Economics

International topics

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Current Issues

Ukraine: The long road West

- The "orange revolution" has put Ukraine back on the European map. The country's prospects for economic development have improved visibly. This report looks at Ukraine's economic outlook after its political rebirth and presents scenarios for its medium-term growth prospects.
- With a population of 50 million, Ukraine has considerable economic potential. On a medium-term horizon it could achieve economic growth in excess of 5%, provided the investment environment improves noticeably. Whether Ukraine will be able to fully exploit its growth potential will depend above all on economic diversification, an increase in the investment ratio and stepping up the pace of institutional reforms.
- The reform window is wide open. Robust growth and the great popularity of both President Yushchenko and Prime Minister Tymoshenko offer a favourable environment for far-reaching structural reform. But the population has equally great expectations. A critical mass of reforms must be initiated in the coming months. Ukraine still has substantial catching-up to do, especially as regards the quality of its legal system and its public administration.
- The government in Kiev is well aware of the manifold political and economic obstacles that could get in the way of quick progress. Taking a careful, consensus-oriented and pragmatic approach, the government will have to strike a balance between the interests of West and East Ukraine as well as the influential "clans". Also, it will need to consider the country's close economic, political and cultural ties to its neighbour, Russia.
- The new political leadership intends to link the economic reform process over the long term to preparations for potential membership in the EU. An external anchor – the prospect of joining the EU – would considerably increase the chances of success for the reform efforts. The powers of transformation related to EU membership represent one of the most important lessons learned from the last fifteen years of transformation in eastern Europe. Stabilisation of investor confidence and inflows of new foreign direct investment (FDI) will hinge decisively on the EU's reaction to the new political era in Kiev.
- The EU, though, has not yet decided whether it is prepared to support Ukraine's membership possibly even in spite of Russia's reservations and welcome Ukraine into the European fold. This question of principle, which would markedly change Europe's geopolitical landscape once again, has yet to be answered. Expectations linked to Mr. Yushchenko's presidency must be realistic. The road West is long - but it is open again for Ukraine.

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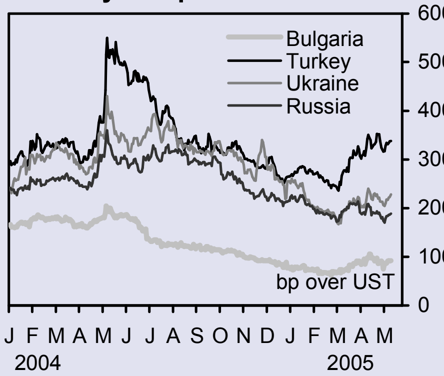
The “orange revolution” has put Ukraine back on the European map. Among Ukrainians there is a strong conviction already today that the political and economic future of their country lies in the West, in Europe – not with Russia or in the no man’s land between Russia and the EU. The impressive economic performance of Ukraine’s western neighbours, which joined the EU last year, and Russia’s political orientation both acted as catalyst for the change of direction that found its expression in the “orange revolution” of December 2004.

In the preceding years the 50 million-strong population had been threatened by economic stagnation and political isolation. Economic reforms progressed only slowly – if at all. Ukraine’s efforts to establish closer ties with western Europe's institutions by and large remained vague declarations of intent. It was Russia, rather than the European Union, that pursued an active policy of enlargement, designed to lead to the establishment of a “single economic area” comprising Russia, Ukraine, Belarus and Kazakhstan. Following its victory in the “orange revolution”, though, the new government in Kiev shelved these plans and aims now to gear its economic policy to Brussels and the West.

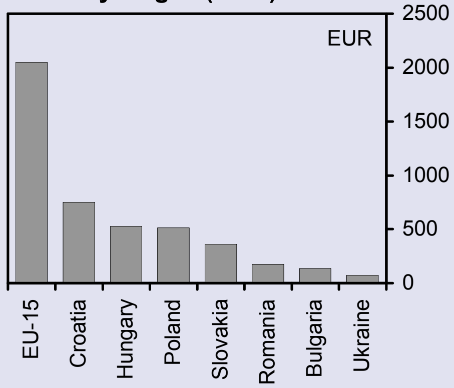
Country risk premia



Financial markets are forward-looking and react sensitively to an improvement in a country’s economic prospects. The upturn in the Ukrainian financial market leaves no room for doubts that a positive economic development has been regarded as conceivable since the “orange revolution”: Ukrainian Eurobonds carry almost the same spread as Russian bonds and are considered much less risky than Turkish paper.

Some experts think Ukraine will become a preferred location for outsourcing – shaped after the Chinese model – on the eastern edge of Europe. With wage costs of currently less than 10% of the EU average, Ukraine could turn into an attractive production location for Europe’s industry, provided the framework conditions can be brought up to the standards of a market economy and investor confidence can be stabilised. But such upbeat scenarios still give rise to a number of questions. Experts frequently point out that the sustainability of the current development is not yet ensured, despite the achievements of the past months. Rather, to use the words of Michael Emerson, the country is stuck "between the elephant and the bear“.[1]

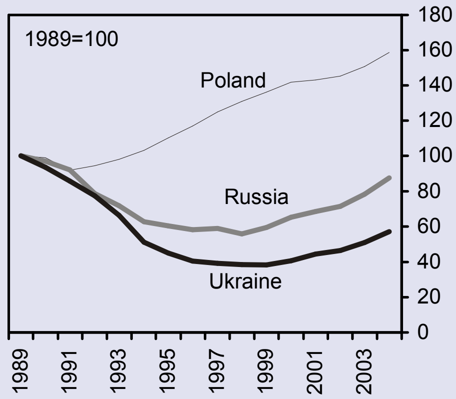
Monthly wages (2004)



Incomplete transformation: a difficult legacy

Following its independence in 1991, Ukraine launched the process of transformation with high hopes. Many experts believed the country’s starting position was good – at least compared with other former Soviet republics: a well-educated population and the highest density of engineers in the entire Soviet Union suggested this economy had remarkable technological potential. Still today, Pivdenmask in Dnepropetrovsk is the largest rocket factory of the world. In addition, Ukraine's fertile, black earth soil forms an optimal basis for modern agriculture. Its geographic position between Russia and the West makes it an interesting location for trade and transit.

