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quarterly predictions

#33, fourth quarter 2005

In this issue, the International Centre for Policy Studies presents an analysis of the political and economic situation in Ukraine for 2005, government policy, and factors that will influence these in the medium term. Forecasts for 2005–2007 are updated.

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MAJOR INDICATORS

Year / Indicator	1998	1999	2000	2001	2002	2003	2004 est.	2005 forecast	2006 forecast	2007 forecast
Economic activity										
GDP, *billions UAH*	102.6	130.4	170.1	204.2	225.8	267.3	344.8	412.8	486.4	552.2
Real GDP, *apc**	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	2.5	5.5	5.5
Real industrial output, *apc*	-1.0	4.0	13.2	14.2	7.0	15.8	12.5	3.0	6.5	6.0
Real agricultural output, *apc*	-9.8	-5.7	7.6	10.2	1.2	-11.0	19.9	2.0	1.0	3.0
Gross investment, *% GDP*	20.8	17.5	19.8	21.8	20.2	22.0	19.1	20.3	19.6	19.3
Real gross fixed investment, *apc*	2.6	0.1	12.4	6.2	3.4	15.8	10.0	-1.0	7.0	9.0
Real total consumption, *apc*	-0.1	-3.7	2.0	9.3	5.0	12.8	9.1	9.9	6.0	5.5
Net FDI, *millions USD*[(1)]	747	489	594	769	688	1,411	1,711	7,200	3,000	2,500
Real disposable household income, *apc*[(2)]	-5.8	1.2	11.1	10.0	18.0	9.1	16.8	20.5	6.0	6.5
Real retail trade, *apc*	-6.6	-7.1	8.1	13.7	15.0	20.5	21.9	22.0	9.0	10.0
Prices										
Consumer price index, *apc*	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	11.5	11.5	7.0
Producer price index, *apc*	35.3	15.7	20.8	0.9	5.7	11.1	24.1	11.1	6.0	6.0
Labor market										
Population, *millions*	50.1	49.7	49.3	48.4	48.0	47.6	47.3	47.1	46.9	46.7
Average monthly real wages, *apc**	-3.9	-8.9	-0.9	19.3	18.2	15.2	23.8	15.0	8.0	7.0
Unemployment rate, % (ILO methodology)	—	11.9	11.7	11.1	10.1	9.1	8.6	8.2	8.0	7.8
Foreign economic activity										
Exports of goods&services, *apc*	-13.4	-7.3	18.0	8.0	10.7	24.0	41.6	6.0	6.0	7.0
Imports of goods&services, *apc*	-14.0	-19.1	17.8	14.1	5.0	28.7	26.0	23.0	11.0	11.0
Current account balance, *% GDP*	-3.1	3.0	4.0	3.7	7.7	5.8	10.5	2.9	0.9	-0.5
Budget										
Revenues, *% GDP* (consolidated)[(3)]	27.3	24.7	26.2	26.9	27.4	28.5	26.5	30.0	29.0	29.0
Balance, *% GDP*[(3)]	-2.7	-2.4	-0.8	-0.3	0.7	-0.2	-3.2	-2.0	-3.0	-2.0
Financial indicators										
Monetary base, *apc*	22	39	39	37	34	30	34	54	31	19
M3, *apc*	25	41	45	42	42	47	32	53	34	22
NBU gold/forex reserves, *millions USD*	793	1,094	1,475	3,089	4,417	6,937	9,525	19,640	21,350	22,300
Official exchange rate, *UAH/USD* (average annual)	2.45	4.13	5.44	5.37	5.33	5.33	5.32	5.12	5.05	5.09
Loan interest, *% pa* (average annual)[(4)]	55	53	40	32	25	18	17.5	16.1	14.0	9.5
Global economy										
Global GDP, *apc*	2.8	3.7	4.6	2.5	3.0	4.0	5.1	4.1	3.4	3.6
GDP of Ukraine's major trading partners, *apc* (2/3 of exports)	0.8	3.0	5.9	2.4	4.0	4.6	5.6	4.5	3.7	3.7

* *apc* = annual percentage change

Notes: [(1)] according to the NBU; [(2)] starting in 2002, indicator of aggregate disposable household income; [(3)] calculation using IMF methodology; [(4)] commercial bank loans, UAH

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

OVERVIEW

With weak investment, dependence on external factors and lack of reform, the economic upswing in Ukraine that began in 2000 has been unsustainable. According to ICPS estimates, Ukraine's GDP grew 2.5% in 2005. Steep price hikes for imports of Russian gas could become a powerful incentive for increasing energy efficiency in the domestic economy and initiating reforms in the residential services sector. Over 2006–2007, Ukraine's economy will grow 5.5% per annum

