#30, 25 August 1999
A publication of the International Centre for Policy Studies

ICPS newsletter

The economic decline in Ukraine is slowing down

A new issue of ICPS's Quarterly Predictions journal will be published this week. We have improved our forecast for economic development in Ukraine in 1999–2000. Real GDP will decline by only 2% in 1999 and by 0.5% in 2000. Determinants of economic stabilisation next year will include maintaining market principles of economic policy, preventing default on foreign debt payments, implementing a tight budget policy, and reducing state intervention in economic activities

The economic situation in Ukraine has improved during the past several months. In the second quarter of 1999 the decline in GDP slowed to 1.5% y-o-y (compared to 4.8% in the first quarter). Industrial production grew by 0.2% during the first six months of 1999 compared to the same period in 1998.

In our opinion, this positive trend has resulted from the following factors:

· stabilisation of the financial market—increasing credibility of the hryvnia, higher real money supply, and lower interest rates have encouraged economic activities, especially since loans are more readily available;

· real hryvnia depreciation—depreciation of the hryvnia against currencies of Ukraine's major trading partners artificially increased the competitiveness of Ukrainian goods, both in the domestic and foreign markets; and

· world economic recovery—positive trends in the Russian economy as well as the end of the crisis in Southeast Asia expanded the foreign markets for Ukrainian goods significantly.

These factors will have no more than a short-term improving effect, for no important steps to improve the structure of the domestic economy or provide better economic conditions have actually been made during this year.

Regardless of the improvements, we have maintained a negative forecast for real GDP in 1999 of -2% (instead of the forecast -4%). Extremely slow agricultural reforms will cause a greater decline in agriculture (-3.5%) compared to that in the industrial sector (-0.5%). Industrial production stabilisation will arise from increased efficiency in some industries, and also by state subsidies of power and gas to loss-making enterprises.

Having revised our forecast for 1999, we have correspondingly assessed Ukraine's prospects for 2000 more optimistically: next year real GDP will decline by 0.5%, instead of the previously projected 1.0%. Our forecast for 2000 as the most successful year during the last ten years rests on several important assumptions:

1. Economic strategy will not radically change after the presidential election. In our previous issue we suggested that the newly elected president will be intelligent and predictable; he will be forced to deal with all the economic problems accumulated during the last few years. Political developments during the last three months have reinforced this assumption.

2. Ukraine will be able to pay its foreign debts. According to the payments schedule, the Ukrainian government and the NBU must repay 3.2 billion USD to foreign lenders in 2000. At the end of July the NBU's foreign exchange reserves amounted to only 1.2 billion USD, which casts into doubt Ukraine's ability to pay its debts.

We foresee that Ukraine will avoid defaulting next year thanks to the following conditions:

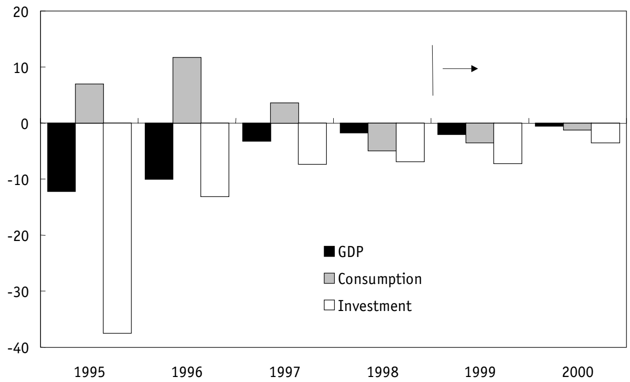
· rapid privatisation aimed at strategic foreign investors (expected injection of no less than 700m USD);

· refinancing of IMF payments (expected inflow of no less than 800m USD) and maximum possible financing from the World Bank and the EU (no less than 600m USD);

· restructuring of debts to private lenders (250m USD of which has already been done); and

Real GDP, real consumption, and investment

Annual % change



Source: State Statistics Committee.
Forecast by Quarterly Predictions.

• a positive current account balance; in this case, the government should provide maximum support to exporters, while the National Bank should take measures to prevent real hryvnia appreciation.

