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Ukraine: in a new political setting

The outcome of the second round of the presidential elections held on 21 November 2004, declaring the incumbent prime-minister Viktor Yanukovich the winner, was widely believed to be rigged and led to large-scale popular protests. Under the pressure, Ukraine's Supreme Court cancelled the election result and ordered a repeated vote for 26 December, which was fairly easily (with 52%) won by Mr. Yanukovich's contender, the right-wing opposition leader Viktor Yushchenko. Although there are certain doubts as to the legal aspects of the 'third round' of the elections, it may have represented the best possible way out of the political stalemate, avoiding both greater violence and a territorial break-up of the country, at least so far. However, the perceived pro-western and anti-Russian stance of the newly elected president depresses his support in the mostly Russian-speaking and generally wealthier eastern and southern regions of the country. Mr. Yushchenko will need a lot of political skills to bridge these regional divisions, as well as to balance the country's external policies between Russia and the EU.

Meanwhile, the presidential powers of Mr. Yushchenko will soon be diluted by constitutional amendments which will enter into force between September 2005 and January 2006 (depending on the adoption of amendments to the legislation on local governments, which is also part of the constitutional package). These amendments, aiming at turning Ukraine from a presidential-parliamentary into a parliamentary-presidential republic, were passed in December 2004 as a concession to the forces supporting the outgoing president Leonid Kuchma, in exchange for alterations to the law on presidential elections, making it more difficult to manipulate the voting in the 'third round'. After the constitutional amendments have taken effect, the government will be formed by a majority coalition in the parliament, although the president will retain his right to propose the ministers of defence and foreign affairs. The next parliamentary elections (which for the first time will be held on an entirely proportional basis) are due only in March 2006. However, even the present parliament will hardly pose any big problems for Mr. Yushchenko, because many of its members who used to form the pro-Kuchma 'centrist' coalition majority prior to the crisis have switched sides in the meantime.

The concern over the outcome of the political crisis after the second round of elections led to a run on Ukraine's currency at the end of last year. The volume of hryvnia deposits in banks dropped by 4.8% in November and by another 2.9% in December, while deposits denominated in hard currencies (dollar and euro) went up. The banks responded by raising interest rates offered on hryvnia deposits by 2-4 percentage points and lowering them on hard currency deposits. In addition, the National Bank intervened heavily in the foreign exchange market (its forex reserves contracted by about EUR 1 billion in the last two

months of 2004 alone) and resorted to a number of other measures, including a moratorium on premature withdrawal of term deposits, a ban on the net expansion of credit portfolios of commercial banks, and stabilization credits extended to some of them. By January 2005, the financial turmoil seemed to be largely over. On 10 January, the National Bank revoked the moratorium on premature withdrawal of term deposits, forex reserves are on the rise again, and some of the banks have expressed interest in paying back the stabilization credits ahead of schedule. Also, the National Bank has abolished its regulation from October according to which the exchange rate could not deviate from the officially set one by more than 2%. There is good reason to believe that the present interest rate spread between hryvnia and dollar deposits, reaching up to 6-7 percentage points, is not sustainable, given the stable outlook for the nominal exchange rate of the hryvnia.

The impact of the banking crisis on real economy has been minimal, with real GDP growing by 12% in 2004 (as compared to 9.6% in 2003). Driven by the booming exports of steel and machinery and the persistently high inflows of remittances, the current account surplus probably reached some 11% of GDP. However, gross industrial output increased 'only' by 12.5%, representing a marked slowdown in comparison to 2003 (15.8%). There is evidence that some branches operate on the verge of their capacity, so that the high aggregate demand increasingly translates into higher inflation rather than into higher production volumes. Also, inflation was fed by the rising gasoline price and the low supply of certain agricultural products (such as meat). As a result, the 2004 consumer price inflation reached 9% on average and 12.3% on the end-year basis, and the surge in industrial producer prices (20.4% and 24.1%, respectively) turned out to be even higher. To ease the inflationary pressure, the National Bank gradually raised the refinancing rate from 7% to 9% p.a., but given the small size of the banking sector, it is no big surprise that the real impact of this measure has so far been limited.

