status. For example, large US companies, among them Boeing, ExxonMobil and Lockheed Martin, supported granting this status to Russia.

PRICES

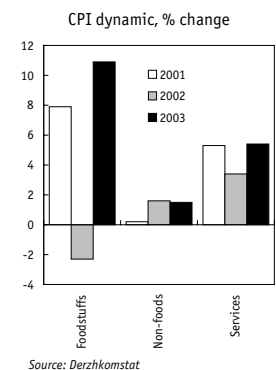
Growing inflation during 2003 resulted from a deficit of raw material for food production because of the Government's inconsistent stabilization policy. Administrative levers will largely be the Government's method of preference to hold inflation in check in 2004, despite rising producer costs and an overheating economy. Inflation is unlikely to fall very low through 2005–2006, because of partial price liberalization after the presidential election, rising energy costs, continuing economic growth, and an investment boom. The growth of producer prices will gradually taper off after a slight deterioration on export prices starting in 2005

Consumer prices

Moderate inflation has replaced the deflationary trends of 2002. The reason behind the growing annual inflation at the end of the year was a perceptible upward trend in price growth due to partial liberalization of flour and grain prices. Yet price growth in Q4 was not that disastrous compared to the same period in 2002,³⁹ which confirms the effectiveness of Government actions in stabilizing markets,⁴⁰ though these are still not economically optimal. Other reasons contributing to inflation are: (1) accelerating demand-driven inflation as exports grow and domestic demand multiplies (see **HOUSEHOLDS**); (2) growing producer costs of input resources,⁴¹ particularly in the food industry.

However, the problems of 2003 and Government efforts to partly resolve them are posing a serious challenge for 2004. The most evident among these is the disproportionate price growth between input materials and finished products, particularly grain and bread.⁴² The new grain crop should ease the pressure on the market, but until then, production costs will keep escalating. Given the need to support its reputation as an effective crisis manager, the Government will try using administrative and financial leverage to keep prices for bread and other foodstuffs from growing until the election. According to ICPS, the government will likely succeed in this difficult task.

Moderate inflation in 2003 ended the short deflationary period



³⁹ 4.8% in Q4'03 versus 2.8% in Q4'02.

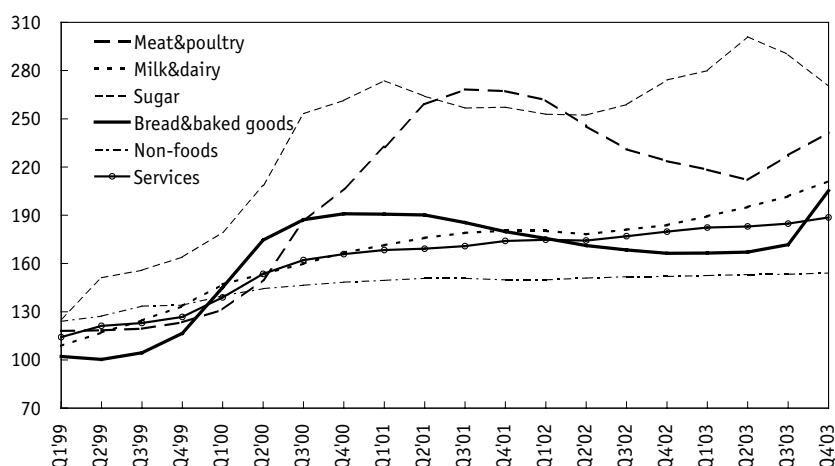
⁴⁰ For more detail on market regulation options, see *quarterly predictions* for Q4'03, p. 22–25.

⁴¹ This has to do with the high cost of fodder for livestock breeding, growing costs of rolled metal and construction materials, anticipated industrial gas price hikes, rising transport tariffs, and so on. In 2002, despite the lower cost of input resources, particularly fodder, producers of foodstuffs such as poultry and dairy managed to get away with bigger-than-ever seasonal price rises, which may testify to the disinflationary effect of competition in 2003.

⁴² The consumer market saw a bread prices jump 36%, while flour prices skyrocket 75%. Meanwhile, the regulatory schemes that were introduced require hefty financing. For example, in 2003, the local government allocated interest-free loans through Khreshchatyk Bank worth more than UAH 200mn to the KyivMlyn company alone.

Figure 2. Consumer Price Index breakdown

index of average quarterly change, seasonally adjusted, Q4'97=100



Source: Derzhkomstat; calculations by Quarterly Predictions

The heating up economy caused demand-driven inflation

Another problem that has taken shape during the period of economic growth is the emergence of demand-driven inflation caused by the heating-up economy. Producers, particularly export-oriented ones, face growing demand and rising prices for their commodities on the foreign markets. The growth of production is partly responsible for the growing incomes of workers, who are spending most of their incomes on investment and consumption,⁴³ thus contributing to demand-driven inflation. Given persistent economic growth, it will become more and more difficult to maintain the same expansion rates for the supply of goods, while competition will fail soon to maintain the same low growth of prices.

In 2004, inflation will be stimulated by the growth of incomes, directly or indirectly related to the presidential election. Increasing government transfers to the general population, growing wages, and cash transfers to support the presidential race could become other factors behind demand-driven inflation.

CPI in 2001–2006

2001	6.1%
2002	-0.6%
2003	8.2%
2004	6.0%
2005	7.0%
2006	4.5%

Therefore, the 6% inflation in 2004 will be based on limited price growth for foodstuffs and a small core price rise for non-food products and services.

Given the gradual slowdown of economic growth and the lack of a great need for voter support, 2005–2006 will see a decline in the impact of demand-driven inflation. However, the weakening administrative component of price regulation⁴⁴ will reinforce inflation, which will be related to: (1) liberalized prices on the foodstuffs market; (2) reforms in the residential services sector; (3) growing energy prices.

On the other hand, better-quality stabilization policy on agricultural markets and growing competition on the food-processing market, especially after

⁴³ According to estimates based on ICPS modeling, for every additional hryvnia of income, the average household will spend UAH 0.97 on consumption and investments. Steep growth in real estate prices, which have more than doubled over the past two years, reflect high demand for residential space.

⁴⁴ According to ICPS, after the 2004 election, the government will ease price controls and will start instituting long-delayed rate hikes, especially for public utilities.

Ukraine's accession to the WTO, should contribute to reducing price fluctuations and dampening inflation connected to growing food prices.

The risks to this ICPS forecast are: (1) stronger interference from monopolistic structures in the market as regulation remains weak; (2) a speculative rush despite government efforts to mitigate unbalanced markets.

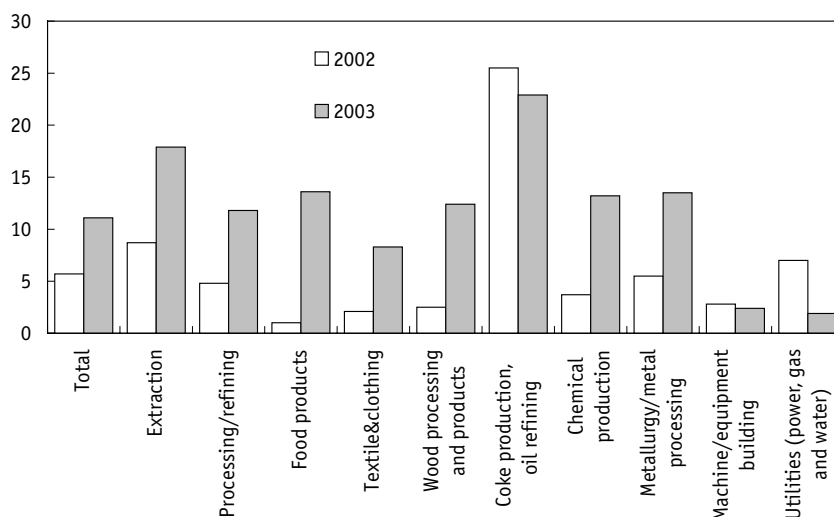
Producer prices

After moderate producer price growth in 2002, inflation rates for producer prices almost doubled in 2003. This happened mainly because of the extremely favorable situation on world metals and chemicals markets. This has encouraged producers to jump at the opportunity and increase export prices (see **FOREIGN TRADE**). However, such rapid growth in the metal industries resulted in a shortage of raw materials and a related price rise, and this, in turn, led to cost-driven inflation.⁴⁵ Moreover, a grain market shortage pushed up the cost of processing food.

**Producer prices
will keep climbing**

Figure 3. Producer Price Index breakdown

% annual



Source: Derzhkomstat

In 2004, inflationary trends will be determined by the situation on world markets. Metal prices will continue upwards and chemical products will become slightly more expensive. However, cost inflation will also continue, since the shortage of raw materials will not be relieved and coke and iron ore will become far more expensive, while energy and transport costs will spiral up-

⁴⁵ According to the *Interfax-Ukraine* newswire of 3 February 2004, prices for ferrous scrap metal grew by 27.6% in 2003, and for iron ore (sintering ore 19.5%, agglomerate 50%, iron-ore concentrate 30%); prices for blast-furnace coke rose by 57.3% because of price growth for coking coal. In addition, the reorganization of the coal market pushed up selling prices for steam coal. Cargo rates for rail transport also surged 10.7%.

PPI in 2001–2006

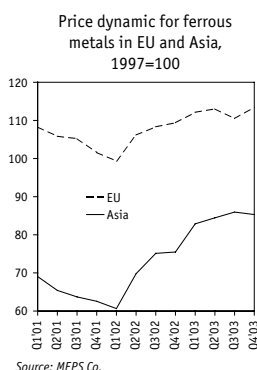
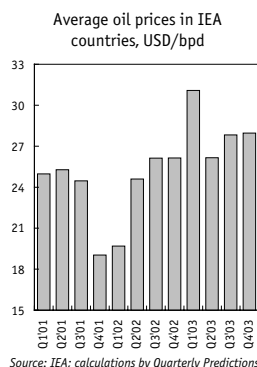
2001	0.9%
2002	5.7%
2003	11.1%
2004	12.0%
2005	7.0%
2006	5.0%

wards.⁴⁶ A decline in food processing prices will only begin to be seen in H2'04.

During 2005–2006, price dynamics will be a bit more moderate. The key factor will be a slowdown in price trends on external markets. However, the need to raise the competitiveness of domestic production, especially after Ukraine accedes to the WTO, will spur price growth for investment materials. In addition, although a decline in power consumption (see **INDUSTRY**) will contribute to lower demand for raw materials, Russia's fuel price liberalization will gradually lead to higher prices for electricity and industrial goods.

Commodity prices

In 2003, oil prices were driven up by an 1.8% growth in world demand for oil. At the same time, hopes for Iraq's rapid re-emergence on the market with its pre-war supply volumes turned out to be unfounded. During 2004, oil prices should stay high due to OPEC's policy of artificially supporting high prices. On 10 February 2004, the oil cartel decided to reduce daily crude production quotas by 1 million bpd starting 1 April 2004, although world oil prices were already higher than the OPEC price corridor. The cartel wants to maintain high profits despite the seasonal decline in demand. In 2004–2005, world demand for oil will grow at the same pace, around 2%, but oil production will expand because of Russia and Iraq. Still, oil prices will not see a moderate decline before 2005.



At the end of 2003, prices on world steel markets resumed growing after a slight stabilization.⁴⁷ This was caused by expanding demand on Asian markets and specifically in China, due to substantial domestic shortage of metal products. The costs of raw materials such as ore and coke picked up, as did international transport costs. Moreover, when setting prices, producers took into account the downward trend of the US dollar against other top currencies. Current production cost trends signal the impossibility of a substantial lowering of prices before 2005, when China and other Asian countries increase their own capacities by more than a third, significantly reducing their own metal shortage.

Growing grain prices continued through the second half of 2003 due to declines in output in Europe and Asia. This growth slowed a bit at the beginning of 2004, when key importing countries revived demand.⁴⁸ The current grain shortage will keep prices higher than the average for the past three years until the end of the current marketing year in June 2004. In 2004, a 27% expansion

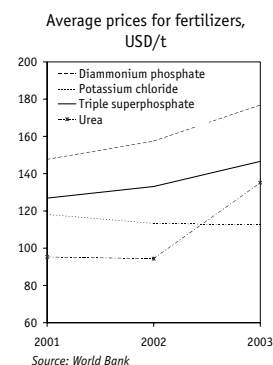
⁴⁶ NAK Naftogaz Ukrainy has managed to raise gas selling prices by 6% since January 2004 and the National Energy Regulatory Commission has added an additional charge to wholesale electricity prices since January 2004, which should increase annual costs for industrial consumers by UAH 1.6bn. In Q1'04, there should be adjustments in public transport rates. UkrZaliznytsia, the national railway corporation, plans to increase export rates for iron ore and coke transport.

⁴⁷ Prices for hot-rolled steel rose 10% over 2003, while cold-rolled steel and products on average became about 35% more expensive. Over 2002–2003, rolled steel prices rose more than 50%.

⁴⁸ For example, prices for Russian grain climbed US \$36 over Q4'03, to US \$158/tonne. In January 2004, world prices for the 2nd grade hard red wheat totaled nearly US \$170/t under FOB Gulf delivery, which was US \$20 higher than in October 2003.

of production in Europe and 3%⁴⁹ expansion in Asia will keep prices growing, despite a 25% decline in world grain reserves compared to the previous marketing year. At the same time, a gradually expanding gap between demand and supply on the world grain market will boost price levels in 2005–2006.

Prices for chemical products grew over 2002–2003, substantially accelerating in 2003. Prices for fertilizers also climbed significantly. Competition on Eastern European markets for highly processed chemical products is limited. Therefore, it is highly unlikely that there will be any essential changes in the pricing situation. Continuing high prices for energy resources and the growth of the world economy will contribute to keeping prices high for the chemical products.



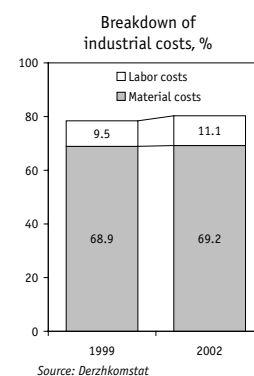
How to overcome cost inflation

Cost inflation can be seen when general price levels grow along with rising input costs for most producers, and thus production costs. Steady cost growth is a persistent factor in price growth—usually not caused by an imbalance of demand and supply—but which can raise inflationary expectations and, thus, social costs. One of the ways to avoid such costs is appropriate market regulation: subsidies, institutional restrictions, and so on.

In recent years, the key sources for cost inflation of manufacturers in Ukraine have been:

- growing real wages;⁵⁰
- growing tax pressure;⁵¹
- growing material expenditures at the expense of energy resources.⁵²
The energy component has been growing, in particular due to oil and gas price hikes for industrial consumers;
- high investment activity,⁵³ which has led to general increases in production costs in various areas of the economy.

The problem is not so much growing production costs per se, but the degree to which they translate into inflation. For example, growing steel product prices in 2003 were caused mostly by high global demand for this commodity. At the same time, bread prices grew because of high prices for the raw material, grain. In the first case, it is possible to lower prices by cutting high profit margins in the sector, while in the second case, there is virtually no way to cut prices.⁵⁴



⁴⁹ According to data from the UN's Food and Agriculture Organization (FAO).

⁵⁰ Industrial labor costs rose from 9.2% in 2000 to 11.1% in 2002.

⁵¹ Budget redistribution of tax revenues grew from 25.7% in 2001 to 28% in 2003.

⁵² The cost of electricity grew 8.9% over 2002–2003, compared a growth of 16.8% in industry as a whole. Prices for imported oil jumped more than 20% in 2003.

⁵³ In recent years, gross investments have been growing faster than GDP, and the investment deflator climbed more rapidly than the GDP deflator. As a result, the investment share of GDP inched up from 19.8% to 20.3% over 2002–2003.

⁵⁴ The assumption is that the level of competitiveness is sufficient and high prices in these sectors are not the result of a monopoly position on the part of the producer.

On the other hand, if it can be expected that medium-term change in costs is not constant (for example, the situation on the grain market in 2003–2004), then it seems premature to speak about continuous cost inflation. If it can be expected that investment costs or the value of gas price growth are passed along to consumers in different markets over the long term, then it is possible to speak about steady cost inflation, which leads to persistent core inflation.⁵⁵

In practice, countermeasures against the cost inflation are fairly complicated. Even if analysis proves that there is high cost inflation, any Government will find it quite difficult to introduce an appropriate stabilization policy: regular administrative, fiscal or monetary instruments can provide only temporary relief from inflationary pressures. The most effective measures are structural reforms, such as introducing energy-saving technologies or strengthening competition. However, putting these into action is a complicated, long-term task that can turn out to be pretty costly.

⁵⁵ Core inflation is a factor used for serious in-depth analysis by central banks among developed countries. Still, changes in food prices, which fluctuate too much, and the energy component are excluded from general inflation.

MONETARY POLICY

The country's tighter monetary policy in late 2003–early 2004 was caused mostly by high expectations of inflation. Nevertheless, the money supply will continue to be high in 2004–2006 and a slowdown in its expansion will be due primarily to a gradual reduction in the supply of foreign currency. The hryvnia exchange rate should remain stable until the liberalization of the financial market just prior to Ukraine's accession to the WTO in 2005. No major lowering of interest rates can be expected in the next few years because of high demand, a limited money supply and moderate inflation

Money market

2003 results

The expansion of the monetary mass in Q4'03 was the lowest in the last three years.⁵⁶ According to ICPS, this was due to a number of factors:

- **REDUCED CURRENCY INFLOWS.** The growth of the balance of payments slowed in Q4'03. While the current account balance (CAB) stood at US \$2.483bn during January–September, by year-end the figure had moved up to US \$2.891bn (see **FOREIGN TRADE**).
- **RISING GOVERNMENT FUNDS IN TREASURY ACCOUNTS.** Reaching a record-high of UAH 7.7bn in both the national and foreign currencies, this was double the balance of the entire domestic banking system. This forced the NBU to limit the money supply and caused interbank lending rates to go up, peaking in November 2003.
- **A FAR LOWER CASH INCREASE.** The share of cash in the money mass dropped from 41% to 35% during 2003. The key reasons behind this decline were the expansion of non-cash transactions⁵⁷ and moderate movement out of the shadow economy.
- **RESTRAINED GROWTH OF BANK CREDIT PORTFOLIOS.** The NBU announced that a more careful lending policy was needed and called on a reduction of the share of overnight lending.

In 2003, the country registered the highest money mass growth—46.5%—in the years since the economy began to grow rapidly in 2000. This can be explained by: (1) record-high economic growth (see **OVERVIEW**); (2) high demand for lending,⁵⁸ (3) continuing macro-financial stability accompanied by slower money circulation.⁵⁹

In Q4'03, monetary policy was tighter than usual at year-end

In 2003, the money mass grew the fastest in the last four years

⁵⁶ The money mass grew 9.9% in October–December 2003, compared to 12.4% growth a year earlier.

⁵⁷ Balance on payment-card accounts rose by 61%, to UAH 3.108bn in 2003.

⁵⁸ Bank credit portfolios rose by 61% in the course of the year.

⁵⁹ According to NBU data, this indicator shrank from 6.26 in 2000 to 3.2 in 2003.

In early 2004, net money supply was lower than in 2003

Current trends

In Q1'04, the net money supply fell compared to 2003: the growth of the money mass slid to 6.4%, against 8.1% over the same period of 2003. This happened despite growing foreign currency inflows into the country.⁶⁰ According to ICPS, the key reason behind the lower money supply is NBU efforts to ensure a well-balanced lending policy for domestic commercial banks⁶¹.

How to make money in Government accounts work more efficiently

Throughout 2003, the Government kept increasing the concentration of its own money in Treasury accounts at the National Bank. This led to lower liquidity in the banking system and fluctuating rates on the inter-bank market. Given the uneven and disproportional financing of Budget spending over the year, the key reason for such supply fluctuations was the Government's inefficient use of temporary free money when the Budget showed a surplus.⁶² By instituting daily oversight of mandatory reserves, the NBU has been only dealing with deteriorating liquidity—a symptom of the real problem.

In most of the world, Government accounts have unstable residues, which require coordinated action between the manager of the Government's money (usually the Treasury) and the central bank.⁶³ At first sight, the best option for the Government seems to be to lend this money, which would increase the country's financial options and give the central bank an opportunity to use an additional monetary policy instrument. However, it is not the best option because of the possibility that the central bank will lose its independence and monetary policy will become careless.

According to ICPS, the best alternative is to improve the way that the Budget operates, which means using Government funds more in accordance with the Budget schedule.⁶⁴

⁶⁰ The volume of net NBU currency purchases during January-March 2004 stood at US \$935.4mn, compared to the US \$622.4mn over the same period of 2003.

⁶¹ This was caused by deteriorating liquidity in the banking system over 2003. The short-term liquidity ratio (H6) slipped from 37.5 in early 2003 to 33.7 at the beginning of 2004.

⁶² In recent years, Ukraine has registered a substantial Budget surplus for most of each year, the result of delaying fulfillment of unprotected expenditure items until the year-end.

⁶³ In 1987, economist Milton Friedman, winner of the 1976 Nobel Prize, in fact suggested the practice of merging central banks and treasuries. He argued that merging these institutions created a single locus of responsibility and helps avoid uncoordinated actions and competition for resources among government institutions.

