



Center for Social and Economic Research

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The Sources of Economic Growth in Ukraine after 1998 Currency Crisis and the Country's Prospects

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Contents

Introduction	6
Chapter 1. Macroeconomic Outlook for the Period 1998-2001	8
1.1. The Pace of Transition	8
1.1.1. GDP Patterns in Transition Economies in the 1990s	8
1.1.2. Ukrainian GDP during 1991-2001	9
1.2. Decomposition of Growth Trend by Components of Global Demand	11
1.3. Decomposition of Growth Trend by Sectors of Real Economy	12
1.4. Inflation and Monetary Policy	14
1.5. Exchange Rate Policy	17
1.6. Labor Market Developments and Incomes of the Population	20
1.6.1. Incomes of the Population	22
Chapter 2. Role of External Sector	25
2.1. Developments of Merchandize Exports and Imports	25
2.2. Evolution of Exchange Rate	26
2.3. Evolution of External Demand	29
2.4. Energy Imports	32
2.5. Diversification of Foreign Trade	33
2.6. Financial Account Developments	35
2.6.1. FDI	36
2.6.2. Capital Flight	39
Chapter 3. Microeconomic Prerequisites for Growth	41
3.1. Privatization and Its Effects on Growth	41
3.2. Decrease in Rent-Pumping as a Source of Growth	46
3.3. Re-Monetization as a Result of Hardening Budget Constrains	51
3.4. Competitive Selection: Controversial Tendencies	53
3.5. SME Development	55
Chapter 4. Agriculture	60
4.1. Introduction	60
4.2. General Trends	60
4.3. Trends in Branches	62

4.4. Factors of Growth	67
4.5. Conclusions	71
Chapter 5. Continuing Fragility and Underdevelopment of the Financial Sector	73
5.1. Positive Trends in Financial Sector and Their Implication for Economic Growth ..	73
5.2. Major Determinants of the Positive Trends in Financial Sector	76
5.2.1. Growing Competition	76
5.2.2. Ceasing of Sources of Speculative Profits	77
5.3. Limited Capacities of the Ukrainian Financial Sector	77
Chapter 6. Fiscal Policy and Attempts of Public Sector Reform	81
6.1. Introduction	81
6.2. Indicators of Improvements in Fiscal Policy	81
6.2.1. Budget Revenues	81
6.2.2. Expenditures and Fiscal Deficit	85
6.2.3. Public Debt Management	87
6.3. Institutional Reforms and Systemic Changes	88
6.3.1. Improvements in Tax System	88
6.3.2. Attempts to Comprehensively Reform Tax System	91
6.3.3. Improvements in Budget Management	92
6.3.4. Introduction of the Budget Code	93
6.4. Conclusions	93
Chapter 7. Future Growth Challenges and Prospects	95
7.1. 'Some Reform' Scenario	96
7.2. 'Status Quo'	99
7.3. Conclusions	100
Chapter 8. Conclusions and Policy Recommendations	101
References	107
Statistical Data Sources	111
Interviews	111
Appendix: Tables and Figures	112

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Introduction

The purpose of this study is to analyze the sources of economic growth in Ukraine, which has been observed from the second half of 1999. In addition, we intend to answer the question what is the sustainability of this growth, i.e. putting in other words, what are the chances and conditions for maintaining growth in the future.

Neither question is easy to answer. Analyzing sources of growth and growth sustainability in any transition country is a serious intellectual challenge, for a number of reasons. First, we do not have any comprehensive growth theory in transition economies so far. What is available, it is a couple of more or less empirically verified hypotheses concerning the influence of various macro and microeconomic factors on growth performance. Second, statistical data series in transition economies are still rather short and unstable as a result of various methodological changes in statistics and structural and institutional changes in the economy, which makes serious econometric analysis risky. This argument is particularly relevant to the Ukrainian economy, which entered structural and institutional changes with significant delay compared to other countries, and where the quality of statistics is below regional average. Third, most of transition economies, including the Ukrainian one, are open in terms of trade and financial flows. They have thus become sensitive to some external factors such as growth fluctuations in the world economy as a whole, varying conditions of Ukraine's major trade partners, changing attitudes of financial investors to emerging markets, etc. We have seen that even countries considered as having strong and sustainable growth potential can seriously suffer from adverse external shocks as it happened in 1998-1999 with the Baltic countries and Poland after the Russian and Ukrainian financial crises.

Nevertheless, we tried to make an in-depth analysis of both macro- and microeconomic factors, which might have influenced the dramatic positive about-turn in growth performance of Ukraine shortly after the 1998 currency crisis. Chapter I contains the macroeconomic outlook for this period. Małgorzata Jakubiak, Anna Myślińska and Artsem Boichanka analyze the growth dynamics and its decomposition, inflation trends, basic monetary aggregates, interest rates, exchange rate behavior as well as employment, wages,

and incomes of the population. Chapter 2 looks at the role of the external sector. Yuriy Kuz'myn analyzes export and import dynamics, the role of major export sectors and dominant export markets, energy import, trade and current account balance, and finally capital account developments. In Chapter 3 Vladimir Dubrovskiy makes a review of the progress achieved in the microsphere with a special emphasis given to privatization, hardening budget constraints and payments discipline, easing the entrepreneurial environment and development of the SME sector. Chapter 4 of Jacek H. Schirmer discusses changes in the agrarian sector. Chapter 5 of Inna Golodniuk reviews the progress achieved in the financial sector and its remaining problems. Chapter 6 deals with the very important area of fiscal policy and fiscal management. Małgorzata Antczak and Magdalena Tomczyńska present changes in trends of budget revenues and expenditures, budget deficit, dynamics of public debt, changes in tax policy and in the budget management system. In Chapter 7 Małgorzata Jakubiak and Anna Myślińska discuss alternative growth scenarios until the end of 2003 depending on the speed of the further reform process. Chapter 8 written by Marek Dąbrowski and Małgorzata Jakubiak contains general conclusions and policy recommendations.

The entire study has been prepared by a joint team of experts from CASE – Center for Social and Economic Research in Warsaw and its daughter organization – CASE-Ukraine in Kyiv. The authors benefited substantially from previous research and policy-advice projects, in the first instance, the USAID-funded Ukraine Macroeconomic Policy Project carried out in the period from 1996 to 2001. The regular analytical and forecasting work done for the purpose of the quarterly CASE publication 'Ukrainian Economic Outlook' has also helped in preparing the macroeconomic part of this study.

