

quarterly predictions

#31, second quarter 2005

In this issue, the International Centre for Policy Studies presents an analysis of the Ukrainian political and economic situation for January–May 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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International Centre for Policy Studies

vul. Pymonenka 13A, Kyiv, Ukraine 04050
www.icps.com.ua/eng

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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	417.9	505.6	568.4
Real GDP, <i>apc</i> *	-1.9	-0.2	5.9	9.2	5.2	9.6	12.1	7.0	6.0	6.5
Real industrial output, <i>apc</i>	-1.0	4.0	13.2	14.2	7.0	15.8	12.5	9.5	8.0	8.0
Real agricultural output, <i>apc</i>	-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	21.8	21.8	22.8
Real gross fixed investment, <i>apc</i>	2.6	0.1	12.4	6.2	3.4	15.8	10.2	7.0	8.0	10.0
Real total consumption, <i>apc</i>	-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, <i>apc</i> ⁽²⁾	-5.8	1.2	11.1	10.0	18.0	9.1	16.5	18.0	5.0	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	14.0	10.0	6.0
Producer price index, <i>apc</i>	35.3	15.7	20.8	0.9	5.7	11.1	24.1	15.0	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
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	10.0
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	14.0
Current account balance, % GDP	-3.1	3.0	4.0	3.7	7.7	5.8	10.5	6.7	3.3	0.4
Budget										
Revenues, % GDP (consolidated) ⁽³⁾	27.3	24.7	26.2	26.9	27.4	28.5	26.2	27.5	28.0	29.0
Balance, % GDP ⁽³⁾	-2.7	-2.4	-0.8	-0.3	0.7	-0.2	-3.4	-3.0	-2.0	-1.0
Financial indicators										
Monetary base, <i>apc</i>	22	39	39	37	34	30	34	38	14	12
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	9,525	13,885	16,004	16,960
Official exchange rate, UAH/USD (average annual)	2.45	4.13	5.44	5.37	5.33	5.33	5.32	5.10	5.04	5.09
Loan interest, % <i>pa</i> (average annual) ⁽⁴⁾	55	53	40	32	25	18	18	16	16	15
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	4.4	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

ICPS economists have downgraded their forecast for economic growth for 2005 to 7%, given a longer-than-expected period of low investment inflows and a temporary decline in steel prices on global markets. In 2006, economic growth will slow down to 6% due to slower growth in consumer demand. The current Administration's victory in the 2006 Verkhovna Rada elections should make it possible for serious reforms to be launched in 2007. Better economic policy and an improving business environment should lead to brisker investment. As a result, real GDP growth will accelerate to 6.5% in 2007

Current situation

The ruling political forces are enjoying a solid base of voter confidence despite a slight decline in their ratings in Spring 2005 (see **POLITICAL ENVIRONMENT**). The opposition still has not become a powerful political force with solid alternative policy proposals and growing public support.

The Government has set clear strategic landmarks...

The quality of the new Administration's economic policy is difficult to evaluate unambiguously. On one hand, the Government has set clear strategic goals: (1) raising living standards for the poorest Ukrainians; (2) combating corruption; (3) supporting macro-financial stability; and (4) integrating into the WTO and the EU. On the other, the policy to achieve these goals is not consistent and does not consider the impact on certain sectors of the economy. In addition, the political goal of winning in the 2006 Verkhovna Rada elections is encouraging popular, short-term objectives instead of long-term reforms. ICPS analysts expect the Government to attempt unpopular large-scale reforms—to the pension system, social security, taxation, power industry, residential services sector, and so on—no sooner than mid-2006.

...but has yet to move steadily in that direction

Over January–May 2005, economic growth slowed significantly

Over January–May 2005, Ukraine's economic growth continued to slow down. According to preliminary data, real GDP grew 4.7% over January–May 2005, less than 50% of GDP growth over the same period in 2004. Key reasons for slower growth were a slowdown in industry (see **INDUSTRY**) and dramatically lower growth in fixed investments: 4.5% in Q1'05 against 52.1% over the same period in 2004 (see **BUSINESS**).

The Government should end privatization reviews as soon as possible

The review of previous privatization contracts, one of the core election promises of the new president, remains unresolved. The lack of a clear and agreed indication of the scale and principles of this process has put a damper on both domestic and foreign investment in Ukraine. ICPS economists argue that the Government needs to identify the terms and conditions underlying this process as soon as possible to enable investment to move into high gear and, thus, to ensure rapid and sustainable economic growth for the next few years.

