

ICPS newsletter[®]

ICPS downgrades its economic forecast

In the newly-published issue of quarterly predictions, analysts from the International Centre for Policy Studies present their updated three-year forecast for political and economic developments in Ukraine. GDP growth is expected to slip to 4% in 2009, rising again to 5% in 2010 and 5.6% in 2011. The global financial crisis will have a negative impact on the two main domestic drivers of economic growth—consumption and investment

Current trends

Over January–August 2008, real GDP grew 7.1% in Ukraine. The pick-up in growth compared to January–July, when it was 6.5%, is mostly because of the record grain harvest.

In the meantime, the dynamic of other major sectors grew worse. The exposure of fictive operations in wholesale trading and a slowdown in retail led to an overall slowdown in the growth of trading. More restricted access to credit deepened a decrease in construction. In addition, a half-percentage contraction in industrial output was recorded in August.

After posting record growth in May y-o-y of 31.1%, consumer inflation began to abate. This was helped by expectations of a good harvest in both Ukraine and the world, lower world prices for oil and farm products, and a slowdown in the growth of disposable incomes.

Meanwhile, producer prices continued to grow at a record pace. This was caused

by the rising cost of raw materials and energy, sharp growth in wages across the economy, high inflationary expectations among manufacturers and consumers alike, and higher freight rates on the railway. Given that producer prices affect consumer prices with a delay of two to seven months, ICPS analysts do not expect a major decline in consumer inflation over the next few months.

In July, the NBU once again began to buy up surplus foreign currency. This improved the liquidity of the banking system and led to a considerable decline in interest rates and the stabilization of the hryvnia-dollar exchange rate on the interbank market. Still, the dollar rose once again on the interbank market in September, going over UAH 5.00/USD since April. This was mostly the result of foreign capital leaving the country as the world economic crisis deepened.

Despite a drop in interest rates on the interbank market, the interest rates remain high because of high inflation and

the growing cost of foreign borrowings. The rapid expansion of lending slowed significantly, which had a negative impact on a slew of sectors, especially construction and retail trade.

The current account deficit in the balance of payments over H1'08 reached US \$6.7bn or 7.7% of GDP as import volumes continued to outpace export volumes and cross-border payments to service external debts rose. In the meantime, inflows to the capital account added up to US \$9.0bn as FDI and debt capital inflows grew.

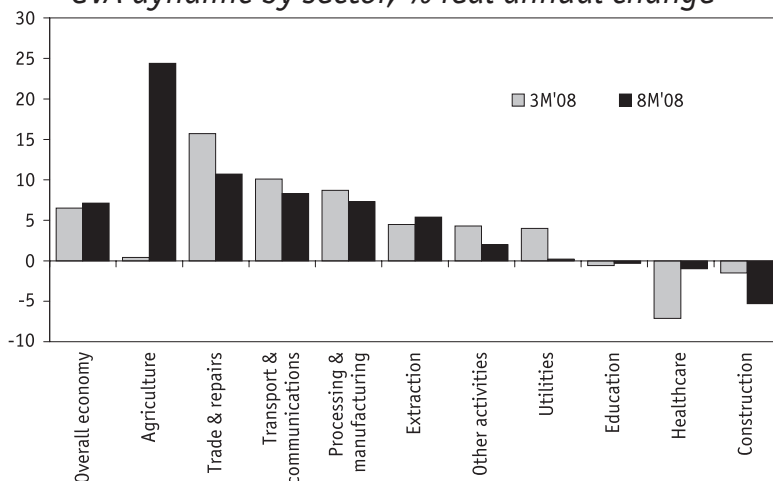
Forecast for 2009–2011

ICPS analysts expect GDP to grow 5.7% over 2008. Given the seasonal nature of agriculture production, the impact of the record harvest on GDP will subside by the end of the year. The trends in trade will be worse, as monthly volumes continue to shrink in real terms until the end of H1'09. The decline in construction will deepen, reaching 8% by the end of the year, while industrial growth will pick up again.

Over 2009–2011, GDP will grow 4%, 5% and 5.6% annually. The domestic engines of economic growth, consumption and investment, will slow down as access to credit becomes more restricted. After growing 15.5% in 2008, the pace of growth of consumption will approach the pace of growth of disposable incomes, settling at 10–11% over 2009–2010. Gross accumulation of fixed assets will grow 11% in 2008, 7% in 2009, 8% in 2010 and 10% in 2011. The accelerated dynamic of lending will cause consumption and investment to pick up in 2011.

