



United Nations Development Program

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POLICY OF MACROECONOMIC STABILISATION OF UKRAINIAN ECONOMY IN THE SHORT- AND MEDIUM RUN: SOME RECOMMENDATIONS

1. Worsening of macroeconomic situation in Ukraine: the diagnosis

Compared to 2000-2003, at the end of 2004 and in 2005 the macroeconomic situation in Ukraine worsened considerably in several respects:

The government budget balance increased from a net deficit of below 1% of GDP (2000-2003) to 3.3% in 2004 and a projected 4% in 2005. This means for the primary budget balance (= net budget balance exclusive of interest payment) a swing from a primary budget surplus in the period 2000-2003 to a primary budget deficit of 2,4% of GDP in 2004 and 3,2% of GDP in 2005. If this swing is not going to be reversed, the government debt/GDP ratio will increase in the medium run.

The inflation rate, measured by the GDP deflator or the consumer price index, from 2004 on has reached again a double-digit number. The circumstance that the consumer price index has increased less (around 12% annually) than the price index of GDP (15% in 2004, more than 16% in 2005) is due to imported consumer goods becoming relatively cheaper compared to domestically produced goods and services because of a stable dollar exchange rate.

Though the weaker dollar (in particular against the euro) at a fixed UAH/USD rate (until 2004) implies some nominal depreciation of the UAH (the revaluation in 2005 tried to correct this somewhat), the significantly higher Ukrainian inflation rates have resulted in a real appreciation of the Ukrainian currency. This real appreciation has damaged the competitiveness of Ukrainian producers at home and abroad. This is one of the reasons why the Ukrainian trade balance and balance of payments on current account have worsened significantly in 2005.

The real appreciation of the UAH, however, has not been the only reason for the deterioration in Ukrainian net exports (= gross domestic savings minus gross domestic investment). The generous rise of public sector wages, the minimum wage and social transfers – a kind of ex post inflation indexation – not only contributed to higher government budget deficits but also to a short-run increase in private disposable incomes. The resulting increase in aggregate consumption flowed mainly into the demand for imports. Therefore the multiplier effect on domestic GDP was weak, and a significant drop in gross domestic savings resulted that, in turn, led to a fall in net exports (trade balance).

The fall in net exports, was combined with a weaker development of gross domestic investment (also government investment), whose ratio in GDP dropped from 22% in 2003 to 19% in the first half of 2005. A similar situation occurred with FDI whose share in GDP went down from 2.6% in 2003 to 2.1% in 2005. The worsening in the development of domestic and foreign investment was closely related to an increase in investment risks due to political mistakes made by Tymoshenko's government, in particular starting the re-privatisation campaign. These factors exerted a significant negative effect on aggregate domestic (effective) demand. This is the main explanation for the sharp drop in the growth rate of real GDP in 2005 (which declined from 12.1% in 2004 to 2.8% in September 2005).

2. What to do? Some recommendations for the short- and medium-run

2.1. *Disinflation should become the primary focus of the monetary policy*

A further appreciation of the real exchange rate should be prevented by allowing the nominal exchange rate to depreciate at a rate equal to the inflation differential (vis-à-vis the USD). However, a more aggressive depreciation ought to be avoided since it would amount to a negative supply shock (by making imported productive imports relatively more expensive), resulting in reduced output and increased prices. Furthermore, a significant depreciation would increase the external debt/ GDP ratio, which would be highly unwelcome.

The first priority has to be given to disinflation: In 2006, the GDP inflation rate has to be brought down to the single-digit range. This is possible without a significant loss in output and employment if, and only if, the government is able to commit itself credibly to such a strategy.

One pillar in an effective strategic commitment to disinflation would be an operationally independent central bank which would publicly agree with the government on a medium run (two-year average, e. g.) inflation target, for which the government takes the political responsibility, while the central bank has the operational freedom to use all the necessary instruments to reach the target and is held accountable for its policy.

