

ICPS newsletter®

Domestic demand keeps the economy moving

*Over 2006–2008, Ukraine's economy will keep growing around 5% per annum. The ICPS forecast is for real GDP to grow 5.5% in 2006, 4.6% in 2007 and 5% in 2008. Growth will deviate from the overall trend the most in 2007 as private consumption slows down, because of slower growth in disposable incomes. The updated ICPS macroeconomic forecast can be found in the latest issue of *Quarterly Predictions**

Once again, world metal prices shape Ukraine's growth dynamic

In Summer 2006, economic growth picked up considerable steam in Ukraine. Over January–August 2006, real GDP grew 5.7%, which was twice as fast as the same period in 2005.

The main factors behind the economic upturn in 2006 are:

- **Strong investment growth.** During H1'06, fixed capital investment grew 12.2%. The main centers of investment activity are sectors producing for the consumer market, food processing and retail trade. Foreign direct investment continues to grow at a very rapid pace, primarily in the banking sector.
- **Improved foreign market situation.** Stabilized world steel prices in early 2006 and renewed growth in Q2'06 led to

renewed growth in exported goods in May 2006 and acceleration in the processing industry.

Expectations for 2006

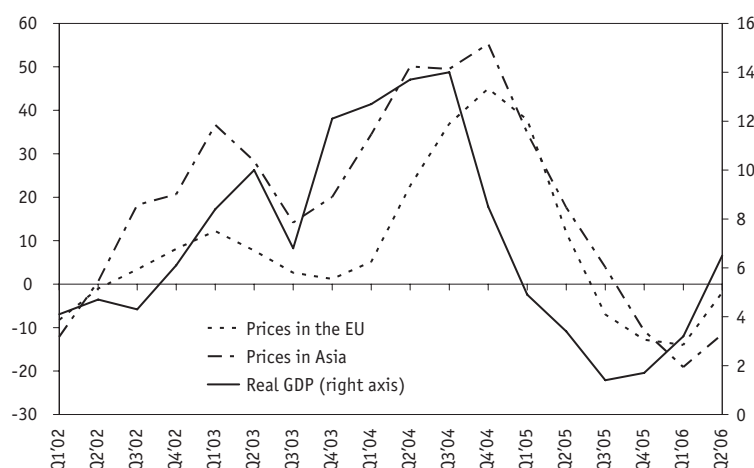
ICPS economists expect GDP to grow 5.5% in 2006. The main driver behind this will be private consumption, which is likely to post 17% growth. At the same time, exports of goods and services will grow 7.4% in real terms, while imports will rise 15.8%. The foreign trade deficit will reach US \$3bn in 2006, or 3% of GDP.

Gross fixed capital investment will grow 9% in 2006. ICPS economists expect FDI into Ukraine to reach US \$4.5bn in 2006.

Given the improved foreign economic situation and more lively growth in domestic demand, ICPS economists have upgraded their forecast for industrial output for 2006 by 2pp, to 5%.

Real GDP growth and global steel prices

% change against the same quarter of the previous year



Sources: Derzhkomstat, MEPS Ltd.; calculations by *quarterly predictions*

By the way...

- As part of the "Public Consultations on the EU–Ukraine Free Trade Agreement" project, ICPS held a roundtable called "The Transport Sector in Ukraine in the Context of a EU–Ukraine Free Trade Agreement" on 10 October 2006.
- An international conference called "The activities of Policy Analysis Groups in Central Executive Bodies and the Secretariat of the Cabinet of Ministers" took place on 6 October 2006. This conference was dedicated to the completion of the ICPS's "Setting up Policy Analysis Groups in Central Executive Bodies" project. This project was commissioned by the Center for Facilitating Institutional Development in the Civil Service under the Main Administration of the Civil Service of Ukraine and implemented by the International Centre for Policy Studies.
- On 5 October 2005, ICPS economists held a press conference on "Current Political and Economic Trends and Forecast." Centre specialists presented the highlights of the latest issue of *quarterly predictions*.
- A roundtable called "Prospects for Developing Ukraine's Steel Industry in the Context of an EU–Ukraine Expanded Free Trade Agreement" took place on 3 October 2006. This roundtable is a part of the "Public Consultations on the EU–Ukraine Free Trade Agreement" project.
- Over 24–29 September 2006, ICPS experts Olha Shumylo and Ihor Shevliakov were in Washington to participate in the Ukrainian–American working group on economics and business as part of the scheduled session of the "US–Ukraine Policy Dialog" project.
- The ICPS began to develop a sector-based forecast for 2007 for *Kompanyon*, a Ukrainian business journal. This is the third time that ICPS has prepared a similar forecast for this analytical publication.

Construction will climb 6%, while trade will grow 8%.

ICPS economists expect the Consumer Price Index to grow 10.2% in 2006, which is nearly identical to the value registered in 2005. There should be further rises in regulated rates in Q4'06. Producer prices will grow 10% in 2006.

