quarterly predictions

#30, first quarter 2005

In this issue, the International Centre for Policy Studies presents an analysis of the Ukrainian political and economic situation for Q1'04, government policy, and factors that will influence it in the medium term. Also in this issue, forecasts for 2005–2006 are updated and a forecast for 2007 introduced.

Contents

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List of tables

List of figures

List of boxes

MAJOR INDICATORS

Year / Indicator	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						(estimate)		(f o r e c a s t)		
Economic activity										
GDP, *billions UAH*	102.6	130.4	170.1	204.2	225.8	267.3	345.9	418.8	507.4	569.6
Real GDP, *apc**	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	8.0	6.0	6.5
Real industrial output, *apc*	-1.0	4.0	13.2	14.2	7.0	15.8	12.5	9.5	8.0	8.0
Real agricultural output, *apc*	-9.8	-5.7	7.6	10.2	1.2	-11.0	19.1	0.5	3.0	2.5
Gross investment, *% GDP*	20.8	17.5	19.8	21.8	20.2	22.0	19.1	20.1	20.1	21.1
Real gross fixed investment, *apc*	2.6	0.1	12.4	6.2	3.4	15.8	10.2	7.0	8.0	10.0
Real total consumption, *apc*	-0.1	-3.7	2.0	9.3	5.0	12.8	13.1	13.1	7.6	7.6
Net FDI, *millions USD*[(1)]	747	489	594	769	688	1,411	1,711	1,800	2,000	2,500
Real disposable household income, *apc*[(2)]	-5.8	1.2	11.1	14.5	18.0	7.8	18.2	15.5	5.0	6.5
Real retail trade, *apc*	-6.6	-7.1	8.1	13.7	15.0	20.5	20.0	17.0	13.0	10.0
Prices										
Consumer price index, *apc*	20.0	19.2	25.8	6.1	-0.6	8.2	12.3	16.0	9.0	6.0
Producer price index, *apc*	35.3	15.7	20.8	0.9	5.7	11.1	24.1	13.4	6.0	7.0
Labor market										
Population, *millions*	50.1	49.7	49.3	49.0	48.0	47.7	47.3	47.1	46.9	46.7
Real wages, *aapc***	-2.8	-5.7	1.0	20.9	21.8	24.0	23.8	10.5	12.0	10.0
Unemployment rate, % (ILO methodology)	–	11.9	11.7	11.1	10.1	9.1	8.0	7.5	7.2	7.0
Foreign economic activity										
Exports of goods&services, *apc*	-13.4	-7.3	18.0	8.0	10.7	24.0	37.2	15.0	8.0	8.0
Imports of goods&services, *apc*	-14.0	-19.1	17.8	14.1	5.0	28.7	26.0	19.0	14.0	15.0
Current account balance, *% GDP*	-3.1	3.0	4.0	3.7	7.7	5.8	10.5	8.0	4.5	1.4
Budget										
Revenues, *% GDP* (consolidated)[(3)]	27.3	24.7	26.2	26.9	27.4	28.5	26.2	28.0	28.0	29.0
Balance, % GDP[(3)]	-2.7	-2.4	-0.8	-0.3	0.7	-0.2	-3.4	-4.0	-2.0	-1.0
Financial indicators										
Monetary base, *apc*	22	39	39	37	34	30	34	42	25	16
M3, *apc*	25	41	45	42	42	47	32	42	28	20
NBU gold/forex reserves, *millions USD*	793	1,094	1,475	3,089	4,417	6,937	9,525	14,400	18,100	20,200
Official exchange rate, *UAH/USD* (average annual)	2.45	4.13	5.44	5.37	5.33	5.33	5.32	5.25	5.13	5.08
Loan interest, *% pa* (average annual)[(4)]	55	53	40	32	25	18	17.5	18.5	17.5	15.5
Global economy										
Global GDP, *apc*	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, *apc* (2/3 of exports)	0.8	3.0	5.9	2.4	4.0	4.6	5.5	4.3	3.7	3.9

* *apc* = annual percentage change   ** *aapc* = average 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

ICPS economists have upgraded their forecast for economic growth in 2005 to 8% due to growing consumer demand and a better-than-expected external situation. In 2006, economic growth will slow down to 6% as the situation on external markets deteriorates somewhat, consumption slows down, and investment grows moderately. A victory of pro-presidential forces in the 2006 Verkhovna Rada elections will ensure consistent government policy and will finally provide an opportunity to launch long-expected reforms in the energy and residential services sectors in 2007. ICPS expects investment activity to accelerate and GDP to grow 6.5% in 2007

The situation in brief

President Viktor Yushchenko started his term in office by fulfilling election promises supported by Ukrainian voters (see **POLITICAL ENVIRONMENT**). The Government continued to raise pensions, approved an increase in wages for employees of Budget-financed institutions, and reduced the military draft to 12 months. The National Security Council adopted a decision to withdraw Ukraine's military contingent from Iraq before the end of 2005.

