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THE SHORT AND MEDIUM-TERM IMPACT OF POLITICAL INSTABILITY ON UKRAINE'S ECONOMY

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The study has been made in the framework of the CIS strategic project based on the agreement between the Hungarian Prime Minister's Office and the Hungarian Academy of Sciences.

As expected before the extraordinary parliamentary elections, Ukraine has yet to obtain the desired degree of political stability, first of all because the representation of this country's political forces has remained almost unchanged in the current Parliament, but with a smaller reserve of stability. There was an adequate majority behind the political forces in the former coalition, though it was diverse in its political ideology. This guaranteed a solid majority in Parliament, even if some deputies were absent. This is not the case with the three-vote majority for the BYT/NU–NS coalition in the new Parliament, which appears in many cases to be insufficient. The situation will call for further compromises of kinds that remain far from being evident, apart from the familiar ideas about the need to unite East, West and South, and the almost identical social commitments of all parties, whose consequences are discussed later in this paper. The latter is a crucial issue, economically and politically, and calls for separate assessment.

The Ukrainian political establishment faces at present three possible scenarios. The first is to attempt to find a consolidated course of action, agreed on by most of the political heavyweights. This will need above all political concessions and moderation of the existing social commitments, which will otherwise continue to be made until the presidential election is held in 2009. The second is a scenario of stalwart opposition, which could even lead to another early dissolution of Parliament, if it proves unable to function. The third is an intermediate scenario assuming that further early elections will bring a political catastrophe for those whom the voters blame for the political instability. So it cannot be ruled out that the situation will remain fragile after the 2009 presidential election, with most major political forces pursuing their own partisan interests. There will be various negotiations over this or that agreement, and the parties will vote either according to the situation or on the basis of political agreements reached and in the context of the 2009 electoral campaign. The third scenario seems the most likely, which means that the political situation will remain unclear in many respects for another two years. Stability can be expected only after the presidential election and the associated changes in the country's Parliament, which will be free to review the Constitution and create new constitutional mechanisms to build the foundations for future stability.

The economic consequences of these forecasting processes are rather complex, and so are the medium-term prospects for Ukraine's economy. Despite some political disorder, Ukraine has actually been quite successful economically over the last four years. Despite a sharp fall in the growth rate in 2005 and a marked increase in inflation (now exceeding 10 per cent), the average annual rate of growth since 2000 has been around 7.5 per cent. So the political disturbances that led in 2004 to a serious political crisis have not made a serious impact on economic growth. Ukraine's economy has quietly survived the sugar, petrol, bread, and most recently gas crises that appeared periodically against the background of political unrest. The most serious for the economy was the gas-price rise from USD 50 to USD 130 per 1000 cu. m., which had an obvious political dimension as well. But Ukraine's economy appears to have been well prepared for such changes, although the present gas prices are still much lower than market prices in a European sense. There are grounds for thinking that Ukraine may enjoy comparatively stable future development, despite some aggravations to be expected in the very near future, but there is no excluding the possibility that the economy's stability and potential for growth may prove insufficient to support further high rates of growth in the short and medium term.

Based on these considerations, this paper is built up as follows. First comes discussion of scenarios and medium-term forecasts for the development of Ukraine's economy, assuming no acute deterioration in the political situation for domestic or external reasons. Then comes an assessment of possible economic developments resulting from major reorientation of public expenditure towards welfare purposes, resulting from political commitments made by all political parties now represented in the Ukrainian legislature. There is also discussion of the possible economic consequences of such a change of course in relation to various external factors, above all the sharp increase in gas prices, as there are certain economic and political indications today that such a course of events may ensue. These two factors, in fact, may greatly destabilize the economy, so that it is advisable to deal with them separately and highlight the possible outcome of them.

The scenarios derived from the forecasts and analyses lead to a definition of the basic strategy as one that is investment-intensive and designed to improve the country's competitiveness, assuming there are no serious destabilizing processes at work.

In that case, the period 2007–15 may mark an important stage in the acceleration of the country's economic and social development, through progressive economic restructuring, deeper foreign integration, and considerable improvements in the functioning of market institutions and deregulation policy. If that is not the case, Ukraine will drift towards a pattern of fully dependent economic development, with continual aggravation of the social contradictions. So the target must be to create conditions for efficient, rapid economic growth based on investment and innovation, to ensure structural and technological modernization of the economy and a steady increase in the wellbeing of citizens. This target, in fact, sets the main line of the state's economic policy. In the basic scenario, it is assumed that economic growth will increase from late 2007 through to 2015, at the cost of economic restructuring, innovation investment, growing competition on domestic and foreign markets, and transformation of the flow mechanisms capital and labour, so promoting more efficient use of the factors of production.

External assumptions

It is assumed that new tendencies in the world economy will put mounting pressure on the developed countries, causing increasing international competition. There will be a comparatively slow increase in gas-import prices, but oil prices will continue to increase in 2007–15, which could bring a considerable loss of competitive advantage for this country's energy-intensive economy, along with a fall in exports and hence GDP growth rates and a simultaneous increase in domestic prices. The negotiations for Ukraine to accede to the WTO will be completed. The market for Ukraine's exports will ease, which could restrict the growth potential of the economy and reduce hard-currency earnings by exporters. There will be a gradual shift from an export-oriented economic pattern to one of modernization and expansion of the domestic market.

Domestic assumptions

The real sector (2007–15)

For the *2007–9* period, the following predictions are made:

* The new government and the corporate sector will aim towards an inno-

vation and investment-based model that will lead to increased demand for scientific and technological, educational and investment services. There will be a moderate increase in the energy component of expenditure in the service sector, especially transport. There will be trade-offs between higher prices for public utilities, the ability of households to pay these, and the profitability of producers and investors.

