

# *quarterly predictions*

*#35, second quarter 2006*

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

The QP editorial team has changed the format of *quarterly predictions* to consolidate the various topics and make the document more user-friendly. The new structure is based on the standard components of economic forecasts and groups the original chapters by theme. Instead of presenting our analysis of trends and outlooks on a sectoral basis, we are now using a format that more closely matches the structure of GDP.

## **Contents**

<i>Major indicators</i> .....	3
<i>Overview</i> .....	4
<i>Political</i> .....	9
<i>Electoral politics</i> .....	10
<i>Foreign policy</i> .....	12
<i>Government policy</i> .....	14
<i>Public finance</i> .....	17
<i>Internal</i> .....	21
<i>Households</i> .....	22
<i>Business</i> .....	26
<i>External</i> .....	37
<i>Foreign trade</i> .....	38
<i>World economy</i> .....	41
<i>Financial</i> .....	47
<i>Monetary policy</i> .....	48
<i>Prices</i> .....	53
<i>Statistical appendix</i> .....	57

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## List of tables

Table 1.	Consolidated Budget revenues .....	17
Table 2.	Social expenditures in the Consolidated Budget .....	18
Table 3.	Key social spending items .....	22
Table 4.	The structure of consumption .....	25
Table 5.	Certain types of completed construction over January–April 2005 .....	29
Table 6.	Share of exports in the use of resources and imports in the supply of resources in 2004 .....	32

## List of figures

Figure 1.	Consumer Confidence Index and Index of Economic Expectations.....	4
Figure 2.	GDP, investment and consumption.....	6
Figure 3.	Breakdown of workers by size of wages .....	24
Figure 4.	Structure of fixed capital investment by source of financing .....	27
Figure 5.	Fixed capital investment .....	27
Figure 6.	Structure of wholesale trade turnover .....	30
Figure 7.	Industrial output.....	31
Figure 8.	Agricultural output by farm type.....	32
Figure 9.	Cattle and poultry headcounts .....	33
Figure 10.	Meat output.....	34
Figure 11.	Agricultural output .....	34
Figure 12.	Growth of foreign direct investment in Q1'06.....	39
Figure 13.	Current account and trade balances .....	40
Figure 14.	Economic growth among key trading partners .....	41
Figure 15.	US dollar exchange rate .....	44
Figure 16.	Business climate indices in the largest euro-area economies.....	44
Figure 17.	Monetary aggregates .....	49
Figure 18.	Opportunity cost of money .....	50
Figure 19.	Nominal hryvnia exchange rate.....	51
Figure 20.	Real effective hryvnia exchange rate .....	52
Figure 21.	Change in the CPI and its components .....	53
Figure 22.	Change in the PPI and its components.....	54

## List of boxes

Highlights of <i>quarterly predictions</i> #35 .....	7
Benefits to children of the war: When promises do not match capacities .....	14
Amendments to legislation needed for WTO accession .....	16
How the minimum wage affects the average wage .....	23
Why is the US dollar falling? .....	42

