

quarterly predictions

#40, third quarter 2007

In this issue, the International Centre for Policy Studies presents an assessment of the political and economic situation in Ukraine for January–August 2007, government policy, and factors that will influence these in the medium term. Forecasts for 2007–2009 are updated and a forecast for 2010 introduced.

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Dear Reader,

*This latest issue of **quarterly predictions** marks 10 years of ongoing macroeconomic forecasting by the International Centre for Policy Studies.*

Ten years ago, Ukraine's economy was very different. The process of privatization was just going into full swing, barter was the standard form of commercial transaction in many sectors, and the official average wage was US \$80.

Compared to 1997, Ukraine's economy has grown 74% in real terms and its dollar value has grown 2.5 times. Our forecast is that foreign direct investment (FDI) in 2007 will be more than 10 times higher than it was in 1997.

In 1997, the economy felt the negative impact of the transformations that began with the fall of the Soviet Union and the slow dismantling of the centrally administrated economy. Economic collapse had not ended and real wages were stagnating.

Still, 1997 was a clear turning point from the macroeconomic point-of-view. Inflation had fallen to 10% from the astronomic heights registered in the mid-90s and the currency rate had stabilized. But the following year saw the emergence of a financial crisis that changed the economy fundamentally by pushing Ukraine to start structural transformation.

The situation today is surprisingly similar to 1997. Many transformations have already happened, the economy is largely stable, and the rate of change is relatively low. Yet it is completely obvious that, in order to ensure continued high growth in the medium and long terms, more changes are needed. On the one hand, the effect of old growth factors is dwindling, and on the other, lively growth is increasing the risks and restrictions connected to lending, energy efficiency and the quality of public services.

While the changes needed in 1997 had ready-made recipes—further privatization, eliminating non-monetary forms of payment, and liberalizing regulation—that is, all those changes through which Ukraine's western neighbors had gone through just a few years earlier, the situation now is less obvious. Reforms to the pension system, education, healthcare, and residential services are much more complicated, having far more dimensions and options.

*Together with our readers, we have tracked the changes in Ukraine's economy and analyzed the consequences of government policy in economic areas for an entire decade. The next few years promise to be no less exciting, and the **quarterly predictions** team will continue to look for ways to improve its understanding of economic processes both now and in the future. Stay tuned!*

