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Ukraine: deteriorating investment climate

The record-high economic growth registered in Ukraine in 2004 (12.1%, according to revised figures) slowed down to a mere 4.7% in the first five months of 2005. Measured in value added, the manufacturing industry (+6.6%) remained one of the principal growth engines, although it has suffered a considerable deceleration as well. In particular, the two leading industrial branches – machine-building and metals – recorded a dramatic slowdown of output growth: from 36.3% to 11.2%, and from 19.1% to -0.3%, respectively. These developments largely reflect a marked weakening of investment activity, albeit from very high levels. In the first quarter of 2005, investments in fixed capital were up only 4.5% year-on-year – compared to 28% in 2004 as a whole and 52% in its first quarter.[1]

The reluctance to invest is hardly surprising given the policies of the new authorities, which launched a major revision of privatization deals concluded by the previous regime of president Kuchma. To make things worse, the government added to investors' worries by a series of contradicting statements regarding both the scope and the particulars of the upcoming re-privatization scheme. In particular, it took the government several months to draft a list of enterprises subject to re-privatization and representing most notably the assets of domestic financial-industrial groups, but also some foreign investment companies, including Russian, Austrian, German and from the US. However, the list has never been officially published (although it was referred to by several high-ranking officials including President Yushchenko), and Prime Minister Tymoshenko denied its very existence. In turn, the State Property Fund has compiled an alternative list of 194 mostly medium-sized enterprises subject to re-privatization, which allegedly does not overlap with the former list. In the meantime, several privatization deals have been annulled in court, including the country's biggest steel producer *Kryvorizhstal'*, but the legal dispute over the enterprise is far from being over, and its ownership status remains unclear. Apart from the re-privatization campaign, the investment climate in the country has suffered from the unilateral abolition of tax and customs benefits granted to the so-called 'special economic zones' (SEZs) and 'territories of priority development' (TPDs).[2]

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1 The latter high figure, though, is partly explained by the one-time completion of nuclear power blocks in Rivne and Khmelnitsk in early 2004. No wonder it is these two regions in Western Ukraine where fixed investments in January-March 2005 plunged the most: by 65% and 49% year-on-year, respectively.

2 The move was aimed at closing the 'loopholes' for smuggling, but it has also hurt investment projects implemented there. Facing the business pressure, more recently the government has revitalized the idea of SEZs and elaborated a draft law on the uniform principles of their functioning (hitherto, each SEZ was regulated by a separate law). As of January 2005, Ukraine reportedly had 11 SEZs and 72 TPDs on its territory, involving 212 and 556 investment projects, respectively.

In contrast to the 'heavy industry', consumption-oriented sectors continue performing well. The food processing industry recorded a healthy 14.8% output growth in January-May 2005, and retail trade turnover was up 18.8% year-on-year. The booming consumption is backed by a strong rise in households' disposable money incomes. The latter jumped by 24.8% in real terms in the first four months of 2005 (year-on-year), reflecting first of all a strong pick-up in government transfers, while the increase in real wages (+15.3%) was more moderate. Increased social spending is partly a legacy of the previous government, which doubled the minimum pension in September 2004, but it is also due to the 2005 budget amendments enacted by the new government in March. In line with those, the minimum pension was raised by another 17% (to UAH 332, or some USD 65 per month), retroactively, from 1 January. The *average* pension increased even more, by nearly 22% – in accordance with the strategy of pension differentiation. Public wages were raised by 57% on average (in nominal terms), and the government has reportedly paid back its wage arrears by early June. The generous fiscal policy will probably continue in the run-up to the parliamentary elections of March 2006, especially taking into account the enhanced powers the new parliament will have after the constitutional reform takes effect.

The rising budget expenditure commitments are to be backed by increased revenues resulting from higher excise taxes on tobacco and fuels, the imposition of VAT on energy imports, a harder stance on smuggling, and the already mentioned abolition of preferences to SEZs. These measures – along with better tax compliance – have already helped boost the consolidated government revenues, which were up by 29% in real terms in the first four months. The 2005 budget is based on the official projections of 8.2% economic growth and 9.7% year-end consumer price inflation. While the growth projection seems now overly optimistic (we expect 6% GDP growth at best), inflation will be almost certainly double-digit. In the first five months, consumer prices rose already by 5.7% against December 2004.