2.2. *A serious fiscal adjustment towards a sufficient primary budget surplus and a sustainable (i.e. constant and sufficiently low) government debt/GDP ratio is needed for combating inflation*

Central bank independence is, however, not sufficient to achieve disinflation after the inflation rate has already reached the double-digit range. At high inflation rates, inflation becomes increasingly driven by inflation expectations. Economic agents (workers and firms) expecting higher inflation rates try to set the prices for their services and products at least as high in order to protect their real position. With high and increasing government debt/GDP ratios, in particular primary deficit/GDP ratio, which signals increasing government debt/GDP ratios for the future, the main source of inflationary expectations, is the government fiscal position. The higher the primary deficit and the debt/GDP ratio are, the stronger is the incentive to "monetize", i.e. inflate away, the debt and to put political pressure on the central bank to go along ("fiscal dominance" of monetary policy)¹. It is obvious that exactly this is already happening in Ukraine. Therefore, the fundamental task is a serious fiscal adjustment towards a sufficient primary budget surplus and a sustainable (i.e. constant and sufficiently low) government debt/GDP ratio.

In the short run, the deficit has to be financed. Previous governments tried several tricks in order to achieve a short-term increase in budget revenues or decrease in expenditures including the

¹ If at a given inflation rate the debt/GDP ratio increases, higher inflation by increasing the nominal value of GDP would temporarily reduce it (the debt/GDP ratio). Therefore allowing higher inflation might be in the short run political interest of the government. Since the private economic agents understand this political motive of the government, they increase their inflationary expectations, which, in turn, lead to acceleration of actual inflation.

following (i) an artificial increase in budget revenues by not refunding VAT, (b) administrative pressure on taxpayers for making advanced tax payments, (c) offset operations with the private sector and between the main administrators of budget funds, and (d) transferring expenditures of the current period to next periods.

Privatisation proceeds are not part of the primary budget surplus. They are, however, helpful in the short run to keep temporarily the debt from growing too fast. In addition, apart from fiscal consideration, they contribute to a progressive private sector development. Therefore, successful conduction of the privatisation deals is important both for the fiscal results of this year and for creating a basis for economic growth in the medium run. Completed tender on privatization of the Kryvorizhstal mill (notwithstanding the parliament passed the resolution that banned it), seems crucial from this perspective.

Success of the concluded privatization deal is important both for the fiscal results of this year and for creating a basis for economic growth in the medium run since it helps the government to fill a fiscal gap that emerged recently due to the undertaken increased social obligations. Moreover, extraordinary financial outcomes of the privatization deal will result in budget surplus worth UAH 14 billion ². At the same time, it is important to take into account that, this deal might increase the risk of serious macroeconomic imbalance, since it implies an anticipated mass inflow of foreign exchange worth US\$ 4.8 billion that will exceed annual earnings from the net export and current transfers. The National Bank will have to utilize this supply by either its redemption (that means a sharp growth of money supply resulting in acceleration of the domestic inflation) or its sterilization by letting the Hryvna exchange rate to appreciate significantly (that will damage heavily the competitiveness of Ukrainian producers at home and abroad).

Not surprisingly, there are growing highly populist appeals to spend proceeds from privatization for the increased social transfers or to compensate lost savings of the population in USSR's Savings bank. The Ukrainian legislation stipulates that budget surplus can be spent only on repayment of state debt. In practical terms, it will mean the reduction of public sector debt from the estimated 20% to 16% of GDP in 2005 as well as the reduction of burden of debt service from estimated 0.7% to 0.6% of GDP next year. The government could also study a possibility to repay its hidden liabilities to private sector and population. Clearing the overdue arrears in VAT refund might be an important step in improving investment climate, since it will signal to private sector the willingness of the government to ensure security of property rights also in the area of fiscal relations between the state and private agents. Another important issue that might be solved with the help of privatisation receipts is eliminating the debt on social transfers to Chernobyl victims. This step will increase confidence of the population in social-oriented government policy.

