

# ICPS newsletter<sup>®</sup>

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## What has the crisis meant for Ukraine?

***Ukraine's economy is slowly recovering after a financial crisis that peaked in 2008. Still, many sectors are unlikely to see output and profits return to pre-crisis levels any time soon. The new President will have to take a series of unpopular steps to prevent a catastrophe with the State Budget. ICPS Senior Economist Ildar Gazizullin writes about this and about the prospects of further economic growth***

### The macroeconomic picture

Most sectors of Ukraine's economy saw production fall even further during 2009. The one pleasant surprise was the farm sector, which came out even after a high baseline from last year, poor weather conditions and limited credit.

Still and all, the depth of the economic downturn has been slowly lessening since Q2'09, mostly because of rising world demand and higher prices for many of Ukraine's export commodities. Ukraine's economic recovery will continue into 2010. The ICPS forecast is for GDP growth to rise to 4%. In 2011 and 2012, the pace of growth should pick up to 5% and 6.7%.

Those sectors oriented on consumer products are seeing output rise slowly, as the level of consumption is not moving up especially quickly. In 2010, wages will grow modestly as business demand for labor will be low with the continuing high level of uncertainty in the economy. Lack of access to credit and lack of confidence among consumers regarding their financial futures will also make it hard for demand to leap forward.

Recovery will also be difficult in those sectors that depend on domestic investment demand. ICPS analysts expect such demand to remain weak in 2010, leaving the situation in construction and machine-building slow. Noticeable improvement will only be felt in 2011.

In addition, economic growth could prove unsustainable. The risk of a second wave of crisis remains. This could be caused by a rally on world stock and commodity markets that is not supported by the fundamentals and would lead to a further reduction in capital investment plans for 2010. This cause demand for steel, fertilizer and machinery, which are

Ukraine's main export commodities, to decline again.

One internal factor that creates risk is a soft Budget policy that, together with a rise in regulated prices for utilities and residential services after the election, could launch an inflationary spiral.

### What about reforms?

The Ukrainian Government's anti-crisis measures during 2009 were largely ineffective, similar to many other governments, and had little serious impact on the economy. For instance, efforts to improve the regulatory environment—which, as a rule, does not require much in the way of Budget spending—failed: most of the related bills did not pass in the legislature. Ukraine was once again unable to raise its low rating significantly in the World Bank's annual survey called Doing Business.

State assistance continues to be improperly directed and poorly administrated. Thus, instead of supporting projects that might spur growth across the economy, such as energy efficiency programs, the Government decided to provide assistance to selected sectors. When the situation on external markets was extremely bad, the Government offered breaks to the steel and chemicals industries in the form of reduced rates for gas and electricity. However, it did not withdraw these benefits even when the situation on foreign markets improved markedly.

Until now, reforms have been largely urged on Ukraine by international financial institutions. Starting in 2000 and throughout the period of strong economic growth, not one Government felt enough incentive to undertake much-needed changes. In 2009, the International