3. The government will implement a tight budget policy and reduce subsides to enterprises as much as possible The reduction of budget expenditures is another important factor in preventing default. We forecast that in 1999–2000 government spending on economic activities will notably decline; as a result of the decline, industrial output will fall significantly—by 1.5%—particularly because of unprofitable firms in heavy industry.

4. Government intervention in economic activities will decrease and business conditions will improve. Low business activity, poor investment even in potentially profitable industries, and layoffs in nonviable industries create dangerous social tension. The new government must solve these problems, with priority focus on those in agriculture. We forecast that agricultural output will decline by only 0.5% in 2000, mainly due to the development of market mechanisms.

If the above assumptions hold, the economic situation in Ukraine will stabilise in 2000. However, subsequent years (especially 2001) will not be less problematic. Loosening the debt noose will depend on the government's taking two strategic steps:

• reinforcing state finances; not only should budget revenues increase thanks to a competitive economic growth strategy, but also budget expenditures should decrease after conducting budget reforms; and

• providing foreign currency inflow into Ukraine, via policies for increasing competitiveness of Ukraine's exports and attracting foreign direct and portfolio investments.

If you wish to receive the ICPS Quarterly Predictions journal regularly, please send your information to the e-mail address: marketing@icps.kiev.ua or contact Oleksii Blinov, ICPS marketing office, tel.(380-44) 463-6337

Next Week

Macroeconomic seminars recommence. ICPS's next macroeconomic seminar, prepared by the German Advisory Group on Economic Reform in Ukraine, will be held on August 31. Participants will discuss the forecast of oil demand to 2010.

Concerning invitations for ICPS seminars, please contact Larysa Romanenko. E-mail: LRomanenko@icps.kiev.ua tel.(380-44) 463-5967

Major indicators

	1998	1999 (forecast)	2000 (forecast)
Economic activities			
GDP, millions UAH	103,869	131,200	157,700
Real GDP, annual % change	-1.7	-2.0	-0.5
Real industrial production, annual % change	-1.5	-0.5	-1.5
Real agricultural production, annual % change	-8.3	-3.5	-0.5
Real household disposable imcome, annual % change	-5.8	-2.0	-3.5
Real retail turnover, annual % change	-3.5	-5.3	-2.4
Gross investment, % of GDP	20.7	19.6	19.0
Foreign direct investment, millions USD (1)	743	300	850
Prices			
Consumer price index, annual % change	20	24	16
Wholesale price index, annual % change	35	18	13
Labour market			
Population, million people	50.1	49.8	49.4
Average monthly wage, average annual % change	0.1	-6.4	0.9
Unemployment, according to surveys, % (2)	11.3	15.0	17.0
Foreign economic activities (1)			
Exports of goods and services, annual % change	-13.4	-4.7	5.7
Imports of goods and services, annual % change	-17.0	4.4	3.2
Current account balance, % of GDP	-3.0	-0.6	0.3
Budget			
Current deficit, % of GDP	2.0	0.6	-1.4
Primary deficit, % of GDP (3)	-0.3	-2.1	-3.5
Foreign debt, millions USD	10,978	11,300	10,700
Monetary indicators			
Monetary base, annual % change	22	26	16
M3, annual % change	25	26	17
NBU gross international reserves, millions USD (4)	685	900	1,100
Official exchange rate as of year end, UAH/USD	3.43	4.55	5.20
Weighted interest rate on loans, yearly % (5)	55	55	50

Notes:

(1) according to the NBU, calculated as foreign investment inflow minus foreign investment outflow from Ukraine

(2) as a share of labour force; methodology has been changed since 1999

(3) calculated as current deficit minus foreign debt servicing

(4) gross liquid international reserves since 1998

(5) commercial bank loans, in hryvnias

Source: State Statistics Committee, NBU, Finance Ministry. Calculations by Quarterly Predictions.

ICPS Newsletter is a weekly publication of the International Centre for Policy Studies. To be included in the distribution list mail to: marketing@icps.kiev.ua.
ICPS Newsletter is published by the ICPS Publications Group.
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