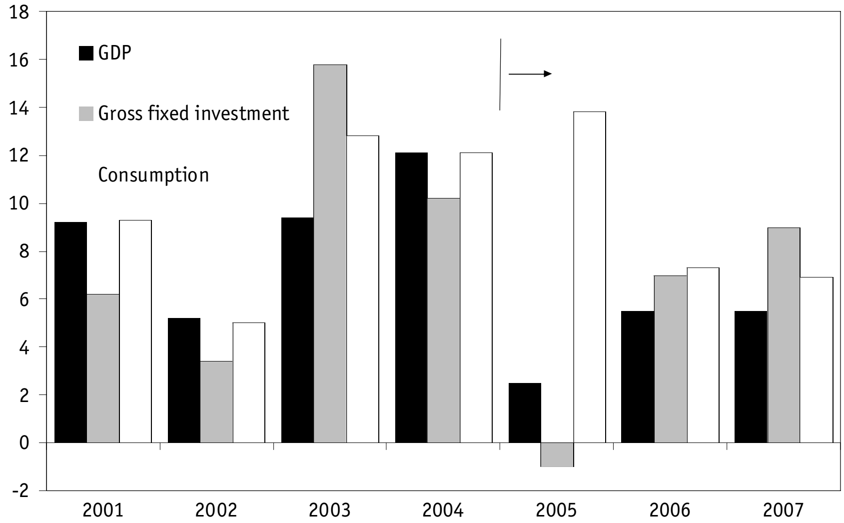
Results for 2005

In 2005, Ukraine's economy grew 2.5%

Over the period of the economic upswing that began in Ukraine in 2000, 2005 has proved to be the year of slowest economic growth. According to ICPS estimates, GDP grew 2.5% in 2005.[1] Despite continued rapid growth of consumption[2] (see **HOUSEHOLDS**), investment in the country's economy shrank.[3] This decline in investment was driven by deep cuts in public investment (see **BUSINESS**). The lack of public resources for capital investment was the result of the new Administration's socially-oriented policies.

Figure 1. GDP, investment and consumption

% real annual change



Source: Derzhkomstat; forecast by ***quarterly predictions***

The balance of trade in goods became negative

According to ICPS estimates, the balance of trade fell to US \$118mn in 2005, after a record-high US \$4.9bn in 2004 (see **FOREIGN TRADE**). In 2005, imports of goods grew almost as fast as during the previous year, whereas exports slowed down from 41.6% growth in 2004 to 6% in 2005. In August 2005, for the first time since 1999, the balance of trade in goods became negative. However, given the National Bank of Ukraine's high gold and currency reserves (see **MONETARY**

[1] In 2004, Ukrainian GDP grew 12.1%.

[2] According to ICPS estimates, overall consumption climbed 13.8% in 2005, while household consumption grew a record-high 17%.

[3] According to ICPS estimates, gross fixed investment shrank 1% in 2005.

Policy), this negative balance does not pose a threat to the country's macroeconomic stability at present. The main factor behind slow growth of exports was a drop in global prices for the steel products that are the main component of Ukrainian exports. Rapid growth of imports was primarily the result of rapid growth in disposable incomes (see **Households**).

Agriculture and industry slowed down

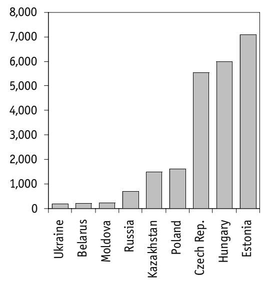
Agriculture and the processing industries slowed down significantly (see **Agriculture** and **Industry**). Slow growth in agriculture is the result of its high dependence on two crops, grain and potato, which causes indicators fluctuate wildly every year. Slow growth in processing industries was primarily the result of a decline in metalworking due to an unfavorable situation with prices on global markets and shrinking domestic oil refining after import duty for petroleum products was reduced and oil supplies to Ukrainian refineries shrank.

Trade shrank 9%

According to ICPS estimates, gross value-added in trade shrank 9% compared to 2004 (see **Business**). ICPS economists say the key factor behind this decline was the collapse of shadow and fictitious brokering schemes in wholesale trade that accounted for a significant share of trade growth throughout 2003–2004.[4]

Although the new government committed many mistakes that contributed little to the country's economic growth,[5] ICPS economists do not think that the steep economic slowdown is mainly the result of failed policies in 2005. Instead, ICPS experts are convinced that the foundation for sustainable economic development was not laid during the previous years. According to ICPS economists, slower economic growth was the result of three long-term factors:

FDI in 2004, USD per capita



Sources: UNCTAD, World Bank

Weak investment. Average growth of gross fixed investment was 7.2% over 1998–2004. During this period, investment was mainly channeled to upgrade capacities from soviet times. The volume of investment in the creation of new companies and innovative technologies was minor. More than half of all capital investment involved company funds, which, given weak financial indicators for domestic businesses, could not be a sustainable, multi-year source of investment. As a rule, public investment was distributed opaquely and priority of government policy goals were not identified in advance. A low level of capitalization among domestic banks, limited access of foreign banks to the Ukrainian market, and high risks of bad debt hampered the development of commercial lending.[6] A high level of corruption in the public sector, difficult access to the Ukrainian market, the lack of a transparent and level playing field for doing business scared foreign business away from investing in Ukraine.

