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Ukraine: signs of 'overheating'

The very high economic growth recorded by Ukraine in 2003 (9.4% according to the latest revised figures) has persisted, even accelerating to 11.3% in the first five months of 2004 (on a year-on-year basis). Over the same period, industrial output rose by 16.9%, driven by marked growth in manufacturing (19.9%), especially in machine-building (36.5%). With an increase of 29.7% in value-added, the construction sector can be seen to be booming as well.

The major factors behind this impressive performance are: (a) the consistently strong external demand for metals (particularly in the Asian markets); (b) rapid economic growth in Russia and the other CIS countries (resulting *inter alia* in a rising demand for Ukrainian machinery and transport equipment); and (c) a further upswing in domestic demand for capital goods. Fixed capital formation continues to expand at an astonishing rate: 31.3% in 2003 and as much as 52.1% in the first quarter of 2004. The particular need for major investment activity in Ukraine becomes readily apparent when viewed against the background of its sharp contraction throughout most of the 1990s. None the less, the investment ratio of 19.3% in 2003 is not particularly high by international standards. If it remains at that level, it will not sustain economic growth at its current pace.

The forceful economic performance has not yet translated fully into a corresponding rise in fiscal revenue. In the first four months of 2004, consolidated budget revenues rose by a 'mere' 6.2% in real terms. In particular, the revenue losses owing to the introduction of a flat 13% personal income tax, effective since January 2004, have been so far only partly offset by a broader tax base and stronger tax compliance (although further improvements in tax compliance are expected). Collection from this tax fell by 7.8% and that from profit tax (the rate of which was lowered from 30% to 25%) by 9.3% in real terms. Nevertheless, given that the GDP growth for the year as a whole is likely to be nearly twice as high as the projections underlying the 2004 budget (4.8%), the central budget expenditures have been revised upwards.

An unpleasant aspect of the current economic boom is a pick-up in inflation. This could well be interpreted as a sign of 'overheating', although the high year-on-year consumer price inflation (7.2% in January-April) reflects first and foremost the rise in food prices, following the abysmal grain harvest in 2003. This year, a good grain harvest is expected (some 35 million tons as against 20 million tons last year) so that inflationary pressure is unlikely to emanate from this side. However, the rise in industrial producer prices (15.2% in January-April, year-on-year) is somewhat alarming; it will spill over increasingly into consumer inflation by the end of the year and in 2005. In May, producer prices rose by

another 2.1% (against April); this time the rise was fuelled by the soaring prices for coke and oil products (+7.7%) – a reflection of the global rise in the price of crude oil.

Customs statistics show a positive trade balance of EUR 1.25 billion in the first four months of 2004 – more than triple the amount in the first four months of 2003 – despite the stronger euro. In 2003 as a whole, the country's balance of payments recorded – for the first time since 1999 – a trade deficit (albeit marginal) in goods: EUR 238 million or 0.5% of GDP. However, the high inflow of current transfers and the revenue from pipeline transit fees accounted for a current account surplus of 5.8% of GDP; a comparable figure may be expected this year. In the first quarter of 2004 alone, the foreign exchange reserves expanded by nearly EUR 1 billion, driven primarily by favourable developments in the current account and the placement of 600 million dollars worth of sovereign Eurobonds in February. In view of the country's strong external position and the mounting inflationary pressure, an intense debate has arisen about whether the *hryvnia* should be allowed to appreciate in nominal terms. However, the National Bank seems intent upon adhering to its policy of maintaining a constant nominal exchange rate to the dollar, not least on account of pressure from the influential exporters' lobby.