ICPS analysts expect that, starting in Q4'08, inflows to the capital account of the balance of payments will no longer be enough to cover the negative balance on the current account, which will sharply rise. In response to this, the National Bank will begin to reduce its gold and currency reserves and the hryvnia exchange rate relative to the US dollar. ICPS analysts expect the rate to be set at UAH 5.05/USD by the end of 2008, UAH 5.30/USD by the

GVA dynamic by sector, % real annual change



Source: Derzhkomstat

end of 2009, and UAH 5.57/USD by the end of 2010 .

Meanwhile, a significant slowdown in inflows of foreign debt capital will slow the domestic lending market even further, a trend that will last until 2011. As a result, the pace of growth of imports, especially investment goods, durable goods and cars will fall considerably. In step with these, the current account deficit will also go down. The ICPS forecast is for it to be 7.5% in 2008, 9.9% in 2009, 8.3% in 2010, and 6.5% in 2011.

With the situation on world financial markets finally turning around in 2011, inflows to the capital account will once again cover the current account deficit. The NBU will once again start buying up currency for its reserves, in order to support the exchange rate at a new level: at the end of 2011, it will be UAH 5.57/USD.

In 2011, crediting will pick up pace again. Still, ICPS analysts say that, after the significant downward shift in the dynamic of lending over 2009–2010, banks will be more careful than in recent years about how they grow their credit portfolios. Risk management approaches will become better, as a result of which high-risk segment of the lending market, especially consumer lending, will grow more quietly than in 2005–Q1'2008. The banking system will also become more able to withstand risks.

ICPS analysts expect the CPI to grow 22% over 2008. A good harvest, cheaper oil and slower growth of disposable incomes will help bring it down over the next few months. On the other hand, the growing cost of transport and residential services will maintain pressure on prices. We expect that services will become the main source of inflation over 2009–2011. The ICPS forecast is for the CPI to grow 14% in 2009 and 10% yearly for 2010 and 2011.

The ICPS forecast is for the Consolidated Budget deficit to be 0.5% of GDP in 2008, and around 1% annually over 2009–2011. The deficit will rise over 2009–2011 as investment and defense spending are increased in the Budget. In addition, Consolidated Budget revenues will fall slightly over 2010–2011 because of the VAT, which will largely be determined by the dynamic of imports.

Because of the limited options for financing it, the deficit will remain low over the forecast period. The main sources of this capital will be privatization and foreign borrowings, whereas internal borrowings will remain low.

ICPS economists have regularly published a forecast for the Ukraine's economy

since 1997. This forecast is updated every quarter and is published in the periodical, **quarterly predictions**. ■

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Major indicators

Indicator \ Year	2006	2007	2008	2009	2010	2011
		esti- mate	forecast			
GDP, billions UAH	544.2	712.9	1,004.1	1,260.5	1,552.7	1,925.4
Real GDP, apc*	7.3	7.6	5.7	4.0	5.0	5.6
Real industrial output, apc	6.2	10.2	6.0	7.5	6.5	7.0
Real agricultural output, apc	2.5	-6.5	18.0	-4.0	2.0	4.0
Gross investment, % GDP	24.8	26.9	29.6	30.7	30.4	30.2
Real gross fixed investment, apc	21.2	24.8	11.0	7.0	8.0	10.0
Real total consumption, apc	12.4	13.4	12.6	9.1	8.2	9.0
Net FDI, millions USD	5,737	9,218	8,000	10,000	11,000	12,000
Real disposable household income, apc	11.8	12.6	13.5	10.5	10.0	10.0
Real retail trade, apc	26.4	29.5	23.0	18.0	17.0	19.0
Consumer price index, apc	11.6	16.6	22.0	14.0	10.0	10.0
Producer price index, apc	14.1	23.3	42.0	19.0	13.0	12.0
Population, millions	46.9	46.6	46.4	46.1	45.8	45.4
Average monthly real wages, apc	18.3	12.5	9.5	12.0	12.0	12.0
Unemployment rate, % (ILO methodology)	6.8	6.4	6.1	5.9	5.7	5.7
Exports of goods&services, apc	13.2	27.4	35.0	26.0	21.0	20.0
Imports of goods&services, apc	22.0	34.8	43.0	30.0	17.0	16.0
Current account balance, % GDP	-1.5	-4.2	-7.5	-9.9	-8.3	-6.5
Revenues, % GDP (consolidated)	31.6	30.8	31.0	31.1	30.8	30.6
Official exchange rate, UAH/USD (average annual)	5.05	5.05	4.96	5.20	5.45	5.57

* apc = annual percent change

Sources: Derzhkomstat, Ministry of Finance, NBU
Calculations and forecast: **quarterly predictions**

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