Broad voter support for these decisions and Mr. Yushchenko's high personal ratings have ensured a working majority in the Verkhovna Rada that is ready to support most initiatives brought to it by the president and the Government.

The new Government has postponed a number of critical tasks

The new Government has deliberately begun by resolving short-term tasks and postponing larger-scale and more complicated measures for some time. The Government's current economic efforts are primarily aimed at raising the incomes of the country's poorest, curbing inflation and filling State coffers, including by revisiting previous privatization tenders.

This orientation of Government policy towards current needs instead of long-term prospects is the result of: (1) the need to implement promises made during the election campaign and the Orange Revolution; (2) the need to make personnel and organizational shuffles in government agencies; and (3) a hangover from the previous Government in the form of many unresolved problems.

Current policies are intended to establish the image of a "Government of national trust"

Fulfilling current short-term tasks to support the image of a "Government of public trust" among Ukrainians is more effective than unfolding long-term, complicated and unpopular reforms. However, the lack of strategic thinking in formulating social and economic tasks could soon translate into short-sighted policies and, eventually, slower development.

Amendments to the Budget reflect two short-term Government goals: increasing social security and combating corruption. According to ICPS analysts, canceling many territorial and sectoral tax exemptions and lowering customs duty rates will help move businesses out of the shadows and into the official sector. Eventually, this approach will be more effective in attracting investment to Ukraine's economy than tax holidays for preferred investors, as it establishes a level playing field for different investors and manufacturers.

According to ICPS, cutting back on capital investment in 2005 is a wise step, as the public investments planned by the previous Government did not meet the current Government's policy priorities and were an ineffective application of public money.

In Q1'05, economic growth slowed down to 5.4%

After a record-breaking 12.1% growth in GDP in 2004, Ukraine's economy slowed down in Q1'05. According to preliminary estimates, GDP grew 5.4% in January–March 2005. The key reason behind this slowdown was a steep decline in industry (see **INDUSTRY**).

Consumer price inflation accelerated as household incomes grew, and along with them a relatively high propensity to consume and increased spending as people continued to expect their incomes to go higher. In Q1'05, consumer prices climbed 4.4% (see **PRICES**).

The financial market recovered relatively quickly from the shocks of Q4'04. Since the beginning of 2005, currency inflows have revived and deposits have been growing rapidly. The National Bank has made the hryvnia exchange rate more flexible, using it as a monetary policy instrument. This has led to a slight appreciation of the hryvnia (see **MONETARY POLICY**).

Forecast for 2005–2007

Conditions on global markets will gradually be less favorable for Ukraine

ICPS analysts expect economic growth around the world and among Ukraine's key trade partners to slow down during the forecast period (see **WORLD ECONOMY**). World commodity markets will also begin to deteriorate starting in H2'05. This will limit opportunities for Ukraine to grow economically through external demand.

An additional external factor will be a global trend towards more expensive capital, which will lead to: (1) the higher cost of lending and investment capital; and (2) the greater appeal of developed economies, especially the US, for investors and the consequent limitation of volumes of potential foreign investment in Ukraine.

Foreign investors will continue to rate Ukrainian markets as high-risk

According to ICPS, foreign investors will continue to view Ukraine as a high-risk country during the forecast period. In other words, during the next three years, sources of FDI will not much expand to include risk-averse investors. New projects in Ukraine will be implemented by those investors who already have experience working in this region or those who deliberately try to get high profits in return for increased risk.

2005

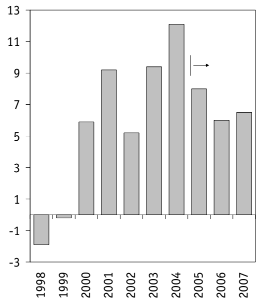
Ukraine's GDP will grow 8% in 2005...

