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ICPS newsletter®

ICPS updates its economic outlook for 2006–2008

Over 2006–2008, domestic demand will be the main growth factor for Ukraine's economy. Rising energy prices, a less favorable external situation and worsening relations with Russia will all conspire to hamper the growth of the export share of GDP. Ukraine's economy will grow more quickly than in 2005, but the overall pace will remain relatively slow. Over 2006–2008, GDP will grow 3.8%, 4.5% and 4.6%. The updated ICPS macroeconomic forecast can be found in the latest issue of "Quarterly predictions"

The export share of GDP will shrink in favor of domestic demand

Expanding domestic demand will be the key feature of economic growth in Ukraine over 2006–2008. During this period, the share of internal demand in overall growth trends will remain higher than the share of external demand. Domestic demand will be driven by three factors:

- **A high propensity to consume.** Based on the ***consumer confidence*** poll, the index of propensity to consume has been above the 100-mark since H2'05. This meant that the majority of Ukrainians believe that now is generally a good time to make major household purchases;
- **Lower risks for sectors oriented on the consumer market.** Growing prices for natural gas will have a marginal impact on this branch. Sectors whose products are intended to satisfy internal demand will continue to expand intensely given the growth of household incomes and the underdeveloped supply of consumer goods&services. The state of production facilities in these sectors is better than that of companies in other industries. In contrast to heavy industry, these industries did not rely on tax breaks and were forced to compete seriously with foreign producers;
- **Growing lending among commercial banks.** The banking system has considerably increased the amount of lending. Increased opportunities for domestic banks to lend is having a positive impact primarily on the consumption sectors, which do not have access to cheap credit on external markets.

Instead, the export share of GDP during the forecast period will be smaller than it was over 2002–2004. This tendency will be driven by three main factors:

- **Growing prices for energy.** Prior to 2006, the low cost of energy made it possible for export-oriented companies in the metals and chemicals industries to produce competitively using outdated production facilities. To remain competitive as energy prices rise, these companies will now have to launch massive reconstruction, which will slow growth in these branches during the forecast period;
- **A less favorable external situation.** Rapid growth in prices for ferrous metal products over 2003–2004 was the main reason for the growth of the export component of the domestic economy during this period. As China expanded its own steel industry, it created downward pressure on world prices in 2005. Given that China is likely to continue to produce more steel, ICPS analysts say it is unlikely that prices will grow again in this sector during the forecast period. Stable world prices will restrain growth in Ukraine's metal industries;
- **Worsening trade relations with Russia.** ICPS economists say that in any possible outcome for the political situation in Ukraine, Ukrainian–Russian relations will remain difficult. There has been a growing the trend towards import substitution in Russia lately, and towards instituting closed cycle production, which Russian politicians say will increase the country's independence. With this in mind, Russia is likely to raise trade barriers, which will also have a negative impact on the expansion of Ukrainian imports to this country.

Find out more!

In the latest issue of ***quarterly predictions*** you can read all about the forecast for Ukraine's economic development, as well as:

- Outlook for the political situation
- Investment demand grows
- Why inflation will pick up in 2007
- How capital flees Ukraine
- Costs and benefits of the arrival of foreign banks in Ukraine
- Prospects for trade relations with Russia
- The cost of offering new benefits to "children of the war"
- State policy on the labor market
- The state of land reform
- Economic trends among Ukraine's key trading partners

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Forecast for 2006–2008

ICPS analysts expect Ukraine's economy to pick up some steam over 2006–2008, although the overall pace of growth will remain relatively low. Ukraine's GDP should grow 3.8% in 2006, 4.5% in 2007 and 4.6% in 2008. Investment will grow more rapidly than consumption.

ICPS analysts expect demand for investment to continue to grow, both among energy-intensive industries that will be looking to introduce more energy-efficient technologies, and among those branches oriented on the consumer market that want to expand production. The share of lending in the structure of investment will grow as companies find themselves without enough working capital to replace equipment on a mass scale.

Enterprises in the energy, metals and chemicals industries will borrow mostly on external markets. ICPS economists also expect the number of initial public offerings (IPOs) to grow starting in 2007. The pace of growth of gross fixed assets will be 7% in 2006, 9% in 2007, and 7% in 2008.