Real GDP since 1989



Ukraine serves as the perfect example that politics is a focal, independent factor in the transformation process. A long series of bad political decisions or non-decisions has set back the country’s economic development by roughly a decade. As in Russia the privatisation process, in particular, failed to have the desired positive effects on competitiveness. Insider trading and "latent privatisation“, i.e. when financial claims against allegedly insolvent state enterprises were

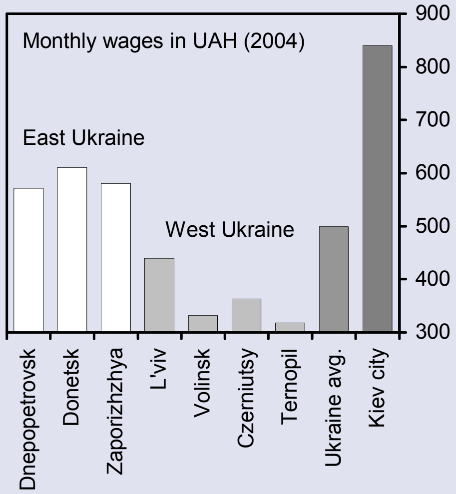
[1] Mentioned in Oleksandr Tschaly (2005). “Zwischen Bär und Elefant – Optionen der Ukraine nach den Wahlen“. Internationale Politik. January 2005

used to transfer stakes in the companies, were commonplace. Only a few months ago, the largest state-owned steel company – Krivorizhstal – was sold for roughly half of its estimated value to the son-in law of the then president, while considerably higher offers from foreign investors were ignored. Even though the reliability of such estimates is hard to gauge, it is believed that roughly half of Ukraine's economy is controlled by only a few industrial "clans".

Ukraine's gross domestic product (GDP) reflects political shortcomings during the transformation process: Following the pronounced slump in GDP in the early years – a widespread phenomenon in the transformation countries of Eastern Europe – even by 2004 Ukraine's GDP had still not managed to climb back to its 1990 level. This is due mostly to the fact that Ukraine's old industrial combines have not yet been completely replaced by newly founded companies, which could have supported real economic growth since 1990 as was the case in the Central European accession countries.

As its transformation is as yet incomplete, Ukraine is split in half not only politically but also economically – and with apparently opposing forces within these two halves: as the industrial combines are located in the Russia-oriented East Ukraine, the East of the country continues to account for a large part of national income. By contrast, Europe-friendly West Ukraine has so far failed to attract new investment due to unattractive economic conditions, and is much poorer than the East. The striking wage difference between the East and the West of the country sets it apart from the Central European countries, where wages are usually highest in the regions neighbouring the EU.

Regional wage differences

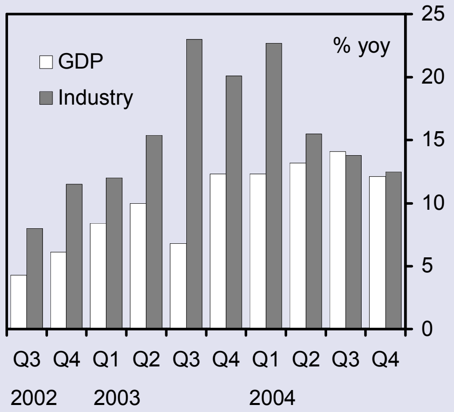


The orange-coloured boom

Despite the manifold structural problems, Ukraine's economy has performed remarkably well over the last five years. Real economic growth reached roughly 12% yoy in 2004 (according to official numbers); this is the highest rate of increase of all European countries. The current year will likely see a slowdown of growth to 5%. Yet over the last five years, growth averaged a respectable 7-8% p.a; this is the result of a combination of three factors:

- Ukraine's currency, the hryvnia, has depreciated strongly in real terms since 2002 in the wake of the financial crisis and the dollar weakness, triggering a production boom for local industry. Imports were substituted, and Ukrainian exports became much more competitive in foreign markets. Thanks to the heavily undervalued currency, the current account surplus came to 10% of GDP in 2004 and exports are growing at an impressive rate. Massive foreign trade surpluses have led to rapidly growing forex reserves at the central bank – interrupted by a temporarily decline during the December political crisis.
- World market prices for Ukrainian exports – above all steel and steel products, which make up around 40% of total exports – have risen substantially. Thus the terms of trade have developed very favourably for Ukraine. Like in Russia, the country's new wealth has found its way into the domestic economy and given a remarkable boost to investment activity in several regions, especially in the building sector. Moreover, Ukraine is automatically insured against high oil prices thanks to its revenues from the transit of oil and gas from Russia.
- Finally, economic growth in Russia has also led to strong demand effects on the Ukrainian economy. Trade relations between the two countries remain close. Roughly 30% of Ukraine's exports and 40% of its imports go to or come from Russia. At the same time, the

GDP growth driven by industry



Export growth & current account surpluses

positive economic climate has reversed the capital flight from the region.

