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Ukraine: parliamentary crisis against the background of strong economic performance

According to preliminary figures, in 2003 Ukraine's GDP grew by 8.5% in real terms – a clear improvement against the previous year (5.2%, according to a recent revision), and well above most forecasts. Indeed, this corresponds to the second-best result in the country's post-Soviet history (only in 2001 was Ukraine's economic growth higher). Measured in value added, among the best-performing sectors were construction (+23.0%), manufacturing (+18.2%), and wholesale and retail trade (+14.4%). Both construction and manufacturing benefited from a strong pick-up in domestic investment – the major engine of growth. In the first nine months of the year, gross fixed capital investment reportedly soared by 32.5% (against 8.9% in 2002 as a whole), fuelled by a favourable external market situation for the major Ukrainian export commodities and improved access to funds. In turn, the booming trade (retail trade turnover went up by 19.4%) reflected rising private consumption, driven by a marked improvement in real wages, which were 16.9% higher than a year before. Still, with an average wage of some USD 100 per month, Ukraine stands at just half of the Russian level and a quarter of that in its western neighbours: Poland, Slovakia and Hungary. The contribution of net exports to GDP growth appears to have been negative, as the growth of merchandise exports (+7.1% in euro terms in January-November) was over-compensated by a 12.6% increase in imports.

Industrial output has grown by a healthy 15.8% (7% in 2002), although nearly half of industrial enterprises are reportedly still loss-making. Within manufacturing, machine-building did particularly well (+35.8%), with production of transport vehicles rising by 62.1%. Production of metals grew by 14.3%, as Ukraine was increasingly establishing itself in the new export markets in Asia and the Middle East. Chemical (including petrochemical) and food processing industries expanded strongly as well, by 16.8% and 20.0% respectively, and goods transport increased by 9.6%. However, agricultural output declined by 10.2%, largely because of the losses of winter cereal crops, which were only partially offset by a fairly good harvest of spring crops. As a result, the 2003 cereal harvest in Ukraine was only half of the 2002 level.

The lax monetary policy of the National Bank certainly contributed to the impressive growth of the economy. Fixing *de facto* the nominal exchange rate against the US dollar implied a real depreciation of the hryvnia against the currencies of its main trading partners, Russia and the EU (due to higher inflation in the former and the strengthening of the euro against the dollar in nominal terms). This ensured the competitiveness of Ukrainian products and helped maintain a positive (though smaller than in the previous year) trade balance. The current account surplus approaching EUR 3 billion (nearly 7% of GDP) translated into a

further accumulation of official foreign reserves, whose stock reached EUR 5.7 billion by the end of October – an all-time high. Consequently, the monetary base expanded strongly, and so did money supply. However, because of the healthy rise in money demand, any inflationary impact was kept within limits. Producer prices in industry increased on average by 7.8% and consumer prices by just 5.2%, although the latter was also due to the price controls for bread imposed in many regions in response to the bad grain harvest. Nevertheless, the end-year consumer inflation stood at 8.2%, and more price spill-over is expected in 2004.

In contrast, fiscal policy has been fairly restrictive: while the economic upswing and improved tax collection have inflated budget revenues (the revenues of the consolidated budget grew by 15.3% in real terms), expenditure items have been almost invariably under-financed. Also, the government has accumulated huge arrears of VAT refunds to exporters, which will be partially converted into bonds. As a result, according to preliminary data, the consolidated budget has recorded a deficit of only 0.2% of GDP, instead of the 0.8% deficit planned originally. The 2004 draft budget signed into law at the end of November targets a deficit of 1.2% of GDP. Budget revenues are projected to fall somewhat following the introduction of a flat 13% personal income tax and the reduction of corporate profit tax from 30% to 25% – both effective since January 2004. However, in the medium run, the measure is intended to broaden the tax base by raising tax compliance. Meanwhile, the share of the shadow economy in Ukraine may stand, according to some estimates, at 50% of official GDP.

