

quarterly predictions

#32, third quarter 2005

In this issue, the International Centre for Policy Studies presents an analysis of the Ukrainian political and economic situation for January–August 2005, government policy, and factors that will influence it in the medium term. Also in this issue, forecasts for 2005–2007 are updated.

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MAJOR INDICATORS

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Indicator							est.	forecast		
Economic activity										
GDP, billions UAH	102.6	130.4	170.1	204.2	225.8	267.3	344.8	412.1	486.5	542.6
Real GDP, <i>apc</i> *	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	4.0	5.5	6.0
Real industrial output, <i>apc</i>	-1.0	4.0	13.2	14.2	7.0	15.8	12.5	5.0	6.5	6.0
Real agricultural output, <i>apc</i>	-9.8	-5.7	7.6	10.2	1.2	-11.0	19.9	3.0	1.0	3.0
Gross investment, % GDP	20.8	17.5	19.8	21.8	20.2	22.0	19.1	19.4	18.9	19.6
Real gross fixed investment, <i>apc</i>	2.6	0.1	12.4	6.2	3.4	15.8	10.2	-2.0	7.0	9.0
Real total consumption, <i>apc</i>	-0.1	-3.7	2.0	9.3	5.0	12.8	12.1	13.1	7.6	7.8
Net FDI, millions USD ⁽¹⁾	747	489	594	769	688	1,411	1,711	1,700	2,000	2,500
Real disposable household income, <i>apc</i> ⁽²⁾	-5.8	1.2	11.1	10.0	18.0	9.1	16.5	19.5	6.0	6.5
Real retail trade, <i>apc</i>	-6.6	-7.1	8.1	13.7	15.0	20.5	20.0	17.0	13.0	10.0
Prices										
Consumer price index, <i>apc</i>	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	13.5	11.5	7.0
Producer price index, <i>apc</i>	35.3	15.7	20.8	0.9	5.7	11.1	24.1	11.0	6.0	6.0
Labor market										
Population, millions	50.1	49.7	49.3	48.4	48.0	47.6	47.3	47.1	46.9	46.7
Average monthly real wages, <i>apc</i> *	-3.9	-8.9	-0.9	19.3	18.2	15.2	23.8	15.0	8.0	7.0
Unemployment rate, % (ILO methodology)	—	11.9	11.7	11.1	10.1	9.1	8.6	8.2	8.0	7.8
Foreign economic activity										
Exports of goods&services, <i>apc</i>	-13.4	-7.3	18.0	8.0	10.7	24.0	37.2	13.0	7.0	8.0
Imports of goods&services, <i>apc</i>	-14.0	-19.1	17.8	14.1	5.0	28.7	26.0	20.0	13.0	15.0
Current account balance, % GDP	-3.1	3.0	4.0	3.7	7.7	5.8	10.5	6.0	2.8	-0.3
Budget										
Revenues, % GDP (consolidated) ⁽³⁾	27.3	24.7	26.2	26.9	27.4	28.5	26.5	30.0	29.0	29.0
Balance, % GDP ⁽³⁾	-2.7	-2.4	-0.8	-0.3	0.7	-0.2	-3.2	-3.0	-2.0	-1.0
Financial indicators										
Monetary base, <i>apc</i>	22	39	39	37	34	30	34	39	23	15
M3, <i>apc</i>	25	41	45	42	42	47	32	38	30	22
NBU gold/forex reserves, millions USD	793	1,094	1,475	3,089	4,417	6,937	9,252	14,475	16,176	17,146
Official exchange rate, UAH/USD (average annual)	2.45	4.13	5.44	5.37	5.33	5.33	5.32	5.11	5.04	5.09
Loan interest, % <i>pa</i> (average annual) ⁽⁴⁾	55	53	40	32	25	18	17.5	15.9	13.3	9.0
Global economy										
Global GDP, <i>apc</i>	2.8	3.7	4.6	2.5	3.0	4.0	5.1	3.7	3.0	3.2
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	0.8	3.0	5.9	2.4	4.0	4.6	5.5	4.3	3.8	3.8