*from the **quarterly predictions** team*

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MAJOR INDICATORS

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Indicator						est.		forecast		
Economic activity										
GDP, billions UAH	204.2	225.8	267.3	345.1	441.4	537.7	667.6	797.7	931.2	1,097.7
Real GDP, <i>apc</i> *	9.2	5.2	9.6	12.1	2.7	7.1	8.0	6.0	5.5	5.5
Real industrial output, <i>apc</i>	14.2	7.0	15.8	12.5	3.1	6.2	9.0	7.0	6.5	6.0
Real agricultural output, <i>apc</i>	10.2	1.2	-11.0	19.7	0.1	2.5	0.0	7.0	2.0	2.0
Gross investment, % GDP	21.8	20.2	22.0	21.2	22.6	24.3	28.3	29.7	30.9	32.4
Real gross fixed investment, <i>apc</i>	6.0	3.4	22.5	20.5	3.9	18.7	22.0	17.0	14.0	15.0
Real total consumption, <i>apc</i>	9.3	5.0	10.0	9.7	15.7	11.9	10.6	10.7	9.8	8.5
Net FDI, millions USD ⁽¹⁾	769	688	1,411	1,711	7,533	5,737	6,200	5,700	6,000	6,300
Real disposable household income, <i>apc</i>	10.0	18.0	9.1	19.6	23.9	13.4	13.0	13.5	12.0	10.0
Real retail trade, <i>apc</i>	13.7	15.0	20.5	21.9	23.4	25.3	27.0	24.0	21.0	18.0
Prices										
Consumer price index, <i>apc</i>	6.1	-0.6	8.2	12.3	10.3	11.6	9.5	9.0	7.0	6.5
Producer price index, <i>apc</i>	0.9	5.7	11.1	24.1	9.5	14.1	16.0	10.0	8.5	7.5
Labor market										
Population, millions ⁽²⁾	48.9	48.5	48.0	47.6	47.3	46.9	46.6	46.2	45.9	45.6
Average monthly real wages, <i>apc</i>	19.3	18.2	15.2	23.8	20.3	18.3	14.0	14.0	12.0	12.0
Unemployment rate, % (ILO methodology)	10.9	9.6	9.1	8.6	7.2	6.8	6.7	6.4	6.2	5.9
Foreign economic activity										
Exports of goods&services, <i>apc</i>	8.0	10.7	24.0	42.6	7.5	13.2	18.9	14.3	12.0	12.0
Imports of goods&services, <i>apc</i>	14.1	5.0	28.7	31.3	20.4	22.0	24.1	20.0	16.7	14.2
Current account balance, % GDP	3.7	7.5	5.8	10.6	2.9	-1.5	-4.0	-6.3	-8.2	-8.8
Budget										
Revenues, % GDP (consolidated) ⁽³⁾	25.7	27.7	28.2	26.5	30.4	31.9	31.8	32.0	32.0	32.0
Balance, % GDP ⁽³⁾	-1.5	0.7	-0.2	-3.2	-1.8	-0.7	-0.6	-1.9	-1.6	-1.3
Financial indicators										
Monetary base, <i>apc</i>	37	34	30.1	34.1	53.9	17.5	32.7	25.2	23.0	19.4
M3, <i>apc</i>	42	42	46.5	32.4	54.3	34.5	39.8	33.8	30.2	24.7
NBU gold/forex reserves, millions USD ⁽⁴⁾	3,341	4,445	6,943	9,715	19,391	22,358	29,158	32,558	31,858	31,858
Official exchange rate, UAH/USD (average annual)	5.37	5.33	5.33	5.32	5.12	5.05	5.05	5.05	5.05	5.05
Loan interest, % <i>pa</i> (average annual) ⁽⁵⁾	32	25	17.9	17.4	16.2	15.2	14.0	12.7	11.1	10.0
Global economy										
Global GDP, <i>apc</i>	2.6	3.1	4.1	5.3	4.9	5.4	4.5	4.4	4.2	4.2
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	2.6	4.0	4.6	5.7	5.0	5.6	4.9	4.5	4.2	4.2

* *apc* = annual percentage change

Notes: ⁽¹⁾ according to the NBU
⁽²⁾ at the start of the year
⁽³⁾ using IMF methodology
⁽⁴⁾ according to balance of payments methodology
⁽⁵⁾ commercial bank loans, UAH

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

OVERVIEW

Over January–August 2007, GDP grew 7.5%

GDP, % annual real change

2004	12.1
2005	2.7
2006	7.1
2007	8.0
2008	6.0
2009	5.5
2010	5.5

Preparations for the 2012 European Football Championship should spur investment in 2010

According to preliminary estimates, Ukraine's real GDP grew 7.5% over January–August 2007. This rapid GDP growth is the result of positive trends in three major sectors: processing, construction and trade.¹ The main factor behind a slight slowdown in the summer was the poor crop² in August 2007 (see **BUSINESS**).

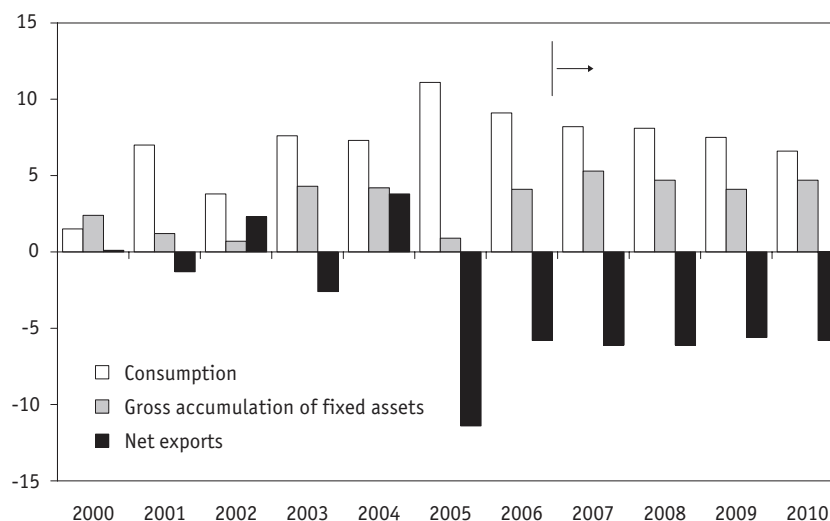
ICPS economists have left their forecast for real GDP growth for 2007 unchanged at 8%. ICPS economists expect economic growth to slow down to 6% in 2008, and to 5.5% per annum over 2009–2010.

