



MACROECONOMIC CHALLENGES AFTER THE ORANGE REVOLUTION¹

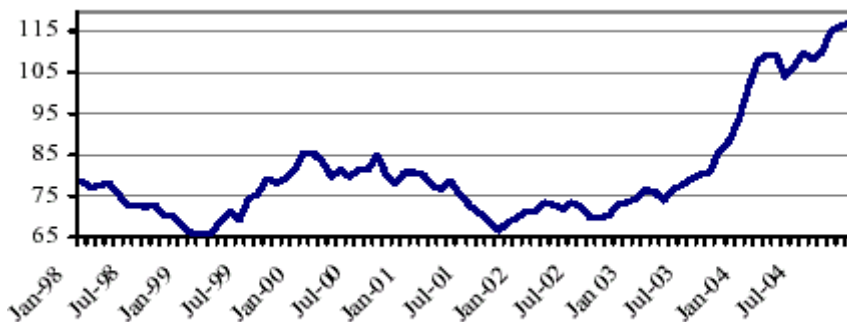
Macroeconomic situation in Ukraine in 2004 was in many ways exceptional, comparing to the preceding years. The rate of GDP growth (12.1%) reached its highest level in the history of the independent Ukraine (see **Table 1**). However, one must remember that it happened only due to very favorable external factors and domestic pro-inflationary policy. The negative effects of the second factor have been already seen in the last quarter of 2004 and even more dramatically in the first months of 2005.

Table 1: Ukraine: Basic Macroeconomic Indicators

Indicator	1999	2000	2001	2002	2003	2004
real GDP growth in %	-0.2	5.9	9.2	5.2	9.4	12.1
annual inflation in %	19.2	25.8	6.1	-0.6	8.2	12.3
UAH/USD exchange rate, eop	5.22	5.4	5.3	5.33	5.33	5.31
current account balance in USD billion	1.7	1.5	1.4	3.2	2.9	7.2
balance of consolidated budget in % of GDP	-1.5	-0.4	-1.6	+0.8	-0.2	-3.1

Source: Ukrainian Economic Outlook (UEO), <http://www.case-ukraine.kiev.ua/main.php?action=prj-full-desc&type=current&id=9&lang=en>

Figure 1. Composite metal price index, 1998-2004



Source: IMF Research Department (Commodity Metals Price Index, 1995 = 100, includes Copper, Aluminum, Iron Ore, Tin, Nickel, Zinc, Lead, and Uranium Price Indices); UEO, 2005 Q1, Figure 7.1

¹ This paper has been written as a contribution to the Blue Ribbon Commission 2 Report initiated by the UNDP Country Office in Ukraine. In preparing this analysis I relied extensively on statistical data, information and opinions provided by the expert team of the "Ukrainian Economic Outlook", a quarterly publication of CASE Ukraine (see <http://www.case-ukraine.kiev.ua/main.php?action=prj-full-desc&type=current&id=9&lang=en>), particularly by its Project Manager and Editor Dmytro Boyarchuk. However, I bear the sole responsibility for the content and quality of this analysis as well as the presented opinions, conclusions and recommendations, which reflect my own views and not necessarily those of CASE, CASE Ukraine and UNDP.

The high international demand and high prices for metallurgical products (see **Figure 1**) helped in continuation of good times for this traditional sector of Ukraine's industry and export. The additional support for exporters came from an exchange rate policy conducted by the NBU: pegging *hryvna* to the US dollar meant its nominal depreciation to other major currencies like Euro, British pound or even Russian ruble.

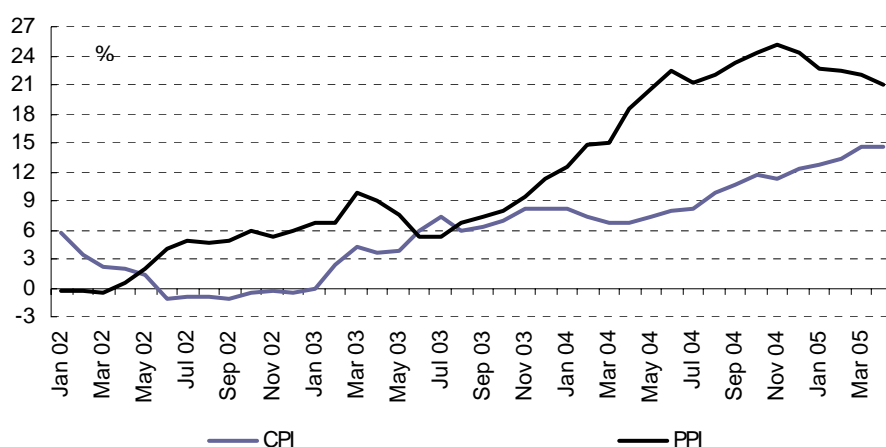
On a domestic front, loose monetary and fiscal policies boosted private consumption and the latter became the main engine of economic growth in 2004 and the first quarter of 2005. Most of rapidly increasing budget spending have been directed to increase public sector wages and salaries and social transfers what must have (and really does have) unavoidable inflationary consequences. Moreover, so high rate growth can hardly be considered as sustainable even in a short term perspective, particularly if one takes into account the above described factors, which contributed to its achievement. The developments of the last half a year have fully confirmed this concern.

