

ICPS newsletter[®]

Economic growth without the support of exports

Over 2006–2008, Ukraine's economy will grow at a moderate pace. The ICPS forecast is for GDP to grow 3.5% in 2006, 3.9% in 2007 and 4% in 2008. Over these three years, foreign trade will actually restrict economic growth and its contribution to real GDP will be negative. The main driver for development will be relatively rapid growth in domestic consumption in combination with a surge in investment growth to 7–9% per annum. ICPS's updated macroeconomic forecast is presented in the latest issue of Quarterly Predictions

The economy picks up pace despite export decline

Business activity has grown livelier since the beginning of 2006. Data for January–May 2006 shows that Ukraine's GDP rose 4%. The main driver of this growth has been more active investment. In Q1, fixed capital investment (FCI) grew 15.9% over the same period of 2005. This rapid growth, in turn, was stimulated by renewed state investment in fixed assets. The fastest growth in fixed capital investment was seen in those sectors that are oriented on the domestic consumer market.

Consumption has continued to grow rapidly since the beginning of the year. According to ICPS economists, household spending grew 13% in real terms over Q1'06. This was driven by continuing growth in incomes and a high inclination to consume.

The greatest growth was seen in those sectors that are oriented on the domestic consumer market. In particular, construction grew 8.2% and transport grew 6.2%. Processing has stagnated somewhat since the beginning of the year because of a decline in ore processing and metalworking, and in petroproduct processing.

The balance of trade has continued to deteriorate since the beginning of 2006.

In Q1'06, the deficit reached US \$1.8bn as exports of goods shrank 4.4%, while imports jumped 30.2%. Export volumes declined because of two main factors: an unfavorable external situation for Ukraine's most important export commodity, steel, and trade wars with Russia, which took a serious bite out of Ukraine's food exports. Such high levels of imports reflected high demand both among households, for consumer goods, and among businesses, for equipment and supplies needed for investment, as well as a major increase in energy prices, especially gas.

In Q1'06, volumes of FDI in Ukraine reached US \$922.5mn, almost four times the amount registered over Q1'05. Foreign investment grew fastest in the banking sector. A rapidly growing domestic consumer market has spurred serious interest among foreign investors in related sectors.

On an annual basis, inflation in May was 7.3%, the lowest level since May 2004. This slowdown in inflation was possible because of the growth in imports of low-inflation consumer goods and because Ukrainians were actively buying up foreign currency during the election period. The main drivers of inflation continue to be the fast pace of growth of disposable incomes, high expectations of inflation, and rising rates for residential gas and electricity.

By the way...

- As part of the People's Voice project, a post-certification audit of Makiyivka's quality management system was carried out over 26–30 June. The People's Voice has been working to introduce procedures and mechanisms that will increase the role of the general public in developing effective and responsible local government.
- ICPS Project Manager Volodymyr Hnat visited Komsomolsk on 6 July. As part of the People's Voice project, the Komsomolsk Municipal Council presented a software program for its performance monitoring system. This is part of an initiative to improve the system of municipal government.
- ICPS Project Manager Oleksandr Liakh visited the European Integration Committee in Poland to learn about Polish experience with Twinning and to present a progress report on Twinning projects in Ukraine.
- As part of the "Public Consultations on the EU–Ukraine Free Trade Agreement" project, ICPS held a roundtable on "The EU–Ukraine FTA: Tackling the investment climate" on 6 July 2006. ICPS economist Borys Bordiuh presented an analytical report for discussion.

Demand for foreign currency began to grow stronger from the beginning of the year, forcing the National Bank of Ukraine to cut into its reserves by 11% or US \$2.1bn. The extended period of political uncertainty put a damper on the growth of personal deposits. Lending, on the other hand, grew rapidly, more than 50% of this growth being personal loans. Nominal interest rates on loans actually

shrank because of growing competition among banks and decelerating inflation.