During the forecast period, private consumption will continue to be the main growth driver. ICPS economists expect private consumption to grow 13% per annum over 2007–2008, slowing down to 11.5% in 2009 and 10% in 2010.

The key factor behind continuing rapid growth in private consumption will be intensive growth in real wages. In real terms, wages will grow 14% in 2007, 12% per annum over 2008–2009, and 10% in 2010 (see **HOUSEHOLDS**).

While private consumption will gradually slow down, the role of investment in economic growth will grow stronger. Gross accumulation of fixed assets will grow 22% in 2007, 17% in 2008 and 14% in 2009. In 2010, with preparations for the 2012 European Football Championship underway, the downward trend in investment growth will come to an end and investment will grow 15% (see **BUSINESS**).

Figure 1. Contribution of GDP components to real growth, pp



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

High prices for exported goods balanced the dynamic of exports and imports

Given the favorable situation with prices for key Ukrainian export commodities—steel products, grain and sunflower—on external markets and active investment demand in CIS countries, Ukraine's exports grew rapidly in H1'07.

¹ For more information, see *quarterly predictions* for Q2'07, p. 4.

² Over January–August 2007, gross value-added in agriculture shrank 2.9% compared with the same period of 2006, whereas the country registered 5.2% growth for January–July 2007.

Over this period, exports grew 32.4% and imports grew 33%.³ Still, the country's trade deficit continued to grow as well, reaching 4.7% of GDP over the first six months of 2007.

ICPS economists expect external trade to slow down in H2'07. Exports will grow only 20% and imports will rise 25% for the year. Exports should then slow down to 15% in 2008, 12% in 2009 and 12% in 2010, mainly as global steel prices dip over 2008–2009. Imports will grow faster than exports throughout the forecast period: the value of imports will grow 20% in 2008, 17% in 2009 and 14% in 2010 (see **FOREIGN TRADE**).

The dynamic development of the country's economy, growing capitalization of companies, and greater investor confidence in prospects for the Ukrainian market will lead to a powerful influx of foreign investment. ICPS economists expect Ukraine to receive US \$6.2bn in foreign direct investment (FDI) in 2007. FDI in Ukraine will be around US \$5.7bn in 2008, US \$6.0bn in 2009 and US \$6.3bn in 2010 (see **FOREIGN TRADE**).

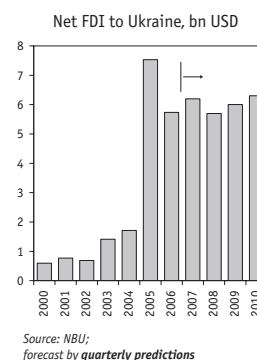
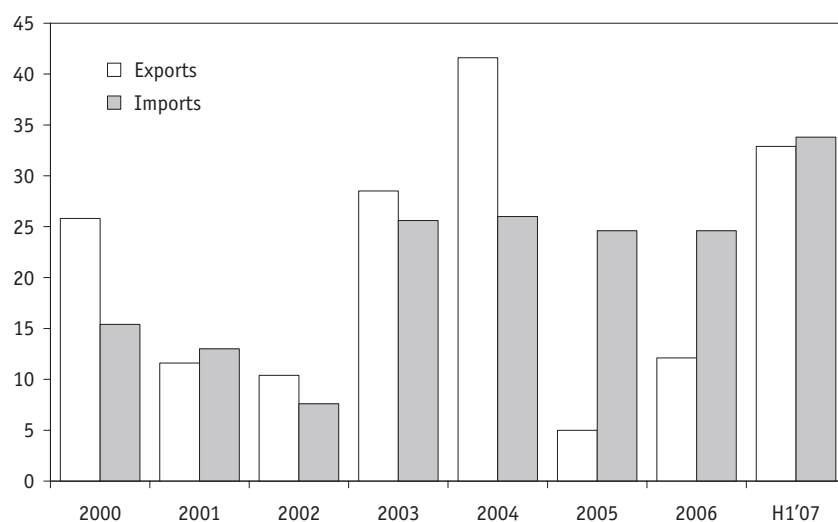


Figure 2. The value of foreign trade in goods

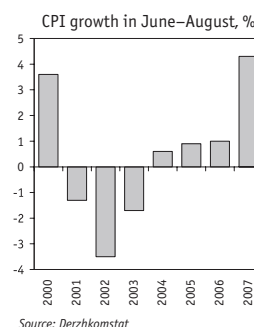
% annual change



Source: Derzhkomstat

In Summer 2007, inflation significantly deteriorated. While prices grew very slightly over January–May 2007,⁴ they rose 4.3% over June–August 2007 (see **PRICES**). The main factors behind the high summer inflation rate:

- a drought and the related poorness of the crop caused prices for flour, bread and animal products to rise;
- the methodology for tracking potato prices was changed;
- prices for fuel went up in Q2'07.



