

# ***quarterly predictions***

*#29, fourth quarter 2004*

In this issue, the International Centre for Policy Studies presents an analysis of changes in government policy, and in economic and other legislation over 2004. This quarterly also analyzes the political and economic situation in Ukraine in Q4'04 and offers an outlook for 2005–2006.

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# MAJOR INDICATORS

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Indicator								(estimate)	(forecast)	
<b>Economic activity</b>										
GDP, billions UAH	93.4	102.6	130.4	170.1	204.2	225.8	264.2	345.9	418.5	472.4
Real GDP, <i>apc</i> *	-3.0	-1.9	-0.2	5.9	9.2	5.2	9.4	12.1	7.0	7.5
Real industrial output, <i>apc</i>	-0.3	-1.0	4.0	13.2	14.2	7.0	15.8	12.5	9.5	8.0
Real agricultural output, <i>apc</i>	-1.9	-9.8	-5.7	9.8	10.2	1.2	-9.9	19.1	2.0	2.5
Gross investment, % GDP	21.5	20.8	17.5	19.8	21.8	20.2	20.3	20.8	21.7	23.2
Real gross fixed investment, <i>apc</i>	2.1	2.6	0.1	12.4	6.2	3.4	15.8	11.0	10.0	12.0
Real total consumption, <i>apc</i>	-1.8	-0.1	-3.7	2.0	9.3	5.0	12.8	13.5	7.3	8.3
Net FDI, millions USD <sup>(1)</sup>	581	747	489	594	769	698	1,411	1,500	1,600	2,000
Real disposable household income, <i>apc</i> <sup>(2)</sup>	5.1	-5.8	1.2	11.1	14.5	18.0	7.8	16.8	8.0	10.0
Real retail trade, <i>apc</i>	8.2	-3.5	-4.8	7.5	11.7	14.8	19.4	20.0	12.0	12.0
<b>Prices</b>										
Consumer price index, <i>apc</i>	10.1	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	11.0	6.0
Producer price index, <i>apc</i>	5.0	35.3	15.7	20.8	0.9	5.7	11.1	24.1	12.0	6.0
<b>Labor market</b>										
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	-0.9	19.3	18.2	15.2	23.8	18.0	15.0
Unemployment rate, % (ILO methodology)	-	-	11.9	11.7	11.1	10.1	9.1	8.5	8.2	8.0
<b>Foreign economic activity</b>										
Exports of goods&services, <i>apc</i>	0.0	-13.4	-7.3	18.0	8.0	10.7	24.0	37.0	10.0	7.0
Imports of goods&services, <i>apc</i>	-2.0	-14.0	-19.1	17.8	14.1	5.0	28.7	25.0	18.0	12.0
Current account balance, % GDP	-2.7	-3.1	3.0	4.0	3.7	7.7	5.8	10.8	7.0	4.0
<b>Budget</b>										
Revenues, % GDP (consolidated) <sup>(3)</sup>	30.0	27.3	24.7	26.2	25.7	27.7	28.5	26.2	27.0	28.0
Balance, % GDP <sup>(3)</sup>	-5.6	-2.7	-2.4	-0.8	-1.5	0.7	-0.2	-3.4	-3.0	-1.0
<b>Financial indicators</b>										
Monetary base, <i>apc</i>	45	22	39	39	37	34	30	34	34	22
M3, <i>apc</i>	34	25	41	45	42	42	47	32	38	25
NBU gold/forex reserves, millions USD	2,359	793	1,094	1,475	3,089	4,417	6,937	9,525	13,400	15,950
Official exchange rate, UAH/USD (average annual)	1.86	2.45	4.13	5.44	5.37	5.33	5.33	5.32	5.29	5.22
Loan interest, % <i>pa</i> (average annual) <sup>(4)</sup>	49	55	53	40	32	25	18	17.5	18	16.5
<b>Global economy</b>										
Global GDP, <i>apc</i>	4.2	2.8	3.6	4.8	2.4	3.0	3.9	4.5	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	5.2	4.2	3.5