For a realistic assessment of Ukraine's economic performance, however, two additional factors must be considered. First, growth has started from a low level and was made possible by increased utilisation of existing capacities. This effect is due to bottom out in 2005. New growth will be more difficult to engineer. Second, higher production is taking place above all in the old heavy industries which are benefiting from strong Asian demand for steel. The rapid development of new steel capacities in these countries harbours considerable medium-term risks for Ukraine's export industry.

So the economic upturn is not (yet) based on domestic and foreign investment and massive productivity gains as is the case in the Central European EU member states. Intensification and diversification will only be possible if the country manages to raise its investment ratio and becomes more attractive for foreign investors. FDI statistics reveal that over the past ten years Ukraine was unable to attract a significant amount of FDI and build up new industries. FDI inflows have been relatively small so far. Despite the positive macroeconomic data, Ukraine's high growth rates invite comparison with the uncertain situation of the Russian economy and its dependence on oil prices, rather than with the robust growth trend in Central Europe.

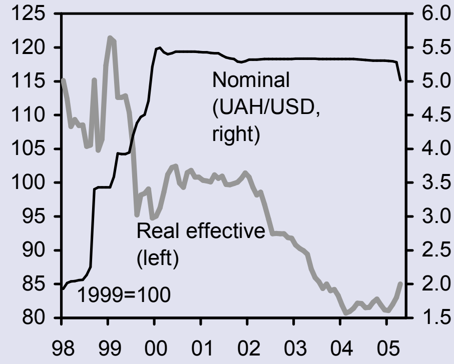
If we note the fact that economic growth in Ukraine depends strongly on external factors, this does not mean we have overlooked the marked improvement in many macroeconomic indicators which are a consequence of the high growth rates registered since the year 2000. External debt and public-sector debt ratios, in particular, have improved noticeably, which will likely be recognised by the international rating agencies in the next few months. Better country risk ratings could make Ukraine more attractive to foreign investors.

In light of massive current account surpluses it is only a matter of time before Ukraine becomes an international creditor. This year already, the national bank's (NBU) forex reserves could exceed the country's external debt. Thus Ukraine would have made the transformation from default to net creditor status within the space of only a few years. We witnessed the same development in Russia last year. However, the comparison with Russia also underlines the problems inherent in large current account surpluses as they are usually accompanied by equally large capital exports abroad. In view of a lack of investment and an old capital stock in the countries of the former Soviet Union, the long-term economic benefit of massive capital exports is doubtful.

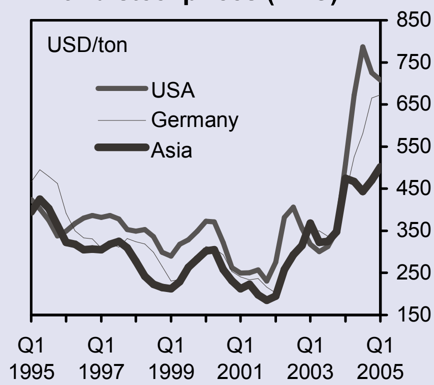
Ukraine's economy in a regional comparison

Despite the positive trend of the past years, a comparison of key structural indicators reveals how far Ukraine is lagging behind other accession candidates in many areas. The EU itself has not yet granted Ukraine the status of a market economy after more than ten years of transformation. Besides the prestige for its economic policy, this would bring important advantages to Ukrainian exporters in anti-dumping lawsuits. To be sure, the private sector's share in GDP has meanwhile risen to roughly 65% and thus to the level of other transformation countries. But the state's influence on prices remains strong in major sectors, especially the energy sector. Among other things, the lack of functioning bankruptcy legislation has so far prevented Ukraine from fulfilling the EU criteria. The rising importance of foreign trade is reflected in the degree of openness, which has soared over the past years thanks to an export boom for metal products. Today, Ukraine is as open to foreign trade as most other Eastern European economies.

Exchange rate

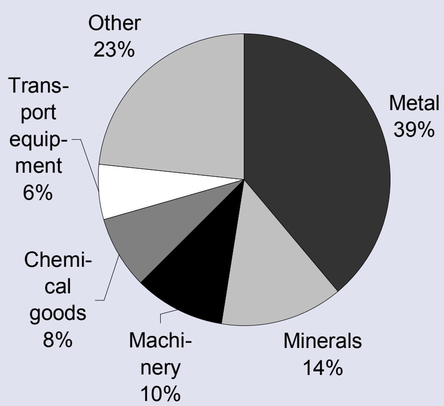


World steel prices (HRC)

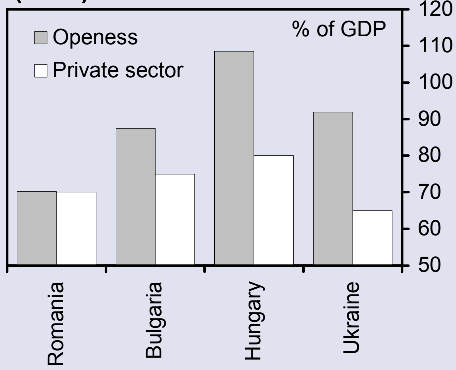


Export goods

(% of total exports, 2003)



Trade openess and private sector (2004)



