

quarterly predictions

#34, first quarter 2006

In this issue, the International Centre for Policy Studies presents an analysis of the political and economic situation in Ukraine for Q1'2006, government policy, and factors that will influence these in the medium term. Forecasts for 2006–2007 are updated and forecast for 2008 introduced

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MAJOR INDICATORS

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Indicator							estimate	forecast		
Economic activity										
GDP, billions UAH	130.4	170.1	204.2	225.8	267.3	344.8	418.5	492.6	544.7	611.1
Real GDP, <i>apc</i> *	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	3.8	4.5	4.6
Real industrial output, <i>apc</i>	4.0	13.2	14.2	7.0	15.8	12.5	3.1	3.0	2.5	3.0
Real agricultural output, <i>apc</i>	-5.7	7.6	10.2	1.2	-11.0	19.9	0.0	0.5	5.0	2.0
Gross investment, % GDP	17.5	19.8	21.8	20.2	22.0	19.2	21.8	21.7	22.2	22.6
Real gross fixed investment, <i>apc</i>	0.1	12.4	6.2	3.4	15.8	10.0	-4.0	7.0	9.0	7.0
Real total consumption, <i>apc</i>	-3.7	2.0	9.3	5.0	12.8	12.1	10.5	6.1	5.7	6.8
Net FDI, millions USD ⁽¹⁾	489	594	769	688	1,411	1,711	7,533	6,000	3,000	2,700
Real disposable household income, <i>apc</i>	1.2	11.1	10.0	18.0	9.1	19.3	20.1	5.5	7.0	8.0
Real retail trade, <i>apc</i>	-7.1	8.1	13.7	15.0	20.5	21.9	23.0	13.5	9.0	9.0
Prices										
Consumer price index, <i>apc</i>	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	12.5	7.0	6.0
Producer price index, <i>apc</i>	15.7	20.8	0.9	5.7	11.1	24.1	9.5	10.0	7.0	6.5
Labor market										
Population, millions	49.7	49.3	49.0	48.0	47.6	47.3	46.9	46.7	46.5	46.3
Average monthly real wages, <i>apc</i> *	-8.9	-0.9	19.3	18.2	15.2	23.8	20.3	14.0	11.0	12.0
Unemployment rate, % (ILO methodology)	11.9	11.7	11.0	10.2	9.1	8.6	7.0	6.7	6.5	6.4
Foreign economic activity										
Exports of goods&services, <i>apc</i>	-7.3	18.0	8.0	10.7	24.0	37.2	11.7	2.9	7.0	7.0
Imports of goods&services, <i>apc</i>	-19.1	17.8	14.1	5.0	28.7	26.0	25.4	9.1	10.2	10.2
Current account balance, % GDP	3.0	4.0	3.7	7.7	5.8	10.5	3.1	0.1	-1.6	-3.1
Budget										
Revenues, % GDP (consolidated) ⁽²⁾	24.7	26.2	26.9	27.4	28.5	26.5	32.0	28.5	29.0	29.0
Balance, % GDP ⁽²⁾	-2.4	-0.8	-0.3	0.7	-0.2	-3.2	-1.9	-2.5	-2.0	-3.0
Financial indicators										
Monetary base, <i>apc</i>	39	39	37	34	30	34	53	29	19	17
M3, <i>apc</i>	41	45	42	42	47	32	54	30	19	19
NBU gold/forex reserves, millions USD	1,094	1,475	3,090	4,417	6,937	9,525	19,394	20,600	20,400	20,400
Official exchange rate, UAH/USD (average annual)	4.13	5.44	5.37	5.33	5.33	5.31	5.12	5.05	5.12	5.20
Loan interest, % <i>pa</i> (average annual) ⁽³⁾	53	40	32	25	20	18	16	14	9.5	9
Global economy										
Global GDP, <i>apc</i>	3.7	1.7	2.4	3.0	4.0	5.1	4.3	3.4	3.6	3.7
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	3.0	6.0	2.5	4.0	4.7	5.7	4.8	4.1	3.8	4.1

* *apc* = annual percentage change

Notes: ⁽¹⁾ according to the NBU;

⁽²⁾ calculation using IMF methodology;

⁽³⁾ commercial bank loans, UAH

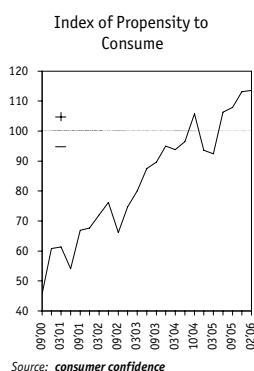
Sources: Derzhkomstat (State Statistics Committee), National Bank of Ukraine, Ministry of Finance; calculations and forecast by **quarterly predictions**

OVERVIEW

Over 2006–2008, domestic demand will be the main growth factor for Ukraine's economy. Rising energy prices, a less favorable external situation and worsening relations with Russia will all conspire to hamper the growth of the export share of GDP. Ukraine's economy will grow more quickly than in 2005, but the overall pace will remain relatively slow. Over 2006–2008, GDP will grow 3.8%, 4.5% and 4.6%