# MAJOR INDICATORS

Year	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	
Indicator							estimate	forecast			
<b>Economic activity</b>											
GDP, billions UAH	130.4	170.1	204.2	225.8	267.3	345.1	424.7	493.2	552.3	605.1	
Real GDP, <i>apc</i> *	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	3.5	3.9	4.0	
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>	-6.9	9.8	10.2	1.2	-11.0	19.9	0.0	0.5	5.0	2.0	
Gross investment, % GDP	17.4	19.7	21.8	20.2	22.0	21.2	22.2	22.5	22.9	24.9	
Real gross fixed investment, <i>apc</i>	0.0	12.3	6.0	3.4	22.5	20.5	-0.3	7.0	9.0	8.0	
Real total consumption, <i>apc</i>	-3.7	2.0	9.3	5.0	10.0	10.0	12.9	7.6	6.0	6.1	
Net FDI, millions USD <sup>(1)</sup>	489	594	769	688	1,411	1,711	7,533	4,500	3,500	3,700	
Real disposable household income, <i>apc</i>	1.2	11.1	10.0	18.0	9.1	19.6	20.1	9.0	7.0	8.0	
Real retail trade, <i>apc</i>	-7.1	8.1	13.7	15.0	20.5	21.9	23.0	15.0	10.0	10.0	
<b>Prices</b>											
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	
<b>Labor market</b>											
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	15.0	10.0	12.0	
Unemployment rate, % (ILO methodology)	11.9	11.7	11.0	10.2	9.1	8.6	7.2	7.0	7.0	7.0	
<b>Foreign economic activity</b>											
Exports of goods&services, <i>apc</i>	-3.2	14.4	8.0	10.7	24.0	42.6	7.5	5.8	6.2	6.2	
Imports of goods&services, <i>apc</i>	-19.1	17.8	14.1	5.0	28.7	31.3	20.4	15.0	10.2	10.2	
Current account balance, % GDP	5.2	4.7	3.7	7.5	5.8	10.6	3.1	-1.2	-3.2	-5.4	
<b>Budget</b>											
Revenues, % GDP (consolidated) <sup>(2)</sup>	24.7	26.2	26.9	27.4	28.5	26.5	32.0	33.0	33.0	33.0	
Balance, % GDP <sup>(2)</sup>	-2.4	-0.8	-0.3	0.7	-0.2	-3.2	-1.9	-2.0	-2.0	-2.0	
<b>Financial indicators</b>											
Monetary base, <i>apc</i>	39	39	37	34	30	34	54	26	19	17	
M3, <i>apc</i>	41	45	42	42	47	32	54	30	19	19	
NBU gold/forex reserves, millions USD	1,159	1,725	3,341	4,445	6,958	9,526	19,391	20,190	18,990	18,990	
Official exchange rate, UAH/USD (average annual)	4.13	5.44	5.37	5.33	5.33	5.31	5.12	5.05	5.10	5.40	
Loan interest, % <i>pa</i> (average annual) <sup>(3)</sup>	53	40	32	25	20	18	16	15	11	9	
<b>Global economy</b>											
Global GDP, <i>apc</i>	3.7	4.8	2.6	3.1	4.1	5.3	4.8	4.0	3.9	4.0	
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	3.0	6.1	2.6	4.0	4.7	5.7	4.9	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

## Current trends

**Ukraine's GDP rose 4% over January–May 2006**

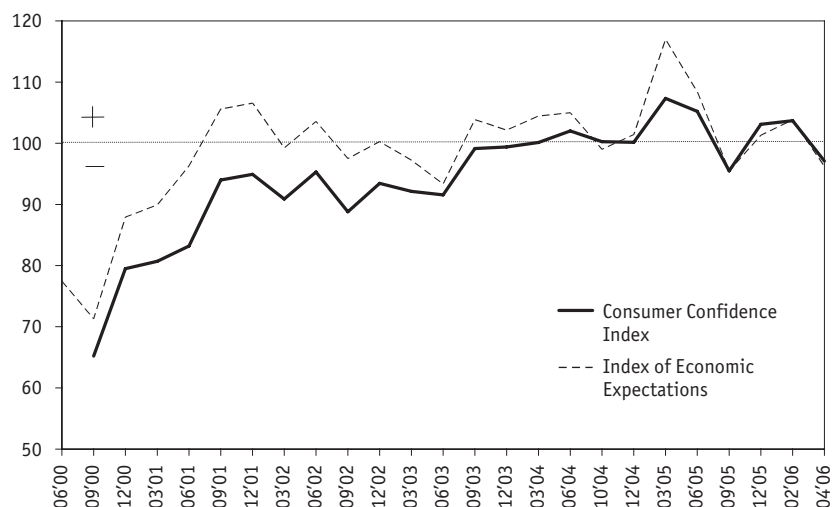
Business activity has grown livelier since the beginning of 2006. Data for January–May 2006 shows that Ukraine's GDP rose 4%.<sup>1</sup> The main driver of this growth has been more active investment. In Q1, fixed capital investment (FCI) grew 15.9% over the same period of 2005<sup>2</sup> (see **BUSINESS**). This rapid growth, in turn, was stimulated by renewed state investment in fixed assets.<sup>3</sup> The fastest growth in fixed capital investment was seen in those sectors that are oriented on the domestic consumer market.

In the Consolidated Budget, both revenues and expenditures have picked up pace. In Q1'06, revenues were up at 35.3% of GDP, while expenditures were at 35%. Growing tax receipts from personal incomes and non-tax fees helped fill the Treasury as planned. The growth in expenditures was largely due, again, due to items related to social security (see **PUBLIC FINANCE**).

**Private consumption has been steaming along...**

Consumption has continued to grow rapidly since the beginning of the year. According to ICPS economists, household spending grew 13% in real terms over Q1'06. This was driven by continuing growth in incomes and a high inclination to consume (see **HOUSEHOLDS**).

