

quarterly predictions

#36, third quarter 2006

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

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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	345.1	424.7	519.2	612.1	721.7
Real GDP, <i>apc</i> *	-0.2	5.9	9.2	5.2	9.6	12.1	2.6	5.5	4.6	5.0
Real industrial output, <i>apc</i>	4.0	13.2	14.2	7.0	15.8	12.5	3.1	5.0	3.0	4.0
Real agricultural output, <i>apc</i>	-6.9	9.8	10.2	1.2	-11.0	19.9	0.0	2.5	5.5	3.0
Gross investment, % GDP	17.4	19.7	21.8	20.2	22.0	21.2	22.0	21.5	21.8	22.8
Real gross fixed investment, <i>apc</i>	0.0	12.3	6.0	3.4	22.5	20.5	-0.3	9.0	10.0	11.0
Real total consumption, <i>apc</i>	-3.7	2.0	9.3	5.0	10.0	10.0	12.8	14.2	8.6	8.7
Net FDI, millions USD ⁽¹⁾	489	594	769	688	1,411	1,711	7,533	4,500	3,500	4,000
Real disposable household income, <i>apc</i>	1.2	11.1	10.0	18.0	9.1	19.6	20.1	16.0	11.0	12.0
Real retail trade, <i>apc</i>	-7.1	8.1	13.7	15.0	20.5	21.9	23.0	23.0	13.0	13.0
Prices										
Consumer price index, <i>apc</i>	19.2	25.8	6.1	-0.6	8.2	12.3	10.3	10.2	9.0	8.0
Producer price index, <i>apc</i>	15.7	20.8	0.9	5.7	11.1	24.1	9.5	10.0	9.5	9.0
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	18.5	11.5	13.0
Unemployment rate, % (ILO methodology)	11.9	11.7	11.0	10.2	9.1	8.6	7.2	6.8	6.6	6.5
Foreign economic activity										
Exports of goods&services, <i>apc</i>	-3.2	14.4	8.0	10.7	24.0	42.6	7.5	7.4	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	15.8	10.2	10.2
Current account balance, % GDP	5.2	4.7	3.7	7.5	5.8	10.6	3.1	-0.8	-2.7	-4.3
Budget										
Revenues, % GDP (consolidated) ⁽²⁾	24.7	26.2	26.9	27.4	28.5	26.5	32.0	34.0	32.0	32.0
Balance, % GDP ⁽²⁾	-2.4	-0.8	-0.3	0.7	-0.2	-3.2	-1.9	-2.5	-2.5	-2.5
Financial indicators										
Monetary base, <i>apc</i>	39	39	37	34	30	34	54	16	18	16
M3, <i>apc</i>	41	45	42	42	47	32	54	30	22	19
NBU gold/forex reserves, millions USD	1,159	1,725	3,341	4,445	6,958	9,526	19,391	19,891	19,691	19,691
Official exchange rate, UAH/USD (average annual)	4.13	5.44	5.37	5.33	5.33	5.31	5.12	5.05	5.17	5.44
Loan interest, % <i>pa</i> (average annual) ⁽³⁾	53	40	32	25	20	18	16	15	12	11
Global economy										
Global GDP, <i>apc</i>	3.7	4.9	2.6	3.1	4.1	5.3	4.9	4.8	4.0	4.1
GDP of Ukraine's major trading partners, <i>apc</i> (2/3 of exports)	3.1	6.1	2.6	4.0	4.7	5.7	4.9	4.6	4.0	4.1

* *apc* = annual percentage change

Notes: ⁽¹⁾ according to the NBU;
⁽²⁾ 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

Over January–August 2006, Ukraine’s GDP grew 5.7%

In Summer 2006, economic growth picked up considerable steam in Ukraine. Over January–August 2006, real GDP grew 5.7%, which was twice as fast as the same period in 2005.

The main factors behind the economic upturn in 2006 are:

In 2006, the main growth factors are renewed investment growth...

