

# ICPS newsletter<sup>®</sup>

## ICPS downgrades its economic forecast for 2005–2007

***The dismissal of the Tymoshenko Government is unlikely spoil the achievements of the Orange Revolution. Growing political competition will foster better quality policy making. ICPS economists have downgraded their forecast for the country's economic growth for 2005 to 4% because of shrinking investment and declining global prices for Ukrainian export commodities. Greater predictability in state policies after the Verkhovna Rada elections should spur investment in 2006–2007***

### The right moment for reforms was missed

President Yushchenko's team failed to launch transformations while the window of opportunity was wide open. High public confidence and economic growth at the beginning of 2005 offered a good foundation for instituting reforms. The new Administration appeared unable to resolve personal clashes within the Government team, to introduce new democratic policymaking approaches, or to react appropriately to criticisms in an uncensored media. The achievements of the Tymoshenko Government include: improved the living standards for the poorest Ukrainians, macro-financial stability and steps to combat corruption. However, these achievements are not sustainable because there are no long-term development plans. Growing social outlays in the context of an unreformed social security system reek of populism, macro-financial stability was supported through inertia, and the war on corruption was compromised by high-profile mudslinging within the Government team itself.

The dismissal of the Tymoshenko Government is unlikely to spoil the achievements of the Orange Revolution. The split in the Yushchenko team has effectively raised standards for politicians and top government officials. The ex-premier's intention to run for the 2006 Verkhovna Rada elections independently will increase political competition and encourage public oversight of government decisions. ICPS analysts say that having Ms. Tymoshenko in the opposition could improve the quality of state policies, provided the political battle concentrates on better ideas and not on redistributing assets.

Unlike the Tymoshenko Government, the next Cabinet will be less inclined to

populist policies. For one thing, the actions of the new Government will not be influenced by the political ambitions of its members. However, this Government will also not launch serious transformations for four reasons:

- *Too short an effective term.* Constitutional amendments come into force on 1 January 2006 that allow the Government to be formed by the Verkhovna Rada. After the March elections, the Government will most likely be replaced.
- *Lack of workable institutional procedures.* Like previous Governments, the new one faces the lack of capacity among government institutions to develop policies in an environment that recognizes competing interests.
- *Weak support in the Verkhovna Rada.* The decline in public trust in the Administration led to the gradual collapse of the working majority in the VR that had supported the decisions of the Government and president.
- *A worsening economic situation.* Slower economic growth increases the likelihood that the government will tackle current problems at the expense of long-term and strategic goals.

### Economic growth has slowed way down

According to preliminary data, real GDP grew only 2.8% over January–August 2005. The main factors behind this economic slowdown are: a decline in investment and a worsening in the foreign economic situation. According to ICPS, this shrinking investment is the result of four factors:

- growing political risks in late 2004–early 2005 made investors postpone investment launches;

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- public investment shrank because of growing social spending in the Budget;
- growing tax revenues led to a decrease in working capital;
- lack of a clear Government position on the criteria for revisiting privatization tenders caused the owners of many privatized companies to delay investment decisions.

The deteriorating external situation resulted in a significant slowdown in Ukrainian industry and a decline in trade. A drop in global metal prices led to shrinking physical export volumes of metals and metal products and, correspondingly, reduced demand for coking coal and iron ore. The decline in trade is due to shrinking wholesale trade in metal products and oil.

Over January–August 2005, consumer prices grew 6.7% compared to December 2004.

There was no seasonal deflation because the price of sugar took off in June and July 2005. Inflation continues to run high due to the rapid growth of personal incomes and high inflationary expectations among Ukrainian consumers. However, producer prices will grow at a substantially slower pace because of a drop in prices for Ukrainian products on foreign markets and because of slower economic growth.

The National Bank of Ukraine will resort to a tighter monetary policy and try to curb inflation by reducing emissions. Despite a goods trade deficit over March–June 2005, the supply of foreign currency continues to outstrip demand on the interbank currency exchange market. However, the NBU reserves are growing more slowly than in Spring 2005, when the Bank allowed the appreciation of the hryvnia.

## Forecast for 2005–2007

ICPS economists have downgraded their forecast for GDP growth for 2005 by 3 pp to 4% due to a worsening in the forecast for investment and a greater-than-anticipated drop in prices for Ukrainian exports in H1'05. ICPS also underestimated the impact and duration of uncertainty in relations between the "Orange" Administration and business: the government failed to meet the expectations of businesses regarding reduced state intervention in commercial activity, the establishment of a level and fair playing field, reduced corruption, and the inviolability of property rights. ICPS economists expect the country's economy to steam ahead in Q4'04, as the external situation stabilizes.

