

ICPS newsletter[®]

Ukraine's economy: Growth through inertia will yield 5–5.5%

This week, the latest issue of "Quarterly Predictions" is out in print, with ICPS's updated political and economic forecast for Ukraine for the next three years. According to the Centre's research, Ukraine's economy will continue along its current growth trajectory out of sheer inertia throughout 2007–2009. Although the pace of growth will remain high at 5–5.5%, there will not be any substantial change in the factors pushing this growth

Economic policy will not be growth-oriented

The current political system is unable to ensure policies that would stimulate Ukraine's economy to a qualitative breakthrough during the forecast period. ICPS economists base this assessment on their evaluation of the political system:

Weak public institutions. They do not guarantee political honesty and transparency or economic competitiveness in the country. Politicians are able to continually change the rules of the game, at the cost of consistency and systematicness in state policy. Weak institutions also allow politicians to interfere in economic processes and to regulate markets using administrative means. This encourages corruption, preserves an unappealing business climate and creates barriers to entry on domestic markets.

A government machine unable to act strategically. State decisions are mostly made in the interests of specific political forces. Typically, they are very narrowly focused and short-term in orientation, in response to either some crisis or the powerful lobbying of specific business circles. As a result, economic policy is reactive rather than proactive. The restructuring of the economy is largely happening under pressure from external shocks and is more the outcome of management decisions on the part of business itself, without the strategic support of the state, which should really be instituting reforms itself and direct the changes.

No system for reaching compromises has been worked out. In a situation where the President and Government belong to different political forces, there is a need to reach compromise in order to make state decisions. On one hand,

Merry Christmas and a Happy New Year!

Dear Readers! The editorial team of the **ICPS newsletter** would like to wish you all the best of the coming New Year and Christmas holidays. The next issue of the newsletter will come out 15 January 2007.

such a system can lead to better quality policy. On the other, there is a risk of a number of negative consequences. First, this need to agree every single decision reduces the efficiency and responsiveness of the state machine. Second, as the last few months have shown, in order to more quickly reach a compromise, the two sides have started to break up major policy decisions, such as the Budget, into smaller components. This kind of fragmentation of state policy will lead to a loss of systemicness and, thence, strategic effectiveness. Third, there is a problem in that the procedure for reaching these compromises is new to Ukraine's political system and time is needed to work out both formal and informal rules for interacting.

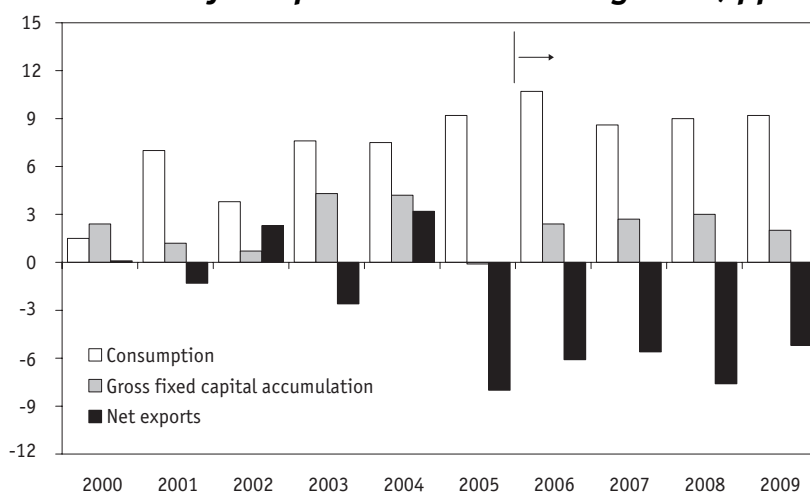
ICPS analysts say that the political situation will evolve without any radical changes to the political system over 2007–2009. Nor will there be any major positive changes in those areas that critically affect the economy: the judiciary, tax policy or combating corruption. The state will continue to merely respond to ongoing economic changes, without stimulating the development of the country's most promising economic sectors.

Forecast of economic trends

ICPS economists expect Ukraine's economy to develop moderately over the forecast period. GDP will grow 5.5% in 2007, 5% in 2008, and 5.5% in 2009.

Throughout this period, private consumption will grow more slowly than

Contribution of components to real GDP growth, pp



Source: Derzhkomstat; calculations and forecast: *quarterly predictions*

in 2006 as household incomes slow their growth and individuals begin to save more. In 2007, private consumption will grow 10% in real terms and 11% in 2008. In 2009, consumption will pick up pace as disposable incomes take another leap, to 13%, when social spending increases in the run-up to the Presidential election.

Over 2007–2008, investment will accelerate to 12% and 13%. ICPS analysts say that investment will mostly go into those sectors oriented on domestic consumer markets and on domestic producers who are looking to update worn-out, energy-intensive equipment and technology. In 2009, investment will slow down to 8% as the state investment component shrinks.