ICPS economists have left their forecast for CPI growth over 2007 unchanged at 9.5%. As the risk of postponing a revision of residential services (utility) rates⁵ became a factor in this forecast, it compensated for the unexpectedly high

³ In 2006, imports grew 24.6%, while exports rose 12.1%.

⁴ For more information, see *quarterly predictions* for Q2'07, p. 54.

⁵ See *quarterly predictions* for Q2'07, p. 55.

***Inflation in 2007
has been partly
transferred to 2008***

growth of prices in Summer 2007. During the forecast period, inflationary pressure will continue to be relatively high, with consumer prices growing 9% in 2008, 7.5% in 2009 and 6.5% in 2010 (see **PRICES**).

The National Bank of Ukraine continues to implement a policy of effectively pegging the hryvnia to the US dollar. High revenues from export operations and the active inflow of debt and investment capital allowed the Bank to increase its gold and foreign currency reserves almost by one-third, US \$6.6bn, over the first eight months of 2007 (see **MONETARY POLICY**).

***The exchange rate will
stay at UAH 5.05/USD
until the end of 2010***

ICPS economists expect the NBU to implement a policy of supporting the exchange rate throughout the forecast period. ICPS economists have changed their forecast for the exchange rate for 2008–2010, given an expected easing in pressure on the foreign currency market during this period (see **MONETARY POLICY**).

Rapid economic growth will lead to a further drop in unemployment. ICPS economists expect the jobless rate to be 6.7% in 2007, slipping to 6.4% in 2008, 6.2% in 2009, and 5.9% in 2010 (see **HOUSEHOLDS**).

Basic assumptions

- ICPS economists expect no major changes in the country's economic policy throughout the forecast period. The emphasis will be on the social aspects of economic policy, disregarding such systemic problems as an unreformed residential services sector, education or healthcare.
- Over 2008–2009, global prices for steel will decline 10–15% per annum.
- The price of imported gas for Ukraine will be US \$150–160/1,000 cu m in 2008, US \$160–170/1,000 cu m in 2009 and US \$190–220/1,000 cu m in 2010.
- The Tax Code will be adopted in 2008 and will come into force in 2009. As a result, the VAT rate will go down to 18%, cut 1pp per annum over 2009–2010, while the tax rate for profits that are reinvested will be reduced by 5%, to 20%, starting in 2009. No new taxes, such as a property tax, will be introduced.
- VAT Odesa Port Plant will be sold to a foreign investor, with revenues from its sale coming in 2008.
- Investment activity as a result of preparations for the 2012 European Football Championship will peak in 2010.
- The ban on selling farmland will be lifted effective 1 January 2009.
- In 2009, the second pillar of the pension system, the accumulation fund, will be launched.

Forecast risks

- The Tax Code is adopted in 2007 and comes into force in 2008.
- Global steel prices fall more than 25% per annum.
- Prices for nitrogen fertilizers fall because of a steep rise in global output.

- Ukraine's main trading partners become more protectionist.
- Ukraine fails to accede to the WTO in 2008.
- The price for imported natural gas rises to the average EU level.
- The accumulative system of pension insurance is not introduced during the forecast period.
- The NBU switches to targeting inflation and lets the hryvnia float.
- Monetary policy priorities change significantly because of shuffles among top NBU officials.
- The US dollar falls below US \$1.50/EUR in 2008.

Highlights of quarterly predictions #40

- *Possible coalitions*
- *A look at key provisions in the Cabinet's draft Tax Code*
- *The cost of a Constitutional Court ruling to revive benefits*
- *An evaluation of the 2007 crop*
- *The prospects for growing rapeseed in Ukraine*
- *Why retail trade is growing faster than personal incomes*

STATISTICAL APPENDIX

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