* Investment spending will move towards medium-term budget funding and priority realization of budget-funded programmes. Such expenditures will be directed primarily to energy saving and efficient use of energy resources (bringing in the longer term some reduction in the country's energy dependence), and realization of government innovation initiatives.
* Ukraine's attainment of market-economy status in the EU and the United States would create conditions for reducing exporters' losses from anti-dumping restrictions (in particular, through revision of anti-dumping duties on imports of Ukrainian goods). These developments would support foreign trade activities in 2008–15.
* The inflation rate in 2007–8 is forecast to be 12–14 per cent (from December to December). This will be due to higher energy prices, which will not lead to crisis thanks to gradual adaptation by firms to the new realities, but it will reduce their profitability and dampen the growth of energy-intensive activities, above all chemicals, metallurgy, and adjacent sectors that consume the output of these. At the same time, a higher inflation rate will result from excessive welfare expenditures in 2004–7, along with uncontrolled expenses on electoral campaigns, large increases in borrowing, especially by corporations and banks, and increasing transfers home by workers abroad, all of which will speed up growth in the money supply. Pessimistic forecasts put the inflation rate at over 15 per cent by late 2008, due to such factors as increases in production costs in 2007 (relating to the increase in energy prices in 2006 and increased payroll costs), further rises in food prices, notably because of the poor harvest in 2007, higher rail fares and public-utility rates, and corresponding multiplier effects.

The main prediction for *2010–15* is an increase in investment, as the decisive factor behind economic growth, and support for stable output dynamics. This will be conditioned by the following developments:

* Ukrainian producers will need to innovate and ensure a vigorous revival of their fixed capital, due to more severe domestic competition after WTO accession and stronger orientation towards EU accession, against a background of reviving integration processes in the post-Soviet area.
* There will be an introduction of energy-saving technologies (above all in the energy-intensive sectors of metallurgy, chemicals, heavy machinery and construction) and stronger modernization in the infrastructure sectors.
* There will be an expansion of mortgage credit to support housing construction on a large scale.
* There will be a stronger inflow of FDI, mainly due to the expanding domestic market. This increase is expected to be USD 6500 million in 2009. There will also be an increase in "long" resources on financial markets, with the expansion of household savings and non-governmental pension funds.

Meanwhile the development of investment activity will be curbed by comparatively high inflation, bringing higher interest rates on financial markets and appreciation of foreign resources for non-government borrowing. The forecast for 2010–11 will be an investment growth rate of 10.2–12.1 per cent, slowing to an annual 7.5–9.3 per cent in 2012–15.

GDP growth (projected at an annual 6.8 per cent in 2009–11, increasing to 7.2 per cent in 2012–15) will be improved by a greater Ukrainian presence on foreign markets and an increase in the capacity of the domestic market, with simultaneous restrictions of exports of finished goods. The basis for such a growth will be structural changes producing a considerable increase in the production of goods with a high value added, along with faster development of certain service sub-sectors, such as business, computer, scientific and engineering services.

As real development rates rise, inflation will ease – at the expense of technological progress, which will cheapen production costs (in particular, the energy component of them), and through saturation of the domestic market with domestic goods, provided there is consistent inflation targeting.

During the forecast period, some Ukrainian workers presently employed abroad will return to the domestic labour market. This trend will be supported by higher rates of economic growth, higher incomes inside the country, and economic restructuring that raises demand for highly qualified workers. On the other hand, low birth rates will tend to aggravate the general shortage of labour, leading to an influx of foreign workers. (These in the main will be workers from the third world willing to work for lower rates of pay than those found in Western countries.) This means there will be a considerable change in the balance of labour flows and a decrease (after 2010) in the overall positive balance of money transfers.

In the basic variant for the development of the services sector in 2008–15, the assumptions are these:

So long as the government and businesses follow a course towards innovation and investment-based development, to promote an increase in demand for scientific and technological, educational and investment services, the expected increase in R & D expenditures will be 3 per cent of GDP by 2010 and 3.5–4.0 per cent by 2013. (The latter was Sweden's level in 2004.) Simultaneously, there will be an increase in earned royalties and licence payments. Ukraine in 2004 earned USD 0.9 in per capita royalties and licence payments. (The figures were USD 1.5 for Russia, USD 54.2 for Ireland, USD 0.384 for Sweden, and USD 178.2 for the United States.)

There will be improved welfare standards, or at least no decrease in the share of expenditures (percentage of GDP) on education, health care and defence, relative to 2005–6.

There will be some fall in the GDP share of the services sector in 2008–9, due to the following factors:

* Renewed growth rates in other sectors.
* A decrease in the relatively high service efficiency, due to renewal of material support of non-market services.
* A decrease in the role of transport services, whose expansion would require considerable investment, time and agreements with other countries.

In the basic scenario, the share of services in GDP in 2015 may be 59–60 per cent (discounting construction services). In the optimistic scenario, it will be 61–3 per cent.

Monetary policy in 2007–15 will be determined by the following:

* The National Bank will follow a reserved (flexible) monetary policy, balance money supply and demand and ensure macroeconomic stability. The increase in the money supply in 2007–8 will be by 30–35 per cent less than in 2005–6.
* There will be a gradual transition to a more flexible exchange rate in 2009–15, with a widening margin of fluctuation, to make for more active

use of interest policy and a shift to a regime of inflation targeting.

* The increase in consumer prices will be curbed by a market mechanism of price regulation, along with efficient anti-monopoly policies and stabilization of the increase rate in household incomes. The dynamics of this will be correlated with the growth of productivity.
* Credit interest rates in national currency in 2007–8 will remain high (13.5–14.0 per cent) but will decrease as inflation slows in 2009–15.

Fiscal policy in 2007–15 will depend on the following:

* No overall increase in the fiscal pressure on the real sector was expected in 2007. The state budget adopted would include amendments to tax legislation (in particular, an increase in the rate of income tax from 13 to 15 per cent, with possible reductions of the VAT rate from 20 to 18 per cent and of profit tax from 25 to 20 per cent).
* If left unchanged for the forecast period, the rules for VAT returns (established in 2005) will create conditions for further expansion of accounts receivables and payables and reduce the circulating funds of economic agents.

