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Ukraine's Macroeconomic Situation and Outlook

by

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1. The macroeconomic situation

The macroeconomic performance of Ukraine in the year 2001 was quite impressive and can be summarised by the following features:

- (i) High growth
- (ii) External stability
- (iii) Low inflation
- (iv) Low fiscal deficit

(i) High growth

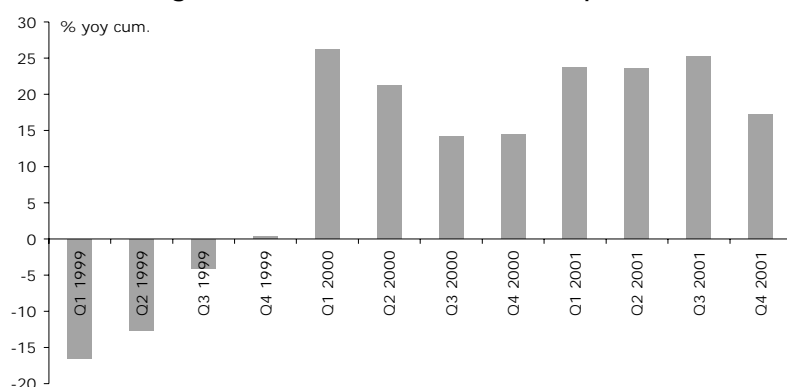
Economic growth in 2001 amounted to 9.0%. Investment in fixed capital grew by 17.2% (Figure 1), accounting for almost one half of the total real GDP growth.¹ Contrary to a widely held view, net exports did not considerably contribute to growth in 2001.

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¹ Exact figures on the contributions to real growth by private consumption, investment, government expenditures and net exports are not presented because of statistical discrepancies.

Figure 1. Investments in Fixed Capital



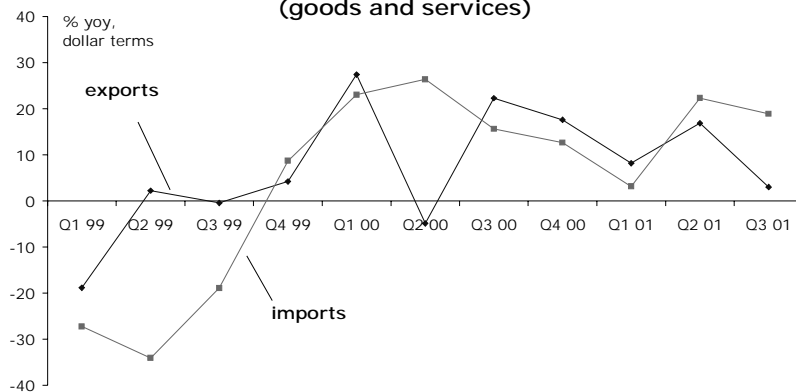
Source: State Committee of Statistics

This investment-led growth was facilitated by increased credits, extended to enterprises by commercial banks. Outstanding credits grew by 46% in 2001. This lending activity was in turn made possible by an increase in deposits by 37%.

(ii) External stability

Both exports and imports grew significantly in dollar terms in 2001 (Figure 2). According to the State Committee of Statistics, the growth rate of merchandise exports was 11.6%, while imports increased by 13%. This rise is smaller in real terms, because of the real appreciation of the Hrivnia relative to the US dollar in 2001.

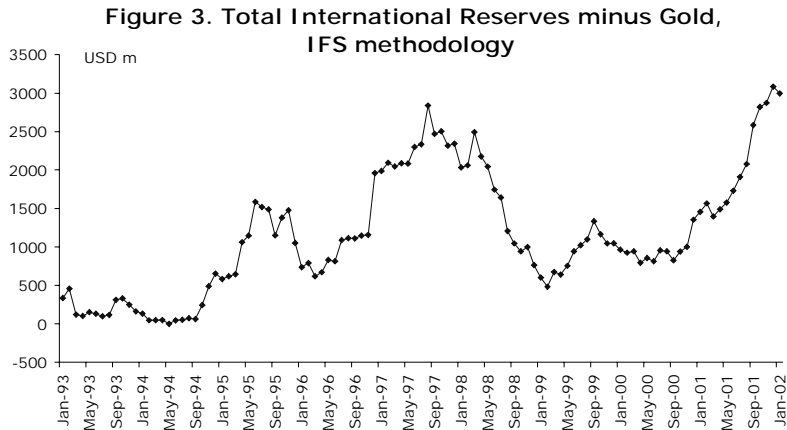
Figure 2. Dynamics of Exports and Imports (goods and services)