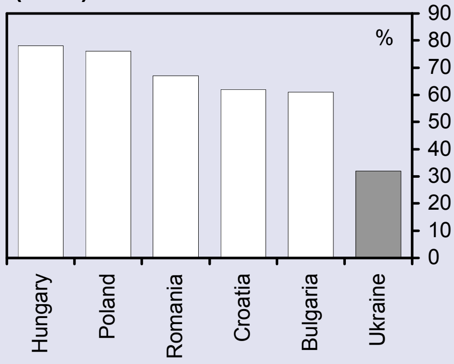
Compared with other countries from the region and another accession candidate, Turkey, one of Ukraine's most striking features is its remarkably low per capita income. At EUR 1,200 at market prices, income per capita is not even half as high as in Russia, Romania and Bulgaria. This is less than 10% of the old EU-15 average. Measured in terms of purchasing power parities, though, per capita income rises to roughly EUR 5,000. Ukraine then reaches roughly the same level as Romania and Bulgaria, whose currencies (in relation to purchasing power) are less strongly undervalued than the hryvnia. Monthly wages in Ukraine currently average USD 80-100; this is only about 15% of the wage level of Poland or roughly 50% of that of Romania. However, Ukraine has not yet managed to play this card in international wage competition; despite its low wage costs it has not yet attracted large numbers of manufacturing jobs.

The redirection of trade from the East to the West was a typical phenomenon in the Central European accession countries in the 1990s. Over the last few years, first signs of a similar development have also emerged in Ukraine. The EU's share of Ukraine's foreign trade has risen above 30% in the last few years – and the trend suggests a further increase. Nonetheless, Ukraine still lags substantially behind the countries of southeast Europe. In the latter, 60% of both imports and exports are with the EU.

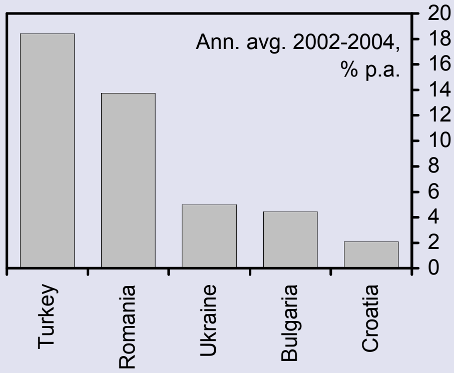
Key economic indicators paint a positive picture. As regards price stability, Ukraine has made progress with macroeconomic stabilisation after the crisis years at the end of the 1990s – also in comparison with other countries. Thanks to the peg of the hryvnia to the USD, inflation was under control and amounted to 5% on average over the last three years. Even though Ukraine has registered rising inflation rates in the recent past, the country is still well ahead of Romania and Turkey. The budget situation is similar. With an average deficit of 1.6% of GDP, Ukraine's budget is on a sounder footing than that of Croatia or Turkey, which have posted an average 5% or over 11% of GDP, respectively, over the last few years.

According to many investors and international rankings, the country's real weak points lie in its institutional framework. In fact, as regards the quality of its legal system and public administration Ukraine not only lags considerably behind the Central European accession countries, but also in many respects even behind Russia, its neighbour to the east.

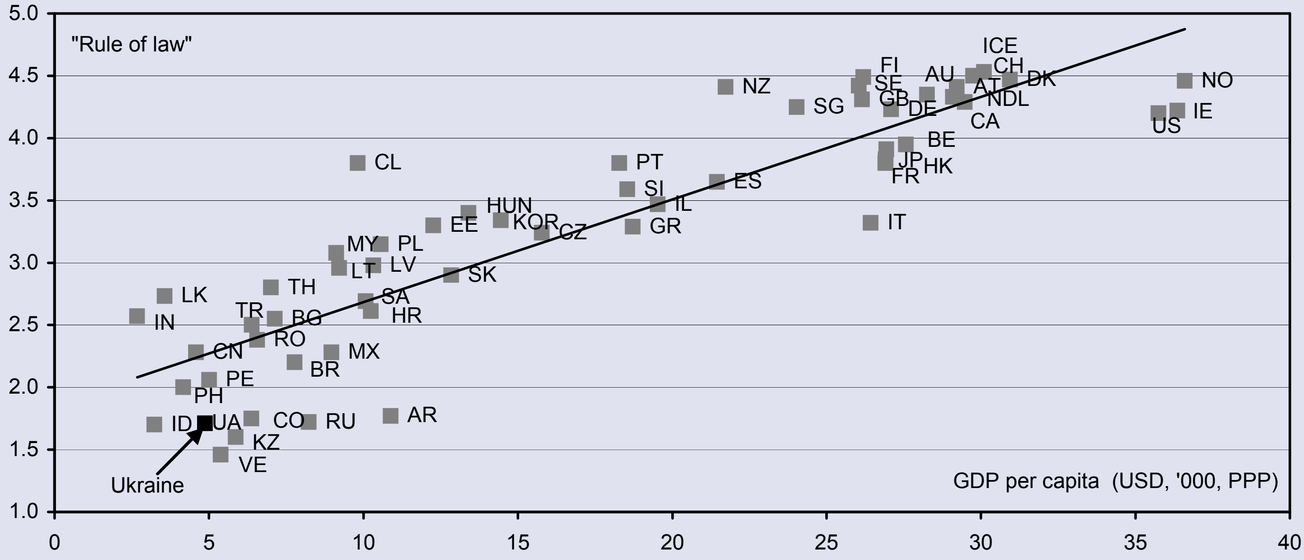
Exports to the EU / total exports (2004)



Inflation



Major concern of investors: legal system



Ukrainian and foreign companies complain regularly about state capture up to the highest offices – i.e. the "penetration" of government institutions by organised interest groups preventing fair competition – and daily "petite corruption" when licences are awarded or contracts enforced. The Investment Climate Index compiled by the Kiev Institute for Economic Reform also cited instability of the institutional framework and a lack of law enforcement as the most frequent obstacles to entrepreneurial activities.