The factors affecting welfare policy in 2007–15 will be these:

* The rate of natural decline in population from 2007 onwards will be higher than in the previous period and the migration balance will remain positive, so that there will be no marked increase in Ukraine's population.
* Rates of increase in disposable incomes and average monthly wages in 2007–8 will be lower than the averages for 2002–6. Most of the increase in nominal and real monthly wages in 2007–8 will correspond with real GDP growth, while being affected secondarily by the review of the single tariff schedule for some groups of budget-funded workers.
* It is assumed that that the share of household disposable incomes in GDP in 2007–8 will be around 64 per cent, and no lower than the average for 2001–6.
* The present increase in household consumption may cease, despite the increases in consumer credit and disposable incomes, and the minimal welfare standards. A modest increase in consumption (an annual average of 6–7 per cent) is expected in the short and medium term, due to the expected introduction of moderate levels of minimum welfare social standards, and to much higher rates of growth in average monthly wages than in 2001–6. The reason for the slowdown is the need to maintain proper competitiveness of companies in the real sector.
* The unemployment rate calculated by ILO methodology for 2007–8 will decline, due to the increase in employment. So it will not be a major destabilizing factor on the labour market, although there will be fluctuations in the unemployment rate for high and low-qualified workers alike.

Factors affecting external economic activity (2007–15) will be these:

* A modest, gradual increase in export rates is expected (from 4.2 per cent in 2007 to 6.4 per cent in 2010), but this will be lower than the rate of real GDP increase. So there will be a progressive decline in the export proportion of domestic production and a growing share supplying the domestic market, whose rate of development will increase.
* An initial growth in the rate of imports of goods and services will occur due to completion of the transition to European prices for natural gas imported from Russia and to very high demand for imports in the period of renewal of production assets. The im-

pact of the gas-price increase will be discussed further. The latter factor will keep imports growing faster than exports until 2009, after which there will be a marked slowdown in the import growth rate, which will begin to lag behind that of exports. That will bring an overall levelling off of the trade and current-account deficits. But with considerable demand for imports remaining in the long period of capital renewal (up to 2015), Ukraine's trade balance will remain negative. Acceleration of the rate of real GDP growth and a rise from 2009 onwards in the nominal exchange rate of the hryvnia, the import share of GDP will tend to decrease (from 51.7 per cent in 2007 to 45.0 per cent in 2015).

* The considerable increase in gas prices will probably be coupled with a further increase in world oil prices, bringing a marked rise in production costs and a relative decline in the price competitiveness of Ukraine's energy-intensive production, which is still central to the country's export potentials. This will encourage massive introduction of energy-saving technologies, and some change in course for Ukrainian industry, towards faster development of segments with low energy intensity. Both will require a considerable increase in investment, including a high level of foreign investment, as well as imports of investment goods. Such trends, coupled with slow export increases (due to partial loss of price competitiveness) will aggravate the trade deficit and hence the current-account deficit.
* There will be a change in the pattern of capital movements, from inward flow to two-way flow (at the expense of accelerated development of legal capital exports), and a gradual levelling of the overall balance of capital flows. The latter is necessary for Ukraine to gain external markets with a high value-added content, as well as high-tech markets that call for a constant commercial presence. The changes will bring an increase in income inflow and a corresponding decrease in the net balance of income flow.
* There will be an increase in FDI inflow over the period of accelerated technological reconstruction. This is expected to peak in 2008–9, as the results of Ukraine's accession to the WTO show themselves to the full (if this has occurred by the end of 2007). However, there may be some devaluation of the national currency – due to an excessively high deficit on the current account under conditions of inward flow of other sources of hard currency inflow. Otherwise there might be a revaluation of the hryvnia with an adverse impact on the rates of economic growth). However, some decrease in annual FDI flows will occur from 2009 onwards, with the annual figure stabilizing at about USD 3800 million. Such a high level of FDI will cause a negative income balance over the whole period, though with a tendency for the level of this to decrease. The retention of quite a high negative balance of income movement under conditions of considerable expansion of legal capital exports will be caused in particular by the fact that business profitability in Ukraine is much higher than in the OECD countries.

The basic scenario assumes that the rate of economic growth in 2007–9 will decrease somewhat to 6.5–6.8 per cent before increasing again to 7.2 per cent in 2010–15 (as period average), due to gradual revival of the investment component in economic development.

The main source of investment will remain companies' own funds, but a revival of investment demand can be expected from 2009 and satisfaction of this will be through domestic borrowing. At the same time, there is expected to be a further increase in budget investment and a corresponding expansion of credit resources *(Table 1)*. Under such conditions, the growth rates of gross investment are expected to be high (an annual average of 9.2–12.1 per cent). In the medium term, assuming that Ukraine accedes to the WTO in late 2007 and establishes more stable and transparent development conditions (through WTO membership), there will be an improvement in the investment and business climate.

High GDP growth will be supported by higher growth rates in domestic and external demand. However, such rates for Ukraine are historically somewhat low, as almost half the national GDP was lost during the transformational recession. Slower price growth is predicted for the forecast period, along with a relatively high inflation rate caused by a notable increase in disposable household incomes (demand-push inflation) and inflationary expectations from producers, due to marked increases in energy prices (supply-push inflation). With the need for members of the new government to meet its election promises on welfare, the expectation is for moderate government activity on the market for external borrowing, leading to concentration of credit activity in the private sector and reflected in lower average weighted interest rates on credit (with a changed NBU approach to the formation of money supply).

Domestic and foreign economic risks for the development of the Ukrainian economy relate to possibly unpredictable changes in the key parameters of global economic development and to the country's possible inability to respond adequately to the main foreign economic challenges, under conditions of aggravated political instability.

Here are some of the risks and restricting factors that appeared in 2005–6 and remain urgent in 2007–15.