**Figure 1. Consumer Confidence Index and Index of Economic Expectations**



Source: *consumer confidence*

**...but consumer confidence has fallen**

Although disposable incomes continued to grow at a high pace, consumer confidence has fallen. In April 2006, the Consumer Confidence Index (CCI) was only 97.1. ICPS analysts say that this loss of confidence is a reflection of the political uncertainty that has shadowed the country for more than half a year now. The results of the March 2006 election failed to raise optimistic expectations in any of the country's regions. Protracted negotiations for a Verkhovna Rada coalition

<sup>1</sup> In 2005, Ukraine's GDP grew an anemic 2.6%.

<sup>2</sup> In 2005, FCI inched up a paltry 1.9%.

<sup>3</sup> Public investment shrank in 2005 by 35% because of a major increase in social outlays.

and new Government increased pessimistic economic expectations (see **ELECTORAL POLITICS**).

The greatest growth was seen in those sectors that are oriented on the domestic consumer market. In particular, construction grew 8.2% and transport grew 6.2%. Processing has stagnated somewhat since the beginning of the year<sup>4</sup> because of a decline in ore processing and metalworking, and in petroproduct processing.

The balance of trade has continued to deteriorate since the beginning of 2006. In Q1'06, the deficit reached US \$1.8bn as exports of goods shrank 4.4%, while imports jumped 30.2%. Export volumes declined because of two main factors: an unfavorable external situation for Ukraine's most important export commodity, steel, and trade wars with Russia, which took a serious bite out of Ukraine's food exports. Such high levels of imports reflected high demand both among households, for consumer goods, and among businesses, for equipment and supplies needed for investment, as well as a major increase in energy prices, especially gas (see **FOREIGN TRADE**).

***In Q1'06, the balance of trade showed a deficit of US \$1.8bn***

On an annual basis, inflation in May was 7.3%, the lowest level since May 2004. This slowdown in inflation was possible because of the growth in imports of low-inflation consumer goods and because Ukrainians were actively buying up foreign currency during the election period. The main drivers of inflation continue to be the fast pace of growth of disposable incomes, high expectations of inflation, and rising rates for residential gas and electricity (see **PRICES** and **MONETARY POLICY**).

Demand for foreign currency grew stronger from the beginning of the year, forcing the National Bank of Ukraine to cut into its reserves by 11% or US \$2.1bn. The extended period of political uncertainty put a damper on the growth of personal deposits. Lending, on the other hand, grew rapidly, more than 50% of this growth being personal loans. Nominal interest rates on loans actually shrank because of growing competition among banks and decelerating inflation (see **MONETARY POLICY**).

***NBU reserves fell 11% over Q1'06***

## Forecast

### 2006

The ICPS forecast for GDP growth for 2006 has been reduced 0.3pp to 3.5%. In particular, ICPS analysts have downgraded the outlook for the external sector, with exports growing only 2% and imports 16%. The trade deficit will reach US \$3.3bn by the end of the year. Exports will grow slowly because of the relatively low demand for Ukrainian metal products on world markets, while imports will continue to be stimulated by high consumer demand<sup>5</sup> and a growing need for goods for industrial investment.

***Annual GDP growth for 2006 will be 3.5%***

Gross accumulation of fixed assets will grow 7%. The highest demand for capital will be among those businesses oriented on the domestic consumer market. At the same time, heavy industry will undergo a process of modernizing facilities in order to reduce the consumption of energy.

***Demand for investment will be high***

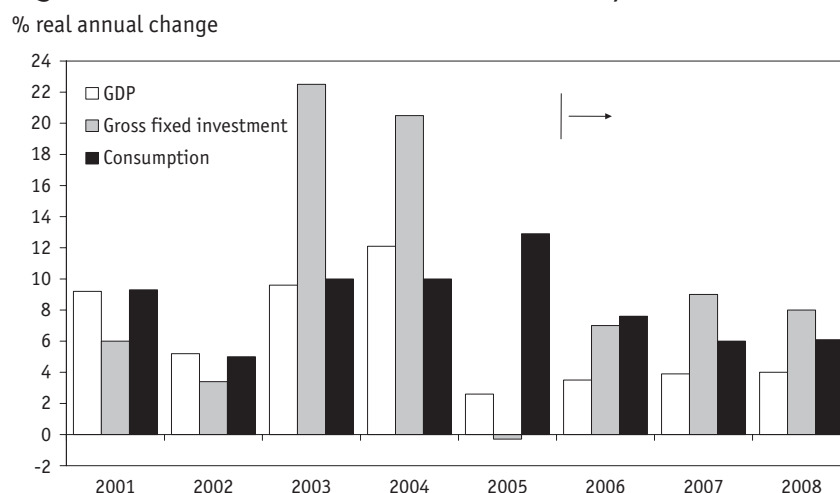
Industrial growth will be slow, with output increasing 3% by the end of the year. The fastest-growing sectors will be trade, at 8%, and construction, at 6%, both sectors that saw a decline in production over 2005. Transport will grow 6%.