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

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

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

# OVERVIEW

2004 was the year the Ukrainian government's policies served short-term interests: raising social benefits and curbing inflation. Following suit, the Verkhovna Rada also adopted mainly short-term resolutions. The rare long-term decisions included amendments to the Constitution and a new version of the Civil Procedural Code. ICPS expects the new authorities to lay the groundwork for serious transformations throughout 2005 and to launch large-scale reforms in spring 2006, after the Verkhovna Rada elections. The situation will continue to favor reforms during 2005–2006 as the economy grows, on average, 7% pa

## Results of 2004 and forecast

*In 2004, Ukraine's economy grew a record-high 12.1%...*

According to preliminary data from Derzhkomstat, the state statistics committee, real GDP grew a record-high 12.1% in 2004. Such speedy growth was due to a very good grain crop (+110%), a construction boom (+18.4%), and an industrial upswing (+12.5%)—in particular, in metalworking, machine-building and chemicals. Economic growth slowed down late in the year.<sup>1</sup>

*... and will continue to grow, albeit at a slower pace*

The election of a new president and the peaceful settlement of the country's most heated socio-political confrontation (see **POLITICAL ENVIRONMENT**) will help stabilize the political situation in 2005. However, the economic upturn will be slower than in 2004, hampered by accelerating inflation (see **FINANCIAL POLICY**) and slower growth in export prices. ICPS economists have left the forecast for real GDP growth unchanged, at 7% in 2005 and 7.5% in 2006.

*Some of President Yushchenko's election promises will be kept*

Maintaining a three-way balance among social benefits, the State Budget and inflation will be the key challenge for the new Government. According to ICPS analysts, it will be impossible to simultaneously fulfill all the tasks that the President has set before the Government: significantly raising social benefits while preventing a Budget deficit and double-digit inflation. Most likely, the Government will carry out a good part of the social commitments made by Viktor Yushchenko during his election campaign. However, this will mean a Budget deficit around 3% of GDP and inflation will likely reach 11%. In H1'05, the Consumer Price Index will grow 16% pa as food prices continue to climb and the Government decides to raise regulated rates and prices, a move that was deliberately postponed throughout 2004. The most felt changes will be growing transit fares and higher rates for residential services.

During the forecast period, the value of Ukrainian imports will grow faster than exports. At the same time, the current account balance will continue to be high, which will help the National Bank to support a stable UAH/USD exchange rate and even start a slight nominal hryvnia appreciation (see **FINANCIAL POLICY**), especially as the US dollar continues to slip worldwide.

*Risks include a steep rise in the deficit and serious price fluctuations on world commodity markets*

ICPS economists base their forecast on the assumption that the new Government will not start a mass increase of social minimums and that it will first take care of Budget revenues, not reallocate its resources. If the new Government raises salaries, pensions and other social benefits in the amounts that were promised during the election campaign, the Budget deficit will reach

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<sup>1</sup> For the reasons behind this slowdown, see *quarterly predictions* for Q3'04, p. 4–5.

UAH 27bn or about 6.5% of GDP, according to ICPS calculations. If this happens, ICPS expects the CPI to hit at least 19% by year-end.

ICPS also bases its forecast on the assumption that there will be no sudden changes on world markets for oil, metals and chemicals.

## Changes in legislation

The policy-making process did not much change in 2004: a slew of adopted laws contradicted existing legislation or had no fiscal support, while much-needed changes to legislation were not instituted. Meanwhile, the presidential election had a noticeable impact on decision-making. In addition to populist steps in the social sphere, the Government resorted to price controls and provided more support for domestic producers compared to 2003 (see **FINANCIAL POLICY, BUSINESS and AGRICULTURE**). These decisions violated the rules of competition, helping some businesses benefit at the expense of others. They also pushed up the Budget deficit, which passed the 3% mark, according to ICPS estimates (see **PUBLIC FINANCE**).