The real sector, 2008–15

The increase in the welfare burden on the economy in 2007–8 coincided with considerable worsening of the economic growth rate in recent years. This presents some risks to the stability of Ukraine's economic development. Last year's GDP growth took place to a great extent at the expense of trade and transport services, which is a sign of accelerated consumption based on high rates of imports of consumer goods. That means a relative slowdown in the expansion of savings, as less of households' money is reaching the banks, where it can become a source of investment funding. Currently there is a return to the ill-considered policy in public finance of not creating favourable conditions for economic growth, but encouraging consumption. This leaves any government's intentions of shifting towards an investment and innovation-based development model and ensuring dynamic and sustainable growth purely declarative. Over the coming years, if these adverse tendencies are considered and the possibility of a third extraordinary parliamentary election and presidential election in 2009, the probability of economic crisis considerably increases.

Anti-dumping measures and restrictive quotas on the Russian market are being used against Ukrainian food producers. The aggravated trade war between Ukraine and Russia in 2006 led to a fall in the volume of Ukrainian food exports to Russia of more than a third, mainly due to the Russian embargo on meat and dairy products of Ukrainian origin. As Russia for many years has been a traditional outlet for Ukrainian producers and the corresponding losses are hard to offset, due to the specific nature of the meat and dairy trade, failure to take proper measures to improve relations with Russia could aggravate the negative tendencies in this field and lead to major losses of exports and output by the Ukrainian food industry.

Table 1
Forecasts of main macro indicators of the Ukrainian economy up to 2015
(basic scenario)*

Indicators	Years and periods of average annual change							
	Actual data				Forecast estimates			
	2002	2003	2004	2005	2006	2007	2008–10	2011–15
Population and employment:								
Population (millions)	47.92	47.52	47.14	46.78	46.55	46.32	45.92	45.47
Employment (15–70 years old, millions)	20.4	20.55	20.44	20.64	20.72	20.81	20.86	20.94
Change in real macro indicators over previous year								
Capital assets, %	0.9	2.9	3.5	1.1	2.2	2.3	2.5	2.8
Industrial output, %	7.0	15.8	12.5	3.1	6.2	10.1	9.6	10.5
GDP, %	5.2	9.6	12.1	2.7	7.1	6.5	6.8	7.2
Including:								
Final consumer expenses, %	4.0	10.0	9.7	15.7	11.2	7.1	6.4	7.0
• by households	6.0	11.5	13.5	20.6	14.2	10.4	7.5	8.1
• by general state sector	-0.1	6.9	1.8	2.9	2.8	2.7	2.1	2.2
Gross generation of fixed capital, %	5.3	22.5	20.5	3.9	18.7	16.1	9.5	10.1
Exports of goods and services, %	11.1	10.3	21.3	-12.2	-3.1	4.5	6.4	7.0
Imports of goods and services, %	7.4	16.4	15.5	6.4	6.3	8.4	6.8	6.4
Prices and exchange rate								
CPI, average annual, %	0.8	5.2	9.1	13.5	9.1	12.5	8.5	4.5
PPI, average annual, %	3.0	7.8	20.4	16.8	9.5	19.3	11.3	5.0
Exchange rate, average annual, HRN > USD	5.33	5.33	5.32	5.12	5.05	5.05	5.2	5.3`
Money and credit								
NBU refinancing rate, % annual	9.2	7.0	9.0	9.3	8.7	8.5	8.0	6.2
Interest rate on credits, % annual	24.8	18.0	17.8	16.0	15.9	13.5	14.0	10.2
Interest rate on deposits, % annual	7.8	7.5	9.3	9.4	9.2	9.2	7.8	6.5
Monetary base, % to previous period	33.6	30.1	34.2	54.2	18.1	32.0	19.0	15.2
Money supply (M3), % to previous period	41.8	46.5	32.3	54.3	35.2	34.2	28.7	25.1
Consolidated budget, % to GDP								
Total revenues	27.4	28.2	26.5	30.4	32.0	29.9	28.3	26.5
Total expenditures	26.7	28.4	29.4	32.2	32.7	30.5	29.8	27.5
Balance	0.7	-0.2	-2.9	-1.8	-0.7	-2.6	-1.5	-1.0
Social indicators								
Real average monthly wage, %	18.2	15.2	23.8	20.3	18.3	12.4	11.7	9.3
Real unemployment rate (calculated according to ILO methodology), %	10.1	9.3	9.2	8.9	8.1	8.0	7.6	6.8

Sources: Statystychnyi schorichnyk Ukrainy (Statistical yearbook of Ukraine) 1990. Kyiv: Derzhromstat Ukrainy, 1991; Statystychnyi schorichnyk Ukrainy 1995. Kyiv: Derzhromstat Ukrainy, 1996; Statystychnyi schorichnyk Ukrainy 2005. Kyiv: Derzhromstat Ukrainy, 2006; Natsional'ni rahunky Ukrainy za 2005 rik (National accounts of Ukraine for 2005). Kyiv.: Derzhromstat Ukrainy, 2004; Monitoryng makroekonomichnyh ta haluzevyh pokaznykiv (Monitoring of macroeconomic and sectional indicators). Kyiv.: Ministry of Economics and European Integration, 2007. 4:84, 5–97; Biuleten' NBU (NBU Bulletin) 2006. No 9, 70; estimates by State Enterprise Institute for Economics and Forecasting, Ukrainian National Academy of Sciences.

There are possible risks associated with the unfavourable conditions on world markets for metals and chemicals. There has been insufficiently active policy to develop the domestic market, a decline in foreign demand for Ukrainian metal and chemicals – though they will remain important export items. These are likely to worsen seriously the country' economic prospects in the forecast period. Proper consideration of these risks requires a revival of endogenous factors of economic development, related first of all to ensuring production restructuring in favour of the sectors producing domestically oriented goods with a high value added.

The political instability may also become a considerable factor behind a decline in investment activity by domestic and foreign investors. This would slow the transition to an investment and innovation-based pattern of economic development.