<sup>4</sup> Over January–May 2006, processing grew only 1.9%.

<sup>5</sup> ICPS estimates are for private consumption to grow 8.5% over 2006.

The ICPS forecast for inflation remains unchanged, with consumer prices growing 12.5% over 2006. ICPS analysts expect rates for residential gas and electricity to continue to rise, as well as passenger fares and rates for landline telecommunication services. Over the year, producer prices should go up 10%.

**Figure 2. GDP, investment and consumption**



Source: Derzhkomstat; calculations: *quarterly predictions*

**The exchange rate will remain stable**

The NBU will maintain a stable hryvnia exchange rate relative to the US dollar.<sup>6</sup> ICPS analysts say that there will be a devaluation of the hryvnia real effective exchange rate (REER) because of the continuing drop in the US dollar against the currencies of Ukraine’s other trading partners.

Risks to the ICPS forecast include:

- the new Government’s adoption of economic policies that seriously damage the business climate and reduce investment inflows;
- a sharp decline in metal and chemical prices on world commodity markets;
- growing trade wars with Russia, that is, bans on other Ukrainian imports or new protective measures against Ukrainian products;<sup>7</sup>
- growing prices for imported natural gas in H2’06.

The ICPS outlook will prove too pessimistic should the farm sector grow more than predicted, based on a higher grain harvest.<sup>8</sup> GDP growth will also be higher if steel prices on world markets improve, which will cause exports to rise more.

**2007–2008**

**The economy will grow 4% over 2007–2008**

Over 2007–2008, economic growth will pick up but levels will remain relatively low. ICPS economists expect GDP to grow 3.9% over 2007 and only 4% in

<sup>6</sup> The average exchange rate for 2006 will remain UAH 5.05/USD.

<sup>7</sup> ICPS analysts say that if Russia continues to expand its trade war against Ukraine, the biggest threat is to exports of heavy machinery.

<sup>8</sup> The ICPS outlook for 2006 is for the farm sector to grow a mere 0.5%, based on a grain harvest of 34.2mn tonnes.

2008. The trade deficit will continue to grow, reaching US \$5.5bn and US \$8bn in 2008. This deficit will be largely the result of fast-growing imports, which are expected to grow nearly twice as much as exports (see **FOREIGN TRADE**).<sup>9</sup>

Investment will grow 9% in 2007, and slip to 8% in 2008. Household consumption will grow 7% annually over 2007–2008. This slowdown in the growth of consumption will be largely a reflection of the slower pace at which disposable incomes will be growing, especially among those with below-average incomes (see **BUSINESS and HOUSEHOLDS**).

ICPS analysts expect the NBU to switch to targeting inflation in its policies, which means that the hryvnia–dollar exchange rate will fluctuate more. The average rate should be UAH 5.10/USD over 2007, rising to UAH 5.40/USD in 2008 (see **MONETARY POLICY**).

Over 2007–2008, inflation should subside somewhat, with consumer prices rising 7% in 2007 and 6% in 2008. Producer prices will grow 7% in 2007, and 6.5% in 2008 (see **PRICES**).

In 2007, the rates for corporate profit tax and the VAT should go down 1pp, to 24% and 19%. At the same time, the personal income tax rate should rise 2pp to 15%. ICPS economists do not expect these changes to have much of an impact on the GDP share of the Consolidated Budget. The ICPS forecast is for Consolidated Budget revenues to be 33% of GDP over 2007–2008, and expenditures 35% (see **PUBLIC FINANCE**).

***In 2007, the NBU will switch to targeting inflation***

***Inflation will gradually slow down***

### ***Highlights of quarterly predictions #35***

- *Threats to the stability of the new VR coalition and Government*
- *An assessment of the policy of offering privileges to “children of the war”*
- *Changes in legislation needed for Ukraine to accede to the WTO*
- *Why the share of GDP distributed via the Budget is growing*
- *The connection between the minimum wage and the average salary*
- *Changes in the structure of investments*
- *Why the trade deficit is growing*
- *The factors behind record-high FDI in Q1’06*
- *What is making the US dollar drop?*
- *Chances to interest rates on deposits and loans*
- *What will make inflation accelerate in H2’06?*

<sup>9</sup> The ICPS forecast is for exports to grow 6% annually over 2007–2008, while imports should grow 11% per annum.

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, 7 October 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 15 June 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

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