2.3. Mid-term fiscal adjustment is necessary

In the medium run (which begins in 2006!) fiscal adjustment is necessary, i.e. measures affecting both the revenue and the expenditure side of the government budget which increase the primary surplus/GDP ratio. Theoretical analysis and empirical research on experience with fiscal adjustment programmes (in OECD countries, emerging market economies, and transition economies) show that successful fiscal adjustments ("successful" in terms of the real GDP growth rates and employment records afterwards) rely mainly on reductions in public consumption expenditure (i.e. public sector wages) and in social spending. Tax rates on income, profit and wages should not be raised. On the expenditure side, government investment in infrastructure should not be cut (but may be complemented by public-private partnerships). Cuts in the public sector payroll should not be brought about by a general cut in the public employees' salaries. Salaries in the public sector ought to become competitive with those in the private sector in order to reduce the extent of corruption – which is one of the most damaging obstacles to growth – and to increase labour productivity in the public sector. The necessary cuts in the public sector payroll have to be achieved by reducing the number of public employees and making the state leaner and more efficient. The cuts in social spending will have to be combined with targeting welfare benefits to the poor (while abolishing

² Net additional proceeds from privatization that take into account planned fiscal deficit of UAH 6.9 billion and UAH 4.8 billion of funds to be returned to previous owners of the Kryvorizhstal mill.

government subsidies for goods and services), and setting up a capital-funded health and pension insurance system.

In the short run, the government should refrain from accepting new social obligations that are not supported by additional regular budget revenues. Increase of salaries in public sector should be limited to indexation of inflation.

3. Improve investment climate by ensuring security of property rights and pushing forward deregulatory activities

In order to resume high rates of economic growth efforts in macroeconomic and fiscal stabilization should be supported by a considerable improvement of investment climate.

In the short –run (before the parliamentary elections) the new government has an opportunity to improve investment climate in three major respects, namely correcting mistakes associated with re-privatization and overnight abolishment of free economic zones, and pushing forward deregulatory activity so that its results are transferred into the lowering of regulatory pressure on business. Though the effect of these measures might not be seen immediately, they are very important for the development of investment activities and growth perspectives of Ukrainian economy in the medium run.

3.1. Re-privatization campaign should be stopped and privatization process has to continue.

First steps in the right direction have been already undertaken. It is important to avoid inconsistency and contradictions between the different branches of power in pursuing the goals and ensure that good intentions receive proper implementation:

- Prime Minister Yekhanurov announced the government's commitment to limit the revision of privatization deals to a small number of cases and to settle the issue on the basis of amicable agreements. However, this intention as such does not close the debates on the scale of revision, in particular on the regional/local level. Therefore, it should be backed by **granting amnesty to the major part of privatization deals** except for select cases, where legitimacy of privatization is to be determined by courts. Ensuring transparency and political independence of courts is of crucial importance.

- Privatization tender on Kryvorizhstal mill was completed. However, attempts of the parliament to leave Kryvorizhstal and other attractive privatization stakes in the state ownership raises great concerns about the perspectives of Ukrainian privatization and security of private property rights. **Development of a convincing privatization strategy for the medium run seems crucial for gaining investors' confidence.** However, this process seems to be stalled. Absence of the privatization program with clear goals and instruments is complemented by the postponement in adoption a new law on the State Property Fund. Meanwhile, confusing signals are sent to the investors concerning the privatization plans. Though recently the President proposed several state owned enterprises to be included in the privatization plans for the coming years, the parliament voted for retaining these enterprises in state ownership. This signals the absence of a consolidated political will to continue privatization. The development of privatization strategy for the medium run is an urgent issue. It could be viewed as a commitment of the state to use privatization as an instrument to develop private sector rather than just a mean of financing fiscal deficit. Besides, it would have the welcome effect of reducing the number of public employees in the public sector at large.

3.2. Violation of investors' rights during the abolishment of free economic zones should be carefully reconsidered.

Levelling the tax burden and cancelling tax privileges has a sound economic justification, since it produces a level playing field for all the investor. However, the investors considered the unexpected change of economic rules that took place last spring as a violation of their rights, since their investment plans accounted for the privileges granted by the Ukrainian government for a limited period. Reconsideration of this issue will signal government's commitment to respect property rights. There two ways to deal with the problem. One is to give back the cancelled privileges and wait until

FEZ “contracts” are over. In this case, the danger of lobbying the prolongation of contracts (or signing the new ones) in the parliament is rather high. The other way is to stick to the decision not to have special tax privileges in the form of free economic zones any more, and to design a special mechanism to compensate (fully or partially) the losses of the investors whose privileges were cancelled. Importantly, this mechanism should use more market-oriented instruments than the previous system (e.g. offering tax credit instead tax waving), offer compensation schemes spread over time, and contain the procedures that are unified for all the investors. This approach will reduce the danger of reviving old practices of more or less uncontrolled granting of numerous tax privileges. Moreover, some of the compensation instruments, after appropriate re-shaping, might be further used for providing investment incentives. It is important that the development of compensation mechanisms goes along with the adoption of the Law on State Aid that is expected to provide a regulatory framework for granting state support.