While the prospects of both domestic consumption and exports remain good, investors' sentiment may be negatively affected in the short run by the political turmoil ahead of the October 2004 presidential elections. The unpopular incumbent President Leonid Kuchma will be unlikely to run, despite the recent ruling of the Constitutional Court providing him with such an option. So far, the 'centrist' elite close to Kuchma has not been able to compromise on a single successor candidate, and the leader of the right-wing opposition party 'Our Ukraine' Viktor Yushchenko has the best chances to win. However, the powers of the next president might be severely curbed as a result of the constitutional amendments initiated by the pro-Kuchma forces, who are looking for a tool to retain power after October 2004. Essentially, the bill drafted by the presidential administration converts Ukraine from a presidential-parliamentary into a parliamentary-presidential republic. According to the bill, the president elected in 2004 will remain in office for one and a half years only; starting from 2006 (the date of the next parliamentary elections), he will be elected by the Rada (parliament) rather than by popular vote. In turn, the Rada itself will be elected on a proportional basis, thus giving advantage to the communists, who are supporting the bill as well. On 24 December 2003, the amendments received preliminary approval by the Rada in a highly controversial voting which was obstructed by the right-wing opposition factions. The latter dubbed the voting as anti-constitutional and have been

blocking the work of the parliament ever since. Nonetheless, the bill has been forwarded to the Constitutional Court for consideration. If approved, its second (and final) reading is due to take place in March, with a two-thirds Rada majority required to enact the changes.

In its foreign and foreign economic policy, Ukraine has been increasingly seeking a further rapprochement with Russia, while those governmental officials critical of the 'new course', including economy minister Khoroshkovskiy, have had to resign. Presidents Kuchma and Putin have finally signed a framework agreement on the joint use of Azov Sea, thus putting an end to the recent conflict over Tuzla island in the Kerch strait. Also, Ukraine has allowed Russia's electricity monopoly RAO UES to participate in the partial privatization of its energy complex. Although an agreement has been reached on extending the Odessa-Brody oil pipeline to the Polish town of Plock, the final decision as to the direction in which the pipeline is to be used has not been taken so far. Given Ukraine's participation in the newly established Common Economic Space (with Russia, Belarus and Kazakhstan), prospects of a WTO accession by 2005, as envisaged before, appear rather unrealistic.

The partial 're-orientation' of the country towards Russia has to a certain extent been facilitated by the position of the EU, which still hesitates to give Ukraine the 'carrot' of possible EU membership. In addition, the incidence of anti-dumping measures against some important items of Ukrainian exports (such as steel) may increase following the EU's enlargement in May 2004 due to the lobbying efforts of the new member countries. Three of these countries – Poland, Slovakia and Hungary – are bordering Ukraine, whereas another three – Lithuania, Latvia and Estonia – enjoy free trade agreements with it, which will be scrapped in the wake of EU accession. Also, the exports of Ukrainian agricultural products to the new member states will face tougher sanitary and phytosanitary standards. As a result – and despite the fact that Ukraine will benefit from the lower nominal import tariffs adopted by the accession countries (the latter will reportedly fall from 9% to 4% on average) – the Ukrainian side estimates the likely losses for domestic producers in 2004-2005 at some USD 350-370 million per year, corresponding to more than 1% of Ukrainian exports.