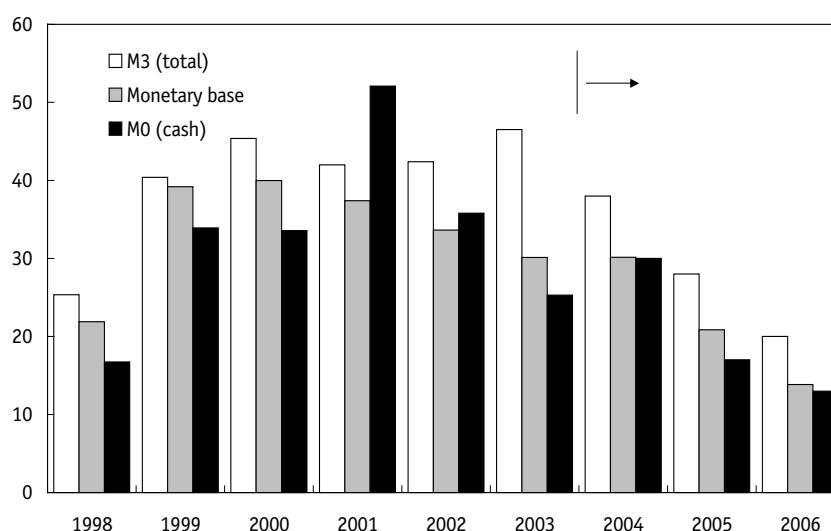
⁶⁴ The Treasury has already agreed to an NBU proposal to combine the possibilities of the electronic payment system and the rapid money transfer system. The Treasury has opened a single Treasury account at the NBU, while oblast branches of the Treasury have accounts in the Treasury's accounting office. Previously, daily funds delivered to the Budget were first collected at the oblast level and then were either transferred to the central Budget or remained at the oblast level. In other words, the Treasury did not have detailed current information about Budget fulfillment and the state of client accounts.

Worse, the problem that concentrations of Government funds in Treasury accounts at the NBU are hard to predict remained unresolved: this actually threatens the effectiveness of the central bank's monetary policy.

Moderate inflation compared to 2003 (see **PRICES**) and accelerating growth in household incomes (see **HOUSEHOLDS**) contributed to a more rapid increase of bank deposits. Accordingly, the monetary base⁶⁵ escalated even faster. In addition, unlike early 2003, volumes of cash in circulation did not shrink substantially.

Figure 4. Money aggregates

% nominal change



Source: NBU; forecast by Quarterly Predictions

Forecast for 2004

According to ICPS, the National Bank's monetary policy during 2004 will aim at resolving a number of priority tasks:

- preventing strong monetary pressure on prices, in particular by heating up economy (see **OVERVIEW**);
- contributing to continuing high economic growth by ensuring a high pace of lending, while at the same time improving the quality of credit portfolios, which should somewhat slow the growth of lending volumes;⁶⁶
- supporting the stability of the national currency, especially the UAH/USD exchange rate.

⁶⁵ In Q1'04, personal bank deposits rose 12.5%, compared to 11.7% in Q1'03. The monetary base went up 3.27% against 1.24% a year ago.

⁶⁶ In Q1'04, bank loans grew 8.2%, against 9.5% in Q1'03 and were rising generally slower than the deposit base.

Thus, despite the expected growth in demand⁶⁷ for money, the NBU will slightly limit money supply growth. In 2003, the central bank paid more attention to quantitative indicators, in 2004 it can be hoped that qualitative factors will become a priority, especially improving the liquidity of the banking system⁶⁸ and greater capitalization of the stock market.

As a result, ICPS is downgrading its forecast for money mass growth to 38%. On the other hand, forecasts for monetary base and cash in circulation indicators remain unaltered at 30%, due to the upcoming presidential election (see **POLITICAL ENVIRONMENT**) and continuing high growth of deposits.

Interest rates will remain high

A imbalance between demand for resources and their supply and high inflationary expectations among the population⁶⁹ will keep interest rates relatively high.⁷⁰ In H2'04, with the presidential election looming, the money supply can be expected to expand and interest rates decline modestly, by 1 pp on average.

Forecast for 2005–2006

The growth of money aggregates will slow down in 2005–2006

We forecast that the growth of money aggregates will see significant decline in 2005–2006 due to several factors:

- a slipping positive current account balance (see **FOREIGN TRADE**);
- the growing monetization of Ukraine's economy, up to 50% in 2006;⁷¹
- a gradual decrease of bank options for rapid expansion of lending due to slower deposit growth. This will be the result of expanding alternatives for investment and a lower pace of household income growth (see **HOUSEHOLDS**).

The money mass should grow 28% in 2005, and 20% in 2006

The ICPS forecast for money aggregates growth has been slightly upgraded for 2005 in light of the improved CAB (see **FOREIGN TRADE**) and net foreign direct investment inflows (see **BUSINESS**). According to ICPS calculations, the money mass should grow 28% in 2005, and the monetary base 21%. Due to considerably lower currency inflows from external trade and an economic slowdown (see **OVERVIEW**), the money mass will likely grow 20% in 2006.

Interest rates will start slipping perceptibly only in 2006, when the inflation rate⁷² drops substantially. According to the ICPS forecast, the average rate for

⁶⁷ The gradual growth of prices for investment resources such as real estate and vehicles, as well as the growing popularity of lending services in a rapidly growing economy have put further demand pressures on credit resources. ICPS expects that the range of non-banking financial services will grow in 2004, which will also require resources.

⁶⁸ As of 1 March 2004, the regulatory capital adequacy ratio (H2) was raised from 8% to 10%.

⁶⁹ The Index of Inflationary Expectations, calculated by ICPS and GfK-USM, stood at 178.3 in March 2004, which means that 178 out of 200 Ukrainians expect escalating inflation.

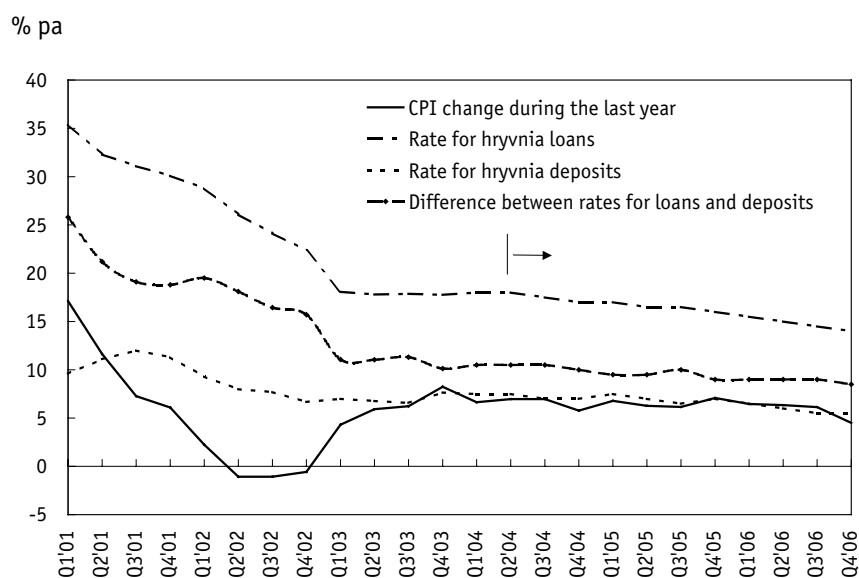
⁷⁰ Average interest rates for loans, excluding overdrafts, dropped to a record-low 17.2% in June 2003, then inched back up to 18% per annum by year's end. Interest rates for annual loans, necessary for business investment programs, remain at 20% per annum and higher.

⁷¹ The majority of CEE countries have 40–50% monetization.

hryvnia deposits should slip from the current 8% to 5.5% per annum in 2006. A cheaper savings base, the greater role of foreign capital on the domestic financial services market as Ukraine accedes to the WTO, and a fairly high level of FDI will stimulate lower rates for hryvnia-denominated loans. Interest on these will deflate from 18% to 14% in late 2006.

In the meantime, as the experience of CEE countries has shown, a number of factors may get in the way of lowering interest rates: (1) high inflationary expectations; (2) unsatisfied demand on the real estate market; (3) the absence of mortgage banks and an underdeveloped non-banking financial sector; (4) the absence of a single registration system for property, land and mortgages.

Figure 5. Opportunity cost of money



Sources: NBU, Derzhkomstat; forecast by Quarterly Predictions

The main risks to this forecast are: (1) consumer prices growing at a high pace in reaction to steep growth in industrial prices in 2004; (2) deteriorating banking liquidity due to a possible increase in bad debts;⁷³ (3) the lack of a well-balanced monetary policy during the pre-election periods in H2'04 and in early 2006.

⁷² As a rule, rates for 30-day or longer time deposits in hryvnia cannot be below the forecast inflation.

⁷³ In 2003, the share of bad debts (overdue or questionable) slipped from 4.5% to 3.4% according to NBU data. However, bank analysts say it is possible that this share will grow shortly, due to risky lending policy exercised by some banks. This made it possible to increase the level of lending in the economy by 61.4% in 2003, as the money mass grew 46.5% and the economy 9.4%. Moreover, bankers say that the real share of problem loans is far higher than what the NBU is admitting.

Foreign exchange market

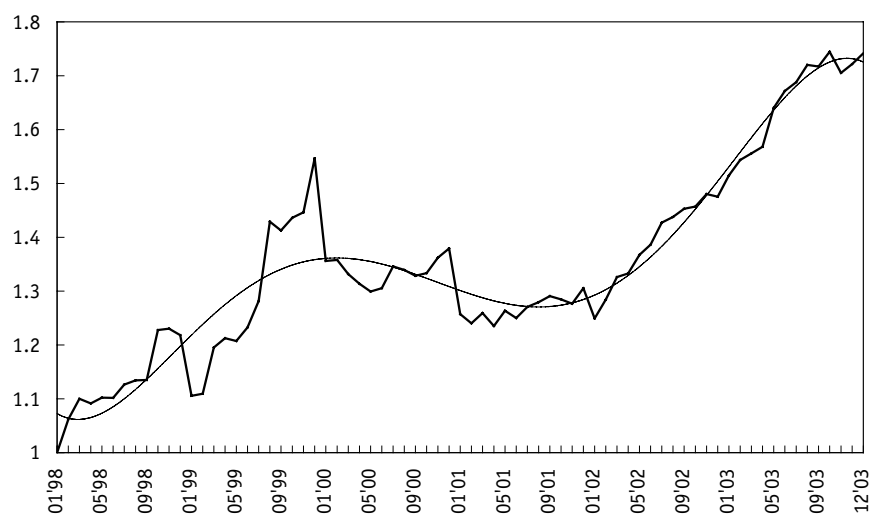
Exchange rate

The UAH/USD exchange rate remains stable, although hryvnia depreciation continues in real terms

Throughout 2003 and early 2004, the UAH/USD exchange rate remained at 5.33/1. At the same time, the steep growth of the euro on world markets led to considerable strengthening of the common European currency in Ukraine, where it reached UAH6.66 in late 2003. This means hryvnia depreciation was 20% against the euro. Real UAH depreciation,⁷⁴ which slowed down at year-end due to escalating inflation in Ukraine, stood at 18% over 2003.

Figure 6. Dynamic of the real effective hryvnia exchange rate

January 1998=1



Sources: NBU, IMF, national statistics agencies; calculations by Quarterly Predictions

Real hryvnia depreciation should slow down in 2004

An end to the euro growth trend on world forex markets will reduce real hryvnia devaluation, according to the ICPS forecast for 2004.

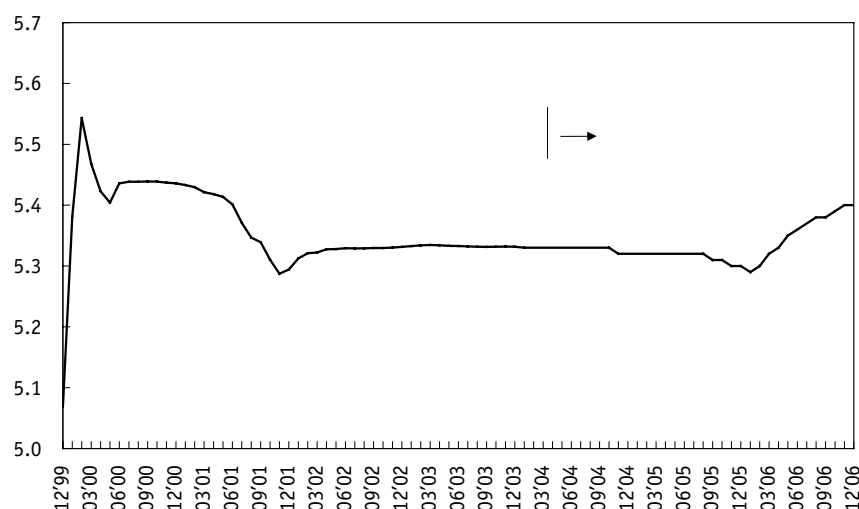
During 2004, the National Bank will remain true to its chosen strategy of effectively pegging the hryvnia to the US dollar,⁷⁵ which will continue at the rate of 5.33/1 for most of the year. According to ICPS specialists, a slight nominal appreciation of Ukraine's currency is possible during the next two years: in 2004, to 5.32/1 and in 2005, to 5.3/1. The reason behind appreciation will be continuing high inflows of foreign currency and an anticipated decline in capital outflow after the 2004 election. However, significant deterioration in the current account balance in 2006 (see **FOREIGN TRADE**) will put pressure on

⁷⁴ ICPS calculates the real effective hryvnia exchange rate (REER) across Ukraine's 12 biggest trade partners, who account for two-thirds of the foreign trade balance.

⁷⁵ The effective pegging of hryvnia to the US dollar is explained by structure of foreign currency transactions: US dollars constituted the lion's share (77%) of foreign currency transactions on the forex market in 2003. The specific gravity of euro transactions rose by 2 pp over the year and reached 13.2%. According to ICPS, the foreign currency structure will see no significant changes over next few years, though the euro portion will gradually expand.

the UAH/USD exchange rate and result in moderate hryvnia depreciation to 5.4/1 by year-end.

Figure 7. Dynamic of the nominal hryvnia exchange rate UAH/USD



Source: NBU; forecast by Quarterly Predictions

Capital flows

According to 2003 balance of payments data published by the NBU, Ukraine is still seeing large volumes of capital flight. Given the NBU's efforts to combat schemes that made it possible to move capital abroad in the form of "portfolio investments,"⁷⁶ this type of capital flight substantially declined in 2003, to US \$922mn from US \$1,716mn in 2002. Instead, "errors and omissions" have grown, indicating that financial agents are actively using and improving different schemes for removing capital from the country. At the same time, reserve assets grew from US \$1,045mn in 2002 to US \$2,045mn in 2003, along with accelerated foreign investment (see **BUSINESS**), signaling the growing investment appeal of the Ukrainian economy.

ICPS expects capital flight rates in Ukraine to slow down in 2004–2006 thanks to: (1) persistent high real GDP growth rates (see **OVERVIEW**) and the ensuing greater appeal of the country's economy; (2) active privatization (see **BUSINESS**); (3) tighter requirements for capital origin declarations in the new EU members, particularly Cyprus; (4) greater oversight of the non-banking financial sector, in particular sham re-insurance schemes.

Assuming lower-than-expected capital flight rates, ICPS has somewhat improved its forecast for the upturn in gold and foreign exchange reserves during 2004. The upward adjustment of the forecast for 2005 is related to an improved forecast for the current account balance (see **FOREIGN TRADE**). ICPS expects that gold and foreign exchange reserves will grow more than US \$2bn a year in 2004–2005. In 2006, growth in reserves will slow down due to a deteriorating CAB.

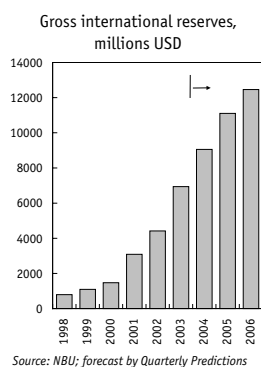
Ukraine still sees large volumes of capital flight

Forecast for CAB and NBU currency reserves growth, mn USD

Years	CAB	Res.
2004	2,400	2,100
2005	2,030	2,050
2006	930	1,350

⁷⁶ For more detail, see *quarterly predictions* for Q1'03, p. 24.

In general, gold and foreign exchange reserves will continue growing at a high pace, reaching 18 weeks of goods and services imports by the end of 2006, compared to the current 13 weeks.



The risks to this ICPS forecast are:

- the playing out of radical scenarios in the 2004 presidential race (see **POLITICAL ENVIRONMENT**), increasing business risk in Ukraine and spurring capital flight;
- possible sudden changes in the world market situation;
- Ukraine's failure to accede to the WTO in 2005;
- pre-term repayment of the IMF debt.⁷⁷

⁷⁷ For more information about the expediency of early repayment of the IMF debt, see *quarterly predictions* for Q3'03, p. 61.

PUBLIC FINANCE

The 2003 Consolidated Budget performed satisfactorily, thanks to better macroeconomic indicators than in 2002. There was no anticipated surplus in Budget revenues because revenues from the VAT were low and the tax base failed to expand. The introduction of special VAT accounts in 2004—provided the Government does a good job—could improve the administration of the VAT. 2004 Budget revenues will reach 27% of GDP, growing to 27.5% in 2005–2006 as the effects of tax reform are felt

Results for 2003

In 2003, Consolidated Budget expenditures rose by 2% of GDP, reaching 28.7%. Budget revenues were 28.5% of GDP, against 27.1% in 2002. The growth of expenditures is explained by improving tax revenues, access to relatively cheap foreign loans, and the fulfillment of the privatization plan. The expenditures were unevenly disbursed during the year. The low level of fulfillment of expenditures in the Consolidated Budget⁷⁸ was caused by flaws in the Treasury servicing system: the current system is designed for a chronic underfulfillment of Budget revenues and is ineffective when Budget revenues are stable.

In 2003, Budget spending grew, but was unevenly disbursed during the year

Table 4. Consolidated Budget revenues

% GDP	2002	2003
Total revenues	27.1	28.5
Tax revenues, including:	20.1	20.6
personal income tax	4.9	5.1
corporate profit tax	4.1	5.0
VAT	6.0	4.8
excise	1.8	2.0
taxes on international trade and external operations	1.1	1.4
Non-tax revenues, including:	6.5	6.9
revenues of Budget-funded organizations	3.4	2.9
Revenues from capital operations	0.5	0.7
Budget balance	0.7	-0.2

Source: Treasury; calculations by Quarterly Predictions

Actual revenues taken by the 2003 Consolidated Budget were 99.8% of planned, although the GDP growth rate substantially surpassed the 4.8% level predicted in the 2003 Budget (see **OVERVIEW**). The reasons behind this are comparatively low VAT Budget revenues and the failure of the tax base to grow. VAT revenues declined due to larger-than-planned payouts of VAT refund arrears to exporters and volumes of VAT export refunds during the year that were higher than in 2002.⁷⁹ This increase is connected to a speedy growth

Economic growth has not been matched by an expanding tax base

⁷⁸ Over 11 months of 2003, disbursements of Budget expenditures stood at 82.7%; for the year, they were 94.7%.

⁷⁹ In 2003, UAH 10.3bn was spent on VAT refund to exporters, according to data from the Treasury.

of exports in 2003 (see FOREIGN TRADE). On one hand, the tax base remained narrow because of tax breaks granted to sectors that were growing rapidly in 2003—car-making and residential construction. On the other hand, tax collections did not rise in line with growing incomes because taxpayers were able to use legitimate loopholes to avoid taxes.

Tax policy

What changes can be expected?

Changes in legislation remain a source of uncertainty to business

In March 2004, the President vetoed a law adjusting tax legislation after the adoption of the Budget.⁸⁰ Among the numerous changes in the law, three are worth mentioning: (1) the revival of some breaks cancelled by the Budget Law; (2) an increase in excise rates for 2004; (3) a change of the VAT rate for 2005–2006. The debate over amendments to the tax system that were supposed to gain force just in 2004, the adoption of the relevant law, and its subsequent cancellation have created uncertainty in a number of business areas: publishing, insurance, agriculture, and the production and sale of alcohol and tobacco products. The lack of an integrated tax reform program, violations of Budget Code norms, and the lack of high-quality impact analysis of the proposed changes—all continue to hamper the transformation of the tax system.

What's in a tax-free minimum?

Since the law on personal income tax was adopted, the term "tax-free minimum" has lost its unequivocal meaning. This happened because the tax-free minimum is now applied not only in its direct sense—to determine incomes not subject to taxation—but also to determine fines for civil and criminal violations, the size of a limited liability company's (TOV) statutory fund, and others. By 2007, the tax-free minimum is expected to be raised to the level of the minimum wage.⁸¹ As of 1 January 2004, the tax-free minimum was raised from UAH 17 to UAH 61.5. To avoid increasing all fees and fines across the board, however, as well as the minimum statutory fund requirements for TOV, the tax-free minimum has been left at UAH 17 in some cases and UAH 61.5 in others.

The tax-free minimum began to be actively applied during periods of high inflation as a kind of automatic indexing of fees and fines, and of certain indicators of commercial activity. Since 2001, however, inflation has stayed below 10% and there has been no real need for indexing. Thus, we think that fines and other bases of commercial activity should hence be defined without reference to the tax-free minimum.

⁸⁰ See Bill No.4000-1 amending certain legislative acts upon the adoption of the 2004 State Budget Law, passed by the Verkhovna Rada 5 February 2004.

⁸¹ The 22 May 2003 Law on personal income tax introduced the definition of social tax deduction identical to the definition of tax-free minimum given in the 26 December 1992 Cabinet Decree on personal profit tax. According to the Law on personal income tax, the social tax deduction is 30% of the 2004 minimum wage, and will rise to 50% in 2005, to 80% in 2006, and to 100% in 2007.

We predict that separate bills that are based on parts of the law amending the State Budget vetoed by the president are not likely to be adopted before summer 2004.

VAT administration

In March 2004, the president proposed⁸² the introduction of special accounts for VAT payments.⁸³ The new system of administrating taxes is intended to improve the transparency of VAT settlements and make it impossible to use illegal VAT refund schemes. The proposed system could substantially increase VAT revenues to the Budget, provided that: (1) the details of how VAT accounts should operate are worked out thoroughly and on time; (2) the rules for operating VAT accounts are the same for all payers of VAT; (3) any future VAT evasion schemes become relatively costly; (4) no new VAT exemptions are introduced.