All the chapters were written between February and June 2002 basing on data available for the end of 2001. The study was then revised and amended in November and December 2002 in response to reviewers' comments. However, the basic statistical data and forecasts remained as in the first version completed in June 2002.

We want to express our deep gratitude to Luca Barbone, John Litwack, Mark Davis, Larisa Leshchenko and Iain Shuker who reviewed the first version of this study and whose valuable comments helped to improve our original analysis. However, the authors accept sole responsibility for the quality of each chapter and the entire study. It reflects only the authors' opinions and not necessarily those of the World Bank, CASE or other institutions where they are affiliated.

Marek Dąbrowski

Chapter I

Macroeconomic Outlook for the Period 1998-2001

Artsem Boichanka, Małgorzata Jakubiak, Anna Myślińska

This chapter gives an overview of the macroeconomic situation in Ukraine during 1998-2001. It provides a background for the more in-depth studies presented in the subsequent chapters, by analyzing dynamics of the components of Ukrainian GDP, monetary and exchange rate policies, as well as trends at the labor market.

1.1. The Pace of Transition

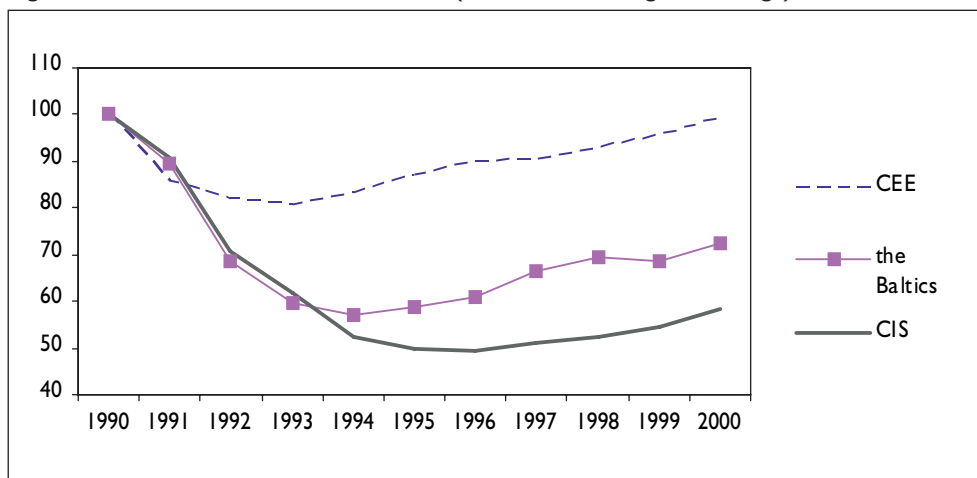
1.1.1. GDP Patterns in Transition Economies in the 1990s

All transition economies have experienced substantial decrease of real output during the first years of transformation. Comparison of different countries shows that the steepest output decrease tends to appear during the first year of transition and then the fall continues for a few years. According to the relative speed of catching-up, three distinct patterns of transitional recession and subsequent output recovery emerge. These are patterns typical for: countries of Central and Eastern Europe, the Baltics and the Commonwealth of Independent States. Average output decline was the smallest in CEE and the most pronounced in CIS. The decline in CIS also lasted longer accumulating over several years whereas countries of CEE and the Baltics started recovering after two years of transition (see Fischer and Sahay, 2000 for details). In countries of CEE and the Baltics official GDP reached its pre-transition level by 1998 whereas CIS did not managed to fully recover even in 2001 (World Bank, 2002).

It can be argued that the officially measured decline was artificially exacerbated by the inadequate measurement methods. Some of the economic activities might have been unnoticed, such as briskly growing private sector. Enterprises might have tried to hide their production instead of overstating it in order to meet plan requirements. Another possible

source of inaccuracies is using deflators anchored in pre-transition period while price structure was quickly changing (Blanchard, 1997). But although the size of the decline may be questionable, the fall in output seems to be out of question.

Figure 1.1. Real GDP in transition economies (1990 = 100, unweighted average)

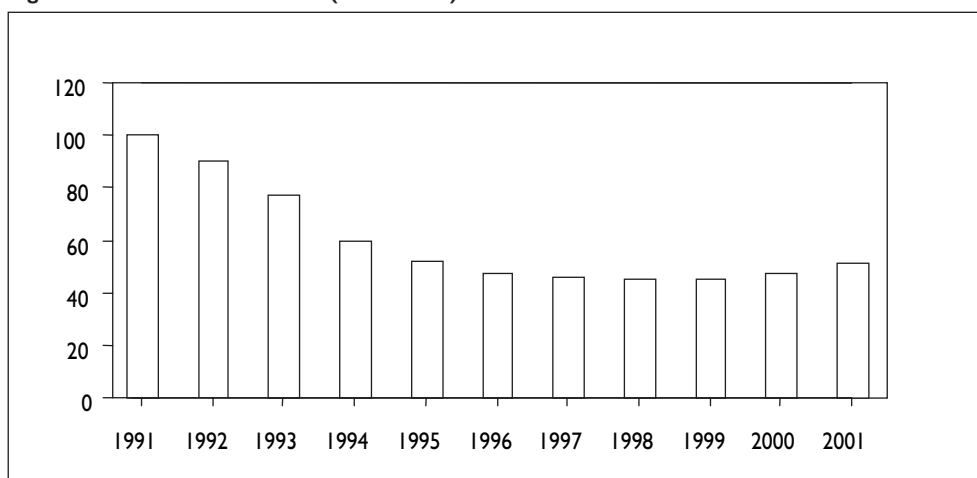


Source: IMF, International Financial Statistics.

1.1.2. Ukrainian GDP during 1991-2001

Ukrainian economy was the last among transition economies to show recovery. The fall in real GDP lasted from the declaration of sovereignty in 1990 to 1999. In 1999, real GDP equaled 44.7 % of the 1991 level (see Figure 1.2). Growth was registered only in 2000.

Figure 1.2. Real GDP in Ukraine (1991 = 100)



Source: NBU and Ukraine State Statistics Committee.

Actually, the first signs of recovery showed in the 2nd half of 1997 but the growth rates were too weak to balance the 1st half and the growth for the whole year remained negative. The moderate growth continued in March-June of 1998 and then upward trends rapidly reversed due to the Russian crisis. In 1999, the situation from 1997 was repeated. Finally, GDP began growing in 2000 reaching impressive rates.