Source: National Bank of Ukraine, own calculations

The merchandise trade balance posted a surplus of USD 490 m², which helped the National Bank to replenish its gross reserves of foreign exchange (Figure 3) and to keep the external value of its currency stable. An appreciation of 2.6% relative to the US dollar took place in 2001.

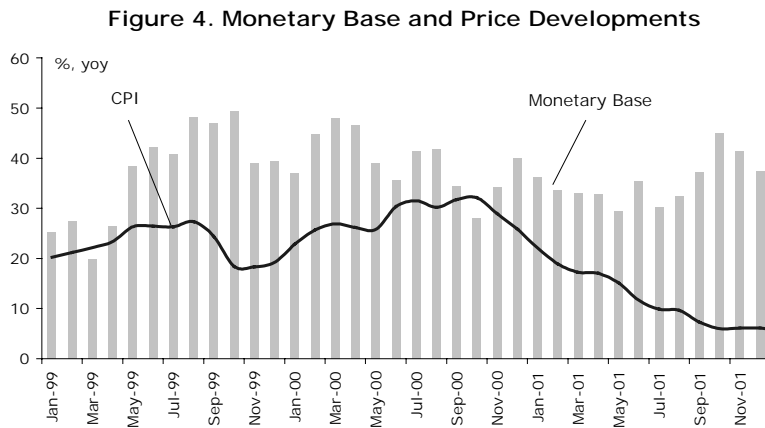
² Source: State Committee of Statistics.



Source: International Financial Statistics (IFS), National Bank of Ukraine

(iii) Low inflation

The net purchases of foreign exchange by the NBU in 2001 resulted in a significant expansion of the monetary base (37.4%). Thanks to high economic growth and further monetisation of the economy, this monetary expansion did not produce a high rate of inflation, as was the case in 2000 (Figure 4). The inflation rate (CPI) came down from 25.8% in 2000 to 6.1% in 2001.

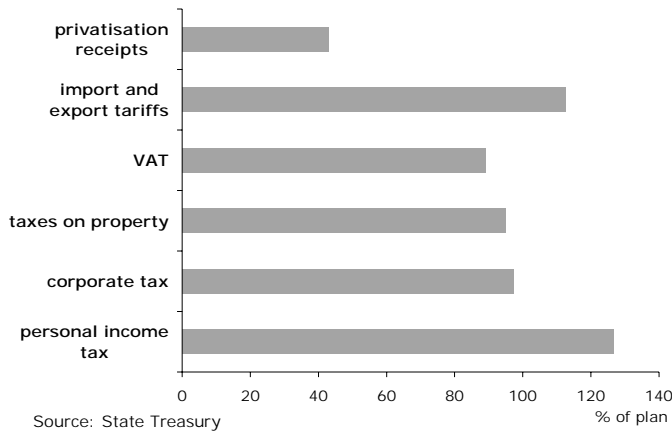


Source: State Committee of Statistics, National Bank of Ukraine

(iv) Low fiscal deficit

According to preliminary figures, the consolidated fiscal deficit amounted to 0.5% of GDP in 2001. Thus, the goal of a zero budget deficit was almost achieved. But behind this apparent success lie a number of serious fiscal problems. In spite of higher than expected economic growth, corporate income revenues were underexecuted, partly because of significant tax write-offs and restructuring. VAT revenues were also underperforming, despite a considerable build-up of state debt to exporters and other enterprises for VAT refunding. Privatisation receipts were also significantly underperforming. These shortfalls were partially compensated by a considerable overexecution of personal income taxes as well as import and export tariffs (Figure 5).

Figure 5. Consolidated Budget Execution in 2001



2. The macroeconomic outlook

(i) Economic growth

This year, the Ukrainian economy is expected to significantly slow down. The government forecast of 6% used in the budget 2002 should be seen as rather optimistic. One major factor for a slowdown will be the relatively bad shape of the world economy. In particular, the expected slowdown in the Russian economy, which takes 23% of Ukrainian exports, might negatively affect growth in Ukraine.