VAT accounts could raise Budget revenues

Table 5. Advantages and disadvantages of special current VAT accounts

Advantages	Disadvantages
VAT evasion by setting up fictitious companies becomes pointless	The state is spending money to introduce VAT accounts
VAT refunds to exporters are unconditional ⁸⁴	Companies have to spend money to switch to the new system, which will tie up working capital
Special VAT accounts will speed up the automation of VAT administration	A high risk that the costs of introducing VAT accounts will outweigh the benefits if they are poorly implemented

One purpose for introducing VAT accounts is to reduce the size of the shadow economy. Should they succeed, tax pressure on the economy will grow, but it will now be more evenly distributed. This effect is likely to cause the general level of prices to rise and the relationship of prices across sectors to shift. Growing tax pressure and accelerating inflation are the price for increasing Budget revenues. In other words, the successful introduction of VAT accounts will mean that the state and the society favor re-distributing a larger share of resources through the Budget.

If VAT accounts succeed, this will raise re-distribution of resources through the Budget

⁸² The 1 March 2004 Presidential Decree on separate current accounts for handling VAT payments and refunds was cancelled 9 April. At the same time, the Verkhovna Rada registered a number of bills to amend relevant tax laws once special VAT accounts were instituted.

⁸³ The idea of special VAT accounts means that, in addition to a basic settlement account, every business has to open a special VAT account, into which VAT payments from buyers of goods and services are deposited. Funds in these special VAT accounts may be used only to pay the VAT or other tax obligations to the Budget, and to transfer VAT payments to suppliers.

⁸⁴ Unconditional VAT refunds to exporters are not likely to come into effect immediately. The 23 March 2004 Cabinet Resolution on issues related to VAT payments anticipated unconditional VAT refunds only to those exporters having an annual export volume at least at UAH 250mn in 2003 and capital assets with a book value of at least UAH 100mn.

We believe that special VAT accounts are not likely to be introduced before H2'04 due to their technical complexity and the opposition of business circles, who will certainly lobby to bury this idea, regardless of the Government's rigorous promotion and awareness campaign.

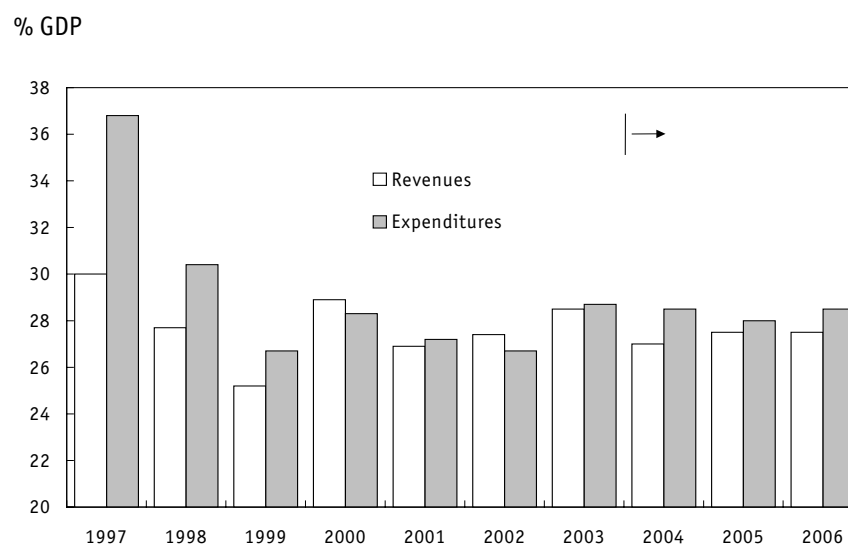
Forecast for 2004–2006

In 2004, the Budget revenue share of GDP will shrink

ICPS expects the GDP share re-distributed through the Consolidated Budget to shrink during 2004. This will happen as a result of reduced personal income tax⁸⁵ and corporate profit tax rates and increased deductions for depreciation.⁸⁶ Consolidated Budget revenues should stand at 27% of GDP. Still, this reduction in the Budget revenues share will not be drastic because:

- the average wage will keep growing more rapidly than the GDP (see **LABOR**);
- the dropping of tax breaks in the 2004 Budget Law⁸⁷ will increase Budget revenues;
- VAT export refunds will be somewhat delayed just before special VAT accounts are introduced;
- although import growth will slow down somewhat compared to 2003 (see **FOREIGN TRADE**), it will continue to contribute to the growth of import duty revenues.

Figure 8. Consolidated Budget revenues and expenditures



Source: Treasury; forecast by Quarterly Predictions

⁸⁵ In January-February 2004, personal incomes tax revenues rose 2.1% compared to 2003. According to ICPS, revenues grew because enterprises delayed paying out 2003 wages until early 2004, when the reduced tax rate came into effect.

⁸⁶ For more detail, see *quarterly predictions* for Q3'03, p. 17.

⁸⁷ For more information, see *quarterly predictions* for Q4'03, p. 15.

Ukraine can expect the 2004 Budget deficit to be 1.5% of GDP. This will enable the financing of social payments during an election year.⁸⁸ The 2004 privatization plan will be over-fulfilled because of increased demand for state property in the run-up to the presidential election (see **BUSINESS**). The Government will continue to favor foreign loans over domestic ones. With the peak repayment period for the principal on the country's external debt in 2003–2005, the possibility of financing expenditures through borrowing will be limited and thus Budget deficits will likely be moderate in the medium term.

The 2004 Budget deficit will be 1.5% of GDP

In 2005–2006, Consolidated Budget revenues will be 27.5% of GDP. Growth in the share of GDP re-distributed through the Budget will be caused, first of all, by a shrinking shadow economy in response, first, to lower tax rates⁸⁹ in 2004 and, then, to reduced VAT rates of 17% in 2005 and 15% in 2006, and the introduction of a new VAT administration system using VAT accounts.

In 2005, the Budget deficit should shrink to 0.5% of GDP...

... and climb back up to 1% in 2006

We see several risks to this forecast:

- low tax revenues in 2004 due to reduced tax rates result in a larger-than-expected financial gap in the 2004 Budget;
- tax breaks suspended by the 2004 Budget Law are revived, curtailing Budget revenues;
- the raise in the minimum wages from UAH 205 to UAH 237 as of 1 September 2004 (and not 1 November, as was in the 2004 Budget Law) substantially increases Budget expenditures and, hence, the financial gap;
- rejection or restricted application of VAT accounts.

⁸⁸ For the first time since 2001, the Government raised stipends for students at post-secondary institutions (see the 17 February 2004 Presidential Decree on measures to improve the system of higher education) and the minimal subsistence level (see the 2004 State Budget Law of 27 November 2003) as of 1 July 2004. As the new pension security law comes into effect, a pension hike of at least 4.2% introduced 1 January 2004 has been increased to 12% (see the 20 November 2003 Cabinet Resolution on measures to improve pension security).

⁸⁹ The rate of the corporate profit tax was reduced from 30% to 25% and personal income taxes from 10–40% to 13% as of 1 January 2004.

INDUSTRY

2003 results show that Ukraine's industry grew 15.8%, mainly due to a lingering favorable situation on world commodity markets. Industrial output accelerated not just in processing but in extraction and utilities (gas, water and electricity) as well. According to ICPS, demand for Ukraine's industrial products will remain high in 2004, while industrial growth indicators will rise 13%. A slight deterioration in the foreign trade situation during 2005–2006 will dampen industrial growth, which will register 9% and 8%

General trends

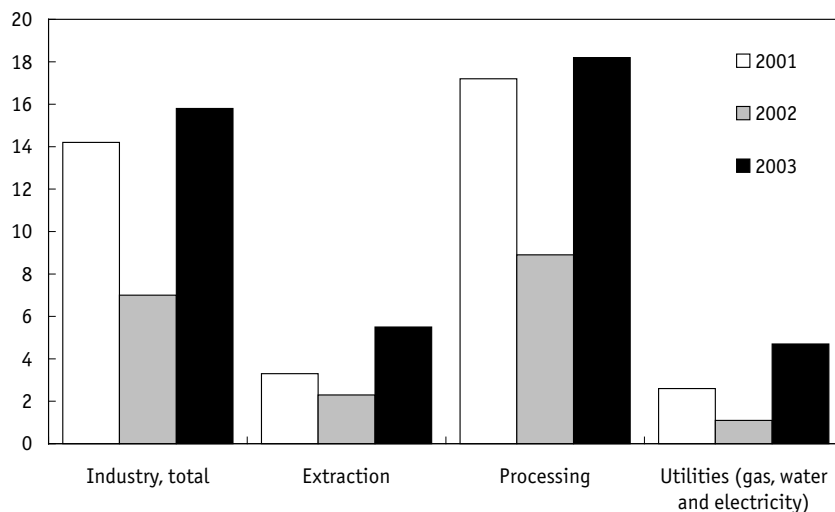
Structure of industrial growth

Industrial growth was decisive for the economy in 2003

Industrial output grew a record-high 15.8% during 2003, which compensated for the recession in agriculture and ensured GDP growth of 9.4% for the year (see **OVERVIEW**).⁹⁰ The processing branches were the key drivers of industrial growth in 2003 because of high demand on foreign markets for metal products⁹¹ and chemicals (see **FOREIGN TRADE**), and on the domestic market for foodstuffs and building materials.

Figure 9. Dynamic of industrial output

% to previous year



Source: Derzhkomstat

⁹⁰ Gross value-added, which was set up in industry in 2003, stood at 29% of GDP.

⁹¹ According to 2003 figures, Ukraine produced 36.707mn tonnes of steel, representing a 7.8% growth, and took seventh place among steel-producing countries for the third year running according to International Iron and Steel Institute (IISI) ratings. See the *Interfax-Ukraine* newswire of 19 January 2004.

An upturn in the processing industry has had a positive effect on output dynamics in the energy sector and in the domestic extraction industry. In 2003, electricity exports grew 54.9% and exports of iron ore grew 8%.

Forecast for 2004–2006

The ICPS forecast for industrial growth has been revised upward because of a more favorable situation on foreign commodity markets for Ukrainian exporters. The slowdown caused by a slight deterioration of the foreign trade situation during 2005–2006 (see **FOREIGN TRADE**) will be insignificant.

One positive risk to the forecast for 2004 is substantial growth in external demand, which could accelerate industrial growth.

Due to growing industrial output in 2003, both exporters and enterprises selling products on the domestic market were facing shortages and higher prices for inputs. According to the ICPS forecast, the impact of cost-driven inflation (see **PRICES**) will be selective:

- exporting companies will be able to raise prices for their products, which will be supported by growing world prices, while
- producers for the domestic market will sustain losses despite anti-inflationary government policy. Purchasing power among Ukrainian businesses and households is growing slower than prices on foreign markets.

According to ICPS, further cost-driven inflation will lead to the redistribution of resources in favor of exporters, pushing uncompetitive businesses out of the market and speeding up the acquisitions of domestic enterprises by Ukrainian financial-industrial groups (FIGs) and multinational corporations looking to diversify their assets.

Extraction

According to figures for 2003, extraction grew 5.5%. Q4'03 saw a further acceleration in the extracting of fuels. The Government managed to stabilize coal extraction volumes, which had been shrinking until then. Stable demand for other extracted products (oil, gas, iron-ore) and active company investment activity have contributed to the continuing expansion of output throughout the year.

A domestic and global resource hunger that was aggravated as metal output grew in 2003 will lead to further price hikes for iron-ore products and coking coal and, as a consequence, for metal products in general (see **PRICES**). However, these growth rates will slow down thanks to the Government's efforts at protecting consumers of metal products and other materials on the domestic market, particularly, construction companies and machine builders.⁹²

Optimistic prospects for further growth of iron-ore on foreign and domestic markets and further structural changes in the coal industry will spur the priva-

The ICPS forecast for industrial output has been upgraded

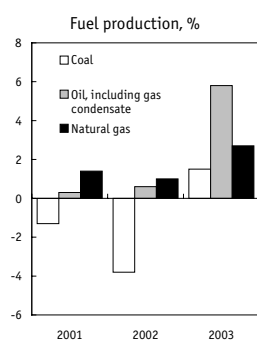
Industrial growth

2001	14.2%
2002	7.0%
2003	15.8%
2004	13.0%
2005	9.0%
2006	8.0%

Extraction growth

2001	3.3%
2002	2.3%
2003	5.5%
2004	6.5%
2005	5.0%
2006	4.0%

⁹² The 1 March 2004 Memorandum on agreeing actions between the Cabinet and producers and domestic consumers of metal products stipulates that prices for certain types of products sold on the domestic market will be frozen. The Government is also considering such measures as changing the structure of transport rates and reducing the number of intermediaries for selling metal products.



Source: Derzhkomstat

Continuing strong prices on world markets are the main driver of growth in the processing industries

tization of extracting companies in 2004.⁹³ Privatization of iron ore mining and enriching enterprises will lead to further expansion and upgrading of capacities. The effectiveness of the PavlohradVuhillia privatization will depend on the Government's decision about implementing coal sector reform during 2005–2006.

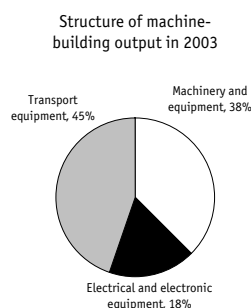
Stable demand for all types of extracted raw materials in 2004 will ensure sectoral growth of 6.5%. By 2005, this sector will have expanded capacities in order to meet demand for iron ore and coking coal in metal industries. The 2004 shortage of inputs on the domestic market will also be compensated by imports.⁹⁴

The ICPS forecast for extraction growth in 2005 and 2006 is upgraded to 5% and 4%. We think that high extraction rates for non-fuel materials and steady development of the oil and gas sector will compensate for any decline in coal mining as unprofitable mines are shut down.

Processing

Growth in the processing industries reached 18.2% according to 2003 figures, ensured mainly by a favorable situation on world markets for the key exporting sectors:

- High demand in Asian countries, particularly China, and in other countries contributed to expanding metal product output. Thus, in 2003 ferrous output went up 10.8%, metal processing jumped 33.6%, and piping, mainly imported by Russia, grew a solid 34.2%.
- Growing exports of metal products had a positive impact on coke production, which grew 12%. High oil prices pushed oil refining to rise by 7%. The growth of the chemicals industry in 2003 was due to continuing high demand for ammonia and urea in Russia and European countries.
- Demand for machinery, particularly for railway and power sector equipment on the CIS market, contributed to growth in the industry throughout 2003.



Source: Derzhkomstat

Table 6. Structural changes in processing industries

Share of all industrial output, %	2002	2003	2003 growth, %
<i>Processing, including:</i>	73.7	77.8	18.2
Metals	22.8	24.4	14.3
Foods	18.0	17.4	20.0
Machine-building	12.5	13.6	35.8
Coke and oil	5.7	7.7	8.7
Chemicals and petrochemicals	6.3	6.6	16.8
Other	8.4	8.1	–

Source: Derzhkomstat

⁹³ In particular, the subsidiary UkrRudProm and VAT PavlohradVuhillia, a state holding company, whose statutory funds amount to UAH 1.3–1.4bn.

⁹⁴ This year, there should be some expansion in the circle of countries supplying ore to domestic metalworks: in addition to Russia and Kazakhstan, imports of coking coal could come from the US and Austria.

More active investment and growing household incomes encouraged expansion of the domestic market, which can be seen in higher-than-average growth in the pulp and paper industry, construction materials, and others.

Another important factor in the growth of the domestic market is the government's protectionist policy, directed at expanding supplies and lowering their cost. Thus, the production of passenger cars—the car-making industry enjoys a number of breaks—doubled during 2003. At the same time, gradual liberalization of the domestic market as Ukraine negotiates accession to the WTO poses a threat to the further development of industries that are protected by government policy.

According to the ICPS forecast, processing will rise 15.5% during 2004, thanks to the continuing influence of the key factors behind growth in 2003.

Processing growth can be expected to slow down during 2005–2006, to 10% and 9%, due to a slight deterioration in the external situation (see **FOREIGN TRADE**). Given expanding domestic demand and the strengthening financial health of companies entering international capital markets, however, there should not be any steep decline.

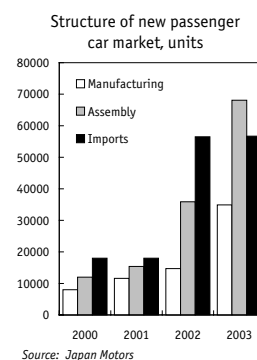
Utilities (power, gas and water)

According to 2003 figures, this sector's growth accelerated to 4.7%, after reaching a mere 1.1% in 2002.⁹⁵ The economic upswing (see **OVERVIEW**) resulted in rising demand for energy resources among all categories of consumers. Ukraine also increased its power exports to the Eastern and Central European countries by 1.9bn kW/h, to 5.2bn kW/h).

We expect this sector to grow 3% during 2004. There will be no substantial price hikes across the oil and gas complex, the power industry or the residential services sector (see **PRICES**) during an election year. At the same time, throughout 2004 the Government will actively prepare to continue residential services sector and power industry reforms. This should not generate any inflationary pressure, as reforms will deal with developing mechanisms for attracting investments into utilities and with changing the model for operating the wholesale electricity market (ORE).

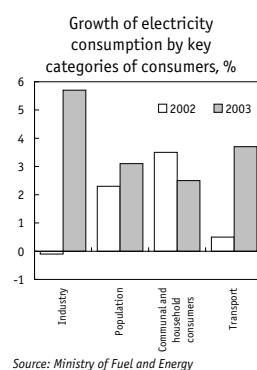
Various factors will have an impact on this industry's dynamic in 2005–2006. On one hand, 2005 should see the launch of full-scale power generation by the two newly-completed reactors at Khmelnytsk and Rivne AESs. As a result, 2005 should see growing power output, including exports, as the oldest energy blocks of thermo-electric stations (TESS) are gradually taken off-line.⁹⁶

On the other hand, the country will considerably reduce its consumption of energy resources starting in 2005. The introduction of reforms in the energy



Processing growth

2001	17.2%
2002	8.9%
2003	18.2%
2004	15.5%
2005	10.0%
2006	9.0%



⁹⁵ A downward growth trend over 2003 (in Q1'03, growth reached 13%) was due to unfavorable weather conditions—a cold winter—, and the large share of electricity exported in early 2003.

⁹⁶ Nuclear power rates are among the lowest, while rates for thermal power are the highest. Still, there will be no substantial drop in wholesale electricity prices, because the costs of finishing the two reactors needs to be reflected in the wholesale prices at the ORE.

industry and residential services sector should lead to rising rates, primarily consumer rates, and reduced inefficiencies with both water and power.⁹⁷

Growth in utilities

2001	2.6%
2002	1.1%
2003	4.7%
2004	3.0%
2005	5.0%
2006	4.0%

The economic upturn and expanding consumption of energy resources have worsened the ecological situation in the country. Uncertainty about the Kyoto Protocol, which Ukraine ratified in late 2003, and lack of mechanisms for stimulating the development of environmentally friendly technologies will lead to further environmental pollution.

How sensible is further concentration in the energy sector?

Recently the government began the process of establishing NAK Energy Company of Ukraine (ECU), whose statutory fund will combine all the state-owned shares⁹⁸ in domestic power utilities. According to ICPS, ECU, which will strengthen the Government's role in managing power companies, is the result of the Government's inability to enforce legislation or lack of legislation on corporate governance. The steps proposed by the president not only do not help tackle problems in the power sector, but could well wreck what reforms have already been carried out in it:

- *despite certain drawbacks, the national regulatory agency and the wholesale power market (ORE) ensure more transparent operation of companies in the industry, compared to the oil and gas sector or the railway system;*
- *separating competitive activities from monopolistic ones in the domestic power industry, that is, unbundling vertically-integrated companies and setting up separate power-generating companies and transporting-distributing companies—prevents unjustified price hikes on the potentially competitive power-generation market.⁹⁹*

Until recently, the Ukrainian state managed monopolist companies mostly through tight control of prices and the collection of dividends. Poor corporate governance frequently resulted in infringements on state interests by other, often minority, shareholders. Greater Government at-

⁹⁷ Price hikes for energy suppliers are the most powerful incentives for energy conservation. The energy intensity of Ukraine's economy is 4–5 fold higher than that of European and US economies—yet the price for power in Ukraine is lower. Still, power companies reduced line losses in 2003 to 31.9bn kW/h—1.3bn kW/h lower than such losses in 2002.

⁹⁸ The 22 January 2004 Presidential Decree on measures to increase the effectiveness of power complex management calls for transferring the stakes of stock and incorporated state-owned power companies to the statutory fund of a newly-created company. This includes companies that generate, transport, distribute and supply electricity at regulated rates and export power. The Government also plans to establish such national companies in other non-infrastructure sectors: titanium production, aircraft building, and farm machinery.

⁹⁹ Shrinking competition in the power sector (primarily on the ORE, the wholesale energy market) is a possible consequence of setting up ECU. Since only one of the five largest generating companies, TOV SkhidEnerg, is a private company, concentrating state companies in the power generation sector will choke competition. Apart from that, by including NEK UkrEnerg, the domestic power grid operator, in ECU, the government is creating a conflict of interests between state and private distributing and generating companies.

tention to the energy sector can be explained, on one hand, by the financial problems in the majority of companies and, on the other, by the risk of losing control over a strategically important sector of the economy.¹⁰⁰

The world experience shows that the state can effectively own and manage assets under market economy conditions. The privatization of natural monopolies often does not solve sectoral problems, and sometimes even aggravates them. On the other hand, it is hard to argue the advantages or drawbacks of setting up vertically-integrated companies and retaining state management in Ukraine's infrastructure industries. The almost total lack of information about the business operations of state-owned monopolies similar to ECU, such as the NAK Naftogaz Ukrainy or UkrZaliznytsia, makes it difficult to do any comparative analysis and come up with substantiated conclusions and recommendations.