*The policy-making process did not change in 2004*

*Table 1. Impact of legislative changes on business in 2004*

Business-friendly changes	Business-unfriendly changes
Involving stakeholders in the regulatory policy-making process	Adopting Civil and Commercial Codes with mutually contradictory provisions
Introducing mortgaging	Postponing the date the Civil Procedural Code comes into force
Setting up a consolidated title registration system for parcels of land and other real estate	Changing tax legislation inconsistently, failing to properly prepare for the introduction of changes long in the planning
Adopting a program to reform the residential services sector	Providing selective support to certain car makers
Compensating some of the costs for sowing spring crops and buying mineral fertilizers	Extending the ban on the sale and purchase of farmland

### *New economic legislation*

2004 saw the coming into force of basic legislation for developing the business environment—the Civil and Commercial Codes—and the Law “On the principles of state regulation of business.” But enforcing certain provisions in these laws proved difficult: the two Codes have different approaches to regulating one and the same issues.<sup>2</sup> Moreover, the government made no efforts to harmonize the Codes during 2004. In short, the regulatory policy-making process did not get any better (see **BUSINESS and ADMINISTRATIVE REFORM**).

*Contradictions in key laws were not eliminated during 2004*

<sup>2</sup> See *policy studies* for January 2004, p. 50–53.

In 2004, new provisions on the registration of business entities came into effect without a “one-stop shop” registration system being set up. Although the Law “On state registration of legal entities and sole proprietors” envisages setting up such a system, it does not require relevant bodies to do so. As a consequence, business registration follows different procedures in different locations.

The Verkhovna Rada laid the foundation for attracting private capital to the water supply and heating markets and fostering competition on the housing and grounds maintenance market.<sup>3</sup> To really institute the reforms envisaged by these laws, a number of by-laws should be adopted and reforms in residential services, local government, and budget transfers should be coordinated. Needless to say, it all needs to be supported by the necessary funding.

The Law “On mortgages” had a positive impact on the development of the financial market. In particular, it helped popularize mortgage lending and reduce risk in such operations. Still, there are quite a few problems hampering the development of mortgaging (see **FINANCIAL POLICY**).

***The Rada extended the ban on the sale of land until 2007***

In 2004, the Government took a number of steps to form a land market (see **AGRICULTURE**). Specifically, the Verkhovna Rada extended a moratorium on the sale and purchase of farmland, which was about to expire in 2005, until 2007. This will make it possible to adopt necessary legislation and complete the exchange of land deeds for state certificates of land ownership. The new Law “On the state registration of real estate property and liens” calls for a unified system of title registration for parcels of land and other real estate. This register should make land and real estate purchase and sale operations more transparent and set up an environment for meaningful mortgage lending.

In 2004, many decisions in agriculture were designed to support producers. The Government introduced partial compensation for the cost of sowing spring crops and purchasing mineral fertilizers. For the first time in several years, the state fulfilled its plan for grain pledges and interventions.

***The Government did not really implement its plans to get nearer to the EU***

Although EU integration is a strategic goal for Ukraine, a slew of related tasks scheduled for 2004 were not carried out. For instance, Ukraine failed to accede to the WTO, it did not fully implement a plan for adapting national legislation to EU standards, and it failed to obtain market economy status (see **FOREIGN TRADE**).

In 2004, the Government also failed to improve its Budget and tax policy. Fulfilling plans rather than achieving results was the main criterion for Budget quality. Changes to tax legislation were chaotic, while decisions to privatize large companies were made spontaneously, without an agreed schedule (see **BUSINESS**).

***Social policy focused on short-term objectives***

Social policy looked more like initiatives aimed at raising household incomes than like long-term, well-reasoned decisions in 2004. The Government significantly raised social benefits, repaid arrears in some social payments, and reduced wage arrears,<sup>4</sup> which stimulated growth in inflation. At the same time, the Government decided not to replace privileges with targeted cash benefits, as it had promised to do in 2002. By introducing targeted subsidies for pen-

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<sup>3</sup> See the 24 June 2004 Laws “On residential services” and “On the state-wide program for reforming and developing the residential services sector for 2004–2010.”