The reform window is wide open

Thanks to robust growth, the macroeconomic environment is conducive to far-reaching reforms. The two leading figures in the orange revolution, President Viktor Yushchenko and Prime Minister Julia Tymoshenko, are riding high on a groundswell of political approval. But expectations are running high among the population as well. A critical mass of reforms must be initiated in the coming months. The next election campaign will probably begin as early as in autumn, as parliamentary elections are to take place in February or March 2006. In addition, the scope for the president to put his stamp on affairs will be drastically restricted by constitutional amendments, which were part of the deal struck with the former leadership. De facto, Ukraine will become a parliamentary republic in the foreseeable future. Only next year's parliamentary elections will show whether the Ukrainians have succeeded in making a radical new start.

In the near future, the government will be faced with a number of macroeconomic challenges. At the top of the list of economic priorities are the preparations for the WTO accession planned for 2006. The new budget for 2005 was signed on March 29. It foresees a pronounced increase in social spending of roughly 50%. The beneficiaries are, above all, pensioners and civil servants. The financing, however, has not yet been totally secured. The government intends to limit new debt and, at the same time, reduce the tax load for companies in order to legalise part of the shadow economy. So the finance ministry will therefore rely, first and foremost, on additional income from the closing of tax loopholes and exceptions. The remaining deficit of roughly UAH 7 bn or 1.6% of GDP is to be covered entirely by privatisation proceeds.

The fiscal easing has served to increase the IMF's concerns over the acceleration of inflation. As a result of the fiscal election gifts, the rate of price increase climbed to double-digit figures and must now be capped again. As the central bank has only a limited number of monetary policy instruments at its disposal, the NBU agreed to let the hryvnia appreciate by roughly 3% in April. However, two-thirds of the consumer price index are food prices, so this could send the wrong signals regarding underlying price pressure in the economy. What's more, Ukraine's industrial sector has little interest in a marked appreciation of the currency, but would rather continue to ride the export wave, triggered by the hryvnia's undervaluation. Regarding future revaluations, the NBU is significantly more cautious than Prime Minister Tymoshenko, the finance ministry and the IMF in its assessment of inflationary pressure and the advantages of a change in the currency regime (moving to a more flexible regime) or pegging at a much higher rate. As the sudden revaluation in April already revealed deep divisions among Ukrainian policy-makers, it is difficult to foresee the future course of exchange rate policy. We think that the central bank will continue to oppose bold moves in the short term. Yet a revaluation of the hryvnia by roughly 10 percent remains conceivable over the medium term, if favourable external trends prevail.

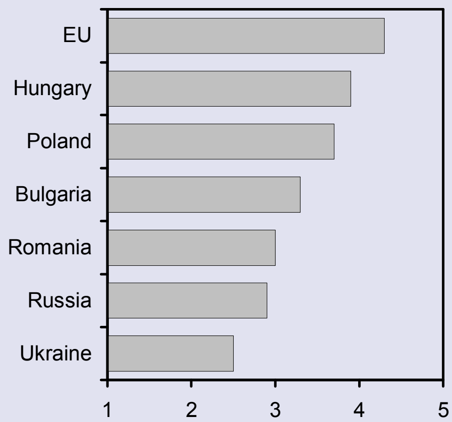
Floating the currency could make sense also with regard to the financial sector as fixed exchange-rate pegs often lead to an excessive concentration of currency risk in the banks' books. Even though the

Corruption

	Index*	Ranking
Hungary	4.8	42
Bulgaria	4.1	54
Croatia	3.5	67
Poland	3.5	68
Turkey	3.2	77
Romania	2.9	87
Ukraine	2.2	122

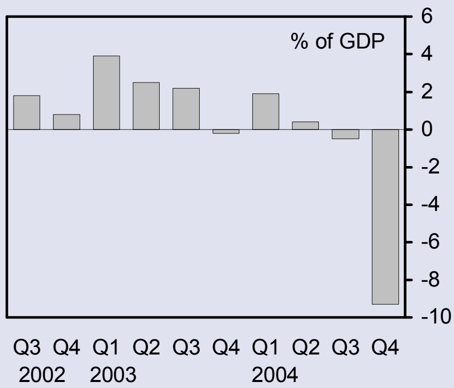
*) 10 = lowest level of corruption
Source: Transparency International 2004

EBRD Transformation Indicator: Business environment (2004*)



*) Average of indicators for corporate reform, market liberalisation, competition policy, financial sector regulation and infrastructure

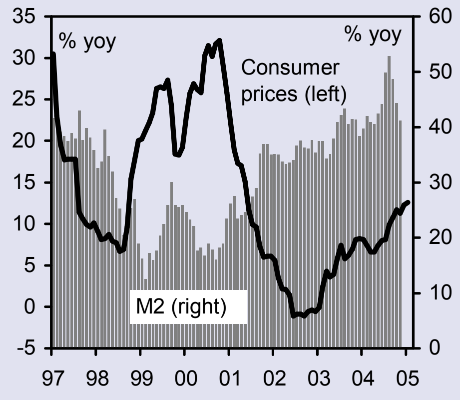
Growing fiscal deficits



country quickly overcame the liquidity crisis in December, Ukraine's financial sector remains vulnerable to crises and currency risk management is still underdeveloped. The banking system is characterised by numerous small banks that are sometimes little more than dubious financial vehicles for certain companies or pocket banks of the industrial clans.

With the remonetisation of the economy, credit volume has risen by over 50% per annum over the past few years; in an international comparison it is still at a low absolute level, though. In light of the low starting level of credit volumes Ukraine offers attractive growth opportunities. Foreign interest in the country's financial sector has jumped since the "orange revolution". This is reflected, for instance, in the planned takeover of Avalbank, Ukraine’s second largest bank, by Raiffeisen International from Austria. The equity market, by contrast, continues to labour under the lack of protection for minority shareholders. New impetus will likely ensure only if the planned law on joint stock corporations is adopted and enforced.