Turning to internal factors, structural reforms slowed down in the second half of 2001 and are not expected to increase significantly in the first half of 2002. A further bottleneck for economic growth is the rather poor state of infrastructure in Ukraine. A substantial inflow of FDI into this sector would facilitate sustainable growth in Ukraine. But the low level of financial intermediation by commercial banks also remains a brake for further economic growth.

The first signs of a slowdown of the Ukrainian economy have already appeared. In January 2002, economic growth and industrial output decelerated to 3.2% and 1.7%, respectively. The Ukrainian policy makers are well advised to resume reforms as soon as possible. Especially they should ensure investment in infrastructure and further increase in financial intermediation by commercial banks.

(ii) External position

The maintenance of external stability should be a major priority for Ukrainian economic policy. For this purpose, a number of measures should be taken.

Exports constitute about 57% of GDP in 2001 and are by far the main source of foreign exchange in Ukraine. The stability of exports is crucial for growth and for the external stability of the country. Unfortunately, Ukrainian exports are quite sensitive to trade disputes: metallurgy accounts for 41% and agriculture for 11% of exports. Thus, Ukraine should be able to defend herself in case of trade conflicts. The most urgent step in that direction is to become a member of the World Trade Organisation

(WTO). In the medium-run, building a more solid institutional basis for the economic relationship with the European Union should be a major goal.

The role of the National Bank in maintaining external stability has to be emphasized. At present, lacking sufficient capital inflows, current account surplus is necessary to service the foreign debt of the country. Thus, the NBU should avoid an unsustainable real appreciation of the Hrivnia, which would in turn hurt net exports. It should be taken into account, that the positive effect of a real devaluation on the trade balance only shows up after two to three quarters.

(iii) Inflation

The yearly inflation rate (CPI) in January 2002 was 5.6%. Thus, the disinflationary trend of 2001 seems to continue. For a projection of price development this year, several factors should be taken into account.

On the one hand, the net purchases of foreign exchange by the National Bank should be significantly lower this year than in 2001. As a consequence, the National Bank will be in a better position to control money creation and keep inflation at a low level. On the other hand, the expected slowdown in economic activity and in the speed of monetisation means that the inflationary pressure of a given money expansion will become bigger. Furthermore, some administered prices, such as communal services, are expected to rise. The net effect of all these factors should be slightly inflationary. But as long as the inflation rate remains in the single digit realm, the negative effect on the economy will not be significant.

This projection for the inflation rate assumes, that the Finance Ministry fully complies with its financial obligations vis-a-vis the National Bank. Should this assumption turn out to be wrong, than a significant increase in money supply and inflation would result. Keeping inflation low is a joint task of the National Bank and the Finance Ministry.

(iv) Public finance

Public finance remains the most critical aspect of Ukrainian policy. There are many potential reasons for a considerable rise in the public deficit. The rather optimistic forecast of 6% real growth used in the budget 2002 is one major risk for lower than expected revenues. Furthermore, the continuation of tax write-offs and restructuring could make public finance less transparent, intensify rent-seeking activities, and reduce the ability of the government to execute planned revenues. The extension of the state subsidisation of enterprises, including the experiment in the ore mining and metallurgy complex, is also a serious threat for the fiscal soundness. The same applies to the extension of social privileges in the 2002 budget.

A failure to privatise Ukrtelecom and the energy distributing companies (oblenergos) would not only have a negative impact on investment and growth, but also on public finance. Thus, a successful and speedy privatisation of these enterprises should be a

political priority for this year. Also the problem of VAT refunding should be solved fairly and quickly.

3. Conclusions

The performance of the Ukrainian economy in 2001 was quite impressive, combining high growth, external stability, low inflation and low fiscal deficit. But the inability of the central government to meet several revenue targets inspite of a much higher than expected economic growth revealed significant structural problems in fiscal policy. These problems will become more apparent this year, because of the expected slowdown in economic activity. A solution to these problems is urgently needed. A substantial fiscal deficit would put an end to the combination of internal and external stability, enjoyed by Ukraine for the last two years. We are confident, that a workable solution will be found.