In Q1'05, Ukraine registered high growth in consumer prices: the CPI grew 4.4% against December 2004. Prices grew because of large social outlays to Ukrainians and high inflationary expectations. Over April–May 2005, government price controls did manage to slow inflation down temporarily: over January–May 2005, the CPI rose 5.7%. However, such measures increased inflationary pressures whose consequences will be felt in H2'05 (see **PRICES**).

In late April, the NBU slightly appreciated the hryvnia. As a result, the exchange rate has grown 5% since the beginning of 2005 (see **MONETARY POLICY**). For the first time since 2001, the real effective hryvnia exchange rate

increased. In the opinion of ICPS economists, the interval and scale chosen by the NBU for this appreciation will not significantly hamper export capacities.

Slower economic growth among Ukraine's key trading partners (see **WORLD ECONOMY**) is somewhat restricting opportunities for Ukraine's own economic growth through the external sector. An additional barrier to export-related growth potential is a temporary halt in the growth of world prices for steel (see **FOREIGN TRADE**), the result of excess reserves coupled with active output expansion by market players in recent years.

Forecast for 2005–2007

According to ICPS experts, the Government will work towards mainly short-term and low-cost objectives throughout 2005 and will simultaneously prepare to carry out large-scale reforms over the next few years because its chances of winning in the 2006 Verkhovna Rada elections are fairly high (see **POLITICAL ENVIRONMENT**).

2005

ICPS economists have downgraded their forecast for real GDP growth for 2005 by 1 pp, to 7%. Key reasons for this slower growth in 2005 are:

- **SLOWER INVESTMENT.** An uncertain situation around the review of previous privatizations coupled with frequent use of administrative pressure on business is preventing Ukraine's investment potential from being realized (see **BUSINESS**). A 6.7% decline in construction over January–May 2005 and a noticeable reduction in the number of press releases about business developments posted by major companies indicate that investment activity has abated. ICPS analysts expect that by Summer 2005, the Government will identify policy principles and measures to review key privatizations and other key investment issues, and that investment activity will accelerate in H2'05.
- **STABILIZED SITUATION ON EXTERNAL MARKETS.** The economies of Ukraine's key trading partners are slowing down (see **WORLD ECONOMY**). In addition, 2005 saw a temporary adjustment in steel prices on global markets, the result of large world reserves and expanding output during the period when prices were high. ICPS analysts expect steel prices to stabilize at the current level in H2'05 (see **FOREIGN TRADE**).
- **ACCELERATING IMPORTS.** Imports are picking up faster than exports as the "Stop Smuggling" program kicks in and imports begin to move out of the shadow economy, and other steps, such as reduced import duty, a stronger hryvnia, simplified customs procedures, and more, have their effect (see **FOREIGN TRADE**).

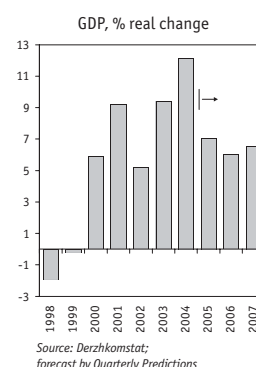
Price controls applied by the Government in April–May 2005 helped hold back CPI growth, but they increased inflationary pressure (see **PRICES**). Given the greater-than-expected effectiveness of these steps, ICPS economists have adjusted their forecast for 2005 CPI growth downward by 2 pp, to 14%. To some extent, production costs will absorb slower consumer price growth and high inflationary expectations. The ICPS forecast for producer price growth for 2005 has been adjusted upward, to 15%.

After it grew stronger in Spring 2005, upward pressure on the hryvnia noticeably subsided. According to ICPS economists, the National Bank will support a stable nominal hryvnia exchange rate against the US dollar throughout 2005

The stronger hryvnia will not significantly hamper export capacities

Throughout 2005, the Government will limit its efforts to short-term low-cost objectives

The ICPS forecast for GDP growth in 2005 has been downgraded to 7%



Consumer price controls raised inflationary pressure

(see **MONETARY POLICY**). Moreover, strengthening the hryvnia further might prove problematic because imports are growing faster than exports.

ICPS economists have upgraded their forecast for the real disposable household income growth for 2005 from 15.5% to 18%, based on an upgrade in the forecast for real wage growth (see **LABOR**). However, the forecast for private consumption growth remains unchanged at 16% because of a trend towards growing wage arrears, especially in the public sector.