<sup>4</sup> See *quarterly predictions* for Q3'04, p. 35–36.

sioners to raise their benefit to the minimum subsistence level, the Yanukovych Government also violated the principles and goals of pension reform (see **SOCIAL POLICY**). In December 2004, the Verkhovna Rada approved a minimum pension in the amount of the minimum subsistence level for unemployable individuals—which will result in a major Pension Fund deficit in 2005.

The crisis of confidence in the financial system that reigned in Ukraine during Q4'04 forced the NBU to resort to decisive steps. The loss of deposits and a destabilized financial situation caused a steep worsening of bank liquidity, which the National Bank tried to improve by refinancing banks and introducing restrictions. Most restrictions were cancelled (see **FINANCIAL POLICY**) as soon as the situation on the financial market stabilized, once the election was over.

### *Political, administrative and judicial reforms*

2004 was a good year for democratic developments. The Verkhovna Rada adopted a new law on the VR elections and amendments to the Constitution (see **POLITICAL ENVIRONMENT**). The former introduced the principle of an entirely proportional vote and set a 3% threshold in the VR election starting in 2006. Amendments to the Constitution extend the Verkhovna Rada's term from four years to five and restrict certain presidential powers in favor of the Verkhovna Rada and the Government. If these amendments come into effect,<sup>5</sup> they will definitely make it possible to prevent abuse of power on the part of the president, although his remaining powers still make him the most powerful figure in Ukrainian politics.

Meanwhile, the Verkhovna Rada has given preliminary approval to Bill №3207-1, which changes the organization of local governments (see **ADMINISTRATIVE REFORM**). This Bill restricts representatives of the executive branch, so-called state administrations, to the oblast level and the two cities of Kyiv and Sevastopol. If this Bill gains a constitutional majority again, it will reduce state interference in local issues, while local governments will gain real powers. However, the division of power between local governments and Kyiv, and the mechanisms for delegating these powers still need to be regulated.

In 2004, the Verkhovna Rada adopted a number of regulations that make it possible to involve voters in the policy-making process. This is the process of holding public consultations and forming community councils attached to executive bodies (see **ADMINISTRATIVE REFORM**). However, effective implementation of these provisions will depend on the initiative of various interest groups, sufficient funding and the level of interest among executive bodies for taking public opinion into account.

As in the previous years, judicial reform failed to become a government policy priority. As a result, the formation of administrative courts<sup>6</sup> was delayed and

***Political reform should foster democratic development***

***Restricting state administrations to the oblast level will expand decentralization***

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<sup>5</sup> Amendments to the Constitution could well be recognized as unconstitutional because their adoption as part of a “packaged” vote took place with violations of proper procedure. In particular, the Bill was not vetted by the Constitutional Court as to its constitutionality and it is generally poor in quality. For example, the Article allowing the president to appoint oblast governors was removed but that power was not transferred to the Verkhovna Rada or the Government.

<sup>6</sup> Administrative courts are being established to allow appeals against decisions, actions or inaction on the part of central and local government bodies or elected and appointed officials. Currently, these functions are carried out by the commercial courts. Administrative procedures could ease the role of the plaintiff, such as a business, in court.

the Administrative Procedural Code was not adopted (see **JUDICIAL REFORM**). The achievements of judicial reform in 2004 include the adoption of the Civil Procedural Code,<sup>7</sup> whose purpose is to facilitate the settlement of private disputes, and the Law “On courts of arbitration,” which opens an alternative way to settle commercial disputes.

## Meaningful directions for reform

Tackling political and economic problems that are widely acknowledged by Ukrainian society is impossible without a well-wrought plan that includes clear priorities. Only when priorities have been properly identified and a variety of solutions considered, is there a possibility to move the resolution of national issues to a new level.

According to ICPS, basic priorities should include:

- reforming the policy-making system;
- establishing conditions for accepting economic initiatives from individuals;
- controlling Budget spending and preventing its resources from being diluted among areas that either are not priorities or are duplicated elsewhere;
- bringing the education system in line with market needs and the global situation.