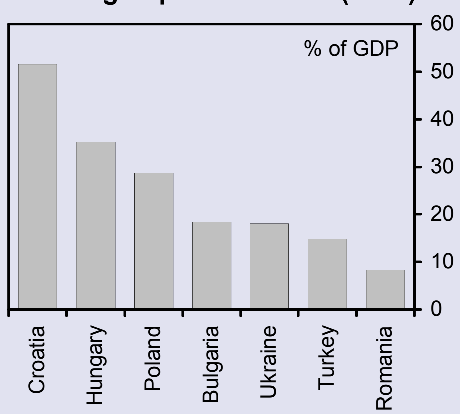
Consumer prices & M2



Rocky road to structural reform

The reform of the big public monopolies and privatisation of key state-owned enterprises (Ukrtelekom, Ukrprom, Ukreximbank) and the opening of so-called strategic industries to foreign investors will be the most difficult tasks facing the new government. Major interest groups are intent on maintaining the status quo. Also, re-examination of earlier privatisation projects could collide with the interests of the powerful clans.

Lending to private sector (2004)



In her dealings with Ukraine’s industrial magnates Mrs. Tymoshenko has a reputation as a hard-liner, while Mr. Yushchenko seems more inclined to seek cooperation. At present the government intends to reverse a number of privatisations which the old regime conducted under dubious circumstances and without regard to higher bids from foreign investors (Krivorozhstal, Ukrrudprom, Nikolaev Alumina). There has been confusion over the total number of companies, whose privatisation is to be reconsidered: PM Tymoshenko previously mentioned a number of 3,000 companies, while a mere 20-30 are considered more likely at the moment. The government intends to present, in the near future, a final list of companies and wants to ensure that the re-examination procedure is conducted properly and transparently. Should the number of reprivatisations be excessively high, there is a risk that in the end the old system will be revived – albeit with new owners.

There will likely be many attempts to delay or block the policy of reform entirely. After all, there can still be huge differences between what is decreed by law and what laws are actually enforced. Several reports suggest that, as in Russia, state institutions have, by and large, become the tool of economic interest groups. At the regional and even at the national level, the different “clans” have bought their way into parliaments, law courts and public administrations and are hindering new reforms and/or the enforcement of existing laws. The state, which should be the tool used for pushing through with reforms, is itself in urgent need of reform.

For a number of reasons, the new government will have to be careful, consensus-oriented and pragmatic.

- West Ukraine’s orientation towards Europe and East Ukraine’s ties to Russia will have to be balanced carefully. The street protests against the reformers in Kiev that followed the removal from office of the Donetsk region governor have made this quite clear.

- The government will have to find a way to deal with the powerful industrial groups which allows sufficient room for political manoeuvre to prepare for potential accession negotiations with the EU.
- At first it will have to rely on the old staff employed in the ministries.

There is a chance, though, that the powerful heavy industry magnates might be prepared to buy into the reforms. On the one hand, the opening of the Western European market to Ukrainian metal exports would dovetail with the commercial interests of the "clans". On the other hand, the much smaller Ukrainian oligarchs fear their powerful Russian counterparts and the "siloviki" in the Kremlin. Even during the orange revolution there was evidence that several groups openly supported Yushchenko.

Close economic ties with Russia

Russia's attitude regarding Ukraine's possible westward orientation is a decisive factor for the country's future development. The political and cultural ties between the two countries go back several centuries. Especially the relationship between East Ukraine and Russia is still close. Few at present believe there will be a genuine geopolitical border between the two countries in the foreseeable future. Rather, many point to the fact that the collapse of the Soviet Union was relatively peaceful precisely because the borders between the individual republics were no real borders.

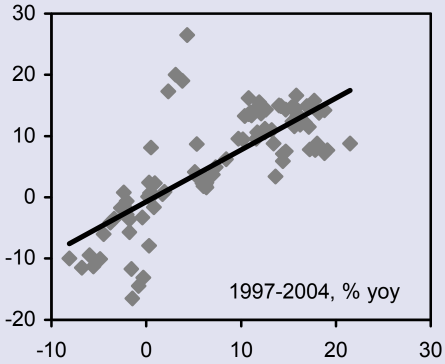
For various reasons, Russian President Putin took the side of the "ancien régime" during the Ukrainian election campaign. This shows that Moscow harbours an intuitive distrust of Ukraine's westward orientation. Russia is only slowly getting used to the fact that it must not see its relationship with Ukraine as a domestic policy issue. With the opposition's victory in the elections, however, Russia's influence over Ukraine's political course has shrunk considerably.

But economic ties with Russia remain close. The two countries' business cycles continue to be strongly correlated. Especially industrial production is very much in line in the two countries. This connection would only loosen if new industries were established and if a de-coupling from the commodity cycles took place. Russia's share of Ukrainian trade has declined and trade has been growing much faster with the EU than with Russia for several years. Nonetheless, Russian companies are among the biggest foreign investors. While official statistics paint an incomplete picture, unofficial reports find there are extensive capital ties with Russia in some sectors. Moreover, Ukraine continues to depend on energy imports from Russia – just like the EU itself. And Moscow needs Ukraine as it is the major transfer country for natural gas and oil transported to Western Europe. So the dependence is mutual.