2006

In 2006, GDP will slow down to 6% as private consumption slows down...

ICPS expects real GDP to slow down to 6% in 2006. The key factor behind this slowdown will be slower growth in private consumption as increases in social payments taper off compared to 2005 (see **HOUSEHOLDS**).

ICPS economists do not anticipate a significant slowdown in investment prior to the 2006 VR elections because the results of these elections are fairly predictable and there are no expectations of significant change in the orientation of economic policy. Overall, investments will grow faster in 2006 than in 2005.

...and exports slow as well

In 2006, economic growth among Ukraine's key trading partners will continue to slow down: ICPS expects growth among Ukraine's key trading partners to shrink from 4.4% in 2005 to 3.8% in 2006 (see **WORLD ECONOMY**). Coupled with a drop in global steel prices, this will slightly limit export growth. ICPS economists forecast that export growth will slow down to 6% in 2006.

After the 2006 VR elections, the Government will shift the key emphasis in its economic policy from improving the current personal financial standing of Ukrainians to implementing large-scale, long-term reforms. The majority of these reforms will likely only be implemented starting in 2007.

2007

In 2007, economic growth will accelerate to 6.5% due to livelier investment

ICPS analysts expect economic growth to speed up to 6.5% in 2007. The key growth driver will be livelier investment because of: (1) a noticeable improvement in the business environment; (2) greater predictability in government policy and the economic situation; and (3) Ukraine's accession to the WTO. Foreign investment into Ukraine should reach US \$2.5bn in 2007 (see **BUSINESS**).

However, the impact of investment on Ukraine's economic growth in 2007 will be limited by the lack of capacity among domestic industries to meet investment demand. A major part of investment resources will have to be imported from other countries, which will push import growth to 16% (see **FOREIGN TRADE**).

2007 should be the year structural economic reforms kick in, according to ICPS analysts, and this will lead to high public spending—30% of GDP. However, because the economy will meanwhile be coming out of the shadow, the Budget deficit should not be higher than 1% of GDP in 2007 (see **PUBLIC FINANCE**).

Inflation will be relatively low in 2007

In 2007, inflation will stabilize at a low level: consumer prices will grow 6%, while producer prices will rise 7% (see **PRICES**). Key factors behind this relatively low inflation will be: (1) stabilized growth in consumer demand; (2) a significant improvement in price regulating policy; and (3) stabilized prices on global markets.

Forecast risks

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

- the Administration's inability to develop and implement necessary reforms;
- reduced tax rates;
- sharp fluctuations on global commodity markets;
- the Government's inability to introduce market mechanisms for regulating prices;
- failure to accede to the WTO in 2006;
- a shift in the forex market to a more flexible exchange mechanism in 2005;
- a revision of GDP figures for 2004.¹

Highlights of quarterly predictions #31

- *The new Administration's prospects in the 2006 Verkhovna Rada elections*
- *The high cost of price controls on meat and gasoline*
- *The impact of a stronger hryvnia on the economy*
- *Why imports are growing and what the future holds*
- *When investment activity will pick up again*
- *What the Tymoshenko Government is doing to improve the business environment*
- *Universal health insurance: problems and options*
- *The slowdown in global economic growth*

¹ In June 2005, top government officials made statements suggesting that the GDP estimate for 2004 was overstated. Specifically, the SBU, the state security service, spoke about a "fictitious UAH 30bn." The main claim is that the GDP indicator for 2004 includes phony foreign trade operations that were used illegally to collect export VAT refunds.

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quarterly predictions team: Yevhenia Akhtyrko (editor-in-chief), Oleksiy Blinov, Hanna Cherednychenko, Ildar Gazizullin, Liudmyla Kotusenko, Vitaliy Lukovych, Natalia Martynenko, Yegor Sobolev, Tetiana Yablonovska, Oleksandr Zholud.

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Postal address of International Centre for Policy Studies:

vul. Pymonenka 13A, Kyiv, Ukraine 04050

Tel. (380-44) 484-4401; fax (380-44) 484-4402

E-mail: qp@icps.kiev.ua. Web: <http://www.icps.com.ua>.

Registered address:

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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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Consumer Confidence					
Ukrainian language			English language		
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Political Commentary					
Ukrainian language			English language		
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