Although the current inflation rates may not necessarily represent an imminent threat to economic growth, the IMF in its most recent statement has named taming inflation a key priority for the new government and the National Bank. The prescribed instruments are standard and include a more restrictive monetary and fiscal policy. In the area of monetary policy, the IMF is *inter alia* advocating direct inflation targeting in place of the *de facto* dollar peg pursued so far. The nominal peg to a currency which has considerably declined in real terms against the currencies of Ukraine's main trading partners – Russia and the EU – has maintained Ukraine's competitiveness over the past few years and has also undoubtedly had a strong expansionary impact. Adopting a more flexible exchange rate regime would almost certainly result in a nominal appreciation of the hryvnia and (hopefully) a lower demand-pull inflation, although growth could suffer as well.

Last year's fiscal policy, too, was much more lax than in previous years. After four years of a nearly balanced budget, the consolidated government recorded a 3.3% budget deficit in

2004, driven by the election-motivated increase in social spending in autumn, and despite the record-high revenues from privatization. The latter reached UAH 9.5 billion (nearly 3% of GDP), largely due to the controversial sale of a 93% stake in Ukraine's biggest plant, and the country's biggest exporter, *Krivorizhstal*. For 2005, privatization revenues are targeted at UAH 4.9 billion, but they may be higher in view of the upcoming re-nationalisation of *Krivorizhstal*, already announced by the new authorities, and its likely

subsequent re-privatization. The move is to be seen as part of the fight of the new power elite against the financial-industrial groups, which benefited the most under the previous regime, and thus resembles somewhat the 'Yukos case' in Russia. Simultaneously, the new authorities appear to stick to the policy of the late Yanukovich government of increased social spending, probably reflecting the growing awareness within the ruling elite that Ukraine should have more of a welfare state than it used to have up to now. Indeed, the present share of consolidated government expenditures in GDP of 31% is low not only by European, but even by US standards.

Given the good prospects of both domestic and foreign demand, the country's economic performance is likely to remain robust. A slight deceleration of growth is possible, but the external position will remain strong. However, inflation will be stubbornly high, fuelled by the planned hikes in regulated prices, spillovers from the recently soaring producer prices, and – last but not least – the possibly further rising price of imported energy.

The recent political changes in Ukraine may bring certain benefits to the country already in the near future. In particular, the European Union seems to be finally ready to grant Ukraine the official status of a market economy, and the USA will probably enact the long-awaited abolition of the so-called 'Jackson-Vanik amendment', which has been in place since 1974 and still applies to some of the successor states of the former Soviet Union. Both moves should reduce the incidence of anti-dumping measures applied to some important Ukrainian export items, such as metals, chemicals, and textiles in the European and the US markets. The negotiations on WTO membership are reportedly progressing well, with 30 (out of 42) bilateral protocols signed by now, and Ukraine hopes to join the WTO already by the end of the year (although the protocols with the United States and China have not been signed yet). However, despite Mr. Yushchenko's eager advances towards Brussels, the EU reaction has been rather lukewarm, and the prospects of Ukraine's EU membership remain as hazy as before.