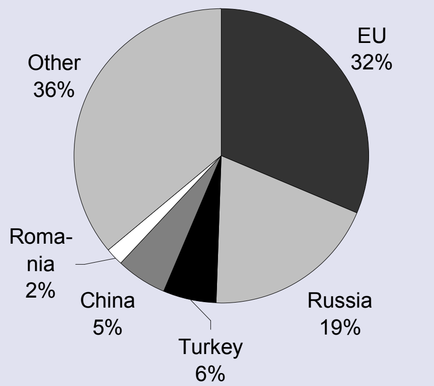
EU prospects a reform anchor?

The new government is Kiev is well aware of the manifold obstacles that could get in the way of quick progress with modernisation. So it is seeking to ensure continuation of the reform process: the modernisation of the country is to be linked to EU accession requirements. The President believes that the target of EU membership can serve as an anchor for economic reform and help overcome political resistance. The Central European accession countries have proven impressively that this strategy can work out. Ongoing reform efforts have a realistic chance of success if they can be justified, again and again, by reference to overarching foreign-policy goals (such as EU membership). Over the medium term, this issue will decide whether Ukraine – like Poland in the last ten years – will stick to its market-oriented course even if governments come and go.

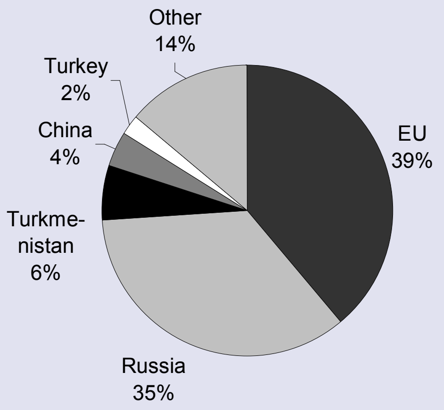
Correlation of industrial output in Ukraine and Russia



Export partners
(% of total exports, 2003)



Import partners
(% of total imports, 2003)



Ukraine's population expects Yushchenko to outline the country's EU prospects in the near future. The EU, however, has not yet pledged full membership for Ukraine even though this has been pressed for by several new member states, e.g. Poland. It cannot be ruled out that several member states will make their continued support of Turkish membership dependent on an accession perspective for Ukraine, too. So far, the EU's action plan foresees facilitating trade integration, supporting legislative harmonisation, providing loans from the European Investment Bank (EIB) and quickly granting "market economy status".

The EU action plan will likely give some boost to the economy even without the hope of full membership, but only a credible prospect of entry would give Ukraine and its new political leadership the external reform anchor that it urgently needs for domestic policy reasons. Also, the stabilisation of investor confidence and the associated massive inflow of foreign direct investment (FDI) that drove real convergence in the Central European accession countries over the past ten years will only materialise quickly with a concrete accession perspective.

If the new government in Kiev achieves clear reform progress, it will be difficult for the EU to deny Ukraine something that Turkey has already been granted – candidate status. On a medium-term horizon, Ukraine could be invited to join the circle of potential candidates for accession. Prior to that, however, a fundamental political decision must be taken. The EU must answer the question as to whether it is prepared to support Ukraine's accession even in case of Russian resistance. For, Ukraine's membership in the EU would once again markedly change Europe's geopolitical map.

Foreign direct investments in Ukraine

	FDI volumes (as of 01/01/2005), USD m	% of total volume
Total	**8353.9**	**100**
of which		
USA	1153.7	13.8
Cyprus	1035.6	12.4
UK	895.9	10.7
Germany	631.6	7.6
Netherlands	548.3	6.6
British Virgin Islands	543.8	6.5
Russia	457.5	5.5
Switzerland	411.3	4.9
Austria	345.6	4.1
Poland	192.3	2.3
Hungary	179.1	2.1
North Korea	172.4	2.1
Other	1786.8	21.4

Ukraine's growth outlook

In order to gain an insight into Ukraine's long-term growth outlook, we have used a method combining scenario technique and empirical growth theory[2]. In a first step, stylised future scenarios are drawn up. In a second step, the performance of key economic indicators is forecast under the different scenarios. These figures are then used in an empirical growth estimate in order to calculate potential growth under the various scenarios.

But estimating potential growth of an economy undergoing transformation is a difficult endeavour. Complex time-series based methods – such as DB Research's *Formel-G*[3] – cannot be applied because the time series available are too short. An alternative is to identify the determinants of economic growth in a broad cross-section of countries which is what we opted for. Additionally, we employ an econometric specification that integrates the institutional environment as an important factor determining growth.[4]

In our model, two factors will strongly determine Ukraine's medium-term growth outlook. For one thing, the investment ratio – as only a pronounced increase in investment volumes could create a broader base for growth and reduce the economy's dependence on heavy industry. For another, the establishment of a framework of market-economy institutions will determine whether the number of company start-ups will rise and overall productivity increases will be achieved.

Econometric estimate of Ukraine's potential growth

For an unprejudiced estimate of Ukraine's potential growth, we have based our calculations on empirical results of cross-section country analyses, which have identified major determinants of economic growth. We use a recent econometric specification by Ali and Crain (2002) which extends the Levine/Renelt (1992) framework to include the quality of institutions. Ali/Crain arrive at the following equation[1]:

$$g=-1.28-0.47Y-1.08POP+1.69SCH +17.7INV+3.37ECO+0.1POL$$

g: real per capita growth (%), Y: initial level of income (USD PPP), POP: annual population growth rate (%), SCH: secondary school enrolment rate (%), INV: gross capital formation/GDP (%), ECO: Economic Freedom Index of Fraser Institute (proxy for economic institutions), POL: political freedom indicator by Freedom House.