* *apc* = annual percentage change

Notes: ⁽¹⁾ according to the NBU; ⁽²⁾ starting in 2002, indicator of aggregate disposable household income; ⁽³⁾ calculation using IMF methodology; ⁽⁴⁾ commercial bank loans, UAH

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

OVERVIEW

The dismissal of the Tymoshenko Government is unlikely spoil the achievements of the Orange Revolution. Growing political competition will foster better quality policy-making. ICPS economists have downgraded their forecast for the country's economic growth for 2005 to 4% because of shrinking investment and declining global prices for Ukrainian export commodities. Greater predictability in state policies after the Verkhovna Rada elections should spur investment in 2006–2007

Current situation

Government policy

The new team failed use the best time to launch reforms

President Yushchenko's team failed to launch transformations while the window of opportunity was wide open. High public confidence and economic growth at the beginning of 2005 offered a good foundation for instituting reforms. The new Administration appeared unable to resolve personal clashes within the Government team, to introduce new democratic policy-making approaches, or to react appropriately to criticisms in an uncensored media (see **POLITICAL ENVIRONMENT**).

The achievements of the Tymoshenko Government include: improved the living standards for the poorest Ukrainians, macro-financial stability and steps to combat corruption. However, these achievements are not sustainable because there are no long-term development plans. Growing social outlays in the context of an unreformed social security system reek of populism, macro-financial stability was supported through inertia, and the war on corruption was compromised by high-profile mudslinging within the Government team itself.

One of the priorities announced by the Tymoshenko Government was accession to the World Trade Organization. However, the Government failed to formulate and promote the advantages of accession or to prepare the necessary changes to legislation and thus lost the right opportunity to gain support for these changes in the Verkhovna Rada. ICPS experts say that Ukraine still has a good chance to accede to the WTO in 2005. However, the approaching deadline for accession¹ will limit Ukraine's bargaining position to get more favorable terms during the final part of the negotiation process (see **FOREIGN TRADE**).

Political competition is growing stronger

The dismissal of the Tymoshenko Government is unlikely to spoil the achievements of the Orange Revolution. The split in the Yushchenko team has effectively raised standards for politicians and top government officials. The ex-premier's intention to run for the 2006 Verkhovna Rada elections independently will increase political competition and encourage public oversight of government decisions. ICPS analysts say that having Ms. Tymoshenko in the opposition could improve the quality of state policies, provided the political battle concentrates on better ideas and not on re-distributing assets.

¹ The terms of accession are most likely to change from 2006: member countries will start a new round of negotiations to further liberalize trade, in particular with agricultural products. For Ukraine, this could force the country to change its proposed tariffs and subsidies, and to hold repeat talks with countries of the Working Group that had already agreed terms of accession with it.

Unlike the Tymoshenko Government, the next Cabinet will be less inclined to populist policies. For one thing, the actions of the new Government will not be influenced by the political ambitions of its members. However, this Government will also not launch serious transformations for four reasons:

- **TOO SHORT AN EFFECTIVE TERM.** Constitutional amendments come into force on 1 January 2006 that allow the Government to be formed by the Verkhovna Rada. After the March elections, the Government will most likely be replaced.
- **LACK OF WORKABLE INSTITUTIONAL PROCEDURES.** Like previous Governments, the new one faces the lack of capacity among government institutions to develop policies in an environment that recognizes competing interests.
- **WEAK SUPPORT IN THE VERKHOVNA RADA.** The decline in public trust in the Administration led to the gradual collapse of the working majority in the VR that had supported the decisions of the Government and president (see **POLITICAL ENVIRONMENT**).
- **A WORSENING ECONOMIC SITUATION.** Slower economic growth increases the likelihood that the government will tackle current problems at the expense of long-term and strategic goals.

Economic trends

According to preliminary data, real GDP grew only 2.8% over January–August 2005. The main factors behind this economic slowdown are: a decline in investment² (see **BUSINESS**) and a worsening in the foreign economic situation (see **FOREIGN TRADE**). According to ICPS, this shrinking investment is the result of four factors:

- growing political risks in late 2004–early 2005 made investors postpone investment launches;
- public investment shrank because of growing social spending in the Budget;
- growing tax revenues (see **PUBLIC FINANCE**) led to a decrease in working capital;
- lack of a clear Government position on the criteria for revisiting privatization tenders caused the owners of many privatized companies to delay investment decisions.

