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Political crisis and its impact on the economy

On April 2, 2007 President Victor Yushchenko signed the decree dissolving the parliament after 11 lawmakers unilaterally left opposition factions to join parliamentary coalition, bringing it close to a 300-seat majority necessary to overrule presidential vetoes. Prime Minister Viktor Yanukovych and coalition majority claimed the dissolution was unconstitutional and appealed to the Constitutional Court. This became the culmination of a severe political crisis that preceded several months of unceasing conflict between the President on the one hand, and the Verkhovna Rada and the Cabinet of Ministers on the other. In a month, at the beginning of May, the preliminary compromise approving early elections was reached.

One of the important issues is whether this political crisis can trigger economic slowdown. The politicians disagreed upon this question. The First Deputy Prime Minister and Finance Minister Mykola Azarov said that it could take months to repair damage done to the current economic upturn if the crisis would not be resolved soon. Further, Economy Minister Anatoliy Kinakh argued that political standoff "could seriously damage Ukraine's reputation, curbing inflows of foreign investment". At the same time President Viktor Yushchenko stated that "the currency markets remain solvent, trade is stable, the budget deficit is under control and there is no risk of stock market destabilization".

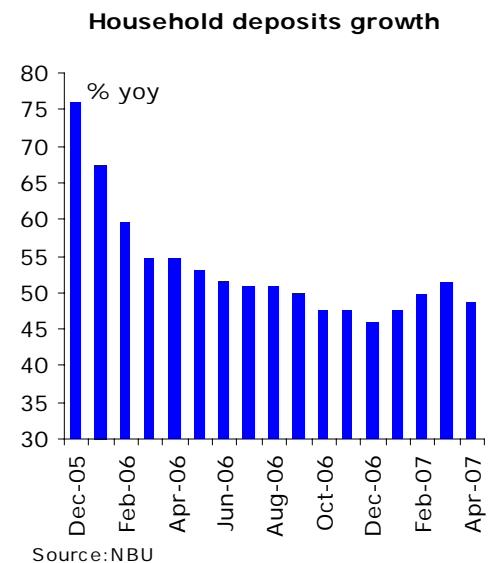
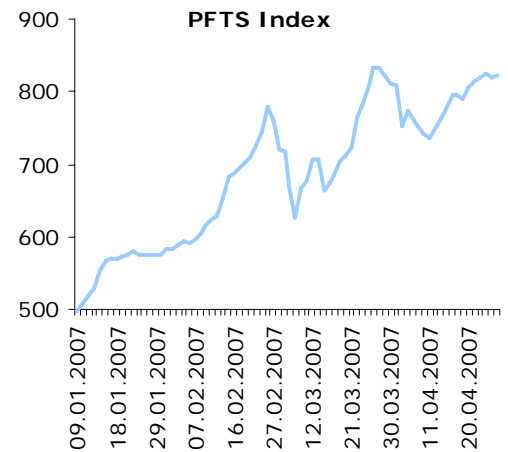
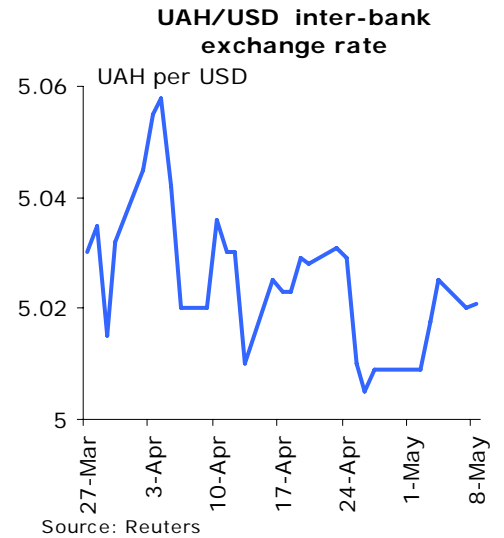
Statistics show that the economy did not significantly react to the political uncertainty in the short run. In particular, on the cash market hryvnia did not depreciate, and even slightly appreciated against the US dollar during April. The same trend was registered at the inter-bank foreign exchange market, although the exchange rate here was a bit more volatile. The appreciation of hryvnia against the US dollar followed the international trends demonstrating that no significant distortions on the domestic market occurred. Also, the financial markets remained calm. After the slowdown in the first week of the crisis, the PFTS index returned its previous level. The household deposits growth remained high (48.7% yoy in April compared to 51.4% yoy in March) and there are no signs of the bank run that occurred during the Orange Revolution. It confirms the stable level of trust to the banking system.