ICPS experts do not think that the expected end of privatization in the power industry is a shortcoming of ECU. Should the Government reject further privatization, it will have to come up with other mechanisms for attracting investment and rules for how the sector should operate. In any case, the privatization of this sector is currently complicated due to the large outstanding debts of power companies. This problem could be resolved by adopting a law on restructuring arrears.

In our opinion, the aims of further Government initiatives in the power industry should be to:

- raise the effectiveness of current institutions such as the National Electricity Regulatory Commission and the ORE;*
- preserve competitiveness on the power-generation market;*
- improve corporate governance in state-owned companies by creating incentives for effective performance by management personnel.*

¹⁰⁰ One of provisions of the decree specifically prohibits the alienation of ECU shares or other state-owned property transferred to the company, making it clear that, for all intents and purposes, the privatization of Ukraine's power sector is dead. Moreover, the intention of setting up a NAK in the energy sector was first announced after Anatoliy Chubais, the boss of UES, a Russian power monopolist, made statements about possibly buying shares in a number of Ukrainian oblenergos.

AGRICULTURE

After the decline in 2003, increased grain production should see the sector grow 9% in 2004, despite a continuing downturn in the livestock sector. The introduction of a new VAT payment regime will likely cause lower growth in 2005 as agricultural producers find their working capital reduced. Moderate growth in 2005–2006 will be accompanied by a renewed upward trend in livestock breeding. Still, the moratorium on selling farmland is most likely to be extended until 2010. This will hamper agricultural development because it will be impossible to transfer land to more efficient owners or attract additional investment, and the soil will become depleted

General situation

2003 results

In 2003, agricultural production slid 9.9%

According to 2003 results, agricultural production slid 9.9% against 2002. Crop output declined 14.9% and livestock 3%. The key reason behind this decline was the low grain crop (see TABLE 7), which led to higher prices for feed and a continuance of the fall in livestock numbers that started in H1'03. The most dramatic drop hit the wheat harvest, which was down 5.7 times, to 3.6mn tonnes, although domestic demand for food wheat alone is 6mn tonnes. Altogether, the country harvested 5mn tonnes of food grain and 15.2mn tonnes of feed grain.

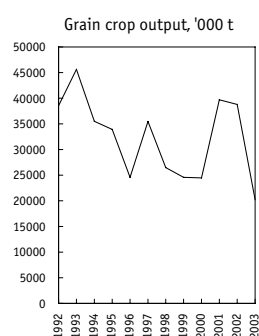


Table 7. Grain crop output in 2002–2003

'000 tonnes	2002	2003	Annual % change
<i>Total grain, including:</i>	38,804.3	20,220.7	-47.9
Winter/spring wheat	20,555.6	3,599.4	-82.5
Winter/spring barley	10,363.8	6,831.5	-34.1
Maize	4,180.3	6,864.5	64.2
Winter/spring rye	1,511.2	624.3	-58.7
Oats	942.9	933.2	-1.0
Buckwheat	209.4	311.0	48.5
Millet	111.5	340.8	205.7
Rice	75.4	84.0	11.4

Source: Derzhkomstat

At the same time, 2003 yielded a record-high sunflower crop of 4.25mn tonnes, 29.9% more than the previous season. The growth was due in part to expanded areas sown under sunflower, when a large share of the winter crop failed and in part to its traditionally high profit margins. Yield, however, slipped from 12 cntr/ha to 11.2 cntr/ha.

Despite a 5.4% growth of sugar beet yields over 2002, 2003 output was down 7.7%, mainly due to reduced sown areas.

In 2003, potato and vegetable crops rose 11% and 12.3%, thanks to improving yields. The areas sown under these crops remained at the 2002 level.

Livestock output slid because of lower headcounts among both cattle and poultry—3.8%, according to ICPS calculations—and lower dairy production (-3.4%). Egg production rose 2%.

Forecast

Low grain crops in 2003 and growing bread price forced the Government to take measures to stimulate grain crop production: the 2004 Budget includes items to compensate a portion of the cost of domestic mineral fertilizers and expenses for sowing spring crops (see **TABLE 8**). According to ICPS, these items will receive financing, given the negative consequences of a bad crop in 2003 and the government's desire to show some positive results before the presidential election.

One positive factor was the more generous financing of long-term needs, such as selection, and long-term lending. Moreover, these Budget expenditures were developed without an increase in overall agricultural expenditures.

***Budget funding
of long-term needs
has increased***

Table 8. Some planned Budget agricultural expenditure items

mn UAH	2003	2004
<i>Total (Ministry of Agricultural Policy), including:</i>	2,766.3	2,441.8
Cheaper short-term/long-term loans	75.0/-	100.0/120.0
Livestock and poultry selection	70.5	100.0
Crop selection	39.4	50.0
Financial support for livestock breeding and crop production	206.1	239.5
Establishing and securing insurance reserves for sorts and hybrid seeds	30.0	70.0
Partial compensation for the cost of Ukrainian-made mineral fertilizers	-	140.0
Partial compensation for expenses for sowing spring crops	-	50.0
Partial compensation for the cost of complex agricultural machinery	20.0	-
Financial support for the grain pledge and intervention procedures	70.0	-

Sources: Laws on the 2003 State Budget and on the 2004 State Budget

ICPS economists expect agricultural output to rise 9% in 2004, mainly due to growth in grain production. Crop output should grow at about 14%, while livestock shrinks 2% because of lower dairy and meat output numbers.

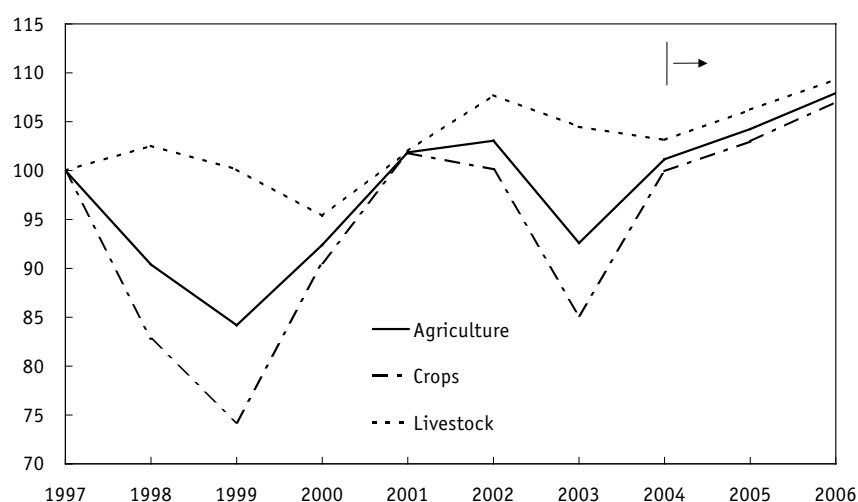
In 2005, the tax regime for agricultural VAT will be amended

In 2005, agricultural output should slow down to 3%. According to ICPS economists, the slowdown will be due to changes in the agricultural value-added tax: the current VAT breaks will be eliminated. Instead, agricultural producers will be able to choose between special and general VAT regimes. The special regime is likely to result in lower VAT rate for agriculture, and producers will not pay it to the Budget, but will retain it to compensate VAT paid when they purchase supplies and machinery. Compared with the current agricultural VAT system, this will likely mean that working capital will be cut somewhat since, at the moment, producers are retaining VAT calculated through the general rate and have the right to compensate VAT paid when purchasing supplies and equipment.

In 2006, agricultural production should climb 3.5% thanks to growth in livestock and crop output. However, it will be impossible to achieve higher growth rates, because the moratorium on land sale will likely be extended and so will the problems it causes.

Figure 10. Agricultural output

index, 1997=100



Source: Derzhkomstat; forecast by Quarterly Predictions

Field crops

Grain

Farmers sowed 7.1mn hectares or 84.7% of total areas for the 2003 crop, including 6.9mn hectares¹⁰¹ of winter grain crops. According to ICPS, the reduction of crop areas can be explained by weather conditions that were not conducive to sowing, and by shortages of seed grain. In view of the smaller areas sown under winter crops, growers increased areas sown under spring crops¹⁰² up to 1mn hectares. On average, areas under spring crops covered only 263,000 hectares from 1998 to 2002. To stimulate spring wheat production, the Budget allocated subsidies, worth a total of UAH 50 per hectare.

¹⁰¹ Winter crops accounted for 8.3mn ha in the 2001 harvest, 8.2mn ha in 2002 and 8mn ha in 2003.

¹⁰² According to the *Interfax-Ukraine* newswire of 19 January 2004.

According to the ICPS forecast, the 2004 grain crop should climb up to about 33mn tonnes, surpassing last year by 65%, though not quite reaching the level of 2001–2002. This is because of the generally smaller areas sown under grain crops, compared to 2001–2002. At the same time, favorable weather conditions have caused only a slight grain loss.¹⁰³

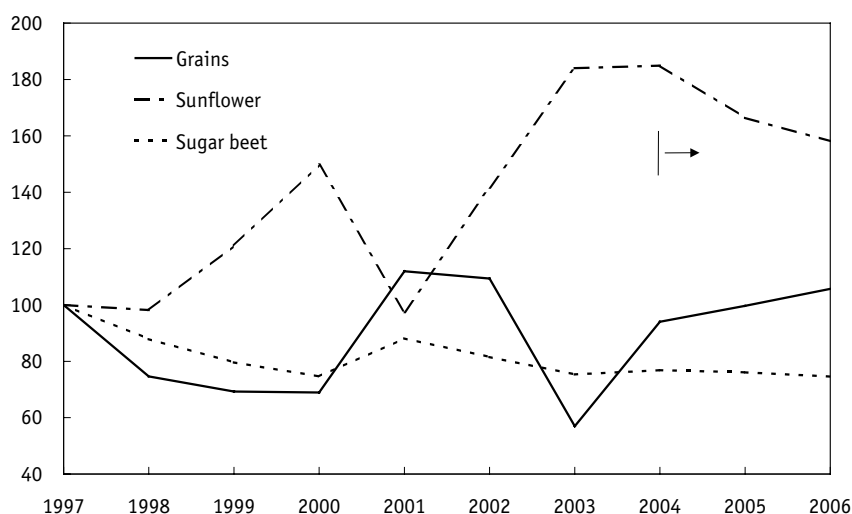
According to the ICPS forecast, favorable weather conditions should contribute to grain crop growth during 2005–2006, especially with better quality seed and ag technologies. The harvests are expected to climb to 35mn tonnes in 2005 and 37mn tonnes in 2006.

Crop output change

2001	12.4%
2002	-1.6%
2003	-14.9%
2004	17.3%
2005	3.0%
2006	4.0%

Figure 11. Crop output

index, 1997=100



Source: Derzhkomstat; forecast by Quarterly Predictions

Sunflower

For the 2003/2004 season, sunflower remains one of the most profitable crops. A favorable situation on external markets has arisen because of high demand and low harvests in Europe and Argentina, and this should continue until the end of the season. That is why prices for sunseeds and sunflower products will likely also stay high. Consequently, areas sown under sunflower will be large in 2004, and a sunflower crop at 2003 levels can be expected. Demand for sunflower and sunoil should also remain high on world markets through 2005–2006. However, prices are likely to slip, compared to the 2003/2004 marketing year, as Argentina and Eastern Europe bring in better crops. This will result in a sunflower output reduction of 10% in 2005, and a further cutback of 5% in 2006.

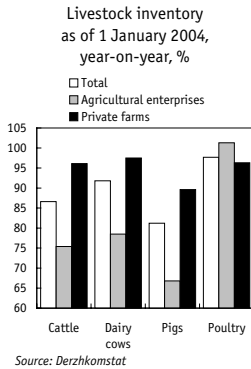
Sunflower remains a high-profit crop

A positive risk for this ICPS forecast is the dropping of the sunflower export duty or the institution of a seasonal duty instead.

¹⁰³ According to the *Interfax-Ukraine* newswire of 15 March 2004, re-sowing of winter crops in 2004 could reach 2–6%, which is way below the average 10%.

Livestock

Headcounts in all types of livestock and poultry shrank compared to 2003



Livestock production change

2001	7.0%
2002	5.1%
2003	-3.0%
2004	-2.2%
2005	3.0%
2006	3.0%

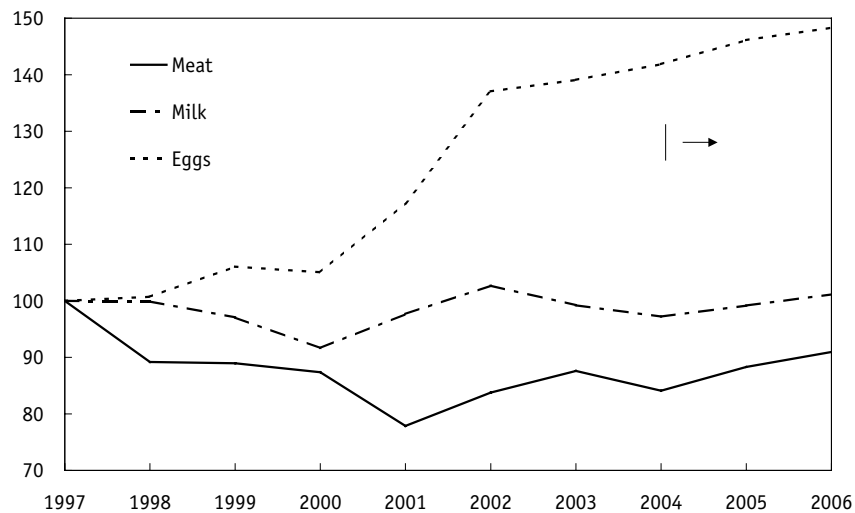
In early 2004, headcounts for all types of livestock and poultry were down compared to 2003. The decline is due to more costly feed, as a result of lower grain crops, and the need to purchase fuel and lubricants.

According to the ICPS forecast, livestock counts will continue shrinking in the first half of 2004, compared to 2003. As a result, meat production will also fall during 2004, since the livestock mass and the headcounts will not see growth. A decline in dairy production will also be seen, as dairy herds shrink. Overall, a 2% decrease in livestock products should be evident over 2004.

During the second half of 2004, a good grain crop should contribute to better fodder for livestock, and headcounts should start growing. This trend should persist through 2005–2006, leading to 3% annual growth of livestock production.

Figure 12. Livestock output

index, 1997=100



Source: Derzhkomstat; forecast by Quarterly Predictions

The moratorium on the sale of farmland will be extended through 2010...

The state of land reform

2003 saw the adoption of numerous laws in the Land Code. However, the moratorium on the sale of farmland, which is currently restricted until 1 January 2005, is very likely to be extended.¹⁰⁴ A number of arguments can be made in favor of extending this ban:

¹⁰⁴ On 4 March 2004, the Verkhovna Rada passed first reading of Draft Law No.3372 amending the Land Code. The law included an extension of the moratorium for the sale of farmland through 2010, and an extension of the moratorium on acquiring the right to private ownership of more than 100 ha of land through 2015. The legislature had debated other bills that suggested extending the moratoria for different terms, as well as one proposal by the Communist Party that eliminated the right to buy and sell land altogether.

- not all owners of land certificates will be able to exchange them into state certificates of ownership by 2005. As of early 2004, only 57.9% of certificate owners had gotten their state certificates.¹⁰⁵ About 25.4% of the certificates are currently being prepared. The rest were to be issued before the end of 2005 within the context of a World Bank loan.¹⁰⁶ However, the Verkhovna Rada did not ratify the loan agreement;
- not all the laws anticipated by the Land Code have been adopted so far, particularly laws on the land title registry system, land markets, and so on;
- owners of land and its potential sellers, including many pensioners, are not aware of their rights and obligations. They could find themselves at a disadvantage in relation to buyers and sell their land at depressed prices.

Yet an extension of the moratorium could lead to a number of negative consequences:

- soil depletion as the short-term leases typical of rural areas at the moment provide no incentive to preserve soil fertility;
- the impossibility of attracting additional (long-term) funds into the farm sector by mortgaging land;
- a prolongation of illegal schemes to acquire and sell land.

According to ICPS, extending the moratorium might be reasonable if, indeed, not all owners can obtain the state certificates of land ownership before 2005, because that would create unequal conditions for the establishment of a land market in different regions.¹⁰⁷

Further delays in allowing the right to sell farmland will get in the way of improving efficiency in the farm sector by transferring the land to a more caring owner who, moreover, will also be able to mortgage this property to draw additional money to invest in it.

... which will hamper the growth of efficiency in the sector

How much does land cost in Ukraine?

The valuation of land in Ukraine is regulated by a number of legislative acts.¹⁰⁸ The Law on land valuation outlines several ways of appraising a parcel of land:

¹⁰⁵ See the *Interfax-Ukraine* newswire of 10 January 2004.

¹⁰⁶ On 17 October 2003, the Cabinet and the World Bank signed a loan agreement for US \$195.13mn to subsidize the issue of state certificates of land ownership and the development of a land title registration system in Ukraine.

¹⁰⁷ According to the *Interfax-Ukraine* newswire of 10 January 2004, the lowest rates for issuing land ownership certificates were in Zhytomyr (26.7%), and Donetsk (39.2%) oblasts and in Crimea (39.3%).

¹⁰⁸ See the Land Code of 25 October 2001, the 23 March 1995 Cabinet Resolution on the methods for monetary assessment of farmland and residential lands, the 11 October 2002 Cabinet Resolution on expert assessments of land plots, and the 11 December 2003 Law on land appraisal.

1. **SOIL TESTING.** A comparative evaluation of soil quality in terms of its natural properties on a 100-point scale: top points are given to a parcel of land with the highest natural fertility. Soil testing provides an opportunity to determine whether the soil is suitable for growing different crops, and is the basis for the commercial appraisal of land.
2. **ECONOMIC LAND VALUATION.** The valuation of land¹⁰⁹ as a natural resource and means of production in farming and forestry. It indicates the land's productivity, the efficiency of its use, and its profitability per unit area. It is useful when comparing the efficiency of parcels of land intended for different uses and as a basis for monetary valuation of land.
3. **MONETARY VALUATION OF LAND:**

The average standard value of land in early 2004 was UAH 8,733/ha; arable land was UAH 9,205/ha

- **STANDARD MONETARY VALUATION.** Used for determining land tax rates, rental fees for parcels under state or communal ownership, state duty during swaps, bequeathing and gifting of parcels of land, the loss of agricultural and forestry production, and so on. It is calculated on the basis of the capitalization¹¹⁰ of rental income from the parcel¹¹¹ received for grain crop production and defined using the data from the 1988 economic appraisal of land. The average standard monetary value of land in early 2004 was UAH 8,733 per hectare, UAH 9,205/ha for arable land, UAH 34,330/ha for land under perennial crops, UAH 4,540/ha for hayfields, and UAH 2,729/ha for pasture land.¹¹²
- **EXPERT MONETARY VALUATION.** Performed in order to determine the market value of land for acquisition or sale, for collateral, to calculate losses inflicted on the owners or users, alienation, land insurance, and so on. This calculation applies the method that ensures the most accurate information: capitalization¹¹³ of rental/net operating revenues¹¹⁴ from the parcel of land; a comparison with selling prices for similar land parcels; and the inclusion of land improvement costs.¹¹⁵ The calculation should also take into account the kinds of crops typical to the area, which will ensure the efficient use of the land and the preservation of the soil.

¹⁰⁹ In cadastral hectares or in monetary form.

¹¹⁰ Capitalization is the calculation of the object's (i.e., land parcel's) current value and future profits.

¹¹¹ Rental income is calculated as the difference between the income for produce grown, its production cost, and the grower's profits (see the 23 March 1995 Cabinet Resolution, *op. cit.*).

¹¹² During 2002–2003, the standard monetary value of land did not change, since it is indexed only when average annual inflation for the previous year passes the 10% mark.

¹¹³ In a simplified version, the rental or net operating income is divided by the capitalization rate, which depends on the selling price for similar parcels.

¹¹⁴ That is, the difference between rental income and annual costs for maintaining and utilizing the parcel of land. See the 11 October 2002 Cabinet Resolution on expert monetary valuation of land parcels.

¹¹⁵ Land improvement includes changing land quality as a result of development, reclamation, reforestation, soil improvement, and so on.

Thus, to start the sale and purchase of farmland requires assessing its value. However, ICPS economists assume that, initially, rural owners will sell their land mostly without prior expert assessments, because:

- The Law on land appraisal makes a land appraisal mandatory only for transactions involving parcels in state or communal ownership for the purpose of calculating losses and collateral value. In other situations, appraisals are made on the agreement of the parties to the transaction.
- The approved methods for expert land valuation presuppose that information on the sale of such land parcels is available. For example, price comparisons require a developed land market, while the capitalization rate needs to include information on the sale of similar land. According to ICPS, then, the application of these methods will be impossible when farmland first comes up for sale and acquisition.

In our opinion, potential land buyers are mainly agribusiness and farms, as well as food-processing businesses that want to be vertically integrated. It is also possible that farmlands will be bought speculatively, since the current land legislation does not contain enough suitable measures to prevent this.

As world experience testifies, prices for land will be relatively low at the beginning. In the long term, land values will grow, particularly as the use of the land shifts, which will be stimulated by demand for land for development purposes closer to urban areas.