If we look for quarterly GDP data the annual growth rate reached its highest level in Q3 2004 (14.2%) and then rapidly decelerated: to 9.1% in Q4 2004 and 5.4% in Q1 2005. While Q4 2004 was marked by the exceptional political circumstances (three rounds of presidential elections and the Orange Revolution), which might affect negatively economic activity, the data for Q1 2005 definitely signals change in a growth trend.

In the light of earlier arguments growth deceleration should not be surprising but one must be aware that continuation of bad macroeconomic policies (particularly of uncontrolled fiscal expansion) and inability to improve business and investment climate (see Chapter 5 of this Report) can further deteriorate growth record in a near future. In particular, unfinished political debate on the past privatization deals and their potential review, uncertainty of how far this process will go and what kind of legal procedures and instruments will be adopted in relation to the questioned transactions, attempts of price control (the examples of oil product and meat markets), and other politically motivated forms of government interference in business activity can substantially deteriorate investors expectations and even provoke a massive capital outflow.

On the other hand, the increasing domestic disequilibrium has been reflected in a number of macroeconomic indicators: inflation, money supply and fiscal deficit.

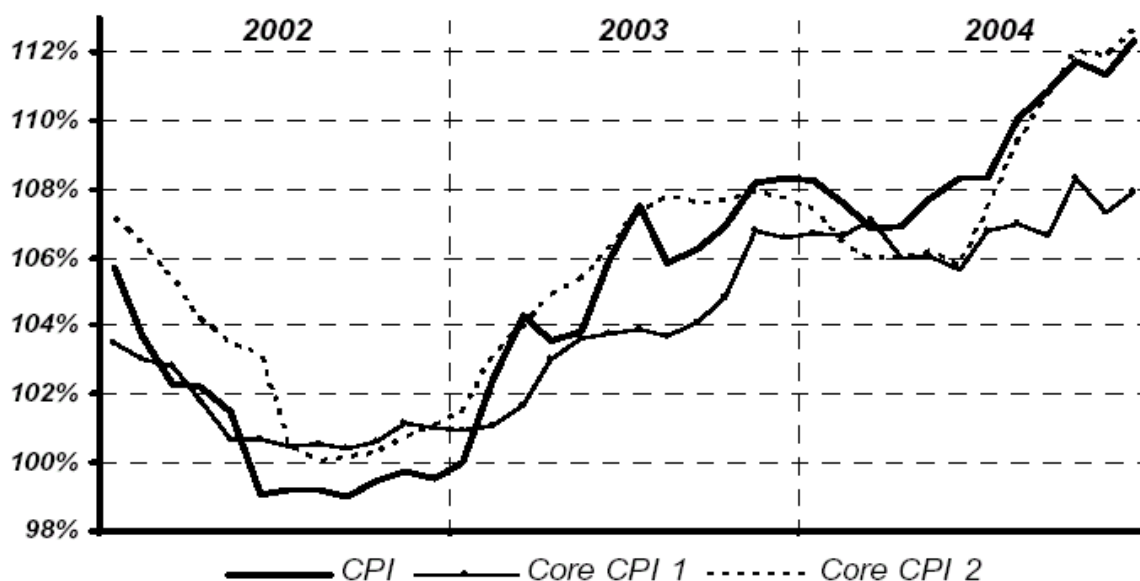
Figure 2: CPI and PPI dynamics, change %, yoy, 2002-2004



Source: State Statistics Committee of Ukraine; UEO database

After reaching its lowest (i.e. negative) level in summer 2002, an annual CPI inflation has systematically increased reaching a two-digit level already in Q3 2004 (see **Figure 2**). One can try to find a number of supply-side factors, which have contributed to this trend in the last two years like bad harvests of 2003 (but this effect was reversed by relatively good harvests of 2004) and high oil and energy prices. This is true (see also the PPI trend in **Figure 2** and core inflation trend in **Figure 3**) but far from being enough to explain so substantial and systematic disinflation reversal as observed in 2003-2005.