Revenues from privatization and the sale of domestic banks to strategic foreign investors will be the main source of FDI in 2006. In 2006 FDI will total US $6bn. Over 2007–2008, FDI will be US $3bn and $2.7bn.

After posting record growth in 2005, household incomes will grow more slowly over the forecast period. The contribution of social assistance to this indicator will shrink. Over 2006–2008, real disposable personal incomes will grow only 5.5%, 7.0% and 8.0%. Over 2006–2007, real household consumption will grow only 6.5% annually, while in 2008 it will grow 8.0%.

Over the forecast period, exports will pick up some steam, but imports will continue to outpace them. There will be a deficit in the trade balance. On one hand, growing prices for imported natural gas will increase imports. On the other, this will raise the cost of Ukrainian goods whose production involves a significant share of natural gas. This, in turn, will reduce their competitive edge over imports.

Given the growth in prices for imported gas, ICPS has raised its forecast for consumer and producer price inflation for 2006. The ICPS outlook is for the CPI to rise 12.5% over 2006, while the PPI will rise 10.0%. Over 2007–2008, the CPI will drop down to 7% and 6%, while the PPI will slow down to 7% and 6.5%.

Over the forecast period, the level of monetization of Ukraine's economy will approach to that of CEE countries. As the growth of individual incomes slows down and the NBU switches to targeting inflation, the money supply will grow at a slower pace.

Joblessness will continue to decline and Ukraine's rate of unemployment will approach its natural level. In 2008, unemployment will be 6.4%.

Key macroeconomic indicators

Years	2004	2005	2006	2007	2008
Indicator	estimate		forecast		
GDP, *mn UAH*	344.8	418.5	492.6	544.7	611.1
GDP, *rcc, %*	12.1	2.6	3.8	4.5	4.6
Real industrial output, *rcc, %*	12.5	3.1	3.0	2.5	3.0
Real agricultural output, *rcc, %*	19.9	0.0	0.5	5.0	2.0
Gross investment, *% of GDP*	19.2	21.8	21.7	22.2	22.6
Real gross fixed investment, *apc, %*	10.0	-4.0	7.0	9.0	7.0
Real consumption, *apc, %*	12.1	10.5	6.1	5.7	6.8
Net FDI, *mn USD*	1,711	7,533	6,000	3,000	2,700
Real disposable household income, *apc, %*	19.3	20.1	5.5	7.0	8.0
Real retail trade, *apc, %*	21.9	23.0	13.5	9.0	9.0
Consumer price index, *apc, %*	12.3	10.3	12.5	7.0	6.0
Producer price index, *apc, %*	24.1	9.5	10.0	7.0	6.5
Population, *mn*	47.3	46.9	46.7	46.5	46.3
Average monthly real wages, *apc, %*	23.8	20.3	14.0	11.0	12.0
Unemployment rate (ILO methodology), %	8.6	7.0	6.7	6.5	6.4
Exports of goods and services, *apc, %*	37.2	11.7	2.9	7.0	7.0
Imports of goods and services, *apc, %*	26.0	25.4	9.1	10.2	10.2
Current account balance, *% of GDP*	10.5	3.1	0.1	-1.6	-3.1
Consolidated Budget balance, *% of GDP*	-3.2	-1.9	-2.5	-2.0	-3.0
Official exchange rate (average annual), *UAH/USD*	5.31	5.12	5.05	5.12	5.20

apc = annual percentage change; rcc = real cumulative change

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

Forecast risks

The main risks to the ICPS forecast are:

- the emergence of a widespread political crisis that includes the collapse of the new coalition and the dismissal of the legislature;
- the introduction of tax breaks and privileges or subsidies in some or all branches of the economy to reduce price shocks caused by rising energy prices;
- the institution of tax reform in Ukraine for the forecast period that includes a reduction in basic tax rates;
- a revision of gas contracts with Russia and Turkmenistan;
- worse-than-expected grain harvests. ■

*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 at marketing@icps.kiev.ua.*

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