In general, the decline of registered output connected with the transition may be explained by several factors (Aslund, 1994, and Blanchard, 1997), such as:

- Moving part of economic activities to unregistered sector;
- Cutting or removing subsidies to state enterprises;
- Change of production structure – reducing production in unnecessary branches;
- Foreign trade shock due to collapse of CMEA and USSR and worsening of terms of trade in exchange with Russia.

The first reason is probably true for the Ukrainian economy – estimates of the shadow sector were growing in the first years of transition. The size of shadow economy measured in percent of GDP that amounted to 16.3 in 1989-1990, increased to 28.4 in 1990-1993 and to 47.3 in 1994-1995¹ (Enste and Schneider, 2000). The hypothesis of changing structure also appears to be justified. The relation of value added generated by industry to GDP declined from 42.3% in 1991 (or even 43.5% in 1992) to 28.4% in 1997, which is to say that industrial production was decreasing much faster than GDP. The structure of industrial production was changing as well. The share of machine building and construction materials was declining. Light industry was declining as well. Reduction in foreign trade was unquestionable, although its exact size is difficult to estimate.²

The Russian crisis of 1998 led to the sudden and significant reduction of Ukraine's exports, first of all to Russia and then to the Western Europe. There was also a capital flight from Ukraine. As foreign financing became scarce, interest rates shoot up. Real interest rate increased by over 10 percentage points in the 3rd quarter of 1998. Following sudden capital outflow and worsening of the investment climate (risk of further devaluation and default), investments rapidly fell. Wages and salaries decreased sharply, which led to a decline of private consumption. Government also reduced consumption in an attempt to control fiscal deficit. The crisis influenced supply side as well. Financial sector was affected by definition – Ukrainian banks held non-indexed government bonds and made heavy losses when interest rates went up (World Bank, 2002). Industry and construction were hit by shrinking demand.

¹ These numbers are only estimates but given the same method used in calculations, one can assume that the direction of changes is showed properly.

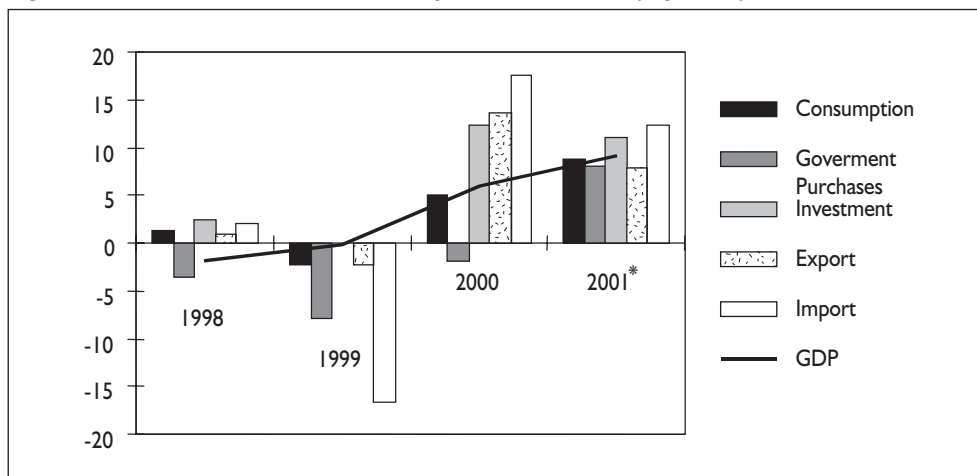
² Official BOP statistics report that only in 1992 exports to Former Soviet Union fell to USD 5.3 billion (from 42.7 in previous year), and imports - to 6.4 (from USD 43.4 billion). However, as Antczak (1996) writes, the official statistics on BOP in the first years of independence (after 1991) give only an approximation of trends in foreign trade, due to poor quality of statistical reporting (Antczak, 1996: 145-149).

At the end of 1999, all negative trends reversed and the country experienced the first year of economic growth for a long time.

1.2. Decomposition of Growth Trend by Components of Global Demand

As it has already been written, the currency crisis brought severe contraction of real activity in 1999. Domestic demand fell by over 6%. Trade volumes decreased as well. However, the devaluation of *hryvnia*, that made import fall by nearly 17% in 1999, led also to an import substitution. As a result, domestic demand rebounded already in 2000.

Figure 1.3. Growth of real GDP and its components, 1998-2001 (in percent)



Source: State Statistic Committee of Ukraine.

Note: * - CASE estimates.

Consumption – that accounts for nearly 60% of Ukrainian GDP – started to rise in the last quarter of 1999. But it was at the beginning of 2000, when household consumption jumped by over 9% following more than 10% rise in real incomes. Relatively high, although decreasing, rates of growth of consumption prevailed through 2000 and first half of 2001. This again was caused by growing incomes; wages and salaries, mainly.

Investment that stayed at the same level in real terms in 1999, have recorded very high rates of growth since the last quarter of 1999. Real growth rate of investment in fixed assets did not fall below 12% through 2000, and according to preliminary estimates was 11.0% in 2001. Such high rates of growth were the reason that investment was giving the strongest impulse to the growth of domestic demand in 2000 (see Table 1.1). When we look at the

Table I.1. Decomposition of real GDP growth, 1998-2001 (in percent)

	1998	1999	2000	2001*
GDP	-1.9	-0.2	5.9	9.1
Aggregate domestic demand	-1.6	-6.6	7.7	11.2
Private Consumption	0.8	-1.3	3.1	5.0
Government Purchases	-0.8	-1.7	-0.4	1.5
Investment	-1.5	-3.6	4.9	4.8
Exports	0.5	-0.9	7.4	4.6
Imports	-0.9	7.3	-9.1	-6.7

Source: CASE estimates on the basis of State Statistic Committee of Ukraine data.

Note: * Preliminary estimates.

gross investment data, it comes out that the highest growth rates in 2001 were recorded in transport and communication (23%) and manufacturing (almost 20%), while the growth of gross investment into mining (15%), construction (14%), and energy (9%) was slower. Taking into account the share of each of these sectors in the value added, we can conclude that the highest contributors into the growth of gross investment in 2001 were manufacturing, transport and communication sectors. However, these are only gross data, so it is not clear how much of these amounts can be attributed to net investment in each sector. But even bearing this in mind, high rates of investment growth in manufacturing (assuming that not all of this can be attributable to the metallurgy) seems to be promising.