The real sector, 2009–11

The lack of progress in realizing large-scale structural reforms designed to strengthen the investment and innovation-based development component, coupled with delay in creating a basis for institutional infrastructure oriented to giving access by medium-sized and small businesses to financial, innovative and staff-development resources, may lead to some losses in potential economic growth. One marked threat to Ukraine's economy is its inability to ensure institutional and regulatory bases for serious structural reforms in the economy, and its radical modernization with an essential increase in the international competitiveness of Ukrainian producers of high value added goods and high tech goods and services. Such a threat impinges on the economy's inability to respond properly to global challenges. If the risks appear, the current exogenous model of economic development will remain with a further increase in the raw-material orientation of production and dependence on foreign technology and capital.

Forecast risks to development of the services sector, 2008–15

* Labour shortages due to the expected decrease in the population (to 41.8 million in 2015, according to a UNDP forecast) will impinge, and so will the worsening of the demographic structure (the share of population under 15 in 2015 is forecast to amount to be 13.5 per cent and of those over 65 16.4 per cent, as opposed to world averages of 25.9 and 8.4 per cent respectively. Added to that will be the effects of legal and illegal emigration. In the services sector, there is expected to be a further increase in the shortage of doctors and nurses, teachers, researchers, and high and medium-level engineers and technicians. (In some service sub-sectors, up to 40 per cent of those employed are pensioners or nearing pensionable age.
* The slowdown of restructuring in the services sectors and in the country's economy as a whole is due to spontaneous inflow of foreign capital to highly profitable sectors of financial services and realty, communication and trade transactions, as TNC branches usually follow the policy of parent companies, i.e. they do not "breed" their potential competitors (especially in high tech areas). They promote imports of goods and services from their base countries (through consumer credit, leasing, *etc.*). They repatriate earned profits after completion of their privatization commitments, instead of investing them in innovations in other countries. (For information, the outflow of profits of foreign investors in the first half year of 2007 increased more than four times over the same period of previous year.)

* Financial risks associated with change in the position of the USD and other currencies in the world economy may lead to a loss of household savings and a fall in living standards.
* Excess over the optimal amount of external debt (including government and corporate debt) may bring financial destabilization and a fall in living standards.

Forecast risks related to budget policy (2008–15):

* There may be unjustified decisions on additional privileges that increase welfare or other expenditures without regard to budgetary constraints. There may be insufficient financing of government investment in innovation, infrastructural development, and qualitative restructuring of the economy.
* Public finances may be strained by gas subsidies to consumers, covering the difference between the consumer price and the import price out of the state budget.
* If the state sector takes a higher share of net domestic credit (mainly to finance the deficit on the state budget), this could reduce the credit available to the real sector, which in turn could damage the liquidity of companies and organizations and reduce their investment and profitability.
* Increased public debt to cover the budget deficit may jeopardize privatization plans.
* Insufficient budget revenues may increase wage arrears.
* Lower budget expenditures on non-market services may reduce incomes in the budget-funded sector, which could have an adverse multiplier effect.

Forecast risks related to monetary policy (2008–15):

* An uncontrolled increase in government borrowing on foreign markets (medium and long-term non-guaranteed credits) would put additional pressure on the exchange market and support a blind-alley development model, with living standards supported by borrowed funds and a rising trade deficit.
* Uncontrolled increases in corporate debt were especially prevalent in 2004–6.
* There may be macroeconomic aggravation arising out of big volumes of consumer credit granted by banks. These may take the forms of an increased foreign-trade deficit, (as the credit is mainly spent on imported durables), and a gap between the rates of increase in real household income and banking credit, which would endanger the stability of the banks, as the growth rate in credit (extended, for instance, to households) would greatly exceed that of household income.
* A worsening trade balance coupled with limited inflows of foreign exchange on the financial account in the country's balance of payments would (due to detoriation of the investment climate) put strong pressure on the hryvnia for devaluation, which would bite into the hryvnia incomes and savings of households and businesses. On the other hand, a big excess of hard currency inflow along various channels should lead to revaluation of the hryvnia, leaving holders of hard currency as the losers. These scenarios may alternate, leading first to losses for those holding hard-currency funds, and then for those with hryvnia funds.
* The government may prove unable to increase the action of market mechanisms on price regulation.

* An uncontrolled increase in the volume of foreign borrowing (medium and long-term non-guaranteed credit) may bring increased demand for hard currency from the corporate sector, with limited chances to earn it, which would put extra pressure on domestic markets and transfer onto the domestic exchange market the impact of external factors arising out of instability on international exchange and financial markets.
* A surge in inflation may bring a higher discount rate.
* There may be external risks related to price fluctuation and increased resource demand (for oil, gas *etc.*)
* Considerable weakening of the dollar and increasing instability on international exchange markets can be expected.

Forecast risks related to social policy (2008–15):

* There may be further unjustified welfare decisions by the government, concerning the level of the minimum wage, subsistence level, and social privileges and benefits.
* We expect considerable risks related to the balance of commodity and financial flows on the consumer market in 2007–8, caused by low growth in real average monthly wages and disposable incomes, due to unfulfilled public expectations on the agreement about minimum welfare standards. (Among the reasons for this is continual divergence of minimum wages and pensions from the subsistence level, and possible failure to implement the second and third stages of the single-tariff schedule for workers in the public sphere.)
* There will be an increase volume of imported goods on Ukraine's consumer market, due to the expansion of household credit, associated with goods that are not "materialized" in their wages. The absorption capacity of Ukraine's consumer market will remain high, while a possible reduction in the rate of VAT would encourage importers (Ukraine's VAT rate being lower than that of other countries) to saturate Ukraine's market with goods, especially from countries with higher VAT rates, as the importers' own market becomes securely protected.
* There will be a risk of inflation, notably an increase in the consumer price associable particularly with higher prices for private cars, land, housing and gold. This would increase further the already high degree of income differentiation and segmentation of demand from high-income consumers.
* Persistence of the high demand-led prices for land and housing will allow the general public to accumulate wealth, but this will not produce sufficiently active consumer demand, and therefore not provide an efficient boost to GDP.