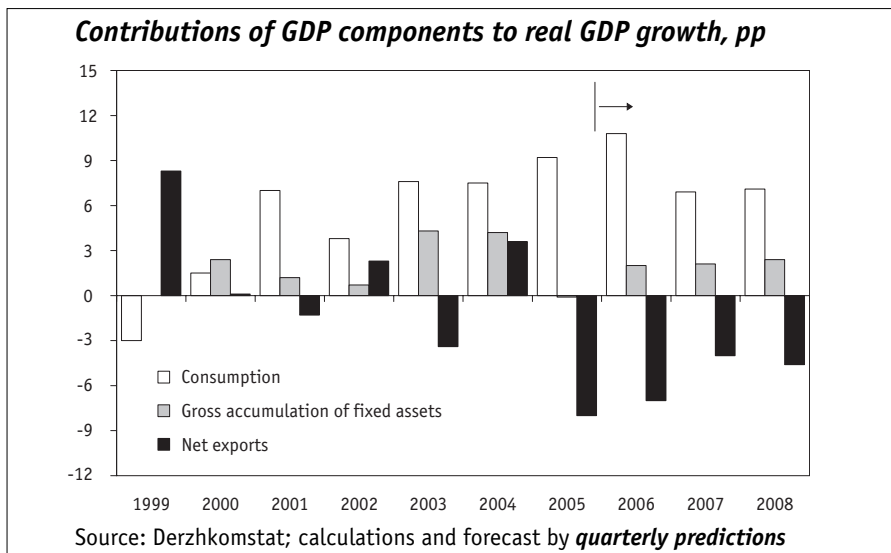
According to the ICPS forecast, the NBU will continue to support the current exchange rate, UAH 5.05/USD, until the end of the year. NBU gold and foreign currency reserves should grow an additional US \$500mn in 2006.

Forecast for 2007–2008

The main assumptions underlying the ICPS forecast for 2007–2008 are:

- Starting in 1 January 2007, Ukraine will be paying US \$130–150/1,000 cu m for imported natural gas;
- The Government will raise domestic gas prices gradually;
- Global steel prices will begin to slip in late 2006 and throughout 2007;
- In 2007, special tax holidays will be reintroduced through SEZs and TPDs.

In 2007, Ukraine's economy will grow 4.6%. Slower economic growth will be the result of a slowdown in private consumption—to about 10%, against 17% in 2006. Industry will slow down to 3% because of a decline in global steel prices and the rising cost of natural gas. In 2008, real GDP will grow 5%.



Over 2007–2008, investment will continue to grow at a rapid pace, the result of a relatively stable business environment and high demand for capital. Gross fixed investment will grow 10% in 2007 and 11% in 2008. Foreign direct investment in Ukraine will total US \$3.5bn in 2007 and US \$4bn in 2008.

ICPS economists expect the NBU to begin a gradual controlled depreciation of the hryvnia in 2007 in order to reduce pressure from the deteriorating balance of payments. The average exchange rate should be UAH 5.17/USD in 2007 and UAH 5.44/USD in 2008.

Over 2007–2008, inflation will gradually slow down. ICPS economists expect the CPI to

grow 9% in 2007 and 8% in 2008. Because of the prospects of even higher prices for imported natural gas, ICPS economists have raised their forecast for producer prices growth for 2007 to 9.5% and for 2008 to 9%.

ICPS economists expect the share of GDP re-distributed through the Budget to shrink to 32% in 2007. The main factor behind shrinking Consolidated Budget revenues will be the re-introduction of tax breaks, largely through special economic zones (SEZs) and territories of priority development (TPDs). In 2008, Consolidated Budget revenues will remain unchanged at 32% of GDP. The Consolidated Budget deficit will reach 2.5% of GDP over 2007–2008.

Forecast risks

The main risks to the ICPS forecast are:

- prices for imported gas above US \$150/1,000 cu m in 2007;
- a stronger orientation of the State Budget towards investment-related spending;
- wild fluctuations in energy prices on global markets;
- growing import duty rates;
- greater-than-expected depreciation of the hryvnia. ■

*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**.*

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Key macroeconomic indicators

Years	2004	2005	2006	2007	2008
	estimate		forecast		
GDP, mn UAH	345.1	424.7	519.2	612.1	721.7
GDP, apc, %*	12.1	2.6	5.5	4.6	5.0
Real industrial output, apc, %	12.5	3.1	5.0	3.0	4.0
Real agricultural output, acc, %	19.9	0.0	2.5	5.5	3.0
Gross investment, % of GDP	21.2	22.0	21.5	21.8	22.8
Real gross fixed investment, apc, %	20.5	-0.3	9.0	10.0	11.0
Real consumption, apc, %	10.0	12.8	14.2	8.6	8.7
Net FDI, mn USD	1,711	7,533	4,500	3,500	4,000
Real disposable household income, apc, %	19.6	20.1	16.0	11.0	12.0
Real retail trade, apc, %	21.9	23.0	23.0	13.0	13.0
Consumer price index, apc, %	12.3	10.3	10.2	9.0	8.0
Producer price index, apc, %	24.1	9.5	10.0	9.5	9.0
Population, mn	47.3	46.9	46.7	46.5	46.3
Average monthly real wages, apc, %	23.8	20.3	18.5	11.5	13.0
Unemployment rate (ILO methodology), %	8.6	7.2	6.8	6.6	6.5
Exports of goods and services, apc, %	42.6	7.5	7.4	6.2	6.2
Imports of goods and services, apc, %	31.3	20.4	15.8	10.2	10.2
Current account balance, % of GDP	10.6	3.1	-0.8	-2.7	-4.3
Consolidated Budget balance, % of GDP	-3.2	-1.9	-2.5	-2.5	-2.5
Official exchange rate (average annual), UAH/USD	5.31	5.12	5.05	5.17	5.44

*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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