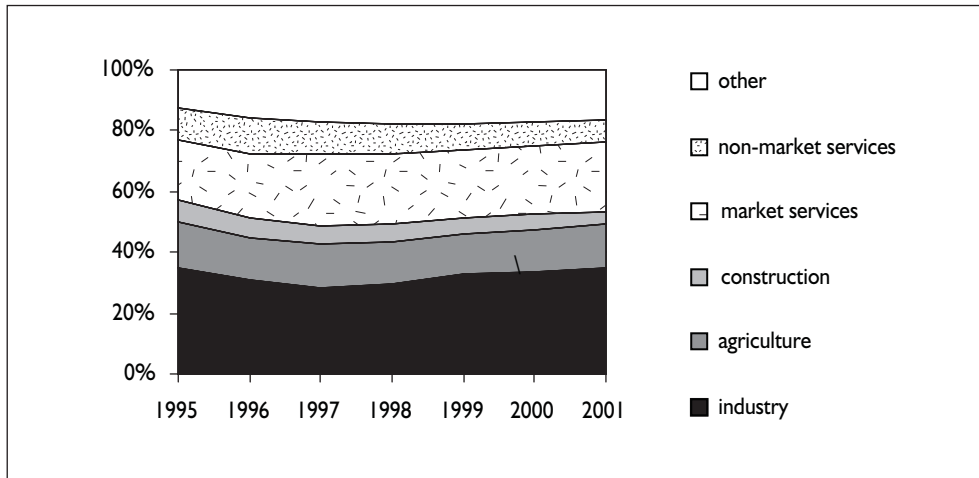
Government purchases (consumption) were still falling in 2000, following the same trend as in the previous years. This was probably the result of higher public spending discipline and limited budgetary resources.

A combination of various factors made export grow very fast, and allowed for trade surplus. Among these factors were: effects of *hryvnia* devaluation, favorable conditions on Ukraine's traditional export markets, and indirect subsidizing of the metallurgical sector. Exports surged by over 20% at the beginning of 2000, recorded a real growth of nearly 14% for the whole year, and gave a strong growth impulse to the economy. Growth of export slowed down in 2001, as the above mentioned positive conditions started to weaken. Import rebounded in 2000 as well, by 17.5%, and by 12% in 2001, as a result of growing consumer demand. However, trade surpluses have been recorded until the end of 2001.

I.3. Decomposition of Growth Trend by Sectors of Real Economy

Structure of Ukrainian value added changed after the 1998 crisis (see Figure I.4). The share of industry in GDP reached its minimum in 1997 and then started growing again to exceed its 1995 level. Services were showing reverse tendencies.

Figure 1.4. Structure of value added in 1995-2001



Source: State Statistic Committee of Ukraine.

Note: Data for 2001 are estimated by the authors in order to ensure comparability with earlier numbers in spite of methodological change.

Decomposition of the growth of value added (see Table 1.2) shows that commencing from 1999, the industrial sector started to give strong and positive growth impulse. Agriculture and construction contributed in 2000 and 2001 although their influence was not that strong. Other sectors had only minor impact. One should remember that industrial growth in 1998-2000 stemmed mainly from the growth in metallurgy (first of all ferrous metallurgy but non-ferrous metallurgy also had a big impact).

Table 1.2. Decomposition of value added growth, in percent, 1998-2001

	1998	1999	2000	2001
Total	-2.0	-0.4	5.4	8.7
Industry	0.0	1.3	4.2	4.1
Agriculture	-1.6	-0.6	0.8	1.4
Construction	0.0	-0.4	0.1	0.3
Market services	0.3	-1.1	0.7	2.4
Non-market services	-0.2	-0.1	-0.2	0.0
Other	-0.6	0.5	-0.1	0.5

Source: State Statistic Committee of Ukraine.

Change in the structure of output – a decrease in the share of heavy industry and an increase in the share of services was typical for a former centrally-planned economies. This kind of change could also be observed in Ukraine. Although the share of industry – especially heavy industries – stayed high – the contribution of services started to gain importance. Hence, growth of market services should be seen as a healthy sign and is expected to

continue. The same can be said about light, food, wood and paper industries that started growing in 1999.

What was specific for Ukraine, was that metallurgy has been the most important contributor to the output growth in the industrial sector in 2000-2001. However, as the demand for the production of this sector depends on the export demand for metals, this branch is likely to grow as long as there are favorable external conditions.

After several years of continuous decline of value added in agriculture, there is a considerable potential for growth. However, it will depend on weather conditions on the one hand, and on institutional changes on the other. The growth experienced in 2000 and 2001 was, to a big extent, accidental and stemmed mainly from temporary factors (see Chapter 4 for details).

1.4. Inflation and Monetary Policy

Before financial crisis in September 1998, the year 1998 was considered as a period of the lowest inflation rate (in Jan-July 1998 the cumulative price growth was equal to 2.1% compared to 5.4% in Jan-July 1997). The 50% *hryvnia* devaluation in September 1998 stimulated an acceleration of inflationary processes and led to a 17.7% (y/y) price growth in the fourth quarter of 1998 (compared to 9.9% y/y in Q4 of 1997). Consumer prices grew by 20% in December, and producer prices – by 35.4%. However, the average annual CPI inflation rate in 1998 was equal to 10.6% which was the lowest level in the period of 1996-2001.

Limited inflationary pass-through of *hryvnia* devaluation can be explained by restrained growth of money supply and better crisis management than in the case of Russia (see Dąbrowski, Górski and Jarociński, 1999). Due to the collapse of the government bond market (foreign capital outflow), the reduction of state subsidies and the absence of crediting of real sector through money emission, there was no significant increase in money supply. In 1998, annual growth rates of monetary aggregates were the lowest in the period of 1996-2001 (22% y/y and 25% y/y for a monetary base and broad money (M3) respectively). As a result, enterprises did not have enough resources to raise wage payments that ultimately led to a reduction in real incomes. From this viewpoint, the low demand for goods (as population was impoverished) may be considered as one of the reasons for the absence of the significant price increases in 1998. Another reason is related to the adoption of the special law by the Verkhovna Rada of Ukraine³ that imposed a restriction on price increases

³ The Law of Ukraine "On Temporary Ban of Increase of Prices And Tariffs For Communal Services And Public Transport Granted to the Citizens of Ukraine", 51-XIV, 23.07.98.

for communal services and public transport, which constituted 70% of the consumer services basket.