***Changing the system of public administration is key to successful reforms***

According to ICPS economists, the new government will be able to implement successful reforms in any area—but only if it changes the public administration system. The current system makes it impossible to develop and implement effective policies. Excessive centralization is the key drawback. As a result, central government bodies function mostly in an administrative capacity, while developing strategies and government policy become, for them, secondary tasks. ICPS analysts suggest that, to change this system for the better, politicians need to:

- **REVIEW THE FUNCTIONS OF GOVERNMENT BODIES.** Some of these functions should be transferred to lower levels, whereas other parts should be entrusted to non-government organizations. Moreover, Government bodies should not provide services that can be provided more efficiently by the private sector.
- **CHANGE THE POLICY-MAKING PROCESS.** Make policy-making less “collective” so that it does not need so many signatures and approvals. Increase the accountability of ministers for the range of issues entrusted to them. Increase the participation of civil society in public administration and institute public consultations on policy at the central and local levels.
- **RAISE INFORMATIONAL OPENNESS AND TRANSPARENCY IN GOVERNMENT.** Introduce regular monitoring, evaluation and performance reports for government bodies, and then arrange free public access to this information.

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<sup>7</sup> This Code will not become effective prior to the Administrative Procedural Code—which has not been adopted yet.

- **STRENGTHEN GOVERNMENT ACCOUNTABILITY.** Develop and institute mechanisms to oversee government by identifying clearly the form and extent of accountability for breaking the law, for both government bodies and government workers, and by simplifying procedures for holding all government branches accountable. Enshrine in law mechanisms for compensating any losses incurred through actions or inaction on the part of government bodies and appointed officials.

Once Ukraine's government system is reformed, the country's economic development strategy can also be revised. ICPS analysts believe that business development should become a priority. Among the benefits of a policy aimed at improving the business environment are lower unemployment and higher living standards among Ukrainians. According to ICPS economists, these priority measures should include:

***The country's economic development strategy should make business development a priority***

- improving regulatory policy: unjustified regulation should be cancelled, while appropriate regulation needs to be more effective;
- reducing tax breaks to provide the most level playing field for businesses;
- combining the social funds to reduce administrative costs for both business and government.<sup>8</sup>

Protecting property rights also needs to become an important element of business development policy. For this purpose, judicial reform is imperative, to establish an effective judicial branch that is independent of the executive. According to ICPS, implementing judicial reform means that the government must:

***Judicial reform should lead to effective protection for property rights***

- provide sufficient funding and logistical support for the courts;
- set up an effective mechanism for preventing administrative pressure on courts;
- develop an effective and transparent mechanism for appointing judges.

The policies of the new Government will be primarily affected by the need to win the VR elections in spring 2006. The election campaign, which in fact has already begun, does not allow the new Cabinet to launch large-scale reforms that might get mixed reviews from voters and will not yield quick positive results.

***The new Government's policies will be primarily affected by the need to win the 2006 election***

According to ICPS, it is worth using the time until the Verkhovna Rada elections to prepare for these reforms, namely: to expand public debate on the problems targeted by reforms, to adopt action plans, and to set up "reform teams." If the preparations for "painful reforms" are public, public support for the Government will get a boost and make it easier to make sound decisions during the reform process.

Once the 2006 VR campaign is over, the Government should launch reforms in the key social sectors that have long stayed unreformed. Changes in these areas will provide a much-needed impact on the quality of life, as these services are among the most important for everyday lives:

***After the VR race is over, reforms can be tackled in key social sectors***

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<sup>8</sup> According to ICPS economists, 2005 will not be the best year to lower tax rates. After tax rates were lowered on 1 January 2004, the share of tax revenues to GDP dropped. Huge social commitments by the Government, on one hand, and a high risk that Budget revenues will decline, on the other, make lowering tax rates a completely unsuitable policy move.