Domestic demand will stimulate growth

Expanding domestic demand will be the key feature of economic growth in Ukraine over 2006–2008. During this period, the share of internal demand in overall growth trends will remain higher than the share of external demand.¹ Rising domestic demand will be driven by three factors:



Source: *consumer confidence*

Over 2006–2008, domestic demand will grow faster than external demand

- **A HIGH PROPENSITY TO CONSUME.** Based on the consumer confidence poll, the index of propensity to consume has been above the 100-mark since H2'05.² This meant that the majority of Ukrainians believe that now is generally a good time to make major household purchases;
- **LOWER RISKS FOR SECTORS ORIENTED ON THE CONSUMER MARKET.** Growing prices for natural gas will have a marginal impact on this branch. Sectors whose products are intended to satisfy internal demand will continue to expand intensely given the growth of household incomes and the underdeveloped supply of consumer goods&services. The state of production facilities in these sectors is better than that of companies in other industries. In contrast to heavy industry, these industries did not rely on tax breaks and were forced to compete seriously with foreign producers (see **BUSINESS**);
- **GROWING LENDING AMONG COMMERCIAL BANKS.** The banking system has considerably increased the amount of lending. Increased opportunities for domestic banks to lend is having a positive impact primarily on the consumption sectors, which do not have access to cheap credit on external markets (see **BUSINESS** and **MONETARY POLICY**).

Instead, the export share of GDP during the forecast period will be smaller than it was over 2002–2004. This tendency will be driven by three main factors:

- **GROWING PRICES FOR ENERGY.** Prior to 2006, the low cost of energy made it possible for export-oriented companies in the metals and chemicals industries to produce competitively using outdated production facilities (see **BUSINESS**). To remain competitive as energy prices rise, these companies will now have to launch massive reconstruction, which will slow growth in these branches during the forecast period;
- **A LESS FAVORABLE EXTERNAL SITUATION.** Rapid growth in prices for ferrous metal products over 2003–2004 was the main reason for the growth of the

¹ This contribution to growth is calculated by multiplying the share of the given component of GDP by the pace of growth of that component (see **STATISTICAL APPENDIX**, Table A3). By internal demand is meant gross national spending, which is the sum of consumption, investment and changes in inventories. External demand is contributed by exports.

² See *consumer confidence* #23.

export component of the domestic economy during this period. As China expanded its own steel industry, it created downward pressure on world prices in 2005. Given that China is likely to continue to produce more steel, ICPS analysts say it is unlikely that prices will grow again in this sector during the forecast period (see **FOREIGN TRADE**). Stable world prices will restrain growth in Ukraine's metal industries;

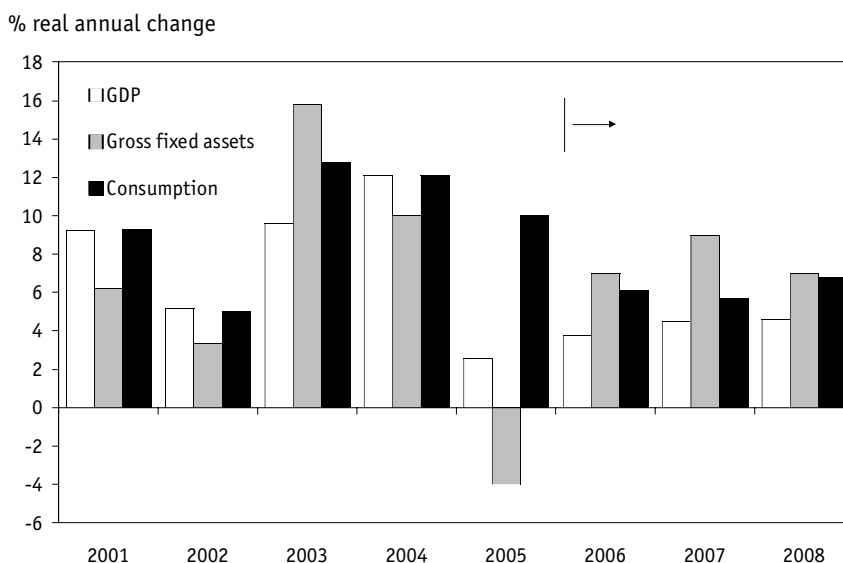
- **WORSENING TRADE RELATIONS WITH RUSSIA.** ICPS economists say that in any possible outcome for the political situation in Ukraine, Ukrainian–Russian relations will remain difficult (see **POLITICAL ENVIRONMENT**). There has been a growing trend towards import substitution in Russia lately, and towards instituting closed cycle production, which Russian politicians say will increase the country's independence. With this in mind, Russia is likely to raise trade barriers, which will also have a negative impact on the expansion of Ukrainian imports to this country³ (see **FOREIGN TRADE**).