Figure 3. CPI and core inflation in 2002 – 2004 (monthly data, yoy % changes)



Source: State Statistics Committee of Ukraine, CASE Ukraine estimates; UEO, 2005 Q1, Figure 5.1

If we look into money supply statistics we will find a very high rate growth of monetary aggregates through the entire post-1998-1999-crisis period. A broad money aggregate M3 increased by 40.5% in 1999, 46.1% in 2000, 41.8% in 2001, 41.7% in 2002, 46.5% in 2003 and 32.4% in 2004. Monetary base grew by 41.4% in 1999, 39.9% in 2000, 37.4% in 2001, 33.6% in 2002, 30.2% in 2003 and 34.1% in 2004 (the faster growth of M3 than monetary base reflected increasing financial intermediation and, therefore, money multiplier)². The rapidly growing international reserves of the NBU (up to USD 13,117.92 million at the end of April 2005³) were the main factor contributing to this extraordinary pace of monetary expansion.

This brings us again to an exchange rate policy, which focused on defending *hryvna* against nominal appreciation through the entire post-crisis period. On the other hand, a stable UAH/USD exchange rate helped in a rapid remonetization (M3/GDP more than doubled – from 16.9% in 1999 to 36.3% in 2004), which absorbed most of increase in money supply. However, remonetization at such high pace could not be continued indefinitely⁴ and from 2003 it became clear that inflationary pressure was increasing rapidly. In addition, the UAH peg to the weakening US dollar meant importing inflation through an import and export pricing channel.

Fiscal expansion constituted another important source of an inflationary pressure. Until 2003 Ukrainian budget was relatively balanced with the deficit not exceeding 1.5% of GDP (see **Table 1**) although in conditions of so high rate of economic growth it should record a substantial surplus rather than deficit. Fiscal situation deteriorated dramatically in the second half of 2004, during the election campaign and Orange Revolution. In Q4 2004 fiscal deficit already accounted for 9.7% of GDP and in the whole 2004 it amounted to 3.1% of GDP. The available fiscal statistics demonstrate that these were rapidly growing expenditures (mostly for public sector wages and salaries and social transfers), which caused this deterioration.

² Analysis of pace of monetary expansion bases on the NBU monetary statistics. See, among others, http://www.bank.gov.ua/Statist/MONEY_/mon.htm

³ See <http://www.bank.gov.ua/SDDS/Dates/dates.htm>

⁴ This argument was repeated several times in the subsequent issues of the „Ukrainian Economic Outlook“ in 2002-2003 where authors expressed their concern about limits of remonetization.

Generally, the first months of 2005 did not improve a gloomy macroeconomic picture and macroeconomic policy of the new authorities did not represent a sufficient consistency and determination to restore macroeconomic equilibrium⁵.

On the monetary and exchange policy front the NBU initiated a modest revaluation of hryvna in March and April 2005 (from 5.30 to 5.05 UAH per 1 USD) what, together with some dollar strengthening *vis a vis* other currencies in recent weeks, should help to mitigate an inflationary pressure going through trade and price channel. This step should also allow slowing down the rapid pace of growth of NBU international reserves and, consequently, money supply (although in a short term it can boost inflow of speculative capital). However, one must remember that such a policy can bring the expected benefits only if fiscal policy works in the same direction. Otherwise, it will lead to deterioration of balance of payment without affecting inflation rate.

In medium term perspective, the NBU must finally discontinue its current hybrid monetary policy regime where it tries to control both exchange rate and money supply (or interest rates). As vast international experience shows that such a regime does not guarantee effectiveness in fighting inflation and involves a risk of serious macroeconomic destabilization in the case of adverse shocks. While the NBU declares (with the support of IMF) moving towards direct inflation targeting (DIT) this is not an easy strategy (in economic and technical terms) and such a choice needs a set of far going modifications in central bank legislation (strengthening NBU independence *vis a vis* both executive and legislative branches of government), monetary and inflation statistics, analyzes and forecasting, NBU operational procedures and its communication with financial markets, etc. However, the most revolutionary change will concern an exchange rate policy: the effectiveness of DIT requires floating exchange rate of national currency and such a step is a precondition of effectiveness of the new strategy.