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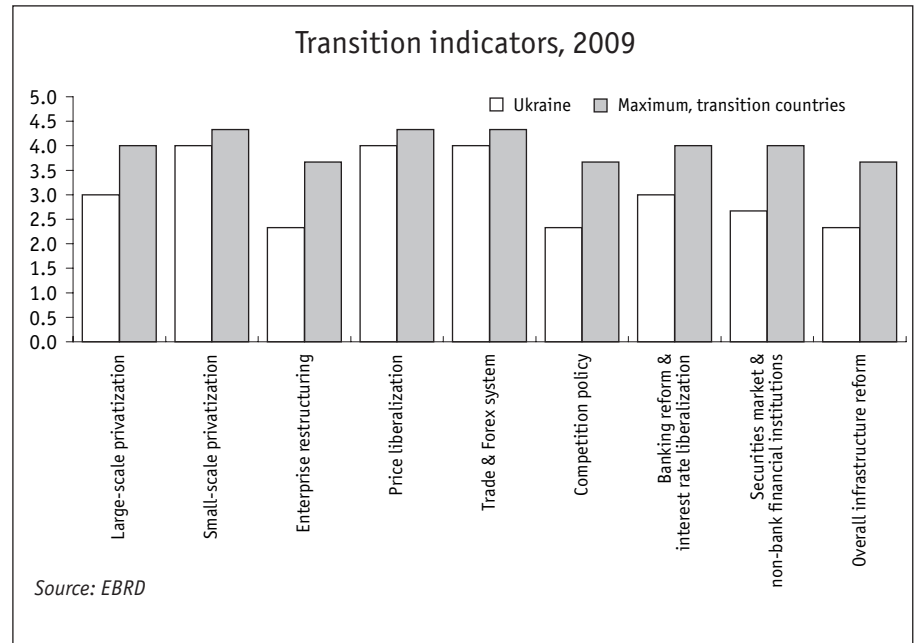
1. *Economic statistics* – a collection of key socio-economic indicators that are the foundation for doing business in Ukraine. This report includes data from Derzhkomstat, the state statistics agency, the National Bank of Ukraine, and the State Treasury. It also contains the Consumer Confidence Index and the Index of Inflationary Expectations calculated by ICPS and GfK Ukraine. Indicators for the current year are provided for the current quarter on a monthly basis.
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Monetary Fund was unable—or did not wish to—persuade the Government for the umpteenth time to start these reforms but simply withdrew its credit. This means there is a risk that the Government and Verkhovna Rada will continue to do nothing, not only in the first quarter, but possibly throughout the first half of 2010 because of the high probability that another snap VR election will be called for Fall 2010.

Still, even if the new Administration hits the ground running with transformations, it will be unable to resolve the accumulated structural problems in the economy very quickly. This includes pension reform, which, like other reforms in the social sector, by its nature is a long-term process that can take as much as a decade to complete. Meanwhile, raising residential gas prices, as is expected in 2010, will not be the magic wand to fix the problems of utility companies because it will not bring enough of an inflow of cash to cover Naftogaz Ukraine's debts.

Moreover, there have been no real transformations in Ukraine for some time now, which might have not only led to the passing of individual laws but also to the modernization of existing



institutions or the establishment of new ones. It is these institutions and not outdated fixed assets or the lower numbers or poorer quality of the labor force that are the weakest point in Ukraine's economy today. In the end, their inadequateness makes the entire

economy vulnerable to external shocks and limits its potential for growth. ■

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### ICPS calls on international community to continue to observe election process

On 22 January, ICPS analysts held a debate for members of the diplomatic community in Ukraine. During this meeting, ambassadors and other diplomats from EU countries, Canada and Switzerland discussed the course and results of the first round of the Presidential election. The center's analysts provided complete information about the legislated manner and timing for counting the vote and for declaring the official results of the run-off election, slated for 7 February.

The main conclusion of this discussion was that the second round should be finalized no later than 21 February 2010—provided that no one violates the law or abuses loopholes in it. Still, the chances that there will be complications both during the actual vote and during the count are high. This makes it extremely important for observers to continue monitoring the election. The role of international observers in this process is hard to overestimate. Their attention should be directed, not only at the electoral commissions but also at the administrative courts that could be the new battleground for the two candidates.

Ukrainians have proved that they can elect according to law. Still, are they able to pass court judgments according to law? Or, as Xavier Solana once put it, Can they play according to rules and not with the rules?

Right now is not the time for Ukraine to think in terms of sectoral reforms, the economy or the Constitution. The main thing is to survive this election and the possible large-scale courtroom battles to gain a new legitimate President before there is a complete collapse of government and a total loss of trust among both Ukraine's voters and its western partners.

Any politician who thinks today that he can control a court could become its victim tomorrow. This is why all political players should support at least one reform immediately after this election: reforming the court system in Ukraine.

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