Therefore, it is likely the economic growth this year will not be notably affected by the political crisis. This year the situation differs from the situation in 2004: the number of protestors is much smaller, protests are organized, and business activity is not disrupted.

Generally, frequent changes in the government do not necessarily cause economic slowdowns or damage investment climate. For instance, it is the case of Italy where on average governments change every year. Corruption, unnecessary government interventions and a weak law enforcement system cause far greater damage to the economy and investment climate.

However, political crisis may still have some negative consequences. The government may stop important strategic activities, such as accession to the World Trade Organization (WTO), as well as land, pension and tax reforms. Additionally, the dissolution of the Verkhovna Rada *de-facto* freezes the legislative activity in the country. Instead, the government may resume populist activities, such as new increases in social payments and various kinds of subsidies to attract voters before the new coming elections. If new elections take place without the reform in the political system, there is no guarantee the conflict will not resume afterwards. This situation would even further delay important decisions and reforms.

Overall, the political crisis seems to have no considerable impact on short-term economic growth. The more important consequences are a further loss of time and opportunities to accomplish strategic reforms necessary for stable long-term growth.



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Quarterly trends

National accounts**		Q2 04	Q3 04	Q4 04	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07
GDP	UAH bn	78.6	99.4	100.1	84.3	97.5	119.4	123.6	105.4	124.1	150.4	157.7	...
GDP (real)	% yoy	12.7	14.3	9.1	4.9	3.4	1.4	1.7	4.1	6.8	6.9	9.5	...
Households consumption (real)	% yoy	18.0	9.7	12.5	14.3	17.7	17.0	17.1	20.2	18.2	11.8	9.9	...
State consumption (real)	% yoy	1.3	3.9	0.9	6.1	0.0	1.0	4.0	9.6	5.8	5.8	1.0	...
Gross fixed capital formation (real)	% yoy	22.6	23.8	16.8	-2.3	-0.5	0.2	0.3	19.9	19.3	17.9	18.3	...
Exports of goods and services (real)	% yoy	21.1	14.3	11.7	-0.6	-14.0	-12.7	-15.5	-14.9	-9.6	3.2	1.0	...
Imports of goods and services (real)	% yoy	10.9	7.2	8.7	2.8	3.2	3.9	-0.9	10.7	0.9	8.3	6.4	...
Agriculture, hunting, forestry (real)*	% yoy	0.2	35.6	11.3	5.8	8.3	2.6	-7.2	3.8	2.8	-5.6	8.1	...
Manufacturing industry (real)*	% yoy	15.0	9.9	6.9	7.0	1.8	-1.1	2.0	-1.5	6.1	7.3	7.2	...
Construction (real)*	% yoy	23.3	11.9	23.3	-8.4	-11.3	-8.5	-7.5	0.1	0.8	1.4	4.2	...
Trade, repair services (real)*	% yoy	17.4	13.9	2.5	-2.1	-10.7	-11.7	-11.9	6.2	16.4	20.0	21.9	...
Transport (real)*	% yoy	14.9	12.5	6.4	6.6	5.7	2.8	7.8	4.9	7.7	9.4	5.3	...
Balance of payments													
Current account balance	USD bn	2.3	2.1	1.1	1.6	0.6	0.4	-0.1	-0.8	0.0	0.5	-1.4	-1.2 ^e
Current account balance	% of GDP	15.8	11.0	5.7	10.1	3.2	1.7	-0.4	-3.7	0.0	1.7	-4.3	-4.6 ^e