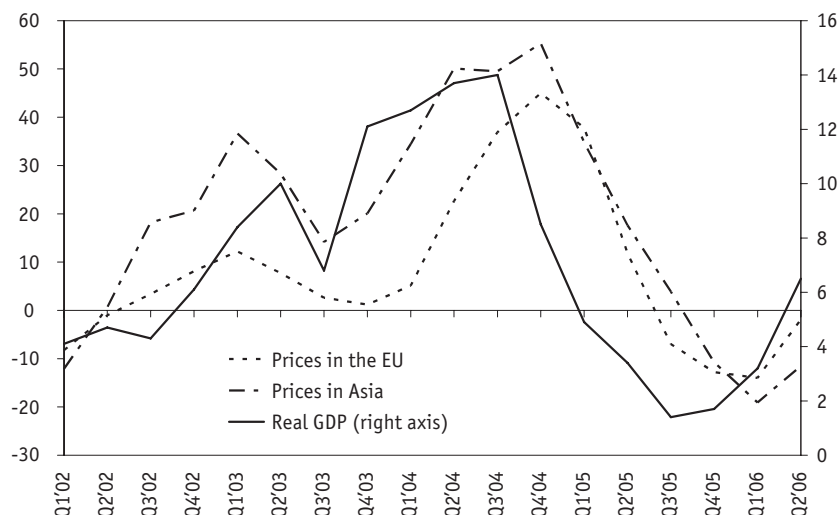
- **STRONG INVESTMENT GROWTH.** During H1’06, fixed capital investment grew 12.2% (see **BUSINESS**). The main center of investment activity are sectors producing for the consumer market, food processing and retail trade. Foreign direct investment continues to grow at a very rapid pace,¹ primarily in the banking sector (see **FOREIGN TRADE**).

...and an upturn in world steel prices

- **IMPROVED FOREIGN MARKET SITUATION.** Stabilized world steel prices in early 2006 and renewed growth in Q2’06 led to renewed growth in exported goods in May 2006 (see **FOREIGN TRADE**) and acceleration in the processing industry (see **BUSINESS**).

Figure 1. Real GDP growth and global steel prices

% change against the relevant quarter of the previous year



Sources: Derzhkomstat, MEPS Ltd.; calculations by *quarterly predictions*

Strong growth on the consumer market is not pushing inflation...

Despite dynamic growth in household incomes, the rate of inflation continues to be moderate. The Consumer Price Index (CPI) slowed down to a record low since 2004. In August, the Index grew 7.4% on annual basis (see **PRICES**). The main driver of consumer prices is an upward revision of regulated rates for the services of natural monopolies. This, in turn, was largely driven by a rise in prices for imported gas in early 2006.

...as imports relieve inflationary pressure

The inflationary pressure of services on the consumer market is being balanced by the supply of imported goods. Over January–July 2006, imports of goods grew 21.3% (see **FOREIGN TRADE**). Rapid growth in disposable incomes has

¹ According to Derzhkomstat data, cumulative FDI in Ukraine doubled over the last year, to US \$18.4bn.

pushed imports of mechanical and electrical equipment² up 18.2%, cars 70%, food products 23%, and furniture 50%.

Competition with imports is becoming a more and more important factor for the development of domestic industries. Food processing, which has relatively strong competitive advantages, is growing at a rapid pace—7.7% over January–August 2006. However, textile industrie, whose competitive environment has been distorted by a high level of illegal imports, continue to stagnate. Over the first eight months of 2006, it actually contracted 3.2%.

Rapid growth of imports in response to high consumer and investment demand, as well as rising prices for resources—primarily oil and gas—, have led to a deficit in the trade and current account balances.³

The pressure of this trade deficit on the exchange rate continues to be limited, mostly thanks to rapid inflows of foreign capital. The National Bank of Ukraine is supporting the exchange rate at a stable level of UAH 5.05/USD and even replenishing its gold and foreign currency reserves by buying up surplus foreign currency⁴ (see **MONETARY POLICY**).

The NBU is replenishing reserves, despite a deficit in the balance of trade

In H1'06, the share of GDP re-distributed through the Consolidated Budget was 35% (see **PUBLIC FINANCE**). The main factor behind this high level of Budget revenues is strong growth in consumption, which explains growing VAT revenues. The Government continues to cover the Budget deficit mainly with the help of major privatization revenues from 2005.

Economic policy

At the moment, the new Government does not have an integrated economic policy. In the first place, the configuration of the coalition remains unclear, that is, whether Nasha Ukraina will participate in this coalition or the Government will continue to work within the framework of the “anti-crisis” coalition (see **POLITICAL ENVIRONMENT**). The only program document that was legitimized by all current and potential participants in this coalition is the Manifesto of National Unity. However, this document is not clear about actual economic policy and identifies few clear directions.

The new Government has not offered its vision of economic policy...

Secondly, the “anti-crisis” coalition does not have an economic policy that has been coordinated with all its participants. The Party of the Regions is taking advantage of the fact that its members dominate the economic block of portfolios to formulate economic policy largely independently.