Over 2006 and 2007, GDP growth will accelerate to 5.5% and 6%, given a more rapid growth of investment. Gross fixed capital investment will grow 7% in 2006 and 9% in 2007. ICPS economists expect investment to grow due to greater predictability in state policies after the Verkhovna Rada elections and a gradual rise in public investment. According to ICPS, the period between the 2006 Verkhovna Rada elections and the 2009 presidential election will be long enough for the Yushchenko Administration to plan and implement large-scale, long-term objectives, instead of aiming all efforts at achieving short-term results to win elections. Over 2006–2007, new standards of political competition will help improve the quality of policymaking.

The ICPS forecast is for consumer price inflation to reach 13.5% in 2005. Given slower producer price growth and growing wage arrears, ICPS economists have downgraded their forecast. With household incomes growing steeply, anti-inflationary steps on the part of the Government will yield little. Over 2006–2007, consumer prices will grow at more slowly pace due to slower growth in household incomes and rising imports. According to ICPS economists, rates for residential services and passenger transport will go up after the 2006 Verkhovna Rada elections. Producer price inflation will slow down during the forecast period.

According to ICPS, the NBU will support a stable UAH/USD exchange rate until late 2005. The ICPS forecast is that the NBU will not resort to targeting inflation after the Rada elections. Over 2005–2007,

interest rates for hryvnia loans at commercial banks will slip to 9% per annum, while hryvnia deposit rates will go down to 7.4% per annum.

ICPS analysts expect the GDP share re-distributed through the Consolidated Budget will grow to 30% in 2005. The ICPS forecast for the 2005 State Budget deficit remains unchanged at 3% of GDP. This deficit will be covered through privatization revenues and international borrowings. Over 2006–2007, the deficit will shrink. ICPS economists do not expect tax rates to go down during the forecast period.

Given an upward adjustment in the forecast for real wage growth, ICPS economists have also upgraded their forecast for the growth of real disposable household incomes for 2005 to 19.5%. Because of slower growth of wages and a decline in social outlays in real terms, real disposable household incomes will slow down to 6% in 2006 and 6.5% in 2007.

In 2005, rapid growth of household incomes and a high propensity to consume will make private consumption grow 16% in real terms. As a result of slower income growth, private consumption will grow at a more sluggish pace over 2006–2007. During this period, private consumption is expected to grow 8% per annum.

## Forecast risks

The risks of the forecast are:

- a sharp decline in public trust in the Administration because of the split in the Yushchenko team;
- the failure of the government to develop and implement reforms;
- shrinking tax revenues as a result of the economic slowdown;
- steep fluctuations in the external situation;
- further rises in the price for Russian gas deliveries to Ukraine as of 2006;
- failure to accede to the WTO in 2005. ■

*ICPS economists have been providing regular forecasts for the economic development of Ukraine since 1997. These forecasts are updated quarterly and published in **quarterly predictions**. If you are interested in receiving this publication on a regular basis, you can subscribe today by contacting Andriy Starynskiy at (380-44) 484-4410 or by e-mail at [marketing@icps.kiev.ua](mailto:marketing@icps.kiev.ua).*

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### Key macroeconomic indicators

Years	2004	2005	2006	2007
Indicators	estimate	forecast		
GDP, billions UAH	344.8	412.1	486.5	542.6
Real GDP, <i>apc</i>	12.1	4.0	5.5	6.0
Real industrial output, <i>apc</i>	12.5	5.0	6.5	6.0
Real agricultural output, <i>apc</i>	19.9	3.0	1.0	3.0
Real gross fixed investment, <i>apc</i>	10.2	-2.0	7.0	9.0
Consumer price index, <i>apc</i>	12.1	13.1	7.6	7.8
Producer price index, <i>apc</i>	12.3	13.5	11.5	7.0
Average monthly real wages, <i>apc</i>	23.8	15.0	8.0	7.0
Unemployment rate (ILO methodology), %	8.6	8.2	8.0	7.8
Exports of goods&services, <i>apc</i>	37.2	13.0	7.0	8.0
Imports of goods&services, <i>apc</i>	26.0	20.0	13.0	15.0
Current account balance, % GDP	10.5	6.0	2.8	-0.3
Consolidated Budget balance, % GDP	-3.2	-3.0	-2.0	-1.0
Official exchange rate (average annual), UAH/USD	5.32	5.11	5.04	5.09

*apc = annual percentage change*

Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by **quarterly predictions**

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