In the fiscal policy sphere the new Government undertook several measures aiming in disciplining a revenue side: it eliminated numerous tax loopholes (like free economic zones), tax exemptions and special tax regimes, increased discipline and started to fight corruption in the tax and custom administration, decreased and simplified a tariff system, etc. Ministry of Finance reports 68% increase of budget revenues in the first four months of 2005, comparing to the same period of 2004⁶. These positive trends continued in May 2005⁷. However, such a favorable short-term outcome might be influenced by one-off factors such as personal changes in the tax and custom administration or settlement of delayed transactions from Q4 2004 and does not necessarily give a ground to expect a similar pace of improvement in a longer run.

At the same time budget expenditures continued to expand as result of both election populism of Yanukovich's government and additional wage and social obligations accepted by the new administration already after the Orange Revolution (see Chapter 3). The revised budget for 2005 approved by the Verkhovna Rada in March 2005 increased both revenues and expenditures by ca. UAH 20 billion, comparing to the previous version. The new revenue projection is built on very optimistic growth and revenue collection assumptions, which may result in a revenue shortfall and expenditure sequestration (as it happened several times in 1995-1998). The practice of budget execution for the first four months of 2005 demonstrates that increased wage and social spending crowd out other expenditure items.

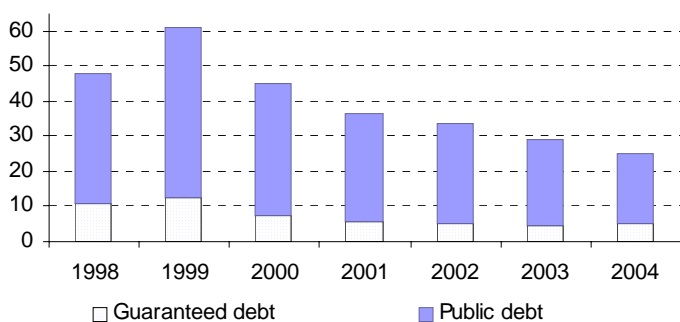
The budget deficit is projected to amount UAH 7 billion and be financed almost totally by privatization revenues, similarly to 2004. However, privatization has been stopped for political reasons (see Chapter 5) and it is very unlikely that the expected amount will be collected. It will effect in much larger public sector borrowing requirements and increasing interest payments in the subsequent fiscal years. Depending on nominal GDP and effectiveness of revenue collection the actual fiscal deficit in 2005 can account for between 4 and 7% of GDP.

⁵ For example, the Press Statement of the IMF Staff Mission to Ukraine (of June 8, 2005) expressed a deep concern related to mounting inflation pressure, fiscal imbalances, and insufficient consistency of the overall macroeconomic policy mix. See <http://www.imf.org/external/country/UKR/rr/2005/ps060805.pdf>

⁶ http://www.minfin.gov.ua/control/en/publish/article?art_id=54475&cat_id=34244

⁷ http://www.minfin.gov.ua/control/en/publish/article?art_id=55046&cat_id=54644

Figure 4. Public debt (including guaranteed debt), % of GDP, 1998-2004



Source: Ministry of Finance of Ukraine

At the moment the level of public debt is not very high (see **Figure 4**) and government can borrow relatively cheaply on both domestic and international financial markets. However, if fiscal situation continues to deteriorate borrowing conditions may become less favorable and Ukraine can easily repeat a dramatic scenario of 1998-1999 with a near-default situation. One must also remember that increasing wage bill or social transfers has a long term consequences for the next budgetary periods and once granted social entitlements cannot be easily withdrawn in bad fiscal times. Ukraine already represents one of the highest levels of social spending (in relation to GDP) in the world and its very unfavorable demographic structure will further increase this ratio.

Ukraine needs urgently a new round of substantial fiscal adjustment, which should include, among other measures, a complex social reform decreasing a number of pensioners (through increase in an effective retirement age), elimination of various pension and social privileges, and better targeting social benefits to the most vulnerable groups of population. Failure to do it will threaten in further deepening of a fiscal crisis and increasing inflation (which reached annual level of 14.6% in May 2005) just before March 2006 parliamentary elections what would be the least desired social and political scenario.