

# ICPS newsletter<sup>®</sup>

## Consumption remains the main driver of economic growth

**The latest issue of quarterly predictions has been published, presenting ICPS's updated forecast for political and economic developments in Ukraine over the next three years. Ukraine's economy will continue to grow at a moderate pace. ICPS analysts expect GDP to grow 6.5% in 2008, 5.7% in 2009, and 5.8% in 2010**

Over January–May, real GDP grew 6.4%. The main drivers were trade and the manufacturing industries. In trade, retail turnover grew at a record pace, driven by the steep rise in household incomes and high inflationary expectations. Manufacturing was driven by machine-building as demand for its products grew.

individuals caused the sector to contract by 3.8%<sup>1</sup> over January–May.

The National Bank of Ukraine officially raised the hryvnia rate from UAH 5.05/USD to UAH 4.85/USD in late May, after the hryvnia had been strengthening on the interbank and cash currency markets for some time. ICPS analysts say that this was appropriate, given

### Forecast for 2008–2010

ICPS analysts expect GDP to grow 6.5%, 5.7% and 5.8% over 2008–2010. Consumption will remain the main economic driver of growth during the forecast period. Still, ICPS analysts expect it to grow more slowly because of slower growth in incomes and consumer lending.

Tougher conditions for borrowing will be the main factor slowing down investment trends in 2008, as well as the importing of cars and investment equipment. The growing cost of borrowing will also cause salaries to grow more slowly. Consumer lending will slow down somewhat less.

After peaking y-o-y in May, consumer price growth will start to taper off. This will be partly due to growing supplies because of better harvests, the stabilization of world prices for food, and lower import duty on foodstuffs as a result of WTO accession. ICPS forecast is for the CPI to grow 21.2%, 14% and 10% over 2008–2010.

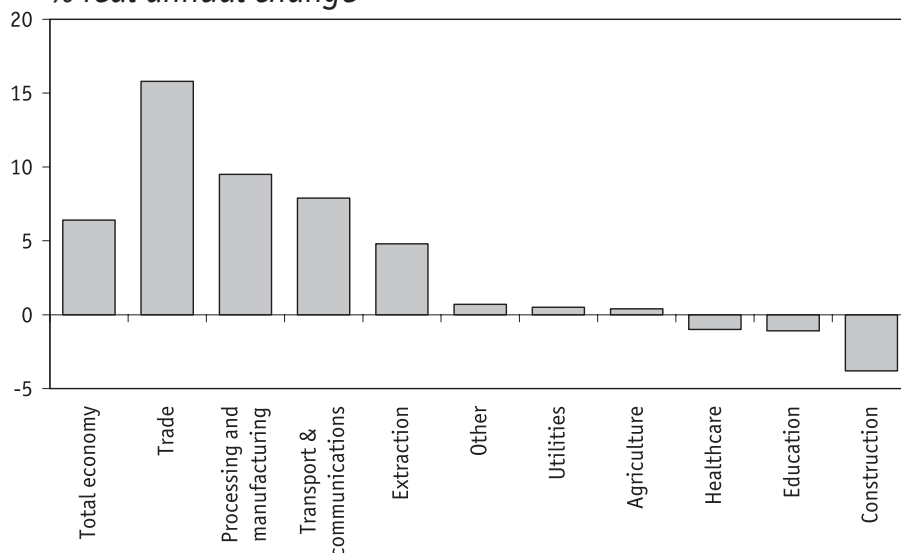
ICPS analysts say that, as soon as inflation begins to slow down, loan rates will also go down, which should encourage more active investment again. As a result, the gross accumulation of fixed assets will rise from 10% growth in 2008 to 15% annually in 2009 and 2010. After stagnating in 2008, construction growth will pick up again to 7% in 2009 and 2010.

Given the long-term greater levels of imports over exports, the negative trade and current account balances will continue to grow worse, reaching 10.3% and 10.1% of GDP in 2010.