The lack of reforms. Despite the urgent need for reforms and regular calls to reforms by various political forces, large-scale systemic transformations have not gotten going in Ukraine. Urgent reforms are needed in the social security system, the infrastructure sector (residential services, communications and transport) and the judiciary. Every year, delays in starting transformations in the social security system have resulted in inefficient use of public resources, while the government's inability to ensure appropriate social security has served as an excuse for taxpayers to avoid paying taxes in full. Ukraine's residential services sector continues to be unprofitable, while the refusal of consumers to pay for poor quality services has only deepened the crisis in this sector. Ukraine's backward pro-

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[4] The Ministry of Economy plans to carry out a special study into the factors behind the decline in wholesale trade. See the *Ukrainian News* newswire of 15 December 2005.

[5] See ***quarterly predictions*** for Q3'05, p. 4.

[6] Over January–September 2004, bank and other loans were 5.8% in the structure of fixed capital investment. However, over January–September 2005, capital investment financed from this source grew 85.1%, and its share climbed 4.5 pp.

vision of telecommunication services and its underdeveloped transport sector hinder commercial development and raise the costs of doing business. This, in turn, makes companies less competitive. The high level of corruption in the Ukrainian court system also raises the cost of doing business and hampers investment.

Economic dependence on external factors. Over the past five years, the country's economic upswing was largely the result of growing exports of metal products. This high dependence on exports and the dependence of these exports on one type of product made the Ukrainian economy hostage to the pricing situation on global markets. Indeed, when metal prices began to slip, the economy revealed its lack of preparedness. The prolonged economic boom relieved successive Governments of the need to look for new drivers of economic growth and to implement policies that would facilitate structural changes in the economy. The low price of gas and other fuels did little to provide incentives for company owners and managers to invest in upgrading technologies and led to the high gas exposure of Ukrainian economy.[7] Steep gas price rises will make products manufactured by such companies uncompetitive.

The gas problem

Ukraine imports 77% of its gas

The share of gas in the consumption of energy resources is 43.3% in Ukraine. The biggest end consumers of natural gas are the residential services sector (41%) and industry (36%). Moreover, Ukraine imports 77% of the gas it consumes.

Average prices for Russian gas in 2004, USD/1,000 cu m

CIS	*50.87*
Baltic countries	*83.52*
CEE countries	*133.43*
Western Europe	*139.59*

Source: OAO Gazprom

Russia wants to revise the 21 June 2002 contract between NAK NaftoGaz Ukrainy and OAO Gazprom agreed deliveries of Russian gas to Ukraine for 2003—2013 in exchange for the Russians' transporting gas through Ukrainian territory to European countries.[8] ICPS economists say that Russia's rejection of previous agreements and its determination to raise the gas price several times for Ukraine for 2006 are based on political considerations. Clear statements by the new Ukrainian government regarding integration into the European economy, intensified negotiations on accession to NATO, rejection of deep integration within the Common Economic Area, and refusal to participate in a gas transport consortium with Russia do not suit Russia's vision of Ukraine in the geopolitical sphere. Russia was selling Ukraine cheap gas in return for the loyalty of the country's top officials to Russian foreign policy (see **Political Environment**). Having lost this loyalty, Russia appears to have decided to deprive Ukraine of gas at discounted prices.

The numerous options for the further development of this situation with gas lie between two extremes:

Radical option I: A steep one-time price hike on Russian gas and later on Turkmen gas. As a result, output in metalworking, chemicals and other industries goes down.[9] Higher productivity and the failure of the least efficient busi-

[7] Gas exposure is the relation between net gas imports and GDP. Only Moldova has higher gas exposure than Ukraine among those countries importing Russian gas. Ukraine's gas exposure is 44 times higher than that of Germany. See *The Impact of Higher Natural Gas and Oil Prices* by Mark Davis, Ruslan Piontkivsky, Olga Pindyuk, and Dejan Ostojic, The World Bank, 6 December 2005.

[8] In 2004, Russian gas transit through Ukrainian territory was 137.1bn cu m. Ukraine consumed 25bn cu m of Russian gas in 2004.

[9] Op. cit. According to the results of econometric modeling, Ukraine could lose up to 9% of GDP in 2006 as a consequence of a steep gas price hike.

nesses will lead to staff reductions. Unemployment will rise steeply because of the low mobility of the workforce in Ukraine and small volumes of FDI, which otherwise would be creating new jobs.