Given the expansionary fiscal policy, the inflation problem is being tackled by monetary and exchange rate instruments. Facing a strong appreciation pressure stemming from the current account surplus and the recent surge in speculative capital inflows, the National Bank in April abandoned the *de facto* nominal peg to the US dollar (at around UAH 5.3 per USD) pursued since 2002 and revalued the hryvnia to UAH 5.05 per USD. The measure was intended to ease the inflationary pressure by depressing the cost of imports (especially energy), on the one hand, and reducing the current account surplus and the resulting inflow of foreign exchange, on the other. In another move, the National Bank scrapped, as of April, the 50% surrender requirement for export earnings which had been in place since the 1998 crisis.

Despite these measures, the upward pressure on the hryvnia has hardly weakened due to the fact that households have started converting their dollar savings into hryvnia in response to the recent revaluation. Also, while Ukraine may still be a risky place for direct (strategic) investors, the country's attractiveness for portfolio (speculative) investors has increased. This applies particularly to the government domestic bonds, the yields on which have fallen sharply from around 11% p.a. last year to just 6.74% for the March 2005 issue as a result of an upswing in demand. In May, Standard and Poor's revised Ukraine's long-term sovereign rating upwards (to BB- in foreign, and BB in domestic currency), and a new influx of speculative capital betting on further hryvnia appreciation cannot be ruled out. However, the National Bank will probably stick to the new exchange rate of UAH 5.05 per USD at least until the end of this year, fearing that any further appreciation would further harm the already weakening economic growth. The current strengthening of the US dollar in the world markets may be another argument for the National Bank to resist further appreciation.

While a decline of inflation as a result of the recent revaluation is rather unlikely, it can be argued that without revaluation, inflation would have turned even higher. On the other hand, imports will be growing at an accelerated pace, leading to a likely squeeze of the trade and current account surplus this year (the latter reached a record level of 10.5% of GDP in 2004). According to the customs statistics, in the first four months of 2005 imports were already growing ahead of exports: by 22.9% vs. 12.4% in dollar terms year-on-year, respectively, and the trade surplus in goods has nearly halved.

Political developments since the 'orange revolution' of late 2004 have been controversial. In particular, the new authorities have embarked upon repressions against their political opponents and the affiliated business structures, usually – and similarly to Russia – under the pretext of criminal charges on economic grounds. Meanwhile, integration into the EU and NATO has been re-instated into Ukraine's foreign policy doctrine. The majority of Ukrainians are in favour of joining the EU, although the latter is very unlikely to acknowledge the country's membership prospects, at least in the short and medium term. Ironically, even the prospects of obtaining a 'market economy status' from the EU have been complicated by the recent government policies.[3] The country's membership in NATO appears more realistic, although most Ukrainians actually oppose it.

[3] In particular, in response to the rising domestic prices of oil products – partly resulting from the introduction of VAT on imported oil and higher excise taxes – the government imposed, in April 2005, caps on the wholesale prices of fuels and a 13% retail margin cap. This has led to widespread fuel shortages, forcing the government to give up administrative price-setting and lower the excise taxes and import duties on oil products instead.