In general, the start of land sale and acquisition will not automatically lead to a steep improvement in production efficiency in the farm sector. Firstly, the transfer of land to a more efficient owner will take more than one year. Secondly, the moratorium on acquiring private ownership of more than 100 ha of land is effective until 2010 and could be extended through 2015. This ban will prevent not so much the concentration of land but mortgaging, since the volume of capital that can be put into such small areas is not lucrative enough for commercial banks to work with them. Of course, the restriction can be bypassed by breaking up a business, but this will not resolve the problems related to lending. In other words, there is little reason to expect a substantial influx of investment into the agricultural sector immediately after the lifting of the moratorium on land sale.

***Land values will grow
in the long term***

***Open sale of land alone
does not guarantee
a steep improvement
of efficiency
in the sector***

BUSINESS

A serious growth in demand contributed to heightened business activity in 2003. Corporate profits grew thanks to favorable export opportunities and growing domestic consumption, encouraging investors to expand production and upgrade equipment. Investments grew fastest in the service and refining industries. In 2004, despite heightened political risk, investment growth rates will persist. A tapering-off of investment activity will become noticeable only in 2006

The business environment

In 2003, business activity grew substantially...

A high level of business activity in 2003 spurred faster economic growth. Record-high investment volumes were financed mostly by internal funds.¹¹⁶ Rising company profits¹¹⁷ were stimulated by favorable conditions for foreign trade and growing domestic demand.

... though regulatory hurdles remain a problem

At the same time, with such strong economic growth, businesses have felt, more than ever, the need to eliminate regulatory hurdles for commercial activity and to encourage developing and strengthening business infrastructure. Key problems in the business environment are: (1) a flawed legislative base and regulatory restrictions; (2) ineffective tax policy; (3) lack of protection for ownership rights; (4) underdeveloped business infrastructure.

Only a comprehensive solution of these issues can help business take advantage of investment opportunities to the fullest and create the necessary conditions for sustainable economic growth.

Business activity will grow more slowly in 2006

The level of business activity will continue to be high in 2004, for the same reasons as in 2003. The pre-election policy of uncertain and unsystematic reforms remains risks to this forecast. During 2005, lower profits among export companies will dampen economic growth, which will, in turn, shrink business investment activity in 2006.

Investment

Gross fixed investment

2003 saw record-high investment growth

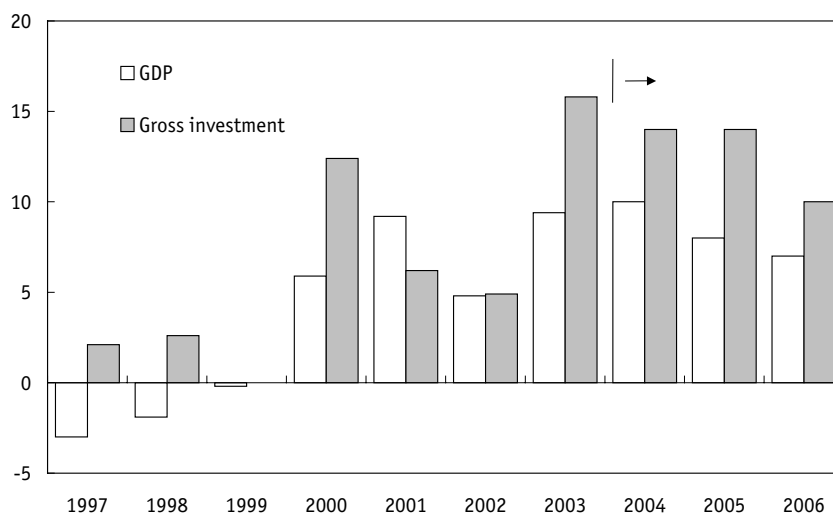
2003 saw record-high growth of gross fixed investment—15.8%. Money was mostly invested into capital construction and purchases of vehicles and equipment, which caused the main component of gross fixed investment—capital investment—to leap to 31.3%.

¹¹⁶ During 2003, the share of retained earnings in companies' investments fell slightly, to 64%. At 7%, the share of loans remains fairly low because of high domestic interest rates.

¹¹⁷ According to Derzhkomstat, the state statistics committee, financial results from the regular pre-tax activity of enterprises and organizations jumped 37% year-on-year in 2003. This is also confirmed by the rising profit index, as calculated by the Institute of Economic Research and Political Consultations. This index grew from -0.02 in Q4'02 to 0.08 in Q4'03. At the same time, the share of businesses whose profit margin declined grew from 21.3% to 25.1% during Q4'03.

Figure 13. Gross investment and GDP growth

real annual change, %



Source: Derzhkomstat; forecast by Quarterly Predictions

During 2003, priority investment areas were the service and refining industries.¹¹⁸ Thus, there has been a steady trend of capital switching to industries oriented towards domestic demand.¹¹⁹

The growth of gross fixed investment slowed down in Q4'03. According to ICPS, the factors that influenced this were all short-term:

- a noticeable slowdown in construction growth due to the high baseline;¹²⁰
- cutbacks in bank loans due to liquidity problems (see **MONETARY POLICY**).

The ICPS forecast for investment growth in 2004 was upgraded to 14%. The forecast was reviewed for two reasons: (1) higher-than-expected growth in machine building and construction, which traditionally require large volumes of investments; (2) rapid growth of profits among exporters.

The trends in 2004 should last for another year: real gross fixed investment will grow 15% in 2005, and then will slow to 10% in 2006, due to a slight deterioration in the global market (see **PRICES**).

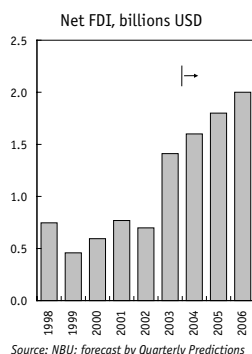
Capital has been steadily switching to industries oriented towards domestic demand

The forecast for investment growth in 2004 is upgraded to 14%

¹¹⁸ During 2003, according to Derzhkomstat, enterprises increased investments into construction and equipment in: light industry (up 74.3%), coke production and oil refining (up 71.7%), other non-metal mineral products (up 58.3%), wholesale and retail trade, car sales (up 54.8%), machine-building (up 54.7%), metallurgy and ore processing (up 41.7%), transport and communication (up 40.5%), food industry and food processing (up 28.5%).

¹¹⁹ See *quarterly predictions* for Q4'03, p. 41–42.

¹²⁰ During April-September 2002, Ukraine saw building starts shrink on an annual basis. Positive growth of +3.5% was achieved only in Q4'02. Accordingly, this influenced the dynamic of construction growth in 2003: in Q3'03 this indicator stood at 30.9% compared to 2002, but only 16.9% in Q4'03.



Sources of FDI in early 2004 (share of total volume)

The US	16.1%
Cyprus	11.7%
The UK	10.3%
The Netherlands	7.0%
Germany	6.6%
Virgin Islands	5.7%
Russia	5.7%
Switzerland	4.8%
Austria	3.8%

Construction growth rates leapt up in 2003

Housing construction grew slower than industrial construction

Foreign direct investment (FDI)

In 2003, 21.7% more foreign capital was channeled into Ukraine's economy. This trend correlates with the growing intensity of gross fixed assets and rising key indicators for business activity in Ukraine. Despite a gradual shrinking of foreign investments over the course of the year, Ukraine received US \$1.4bn during 2003, which was more than doubled the 2002 figure.

Foreign investors still see wholesale trade and brokering (15% of overall investment), and the food processing industry (14.8%) as the most attractive spheres in Ukraine. Due to a steep growth in machine-building, about 9% of investment was channeled into this industry.

During 2003, the most active investment growth came from Germany (39%) and the UK (28%). Gradual revival of capital investment from Western European countries confirms a real increase of FDI and not just the repatriation of Ukrainian capital.

The ICPS forecast for net FDI inflows in 2004 is also upgraded, to US \$1.6bn for four reasons:

- high rates of economic growth in a relatively stable socio-economic environment;
- Ukraine's removal from the FATF blacklist;¹²¹
- the offer of large objects for sale in the national privatization program;
- investors actively moving production capacities from Ukraine's neighbors who were joining the EU in 2004¹²² to Ukrainian territory to cut labor costs.

The ICPS forecast for net FDI inflows is also upgraded for 2005 and 2006, to US \$1.8bn and US \$2bn. The forecast was adjusted upwards for two reasons: (1) persistent high growth rates (see **OVERVIEW**); (2) improved ratings of Ukraine by international rating agencies.

Construction

During 2003, construction grew at 23.1%. The revival in construction was mainly driven by gross investment growth, which included expenditures on construction and installation works. Businesses were expanding production capacities, while household demand led to a growing housing market.

Housing construction grew slower than industrial construction¹²³ during 2003, though the gap will narrow as the population prospers (see **HOUSEHOLDS**) and mortgage lending becomes more widespread. Factors influencing the housing market were primarily legislative amendments and their anticipation by market operators (see **TABLE 9**).

¹²¹ For more information see *quarterly predictions* for Q1'03, p. 26–27.

¹²² See ICPS research "The Impact of EU Enlargement in 2004 on Ukraine's Foreign Trade" at: http://www.icps.kiev.ua/doc/EU_Enlargement_en.doc.

¹²³ Growth in construction and installation reached 35.1%, while housing construction grew only 5.9%. The share of housing construction in the total volume of construction was 30% during 2003.

Table 9. Regulatory impact on the housing market

Amendment	Intent	Impact
1. Sec. 49 of Art. 80 of the 27 November 2003 Law on the 2004 State Budget suspends Sub-Sec. 5.1.20 of the 3 April 1997 Law on the Value Added Tax for 2004	Eliminating VAT exemptions for the sale or transfer into ownership of new housing to private individuals for residential purposes	Steep short-term increase of demand on primary markets in late 2003 Slowing demand in early 2004, which will stop after market prices adjust to changes in legislation
2. The 22 May 2003 Law on personal income tax	Notarized housing sales/purchases completed in 2004 are not taxed (except for re-sales, which are classified as a commercial activity) As of 2005, real estate sales will be taxed ¹²⁴	During 2004, supply should grow on the secondary housing market, mainly at the expense of "investment" ¹²⁵ apartments During 2005, prices will rise on the secondary market
3. The 19 June 2003 Law on lending mechanisms and property management during housing construction and real estate transactions	As of 1 January 2004, investors can invest in housing construction only through the banks or non-banking financial entities	During the first half of 2004, while construction companies adjust to changes in the law, the supply of new housing will shrink
4. The 5 June 2003 Law on mortgages ¹²⁶	Launches and regulates banking activity in lending for housing purchases	Demand should grow on the primary and secondary markets; money from re-financing will allow building companies to increase supply

According to ICPS, amendments (1) and (2) will perceptibly change the situation on the domestic real estate market, since their impact will mostly be felt in 2004 and 2005. Amendments (3) and (4) will contribute to long-term equilibration of the housing market, but in 2004–2005, their impact will be moderate.

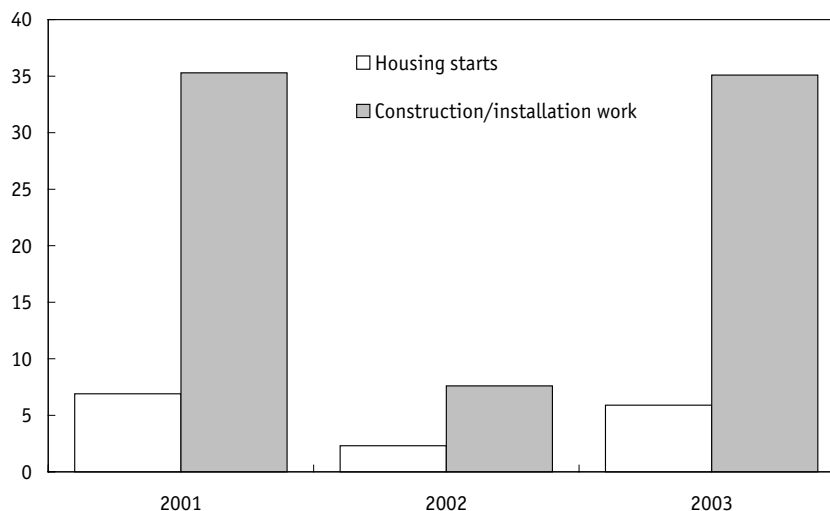
¹²⁴ The law sets the tax rate at 1–5% of the revenue from selling real estate (the price indicated in the purchase and sale agreement); at 13% of profits from selling real estate (the difference between the selling price and the cost) until the end of 2006, and up to 15% as of 2007. Currently, only a state registration fee of 1% of the agreement price and a Pension Fund fee of 1% of the agreement price are levied on property sales.

¹²⁵ Those purchased on terms where apartment prices appreciate faster than the interest rate on deposits.

¹²⁶ According to the Law on mortgages, a State Mortgage Register will be set up to protect creditor rights: one and the same mortgaged object may be pledged to several creditors, but the primacy of lien on the property belongs to the creditor who first registers the relevant agreement.

Figure 14. *Growth of housing starts and total volume of construction/installation*

change against the previous year, %

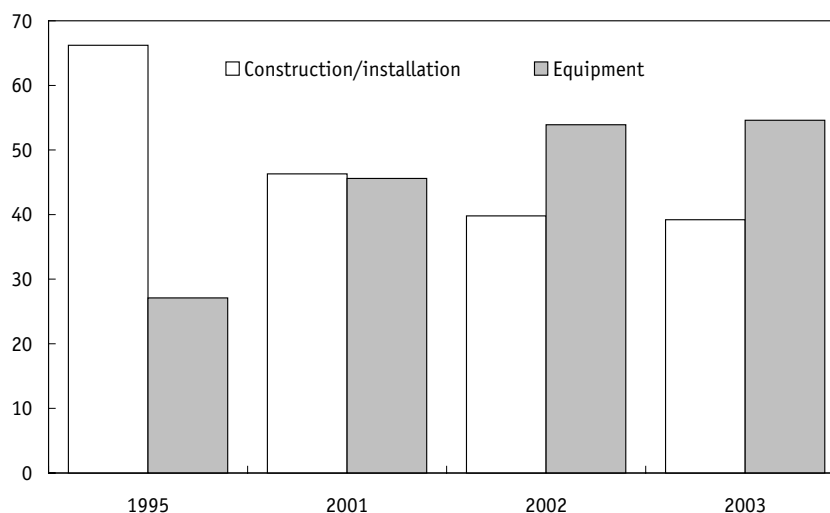


Source: Derzhkomstat

One characteristic of construction is its cluster-like nature: major construction has been concentrated in the capital and industrially-developed regions. The heart of construction is the nation's capital, where almost a fourth of all new construction is located. During 2003, commercial construction in Kyiv was growing at a fast pace: the area under office premises jumped 35% over 2002. At the same time, the commercial vacancy rate is 7%.

Figure 15. *Share of construction/installation and equipment in capital investment*

%



Source: Derzhkomstat

The ICPS forecast for the construction sector has been adjusted upward, to 20% in 2004 for two reasons:

- an improved outlook for economic (see **OVERVIEW**) and household income growth (see **HOUSEHOLDS**);
- pressure to further expand industrial capacities and develop business infrastructure as commercial activity steams ahead.

During 2005–2006, construction growth should slow down to 15% and 10% due to two factors: (1) slower growth of corporate profits as the export situation deteriorates somewhat; (2) gradual switch from investments into industrial construction to investments into equipment.

The forecast for construction growth in 2004 is upgraded to 20%

In 2005–2006, construction growth will slow down

Transport and communication

Transport output surged 12.5% in 2003, continuing the upward trend of recent years. Since transport growth steamed ahead of GDP growth, the GDP share of the transport industry rose to 13.3% according to estimates for 2003.

The key driver behind transport growth was rising rail cargo volumes. It was a response to improving export dynamics resulting from a favorable situation in the international markets (see **FOREIGN TRADE** and **PRICES**). On the whole, 2003 saw growth in both cargo and passenger kilometers for all forms of transportation.

The breakdown of cargo volumes shows that the share of rail transport is growing, while the portion of pipeline transport is going down (see **TABLE 10**).

The share of pipeline transport is shrinking

Table 10. Distribution of cargo

%				
Year	Railroad	Ferry	Truck	Pipeline
2001	48.7	2.0	20.9	28.5
2002	45.9	2.1	21.1	26.0
2003	51.8	2.2	20.6	25.4

Source: Derzhkomstat

Demand for rail transport was mainly driven by makers and users of cement—up 36.5% during 2003—, oil and oil products (up 27.1%), and wood and wood products (up 20.5%). If the transport of cement and wood products reflects the revival of construction, rail oil transport was actually competing with domestic pipelines. Despite the incomplete load of the pipeline system,¹²⁷ rail transport has the advantage because: (1) contracts for pipeline oil transport are usually long-term; (2) the rail system is more distributed than the pipelines; (3) politicized decisions on the use of trunk pipelines have led to uncertainty.¹²⁸

¹²⁷ According to information from VAT UkrTransNafta, in 2003 Ukraine's oil transport network was operating at only 52% capacity. Specifically: the Druzhba trunk pipeline was at 70% of capacity; the Prydniprovya trunk pipeline at 90% (higher capacity is not possible, because the line requires upgrading); and Odesa-Brody was only loaded in test mode.

¹²⁸ In 2004, a decision was made to use the Odesa-Brody pipeline in its primary direction. But despite Government assurances that the pipeline would be quickly launched into operation, it looks like it will be impossible to load the line with Caspian oil in the next while.

During 2003, mobile operator revenues grew fastest in the communication industry

The communication sector showed revenue growth of 23.7% over 2003. Computer and mobile communication services¹²⁹ saw the fastest growth rates. This sector is very attractive for both domestic and foreign investors, since currently:

- a potential for further development is high: telephone density is still relatively low;¹³⁰
- as competition grows, corporate development in other sectors of the economy requires complex communications decisions to improve operating efficiency;
- compared to other infrastructure industries, communication suffers less state interference and the market has a number of powerful private operators.

In 2004, transport and communication will continue growing at 12%, but 2005–2006 will see a slowdown

The ICPS forecast for transport and communication growth in 2004 is being upgraded to 12% thanks to an improving outlook for foreign trade turnover (see FOREIGN TRADE).

In 2005–2006, ICPS anticipates: (1) in transport, old roads will be upgraded at a faster pace than new ones will be built; (2) in communication, the mobile communication market will gradually become saturated. In other words, growth rates in transport and communication will probably drop to 10% and 6%.

Privatization

Privatization steamed ahead in 2003

For the first time in recent memory, the State Property Fund (SPF) fulfilled the privatization plan written into the State Budget in 2003 and brought in UAH 2.15bn¹³¹ in revenues. The key reason behind the renewal of the privatization process was the common interest of big business, which wants to squeeze maximum benefits from its support of the ruling coalition prior to the presidential election, and the Government, which wants to increase social hand-outs in the run-up to the election.

During 2004, privatization will proceed even more actively

The ICPS forecast for privatization revenues is being upgraded to UAH 3bn in 2004. Privatization processes will be driven by the same factors as in 2003. Privatization is also being spurred by the 2004 State of the Nation address by President Kuchma, which indicated his intention to sell all state-owned stakes in large enterprises that are at least 50% plus one, by the end of 2005.¹³²

¹²⁹ The law on free incoming calls had no significant impact on mobile operator revenues: huge growth in the subscriber base compensated for lower profits per subscriber.

¹³⁰ According to Derzhkomzviazok, the state communication and informatization committee, by the end of September 2003, there were 46 main fixed lines for every 100 Ukrainian households, 1.5 times lower than the European average.

¹³¹ In 2003, the State Budget received UAH 800mn from the privatization of UMC, the top mobile operator (including UAH 450mn, transferred for the stake sold in 2002); UAH 410mn from the privatization of the Nikopol Steelworks; UAH 350mn from privatizing the Crimean Malt Plant; UAH 122mn for AzovStal; UAH 119mn from the Black Sea Shipyard; and UAH 89mn from Pivnichniy Ore Mining and Enrichment. The sum of revenues from selling these objects added up to 95% of total revenues.

¹³² Among large privatization objects that the SPF is preparing for privatization and which could possibly go on the block in 2004–2005 are: PavlohradVuhillia, KryvorizhStal, Ukrtelecom, Odesa Port Chemical Plant, and power plants. Expected revenues from privatization of these enterprises alone amount to at least UAH 7bn.

Despite active efforts on the part of the SPF, privatization policy continues to be flawed. In particular, it is not aimed at expanding the circle of participants and improving competitiveness. SPF efforts are directed primarily at balancing the interests of the Ukrainian FIGs and influential foreign investors. This is being done by developing tender conditions that, as a rule, determine the winner *a priori*. For instance, the privatization of Dzerzhynskiy Dniprovskiy Metalworks had, in fact, the only bidder. The result was that the selling price was depressed.

We forecast that annual privatization revenues to the Budget during 2005–2006 will fall compared to the 2004 level, to UAH 1.5–2bn, as the political cycle comes to a close and the political elite changes somewhat.

LABOR

In 2003 wages grew at a record-high pace, thanks to unprecedented growth in the economy, rising productivity, and an increase in the minimum wage. According to ICPS, these factors, as well as further growth in demand for skilled labor, will create an opportunity for sustained growth in wage rates during the forecast period. In 2003, the unemployment rate in Ukraine kept rolling back, averaging 9.1% over the year. The unemployment rate is expected to keep shrinking in 2004, inching down to 9% in 2005 and 8.8% in 2006

Wages

2003 results

During 2003, wages grew a record-high 24%

During 2003, Ukraine saw wages growing 24% in real terms. Such record-high growth of this particular indicator was caused by a number of factors:

- ever-more-rapid economic growth (see **OVERVIEW**) resulted in an improved financial position among businesses (see **BUSINESS**), which enabled further growth of wages;
- productivity increased further;¹³³
- minimum wages were raised twice during the year and both salary scales and qualification ratings were adjusted;¹³⁴
- growing investments (see **BUSINESS**) spurred demand for skilled labor and thus fueled competition among employers to offer higher wages to new hires.