In the international arena, the country's record has been mixed. On the one hand, in February Ukraine was struck from the 'black list' drawn up by the Financial Action Task Force of those countries that failed to combat money laundering, following the entry into force of pertinent legislation in June 2003. Furthermore, a twelve-month precautionary stand-by arrangement has since been reached with the IMF on a possible USD 605 million loan, even though it is highly unlikely that the country will need a loan of that order in the foreseeable future. On the other hand, Ukraine has essentially given up its initial demands for 'compensation' from the EU (which would offset the anticipated negative effects of EU enlargement) by extending the current Partnership and Cooperation Agreement with the EU-15 to the new members. Meanwhile, the EU-15 quota for imports of Ukrainian steel remains unchanged and will be applied to the imports to the EU-25. For all the flow of optimistic rhetoric, little progress has been made to date on implementing the recently signed Common Economic Space (CES) with Russia, Belarus and Kazakhstan, even though the parliaments of all four countries have since ratified the document. Most importantly, Russia reportedly does not plan to stop levying VAT on its fuel exports – one of the main incentives for Ukraine's participation in the CES – before 2006

In early 2004, Ukraine's relations with Poland suffered a temporary setback, after a Ukrainian company, *Donbas Industrial Union Corporation*, failed to win the tender for the privatization of the Polish steel corporation, *Huta Czestochowa*. The Ukrainian government claimed, probably not without good reason, that the Polish authorities had taken the decision largely on political grounds. As a result, the outcome of the tender has been declared null and void. However, political considerations also seem to have a bearing on

Ukraine's own privatization policy; it is often aimed at preventing Russian industro-financial groups from taking over Ukrainian assets by adjusting the terms of the tenders accordingly. Featuring on the list of enterprises to be privatized this year are: *Kryvorizhstal* (the largest Ukrainian metallurgical plant and the country's largest exporter); *Odessa State Port Plant* (the second largest producer of nitrogen fertilizers); *Pavlogradvuhillya* (a large coal-mining company); and *Ukrudprom* (an ore-extracting holding company which is to be split up into several competing units). In addition, the moratorium on the free sale of agricultural land has been prolonged until 2015 (initially, the moratorium was supposed to expire in 2005).

In March, the Ukrainian parliament (*Verkhovna Rada*) approved a proportional representation system for parliamentary elections (in lieu of the current semi-proportional, semi-majoritarian principle), while simultaneously lowering the threshold for parties entering parliament from 4% to 3%. The passage of the law was seen as being of crucial significance for the approval of far-reaching constitutional reforms, which were pushed through by the pro-Kuchma forces and envisaged, most strikingly, a reduction in presidential power in favour of parliamentary rule. However, the reform failed to obtain the requisite two-thirds majority. Thus, the importance of the presidential elections to be held on 31 October 2004 has risen correspondingly. While the opposition forces remain split, the pro-presidential coalition has agreed on a single candidate, Prime Minister Viktor Yanukovich. Although Mr. Yanukovich currently enjoys somewhat lower ratings than his main contender, the right-wing opposition leader Viktor Yushchenko, the outcome of the election is far from clear. None the less, whoever becomes Ukraine's next president will most probably have to chart a political course that runs warily between the interests of both Russia and the EU – very much akin to the policy pursued by the current president, Leonid Kuchma.