3.3. Push forward deregulatory activities.

Quick revision of over 9,000 regulatory acts initiated by the President in June 2005 has brought its first outcome: Over 4,000 regulatory acts have been selected for the abolishment or changing in order to comply with the principles of regulatory policy. This helps to clean the regulatory environment from the outdated acts. Moreover, this initiative pushed forward the establishment of the dialogue between the state authorities and civil society and contributed to the increase in transparency of the state. However, the substantial reduction in regulatory pressure is not yet reached. At this stage, it is important to invest additional efforts in deregulation process so that two goals are reached. The first one is to proceed from the revision of regulatory acts to the revision of legislation with respect to its compliance with the requirements of the principles of regulatory policy. This will help to achieve a perceivable reduction in regulatory pressure and increase confidence of the entrepreneurs in government’s commitment to improve business climate in Ukraine. Another goal is to turn the deregulatory initiative (which is perceived by some bureaucrats as a short campaign) into a normal day-to-day working procedure that ensures implementation of principles of regulatory policy. This requires a substantial investment in capacity building of both the representative of regulatory authorities and civil society.

There are another two important issues that could considerably improve investment climate in Ukraine. It is an adoption of the Law on Joint Stock Companies and an abolishment of the Commercial Code with a simultaneous re-shaping of Civil Code. Though implementation of these measures before the parliamentary elections is highly unlikely, it is important at least to keep them high on the political agenda.

4. Adopt the Law on the Cabinet of Ministers and enhance government’s capacities for policy coordination.

The success of the efforts aimed at macroeconomic stabilization highly depends on the level of government’s commitment and ability of policy coordination. Present (and future) government should avoid the mistakes of the predecessors who worked without a consistent and well-coordinated strategy as a fire brigade.

As a consequence of political reform, in January 2006 the role of the prime minister and the government in conducting economic policy will increase. This means that potential negative effects of uncoordinated policies will also rise. Therefore, radical steps in reforming public administration have to be taken without further delay. The most urgent ones include conducting functional revision of the ministries.

Greater accountability of all central executive bodies to the Cabinet of Ministers is the issue of utmost importance. One should be aware that it has a direct connection with the budgetary process, since the effective implementation of fiscal adjustment requires institutional arrangements supporting budgetary discipline. The following elements of the budgetary process are critical:

- A strong emphasis on numerical budget targets negotiated among all members of the executive at the beginning of the annual budget cycle and regarded as binding for all spending ministries; preferably, these targets ought to be backed up by multi-annual fiscal programs;

- A finance minister vested with strong monitoring and enforcement capacities in the implementation of the budget;
- Strong monitoring capacities of parliamentary committees overseeing the activities of the spending ministries;
- Transparency of the budget to promote accountability and facilitate monitoring of all agents involved in it.

5. Accelerate international economic integration

The prospects for accessing WTO before the end of 2005 are rather deem. However, accession issue should remain among the top short-term priorities of the government. The efforts should be made to consolidate political will of all branches of power in order to adopt all remaining WTO-related legislation before the new elections. After joining WTO, export oriented sectors of Ukrainian economy would get immediate benefits from the extended opportunities on the external markets due to the removal of trade barriers and would be able to withstand competitive pressure on the external markets more effectively.

The short run effect from joining WTO should not be overestimated, since Ukraine has already signed agreements on trade cooperation with the most f its trading partners that enables MFN treatment. At the same time, Ukraine can get significant benefits from getting market economy status (e.g. avoiding of anti-dumping investigations). This task is achievable before the end of 2005 and should be pushed forward.

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