Over 11 months, wage arrears shrank 8.2%

During 2003, wage arrears declined sharply. Over 11 months of 2003, they shrank 8.2%.¹³⁵ Public sector arrears plunged 47.4% over the year, and by year-end this indicator stood at 1% of the overall amount. The high pace of paying out public sector wage arrears is likely due to the satisfactory fulfillment of Budget revenues during 2003 (see **PUBLIC FINANCE**).

Forecast

During 2004, wages should continue growing at a high pace. We think that several processes will influence wage dynamics in Ukraine during the year:

¹³³ See *quarterly predictions* for Q3'03, p. 68.

¹³⁴ As of 1 January 2003, the minimum wage stood at UAH 185. On 1 December 2003, this was raised to UAH 205, a yearly increase of 10.8%. The process of updating qualification ratings is particular mostly to the healthcare and education sectors, which saw average nominal wages grow by 27.5% and 24.5% over 2003.

¹³⁵ As of January 2004, wage arrears do not include data from businesses that ceased activity before 1 January 2004, including those, which filed for bankruptcy in bankruptcy court. Henceforth, data on wages arrears will not be compared to 2003 figures.

- a continuing high pace of economic growth (see **OVERVIEW**) will provide businesses with an opportunity to both increase cashflow and profits, and to direct more money towards wages;
- with the personal income tax rate cut (see **PUBLIC FINANCE**), there could be a tendency to increase the net wages offered during staff selection for new jobs or when replacing staff;¹³⁶
- the minimum wage will rise¹³⁷ and qualification ratings will be upgraded in response;
- growing demand for skilled labor will stimulate wage growth.

According to the ICPS forecast, average wages will jump a further 12%¹³⁸ in real terms in 2004. Beyond that, wage growth will slow down a little, gradually adjusting to the pace of overall economic growth, as the country's average wage has already passed the minimum subsistence level.¹³⁹ During 2005–2006 wages can be expected to grow 10% annually.

In 2004, wages will grow 12%, but only 10% in 2005–2006

One of the effects of tax and pension reforms could be the gradual legitimization of wages. If this process does occur, the wage growth indicator may reveal not only an increase in wages, but also an increase of that “official” part of wages paid by employers, that is, along with income taxes and mandatory deductions for social funds.

A change in wage calculation methodology as of 2004 has made it impossible to track the legitimization of wages using data on the pace of growth of this indicator, since the data is no longer consistent over time. Other statistical evidence for this process might be a significant gap in growth rates between retail turnover and wage rises.

Unemployment

Current trends

During 2003, the level of unemployment in Ukraine shrank 1 pp, to 9.1%. This decline was caused by growing demand for both skilled and unskilled labor. Just as before, demand for unskilled labor was spurred mostly in the construction sector and retail sales, both of which showed high growth rates (see **BUSINESS** and **HOUSEHOLDS**). An upswing in demand for skilled workers is the result of the continuing economic upturn and accelerated investment in 2003.

Unemployment was 9.1% over 2003

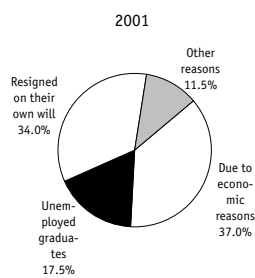
¹³⁶ This is most likely to emerge in the private sector, where staffing is more flexible, than in the public sector or state-owned enterprises.

¹³⁷ The Government plans to increase the minimum wage to UAH 237 as of autumn 2004, and to UAH 262 as of early 2005.

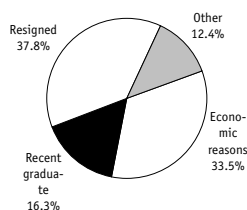
¹³⁸ As of January 2004, Derzhkomstat has switched to a new wage statistics system which follows international recommendations and System of National Accounts standards.

¹³⁹ In February 2004, average nominal wages throughout Ukraine stood at UAH 510.06, when the minimum subsistence level was UAH 342.

Main reason for unemployment, age 15–70



2002



Source: Derzhkomstat

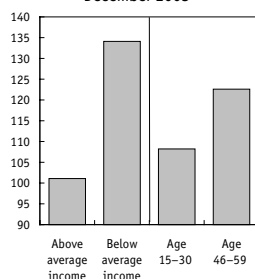
Comparative analysis of the main factors behind unemployment developed on the basis of Derzhkomstat surveys shows that a number of changes emerged in 2002 compared to 2001:

- the share of employees dismissed for economic reasons and staff reductions declined, which was clearly the result of an improving economic situation and the improved financial and operational position of businesses;
- the share of employees who quit of their own accord went up, which most likely indicates to a dynamic labor market, that is, an increase in the number of people who are dissatisfied with their current working conditions and want to change jobs, without worrying that they may remain unemployed for a while;
- the share of unemployed high-school and university graduates has shrunk, indicating improved adaptation among young workers to the conditions of the labor market. This tendency is confirmed by an average unemployment period among young people that is shorter than that of the older generation.

Forecast

During the forecast period, the unemployment should continue its downward trend, but at a slightly slower pace compared to 2001–2002. High demand for low-skilled labor will gradually lose its impact as a factor reducing unemployment. At the same time, demand for skilled workers will continue to grow gradually.

Index of expected unemployment trends, December 2003



Source: Consumer Confidence

A study of consumer confidence¹⁴⁰ shows that the general expectations of Ukrainians in terms of unemployment dynamics are improving. However, expectations about the unemployment rate are far more positive among young people and those with high incomes, than among the poor and the elderly. Given the higher share of skilled labor among the young and the well-to-do, i.e., those with skills and knowledge that are in high demand in the current labor market, this serves to confirm that demand for unskilled labor will steadily fall.

According to the ICPS forecast, the average unemployment rate in Ukraine will be 9% for 2004 and will decline to 8.8% in 2005–2006.

¹⁴⁰ See *consumer confidence* for January 2004.

HOUSEHOLDS

The growth of real disposable incomes slowed down to 5.8% in 2003, mainly due to escalating inflation and the dearth of Government decisions aimed at raising social benefits to the citizens. In 2004, real disposable income growth should accelerate to 7.5% as a result of a boost in social benefits. A high propensity to consume and the long period of growing incomes mean household consumption should steam ahead at a high pace, to 12% in 2004, and continue at 9% throughout 2005–2006. Retail turnover will grow faster than consumption over the next three years

Incomes

2003 results

In 2003, real disposable household incomes grew 5.8% in Ukraine. A substantial slowdown in this growth compared to 2002¹⁴¹ was the result of several factors:

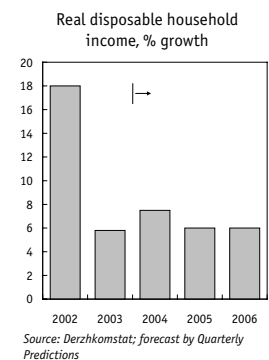
- escalating inflation (see **PRICES**);
- slow growth of incomes in the “Social benefits and other current transfers” category, which jumped 5.7% in 2003 in real terms, compared to 30.7% in 2002. Slower growth in this category of household incomes was due to the lack of Government measures to raise pensions and social benefits during 2003;
- slower growth of incomes in the “Profits and mixed income” category, where growth fell from 7% in 2002¹⁴² to 3.9% in 2003;
- the share of paid personal income taxes increased during 2003, in addition to which this indicator jumped 11.8% in real terms. This is another reason why real disposable incomes grew slower during the year.

Forecast

We predict that real disposable household income growth should accelerate to 7.5% in 2004. In our opinion, the drivers of accelerated growth rates will be:

- lower inflation (see **PRICES**);
- accelerating growth of incomes in the “Social benefits and other current transfers” category due to increased pensions, as pension reform

Household incomes rose 5.8% over 2003



Household real disposable incomes should jump 7.5% in 2004...

¹⁴¹ In 2002, real disposable household incomes rose by 17.8% in Ukraine.

¹⁴² For more information on reasons for slower growth rates in this category of household incomes see *quarterly predictions* for Q4'03, p. 64.

kicks in¹⁴³ and increased Government decisions aimed at improving social benefits.¹⁴⁴

The risks to the ICPS forecast are growing inflation (see **PRICES**) and possible sabotage on the part of the Pension Fund of the process of raising pensions.¹⁴⁵

... and continue at 6% annually during 2005–2006

Real disposable household incomes should grow 6% per annum during 2005–2006. According to ICPS, 2005 will see changes in the simplified tax systems affecting sole proprietors, which should slow down the growth of incomes in the “Social benefits” category. This will be related to the Government making more socially-oriented concessions on the eve of the 2006 Verkhovna Rada election.

Reforming blanket privileges: What's next?

On 14 April 2004, the Cabinet rescinded the Strategy, adopted 2 March 2002, to replace the system of privileges with targeted cash benefits to eligible individuals,¹⁴⁶ and other documents aimed at implementing the Strategy.¹⁴⁷ The Labor Ministry announced that this step had been taken to preserve and reinforce social guarantees to the most vulnerable groups of the population: invalids, veterans, Chernobyl victims, and pensioners.

However, the decision itself does nothing to reinforce social guarantees, since the most vulnerable groups only get to keep those privileges they already have. On the same day, the Government, in fact, approved another resolution¹⁴⁸ which will replace residential services subsidies with cash payments in Brovary (Kyiv oblast) and Smila (Cherkasy oblast) during 2004.

Currently, the Labor Ministry is developing a Concept for a gradual transition to allocating cash benefits to certain categories of the population, instead of the Strategy. The majority of measures in the draft Concept replicate those in the Strategy. However, the Concept puts more emphasis on a gradual transition to targeted cash payments and provides an

¹⁴³ On 11 March 2004, the Cabinet introduced amendments to Resolution No.1783 of 20 November 2003 increasing pensions for those eligible for higher pensions after recalculation according to Art.43 of the Law on general mandatory social security.

¹⁴⁴ According to the Cabinet Resolution amending the procedure for assigning and paying out government benefits to families with children and the procedure for assigning and paying out social benefits to low-income families of 17 December 2003, as of 2004, the amount of the one-time cash benefit for the birth of a child in Ukraine will be double the rate of the minimum subsistence level. This same Resolution also stipulated that the minimum subsistence level for children having one or both parents who are Group I or Group II invalids was raised 20%.

¹⁴⁵ The number of applications to the Pension Fund requesting a review of pensions computed in accordance with the new law has been growing since the beginning of 2004. There is evidence of unlawful refusals of applications by Pension Fund staff. For details, see *Pensiya* magazine, February 2004.

¹⁴⁶ For more about the Strategy, see *quarterly predictions* for April 2002, p. 51.

¹⁴⁷ See the 14 April 2004 Cabinet Resolution invalidating certain acts of the Cabinet.

¹⁴⁸ See the 14 April 2004 Cabinet Resolution on a pilot program to provide cash subsidies to specific categories of citizens to pay for housing and utilities.

opportunity to benefit recipients to choose either cash or non-cash benefits during the initial stages. The document also does not cancel service-based privileges. Finally, unlike the Strategy, the Concept does not specify deadlines for implementing the reform.

All this proves that, despite ostensibly rescinding the Strategy, the Government really is working to replace the system of privileges with targeted benefits. However, the Government has dropped the term “targeted cash assistance,” replacing it with the simpler “cash benefits,”¹⁴⁹ because of the negative attitude among the public towards the former—which formed as a result of inadequate informational support for such a political hot potato.

Compared to blanket privileges, targeted benefits have a number of advantages, as they:

- better ensure social justice, since a mandatory condition for providing it is a low income and so the Government supports only those who most need it;
- are more efficient: their targeted nature prevents the dissipation of Budget money, and transfers it to priority individuals, for priority purposes. This increases support to those who, other conditions being equal, are the neediest;
- assures market settlements among different business agents, which improves the financial standing of businesses providing subsidized services;
- help economize, since they are always limited, unlike blanket subsidies, whose consumption is not always regulated.

Among the key factors that could continue to impede the introduction of a system of targeted cash benefits are:

- “politicizing” the issue of subsidies and targeted assistance and, as a result, a lack of consensus and inability to adopt the necessary reform legislation;
- resistance from interest groups, particularly low-income households, who think that replacing privileges by targeted assistance means losing privileges altogether.

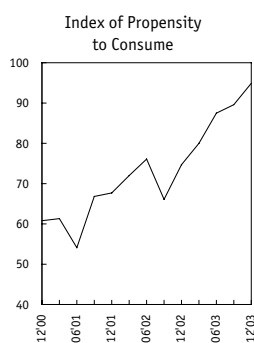
As these hurdles will hamper transition to targeted cash assistance for the next while, a gradual transition to the system of targeted cash assistance and partial preservation of the privileges are a sensible approach during the intermediate reform stage. This approach requires a number of other actions:

- dropping unnecessary privileges, such as out-of-turn servicing, purchasing high-demand goods;
- keeping social privileges;
- canceling service privileges, but keeping them for low-income individuals in this category;
- reforming the privileges allocated to individuals suffering from the Chernobyl disaster.

¹⁴⁹ Cash benefits, unlike targeted cash assistance, are not tied to the level of the recipient’s household income.

Consumption

Household consumption jumped a record-high 12.1% over 2003



Source: Consumer Confidence

Consumption will grow 12% in 2004 and 9% per annum in 2005–2006

Retail trade turnover surged 19.4% in 2003

Retail growth will slow to 17% during 2004 and to 12% per annum in 2005–2006

Household consumption showed record-high growth during 2003, rising 12.1% by year-end. Such growth rates were caused by several factors:

- record-high wage growth (see **LABOR**), the key income source for the most active consumers;
- improved consumer confidence;¹⁵⁰
- growth of real household incomes for several years in a row, yielding a new population group who now can afford to buy durable goods;
- high inflationary expectations,¹⁵¹ which are spurring consumers to buy now;
- the development of consumer lending, which makes it possible to buy more things at once without a long period of accumulating savings;
- a well-developed retail trade sector¹⁵², so consumers with different level of incomes have more opportunities to satisfy their needs.

The ICPS forecast for private consumption is being upgraded: this indicator should grow 12% in real terms over 2004. High consumption rates will persist, due to a high pace of household income growth and a high propensity to consume. Consumption will grow 9% per annum in 2005–2006. Overall, high consumption growth rates during the forecast period will mostly be driven by steadily growing numbers of people who, thanks to income rises that have persisted for some time, can spend their money on non-foods, particularly durable goods.

Retail trade

In 2003, retail turnover, like consumption, grew at a record-high pace, rising 19.4% in comparative prices. High growth rates in retail turnover were the result of significant growth in household consumption.

As consumption growth continues apace, retail turnover will also continue rising rapidly during the forecast period, 17% in 2004 and 12% a year in 2005–2006. The faster growth in retail turnover compared to consumption can be explained by the growing share of purchases through official retail networks, with a parallel reduction in purchases at “grey market” outlets.

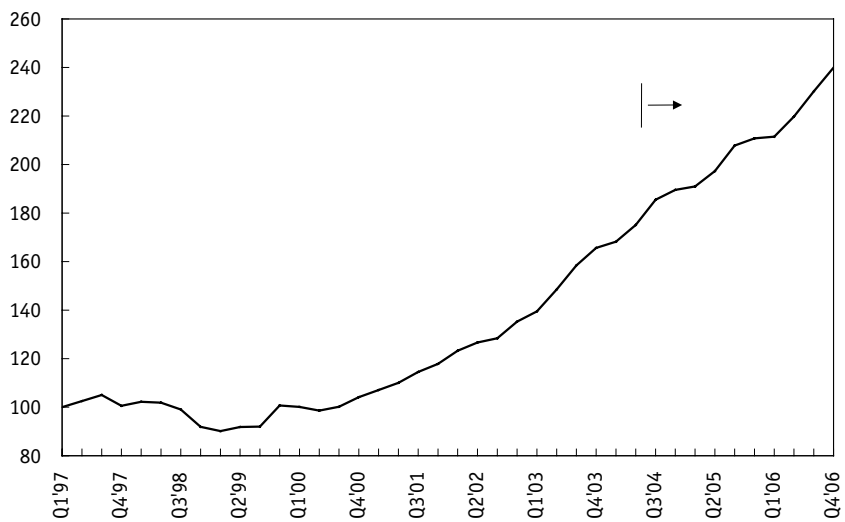
¹⁵⁰ The Consumer Confidence Index and Index of the Current Situation, which are calculated by ICPS and GfK-USM, reached new records in December 2003: 99.4% and 95.3%.

¹⁵¹ In December 2003, the Index of Inflationary Expectations, which is calculated by ICPS and GfK-USM, reached a new record-high for the past three years—186.1 out of a possible 200.

¹⁵² See *quarterly predictions* for Q4'03, p. 66–67.

Figure 16. Retail trade turnover

index, Q1'97=100, seasonally adjusted



Source: Derzhkomstat; forecast by Quarterly Predictions

WORLD ECONOMY

Ukraine's trade partners continued to grow more rapidly than the overall world economy in 2003. Russia remained the center of growth, primarily due to its lion's share of Ukraine's foreign trade, and also due to its high pace of real GDP growth. In 2004–2005, Ukraine's trade partners will maintain their speedy upward trends. 2006 will see a certain slowdown because of less active economic development in Russia, the US and China

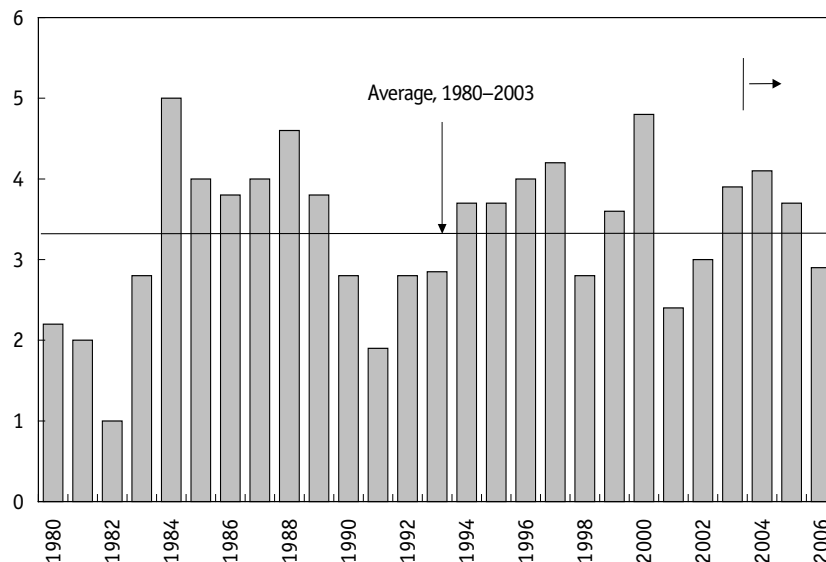
General trends

According to the latest IMF estimates, the world economy grew 3.9% over 2003. The key centers of growth remained the US and China. In line with the ICPS forecast, euro-area countries showed low rates of development, mainly due to structural problems and a strong euro.

In 2003, Ukraine's trading partners passed the global economy in economic growth

Ukraine's trade partners picked up steam at a pace higher than the world economy, averaging about 4.5%. The key role in this belongs to the Russian Federation, whose economic growth reached 7.3%.¹⁵³ As world oil prices remain at a relatively high level in 2004, Russia's growth should continue to be the major external factor stimulating the Ukrainian economy (see PRICES).

Figure 17. World economic growth
real annual change, %



Source: IMF; forecast by Quarterly Predictions

¹⁵³ Russia's economic growth has contributed about 2% to the upswing among Ukraine's trading partners.

Ukraine's leading trade partners will maintain high rates of economic growth (4.1–4.7%) throughout 2004–2005. The key role in this growth will belong to accelerating economic development among European countries and continuing high growth in Russia. In 2006, the real GDP dynamic of Ukraine's trade partners will slow down to 3.4%, mainly due to more sluggish economies in Russia, the US and China.

The US

Over 2003, the American economy went up 3.1%. According to earlier ICPS forecasts, consumer demand slowed considerably in Q4'03 as the influence of tax breaks faded.

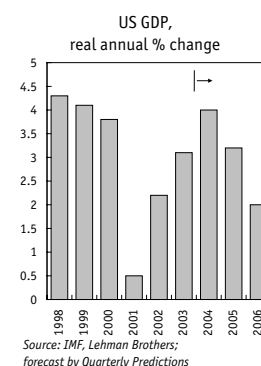
High corporate profits among the US businesses, which held steady through the last quarter of 2003, served to keep up an active investment trend. The decline of consumer demand resulted in high inventories of finished products, which will cause additional deflationary pressure on the US economy. If this tendency persists, the US economy is at risk. However, we expect high consumer demand growth to return and the appearance of new export opportunities due to further devaluation of the US dollar in 2002–2003,¹⁵⁴ as well as accelerated economic growth in EU countries. These factors should help move inventory stockpiles at US companies.

In 2004, the American economy will show a strong economic growth of about 4%, driven by three main factors:

- low interest rates,¹⁵⁵ especially compared to other world economies;¹⁵⁶
- high 2003 corporate profits, which sustained domestic demand;
- the depreciation of the dollar, which has considerably improved the competitiveness of American goods, not only on foreign markets, but also internally.

However, these factors are expected to fade somewhat in 2005–2006, as the US Administration is forced to respond to the urgent problem of the high cost of financing its Budget deficit.¹⁵⁷ The US economy growth will slow down to 3.2% over 2005, and to 2% over 2006.

High US corporate profits for 2003 will support active demand for investment



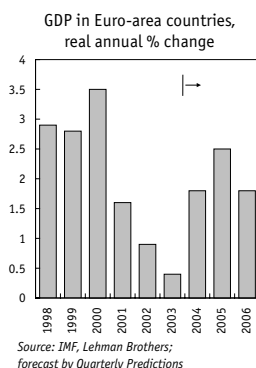
¹⁵⁴ Over 2002–2003, the US dollar depreciated by 40% against the euro. For the year prior to 10 April 2004 alone, the real effective exchange rate of the US dollar fell by 12%.