Despite the appreciation of the hryvnia in Spring 2008, a rapidly rising current account deficit will begin to put downward pressure on the currency in the medium term. Given this, ICPS analysts say the NBU will settle for a more flexible exchange rate and will reduce its own participation on the currency market. The result of this will be greater balance between the current and financial accounts of the balance of payments as the hryvnia fluctuates more against the US dollar. The ICPS forecast is for the hryvnia-dollar exchange rate to settle at UAH 5.10/USD by the end of 2008, UAH 5.36/USD by

### GDP dynamic, January–May 2008

% real annual change



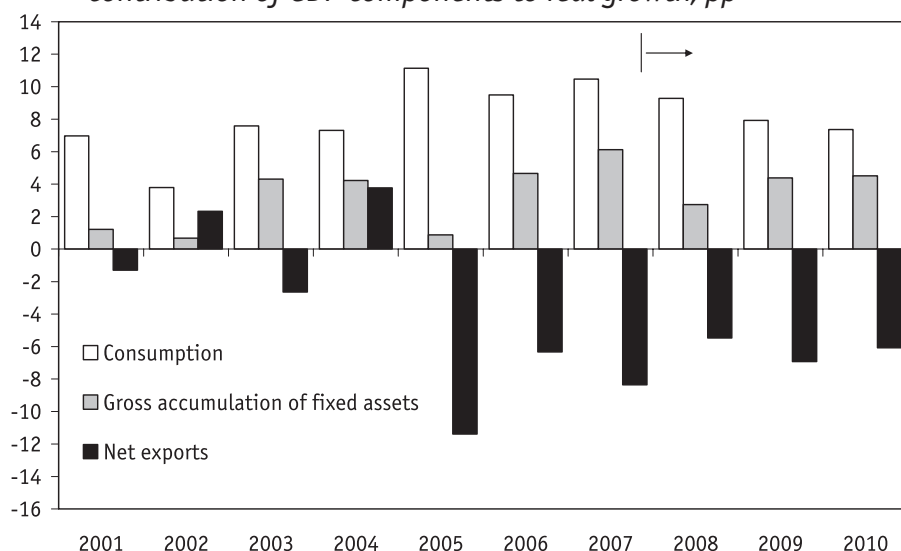
Source: Derzhkomstat

Consumer prices continued to grow as the main inflationary factors remained unchanged. The CPI grew a record 31.1% in May, y-o-y. But Government efforts to stifle this inflation had little impact. The NBU's tighter monetary policy in the face of rising inflation and reduced access to external credits for domestic banks were the main factors that made loans more costly in Ukraine. The construction sector, whose GVA had begun to decline in Q1'08, reacted the fastest to this change. More restricted access to loans for both builders and

that keeping the rate unchanged would have led to a greater money supply across the economy and would have countered all the NBU's other anti-inflationary efforts.

The current account deficit in the balance of payments grew to 9.6% of GDP in Q1'08. This was the result of a steep rise in imports since the beginning of the year, at the same time as exports grew much more slowly. However, the inflow of capital to the financial account was equal to the current account deficit because of growing inflows of FDI and debt capital to Ukraine.

## Contribution of GDP components to real growth, pp



Source: Derzhkomstat. Calculations and forecast: *quarterly predictions*

the end of 2009 and UAH 5.62/USD by the end of 2010.

ICPS analysts say that the Consolidated Budget deficit will be no more than 1.5% of GDP over the forecast period. The main source of financing to cover this deficit in the 2008 Budget will be external borrowings, whereas in 2009 and 2010 privatization and domestic bonds will play a higher role.

The expected revision of indicators in the 2008 Budget will mostly affect expenditures related to economic and investment needs, which were seriously underfinanced in Q1'08. Any revision of social indicators will be modest in order to keep some control over inflation.