Trade balance in goods	USD m	1552	774	482	1020	-236	-1131	-788	-1353	-935	-884	-2022	-1800 ^e
Trade balance in services	USD m	198	749	157	188	392	1035	191	219	506	1054	347	154 ^e
Current transfers	USD m	758	720	623	626	694	745	780	622	790	851	910	...
Direct investment (FDI)	USD m	614	420	344	247	365	477	6474	1053	1389	1636	1258	969 ^e
Portfolio investments	USD m	149	1313	156	397	923	90	1347	4	-141	370	3350	...
Gross international reserves	USD bn	9.6	12.1	9.5	12.0	13.1	14.3	19.4	17.3	17.6	19.1	22.3	23.5
Exchange rate, UAH/USD	aop	5.33	5.31	5.31	5.30	5.10	5.05	5.05	5.05	5.05	5.05	5.05	5.05
Fiscal indicators													
Consolidated fiscal revenues	% of GDP	26.9	26.3	25.9	32.1	35.1	31.5	31.0	31.2	31.7	31.9	32.8	33.3
Personal income tax	% of GDP	4.1	3.8	3.8	4.3	4.4	3.9	4.2	4.4	4.6	4.1	4.1	5.1
Enterprise profits tax	% of GDP	4.0	4.1	6.1	4.8	5.9	5.3	6.3	3.4	4.6	4.3	6.7	3.8
Value-added tax	% of GDP	5.7	5.1	4.1	8.6	9.2	7.9	7.3	9.2	9.2	9.7	9.3	10.4
Excise tax	% of GDP	2.1	2.0	1.8	2.0	2.0	2.0	1.7	1.8	1.7	1.5	1.5	1.8
Consolidated fiscal expenditures	% of GDP	26.5	26.8	35.2	28.3	36.4	28.1	41.7	30.9	32.8	29.4	36.6	28.4
Current expenditures	% of GDP	22.7	21.7	27.2	26.5	33.6	24.0	34.2	28.9	29.7	24.9	29.2	26.9
Capital expenditures	% of GDP	3.8	5.1	8.0	1.8	2.7	4.1	7.5	1.9	3.2	4.5	7.4	1.6
Consolidated fiscal balance	% of GDP	0.4	-0.5	-9.3	3.7	1.0	-5.0	6.2	-0.4	1.1	-2.4	4.0	-4.8
Privatisation receipts	% of GDP	3.7	3.5	1.0	0.2	0.6	0.6	16.0	0.1	0.1	0.1	0.1	0.5
Labour market													
Average wage (real)	% yoy	18.6	14.7	15.4	15.0	19.0	19.6	26.4	23.8	22.6	18.8	11.3	11.5
Household income (real)	% yoy	16.3	11.3	16.6	24.0	28.0	19.4	18.9	22.1	18.6	20.3	16.3	11.1
Unemployment rate (ILO methodology)	% cum	8.3	8.1	8.7	8.7	7.1	5.2	7.8	7.9	6.8	6.4	6.8	...
Banking system													
Monetary aggregate M0	% yoy cum	25.6	37.1	27.9	28.2	39.1	31.1	42.2	36.2	25.3	23.7	24.5	22.9
Monetary aggregate M2	% yoy cum	44.8	51.5	32.3	38.9	37.4	31.3	53.9	39.2	36.6	36.7	34.3	38.6
Household deposits in national currency	% yoy cum	67.3	67.9	26.2	28.3	31.6	30.4	90.8	54.6	41.1	39.7	37.3	50.7
Household deposits in foreign currency	% yoy cum	61.7	55.2	54.3	51.8	45.4	46.4	59.1	54.5	66.2	64.3	57.5	52.3
Com. bank credits in national currency	% yoy cum	52.1	44.3	29.4	28.3	32.6	43.4	58.7	59.8	53.7	49.0	52.3	52.4
Com. bank credits in foreign currency	% yoy cum	56.2	43.5	32.2	33.1	36.8	47.1	66.3	72.0	82.1	90.4	95.4	98.9
Long-term com. bank credits	% yoy cum	102.7	82.7	57.1	49.5	53.0	70.1	84.6	87.6	86.7	76.6	79.5	84.1
Long-term com. bank credits	% of total	49.3	50.9	54.2	54.4	56.1	59.7	61.8	63.1	63.4	63.5	64.9	65.8
Average lending rate on national cur. credits	% p.a.	16.6	17.0	17.6	17.0	15.4	15.4	16.4	15.8	15.5	14.6	15.1	14.0
Average lending rate on foreign cur. credits	% p.a.	12.1	12.6	12.2	12.1	11.0	11.3	11.7	11.5	11.3	11.3	11.5	11.5

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added

** 2006 figures are preliminary

^e preliminary

Notes:
yoy year on year change

p.a. per annum