Table UA

Ukraine: Selected Economic Indicators

	1997	1998	1999	2000	2001	2002	2003 ¹⁾	2004 forecast	2005 forecast
Population, th pers., end of period ²⁾	50499.9	50105.6	49710.8	49291.2	48457.1	48003.5	47615.8	47350	.
Gross domestic product, UAH mn, nom.	93365	102593	130442	170070	204190	225810	257700	292300	326900
annual change in % (real)	-3.0	-1.9	-0.2	5.9	9.2	5.2	8.5	6	6.5
GDP/capita (EUR at exchange rate)	872	737	595	683	872	931	900	.	.
GDP/capita (EUR at PPP - wiiw)	3310	3340	3400	3690	4190	4560	5090	.	.
Gross industrial production									
annual change in % (real)	-0.3	-1.0	4.0	12.4	14.2	7.0	15.8	8	9
Gross agricultural production									
annual change in % (real)	-1.8	-9.6	-6.9	9.8	10.2	1.2	-10.2	.	.
Goods transport, bn t-kms	402.3	391.7	388.0	394.1	394.0	411.3	450.7	.	.
annual change in %	-10.7	-2.6	-0.9	1.6	0.0	4.4	9.6	.	.
Gross fixed investment, UAH mn, nom.	12437.0	13958.0	17552.0	23629.0	32573.0	37177.9	50100	.	.
annual change in % (real)	-8.8	6.1	0.4	14.4	20.8	8.9	25	15	15
Construction output total									
annual change in % (real)	-9.9	2.7	-8.0	9.1	16.7	-0.7	23.1	.	.
Dwellings completed, units	80000	70000	73000	62600	65000	64000	.	.	.
annual change in %	-9.2	-12.5	4.3	-14.2	3.8	-1.5	23.3 ^{l-xi)}	.	.
Employment total, th pers., average	22597.6	22348.7	21823.7	21268.5	20941.9	21378.6	.	.	.
annual change in %	-2.7	-1.1	-2.3	-2.5	-1.5	2.1	.	.	.
Employees in industry, th pers., average ³⁾	4273.0	4142.0	3932.0	3445.0	3806.0	3578.1	.	.	.
annual change in %	-7.9	-3.1	-5.1	-12.4	-6.1	-6.0	.	.	.
Reg. unemployed, th pers, end of period	637.1	1003.2	1174.5	1155.2	1008.1	1034.2	988.9	.	.
Reg. unemployment rate in %, end of period	2.3	3.7	4.3	4.2	3.7	3.8	3.6	3.5	3.5
LFS - unemployment rate in %, average	8.9	11.3	11.9	11.7	11.1	10.1	9.5	9	8.5
Average gross monthly wages, UAH ³⁾	143.0	153.0	177.5	230.1	311.1	376.4	462.6	.	.
annual change in % (real, gross)	-2.1	-3.2	-5.4	1.1	20.7	20.0	16.9	.	.
Retail trade turnover, UAH mn	18933	19317	22151	28757	34417	39691	48914	.	.
annual change in % (real)	0.2	-6.6	-7.1	8.1	13.7	15.0	19.4	.	.
Consumer prices, % p.a.	15.9	10.6	22.7	28.2	12.0	0.8	5.2	7	5
Producer prices in industry, % p.a.	7.7	13.2	31.1	20.9	8.6	3.1	7.8	5	5
General government budget, UAH mn									
Revenues	28112.0	28915.8	32876.4	49117.9	54934.6	61954.3	75165.4	60702.4 ⁴⁾	.
Expenditures	34313.0	31195.7	34820.9	48148.6	55528.0	60318.9	75655.3	64192.2 ⁴⁾	.
Deficit (-) / surplus (+)	-6201.0	-2279.9	-1944.5	969.3	-593.4	1635.4	-489.9	-3489.8 ⁴⁾	.
Deficit (-) / surplus (+), % GDP	-6.6	-2.2	-1.5	0.6	-0.3	0.7	-0.2	-1.2 ⁴⁾	.
Money supply, UAH mn, end of period									
M0, Currency outside banks	6132	7158	9583	12799	19465	26434	33100	.	.
Broad money	12541	15705	22070	32252	45755	64870	95000	.	.
Refinancing rate of NB % p.a., end of period	34.8	60.0	45.0	27.0	12.5	7.0	7.0	.	.
Current account, EUR mn ⁵⁾	-1176	-1147	1559	1602	1565	3360	2800	2400	1800
Current account in % of GDP	-2.7	-3.1	5.2	4.7	3.7	7.5	6.5	5.3	3.5
Gross reserves of NB excl. gold, EUR mn ⁵⁾⁶⁾	2121	650	1042	1453	3353	4088	5705 ^{Oct}	.	.
Gross external debt, EUR mn ⁵⁾	8657	9806	12381	11123	13730	9830	12324 ^{Sep}	.	.
Exports total, fob, EUR mn ⁷⁾	12550	11283	10856	15771	18159	19004	20500	22350	23700
annual change in %	10.5	-10.1	-3.8	45.3	15.1	4.7	8	9	6
Imports total, cif, EUR mn ⁷⁾	15103	13103	11104	15104	17612	17967	20000	22400	24200
annual change in %	8.8	-13.2	-15.3	36.0	16.6	2.0	11	12	8
Average exchange rate UAH/USD	1.862	2.450	4.130	5.440	5.372	5.327	5.333	5.3	5.3
Average exchange rate UAH/EUR (ECU)	2.113	2.768	4.393	5.029	4.814	5.030	6.024	6.4	6.4
Purchasing power parity UAH/USD, wiiw	0.507	0.561	0.705	0.850	0.913	0.949	0.987	.	.
Purchasing power parity UAH/EUR, wiiw	0.556	0.611	0.768	0.932	1.001	1.027	1.060	.	.

Notes: 1) Preliminary. - 2) In 2001 according to census 5 Dec 2001. - 3) Excluding small enterprises. - 4) Budget passed by Parliament end November 2003. - 5) Converted from USD to NCU, and from NCU to EUR at the official exchange rates. - 6) Useable. - 7) Exports and imports of goods according to customs statistics, adjusted for oil, gas and non-declarable goods. Converted from USD to EUR using the ECB EUR/USD foreign exchange reference rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.