**1. REFORMING SOCIAL PRIVILEGES.** At the moment, privileges do not support poorest among Ukraine's citizens. What is more, the Government could not provide privileges to those who are eligible, as almost one third of Ukraine's population would qualify. To tackle this problem, a few things need to be identified: what function privileges should serve, and to whom and on what basis they should be given. The first stage of reform should be to bring order to the system of privileges. During this phase, the Government should keep giving out most social privileges, revise those for Chernobyl groups, and cancel those that are service-based. In the second stage, targeted cash benefits should be introduced over the long run.

**2. REFORMING RESIDENTIAL SERVICES.** Residential service providers produce about 10% of GDP. Still, they cannot provide high-quality services: the heating season often starts late and ends early; in some regions, water is supplied on a rotating basis; and there are many accidents in both networks. The lack of investment into this sector has led to growing problems with the existing plant and infrastructure. Reforming this sector will require investment. According to ICPS, possible sources are: consumers (by raising rates while guaranteeing better quality), cutting operating costs, and private capital. ICPS analysts argue that, to attract private capital, it will be necessary to either turn residential services providers into concessions or to privatize them. Rate regulation methods also need changing: clear methods are needed to plan costs for capital investments, and the cross-subsidies to households provided involuntarily by industrial consumers need to be eliminated.

*Will new moves to reform  
the residential services sector work?*

*One outcome of the 2004 adoption of key laws<sup>9</sup> in this sector could be the emergence of competition on the housing and grounds maintenance market and the attraction of private capital to the water supply and heating markets.*

*For the moment, the development of the residential services sector is complicated because of the market is monopolized and government regulation of natural monopolies in water supply, sewage and heating is inadequate. Developing by-laws and establishing a new regulatory base should fill the legislative vacuum in the residential services sector.*

*However, some unrealistic provisions in the new laws could once more put a brake on reform in this sector. For instance, the decision to make regulatory bodies—in this case, local government bodies—compensate economically unjustified rates is not anticipated in either the State Budget or local budgets.*

*The effectiveness of further reform will depend on how successfully the State Residential Services Committee coordinates its policies with other stakeholders, particularly the Ministry of Economy and European Integration, the Ministry of Finance, the National Electricity Regulatory Commission, and local governments.*

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<sup>9</sup> See the 24 June 2004 Laws "On residential services" and "On the state-wide program for reforming and developing the residential services sector for 2004–2010."

**3. INTRODUCING MANDATORY HEALTH INSURANCE.** The most urgent problems facing the healthcare system are low-quality medical services, the unaffordability of proper quality services for some categories of the population, and a growing trend towards infectious diseases. Under today's economic conditions, the Government cannot properly finance this sector. One way to attract money is to introduce mandatory health insurance. Both employers and employees can pay mandatory contributions for health insurance. But in order to introduce such insurance, the Government needs to facilitate the emergence of a well-developed insurance services market, provide incentives such as tax rebates for health insurance, and adopt appropriate regulations. Thus, mandatory health insurance should be introduced gradually, keeping parallel Government funding.

Without any doubt, the Verkhovna Rada elections limit the options for the Government to implement reforms. Still, the Government need not fully subordinate its policies to the short-term objective of winning in the vote, as the Yanukovich Government did. Policies oriented on elections are likely to ruin the achievements of earlier reforms. Thus, raising pensions without a commensurate increase in Pension Fund revenues from insurance contributions will ruin the pension security system altogether. And a raise in the minimum wage for public sector workers that is not based on increasing Budget tax revenues will simply damage the fiscal system: financing for salaries is already squeezing all other Budget items. According to ICPS economists, the credit of public trust that the new Administration enjoys right now should help Ukraine's Government manage without resorting to populist election maneuvers.

***Policies oriented purely  
on elections could ruin  
the achievements  
of reform***

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

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


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

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


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

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


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Ukrainian language			English language		
12 months	6 months	3 months	12 months	6 months	3 months
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<b>Political Commentary</b>					
Ukrainian language			English language		
12 months	6 months	3 months	12 months	6 months	3 months
@ 	@ 	@ 	@ 	@ 	@ 

<b>Economic Statistics</b>					
Ukrainian language			English language		
12 months	6 months	3 months	12 months	6 months	3 months
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