Such autonomy of one of the coalition participants raises the serious risk that the Government structure will turn unstable. Even if the Party of the Regions does not have to compromise with Nasha Ukraina because the latter refuses to join the coalition, sooner or later, it is likely have to face internal opposition from the CPU or SPU or even from certain interest groups within the Party itself.

² This group includes household appliances.

³ In H1'06, the negative balance of the current account was 1.9% of GDP and the negative trade balance was 3.8% of GDP.

⁴ Over May–August 2006, the balance of NBU interventions was positive and grew steadily.

...however, the Draft Budget establishes certain targets

Still, the Draft 2007 State Budget developed by the Ministry of Finance already establishes certain targets:

- **REVIVING SPECIAL TAX REGIMES.** The Government clearly announced its intention to renew SEZs and TPDs starting 1 January 2007. It plans to partly compensate the resulting loss of tax revenues through increased tax revenues from other business entities.⁵
- **LIMITING SOCIAL SPENDING.** The Government is trying to check the growth of social spending by pegging benefits to incomes.
- **BALANCING THE FINANCES OF THE PENSION FUND.** In order to be able to continue pension reform in 2008, the Government plans to make the Pension Fund financially sustainable in 2007. The hope is to introduce the accumulative pillar.
- **CHANNELING INVESTMENT INTO CERTAIN SECTORS.** The Government has pegged a number of special multi-vector Budget items to privatization revenues and, in fact, set up a “parallel” Budget (see **DOMESTIC POLICY**). These items are risky from the perspective of financial support, as the projections for privatization revenues are very optimistic⁶ and they simultaneously serve as a “special reserve,” because the definition of these items leaves plenty of room to maneuver how these funds are spent.⁷

The Government is ready to continue with accession to the WTO

ICPS economists expect the Government to continue to adopt the legislation needed to accede to the WTO and to continue with negotiations. It is unlikely to undertake a significant revision of existing agreements.

Forecast

2006

In 2006, GDP will grow 5.5%

ICPS economists have upgraded their forecast for GDP for 2006 by 2pp, to 5.5%. The main factor behind this upward revision of the previous forecast is higher-than-expected growth in private consumption. ICPS economists have upgraded their forecast for real consumption growth for 2006 to 17% (see **HOUSEHOLDS**).

ICPS economists have also revised their forecast for the external sector and expect exports of goods and services to grow 7.4% in 2006. According to ICPS estimates, the foreign trade deficit will reach US \$3bn in 2006, or 3% of GDP (see **FOREIGN TRADE**).

Gross fixed investment will grow 9% in 2006

Gross fixed capital investment will grow 9% in 2006. ICPS economists expect FDI into Ukraine to reach US \$4.5bn in 2006.

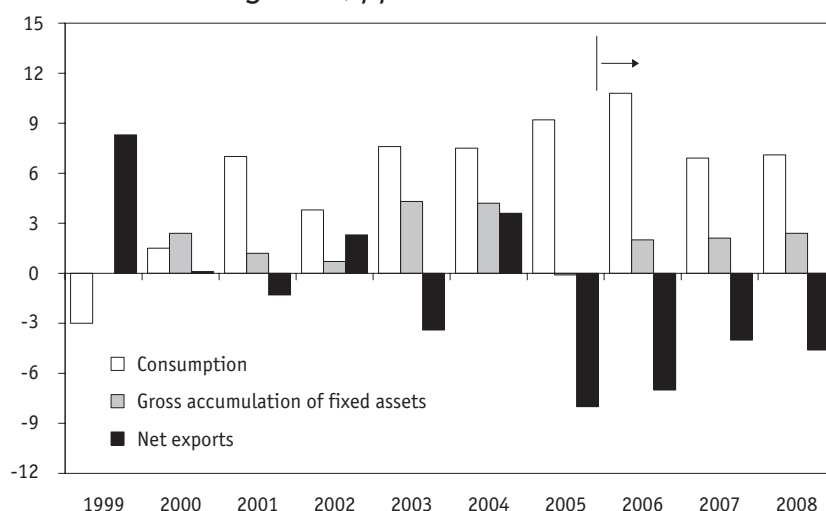
Given the improved foreign economic situation and more lively growth in domestic demand, ICPS economists have upgraded their forecast for industrial output for 2006 by 2pp, to 5%. Construction will climb 6%, while trade will grow 8% (see **BUSINESS**).

⁵ Specifically, in 2007, the personal income tax rate is supposed to be raised and the tax base in the banking system expanded by changing the procedure for forming reserves for ongoing operations.