Forecast risks related to foreign trade (2008–15):

Ukraine's terms of trade will worsen further in 2007–9, due to a sharp decrease in world prices for metal and chemical products and further increases in world prices for oil. These changes will leave the main Ukrainian exports less competitive.

* There will be additional requirements for Ukraine's accession to the WTO.
* There may be abrupt abandonment of the nominal anchor (stable exchange rate) under conditions of continual deterioration of the balance of foreign trade.

The more serious external threats to Ukraine's economy in 2007–15 include:

* There is a possibility of new global antagonism between East and West arising out of change in the geo-economic balance of power and a strengthening of Asia's role in the world economy. Such circumstances may greatly complicate Ukraine's use of its geo-economic location. It would also bring a marked increase in defence spending, with corresponding structural correction in the development of the whole economy.
* Mounting international political tensions in the main oil-producing regions (the Islamic factor in the Middle East, anti-Americanism in Venezuela, growing discontent with the United States and other Western countries in Africa) may bring further increases in world prices for energy materials.
* There is a possibility that Ukraine may become caught between the Eastern and Western regional alignments under conditions in which an orientation towards the EU would not bring benefits in the near future (perhaps independently of Ukraine's actions, but due to internal EU processes). Under such conditions, Ukrainian producers would lose, not gain foreign markets which could result in forced diversion of Ukrainian trade flows towards third countries further afield.
* The possibility of grave exacerbation of global environmental problems may cause the world community to adopt much stricter ecological standards. This could lead to a situation in which some Ukrainian sectors that are now effective hard-currency earners face serious restrictions and changes in the structure of the world economy. In that case, the trade and current-account balances may deteriorate instead of improving, with devaluation of the national currency rather than revaluation, leading to Under such conditions, instead of leveling of the trade and current account balances, their growth may take place and, instead of the tendency towards nominal revaluation of the national currency, devaluation tendencies will appear, which will inevitably lead to the increase of GDP deflator and a corresponding decline of real GDP growth rate.

These risks apply to the 2007–15 period, but the probability of them will be lower if structural reforms and updated technology can be implemented.

It is calculated that if Ukraine's slow long-term development, with low average GDP growth of 3, 0–3 or 5 per cent in 2008–15, coupled with low investment, virtual exhaustion of traditional sources of economic growth, and possible economic crises and external shocks under conditions of growing international competition, the country's global position will worsen markedly, preventing it from modernizing its economy or competing with other nations. This scenario falls beyond the forecasting range, but one thing is well understood and defined: if such risks obtain, Ukraine will be unable to achieve requisite rates of social and economic development or solve existing contradictions discussed earlier in the paper. The scenarios and forecast were developed at the Institute for Economics and Forecasting, Ukrainian National Academy of Sciences, under its Strategy of Economic and Social Development.

Another serious obstacle to applying the strategy and to the realism of the forecast besides the provisos made so far may be the efforts of parliamentary parties to meet their electoral commitments. The political commitments recorded on the eve of the election at the Institute of Economic Research and Political Consultations, under the direction of I. Burakovsky, were mainly of a welfare nature. An attempt has been made, based on these, to carry out an evaluation of the changes that may occur in the distribution of the country's GDP and consolidated budget, if the commitments are met, and to define the degree of the feasibility of such changes. In our calculations, we have allowed only for minimal additional expenses to meet party political commitments. We have not considered the more generous commitments, because as shown below, even the minimal additional expenses are hardly feasible, if the government wishes to avoid a major economic shock that would lead to macroeconomic instability and eventually to an economic crisis.

Table 2 shows the calculations made from the expected figures for GDP growth and implementation of the 2007 budget, as an economic evaluation of these political decisions, carried out in 2007 prices.

meet its electoral commitments, the increase rate in welfare spending will be even higher, as it is impossible to find such resources by redistributing budget expenditures and equally impossible by making more efficient use of present budget funds. Such an assessment is based on the assumption that the power coalition includes the Party of Regions and adopts the minimum commitments of that party, while the maximum commitments could leave the amounts in Table 2 four times as high.

If the government coalition, quite probably, does not include the Party of Regions, meeting the commitments of the other two most probable coalition members (BYT and NU–NS) would raise the tax burden on the budget even more (by an additional 15 percentage points), while would greatly increase the level of business taxation, because it will be impossible to raise rapidly the tax yield from the employed, due to the forthcoming presidential election – the incumbent would have no chance of re-election if such an increase were made; he is in practice the putative leader of any BYT/NU–NS coalition. Such a hike in business taxation would reverse the process by which actors in the shadow economy are being wooed into becoming legal, taxpaying businesses, which would in itself jeopardize the resources required.

Table 2
Comparative assessment of drain on the budget and economy of meeting political commitments of parties elected to the Ukrainian legislature in 2007, as % of consolidated budget and GDP expected in 2007

	Expected 2007	Party of Regions	BYT	NU–NS	CPU	Lytvyn's Bloc
Total expenditures of consolidated budget, % of GDP	33.34	40.7	55.4	47.3	76.0	60.7
Welfare expenditures for consolidated budget purposes, % of GDP	7.35	15.4	22.1	22.0	51.5	34.6

It can be seen that even the minimum commitments (of the Party of Regions) would increase the tax burden by over 7 percentage points and welfare expenditures by over 8 percentage points. It should be pointed out that all the political initiatives were taken on annual basis. Such a drag on the economy, even by the minimum commitments of the Party of Regions, would be 12.3 percentage points higher than in 2003, the last year before the continuing period of political instability. Since then, the welfare expenditures of the consolidated budget have been growing steadily. They made up 29.39 per cent in 2004, as opposed to 28.35 per cent in 2003, 32.1 per cent in 2005, 32.6 per cent in 2006, and a planned 33.34 per cent in 2007. Practically all the years of political instability have raised the burden. So it is not hard to foresee further increases in it in future. If the coalition of 2007 begins to

At the same time, all possible scenarios of political developments predict a rise, not a fall, in the level of GDP redistribution through the budget, although not so rapid as the one shown in Table 2. Realistically, the share of expenditures of the consolidated budget to GDP will increase from 33–4 per cent in 2007 to 35–6 per cent, even in 2008. The expenditures on economic development would not increase, as the times require, despite the fact that the BYT and NU–NS coalition will first cancel many of the existing tax incentives (as it is quite difficult to meet even some of the previous commitments without doing so.)