Table UA

Ukraine: Selected Economic Indicators

	1999	2000	2001	2002	2003 ¹⁾	2003	2004	2004	2005
						1st quarter		forecast	
Population, th pers., end of period ²⁾	49710.8	49291.2	48457.1	48003.5	47622.4	47879.4	47516.7	47300	47000
Gross domestic product, UAH mn, nom.	130442	170070	204190	225810	264165	51535	62094	309500	357700
annual change in % (real)	-0.2	5.9	9.2	5.2	9.4	8.4	10.8	9.5	7
GDP/capita (EUR at exchange rate)	595	683	872	931	917	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	3400	3690	4190	4570	5150	.	.	.	.
Gross industrial production									
annual change in % (real)	4.0	12.4	14.2	7.0	15.8	10.7	18.8	15	10
Construction output total									
annual change in % (real)	-8.0	9.1	16.7	-0.7	23.1	18.2	29.9	.	.
Consumption of households, UAH mn, nom.	71310	92406	112260	119899	203696	.	.	.	.
annual change in % (real)	-1.9	2.5	9.6	5.6	.	.	.	.	.
Gross fixed investment, UAH mn, nom.	17552	23629	32573	37178	51011	6124	10236	.	.
annual change in % (real)	0.4	14.4	20.8	8.9	31.3	23.1	52.1	30	15
LFS - employed persons, th, avg.	20048.2	20419.8	20238.1	20400.7	20554.7	20356.2	.	.	.
annual change in %	-12.8	1.9	-0.9	0.8	0.8	1.2	.	.	.
Reg. employees in industry, th pers., avg. ³⁾	3932.0	3445.0	3811.0	3578.1	.	.	.	.	.
annual change in %	-5.1	-12.4	-6.2	-6.1	.	.	.	.	.
LFS - unemployed persons, average	2698.8	2707.6	2516.9	2301.0	2059.5	2121.4	.	.	.
LFS - unemployment rate in %, average	11.9	11.7	11.1	10.1	9.1	9.4	.	9	8.5
Reg. unemployment rate in %, end of period	4.3	4.2	3.7	3.8	3.6	4.0	3.9	3.5	3.5
Average gross monthly wages, UAH ³⁾	177.5	230.1	311.1	376.4	462.3	402.4	518.3	.	.
annual change in % (real, gross)	-5.4	1.1	20.7	20.0	16.7	17.6	19.9	.	.
Consumer prices, % p.a.	22.7	28.2	12.0	0.8	5.2	2.2	7.4	7	8
Producer prices in industry, % p.a.	31.1	20.9	8.6	3.1	7.8	7.8	14.1	14	7
General governm.budget, nat.def., % GDP									
Revenues	25.2	28.9	26.9	27.4	28.5	29.8	28.2	21.1 ⁴⁾	.
Expenditures	26.7	28.3	27.2	26.7	28.6	26.2	26.2	23.3 ⁴⁾	.
Deficit (-) / surplus (+), % GDP	-1.5	0.6	-0.3	0.7	-0.2	3.6	1.9	-2.3 ⁴⁾	.
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Refinancing rate of NB % p.a., end of period	45.0	27.0	12.5	7.0	7.0	7.0	7.0	.	.
Current account, EUR mn ⁵⁾	1559	1602	1565	3360	2559	1004	1335	2800	2400
Current account in % of GDP	5.2	4.7	3.7	7.5	5.8	11.1	14.3	5.8	4.3
Gross reserves of NB excl. gold, EUR mn ^{5/6)}	1042	1453	3353	4088	5386	4145	6328	.	.
Gross external debt, EUR mn ⁵⁾	12381	11123	13730	9830	12190	.	.	.	.
FDI inflow, EUR mn ⁵⁾	466	644	884	734	1261	221	248	.	.
FDI outflow, EUR mn ⁵⁾	7	1	26	-5	12	1	0	.	.
Exports of goods, BOP, EUR mn ⁵⁾	12400	17008	19074	19770	21013	4739	5876	24500	26000
annual growth rate in %	2.3	37.2	12.1	3.6	6.3	3.3	24.0	17	6
Imports of goods, BOP, EUR mn ⁵⁾	12170	16165	18853	19018	21251	4451	5263	24500	26400
annual growth rate in %	-15.6	32.8	16.6	0.9	11.7	3.2	18.2	15	8
Exports of services, BOP, EUR mn ⁵⁾	3637	4111	4459	4958	4615	1120	1099	4500	4500
annual growth rate in %	4.8	13.0	8.5	11.2	-6.9	-4.8	-1.9	-2	0
Imports of services, BOP, EUR mn ⁵⁾	2155	3433	3995	3743	3237	759	665	3000	3000
annual growth rate in %	-4.3	59.3	16.4	-6.3	-13.5	-12.1	-12.4	-7	0
Average exchange rate UAH/USD	4.130	5.440	5.372	5.327	5.333	5.334	5.330	5.3	5.3
Average exchange rate UAH/EUR (ECU)	4.393	5.029	4.814	5.030	6.024	5.718	6.662	6.4	6.4
Purchasing power parity UAH/USD, wiiw	0.705	0.850	0.913	0.949	0.999	.	.	.	.
Purchasing power parity UAH/EUR, wiiw	0.768	0.932	1.001	1.026	1.072	.	.	.	.

Notes: 1) Preliminary. - 2) In 2001 according to census 5 Dec 2001. - 3) Excluding small enterprises. - 4) Central budget, incl. amendments passed by Parliament in mid-June 2004. - 5) Converted from USD to NCU, and from NCU to EUR at the official exchange rates. - 6) Useable.

Source: wiiw Database incorporating national statistics; wiiw forecasts.