⁶ The Draft 2007 State Budget declares that privatization revenues will be UAH 10bn in 2007.

⁷ Such as a Stabilization Fund worth UAH 3bn.

Figure 2. Contributions of GDP components to real GDP growth, pp



Source: Derzhkomstat; calculations and forecast by *quarterly predictions*

ICPS economists expect the Consumer Price Index to grow 10.2% in 2006, which is nearly identical to the value registered in 2005. There should be further rises in regulated rates in Q4'06. Producer prices will grow 10% in 2006 (see **PRICES**).

In 2006, inflation will hit 10.2%

According to the ICPS forecast, the NBU will continue to support the current exchange rate, UAH 5.05/USD, until the end of the year. NBU gold and foreign currency reserves should grow US \$500mn in 2006.

2007–2008

ICPS economists have upgraded their forecast for growth for 2007–2008 due to better-than-expected prospects for all three components of the economy—consumption, investment and exports. As a result, real GDP should grow 4.6% in 2007 and 5% in 2008. The main factor slowing down economic growth in 2007 will be slower growth in private consumption, the result primarily of much slower growth in social benefits compared to recent years.

The economy will grow 4.6% in 2007 and 5% in 2008

Household consumption will grow 10% per annum over 2007–2008. This will be the reason behind retail trade turnover growing 13% per annum (see **HOUSEHOLDS**).

Throughout the entire forecast period, imports will grow much faster than exports. In particular, this will be linked to prices for imported gas rising to US \$130–150/1,000 cu m in 2007. ICPS economists expect imports of goods and services to grow 12% in 2007 and 13.1% in 2008 in real terms. Exports will grow 4% in 2007 and 4.1% in 2008 in real terms. The trade deficit will likely grow to 4.4% of GDP in 2007 and 5.8% of GDP in 2008 (see **FOREIGN TRADE**).

Over 2007–2008, investment will continue to grow at a rapid pace, which will be the result of a relatively stable business environment and high demand for capital. Gross fixed investment will grow 10% in 2007 and 11% in 2008 (see **BUSINESS**).

Investment will grow 10–11% per annum

ICPS economists expect the NBU to begin to carry out gradual controlled depreciation of the hryvnia in 2007 in order to reduce pressure from a deteriorat-

ing balance of payments. The average exchange rate should be UAH 5.17/USD in 2007 and UAH 5.44/USD in 2008 (see **MONETARY POLICY**).

Inflation will gradually slow down

Over 2007–2008 inflation will gradually slow down. ICPS economists expect the CPI to grow 9% in 2007 and 8% in 2008. The main factor behind subsiding inflation will be slower growth in disposable incomes. Because of the prospects of even higher prices for imported natural gas, ICPS economists have raised their forecast for producer prices growth for 2007 to 9.5% and for 2008 to 9% (see **PRICES**).

ICPS economists expect the share of GDP re-distributed through the Budget to shrink to 32% in 2007. The main factor behind shrinking Consolidated Budget revenues will be the re-introduction of tax breaks, largely through special economic zones (SEZs) and territories of priority development (TPDs). In 2008, Consolidated Budget revenues will remain unchanged at 32% of GDP. The Consolidated Budget deficit will reach 2.5% of GDP over 2007–2008 (see **PUBLIC FINANCE**).

The macroeconomic situation on external markets will be favorable

During the forecast period, the macroeconomic situation on key external markets for Ukrainian exports will continue to be dynamic. Despite a slight slowdown in economic growth among Ukraine's key trading partners, these economies will grow at a relatively rapid pace: 4% in 2007 and 4.1% in 2008 (see **WORLD ECONOMY**).

The risks to the ICPS forecast for this period are:

- wild fluctuations in global prices for metal and chemical products;
- a stronger orientation of the State Budget towards investment-related spending;
- prices for imported gas above US \$150/1,000 cu m in 2007;
- wild fluctuations in energy prices on global markets;
- greater-than-expected depreciation of the hryvnia;
- growing import duty rates.

Highlights of quarterly predictions #36

- *Key provisions in the Manifesto of National Unity*
- *Possible scenarios of the Verkhovna Rada and Government coalition-building*
- *Main drawbacks in the Draft 2007 State Budget*
- *The impact of minimal prices for raw milk*
- *Shifts in the structure of incomes*
- *The threat of shrinking liquidity among domestic banks*
- *Unstable trends in interest rates*
- *The risk of economic instability in Turkey*

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


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