Table UA

Ukraine: Selected Economic Indicators

	2000	2001	2002	2003	2004 1)	2004	2005	2005	2006
						1st quarter		forecast	
Population, th pers., end of period 2)	48923.2	48457.1	48003.5	47622.4	47280.8	47516.7	47166	47000	46800
Gross domestic product, UAH mn, nom.	170070	204190	225810	267344	344822	64746	79356	407500	475200
annual change in % (real)	5.9	9.2	5.2	9.6	12.1	12.7	5.4	5.5	6
GDP/capita (EUR at exchange rate)	688	872	931	928	1099	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	3770	4230	4610	5120	5920	.	.	.	.
Gross industrial production									
annual change in % (real)	13.2	14.3	7.0	15.8	12.5	18.8	7.1	7	7
Construction output total									
annual change in % (real)	0.4	3.5	-5.8	26.5	17.2	29.9	-5.9	.	.
Consumption of households, UAH mn, nom.	92406	112260	124560	146301	185533	.	.	.	.
annual change in % (real)	2.5	9.6	9.5	12.4	15.1	.	.	.	.
Gross fixed investment, UAH mn, nom.	23629	32573	37178	51011	75714	10236	12638	.	.
annual change in % (real)	14.4	20.8	8.9	31.3	28.0	52.1	4.5	10	10
LFS - employed persons, th, avg. 3)	20175.0	19971.5	20091.2	20163.3	20295.7	19974.6	.	.	.
annual change in % 4)	1.9	-1.0	0.6	0.4	0.7	.	.	.	.
Reg. employees in industry, th pers., avg. 5)	3445.0	3811.0	3578.1	3416.0	3408.3	.	3427.9	.	.
annual change in %	-12.4	-6.2	-6.1	-4.5	-0.2	.	.	.	.
LFS - unemployed, th pers., average 3)	2655.8	2455.0	2140.7	2008.0	1906.7	2055.2	.	.	.
LFS - unemployment rate in %, average 3)	11.6	10.9	9.6	9.1	8.6	9.3	.	8.0	8
Reg. unemployment rate in %, end of period	4.2	3.7	3.8	3.6	3.5	3.9	3.6	3.4	3.4
Average gross monthly wages, UAH 5)	230.1	311.1	376.4	462.3	589.6	517.5	676.4	.	.
annual change in % (real, gross)	1.1	20.7	20.0	16.7	17.0	18.3	15.0	.	.
Consumer prices, % p.a.	28.2	12.0	0.8	5.2	9.0	7.4	13.5	12	10
Producer prices in industry, % p.a.	20.9	8.6	3.1	7.8	20.4	14.1	22.3	19	15
General governm.budget, nat.def., % GDP									
Revenues	28.9	26.9	27.4	28.1	26.3	28.2	32.1	.	.
Expenditures	28.3	27.2	26.7	28.3	29.4	26.2	28.2	.	.
Deficit (-) / surplus (+), % GDP	0.6	-0.3	0.7	-0.2	-3.4	1.9	3.7	.	.
Public debt in % of GDP	45.3	36.5	33.5	29.0	24.7	.	.	.	.
Refinancing rate of NB % p.a., end of period	27.0	12.5	7.0	7.0	9.0	7.0	9.0	.	.
Current account, EUR mn 6)	1602	1565	3360	2559	5476	1308	.	3500	2500
Current account in % of GDP	4.7	3.7	7.5	5.8	10.5	13.5	.	5.2	3.1
Gross reserves of NB excl. gold, EUR mn 7)	1453	3353	4088	5386	6838	6328	9066	.	.
Gross external debt, EUR mn 8)	12759	13785	12247	19055	22487	20213	.	.	.
FDI inflow, EUR mn 6)	644	884	734	1261	1380	267	.	.	.
FDI outflow, EUR mn 6)	1	26	-5	12	3	1	.	.	.
Exports of goods, BOP, EUR mn 6)	17008	19074	19770	21013	26906	5855	.	29500	32500
annual growth rate in %	37.2	12.1	3.6	6.3	28.0	23.5	.	10	10
Imports of goods, BOP, EUR mn 6)	16165	18853	19018	21251	23895	5108	.	29000	33000
annual growth rate in %	32.8	16.6	0.9	11.7	12.4	20.3	.	21	14
Exports of services, BOP, EUR mn 6)	4111	4459	4958	4615	5060	1173	.	5000	5000
annual growth rate in %	13.0	8.5	11.2	-6.9	9.6	4.7	.	-1	0
Imports of services, BOP, EUR mn 6)	3433	3995	3743	3237	4149	907	.	4000	4000
annual growth rate in %	59.3	16.4	-6.3	-13.5	28.2	-5.8	.	-4	0
Average exchange rate UAH/USD	5.440	5.372	5.327	5.333	5.319	5.330	5.299	5.1	4.9
Average exchange rate UAH/EUR (ECU)	5.029	4.814	5.030	6.024	6.609	6.662	6.956	6.1	5.9
Purchasing power parity UAH/USD, wiiw	0.849	0.912	0.944	1.003	1.131	.	.	.	.
Purchasing power parity UAH/EUR, wiiw	0.917	0.991	1.017	1.092	1.228	.	.	.	.

Notes: 1) Preliminary. - 2) In 2001 according to census December 2001. - 3) From 2000 revised data according to census 2001. - 4) In 2000 unrevised data. - 5) Excluding small enterprises. - 6) Converted from USD to EUR at the official cross exchange rate. - 7) Useable. - 8) Up to 2002 long-term debt only.

Source: wiiw Database incorporating national statistics; wiiw forecasts.