In 1999, the National Bank of Ukraine (NBU) turned from liquidity restrained policy to monetary expansion. During this period, money base and broad money (M3) grew by 39% and 41% respectively. The NBU conducted money emission in two ways. First, to service foreign debt payments and to rebuild international reserves, the NBU purchased dollars in the Inter-Bank Currency Exchange. Second, taking into account unattractiveness of OVDPs (domestic Treasury bills) for commercial banks, the NBU had to buy them to provide the Ministry of Finance with sources for financing budget deficit and rolling-over the existing debt stock (violating the provisions of the new NBU law being effective from mid-1999). At the same time, the NBU decreased discount rate and the rate of lombard credits (from 50% to 45% and from 55% to 50% respectively).

Acceleration in the growth of monetary aggregates together with the depreciation of *hryvnia* in 1998 and 1999, led to the increase in the average annual inflation rate from 10.6% y/y in 1998 to 22.7% y/y in 1999. In spite of the administrative price controls on some foodstuffs that were imposed in the eve of the President elections, poor harvest led to a 27.8% y/y rise in food prices (compared to 11.8% y/y in 1998). At the same time, prices for other commodities and services grew by 22.1% y/y and 13.7% y/y (compared to 7.5% y/y and 9.9% y/y in 1998). It could be explained by a shortage of oil products in Ukraine and an administrative rise in communal and electricity tariffs in line with the IMF requirements on tariffs increase to the producers' cost level. The inflation rate started to fall towards the end of 1999, and in December CPI grew by 19.2%, while PPI 15.7% on the annual basis.

Table 1.3. Inflation and monetary aggregates in Ukraine in 1997-2001

	CPI	PPI	Monetary base		Currency in circulation (M0)		Broad money (M3)	
	y/y	y/y	UAH mil.	y/y	UAH mil.	y/y	UAH mil.	y/y
1997	10.1	5.0	7058	44.6	6132	51.7	12541	33.9
1998	20.0	35.4	8625	22.2	7158	16.7	15705	25.2
1999	19.2	15.7	11988	38.0	9583	33.9	22070	40.5
2000	25.8	20.6	16777	39.9	12799	33.6	32084	45.4
2001	6.1	0.9	23050	37.4	19465	52.1	45555	42.0

Source: NBU data.

Note: CPI and PPI are end-year percentage changes.

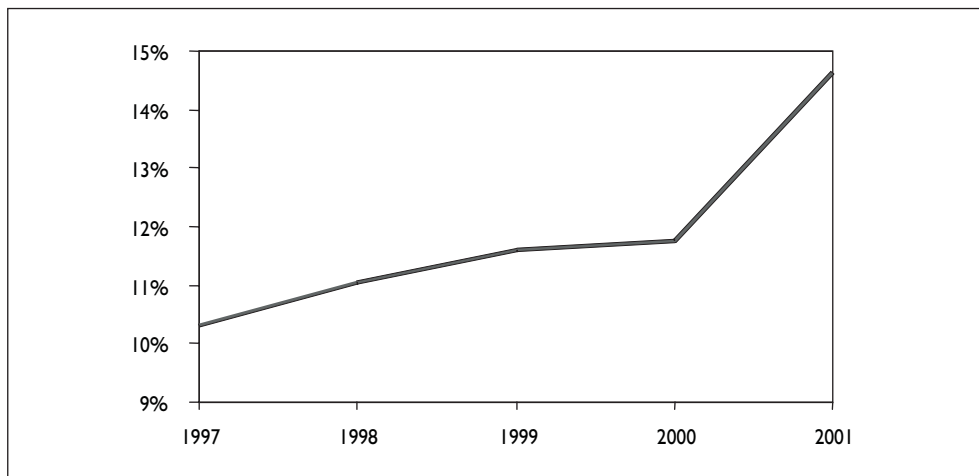
In 2000, the NBU continued conducting non-restrictive monetary policy aimed at increasing the liquidity of the banking system and its credit to the real sector. For this purpose, it decreased reserve requirements (from 17% to 15%) and diminished discount and lombard credits rates (from 45% to 27% and from 40% to 30% respectively). Such policy accompanied by the NBU's interventions in a foreign exchange market led to a 40% y/y and 45% y/y growth in money base and broad money (M3) respectively. Monetary

expansion contributed to a further acceleration of average annual CPI growth from 22.7% y/y in 1999 to 28.2% y/y in 2000. End-year CPI inflation was 25.8%. A 28.4% y/y rise in foodstuff prices recorded in December 2000 was induced partially by the poor harvest in 1999 and the relatively high demand on food and agricultural products that was stimulated by growing incomes of households. At the same time, several administrative rises in tariffs for communal and telecommunication services led to a 31.2% y/y increase in prices for services in December 2000 compared to 11.9% y/y at the end of 1999.

To stimulate further the increase of credit to the real sector by commercial banks⁴, the NBU kept its expansionary monetary policy in 2001 as well. The NBU's interventions in foreign exchange market along with the reduction in reserve requirements for commercial banks (from 14% to 6%) and of the discount rate (from 27% to 12.5%) contributed to a 37% y/y and 40% y/y increase in money base and broad money (M3) respectively. However, unlike the previous years, such increase in monetary aggregates was accompanied by lower rate of inflation. CPI increased by 6.1% in 2001, and PPI by 0.9%. This was much less than the end-year inflation for 2000 (when CPI grew by 25.8%) and 1999 (CPI grew by 19.2%). The increase in money supply was absorbed by an increase in the demand for domestic currency.

Changes in money demand in Ukraine are analyzed by looking at the level of monetization (ratio of monetary aggregates to GDP). Monetization can be considered as an indicator that reflects the degree of trust of economic agents and society into national

Figure 1.5. Monetization (M2 less foreign currency deposits to GDP) in Ukraine, 1997-2001



Source: Authors' calculations based on NBU data.