ICPS economists have upgraded their economic growth forecast for 2005 to 8% due to increased social benefits and a better-than-expected external situation. Higher household incomes, a relatively high propensity to consume and positive expectations of future income growth will push private consumption among Ukrainians up by 16%.

Imports of goods and services will grow faster than exports for three reasons: price hikes for imported gas and oil, the Government's policy of moving imports out of the shadow and lowering import duty, and the growing buying power of Ukrainian consumers.

ICPS has downgraded its forecast for the growth of gross fixed assets to 7%. Its economists consider the investment climate to be unfavorable because of: (1) the lack of mechanisms for revisiting privatization agreements;

(2) accelerating inflation (see **PRICES**); and (3) reduced public capital investment as large social outlays absorb financing from the State Budget (see **PUBLIC FINANCE**).



Source: Derzhkomstat; forecast by Quarterly Predictions

As a result of amendments to the 2005 State Budget, the share of GDP redistributed through the budget will be close to one third. Tax pressure on the economy as a whole will grow, in part due to dropping tax exemptions and closing loopholes that allowed tax evasion. In 2005, Consolidated Budget expenditures will grow to 32% of GDP, mainly due to increased social outlays. According to ICPS calculations, real expenditures will be higher than the Government anticipated, as the amended Budget does not take full account of the costs of covering the Pension Fund deficit. The Budget deficit will grow to 4% of GDP (see **PUBLIC FINANCE**).

ICPS economists have upgraded their forecast for the 2005 inflation to 16% in light of the steep increase in the Government social outlays. Having shown record-high growth in 2004, producer prices will rise at a more moderate pace in 2005 (see **PRICES**).

The continuing high current account and trade balances will provide an opportunity for the National Bank to replenish gold and forex reserves and allow a moderate appreciation of the hryvnia against the US dollar.

2006

ICPS expects pro-presidential forces to win the Verkhovna Rada elections in March 2006, as President Viktor Yushchenko will continue to enjoy high ratings among voters. Because there will be no major shuffles, the Government will have a good chance to make consistent decisions, thus, the quality of government policies should improve.

...6% in 2006...

The ICPS forecast is for Ukraine's economy to grow 6% in 2006. Slower growth will be primarily due to external factors: slower economic growth among Ukraine's trade partners and lower global prices for the metal products that Ukraine exports. Additional factors holding back growth will be moderate increases in consumption and investment.

2007

...and 6.5% in 2007

In 2007, real gross fixed capital will grow to 10% thanks to continuing political stability, subsiding inflation and lower lending rates. ICPS economists expect 2007 to see the beginning of real reforms, in particular in the energy and residential services sectors, as well as changes in the structure of Ukraine's economy. In line with this forecast, Ukraine's GDP will grow 6.5%.

Pressure on the hryvnia will be weaker because of lower currency inflows. As a result, ICPS expects the nominal hryvnia exchange rate to stabilize in 2007.

Forecast risks

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

- failure on the part of the Government to implement its announced transformations, which will disappoint voters and make it impossible to form a majority after the 2006 Verkhovna Rada elections;
- a steep appreciation of the hryvnia on the domestic market;
- sharp price fluctuations for Ukrainian exports on external markets;

- lower-than-expected Budget revenues in 2005 and a commensurate increase in the deficit;
- deteriorating relations with Russia and possible economic wars;
- failure to accede to the WTO in late 2005—early 2006;
- sharp fluctuations of the US dollar on global markets.

*Highlights of **quarterly predictions** #30*

- *The new government's prospects in the March 2006 elections;*
- *Problems with the Budget's Special Fund;*
- *The consequences of introducing the second pillar of pension system in 2007;*
- *The roots of growing consumer prices;*
- *The dangers of hryvnia appreciation;*
- *An evaluation of the new Government Program's approach to the farm sector;*
- *Economic inefficiencies and UkrZaliznytsia's rate policy;*
- *Does it make sense to cancel exemptions for SEZs and TPDs?*
- *Problems with current customs policy;*
- *Slower world economic growth.*

STATISTICAL APPENDIX

The ***quarterly predictions*** was established in September 1997 by the International Centre for Policy Studies (ICPS), in cooperation with the New Zealand Institute of Economic Research.

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Consumer Confidence											
Ukrainian language						English language					
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Political Commentary											
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