¹⁵⁵ ICPS economists base their assumptions on the likelihood that the Federal Reserve will start raising interest rates only in H2'04.

¹⁵⁶ The Bank of England fixed its repo rate, the country's benchmark lending rate, at 4% and the refinancing rate of the European Central Bank is 2%, while the US prime rate, for federal funds within the US Federal Reserve System, is only 1%.

¹⁵⁷ According to different assessments, the US Federal Budget deficit for the fiscal year 2004, which ends 30 September 2004, will reach 4.2–5.1% of GDP.

The Euro-area showed extremely slow growth in 2003



Euro-area countries

The economy of Euro-area countries was unable to improve growth rates by the end of 2003, and the result was growth of only 0.4%. This low rate can be explained by structural problems of the large Euro-area economies, Germany, France and the Netherlands. In 2003, these countries showed zero economic growth or even shrinkage. The revaluation of the euro was an additional hindrance, especially in light of the fact that, in recent years, the economies of the 12 European Monetary Union countries had grown only thanks to exports as domestic demand stagnated.

However, ICPS economists expect domestic demand to begin to expand in 2004, which should perk economic growth up to 1.8% in the Euro area. To a large extent, this growth will be triggered by reforms launched by the Governments of Germany and France in order to reduce tax pressure.¹⁵⁸

The ICPS forecast is for 2005–2006 to see the negative impact of a high euro to soften. Over 2005, the overall European economy is expected to zip up to 2.5%, but in 2006 it will slip back down to 1.8% as unfinished reforms and high cost of assimilating the 10 new EU members hit home.

Central European countries became EU members on 1 May 2004

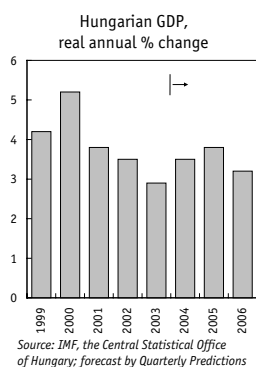
Central Europe

Reforms in Central European countries that were directed at EU accession should ensure positive results for their economies. During the entire forecast period, these countries will show brisk enough economic growth—far higher than the development rates of other EU countries. The general problem of the Visegrad Group¹⁵⁹ countries remains high Budget deficits of up to 6% of GDP, which, if they persist, could restrict the further possibilities of European integration. Coupled by a balance of payments deficit, this will be responsible for powerful pressure on the financial sphere.

The depreciation of the forint against the euro accelerated the Hungarian economy at the end of 2003

Hungary

In 2003, Hungary's real GDP rose to 2.9%, which is somewhat higher than the ICPS forecast of 2.7%. The acceleration of the Hungarian economy at the end of 2003 was mainly due to growing exports in the context of a more expensive euro. As ICPS had predicted, substantial wage increases made themselves felt by year-end as retail trade picked up noticeably.



However, by the end of 2003, wage growth rates slowed down considerably, and this factor will play a lesser role in 2004. ICPS analysts still expect Hungary's economic growth to increase to 3.5% in 2004, mainly caused by a positive export situation and by the benefits from accession to the EU. The domestic market will grow little due to the urgent need to curb both the deficit and expanding inflation. According to ICPS estimates, economic growth rates should still surpass the 3% mark in 2005–2006 as well.

¹⁵⁸ There is a serious risk that these reforms will be derailed by pressure from voters. For example, in late March, the Government of France was forced to resign when the unpopularity of its reforms caused the incumbent party to do poorly in regional elections.

¹⁵⁹ The Czech Republic, Hungary, Poland and Slovakia.

Poland

According to 2003 results, Poland's real GDP grew 3.7%. As in the majority of Central European countries, the drivers of this growth were export-oriented businesses. The depreciation of zloty¹⁶⁰ was a substantial stimulus for Polish exports.

ICPS expects Poland's economy to reach a growth rate of 4% in 2004. This will largely be sustained by a considerable increase in social outlays from the Budget, which should stimulate domestic consumption. The main risk to this forecast is an aggravated domestic political situation if there is no consensus on the formation of a new Government. In 2005–2006, the economy will grow at a somewhat slower rate, 3.8% and 3.6%, as Budget spending faces cutbacks.¹⁶¹ One of the growth drivers during these years will be the additional economic incentives resulting from EU structural funds being distributed to Poland.

Slovakia

The Slovak economy grew 4.2% in 2003. This high economic growth rate can be attributed to economic reforms, particularly the introduction of a flat rate for personal income taxes and a corporate profit tax of 19%. Slovakia also managed to make good use of investor interest in countries joining the EU in 2004 and becoming part of the single European market.

The ICPS forecast is that Slovakia will maintain economic growth at 4% for 2004. Foreign investments, particularly in machine-building,¹⁶² will play a major role. In addition, this will resolve the unemployment problem, since, according to ILO methodology, joblessness stands at 16.5% at the moment.¹⁶³ A powerful influx of foreign investments will ensure that the country's economy grows up to 5–5.3% during 2005–2006. As can be seen from the choices world car-makers have made in selecting Central European locations for their production facilities, Slovakia conveniently stands out among other countries of the region:

- in Hungary, the standard of living, and thus wages, is almost 50% higher than in Slovakia;
- in Poland, investors say the problem is relatively underdeveloped infrastructure and an unfavorable tax environment. In particular, tax administration procedures are rather complicated and the entire tax system is too unpredictable.

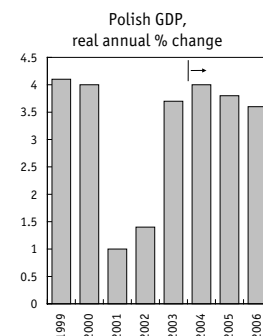
¹⁶⁰ As of 2003 beginning, EUR/PZL was 4.13:1, in the end of December 2003 it has reached 4.72:1.

¹⁶¹ Calculated using ESA 95 methodology, Poland's Budget deficit stood at 5.6% of GDP in 2003; in 2004, it is expected to reach 7.2% of GDP. Still, in order to join the eurozone, which the Polish Government hopes to do in 2007, the country has to meet a number of criteria, including: a Budget deficit that averages 3% of GDP and national debt that does not exceed 60% of GDP. Poland has already passed 51% with its national debt.

¹⁶² Currently, a Volkswagen car plant with a production capacity of 300,000 units per year is already operating on Slovak territory. Peugeot-Citroën, a French car maker, plans to launch a car-making facility, also with a 300,000 unit per year capacity, in 2006. In early March 2004, Kia Motors, a division of Korea's Hyundai Group, has decided to build a plant with a capacity of 200,000 cars per year. This investment is worth US \$1.5bn and operation is scheduled to start in 2007.

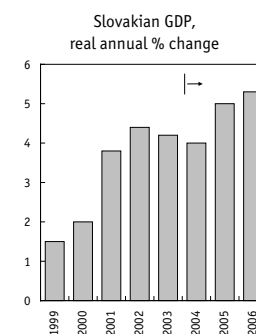
¹⁶³ Reducing social pressure on government finances is a necessary pre-condition for Slovakia to achieve the target Budget deficit level of below 3% of GDP in 2006.

An aggravated political crisis threatens the Polish economy



Source: IMF, the Central Statistical Office of Poland; forecast by Quarterly Predictions

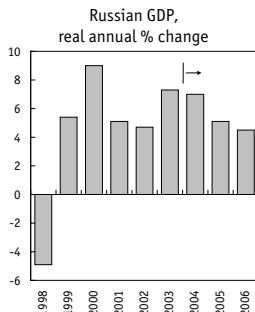
Slovakia may serve as a model of successful policy for attracting investors



Source: IMF, Statistical Office of the Slovak Republic; forecast by Quarterly Predictions

Russia

Over 2003, the Russian economy perked up 7.3% thanks to rising investment demand



Source: IMF, State Statistics Committee of the Russian Federation; forecast by Quarterly Predictions

The Russian Government's disinflation policy is yielding results

Dropping oil prices will inevitably lead to an economic slowdown in 2005–2006

According to the latest estimates, real GDP in Russia rose 7.3% over 2003. This growth was mostly driven by foreign trade: Russian exports jumped 25.3%, while imports steamed ahead at 22.7%. The share of imports in the retail trade has remained practically flat, which testifies to the correlation between the development rate of domestic consumer goods manufacturing and expansion rate of the domestic consumer market. In the food industry, which typically offers a quick return on investment, imports are gradually being replaced by domestic equivalents.¹⁶⁴

Internal growth factors were rooted in investment demand. Over the year, investment into capital assets surged to 12.5%, accelerating by year-end in response to:

- a complete lack of political ambiguity prior to presidential election in March 2004;
- the gradual fading of the scandal around Russian oil giant YUKOS.

The Government of Russia managed to keep inflation at the target level: consumer prices rose only 12% in 2003. However, this was largely achieved through administrative control of residential services prices. Throughout the year, the monthly growth of residential services rates shrank from 7% to 0.5%, which had an extremely negative impact on the economic efficiency of utility companies and thus on their development prospects.

Since political uncertainty has finally ceased to exert an influence over investment decisions of Russian players, the key problem will remain relations between business and the bureaucracy,¹⁶⁵ which means it is imperative that administrative reforms continue.

The ICPS forecast for Russian economic growth has been upgraded to 7% in 2004, given upward adjustments for world oil prices (see **PRICES**). A gradual reduction of oil prices in 2005–2006 and lack of capacities for increasing actual export volumes¹⁶⁶ mean slower economic growth – 5.1% and 4.5%.¹⁶⁷

¹⁶⁴ Imports of food products into Russia declined 2.1% in 2003, in response to the 5.1% growth of production output in the country's food industry.

¹⁶⁵ This refers mostly to SMEs: public oversight of large operations will not be dropped, as it is the foundation of the Russian system of governance. According to a recent study conducted by the World Bank, the 23 Russian largest business groups provide about 30% of sales and jobs in the country's economy.

¹⁶⁶ Neither the Northern Oil Export Project (through Murmansk/Arkhangelsk), nor the Eastern Oil Export Project (Daqing/Nakhodka) will go on line during the forecast period. Currently, almost the only source for increasing oil exports in Russia is expanding the Baltic Pipeline System.

¹⁶⁷ Economic medium-term rates of growth will be largely determined by the Government's policy on forming the foundations for sources of domestic growth. The ICPS forecast is using a moderate scenario, which envisages the introduction of key reforms: administrative, consolidated social tax system, pensions, housing and utility services, a new phase in the power industry, etc. However, these reforms are unlikely to be implemented in full.

Stabilization funds: Global experience

The setting up of a Stabilization Fund¹⁶⁸ in Russia in 2004 signals a new quality in Russian government policy regarding the use of Budget revenues from the oil and gas industries. This policy is aimed at preventing dissipating the windfall revenues from high oil prices.

Today, more than ten countries and autonomous regions whose economies are oriented towards exporting extracted resources operate stabilization funds. Mostly, they apply to petroleum, though there are exceptions, such as Chile's "copper fund." Such funds are shaped on a single principle: to take in windfall Budget revenues or state corporate profits that have accumulated during a time of high prices for the given commodity.

There are two types of such funds:

- *pure stabilization funds (Alaska, Chile, Columbia, Kuwait, Nigeria, Norway, and Venezuela), which are set up to level out fluctuations in the balance between Budget revenues and expenditures, or to provide additional financing for development in the areas where these resources are extracted;*
- *funds for future generations (Alaska, Alberta, Kuwait, Oman, and others), which are aimed at keeping the funds for a time when the deposits have been exhausted or to distribute them to the local population.*

The sizes of such funds vary substantially. For example, during 1996–1999 alone, the revenues in The Government Petroleum Fund of Norway jumped from 5% to 17.7% of GDP, whereas State General Reserve Fund of Oman stood at 400% of GDP during its peak period. Sometimes countries use both types of funds at the same time. Alaska serves as an example here: it has a savings fund (to accumulate money) and a reserve fund (to finance cash gaps when fulfilling its state budget).

Global experience with setting up stabilization funds is that they make sense, but their activity needs to be regulated by certain conditions:

- *strict Budget policy;*
- *transparent policy regarding the spending of the fund, supported by analytical assessments and forecasts, and relevant oversight;*
- *avoiding conflict of interests in the management of such funds.*

The Russian Fund has been set up to be a real stabilization fund, whose cash is intended to finance Budget gaps or debt obligations during periods when prices for hydrocarbons are low on global markets.

¹⁶⁸ The Stabilization Fund was established using all the excess State Budget revenues that appeared as a result of world oil prices being above the \$20 per barrel mark. Money in the Stabilization Fund is invested only into blue-chip securities (in fact, US government bonds).

The creation of reserves is a sensible solution to the problem of frittering away windfalls and having to then fight "Dutch disease." Still, in the case of Russia, the procedures for disbursing Stabilization Fund resources have not yet been worked out well enough. The accumulative nature of the Fund requires a conservative investment policy that is analogous to gold and foreign currency reserves: investing in the bonds of the most stable world economies, and not directly into the Russian economy.

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Table A1. GDP and gross national disposable income, 1998–2006, millions UAH, unless specified otherwise

	1998	1999	2000	2001	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
Gross domestic product	102,593	130,442	170,070	204,190	225,810	264,165	315,300	357,500	405,500
Consumption	83,569	100,481	128,901	156,344	170,325	203,696	241,100	273,200	310,600
Private consumption	61,449	74,615	96,315	116,277	128,786	149,709	177,500	203,700	234,500
Public consumption	22,120	25,866	32,348	40,067	41,539	53,987	63,600	69,500	76,100
Gross investment	21,357	22,746	33,531	44,525	45,594	53,600	69,100	80,500	96,200
Net export of goods and services	-2,333	7,215	8,557	3,321	9,898	6,865	5,080	3,840	-1,270
Export of goods and services	42,974	70,884	106,200	113,245	124,461	154,319	174,980	182,340	191,000
Import of goods and services	-45,307	-63,669	-98,562	-109,924	-114,563	-147,454	-168,900	-178,500	-192,300
Consumption, % GDP	81.5	77.0	75.2	76.6	75.4	77.1	76.5	76.4	76.6
Private consumption, % GDP	59.9	57.2	56.6	57.0	57.0	56.7	56.3	57.0	57.8
Public consumption, % GDP	21.6	19.8	18.6	19.6	18.4	20.4	20.2	19.4	18.8
Gross investment, % GDP	20.8	17.5	19.8	21.8	20.2	20.3	21.9	22.5	23.7
including change in inventory, % GDP	1.1	-1.9	0.0	2.1	1.0	0.5	0.5	-0.3	0.3
Net export of goods and services, % GDP	-2.3	5.5	5.0	1.6	4.4	2.6	1.6	1.1	-0.3
Export of goods and services, % GDP	41.9	54.3	62.4	55.4	55.1	58.6	55.4	51.2	47.3
Import of goods and services, % GDP	-44.2	-48.8	-58.0	-53.8	-50.7	-56.0	-53.8	-50.1	-47.6
Annual real change in GDP, %	-1.9	-0.2	5.9	9.2	5.2	9.4	10.0	8.0	7.0
GDP deflator, ¹⁶⁹ %	12.0	27.3	23.1	9.9	5.1	6.9	8.5	5.0	6.0

Table A2. Gross domestic product by income source, 1998–2006, millions UAH, unless specified otherwise

	1998	1999	2000	2001	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
Wages	49,307	57,838	71,930	86,440	103,117	119,591	148,200	171,600	194,600
Taxes net of subsidies	19,758	22,975	28,523	27,264	27,639	31,884	36,300	44,700	48,700
Operating surplus	33,528	49,629	69,617	90,486	95,054	112,690	130,800	141,200	162,200
<i>Structure of GDP, %</i>									
Wages	48.1	44.3	42.3	42.3	45.7	45.3	47.0	48.0	48.0
Taxes net of subsidies	19.3	17.6	16.8	13.4	12.2	12.1	11.5	12.5	12.0
Operating surplus	32.7	38.1	40.9	44.3	42.1	42.6	41.5	39.5	40.0

Source: Derzhkomstat; calculations and forecast by Quarterly Predictions

¹⁶⁹ GDP deflator is the weighted sum of the deflators of its components.

Table A3. Breakdown of real GDP change factors, 1998–2006,¹⁷⁰ %

	1998	1999	2000	2001	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
Private consumption	0.7	-1.3	1.3	9.1	5.1	6.9	6.8	5.0	5.1
Public consumption	-0.8	-1.7	0.2	1.9	-1.3	2.7	2.4	0.8	0.8
Total consumption	-0.1	-3.0	1.5	11.0	3.8	9.6	9.3	5.9	5.8
Gross fixed investment	0.5	0.0	2.4	1.2	0.7	3.2	2.8	3.1	2.2
Change in inventories	-0.4	-3.6	0.0	0.4	-1.2	0.5	0.5	-0.3	0.3
Gross national spending ¹⁷¹	0.0	-6.6	3.9	12.7	3.4	13.3	12.6	8.6	8.3
Export of goods and services	0.5	-0.9	11.7	2.2	5.0	5.8	4.7	1.7	2.0
Import of goods and services	-0.9	7.4	-11.6	-3.5	-2.0	-8.5	-7.3	-2.1	-3.5
GDP change by expenditure groups	-0.4	-0.1	4.0	11.4	6.4	10.6	10.0	8.1	6.9
Statistical discrepancies	-1.5	-0.1	1.9	-2.2	-1.2	-1.2	0.0	-0.1	0.1
GDP change	-1.9	-0.2	5.9	9.2	5.2	9.4	10.0	8.0	7.0
<i>Annual real change</i>									
Private consumption	1.3	-2.2	2.3	9.0	9.0	12.1	12.0	9.0	9.0
Public consumption	-3.5	-7.9	1.0	10.4	-6.7	14.8	12.0	4.0	4.0
Total consumption	-0.1	-3.7	2.0	9.3	5.0	12.8	12.0	7.7	7.8
Gross fixed investment	2.6	0.1	12.4	6.2	3.4	15.8	14.0	14.0	10.0
Change in inventories	-27.3	...	0.0	2.1	1.0	0.5	0.5	-0.3	0.3
Export of goods and services	1.2	-2.2	21.5	3.5	7.4	10.3	8.0	3.0	4.0
Import of goods and services	2.0	-16.7	23.8	6.0	3.3	16.4	13.0	4.0	7.0

Source: Derzhkomstat; calculations and forecast by Quarterly Predictions

¹⁷⁰ Items contributing to GDP change are given as the real annual change of the item, multiplied by its proportion. Data are rounded off and therefore may not add up exactly.

¹⁷¹ Comprises consumption, investment, and change in inventories.