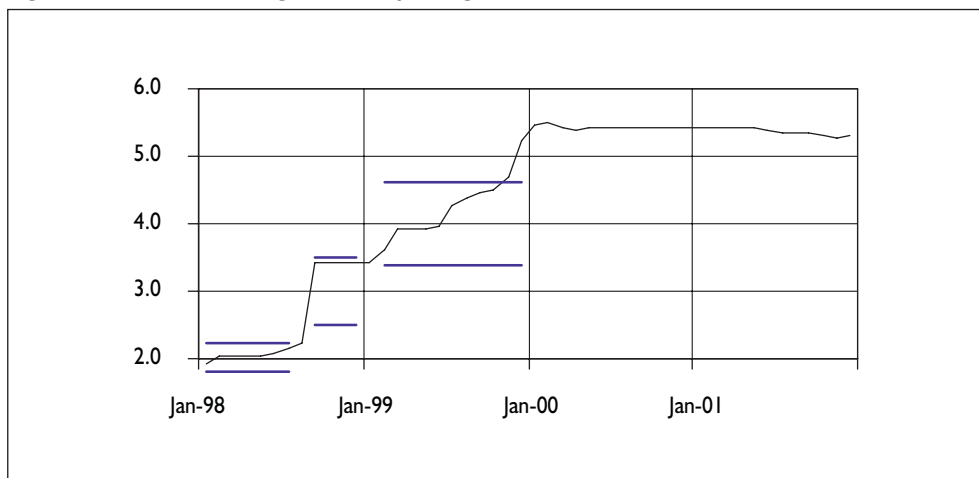
⁴ The actual rate of credit growth in 2001-2002 may prove excessive if one takes into account the limited absorption capacity of the banking and credit sectors – see Chapter 5 for the analysis of fragility of financial sector.

currency and monetary policy conducted by the central bank. Thus, an increase in monetization can be interpreted as an increase in the demand for money. A growth in monetization demonstrates the ability of the economy to absorb an increase in money supply without the pass-through on inflation.

Figure 1.5 demonstrates levels of monetization (as a ratio of broad money less foreign currency deposits to GDP) in Ukraine during 1997-2001. The first observation is that Ukrainian economy is monetized to a very small extent. Foreign currency deposits were subtracted from the M2 aggregate in order to give a better picture of the *hryvnia* demand. But even when we consider the usual indicator of monetization, that is M2/GDP, it still remains low for Ukraine. It reached the level of 22.3% by the end of 2001 (compared to 60-70% of GDP in developed countries). Nevertheless, it can be seen from the Figure 1.5 that there was a significant acceleration in the increase of the demand for domestic currency in 2001. Thus, the monetary expansion of 2001 was coupled with the considerable increase in the confidence to *hryvnia*. The high money supply growth in 2001 (52.1% y/y for M0 and 40% y/y for M3) was absorbed by the increased demand, and the country recorded one of the lowest inflation rates in 1997-2001 (6.1% y/y in December 2001). The trend of lowering inflation expectations continued through the first months of 2002, and CPI grew on the annual basis only by 2.1% in May 2002 (5.6% in January). The open question is whether the observed increasing demand for *hryvnia* reflecting higher confidence to a national currency will be sustainable in longer run.

1.5. Exchange Rate Policy

To overcome the financial crisis in August 1998 and to prevent significant *hryvnia* devaluation, the NBU introduced a number of restrictions in a foreign exchange market. In particular, it reduced a maximum allowed deviations of cash-market exchange rate from the official exchange rate, imposed a surrender requirement of 75% for export proceeds and restricted access to foreign exchange market for the so-called speculators. In 1998, the NBU's reserves went down by USD billion 1.579 to USD million 761.3. All this allowed the NBU to keep the official exchange rate at the almost constant level of UAH/USD 3.43 beginning from October 1998. Nevertheless, in 1998 *hryvnia* was devalued against US dollar by 80% (to UAH/USD 3.427), and the majority of this change took place during September 1998. Taking into account lower rate of inflation (about 20%) during the same period, it is clear that in 1998 *hryvnia* was devalued in real terms as well. This real devaluation was playing an important role in stimulating Ukrainian exports during the years that followed, which – together with import substitution – stimulated economic growth in 2000. The more detailed

Figure 1.6. Nominal exchange rate of hryvnia against US dollar in 1998-2001

Source: NBU data.

discussion on this issue can be found in Chapter 2. On the other hand, it contributed to the higher rate of inflation at the end of 1998 and 1999.

At the beginning of February 1999, the NBU announced the new band of UAH/USD 3.4-4.6 for 1999. At the same time, the NBU increased reserve requirements, striving for reduction of the speculative demand on the foreign exchange market. Following the agreement between Ukraine and the IMF, Ukraine had to abolish gradually foreign exchange restrictions. In particular, on March 19, 1999, the NBU allowed transactions on the Inter-Bank Currency Exchange, which contributed to the convergence of the official and black market exchange rates. During the first week of operations on the Inter-Bank Currency Exchange, the *hryvnia* depreciated from UAH/USD 3.76 to 3.93 (see Figure 1.6).

After expanding the maximum allowed deviations of cash-market exchange rate from official exchange rate from 5% to 10%, as the next step the NBU eliminated any remaining restrictions in this sphere. On the other hand, the NBU maintained the surrender requirement of 50% for export proceeds⁵. This contributed to the excess of the foreign exchange supply over importers' demand and the NBU obtained an opportunity to replenish its foreign exchange reserves. In 1999, they grew by USD 285.1 million and reached USD 1.046 billion level.

While in the first half of 1999 the NBU's interventions managed to maintain slight fluctuations in *hryvnia* rate within limits of UAH/USD 3.93 to 3.95, in the second half of 1999 both the domestic oil market crisis and the monetary expansion stimulated significant *hryvnia* depreciation from UAH/USD 3.95 to 4.46. Shortage of oil products led to the increase in

⁵ The NBU Board Resolution #139 "On the Introduction of Changes to the Rules of Operations on Inter-Bank Currency Exchange of Ukraine" as of March 24, 1999.

their prices and induced an increase in the demand for US dollars. At the same time, facing sharp *hryvnia* depreciation, exporters reduced the supply of foreign currency striving to make higher profits from further devaluation. As a result, the exchange rate overcame the upper margin of the UAH/USD 3.4-4.6 band and reached the level of UAH/USD 5.2 (see Figure 1.6). An introduction of the NBU's restrictions on the liquidity of the banking system and a decrease in dollar demand from the side of oil importers contributed to a gradual *hryvnia* appreciation at the initial stage. Nevertheless, during the whole year 1999 *hryvnia* depreciated by 52% (to UAH/USD 5.22). The 1999 inflation of 19% meant that the domestic currency continued to depreciate in real terms. This further stimulated import substitution and spurred the increase in Ukrainian export. As a result, in 1999 positive trade balance (USD 1.82 billion) was observed for the first time during the five consecutive years (trade deficit was usually around 3% of GDP).