The real increase in the burden on the economy and in the level of welfare protection will continue the tendency of the previous eight years, with GDP growth lagging behind the growth in household incomes. So one should expect further uncontrolled inflation, with consequent development of the scenario of macroeconomic destabilization, followed by an increase in domestic prices and revaluation of the hryvnia. This will deal a simultaneous blow to exporters and to suppliers of the domestic market, as well as to the public. The need is for a macroeconomic policy that will differ radically from one based on the prior political commitments made by the leading parties. Otherwise, we must expect not only macroeconomic destabilization, but an economic slump, with output decline and lower living standards. So the welfare commitments made by the electioneering politicians poses a danger to the country. Another dangerous scenario with a political dimension is a sharp increase in gas prices, which can be expected to begin as early as 2008, for there were already signs of it in late 2007. Assessments of the possible consequences have been made in Ukraine more than once, including one by the Institute for Economics and Forecasting, done by B. Kvasniuk and O. Bolkhovitinova, which in our opinion gives the best considered estimate, as the factors are mutually related and based on official (not departmental) statistics. The authors of this forecast based their estimates on the assumption that the gas price in the first half of 2006 was not the final one and would increase further to a level 1.5–2.0 times that of 2004, though that might still be insufficient in the medium term. Calculations have shown that such an increase will be highly detrimental to overall economic performance.

The forecast in this case is that the chemical industry would find its operating costs rising by 24–32 per cent, with rises of 20–27 per cent for ferrous metallurgy, 14–19 per cent for building materials, 8–11 per cent for pulp and paper, 6.9 per cent for wood processing industry, 2.0–2.7 per cent for food processing, and 1.1–1.4 per cent for light industry. Operating costs in the power sector will rise by 11–15 per cent.

The overall results of the realistic forecast based on the impact of the gas-price increases appear in *Table 3*. The assumptions are based on a sales growth rate of 5 per cent, but the impact of the inflation factor will worsen the financial conditions for most sectors to such an extent that the prospect of an overall increase in selling prices becomes inevitable, as operating profitability falls below zero. If the sales rate is negative (a pessimistic realistic forecast), the financial results of operational activities will be those shown in columns 4 and 5 of the table. Then the inflation component of economic growth becomes much stronger and there appears a high risk of slowdown in investment-based development, particularly in the introduction of energy-saving technologies.

The data in *Table 4* show the approximate level of increase in selling prices expected in the economy if the producers, faced with rising prices for gas and some other elements in production costs, try to hold their profitability at 2004 levels. We have deliberately abstained from giving quantified parameters for the forecast based on a crisis scenario – on the assumption that a considerable overall decline in output

Table 3
The operating profitability of Ukrainian firms, assuming volume sales increases of 5 and 2 per cent, with symmetrical growth in non-gas operating costs and increases in average gas prices of 150 and 200 per cent over 2004 prices

	Profitability of operating activities of Ukrainian firms, %				
	Actual (2004)	With a 5 per cent increase in output sold, symmetrical non-gas cost growth, and a gas-price increase of:		With a 2 per cent increase in output sold, symmetrical non-gas cost growth, and a gas-price increase of:	
		150%	200%	150%	200%
		Realistic forecast		Pessimistic realistic forecast	
Economy total	4.0	-2.7	-3.4	-5.7	-6.5
Agriculture, hunting, forestry	2.0	-3.5	-3.8	-6.6	-6.9
Industry	6.5	-4.8	-7.2	-7.8	-10.3
Mining	1.2	-5.3	-5.9	-8.4	-9.0
Manufacturing	7.8	-3.3	-5.7	-6.3	-8.8
Food and processing	1.2	-5.1	-5.7	-8.2	-8.8
Food industry	2.8	-3.6	-4.2	-6.6	-7.3
Light industry	-1.8	-7.7	-8.0	-10.8	-11.2
Lumber and wood working	2.8	-4.5	-5.5	-7.6	-8.6
Pulp and paper; printing	6.4	-5.1	-7.6	-8.2	-10.7
Chemicals and petrochemicals	13.0	-5.1	-10.1	-8.2	-13.4
Chemicals	15.3	-6.8	-13.3	-9.9	-16.6
Other mineral items (building materials etc.)	5.6	-10.9	-15.1	-14.1	-18.5
Metallurgy and metal working	13.0	-4.4	-9.2	-7.5	-12.4
Metallurgy	12.9	-5.9	-11.1	-9.0	-14.4
Ferrous metallurgy	14.3	-5.1	-10.6	-8.2	-13.9
non-ferrous metallurgy	6.1	-5.8	-8.5	-8.9	-11.7
Machine building	4.6	-2.3	-3.1	-5.3	-6.2
Generation and distribution of electricity, gas and water	2.9	-11.4	-14.8	-14.6	-18.2
Generation and distribution of electricity	6.5	-5.7	-8.5	-8.8	-11.6
Production and distribution of gas-type fuels	-5.7	-18.0	-20.6	-21.5	-24.2
Production and distribution of heating	-16.5	-53.5	-64.7	-58.0	-69.6
Construction	2.2	-2.5	-2.6	-5.5	-5.6
Trade	1.4	-3.3	-3.3	-6.3	-6.4
Hotels and restaurants	-7.9	-13.2	-13.2	-16.5	-16.6
Transports	14.4	8.0	7.1	5.3	4.4
Surface transport	12.6	2.2	0	-0.6	-2.9

Source: Calculations based on data of 4–MTP (annual) statistical form "Report of residuals and use of energy materials and oil processing products".