### Assumptions

- The price of imported natural gas will be US \$179.50/1,000 cu m in 2008, US \$280–300 in 2009, and US \$320–350 in 2010;
- World steel and food prices will stabilize at a new, higher level in H2'08 and will stay at that level;
- Prices for fertilizers will continue to rise;
- tax legislation will remain largely unchanged;
- VAT Odesa Port Plant and VAT Ukrtelecom will be privatized in 2009 or 2010;
- UAH 9–10bn will be spent annually on compensating depreciated soviet savings over 2008–2010;
- The 2008 harvest will be greater than the 2007 one;
- The exchange rate will be more flexible.

### Risks

- A sharp fall in world steel prices in 2009 and 2010, which would slow Ukraine's

exports and, therefore, GDP below forecast levels;

- Major fluctuations in world prices for farm products, that is, more than 25%;
- A much-higher-than-expected price of imported natural gas in 2009, which would slow down industrial output and raise prices higher than forecast;
- A significant increase in social outlays in the 2008 Budget after a review, which would cause inflation to grow beyond forecast levels;

- A sharp reduction or rise in the amount of compensation being paid out for depreciated soviet savings over 2009 or 2010;
- The introduction of the accumulative pillar of the pension system in 2009;
- The privatization of VAT Ukrtelecom and VAT Odesa Port Plant in 2008;
- The introduction of a property tax in 2009 or 2010, bringing the Budget tax receipts higher than forecast;
- A switch to targeting inflation, as a result of which price growth will slow down below forecast levels and the exchange rate will be more volatile;
- Unexpected changes in the inflow of capital to Ukraine, which will cause the hryvnia-dollar exchange rate to fluctuate considerably more—over 10% on average annually—than forecast. ■

ICPS economists have been providing regular forecasts for the development of the country's economy since 1997. The ICPS forecast is updated on a quarterly basis and published in *quarterly predictions*. To subscribe to this publication, contact Svitlana Borenko by telephone at (380-44) 484-4400 or via e-mail at [marketing@icps.kiev.ua](mailto:marketing@icps.kiev.ua). For additional information, contact ICPS Senior Economist Ildar Gazizullin by telephone at (380-44) 484-4400 or via e-mail at [igazizullin@icps.kiev.ua](mailto:igazizullin@icps.kiev.ua).

## Key macroeconomic indicators

Years	2006	2007	2008	2009	2010
<b>Indicator</b>	estimate		forecast		
GDP, mn UAH	544.2	712.9	960.8	1,202.1	1,467.8
GDP, apc, %*	7.3	7.6	6.5	5.7	5.8
Real industrial output, apc, %	6.2	10.2	8.0	7.5	6.5
Real agricultural output, acc, %	2.5	-6.5	7.0	2.0	2.0
Gross investment, % of GDP	24.8	26.9	28.8	29.9	31.0
Real gross fixed investment, apc, %	21.2	24.8	10.0	15.0	15.0
Real consumption, apc, %	12.4	13.4	12.0	10.1	9.3
Net FDI, mn USD	5,737.0	9,218.0	10,000.0	11,000.0	12,000.0
Real disposable household incomes, apc	11.8	12.6	14.0	11.5	10.5
Real retail trade, apc, %	26.4	29.5	27.0	22.0	20.0
Consumer price index, apc, %	11.6	16.6	21.2	14.0	10.0
Producer price index, apc, %	14.1	23.3	30.7	12.0	10.0
Population, mn	46.9	46.6	46.4	46.1	45.9
Average monthly real wages, apc, %	18.3	12.5	11.0	12.0	12.0
Unemployment rate (ILO methodology), %	6.8	6.4	6.1	5.9	5.7
Exports of goods and services, apc, %	13.2	27.4	22.8	20.2	20.0
Imports of goods and services, apc, %	22.0	34.8	31.2	24.4	20.0
Current account balance, % of GDP	-1.5	-4.2	-7.4	-9.6	-10.1
Consolidated Budget balance, % of GDP	-0.7	-1.1	-1.3	-1.5	-1.5
Official exchange rate (average annual), UAH/USD	5.05	5.05	4.97	5.25	5.50

\* apc = annual percentage change

Sources: Derzhkomstat, Ministry of Finance, NBU; calculations and forecast by *quarterly predictions*.

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