2 See Beck, Roland and Moritz Schularick (2003). Russia 2010: It's a Russian bear, not a bull! In Deutsche Bank Research, special issue of our Current Issues series, April 1, 2003. Frankfurt am Main.

3 See Bergheim, Stefan et al. (2005). Global growth centres 2020 – *Formel-G* for 24 economies. In Deutsche Bank Research, Current Issues, March 23, 2005. Frankfurt am Main.

4 Ali, Abdiweli M. and W. Mark Crain, (2002). Institutional Distortions, Economic Freedom, and Growth. In Cato Journal, Vol. 21, No. 3 (Winter 2002).

Three different scenarios are to shed some light on Ukraine's potential growth paths based on different assumptions regarding the development of the investment ratio and the speed of structural reforms. It is important to note that the following estimates refer to long-term potential growth. Cyclical and external factors (such as strong price fluctuations for major export goods) can lead to pronounced deviations from the estimated figures.

- **Scenario 1 – "Rapid EU integration":** this optimistic scenario is based on the assumption of Ukraine's fast orientation towards the EU, which in turn would quickly award candidate status to the country. As a result, the speed of reforms in Ukraine would pick up, the reform process would be firmly anchored and investors' future expectations would be stabilised quickly. Massive inflows of foreign direct investment, the return of flight capital and a speedy increase in foreign investment activity would send the investment ratio up from just under 20% to 30% of GDP. It would thus come to roughly the level reached by the Central European accession candidates at the end of the 1990s. Fast institutional reforms would bring the country up to the legal and political standards of the Central European candidates. Thanks to its industrial know-how and low wage costs Ukraine would become a magnet for FDI and a manufacturing powerhouse in the East of Europe. Under these assumptions, we project average annual growth at over 5% (or almost 6% on a per capita basis, factoring in the slight decline of the population).
- **Scenario 2 – "Gradual progress":** in this baseline scenario (with the highest probability) there is gradual progress with reforms in Ukraine. Even though the clocks will not be turned back in Kiev, the high hopes of quick EU integration will not be fulfilled. The reform process advances but without any spectacular achievements. In particular, reforms of the legal system and the public administration apparatus turn out to be more time-consuming than in the optimistic scenario. Under these circumstances the investment ratio rises more slowly, to roughly 25% of BIP over the medium term. Institutional indicators improve less quickly and reach the current level of the southern European accession countries over the medium term. Ukraine's growth potential would be slightly below 4% in this environment.
- **Scenario 3 – "Stop and Go":** the pessimistic scenario is based by and large on the assumption that the trend witnessed over the last few years will continue. There is a drive towards reform in certain areas but only a standstill in others. The estimates correspond with the average of the last five years. Should there be no improvement, Ukraine's growth rate would remain unchanged at 2.6%. By comparison: average growth in the years between 1996 and 2004 was 2.9% p.a.

In Scenario 2, the baseline scenario, which we regard as the most likely, Ukraine would need roughly 20 years to catch up with Hungary's current income level. Under the optimistic assumptions, this period would be shortened to just under 15 years. Such projections reveal just how backward the country is after nearly fifteen years of transformation.

Conclusion: Western hopes and Eastern realities

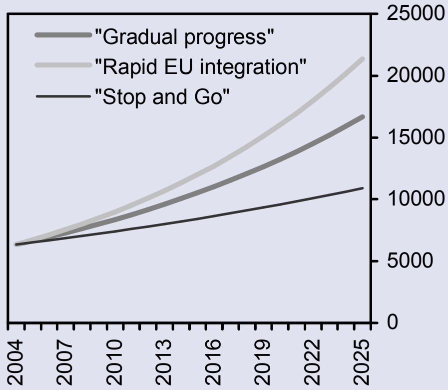
With the "orange revolution", Ukraine has returned to the group of countries in which sustainable growth is conceivable and actually possible. It has achieved macroeconomic stabilisation in recent years. Under the new government, structural reforms can now be tackled with determination. Yet despite the positive changes that have taken place, expectations linked to Mr. Yushchenko's presidency must be realistic.

Ukraine's growth potential under different scenarios

	Stop&Go	Gra-dual	Inte-gration
GDP per capita 2004 ('000 USD, PPP)	6.35	6.35	6.35
Population, % yoy	-0.80	-0.80	-0.80
Human capital	0.97	0.97	0.97
Investment ratio	0.20	0.25	0.30
Economic freedom*	0.50	0.60	0.70
Political freedom*	0.40	0.50	0.70
GDP per capita growth, %	3.41	4.70	5.95
GDP growth, %	2.61	3.90	5.15
Avg. growth rate (1999-2004)	4.5		

* Fraser Institute Index of Economic Freedom and Freedom House

GDP per capita: up to 2025



There is no doubt that the economic outlook for Ukraine took a turn for the better with the victory of the pro-Western democrats in the orange revolution. The president and the prime minister are determined to push for the Western integration of the country. However, Ukraine has to start the reform process more or less from scratch in many areas. Both domestic and foreign investors still need to be convinced of the stability of the political and institutional framework. A special difficulty lies in the fact that the state institutions have been weakened considerably over the last ten years. The implementation of reforms is far from guaranteed, even if political resistance can be overcome in the legislative process.

For the foreseeable future the country will be torn between Western hopes and Eastern realities. It will take great political skill to maintain a broad consensus for reform over a number of years. An external anchor – the prospect of EU accession – would considerably increase the chances of success for the policy of reform. This is one of the most important lessons learned from the last fifteen years of transformation in Eastern Europe. The EU has not yet decided, however, whether it wants to welcome Ukraine into the European fold. So the road West is long – but it is open for Ukraine.

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