Table UA

Ukraine: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 ¹⁾	2005	2006 forecast
Population, th pers., end of period ²⁾	50105.6	49710.8	49291.2	48457.1	48003.5	47622.4	47280.8	47000	46800
Gross domestic product, UAH mn, nom.	102593	130442	170070	204190	225810	264165	322500	386700	446900
annual change in % (real)	-1.9	-0.2	5.9	9.2	5.2	9.4	12.0	9	7
GDP/capita (EUR at exchange rate)	737	595	683	872	931	917	1030	.	.
GDP/capita (EUR at PPP - wiiw)	3310	3400	3740	4230	4600	5110	5830	.	.
Gross industrial production									
annual change in % (real)	-1.0	4.0	13.2	14.3	7.0	15.8	12.5	12	10
Gross agricultural production									
annual change in % (real)	-9.6	-6.9	9.8	10.2	1.2	-10.2	19.1	.	.
Construction output total									
annual change in % (real)	2.7	-8.0	9.1	16.7	-0.7	23.1	21.8 ^{I-XI}	.	.
Consumption of households, UAH mn, nom.	58323	71310	92406	112260	124560	144954		.	.
annual change in % (real)	2.0	-1.9	2.5	9.6	9.5	12.4		.	.
Gross fixed investment, UAH mn, nom.	13958	17552	23629	32573	37178	51011	42116.0 ^{I-X}	.	.
annual change in % (real)	6.1	0.4	14.4	20.8	8.9	31.3	34.5 ^{I-X}	25	20
LFS - employed persons, th, avg. ³⁾	22998.4	20048.2	20419.8	20238.1	20400.7	20163.3	20369.1 ^{I-X}	.	.
annual change in % ⁴⁾	-3.2	-12.8	1.9	-0.9	0.8	0.8	.	.	.
Reg. employees in industry, th pers., avg. ⁵⁾	4142.0	3932.0	3445.0	3811.0	3578.1	3415.6	.	.	.
annual change in %	-3.1	-5.1	-12.4	-6.2	-6.1	-4.5	.	.	.
LFS - unemployed, th pers., average	2937.1	2698.8	2707.6	2516.9	2301.0	2008.0	1732.9 ^{I-X}	.	.
LFS - unemployment rate in %, average	11.3	11.9	11.7	11.1	10.1	9.1	8.0	7.5	7.5
Reg. unemployment rate in %, end of period	3.7	4.3	4.2	3.7	3.8	3.6	3.6	3.5	3.5
Average gross monthly wages, UAH ⁵⁾	153.0	177.5	230.1	311.1	376.4	462.3	589.6	.	.
annual change in % (real, gross)	-3.2	-5.4	1.1	20.7	20.0	16.7	17.0	.	.
Consumer prices, % p.a.	10.6	22.7	28.2	12.0	0.8	5.2	9.0	10	8
Producer prices in industry, % p.a.	13.2	31.1	20.9	8.6	3.1	7.8	20.4	10	7
General governm. budget, nat. def., % GDP									
Revenues	28.2	25.2	28.9	26.9	27.4	28.5	28.1	.	.
Expenditures	30.4	26.7	28.3	27.2	26.7	28.6	31.4	.	.
Deficit (-) / surplus (+), % GDP	-2.2	-1.5	0.6	-0.3	0.7	-0.2	-3.3	.	.
Public debt in % of GDP	48.1	61.0	45.3	36.5	33.5	29.4	26.5	.	.
Refinancing rate of NB % p.a., end of period	60.0	45.0	27.0	12.5	7.0	7.0	9.0	.	.
Current account, EUR mn ⁶⁾	-1147	1559	1602	1565	3360	2559	5500	5500	4000
Current account in % of GDP	-3.1	5.2	4.7	3.7	7.5	5.8	11.3	9.5	6
Gross reserves of NB excl. gold, EUR mn ⁶⁾⁷⁾	650	1042	1453	3353	4088	5386	6838	.	.
Gross external debt, EUR mn ⁶⁾⁸⁾	10420	13456	12759	13785	12247	19055	23491 ^{I-X}	.	.
FDI inflow, EUR mn ⁶⁾	658	466	644	884	734	1261	1500 ⁹⁾	.	.
FDI outflow, EUR mn ⁶⁾	-4	7	1	26	-5	12	0 ⁹⁾	.	.
Exports of goods, BOP, EUR mn ⁶⁾	12124	12400	17008	19074	19770	21013	27100	30000	33000
annual growth rate in %	-10.8	2.3	37.2	12.1	3.6	6.3	29	11	10
Imports of goods, BOP, EUR mn ⁶⁾	14411	12170	16165	18853	19018	21251	24500	27000	31000
annual growth rate in %	-16.6	-15.6	32.8	16.6	0.9	11.7	15	10	15
Exports of services, BOP, EUR mn ⁶⁾	3471	3637	4111	4459	4958	4615	4500	4500	4500
annual growth rate in %	-20.2	4.8	13.0	8.5	11.2	-6.9	-2	0	0
Imports of services, BOP, EUR mn ⁶⁾	2252	2155	3433	3995	3743	3237	3000	3000	3000
annual growth rate in %	12.7	-4.3	59.3	16.4	-6.3	-13.5	-7	0	0
Average exchange rate UAH/USD	2.450	4.130	5.440	5.372	5.327	5.333	5.319	5.3	5.3
Average exchange rate UAH/EUR (ECU)	2.768	4.393	5.029	4.814	5.030	6.024	6.609	6.7	6.7
Purchasing power parity UAH/USD, wiiw	0.561	0.705	0.849	0.912	0.944	0.993	1.071	.	.
Purchasing power parity UAH/EUR, wiiw	0.617	0.768	0.919	0.992	1.018	1.082	1.165	.	.

Notes: 1) Preliminary. - 2) In 2001 according to census 5 Dec. 2001. - 3) From 2003 revised data according to census 2001. - 4) In 2003 unrevised data. - 5) Excluding small enterprises. - 6) Converted from USD to NCU, and from NCU to EUR at the official exchange rates. - 7) Useable. - 8) Up to 2002 long-term debt only, - 9) wiiw estimate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.