Table 4
Expected growth in selling prices necessary to maintain profitability at 2004 levels, with increases in average gas prices of 150 and 200 per cent over 2004

	Operating profitability in 2004, %	Expected growth of selling prices required to maintain profitability at the 2004 level, with an average gas-price increase of:	
		150 %	200 %
Economy total	4.0	111.8	112.6
Agriculture, hunting, forestry	2.0	110.7	111.1
Industry	6.5	116.5	119.1
Mining	1.2	111.7	112.4
Manufacturing	7.8	116.3	118.8
Food processing	1.2	111.6	112.2
Food industry	2.8	111.5	112.2
Light industry	-1.8	111.2	111.6
Timber and wood processing	2.8	112.5	113.6
Pulp and paper; printing	6.4	116.7	119.3
Chemicals and petrochemicals	13.0	123.4	128.7
Chemicals	15.3	127.5	134.3
Other mineral items (building materials etc.)	5.6	122.0	126.5
Metallurgy and metal working	13.0	122.7	127.7
Metallurgy	12.9	124.1	129.6
Ferrous metallurgy	14.3	124.7	130.5
Non-ferrous metallurgy	6.1	117.2	120.0
Machine building	4.6	112.0	112.8
Production and distribution of Electricity, gas and water	2.9	119.8	123.4
Generation and distribution of electricity	6.5	117.5	120.4
Production and distribution of gas-type fuels	-5.7	118.2	121.0
Production and distribution of heat	-16.5	144.7	156.5
Construction	2.2	109.9	109.9
Trade	1.4	109.9	109.9
Hotels and restaurants	-7.9	110.9	111.0
Transports	14.4	111.1	112.0
Surface transport	12.6	115.2	117.6

Source: Calculated basing on data of 4-MTP (annual) statistical form “Report of residuals and use of energy materials and oil processing products” occurs. However, such a scenario is probable too. An economy such as Ukraine's, which has exhausted the scope for renewal growth, can develop further only within an investment-based pattern and after solving the problem of energy resources, where the essential ingredient is energy saving. Considering the current obsolescence in Ukraine (for example, wear and tear on fixed capital in metallurgy has reached 60–70 per cent), the volume of investment necessary to implement energy saving programmes would be very big. According to the most likely estimates, the investment required to introduce energy-saving technologies in metallurgy alone would be USD 10–30 billion.[1]

Replacement of equipment and introduction of energy-saving technologies needs to occur not only in metallurgy, but in chemicals and in pulp and paper, as well as in production of building materials, machine engineering, and all other spheres tied to these. In the opinion of Lars Handriks (Institute for Economic Research – DIW), an expert on Eastern Europe and member of German Consultative group in Ukraine, the investment requirement for energy-saving purposes, with due regard to intersectoral ties, amounts to USD 110 billion.[2]

The companies whose business position allows them to raise their prices will do so to boost their profitability and generate investment resources. For example, a gas price of USD 160–80 per cent is likely to bring an increase of 25–30 per cent in the prices for Ukrainian cement. This will follow earlier, 2006 cement-price increases of 7–8 per cent and an imminent second increase of 14–15 per cent. According to expert calculations, the price for M400 cement will rise by 40 per cent, etc.

The cost of Ukrainian paper will probably grow by 7–8 per cent, so that it loses its price advantage over imports. (The market share of domestically produced paper is expected to fall from 35 to 30 per cent.) If the gas price approaches USD 160 per 1000 cubic metres, Ukrainian paper will rise in price by another 20–30 per cent. Similar figures can be cited for many other sectors. This means Ukraine faces a considerable increase in its trade deficit. All consumer categories obviously face a further gas-price increase in the very near future.[3] It can be hoped that the eventual transfer of the price increase to consumers will be gradual, although that too will place a burden on the budget with obvious consequences.

Based on these considerations, it can be foreseen that the only source of investment source for the economy in the short, and possibly the medium run will be credits and foreign technology. Meanwhile a potential crisis is building up in the economy, which will reduce the country's ability to raise credit and its attractiveness to investors. This makes it urgent to address the question of the quality of foreign borrowing and investment. Ukraine will no longer be in a position to choose among suitors; it will need to be chosen. Foreign investors will come to the most profitable sectors, such as banking, trade, telecommunications, metallurgy, and possibly the fuel sector, and probably also to gas transportation and other strategic facilities. There are risks involved in permitting excessive de-

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[1] нергосбережения и новые технологии. Совместное приложение Дело, ИнвестГазета, изд-во «Экономика». - №1. - март 2006. – .46, 56; http://www.from-ua.com/eco.

[2] http://Handelsblatt, 24.03.2006.

[3] Russia' Gazprom officially advised Ukraine's Naftogaz that from July 1, 2006, the selling price would be USD 130 per 1000 cubic metres. This is not yet the final price, however. O. Medvedev, the deputy director of Gazprom, said in an interview, "On July 1, 2006, the question of price revision will be discussed… As regards the market price, we have mentioned it long ago. It is USD 230 per 1000 cubic meters. And we even put that parameter in the price formula fixed in our agreements…" Kontrakty 16:727, April 17, 2006.

pendence on foreign credit, which can undermine the financial system, the more so as the current one is not investment directed, but used for consumer credit that is provoking further price inflation.

Short-term increases in the price of imported natural gas will place a considerable extra burden on the Ukrainian economy, above all its fuel-intensive sectors, such as metallurgy, chemicals, building materials, pulp and paper, and food, which, through inter-sectoral ties, will lead to an overall price increase in the economy. Under such conditions, domestic investment potential will be considerably reduced and real investment in the economy funded by companies themselves may fall by 20–40 per cent from the previous year. Inflation will also bring a decline in household bank deposits, with a consequent cost increase and reduction of long-term credit available for the real sector.

Ukrainian society is undergoing a very high degree of politicization. Political leaders with wide influence on the public have a big chance to begin explaining the objective economic difficulties and justifying an anti-crisis policy that will undoubtedly involve a temporary freeze on living standards. At the same time, leaders could draw up a new investment strategy that considers all the difficulties of the economic situation and identifies in detail the potential sources of investment.

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