An increase in Ukrainian exports (especially, in metallurgy sector due to indirect subsidizing and favorable conditions on Ukraine's traditional export markets) as well as foreign exchange inflows from privatization transactions led to a change in the exchange rate trends since the beginning of 2000.⁶ In 2000, the NBU maintained a *hryvnia* exchange rate at the almost stable level (around UAH/USD 5.44). Growing export revenues and foreign exchange inflows from privatization resulted in the excess supply of foreign exchange. At the same time, striving to prevent a decrease in Ukrainian exports due to the possible *hryvnia* appreciation, the NBU started purchasing dollars at the Inter-Bank Currency Exchange. As a result, the NBU's foreign reserves grew from USD 1.04 billion to USD 1.35 billion at the end of 2000, while *hryvnia* was devalued only by 4.18% compared to its 52% depreciation in 1999. At the same time, 25% annual inflation recorded in December 2000 reversed real exchange rate trend from real *hryvnia* depreciation to its real appreciation.

In 2001, Ukraine experienced a significant inflow of foreign currency (in a form of large export earnings and increased amount of financial transfers into Ukraine in the eve of the parliamentary elections). As in the previous period, foreign exchange supply exceeded demand. In the first half of 2001, significant foreign exchange supply was stimulated by the expected shift from origin to destination principle of VAT in Russia's trade with Ukraine (beginning from July 1, 2001). Trying to avoid negative effects of the new mechanism, the exporters increased their supplies to Russia and tried to meet their quotas (on products of metallurgical sector) during the first half of 2001. Imposition of administrative restrictions on the foreign exchange market allowed avoiding the panic accompanied by the growth of speculative operations that were caused by the New York tragedy in September 2001. At the same time, revenues from agricultural exports of new harvest and foreign exchange inflows from abroad that were associated with financing the parliamentary election campaign

⁶ Average daily volume of transactions on the Inter-Bank Currency Exchange was amounted to USD 30-40 million; and so, even a slight change in either output volumes or prices in export-oriented sectors strongly affected the *hryvnia* exchange rate.

could be considered as factors that stimulated an increase in foreign exchange supply during the second half of 2001. In general, the excess of foreign exchange supply over demand made it possible for the NBU to enlarge further its foreign reserves. As a result, at the end of 2001, the official NBU's foreign exchange reserves reached the record level of USD 3 billion. At the same time, the NBU allowed for nominal *hryvnia* appreciation by 3% (to UAH/USD 5.27) contributing to further strengthening of the real exchange rate.

From the analysis of monetary and exchange rate policies, it is clear that, notwithstanding continued monetary expansion in 1999-2001, inflation went down in 2001. Growing money supply was absorbed by increased confidence to the domestic currency (stable exchange rate and economic growth were probably the most important factors here). As to the factors that contributed to this economic growth, the post-crisis devaluation and hence real depreciation of *hryvnia* were driving the 1999-2000 exports expansion. However, real appreciation of *hryvnia* in 2000 and 2001 demonstrated that future economic growth in Ukraine would depend more on improvements in productivity than on price advantages due to a real depreciation as it was observed earlier.

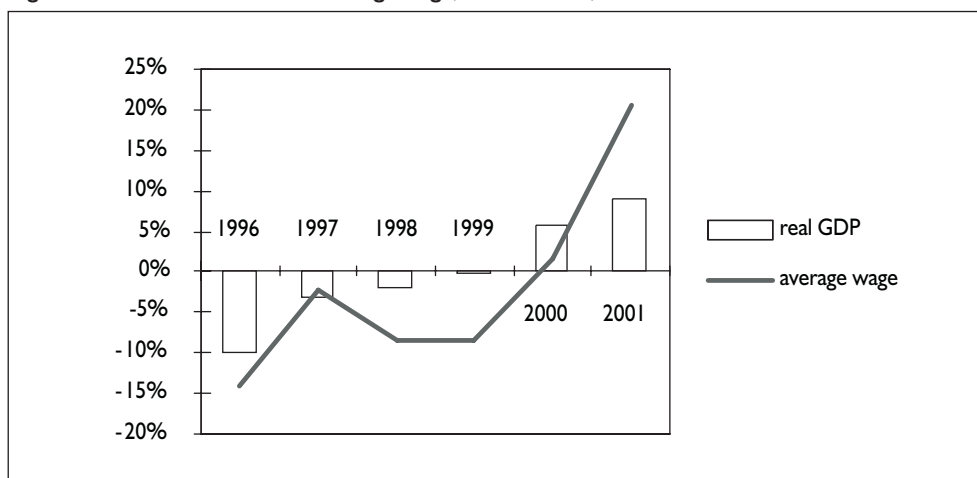
1.6. Labor Market Developments and Incomes of the Population

Labor market adjustments in the 1990s followed the pattern typical for a CIS economy. Decline in employment was significantly smaller than the fall in production and labor demand. This was not the actual employment that absorbed the shock connected with the collapse of the centrally planned economy, but lower real wages, together with growing wage and pension arrears. As a result, the ratio of employed to the working age population remained practically unchanged. Unemployment rate dynamics have not been moving together with output.

The similar pattern prevailed after the 1998 currency crisis. Neither the actual employment, nor its structure changed significantly during 1998-2001. These were mainly movements of wages that absorbed the shock and the catch-up that followed. The number of employed⁷ to the working age population was gradually falling throughout 1996-2000, and was unresponsive to changes in overall economic conditions. Employment in agriculture accounts nearly for 30% of official total employment, and employment in industry has a slightly higher share. The rest of employment is accounted for services and people working in other sectors of the economy.

Unemployment rate that stabilized in 1999-2000, decreased a little in 2001, and according to the employment office records, was 3.7% at the end of 2001. However,

⁷ Officially registered.

Figure I.7. Growth of GDP and average wage, in real terms, 1996-2001

Source: State Statistic Committee.

findings from the Labor Force Survey suggest that the true unemployment rate is much higher, and that in 2001 it was on average above 10%. The still existing discrepancy between the two numbers indicates the persistence of hidden unemployment and shadow labor market. The hidden unemployment may take various forms, such as shortened work days, unpaid leaves, and partial employment. The unemployment benefit – although increased from 50 UAH per month on average in 1999 to 85.23 UAH in 2001 (which is less than 16 USD, without taking into account purchasing power differences) – is still very low, and it does not create enough incentives to become registered as unemployed. Instead, people still prefer to be registered as employed, benefit from the ‘employed’ status, and use their free time to engage in unofficial activities (Zhurzhenko, 1998). Data on unemployment suggest that we still have the situation where the significant part of the population supplements its official income with the secondary, informal job, revenues from which are often higher than from the ‘registered’ occupation.