The trade deficit will grow throughout the forecast period and by the end of 2009 will reach nearly US \$12bn. Imports will continue to grow faster than exports. Throughout this period, the structure of Ukrainian exports will undergo significant shifts. World prices for traditional export commodities will be less favorable. Imports will satisfy

the economy's demand for investment as well as continuing high consumer demand.

Inflation will subside throughout the forecast period. Consumer prices will grow more slowly as disposable incomes slow down, imports continue to be price stable, and the supply of consumer goods expands. In 2007–2009, the CPI will grow 9%, 8% and 6%. Stabilization and even a touch of price deflation on steel markets will slow the growth of producer prices. In 2007, these will grow relatively high because of the increased price of imported gas. The PPI will grow 10.5%, 9% and 7.5% over 2007–2009.

The increase in gas prices as of 1 January 2007 to US \$130/1,000 cu m will have a negative impact on the chemicals industry, the fuel and energy complex, and the residential services sector. This will cause industrial output to slow down. In 2007, industrial growth will reach only 3%. Real growth in household incomes will lead to high demand for machinery and food products. Industrial output will then pick up, growing 4% in 2008 and 4.5% in 2009.

With a sharp upswing in livestock breeding, farm output will grow 6% in 2007. Slower growth in field crops will hold back overall growth in the agricultural sector. Over 2008–2009, agricultural output will grow 3% per year. ICPS economists expect the ban on the sale of agricultural land to be extended to 2008.

ICPS analysts say that in 2007 the National Bank of Ukraine will begin a gradual devaluation of the hryvnia because of the relatively low inflows of foreign capital. These will not help cover the deficit on the current account balance. By the end of 2007, the hryvnia will be at UAH 5.30/USD, while in 2008 and 2009 it will drop to UAH 5.50/USD.

ICPS economists expect the share of GDP redistributed through the Budget to grow smaller in 2007–2009. In 2009, it should be down to 31.4%. At the same time, the Consolidated Budget deficit will grow to 3.0% in 2009 as social spending is expanded in the run-up to the Presidential election.

Forecast risks

The main risks to the ICPS forecast are:

- a rise in the price of imported gas above the US \$130/1,000 cu m mark in 2008–2009;
- sudden changes in world prices for metals and chemicals;
- reduced tax receipts in the Budget as the result of major tax breaks and/or an increase in shadow operations involving investment projects in SEZs and TPDs;
- a higher-than-forecast devaluation 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**. 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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Key macroeconomic indicators

| Years | 2005 | 2006 | 2007 | 2008 | 2009 |
|--|-------|-------|----------|-------|-------|
| Indicator | est. | | forecast | | |
| GDP, bn UAH | 424.7 | 525.5 | 610.5 | 726.5 | 867.6 |
| GDP, apc, %* | 2.6 | 6.8 | 5.5 | 5.0 | 5.5 |
| Real industrial output, apc, % | 3.1 | 5.5 | 3.0 | 4.0 | 4.5 |
| Real agricultural output, acc, % | -0.1 | 0.0 | 6.0 | 3.0 | 3.0 |
| Gross investment, % of GDP | 22.0 | 22.9 | 23.4 | 24.0 | 24.7 |
| Real gross fixed investment, apc, % | -0.3 | 11.0 | 12.0 | 13.0 | 8.0 |
| Real consumption, apc, % | 12.8 | 14.0 | 10.8 | 10.8 | 10.9 |
| Net FDI, mn USD | 7,533 | 4,500 | 3,500 | 4,000 | 4,500 |
| Real disposable household income, apc, % | 20.1 | 16.5 | 11.0 | 12.0 | 14.0 |
| Real retail trade, apc, % | 23.0 | 23.0 | 13.0 | 13.0 | 15.0 |
| Consumer price index, apc, % | 10.3 | 12.5 | 9.0 | 8.0 | 6.0 |
| Producer price index, apc, % | 9.5 | 14.5 | 10.5 | 9.0 | 7.5 |
| Population, mn | 47.3 | 46.9 | 46.6 | 46.3 | 46.1 |
| Average monthly real wages, apc, % | 20.3 | 19.0 | 13.0 | 13.0 | 14.0 |
| Unemployment rate (ILO methodology), % | 7.2 | 6.7 | 6.4 | 6.2 | 6.1 |
| Exports of goods and services, apc, % | 7.5 | 12.7 | 6.9 | 7.8 | 9.3 |
| Imports of goods and services, apc, % | 20.4 | 21.7 | 14.1 | 11.9 | 10.2 |
| Current account balance, % of GDP | 3.1 | -1.1 | -4.4 | -6.2 | -6.2 |
| Consolidated Budget balance, % of GDP | -1.8 | -2.9 | -2.7 | -2.0 | -3.0 |
| Official exchange rate (average annual), UAH/USD | 5.12 | 5.05 | 5.12 | 5.44 | 5.50 |

*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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