Forecast for 2006–2008

ICPS analysts expect Ukraine's economy to pick up some steam over 2006–2008, although the overall pace of growth will remain relatively low. Ukraine's GDP should grow 3.8% in 2006, 4.5% in 2007 and 4.6% in 2008. Investment will grow more rapidly than consumption.

Economic growth will pick up over 2006–2008

Figure 1. GDP, investment and consumption



Source: Derzhkomstat; forecast: **quarterly predictions**

ICPS analysts expect demand for investment to continue to grow, both among energy-intensive industries that will be looking to introduce more energy-efficient technologies, and among those branches oriented on the consumer market, in order to expand production. The share of lending in the structure of investment will grow as companies find themselves without enough working capital to replace equipment on a mass scale. Enterprises in the energy, metals and chemicals industries will borrow mostly on external markets. ICPS econ-

Lending will have a growing share of investment

³ Russia's growing share in Ukrainian exports over 2005 was the result of declining exports of metals and equipment to the EU and mineral products and equipment to the US and a commensurate decline in the share of these trading partners in Ukraine's exports. However, ICPS economists do not expect Russia's share of Ukrainian exports to grow over the forecast period.

omists also expect the number of initial public offerings (IPOs) to grow starting in 2007. The pace of growth of gross fixed assets will be 7% in 2006, 9% in 2007, and 7% in 2008.

Revenues from privatization and the sale of domestic banks to strategic foreign investors will be the main source of FDI in 2006. In 2006 FDI will total US \$6bn. Over 2007–2008, FDI will be US \$3bn and \$2.7bn (see **BUSINESS**).

***Private consumption
will grow moderately***

After recording record growth in 2005,⁴ household incomes will grow more slowly over the forecast period. The contribution of social assistance to this indicator will shrink. Over 2006–2008, real disposable personal incomes will grow only 5.5%, 7.0% and 8.0%. Over 2006–2007, real household consumption will grow only 6.5% annually, while in 2008 it will grow 8.0% (see **HOUSEHOLDS**).

***The trade balance
will be negative***

Over the forecast period, exports will pick up some steam, but imports will continue to outpace them. There will be a deficit in the trade balance. On one hand, growing prices for imported natural gas will increase imports. On the other, this will raise the cost of Ukrainian goods whose production involves a significant share of natural gas. This, in turn, will reduce their competitive edge over imports (see **FOREIGN TRADE**).

Given the growth in prices for imported gas, ICPS has raised its forecast for consumer and producer price inflation for 2006. The ICPS outlook is for the CPI to rise 12.5% over 2006, while the PPI will rise 10.0%. Over 2007–2008, the CPI will drop down to 7% and 6%, while the PPI will shrink slightly, to 7% and 6.5% (see **PRICES**).

Over the forecast period, the level of monetization of Ukraine's economy will approach to that of CEE countries. As the growth of individual incomes slows down and the NBU switches to targeting inflation, the money supply will grow at a slower pace (see **MONETARY POLICY**).

***Unemployment
is approaching
natural levels***

Joblessness will continue to decline and Ukraine's rate of unemployment will approach its natural level. In 2008, unemployment will be 6.4% (see **HOUSEHOLDS**).

Forecast risks

The main risks to the ICPS forecast are:

- the emergence of a widespread political crisis that includes the collapse of the new coalition and the dismissal of the legislature (see **POLITICAL ENVIRONMENT**);
- the introduction of tax breaks and privileges or subsidies in some or all branches of the economy to reduce price shocks caused by rising energy prices;
- the institution of tax reform in Ukraine for the forecast period that includes a reduction in basic tax rates;
- a revision of gas contracts with Russia and Turkmenistan;
- worse-than-expected grain harvests.

⁴ Real disposable personal incomes grew 20.1% over 2005.

*Highlights of **quarterly predictions** #34:*

- *Outlook for the political situation*
- *Investment demand grows*
- *Why inflation will pick up in 2007*
- *How capital flees Ukraine*
- *Costs and benefits of the arrival of foreign banks in Ukraine*
- *Prospects for trade relations with Russia*
- *The cost of offering new benefits to “children of the war”*
- *State policy on the labor market*
- *The state of land reform*
- *Economic trends among Ukraine’s key trading partners*

STATISTICAL APPENDIX

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ISSN 1816-7276

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.

quarterly predictions is a publication registered with the State Broadcasting Committee of Ukraine, Certificate KB № 9239, 10 December 2004.

quarterly predictions presents our forecast of Ukraine's economic performance, based on comprehensive research of all its sectors. These forecasts are estimations based on the information available up to the stipulated date. This issue was prepared using information available as of 10 March 2006.

quarterly predictions activities are supported by the Open Society Institute.

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Information for **quarterly predictions** is provided by Derzhkomstat, the state statistics committee of Ukraine; the Ministry of Economy of Ukraine; the Ministry of Finance of Ukraine; the National Bank of Ukraine; *Interfax-Ukraine* and *Ukrainian News* agencies.

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English version editor: L.A. Wolanskyj

Design and layout: Ostap Stasiuk

By subscription only.

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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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