Forecast for 2006–2008

The ICPS forecast for GDP growth for 2006 has been reduced 0.3pp to 3.5%. In particular, ICPS analysts have downgraded the outlook for the external sector, with exports growing only 2% and imports 16%. The trade deficit will reach US \$3.3bn by the end of the year. Exports will grow slowly because of the relatively low demand for Ukrainian metal products on world markets, while imports will continue to be stimulated by high consumer demand and a growing need for goods for industrial investment.

Over 2007–2008, economic growth will pick up but levels will remain relatively low. ICPS economists expect GDP to grow 3.9% over 2007 and only 4% in 2008. The trade deficit will continue to grow, reaching US \$5.5bn and US \$8bn in 2008. This deficit will be largely the

result of fast-growing imports, which are expected to grow nearly twice as much as exports. Household consumption will grow 7% annually over 2007–2008. This slowdown in the growth of consumption will be largely a reflection of the slower pace at which disposable incomes will be growing, especially among those with below-average incomes.

Gross accumulation of fixed assets will grow 7% over 2006. The highest demand for capital will be among those businesses oriented on the domestic consumer market. At the same time, heavy industry will undergo a process of modernizing facilities in order to reduce the consumption of energy. Investment will grow 9% in 2007, and slip to 8% in 2008.

The ICPS forecast for inflation remains unchanged, with consumer prices growing 12.5% over 2006. ICPS analysts expect rates for residential gas and

electricity to continue to rise, as well as passenger fares and rates for landline telecommunication services. Over the year, producer prices should go up 10%. Over 2007–2008, inflation should subside somewhat, with consumer prices rising 7% in 2007 and 6% in 2008. Producer prices will grow 7% in 2007, and 6.5% in 2008.

In 2006, the NBU will maintain a stable hryvnia exchange rate relative to the US dollar. ICPS analysts expect the NBU to switch to targeting inflation in its policies, which means that the hryvnia–dollar exchange rate will fluctuate more. The average rate should be UAH 5.10/USD over 2007, rising to UAH 5.40/USD in 2008.

Forecast risks

The main risks to the ICPS forecast are:

- the new Government's adoption of economic policies that seriously damage the business climate and reduce investment inflows;
- a sharp decline in metal and chemical prices on world commodity markets;
- growing trade wars with Russia, that is, bans on other Ukrainian imports or new protective measures against Ukrainian products. ICPS analysts say that if Russia continues to expand its trade war against Ukraine, the biggest threat is to exports of heavy machinery;
- growing prices for imported natural gas in H2'06.

*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. For more information about economic forecasts, contact the ICPS Director of Publications and Economic Research, Oleksiy Blinov, at (380-44) 484-4403 or at oblinov@icps.kiev.ua.*

Key macroeconomic indicators

Years	2004	2005	2006	2007	2008
Indicator	estimate		forecast		
GDP, mn UAH	345.1	424.7	493.2	552.3	605.1
GDP, rcc, %	12.1	2.6	3.5	3.9	4.0
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	21.2	22.2	22.5	22.9	24.9
Real gross fixed investment, apc, %	20.5	-0.3	7.0	9.0	8.0
Real consumption, apc, %	10.0	12.9	7.6	6.0	6.1
Net FDI, mn USD	1,711	7,533	4,500	3,500	3,700
Real disposable household income, apc, %	19.6	20.1	9.0	7.0	8.0
Real retail trade, apc, %	21.9	23.0	15.0	10.0	10.0
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	15.0	10.0	12.0
Unemployment rate (ILO methodology), %	8.6	7.2	7.0	7.0	7.0
Exports of goods and services, apc, %	42.6	7.5	5.8	6.2	6.2
Imports of goods and services, apc, %	31.3	20.4	15.0	10.2	10.2
Current account balance, % of GDP	10.6	3.1	-1.2	-3.2	-5.4
Consolidated Budget balance, % of GDP	-3.2	-1.9	-2.0	-2.0	-2.0
Official exchange rate (average annual), UAH/USD	5.31	5.12	5.05	5.10	5.40

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**

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