The other important issue associated with Ukrainian labor market is labor migration. It was estimated, that the total number of labor migrants from Ukraine was no smaller than

Table I.4. Employment, labor force, unemployed, 1996-2001

	1996	1997	1998	1999	2000	2001
Employment (in thousands)*	20868	19835	19415	18790	18063	-
Employment/working age population	73.2%	70.0%	68.8%	66.3%	63.5%	-
Officially registered unemployment rate	1.6%	3.1%	4.8%	5.8%	5.8%	3.7%
Labour Force Survey unemployment rate	7.6%	8.9%	11.3%	11.9%	11.7%	10.3%

Source: State Statistic Committee, own calculations.

Note: * - Annual average, excluding self-employed.

one million of persons in 2000 (Libanova, Poznyak 2002), which was equal to 4.3% of the economically active population (aged 15-70). The majority of migrants (81%) declared to hold no constant work in Ukraine at the time of their migration, and only 7% of them were on unpaid leave. The migrants were mainly young people with some working experience (30-34 age group was most frequently represented), with secondary education, and coming from rural areas. More than one half of them traveled to Western and Central Europe (among them 1/3 to Poland, then to the Czech Republic and Italy), and over 1/3 to Russia (mainly older workers).

1.6.1. Incomes of the Population

Total reported incomes of the population amounted to nearly 109 UAH billion in 2001 (61.9 UAH billion in 1999). Although their growth during the last two years was significant, their structure has practically not changed. Around half of this comes as a revenue from employment, and next 21% (in 2001; 25% in 1999) is accounted for by pensions. Sale of foodstuffs – that increased during last three years – and falling incomes from the sale of foreign currency represent around 5% of total incomes. The rest – 15-20% is classified as ‘other income’.

Real incomes of the population started to grow (at the annual basis) in the first months of 2000, and in 2001 they were already higher in real terms than in the crisis year of 1998. After falling by 1.6% in 1998 and by 9.1% in 1999, they grew by 9.6% in 2000 and by 12.4% in the following year. The largest growth impulse came from the earnings from wages and salaries, then from the income from the sale of agricultural products, and in 2001 even real incomes from pensions and stipends rose. Income from foreign currency sales was still falling in real terms in 2001, indicating gradual de-dollarization of the economy.

There is the hypothesis saying that the growth of incomes of the population has been highly stimulated by the repayment of wage and pension arrears. And that it gave a strong growth impulse to the domestic industries producing ‘first-need’ commodities. The argument was supported by the fact that around $\frac{3}{4}$ of the population income is spent on the purchases of goods and services. However, when we look at the aggregate figures, it comes out that the repayment of budgetary social arrears was only a fraction of the total income of population from wages, pensions, and the like (around 2% on average during 1999-2000). Also the nominal increase in income is explained in major part by other factors. Even in 1999, the repayment of social arrears was not able to provide a strong enough impulse for the growth of real incomes. Thus, the repayment of these arrears, although contributed directly to the growth of incomes, played rather a minor role.

It is also worth noticing that the relative size of unreported incomes of the population shrank in 2000. It probably reflects the decline of unregistered economic activity in the

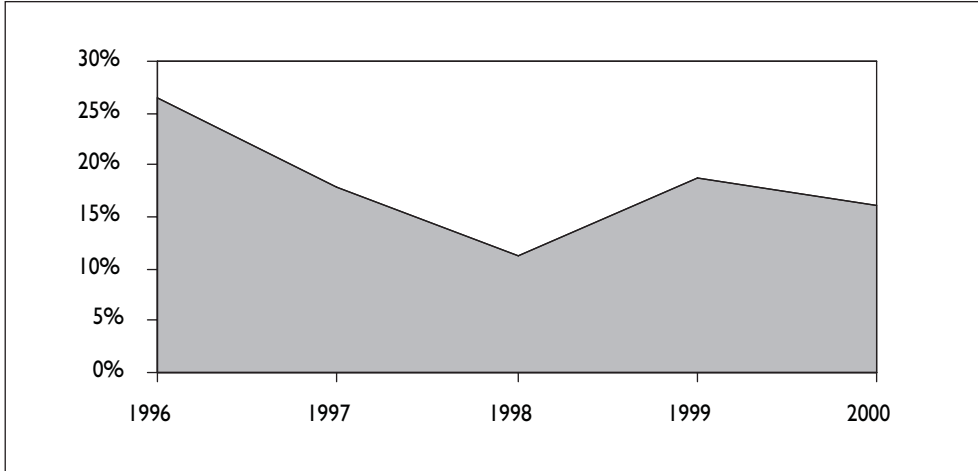
Table 1.5. Incomes of the population and repayment of budgetary social arrears, 1998-2001

	1998	1999	2000	2001
Total incomes (UAH mil.)	55 322	61 865	86 859	108 835
Real growth (in %)	-1.6	-9.1	9.6	12.4
Repayment of budgetary social arrears* (UAH mil.)	-	816	1 607	773
in % of nominal income growth	-	12.5	6.4	3.5
in % of nominal growth of incomes from wages, pensions, stipends, etc.	-	12.5	11.0	4.2

Source: State Statistic Committee and Ministry of Finance, own calculations.

Note: * - Difference between social arrears of the consolidated budget at the end and at the beginning of a specified period.

household sector. The reasoning that stands behind this argument is as follows. If we compare total incomes of the population with household consumption, it turns out that registered incomes are significantly lower than the value of consumption. This situation occurs because people do not report all their incomes, but these amounts are nevertheless counted when being spent, as household consumption expenditure⁸. Therefore, if we estimate household savings, and add it to the household consumption, we obtain the

Figure 1.8. Difference between estimated disposable incomes and reported incomes of population, in % of official consumption of households, 1996-2000

Source: CASE estimates on the basis of data from State Statistics Committee of Ukraine and NBU.

Note: Disposable income of households was calculated by adding household consumption expenditures and the estimate of household savings. Savings were calculated as a sum of change in the amount of cash (UAH and hard currency, the latter estimated as the difference between purchases of foreign currency by households and people's income from foreign currency sales) and household deposits, change in the amount of household credits, and household investment in fixed assets and change in inventories from NA. For the year 2000, it was assumed that household saving rate was equal to the 1999 rate, i.e. that it was 5.6%.

⁸ In National Accounts.

estimate of the disposable income of households, which can be then compared with 'total incomes of the population' as reported by the State Statistic Committee. This difference – between the approximation of disposable incomes of the population and reported incomes – is shown in the Figure 1.8. The 'income gap', expressed in terms of household consumption, was falling up to 1998, grew in the post-crisis year of 1999, and narrowed again in 2000. Thus, the unregistered economic activity of the household sector decreased in 2000 as compared to the previous period.