Table A4. Gross value-added by sector, 2001–2006, real % change

	2001	2002	2003 (est.)	2004 (forecast)	2005 (forecast)	2006 (forecast)	% of gross value-added in 2003
Agriculture, hunting, and forestry	10.2	2.0	-9.9	9.0	3.0	3.5	11.9
Extraction	10.8	2.4	5.5	6.5	5.0	4.0	4.8
Processing industry	14.0	9.5	18.1	15.5	10.0	9.0	21.2
Utilities (power, gas, and water)	3.8	1.7	4.7	3.0	5.0	4.0	5.2
Construction	7.8	-2.6	23.1	20.0	15.0	10.0	4.1
Wholesale/retail trade, trade in motor vehicles; repair services	43.0	7.8	19.6	15.0	12.0	10.0	12.8
Transport	19.0	7.4	12.4	12.0	10.0	6.0	13.3
Education	5.1	-0.5	1.9	6.0	2.0	2.0	5.3
Healthcare and social security	5.1	4.6	2.8	5.0	1.5	2.0	3.5
Other types of economic activity	0.8	...	8.3	4.0	6.5	6.5	17.9
Net tax on products	-16.1	0.5	10.9	9.0	9.0	9.0	
GDP	9.2	5.2	9.3	10.0	8.0	7.0	

Table A5. Industrial output, 2001–2006

	2001		2002		2003		2004			2005		2006	
	millions UAH	arc, %	millions UAH	arc, %	millions UAH	arc, %	arc, %	arc, %	arc, %	arc, %	arc, %	arc, %	arc, %
arc = annual real change													
Total industrial output	155,891.1	14.2	171,206.7	7.0	220,605.1	15.8	13.0	9.0	8.0				
Extraction	19,116.0	3.3	19,822.0	2.3	21,900.4	5.5	6.5	5.0	4.0				
Fuel extraction	12,652.7	4.8	13,026.5	-0.8	13,778.7	3.6	3.5	3.0	3.0				
Non-fuel extraction	6,463.3	0.2	6,795.5	7.7	8,121.7	9.1	11.0	9.0	5.0				
Processing industry	112,397.9	17.2	126,186.0	8.9	171,592.6	18.2	15.5	10.0	9.0				
Food industry and processing of farm output	27,795.2	18.2	30,883.6	8.4	38,409.0	20.0	10.0	9.0	8.0				
Textiles/apparel	2,403.4	13.8	2,216.9	0.4	2,498.1	4.0	7.0	6.0	4.5				
Timber production and wood products	837.3	28.0	1,002.4	23.4	1,499.4	23.6	22.0	20.0	20.0				
Pulp&paper, printing, and publishing	2,900.5	18.2	3,327.6	8.4	4,294.7	25.7	25.0	20.0	18.0				
Coke production and petroleum refining	6,068.3	54.3	9,837.3	25.5	16,896.9	8.7	9.0	5.0	4.0				
Chemicals and petrochemicals	10,592.1	10.6	10,789.4	6.5	14,523.1	16.8	12.5	8.0	5.0				
Other non-metal mineral products	5,061.1	11.4	5,378.7	5.3	6,797.3	17.9	21.0	15.0	15.0				
Metallurgy and metal processing	35,270.4	4.9	39,031.0	3.9	53,650.9	14.3	12.0	6.0	4.0				
Machine building	18,975.3	18.8	21,309.4	11.3	30,091.4	35.8	32.5	18.0	16.0				
Utilities (electricity, gas, and water)	24,377.2	2.6	25,198.7	1.1	27,112.1	4.7	3.0	5.0	4.0				

Source: Derzhkomstat; calculations by Quarterly Predictions

Table A6. Budget revenues and expenditures, deficit, and state debt, 2002–2006, % GDP

	2002			2003 (estimate)			2004	2005	2006
	Consolidated	State	Local	Consolidated	State	Local	Consolidated (forecast)		
Total revenues	27.1	20.4	12.6	28.5	20.8	13.0	27.0	27.5	27.5
Tax revenues	20.1	23.8	7.2	20.6	13.5	7.0	19.0	20.0	20.0
Personal income tax	4.9	0.0	4.9	5.1	0.0	5.1	3.5	4.0	4.0
Corporate profit tax	4.1	3.6	0.6	5.0	5.0	0.1	4.0	4.8	4.8
VAT	6.0	6.0	0.0	4.8	4.8	0.0	5.3	5.5	5.5
Excise	1.8	1.7	0.1	2.0	1.9	0.0	2.7	2.7	2.7
Tax on foreign trade	1.1	1.1	0.0	1.4	1.4	0.0	0.8	0.8	0.8
Land excise fees	0.8	0.0	0.8	0.8	0.0	0.8	1.0	1.0	1.0
Local taxes and levies	0.2	0.0	0.2	0.2	0.0	0.2	0.2	0.2	0.2
Non-tax revenues	6.5	5.6	0.9	6.9	6.0	0.9	6.5	6.6	6.6
Own receipts of budget organizations	3.4	2.7	0.7	2.9	2.2	0.7	3.0	3.0	3.0
Revenues from capital operations	0.5	0.2	0.3	0.7	0.3	0.4	0.6	0.6	0.6
State targeted funds	0.2	0.1	0.1	0.3	0.1	0.2	0.3	0.3	0.3
Official transfers	—	1.1	0.1	—	0.9	4.4	—	—	—
Total spending	26.4	19.7	12.2	28.7	21.2	12.8	28.5	28.0	28.5
Welfare	3.7	2.9	0.7	3.8	3.0	0.8	4.1	4.1	4.1
Education	1.0	1.1	0.0	0.9	0.9	0.0	1.2	1.3	1.3
Healthcare	0.3	0.3	0.0	0.1	0.1	0.0	0.3	0.4	0.4
Science	1.6	1.6	0.0	2.0	2.0	0.0	2.1	1.9	2.0
Defence	2.1	2.1	0.2	2.2	2.2	0.1	2.4	2.3	2.3
Public administration and law enforcement	3.0	2.5	0.7	4.6	3.5	1.1	3.4	3.4	3.4
Housing and public utilities	0.3	0.2	0.1	0.3	0.3	0.1	0.3	0.2	0.2
Economy	5.6	3.1	2.3	4.9	2.6	2.3	5.8	5.5	5.8
Chernobyl disaster	5.4	2.2	3.2	5.7	2.2	6.5	5.7	5.7	5.8
Foreign debt servicing	3.3	0.7	2.6	3.7	0.9	2.8	3.6	3.6	3.6
Domestic debt servicing	0.6	0.0	0.6	0.7	0.0	0.7	0.6	0.6	0.6
Other expenditures	0.6	4.0	1.7	0.8	0.2	0.5	0.7	0.7	0.7
Budget balance (IMF methodology)	0.7	0.6	0.1	-0.2	-0.4	0.2	-1.5	-0.5	-1.0
Privatization proceeds	0.3	0.3	—	0.8	0.8	—	1.0	0.4	0.5
Total debt	—	33.5	—	—	29.5	—	26.2	24.1	22.5
Foreign debt	—	24.1	—	—	21.7	—	18.7	16.7	15.0
Domestic debt	—	9.5	—	—	7.8	—	7.5	7.4	7.5

Sources: Treasury, Ministry of Finance; calculations and forecast by Quarterly Predictions

Table A7. Major indicators of monetary policy, 1996–2006, millions UAH, at end of period¹⁷²

	Monetary base	%	Broad money M3	%	Cash in circulation	%	Exchange rate, UAH/USD	NBU gross reserves, millions USD	Reserve/monetary base ratio, %	Commercial bank interest rates on loans, % pa	Lending from commercial banks	Deposits at commercial banks
12'96	4,882	38	9,364	35	4,041	54	1.8930	1,972	77	61.4	5,452	5,145
12'97	7,058	45	12,541	34	6,132	52	1.8990	2,359	64	42.7	7,295	6,357
12'98	8,625	22	15,705	25	7,158	17	3.4270	793	29	60.4	8,873	8,278
3'99	8,562	—	15,923	—	6,717	—	3.9264	703	32	68.0	9,571	8,914
6'99	10,334	—	18,579	—	7,916	—	3.9489	975	37	47.4	9,618	10,353
9'99	11,069	—	20,468	—	9,008	—	4.4697	1,377	55	50.9	11,080	11,037
12'99	11,988	39	22,070	41	9,583	34	5.2163	1,094	50	51.9	11,787	12,156
3'00	12,580	—	24,211	—	9,465	—	5.4276	1,074	46	42.5	13,849	13,870
6'00	14,124	—	27,098	—	10,783	—	5.4382	940	36	39.7	15,266	16,315
9'00	14,888	—	28,975	—	11,541	—	5.4397	986	36	39.7	16,828	16,576
12'00	16,780	39	32,252	45	12,799	34	5.4345	1,476	50	37.3	19,574	18,738
3'01	16,742	—	33,029	—	12,736	—	5.4192	1,516	49	33.8	21,547	20,022
6'01	18,998	—	36,956	—	14,487	—	5.3828	1,860	53	32.1	24,466	21,907
9'01	20,434	—	39,643	—	16,208	—	5.3311	2,723	71	30.6	25,947	22,852
12'01	23,055	37	45,755	42	19,465	52	5.2985	3,090	72	29.6	28,373	25,674
3'02	25,076	—	47,345	—	19,646	—	5.3220	3,112	66	27.6	29,669	27,101
6'02	26,227	—	51,195	—	21,441	—	5.3288	3,405	69	25.0	32,653	29,296
9'02	29,158	—	57,729	—	23,655	—	5.3295	4,019	73	23.5	36,400	33,533
12'02	30,808	34	64,870	42	26,434	36	5.3316	4,417	76	21.8	42,035	37,715
3'03	31,191	—	70,114	—	26,002	—	5.3345	4,615	79	18.0	46,021	43,503
6'03	35,178	—	79,034	—	29,375	—	5.3328	6,172	94	17.2	52,656	49,017
9'03	38,021	—	86,495	—	30,862	—	5.3315	6,682	94	17.2	60,491	54,946
12'03	40,089	30	95,043	47	33,119	25	5.3315	6,937	92	17.7	67,835	61,365
12'04 (f.)	52,200	30	131,200	38	43,100	30	5.3200	9,050	92	17.0		
12'05 (f.)	63,100	21	167,900	28	50,400	17	5.3000	11,100	94	16.0		
12'06 (f.)	71,800	14	201,500	20	56,900	13	5.4000	12,450	93	14.0		

Source: NBU; forecast by Quarterly Predictions

¹⁷² Starting 2000, the monetary indicators include accrued interest.

Table A8. Consumer and producer prices, 1998–2006

Year	Quarter	Consumer prices			Producer prices				
		Quarterly change	End of period	Average	Index, 12'95 = 100	Quarterly change	End of period	Average	Index, 12'95 = 100
1998			20.0%	10.6%	184.6		35.4%	13.2%	166.7
1999			19.2%	22.8%	220.2		15.7%	32.0%	192.6
2000			25.8%	28.2%	276.8		20.9%	20.9%	232.6
2001			6.1%	12.2%	293.7		0.9%	8.9%	234.7
2002			-0.6%	0.8%	292.0		5.7%	3.0%	248.1
2003			8.2%	5.2%	316.1		11.1%	7.7%	275.7
2004 (f.)			6.0%	7.0%	335.1		12.0%	14.2%	308.6
2005 (f.)			7.0%	6.5%	358.7		7.0%	7.6%	330.3
2006 (f.)			4.5%	6.0%	374.9		5.0%	6.1%	346.8
2002	I	-1.1%			290.4	-0.5%			233.5
	II	-0.7%			288.3	5.0%			245.1
	III	-1.5%			284.0	0.9%			247.3
	IV	2.8%			292.0	0.3%			248.1
2003	I	3.7%			303.0	3.3%			256.4
	II	0.8%			305.4	0.6%			257.9
	III	-1.2%			301.7	2.9%			265.5
	IV	4.8%			316.1	3.9%			275.7
2004	I	2.4%			323.7	6.8%			294.5
	II (f.)	1.1%			327.3	4.5%			307.9
	III (f.)	-1.2%			323.4	0.2%			308.5
	IV (f.)	3.6%			335.1	2.4%			316.0
2005 (f.)	I	3.2%			346.0	2.5%			323.9
	II	0.6%			348.1	1.3%			328.2
	III	-1.3%			343.4	0.7%			330.8
	IV	4.5%			358.7	2.2%			338.1
2006 (f.)	I	2.6%			368.1	1.9%			344.6
	II	0.5%			369.9	1.3%			349.1
	III	-1.5%			364.2	0.4%			350.5
	IV	2.9%			374.9	1.3%			355.1

Source: Derzhkomstat; forecast by Quarterly Predictions

Table A9. Balance of payments, 1998–2006,¹⁷³ millions USD

	1998	1999	2000	2001	2002	2003	2004 (forecast)	2005 (forecast)	2006 (forecast)
Current account balance	-1,296	1,658	1,481	1,402	3,173	2,891	2,400	2,030	930
Trade balance in goods and services	-1,207	1,821	1,575	613	1,857	1,288	950	720	-240
Merchandise trade balance	-2,584	244	779	198	710	-269	-790	-1,110	-2,030
Exports of goods	13,699	13,189	15,722	17,091	18,669	23,739	27,060	28,400	29,550
Imports of goods	-16,283	-12,945	-14,943	-16,893	-17,959	-24,008	-27,850	-29,520	-31,600
Balance of services	1,377	1,577	796	415	1,147	1,557	1,740	1,830	1,800
Exports of services	3,922	3,869	3,800	3,995	4,682	5,214	5,580	5,860	6,150
Imports of services	-2,545	-2,292	-3,004	-3,580	-3,535	-3,657	-3,840	-4,030	-4,350
Income	-871	-869	-942	-667	-606	-581	-540	-570	-600
Transfers	782	706	848	1,456	1,922	2,184	1,945	1,770	1,610
Capital account (excluding changes in reserves)	782	-421	-925	435	-1,243	107	-300	20	420
Direct investments ¹⁷⁴	747	489	594	769	698	1,411	1,600	1,800	2,000
Portfolio investments	47	-86	-201	-866	-1,716	-922	-1,500	-1,300	-1,100
Other investments	-9	-814	-1,318	529	-240	-365	-400	-480	-480
Net change in NBU reserves	1,324	-283	-398	-1,606	-1,045	-2,045	-2,100	-2,050	-1,350
Errors/omissions	-820	-954	-150	-231	-885	-953	0	0	0

Source: NBU; forecast by Quarterly Predictions

¹⁷³ Table is constructed using NBU methodology. Data is rounded off and therefore may not add up exactly.

¹⁷⁴ Calculated as net foreign investments in Ukraine minus net investments of Ukrainian residents abroad.

Table A10. Gross agricultural output, 1996–2006

	Total, millions UAH	Annual real change, ¹⁷⁵ %	Crop production, millions UAH	Annual real change, %	Livestock production, millions UAH	Annual real change, %
1996	26,694.4	-9.5	15,271.8	-8.9	11,422.6	-10.4
1997	30,032.0	-1.8	18,550.1	6.1	11,481.9	-12.3
1998	32,758.0	-9.6	18,562.3	-17.3	14,237.7	2.5
1999	37,683.0	-6.9	20,314.0	-10.3	16,926.0	-2.4
2000	54,259.0	9.8	31,242.1	22.0	20,857.9	-4.8
2001	69,536.0	10.2	42,889.4	12.4	26,646.6	7.0
2002	64,380.0	1.2	38,344.4	-1.6	26,035.7	5.1
2003 (estimate)	64,473.0	-9.9	36,548.8	-14.9	27,924.2	-3.0
2004 (forecast)	73,746.0	9.0	44,892.6	17.3	28,853.4	-2.2
2005 (forecast)	81,313.0	3.0	49,509.5	3.0	31,803.4	3.0
2006 (forecast)	87,975.5	3.5	53,767.8	4.0	34,206.7	3.0

Table A11. Major agricultural commodities, 1993–2006

	Grain, thous tons	Annual change, %	Sunseeds, thous tons	Annual change, %	Sugar beets, thous tons	Annual change, %	Meat, thous tons (live weight)	Annual change, %	Milk, millions tons	Annual change, %	Eggs, millions	Annual change, %
1993	45,623	18.4	2,075	-2.4	33,717	17.1	4,312	-16.3	18.4	-4.0	11,794	-12.6
1994	35,497	-22.2	1,569	-24.4	28,138	-16.5	4,115	-4.6	18.1	-1.3	10,154	-13.9
1995	33,930	-4.4	2,860	82.3	29,650	5.4	3,581	-13.0	17.3	-4.8	9,404	-7.4
1996	24,571	-27.6	2,123	-25.8	23,009	-22.4	3,351	-6.4	15.8	-8.4	8,763	-6.8
1997	35,472	44.4	2,308	8.7	17,663	-23.2	2,976	-11.2	13.8	-13.0	8,242	-5.9
1998	26,471	-25.4	2,266	-2.0	15,523	-13.2	2,653	-10.8	13.8	-0.1	8,301	0.7
1999	24,581	-7.1	2,794	23.3	14,064	-9.4	2,647	-0.3	13.4	-2.8	8,740	5.3
2000	24,439	-0.6	3,460	23.8	13,185	-6.2	2,600	-1.8	12.6	-5.6	8,659	-0.9
2001	39,706	62.5	2,251	-35.0	15,489	17.5	2,317	-5.0	13.4	6.0	9,652	8.0
2002	38,792	-2.3	2,970	32.0	14,400	-7.5	2,509	7.6	14.1	5.2	11,297	16.8
2003 (estimate)	20,221	-47.9	4,248	29.9	13,339	-7.4	2,607	3.5	13.7	-3.4	11,464	1.5
2004 (forecast)	33,364	65.0	4,269	0.5	13,606	2.0	2,502	-4.0	13.4	-2.0	11,693	2.0
2005 (forecast)	35,366	6.0	3,842	-10.0	13,470	-1.0	2,628	5.0	13.7	2.0	12,044	3.0
2006 (forecast)	37,488	6.0	3,650	-5.0	13,200	-2.0	2,706	3.0	13.9	2.0	12,225	1.5

Source: Derzhkomstat; calculations and forecast by Quarterly Predictions

¹⁷⁵ The ratio of gross output of the current year (in 2000 prices) to the same indicator of the previous year.

<i>Table A12. Wages, 2001–2006</i>						<i>Table A13. Retail turnover and housing starts, 2001–2006</i>			
	Quarter	Nominal monthly wage, UAH	Real % change, quarter-on-quarter	Real % change, year-on-year	Annual average, % change ¹⁷⁶	Retail turnover, quarterly, millions UAH	Year-on-year quarterly % change, real terms ¹⁷⁷	Private housing starts, quarterly, millions UAH	Year-on-year quarterly % change, real terms
2001	Q1	266.03	-3.8	15.3	4.6	7,262	7.2	253.043	-1.5
	Q2	303.23	11.2	24.7	11.0	8,149	11.4	257.241	8.3
	Q3	327.67	9.7	24.2	16.9	8,971	13.7	297.858	29.9
	Q4	349.55	4.3	22.4	21.8	9,369	13.7	549.318	14.8
2002	Q1	334.76	-3.2	23.2	23.6	8,207	15.2	284.449	14.2
	Q2	364.02	9.5	21.3	22.7	9,313	14.9	291.956	11.1
	Q3	393.10	9.6	21.2	22.0	10,313	11.9	341.309	11.9
	Q4	412.02	4.8	21.8	21.8	11,359	15.0	653.086	12.5
2003	Q1	402.43	-2.4	22.8	21.8	9,895	13.2	278.345	-11.8
	Q2	446.00	10.8	24.3	22.6	11,314	17.2	359.462	15.0
	Q3	488.98	9.6	24.3	23.4	13,129	23.3	383.126	2.1
	Q4	512.94	4.8	24.4	24.0	17,654	22.5	801.351	10.4
2004 (f.)	Q1	—	—	—	—	12,701	20.6	343.993	8.0
	Q2	—	—	—	—	15,024	17.9	448.604	7.0
	Q3	—	—	—	—	16,588	17.1	465.376	7.0
	Q4	—	—	—	12.0 ¹⁷⁸	17,924	14.5	950.797	6.0
2005 (f.)	Q1	—	—	—	—	15,806	13.5	393.216	6.0
	Q2	—	—	—	—	17,980	12.7	506.663	6.0
	Q3	—	—	—	—	19,779	12.0	528.815	6.0
	Q4	—	—	—	10.0	21,333	11.2	1,068.537	5.0
2006 (f.)	Q1	—	—	—	—	18,669	10.7	443.420	6.0
	Q2	—	—	—	—	21,285	11.4	566.024	5.0
	Q3	—	—	—	—	23,268	10.8	588.251	5.0
	Q4	—	—	—	10.0	25,465	13.8	1,189.231	6.0

Source: Derzhkomstat; forecast by Quarterly Predictions

Source: Derzhkomstat; forecast by Quarterly Predictions

¹⁷⁶ The ratio of average real wage during the quarter and during the three preceding quarters to the real average wage during the corresponding quarter of the previous year and during the corresponding three preceding quarters.

¹⁷⁷ The retail price index is used to calculate real monthly retail turnover. Beginning in 2001, retail turnover has been calculated in accordance with the Classification of Types of Economic Activity (KVED in Ukrainian).

¹⁷⁸ In January 2004, Derzhkomstat changed its methodology for calculating wage statistics. The new methodology takes into account international recommendations and the standards of System of National Accounts. Data for 2004 and the following years is incomparable with previous periods data.

Table A14. Household income and spending, 2002–2006, millions UAH, unless specified otherwise

	2002	2003 (estimate)	2004 (forecast)	2005 (forecast)	2006 (forecast)
Household income ¹⁷⁹	186,073	211,922	—	—	—
Wages	79,026	90,491	—	—	—
Operating surplus	33,498	34,543	—	—	—
Property incomes	5,182	5,086	—	—	—
Social assistance and other current transfers	31,647	36,663	—	—	—
Disposable income	141,618	157,288	—	—	—
Real disposable income after taxes, annual % change	18.0	5.8	7.5	6.0	6.0
Expenditures	168,015	199,908	—	—	—
Real consumption, ¹⁸⁰ annual % change	5.6	12.2	12.0	9.0	9.0
Savings	17,058	12,014	—	—	—

Source: Derzhkomstat; forecast by Quarterly Predictions

¹⁷⁹ Overall household income, less income from the sale of foreign currency.

¹⁸⁰ Given in accordance with the System of National Accounts (SNA) (non-profit organizations delivering services to households excluded).

Table A15. Real GDP among Ukraine's major trading partners, 1996–2006, % change

	1996	1997	1998	1999	2000	2001	2002	2003 (est.)	2004 (forecast)	2005 (forecast)	2006 (forecast)	% in Ukraine's exports (2003)	% in world output (2003)
Russia	-3.4	0.9	-4.9	5.4	9.0	5.1	4.7	7.3	7.0	5.1	4.5	18.7	2.6
Euro area	1.4	2.3	2.9	2.8	3.5	1.6	0.9	0.4	1.8	2.5	1.8	18.2	15.9
China	9.6	8.8	7.8	7.1	8.0	7.5	8.0	9.1	8.0	6.5	5.0	4.3	12.6
Turkey	6.9	7.6	3.1	-4.7	7.4	-7.5	7.8	4.5	4.7	4.5	3.0	3.9	—
Hungary	1.3	4.6	4.9	4.2	5.2	3.8	3.5	2.9	3.5	3.8	3.2	3.7	—
Poland	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.7	4.0	3.8	3.6	3.3	—
USA	3.6	4.4	4.3	4.1	3.8	0.5	2.2	3.1	4.0	3.2	2.0	3.1	21.1
Romania	3.9	-6.1	-4.8	-1.2	2.1	5.7	5.0	4.9	5.0	5.0	5.0	2.2	—
Moldova	-5.9	1.6	-6.5	-3.4	2.1	6.1	7.8	6.3	5.3	5.5	4.0	2.1	—
Belarus	2.8	11.4	8.3	3.4	5.8	4.7	5.0	6.8	6.0	4.5	4.0	1.5	—
Bulgaria	-8.0	-5.6	4.0	2.3	5.4	4.1	4.8	4.3	5.0	4.5	4.0	1.4	—
Slovakia	5.8	5.6	4.0	1.5	2.0	3.8	4.4	4.2	4.0	5.0	5.3	1.3	—
UK	2.6	3.4	2.9	2.4	3.1	2.1	1.7	2.3	2.4	2.5	1.5	1.3	3.2
Latvia	3.3	8.6	3.9	1.1	6.8	7.9	6.1	6.7	6.5	5.5	5.0	1.2	—
Total	1.2	3.1	0.9	2.7	5.7	2.4	4.0	4.5	4.7	4.1	3.4	66.1	—

Source: IMF; forecast by Quarterly Predictions

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