The deteriorating external situation resulted in a significant slowdown in Ukrainian industry and a decline in trade. A drop in global metal prices (see **FOREIGN TRADE**) led to shrinking physical export volumes of metals and metal products³ and, correspondingly, reduced demand for coking coal and iron ore. The decline in trade is due to shrinking wholesale trade⁴ in metal products and oil.

The new Government is unlikely to launch reforms

Economic growth suddenly slowed down...

...because of declining investment...

...and a deteriorating external situation

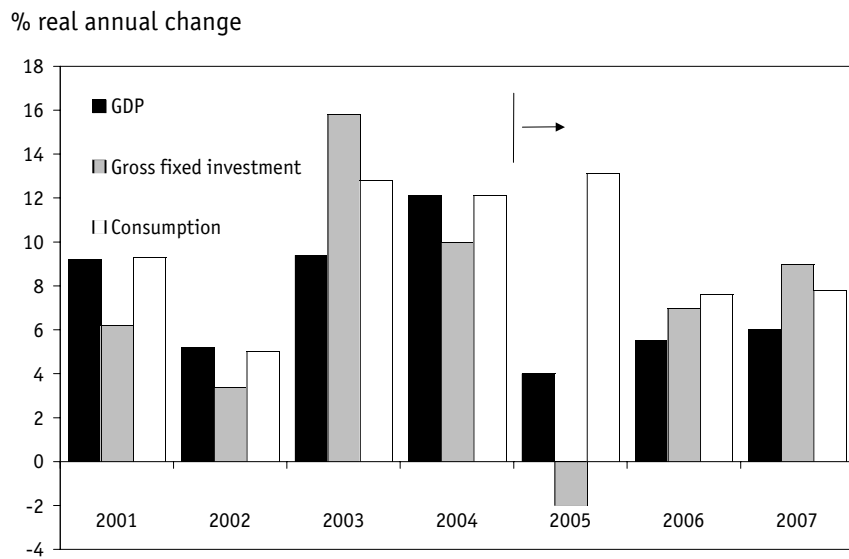
² In Q1'05, gross fixed investment shrank 2.6% compared to the same period in 2004.

³ Over January–July 2005, physical export volumes of metal products shrank 7.3, whereas the value of these exports grew 22.4% compared to the same period in 2004.

⁴ As a GDP component, the trade indicator consists of wholesale and retail trade. Wholesale trade accounts for about 75% of total trade volumes.

In 2005, Ukraine harvested a good grain crop. However, given the high baseline of 2004 and the slow growth of livestock, agricultural output will climb only 3% (see **AGRICULTURE**).

Figure 1. GDP, investment and consumption



Source: Derzhkomstat; forecast by Quarterly Predictions

Inflation continues to run high

Over January–August 2005, consumer prices grew 6.7% compared to December 2004. There was no seasonal deflation because the price of sugar took off in June and July 2005. Inflation continues to run high due to the rapid growth of personal incomes (see **HOUSEHOLDS**) and high inflationary expectations among Ukrainian consumers.⁵ However, producer prices will grow at a substantially slower pace because of a drop in prices for Ukrainian products on foreign markets and because of slower economic growth (see **PRICES**).

The National Bank of Ukraine will resort to a tighter monetary policy and try to curb inflation by reducing emissions. Despite a goods trade deficit over March–June 2005, the supply of foreign currency continues to outstrip demand on the interbank currency exchange market. However, the NBU reserves are growing more slowly than in Spring 2005, when the Bank allowed the appreciation of the hryvnia (see **MONETARY POLICY**).

Forecast for 2005–2007

ICPS has downgraded its forecast for real GDP growth in 2005 to 4%

ICPS economists have downgraded their forecast for GDP growth for 2005 by 3 pp to 4% due to a worsening in the forecast for investment and a greater-than-anticipated drop in prices for Ukrainian exports in H1'05. ICPS also underestimated the impact and duration of uncertainty in relations between the “Orange” Administration and business: the government failed to meet the expectations of businesses regarding reduced state intervention in commercial activity, the establishment of a level and fair playing field, reduced corruption, and the inviolability of property rights. ICPS economists expect the country’s economy to steam ahead in Q4'04, as the external situation stabilizes.