Radical option II: Ukraine transfers its gas transport system into Russian management and effectively renounces the option of an independent foreign policy. The economic consequence of this decision will be the preservation of soviet-style economic inefficiency. However, this will not protect Ukraine against further attempts to raise gas prices.

Domestic gas prices should not be lower than import prices

Another extremely dangerous development would be for Ukraine to establish domestic consumer gas prices below the price for imported gas. The difference between these two prices would then have to be covered by the Budget—effectively state subsidies for gas consumers. The main consequences of this step are that, as before, companies will not little incentive to increase efficiency and public finances will go into a tailspin.

Gradual gas price increases is the best option for Ukraine

According to ICPS analysts, the best alternative for Ukraine would be gradual price increases in domestic gas prices to the level at least of the price for imported gas. Rising gas prices will force companies invest in upgrading production facilities in order to improve efficiency. Of course, some companies will have to cut production under these new conditions, while others—the least efficient ones—will have to leave the market.

Rising gas prices are a signal to start reforming residential services

ICPS analysts predict that, regardless of the outcome, the Government will raise gas prices more steeply for industrial customers than for residential ones, given the political sensitivity of the issue of utility prices for ordinary consumers. However, ICPS economists consider Russia's attempts to raise prices for Ukrainian gas imports the best spur to beginning the long-awaited reform of the residential services sector. Wide media coverage of the Russian gas dilemma in Ukraine has pretty well braced Ukrainian consumers for the negative consequences of this process.

In the opinion of ICPS economists, rising gas prices should push the Government to develop a national energy conservation program. It should provide incentives for applying energy-saving technologies and for implementing transparent schemes for distributing gas among different sectors of the economy (see **Industry**).

Forecast for 2006–2007

The ICPS forecast for 2006—2007 is for the economy to grow 5.5% per annum. The acceleration in 2006 will be driven by renewed investment flows, which are expected to grow 7% according to the ICPS forecast on the back of increased commercial lending and public investment. In 2007, investment will accelerate to 9% per annum (see **Business**).

During 2006–2007, Ukraine's GDP will grow 5.5% per annum

After a record-high growth throughout 2005, private consumption will slow down to 8% in 2006 and remain flat in 2007. The slowdown in household consumption will be because of slower growth in personal incomes (see **Households**).

As in 2005, imports will grow faster than exports throughout the forecast period. The value of trade in goods will climb 6% in 2006 and 7% in 2007, whereas imports will grow 11% per annum. The balance of trade will become negative in 2006; while the current account balance will grow negative in 2007 (see **Foreign trade**).

According to the ICPS forecast, consumer prices will grow as fast in 2006 as they did in 2005, 11.5% per annum. In 2007, prices should slow down to 7%, as personal income growth slows. Producer prices will also grow more slowly. Provided there are no unpredictable fluctuations on external markets, the Producer Price Index will grow 6% in 2006 and 7% in 2007 (see **Prices**).

The share of GDP re-distributed through the Consolidated Budget will fall back to 29% over 2006–2007. As social benefits grow more slowly, Consolidated Budget expenditures will remain flat in 2006, at 32% of GDP, and then shrink to 31% of GDP in 2007. ICPS economists do not expect a significant decline in tax rates throughout the forecast period (see **Public finance**).

According to the ICPS forecast, interest rates for hryvnia loans will gradually fall closer to interest rates for hard currency loans. The average rate for hryvnia loans will shrink to 9% by late 2007 (see **Monetary policy**).

Forecast risks

The ICPS forecast could prove overly optimistic under these five circumstances:

- significant price hikes for Russian gas coupled with a full-scale trade war with Russia that will include removing goods from the free trade regime, a growing number of anti-dumping investigations against Ukrainian exports, and restrictive import quotas;
- further price declines for Ukrainian export commodities on external markets;
- low tax receipts as business performance falls off;
- the inability of a pro-government party to ensure coalitional majority in the Verkhovna Rada, which would make it difficult to adopt key government decisions;
- the NBU switching to a more flexible exchange rate, which could significantly influence hryvnia and foreign currency rates.

*Highlights of **quarterly predictions** #33*

- *ICPS predicts the political situation*
- *The consequences of switching to a proportional voting system*
- *The drawbacks of the Draft Concept for reforming the tax system*
- *Factors behind low unemployment in Ukraine*
- *The need to establish a policy towards state-owned banks*
- *Inflation on its way down*
- *The progress and prospects for accession to the WTO*
- *How to encourage energy-saving*
- *What's behind shrinking investment in 2005*
- *The high cost of protecting domestic poultry producers*
- *Economic trends among Ukraine's key trading partners*

STATISTICAL APPENDIX

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Consumer Confidence											
Ukrainian language						English language					
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