Over 2006 and 2007, GDP growth will accelerate to 5.5% and 6%, given a more rapid growth of investment. Gross fixed capital investment will grow 7%

⁵ See **consumer confidence** #21.

in 2006 and 9% in 2007. ICPS economists expect investment to grow due to greater predictability in state policies after the Verkhovna Rada elections and a gradual rise in public investment. According to ICPS, the period between the 2006 Verkhovna Rada elections and the 2009 presidential election will be long enough for the Yushchenko Administration to plan and implement large-scale, long-term objectives, instead of aiming all efforts at achieving short-term results to win elections. Over 2006–2007, new standards of political competition will help improve the quality of policy-making.

Ukraine's economy will grow 5.5% in 2006 and 6% in 2007

The ICPS forecast is for consumer price inflation to reach 13.5% in 2005. Given slower producer price growth and growing wage arrears, ICPS economists have downgraded their forecast. With household incomes growing steeply, anti-inflationary steps on the part of the Government will yield little. Over 2006–2007, consumer prices will grow at more slowly pace due to slower growth in household incomes and rising imports. According to ICPS economists, rates for residential services and passenger transport will go up after the 2006 Verkhovna Rada elections. Producer price inflation will slow down during the forecast period (see **PRICES**).

Over 2006–2007, consumer prices will slow down

According to ICPS, the NBU will support a stable UAH/USD exchange rate until late 2005. The ICPS forecast is that the NBU will not resort to targeting inflation after the Rada elections. Over 2005–2007, interest rates for hryvnia loans at commercial banks will slip to 9% per annum, while hryvnia deposit rates will go down to 7.4% per annum (see **MONETARY POLICY**).

Loan and deposit rates will decline somewhat

ICPS analysts expect the GDP share re-distributed through the Consolidated Budget will grow to 30% in 2005. The ICPS forecast for the 2005 State Budget deficit remains unchanged at 3% of GDP. This deficit will be covered through privatization revenues and international borrowings. Over 2006–2007, the deficit will shrink. ICPS economists do not expect tax rates to go down during the forecast period (see **PUBLIC FINANCE**).

Given an upward adjustment in the forecast for real wage growth, ICPS economists have also upgraded their forecast for the growth of real disposable household incomes for 2005 to 19.5%. Because of slower growth of wages and a decline in social outlays in real terms, real disposable household incomes will slow down to 6% in 2006 and 6.5% in 2007.

Private consumption will slow down over 2006–2007

In 2005, rapid growth of household incomes and a high propensity to consume will make private consumption grow 16% in real terms. As a result of slower income growth, private consumption will grow at a more sluggish pace over 2006–2007. During this period, private consumption is expected to grow 8% per annum (see **HOUSEHOLDS**).

Forecast risks

Key risks to the ICPS forecast for 2005–2007 are:

- a sharp decline in public trust in the Administration because of the split in the Yushchenko team;
- the failure of the government to develop and implement reforms;
- shrinking tax revenues as a result of the economic slowdown;
- steep fluctuations in the external situation;

- further rises in the price for Russian gas deliveries to Ukraine as of 2006;
- failure to accede to the WTO in 2005.

Highlights of quarterly predictions #32

- *ICPS predictions for the political situation;*
- *Factors in the way of reform;*
- *Plans to reform the law enforcement system;*
- *The pros and cons of the 2006 Draft Budget;*
- *Why the consumer basket does not reflect real change in consumer prices;*
- *The ICPS forecast for changes in the hryvnia exchange rate;*
- *The progress of Ukraine's accession to the World Trade Organization;*
- *How effective has the "Stop Smuggling" program been;*
- *The shrinking foreign trade surplus;*
- *How to avoid a new "sugar crunch;"*
- *Problems with determining just how undervalued China's currency is.*

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

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


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

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


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

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


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